ACKNOWLEDGEMENTS

First of all, the Editorial Board wants to thank all the authors whose works compose the second number of volume three of the *University of Puerto Rico Business Law Journal*. This second number includes a varied discussion of subjects ranging from an analysis of the intellectual property system in China; a comparative study of debt issued in foreign currency by our first international author; an analysis of the current state of consumer financial protection and suggestions to improve it; a discussion of copyright infringement in social media websites; an article also related to social media websites, their use by employees and its implications for employers under Puerto Rico labor laws; an article related to trademarks in political speech; and finally a study on Puerto Rico government sponsored housing incentives from 2007 to 2011.

Now, I want to acknowledge the outstanding work of all the members of the *Business Law Journal* during the editing process. I would like to give particular thanks to Paola Medina, Rafael Gonzalez, Hector Orejuela, Daphne Calderon, Nicolas Perez, Myrel Marin, Juan Charana and Cristina Tamayo for their assistance during the final stages of editing and publication of this number.

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Finally, the *Business Law Journal* will continue its mission of using the Law, as a mediator, to promote and protect economic growth by providing a forum for academics, practitioners, entrepreneurs, and students who want to help improve the quality of our standard of living. To achieve this and other goals, the *Business Law Journal* will ensure that *all ideas* are heard and considered on their merits and not on who expresses a particular idea.

With the utmost gratitude and appreciation,

Yarot T. Lafontaine-Torres
Editor in Chief, Volume 3
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A CRITICAL LOOK AT WESTERN PERCEPTIONS OF CHINA'S INTELLECTUAL PROPERTY SYSTEM

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I. INTRODUCTION

Intellectual Property Rights (hereinafter, "IPR"), are a body of rights that have long been recognized under international and national law as being a mechanism to incentivize innovation; the means by which to encourage the creation of new inventions in order to propel economic growth in an economy at large, as well as to promote technology transfer and diffusion to render it easier for more people to share in the welfare of human creativity and knowledge, in order to promote social and economic progress and raise living standards.[1] Within the scope of these rights is the protection of patents for a product or process, trademarks for a logo, and copyrights for literary or artistic works. In addition, rights are extended to provide for the protection of undisclosed information or trade secrets (e.g. for a recipe or formula), industrial designs (e.g. for the design of industrial components), and geographic indications (e.g. a reference to a geographic region which acts as a means of certification of the quality of certain products).[2] Due to the fluid nature of intellectual property, it is widely acknowledged that such rights can only be fully protected if recognized under international law, so that intellectual property (hereinafter,"IP") cannot be stolen or reproduced in one region of the world and then imitated and distributed in another.[3] Since the nineteenth century, an international regime has existed for the protection of intellectual property.[4]

During 2011, there could be no doubt that IPR holders faced significant challenges when attempting to protect their rights abroad. In a world increasingly marked by the forces of globalization and the exodus of people, goods and services across borders, and propelled by international agreements (e.g. the General Agreement on Tariffs and Trade) it has become more necessary than ever to construct a global mindset when attempting to

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[1] Zhongfa Ma, *Perception of the Objectives of Intellectual Property Legal System, the Essence of a Patent and the Missions of Patent Institution—in Aspect of Low Rate of Patented Technology Commercialization in China*, 2 INT'L J. BUS. & SOC. SCI. 164, 165 (2011), http://www.ijbssnet.com/journals/Vol._2_No._3_%5BSpecial_Issue_-_January_2011%5D/19.pdf.

[2] *Overview: the TRIPS Agreement*, WORLD TRADE ORG., http://www.wto.org/english/tratop_e/trips_e/intel2_e.htm (last visited Oct. 9, 2011).

[3] *See, e.g.* Elhanan Helpman, *Innovation, Imitation and Intellectual Property Rights*, ECONOMETRICA, November 1993, at 1247, http://faculty.arec.umd.edu/cmcausland/RAKhor/RAkhor%20Task3/Helpman.pdf.

[4] SIMON NICHOLAS LESTER & BRYAN MERCURIO, WORLD TRADE LAW: TEXT, MATERIALS AND COMMENTARY (2008).

enforce IPRs. Today, China presents a particular threat in that regard. Although a member of the World Trade Organization since 2001, this country is one that has historically been reluctant to recognize western norms of the rule of law.[5] Whether on the streets of Shanghai or in popular shopping malls such as the Silk Market in Beijing (秀水街), it is not uncommon to see an array of counterfeited consumer goods ranging from luxury handbags, clothes, shampoo and toothpaste to fake DVDs, notebook computers and electronics, and even prescription medicine such as Tamiflu and Viagra.[6]

On May 25, 2011, the European Union Chamber of Commerce in China released its Business Confidence Survey 2011. Among its conclusions, seventy–three percent (73%) of survey respondents believed China's written intellectual property law to be adequate; while twenty-seven percent (27%) of respondents believed the enforcement of such law to be adequate. Moreover, forty-two percent (42%) of respondents ranked the discretionary enforcement policy of broadly drafted laws and regulations to be the most significant regulatory obstacle to do business in Mainland China; and forty-six perfect (46%) of survey respondents concluded that China's regulatory environment is likely to worsen over the next two years for foreign invested enterprises operating in China.[7] This report follows one previously issued on March 2011, by the American Chamber of Commerce (hereinafter, "AmCham") in China, which similarly concluded that seventy percent (70%) of American businesses operating in China believed its IP system is weak and ineffectual. Also, according to twenty-four percent (24%) of survey respondents, IP infringement was reported to be among the top five (5) business challenges; in comparison with an increase from the nineteen percent (19%) as reported the previous year.[8]

Acknowledging to these survey results, multinational businesses based outside of China would appear to have little access to recourse their individual IPRs protection in China. However, the question still remains whether these survey results truly reflect the business operating environment in China or whether they merely reflect the collective business consciousness and perception that, because of the amount and visibility of IP infringement in China, its IP regulatory and enforcement regime is weak.

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[5] *See, e.g.,* Katherine R. Xin & Jone L. Pearce, *Guanxi: Connections as Substitutes for Formal Institutional Support*, 39 ACAD. OF MGMT. J., 1996, at 1641, http://iweb.swufe.edu.cn/jiarui/Management_Resources/%E4%BC%81%E4%B8%9A%E7%AE%A1%E7%90%86/Guanxi%20Connections%20as%20Substitutes%20for%20Formal%20Institutional%20Support.pdf.

[6] REBECCA ORDISH & ALAN ADCOCK, CHINA INTELLECTUAL PROPERTY - CHALLENGES & SOLUTIONS: AN ESSENTIAL BUSINESS GUIDE (2008).

[7] *Business Confidence Survey 2011*, EUR. CHAMBER OF COMMMERCE (May 25, 2011), http://www.europeanchamber.com.cn/view/media/publications/#bd (follow European Confidence Survey 2011 "EN" hyperlink).

[8] *See 2011 Business Climate Survey*, AM. CHAMBER OF COMMERCE (Mar. 22, 2011), http://www.amchamchina.org/upload/cmsfile/2011/03/22/efb2ab9d3806269fc343f640cb33baf9.pdf.

Consequently, the existence of IP theft in China does not necessarily equate with the existence of a weak regulatory regime and legal system for enforcing IPRs. Yet, if these surveys are assumed to be representative of China's IP system, they may have the effect of discouraging business executives from making the decision to operate, invest, or establish operations in China. In addition, once a business is operating in China, these reports may discourage such executives from participating in China's IP system altogether and may serve to justify whatever losses may result therein. From a corporate standpoint, it is imperative that the IP environment in China be analyzed objectively and free from subjective constraints from survey data presented by Chambers of Commerce; organizations that seek to arouse public sentiment in support of pro-business policies irrespective of the existing business operating environment.

II. CONTEXT/BACKGROUND

A. Brief History of China's Intellectual Property System

China's modern IP system is a relatively recent creation. Although the concept of IP has been recognized throughout Chinese history from its first imperial dynasty, the *Qin* (秦朝) of 221-206 BC, to its last imperial dynasty, the *Qing* (清朝) of 1644-1911 AD, in reference to copyrights possessed by the imperial court, the underpinnings of a modern IP system were not developed until the early twentieth century. During this time, the *Kuomingtang* (国民党) nationalist government developed the first patent law in China.[9] In 1949, when Mao Zedong and the Chinese Communist Party founded the People's Republic of China and exiled the nationalists to Taiwan, the communists sought to "start with a clean slate" and proceeded to "eliminat[e] all previous regulations and laws."[10]

In the three decades that followed, the communist government instituted a "reward system" whereby innovators could "obtain bonuses, medals, certificates, and even honorary degrees" as part of its effort to implement "the transition from private ownership to full national control."[11] The guiding principle was a belief that "a formal legal system for many areas of national life was unnecessary" given that "the economy was centrally controlled" and that "conflicts could be resolved via mediation or administration mechanisms without reference to legal rights and

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[9] ORDISH & ADCOCK, *supra* note 6; Deli Yang, *The Development of the Intellectual Property in China* (Bradford U. Sch. of Mgmt., Working Papers Series, Working Paper 2, 2002), http:// www.brad.ac.uk/acad/management/external/pdf/workingpapers/Booklet_02-24.pdf.

[10] Yang, *supra* note 9, at 6.

[11] Yang, *supra* note 9, at 6-7.

obligations."[12] In the three decades which followed, as a result of such policies, scholars have identified several adverse effects, including a lack of incentive for invention and creation, encouragement of a lack of respect for the pursuit of knowledge, the creation of a "paucity of communication" with the outside world in regards to technology and information, and the demonization of intellectuals.[13]

China's economy underwent a significant shift with the death of Mao Zedong in 1976 and the ascendance of Deng Xiaoping to power in 1978. Deng introduced a program known as the "four modernizations," (四个现代化) in which he sought to modernize four aspects of Chinese economy, which included the modernization of agriculture, industry, science and technology, and national defense.[14] Deng drastically altered economic relations with the outside world when he allowed foreign investment and trade through his adopting of the so-called *Open Door Policy* (门户开放政策) in 1978.[15] Since then, the country has seen massive and rapid enactment of laws and regulations, with particular emphasis on those regulating economic and commercial relations.[16] Today, China ranks among those countries with the greatest number of laws on their books.[17]

With respect to IP, the Chinese government had its first brush with IP issues in the modern age when, in 1979, U.S. President Jimmy Carter refused to sign a bilateral investment treaty focusing on science and technology in the absence of sufficient protection for IP concerns.[18] In the aftermath of these negotiations, it has been said that Chinese officials developed an "*IPR fever"* as they proceeded to commence intensive research on IP in order to encourage local innovation and foreign investment.[19] During the following years, China proceeded to embed itself in the international IPR system and developed the underpinnings of a modern domestic IPR system. Among the most significant markers of these developments are China's decision to join

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[12] Jingjing Liu, *Overview of the Chinese Legal System*, AMERICAN BAR ASSOCIATION at 1 (May 9, 2010), http://www2.americanbar.org/calendar/section-of-international-law-2011-spring-meeting/Documents/Thursday/Evolution%20of%20Environmental%20Rule%20of%20Law%20in%20China%20and%20India/Final_Overview_of_Chinese_Legal_System_May_9_2010%5B1%5D.pdf.

[13] Yang, *supra* note 9, at page 7.

[14] 2 TAKASHI KANATSU, ASIAN POLITICS: TRADITION, TRANSFORMATION AND FUTURE 128 (2008).

[15] *Id.* at 142.

[16] Liu, *supra* note 12.

[17] Michael Xu, Lecture at the Capital Hotel Beijing in China: Private Equity: Why China Behaves Differently (June 15, 2010).

[18] Deli Yang, *The Development of the Intellectual Property in China* (Bradford U. Sch. Of Mgmt., Working Papers Series, Paper No. 2, 2002), at 8, http://www.brad.ac.uk/acad/management/external/pdf/workingpapers/Booklet_02-24.pdf; Agreement on Cooperation in Science and Technology (with Exchange of Letters), U.S.-China, Jan. 31, 1979, 1150 U.N.T.S. 18076. http://treaties.un.org/doc/Publication/UNTS/Volume%201150/v1150.pdf.

[19] YANG, *supra* note 18, at 8; ORDISH & ADCOCK, *supra* note 6, at 6.

the *Convention for the Establishment of the World Intellectual Property Organization* or WIPO (a specialized agency of the United Nations tasked with promoting IPR and administering IP-related agreements) in 1980,[20] when it ratified the *Paris Convention* (for international harmonization of policies related to trademarks) in 1985[21] and the *Madrid Protocol* (for the international registration of trademarks) in 1989,[22] and finally when it became a signatory country to the *Integrated Circuits Treaty*[23] (for the international harmonization of IP policies related to layout designs of integrated circuits) in 1989.[24] Additionally, when China joined the World Trade Organization in 2001, and adopted all of the ancillary agreements to the *General Agreement on Tariffs and Trade* to include the *Agreement on Trade-Related Aspects of Intellectual Property*, it signaled a willingness of the Chinese government to adopt a host of additional obligations with respect to IPR as required as a condition of membership.[25] On the domestic front, during the Deng administration, China created several administrative agencies to be tasked with IP registration and enforcement, along with attendant regulatory guidelines and rules setting forth how these agencies would operate.[26] The government also restructured the judiciary to provide for a process to advance IP litigation through the courts and promulgated a wide range of IP-related laws, policies and judicial pronouncements.[27] During the span of only three decades, China has developed the underpinnings of a modern legal framework along with the physical infrastructure necessary to protect and enforce IPRs.

[20] *See* Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, 1867 U.N.T.S. 154; 33 I.L.M. 1144 (1994). http://www.wto.org/english/docs_e/legal_e/04-wto.pdf.
[21] *See, e.g.,* Paris Convention for the Protection of Industrial Property, as last revised at the Stockholm Revision Conference, July 14, 1967, 21 U.S.T. 1583; 828 U.N.T.S. 303, http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html.
[22] Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks, June 17, 1989, http://www.wipo.int/madrid/en/legal_texts/trtdocs_wo016.html.
[23] Treaty on Intellectual Property in Respect of Integrated Circuits, May 26, 1989, http://www.kenyalaw.org/treaties/treaties/1038/Treaty-on-Intellectual-Property-in-Respect-of-Inte.
[24] Yang, *supra* note 18, at 8; *What is W.I.P.O.*, WORLD INTELL. PROP. ORG., http://www.wipo.int/about-wipo/en/what_is_wipo.html (last visited Sept. 3, 2011).
[25] Thomas Rumbaugh & Nicolas Blancher, *China: International Trade and WTO Accession* (IMF, Working Paper No. 04/36, Mar. 2004), http://www.ppl.nl/bibliographies/wto/files/1370.pdf.
[26] ORDISH & ADCOCK, *supra* note 6, at 7.
[27] Yang, *supra* note 18, at 8; ORDISH & ADCOCK, *supra* note 6, at 7.

B. Western Perceptions of China's Intellectual Property System Today

As the survey data presented by the Chambers of Commerce indicate, western companies have very low confidence in China's IP system. Yet, further investigation reveals that the vast majority of foreign businesses are not even making an attempt to register and enforce their IP concerns while operating in China. According to the time-series data released by China's State Intellectual Property Office, 1,222,286 patent applications were filed in total during year 2010, of which 1,109,428 (90.76%) were from domestic sources, with only 112,858 (9.23%) from foreign sources.[28] Over the past few years, the percentage of foreign patent applications as a percentage of the total received by the State Intellectual Property Office has been on the decline (15% in 2007; 13.4% in 2008; 10.1% in 2009, and 9.2% in 2010).[29] In comparison with the United States, the percentage of foreign to domestic patent applications received during the same year hovered around 50 percent (50%).[30] Furthermore, according to statistics set forth in an April 2011 White Paper issued by China's Supreme Court, of the IP-related cases closed by Chinese courts in 2010, only 3.28 percent of them involved foreign litigants.[31] Considering the fact that "about one-third of Chinese commerce involves foreign enterprises," it cannot be denied that a large proportion of these companies are leaving themselves out of the Chinese legal process.[32]

As to the report issued by the American Chamber, respondents were asked "[h]ow would you rate China's enforcement of intellectual property rights?"[33] Similarly, although the specific questions asked were not presented in the 2011 European survey, the 2010 survey asked its members to rate the "perceived effectiveness of enforcement of China's IPR laws and regulations."[34] The phrasing of both questions asked were such that business leaders not even attempting to enforce IP rights in China could nonetheless answer the questions based upon their own subjective perceptions.

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[28] *SIPO Annual Report*, ST. INTELL. PROP. OFF. OF THE P.R.C., http://english.sipo.gov.cn/laws/annualreports/2010/ (last visited Sept. 3, 2011).
[29] *Id.*
[30] *U.S. Patent Statistics Summary Table, Calendar Years 1963 to 2011, U.S. Patent and Trademark Office* (Apr. 20, 2010), http://www.uspto.gov/web/offices/ac/ido/oeip/taf/us_stat.htm (last visited Aug. 21, 2010).
[31] Supreme People's Court, *Intellectual Property Protection by Chinese Courts in 2010* (China Pat. Agent, White Paper, 2011), http://www.cpahkltd.com/UploadFiles/20110509082512655.pdf.
[32] Ewan Bewley, *IP Rights in China –the Giant Awakens*, LEXOLOGY (Aug. 21, 2010), http://www.lexology.com/library/detail.aspx?g=13078243-f69a-45b7-adcc-e7083af0f6a3.
[33] *2011 Business Climate Survey*, AM. CHAMBER OF COMMERCE (Mar. 22, 2011), at 15, http://www.amchamchina.org/businessclimate2011.
[34] *Business Confidence Survey 2010*, EUR. CHAMBER OF COMMERCE (Jun. 29, 2010), at 15, http://www.europeanchamber.com.cn/view/media/publications/#bd (follow European Confidence Survey 2010 "EN" hyperlink).

Furthermore, regarding the American report, while only 251 of the Chamber's over 3,000 members responded to the question pertaining to IP rights, the Chamber nonetheless suggested them as indicative of the views of "U.S. business" as a whole.[35] Similarly, regarding the European report, although no data regarding the sample size of the population surveyed was presented in the 2011 report, the 2010 report rendered its conclusions based on a sample size of less than 150, and the results were extrapolated to the "European business community" as a whole.[36] Although it is not inconceivable that representative conclusions be drawn from survey data based on small sample sizes, there is no indication that either Chamber of Commerce has done much to ensure statistical accuracy other than by endeavoring to show trends among their own members by keeping the survey questions consistent from year to year.[37] Given that the responses to the relevant questions were not limited to those companies actually attempting to enforce their IPR through the Chinese system, that survey respondents could conceivably have answered the questions based solely on their perceptions-and the relatively small sample sizes of the data which was collected without verification of statistical accuracy- makes it difficult to conclude that the results reported by the two Chambers of Commerce are truly reflective of the overall business environment in China.

III. THEORETICAL FRAMEWORK- THEORY OF REASONED ACTION

The Theory of Reasoned Action (TRA) is perhaps best equipped to explain how Western perceptions of the Chinese IP system, lacking in impartiality, contribute to business executives' unwillingness to take part in the existing system; despite evidence that the IP enforcement environment might actually be improving. The TRA has its roots in the field of social psychology, and was first elucidated as a comprehensive theory in 1980 through the work of American social psychologists Martin Fishbein and Icek Ajzen.[38] The TRA seeks to examine the relationships between *beliefs*, *attitudes*, *intentions*, and *behavior*.[39]

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[35] David Truckety, Lecture at the American Chamber of Commerce: China Briefing: American Chamber of Commerce (June 24, 2010); 2011 Business Climate Survey, *supra* note 33, at 2 & 15.

[36] 2011 Business Climate Survey, *supra* note 33, at 3 & 15.

[37] Truckety, *supra* note 35; 2011 Business Climate Survey, *supra* note 33.

[38] *See e.g.,* ICEK AJZEN & MARTIN FISHBEIN, UNDERSTANDING ATTITUDES AND PREDICTING SOCIAL BEHAVIOR (1980).

[39] *Theory of Planned Behavior/Reasoned Action. Public Relations, Advertising, Marketing and Consumer Behavior*, U. OF TWENTE (Sept. 2004), http://www.utwente.nl/cw/theorie enoverzicht/Theory clusters/Public Relations, Advertising, Marketing and Consumer Behavior/theory_planned_behavior.doc/.

Fishbein and Ajzen start from the premise that people are *rational* and that behavior is "under [one's] volitional control."[40] According to this theory, "a person's behavior is determined by his/her intention to perform the behavior and that this intention is, in turn, a function of his/her attitude toward the behavior and his/her subjective norm."[41] The TRA posits that intentions are "the best predictor of whether or not a…behavior is performed."[42] These intentions are best described as "cognitive representation[s] of a person's readiness to perform a given behavior," and are presented as the "immediate antecedent of behavior."[43] Intentions are directly determined by one's "*attitude* towards the behavior and *subjective norm* associated with the behavior."[44] Attitude is said to refer to "*a learned pre-disposition to respond in a consistently favorable or unfavorable manner with respect to a given object,"* whereas, subjective norms are said to refer to "a person's positive or negative value associated with a behavior."[45] Notably, with respect to subjective norms, individual behavior is said to be dependent upon "the person's beliefs that specific individuals or groups think he/she should or should not perform the behavior and his/her motivation to comply with the specific referents."[46]

Some have argued that the model is not suited for use in evaluating decisions in an organizational context based upon "the dynamic and intricate multiphase, multi-person, multi-departmental and multi-objective nature of the decision processes in organization."[47] However, it has been said that if the framework is applied in situations where "business decisions tend to be the domain of a single individual," the theory is more convincing.[48] Most frequently, the TRA has been applied to evaluate a range of consumer behaviors.[49] However, as a theory that focuses on individual decision-

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[40] Julie Denison, *A Summary of Four Major Theories*, FAMILY HEALTH INTERNATIONAL (Mar. 2011), at 10, http://www.fhi360.org/nr/rdonlyres/ei26vbslpsidmahhxc332vwo3g233xsqw22er3vofqvrfjvubwyzclvqjcbdgexyzl3msu4mn6xv5j/bccsummaryfourmajortheories.pdf.

[41] *Theory of Planned Behavior/Reasoned Action. Public Relations, Advertising, Marketing and Consumer Behavior*, *supra* note 39.

[42] D. Montano & D. Kaspryzk, Theory of Reasoned Action, AIDS PROJECT LOS ANGELES (2008), http://www.apla.org/accionmutua/pdf/Theory_of_Reasoned_Action.pdf.

[43] *Theory of Planned Behavior/Reasoned Action. Public Relations, Advertising, Marketing and Consumer Behavior*, *supra* note 39.

[44] Montano & Kaspryzk, *supra* note 42, at 1.

[45] MARTIN FISHBEIN & ICEK AJZEN, BELIEF, ATTITUDE, INTENTION, AND BEHAVIOR: AN INTRODUCTION TO THEORY AND RESEARCH 6 (1975); Montano & Kaspryzk, *supra* note 42, at 1.

[46] ICEK AJZEN & MARTIN FISHBEIN, UNDERSTANDING ATTITUDES AND PREDICTING SOCIAL BEHAVIOR 8 (1980).

[47] Gregory Southey, *The Theories of Reasoned Action and Planned Behaviour Applied to Business Decisions: A Selective Annotated Bibliography*, 9 J. NEW BUS. IDEAS & TRENDS, no. 1, 2011 at 43, 44, *available at* http://www.jnbit.org/upload/JNBIT_Southey_2011_1.pdf.

[48] *Id.*

[49] *Id.*

making, the TRA can, and has, been applied to senior management officials in the context of their making of business-related decisions.[50] In fact, the model has been applied to several business activities, including financial and investment decision making among individuals;[51] strategic decision making related to environmental preservation and information systems among senior management;[52] and in the accounting profession, to examine choices related to business ethics among executives.[53] Significantly, the TRA has also been applied to analyze Chinese culture and the reasons as to why copyright theft persists among the Chinese despite the existence of a legal regime for enforcing IPR.[54] Although Tian's study focuses on the causes of the persistence of IP theft from the perpetrator's perspective, an argument can be made that foreign business executives similarly come to believe that in China, "copyright piracy is so common that it is hard not to follow the stream" and as such, they refrain from giving due consideration to their enforcement options.[55]

With respect to IP, the most influential members of a corporation are those senior legal staff tasked with responsibility for IP or technology and who often fill roles such as Assistant General Counsel, Vice President, or Chief Patent Counsel.[56] These same individuals are often tasked with making the

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50 Mark Yang & Lim Jeen, *The CEO's Decision Making Process Model on Offshore Outsourcing: Using Theory of Reasoned Action (TRA)*, DECISION SCIENCES (2008), http://www.decision sciences.org/Proceedings/DSI2008/docs/449-4143.pdf; Peter P. Mykytyn & David A. Harrison, *The Application of the Theory of Reasoned Action to Senior Management and Strategic Information Systems*, INFO. RESOURCES MGMT. J., Spring 1993, at 15, *available at* http://www.irma-international.org/viewtitle/50976.

51 Robert East, *Investment Decisions and the Theory of Planned Behaviour*, J. ECON. PSYCH., 1993, at 337.

52 O. Branzei, T.J. Ursacki-Bryant, I. Vertinsky & W. Zhang, *The Formation of Green Strategies in Chinese Firms: Matching Corporate Environmental Responses and Individual Principles,* STRATEGIC MGMT. J., Sep. 23, 2004, at 1075; M. Cordano & I.H. Frieze, *Pollution Reduction Preferences of U.S. Environmental Managers: Applying Ajzen's Theory of Planned Behavior*, ACAD. MGMT. J., Aug. 2000, at 627; Mykytyn & Harrison, *supra* note 50.

53 J.M. Stevens, H.K. Steensma, D.A. Harrison & P.L. Cochran, *Symbolic or Substantive Document? The Influence of Ethics Codes on Financial Executives Decisions*, STRAT. MGMT. J., no. 2, 181-195; Gregory Southey, *supra* note 47, http://www.jnbit.org/upload/JNBIT_Southey_ 2011_1.pdf.

54 Dexin Tian, Chinese Cultural Perceptions of Innovation, Fair Use, and the Public Domain: A Grass-Roots Approach to Studying the U.S.-China Copyright Disputes (Dec. 2008) (unpublished Ph.D. dissertation, Bowling Green State University) at 104, http://etd.ohiolink. edu/sendpdf.cgi/Tian%20Dexin.pdf?bgsu1224963994.

55 *Id.*

56 Iain M. Cockburn & Rebecca Henderson, Survey Results from the 2003 Intellectual Property Owners Association Survey on Strategic Management of Intellectual Property (Oct. 2005), at A1 (presentation, survey overview and survey results *available at* http://www.ipo. org/AM/Template.cfm?Section=Past_Meetings_and_Events&Template=/CM/HTMLDisplay.cf m&ContentID=13628 following "presentation", "survey overview" and "survey results" hyperlinks).

decision of whether or not to file the organization's IP concerns and whether to enforce those rights through the Chinese system. It is notable that oftentimes, "IP protection strategies used at headquarters [of a foreign corporation] are [often] not transplanted to China for implementation" and that business executives "often choose to send operational staff who have little to no understanding of China, and of the need to invest in IP protection strategies."[57] These decision makers bring with themselves a set of underlying "attitudes," or "personal beliefs about the positive or negative value associated with" participating in China's IP system.[58] As will be shown, many of the beliefs that lead these decision makers to develop the intention to refrain from actively participating in the domestic IP system are the product of their own flawed assumptions about the potential to protect IP in China. Some foreign concerns may choose to avoid doing business in China altogether due to their belief that the transfer of technology is the price of doing business in China. Yet the fact remains that many foreign rights holders are *already* doing business in China and refraining from participating in China's IP system.[59] Based on a belief that participating in China's IP system is not worth the time, cost, and effort, many companies refrain from filing for IPR protection and enforcing their rights through existing judicial and administrative mechanisms; choosing instead to "focus on achieving rising market share value and volume, and on showing management that profitability is just around the corner."[60] This practice only perpetuates the perception that China is weak on IPR enforcement and fuels the belief among foreign concerns that the forfeiture of technology is the price of access to the Chinese market.

With respect to subjective norms, it can be argued that individual business leaders confronted with making IP decisions in China engage in "group think" and find "motivation to comply" with the negative views and expectations of China's IP system as shared by the larger Western business community, who in combination act as "specific referents" in establishing subjective norms.[61] These subjective norms are in part shaped by the reports issued by the American Chamber of Commerce and the European Union Chamber of Commerce. It is important to note that these organizations are tasked with the primary function of lobbying the Chinese government for policy changes that would benefit the business community, and therefore it is not unexpected that they would take a critical view of China's IP system. In fact, the stated mission of the U.S. Chamber of Commerce, which coordinates the operations of its affiliate organizations abroad, including AmCham-China,

[57] ORDISH & ADCOCK, *supra* note 6, at 9-14.
[58] Montano & Kaspryzk, *supra* note 42, at 1.
[59] Truckety, *supra* note 35.
[60] ORDISH & ADCOCK, *supra* note 6, at 15.
[61] Denison, *supra* note 40, at 12.

is "to fight for free enterprise before Congress, the White House, regulatory agencies, the courts, the court of public opinion, and governments around the world,"[62] and on its website, the organization boasts that among Washington-based organizations, it "consistently leads the pack on lobbying expenditures."[63] AmCham-China similarly lists on its website its first objective as being to "enhance the business environment in China."[64] Yet, too often the views presented in survey data and reports issued by these Chambers of Commerce are relied upon as proof of the operating environment in China, and their conclusions accepted as truth as they become part of the larger business consciousness.

Another contributing factor to subjective norms relating to the Chinese IP system rests with the incessant reporting by the western media of images of open markets selling counterfeited goods, as well as the instances where disgruntled employees have stolen their employer's trade secrets and sold them to the highest bidder; competitors who have endeavored to undermine others' patent registrations, or register elements of preexisting products in an effort to claim the technology as their own, and illicit companies claiming to set up branch offices of legitimate corporations in an attempt to profit from the latter's IP holdings.[65] It is said that while there are instances of these events occurring, this perception is not representative of the available IP enforcement mechanisms and does little more than "provid[e] great fodder to the Chinese spook mill as to why foreign investors should be wary, distrustful, and cautious in China."[66]

Subjective norms are further shaped by the issuance of reports by politicians-turned-lobbyists, such as the annual *Special 301 Report* issued by Ambassador Ron Kirk, the United States' Trade Representative to China, castigating Chinese leaders for establishing the *indigenous innovation law* and for failing to maintain adequate protection for American IP holders.[67] Thus, the largely negative views of China's IP system, shared by individual decision makers in the business community who are called upon to make decisions as to whether to file and enforce their IP concerns through the Chinese system, are a product of their individual *attitudes* and the *subjective norms* which are drawn from the views and expectations of the larger business community; views largely influenced by organizations representing

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[62] *About the U.S. Chamber of Commerce*, U.S. CHAMBER OF COMMERCE (Sept. 3, 2011), http://www.uschamber.com/about.
[63] *Id.*
[64] *Constitution of the American Chamber of Commerce in the People's Republic of China*, AM. CHAMBER OF COMMERCE (Nov. 12, 2008), http://www.amchamchina.org/article/89.
[65] ORDISH & ADCOCK, *supra* note 6, at 3.
[66] *Id.* at 3-4.
[67] Ron Kirk, *2010 Special 301 Report*, OFF. OF THE U.S. TRADE REP. (Apr. 30, 2010), 19-27, http://www.ustr.gov/webfm_send/1906; DANIEL C. K. CHOW, THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA IN A NUTSHELL 413 (2009).

business interests, the statements and positions of political leaders, and also general views of Chinese stereotypes.

IV. DATA PRESENTATION AND ANALYSIS

A. Substantive Law Protecting IP in China

As the following analysis will reflect, China maintains a sophisticated regime for the protection of IPRs. In this section, it will be demonstrated that China maintains a robust portfolio of substantive law that sets forth a conceptual framework, as well as a procedural foundation which provides foreign businesses with a predictable structure for protecting their IP in China.

In China, domestic law and policy is developed and enforced pursuant to the principals of the civil law tradition, according to which statutes are of key importance and court judgments formally have no precedential effect, yet they do often serve as guidance to judges in subsequent cases.[68] There are several sources of written law in China, and they are arranged in a particular hierarchy. At the top of this hierarchy is China's Constitution, followed by laws issued by the National People's Congress and the Standing Committee of the National People's Congress; administrative regulations issued by the State Council; Local People's Congress Regulations issued by local congresses and standing committees of provinces, and finally, governmental rules issued by local governments of provinces as well as ministry rules issued by central-level ministries (commissions and agencies directly under the State Council).[69] The Supreme Court also has the authority to issue judicial interpretations, or regulations (a practice to which it avails itself frequently).[70] It should be noted that China maintains a "single, unified political-legal system (*zhengfa xitong*) as opposed to separate equal branches of government," and as a result, the Chinese government is comprised of "legislative bodies, administrative and regulatory organs, courts, prosecutors, and police with overlapping legislative, judicial, and administrative powers within one system."[71]

1. Patents

In China, a patent may be obtained for a new product or process, or for an improvement to an existing product or process, and a patent right can

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[68] Liu, *supra* note 12.
[69] *Id.*
[70] *Id.*
[71] CHOW, *supra* note 67, at 146.

be bought or sold, as similar to other types of property.[72] China operates according to the *first-to-file* principle, as opposed to a *first-to-invent* principle, which renders the timing of patent registration critical.[73] China recognizes three types of patents: (1) *invention patents*, which are issued "for inventions, including products and processes, that are 'novel' and not obvious and which have been developed to the point where they can be utilized in industry; (2) *utility model patents*, which are "creations or improvements related to the form construction, or fitting of a product" (but not a process) with lesser technical requirements than an invention patent; and (3) *design patents*, which are issued for "[o]riginal designs relating to the shape or pattern of an object, or to a combination of shape and pattern, or a combination of color and shape or pattern."[74]

In 2010, the State Office of Intellectual Property (hereinafter, "SIPO") reported having received 391,177 applications for invention patents, 409,836 applications for utility model patents, and 421,273 applications for design patents, of which 20 percent, 0.6 percent, and 2.8 percent, respectively, were filed by foreign parties.[75] In the same year, the Chinese courts handled 5,785 first-instance civil cases related to patent infringement, which represented a 30.82 percent year-on-year increase.[76]

2. Copyrights

Copyrights protects "original work[s] of authorship" to include "books, plays, musical compositions (words and/or music), audio and video records, choreographic works, motion pictures, filmstrips, TV programs, photographs, paintings, drawings, maps, architectural designs, jewelry designs, fabric designs, scale models, prototypes, crafts, computer programs, databases, Web sites, and even oral speeches and lectures."[77] Pursuant to Chinese law, copyright holders are said to hold a number of exclusive rights with respect to their copyrighted work, including the rights of publication, alteration, protection against distortion, reproduction, leasing, public performance of a mechanical work, exhibition, performance, broadcast, distribution over an information network, adaptation and translation, compilation, and annotation.[78] In China, copyrights are protected pursuant to the 1991 *Copyright Law* and its ancillary *Implementing Regulations*, as

[72] ORDISH & ADCOCK, *supra* note 6.
[73] *Id.* at 107; *IPR Toolkit: Patent*, EMBASSY OF THE UNITED STATES, BEIJING, CHINA, http://beijing.usembassy-china.org.cn/iprpatent.html (last visited Sept. 3, 2011).
[74] ORDISH & ADCOCK, *supra* note 6.
[75] *SIPO Annual Report*, *supra* note 28.
[76] Supreme People's Court, *supra* note 31.
[77] ORDISH & ADCOCK, *supra* note 6, at 124.
[78] *IPR Toolkit: Copyright*, EMBASSY OF THE UNITED STATES, BEIJING, CHINA, http://beijing.usembassy-china.org.cn/copyright.html (last visited April. 23, 2012).

amended in 2001 to harmonize China's copyright policies with its obligations under the *TRIPS Agreement*.[79] As a result of the 2001 amendment, regulations were strengthened for the protection of public performances, compilation works, and the dissemination of materials through networks and databases.[80] Preliminary injunctions were made available to copyright holders, and statutory damages for copyright infringement were increased to RMB 500,000, or just over U.S. $78,000.[81] In November 2010, it was announced that in the first half of the year, over 35,000 copyrights had been registered for computer software alone. This represented a 24.02 percent increase as compared to the same period the previous year.[82] In 2010 as a whole, Chinese courts heard 24,719 first-instance civil matters pertaining to copyright infringement, representing a year-on-year increase of 61.54 percent.[83]

3. Trademarks

A trademark is "any word, phrase, symbol, design or combination of colors, product configuration, group of letters or colors, or combination of these used by a company to identify its products or services and distinguish them from the products or services of others."[84] Pursuant to Article 8 of the *Trademark Law*, China recognizes four types of trademarks: *product trademarks*, which affixed to and identify goods; *service trademarks*, which are used to identify a service provider (e.g. an airline logo); *certification marks*, which identify the origin of raw materials or of a product's manufacture, and *collective trademarks*, which are used by groups or associations to indicate membership in an organization.[85]

Today, trademarks in China are regulated pursuant to the 1983 *Trademark Law*, as amended in 1993 and 2001 (which added protections for geographic indications in order to comply with WTO standards), along with its implementing guidelines.[86] Pursuant to the most recent amendment, statutory damages for trademark infringement are RMB 500,000, or just above U.S. $78,000. In 2003, the *Regulations for the Recognition and Protection of Well Known Marks* was promulgated, which added protection for so-called *well-known* trademarks. For these, upon the granting of such

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79 ORDISH & ADCOCK, *supra* note 6, at 123.
80 *Id.* at 124.
81 *Id.* at 114.
82 *35,000 Software Registered Copyrights in China*, CHINA INTELLECTUAL PROPERTY, CHINA DAILY (Nov. 25, 2010), http://ipr.chinadaily.com.cn/2010-11/25/content_11610980.htm.
83 Supreme People's Court, *supra* note 31.
84 ORDISH & ADCOCK, *supra* note 6, at 114.
85 *IPR Toolkit: Trademark*, EMBASSY OF THE UNITED STATES, BEIJING, CHINA, http://www.beijing.usembassy-china.org.cn/iprtrade.html (last visited Sept. 3, 2012).
86 ORDISH & ADCOCK, *supra* note 6, at 113.

status by the People's Courts, the Trademark Office, and the Trademark Review and Adjudication Board, formal registration is not required to obtain the right.[87] In April 2011, Tian Lipu, Director of SIPO, announced that China had received over one million trademark applications in 2010, and at the end of the year, the country had attained the position of having more trademark applications and more valid registered trademarks than any other country in the world.[88] In 2010, a total of 2,026 first-instance trademark-related cases were brought before administrative bodies, representing a year-on-year increase of 47.23 percent.[89]

4. Trade Secrets

Trade secrets are defined in Article 10 of the PRC *Anti-Unfair Competition Law* as "technical and business information which is not known to the public, which has economic value and practical utility, and for which the trade secret owner has taken measures to maintain its confidentiality."[90] The most widely cited example of a trade secret is the formula for the manufacture of Coca-Cola, which is kept secret from the public. Although, a trade secret can be any secret recipe, a new invention that has yet to be patented, a marketing strategy, a client list, a manufacturing technique, or a computer algorithm.[91] Trade secrets are considered part of the domain of IP rights because their existence can give a company its competitive advantage vis-à-vis others, and its disclosure to the public could substantially affect operations.[92] A trade secret is not filed or registered with any agency, yet a right to a trade secret can be enforced in court.

Pursuant to China's *Anti-Unfair Competition Law*, a trade secret holder can pursue civil litigation in the People's Courts, or administrative action through the Administration for Industry and Commerce against an infringer, if he or she can prove that: (1) a trade secret exists and that a company has implemented policies and procedures to protect it; (2) that a defendant *knowingly* used such *stolen* information; (3) that the plaintiff has suffered damage; and (4) that the damage was caused by the defendant's actions.[93]

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[87] *Id.*

[88] *China Has World's Most Registered Trademarks*, CHINA DAILY (Apr. 21, 2011), http://www.chinadaily.com.cn/business/2011-04/21/content_12371841.htm.

[89] Supreme People's Court, *supra* note 31.

[90] J. Benjamin Bai & Guoping Da, *Strategies for Trade Secrets Protection in China*, 9 NW. J. TECH. & INTELL. PROP. 351, 356 (2011), *available at* http://scholarlycommons.law.northwestern.edu/njtip/vol9/iss7/1.

[91] ORDISH & ADCOCK, *supra* note 6, at 127.

[92] *Id.*

[93] *Protect Your Intellectual Property from Infringers in China*, MALONEY & NOVOTNY, LLP (June 15, 2011), http://www.maloneynovotny.com/news-resources/latestnews/2011/061511.html; ORDISH & ADCOCK, *supra* note 6, 127.

There is no limitation as to the duration in which a right to a trade secret can exist. Although recent statistics with respect to trade secret disputes brought to Chinese courts are unavailable due to the fact that for reporting purposes they have recently been combined with other unfair competition cases in official statistics, it is nonetheless believed that approximately five-hundred (500) disputes pertaining to trade secrets are commenced each year.[94]

B. Specific Procedures for Protecting IPR in China

In addition to its substantive law, China maintains a comprehensive body of procedural laws that dictate the functioning of administrative agencies and the court system. Whether with respect to the process of applying for patent, copyright or trademark protection, or enforcing that protection through administrative procedures through the Chinese bureaucracy or litigation through the court system, a clear and transparent set of procedures exist, applicable to both foreign and domestic parties alike.

1. Registration Procedures

Comprehensive policies are in effect which provide for transparent procedures for the filing of IPRs in China. With respect to patents, inventors or designers can apply for registration for patents by claiming priority pursuant to the *Paris Convention*, to which China is a signatory. After submitting an application, the inventor will be required to register with Chinese authorities, within twelve months (in the case of an invention patent) or six months (in the case of a utility model patent or design patent), in order to preserve their priority date.[95] Additionally, foreign inventors can choose to designate China when filing a Patent Cooperation Treaty (PCT) application, which provides the inventor with an additional thirty months before having to file their application with Chinese authorities.[96] Applications for invention patents must be filed with SIPO, which undertakes a substantial examination of the application and conducts research in China and abroad to determine whether the application satisfies the three prongs of the *test of patentability*, which includes a determination of whether the invention is: (1) *new*; (2) *non-obvious*; and (3) *useful*.[97] If the company holding the IP concern does not maintain an office in China, that company must submit their application to SIPO using an *authorized patent agent*.[98] Utility model patents and design patents are exempted from this examination process, and are

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[94] Bai & Da, *supra* note 90.
[95] ORDISH & ADCOCK, *supra* note 6, at 109; *IPR Toolkit: Patent*, *supra* note 73.
[96] *Id.*
[97] *Id.* at 110.
[98] *Protect Your Intellectual Property from Infringers in China*, *supra* note 93, at 1.

merely reviewed by SIPO for compliance with procedural formalities.[99] Once the patent is granted, it is officially published in SIPO's journal, and lasts for twenty years (in the case of an invention patent), or ten years (in the case of a utility model patent or design patent).[100]

With respect to trademarks, in the absence of the establishment of a representative office or other foreign-invested enterprise in China, a foreign applicant must file an application through a *designated trademark agent*, of which there are hundreds and which charge a standard fee of 2,000 RMB per application, or just above U.S. $300.[101] However, recent amendments to the Implementing Regulations of the Trademark Law permit local branches or subsidiaries of foreign companies to register a trademark directly without using a Chinese agent.[102] In turn, the designated trademark agent (or the company directly) files an application with the Trademark Office of the State Administration of Industry and Commerce (SAIC).[103] Once the application is submitted to the Trademark Office, it is reviewed for completeness, and an internal evaluation is conducted to determine whether there exist any similar marks that are already registered.[104] If there are no conflicting findings, then the application is posted to the Trademark Office's *gazette*, where it remains for a period of three months, during which time the public is invited to object the registration of the mark.[105] If an objection is raised, or the application is rejected due to the finding of a conflict with a previously existing mark, parties may appeal through administrative channels, including the Trademark Office and the Trademark Review and Adjudication Board, and further appeals can be made through the courts.[106] In the event no objection is raised, a registration certificate is issued for the mark. Once the certificate is issued, the trademark remains valid for ten years and is renewable indefinitely in ten-year periods.[107]

As opposed to patents and trademarks, *copyrights* do not need to be registered in China in order to exist.[108] As a member of the *Berne Convention*, the works of an author, whether domestic or foreign, are automatically protected in China as long as the author is from a country that is also a member state.[109] However, just as in the United States, a voluntary procedure exists in China which permits authors to register or *record* their works with

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[99] ORDISH & ADCOCK, *supra* note 6, at 110.
[100] *Id.* at 111.
[101] *Id.* at 116; *IPR Toolkit: Trademark*, *supra* note 85.
[102] *IPR Toolkit: Trademark*, *supra* note 85.
[103] *Id.*
[104] *Id.*
[105] ORDISH & ADCOCK, *supra* note 6, at 118.
[106] ORDISH & ADCOCK, *supra* note 6.
[107] *Id.*
[108] *Id.*
[109] *Id.*

the National Copyright Administration (NCA), which is said to serve as *good evidence of subsistence*, or as proof that the government has accepted the copyright as valid, and as *ownership* or proof of the author's identity as such.[110] The procedure for voluntary registration of copyrights is embedded in the *Measures for Voluntary Works Registration*, which was adopted by the NCA in 1994 and which provides for a process by which a copyright holder can submit an application to the NCA. After the NCA examines the application, and if the claim is determined to be valid, it will issue a *certificate of copyright* that can serve as documentary evidence of the copyright's validity.[111] Copyrights are protected for the duration of the author's life, plus an additional fifty years. This protection does not extends to photographic, cinematographic, television, or audiovisual work, as well as works created by *corporate* authors; these are protected for a period of fifty years from the date of the work's first publication, as well as ten years from the date of first publication for the typographical arrangement or design of a book or periodical.[112]

2. *Enforcement Procedures*

China maintains a *dual-track approach* to enforcing IPRs, with litigation being one approach, and administrative enforcement being a second available option.[113]

a. The Judicial Option

Chinese courts are open to parties seeking to enforce their IPR. In fact, in 2009, Chinese courts saw 30,626 civil cases related to IP filed in its first instance courts. In contrast, only 8,261 IP cases were commenced in the same year in U.S. federal district courts.[114] Of those civil cases commenced in Chinese courts, 15,302 pertained to copyright infringement, 4,422 pertained to patent infringement, and 6,906 pertained to trademark infringement. On the other hand, there were 2,018 copyright-related cases; 2,800 patent-related cases, and 3,443 trademark-related cases commenced in U.S. courts during the same year.[115] Since 2005, China has maintained the position of being the world's most litigious country for IP disputes.[116]

In the Chinese legal system, foreign litigants have certain procedural advantages vis-à-vis their Chinese counterparts. One such benefit concerns

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[110] *Id.* at 125.
[111] *IPR Toolkit: Copyright, supra* note 78.
[112] ORDISH & ADCOCK, *supra* note 6, at 126.
[113] *Id.* at 7.
[114] Bai & Da, *supra* note 90.
[115] *Id.*
[116] *Id.*

the structure of the court system itself. In China, there are four levels of courts, including the Supreme People's Court (SPC) at the central government level, the High People's Courts at the provincial level, and the Intermediate and Basic People's courts at the sub-provincial local level.[117] Additionally, there are several types of specialized courts that focus on specific substantive areas of the law, including: military courts, maritime courts, courts of forestry affairs, courts of railway transportation, and courts of agriculture cultivation.[118] Since 1993, specialized *Intellectual Property Tribunals* have been maintained as divisions of courts at the intermediate level or higher.[119] The SPC has original jurisdiction over cases that have major impact upon the country as a whole as well as appellate jurisdiction over lower courts, including specialized courts.[120] There are also over thirty High People's Courts at the provincial level, which have original jurisdiction over cases that have major effects in an entire province and which also hear lower court appeals. About four hundred (400) Intermediate Courts are located in cities and prefectures within provinces which hear appeals from the provincial courts and have original jurisdiction over major criminal cases and civil cases involving foreign parties. Finally, there are over 3,000 Basic Courts at the county or district level, which have original jurisdiction over most criminal, civil, and administrative cases.[121]

Understanding the levels of the court system is significant, in that cases against foreign litigants are automatically commenced in Intermediate Courts.[122] This procedural distinction is said to benefit foreign litigants, as basic courts below the intermediate level have traditionally been staffed by judges who are "poorly educated…demobilized army officers."[123] Based in part upon the structure of the Chinese court system, in December 2010, the Intermediate People's Court in Beijing announced that "the claims of foreign firms were given support or partial support in about 55.2 percent of the 2,691 foreign-related IPR cases handled by the court between 2006 and October 2010."[124] More recently, according to both official and unofficial

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[117] Liu, *supra* note 12.
[118] *Id.*
[119] *IPR Toolkit: Protecting your Intellectual Property Rights (IPR) in China*, EMBASSY OF THE UNITED STATES, BEIJING, CHINA, http://beijing.usembassy-china.org.cn/protecting_ipr.html (last visited Apr. 23, 2012).
[120] Liu, *supra* note 12.
[121] *Id.*
[122] ORDISH & ADCOCK, *supra* note 6.
[123] Donald C. Clarke, *Power and Politics in the Chinese Court System: The Enforcement of Civil Judgments*, 10 COLUM. J. ASIAN L. 1, 10 (Spring 1996), *available at* http://docs.law.gwu.edu/ facweb/dclarke/pubs/Clarke,%20Power%20and%20Politics%20%28CJAL%29.pdf.
[124] Cao Yan, *IPR Cases Jump as Awareness Increases*, PEOPLE'S DAILY ONLINE (Dec. 25, 2010), http://english.peopledaily.com.cn/90001/90776/90882/7242165.html.

data, the win rate for multinational companies in IP infringement suits in China is "greater than 60% and, in some cities, exceeds 90%."[125]

Another benefit afforded to foreign litigants in Chinese courts is that whereas Chinese defendants have fifteen days in which to file a defense after the service of a civil complaint, foreign parties have thirty days in which to do so.[126] Also, whereas judges are required to issue judgments within six months and issue rulings on appeal within thirty days of the commencement of an action, no such rules apply with respect to cases involving foreign litigants, which provide for the possibility of additional time for foreign parties to collect and submit evidence.[127] Additionally, whereas domestic parties have fifteen days to file a notice of appeal, foreign parties have thirty days; thus providing foreign litigants with additional time in which to prepare their appeals.[128] These policies have the practical effect of providing foreign litigants with greater time to obtain evidence and file the necessary paperwork with the court.

Some have said that another reason why foreign firms refuse to take part in the Chinese IP system is the exorbitant costs associated with filing and enforcing IP rights in China.[129] One basis for these costs is that unlike in the United States, where most day-to-day legal work concentrates on discovery or the process by which opposing counsel share pertinent

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[125] Benjamin Bai, *China IP Strategies: Don't Go to China Without Them!*, ALLEN & OVERY (July 20, 2011), http://www.allenovery.com/AOWeb/binaries/62394.pdf.

[126] ORDISH & ADCOCK, *supra* note 6; "If a defendant has no domicile in the People's Republic of China, the people's court shall serve a copy of the bill of complaint on the defendant and notify him or her to forward his or her bill of defense within 30 days after he receives the copy of the bill of complaint. Any extension of the term requested by the defendant shall be at the discretion of the people's court." Civil Procedure Law (民事诉讼法), Art. 248 [Law of Civil Procedure of the People's Republic of China], (promulgated by the Order No 44 of the President of the People's Republic of China, Apr. 9, 1991), *available at* http://www.wipo.int/wipolex/en/text.jsp?file_id=181812 (last visited May 25, 2012) (P.R.C.).

[127] ORDISH & ADCOCK, *supra* note 6; "The period for the trials of civil cases involving foreign element by the people's court shall not be restricted by the provisions of Articles 135 and 159 of this Law." Civil Procedure Law (民事诉讼法), Art. 250, *supra* note 126.

[128] ORDISH & ADCOCK, *supra* note 6; "If any party who has no domicile in the People's Republic of China is dissatisfied with a judgment or order made by a people's court of first instance, the party shall have the right to file an appeal within 30 days from the date the written judgment or order is served. The appellee shall forward his or her bill of defense within 30 days after he or she has received a copy of the appeal petition. If a party is unable to file an appeal or forward a bill of defense within the period of time prescribed by law, and therefore requests an extension of the period, the people's court shall decide to approve or disapprove it." Civil Procedure Law (民事诉讼法), Art. 249, *supra* note 126.

[129] Jay Honig, Lecture at the American Chamber of Commerce: China Briefing: American Chamber of Commerce, (June 25, 2010); David S. Bloch S., George Chan & Euan Taylor, *Chinese Intellectual Property Litigation: Theories and Remedies*, *in* DOING BUSINESS IN CHINA, §10.6 (Michael J. Mosler & Fu Yu, Gen. Eds., last updated 2011), *available at* http://www.winston.com/siteFiles/Publications/13-IP%20Litigation%20_2_.pdf.

information with one another about the case, there is no procedure similar to discovery in China.[130] Instead, counsel must rely on their own research, hire private investigators, or even purchase replicas of the infringing goods at issue.[131] In fact, a prominent business consultant suggested that he would not even *pick up the phone* to provide advice to a foreign company on IP matters unless a consulting fee of over $2,000 was paid to him upfront.[132] Another basis for the supposedly significant costs of bringing an IP suit is associated with traditional evidentiary rules requiring that only original notarized documents be submitted to the Court for examination.[133] Pursuant to Article 242 of the *Civil Procedure Law*, foreign documents such as powers of attorney, certificates of incorporation, or evidence to demonstrate the existence of a corporate relationship between a parent and subsidiary for use in civil litigation should be both *notarized* and *legalized*.[134] By virtue of the fact that there is no Chinese equivalent of the notion of being held in *contempt* for lying to a court, judges traditionally presume all parties to be lying unless proven otherwise by concrete, original, and written evidence.[135] Finally, concerns are often voiced regarding the rampant corruption facing the Chinese legal system as a whole, and the belief that favorable judicial decisions can be bought by and sold to the highest bidder is widespread.[136] In fact, according to some, on the rare occasion that an injured party chooses to go to Court, the "outcome depends on who offers the judge the largest bribe."[137]

However, further investigation into these criticisms reveals that the factors supposedly contributing to high costs are exaggerated. Prominent lawyers in the field have noted that while an average IP case from start to finish might cost a company between $1-2 million in the United States, a similar case brought in China might cost that company $100,000 or less.[138] On average, it is suggested that the costs of legal services performed in China are often less than one-half of the costs of similar legal services performed in

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[130] ORDISH & ADCOCK, *supra* note 6.
[131] *Top Ten Trials*, MANAGING INTELLECTUAL PROPERTY (Dec. 1, 2009), http://www.managingip.com/article/2364977/Top-ten-trials.html (last visited May 23, 2010).
[132] Honig, *supra* note 129.
[133] Geoffrey Lin, *Introduction to PRC Patent Practice*, LOVELLS (Oct. 2009), *available at* http://www.mnbar.org/sections/international-business/Lovells%20Intro%20to%20PRC%20Patent%20practice.pdf; J. Benjamin Bai, Keith D. Lindenbaum, Yi Qian & Cynthia Ho, *From Infringement to Innovation: Counterfeiting and Enforcement in the BRICs*, 5 N.W. J. TECH. & INTELL. PROP. 525 (2010), *available at* http://www.law.northwestern.edu/journals/njtip/v5/n3/9/.
[134] ORDISH & ADCOCK, *supra* note 6, at 11.
[135] *Id.* at 194.
[136] Xu, *supra* note 17.
[137] *Id.*
[138] Interview with Donghui Wang, Attorney at Lehman, Lee & Xu (June 18, 2010).

the U.S.[139] Furthermore, Chinese practitioners have suggested that the absence of discovery actually serves to the plaintiff's advantage insofar as it limits the amount of evidence that must be shared with the defendant; and in China, it is the defendant that has the burden of proving his or her innocence.[140] It has also been noted that cases progress through the Chinese legal system at a much more rapid rate than similar cases progress in western countries, thus limiting the total cost of legal services in China.[141]

With respect to requirements that original notarized and legalized documents be submitted to Chinese courts, the process of obtaining authenticated documents is said to be *relatively straightforward*. Such process involves the notarization of an original signature by a local notary public in any jurisdiction and subsequent submission to a Chinese Embassy or Consulate, where an officer will inspect the document and affix a *legalization notice*, which provides *prima facie* evidence of its authenticity.[142] Additionally, recent decisions have indicated that judges are increasingly becoming willing to undertake *detailed analysis* and utilize *photographs* instead of requiring the submission of original documentation; thus indicative of the growing *sophistication*, *thoroughness* and *maturity* of court decision-making practices.[143]

Finally, despite the widespread concerns related to corruption in the Chinese legal system, prominent attorneys in the field suggest that they themselves have never come across a situation in which one party has bribed a judge in an IP-related case.[144] Among the reasons offered for the absence of corruption in IP cases is that many such cases are automatically referred to intermediate courts located outside of rural areas and within which judges are more scrutinized than they might be outside of the cities.[145] Additionally, it is noted that there is a significant amount of prestige associated with being a Chinese judge and these individuals are often reluctant to do anything that might jeopardize their positions, including asking for or accepting a bribe.[146] According to a 2010 survey released by the National Bureau of Statistics, 83.8

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139 Interview with Shenjun Chen, Attorney with the Shanghai Pat. & Trademark L. Off. (Jun. 25, 2010).

140 Wang, *supra* note 138; ORDISH & ADCOCK, *supra* note 6.

141 Chen, *supra* note 139; Esther H. Lim & Brandon C. Rash, *China Court Swiftly Enforces U.S. Company's IP Rights Against Chinese Company in Motorola v. Guangzhou Weierwei*, FINNEGAN, HENDERSON, FARABOW, GARRETT & DUNNER, LLP (Mar. 2008), http://www.finnegan.com/resources/articles/articlesdetail.aspx?news=ac1bec74-c483-4f26-8202-e603d78626fa.

142 ORDISH & ADCOCK, *supra* note 6, at 11.

143 Gary Zhang, Xiang An, Jinhua Lu, & Guangliang Zhang, *China's IP System Comes of Age*, MANAGING INTELLECTUAL PROPERTY (Apr. 1, 2010), http://www.managingip.com/Article/2460070/Chinas-IP-system-comes-of-age.html.

144 Chen, *supra* note 139;Wang, *supra* note 138.

145 Chen, *supra* note 139.

146 *Id.*

percent of Chinese believe corruption among government officials to be *reduced to some extent*.[147]

Although there have been instances of corruption in the judiciary, the Chinese government has endeavored to deter corruption by issuing tough penalties against those judges which do abuse their power. In one representative case that culminated in January 2010, Huang Songyou, the former Vice President of the Supreme People's Court, was sentenced to life imprisonment after being convicted of accepting more than RMB 3.9 million (approximately U.S. $610,500) in bribes from 2005 through 2008.[148] Going forward, Xiong Xuanguo, the current Vice President of the People's Supreme Court, pledged in December 2010 that "corrupt judges in China will face severe punishments as their practices harm the justice system and interests of the public," a statement which followed the March 2010 deployment of over 27,700 discipline supervisors to oversee judicial practices in almost 3,000 courts nationwide.[149]

b. The Administrative Option

Administrative actions are said to be a "popular alternative to civil litigation for IP enforcement in China."[150] With respect to patents, it has been said that utilizing administrative enforcement mechanisms is advantageous in that "investigations may occur soon after filing the complaint, the patent holder may be able to participate in the investigation, and the time required for determining whether infringement has occurred can be shorter than in a court of law."[151] In order to commence an administrative investigation, a patent holder files a written complaint with the local SIPO office having jurisdiction over the location in which the alleged infringement is believed to be occurring, after which point the claim is investigated and when appropriate, remedies are issued in the form of injunctions, cease and desist orders, confiscation of illegal earnings, and fines of up to RMB 50,000, or just below U.S. $8,000.[152]

With respect to trademarks, the procedure for filing a complaint is slightly different depending upon whether the complainant is Chinese or foreign. Whereas domestic parties can submit their complaints directly to local administrative agencies, foreign parties should "entrust a qualified

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[147] *Corrupt Chinese Judges to Face Harsh Punishments: SPC Vice President*, PEOPLE'S DAILY ONLINE (Dec. 30, 2010, 8:27 AM), http://english.peopledaily.com.cn/90001/90776/90785/7246345.html.
[148] *Id.*
[149] *Id.*
[150] ORDISH & ADCOCK, *supra* note 6, at 13.
[151] *IPR Toolkit: Patent*, EMBASSY OF THE UNITED STATES, BEIJING, CHINA, http://beijing.usembassy-china.org.cn/iprpatent.html (last visited Apr. 23, 2012).
[152] *Id.*

trademark or patent agency in China" with this responsibility.[153] If the infringement claimed involves a trademark, a trademark registration certificate must be submitted to the agency, or in the case of foreign parties, proof of the domestication of a foreign trademark through the Trademark Office.[154] While all parties are required to submit samples or photographs of the infringing goods, Chinese parties must submit copies of their business licenses and national identification cards; whereas foreign parties need only submit notarized and legalized powers of attorney.[155]

Pursuant to Article 53 of the Trademark Law, the owner of a registered trademark may seek redress for trademark infringement through the courts or administrative adjudication; and it is said that "when the infringement is serious, the Trademark Office should refer the complaint to the Public Security Bureau for prosecution."[156] Once the Trademark Office receives a complaint from a party holding an IPR right, it delegates the handling of the complaint to the provincial Administration for Industry and Commerce Office holding jurisdiction over the alleged violation. After that, this office investigates the complaint and where appropriate, seizes evidence and issues remedies to include cease and desist orders; confiscation and destruction of trademarks from goods (when the mark can be separated from the goods, the goods are returned to the infringer); confiscation and destruction of counterfeit goods (when the mark cannot be separated from the goods); confiscation of tools and equipment used primarily for the production of the infringing goods and trademark representations; and fines of up to three times the illegal profit, or in cases where this profit cannot be determined, a maximum fine of RMB 100,000 or over U.S. $15,000.[157] It is noted that actual or compensatory damages (beyond the amount of the illegal profit) are not available through administrative mechanisms, but are available through the courts.[158]

With respect to copyrights, the NCA and the SAIC are empowered with the authority to impose administrative penalties for infringement, with the former agency doing so primarily in cases of national significance and the latter agency doing so in local or regional cases.[159] In order to commence an administrative complaint for copyright infringement, a copyright holder must submit a complaint to the appropriate agency that identifies the individual infringer's name, address and occupation. In the case of a

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[153] ORDISH & ADCOCK, *supra* note 6, at 13.
[154] *Id.*
[155] *Id.*
[156] *IPR Toolkit: Trademark*, *supra* note 85.
[157] *Id.*
[158] Taylor Jones, Shen Hong & Anatole Krattiger, *Intellectual Property in China*, IP HANDBOOK OF BEST PRACTICES (Jan. 13, 2010), http://www.iphandbook.org/handbook/resources/Country/China/.
[159] *IPR Toolkit: Copyright, supra* note 78.

company, the following must be submitted: (1) the name and position of its legal representative; (2) proper documentation to establish copyright ownership; (3) a sample or copy of the infringed work; (4) a claim for compensation; (5) a factual description of the infringement; and (6) documentary evidence, to include names and addresses of witnesses.[160]

Upon receipt of a complaint, the agencies will determine whether to accept or reject the complaint and upon acceptance, it will designate at least two (2) law enforcement officers to investigate the underlying claims, collect and review evidence, seize the infringing products, and interview witnesses.[161] Upon completion of their investigation, the law enforcement officers will prepare a *Copyright Administrative Penalty Opinion*, which will include a recommended penalty and after its issuance, the alleged infringer will be given the right to respond.[162] If the infringing party fails to respond within three days, the recommended penalty stands, which could include sanctions such as administrative fines, injunctions, revocations of business licenses, confiscation of machinery used to produce the infringing goods, or the referral of the infringing party for criminal prosecution.[163]

Another administrative method available to combat IP infringement is through the General Administration of Customs.[164] Pursuant to the *Implementing Measures of Customs for the Protection of Intellectual Property Rights*, and the subsequent *Regulations of the People's Republic of China on the Customs Protection of Intellectual Property Rights*, rules and guidelines have been promulgated which provide for a role of Customs in IPR enforcement.[165] By registering with the General Administration of Customs in Beijing, an IPR holder can protect his or her rights at the border through the prohibition of the import or export of goods in violation of those rights.[166] Registration of IPR with the General Administration of Customs can occur proactively, prior to the existence of infringement, and once approved, requests can be made to have infringing goods confiscated and destroyed at the border. In addition to the seizure and forfeiture of offending goods, customs authorities "may also impose penalties equivalent to the CIF[167] price (in the case of imports) or FOB[168] price (in the case of exports) of the goods."[169]

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[160] *Id.*
[161] *Id.*
[162] *Id.*
[163] *Id.*
[164] *IPR Toolkit: Trademark*, *supra* note 85.
[165] *Id.*
[166] *Id.*
[167] Refers to *cost, insurance* and *freight* prices.
[168] Refers to *free on board* price.
[169] *IPR Toolkit: Trademark*, *supra* note 85.

c. Criminal Enforcement

China is said to be "among the few countries where serious IP infringement may subject the infringer to criminal penalties."[170] In 2010 alone, Chinese courts prosecuted 3,992 new criminal cases related to IP infringement, representing a year-on-year increase of 9.58 percent.[171] Among these, 1,294 cases involved the allegation of IP-specific crimes such as trademark infringement; 596 involved the production or sale of inferior or counterfeit goods; 2,078 were infringement cases pertaining to illegal business operations, and 24 were other miscellaneous criminal cases which were found to pertain to IP infringement.[172] In 2010, sentences were effectuated in 6,000 separate IP-related criminal cases based on guilty pleas alone.[173] As an example of recent criminal enforcement efforts, last year, a specific coordinated crack down on IP infringement surrounding the Shanghai Expo (上海市博会) led to over sixty (60) arrests at one site.[174]

According to Articles 213, 214 and 215 of the Criminal Law, and judicial interpretations issued in 2004 and 2007 by the Supreme People's Court and the Supreme People's Procuratorate, the court can impose prison sentences of up to three (3) years and fines if the losses incurred are *serious*, which is defined as a loss of more than RMB 500,000, or about U.S. $78,000.[175] If the loss incurred is considered *exceptionally serious* -defined as a loss of over RMB 2,500,000, or just over U.S. $390,000- the defendant can be imprisoned for three (3) to seven (7) years in addition to receiving a fine.[176] In the area of trademarks, the Trademark Office is explicitly required to refer a complaint to the Public Security Bureau for criminal investigation when the infringement is considered *serious*, a determination to be made on the basis of the *quantity of the infringing products produced*, the *amount of illegal gain*, or the *prospective injury to public health and safety*.[177] In turn, the Public Security Bureau may recommend prosecution to the People's Procuratorate, or prosecutor.[178] Although a number of sentencing options are available in the courts, approximately three-hundred (300) people are sentenced each year to a term of imprisonment for IP infringement.[179] In

170 Bai & Da*, supra* note 90.
171 Supreme People's Court, *supra* note 31.
172 *Id.*
173 *Id.*
174 Christopher Carothers, *Scams and Scandal Shadow Expo*, WALL ST. J. (July 8, 2010, 12:26 AM), http://blogs.wsj.com/chinarealtime/2010/07/08/scams-and-scandal-shadow-expo/.
175 *IPR Toolkit: Trademark*, *supra* note 85.
176 *Id.* at 364-365; Bai, Lindenbaum, Qian, & Ho, *supra* note 133.
177 *IPR Toolkit: Trademark*, *supra* note 85.
178 *Id.*
179 Bai, Lindenbaum, Qian & Ho, *supra* note 133.

comparison, in the United States, it is suggested that no more than ten (10) individuals per year are sentenced to imprisonment for IP-related crimes.[180]

One basis for western criticism is the supposed lack of enforcement by the police against the actions of blatant perpetrators of IP theft.[181] However, the issue is not that these authorities are refusing to enforce criminal sanctions. Rather, the concern is that business representatives are failing to gain an understanding of and learn to work within the Chinese system. In China, enforcing IP-related criminal statutes is not considered to be within the mainstream public interest and police officers traditionally will not act on their own accord to arrest infringers.[182] Instead, law enforcement authorities will only act based upon a complaint submitted by an IPR holder to the proper administrative authorities.[183] Only then will these authorities conduct raids, seize and destroy the offending goods and imprison those responsible for the counterfeit goods to sentences of up to seven (7) years.[184] Yet despite this practice, the blanket allegation that China does not provide for the enforcement of criminal sanctions against perpetrators of IP infringement appears to be without merit.

C. Note on China's Indigenous Innovation Policy

Many have spoken of the *indigenous innovation policy* as one reason why foreign firms are turning away from filing for IP protection with the Chinese authorities and are using Chinese courts to enforce their rights.[185] This policy refers to a group of regulations seeking to promote domestic innovation by giving preference to domestic innovators in procurement contracts and boosting domestic research and development capabilities.[186] In 2006, the Chinese government launched a comprehensive indigenous innovation plan with the objective of "turn[ing] the Chinese economy into a

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[180] Bai, Lindenbaum, Qian & Ho, *supra* note 133.
[181] Christopher J. Paun, Comment to Brian Safran, *Challenging the Presumption that China is Weak on Intellectual Property*, OPEN THINK TANK (July 5, 2010), http://www.atlantic-community.org/index/Open_Think_Tank_Article/Challenging_the_Presumption_that_China_is_Weak_on_Intellectual_Property.
[182] Wang, *supra* note 138.
[183] ORDISH & ADCOCK, *supra* note 6.
[184] Wang, *supra* note 138; Chen, *supra* note 139; ORDISH & ADCOCK, *supra* note 6.
[185] Loretta Chao, *China Defends Rule on "Indigenous" Tech*, WALL ST. J. (Dec. 15, 2009), http://www.online.wsj.com/article/SB126079913899790519.html; *U.S. Companies Criticize Chinese Market Obstacles*, THE CHINA POST, Apr. 2, 2010, http://www.chinapost.com.tw/business/asia/b-china/2010/04/02/250945/US-companies.htm.
[186] Juliana Gruenwald, *Firms Urge China to Repeal Indigenous Innovation Policy*, NATIONAL JOURNAL (May 10, 2010), http://techdailydose.nationaljournal.com/2010/05/firms-urge-china-to-repeal-ind.php; Kenneth Jarrett, Lecture at East China Normal University, Shanghai, China for course China's Reemergence: The Changing Political, Economic and Social Landscape: China Briefing: U.S.-China Affairs (June 21, 2010).

technology powerhouse by 2020 and a global leader by 2050."[187] Among the most significant regulations were embedded in a landmark document entitled *The National Medium- and Long-Term Plan for the Development of Science and Technology*.[188] In this document, it is explicitly stated that China has set its aim on "enhancing original innovation through co-innovation and re-innovation based on the assimilation of imported technologies," and has been seen by some technology-intensive companies as a "blueprint for technology theft on a scale the world has never seen before."[189]

It has been suggested that these *indigenous innovation policies* permit Chinese companies to "buy up foreign … intellectual property" and "demand technology transfer to China."[190] Others have noted that the policy "tries to compel transfers of intellectual property rights for key technologies as the price of market access."[191] However, these statements appear to be embellishments on the truth regarding the operation of the policy. According to Stan Abrams, a prominent practicing Chinese IP attorney, although the *indigenous innovation law* might require a foreign company seeking to enter the procurement market to transfer their IP concerns to a Chinese company, the Chinese company to which they transfer their IP rights can be a subsidiary of the foreign company, and as such, the policy "would not force an American company to give that patent away somehow to an unaffiliated Chinese company."[192] According to Dan Harris, the foreign companies whose intellectual property he registers "typically have no connection with Chinese companies."[193] With respect to multinational companies, it has been asserted that "there already is or should be a licen[se] from the parent company to the Chinese subsidiary" if they are operating in China.[194] Therefore, the notion

[187] James McGregor, *China's Drive for 'Indigenous Innovation': A Web of Industrial Policies*, U.S. CHAMBER OF COMMERCE (July 28, 2010), at 4, http://www.uschamber.com/sites/default/files/reports/100728chinareport_0.pdf.
[188] *Id.*
[189] *Id.*
[190] Isabel Hilton, *Is Google Just the Start?*, THE GUARDIAN (July 13, 2010), http://www.guardian.co.uk/commentisfree/2010/jul/13/google-china-business-with-the-west.
[191] Robert Holleyman, *How to Repair Our Economic Ties with China*, WASH. POST (July 12, 2010), http://www.washingtonpost.com/wpdyn/content/article/2010/07/11/AR2010071103037.html.
[192] Stan Abrams, *BSA Fear Mongering on China Software Piracy- Part. II*, CHINA HEARSAY (July 13, 2010), at 2, http://www.chinahearsay.com/bsa-fear-mongering-on-china-software-piracy-part-ii/.
[193] Survey with Dan Harris, Attorney with the Harris & Moure, PLLC and lead writer at China Law Blog (Nov. 7, 2011).
[194] Erica Poon, *US Report on China's Indigenous Innovation Slammed*, MANAGING INTELLECTUAL PROPERTY (Jan. 06, 2011), http://www.managingip.com/Article/2744131/US-report-on-Chinas-indigenous-innovation-slammed.html (last visited Sept. 3, 2011).

that China is somehow *stealing* foreign IP through its *indigenous innovation policy* appears to be without merit.[195]

In November 2010, a 196-page report issued by the U.S. International Trade Commission castigated the Chinese government for granting special treatment to domestic innovators in areas including government procurement, technical standards, competition policy, and tax policy.[196] Among the assertions embedded in this report is a claim that a new draft regulation will require products to be "locally researched and developed, including licensing of IP usage rights in China, with the R&D led by a Chinese entity" in order for the innovator to qualify for government procurement contracts.[197] Yet despite this regulation, practitioners have suggested that a foreign parent working with its Chinese wholly owned foreign enterprise (WOFE) or subsidiary to establish a Research & Development (R&D) center would comport with this rule and permit the foreign parent to retain *100% ownership and control* over any IP developed at the Chinese research lab.[198] It should be noted that even prior to the publication of this rule, "there [were] more than 2,000 R&D centers set up by multinational companies in China."[199] Many of the world's largest multinational companies, such as Microsoft, Nokia, Motorola, and General Electric, have maintained R&D centers for several years.[200] These corporations have found that R&D centers have served their own interests, as they function to "draw elite local professionals who… contribute tremendously to their business development" and "ai[m] to develop new products tailored to China's market demands."[201] According to Louis Brands Savage, an attorney with the Beijing Arbitration Commission, companies often decide to maintain their core research and development operations outside of China and establish R&D centers within China to focus solely on product development and product differentiation specific to the Chinese market.[202] Doing so may not only qualify the foreign company for government procurement contracts pursuant to the *indigenous innovation policy*, it also serves to generate significant goodwill from the Chinese

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[195] Holleyman, *supra* note 191; Abrams, *supra* note 192.

[196] *China: Intellectual Property Infringement, Indigenous Innovation Policies, and Frameworks for Measuring the Effects on the U.S. Economy*, U.S. INT'L TRADE COMM'N (Nov. 2010), http://www.usitc.gov/publications/332/pub4199.pdf.

[197] *Id.* at 105.

[198] Harris, *supra* note 193; Savage, survey respondent, *China's Intellectual Property System*, Nov. 7, 2011; Fred Greguras, *Intellectual Property Strategy and Best Practices for R&D Services in China*, FENWICK & WEST LLP (May 16, 2007), http://www.fenwick.com/Fenwick Documents/IP_Strategy_BP_China.pdf.

[199] Poon, *supra* note 194.

[200] *Transnationals Locate More R&D Centers in China,* CHINA INTERNET INFORMATION CENTER (Mar. 20, 2003), http://www.china.org.cn/english/scitech/58806.htm.

[201] *Id.*

[202] Savage, *supra* note 198.

government, while at the same time permitting the foreign company to protect its core intellectual property.[203]

Based on these findings, it appears that many multinational companies would already meet the requirements of the *indigenous innovation policy*. For those that do not, their operations could be adjusted to bring them into compliance without needing to fear that their IPR would disappear. Although the *indigenous innovation policy* might require certain measures be taken to ensure compliance, such as developing a Chinese subsidiary and research center in order to qualify for certain treatment, they do not mandate the transfer of technology. It should also be noted that it is not only China that has sought to promote domestic innovation by giving preference to domestically produced products. In fact, in the United States, the Buy American Act of 1933[204] has required the United States government to give preference to products made within the United States in making government purchases, and the American Recovery and Reinvestment Act of 2009[205] also had a *buy American* provision within it.[206]

V. International Law Affecting IP Enforcement in China

A. World Intellectual Property Organization (WIPO)

China is party to a wide array of international agreements that pertain to IP. Many of these agreements are administered by the World Intellectual Property Organization (WIPO), which China has been a member of since 1980. In fact, according to the WIPO website, currently China is party to fourteen (14) active international treaties which pertain to IP.[207] Among the most significant are the *Patent Cooperation Treaty* (*PCT)*[208] and the *Madrid Protocol for the Registration of Marks* (*Madrid Protocol)*.[209]

The *PCT* is significant in that it permits a patent applicant to "seek patent protection for an invention in each of a large number of countries by filing an 'international' patent application."[210] So long as the applicant is a

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[203] *China: Intellectual Property Infringement, Indigenous Innovation Policies, and Frameworks for Measuring the Effects on the U.S. Economy*, *supra* note 195, at 105; Savage, *supra* note 197.
[204] Buy American Act (BAA) of 1933, 41 U.S.C. §§ 10a-10d.
[205] American Recovery and Reinvestment Act (ARRA) of 2009, Pub. L. 111-5.
[206] Fred Teng, *Indigenous Innovation can Benefit the Whole World*, THE HUFFINGTON POST (May 20, 2010), http://www.huffingtonpost.com/fred-teng/indigenous-innovation-can_b_580896.html.
[207] Contracting Parties: China, WORLD INTELL. PROP. ORG., http://www.wipo.int/treaties/en/ShowResults.jsp?country_id=38C (last visited Sept. 3, 2011).
[208] Patent Cooperation Treaty, June 19, 1970, 28 U.S.T. 7645, http://www.wipo.int/pct/en/texts/pdf/pct.pdf.
[209] Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks, *supra* note 22.
[210] Patent Cooperation Treaty, *supra* note 208, at 1.

national or resident of a state party to the treaty, he or she may submit a single international patent application to his or her national patent office, which will then forward the application to a major patent office which will conduct an *international search* to determine the *patentability* of the application and will prepare an international search report and issue a written opinion.[211] If the applicant chooses to proceed after the issuance of the search report and opinion, the search report is published along with the application by WIPO's International Bureau.[212] Once the search report is published, the patent applicant is granted several advantages, including the granting of an additional eighteen-month period during he or she can apply for streamlined national recognition.[213] The fact that China is party to the PCT provides foreign patent applicants with access to these benefits, as well as the ability to pursue registration of their patents by way of an international review process by an impartial third party.

A second influential WIPO-administered treaty to which China is party is the *Madrid Protocol*. According to this treaty, a trademark holder in one country party to the treaty is permitted to secure trademark protection abroad, simply by "filing one application directly with his own national or regional trademark office."[214] This procedure permits the trademark owner to amend or renew his filing application with "a single procedural step."[215]

Although the *Madrid Protocol* provides IP owners with an efficient system for registering and protecting their IP internationally, there are said to be significant disadvantages with this system when attempting to enforce trademark rights in China. According to business and legal practitioners operating in China, securing trademark protection by way of domestic channels gives the IP rights holder a *much stronger position* and *better legal standing* in court when compared to those who limit their trademark profile to international filings through WIPO procedures, simply because of *legacy*

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[211] *Id.*
[212] *Id.*
[213] During this period, in order to "reflect on the desirability of seeking protection in foreign countries, to appoint local patent agents in each foreign country, [and] to prepare the necessary translations and to pay the national fees," the applicant "is assured that, if his international application is in the form prescribed by the PCT, it cannot be rejected on formal grounds by any designated Office during the national phase of the processing of the application" and that "on the basis of the international search report or the written opinion, he can evaluate with reasonable probability the chances of his invention being patented." The applicant is also assured that "the search and examination work of patent offices can be considerably reduced or virtually eliminated thanks to the international search report, the written opinion and where applicable, the international preliminary examination report that accompany the international application." *Id.*
[214] *Madrid System for the International Registration of Marks,* WORLD INTELL. PROP. ORG., http: //www.wipo.int/madrid/en/ (last visited Aug. 21, 2010).
[215] *Id.*

concerns.[216] Additionally, it is noted that reliance on the *Madrid Protocol* has the added disadvantage of making it simple "to apply for international registration in [China] without knowing local standards or searching local marks through early consultancy by local IP attorneys" which as a result, renders it "more difficult to address potential problems later."[217]

Therefore, even if the statistics concerning the ratio of foreign-to-domestic applicants as cited above were to fail to account for foreign applicants who choose to file for trademark protection through the *Madrid Protocol*, such applicants are nonetheless placing themselves at a competitive disadvantage by refraining from registering for such protection directly with domestic authorities. Accordingly, the instances of filings made by foreign IP holders through WIPO procedures as a substitute for them filing directly with domestic authorities only further demonstrates that Western companies are not taking full advantage of the IP protections that exist for them in China.

B. World Trade Organization and the TRIPS Agreement

In 2001, after a long and arduous accession process, the People's Republic of China acceded to the World Trade Organization (WTO). As a WTO member, China avails itself to several benefits, including reduced tariff and non-tariff barriers to trade and the attendant potential for greater access to goods and services and rising income levels among the Chinese people, as well as access to a system of constructive dispute resolution. However, accompanying these benefits are a series of responsibilities.

Although once focused primarily on trade in goods across borders, the global trading system has since undergone a significant expansion in the scope of its purview. The conclusion of the Uruguay Round of trade negotiations in 1994, which paved the way for the creation of the WTO, introduced a series of new multilateral agreements to which all prospective members would be obliged to accede.[218] Among these agreements were those which promote non-discrimination between trading partners; provide for predictability and stability with respect to the openness of the system; discourage unfair practices such as export subsidies and dumping; offer special protections for the benefit of less developed countries; and provide protections for the environment.[219] Notably, IPR were also introduced to the

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[216] Jason Inch, Lecture at East China Normal University, Shanghai, China for course China's Reemergence: The Changing Political, Economic and Social Landscape: Doing Business in China (June 22, 2010).

[217] Yoshitoshi Tanaka & Nguyen Thi Ngoc Bich, *International Registration of Trademark Under Madrid Protocol & Madrid Agreement*, JAPAN PATENT OFFICE (2008), http://www.jpo.go.jp/torikumi_e/kokusai_e/pdf/ipcoop_asia-pacific_e/vietnam.pdf.

[218] Marrakesh Agreement, *supra* note 20, Art. II.

[219] *Overview: the TRIPS Agreement*, WORLD TRADE ORG., http://www.wto.org/english/tratop_e/trips_e/intel2_e.htm (last visited Oct. 9, 2011).

multilateral trading system through the *Agreement on Trade-Related Aspects of Intellectual Property*, commonly known as the *TRIPS Agreement*.[220]

The *TRIPS Agreement* established minimum standards of protection to be provided by each WTO member with respect to copyrights, trademarks, geographical indications, industrial designs, patents, layout designs of integrated circuits, and trade secrets, by providing definitions for each category of intellectual property and specifying a common duration of protection.[221] In addition, the agreement set forth standards with respect to domestic procedures and remedies for IPR infringement (to include criminal penalties), made disputes pertaining to IPR subject to the WTO's dispute settlement procedures, and applied certain basic principles of international trade to IPR such as national treatment and most-favored nation treatment.[222]

As a member of the WTO, China assumes the obligations of the *TRIPS Agreement*, which is binding upon the country under international law. Even before becoming a member of the WTO, China realized that it would need to undertake a substantial revision of its domestic law in order to conform to the requirements of the agreement. For example, in October 2001, in preparation for its December 2001 admission to the WTO, China undertook a substantial revision of its *Copyright Law* which enlarged the scope of protection, clarified the rights of performers and producers, added the possibility of interim relief through the seizing of property and the preservation of evidence, and quantified the amount of statutory damages to be awarded.[223] In 2000, an amended *Patent Law* went into effect that extended the scope and duration of patent protection, and extended patent protection over chemical products, pharmaceutical products, foods, beverages and flavorings.[224] A revised *Trademark Law*, also introduced in 2001, broadened the range of symbols meeting the criteria for characterization as a distinctive mark, extended protection over well-known trademarks, and established protections for geographical indications.[225]

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[220] *See* JOHN H. JACKSON, THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATION (2d ed. 2007).
[221] *Overview: the TRIPS Agreement, supra* note 219.
[222] Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the Word Trade Organization, Annex 1C, 1869 U.N.T.S. 299; 33 I.L.M. 1197(1994), *available at* http://www.wto.org/english/docs_e/legal_e/27-trips.pdf; *Overview: the TRIPS Agreement, supra* note 219.
[223] Kristie Thomas, Ping Wang & Fanshu Yang, *Recent WTO Disputes Involving the Protection and Enforcement of Intellectual Property Rights in China: Legal and Political Analysis*, 24 CHINA POL'Y INST. 1 (2007), http://www.nottingham.ac.uk/cpi/documents/briefings/briefing-24-china-intellectual-property-rights.pdf.
[224] *Id.*
[225] *Id.*

These revisions were understood as necessary in order to bring China into compliance with the requirements of the *TRIPS Agreement*.[226]

As outlined in the *Dispute Settlement Understanding*,[227] WTO obligations are enforceable through the organization's dispute settlement mechanism, which "features compulsory jurisdiction and binding decisions" and it is noted that the "[f]ailure to implement dispute settlement rulings may lead to trade sanctions authorized by the WTO."[228] To date, China has been a complainant in eight (8) such cases and a respondent in twenty-three (23) cases.[229]

Of the disputes brought against China as a respondent, only one (1) pertained directly to its system of IPR rights. This case, known as *the China-IPR case*, was commenced by the United States in April 2007, when it requested consultations with China concerning certain aspects of China's IP practices based on its belief that China had failed to implement the requirements of the *TRIPS Agreement* in its domestic law.[230] Specifically, the United States believed that China had failed to provide for the common thresholds required by the *TRIPS Agreement* to subject an infringing party to criminal penalties; requirements concerning the disposal of infringing goods by customs authorities, the scope of criminal enforcement against copyright violators, and China's alleged failure to protect copyrights for works not authorized for distribution within China.[231] After more than two (2) years of consultation and deliberation, a Dispute Settlement Body panel determined that certain aspects of China's *Copyright Law* and its practices with respect to customs failed to comply with the *TRIPS Agreement*.[232] In April 2009, China announced its intention to comply with the findings of the Dispute Settlement Body.[233] By March 2010, the *Standing Committee of the Eleventh National People's Congress* approved amendments to China's *Copyright Law* as well as revisions to its *Regulations for Customs Protection* in direct

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[226] *Id.*

[227] Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, 1869 U.N.T.S. 401, 33 I.L.M. 1226(1994), *available at* http://www.wto.org/english/tratop_e/dispu_e/dsu_e.htm.

[228] Julia Ya Qin, Trade, *Investment and Beyond: The Impact of WTO Accession on China's Legal System*, *in* CHINA'S LEGAL SYSTEM: NEW DEVELOPMENTS, NEW CHALLENGES 168 (Donald C. Clarke ed., 2008).

[229] *Disputes by Country/Territory*, WORLD TRADE ORG., http://www.wto.org/english/tratop_e/dispu_e/dispu_by_country_e.htm (last visited Oct. 9, 2011).

[230] Thomas, Wang & Yang, *supra* note 223.

[231] *China - Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, WORLD TRADE ORG., http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds362_e.htm (last visited Oct. 9, 2011).

[232] *Id.*

[233] Thomas, Wang & Yang, *supra* note 223.

response to the findings.[234] Although the United States has been reluctant to concede that it shares China's claim that it has implemented the recommendations and rulings of the Dispute Settlement Body in this dispute, it is important to note that no new allegations pertaining to China's non-compliance with its obligations *TRIPS Agreement* have been brought by any member state since this dispute was decided.[235] What is also clear is that by amending its domestic law, China has acknowledged that it can no longer operate a domestic IPR system free from international constraint. Instead, China realizes that its policies and practices must comport with the rules of the international trading system.

VI. NOTE ON THE IMPACT OF CONFUCIAN CULTURE ON CHINA'S LEGAL SYSTEM

Some have argued that the Chinese legal system operates in an environment where interpersonal relationships are deemed higher than the law, and that any attempt to understand the Chinese system by looking at case decisions or legal procedures misconstrues the cultural setting.[236] The notion of *guanxi* (关系), or *connections*, is said to permeate all bases of the Chinese society.[237] In fact, intellectual property has "traditionally been considered more a communal right than an individual one."[238] It has been argued that in China, "people tend to operate outside the framework of law" and that as such, "for China to build a social system based on law is impossible."[239] However, even if the law in general and legal matters are in several contexts deemed secondary to personal relationships, the fact is that applications for IP protection and lawsuits seeking to enforce that protection are being filed; however, these filings are primarily not being made by foreigners.

It has also been suggested that basing a study of IP on official data or written laws and policies is insufficient, as these indicators may not give a complete understanding of China's IP system.[240] In fact, when it comes to official data, the Chinese government may be intentionally boosting the statistical data when it comes to domestic IP filings in an attempt to show the

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[234] *Id.*
[235] *Id.*
[236] Xu, *supra* note 17.
[237] Inch, *supra* note 216.
[238] ORDISH & ADCOCK, *supra* note 6, at vii.
[239] Andrew Field, Lecture at East China Normal University, Shanghai, China for course China's Reemergence: The Changing Political, Economic and Social Landscape: Modern Chinese History (June 21, 2010); Xu, *supra* note 17.
[240] Christian Brauchle, Comment to Brian Safran, *Challenging the Presumption That China Is Weak on Intellectual Property*, OPEN THINK TANK (July 10, 2010), http://www.atlantic-community.org/index/Open_Think_Tank_Article/Challenging_the_Presumption_that_China_is_Weak_on_Intellectual_Property (last visited Aug. 20, 2010).

world that Chinese companies are becoming increasingly innovative. At the same time, there exists a significant discrepancy between policies regarding how they are enacted and how they are enforced in practice.[241] As is stated, China has a greater number of laws on its books than most other countries in the world.[242] Yet, it is not suggested that the mere enactment of a law will inevitably lead to its infallible enforcement throughout the country.[243] It is for these reasons that relying on statistical data provided by government sources or simply comparing written law is insufficient. When it comes to the present study, the findings that western businesses are largely refraining from participating in China's IP system -and that mechanisms are available to them for enforcing IP rights- are those which are borne out not only by written law or government statistics alone, but also by the experiences and insights of leading Chinese academics, practicing attorneys, and business practitioners.

VII. ANALYZING THE ENFORCEMENT POTENTIAL

A. Case Law Pertaining to Intellectual Property

Despite common perceptions, intellectual property holders can, in fact, prevail in Chinese courts. For example, the overall win rate for patent owners in China's twenty (20) largest cities range from sixty (60) percent to ninety (90) percent; whereas in the U.S. and Europe, the win rate for patent holders is less than sixty (60) percent.[244] Similarly, it has been said that both official and unofficial data suggest that the overall win rate for multinational companies bringing lawsuits to enforce their IPR in Chinese courts is greater than sixty (60) percent; in some cities it exceeds ninety (90) percent.[245]

Some suggest that even making an attempt to enforce IPR in China is not worth the efforts of western businesses, which often find prevailing in Chinese courts too costly. For example, in a June 2010 meeting, a representative from the American Chamber of Commerce in Shanghai indicated that the average judgment in IP cases issued by Chinese courts is approximately U.S. $25,000.[246] Yet there have been several notable cases over the past few years that call into question the validity of this *static* figure.

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[241] Xu, *supra* note 17.
[242] *Id.*
[243] Dan Guttman, Lecture at East China Normal University, Shanghai, China for course China's Reemergence: The Changing Political, Economic and Social Landscape: Chinese Law (June 22, 2010).
[244] Bai, *supra* note 125.
[245] *Id.*
[246] Truckety, *supra* note 35; Honig, *supra* note 129.

In the *Schneider Electric case*,[247] the Chint Group -a Chinese company- was issued a judgment against Schneider Electric (China) Investment Co., Ltd. -a French Company- for approximately U.S. $48.5 million in response to the latter's infringement of a patent possessed by the former pertaining to a circuit breaker.[248] In the end, the parties settled the suit for approximately U.S. $22 million.[249] This settlement, reached in 2009, represents the largest settlement agreement ever reached for an IP-related matter in China and evidences the emergence of a modern IP system, whereby parties on both sides are increasingly aware of the potential for the awarding of significant damages if an IP case were to proceed in Court.[250] It has been said that *Schneider Electric* serves as a *wake-up call* to foreign companies who must now consider the ever-growing possibility of Chinese companies going into court to protect their IP rights.[251] Yet, although the IP system may be improving for Chinese companies, one might wonder whether the same changes can be seen with respect to foreign parties in Chinese IP lawsuits.

Several decisions can be pointed to which suggest that the operating environment for foreign businesses within the Chinese legal system is also significantly improving. For example, in *Neoplan v. Zhongtong*, Neoplan Bus GmbH -a German bus manufacturer- sued the Zonda Industrial Group -a Chinese company- for plagiarizing the design of a bus.[252] In January 2009, the Beijing No. 1 Intermediate People's Court awarded the German company a

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[247] Chint Group v. Schneider Electric (正泰集团诉施耐德电气) [Chint v. Schneider Electric] (Wenzhou City Intermediate People's Court, 2009, rule 10.5); *see Theory and Practice Related to Patent Infringement Damages*, Legal Dept. of China Pat. Agent (H.K.) Ltd., CHINA PAT. AND TRADEMARKS, No. 4, 2009, 103, 103-104, *available at* www.cpt.cn/en/show.aspx?n=2010041 4095517650076; *see also* Robert L. Burns, *Will China Become the World Leader in Patent Litigation?*, LEXISNEXIS CHINA LEGAL REV. (Dec. 2007), *available at* http://www.finnegan.com/ resources/articles/articlesdetail.aspx?news=5baf99 31-12cd-4d65-8f27-4644b9010b98; *Chint v. Schneider, A Milestone of Patent Enforcement* (Apr. 9, 2010), http://blog.sina.com.cn/s/blog_624422bf0100i73v.html

[248] Benjamin Bai, *Yes, China Does Protect Intellectual Property; Multinational Companies Just Need to Take Better Advantage of Opportunities to Defend Their Patents*, WALL ST. J. (Feb. 11, 2010), http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704259304575044 150656353806.html; Benjamin Bai, *Ignore at Your Own Peril: Intellectual Property Strategies for China*, CHINA INVESTMENT WEEKLY (Mar. 4, 2010), http://search.proquest.com/docview/44 3287656/1358C3D73C46F04E2BA/1?accountid=44825.

[249] Bewley, *supra* note 32; Bloch, Chan & Taylor, *supra* 129.

[250] Lim & Rash, *supra* note 141.

[251] Bewley, *supra* note 32, at 1.

[252] Neoplan v. Beijing Zhongtong Xinghua Automobile Selling Co., Ltd., et al. (教育考试服务中心诉北京市海淀区私立新东方学校) [Neoplan v. Zhongtong] (Beijing First Intermediate's People's Court, Jan. 14, 2009, rule 10.5), *available at* www.cpt.cn/en/show. aspx?n=20100316134237060977; *see also German Auto Firm Wins Lawsuit Over Design Rip-off*, CHINA DAILY (Jan. 22, 2009), http://www.chinadaily.com.cn/bizchina/200901/22/conte nt_7419231.htm.

judgment of 21 million Yuan, or approximately U.S. $3.1 million.[253] In this case, the Zonda Automotive Group as well as its subsidiaries Yancheng Zhongwei Passenger Coach Co. Ltd. and Beijing Zhongtong Xinhua Automobile Sales Company were accused of effectively reproducing Neoplan's Starliner model coach bus in designing its own A9 model.[254] The case demonstrated that foreigners may stand to obtain significant compensation for violations of their IPR by participating in China's evolving IP system.[255] In fact, the *Neoplan* verdict represents the largest award ever issued by a Chinese court in favor of a foreign company for patent infringement.[256] In addition to the significant amount of the damages, the case was notable because it indicated that traditional notions of the placement of the burden of proof on the defendant was a principle that could be enforced effectively against Chinese companies.[257] For instance, the Court's decision emphasized that "Zonda could not provide enough evidence to prove that the Zonda A9 is a result of their own research."[258] It should also be noted that *Neoplan* is often cited as exemplifying the supposed exorbitant costs of working within the Chinese legal system, as the plaintiff in this case was required to purchase a model of the infringing bus in order to meet the notoriously high standard of evidence required by the Court.[259] Yet, in the end the expense incurred by purchasing a model of the infringing bus amounted to only a small fraction of the total judgment amount awarded by the Court.[260]

A second case, *Strix Ltd. v. Jiatai*, involved the British kettle manufacturer Strix suing two Chinese manufacturers for infringing a design patent possessed by Strix for the manufacture of safety valves in kettles that automatically shut off when the water inside the kettle boils.[261] Here, the

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[253] Aoxue Li, *Zonda Loses Case to German Company*, CHINA DAILY (Jan. 22, 2009), http://www.chinadaily.com.cn/cndy/2009-01/22/content_7419004.htm.; *Top Ten Trials*, *supra* note 131.
[254] Li, *supra* note 253, at 4.
[255] *Top Ten Trials*, *supra* note 131.
[256] Neoplan v. Beijing Zhongtong Xinghua Automobile Selling Co., Ltd., et al. (教育考试服务中心诉北京市海淀区私立新东方学校) [Neoplan v. Zhongtong] (Beijing First Intermediate's People's Court, Jan. 14, 2009, rule 10.5), *available at* www.cpt.cn/en/show.aspx?n=20100316134237060977; Bai, *supra* note 248.
[257] ORDISH & ADCOCK, *supra* note 6.
[258] Li, *supra* note 2533, at 4.
[259] Maya Shmailov, Hava Caner & Ilan Cohn, *Changes in the IP Environment in China*, IP NEWSLETTER (2010), http://www.rcip.co.il/download/files/ChinalongFINAL.pdf; *Top Ten Trials*, *supra* note 131.
[260] *Top Ten Trials*, *supra* note 131.
[261] Strix Ltd. v. Jiatai Electrical Appliance Manufacture Co., Ltd. & Yueqing FaDa Electrical Appliance Co., Ltd. (施特里克斯有限公司诉嘉泰电器制造有限公司乐清市发达电器有限公司) (Beijing. First Intermediate's People's Court, 2010, rule 10.5); *See Chinese Courts Uphold Patents of Strix*, FRANKS & CO (Feb. 25, 2010),

British company was awarded a judgment approximating U.S. $1.3 million in February 2010.[262] This case was notable not only for the size of the judgment awarded, but also because the Beijing No. 1 Intermediate People's Court froze the defendant's liquid assets -including bank accounts at the commencement of the proceeding- thus helping to ensure that the plaintiffs would be able to collect in the event they were to win the case.[263] *Strix* indicates a willingness on the part of a Chinese court to protect a foreign party from a potential loss in the event the Chinese defendants were to be found liable. Undeniably, *Strix* and the aforementioned measures taken to protect the foreign litigants evidences the gradual emergence of an IP system favorably amenable to supporting foreign complainants in suits levied against domestic infringers.

A third case in which a foreign company was able to attain a significant judgment was *Educational Testing Services vs. Beijing New Oriental School*.[264] In a decision issued in December 2004, a court in Beijing issued judgments amounting to U.S. $1.2 million in favor of Educational Testing Services, a U.S.-based company which provides test preparation services and materials to prospective graduate students, and against the Beijing New Oriental School, a school which was found responsible for copying test materials and infringing upon trademark and copyright protections possessed by the plaintiff.[265] Although on appeal the judgment with respect to the underlying trademark case was overturned on largely technical grounds, the judgment with respect to copyright infringement was sustained and the school was required to pay ETS approximately U.S. $450,000.[266]

Another set of cases indicating an improving IP environment for foreign businesses are those cases won in recent years by Microsoft, which are related to the piracy of its operating system software. One such case was *Microsoft v. Tomato Garden*,[267] within which the main perpetrator of the IP theft was an individual named Hong Lei. Mr. Hong was responsible for creating a clone of Windows XP known as the Tomato Garden edition of Windows XP, as well as for overseeing a complex distribution network that

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http://www.franksco.com/news/2010/2/chinese-courts-uphold-kettle-patents-of-strix; S*ee also* Bai, *supra* note 248.

262 Bai*, supra* 248.

263 Dan Harris, *No IP Enforcement in China. That Cannot Be True*, CHINA LAW BLOG (Feb. 1, 2010), http://www.chinalawblog.com/2010/02/no_ip_enforcement_in_china_tha.html.

264 Educational Testing Services v. Beijing Haidian District Private New Oriental School (教育考试服务中心诉北京市海淀区私立新东方学校) [E.T.S. v. New Oriental School] (Beijing High Court, Dec. 27, 2004, rule 10.5), *available at* http://old.chinacourt.org/public/detail.php?id=149380.

265 Bloch, Chan & Taylor, *supra* 129.

266 *Id.*

267 Microsoft v. Tomato Garden (微软诉番茄花园) (Suzhou Intermediate People's Court, 2010, rule 10.5).

was responsible for bringing the operating system to computer users without cost.[268] In August 2009, Mr. Hong and three of his associates were fined approximately one million RMB, or U.S. $150,000, and sentenced to imprisonment for a term of three-and-a-half years.[269] In another Microsoft case, a Court in Shanghai ordered Dazhong Insurance to pay 2.17 million RMB, or approximately U.S. $317,900, to Microsoft for allegedly installing and permitting the use of several pirated Microsoft software applications on their employees' computer terminals.[270] Commentators have noted that this case was the first in which Microsoft has "taken a large Chinese company to court over copyright infringement" and represents the *largest sum of damages* Microsoft has been awarded in China to date.[271]

The amount of the damages awarded in the civil judgments noted are undoubtedly less than that which many Westerners might be accustomed to. However, legal practitioners are quick to point out that the system does not discriminate against foreigners and they note that overall, foreign IPR-holders have an even easier time winning IP cases through the Chinese courts than do domestic IPR-holders.[272] It is noted that the basis for the discrepancy in damages is not the national origin of the rights holder, but rather the emphasis the Chinese legal system places on *injunctions*, or court orders that mandate the infringing party to stop their illegal activities and which seek to prevent future infringing conduct.[273] In contrast, in the West, emphasis is placed on the allocation of *punitive damages*, which seek not only to put an end to the illegal activities, but also to punish the wrongdoer for their past conduct.[274] In China, except in the limited area of product liability, punitive damages are not available.[275] Despite these differences in legal culture, the relatively large awards referenced above evidence a system adaptable to change and committed to improvement. Furthermore, they demonstrate the emergence of a system of courts increasingly willing to award unprecedentedly large IP judgments, and more specifically, to award

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268 Loretta Chao, *China Defends Rule on "Indigenous" Tech*, WALL ST. J. (Dec. 15, 2009), http://online.wsj.com/article/SB126079913899790519.html; Shmailov, Caner & Cohn, *supra* note 259; Bewley, *supra* note 32.

269 Bai, *supra* note 247; Bewley, *supra* note 32; Kathrin Hille, *Microsoft Wins in Court over China's Pirates*, FIN. TIMES (Apr. 22, 2010), http://www.ft.com/intl/cms/s/2/66a1b906-4e09-11df-b437-00144feab49a.html#axzz1s4dBAThL.

270 Microsoft Co. Ltd. v. Dazhong Insurance Co., Ltd. (微软有限公司诉大众保险股份有限公司有限公司) [Microsoft v. Dazhong Insurance] (New Area People's Court, Apr. 22, 2010, rule 10.5) (China); S*ee also Microsoft Wins Software Piracy Lawsuit in China*, GLOBAL TIMES (Apr. 23, 2010), http://business.globaltimes.cn/industries/2010-04/525352.html.

271 *Id.* at 1.

272 Chen, *supra* note 139.

273 *Id.*

274 *Id.*

275 *Id.*

these judgments to foreign companies over the objections of Chinese defendants. Although one might see cases such as those referenced to be exceptions to the rule, the fact is that a similar array of case decisions could not have been cited just a few years ago.[276]

Some have argued that even though the case decisions cited above are noteworthy, they do not necessarily indicate a trend, as the courts granting awards such as these appear primarily to be limited to the major cities of Beijing and Shanghai.[277] It has been suggested that even though major cities have evidenced some notable improvements in enforcement, many of the courts in the more rural areas are trailing behind.[278] One basis for this conclusion is the alleged persistence of local protectionism in China's more remote regions.[279]

Although it is true that the majority of IP disputes have been heard by courts in major population centers, this fact alone does not necessarily prejudice foreign businesses seeking to enforce their IPR in China. First, in major cities, IP disputes are often heard by specialized tribunals dedicated to intellectual property matters.[280] As a result, courts in these areas have more experience and expertise in adjudicating IP disputes.[281] In fact, it has been suggested the judges that adjudicate IP disputes in the major cities are often more educated than similarly situated judges in western countries, as many Chinese judges have degrees in electrical engineering or have other technical and practical backgrounds.[282] Secondly, the court system is designed in such a way that patent cases are automatically adjudicated during the first instance in the Intermediate Level People's Courts (or in the IP division thereof), which are located in the capital city of each province.[283] Therefore, at least with respect to patents, these cases are never actually heard outside of the larger cities.[284] George Chan, a business consultant with the Rouse Consulting Group, has noted that in recent years "IP-related judgments being issued by Courts in second and third tier cities are much more comprehensive and the[ir] analyses of the facts and law are much more detailed."[285] Third, and perhaps most significantly, jurisdictional rules in China permit litigants to bring a case either at the place of infringement, the

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[276] Wang, *supra* note 138; Chen, *supra* note 139.
[277] Inch, *supra* note 216.
[278] *Id.*
[279] Guttman, *supra* note 243.
[280] Jie Gao, Lecture at the Office of the National Resources Defense Council, Beijing, China: The National Resources Defense Council and the Environmental Law Project (June 17, 2010); Chen, *supra* note 139.
[281] *Id.*
[282] Bai, Lindenbaum, Qian, & Ho, *supra* note 133.
[283] Chen, *supra* note 139.
[284] *Id.*; ORDISH & ADCOCK, *supra* note 6.
[285] Poon, *supra* note 194.

defendant's domicile, or even at the place of distribution.[286] For instance, pursuant to the Chinese Supreme Court's regulatory interpretation entitled *Several Questions on the Application of Law in Trial of Trademark Civil Dispute Cases*, under Article 6, "a registered trademark owner may file a lawsuit in the place (a) where trademark infringement occurred, (b) where infringing products are stored, sealed, or detained, or (c) where the infringer is domiciled" and pursuant to Article 7, a foreign IPR holder may "file its complaint before the Economic or Intellectual Property Division of the People's Intermediate Court nearest to one of these three places."[287] Similar rules exist for patent and copyright infringement.[288] This permits a plaintiff a certain degree of freedom to choose a favorable forum. For example, in the 2007 case of *Motorola v. Guangzhou Weierwei*,[289] an action was brought by Motorola to enforce a design patent on a two-way radio against a Chinese radio manufacturer in Guangdong province.[290] Despite the fact that the alleged incident occurred in Guangdong, Motorola and its legal team were able to take advantage of China's jurisdictional rules and bring the case in Beijing, allowing the company to avoid the possibility of local protectionism in Guangdong province and permitting it to take advantage of the experience of the Beijing courts in dealing with IP matters.[291]

In more recent years, multinational companies have been beneficiaries of China's new practice of utilizing its criminal justice system to enforce IP rights against infringers and deter others from infringing in the first place. For instance, in 2010, fifteen individuals were sentenced for having transported and stored counterfeit cigarettes involving six foreign brands, including Benson and Hedges.[292] The defendants were found guilty of selling counterfeit products and the ringleaders of the operation were both sentenced to fifteen years imprisonment and forced to pay fines of 5 million RMB (approximately U.S. $782,000) and 2 million RMB (approximately U.S. $312,778) respectively; the remaining defendants were sentenced to indeterminate prison sentences of one (1) year and six (6) months to ten (10) years, with fines of up to RMB 700,000 (approximately U.S. $109,500).[293]

In another significant criminal matter involving a music and internet-related copyright dispute, Wang Jiahao was found by the Changshu People's

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[286] Chen, *supra* note 139; ORDISH & ADCOCK, *supra* note 6.
[287] *IPR Toolkit: Trademark*, *supra* note 85.
[288] ORDISH & ADCOCK, *supra* note 6.
[289] Motorola v. Guangzhou Weierwei Electronic Science and Technology Co. (摩托罗拉诉广州威而威电子科技) (Beijing First Intermediate People's Court, Dec. 2007, rule 10.5).
[290] Lim & Rash, *supra* note 141.
[291] *Id.*
[292] *2010 IP Cases*, CHINA INTELL. PROP. MAG. (Apr. 27, 2011), http://www.chinaipmagazine.com/en/journal-show.asp?id=680.
[293] *Id.*

Court to have violated copyrights possessed by Universal Music Ltd. and Warner Music Taiwan Ltd., after it was alleged that he had created an online music network permitting anonymous internet users to obtain trial subscriptions and listen to music without charge while Mr. Wang collected fees totaling over RMB 1.28 million (approximately U.S. $200,177) from advertisers.[294] In 2010, Mr. Wang was found guilty of copyright infringement and was sentenced to six (6) months in prison with, a one-year suspension, and fined 15,000 RMB (approximately U.S. $2,350), in addition to being required to return all of the proceeds obtained through his criminal activity.[295]

Also in 2010, defendant Liu Zhaolong was convicted and sentenced to four (4) years imprisonment and fined 150,000 RMB (approximately U.S. $23,500) for counterfeiting foreign-brand liquor.[296] Mr. Liu had been found to be producing Chivas Regal liquors; products which were protected by a well-known trademark possessed by Pernod Ricard, an international wine and spirits group.[297] In part stemming from Mr. Liu's initial arrest in 2009, a partnership between the International Federation of Spirit Producers and officials at the State Administration of Industry and Commerce has led to the investigation of twenty-two (22) large-scale cases of counterfeited spirits, and the conviction of seventy-one (71) defendants; eight (8) of whom were sentenced to over four (4) years imprisonment, with the most severe sentence amounting to six-and-a-half years of imprisonment.[298] In addition to prison sentences, the defendants were issued fines collectively totaling over 5 million RMB (approximately U.S. $782,000).[299]

B. The Challenges Facing the Western Multinational Corporation Operating in China

The purpose of this paper is not to suggest that China's IP system is perfect. There are, of course, instances where IP rights have been violated either explicitly or implicitly, and other cases where IP has been outright stolen. As an example, it is hard to conclude that Chinese government-owned aerospace manufacturer Commercial Aircraft Corporation of China, Ltd. (COMAC), which has developed plans to design and build large commercial aircraft, has developed such plans based on its own technological discoveries without consulting blueprints derived from the factories Boeing has set up in

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[294] *Id.*
[295] *Id.*
[296] Ti Zhuang, *Court Case: Spirited Fight Against Liquor Counterfeits*, CHINA DAILY (June 29, 2011), http://www.chinadaily.com.cn/cndy/2011-06/29/content_12797594.htm.
[297] *Id.*
[298] *Id.*
[299] *Id.*

China to build key aircraft components.[300] It also cannot be argued that there are not instances where companies have successfully registered the intellectual property of others as their own and asserted their rights in Chinese courts to *junk patents*.[301] Additionally, despite anecdotal evidence suggesting that in recent years the win rate for multinational companies bringing their IP cases to court exceeds sixty (60) percent, with the win rate in some cities exceeding ninety (90) percent, China can still certainly do more to ensure the consistent application of its laws throughout the country.[302]

Yet China's IP system is a work in progress. Given the fact that the first modern Chinese patent law was devised only in 1984, China's IP system has come quite a long way in a relatively short amount of time.[303] Unlike China, western countries are said to "have a century or more of IP experience under their belts."[304] Legal practitioners note that, although China's IP system might be weaker than those in the United States and Western Europe, it is still stronger than those of India and even South Korea and Taiwan.[305] Yet despite its flaws, the aforementioned analysis has demonstrated that there are significant untapped resources available to foreign businesses seeking to protect and enforce their IPR's in China, most especially for those companies that possess intellectual property and already operate in China and refrain from participating in China's IP system.

C. Best Practices and Winning Strategies among Multinational Corporations in China

Multinational companies which decide to set up operations in China would be well-advised to develop an IP strategy specific to their company's operations designed to ensure that their rights are fully protected in China. This means filing for IP protection, consulting with local counsel and business consultants, and submitting to available administrative, judicial and criminal procedures available for enforcing those rights. Companies with IP concerns should seek to obtain a *robust portfolio* of patents, copyrights and trademarks before operating in China.[306] By virtue of the fact that domestic filings are preferred by Chinese courts over international filings made

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[300] Brett Davis, Don Dennis, Tras Obsuwan, Kyungwhan Park & Ryan Wegner, *The ABC's of Aviation: Airbus, Boeing, China*, FORBES INDIA MAG. (Nov. 3, 2011), http://business.in.com/printcontent/29372.
[301] *American Business in China White Paper*, AM. CHAMBER OF COM.- CHINA (Apr. 26, 2011), at 72, http://amchamchina.org/whitepaper2011.
[302] *Id.*; Bai, *supra* note 248.
[303] Chen, *supra* note 139.
[304] ORDISH & ADCOCK, *supra* note 6, at 302.
[305] Wang, *supra* note 138; Chen, *supra* note 139.
[306] Lim & Rash, *supra* note 141.

through WIPO, business executives should seek to file their IP concerns directly with the proper domestic administrative authorities.[307]

Many western businesses operating in China to date have chosen to focus on *achieving rising market share value and volume* without investing in IP protection.[308] Yet, as demonstrated by the significant award issued by the Court in *Neoplan*,[309] foreign parties to IP lawsuits willing to make the initial investments into evidence-gathering as required to meet China's unique evidentiary requirements and to familiarize themselves with Chinese legal procedures can obtain access to redress when their rights are violated.[310] It is noted that "IP protection strategies used at headquarters are [often] not transplanted to China for implementation" and that business executives "often choose to send operational staff who have little to no understanding of China, and of the need to invest in IP protection strategies."[311] Businesses which seek to take full advantage of China's IP system therefore must be willing to "send technical or IP professionals to oversee their proprietary property" and assist them in navigating the system.[312] Multinational companies must not only be willing to sue to enforce their IP rights, but must choose a team capable of providing the business with an "in-depth understanding of the Chinese judicial system and relevant legal doctrines and an ability to maneuver through the intricacies of law and politics."[313]

Some have suggested that the filing of IP with domestic authorities and pursuing claims through existing enforcement mechanisms are a necessary but not sufficient method for protecting IP rights in China. In fact, the changing IP environment in China has forced multinational companies to rethink how they view, value, and protect their IP. Moreover, in addition to protecting their IP through legal mechanisms, companies are increasingly seeking to "holistically cultivat[e] and retai[n] value through higher-level business strategies" by assuming a *value management approach* to protecting IP.[314]

Given the focus of Chinese companies on developing derivative products based on pre-existing patents, and mass producing them for

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307 Inch, *supra* note 216.
308 ORDISH & ADCOCK, *supra* note 6, at 15.
309 Neoplan v. Beijing Zhongtong Xinghua Automobile Selling Co., Ltd., et al. (教育考试服务中心诉北京市海淀区私立新东方学校) [Neoplan v. Zhongtong] (Beijing First Intermediate's People's Court, Jan. 14, 2009, rule 10.5), *available at* www.cpt.cn/en/show.aspx?n=201003 16134237060977.
310 *Top Ten Trials*, *supra* note 131.
311 ORDISH & ADCOCK, *supra* note 6, at 9 & 14.
312 *Id.* at 9.
313 Bai, *supra* note 248, at 1.
314 *Redefining Intellectual Property Value: The Case of China*, PRICEWATERHOUSECOOPERS: TECHNOLOGY AND INNOVATION CENTER (2005), http://www.pwc.com/en_US/us/technology-innovation-center/assets/ipr-web_x.pdf.

consumption by the Chinese market, western companies seeking to compete in China are advised to "align their IP strategy with overall business objectives" and "recognize that IP value can be preserved not only in goods and manufacturing itself, but with related channel and distribution controls, service adjuncts, and other non-merchandise activities."[315] As part of this process, it is recommended that manufacturing remain flexible through "rapid versioning, agility in increasing or reducing capacity of product lines, and supply chain responsiveness" in order to "introduce new technology more quickly than the competition" and "maximize the value of new features and functions."[316] In addition to rapid versioning, companies are advised to set aggressive, competitive prices and market global product launches in order to make it difficult for less capable manufacturers to keep pace and add value to product lines through brand attributes and services.[317] Also, businesses are advised to "[c]onsider merger and acquisition (M&A) and partnering activities" through "deeper, more definitive and exclusive equity relationships along the supply chain" in order to "align the interests of participants around protecting core IP value."[318] With respect to communications with stakeholders, companies are advised to "publish [its] successes in enforcing IP rights, as well as publically naming and shaming perpetrators."[319]

When it comes to the relationship between company executives and the Chinese community, it is recommended that companies should "[e]ncourage positive legal development in China by engaging at various levels with government, business and academic leaders."[320] As part of this practice, companies are advised to "[c]ontinue engagement with the related central government agencies to improve their knowledge and law enforcement capacity-building exercises," and "align interests with local government parties" while "proactively buil[ding] strong relationships with the bodies responsible for IP protection and enforcement, including customs, at a local or provincial level" should the company need to enforce its rights in the future.[321] Companies are also advised to "engage in local standards debates and elevating protection initiatives in international standards groups."[322] When an industry is faced with IP infringement, competitors have been known to collaborate, exchange information and "jointly fund or drive

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[315] *Id.* at 6.
[316] *Id.*
[317] *Id.*
[318] *Id.*
[319] Dr. Heinrich v. Pierer, President & C.E.O. at Siemens AG, Press Conference: Leveraging IP as Part of Your Corporate China Business Strategy (Jan. 6, 2005) (transcript *available at* http: //ebookbrowse.com/gdoc.php?id=279821066&url=9c1af86b7988d72710af3d64f19c00ed).
[320] *Redefining Intellectual Property Value: The Case of China*, *supra* note 314, at 6.
[321] *Id.*; Pierer, *supra* note 319.
[322] *Redefining Intellectual Property Value: The Case of China*, *supra* note 314, at 6.

investment protection measures, or even create an industry pressure group to convince the authorities to be more active in protecting IP rights" such as the Pharma Association of China.[323] Companies are also advised to "organize government education efforts that stress and quantify the benefits of IP protection for China's industrial development," "encourage local IP holders to support the cause of IP preservation," and "nurture alliances with researchers, academics, and policy advisors [in order to help] them expand their knowledge and influence."[324] These multifaceted strategies permit a company to leverage best practices and assert their IP rights despite the challenges associated with operating a business in China.

Yet as it has been shown, company executives that succumb to their fears and leave themselves out of China's IP system altogether are left at a competitive disadvantage. As famously suggested by Jiang Zhipei, the Chief Justice of the Intellectual Property Rights Tribunal of the Chinese Supreme People's Court: "[f]oreign companies should take their complaints to courts rather than to the newspapers or their politicians" and "[f]oreign companies should complain less and act more."[325] Given the improvements made to China's IP system over the past several years, Jiang's words encapsulate the best advice that can be given to a western company with IP concerns seeking to protect its intellectual property while operating in China.

VIII. CONCLUSION

A. The Implications for the Western Multinational Corporation

China does not have a perfect IP system. Yet, as it has been shown, its weakness is in part due to multinational businesses, which "in their rush to enter the world's largest market, [they often fail] to include intellectual property in their entry strategies."[326] As it has been shown, *group think* has prevailed in discussions surrounding China's IP system and this thinking has ultimately led top-level decision makers to refrain from critically analyzing the bases for their subjective perceptions and to choose to abstain from participating in China's IP system. Yet the aforementioned analysis has demonstrated that the Chinese IP system, despite its complexities, is one from which foreign parties can increasingly stand to benefit if only they chose to take part in it.

It is important to note that organizations such as the American Chamber of Commerce and the European Chamber of Commerce are, at their heart, lobbying organizations whose primary purpose is to lobby for policies

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[323] Pierer, *supra* note 319, at 3.
[324] *Redefining Intellectual Property Value: The Case of China*, *supra* note 313, at 6.
[325] ORDISH & ADCOCK, *supra* note 6, at 182.
[326] *Id.* at 9.

that promote and protect the interests of a particular constituency.[327] This is most readily apparent in publications such as AmCham's 2011 White Paper entitled *American Business in China*, which presents an imbalanced view of China's IP system, providing only very general praise for improvements made, and offering much more specific and detailed criticisms of China's IP system complete with a slew of complaints aimed at encouraging Chinese leaders to transform almost every aspect of the Chinese socio-legal system.[328] Rather than continuing to channel their collective energies into organizations such as these in an attempt to change Chinese policy, business executives may find it more fruitful to learn to work within the existing system.

B. Policy Recommendations

The foregoing analysis suggests that decision making by western business leaders doing business in China, faced with having to choose whether to build a comprehensive portfolio of IP rights and enforce those rights through the Chinese system upon infringement is reflective of the Theory of Reasoned Action. Based on a combination of personal attitudes and subjective norms within the business community, many corporate executives with operations in China have largely chosen to avoid partaking in China's IP system. Yet this study has demonstrated that these attitudes and norms are largely based on a series of misguided and flawed assumptions.

It has been suggested that there is a widespread belief that China's IP system is weak. However, the aforementioned analysis shows that there is a robust system for protecting intellectual property in China. From the specific step-by-step guidance Chinese law provides to companies seeking to register intellectual property with domestic authorities, to the several avenues available to companies seeking to enforce those rights, China's IP system has made significant strides in its short lifespan. A series of recent case decisions demonstrate that Chinese courts have shown an increasing willingness in recent years to rule in favor of non-Chinese IP owners and assess significant damages in IP-related cases; none of which could have been cited just a few years ago. Despite these decisions, some have noted that improvements are limited to major cities and that IP enforcement in rural areas remains weak. Conversely, it has been shown that China maintains relatively loose jurisdictional rules that permit IP rights holders to commence lawsuits in these major cities without much impediment. Some also suggest that Chinese socio-legal culture is such that personal relationships trump legal relationships, discounting the relevance of legal processes and court decisions. Notwithstanding the cultural divergences between China and the

[327] Wang, *supra* note 138; Truckety, *supra* note 35.
[328] *American Business in China White Paper, supra* note 301.

West, many Chinese businesses are participating in the legal process by filing for IP protection as well as seeking to enforce their rights through Chinese courts, whereas foreigners are largely leaving themselves out of the process.

Some have questioned the *indigenous innovation policy* and the perceived risk of IP thievery by China, based on the requirement that IP be transferred to a Chinese entity before a foreign business can qualify for Chinese government procurement contracts. However, the *indigenous innovation policy* does not prohibit a foreign firm from establishing a business relationship with a Chinese subsidiary and transferring the IP to it in satisfaction of this requirement; thus providing a method by which to circumvent the supposed obligation that foreign IP be transferred to a Chinese entity totally unrelated to the foreign IP holder. Additionally, while the *indigenous innovation law* may require a foreign company to maintain a domestic R&D center in order to qualify for procurement contracts, companies have shown that it is possible to maintain such R&D centers without risking the appropriation of their IP by Chinese authorities. Evidence has also shown that concern regarding the costs of enforcing IP rights in China is largely misguided and that such costs are often significantly less than similar expenses associated with enforcing such rights in western countries. Furthermore, despite the allegation that China fails to enforce criminal sanctions against those responsible for IP infringement, evidence suggests that China does in fact enforce such sanctions, subject to its own unique complaint filing requirements.

Some have also taken issue with the statistics that indicate limited foreign participation in China's domestic IP system, viewing them as an insufficient indicator to conclude that western businesses are not attempting to enforce their rights through the Chinese system given the existence of the WIPO's international filing system. Yet, as noted, practitioners in the field assert that IP owners that fail to file directly with Chinese authorities are left at a competitive disadvantage upon attempting to enforce their rights in Chinese courts. Some have also noted that any effort to analyze China's IP system based on government statistics or written statutes fails to encompass the true operation of China's legal system. For this very reason, this study has focused on the views and experiences of those business and legal practitioners with direct expertise in the field, as opposed to a solely textual analysis or comparison of existing Chinese law. Finally, despite concerns regarding the inconsistent application of Chinese law, this study suggests that ample opportunities exist for foreigners to enforce their IPR in China. Given the relative infancy of China's IP system, and the fast-paced improvements made to that system over the past few years, there can be no doubt that China's IP system will provide an even more consistent framework for doing business in China as the years progress.

As it has been presented, the conclusions reached by the American Chamber of Commerce and the European Chamber of Commerce fail to accurately depict the opportunities available to western businesses for enforcing their IPR in China in 2012. Before complaining to their respective Chambers of Commerce, western businessmen would be well-advised to work within the existing system. This means filing for IP protection, seeking representation by local counsel and patent agents, and putting forth a salient effort to utilize existing administrative processes and the court system to enforce their rights. In the end, they may find themselves surprised by the results.

CHOICE OF LAW IN FOREIGN CURRENCY DEBTS: A COMPARATIVE STUDY

YEHYA BADR*

I. INTRODUCTION

Choice of law in foreign currency debts is an area where several contradictory rules exist; leaving it unclear how a court will treat said issue. This article aims to explain the reasons courts have created uncertainty in this field. In Part One, I will survey the choice of law rules on foreign currency debts in four different jurisdictions. The first two jurisdictions are the United States and England, which are common law jurisdictions while the other two, France and Egypt, are civil law jurisdictions. In Part One, I demonstrate that courts tend to deal with foreign currency debts not as a single legal issue governed by a single choice of law rule but as a set of legal issues that requires the use of several choice of law rules and doctrines.

In Part Two, I examine the manner in which courts have handled choice of law in foreign currency debts through the evaluation of courts' use of the choice of law rules and doctrines. I explain that, in most cases, courts have misused the choice of law rules and that the real explanation for their attitudes towards the choice of law in foreign currency debts is a desire to balance the need for enforcing agreements to the maximum extent possible, which requires using the party autonomy choice of law rule, and the need for complying with restrictions, imposed by the forum's law, foreign law, or even the International Monetary Fund (IMF) Agreement, (the "IMF Agreement"),[1] that guide courts towards other choice of law rules or doctrines such as *lex loci solutionis*.[2]

In Part Three, I suggest a better choice of law approach to foreign currency debt that is based on enforcing the parties' agreement by using the parties' autonomy as a basic choice of law rule. However, the use of a party's autonomy choice of law rule will be restricted in accordance with the IMF Agreement whenever the parties' agreement contradicts the law of a member state. I explain that this restriction should take place once the parties' agreement, at the time of conclusion or at the time of enforcement, will affect the IMF member state's monetary system.

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[1] Bretton Woods Agreement, July 22, 1944, 60 Stat. 1401, 2 U.N.T.S. 39, as amended through June 28, 1990, available at http://www.imf.org/external/about.htm.

[2] *Lex Loci Solutionis* is the Law of the place where the payment or performance of a contract is to be made. *See* BLACK'S LAW DICTIONARY 911 (6th ed. 1990).

II. Choice of Law and Foreign Currency Debts

In this part, I survey the choice of law rules and doctrines used by courts in the selected jurisdictions. Here distinctions must be made among four separate issues. First, the determination of the debt's nominal value, which I will refer to as the "Money of Account", which courts usually determine via the parties' autonomy choice of law rule. Second, the actual payment of the debt is governed by the *lex loci solutionis* choice of law rule. Third, the forum's law governs the court's ability to issue judgments and may mandate issuing the judgment in the forum's currency, which means that the court will have to convert the parties' claims from the foreign currency to the forum's currency and vice-versa. These "Conversion Rules", actually reflect the court's desire to effectuate substantive justice and to overcome its inability to award any damages beyond interest. Fourth, the effect of the Foreign Currency Control Rules (F.C.C.R.) and how the courts apply or ignore Article VIII 2(b) of the IMF Agreement.[3]

A. United States

1. *Currency of Account*

So far no American court has placed any limitation on the parties' choice of currency in denominating debts. American courts apply the principle of nominalism[4] to all debts irrespective of the currency used by the parties. Therefore, an obligation to pay a sum of money in a certain currency is not affected by the changes that occur in that currency's value.[5] This rule is applied to debts denominated in both U.S. dollars and foreign currencies. An example is *Strenberg v. West Coast Insurance Co.*, where the California Court of Appeals ruled that an insurance policy made in California that required the insured to pay the premiums in Chinese currency was enforceable even though the Chinese currency had depreciated in value to such an extent that it had become worthless.[6] The court did not accept the defendant's argument that a plaintiff's duty to pay should have been altered in light of the Chinese currency's depreciation.[7]

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[3] Bretton Woods Agreement, *supra* note 1.

[4] Nominalism means that the creditor can discharges his debt by paying off the face value of the amount owed to the debtor regardless of any changes that might occur in the currency's purchasing power due to inflation or debasement of the currency itself. *See* Gilbert v. Brett (Case De Mixt Moneys) (1604) Davis 18 (P.C. of Ireland).

[5] Knox v. Lee Parker, 79 U.S. 457, 508 (1870); *see also* Die Deutsche Bank Filiale Nurnberg v. Humphrey, 272 U.S. 517, 519 (1926).

[6] Sternberg v. West Coast Life Ins. Co., 196 Cal. App. 2d 519, 521 (Cal. Ct. App. 1961).

[7] *Id.* at 526.

2. *Currency of Payment*

American courts apply the law of the place of payment to determine all legal issues related to paying a debt.[8] The law of the place of payment will both supersede any agreement made by the parties concerning the debtor's duty to pay the debt and determine the legal tender status of the currency used to pay the debt.[9] In *Johansen v. Confederation Life Association*, the Federal Court of Appeals for the Second Circuit ruled that the currency of payment should be Cuban pesos even though the insurance policy mandated payment in U.S. dollars. The policy stipulated that payment would take place in Cuba and since U.S. dollars were no longer legal tender under Cuban law, the debtor's obligation to pay could be discharged only through a payment in Cuban pesos.[10]

3. *Conversion Rules*

Traditionally, American courts have held that they were unable to issue their judgments in a foreign currency due to the Dollar Judgment Rule.[11] However, American courts differ about the reasons behind adopting this rule. Some emphasize the need to respect the forum's sovereignty, which means that courts must not issue judgments in a currency other than the forum's currency. Other courts have justified the rule by constructing section 20 of the 1792 Coinage Act.[12] As a result, it became necessary for American courts to issue their judgments in U.S. dollars and then convert those judgments into foreign currencies. Now there are two main conversion rules

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[8] Johansen v. Confederation Life Association, 447 F. 2d 175, 177 (2d Cir. 1971).

[9] *Id.*

[10] *Id.* at 177.

[11] Hicks v. Guinness et al., 269 U.S. 71 (1925); Frontera Transportation Co. v. Abaunza, 271 F. 199, 202 (5th Cir. 1921); Liberty National Bank v. Burr, 270 F. 251, 252 (E.D. Pa. 1921).

[12] § 20 of the 1792 Coinage Act stated that "[A]nd be if further enacted, that the money of account of the United States shall be expressed in dollars, or units, . . . of a dollar . . . and that all accounts in the public offices and all proceedings in the courts of the United States shall be kept and had in conformity to this regulation." This section was constructed, rightly, to be an impediment against issuing judgments in foreign currency by the Courts in the United States. International Silk Guild, Inc. v. Rogers, 262 F.2d 219, 224 (D.C. Cir. 1958). *See also* Shaw, Savill, Albion & Co. v. The Fredericksburg, 189 F.2d 952, 954 (2d Cir. 1951). However, § 20 of the Coinage Act was repealed by the enactment of 31 U.S.C. § 5101 (1988) which omitted the phrase "all accounts in the public offices and all proceedings in the courts of the United States shall be kept and had in conformity to this regulation." The Dollar Judgment Rule still stands as good law because of the House Report on section 5101 that clearly indicates that the recodification was not intended to change the law which prohibits the Courts in the United States form issuing their judgment in a foreign currency. For more details *See* Note, The Uniform Foreign-Money Claims Act: No Solution to an Old Problem, 69 TEX. L. REV. 1203, 1209-14 (1990).

followed by American courts, the Breach Day Rule and the Judgment Day Rule.

a. Breach Day Rule

The Breach Day Rule is considered the basic conversion rule used by both state and federal courts if the cause of action arises under U.S. domestic law. This rule mandates the conversion of a court's dollar judgment into the foreign currency at the exchange rate prevailing when the creditor brought the action[13] regardless of whether the debt was the result of a duty to compensate for a tort[14] or a debt on an unpaid negotiable instrument.[15]

b. Judgment Day Rule

The Judgment Day Rule is followed exclusively by federal courts. It was introduced by the United States' Supreme Court in a lawsuit filed by a U.S. citizen to recover German marks deposited in a bank located in Germany.[16] Due to currency restrictions in Germany, the bank did not allow him to do so until the marks had depreciated severely.[17] The Court decided to adopt the Judgment Day Rule instead of the Breach Day Rule because the German bank's duty to remit the deposit was governed by German law, which meant that the conversion of the Court's U.S. dollar judgment into German marks would take place at the time the Court authorizes the enforcement of its judgment.[18] Nonetheless, this rule is considered secondary to the Breach Day Rule because it is only applied by the federal courts when the cause of action is based on foreign law.[19]

c. Explanation

There have been various attempts by courts and scholars to explain the existence of two different conversion rules within U.S. federal law. Some

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[13] Ladd v. Parkell 40 Super. (8 J. & S.) 150 (1875); Hoppe v. Russo-Asiatic Bank, 235 N.Y. 37; 138 N.E.497 (1923), *aff'd,* 200 App. Div. 460, 193 N.Y. Supp. 250 (1st Dept. 1922); Redo y Cia v. First National Bank, 200 Calif. 161, 252 P. 587(1926); Hicks v. Guiness et al., 269 U.S. 71 (1925); Det Forenede Dampskibs Selskab v. Insurance Co. of North America, 31 F.2d 658, *affirming* D.C. 28 F.2d 449, *cert. denied,* 280 U.S. 571 (1929); The Muskegon 10 F.2d 817 (D.C.N.Y. 1926); Taubenfeld v. Taubenfeld, 276 A.D. 873 (1949).

[14] Simonoff v. Granite City Nat. Bank, 279 Ill. 248 (1917); Pavenstedt v. New York Life Ins. Co., 203 N.Y. 91 (1911).

[15] Gross v. Mendel, 171 App. Div. 237 (1916).

[16] Die Deutsche Bank Filiale Nurnberg v. Humphrey, 272 U.S. 517 (1926).

[17] *Id.* at 529.

[18] *Id.*

[19] *Id*. *See also* Zimmermann v. Sutherland, 274 U.S. 253 (1926); Thornton v. National City Bank of New York, 45 F.2d 127 (C.C.A. 2d 1930); Royal Ins. Co. v. Compañía Transatlántica Española, 57 F.2d 288 (E.D. N.Y. 1923).

have suggested that the conversion rules reflect differing choice of law approaches. According to them, the Breach Day Rule will be used if the court adopts the local law theory because it cannot enforce a right beyond the limits of the foreign law.[20] In other words, the court is only enforcing a pre-existing right and not creating a new right, which directs the court towards converting its dollar judgment into the foreign currency according to the prevailing exchange rate at the time the plaintiff brought suit. On the other hand, if the court follows the vested rights theory then it would be expected to use the Judgment Day Rule to indemnify the plaintiff to the largest extent possible by delaying the date of conversion until the court issues its judgment.[21]

I find this explanation to be unsatisfactory for a number of reasons. First, this explanation tries to tie the conversion rules and the theory used by the court in dealing with foreign law. In reality, such connections do not exist because just as the American courts disagreed on how to deal with the foreign law they also disagreed on which conversion rule should be used in converting foreign currency debts from a foreign currency into U.S. currency. Second, this explanation does not explain why courts differ among themselves in characterizing the conversion rules. Some courts characterize conversion rules as substantive rules,[22] so that a federal court sitting in diversity must follow the state's conversion rule; while others characterize them as procedural rules governable by federal law.[23] The local law and vested rights theory explanation would be valid if the conversion rules were always treated as substantive, but they are not.[24]

A second explanation is that the courts are trying to provide the plaintiff-creditors with the maximum amount of protection against fluctuations in the foreign currency's value. The courts are supposedly motivated by the common law doctrine barring creditors from achieving any compensation beyond interest for the debtor's delay in paying the debt.[25] Therefore, a court will resort to the Judgment Day Rule instead of the Breach Day Rule if the currency of payment depreciates because the Judgment Day Rule will allow the court to compensate the creditor by issuing a dollar judgment that will be converted into the foreign currency at that time. Thus, the court will be able to compensate the creditor and prevent the debtor form achieving a profit through breaching his duty to pay because the

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[20] J.G.G., *The Measurement of Foreign Money Obligations*, 36 VA. L. REV. no. 2, at 215, 222 (1950).
[21] *Id.*
[22] In re Oil Spill by The Amoco Cadiz Off the Coast of France, 954 F.2d 1279, 1330 (7th Cir. 1992).
[23] Vishipco Line v. Chase Manhattan Bank, 660 F.2d 854, 865 (2d Cir. 1981).
[24] *Id.*
[25] J.G.G., *supra* note 20, at 217. *See also* Joseph Dach, *Conversion of Foreign Money: A Comparative Study of Changing Rules*, 3 AM. J. COMP. L. no. 2, at 155, 182 (1954).

conversion from the foreign currency to the U.S. dollar according to the Judgment Day Rule will adopt the exchange rate prevailing at the time the court issues its judgment.[26] In other words, it will be the debtor, not the creditor, who will bear the foreign currency's loss of value by paying his debt with a higher amount of U.S. dollars than if he had paid the debt when it was due.

I find this to be a reasonable explanation. First, the Nurnberg case, the first U.S. Supreme Court case adopting the Judgment Day Rule, involved a currency that had depreciated in value at a phenomenal rate.[27] In that case, if the Supreme Court had followed the Breach Day Rule it would have amounted to punishing the creditor while allowing the debtor to take advantage of the currency's depreciation.[28]

Another example is *Competex v. LaBow*.[29] LaBow was a New York citizen who had lost a substantial amount of money on the London Metal Exchange Market, leaving a debt that was paid by LaBow's broker, Competex. Competex demanded reimbursement and obtained a default judgment against LaBow before the English High Court of Justice for £187,929,82 (English pounds), when the exchange rate was one (£1) pound for $2.20 U.S. dollars.[30] Competex sought to enforce the English judgment in New York and by then the English pound had depreciated to one (£1) pound for $1.50 U.S dollars.[31] LaBow moved the court to allow him to pay the English judgment in English pounds, which would have saved him $236,000.[32]

In normal circumstances, as we have seen, the federal court should follow the Judgment Day Rule and convert the English judgment to U.S. dollars at the new exchange rate as of the time of enforcement. However, the court followed the New York Breach Day Rule by characterizing the conversion rules as substantive rules to be governed by New York law.[33] This enabled the court to protect Competex from the loss resulting from the new exchange rate because the action was brought in diversity.[34]

The drive to adopt an approach that achieves protection for creditors from fluctuations in the exchange rate between the U.S. dollar and foreign currencies led to the emergence of a flexible approach. One approach is the one mentioned in the Restatement Third of Foreign Relations Law, section 823 (2) which states that a court should choose a date of conversion such that the exchange rate will "make the creditor whole and will avoid

[26] Comment, *Damages in Foreign Currency*, 31 YALE. L.J. 198 (1921).
[27] Die Deutsche Bank Filiale Nurnberg v. Humphrey, 272 U.S. 517 (1926).
[28] *Id.*
[29] Competex, S.A. v. Labow, 783 F.2d 333, 334 (2d Cir. 1986).
[30] *Id.*
[31] *Id.* at 335.
[32] *Id.*
[33] *Id.* at 334.
[34] *Id.*

rewarding a debtor who has delayed in carrying out the obligation."[35] This view has been adopted by several courts[36] despite the fear that it could give plaintiffs windfalls.[37]

4. Foreign Currency Control Rules (F.C.C.R.)

Prior to the establishment of the IMF, courts in the U.S. had generally enforced the American F.C.C.R. while ignoring the F.C.C.R.'s of other nations.[38] If the law governing the cause of action was American, whether state or federal, then an American court would refuse to apply the foreign F.C.C.R. as a defense to the contract even if doing so made it impossible for the debtor to pay his debt.[39] The courts either characterized the F.C.C.R. as a foreign revenue law that had no effect beyond the territory of the foreign sovereign[40] or saw it as violating the forum's public policy.[41] They continued to ignore foreign F.C.C.R.'s even when the law governing the claim was foreign, arguing that those rules affected the performance of the debt, which was a procedural matter, governed solely by the forum's law.[42] In short, the application of a foreign F.C.C.R. by American courts was the exception rather than the rule.

Unfortunately, U.S. courts continued to ignore foreign F.C.C.R.'s after the enactment of the IMF Agreement because they were foreign revenue rules[43] or by interpreting Article VIII (2)(b) in a very narrow manner that

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[35] Comment (c) to § 823 states that "the date used for conversion should depend on whether the currency of obligation has appreciated or depreciated depending relative to the dollar. In general, if the foreign currency has depreciated since the injury or breach, judgment should be given at the rate of exchange applicable on the date of injury or breach; if the foreign currency has appreciated since the injury or breach, judgment should be given at the rate of exchange applicable on the date of judgment or the date of payment. . . ."

[36] Nikimiha Securities Ltd., v. The Trend Group Ltd., 646 F. Supp. 1211 (1986); El Universal v. Phoenician Imports Inc., 802 S.W. 2d. 799, (1990); Teca-Print A.G. v. Amacoil Machinery, Inc., 138 Misc. 2d 777, 525 N.Y.S. 2d 525 (1988); Aker Vedal A/S v. Neil F. Lampson, 828 P.2d 610 (1942); Siematic Mobel Werke GmbH v. Simatic Corp., 669 F. Supp. 156 (S.D.N.Y. 1979).

[37] *Competex*, 783 F. 2d at 333; S.A.R.L. Aquantonic-Laboratories PBE v. Marie Katella, Inc., 2007 U.S. Dist. LEXIS 61682 (D. AZ 2007).

[38] Hartmann v. United States, 65 F. Supp. 397 (1946); Norman v. Baltimore & O.R. Co., 294 U.S. 240 (1935).

[39] Barnes v. United Steel Works Corp., 11 N.Y.S. 2d 161 (Sup. Ct. 1939); Central Hanover Bank & T. Co. v. Siemens & Halske Aktuen-Gesellshcaft., 15 F. Supp. 927 (S.D.N.Y. 1936); David v. Veitscher Magnesitwerke Actien Gessellschaft, 348 Pa. 335(1944); Loeb v. Bank of Manhattan Co., 180 N.Y.S. 2d 497 (Sup. Ct. 1939); Lann v. United States Works Corp., 166 Misc. 465, 470 (Sup. Ct. 1938).

[40] Marcu v. Fischer, 65 N.Y.S. 2d 892 (Sup. Ct. 1946); Bercholz v. Guaranty Trust Co., 18 Misc. 1043 (Sup. Ct. 1943).

[41] A.W.B. & Berrien C. Eaton, *The Treatment of Foreign Exchange Controls in the Conflict of Laws*, 34 VA. L. REV. no. 6, at 697, 702 (1948).

[42] Sabl v. Laenderbank Wein Aktiengesellschaft, 30 N.Y.S. 2d 608 (Sup. Ct. 1941); Cermak v. Bata Akciova Spolecnost, 80 N.Y.S. 2d 782 (Sup. Ct. 1948).

[43] Banco Do Brasil v. A.C. Israel Commodity Co., 12 N.Y. 2d 371 (1963).

allowed the U.S. courts to enforce contracts that violated a foreign F.C.C.R.[44] Even when the courts applied a foreign F.C.C.R. it was through the act of state doctrine, which requires the payment of the debt to occur within the borders of the foreign state in question.[45] This means that U.S. courts have applied foreign F.C.C.R.'s in a territorial manner both before and after the enactment of the IMF Agreement.

B. England

1. Currency of Account

Like their American counterparts, English courts apply the principle of nominalism to measure the quantum of the parties' obligations regardless of the law governing the claim itself.[46] As to the determination of the currency used by the parties in setting their obligations the English courts apply the *lex pecuniae*. Therefore, a promise to pay a sum in a foreign currency is a promise to pay whatever is considered legal tender under the *lex pecuniae*.[47] So if the parties agree to use the Egyptian pound ("EGP") then the EGP will be defined according to Egyptian law. However, if the *lex pecuniae* provides a special definition for what constitutes legal tender for the proposed transaction in other states then that definition will be determinative.[48] In other words, sometimes a foreign state will grant its currency the status of legal tender in regards to domestic transactions only in order to impose a limit on the currency's circulation. In this case, the English courts will consider that the parties did not specify a currency for their contract if the foreign currency was used in an international transaction and that they have therefore implicitly chosen the currency of the *lex contractus*.

It should be noted that the construction and legality of the duty to pay the foreign currency debt are considered by the English courts to be matters governed by the *lex contractus* and not the *lex pecuniae*. Consequently, if there was ambiguity over the debt's currency, such as whether the word

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[44] *See* J. Zeevi & Sons, Ltd. v. Grindlays Bank (Uganda), 37 N.Y.2d. 220 (N.Y. 1975) ("Exchange Contract" in Article VIII 2(b) does not include letters of credit).

[45] Allied Bank International v. Banco Credito Agricola de Cartago, 757 F.2d 516, 521 (2d Cir. 1985). *See also* William Blair Q.C., *Interference Of Public Law In The Performance Of International Monetary Obligations*, *in* INTERNATIONAL MONETARY LAW ISSUES FOR THE NEW MILLENNIUM 395 (Mario Giovanni ed., 2000).

[46] Gilbert v. Brett (Case de Mixt Moneys) (1604) Davis 18 (P.C. of Ireland); 2 DICEY, MORRIS AND COLLINS ON THE CONFLICT OF LAWS 1978 (Lawrence Collins et al eds., Sweet & Maxwell 14th ed. 2006).

[47] In re Chesterman's Trusts, (1923) 2 Ch. 466, 478; Pyrmont Ltd., v. Schott, (1939) A.C. 145, 157 (P.C.); Geoffrey Cheshire and Peter North, PRIVATE INTERNATIONAL LAW 499 (11th ed. 1987); F.A. Mann, *Problems of the Rate of Exchange*, 8 MOD. L. REV. 177, 181 (1945).

[48] Marrache v. Ashton, (1943) A.C. 311; Ottoman Bank v. Chakarian, (1938) A.C. 260; MARTIN WOLFF, PRIVATE INTERNATIONAL LAW 472 (1945).

"dollars" should mean Canadian dollars, Australian dollars, or American dollars, then that will be determined according to the rules of construction under the *lex contractus*.[49] Also, the determination of whether a gold clause is a gold value clause or a gold payment clause is made according to the *lex contractus*.[50] Finally, the legality of using a foreign currency in setting the parties' obligation or the legality of using gold or index clauses will be determined according to the *lex contractus* and not the *lex pecuniae*.[51] In a similar manner, revaluation of the foreign debt will be determined according to the *lex contractus* because it affects the content of the parties' contractual duties by resetting the quantum of their obligations.[52]

2. Currency of Payment

English courts have consistently applied the *lex loci solutionis* to decide all legal issues relating to acceptable modes or methods to perform the duty to pay a foreign currency obligation.[53] As a result, the place of payment will determine which currency is to be used in discharging the debt since the currency of payment might not be the currency of account. For instance, it is a general rule under English law that debts payable in England can be discharged by paying them in sterling pounds regardless of the law governing the debt and without regard to the currency of contract. Finally, English courts presume that, unless otherwise stated by the parties' agreement or by the *lex loci solutionis*, the currency of account and the currency of payment are identical.[54]

3. Conversion Rules

English courts follow the Breach Day Rule.[55] The rationale behind adopting this rule was to put the creditor in the same position he would have

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[49] Adelaide Electric Supply Co. Ltd v. Prudential Assurance Co. Ltd., (1934) A.C. 122, 145; Auckland City Council v. Alliance Assurance Co., (1937) A.C. 587, 599. *See also* Bonython v. Commonwealth of Australia, (1951) A.C. 201, 221.

[50] R. v. International Trustee for the Protection of Bondholders (1937) A.C. 500; WOLFF, *supra* note 48, at 457; DICEY *supra* note 46, at 1998.

[51] *Id.* at 1997; John G. Fleming, *The Impact of Inflation on Tort Compensation*, 26 AM. J. COMP. L. 51, 53 (1978); J.H.C. MORRIS & P. M. NORTH, CASES AND MATERIALS ON PRIVATE INTERNATIONAL LAW 509 (Butterworths ed. 1984).

[52] Anderson v. Equitable Assurance Society of the U.S. (1926) 134 L.t. 557, 566; DICEY, *supra* note 46, at 1994; CHESHIRE & NORTH, *supra* note 47, at 500.

[53] DICEY *supra* note 46, at 2001; WOLFF, *supra* note 48, at 467.

[54] DICEY *supra* note 46, at 1986.

[55] Owners of SS Celia v. Owners of SS Volturno (1921) 2 A.C. 545; Re United Railways of Havana and Regla Warehouses Ltd., (1961) A.C. 1007.

enjoyed had the payment took place.[56] The English courts use the commercially usual and published rate at the time payment was due.[57] However, unlike the American courts, the English courts have developed a rule that allows them to issue judgments in a foreign currency if the contract is governed by a foreign law and the currency of the contract was a foreign currency. This is known as the Miliangos Rule, created by the House of Lords.[58]

This seems to be an attempt to protect creditors against changes in exchange rates. By allowing the English courts to issue their judgments in foreign currencies, the House of Lords has opened the door to a solution similar to the Judgment Day Rule because the conversion will take place at the time the enforcement of the English judgment is authorized. Thus, the English court will be able to overcome the common law doctrine that restricts compensation for the delay in performing the duty of payment to awarding interest[59] and rendering the depreciation of the foreign currency's value against the sterling pound too remote a consequence for the breach of contract.[60] The Miliangos Rule allows English courts to take into consideration the depreciation of the foreign currency by rendering its decision in the foreign currency instead of the sterling pound after calculating the amount of damages necessary to compensate the creditor for the delay in paying the debt. This shifts the risk of depreciation to the debtor to protect the creditor. This might explain why the English courts have extended the Miliangos Rule to tort cases.[61] The rationale behind this is the need to assess the damages inflicted by the defendant in the currency in which his loss was felt and that was reasonable for the defendant to foresee.

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[56] F.A.Mann, *The Rate of Exchange: An Urgent Appeal for a Minor Reform*, 15 MOD. L. REV. 369, 370 (1952).

[57] Versicherungs und Transport A.G. Daugava v. Henderson, (1934) 49 Ll. L. Rep. 252; Cummings v. London Bullion Co., Ltd., (1952) 1 All E.R. 383; Mann, *supra* note 47, at 192. However there are some courts that followed the black market exchange rate instead of the official exchange rate. *See e.g.*, Graumann v. Treitel (1940) 2 All E.R. 188.

[58] Miliangos v. George Frank (Textiles) Ltd., (1976) A.C. 443. Lord Wilberforce explained that there are several reasons to allow the English Courts to issue foreign currency judgments. The most important from my point of view are: 1) English Case Law has shown a tendency towards issuing foreign currency judgments; 2) English Courts have already allowed Arbitral Awards issued in foreign currency to be enforced despite the fact that the arbitration took place in London and therefore the same rule should apply to the English Court's judgments; 3) justice demands that a creditor should be protected from fluctuations in the value of the Sterling Pound when he has bargained for his own currency; and 4) providing substantive justice for the parties must prevail over procedure.

[59] HALSBURY'S LAWS OF ENGLAND 175 note (e);(f);(g) (Sarah L. Hornsby ed., Butterworths 1931).

[60] Di Ferdinando v. Simon, Smits & Co., (1920) 3 K.B. 409.

[61] Services Europe Atlantique Sud (SEAS) v. Stockholms Rederi AB Svea (The Folias) [1979] AC 685.

For example, In *The Despina R*, the plaintiff-creditor, the owner of the Eletherotira, had incurred expenses in Chinese yuan, Japanese yen, and U.S dollars to fix a ship after a collision off the coast of China.[62] However, the plaintiff had its principal place of business in New York City and the bank account used to cover the cost of repairs was an account denominated in U.S. dollars, so it was reasonable to expect that the plaintiff felt the loss in terms of U.S. dollars and that it was reasonable for the defendant to expect to pay for the loss in that currency, so the court awarded damages in U.S. dollars.[63]

Later on, the English courts extended the Despina R doctrine to include cases where the loss resulted from breach of a contract governed by English law. In *Services Europe Atlantique Sud of Paris v. Redteriktiebload Svea*, the court awarded the plaintiff damages in French francs.[64] The plaintiff had signed a charter party with the defendant, governed by English law, to ship onions from Spain to Brazil with the freight payable in U.S dollars.[65] However, the shipment was damaged due to a malfunction in the ship's refrigeration system and the plaintiff paid the receivers an indemnity in Brazilian cruzeiros.[66] Yet the court awarded damages in French francs[67] because that was the currency used by the plaintiff in operating his business and keeping all his books and bank accounts, and because to pay the indemnity he had had to sell French francs to obtain Brazilian cruzeiros.[68] The court did not award the damages in U.S. dollars because it deduced from the circumstances that the parties' choice of U.S. dollars was not meant to be the currency used to assess the damages resulting from breach of contract.[69]

In other words, if the parties choose a currency for their contract and contemplate its use to measure their obligations; then, their choice will be respected by the English courts. If they did not contemplate the use of the contract's currency to assess damages for breach of contract then an English court will issue its judgment in the currency in which the plaintiff's loss was felt. Accordingly, an English court's power to issue its judgments in a foreign currency is no longer restricted to a specific rule but is now contingent upon the circumstances of the case and the need to protect the plaintiff from the risk of depreciation.

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[62] MORRIS, *supra* note 51, at 519.
[63] *Services Europe Atlantique Sud (SEAS)*, [1979] AC 685.
[64] MORRIS, *supra* note 51, at 519.
[65] *Services Europe Atlantique Sud (SEAS)*, [1979] AC 685.
[66] MORRIS, *supra* note 51, at 522.
[67] *Id.*
[68] *Id.*
[69] *Id.* at 523.

4. Foreign Currency Control Rules

The English courts enforce the English F.C.C.R. to the fullest extent, and it does not allow the transfer of foreign currency or sterling pounds abroad unless the debtor obtains permission. The debtor's duty to pay arises only after he obtains that permission.[70] As to foreign F.C.C.R.'s, English courts do enforce them but are not consistent in using a single choice of law rule. Some English courts apply the F.C.C.R. as a part of the law governing the contract,[71] which is in accordance with applying the *lex contractus*.[72] Other English courts apply the F.C.C.R. as part of the *lex loci solutionis*, which is in accordance with applying the law of the place of payment. In other words, the English courts do not consider foreign F.C.C.R.'s as foreign revenue rules or foreign public law rules that English public policy would bar from being applied by English courts. On the contrary, those rules are applied as an integral part of the *lex contractus* or *lex loci solutionis*. In an interesting contrast to the American courts, English courts had consistently applied foreign F.C.C.R.'s even prior to the establishment of the IMF.

C. France

The French law on foreign currency debts is characterized by distinguishing between international contracts and domestic contracts.[73] In international contracts the parties can choose a foreign currency and stipulate that the payment of the debt will be in said foreign currency. However, domestic contracts must be denominated in euros and any stipulation that mandates the use of a foreign currency will be void because it breaches French public policy. For the sake of providing an accurate account of French law I will examine the foreign currency rules for both types of contracts.

1. Currency of Account

Parties to international contracts have the freedom to establish their obligations in a foreign currency or to include gold and index clauses.[74] However, such freedom does not exist in domestic contracts and if the

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[70] Mann, *supra* note 47, at 369.
[71] R. v. International Trustee for the Protection of Bondholders A.G. (1937) A.C. 500.
[72] De Béeche v. South American Stores, (1935) A.C. 148; St. Pierre v. South American Stores, (1937) 1 All E.R. 206; DICEY, *supra* note 46, at 2003; WOLFF, *supra* note 48, at 480; Trevor C. Hartley, *Mandatory Rules in International Contracts: The Common Law Approach*, 266 RECUEIL DES COURS 341, 422 (1997).
[73] Dach, *supra* note 25, at 162.
[74] PIERRE MAYER, DROIT INTERNATIONAL PRIVÉ 518-19 (1977); BERNARD AUDIT, DROIT INTERNATIONAL PRIVÉ 709 (3d ed. 2000).

parties attempt to use foreign currency or gold clauses in domestic contracts the French courts will void that clause for breach of French public policy.[75] In any event, the French courts will apply the principle of nominalism enshrined in Article 1895 of the *Code Civil* to all contracts regardless of the currency used in defining the parties' obligations.[76] Therefore, a promise to pay a certain sum, whether in euros or not, will be a promise to pay the exact number of currency units specified by the contract.

The legal definition of the foreign currency is the *lex pecuniae*, provided that the contract is an international one.[77] However, the construction and legality of gold and index clauses are determined according to the *lex contractus*, similar to the English courts' practice.[78] Nonetheless, revalorization of debts is absolutely forbidden under French law regardless of the *lex contractus* or the *lex pecuniae* because revalorization means resetting the parties' obligations, which is contrary to the principle of nominalism under French law.[79]

2. Currency of Payment

French courts adhere to applying the *lex loci solutionis* to all legal issues concerning the payment of debt denominated in foreign currency. Consequently, the *lex loci solutionis* will determine which currency the debtor can use to discharge his debt.[80] Therefore, if the payment is to take place in France or if the plaintiff-creditor is seeking to enforce a foreign judgment in France, then French law would mandate that the payment be made in euros even if the debt in question was the result of a transaction that occurred outside France and was governed by foreign law.[81]

Nonetheless, this does not mean that French courts will not take into account the *lex contractus*. The legal effects of payment on the parties' contractual rights and obligations will be governed by the *lex contractus*.[82] For example, the *lex contractus* will determine if the payment will allow the debtor to subrogate the creditor if there were other co-debtors. Also, the *lex contractus* will determine if there were defenses that the defendant-debtor

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[75] FRANCOIS TERRE, PHILIPPE SIMLER AND YVES LEQUETTE, DROIT CIVIL: LES OBLIGATIONS 992 (6th ed. 1996); Fleming, *supra* note 51, at 53.
[76] CODE CIVIL [C.CIV] art. 1895 (Fr.).
[77] MAYER, *supra* note 74, at 518; 3-2 ERNEST RABEL, THE CONFLICT OF LAWS: A COMPARATIVE STUDY 32 (1958).
[78] Philipe Malaurie, *Les Obligations Libellés en Monnaies Etrangères*, TRAV. COM. FRA. DR. INT. PRIVÉ (1975-1977) 18, 19; AUDIT, *supra* note 74, at 708.
[79] Mann, *supra* note 47, at 288.
[80] HENRI MAZEAUD, LEON MAZEAUD AND JEAN MAZEAUD, 2 LEÇONS DE DROIT CIVIL: PREMIERE VOLUME 939 (François Chabas ed., 6th ed. 1978).
[81] Philipe Malaurie, *Note sur C.A.M.A.I. v. García et Société Dabi*, 1 R.C.D.I.P. 73, 75 (1976).
[82] HENRI BATIFFOL, LES CONFLITS DE LOIS EN MATIÈRE DE CONTRAT 447 (1st ed. 1938).

could use to dismiss the plaintiff-creditor's claim, such as the application of moratoriums or the plaintiff-creditor's action being barred by limitation.[83]

3. *Exchange Rate*

French courts, like their American counterparts, as a general rule can only issue their judgments in euros.[84] As a result, there is a need to convert the French euro-denominated judgment into the foreign currency through the use of conversion rules. However, unlike the American and English courts the French courts have an array of conversion rules that are applied according to the circumstances of the case and the attitudes of both the plaintiff-creditor and the defendant-debtor.

The first conversion rule is the Due Payment Day Rule, under which the court converts its judgment into the foreign currency at the prevailing exchange rate when the debt was due. It is applied in the following situation: first, if the defendant-debtor pays his debt at the specified time; second, if there was a delay in payment that was not accompanied by objection from the plaintiff-creditor; and third, if the delay in payment was due to circumstances beyond the defendant-debtor's control.[85] In this case, the defendant-debtor's attitude was the attitude of a person who was acting in good faith and therefore deserves protection against fluctuations in the exchange rate between the euro and the foreign currency.

The second conversion rule is the Date of Proceedings Rule, under which the court converts its judgment into the foreign currency at the exchange rate prevailing when the creditor brought his lawsuit. In this case the defendant-debtor's attitude was the attitude of a person who is behind in paying his debt and should bear the consequences of his delay after the plaintiff-creditor has officially stated his wish to be paid.[86]

The third conversion rule is not a rule but rather an approach that allows the court to apply the most favorable exchange rate from the plaintiff-creditor's point of view. This rule is followed when the defendant-debtor acted deliberately in bad faith by speculating on the change of the exchange rate in his favor or when the creditor resorted to the *mise en demeure* procedure.[87] In these cases the defendant-debtor should be liable for any

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[83] MAYER, *supra* note 74, at 520.
[84] Malaurie, *supra* note 81, at 30.
[85] RABEL, *supra* note 77; GEORGES R. DELAUME, AMERICAN-FRENCH PRIVATE INTERNATIONAL LAWS 60 (1965); TERRÉ, *supra* note 75, at 992.
[86] Dach, *supra* note 25, at 165.
[87] *Mise en Demeure* is a procedure whereby the debtor serves the creditor through an official process server with a writ that directs the creditor to perform this due debt. It is used to official demand the performance of the debt and to establish the creditor's failure to pay the debt on time. *See* LEXIQUE DES TERMES JURIDIQUES 379 (14th ed. 2003).

potential loss including an unfavorable exchange rate for the plaintiff-creditor.[88]

The main remark that I have on the French conversion rules is their application on all international contracts regardless of the law governing the contract. Although French law requires a contract to be an international one in order for the parties to choose a foreign currency to denominate their obligations, there is no mention of the choice of law. Thus, the French conversion rules, unlike the American and English rules, are treated as a legal issue independent of the law governing the contract or the *lex loci solutionis*. In other words, the French conversion rules are not associated with the choice of law analysis, but with achieving justice in the case. Here, the French courts are trying to overcome their inability to provide plaintiff-creditors with compensation beyond awarding interest through adopting a set of conversion rules that are applied according to the circumstances of the case.[89]

4. Foreign Currency Control Rules

French courts are consistent in applying the French F.C.C.R. but they have not adopted a unified approach towards applying foreign F.C.C.R.'s. There are instances of French courts refusing to annul contracts that violated foreign F.C.C.R.'s or contracts that were concluded with an aim to violate foreign F.C.C.R.'s.[90] An example is *Basso es-Qualité v. Janda*, where the French Cour De Cassation refused to annul a contract made between Czech citizens in violation of the Czech F.C.C.R.[91] Although the contract was made specifically to smuggle a sum of U.S. dollars from Czechoslovakia to France to avoid the Czech F.C.C.R., the court did not annul the contract as it usually does with contracts that aim at violating the laws of other nations.[92] The court held that F.C.C.R.'s are territorial rules because they are public law rules that are not applicable by French courts beyond the borders of the sovereign that issued them.[93] Nevertheless, the majority of French cases support annulling contracts that violate foreign F.C.CR.'s so that the law on foreign currency obligations will be in line with French law on the choice of law rules especially the doctrine of *Fruade à Loi*.[94]

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88 JACQUES FLOUR, JEAN-LUC AUBERT ET AL., LES OBLIGATIONS: LE RAPPORT D' OBLIGATION 110 (12th ed. 2007).
89 CODE CIVIL [C.CIV] art. 1153 (Fr.); TERRÉ, *supra* note 75, at 611.
90 PIERRE MAYER & VINCENT HEUZÉ, DROIT INTERNATIONAL PRIVE 499 (7th ed. 2001).
91 Jean-Pierre Eck, *Place Actuelle de la Théorie du Paiement International dans le Droit Monétaire Français*, 53 R.C.D.I.P. 441 (1964).
92 *Id.* at 662.
93 *Id.*
94 *Fruade à Loi* is a French choice of law doctrine that allows the court to disregard the normal operation of the choice of law rules if it believes that it was manipulated by a party

D. Egypt

1. Currency of Account

Egyptian law adopts nominalism and one would expect it to be applied to all debts regardless of the currency used.[95] However, according to the Egyptian Civil Code Official Explanatory Memorandum (the "Explanatory Memorandum"), the principle of nominalism applies to all debts denominated in EGP while the principle is applied to foreign currency obligations only if those currencies have a *cours legal*.[96] Foreign currencies that do not have a *cours legal* are not subject to the principle of nominalism. The Explanatory Memorandum explains that nominalism is not considered a matter relating to public policy and if the parties insert a clause in their contract that violates the *cours legal* of the currency then the Egyptian court will void that clause.[97] This is interesting considering Egypt's long history in imposing its F.C.C.R. to protect the Egyptian economy from imbalances in its balance of payments since the First World War.[98]

On the other hand, Egyptian law does not know the French law distinction between international and domestic contracts and as a result gold and index clauses are prohibited and as a general rule obligations that are to be enforced in Egypt should be denominated in EGP unless Egyptian law allows the parties to set their obligations in a foreign currency.[99] Articles 429

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for the sake of achieving an illicit gain such as avoiding mandatory rule, in our case the F.C.C.R. MAYER, *supra* note 74, at 520. For a more detailed discussion on the *Fraude à Loi* doctrine see, Géraud De La Pradelle, *Fraude à Loi*, TRAV. COM. FRA. DR. INT. PRIVÉ (1972-1974) 117.

[95] Article 134 of Law No. 131 of 1948 (the "Egyptian Civil Code") states that "[when the object of an obligation is a sum of money, the debtor is bound only to the extent of the actual figure of the sum of money stated in the contract, whatever be the increase or decrease in the value of such money at the date of payment. . . ." Law No. 131 of 1948 (Civil Code) *Al-Jarida Al-Rasmiyya*, 29 July 1948, §134 (Egypt).

[96] Al-Qanun al-madani: magmu'at al-a'mal al-tahdiriyyah, vol. 1, page 230. Article 134 is an echo of Article 241 of the old Egyptian Civil Code.

[97] *Id.* at 230.

[98] *See* Arvind Subramanian, *The Egyptian Stabilization Experience: An Analytical Retrospective*, IMF Working Paper, September 1997; C. Bresciani-Turroni, *Some Considerations on Egypt's Monetary System*, 1 REVUE AL QUANON WAL IGTISAD (1934); David Seddon, *The Politics of Adjustment: Egypt and the IMF* 1987-1990, 17 no. 47 REVIEW OF AFRICAN POLITICAL ECONOMY 95 (1990).

[99] Article 108 of Law No. 88 of 2003 (the "Law of the Central Bank") and Article 42 of the Presidential Decree No. 101 of 2004 (the "Executive Regulation of Law No. 88") exempts certain operations from the need to demonetize the obligations in EGP such as tourist operations, free trade zone operations, and financial instruments. Law No. 88 of 2003 (Law of the Central Bank, the Banking Sector, and Monetary Policy), *Al-Jarida Al-Rasmiyya*, 15 June 2003, Article 108 (Egypt); Presidential Decree No. 101 of 2004 (Promulgating the Executive

and 510 of the New Commercial Code, allows the parties to draw up negotiable instruments in a foreign currency, are an example of the above.[100]

2. Currency of Payment

The parties' freedom to denominate their obligations in a foreign currency is limited by statute. As a result, Egyptian courts will allow creditors to demand the payment in a foreign currency if Egyptian law allowed the parties to set their obligations in the foreign currency from the outset, as is the case under Article 510 of the Egyptian Commercial Code.[101] Thus in some circumstances, unlike French or English law, Egyptian law does not mandate that payment be in EGP.

Another important feature of Egyptian law is the distinction between the legality of the duty to pay the foreign currency debt and the legality of the method used in paying the debt. If Egyptian law allows the parties to denominate their obligations in foreign currency then the payment of that debt must occur according to Egyptian law through an authorized institution.[102] If the parties agreed through a clause in their contract that the payment should take place through black market operations in order to bypass the Egyptian F.C.C.R., then the Egyptian court will void that clause.[103]

3. Conversion Rules

As previously mentioned, Egyptian courts can issue judgments in a foreign currency but the Egyptian Cassation Court has not adopted a universal conversion rule. As discussed in the Explanatory Memorandum the Egyptian Civil Code draft used the Due Payment Day Rule as a basic conversion rule.[104] However, the revision committee decided to leave the matter for judicial discretion because it requires the consideration of the economic circumstances surrounding each individual case.[105] On the other hand, Article 510 of the Egyptian Commercial Code adopts the Due Payment

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Regulations of the Law of the Central Bank, the Banking Sector and Money), 21 March 2004, Article 42 (Egypt).

[100] Law No. 17 of 1999 (Commercial Code), *Al-Jarida Al-Rasmiyya,* 17 May 1999, Article 429 & 510 (Egypt).

[101] Case no. 263/1989/Court of Cassation (Egypt); Case no. 2543/1990/Court of Cassation (Egypt).

[102] Law No. 88 of 2003 (Law of the Central Bank, the Banking Sector, and Monetary Policy), *Al-Jarida Al-Rasmiyya*, 15 June 2003, Article 111 (Egypt).

[103] Case no. 2479/1988/Court of Cassation (Egypt); Case no. 163/1989/Court of Cassation (Egypt).

[104] The Egyptian Civil Code Official Explanatory Memorandum, *supra* note 96, at 230.

[105] *Id.* at 231.

Day Rule for negotiable instruments,[106] while Article 429 adopts a creditor's choice conversion rule.[107] This means that, other than with cases involving negotiable instruments, an Egyptian court is not bound to follow a particular conversion rule. This leaves the Egyptian court freedom to adopt the French model of conversion rules though a case-by-case approach especially since Egyptian law does not allow courts to award damages beyond interest for injury resulting from the delay in paying a debt.[108]

4. Foreign Currency Control Rules

Egyptian courts enforce the Egyptian F.C.C.R. vigorously because of Egypt's economic situation requiring tight control over transactions involving foreign currencies.[109] As a result, the Egyptian courts have characterized the F.C.C.R. as being related to Egyptian public policy that may override the parties' agreement[110] and it can be applied to all contracts involving foreign currency, even retroactively.[111] However, I could not find any Egyptian judgment dealing with the enforcement of a foreign F.C.C.R., which could be explained by several reasons. First, Egypt is not an international financial center such as the U.S., England, or France, which makes it less likely for the Egyptian courts to hear cases about enforcing foreign currency obligations. Second, Egypt adopted a command economy during the mid-1950's through the 1990's which left little or no room for individuals to use foreign currencies in their contracts.[112] Third, the presence of an extensive F.C.C.R. in Egyptian law made it more likely that disputes heard before the Egyptian courts involved evading the Egyptian F.C.C.R. and not a foreign F.C.C.R.

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[106] Law No. 17 of 1999 (Commercial Code), *Al-Jarida Al-Rasmiyya,* 17 May 1999, Article 429 (Egypt).

[107] The creditor has the choice between the rate of exchange when the bill of exchange was due or the rate of exchange when the bill of exchange was paid if the payee did not honor the bill of exchange. Law No. 17 of 1999 (Commercial Code), *Al-Jarida Al-Rasmiyya,* 17 May 1999, Article 429 (Egypt).

[108] Article 226 of the Egyptian Civil Code; Ramadan Abuel Seoued, Ahkam Al-Iltizam, 150 (2008). I believe that the Egyptian Courts should model their conversion rules according to the attitude of the parties, the plaintiff-creditor and the defendant-debtor, as in article 429 of the New Commercial Code which gives the creditor the choice if the bill of exchange was not honored.

[109] *See* Denis J. Sullivan, *The Political Economy of Reform in Egypt*, 22 INT'L J. MIDDLE EAST STUDIES 317 (Aug. 1990).

[110] Case no. 1332/1981/Court of Cassation (Egypt); Case no. 385/1985/Court of Cassation (Egypt).

[111] Case no. 1617/1997/Court of Cassation (Egypt).

[112] Farouk Abdelwahed, *Egypt's Road to a Mixed Economy*, 18 MGMT. INT'L REV. 23 (1978).

E. General Remarks

One can draw from the law on foreign currency debts several observations. First, the parties' freedom to choose a currency for their contract is not absolute. Their freedom can be restricted by the need to meet certain requirements, such as the need to have an international contract, as in French law, or to respect the national F.C.C.R., as in Egyptian law. Second, the place of payment plays an important role in determining the modes and methods through which a debtor can pay his creditor. The place of payment will determine if the foreign currency has legal tender status because if that is not the case then the debtor can legally discharge his debt by paying through the domestic currency irrespective of the parties' original choice of currency. Third, the parties' selection of a given currency is considered a reference to the issuing state's law to determine what constitutes that currency. Therefore, the parties can provide a definition for their currency other that provided by the issuing state. Fourth, nominalism is applied by all jurisdictions to all foreign currency debts in the same manner the principle is applied to all domestic currency debts. Fifth, the courts in the surveyed jurisdictions will attempt to convert their domestic currency judgments into the foreign currency chosen by the parties using the conversion rule that achieves substantive justice because they cannot award any damages beyond interest. To that end, courts will try not to adhere to a conversion rule that will harm a party acting in good faith whether that party was the creditor or the debtor. Alternatively, the courts will try to issue their judgments in the foreign currency in question, if they may do so, to avoid using conversion rules. Finally, the courts enforce their own countries' F.C.C.R.'s, but tend not to apply foreign F.C.C.R.'s even though the surveyed jurisdictions are members of the IMF.

III. Evaluation of the Choice of Law in Foreign Currency Debts

How do we explain the current law on foreign currency debts through the choice of law doctrines used by the courts? In other words, is there a single choice of law doctrine that could explain how the courts apply the law on the foreign currency debts? Do the courts use the choice of law doctrines properly? I will examine the party autonomy and place of payment as choice of law rules or what I call "Positive Indicators." These "Positive Indicators" allow the courts to apply both the *lex fori* and foreign law to resolve choice of law issues related to foreign currency debts beside the public policy and foreign revenue rule choice of law doctrines or what I will call "Negative Indicators" that prevent the courts from applying foreign laws.

A. Positive Indicators

The Positive Indicators are the choice of law rules that allow courts to apply either their laws or foreign laws to foreign currency debts. In Part One, I examined three positive indicators: (1) the party autonomy choice of law rule, (2) the *lex loci solutionis*, and (3) Article VIII 2(b) of the IMF agreement. Here, I will evaluate how courts in the surveyed jurisdictions have applied these rules in light of the prevailing choice of law jurisprudences in their jurisdictions.

1. Party Autonomy

Party autonomy is a very simple choice of law rule. Under this rule, the parties have the freedom to choose the law governing their contract as part of their general freedom to contract.[113] Therefore, when the parties choose a law to govern their contract, that law will determine all legal issues under it, including the duty to pay a foreign currency debt.[114] Accordingly, the party autonomy choice of law rule mandates, at least in theory, that if the parties choose a certain currency for payment, or use a variable indicator for setting their rights such as gold clauses or index clauses as a device for hedging against inflation and depreciation, then their choices should be enforced.

Nonetheless, the courts in the surveyed jurisdictions do not consider the parties' freedom of contract to be absolute and, as a result, the party autonomy choice of law rule's scope of application is restricted by excluding several issues such as defining the currency of contract and the legality of gold or index clauses. All the surveyed jurisdictions define the currency of contract through the *lex pecuniae*, while some courts in the surveyed jurisdictions consider the legality of the gold and index clauses to be a matter resolved through the *lex loci solutionis*. The same thing occurs with the most crucial part of the contract, the payment of the foreign currency denominated debt, where the party autonomy choice of law rule is replaced with the *lex loci solutionis*.

It is true that the construction of the duty to pay the foreign currency debt is done according to the *lex contractus*, but it is the *lex loci solutionis* that determines how the debtor may pay. If the *lex loci solutionis* allows the debtor to pay his debt in the domestic currency because it has legal tender status or prohibits the payment of the debt in a foreign currency, then this will override any agreement to the contrary. This leads to the following

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[113] MAYER & HEUZE, *supra* note 90, at 472.

[114] F.A. MANN, THE LEGAL ASPECT OF MONEY: WITH SPECIAL REFERENCE TO COMPARATIVE PRIVATE AND PUBLIC INTERNATIONAL LAW 442 (5th ed. 1992); J.G.G. *supra* note 20, at 220; Anthony G. Guest, *Instruments Denominated in a Foreign Currency*, 27 AM. J. COMP. L. 533, 534 (1979).

question: are the courts applying the *lex loci solutionis* as the primary choice of law rule in regards to foreign currency debts?

2. Lex Loci Solutionis

The *lex loci solutionis* is a simple choice of law rule. The court applies the law of the place where the payment takes place. As we have seen previously, the courts in the surveyed jurisdictions consider the *lex loci solutionis* to be the only applicable law rule to determine the acceptable means, including the currency of payment, which the debtor may use to pay.[115] Nonetheless, the courts in the surveyed jurisdictions have not explained why the *lex loci solutionis* has an overriding power over the parties' choice of law. There are two possible explanations: either the courts apply the *lex loci solutionis* as part of the parties presumed choice of law or they apply the *lex loci solutionis* as a mandatory rule.

The application of the *lex loci solutionis* as a part of the parties' choice of law can be explained through adopting a part reference approach to the party autonomy choice of law rule. This means that the parties' choice of law is a choice of legal system, including that system's choice of law rules, even if they may result in voiding the contract itself or frustrating the parties' intentions.[116] In other words, the parties' choice of law indicates their willingness to submit the contract to the chosen law.[117]

However, this is not a satisfactory explanation for several reasons. First, if the parties' choice of law is the basis for applying the *lex loci solutionis* then it would be more reasonable to enforce the parties' express choice of law instead of their presumed choice of law. This means that the *lex contractus* should prevail over the *lex loci solutionis*. Second, not all courts and choice of law scholars agree that the party autonomy choice of law rule should be dealt with a reference approach. On the contrary, there are those who believe that the best approach to party autonomy should be the incorporation of the chosen law into the contract.[118] Therefore, it will not be possible for the court to ignore the *lex contractus* under any circumstance because the contract is the only legal framework it may use.[119] Third, none of the case law on the subject suggests, even remotely, that the parties' explicit choice of the *lex loci solutionis* is the basis for applying that law instead of the *lex contractus*.

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[115] *See supra* text accompanying note 4.

[116] Mo Zhang, *Parties Autonomy & Beyond: An International Perspective of Contractual Choice of Law*, 20 EMORY INT'L L. REV. 511, 530 (2006); Jean-Michel Jacquet, *L'Incorporation de la Loi dans le Contrat*, TRAV. COM. FRA. DR. INT. PRIVÉ (1993-1994) 24, 27.

[117] MAYER & HEUZE, *supra* note 90, at 481.

[118] Zhang, *supra* note 1166, at 530; RESTATEMENT (SECOND) ON THE CONFLICT OF LAWS §183 (1972).

[119] Jacquet, *supra* note 1166, at 27.

On the other hand, applying the *lex loci solutionis* as a mandatory rule has its logic. Mandatory rules, in a strict sense, reflect the state organization of a certain field of law that cannot be overridden by contract.[120] This is the case with rules governing foreign and national currency because no currency can function, legally or economically, without a monetary system set up through a set of rules.[121] For example, no currency can act as a medium of exchange unless it has the status of legal tender that forces creditors to accept it as a means to discharge debts or else the creditors, alongside other market actors, could choose to refuse payment in that currency.[122]

Usually, mandatory rules are enforced through either a built in criterion[123] or through a choice of law analysis that aims at defining the mandatory rule's scope of application through discovering the policy behind enacting that rule.[124] An example of the built in criterion is Article 42 of the Egyptian Central Bank Law's Executive Regulation. Article 42 states that "[a]ll operations taking place in Egypt should be denominated in Egyptian Pounds."[125]

Nonetheless, the above should have directed the courts to enforce the F.C.C.R. at the *lex loci solutionis* along with any prohibitions irrespective of the parties' will or the *lex contractus* in order to prevent them from evading those rules where the court has ignored a foreign F.C.C.R. This is not what we have seen in the law on foreign currency debts. In addition, the courts tend to follow their own conversion rules to convert their judgments form the forum's currency to the foreign currency in question without any reference to the *lex loci solutionis* even if this means jeopardizing not only the creditor's

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120 Ph. Francescakis, *Quelques Précisions sur les "Lois D'Application Immédiate" et leurs Rapports avec les Règles sur les Conflits de Lois*, 55 R.C.D.I.P. 1, 13 (1966); Thomas G. Guedj, *The Theory of the Lois de Police: A Functional Trend in Continental Private International Law: A Comparative Analysis with Modern American Theories,* 39 AM. J. COMP. L. 661, 678 (1991); YVON LOUSSOUARN ET PIERRE BOUREL, PRÉCIS DE DROIT INTERNATIONAL PRIVÉ 121 (1999); F. Mosconi, *Exceptions to the Operation of Choice of Law Rules*, 217 RECUEIL DES COURS 9-214, 139-40 (1989).

121 Geneviève Burdeau, *L'Exercice des Compétence Monétaries par les États*, 212 RECUEIL DES COURS 221-370, 235 (1988).

122 There is a phenomenon known as "currency substitution" where a foreign currency replaces, totally or partially, the domestic currency as a store of value, medium of exchange and as a unit of account. *See* Mohamed El-Erian, *Currency Substitution in Egypt & The Yemen Arab Republic: A Comparative Quantitative Analysis*, 35 IMF STAFF PAPERS no. 1 at 85 (March, 1988).

123 Guedj, *supra* note 1200, at 665; UKASHA ABDEL EL, TANAZ' AL QUANEEN: DIRASHA MUQARNAH 474 (2002).

124 LOUSSOUARN & BOUREL, *supra* note 1200, at 123; Franceskis, *supra* note 1200, at 17.

125 Presidential Decree No. 101 of 2004 (Promulgating the Executive Regulations of the Law of the Central Bank, the Banking Sector and Money), 21 March 2004, Article 42 (Egypt).

interest in receiving payment in the currency he bargained for but also neglecting the place of payment's interest in enforcing its F.C.C.R.[126]

3. *Article VIII(2)(b) of the IMF Agreement*

Article VIII(2)(b) of the IMF Agreement is the last positive indicator used by the courts to justify their decisions on foreign currency debts. According to Article VIII(2)(b), "exchange contracts which involve the currency of any member and which are contrary to the exchange control regulation of that member maintained or imposed with this agreement shall be unenforceable in the territories of any member."[127] This Article clearly states that a contract that violates the F.C.C.R. of any member of the IMF Agreement shall be enforceable if the F.C.C.R. was maintained according to the IMF Agreement. Article VIII(2)(b) is a codification of a well-established rule of international law that imposed the duty on every state to respect the monetary sovereignty of other states. Monetary sovereignty is the prerogative power of the states to issue, replace or abolish its own currency along with establishing the foreign currency exchange regime that best suits the state's interests.[128]

The IMF was established, partly, to monitor the exercise of the monetary sovereignty of the member states in order to prevent members from abusing their monetary sovereignty, avoid currency wars, and protect the stability of the international monetary system.[129] As a result, a member state that wishes to adopt an F.C.C.R. or an official exchange rate between its currency and a foreign currency must notify the IMF first.[130] The IMF will then inform the other members.[131] In this case all member states of the IMF are obliged to enforce the other member state's F.C.C.R. to the extent that their courts cannot use their own public policy as a bar against enforcing those rules.[132] However, this does not help explain the current law on foreign currency debts because several courts have ignored that rule when faced with defenses based on the application of another nation's F.C.C.R. This brings us to the following question: why did the courts ignore the application of Article VIII(2)(b)?

I believe that courts could not rely on Article VIII(2)(b) despite their willingness, in general, to avoid contracts that were concluded with the

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126 Guest, *supra* note 114, at 535.

127 Bretton Woods Agreement, July 22, 1944, 60 Stat. 1401, 2 U.N.T.S. 39, as amended through June 28, 1990, available at http://www.imf.org/external/about.htm.

128 Burdeau, *supra* note 1211, at 229; ROSA M. LASTRA, LEGAL FOUNDATIONS OF INTERNATIONAL MONETARY STABILITY 23 (2006).

129 Bernard Audit, Note, 1 J.D.I. 66, 71 (1975); Burdeau, *supra* note 1211, at 257.

130 JOSEPH GOLD, EXCHANGE RATES IN INTERNATIONAL LAW AND ORGANIZATION 113 (1988).

131 Art VIIIIII § 5 IMF Agreement (1944).

132 Audit, *supra* note 129, at 113.

purpose to evade foreign law without the need for an express rule such as Article VIII(2)(b). This lack of reliance is caused by the manner in which Article VIII(2)(b) was drafted. The rule was drafted so ambiguously that it cannot be a clear authority on how courts should handle an F.C.C.R.

For instance, the phrase "exchange contract" is not defined in the IMF Agreement. Some writers and courts believe that the word "exchange contract" is limited to contracts that involve the exchange of one currency for another.[133] Others believe that the phrase should have a wider meaning to include all contracts that involve payment, which virtually includes all contracts that use foreign currency given that the purpose of Article VIII(2)(b) is to protect the member states' foreign currency reserves from depletion.[134] Other writers believe that the phrase should include all forms of transactions, whether or not in contract form, that have an effect on the member state's foreign currency reserves.[135] Another example of the difficulties the courts face while implementing Article VIII(2)(b) is interpreting the word "currency". Is the word "currency" a reference to the currency of the member states, which is the traditional interpretation of the word in light of Article VIII(2)(b)? Or does the word "currency" refer to all methods of payment such as gold coins, titles of ownership, and negotiable instruments, since they are usually subject to a F.C.C.R.?[136]

Even if the courts were able to find an appropriate interpretation for Article VIII(2)(b), the penalty for violating the rule is not clear. Article VIII(2)(b) states that a contract that violates the F.C.C.R. of a member state is unenforceable in the courts of all IMF members, but does this means that the contract creates an *obligation naturalis*[137] or does it mean that the contract is null and void?[138] Another question that arises is, when is the contract to be considered unenforceable? Article VIII(2)(b) does not offer direction in this regard. Do we look to the F.C.C.R. at the time the contract was concluded[139] or the time the parties sought to enforce the contract?[140]

Finally, Article VIII(2)(b) does not have a clear structure. If we consider that Article VIII(2)(b) is a choice of law rule, then what type of

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[133] F.A. Mann, *The Private International Law of Exchange Control Under the IMF Agreement*, 2 INT'L & COMP. L.Q. 97, 101; Elisa Kripis, *Money in International Private Law*, 120 RECUEIL DES COURS 192-306 (1967).

[134] Audit, *supra* note 129, at 70. *See also* Mann, *supra* note 133, at 101.

[135] Kripis, *supra* note 1333, at 288.

[136] The Court in J. Zeevi & Sons, Ltd. v. Grindlays Bank, Ltd. (Uganda), 37 N.Y.2d. 220 (1975) held that "currency" is restricted to the literal meaning while other writers see otherwise. *See e.g.*, Mann, *supra* note 133, at 102.

[137] Hans W. Baade, *The Operation of Foreign Public Law*, 30 TEX. INT'L L.J. 429, 472 (1995); Kripis, *supra* note 133, at 298.

[138] Mann, *supra* note 1333, at 102.

[139] *Id.* at 370.

[140] Kripis, *supra* note 1333, at 297.

choice of law rule is it? If we consider it a traditional choice of law rule then it must have a connecting factor and if the connecting factor is the currency we have several problems. First, the parties might choose one currency as the currency of account and choose another as the currency of payment. Which "currency" should we use to implement Article VIII(2)(b), the currency of account or the currency of payment? Second, if we choose the currency as a connecting factor then this means that the applicable F.C.C.R. will be the one included in the *lex monetae*. Nonetheless, there are writers who believe that the proper application of Article VIII(2)(b) requires that we apply the F.C.C.R. of the member state whose foreign currency reserves are affected.[141] In other words, the courts should apply the F.C.C.R. of the *lex partimoni* instead of the *lex monetae*.

On the other hand, we cannot consider Article VIII (2)(b) as an expression of a forum's legislative policy on how courts should handle foreign currency debts that can be used in forming a "government interest" analysis or a "most significant relationship choice of law" analysis because Article VIII(2)(b) merely directs the member state courts to respect other member states F.C.C.R. If we use government interest analysis, as a choice of law analysis, while implementing Article VIII(2)(b) this would allow the courts to refuse the application of the F.C.C.R. either to advance the forum's interest when the court finds that applying the F.C.C.R. to the merits of the case will have adverse effects on the forum's interests[142] or when ignoring the F.C.C.R., instead of enforcing it, will benefit the forum's citizens.[143] The same results will occur if the court adopts a choice of law analysis based on the most significant relationship because the court should consider that it is advancing the forum's interest as a factor under this approach when implementing the Article VIII(2)(b), which will open the door to reach similar results had the court adopted a government interest analysis.[144]

Second, if we consider Article VIII(2)(b) to be a substantive rule then it will be useless because we will be limiting its scope of application to the instances where the forum's law is the applicable law. For example, if the forum was an American court and Article VIII(2)(b) was a substantive federal law then it would be applied if the applicable law was a U.S. state or federal law because it would be both the *lex contractus* and *lex loci solutionis*.

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[141] *Id.* at 290-1; Mann, *supra* note 133, at 103.

[142] A. Hill, *Governmental Interest Analysis and the Conflict of Laws - A Reply to Professor Currie*, 27 U. CHI. L. REV. 463, 481 (1960).

[143] Mahmood Bagheri, *Conflict of Laws, Economic Regulations and Corrective/Distributive Justice*, 28 U. PA. J. INT'L. ECON. L. 113, 121 (2007).

[144] Robert A. Leflar, *Choice-Influencing Considerations in Conflicts Laws*, 41 N.Y.U. L. REV. 267 (1966); Robert A. Leflar, *Conflicts Law: More on Choice-Influencing Considerations*, 54 CAL. L. REV. 1589, 1585 (1966).

However, if the applicable law is a foreign law then Article VIII(2)(b) as a substantive federal rule of law would not be applicable. In this case, if Article VIII(2)(b) was not a part of the *lex contractus* or the *lex loci solutionis* the F.C.C.R. of a member state will not be enforced and the contract that violated that member state's F.C.C.R. will be enforceable contrary to the purpose of Article VIII(2)(b). Some might say that all jurisdictions should follow the English courts' lead by applying the F.C.C.R. as a part of the *lex contractus* or the *lex loci solutionis*.[145] In my opinion, this leaves room for the parties to evade the member state's F.C.C.R. by selecting a law governing their contract and a place of payment that does not have a substantive rule that implements Article VIII(2)(b) or contains a less restrictive F.C.C.R .

To conclude, Article VIII(2)(b) does not provide clear authority for courts to apply the F.C.C.R.'s of other nations due to the Article ambiguous drafting. As a result, the outcome of any case will depend on how the court constructs Article VIII(2)(b) before applying it to the particular facts of the case. This explains why the courts hesitate to enforce other nations' F.C.C.R.'s despite what appears to be clear authority in the IMF Agreement to do so.

B. Negative Indicators

I previously mentioned that there were two negative indicators used by the courts to justify their rules on foreign currency debts. Public policy was used as an excuse for not enforcing other nation's F.C.C.R.'s because their application would create results repugnant to the forum's public policy. Other courts resorted to the Foreign Revenue Rule Doctrine to justify their refusal to enforce the F.C.C.R.'s of other nations, treating them as revenue rules which have a territorial scope of application. In this section, I will examine both indicators to see if they are truly is an obstacle against enforcing foreign F.C.C.R.'s.

1. Public Policy

As we have seen in Part I, some courts refused to apply foreign F.C.C.R.'s as a matter of public policy. Here I will answer the following question: do those public policies actually prevent a court from enforcing the F.C.C.R.'s? To answer this question we have to define public policy.

Public policy is the fundamental principle of the forum's legal system that cannot be disregarded when the court applies a foreign rule of law.[146] In

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[145] Friedrich K. Juenger, *A Third Conflicts Restatement*, 75 IND. L.J. 403, 405 (2000).

[146] Mosconi, *supra* note 120, at 62; Monard G. Paulsen & Michael I. Sovern, *The Pubic Policy in the Conflict of Laws*, 56 COLUM. L. REV. 969, 981 (1956); Holly Sprague, *Choice of Law: A Fond Farewell to Comity and Public Policy* , 74 CALIF. L. REV. 1447, 1450 (1986); Andreas Bucher, *L' Ordre Public et le But Social des Lois en Droit International Privé*, 239 RECEUIL DES COURS 9-116 (1993).

other words, public policy represents the core values or prudential considerations of a forum that foreign rules of law must not violate in order to be enforced.[147] An example is a forum's refusal to apply a foreign rule of law that allows the sale of human organs or facilitates illicit transactions such as trafficking in persons.

An important feature of public policy as a legal concept is that its content differs from one jurisdiction to another and can change within the same jurisdiction depending on socio-economic development.[148] The elastic nature of public policy draws criticism from writers who see it as an easy escape device that allows courts to avoid unwanted results.[149] Nonetheless, public policy is used by the courts when two requirements are met.

The first requirement is that the application of foreign law would produce effects that are not compatible with the forum's values. Therefore, the mere difference in the content between the foreign F.C.C.R. and the corresponding rule in the forum's F.C.C.R. should not be a sufficient basis to use the forum's public policy as a bar against enforcing the foreign F.C.C.R.[150] In order for the court to use public policy as a bar against enforcing the foreign F.C.C.R., it must, for instance, deprive the creditor of the foreign currency through confiscation without indemnity or discriminate between domestic creditors and foreign creditors.

The second requirement is the presence of a sufficient relationship between the forum and the facts of the case, to ensure that the forum's core values are indeed in danger of harm if the forum enforces the foreign rule of law.[151] Therefore, an American court, whether state or federal, should not use the forum's public policy if the case was about enforcing the Egyptian F.C.C.R. on a contract of sale made in France and denominated in euros. In this example, there is no relationship between the court and facts of the case to suggest that the forum's core values would be harmed if the Egyptian F.C.C.R . was enforced.

Even when the above requirements are present, the court does not have full freedom to disregard the foreign law. The court will only have the power to refuse to apply those that are repugnant to the forum's public policy and to replace those repugnant rules with corresponding rules from

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[147] Bucher, *supra* note 146, at 47; UKASHA, *supra* note 123, at 468.
[148] Mosconi, *supra* note 120, at 80; UKASHA, *supra* note 123, at 492.
[149] AUDIT, *supra* note 74, at 264; Bucher, *supra* note 146, at 66.
[150] UKASHA, *supra* note 123, at 511; Mosconi, *supra* note 120, at 66.
[151] Home Insurance Co. v. Dick, 281 U.S. 397 (1930) (upheld the Texas Supreme Court's decision to refuse the Texas public policy defense to bar an action made by the insured against the insurance company because the insurance policy was made to cover the danger of fire over a vessel within the Mexican waters). *See also* Holzer v. Deutsche Reichsbahn Gesellschaft, 277 N.Y. 474 (1934); Dougherty v. Equitable Life Assurance Soc., 266 N.Y. 71 (1934); Boardman v. United Servs. Auto. Assoc., 470 So. 2d 1024 (Miss. 1985); Paulsen & Sovern, *supra* note 146, at 970; AUDIT, *supra* note 74, at 270.

the forum's law, if possible.[152] In other words, the forum's law might not completely replace the foreign law. For instance, suppose that a French court saw that an Egyptian F.C.C.R. rule had a discriminatory effect on a contract made in France to export perfumes to Egypt and the contract was denominated in Egyptian pounds. In this case, the French court should not replace the Egyptian F.C.C.R as a whole and replace it with the French F.C.C.R., but it should replace the Egyptian F.C.C.R. rule that has the discriminatory effect while applying the rest of the Egyptian F.C.C.R. as is.

Nevertheless, despite the above being the logical consequence to the use of public policy as a defense against enforcing a foreign F.C.C.R, it does not explain the current law on foreign currency debts. It is true that some American courts, both state and federal, refuse to apply a foreign F.C.C.R. under the pretext of protecting public policy, but the use of the public policy was not done as previously explained. It is not clear why American courts find foreign F.C.C.R.'s repugnant to public policy nor have they established in their reasoning a sufficient connection between the court and the facts of the case to justify the use of the public policy defense. In fact, the courts should have refrained from resorting to the public policy defense due to the IMF Agreement prohibition on member states' courts resorting to public policy as a bar against enforcing any F.C.C.R. compatible with the IMF Agreement.[153]

In conclusion, the public policy defense has been inappropriately used by courts to avoid enforcing F.C.C.R.'s despite being required to do so under the IMF Agreement. Public policy as a defense against applying foreign law does not give the courts absolute power to ignore the foreign law unless there is a strong violation of the forum's core values. This is not the case with foreign F.C.C.R.'s.

2. *Foreign Revenue Rule Doctrine*

The Foreign Revenue Rule Doctrine has been used by courts in several jurisdictions as an excuse for not enforcing an F.C.C.R. Under this doctrine, foreign revenue rules have only a territorial scope of application and therefore are not applicable beyond the borders of the sovereigns that issued them.[154]

The conventional wisdom behind the Foreign Revenue Rule Doctrine is that foreign penal rules or public law rules could not be applied by a court outside the sovereign that issued those rules because that would require

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[152] Nevcal Enterprises, Inc. v. Cal-Neva Lodge, Inc., 194 Cal. App. 2d 177 (1961); AUDIT, *supra* note 74, at 274.

[153] United States v. Pink, 315 U.S. 203 (1942); Perutz v. Bohemian Discount Bank in Liquidation, 304 N.Y. 533, 537 (1953).

[154] Att'y Gen. v. Lutwydge (1729) 145 Eng. Rep. 675 (Ex. Div.); Holman v. Johnson, (1775) 98 Eng. Rep. 1120, 1121 (K.B.); Kripis, *supra* note 133, at 283.

allowing the court to review the validity of another state's revenue laws in light of the court's own constitutional requirements, which is not consistent with the court's respect for the other state's sovereignty.[155] For example, if an F.C.C.R. contains a criminal penalty for selling foreign currency in an unofficial market then this penalty cannot be enforced by a foreign court unless that criminal penalty meets the constitutional requirements within the forum's law. If the F.C.C.R.'s criminal penalty did not meet the constitutional requirements of the forum's law then that would prevent the court from enforcing it.

Nonetheless, I believe that courts have used the Foreign Revenue Rule Doctrine inappropriately as a bar against enforcing foreign F.C.C.R.'s just as other courts have with the public policy defense. First, F.C.C.R.'s are not revenue or tax law rules or penal rules because they are mandatory substantive rules that aim at regulating the movement of foreign currency to protect foreign exchange resources.[156] Second, there is no direct legal bar against enforcing other nations' foreign revenue rules if they do not prescribe criminal penalties.[157] A foreign revenue rule that mandates the payment of taxes or compliance with certain procedures is no different than a foreign rule that mandates compensation for injuring a creditor or requires the registration of a land conveyance. Even if a foreign revenue rule contains a criminal sanction, it is always possible to exercise *dépeçage* in order to separate the civil aspects of the rule in question from its criminal aspects and to apply the earlier only to the case.[158] Third, some courts have in fact enforced foreign revenue rules as a part of the *lex contractus* or the *lex loci solutionis* and courts have referred to the foreign currency rules to define what constitutes the foreign state's currency and the acceptable modes of payment. This means that even if a court treats a F.C.C.R. as a foreign revenue rule, it is not *per se* a sufficient reason for not applying those rules.

To conclude, the Foreign Revenue Rule Doctrine is not a hurdle against enforcing the F.C.C.R.'s of other nations, rather, it is the courts' unwillingness to engage in enforcing the foreign F.C.C.R.'s. Courts are capable of enforcing those rules but choose not to. This is counter-intuitive to the purpose of Article VIII § 2 (b) that aims at regulating the monetary relations between member states and the need to ensure mutual respect of monetary sovereignty as a governing principle of public international law.

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[155] Moore v. Mitchell, 30 F.2d 600, 604 (2d Cir. 1929); P.B. Carter, *Transnational Recognition and Enforcement of Foreign Public Laws*, 48 C.L.J. 417, 423 (1989). For more detailed discussion on the foreign revenue doctrine see Brenda Mallinak, *The Revenue Rule: A Common Law Doctrine for the Twenty-First Century*,16 DUKE J. COMP. & INT'L L. 79 (2006).

[156] John S. Williams, *Enforcement of Foreign Exchange Control Regulations in Domestic Courts*, 70 AM. J. INT'L L. 101, 105 (1976); A.W.B. & Berrein, *supra* note 41, at 70; Kripis, *supra* note 133, at 284; RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE U.S. § 822 cmt. (1987).

[157] Mosconi, *supra* note 120, at 134; Carter, *supra* note 155, at 423.

[158] Kripis, *supra* note 133, at 284.

IV. SUGGESTED APPROACH

In this part, I will discuss the choice of law approach that would best govern the current law on foreign currency debts in a manner that is both clear and predictable without sacrificing the need for individual justice. As mentioned in Part II, none of the positive or negative choice of law indicators alone is capable of providing a clear basis for explaining the current state of the law. This drove me to suggest a hybrid approach that combines the party autonomy choice of law rule and the mandatory rule approach. I believe that a balance must be struck between parties' needs to choose the law and the currency of their contracts and the need to enforce all F.C.C.R.'s in accordance with the IMF Agreement's aim of a stable international monetary system.[159]

I suggest that courts apply the party autonomy choice of law rule to determine all issues relating to foreign currency debts as a general rule. This means that determining whether a certain currency is the currency of account or currency of payment should be done according to the *lex contractus*. The same law will be used in defining the species of the currency used or in constructing and determining the legality of any gold or index clauses. The same solution should be followed with conversion rules if the court is not capable of issuing its judgment in a foreign currency. This would eliminate the discrepancies among the conversion rules followed by the courts because they will apply the conversion rule provided by the *lex contractus*. If the *lex contractus* does not provide a conversion rule then the court should look for the conversion rule that corresponds to the parties' expectations. As previously explained, conversion rules used by the courts are not meant to be procedural rules but instead are meant to be used to achieve substantive justice.[160] The lack of uniformity would be eliminated by leaving the substantive issue of conversion to the law that governs all other substantive issues related to the foreign currency debt, the *lex contractus*.

At the same time, Article VIII(2)(b) should be interpreted as a mandatory rule within the forum's law that mandates the unenforceability of any contract that violates an F.C.C.R. whether domestic or foreign. This rule should be enforced to ensure that all issues relating to the currency as an element of a state's monetary system should be resolved according to that state's law irrespective of the parties' choice of law. For example, the definition of what constitutes U.S. dollars should be made according to American federal law. However, this does not mean that Article VIII(2)(b) should be used as a choice of law rule that uses the currency of contract as a

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[159] Philip J. McConnaughay, *Reviving the Public Law Taboo in International Conflict of Laws*, 35 STAN. J. INT'L L. 255, 290 (1999).

[160] *See* Patrick Kinsch, *Principale D' Égalité et Conflit de Lois*, TRAV. COM. FRA. DR. INT. PRIVÉ 117, 130 (2002-2004); RESTATEMENT (FIRST) ON CONFLICT OF LAWS § 1-7 (1934).

connecting factor because it states that the court is to apply the F.C.C.R.'s of other member states if the contract in question "involve the currency of any member." Therefore, if a contract affects or involves the currency of any member state, then, that should be a sufficient basis for applying that member state's F.C.C.R.

Suppose that an Egyptian car dealer reached an agreement with an American car manufacturer to export hybrid cars to Egypt, with the Egyptian buyer agreeing to pay for the cars in U.S. dollars. In this case, the court should look at the details of the method of payment to determine whether the Egyptian pound was involved in the transaction. If the Egyptian buyer was supposed to pay for the cars using U.S dollars deposited in his Egyptian bank account, or by converting Egyptian pounds into U.S. dollars, then the contract must not violate the Egyptian F.C.C.R. In the first case, the Egyptian seller is transferring overseas U.S. dollars held in his bank account in Egypt, which affects the Egyptian balance of payments and Egyptian monetary system. In this situation, U.S. dollar holdings in Egypt will decrease; as so, the transaction should be regulated according to the Egyptian F.C.C.R. to maintain the stability of the Egyptian monetary system. In the second situation, the payment occurs after converting the Egyptian pounds into U.S. dollars. Once again, this transaction affects the Egyptian balance of payments and the Egyptian monetary system. In both cases, if the parties did not respect the Egyptian F.C.C.R., then Egypt's U.S. dollar holdings will fluctuate beyond Egypt's control and the exchange rate between the Egyptian pound and the U.S. dollar will be left for the individuals to decide rather than the Egyptian Central Bank. Here, Article VIII(2)(b) mandates that the Egyptian F.C.C.R. should be respected by the parties.

In other words, the phrase "involve the currency of any member state" should be interpreted as a requirement for a substantial relationship between the contract in question and the F.C.C.R. of any member state. This should not be a novelty for the courts because, as previously mentioned, this was used with the public policy defense. The only difference is that I suggest extending this view to treat F.C.C.R.'s as mandatory rules. The substantial relationship should be based on the possible effects that the contract has on the monetary system of any member state. This suggestion will help us clear out the current law on foreign currency debts for several reasons.

First, my suggestion makes use of the party autonomy as the basic choice of law rule for all legal issues related to foreign currency debts. This means that the parties' choice of law will be respected and will not be ignored unless necessary. Second, this approach allows the courts to apply F.C.C.R.'s, whether domestic or foreign, through a choice of law rule that will be predictable and consistent because parties will know beforehand which F.C.C.R. applies to their contract. It would also avoid any under-regulation resulting from evasion of F.C.C.R.'s through forum shopping.

V. CONCLUSION

In this article, I demonstrated that the law on foreign currency debts is currently divided into four separate choices of law issues governed by four different choices of law doctrines. This is caused by the inappropriate use of the choice of law doctrines as the courts tried to achieve substantive justice in every individual case involving foreign currency. The result of this is the vagueness of the rules resolving choice of law issues in foreign currency debts while distorting the choice of law doctrines in the process. I suggest an alternative, which is the use of a single choice of law: the party autonomy choice of law rule that should be applied unless that will violate a mandatory rule of an IMF member state.

CONSUMER FINANCIAL PROTECTION POST DODD-FRANK: SOLUTIONS TO PROTECT CONSUMERS AGAINST WRONGFUL FORECLOSURE PRACTICES AND PREDATORY SUBPRIME AUTO LENDING

CHRISTOPHER K. SEIDE*

I. INTRODUCTION

The financial crisis of 2008 was the most severe economic crisis to affect the United States since the Great Depression in 1929.[1] Once United States ("U.S.") government officials and policymakers saw the financial markets begin to collapse, they attempted to avert the economic crisis.[2] However, despite the injection of large monetary stimulus packages into the U.S economy in early 2008, the financial crisis was not avoided.[3] As concerns about financial losses stemming from toxic assets[4] led to issues surrounding the solvency and funding of major financial institutions, the financial crisis continued to dig its roots into our everyday lives.[5]

Economists, financial experts, policymakers and governmental leaders disagree as to the fundamental causes of the financial crisis. Benjamin S. Bernanke, Chairman of the Federal Reserve, argued that lax regulation and the overall regulatory failures of the Federal Reserve caused the housing bubble and the financial crisis to occur.[6] However, Lloyd Blankfein, Goldman Sachs CEO, blamed Congress, pointing to federal laws and policies that led to housing and credit bubbles, an unbalanced trade deficit, and low interest

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[1] Benjamin S. Bernanke, Remarks at the Economic Club of Minnesota 2011-2012 Speaker Series (Sept. 8, 2011), http://www.bloomberg.com/news/2011-09-08/crisis-recovery-is-much-less-robust-than-hoped-bernanke-says-full-text.html.

[2] *Id.*

[3] *Id.*

[4] Definition of Toxic Assets: "An asset that becomes illiquid when its secondary market disappears. Toxic assets cannot be sold, as they are often guaranteed to lose money. The term 'toxic asset' was coined in the financial crisis of 2008, in regards to mortgage-backed securities, collateralized debt obligations and credit default swaps, all of which could not be sold after they exposed their holders to massive losses". *Toxic Asset Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/t/toxic-assets.asp#axzz1uZs9wLQt (last visited May 05, 2012).

[5] Nikola Spatafora, *World Economic Outlook: Crisis and Recovery*, *in* THE GLOBAL FINANCIAL CRISIS 2009: PREPARING FOR THE FUTURE (2009).

[6] Catherine Rampell, *Lax Oversight Caused Crisis, Bernanke Says*, N.Y. TIMES (Jan. 3, 2010), http://www.nytimes.com/2010/01/04/business/economy/04fed.html.

rates.[7] In support of his contention, Mr. Blankfein noted that the Federal Reserve had the power to stop the issuance of subprime mortgages by creating and implementing responsible mortgage lending standards but failed to do so.[8] His contention is also supported by the following fact: between 2000 and 2006, the Federal Reserve only referred three cases of predatory lending to the Department of Justice.[9] This indicates that enforcement against predatory subprime lending by governmental regulators was practically non-existent.[10] Others believe that large financial institutions significantly contributed to the onset of the crisis by using collateralized debt obligations[11] ("CDO's") to turn pools of subprime mortgages[12] into toxic assets, ultimately creating the need for financial rescue bailouts[13] by the U.S. government.[14] Additional factors cited as helping

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[7] Patrice Hill, *CEO's trade blame with Congress over financial crisis*, THE WASHINGTON TIMES (Jan. 14, 2010), http://www.washingtontimes.com/news/2010/jan/14/ceos-trade-blame-with-congress-over-finance-crisis/?page=all.

[8] Phil Angelides et al., *Financial Crisis Inquiry Commission*, *in* THE FINANCIAL CRISIS INQUIRY REPORT XVII (2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf (stating that in response to out of control subprime lending in the late 1990's, the Federal Reserve passed rules that only affected 1% of lenders dealing in subprime loans. In 2006, the Federal Reserve only issued voluntary guidance rules and did not address any wide scale mandatory rules related to predatory lending until 2008).

[9] *Phil Angelides: The Financial Crisis Inquiry Report (3/3/11)*, THE COMMONWEALTH CLUB OF CALIFORNIA RADIO PROGRAM (Mar. 14, 2011), http://www.apple.com/itunes/podcast. Also *available* at http://www.youtube.com/watch?v=Vpn87fyKFNk (last visited May 5, 2011).

[10] *Id.*

[11] Definition of collateralized debt obligation: "an investment-grade security backed by a pool of bonds, loans and other assets. CDO's do not specialize in one type of debt but are often non-mortgage loans or bonds".*Collaterized Debt Obligation Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/c/cdo.asp#axzz1uZs9wLQt (last visited May 05, 2012).

[12] Definition of Subprime Mortgage: "a type of mortgage that is normally made out to borrowers with lower credit ratings. As a result of the borrower's lowered credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan. Lending institutions often charge interest on subprime mortgages at a rate that is higher than a conventional mortgage in order to compensate themselves for carrying more risk." *Subprime Mortgage Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/s/subprime_mortgage.asp#axzz1uZs9wLQT (last visited May 6, 2012).

[13] Definition of bailout: "a situation in which a business, individual or government offers money to a failing business in order to prevent the consequences that arise from a business's downfall. Bailouts can take the form of loans, bonds, stocks or cash. They may or may not require reimbursement." *Bailout Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/b/bailout.asp#axzz1uZs9wLQt (last visited May 06, 2012).

[14] Adam Davidson, *How Wall Street Made The Mortgage Crisis Worse*, NATIONAL PUBLIC RADIO (Aug. 27, 2010), http://www.npr.org/blogs/money/2010/08/26/129454550/inside-the-sausage-factory-how-wall-street-made-the-financial-crisis-worse.

to create the financial crisis[15] include: (1) low global savings rates; (2) misjudgments and conflicts of interest between credit rating agencies; (3) lack of transparency regarding extreme risks banks were taking in pursuit of short term profits; (4) industry reliance on faulty mathematical formulas that incorrectly priced financial risks; (5) flawed executive compensation models; (6) monetary and fiscal policies like "too big to fail";[16] and (7) flawed Treasury Department responses to worsening economic conditions in 2007.[17] Nevertheless, whatever its main causes, the financial crisis was the culmination of a series of events that deeply plagued the financial markets and global economy more than anyone could have ever imagined.

This article will identify how the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[18] responded to the financial crisis, effectively preventing predatory subprime mortgage lending practices but failing to protect consumers against wrongful foreclosure and home loan modification programs as well as subprime auto lending. Part I will address a critical timeline of events and subprime mortgage lending practices that caused the financial crisis of 2008. Part II will discuss key substantive and structural provisions of the Dodd-Frank Act that effectively protect consumers against subprime mortgage lending practices. Part III will identify current predatory practices that continue to threaten economic recovery and consumer financial safety including wrongful mortgage foreclosures, home loan modification practices, and subprime auto lending. Part IV will propose solutions to amend the Dodd-Frank Act to: (1) provide bailouts to consumers negatively affected by wrongful foreclosure and home loan modification practices while continuing to stabilize the overall economic recovery and (2) bring consumer financing arrangements, including auto lending practices, under the regulatory control of the U.S. government. Ultimately, successful implementation of these additional measures will provide better consumer protection for all Americans in the aftermath of the financial crisis of 2008.

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[15] Jacob Weisberg, *What Caused the Economic Crisis?*, SLATE (Jan. 9, 2010, 6:59 AM), http://www.slate.com/id/2240858/.

[16] Definition of Too Big to Fail: "the idea that a business has become so large and ingrained in the economy that a government will provide assistance to prevent its failure. 'Too big to fail' describes the belief that if an enormous company fails, it will have a disastrous ripple effect throughout the economy." *Too Big to Fail Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/t/too-big-to-fail.asp#axzz1uZs9wLQt (last visited May 6, 2012).

[17] Weisberg, *supra* note 15.

[18] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of U.S.C) [hereinafter Dodd-Frank Act].

II. Overview of the Largest Financial Crisis since the Great Depression

A. A Timeline of Critical Events Leading to the 2008 Financial Crisis

A series of critical events dating back to the 1970's led to the worst financial crisis since the Great Depression. Some may have viewed the financial crisis of 2008 as a very short, rapidly unfolding series of news headlines that flashed across television screens during nightly news reports. However, the foundation of the financial crisis was established over three decades ago.

1. Early Causes of the Crisis: Deregulation and Soaring Interest Rates

The events that culminated in the financial crisis began to unfold during the late 1970's under the Carter Administration and subsequently during the early to mid-1980's under the Reagan Administration.[19] As competition in unregulated financial markets outside the U.S. increased, lower interest rates for investors caused large depositor institutions to seek higher interest rates outside of the regulated U.S. financial markets.[20] This ultimately led to deregulation by the federal government within the U.S financial and banking industries in an attempt to remain competitive.[21] However, as a result of deregulation, inflation became an issue and the Federal Reserve, during the Carter Administration, adopted a policy of "tight money,"[22] a series of actions by the Federal Reserve to reduce spending or

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[19] Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 BROOK. L. REV. 1295, 1309-1310 (1995). (discussing how both President Carter and President Regan accepted certain market theories that completely violated market realities which ultimately led to deregulation in the banking and finance industries and the abolishment of interest rate ceilings in the marketplace).

[20] *Id.* at 1310.

[21] *Id.* (showing that ". . . the Democratic Administration and Congress opted not to extend the scope of regulation to nonbank institutions and failed to harmonize policy with peripheral jurisdictions. Interest rates were allowed to rise at the expense of national economic objectives and the federal government bowed to the myriad pressures for financial deregulation").

[22] Greg Ip & Mark Whitehouse, *How Milton Friedman Changed Economics, Policy, and Markets*, WALL ST. J. (Nov. 17, 2006), http://online.wsj.com/public/article/SB116369744597625238-foIWt7vDyt4ralPtdifXt5Ux3Lo_20061216.html?mod=tff_main_tff_top (the concept of "tight money" was adopted under the theory of "monetarism" which is an economic theory that focuses on the macroeconomic effects of the supply of money and central banking. Formulated by Milton Friedman, it argues that excessive expansion of the money supply is inherently inflationary and that monetary authorities should focus solely on maintaining price stability).

curb inflation in an economy that appeared to be growing too quickly.[23] This policy increased short-term interest rates, which in turn reduced the amount of borrowing.[24] While some economists say that "tight money" lowered inflation, others say that it ultimately did not work.[25]

Under the Reagan Administration, the ceiling on interest rates was removed.[26] Consequently, as a result of the deregulation of the financial markets coupled with the seemingly limitless rise of real (inflation-adjusted) interest rates, a deterioration of the American way of life began to take place.[27] Furthermore, predatory practices, similar to those used in the subprime mortgage market leading up to the financial crisis of 2008, existed in the financial markets in the mid-1980s.[28] All of these factors led to unsustainably high interest rates, which ultimately caused subprime and prime borrowers to default on their loans and go into foreclosure.[29] Deregulation and the removal of interest rate ceilings appear to have been major building blocks in the chain of events leading to the financial crisis of 2008.[30]

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[23] Canova, *supra* note 19, at 1311-1312 (stating that "Under Volcker, the Fed announced that it would ignore the rising level of interest rates. Instead, it would try to control the entire supply of money and credit in a $3.5 trillion economy by targeting the growth of volatile money aggregates").

[24] *Id.*

[25] *See Id.* at 1314 (illustrating that "by the end of 1980, tight money had proven largely fatal to the Carter administration. More importantly, the monetary experiment had made financial deregulation inevitable. Double digit interest rates had imperiled the entire structure of regulated interest rates").

[26] *See Id.* at 1320 (the Garn-St. Germain Depository Institutions Act of 1982 allowed depository institutions to open special accounts and set a special timeline for when all depository interest rate limits would no longer exist in 1986).

[27] *See Id.* at 1324 ("Those with wealth and savings took advantage of the opportunity to profit from the high returns. Those dependant on credit found themselves paying the highest sustained real interest rates of the century. As the cost of capital and credit rose, risk-taking and entrepreneurialism suffered. The American dream of home ownership, of business ownership, of directing and managing a productive enterprise, and of creating new wealth was becoming more difficult to fulfill").

[28] *See Id.* at 1328 (banks started to implement more aggressive lending practices in order to realize higher yields. Competition to lend money to certain commodities markets led to degradation in lending standards which resulted in a large number of defaulting loans).

[29] *Id.* at 1332.

[30] *See Id.* at 1339 (stating that "since the late 1970's, real interest rates for most individuals, businesses, and all levels of government have remained at unprecedented levels, more than triple the historical average. The massive redistributions of wealth and income have continued unabated into the Presidency of Bill Clinton. This consequence may be the most troubling and least recognized effect of financial deregulation and high real interest rates").

2. The Unraveling of the U.S. Economy

In early 2007, concerns began to grow that subprime mortgage borrowers would not be able to make good on their obligations and that the negative effects of these risky mortgages would spread to other, more conventional loans not considered to be as risky.[31] As the economy began to show signs of weakening in early 2007, borrowers who had taken out loans during the first six months of 2007 started to default on those loans at a faster pace than those who had borrowed money prior to 2007.[32] Furthermore, during the housing boom of 2005 and 2006, borrowers flocked to adjustable rate mortgages ("ARM's") to take advantage of lower interest rates for the first few years of their loans, planning to refinance when mortgage rates would start to increase.[33] However, as home values declined, this practice became unsustainable.[34] As worries about the rising default rate on non-traditional and subprime mortgages grew, investors in mortgage-backed securities were unable to accurately determine the present value of their investments and began to fear they had overpaid for their securities.[35] This created a panic in the financial markets that rattled investors.

In the summer of 2007, as their short term obligations began to come due, large mortgage lenders began to encounter trouble funding their operations. Countrywide Financial Corporation ("Countrywide") relied on short-term debt to fund new loans and to pay employee salaries.[36] As turmoil rocked the mortgage markets, Countrywide had major problems obtaining funding.[37] Furthermore, as funding sources for other large banks and mortgage lenders were quickly drying up, BNP Paribas, a French bank with major investments in the United States, halted operations in three of its

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[31] Vivien Lou Chen, *Subprime Crisis to Spread to Higher-Tier Loans, Economist Says*, BLOOMBERG (Apr. 2, 2007, 8:00 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJokNoiwQHwU&refer=home. (stating that top executives at major financial institutions did not know the terms of the mortgage securities they purchased on the secondary markets nor did they pay attention to the individual agreements that made up these mortgage securities that their firms acquired, causing panic across the entire lending market).

[32] Vikas Bajaj, *As Defaults Rise, Washington Worries*, N.Y. TIMES (Oct 16, 2007), http://www.nytimes.com/2007/10/16/business/16lend.html.

[33] *Id.*

[34] *Id.*

[35] Bankrate.com*, Countrywide, the mortgage mess and you*, MSN MONEY (Aug. 17, 2007, 12:22 PM), http://articles.moneycentral.msn.com/Banking/HomeFinancing/CountrywideTheMortgageMessAndYou.aspx.

[36] Jim Zarroli, *Countrywide Financial Struggles Under Credit Woes*, NATIONAL PUBLIC RADIO, (Aug. 16, 2007), http://www.npr.org/templates/story/story.php?storyId=12847195.

[37] *Id.*

investment funds because of an inability to value its own assets.[38] As the ability of large banks to find funding drastically decreased, perceptions of what might be looming on the horizon started a chain of panic-stricken events that rose in magnitude during the ensuing months.

In late 2007, massive losses resulting from the subprime mortgage markets provided strong evidence of the deepening financial crisis.[39] Standard and Poor's Rating Services lowered the credit rating of Merrill Lynch as the company reported a $7.9 billion third quarter loss, nearly double what analysts had expected for that quarter.[40] Due to banks' massive exposure to the subprime mortgage markets and investment grade ratings being given to many CDO's by credit agencies despite being extremely risky and undeserving of said grade,[41] analysts began to be concerned about company risk management and asset valuation practices.[42] Moreover, as financial institutions were forced to write-down[43] the value of their holdings and brace for massive losses from the subprime mortgage market, credit rating agencies put $534 billion worth of bonds and collateralized debt obligations connected to subprime mortgages on review.[44] Money had quickly evaporated from the financial markets and the effects of the housing bubble were starting to show up on the balance sheets of major financial

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38 *BNP Paribas suspends funds because of subprime mortgage problems*, N.Y. TIMES (Aug. 9, 2007), http://www.nytimes.com/2007/08/09/business/worldbusiness/09iht09bnp.7054054.html.

39 Standard and Poor's Ratings Direct, *S&P Downgrades Merrill Lynch After "Startling" Loss*, BUSINESSWEEK (Oct. 24, 2007, 11:16 AM) http://www.businessweek.com/investor/content/oct2007/pi20071024_195861.htm.

40 *Id.*

41 Matthew Leising & Andrew Frye, *Moody's Chief Says CDO Ratings Were 'Deeply Disappointing'*, BLOOMBERG (June 2, 2010, 8:52 AM), http://www.bloomberg.com/news/2010-06-02/moody-s-chief-mcdaniel-says-ratings-of-cdos-were-deeply-disappointing-.html (indicating that subprime collateralized debt obligations and mortgage-backed securities were given AAA investment grade ratings by the credit rating agency cartel).

42 *Id.*

43 Definition of write-down: "reducing the book value of an asset because it is overvalued compared to the market value." *Write-down Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/w/writedown.asp#axzz1uZs9wLQt (last visited May 06, 2012).

44 Elliot Blair Smith, *'Race to Bottom' at Moody's, S&P Secured Subprime's Boom, Bust*, BLOOMBERG (Sept. 25, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya_Vtdo. (noting that credit rating agencies were responsible for analyzing and assigning a credit rating for bundles of subprime mortgages that were sold on the secondary markets to investment banks. Prior to the financial crisis, credit rating agencies gave many subprime mortgage pools the highest credit rating, AAA, even though these securities were very risky and did not deserve a AAA credit rating. As borrowers began to default on their mortgages, credit rating agencies were forced to downgrade the ratings of these subprime mortgage pools which in turn negatively affected their values and created even bigger losses in the secondary markets).

institutions deeply tied to the subprime mortgage market. All of these events severely and adversely impacted the U.S. economy.

In March of 2008, investment bank Bear Stearns became the first massive casualty of the financial crisis.[45] Bear Stearns had been in business for eighty-five years; it had survived the Great Depression and eleven subsequent recessions.[46] The firm went from apparent financial health to insolvency in an astonishing seventy-two hours.[47] On March 13, 2008, Bear Stearns' executives discovered that they were nearly out of cash; with only $3 billion in liquidity, they did not have enough money to open for business the next day.[48] Bear Stearns' failure was a result of creditors no longer believing that the investment bank could repay its loans.[49] Worse than not believing the company could make good on its short-term "overnight" debt, investors did not have faith that the investment bank could keep up with the complex agreements it had made with Wall Street.[50] On the brink of bankruptcy, Bear Stearns agreed to sell itself to investment bank JPMorgan Chase for a mere $2 per share on March 16, 2008.[51] One year prior, Bear Stearns' stock had been worth $170 per share.[52] In addition to JPMorgan Chase rescuing Bear Stearns from collapse, the New York Federal Reserve agreed to provide JPMorgan Chase with financing and to fund $30 billion of Bear Stearns' non-liquid assets.[53] Despite the government's help, the negative impact on the financial markets was significant.

Throughout late spring and summer of 2008, systemic risk in the financial sector began to materialize due to the huge risks that financial institutions had taken with regard to investment practices and the lack of regulatory oversight.[54] Prior to the financial crisis, over-the-counter derivatives ("OTC derivatives")[55] were widely used by financial institutions

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[45] Kate Kelly, *Inside the Fall of Bear Stearns*, WALL ST. J. (May 9, 2009), http://online.wsj.com/article/SB124182740622102431.html.
[46] Andrew Ross Sorkin & Landin Thomas Jr., *JPMorgan Acts to Buy Ailing Bear Stearns at Huge Discount*, N.Y. TIMES (Mar. 16, 2008), http://www.nytimes.com/2008/03/16/business/16cnd-bear.html.
[47] *Id.*
[48] *Id.*
[49] David J. Lynch & John Waggoner, *Red Flags in Bear Stearns' Collapse*, USA TODAY (Mar. 19, 2008, 10:07 AM), http://www.usatoday.com/money/industries/banking/2008-03-17-bear-stearns-bailout_N.htm.
[50] *Id.*
[51] Ross Sorkin & Thomas Jr., *supra* note 46.
[52] *Id.*
[53] *Id.*
[54] Tyler Cowen, *Three Trends and a Train Wreck*, N.Y. TIMES (Oct. 17, 2008), http://www.nytimes.com/2008/10/19/business/19view.html?scp=19&sq=derivatives%20assessing%20risk%20in%20financial%20markets%202008&st=cse.
[55] Definition of derivative: "a security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more

such as Bear Stearns, Lehman Brothers, and American Insurance Group ("AIG") in their daily trading of securities.[56] As the financial crisis began to impact Wall Street, the massive losses and systemic problems at these large financial institutions showed how uncertainty and interconnectedness in the OTC derivatives market ultimately led to the tightening of available credit and the "freezing" of economic activity.[57] Lack of transparency[58] in the OTC derivatives market enabled large institutions to over-leverage themselves and sell more credit protection for risky securities than they could cover with liquid assets.[59] This lack of transparency led to the danger of counterparty risk,[60] which created fears in the marketplace.[61] Overall, unlike non-financial firms, the potential failure of large financial institutions presented systemic risks in the financial markets due to their interconnectedness, high degree of leverage, and financing of long-term holdings of relatively illiquid assets[62]

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parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Most derivatives are characterized by high leverage." *Derivative Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/d/derivative.asp#axzz1uZs9wLQt (last visited May 6, 2012).

[56] Kent Cherny & Ben R. Craig, *Reforming the Over-the-Counter Derivatives Market: What's to Be Gained?* (July 7, 2010), FEDERAL RESERVE BANK OF CLEVELAND, http://www.clevelandfed.org/research/commentary/2010/2010-6.cfm (for example, AIG insured more than $79 billion of CDO's backed by subprime mortgages, selling insurance to large financial institutions like Merrill Lynch and UBS who then called on AIG to make good on all of their CDO obligations, creating a cash strain on AIG that ultimately required government bailout).

[57] *Id.*

[58] Meaning that the day-to-day transactions in the marketplace were difficult if not impossible for regulators to monitor and track due to the complexity and hidden nature of the transactions.

[59] Austin Kilgore, *Geithner Blames Lack of Transparency for OTC Derivatives Hit on Market*, HOUSING WIRE (July 10, 2009, 5:02 PM), http://www.housingwire.com/2009/07/10/geithner-blames-lack-of-transparency-for-otc-derivatives-hit-on-market.

[60] Definition of counterparty risk: "the risk to each party of a contract that the counterparty will not live up to its contractual obligations. Counterparty risk is a risk to both parties and should be considered when evaluating a contract. Counterparty risk can be diminished when one party mandates a co-signer or a highly rated guarantor." *Counterparty Risk Definition*, INVESTOPEDIA, www.investopedia.com/terms/c/counterpartyrisk.asp#axzz1uZs9wLQt (last visited May 6, 2012).

[61] James Bullard, Christopher J. Neely, & David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, 91 no. 5 (Part 1) FEDERAL RESERVE BANK OF ST. LOUIS REVIEW, 403 (September/October 2009), *available at* http://research.stlouisfed.org/publications/review/09/09/part1/Bullard.pdf.

[62] Definition of illiquid assets: "the state of a security or other asset that cannot easily be sold or exchanged for cash without a substantial loss in value. Illiquid assets also cannot be sold quickly because of a lack of ready and willing investors or speculators to purchase the asset. The lack of ready buyers also leads to larger discrepancies between the asking price (from the seller) and the bidding price (from the buyer) than would be found in an orderly market with daily trading activity." *Illiquid Assets Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/i/illiquid.asp#axzz1uZs9wLQt (last visited May 6, 2012).

with short-term debt.[63] Ultimately, government intervention was required in order to attempt to stabilize the financial markets.[64]

In early September 2008, as losses from declining home values and rising foreclosures started to accumulate in Fannie Mae and Freddie Mac,[65] the U.S. government placed both companies into conservatorship,[66] retaining complete control over both companies.[67] At the time of the government takeover, both companies owed a combined $5.4 trillion in mortgage debt with taxpayers ultimately responsible for guaranteeing those debt obligations.[68] The takeover plan allowed the government to supply up to $100 billion for each company to cover potential shortfalls in capital.[69] The plan also permitted the U.S. Treasury to, if needed, buy each company, banned both companies from lobbying efforts, and eliminated dividend payments to shareholders while securing principal and interest payments on their existing debt.[70] Subsequently, Fannie Mae and Freddie Mac were given access to over $400 billion in taxpayer dollars, leading many economists to fear that it would be very difficult for them to repay the amount borrowed

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[63] *Id.*

[64] Cherny & Craig, *supra* note 56 (stating that Fannie Mae and Freddie Mac are government-sponsored enterprises that provide a secondary investment market in home mortgages. They purchase mortgages from banks and other lenders to generate more cash for those lenders to make additional home loans. Together, Fannie Mae and Freddie Mac hold or guarantee $5.4 trillion worth of home mortgages, about one half of the outstanding home loans in the United States).

[65] Peter J. Wallison, *Government Housing Policy and the Financial Crisis,* 30 no. 2 CATO J. 397 (2010) (there were significant U.S. government housing policies that contributed to predatory lending which ultimately created the need for a massive government bailout of organizations guilty of predatory lending. In 1992, Congress amended the charters of Fannie Mae and Freddie Mac to include an affordable housing mission which enabled them to accept loans with subprime characteristics that they had previously rejected. Also regulations under the Community Reinvestment Act ("CRA") were changed to require banks to lend to all members of their communities, forcing banks to loosen their underwriting standards and approve loans with subprime borrowers).

[66] Definition of conservatorship: "a circumstance in which the court declares an individual unable to take care of legal matters and appoints another individual, known as a conservator, to do so." *Conservatorship Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/c/conservatorship.asp#axzz1uZs9wLQt.

[67] David Ellis, *U.S. Seizes Fannie and Freddie*, CNN MONEY (Sept. 8, 2008, 8:28 PM), http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm.

[68] Stephanie Armour & James R. Healy, *Taxpayer take on trillions in risk in Fannie, Freddie takeover*, USA TODAY (Oct. 20, 2008, 9:40 PM), http://www.usatoday.com/money/economy/housing/2008-09-07-fannie-freddie-plan_N.htm

[69] Edmund L. Andrews & Stephen Labaton, *In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. TIMES (Sept. 7, 2008), http://www.nytimes.com/2008/09/08/business/08fannie.html?pagewanted=all\.

[70] *Id.*

and the attached interests.[71] Even though the government stepped in to help cover the losses at Fannie Mae and Freddie Mac, the impact of the defaults on mortgages stemming from failed government policies had major effects on housing prices, consumer confidence, consumer purchasing power, and the degradation of neighborhoods throughout the United States.[72]

In September 15, 2008, as the financial crisis continued to spiral out of control, Lehman Brothers Holdings Inc. ("Lehman Brothers"), a 158-year-old investment bank, undermined by bad bets in the real estate and derivatives markets, and by short-selling,[73] was forced to file for Chapter 11 bankruptcy when it was unable to find a buyer to rescue the company from collapse.[74] President Bush stated that the U.S. government would not continue to provide emergency financial bailout packages to Wall Street, and that no form of government aid would be provided to Lehman Brothers.[75] After Barclay's Bank and Bank of America backed out of talks to purchase Lehman Brothers, the Lehman Brothers Board of Directors had no choice but to file for bankruptcy protection.[76]

Immediately following the collapse of Lehman Brothers, the U.S. government took control of AIG, one of the world's largest insurers, with an $85 billion bailout package.[77] The reason that the U.S. government bailed out AIG in the wake of letting Lehman Brothers collapse was that federal officials viewed AIG as "too big to fail"[78] and too widely interconnected with global

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[71] Charles Duhigg, *U.S. Likely to Keep the Reins on Fannie and Freddie,* N.Y. TIMES (Mar. 2, 2009), http://www.nytimes.com/2009/03/03/business/03mortgage.html.

[72] Les Christie, *The Next Wave of Mortgage Defaults*, CNN MONEY (Aug. 16, 2008, 4:34 PM), http://money.cnn.com/2008/08/12/real_estate/prime_defaults_price_drops/index.htm (Greenspan claimed that "the benefits of broadened home ownership" justified the risks of unregulated lending, but even though most of the subprime lending took place between 2004 and 2006, as of early 2008, homeownership levels were back down to the levels prior to 2003).

[73] Definition of short selling: "the selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short." *Short Selling Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/s/shortselling.asp#axzz1uZs9wLQt.

[74] Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES (Sept. 14, 2008), http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all.

[75] MSNBC News Services, *Wall Street scrambles as Lehman, Merrill falter*, MSNBC.COM (Sept. 15, 2008, 5:54 AM), http://www.msnbc.msn.com/id/26709927/ns/business-us_business/t/wall-street-scrambles-lehman-merrill-falter/.

[76] David Ellis, *Wall Street on Red Alert*, CNN MONEY (Sept. 18, 2008, 4:40 AM), http://money.cnn.com/2008/09/14/news/companies/lehman_brothers/.

[77] Matthew Karnitsching, Jon E. Hilsenrath, Liam Pleven & Deborah Soloman, *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, THE WALL ST. J. (Sept. 16, 2008), http://online.wsj.com/article/SB122156561931242905.html.

[78] Alton E. Drew, *Banks 'Too Big to Fail'? Wrong*, BLOOMBERG BUSINESSWEEK (Feb. 18, 2009, 8:48 PM), http://www.businessweek.com/bwdaily/dnflash/content/feb2009/db20090218

financial markets.[79] The majority of AIG's problems stemmed from being forced to come up with huge amounts of collateral due to over-exposure to complex derivatives called credit default swaps or "CDS's,"[80] which some believed threatened to bring down the derivatives division of AIG and, potentially, the entire company and the global economy along with it.[81] Two months after the initial AIG bailout, the U.S. government extended an additional $85 billion in emergency funds, bringing the total bailout to $150 billion.[82] At this point, it was clear that the financial crisis would not only involve the U.S. government, Wall Street, and Main Street, but also the global economy.

Public and institutional panic was now in full swing and a series of rapid-fire events continued to deepen the financial crisis. For example, money market funds, characterized as a low-risk safe haven to put money, "broke the buck"[83] and began to raise questions from ordinary people as to where money should be stored and invested.[84] Morgan Stanley, a large investment bank, feared that it would fail next and reached out to its 8,000 financial advisers in an attempt to reduce investors' worries about its falling stock price, severe market volatility, and possible merger with several other financial institutions.[85] Additionally, Washington Mutual, the largest U.S. savings and loan association, went into receivership under the Federal

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_166676.htm (describing too-big-to-fail as financial institutions that are so large and so interconnected that their failure will be disastrous to an economy. Proponents of this theory believe that these institutions should become recipients of beneficial financial and economic policies from governments or central banks to keep them alive and prevent them from going out of business. Others contend that these large financial institutions should go out of business and not be rescued if they do not have effective risk management in place).

[79] Justin Fox, *Why the Government Wouldn't Let AIG Fail*, TIME BUSINESS (Sept. 16, 2008), http://www.time.com/time/business/article/0,8599,1841699,00.html.

[80] Definition of credit default swap: "a swap designed to transfer the credit exposure of fixed income products between parties." *Credit Default Swap Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/c/creditdefaultswap.asp#axzz1uZs9wLQt .

[81] Mark Felsenthal & Lilla Zuill, *AIG gets $150 billion government bailout; posts huge losses*, REUTERS (Nov. 10, 2008, 2:28 PM), http://www.reuters.com/article/2008/11/10/us-aig-idUSTRE4A92FM20081110.

[82] *Id.*

[83] Definition of "breaking the buck": "when the net asset value (NAV) of a money market fund falls below $1. Breaking the buck can happen when the money market fund's investment income does not cover operating expenses or investment losses. This normally occurs when interest rates drop to very low levels, or the fund has used leverage to create capital risk in otherwise risk-free instruments." *Breaking the Buck Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/b/breaking-the-buck.asp#axzz1uZs9wLQt.

[84] Tara Siegel Bernhard, *Money Market Funds Enter a World of Risk*, N.Y. TIMES (Sept. 17, 2008), http://www.nytimes.com/2008/09/18/business/yourmoney/18money.html.

[85] *Morgan Stanley Execs Tell Advisers: Calm Clients' Fears*, WALL STREET JOURNAL CRISIS ON WALL STREET BLOG (Sept. 18, 2008, 4:15PM), http://blogs.wsj.com/wallstreetcrisis/2008/09/18/morgan-stanley-execs-tell-advisers-calm-clients-fears/.

Deposit Insurance Corporation ("FDIC") and was subsequently purchased by JPMorgan Chase after suffering subprime mortgage related losses, a 95% decline in stock price over a fifty-two week period, and a credit ratings downgrade.[86] Wachovia, a large U.S. bank, amidst an inability to remain viable, was sold to Citigroup for $1 per share, which concentrated the U.S. banking power in the hands of only six large institutions: JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley.[87]

In response to the perceived threat of a domino-like collapse of failing financial institutions, Treasury Secretary Henry Paulson proposed and implemented the Troubled Asset Relief Program ("TARP").[88] TARP was a proposal by the government to get bad mortgages off of the balance sheets of large financial institutions in order to allow lenders to continue producing new loans and generating activity in the financial markets.[89] As housing prices continued to fall and overleveraged banks attempted to shore up balance sheets, falling share prices of companies and stringent lending conditions sent a wave of panic and fear through the financial markets that caused the worst recession in the United States since the Great Depression.[90] Each traumatic event seemed to bring more government intervention than the previous one, but not without a greater risk of unintended consequences.[91] Arguably one of the largest causes of the financial crisis was

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86 Marcy Gordon, Sara Lepro, & Madlen Read, *JPMorgan Chase Buys WaMu Assets after FDIC Seizure*, HUFFINGTON POST (Sept. 25, 2008, 11:59 PM), http://www.huffingtonpost.com/2008/09/25/jp-morgan-to-buy-wamu-ass_n_129451.html.

87 Andrew Ross Sorkin, *Citigroup to Buy Wachovia's Bank Assets for $1 a Share*, N.Y. TIMES (Sept. 29, 2008, 7:33 AM), http://dealbook.nytimes.com/2008/09/29/citigroup-nears-a-deal-for-wachovia/.

88 Politico Staff, *Paulson's Rescue Plan is Called TARP*, POLITICO (Sept. 19, 2008, 10:17 AM), http://www.politico.com/news/stories/0908/13609.html (Henry Paulson stated the reasons behind why the TARP program was needed and how it would relieve stress on the financial markets and U.S. economy: "The federal government must implement a program to remove these illiquid assets that are weighing down our financial institutions and threatening our economy. TARP must be properly designed and sufficiently large to have maximum impact, while including features that protect the taxpayer to the maximum extent possible. The ultimate taxpayer protection will be the stability that TARP provides to our financial system, even though it will involve a significant investment of taxpayer dollars.").

89 *Id.*

90 Jon Hilsenrath, Serena Ng & Damian Paletta, *Worst Crisis Since '30s, With No End Yet in Sight*, WALL ST. J. (Sept. 18, 2008), http://online.wsj.com/article/SB122169431617549947.html (colorfully describing the financial crisis and its impact on the U.S. economy: "The U.S. financial system resembles a patient in intensive care. The body is trying to fight off a disease that is spreading, and as it does so, the body convulses, settles for a time and then convulses again. The illness seems to be overwhelming the self-healing tendencies of the markets. The doctors in charge are resorting to ever-more invasive treatment, and are now experimenting with remedies that have never before been applied.").

91 *Id.*

the huge volume of mortgage payment defaults and foreclosures, precipitated by many years of abusive and predatory mortgage lending practices by both lenders and borrowers.

B. Key Predatory Mortgage Lending Practices as a Major Cause of the Financial Crisis

A majority of analysts believe that one of the largest causes of the 2008 financial crisis in the United States involved the predatory mortgage lending practices of many financial institutions which ultimately drove many homeowners into foreclosure as the crisis began to accelerate. The National Community Reinvestment Coalition points to failed regulatory and oversight policies as having produced unfair, deceptive, and abusive mortgage lending practices.[92] Major deceptive and abusive lending practices included inflated property appraisals, large mortgage broker fees, abusive prepayment penalties, risky and irresponsible loan products, fraud in servicing the loan products, and ineffective underwriting standards.[93] Additional predatory lending practices included: borrowers being encouraged to lie on loan applications and to inflate their income in order to qualify for loans, introductory ARM's with interest rates that reset to significantly higher rates, prepayment penalties that made it costly to refinance a loan, and encouragement to refinance and/or borrow against the equity in one's residence in order to get cash.[94]

The dangers of unfair, abusive and deceptive mortgage lending practices were predicted by many public and private organizations, economists, and even a few legal scholars, but were essentially ignored by federal regulatory agencies.[95] For example, in 2000, Lyle Gramlich, Federal

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[92] Press Release, National Community Reinvestment Coalition, Statement from National Civil Rights, Consumer, Community Development and Housing Groups Regarding Attacks on the Community Reinvestment Act (CRA) (Oct. 13, 2008), http://www.nclc.org/images/pdf/foreclosure_mortgage/predatory_mortgage_lending/pr_cra-statement-oct08.pdf (pointing out that for more than a decade there have been major concerns among community and civil rights leaders that unfair, deceptive, and abusive lending practices have undermined homeownership aspirations for many Americans. They also contend that proper regulatory policies and oversight were ignored by the government. They argue that in some cases, regulations and policy made it easier to embrace predatory lending practices in low-income neighborhoods and communities of color).

[93] James H. Carr, Nat'l Cmty. Reinvestment Coal., Speech at the NAACP Annual National Convention in Cincinnati, Ohio: Understanding the Foreclosure Crisis: Don't Believe the Hype! 4 (July 14, 2008), http://assetfunders.org/library/documents/jamescarrnaacpremarks.pdf.

[94] COMMUNITY HEALTH LAW PROJECT, PREDATORY LENDING PRACTICES AND WHAT TO DO IF YOU ARE AT RISK OF FORECLOSURE (2008-2009), *available at* http://www.chlp.org/docs/predlending.pdf.

[95] James H. Carr & Kate Davidoff, *Legislative and Regulatory Responses to the Foreclosure Crisis*, 17 J. AFFORDABLE HOUS. & CMTY DEV. L. 283, 288 (2008) (arguing that the Federal

Reserve Governor from 1997-2005, proposed to Alan Greenspan, Chairman of the Federal Reserve, that the Federal Reserve use its power to send examiners to the offices of lenders who were part of the government regulated bank holding companies.[96] In response, Greenspan purportedly rejected this proposal for increased regulatory scrutiny, ultimately contributing to the massive volume of foreclosures.[97]

While the majority of government and industry officials view "government regulatory weakness, Wall Street avarice, and corporate incompetence"[98] as the primary causes of the financial crisis, there are critics who hold different views.[99] Regarding predatory mortgage lending, some critics contend that mortgage fraud by lenders was not a primary cause of the financial crisis, but rather was simply a contributing factor to the crisis and a result of the housing bubble.[100] Additionally, others argue that mortgage lenders were not primarily responsible for creating and building up the arsenal of subprime loans,[101] but rather, that the subprime loan problem was a result of predatory borrowers who sought out loans they could not afford.[102] In support of this notion, critics argue that the extent to which subprime loans were pushed onto borrowers was never known and that the real problem was borrowers who manipulated the home mortgage

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Reserve Board never fully exercised their power to reduce and prohibit unfair and deceptive mortgage lending practices from plaguing consumers).

[96] Greg Ip, *Did Greenspan Add to Subprime Woes?*, WALL ST. J. (June 9, 2007), http://online.wsj.com/article/SB118134111823129555.html (Lyle Gramlich stated that Greenspan blocked a proposal to increase scrutiny of subprime lenders under the Fed's broad authority. That added scrutiny might have helped curtail questionable lending practices now blamed for soaring defaults by mostly low-income borrowers).

[97] *Id.* (Alan Greenspan defended his response by saying that there are a large number of small financial institutions and it would be extremely difficult, if not impossible, for the Federal Reserve to detect when they are doing something wrong. Furthermore, he stated that he did not think that it would have been worthwhile for the Federal Reserve to go in and audit all of these small institutions and their mortgage lending practices because they probably would not have been able to find out any significant information).

[98] Sewell Chan, *Dissenters Fault Report on Crisis in Finance*, N.Y. TIMES (Jan. 26. 2011), http://www.nytimes.com/2011/01/27/business/economy/27inquiry.html.

[99] *Id.*

[100] Angelides, *supra* note 8 at 424 (stating that questionable lending standards were much more likely to be responsible for creating so many bad mortgages, not mortgage fraud. Due to low lending standards, it is likely that the housing bubble would still have occurred even if there had been no mortgage fraud).

[101] *Id*. at 447 (highlighting that the view of predatory lending might be a good explanation for the subprime financial crisis if there was actually evidence that showed predatory lending to be so pervasive and widespread as to have produced the volume of high risk loans that were found to have been originated).

[102] *Id.* (stating that predatory borrowers took advantage of poor mortgage underwriting standards to gain and benefit from mortgages they knew they could not afford, unless they were able to sell for more than they borrowed or refinance and draw additional equity out of their house).

market.[103] These critics contend that the best response by the government would have been even less involvement and regulation in the mortgage markets; not the implementation of new regulations.[104]

Despite these views, a lack of regulation and oversight opened the door to predatory lending practices by greedy and unscrupulous subprime mortgage lenders, which led to a massive foreclosure crisis that spread like wildfire throughout the economy. In the aftermath of the financial crisis, voters demanded answers and changes in an effort to better understand how to avoid a similar financial catastrophe in the future.

III. DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

A. Overview and Key Provisions Related to Predatory Mortgage Lending

In response to the financial crisis, Rep. Barney Frank, Chairman of the House Financial Services Committee, presented a proposed legislation to the House of Representatives on December 2, 2009. That same day, Sen. Christopher Dodd, Chairman of the Senate Banking Committee, did the same in the Senate.[105] These bills became the Dodd-Frank Act, which was signed into law by President Obama on July 21, 2010, impacting nearly the entire American financial services industry.[106] The Dodd-Frank Act addresses a wide range of topics, including key provisions such as: (1) consumer protections; (2) systemic risk oversight; (3) executive compensation regulation; (4) bank capital requirements; (5) ending "too big to fail" bailouts; (6) transparency and accountability relating to complex financial instruments; (7) enforcement of current regulations; (8) reform of the Federal Reserve; (9) mortgage lending reform; (10) hedge fund oversight; (11) control over credit rating agencies; (12) reform of insurance regulations

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[103] Eli Lehrer, *Subprime Borrowers: Not Innocents*, BLOOMBERG BUSINESS WEEK, http://www.businessweek.com/debateroom/archives/2008/03/subprime_borrowers_not_innocents.html (stating that mortgage lenders are not only innocent of the predatory practices that borrowers complain about, but also feel the same pain that borrowers feel when a subprime loan fails and goes into foreclosure. These lenders do not prosper in these circumstances since a lender typically loses one third of its loan value when a foreclosure happens. Therefore, lenders do not have an incentive to make or purchase loans that it genuinely believes a borrower cannot repay. However, unlike borrowers, predatory lenders were able to sell the loans through securitization to reduce their exposure to risk).

[104] *Id.*

[105] Damian Paletta, *It Has a Name: The Dodd/Frank Act*, WSJ BLOGS (June 25, 2010, 6:06 AM), http://blogs.wsj.com/washwire/2010/06/25/it-has-a-name-the-doddfrank-act/.

[106] William Sweet, *Dodd-Frank Act Becomes Law,* THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (July 21, 2010, 11:49 AM), http://blogs.law.harvard.edu/corpgov/2010/07/21/dodd-frank-act-becomes-law/.

and investor protections; and (13) addressing securitization and municipal securities.[107]

In an effort to provide better consumer financial protection, the Dodd-Frank Act contains two sections that largely overhaul the consumer lending landscape in the United States and greatly increase the level of scrutiny over government providers of consumer financial services. These are: (1) Title X, known as the Consumer Financial Protection Act of 2010,[108] which creates the Consumer Financial Protection Bureau ("CFPB"), to provide major structural changes to the regulation and enforcement of financial consumer protections;[109] and (2) Title XIV, known as the Mortgage Reform and Anti-Predatory Lending Act,[110] which creates new substantive changes for a variety of consumer financial products, most notably of which are mortgage loans.[111] The discussion below specifically addresses how the Dodd-Frank Act attempts to combat and curtail past consumer predatory and abusive lending practices in the wake of the financial crisis.

B. New Substantive Consumer Protection Requirements Related to Mortgage Lending

Title XIV of the Dodd-Frank Act encompasses the Mortgage Reform and Anti-Predatory Lending Act[112] ("MRAPLA"), which in turn substantially amends the Truth in Lending Act ("TILA"), the Real Estate Settlement Procedures Act ("RESPA"),[113] and the Home Ownership and Equity Protection Act[114] ("HOEPA"). Many of these amendments took effect when

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[107] *See* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[108] *Id.* at § 1001.
[109] *Id.* at § 1011.
[110] *Id.* at § 1400.
[111] Zachary Best, Nina Simon, & Linda Singer, *Breaking Down Financial Reform*, 14 no. 2 J. Consumer & Com, L., 2, 6 (Sept. 2010), http://www.jtexconsumerlaw.com/V14N1/V14N1 _Financial.pdf.
[112] Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, SOCIAL, SCIENCE RESEARCH NETWORK (Oct. 8, 2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=192 4831 (this section of The Dodd-Frank Act is classified as Enumerated Consumer Law and will primarily focus on standardizing data collection for underwriting loans as well as put new obligations on originators to only lend to borrowers who are likely to repay their loan based on various criteria).
[113] Lynnley Browning, *Curbing Closing Costs*, N.Y. TIMES (Jan. 30, 2011), http://nylsblog.com/ tag/truth-in-lending-act (prior to its Dodd-Frank amendments, the Truth In Lending Act from 1968 gave borrowers the ability to undo a home refinancing or home equity loan within three years if the lender did not make proper disclosures. Disclosure is usually one of the only protections for borrowers in the home mortgage market).
[114] Craig Torres, *Fed Opposes Stripping Power Over Consumer Lending (Update 1)*, BLOOMBERG (June 18, 2009, 11:24 AM), http://www.bloomberg.com/apps/news?pid=newsarchive &sid=atu6O_F8GJRg (in 1994, Congress enacted the Home Ownership and Equity Protection Act, or HOEPA, to amend the Truth in Lending Act, or TILA, and respond to anecdotal

the Dodd-Frank Act was enacted, but some of these provisions will require further definition through rulemaking.[115]

1. Dodd-Frank Act Substantive Amendments to the Truth in Lending Act and the Real Estate Settlement Procedures Act

The MRAPLA amended TILA to prevent home mortgage lenders from receiving compensation for originating a loan based on the specific variable terms of each loan, other than the principal amount of the loan.[116] This included banning yield-spread premiums, which are payments received by mortgage brokers from loan originators in exchange for guiding consumers towards loans with riskier terms or higher interest rates.[117] The only exception to this ban is when the originator does not receive any compensation directly from the consumer and the consumer does not make any upfront payments other than standard third-party charges.[118]

Additionally, amendments to TILA create a class of "qualified mortgages" which encourage lenders to move to "plain vanilla" mortgages by guaranteeing that this special class of loans meets the strict new regulatory guidelines.[119] In order for a loan to be considered a "qualified mortgage," the following basic criteria must be met: (1) regular payments do not result in negative amortization[120] or allow payments to be deferred; (2) no balloon payments; (3) qualifying income and financial resources are verified and documented; (4) reliable underwriting standards are used to determine affordability of the loan; (5) compliance with debt-to-income ratio guidelines and other metrics that confirm a borrower's ability to repay the loan; and (6) total points and fees of the loan do not exceed 3% of the principal amount.[121]

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evidence of abusive lending practices in the home-equity lending market and govern the part of TILA that specifically deals with high-cost mortgages).

[115] *See* § 1400(c) of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (highlighting that all of the regulations and amendments under the Mortgage Reform and Anti-Predatory Lending Act must be finally determined and implemented no later than 18 months after their designated transfer date and no later than 12 months after their date of issuance).

[116] *See* § 1403 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[117] Meena Thiruvengadam, *Fed Unveils Slew of Mortgage Rules*, WSJ BLOGS (Aug. 16, 2010, 3:31 PM), http://blogs.wsj.com/economics/2010/08/16/fed-unveils-slew-of-mortgage-rules/.

[118] *See* § 1403 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[119] *Id.* at § 1414.

[120] Definition of negative amortization: "an increase in the principal balance of a loan caused by making payments that fail to cover the interest due. The remaining amount of interest owed is added to the loan's principal amount, ultimately causing the borrower to owe more money." *Negative Amortization Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/n/negativeamortization.asp#axzz1uZs9wLQt (last visited May 6, 2012).

[121] Best, Simon & Singer, *supra* note 111, at page 6.

Prior to the financial crisis, over 80% of the subprime loans had prepayment penalty[122] provisions that allowed lenders to recoup the commissions they had paid to brokers if the borrower paid back the loan before it was due.[123] The Dodd-Frank Act prohibits prepayment penalties for loans that are not "qualified mortgages" or loans with adjustable interest rates.[124] Also, the Dodd-Frank Act limits prepayment penalties for fixed rate mortgages and prevents fixed rate mortgages with prepayment penalties from being offered to a prospective borrower unless a fixed rate loan without a prepayment penalty is also offered.[125] This represents a major change from past practices in the home mortgage-lending arena.[126]

Other provisions seek to protect consumers from predatory mortgage practices. The Dodd-Frank Act requires mortgage lenders to determine, based on verified and documented evidence, that the consumer has a reasonable ability to repay the loan,[127] and to require any mortgages that have a negative amortization, like option ARM's[128] to include certain

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[122] Definition of prepayment penalty: "a clause in a mortgage contract that says if the mortgage is prepaid within a certain time period, a penalty will be assessed. The penalty is usually based on a percentage of the remaining mortgage balance or a certain number of months worth of interest." *Prepayment Penalty Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/p/prepaymentpenalty.asp#axzz1uZs9wLQt (last visited May 6, 2012).

[123] *See* Eric Stein, *Quantifying the Economic Cost of Predatory Lending*, COALITION FOR RESPONSIBLE LENDING (July 25, 2001), http://www.selegal.org/Cost%20of%20Predatory%20Lending.pdf

[124] *See* § 1414 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[125] *Id.* at § 1423.

[126] Bill Thomas, *What is Predatory Lending?*, MORTGAGE NEWS DAILY (Nov. 16, 2011), http://www.mortgagenewsdaily.com/mortgage_fraud/Predatory_Lending.asp (stating that while roughly 2% of conventional, non-subprime mortgages have an abusive prepayment penalty, nearly 80% of subprime mortgages contain a predatory prepayment penalty. When subprime borrowers would take out a subprime loan, if they ever wanted to refinance after rebuilding their credit, these prepayment penalties would prevent them from doing so by essentially draining any available equity in the house. This was a common practice that was aimed at keeping subprime borrowers locked in to the mortgage they had taken, preventing them from refinancing or getting out).

[127] *See* § 1411 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (in determining whether a borrower can repay, the lender must consider and include the borrower's credit history, income, obligations, debt-to-income ratio, employment status, and other relevant factors while using a fully amortizing payment schedule. Prior to the financial crisis, lenders qualified home mortgage borrowers at the initial, introductory teaser rate which allowed the loan to be made and then sold on the secondary market. Today, legitimate lenders can shield themselves by triggering a rebuttable presumption that borrowers have an ability to pay their qualified mortgages).

[128] Definition of Payment Option ARM: "a type of mortgage where the mortgagor (borrower) has several options as to which type of payment is made to the mortgagee (lender). In addition to having the choice of making payments of interest and principal that amounts to those made in conventional mortgages, option ARM's also have alternative payment options where the mortgagor can make significantly smaller payments by making

disclosures.[129] The Dodd-Frank Act also amends RESPA by requiring that lenders make various types of disclosures to borrowers[130] and create an escrow account for taxes and insurance for residential mortgages.[131] Additionally, mortgage servicers are now banned from imposing force-placed insurance on borrowers who they think have not maintained hazard insurance as required by the mortgage contract.[132] The Dodd-Frank Act also amends TILA and RESPA to protect borrowers from foreclosure actions

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interest-only payments or minimum payments." *Payment Option ARM Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/p/paymentoptionarm.asp#axzz1uZs9wLQt.

[129] *See* §§ 1414-1420 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (requiring the disclosure to state: (1) the loan, once issued, could result in negative amortization; (2) negative amortization increases the principle balance on the loan; and (3) negative amortization decreases the amount of equity in the borrower's property. Also, lenders cannot require borrowers to make up the difference between the foreclosure amount and the remaining balance on the loan, unless allowed under state law. Other disclosure requirements mandated under the TILA amendments include disclosures required on monthly mortgage statements, notice that an ARM loan with a temporary fixed rate will reset, and notice of any loss of protection under state laws from provisions requiring borrowers to pay the difference between the foreclosure amount and remaining balance on the loan).

[130] *Id.* at §§ 1418-1420 (stating that under RESPA, lenders and servicers are required to give six months advance written notice to a borrower before their mortgage interest rate switches from a fixed interest rate to a variable interest rate. The new Dodd-Frank Act disclosures now require lenders to show the borrower how the new interest rate will be calculated, make a good faith estimate of what the new monthly payment will be, and disclose all of the borrower's available alternatives before the interest rate adjusts upward. Lenders are also required to make certain disclosures on the monthly mortgage statements (or on a separate disclosure document) including, but not limited to the: (1) principal balance owed; (2) date of the interest rate adjustment; (3) prepayment penalty fees (if any); (4) late payment fees (if any); (5) lender direct contact information; and (6) borrower counseling contact information).

[131] *Id.* at § 1461 (preventing borrowers from unknowingly refinancing a mortgage to reduce their monthly payment, only to learn that, with taxes and insurance included, the monthly payment is larger than before).

[132] *Id.* at § 1463 (describing force-placed insurance as insurance taken out by a creditor for an uninsured debtor on a property placed as collateral. This refers to (1) the hazard insurance purchased by a servicer on a borrower's home or property when the policy purchased directly by the borrower on a non-escrow mortgage account has lapsed; (2) when a mortgage servicer contends that the borrower has failed to provide proof of insurance coverage; or (3) when the account is in default. This is general liability insurance for residential and commercial properties and foreclosed properties. Force-placed insurance is very expensive and when forced onto borrowers by mortgage servicers, this can lead to the borrower having to default or go into foreclosure on the loan due to the inability to cover the increased monthly insurance cost. The Dodd-Frank Act requires that mortgage servicers only impose the force-placed insurance if they have a "reasonable belief" that the borrower has failed to maintain the insurance and if the servicer has met the procedural requirements to impose such insurance).

brought by lenders if the lender has used certain abusive lending practices in making the loan.[133]

2. Dodd-Frank Act Substantive Amendments to the Home Ownership and Equity Protection Act

In addition to amending other sections of TILA, the Dodd-Frank Act makes substantive changes to the high-cost mortgage provisions of TILA that are regulated under HOEPA and expands HOEPA's reach to protect consumers in new ways.[134] The Dodd-Frank Act lowers the loan-pricing threshold at which HOEPA regulations will apply, requiring more loans to conform to the amended regulations and new requirements.

Instead of HOEPA only applying to certain types of loans, it has been expanded to cover all types of loans that are secured by the borrower's primary residence, except for reverse mortgages.[135] This brings HOEPA regulations more in line with some of the state mandatory mortgage regulations and helps to standardize protection for all borrowers.[136] Additionally, HOEPA now requires all borrowers to undergo pre-loan counseling before they take out a loan that qualifies under HOEPA.[137] Prior to the financial crisis, if borrowers had been required to receive pre-loan counseling, many of them would have been notified about lower-cost loan programs and would have been able to determine how much money they needed to borrow rather than simply accepting the lender's first offer.[138] This might very well have averted many abusive and predatory lending practices.

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[133] *Id.* at § 1416 (stating that unlike a standard claim and defense which is regulated by a statute of limitations, borrowers who are subject to predatory, abusive practices by their lender are not time barred by any statute of limitations in asserting their defense to a foreclosure action by the lender. The availability of a borrower to assert a defense at any time for subprime loans should reduce the secondary financial markets' interest in purchasing non-qualified, subprime loans. Also, the damage caps placed on certain TILA violations was increased from $500,000 to $1,000,000 for class action law suits brought against lenders. The damage caps placed on RESPA mortgage servicing violations were increased to $1,000,000 for class action law suits and $2,000 for individual law suits).

[134] Best, Simon & Singer, *supra* note 111, at 9.

[135] *See* § 1431 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[136] Dennis P. Ryan, *New Origination Requirements Under the Dodd-Frank Act*, AMCFIRST, http://www.amcfirst.com/page/Dodd-Frank-Act-.aspx.

[137] *See* § 1433 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[138] Norma P. García, *Comments by Norma P. García at the Hearing Before the Federal Reserve Board of Governors Predatory Lending Practices,* CONSUMER UNION (Sept. 7, 2000), http://www.consumersunion.org/finance/predatorywc900.htm.

3. *New Structural Changes to the Regulation and Enforcement of Consumer Financial Protections via Implementation of the Dodd-Frank Act Consumer Watchdog*

The Dodd-Frank Act created the Consumer Financial Protection Bureau ("CFPB") which serves as the primary regulatory authority over consumer financial products and almost every consumer financial protection statute in the United States.[139] The CFPB's primary mission is to police activities relating to financial products and services for possible predatory, abusive, and unfair practices and to examine depository and non-depository financial institutions for regular compliance with federal consumer financial laws.[140] The CFPB is charged with acting as a consumer watchdog and ensuring that markets in consumer financial products are fair, transparent, and competitive.[141] The CFPB is housed within and receives its funding from the Federal Reserve, but the Federal Reserve has no power over CFPB officers or the ability to control its rules or orders.[142]

Even though the CFPB is an independent agency, it is created by the merger of several consumer financial regulatory departments from: (1) the Federal Reserve; (2) the Office of Thrift Supervision; (3) the FDIC; (4) the Office of the Comptroller of the Currency; (5) the National Credit Union Administration; and (6) the U.S. Department of Housing and Urban Development ("HUD").[143] All of these departments transferred their consumer financial protection powers and employees to the CFPB.[144]

Much of the CFPB's power comes from the application of the "abusive" standard.[145] Prior to the Dodd-Frank Act, federal regulators had the authority to ban activities or practices that were deemed "unfair or deceptive," but adding the word "abusive" greatly expands the type of misconduct that can be regulated.[146] This broad grant of authority to the CFPB gives it the

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139 Beth DeSimone, Jeremy Hochberg, Brian Larkin, & Michael Mierzewski, *The Dodd-Frank Act Establishes the Bureau of Consumer Financial Protection as the Primary Regulator of Consumer Financial Products and Services*, 127 BANKING L.J. 722, 1 (2010).
140 *Id.*
141 *See* § 1021 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
142 Amanda L. Wait, *The New Bureau of Consumer Financial Protection—An Overview*, 4.5 THE ANTITRUST COUNS. (Sept. 2010), http://www.hunton.com/files/Publication/ca26910d-6ecd-4108-86a8-431f3e390fc5/Presentation/PublicationAttachment/a06c15de-97ef-4997-b898-c5190e5f6cf0/Antitrust_Counselor_Sept_2010.pdf.
143 *See* § 1061 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
144 *Id.*
145 *See* § 1031 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (stating that the CFPB is authorized to take any action to prevent a credit or service provider from committing or engaging in unfair, deceptive or abusive acts or practices in connection with a consumer financial product).
146 Tiffany S. Leeal, *No More Abuse: The Dodd-Frank and Consumer Financial Protection Act's "Abusive" Standard*, 14 J. CONSUMER & COM. L 118 (2011).

potential power to increase protection of consumers in the financial marketplace.[147]

When President Obama signed the Dodd-Frank Act into law, the CFPB was scheduled to assume consumer financial protection powers on July 21, 2011.[148] Charged with the mission of being the primary consumer watchdog among financial and related products in the marketplace, there are several notable areas in which the CFPB has concentrated its efforts in order to begin fulfilling its mandate to increase consumer protection. For example, Elizabeth Warren, charged with setting up the CFPB, traveled throughout the United States to meet with consumers, bankers, and public interest groups to gather input on potential consumer protection regulations.[149] Furthermore, on its one-year anniversary, both the Federal Reserve and the Department of the Treasury Inspector Generals reported no criticisms of the CFPB's preliminary efforts over the past year.[150] As the CFPB continues to develop, consumer groups have encouraged the CFBP to create substantive protections in a number of key areas including: bank overdraft loans,[151] fees

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[147] Desimone, Hochberg, Larkin, & Mierzewski, *supra* note 139 (stating that the chief areas that give the CFPB its power include: (1) an independent director as opposed to a commission of directors; (2) the definition of "covered persons," giving it power to regulate and police a broad group of people and institutions in the financial industry; (3) a broad and expansive rulemaking authority related to financial regulation; (4) the ability to assess existing financial regulations currently in place; (5) the ability to proactively educate consumers as to the various risks related to financial products; (6) broad examination authority over depository and non-depository financial institutions; and (7) the ability to increase damage penalties for financial institutions that violate consumer financial laws).

[148] Drake Bennett & Carter Dougherty, *Elizabeth Warren's Dream Becomes a Real Agency She May Never Get to Lead*, BLOOMBERG (July 7, 2011, 2:01 PM), http://www.bloomberg.com/news/2011-07-07/elizabeth-warren-s-dream-becomes-a-consumer-bureau-she-may-never-lead.html.

[149] Dana Milbank, *Elizabeth Warren's Winning Formula*, WASHINGTON POST (Oct. 28, 2011), http://www.washingtonpost.com/opinions/elizabeth-warrens-winning-formula/2011/10/28/gIQAjNSIPM_story.html (stating that the CFPB's website is unusually accessible as compared with other federal agencies, emphasizing its clear language and offering the public opportunity to comment on new rules and regulations. For example, when the CFPB created new mortgage disclosure prototype forms, it posted the form on its website and received thousands of suggestions).

[150] *Review of CFPB Implementation Planning Activities*, OFFICES OF INSPECTOR GENERAL, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND BUREAU OF CONSUMER FINANCIAL PROTECTION, DEPARTMENT OF THE TREASURY, FRB OIG 2011-03, OIG-11-088, (July 15, 2011), *available at* http://www.federalreserve.gov/oig/files/OIG_2011_Review_of_CFPB_Implementation_Planning_Activities.pdf(stating that the CFPB identified the activities it had to undertake to meet its Dodd-Frank Act obligations, that it was developing and implementing appropriate plans to meet its mandates, and that it was communicating its plans effectively to employees and financial regulators with which it must collaborate).

[151] George Gombossy, *Bank Consumer Traps and Tricks Continue Despite Congressional Financial Reform*, CTWATCHDOG.COM (Mar. 16, 2011, 12:41 PM), http://ctwatchdog.com/2011

and protections relating to prepaid credit cards, and wrongful foreclosure and abusive mortgage servicer practices.[152]

However, despite the Dodd-Frank Act's efforts to increase consumer protection in the financial marketplace, a number of existing and emerging predatory practices continue to threaten consumers. The Dodd-Frank Act, through the CFPB, must have the ability to effectively, efficiently, and swiftly respond to these predatory practices in order to better protect consumers, help to stave off a double-dip recession,[153] and to restore safety and security within the financial industry in order to avoid a future financial crisis.

IV. Current Predatory Practices that Continue to Threaten Economic Recovery and Consumer Safety in the Financial Marketplace

Even after the many trials and tribulations experienced by financial institutions and consumers as a result of the financial crisis, significant predatory practices directed at consumers continue to threaten their safety in the financial marketplace and the overall health of the economic recovery.[154] These predatory practices do not appear to be regulated or controlled by the Dodd-Frank Act.[155]

/03/16/bank-consumer-traps-tricks-continue-despite-congressional-financial-reform (stating that banks continue to charge steep and multiple fees for overdraft loans, requiring immediate repayments, and they take payment first out of account holders' next pay deposit, before other debits are paid. Some banks also continue to manipulate the order in which they pay debits to consumers in order to increase the number of overdrafts that occur and the amount of fees consumers must pay).

[152] Nick Timiraos & Alan Zibel, *Reviews Begin for Borrowers Disputing Foreclosures*, WALL ST. J. (Nov. 2, 2011), http://online.wsj.com/article/SB10001424052970203707504577012130 274478996.html (some banks have acknowledged that they have foreclosed on active-duty military families and overcharged many others in violation of federal law. Additionally, millions of homeowners have been harmed by the fraudulent and abusive practices of mortgage servicers whose staff are trained for collection activities instead of loss mitigation, whose infrastructure cannot handle the volume and intensity of the demand, and whose business records are a mess).

[153] Definition of double-dip recession: "when gross domestic product ("GDP") growth slides back to negative after a quarter or two of positive growth. A double-dip recession refers to a recession followed by a short-lived recovery, followed by another recession." *Double-dip Recession Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/d/doubledip recession.asp#axzz1uZs9wLQt.

[154] Jennifer Liberto, *Wall Street reform: A year down a bumpy road*, CNN MONEY (July 21, 2011, 5:27 AM), http://money.cnn.com/2011/07/21/news/economy/dodd_frank_reform/index. htm (stating that despite the enactment of the Dodd-Frank Act and the setup of the CFPB, great uncertainty continues to exist and many necessary reforms in mortgage regulation, the derivatives markets, and other critical areas have not taken place, leaving consumers at risk).

[155] *Id.*

Reverse mortgages,[156] which are predominantly aimed at the elderly, continue to be heavily marketed through mid-day and late night television commercials, deceptive direct mailing campaigns, and endorsements by older celebrities as a safe and secure solution to obtain cash directly from the equity of a person's home.[157] Predatory credit card offers made to subprime consumers are rising after a lull in the availability of consumer credit following the financial crisis of 2008.[158] Additionally, due to the lack of available credit,[159] more Americans are finding the need to go to payday lenders, pawn shops and local loan sharks, in part because banks and financial institutions appear to be hoarding large amounts of cash in an effort to reduce risk in the face of regulatory uncertainty. [160]

While a variety of predatory practices continue to be used by financial institutions looking to boost profits and generate new business in the short term, non-traditional predatory practices have emerged. The Dodd-Frank Act inadequately addresses these non-traditional predatory practices. Two of the most prevalent predatory practices that continue to negatively impact consumers include: (1) mortgage foreclosure and home loan modification

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[156] Definition of reverse mortgage: "a type of mortgage in which a homeowner can borrow money against the value of his or her home. No repayment of the mortgage, principal or interest, is required until the borrower dies or the home is sold. After accounting for the initial mortgage amount, the rate at which interest accrues, the length of the loan and rate of home price appreciation, the transaction is structured so that the loan amount will not exceed the value of the home over the life of the loan. Reverse mortgages have large origination costs and interest rates relative to other types of loans." *Reverse Mortgage Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/r/reversemortgage.asp#axzz 1uZs9wLQt.

[157] Anne Tergesen, *Mortgage Fraud: A Classic Crime's Latest Twists*, WALL ST. J. (Aug. 27, 2009, 10:41 AM), http://online.wsj.com/article/SB100014240529702040442045743626413381 97748.html (stating that in the wake of the subprime mortgage crisis, regulators and law enforcement officials view reverse mortgage lending as another mortgage scam aimed at consumers. Additionally, even though many lenders are taking steps to curtail abuses in the reverse mortgage market, elderly consumers are still at risk from non-traditional predators).

[158] Clinton Hultman, *Subprime consumers receiving more card offers*, CREDITCARDS.ORG (Feb. 1, 2011, 11:42 AM), http://www.creditcards.org/article/subprime-consumers-receiving-more-card-offers-800375342.html (reporting that market research firm, Synovate, found that the overall number of credit card offers rose from 1.39 billion in 2009 to 2.73 billion in 2010, showing that the credit card mailing offers targeted subprime consumers with low credit scores as the market for high credit score consumers became saturated with offers during the economic downturn. Furthermore, due to slow economic growth, banks are trying to increase the amount of new credit cards that they issue in order to grow new business and boost overall profits).

[159] Commonly referred to as the "credit crunch" or "credit crisis."

[160] Todd Zywicki, *Dodd-Frank and the Return of the Loan Shark*, WALL ST. J. (Jan. 4, 2011), http://online.wsj.com/article/SB10001424052748704735304576058211789874804.html #articleTabs%3Darticle (stating that while the Dodd-Frank Act regulates pay day lenders, the bigger issues continuing to impact consumers concern the lack of access to available credit through traditional channels such as banks and credit card companies).

programs; and (2) the increased popularity of subprime auto loans, for both consumers and investors.

A. Consumer Fraud and Abuse Relating to the Mortgage Foreclosure and Home Loan Modification Process

As a result of the massive volume of defaults[161] by borrowers on their monthly mortgage payments, banks were confronted with a huge volume of foreclosures that destabilized their balance sheets, erased profits, threatened their financial stability and had an immense impact on the entire U.S. real estate market.[162] With over one million foreclosures in 2010, banks began authorizing employees to put home mortgages into foreclosure without following proper legal procedures.[163] Banks and mortgage servicers became so overwhelmed with the volume of foreclosures that many decided to authorize the practice of "robo-signing"[164] foreclosure documents. Initially thought to have been restricted only to foreclosure documents, it was recently discovered that robo-signing practices have tainted many mortgage documents that date back as far as 1998, creating massive legal and title problems.[165]

Another form of predatory foreclosure action by banks is temporary mortgage modifications that purport to allow homeowners a permanent

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[161] Definition of default risk: "the event in which companies or individuals will be unable to make the required payments on their debt obligations. Lenders and investors are exposed to default risk in virtually all forms of credit extensions. To mitigate the impact of default risk, lenders often charge rates of return that correspond to the debtor's level of default risk. The higher the risk, the higher the required return, vice versa." *Default Risk Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/d/defaultrisk.asp#axzz1uZs9wLQt.

[162] Chris Arnold, *Major U.S. Banks Investigated For Foreclosure Fraud*, NATIONAL PUBLIC RADIO (Oct. 8, 2010), http://www.npr.org/templates/story/story.php?storyId=130421557.

[163] Pallavi Gogoi, *Robo-Signing Practices Older, More Pervasive Than First Thought*, HUFFINGTON POST (Sept. 1, 2011, 8:50 PM), http://www.huffingtonpost.com/2011/09/01/robo-signing-practices-1990s_n_945867.html (stating that many states have laws that require a lender to file an affidavit with the court before they foreclose and take a home back. The affidavit represents an authorized bank employee who signs under oath that s/he has reviewed a case and that everything is accurate. However, bank employees admitted that they were signing and authorizing thousands of foreclosure documents without reviewing the case or the facts of each situation).

[164]Definition of robo-signer: "an employee of a mortgage servicing company that signs foreclosure documents without reviewing them. Rather than actually reviewing the individual details of each case, robo-signers assume the paperwork to be correct and sign it automatically, like robots." *Robo-signer Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/r/robo-signer.asp#axzz1uZs9wLQt.

[165] Gogoi, *supra* note 163 (stating that since many mortgage documents were improperly authorized, mortgages and chains of title are being invalidated by the courts, which prevents borrowers from proving that they own the property that they bought with the mortgage and banks cannot prove that they had the right to sell houses or issue the mortgage).

payment plan modification in order to stay in their homes.[166] However, after presenting all required documents and making all modified payments under the temporary plan, banks are then denying homeowners the ability to permanently modify their mortgage payments under the terms of the plan, leading to a litany of abuse, confusion, and an increase in foreclosures.[167] Additionally, private companies that promise homeowners a mortgage modification in exchange for a one-time upfront fee have emerged.[168] Often, however, after the homeowner pays the fee, he/she learns that the modification service promised to them by the private company is non-existent, often causing the borrower to forfeit the chance to renegotiate their mortgage with the bank.[169] Even if these private companies do obtain some sort of mortgage modification, many times it is not feasible for homeowners to make the new payments under the modified terms.[170] These predatory home mortgage modification programs are hurting consumers in a number of ways.[171]

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[166] Peter N. Freiberg, *Are Temporary Loan And Mortgage Modifications A Scam*, CLASS ACTION BLOG (Sept. 14, 2010), http://classactionblog.mdpcelaw.com/2010/09/articles/mortgage-scams/are-temporary-loan-and-mortgage-modifications-a-scam/.

[167] Stacie Spring, *ASU law students help homeowners facing foreclosure, fraud*, EAST VALLEY TRIBUNE (Oct. 1, 2011, 6:30 AM), http://www.eastvalleytribune.com/arizona/article_567b5f36-eaf3-11e0-a5c8-001cc4c002e0.html (giving an example of a homeowner who applied for and received a trial mortgage modification from his bank. The homeowner turned in all of his paperwork and met all of the trial mortgage payments. Then, he was advised that his modification was permanent. However, when the homeowner went to make his first payment under the permanent modification, the bank informed him that his house had not only been foreclosed on, but had also been sold).

[168] John Leland, *Swindlers Find Growing Market in Foreclosures*, N.Y. TIMES (Jan. 14, 2009), http://www.nytimes.com/2009/01/15/us/15mortgage.html?pagewanted=all (since many homeowners have little to no equity in their homes after the financial crisis and real estate market downturn, companies present themselves as "mortgage foreclosure rescue companies." After being charged $2,000 to $4,000 upfront, borrowers learn that the modification either failed with the bank or the company never even attempted to modify the borrowers' mortgage payments).

[169] *Id.*

[170] Charles Feldman, *A pocket guide to avoiding mortgage modification scams*, DAILY FINANCE (Dec. 29, 2009), http://www.dailyfinance.com/2009/12/29/a-pocket-guide-to-avoiding-mortgage-modification-scams/ (pointing out that even if private mortgage modification companies are successful in getting a borrower a loan modification, often the terms of the modification require the borrower to make a large "balloon payment" that they cannot afford prior to the permanent mortgage modification going into effect. This results in the borrower being unable to take advantage of the mortgage modification. Many borrowers eventually end up in foreclosure).

[171] Press Release, Loan Modification Scam Prevention Network, LMSPN Spotlights Loan Scams for National Consumer Protection Week (March 3, 2011), http://www.preventloanscams.org/newsroom/press_releases?id=0003 (listing a number of ways that private home mortgage modification programs are negatively impacting consumers including: (1) asking for an upfront fee prior to working with a lender and then not performing any type of modification service after collecting the fee; (2) falsely guaranteeing that a foreclosure can

Consumers are also being negatively impacted by mortgage foreclosure and home modification scams. First, a bank that does not even own the actual mortgage and promissory note can foreclose because of the MERS[172] system of recording.[173] Not only is the home essentially stolen in the fraudulent foreclosure action, but the actual owner of the mortgage and promissory note can come back and sue the former homeowner for payment of the full amount of the mortgage. Second, when a bank wrongfully takes back a foreclosed home and then sells the property to a new owner, the bank may not be the actual owner of the property.[174] This creates a potential future problem for the purported new owners who may find that they legally do not own the home that they thought they had purchased from the bank.

The Dodd-Frank Act has a number of provisions directed at the prevention of predatory mortgage foreclosure practices and home modification scams. These provisions include: (1) providing borrowers with a defense against foreclosures;[175] (2) conducting studies of defaults and foreclosures;[176] (3) setting up a default and foreclosure database;[177] (4) warning consumers of foreclosure rescue scams;[178] (5) initiating a

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be stopped or that a home mortgage can be modified; (3) requesting that the borrower stop paying monthly mortgage payments to the original lender and make the payments to the private company instead; (4) pressuring the borrower to sign over the deed to the modification company or sign documents that they have not had a chance to read; and (5) a request to release personal financial information online or over the phone).

172 Gretchen Morgenson & Michael Powell, *MERS? It May Have Swallowed Your Loan*, N.Y. TIMES (Mar. 5, 2011), http://www.nytimes.com/2011/03/06/business/06mers.html?pagewanted=all (stating that MERS, Mortgage Electronic Registration Systems, a private mortgage registry that was developed for Wall Street, has replaced the majority of public land ownership records in the United States. In the aftermath of the subprime mortgage crisis, bankruptcy and state courts have found that MERS and its member banks often confused and misrepresented who owned mortgage notes, losing and destroying loan documents in many cases).

173 LeNoir Law Firm, *What is Foreclosure Fraud and How Does It Affect Home Owners and Buyers?*, DEBTINVERSION.COM, (Jan. 29.2011), http://www.debtinversion.com/blog/2011/01/29/what-is-foreclosure-fraud-and-how-does-it-affect-home-owners-and-buyers/.

174 *Id.*

175 *See* § 1413 of Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (permits a borrower to assert a defense to foreclosure against a creditor or assignee or other holder of a mortgage loan in a judicial or non-judicial foreclosure or any other action to collect debt in connection with a mortgage loan when there is a violation of anti-steering and ability to repay provisions. A claim can lead to actual damages, statutory damages and enhanced damages including return of finance charges).

176 *Id.* at § 1446 (requires HUD to conduct an extensive study of the root causes of foreclosures using empirical data).

177 *Id.* at § 1447 (requires HUD in consultation with federal financial regulatory agencies to establish and maintain a database on foreclosures and defaults that will be collected, aggregated and made available on a census tract basis).

178 *Id.* at § 1452 (provides assistance to the Neighborhood Reinvestment Corporation to provide notice to delinquent borrowers concerning foreclosure rescue scams).

Government Accountability Office ("GAO") study on government efforts to combat mortgage foreclosure rescue scams;[179] (6) creating a multifamily mortgage resolution program;[180] and (7) making amendments to TILA that prevent modification and deferral fees.[181]

However, in spite of efforts by Congress to protect consumers in this area, the Dodd-Frank Act fails to hold banks, financial institutions, and private companies liable for committing foreclosure and modification fraud. On February 9, 2012, the "AG Settlement" was announced whereupon the U.S. Department of Justice and attorney generals from 49 states (except Oklahoma) entered into an agreement with Bank of America, Wells Fargo, JPMorgan Chase, Citigroup, and Ally Financial Inc., to settle claims related to foreclosure and modification fraud.[182] However, the $26 billion settlement consists mostly of reductions. That is, only $5 billion will be paid out in cash by the banks. The remainder of the settlement accounts for several reductions that will be conceded to homeowners. For instance, $17 billion of the settlement is made up of principal reductions for up to 1 million homeowners and $3 million accounts for refinancing to be offered to 750,000 "underwater" homeowners.[183] The banks also agreed to totally ban robo-signing. Although homeowners would still have the ability to pursue claims against banks, the state Attorney Generals would not be able to bring additional origination or servicing claims against the participating banks. Moreover, the settlement would not shield banks from prosecution related to criminal activities, claims based on mortgage securities violations, fair lending suits, or claims against MERS.[184] Thus, although not totally negative, the AG Settlement lets the banks off relatively easily. Criminal prosecutions

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[179] *Id.* at § 1492 (requiring the Comptroller General to report to Congress on effectiveness of an inter-agency task force to combat mortgage foreclosure rescue and modification scams, recommendations for legislative protections, and sufficiency of resources to crackdown on scams).

[180] *Id.* at § 1481 (authorizes the development of a HUD administered program to provide foreclosure assistance to promote transfer of properties with five or more units that are at risk of foreclosure. As result of foreclosure, tenants would be protected from losing their homes. It also calls for development of a program to provide financing to consumers and might include subsidies, rehabilitation and reserves for property. The goal of the program would be to transfer property to new, responsible and lawful owners committed to continued affordability of property and to maintain services to existing tenants).

[181] *Id.* at § 1433 (prohibits a creditor or third-party from charging an upfront fee to modify, renew, extend or amend high-cost mortgages or to defer payments).

[182] Chris Isidore & Jennifer Liberto, *Mortgage Deal Could Bring Billions in Relief*, CNN MONEY (Feb. 15, 2012, 3:17 PM), http://money.cnn.com/2012/02/09/news/economy/mortgage_settlement/index.htm?iid=EAL.

[183] *Id.*

[184] Press Release, Center for Responsible Lending, AG Settlement: Not Perfect, but Significant Reform of Mortgage Servicing (January 24, 2012), http://www.responsiblelending.org/media-center/press-releases/archives/AG-Settlement-Not-Perfect-but-Significant-Reform-of-Mortgage-Servicing.html.

have a higher standard of proof than a civil lawsuit and individual homeowners are at a serious disadvantage in litigating against banks. Overall, while the Dodd-Frank Act is proactive in its attempt to prevent foreclosure and modification abuses from occurring in the future, it fails to hold large financial institutions and banks responsible for the immense amount of damage, harm, and fraud that they have already caused.

B. Auto Lending—The New Subprime Money Maker for Wall Street

The prevalence and increase in subprime auto loans made to consumers who cannot afford monthly car payments mirror the same types of predatory lending practices associated with the subprime mortgage lending crisis in 2007-2008.[185] While auto lending is not mortgage lending, financial institutions are using this other "market" to make quick and easy money in the face of Dodd-Frank Act regulations, which have brought subprime mortgage lending practically to a halt. "Buy Here, Pay Here"[186] dealerships are issuing car loans to consumers who have bad credit and then packaging the loans and selling them to investors in secondary financial markets.[187] The origination of new subprime auto loans has been steadily rising since the 2008 financial crisis.[188] Investors view pools of auto loans as a relatively safe investment because the loans are collateralized[189] and

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[185] David Heath, *Buyer Beware: Predatory Tactics That Led To Mortgage Meltdown Still Plague Auto Loans*, I WATCH NEWS (April 11, 2011, 4:00 PM), http://www.iwatchnews.org/2011/04/11/4070/buyer-beware (demonstrating how Wall Street is buying up bundled packages of subprime auto loans, growing a secondary investment market that is aimed at the most vulnerable consumers, and relieving the dealerships, who sell the cars and make the loans, of any risk associated with making subprime auto loans).

[186] Jon Acuff, *Buy Here Pay Here Financing Basics*, AUTOTRADER.COM, (last updated Sept, 2, 2011), http://www.autotrader.com/creditcenter/credit/article-25356/buy-here-pay-here-financing-basics.jsp (stating that "Buy Here Pay Here" financing means that a consumer can arrange a loan and make payments on it at the dealership. Consumers purchase the car through in-house financing at the dealership versus through a third party, such as a bank).

[187] Joseph Marco, *Dealership Package Billions Of Dollars Worth Of Subprime Auto Loans Into Securities*, HUFFINGTON POST (Nov. 11, 2011, 8:08 PM), http://www.huffingtonpost.com/2011/11/01/auto-subprime-securities_n_1070328.html (stating that $15 billion worth of pooled car loans have been packaged and sold on secondary markets to large financial institutions over the past two years. As potential car buyers with poor credit find it easier to get car loans, the practice of subprime auto lending may become as popular as subprime mortgage lending).

[188] *Id*. (new car loans for buyers with subprime credit scores rose 20% in the second quarter of 2011 as compared with the second quarter in 2010).

[189] Definition of collateralization: "the act where a borrower pledges an asset as recourse to the lender in the event that the borrower defaults on the initial loan. Collateralization of assets gives lenders a sufficient level of reassurance against default risk, which allows loans to be issued to individuals and companies with less than optimal credit history rating." *Collateralization Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/c/collateralization.asp#axzz1uZs9wLQt (last visited May 6, 2012).

repossessing cars is much easier than foreclosing on homes in the event of borrower defaults.[190]

The subprime auto lending market appears to be very similar to the subprime mortgage lending market that existed prior to the financial crisis of 2008. Some of the current tactics used by subprime auto lenders include: charging consumers hidden fees, lying about interest rates, and inaccurate reporting of facts on borrowers' loan applications.[191] The packages of pooled car loans sold to financial institutions are backed by contracts signed by borrowers who cannot even qualify for a credit card.[192] Popular auto trading and review companies are advertising subprime auto loans as a great way for consumers with bad credit to acquire a new car that they might not otherwise be able to afford.[193]

While the Dodd-Frank Act contains new provisions and rules, as well as an entire agency (the CFPB) largely dedicated to preventing another subprime mortgage lending crisis, Congress specifically kept auto lending regulation out of the reach and protection of the CFPB.[194] Auto industry lobbyists were successful in keeping car loans, made by auto dealers, away from the reach of the CFPB.[195] This has left the CFPB powerless to safeguard consumers from threats posed by subprime auto lending.[196] Unlike the

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190 Monica Davis, *Lenders Making More Subprime Car Loans*, FOX BUSINESS (Aug. 30, 2011), http://www.foxbusiness.com/markets/2011/08/30/us-lenders-making-more-subprime-car-loans-report/.

191 Heath, *supra* note 180.

192 Davis MacMillan, *Subprime Auto Loans Look An Awful Lot Like Bubble-Era Subprime Mortgages*, MINYANVILLE.COM (Nov. 7, 2011, 12:11 PM), http://www.minyanville.com/dailyfeed/2011/11/07/subprime-auto-loans/ (reporting that a borrower who takes out a subprime auto loan typically pays double the Kelley Blue Book value of the car and is charged an interest rate close to 30%. Additionally, subprime auto securities sold in secondary financial markets increased from $3 billion last year to $7 billion this year. Ironically, many of the dealers are so sure that the consumers will default on these subprime auto loans that they install GPS trackers and ignition blockers in the cars).

193 Warren Clarke, *Tips for Subprime Borrowers: Getting a Car Loan with Bad Credit*, EDMUNDS.COM (April, 30, 2009), http://www.edmunds.com/car-loan/tips-for-subprime-borrowers.phtml (advising consumers that there are plenty of credit grantors specializing in subprime auto lending who are eager and willing to loan money to people with bad credit).

194 Heath, *supra* note 185.

195 Daniel Indiviglio, *5 Ways Lobbyists Influenced the Dodd-Frank Bill*, THE ATLANTIC (July 5, 2010, 10:15 AM), http://www.theatlantic.com/business/archive/2010/07/5-ways-lobbyists-influenced-the-dodd-frank-bill/59137/.

196 Jeff Crenshaw, *Car dealers mostly escape CFPB, but may face scrutiny elsewhere*, CONSUMER REPORTS (July 22, 2010, 4:30 PM), http://news.consumerreports.org/money/2010/07/consumer-financial-protection-bureau-new-law-exempts-loans-car-auto-dealers-still-regulated-ftc-powe.html (stating that final Dodd-Frank Act legislation gives the CFPB authority only over dealers who make direct loans to consumers and who do not transfer their loans to third parties, as is the common practice in the auto industry. This effectively prevents most dealer-assisted financing arrangements from being regulated under the Dodd-Frank Act since most dealers act as brokers in the lending process).

MRAPLA, which amended TILA, to ban yield spread premiums used by mortgage originators, the Dodd-Frank Act does not ban the similar practice in the auto industry of "dealer reserve."[197] Ultimately, the end result is an auto industry which continues to be incentivized to take advantage of subprime consumers shopping for a car that they cannot afford, and taking on an obligation that will ultimately end in default. While the effect of these subprime auto loans on the economy, in general, is not as great as those in the subprime home loan industry, it still poses a significant danger to economic recovery and long term economic health.

V. SOLUTIONS TO AMENDING THE DODD-FRANK ACT TO BETTER PROTECT CONSUMERS

While a number of provisions in the Dodd-Frank Act aim to better protect consumers in the financial marketplace from the predatory practices of unscrupulous lenders and financial institutions, it fails to ensure that consumers will have complete access to fair and just compensation for past wrongs inflicted upon them by predatory foreclosure practices; nor will they gain complete protection against financial industry lobbyists who continue to pressure Congress for carve-out exceptions to consumer regulatory safeguards.

A. Possible Solutions

There are a number of possible solutions that might protect consumers against wrongful foreclosure actions and predatory auto loans. However, while the two possible solutions discussed below attempt to provide consumers with a workable remedy, they are not ideal solutions for a variety of reasons.

1. A Possible Solution to Wrongful Foreclosures/Loan Modifications

One possible solution to providing consumers with adequate relief was to amend the Dodd-Frank Act to prevent any "AG Settlement" from being approved. By allowing banks to settle for pennies on the dollar in comparison to the amount of harm they have caused, the government is essentially providing banks with another massive bailout program.[198] A $20-$25 billion

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[197] "Dealer reserve" is a practice by auto dealers in directing subprime borrowers towards more expensive loans in exchange for a monetary kickback from the subprime auto lender. *See* Delvin Davis & Joshua M. Frank, *Under the Hood: Auto Loan Interest Rate Hikes Inflate Consumer Costs and Loan Losses*, SOCIAL SCIENCE RESEARCH NETWORK (April 19, 2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1860188.

[198] Matt Taibbi, *The Next Big Bank Bailout*, ROLLING STONE: POLITICS: TAIBBLOG (Oct. 5, 2011, 9:34 AM), http://www.rollingstone.com/politics/blogs/taibblog/attorneys-general-

settlement amount is far less than the total monetary amount of damage for which financial institutions are actually responsible. Giving consumers their day in court would give them the ability to prove their case against the financial institution and to obtain a fair judgment for the losses and harm they sustained from wrongful foreclosure actions. However, this possible solution would take years to achieve, flood the court system, and would create a significant risk that the affected financial institutions would have to file for bankruptcy protection as the number of judgments against them would likely be much greater than the amount they could ever pay out to consumers.[199]

2. *A Possible Solution to Prevent Future Problems Similar to Subprime Auto Lending*

One possible solution for getting rid of carve-outs and exceptions included in legislation is to ban all lobbying efforts by private companies, industry associations, and related special interest groups. However, this would be difficult and impractical to do for many reasons. Identifying lobbyists and preventing them from influencing politicians without violating their constitutional rights guaranteed by the First Amendment would be difficult for the government to do. [200] Additionally, banning special interest groups, who strive to lobby on behalf of consumers by positively influencing politicians in drafting and passing legislation, would detrimentally affect consumer safety. Moreover, devising a system that effectively insulates politicians who draft legislation from the external, negative influences of the outside world would be nearly impossible to do.

B. Alternative Solutions

In order to overcome the weaknesses in the potential solutions discussed above, this article proposes two alternative solutions that would

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settlement-the-next-big-bank-bailout-20111005(stating that Bank of America settled a lawsuit for bad mortgage-backed securities that it inherited from Countrywide Bank for $8.5 billion, but that this amount only represented 2% of the face value of the loans when they were originally sold on the secondary markets to investors (value of $424 billion) and represents only 4% of the principal amount still outstanding on these loans (current value of $221 billion)).

[199] *Id.*

[200] United Mine Workers of America, District 12 v. Illinois Association et al., 389 U.S. 217 (1967) (holding that the rights to assemble peaceably and to petition the government for a redress of grievances are among the most precious of the liberties safeguarded by the Bill of Rights. These rights, moreover, are intimately connected, both in origin and in purpose, with the other First Amendment rights of free speech and free press).

increase the protection of consumers from wrongful foreclosure actions and predatory auto loans.

1. Solution #1—Provide Bailouts to Consumers while Stabilizing the Economy

The first solution is to amend the Dodd-Frank Act to: (1) give the CFPB the authority to approve or deny a settlement with banks after having conducted a study that identifies the total dollar amount that banks are realistically able to pay out for their wrongs while remaining solvent; (2) direct the Federal Reserve to provide funds to bailout consumers who have suffered from wrongful foreclosure actions and mortgage modification programs to make up for the difference between what banks are able to pay and the total amount of harm caused; and (3) give the CFPB the authority to create a federally controlled program to administer government bailout funds to consumers in a fair and efficient manner.[201] While this proposed solution initially holds taxpayers responsible for bailing out consumers for wrongs committed by the financial institutions, by giving the CFPB the power to set a settlement floor based on what financial institutions can actually pay (compared with what they propose to pay), it may prevent financial institutions from filing bankruptcy. Bankruptcy filings by financial institutions potentially have a much greater negative impact on the economy than the repercussions of increased bailout dollars.

Furthermore, even though this proposed solution would increase the federal deficit, it effectively prevents financial institutions from obtaining another windfall in the form of paying next to nothing for their wrongs, while providing consumers with a program that allows them to remain in their homes and covers some or all of their losses. One benefit of this solution is that it would provide consumers with stability and additional cash which would enable them to pay their fair share of taxes and purchase goods and services, all of which would have a beneficial effect on the economy.

2. Solution #2—Bring All Consumer Financing Arrangements under the Umbrella of the CFPB

The second solution is to bring the regulation of auto dealer financing under the regulatory protection of the CFPB by amending the Dodd-Frank

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[201] Components of a consumer bailout program could include: (1) requiring consumers to complete and submit standardized claim forms and personal financial documents to prove their wrongful losses; (2) devising a priority system to rank which consumers are most in need; (3) sending federal personnel to maintain special departments within the major banks to help streamline the flow of funds from the government to banks on behalf of consumers; (4) coming up with new streams of revenue that would cover the payment of bailout funds to consumers while contributing to economic growth.

Act to: (1) allow the CFPB to have regulatory authority over all existing and future consumer financing arrangements offered in the marketplace; (2) require all special interest groups to register with the CFPB prior to being able to lobby politicians and legislators and obtain special carve-outs in their favor; (3) draft new rules and regulations that prevent exceptions from being written into new laws that have a substantial negative impact on consumer protection and economic stability of the financial markets; and (4) create a department in the CFPB that monitors all registered special interest lobbying efforts, making recommendations to Congress about potential risks to consumers from proposed legislation prior to enactment of that legislation into law. Giving the CFPB complete authority to regulate all types of consumer financing will help to ensure that consumers do not fall victims to predatory lending practices in both the home loan and auto loan industries (and possibly other industries yet to be "imagined").

VI. Conclusion

In response to the financial crisis of 2008, the Dodd-Frank Act effectively limits the harm to consumers from predatory subprime mortgage lending practices. However, the Dodd-Frank Act fails to adequately prevent wrongful foreclosure and home loan modification practices and predatory auto lending. The continued existence of these predatory practices threatens the economic recovery and overall safety of consumers in the financial marketplace. Additional amendments to the Dodd-Frank Act must be made in order to avert another financial crisis and its negative impact on the U.S. and global economies.

Overall, holding large banks responsible for a reasonable amount of damage as a result of foreclosure and home loan modification fraud, while providing consumers with a financial bailout, will help further the economic recovery. Additionally, empowering the CFPB to have complete regulatory authority over all types of consumer financial arrangements will help ensure transparency and fairness in the marketplace, while continuing to encourage free trade and economic growth.

SHARING MEDIA ON SOCIAL NETWORKS: INFRINGEMENT BY LINKING?

JEAN G. VIDAL FONT*

I. INTRODUCTION

Social networking sites such as Facebook, MySpace, and Twitter have become so popular that they are now used as verb tenses in the same way Google is used to describe an online search.[1] Facebook, for one, claims over 901 million monthly active users.[2] One of the most popular features that Facebook has is the "share" feature, which allows users to "post" web content

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[1] As in "I *facebooked* you but I couldn't find you," "Did you *twitter* about it?", etc.

[2] FACEBOOK, http://newsroom.fb.com/content/default.aspx?NewsAreaId=22 (last updated Mar. 2012).

on their profiles.[3] By posting web content on their profiles, the user's "friends" (or people whom the user authorizes to see his/her profile) can see the web content that the user posted. Also, they can be invited to access it. Facebook boasts that over 30 billion pieces of content are shared every month.[4] This content includes, but is not limited to, Internet links, videos, web pages, photos, and any other content that a user can find on the Internet. To take a single act as the basis for the question posed here, and to serve also as an illustrative example; a user can go to YouTube, select a video, which the user knows (or should know) that is infringing of the artist's rights, and "shares" it on his[5] profile.[6] In a simple sequence of acts that can take less than ten seconds, the user has now made the link available to possibly hundreds (or even thousands) of his or her "friends."[7] Assuming now that the content being shared is infringing, is the user who "shares" it guilty of contributory infringement?

This paper will analyze a situation in which millions of users find themselves doing each day: sharing web content on their social networking profiles. Part II of this paper will discuss the exclusive rights that the Copyright Act affords authors and the remedies those authors have to protect their rights, including but not limited to the two prevailing theories of secondary infringement, namely (1) contributory infringement and (2) vicarious infringement, as well as a more recent development known as infringement by inducement. Part III will discuss the *Perfect 10 v. Google*[8] decision by the Ninth Circuit and its relevance to the situation before us, since said case deals with "in-frame linking," a feature which is crucial to the Facebook "share" feature. Part IV will analyze the "sharing" feature in light of the doctrines discussed and determine if sharing content on a profile is akin

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[3] This article will not discuss the "video" feature found on Facebook. The "video" feature allows users to upload (onto the Facebook servers) their own videos, thereby embedding them onto their profiles. This feature is different than the "sharing" feature in regards to the possible liability the user might incur since, if the video were to be infringing, the user would be liable for direct infringement. This paper focuses on the possible contributory infringement liability that the user might incur when he "shares" preexisting content that is uploaded/hosted by an unrelated third party.

[4]FACEBOOK, http://www.facebook.com/applications/Posted_Items/2309869772#/press/ info.php?statistics (last updated Dec. 2011).

[5] Throughout the article I will refer to the user as a "he" since a gender neutral term results in confusing language given the many references I make to an individual user's actions.

[6] YouTube is a user-generated video portal that is owned by Google, Inc. Users can upload their own videos onto YouTube and they are available for anyone to see.

[7] Facebook has since lifted the limit it used to impose on the maximum number of "friends" a user could have. It was previously set to 5,000 users but has since been lifted. *See* Michael Arrington, *Facebook To Lift 5,000 Friends Limit*, TECHCRUNCH (Friday, May 9th, 2008) http://techcrunch.com/2008/05/09/facebook-to-lift-5000-friends-limit/ (last accessed on April 14th, 2012).

[8] Perfect 10 v. Google, Inc., 416 F. Supp. 2d 828 (C.D. Cal. 2006).

to distributing or making available, and if the user's actions fall under one of the secondary liability doctrines developed by the courts. Part V will conclude that, in some cases, when a user shares content that is visibly infringing to a large number of "friends," he could be liable under the doctrine of secondary liability.

II. Rights and Remedies

A. Exclusive Rights in Copyright

Congress, pursuant to Article I Section 8 of the Constitution, affords copyright owners a set of exclusive rights to exploit in regards to their works.[9] The Copyright Act of 1976[10] (hereinafter "the Act") lists those six exclusive rights and the scope of their extent.[11] The Act gives the owner of a copyright the right to: (1) reproduce copies; (2) prepare derivative works; (3) distribute copies; (4) publicly perform; (5) display the work; and (6) the right to the digital public performance of the underlying sound recording.[12] The mentioned rights are the key for this analysis given that infringement can only be found when any of the said rights are violated and secondary liability can only be determined if direct infringement is found. This article will be limited to discussing only those rights that are primarily (and possibly) affected by the "sharing" feature found in Facebook.

1. *Reproduction*

Section 106(1) of the Copyright Act affords the owner of the work the exclusive right to reproduce the copyrighted work in copies or phonorecords. Copies and phonorecords, as used in the Act, consist of material objects in which the work is fixed and it is only the reproduction of those material objects that is included in the reproduction right.[13] The copy in question must be one that can be perceived, reproduced or otherwise communicated for a period of more than a transitory duration.[14] Furthermore, it is not required to distribute or sell the copy in order to violate the exclusive right. The mere unauthorized (and presumably not protected under the fair use doctrine) reproduction of the work is enough ground for infringement of the reproduction right.[15]

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[9] U.S. CONST. art. I, § 8.
[10] Copyright Act of 1976, 17 U.S.C. §§ 101-810.
[11] 17 U.S.C. § 106 (2009).
[12] *Id.*
[13] NIMMER, NIMMER ON COPYRIGHT 8-31, (2010).
[14] 17 U.S.C. § 101 (2009); NIMMER, *supra* note 13 at 8-32.
[15] NIMMER, *supra* note 13 at 8-35.

In the computer world, courts have found that the copying of computer software to the random access memory ("RAM") constitutes "copying" for the purpose of the reproduction right in Section 106 of the Act.[16] In *Mai Systems Corps. v. Peak Computers,* the court, recognizing its own limitations, held:

> However, it is generally accepted that the loading of software into a computer constitutes the creation of a copy under the Copyright Act. . . . We recognize that these authorities are somewhat troubling since they do not specify that a copy is created regardless of whether the software is loaded into the RAM, the hard disk or the read only memory ("ROM"). However, since we find that the copy created in the RAM can be "perceived, reproduced, or otherwise communicated," we hold that the loading of software into the RAM creates a copy under the Copyright Act.[17]

RAM copying is the more traditional form in which a work can be copied into a computer, be it by the user's specific command or by the operation of a computer program. In the context of Internet browsing, "caching" is the most common form of reproducing or copying objects or data that is later used by the Internet browser.[18] The Digital Millennium Copyright Act (DMCA) recognizes the reproduction (and hence, violation) caused by "caching" by exempting Internet Service Providers from infringing under the "System Caching Safe Harbor."[19] Websites such as Youtube and most online streaming media work on the user's computer by caching the media in an unknown folder (to the user), and storing it there until the browser deletes the "cache". However, armed with a little technical knowledge and a quick search on Google, users can easily access the cache folder and the media stored in it, therefore making the copies accessible and perceivable to the user. Moreover, many users nowadays are "permanently" connected to the

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[16] *See* MAI Systems. Corp. v. Peak Computer, Inc. 991 F.2d 511, 518 (9th Cir. 1993).

[17] *Id.* at 519 (internal citations omitted); *see* NIMMER, *supra* note 13 at 8-131 (Nimmer agrees with the ruling, and points out that the U.S. Copyright Office is also in agreement with the ruling).

[18] Matthew Fagan, *Can you do a Wayback on that? "The Legal communities use of cached web pages in and out of trial,"* 13 B.U. J. Sci & Tech. L. 46, 50 (2007) (stating "In the Internet context, caching similarly means "the storing of copies of content [that subscribers wish to see most often] at locations in the network closer to subscribers than their original sources .. . . in order to provide more rapid retrieval of information." Web browsers like Firefox and Internet Explorer store cached web pages at the location closest to the user (the local computer itself), while Internet service providers ("ISPs") cache web pages on proxy servers in order to provide streamlined access to the most popular pages among a large group of users. In this way, users get their copies from the proxy server instead of the site owner's server, which is likely to be slower and more congested than the proxy server.").

[19] 17 U.S.C. § 512(b) (2009).

Internet through their home networks, high speed cellular networks, and office networks, thus, the "streaming copy" needs to be viewed under today's use and how accessible it is to the user. This last point will be discussed in greater detail in Part V.

2. The Right to Distribute

Section 106(3) of the Act affords copyright owners the exclusive right to "distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending."[20] The right does not apply to any distribution of copies but only such distributions that are made to the public.[21] In order to have a valid claim under a violation of Section 106(3), the owner must prove ownership of the right and prove an actual dissemination of either copies or phonorecords.[22] The term "dissemination" has not been without controversy, and there seems to be a disagreement over its reach between two Circuit Courts.

The Ninth Circuit affirmed the holding of the district court in *Perfect 10 v. Google*; it held that public distribution in the Internet context requires the actual transfer of the file from one user to the other.[23] However, the Fourth Circuit held in *Hotaling v. Church of Jesus Christ* that a violation to the right to distribute is found when the alleged infringer makes the work available to the public, regardless of the public's acceptance of that offer.[24] In that same case, the court distinguished the right of the owner of a legally acquired copy of a work to lend or lease said copy without violating the author's 106(3) right from the distribution of unlawful copies, the latter being a violation of the right to distribute.[25] The difference between the two circuits seems to lie in what constitutes distribution. The Fourth Circuit holds that *making available is enough to constitute distribution* while the Ninth Circuit requires the *actual dissemination* of the work (in the context of the Internet).[26] Although the "black letter law" might be unclear, what is clear, though, is that it remains the sole right of the copyright owner to control the distribution of his work to the public.

[20] 17 U.S.C. §106(3) (2002).
[21] NIMMER, *supra* note 13 at 8-148.
[22] *Id.*, citing National Car Rental Sys. Inc. v. Computer Assoc., 991 F.2d 426, 434 (8th Cir. 1993).
[23] Perfect 10 v. Google, Inc., 416 F. Supp. 2d 828, 844 (C.D. Cal. 2006).
[24] Ahern v. County of Nassau, 118 F. 3d 119 (4th Cir. 1997).
[25] *Id.* at 203.
[26] Robert Kasunic, *Making Circumstantial Proof of Distribution Available*, 18 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 1145,1153-1154 (2008).

3. The Right to Display and Perform

Sections 106(4) and 106(5) grant the owner the exclusive right to publicly perform and/or display his work, so long as it is within the scope of the right. Sections 106(4) and (5) state that:

> (4) [I]n the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;
>
> (5) [I]n the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly.[27]

Therefore, it is only in the enumerated works that the above-mentioned rights will apply. The display and performance rights only protect the public performance/display of such. In contrast, the Act defines a public performance or display as:

> (1) [T]o perform or display it at a place open to the public or at any place where a substantial number of persons outside of a normal circle of a family and its social acquaintances is gathered; or
>
> (2) to transmit or otherwise communicate a performance or display of the work to a place specified by clause (1) or to the public, by means of any device or process, whether the members of the public capable of receiving the performance or display receive it in the same place or in separate places and at the same time or at different times.[28]

The phrase "open to the public" has not been without debate, but a clear expression was found in *Columbia v. Aveco.*[29] The court held, and so far it has not been overruled, that a public space need not be crowded with people for a public performance (or display) to take place just as long as the space is, in fact, open to the public.[30] Whereas this provided a clear guidance in traditional settings, it is less clear on how it applies to the Internet and social networking sites, which are, in essence, *de facto* public spaces.

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[27] 17 U.S.C. § 106 (4)-(5)
[28] *Id.* at § 101.
[29] Columbia Pictures Industries, Inc. v. Aveco, Inc., 800 F.2d 59 (3rd Cir. 1986).
[30] *Id.*

The Act defines displaying as "to show a copy of it, either directly or by means of a film, slide, television image, or any other device or process or, in the case of a motion picture or other audiovisual work, to show individual images nonsequentially."[31] The right, similar to the right of distribution, affords the owner of a lawfully made copy the right to display it publicly, yet the same privilege is not conferred to those who obtain unlawfully made copies.[32] A Congressional House Report, published soon after the enactment of the 1976 Act, stated that the privilege is also limited when the work is performed or displayed by transmissions. This Report elaborated that the owner cannot transmit the display to members of the public who are located in a different place where the work is held, whereas he can display it (via transmission) to the public as long as they are in the same place where the work is held.[33] In other words, the owner of a work cannot transmit the display (and presumably, the performance) of the work through the Internet to users who are located outside the physical location of where the work is being held.

The Act defines a performance as "to recite, render, play, dance, or act it, either directly or by means of any device or process or, in the case of a motion picture or other audiovisual work, to show its images in any sequence or to make the sounds accompanying it audible."[34] Although similar, the rights apply to different means of communicating the work. In the matter that concerns this article, users are "performing" the work when they open audiovisual media clips that are usually scenes (if not the entire work) of movies, television shows or music videos, and are usually "displaying" the work when they open images or display a literary piece on their computer monitors.

Although the rights so far discussed are not all the rights that appear under the Act, they are, however, the rights that seem to be in play as far as the rights which are affected the most in "in-frame" linking posts on social networking sites. Having thus constructed a clear frame of which rights are in play and their scope, we now turn to the remedies that are afforded to copyright owners to protect said rights.

B. Remedies

Section 501 of the Act states that copyright owners have the power to enforce their rights against those who directly infringe on their exclusive rights.[35] Generally, the Act allows the owner to recover actual damages

31 17 U.S.C.§ 101.
32 NIMMER, *supra* note 13 at 8-285.
33 H. R,. . No. 94-1476, at 79-80 (1976).
34 17 U.S.C. § 101.
35 17 U.S.C. § 501.

and/or statutory damages as defined in sections 504(b) and 504(c).[36] Moreover, what is important is that copyright owners can enforce their right on two distinct groups, those who directly infringe on their rights, and those who contribute or are vicariously responsible to the direct infringement of another person.

Direct infringement is aimed at the person who directly infringes on the exclusive rights afforded by the Act whereas secondary infringement is aimed not at the principal culprits, but at those who facilitate said infringement. On one hand, in order to prevail on direct infringement, the plaintiff must prove ownership of the alleged infringed material and must demonstrate that the alleged infringer has violated at least one exclusive right of the plaintiff's copyright.[37] On the other hand, the courts have developed the doctrine of secondary liability in two strands: (1) vicarious infringement (liability); and (2) contributory infringement.

1. Vicarious Liability

Vicarious liability for copyright infringement, like contributory infringement, was developed by jurisprudence rather than by statute. Vicarious liability was the result of a series of decisions of the Second Circuit as "an outgrown of the agency principles of *respondent superior.*"[38] In *Gershwin Publishing v. Columbia Artists Management, Inc.*,[39] the Second Circuit created the test that would become the "standard test" for vicarious liability. The court held, "even in the absence of an employer-employee relationship one may be vicariously liable if he has the right and ability to supervise the infringing activity and also has a direct financial interest in such activities."[40] Given the requisite of "direct financial interest" for the finding of vicarious liability, one may conclude that most Facebook users would not be liable under this doctrine since there is no financial interest in "sharing" web content with their friends on the social network. However, the same cannot be said for contributory infringement, since this doctrine does not require a direct financial interest.

2. Contributory Infringement

In *Gershwin Publishing v. Columbia*, the Court of Appeals for the Second Circuit summed the concept of contributory infringement, stating that "[s]imilarly, one who, with knowledge of the infringing activity, induces,

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[36] 17 U.S.C. § 504(b)-(c).
[37] Perfect 10 v. Google, 508 F.3d 1146, 1159 (9th Cir. 2007).
[38] Fonovisa v. Cherry Auctions, Inc., 76 F.3d 259, 261-262 (9th Cir. 1996).
[39] Gershwin Pub. Corp. v. Columbia Artists Management, Inc., 443 F.2d 1159 (2d Cir. 1971).
[40] *Id.* at 1162.

causes or materially contributes to the infringing conduct of another, may be held liable as a 'contributory' infringer."[41] The Supreme Court addressed this issue in the *Sony-Universal City* case, holding that copyright law had to "strike a balance between a copyright holder's legitimate demand for effective-not merely symbolic-protection of the statutory monopoly, and the rights of others freely to engage in substantially unrelated areas of commerce."[42] Contributory infringement, unlike vicarious, can occur in settings in which no financial benefit is being transferred between the parties, but where a party is directly infringing at the inducement or encouragement of another. The development of this doctrine, beginning with the Supreme Court's decision in *Kalem v. Harper Brothers* up to their most recent decision in *Metro-Goldwyn v. Grokster*,[43] is worth tracing in order to understand not only what is held to be contributory liable, but also what defenses can a party bring against it.

In *Kalem v. Harper Brothers*,[44] Harper Brothers brought suit against Kalem for the alleged infringement of the copyright in General Lew Wallace's *Ben Hur* by the exhibition of moving pictures of the incidents told in the book. Kalem was in the business of producing moving-picture films, one of them being the object of litigation in the suit. Although the Court found Kalem liable for copyright infringement, it did express what would later become the "staples of commerce" doctrine. The Court distinguished between the merchant who sells his product, capable of being used in illegal activities, without knowing it would be used for said activities against the seller who sells it with a view to the illegal resale. In this case, Kalem not only produced the machines, but also advertised the use of his film for dramatic reproduction. It was not until 1984, in the *Sony-Universal City* case, that the Court elaborated on this holding.

In *Sony Corporation v. Universal City*, the Court debated whether Sony could be held liable for any infringement done by consumers with their Betamax video recorders. The Court distinguished this case from *Kalem*, holding that whereas in *Kalem* the producers "did not merely provide the 'means' to accomplish an infringing activity, the producers supplied the work itself", Sony did not supply Betamax consumers with the "respondents' works".[45] The Court, in seeking to determine what responsibility, if any rested on Sony, turned to patent law. More specifically, they turned to the "staples of commerce" doctrine. This doctrine holds that "[u]nless a commodity 'has no use except through practice of the patented method' . . . the patentee has no right to claim that its distribution constitutes

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41 *Id.*
42 Sony Corp. v. Universal City, 464 U.S. 417, 442 (1984).
43 Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd., 545 U.S. 913 (2005).
44 Kalem Co. v. Harper Bros., 222 U.S. 55 (1911).
45 *Sony Corp.* 464 U.S., at 446.

contributory infringement."[46] The Court, mindful of the differences between patent and copyright law, sought to strike a balance between the copyright holder's legitimate demand for effective, not merely symbolic, protection of the statutory monopoly, and the rights of others freely to engage in substantially unrelated areas of commerce."[47]

As such, the Court held that the sale of articles of commerce will not constitute contributory infringement if the product is "widely used for legitimate, unobjectionable purposes. Indeed, it may merely be capable of substantial non-infringing uses."[48] The "Sony Rule" would not be revisited by the Supreme Court until 2005, and even then, the Court made it clear that it was not changing said Rule.

In 2005, the Supreme Court held, by unanimous vote, that Grokster was to be liable for copyright infringement by using a doctrine known as "inducement" which, just like the Sony rule, had its origins in patent law. In *Metro-Goldwyn-Mayer Studios v. Grokster*,[49] the Court faced a *de facto* successor to the popular file-sharing program called Napster. Grokster was a similar file sharing program but, unlike Napster, it did not hold a centralized server. It did, however, rely on a technology called "Peer to Peer" which uses the users' computers as "mini routers" to connect to other users.[50] The Ninth Circuit had affirmed the District Court's finding in that Grokster was not liable for secondary liability for its users direct infringement under the "Sony Betamax" doctrine, holding that Grokster was a commercial product capable of substantial non-infringing use.[51] In reversing the Ninth Circuit's decision, the Supreme Court refused to discuss Grokster's responsibility under the staples of commerce doctrine, choosing instead to hold Grokster responsible under the "inducement doctrine."

The Court, citing *Oak Industries Inc. v. Zenith Electronics*,[52] described the "inducement doctrine," as evidence of active steps taken to encourage direct infringement, "such as advertising an infringing use or instructing how to engage in an infringing use . . . overcomes the law's reluctance to find liability when a defendant merely sells a commercial product suitable for

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[46] *Id.* at 441.
[47] *Id.* at 442.
[48] *Id.*
[49] Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd., 545 U.S. 913 (2005).
[50] A&M Records, Inc. v. Napster, 239 F.3d 1004 (9th Cir. 2001) (holding that Napster, an online file-sharing service that had centralized servers, was liable for vicarious and contributory copyright infringement for the direct infringement that its users were committing. The court recognized that Napster had significant non-infringing use, but the degree of control that Napster had over its servers and the volume of infringing material that passed through its network outweighed the use of the "Betamax" defense).
[51] Metro-Goldwyn-Mayer Studios, Inc. v. Grokster Ltd. . 380 F.3d 1154 (9th Cir. 2004).
[52] Oak Industries, Inc. v. Zenith Electronics Corp., 697 F. Supp. 988, 992 (N.D. Ill. 1988).

some lawful use."[53] Finally, the Court, adopting the doctrine the same way it adopted the staple-article doctrine of patent law in Sony, held "that one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties."[54] The Court distinguished between "mere knowledge of infringing potential or of actual uses" (which would not be actionable) and "purposeful, culpable expression and conduct" (which would be actionable).

However, it is not clear if the Court treats infringement by inducement as a separate doctrine of secondary liability or if it is a "type" of contributory liability. Furthermore, there is legitimate concern with the degree to which the courts could take the "inducement rule" in every day scenarios, thus applying it to "almost anyone whose behavior regularly supports infringement by others."[55] However, given its distinct requirements when compared to contributory infringement, I would argue that it is a third doctrine of secondary liability which we will treat separately for our analysis.[56] This brings us to what courts held (prior to *Perfect 10*) on what contributory responsibility might befall on websites that "link" to infringing material.

3. Infringement By Linking

Prior to the *Perfect 10* case, one of the cases that best dealt with "infringement by linking"[57] was an Indiana District Court case, *Batesville Services v. Funeral Depot.*[58] In *Batesville*, the defendant, Funeral Depot, operated a website through which it sold caskets which included the brand name caskets sold by Batesville. Funeral Depot was not an authorized reseller of Batesville caskets, but they had arrangements with other authorized dealers in order sell the caskets to the customers. The copyright issue arose from Funeral Depot's use of Batesville images, which were hosted on third party servers (which were authorized dealers). Funeral Depot would display a thumb-nail sized image on their website of a Batesville casket. The user would click on the thumbnail and a bigger picture would appear. The larger image was hosted on a reseller's website but it would display Funeral Depot's phone number. The website would also tell the user that the

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[53] *Grokster, Ltd.*, 545 U.S. at 915, (citing Water Technologies Corp. v. Calco, 850 F.2d 660, 668 (C.A. Fed. 1988)).
[54] *Id.* .
[55] Alfred C. Yen, *Third-Party Copyright Liability After Grokster*, 91 MINN. L. REV. 184, 231 (2006).
[56] This view is also shared by some in academia, such as Professor Alfred Yen, *See id.* at 239.
[57] By "linking" I refer to hyper linking within a website to a different site or file which is hosted in an independent server from the one hosting the website being viewed.
[58] Batesville Services, Inc. v. Funeral Depot, Inc., 2004 WL 2750253 (S.D. Ind. 2004).

displayed image was shown through the authorized reseller and not through Funeral Depot. Batesville alleged that Funeral Depot was not authorized to use their copyrighted photographs and that the fact that they were hosted on a different server did not affect the copyright liability that Funeral Depot had accrued.

Although the controversy in the case dealt with various issues, the relevant issue here was the court's discussion on linking. Funeral Depot argued that linking can never amount to a copyright violation.[59] In support, they cited two district court opinions from California.[60] The holding in those two cases did not, however, convince the court. The court concluded that the two cases that Funeral Depot cited showed "that it may be difficult to prove copyright infringement or contributory infringement from the use of hyperlinks, indeed, hyperlinks are essential to the operation of the Internet for a host of legitimate purposes."[61] However, the court refused to embrace Funeral's argument, that the district cases embraced a "sweeping per se rule" that linking did not constitute infringement. The court instead referred to a district court opinion from Utah in which the court upheld an injunction against a defendant who was providing addresses of websites containing infringing material he had previously hosted and was ordered to remove.[62] The court found that Funeral Depot acted more like the defendant in *Intellectual Reserve, Inc. v. Utah Lighthouse Ministry, Inc.,* than the defendant in *Ticketmaster* or *Bernstein* since Funeral Depot did not "casually" link the images owned by Batesville, but created the pages and links, paid for them and still controlled them.[63]

Batesville, as well as the cases cited by the court, demonstrate the "gray area" in which the courts in *Perfect 10 v. Google* had to engage and decide. On one hand, the person who "links" the material is not hosting nor creating the material, since it is already there due to the work of a third party. On the other hand, the person who "links" is directing traffic and giving a third party site more publicity than it previously had, therefore increasing the number of people who visit it and contributing to the infringing activity. None of the cases prior to *Perfect 10* engaged in depth this issue, particularly the discussion over the combination of linking and "in-frame linking".

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[59] *Id.* at 11.
[60] Ticketmaster v. Tickets.com, 2000 WL 525390 (C.D. Cal.); Bernstein v. JC Penney, 1998 WL 906644 (C.D. Cal.).
[61] *Batesville Services, Inc.*, 2004 WL at 11.
[62] Intellectual Reserve, Inc. v. Utah Lighthouse Ministry, Inc., 75 F. Supp. 2d 1290 (D. Utah 1999).
[63] *Batesville Services*, *Inc.*, 2004 WL at 12.

III. PERFECT 10 AND IN-FRAME LINKS

A. The Case at the District Court

The plaintiff in this case is a publisher of adult magazines known as "Perfect 10" and the operator of a subscription website under the same name. Plaintiffs owned the copyright on all the images of the models that they used in their publications and websites. Perfect 10 exploited these images and derived profits from the sale of their publications and the subscriptions to their websites. Perfect 10 grew concerned with the distribution and unauthorized reproductions of their images on a variety of websites. Aware of the violation to their exclusive rights under the Act, they naturally proceeded to go against the infringing parties. Their search led them to the defendant, Google. Google operates a well-known search engine (www.google.com), which also includes an "image search" engine. Google's engine would "crawl" the Internet (thus indexing websites and their content) in order to provide the user with search results. Among those websites indexed were the websites who were infringing on Perfect 10's copyright over the images. When a user searched for images, he would be shown several thumbnail images, which Google hosted. The user would then click on the thumbnail and would be taken to that party's website. However, Google would "frame" the third party's website within their own website, so the user would see Google's frame in the upper part of their browser, with the third party's website beneath the frame. This could give the user the impression that he was still navigating within Google's search engine; when in fact, he was not.[64]

Perfect 10 filed suit against Google in the Central California District Court asserting both copyright and trademark claims.[65] Among the copyright claims, Perfect 10 alleged direct copyright infringement, vicarious copyright infringement, and contributory copyright infringement. Perfect 10 alleged that Google's thumbnails of images belonging to Perfect 10 were a direct copyright violation, while Google's linking to websites containing infringing material were both a vicarious infringement (due to Google's revenue deriving from advertisements) and a contributory infringement. In their part, Google claimed a fair use defense against the direct copyright claim (and succeeded on those merits) and argued that it bore no responsibility for the infringing content to which it linked.

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64 *See* Perfect 10 v. Google, Inc., 416 F. Supp. 2d 828, 833 (C.D. Cal. 2006). (defining the term "Framing" as " . . . a method of "combin[ing] multiple pages in a single window so that different content can be viewed simultaneously, typically so that one 'frame' can be used to annotate the other content or to maintain a link with an earlier web page").

65 *Id.* at 828.

The court discussed several issues that are of particular importance here, namely whether an "in-line link" constituted a display and which test should be applied to make that determination. Perfect 10 alleged that Google was violating their display right by displaying the infringing site framed within Google's page since the display was the "mere act of incorporating content into a webpage that is then pulled by the browser" under a test called the "Incorporation Test."[66] Under this test the entity who hosts the webpage which incorporates the infringing material is the entity who displays said image. Google, however, argued for a "server test" which would define a "display" as "the act of serving content over the web, i.e. physically sending ones and zeroes over the Internet to the user's browser."[67] Under this definition, the party that hosts the data and transmits it is the entity who displays the image. The court then recognized the dangers that an absolute adoption of either test could have. On one hand, the server test would shield a user who created a website with the clear intent to facilitate infringing content without actually hosting any of it, while the incorporation test could cause a chilling effect on a core aspect of the Internet, its capacity to link to other sites.[68]

The court acknowledged the lack of precedents on this matter and highlighted several decisions that had dealt with contributory infringement and linking while, at the same time, dismissing Perfect 10's reliance on an opinion by the Ninth Circuit in *Kelly v. Arriba*,[69] which was withdrawn in a subsequent opinion by the same court. However, this court, lacking a binding precedent on which to determine the case, decided to adopt the server test for several reasons. First, it concluded that the test is an accurate reflection of what happens "at the technological level as users browse the web and thus, reflects the reality of how content" travels over the Internet.[70] Second, the court concluded that the server test did not invite infringement by a search engine nor preclude liability for direct infringement while maintaining a test which website operators can easily understand and the courts can apply with ease. Finally, the court concluded that the server test recognizes the third parties as the direct infringers, and not the search engine while, at the same time, maintaining a delicate balance for which copyright strives to maintain between technology and creativity.[71] Applying the test, the court held that Google did not directly infringe on Perfect 10's display rights.

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[66] *Perfect 10*, 416 F. Supp. 2d at 839.
[67] *Id.*
[68] *Id.* at 840.
[69] Kelly v. Arriba Soft Corp. 280 F.3d 934 (9th Cir. 2002) *withdrawn by* Kelly v Arriba Soft Corp., 336 F.3d 811 (9th Cir. 2003). (First citation is Kelly I and the second citation is Kelly II).
[70] *Perfect 10*, 416 F. Supp. 2d at 843.
[71] *Id.*

The court then focused on the secondary liability alleged by Perfect 10. It determined that Google lacked the *actual* or *constructive* knowledge necessary for contributory liability to exist. Google could not monitor all the websites it "crawled" and indexed since its operation is controlled by mathematical algorithms and not by direct human input. Google, the court concluded, did not materially contribute to the infringement done by third parties since it only facilitated searches directed by the user, in contrast to Napster, which dedicated itself to helping users locate infringing audio files on their servers. The court distinguished Google from the defendants in *Columbia Pictures v. Redd Horne*,[72] in that Google did not conduct all the advertising and promotional work for the alleged infringers. Google provides advertisement based on the normal use of their search engines but not on the particular infringing work. As such, the court determined that Perfect 10 did not meet the burden necessary to succeed on their injunctions based on contributory infringement. Finally, the court held there was no merit to Perfect 10's claim of vicarious infringement since Google lacked the "right and ability to control" the infringing activity of others as required under the doctrine of vicarious liability.[73] Predictably, Perfect 10 appealed the decision to the Ninth Circuit Court.

B. Court of Appeals

The Ninth Circuit Court began its opinion by reiterating the working definitions for the two technological features in the case; the "in-line linking" and the "framing" feature as used by Google. "In-line linking" was described as the process by which the webpage directs a user's browser to incorporate content from different computers into a single window, whereas framing refers to the process by which information from one computer appears to frame and annotate the in-line linked content from another.[74] The in-line linking allowed Google to display an image search result which could include an infringing copy of a picture owned by Perfect 10, within the "Google search frame" but without Google itself making a copy of it; instead directing the user to the alleged infringer's website.

The court addressed two issues on appeal: (1) the claim on direct infringement (based on the display right and the distribution right) and (2) the claim on secondary liability. With regards to the direct infringement, the court began with the claim on the display right. The court distinguished the display of the thumb-nail sized pictures that Google hosted and the full size pictures that Google linked to, adding "in sum, based on the plain language of the statute, a person displays a photographic image by using a computer to

[72] Columbia Pictures Industries, Inc. v. Redd Horne, Inc. 749 F.2d 154 (3rd Cir. 1984).
[73] *Perfect 10*, 416 F. Supp. 2d at 858.
[74] Perfect 10 v. Google, 508 F.3d 1146, 1156 (9th Cir. 2007).

fill a computer screen with a copy of the photographic image fixed in the computer's memory."[75] The court, thus, held that Perfect 10 had made a *prima facie* case that Google had directly infringed its display right in regards to the thumbnail images.[76] The court determined since the full size image was hosted on a different website, direct liability could not be found.

Perfect 10 argued that merely making images available infringed the copyright owner's distribution rights. They relied on *Hotaling v. Church of Jesus Christ*,[77] holding that an owner of a collection of works who makes them available to the public may be deemed to have distributed copies of the works. The court rejected Perfect 10's argument, and held that the "deemed distribution" rule did not apply to Google since they do not own Perfect 10's copyrighted work and they (Google) do not communicate these images to the users that use Google's search engine. The court distinguished the case against Google from the holding in *Napster* and *Hotaling* in so much as Google did not own the Perfect 10 images nor did they communicate those images to the people using Google's search engine. The court held against Perfect 10 on the likelihood of success in the injunction sought.

Turning then to the issue of contributory infringement, the court began by stating that their test for contributory infringement was consistent with the rule set forth in *Grokster*[78] and in *Gershwin*.[79] The court emphasized that the infringer must be found to "induce, cause or materially contribute to the infringing conduct of another" with knowledge of the infringing activity.[80] The Circuit Court held that "a computer system operator can be held contributorily liable if it 'has actual knowledge that specific infringing materials is available using its system' and can 'take simple measures to prevent further damage' to copyrighted works, yet continues to provide access to infringing works."[81] The Circuit Court determined that the district court did not analyze the facts surrounding the notice or knowledge that Google may have over the existence of infringing pictures in their search engine, adding "[a]pplying our test, Google could be held contributorily liable if it had knowledge that infringing Perfect 10 images were available using its search engine, could take simple measures to prevent further damage. . . and failed to take such steps."[82] The court remanded to the district to resolve the factual disputes over the adequacy of Perfect 10's notices and Google's

[75] *Id.* at 1160.
[76] The court would later on determine that Google was not liable due to a fair use defense.
[77] Hotaling v. Church of Jesus Christ of Latter-Day Saints 118 F.3d 199 (4th Cir. 1997).
[78] Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd., 545 U.S. 913 (2005).
[79] Gershwin Pub. Corp. v. Columbia Artists Management, Inc., 443 F.2d 1159 (2d Cir. 1971).
[80] *Perfect 10*, 508 F.3d at 1171 (citing Gershwin Publishing Corp. v Columbia Management, Inc., 443 F.2d 1159, 1162 (2d Cir. 1971)).
[81] *Id.* at 1172 (citing A&M Records v. Napster, 239 F.3d 1004, 1022 (9th Circ. 2001) *and* Religious Tech Center v. Netcom, 907 F. Supp. 1361, 1375 (N.D. Cal. 1995)).
[82] *Id.*

response to these notices. The court then discussed the vicarious liability, if any, incurred by Google, concluding that Perfect 10 did not show a likelihood of success at establishing Google's ability to stop or limit the content. This showing was necessary to prove vicarious liability. Finally, the court instructed the district court to determine if Google could qualify for immunity under Title II of the Digital Millennium Copyright Act for service providers.[83]

In sum, *Perfect 10* holds that linking and in-frame displays do not produce an absolute responsibility, nor does it completely shield from responsibility. Incidentally, it must also be pointed out, had the court ruled against Google, search engines as a whole could have been detrimentally affected and with that, the flow of information on the Internet could have been dramatically impacted. Furthermore, Google lacked direct control over how its algorithm produced any given search result in a way similar to the one Napster had under its centralized servers. However, although the court reaffirmed the use of the server test as the more "technologically appropriate" test, its application has yet to be seen to the new wave of user generated websites which actively link to third party infringing content.

IV. Facebook, In-Frame Linking, and User Inducement: Secondary Liability?

A. Background on Facebook and the "Share" Feature

1. Facebook: What is it?

Facebook is a social network (arguably the largest) in which users can connect to other users and communicate with each other, share and upload pictures, videos, notes, information, and embed web content, among many other features. Although users can control their levels of privacy, the default settings allow for any update a user makes to their profile to be displayed in the "news feed." The "news feed" is the "home page" that every user sees when they first log in to their account. Users, when logging in to their home page, will then see all their friends' "feeds", or updates, on their "news feed." In other words, every time a user updates his page, Facebook proceeds to "publish" his update to the "news feed." When a user shares web content, said "posting," is then broadcasted to his friends, who will see a thumbnail version of the content posted on their news feed. Although the update does not get directed at any one person in particular (although this is an available option), the fact that said update is shown on the home page of the other users is hard to ignore. Furthermore, users are likely to open the web content posted by their friend, since it is being posted for the sole reason of "sharing it" with said friends. The user who posts the content also has the option of

[83] 17 U.S.C. § 512 (2009).

placing a caption or message with the post. Usually the caption will be an invitation to see the content.

When the other users see this posting, and open it, Facebook directs the user to the source website. Facebook does not make a copy of the content, but merely links to it by using an "in-line linking" within a frame, much like Google uses in its image search. Take for example, the posting of a YouTube video clip. The posting user (the poster) finds the video while browsing YouTube, he clicks on his web browser's toolbar, and selects a button, installed by Facebook, to "share." The browser opens a new window, in which it logs into the user's Facebook account, and asks the user if he wants to "post it to his profile" or "send as a message" to another user. The window also allows the poster to write a caption or message that will be displayed with the posted content. The poster decides that the video is funny and could include a caption such as "Great video, a must see!" Once the poster selects the "post" button, the content is then displayed as a thumbnail on his profile. Later, his friends, when they log on to see his profile page, will immediately see the thumbnail and caption of the content on the profile. Alternatively, they will see the preview of the content on their "news feed" when they log in. Upon seeing it, they could click on the thumbnail, which will direct the web browser to open a new window, displaying the page in which the content originally located. However, Facebook frames the page by maintaining a horizontal bar on top of the page (which the user can remove) in which Facebook allows the user to "comment" on the content or to "share" it, thus allowing the user to "repost" the content on his own profile.

2. *Shared Content: How Can It Be Seen and Controlled?*

Now assume that the content posted is clearly infringing; it could be a clip from the rock band Metallica, uploaded by an individual user. The poster has taken a video clip, which is infringing, and has made it available to a multitude of users known as "friends." Those users will now have access to an infringing clip that they may have otherwise never found. If the poster has a copious friend list, it could mean that hundreds or thousands of users are now aware of this video clip and could, in theory, access it. The end result is that infringing content is propagated and distributed across the Facebook network by means of linking and embedding. This web content could be displayed on the profiles of hundreds, or dozens of thousands of people as can be the case with popular celebrities or "Internet stars" who can now have unlimited friends. Now, the user can control where his "shared content" is distributed to, since they could alter the privacy settings so that it does not "broadcast" on their friends "news feed", in which case it would only appear on their profile. Under this scenario, their friends would not be alerted of the shared content whereas in the more typical scenarios, all friends are alerted.

Given that the user can customize his Facebook "presence" and "broadcasting" in a variety of ways and degrees, we will focus on the most general type of setting, which is the default setting that all users get when they sign up, and the one that a user who seeks to purposely "reach" many people would have.

B. Where is the Infringement?

For a user to be held contributory liable, there needs to be a direct infringement by another.[84] Therefore, for the user to be liable, it must be true that the content they are sharing is, by itself, infringing. This question is easily answered with multimedia content such as audiovisual clips hosted on video-sharing sites (such as Youtube), and to an extent, images. Assuming the clip is an unauthorized reproduction or adaptation of a protected work, direct infringement can be rapidly determined. Both audiovisuals and images are reproduced on the site hosting them (to which the site can refute a secondary liability claim if it complies with the requirements of the DMCA) and are perceivable to the public. Upon "playing" the video, display rights and performance rights are infringed since the performance/display is occurring over a transmission to the public which can number anywhere from a dozen to several million viewers at any given time. Furthermore, once the video is uploaded, it is indexed in the respective video-sharing site. It is usually available via a simple Internet search engine since the video is both available by index and is also being "transferred" from the host site to the user every time it is accessed, it violates the distribution right both under the *Hotaling*[85] holding as well as the *Perfect 10*[86] holding. The "open" and public manner in which most video hosting sites operate also likens them to a space "open to the public," thus under *Columbia v. Aveco,*[87] the performance of these audiovisual clips would be a public performance and display (when appropriate).

Having established the initial direct infringement, the first prerequisite for contributory infringement to exist is met. The question now turns to the end user who views the uploaded media content; who is allegedly infringing. Are the end users who open and view the infringing clip actually infringing? In *A&M Records, Inc. v. Napster,*[88] the Ninth Circuit acknowledged the district court's assertion that the Napster users were directly infringing both when they uploaded music files and when they

[84] *Gershwin*, 443 F.2d at 1159.
[85] Hotaling v. Church of Jesus Christ of Latter-Day Saints, 118 F.3d 199 (4th Cir. 1997).
[86] Perfect 10 v. Google, Inc., 416 F. Supp. 2d 828, 833 (C.D. Cal. 2006).
[87] Columbia Pictures Industries, Inc. v. Aveco, Inc., 800 F.2d 59 (3rd Cir. 1980).
[88] A&M Records, Inc. v. Napster, Inc., 239 F.3d 1004 (9th Cir 2001) (stating "Napster users who download files containing copyrighted music violate plaintiff's reproduction rights.").

downloaded said files. It could be argued that Youtube users differ from Napster users in a crucial way. Youtube users do not download a copy on to their computer, which they could easily access at any time.

This argument, although on its face seemingly true, does not conform to the way users access data nowadays. It used to be; now it is not the only way. With the advent of broadband and Wi-Fi networks, including public Wi-Fi and smart phones capable of accessing the Internet, there is less need for users to physically host data when streaming the same data is just as seamless. Users today have the same access to files they had with Napster, only they need not download a physical file since they can stream it from a variety of places at any time. Furthermore, as was explained in Part II, computers do make a copy of the work being streamed even though it is not readably available to the user. However, even if the cached copy is held not to be a reproduction under the Act, the fact is that users now have "virtual copies" they can download on demand anywhere they are. The "copy" thus, need not be on the user's hard drive, but merely at the user's fingertips. Therefore, the end users who view an audiovisual clip from Youtube, for example, can be infringing in the same manner that the Napster end users were when they downloaded the copyrighted file. Both users have succeeded in being able to access unauthorized copies of copyrighted works "on demand" and can perform them whenever they wish. With direct infringers at both ends of the line, we now look at the role of the Facebook user who shares the content, facilitating the initial infringement of one to the subsequent infringement of the other.

V. Linking Content: When Sharing Becomes Infringing and What Can Be Done

A. Secondary Liability by Linking

A person is held to contributory infringe when they induce, cause, or materially contribute to the infringing conduct of another.[89] In this scenario, it is the "middle man," the Facebook user who finds the infringing content and "shares" it with his group of friends; which is essentially a distribution list. It is that user who not only finds the content and broadcasts it on his profile page and on the page of the friends he is connected with but the one who can also induce them to view it by adding suggestive comments on the link. It is my conclusion that contributory infringement liability should be found when the users satisfiy four requirements: (1) they must share content that a reasonable person would find to be infringing (such as a music video uploaded by someone who is clearly not the artist or label); (2) their "privacy settings" should be such that would "broadcast" the posting of the content to all their "friends"; (3) their "friends" should be a number that reasonably

[89] *Gershwin*, 443 F.2d at 1159.

exceeds the "normal circle of family and social acquaintances" standard; and (4) the user must include suggestive or enticing comments on the link as to invite their friends to open it.[90]

My conclusion begins with requiring that the content be one that would make a reasonable person believe it is not authorized. Although liability is not waived by the infringing acts of a user who "had no reason to believe that his or her acts constituted an infringement,"[91] contributory infringement requires active knowledge of infringing activity. Second, the user must, upon "posting" the content, broadcast it so that the posting appears on all his "friends" news feed, therefore maximizing the reach of his broadcast and allowing the content to reach his friends without them having to access his profile first. If the user's privacy settings are set so that it does not "broadcast" his posting, the content will not be accessible to his friends unless they go to his profile and actively seek his posted content. It is important that the content be published on his friend's pages, so as to maximize the user's active steps to share and distribute the media. Third, a modest amount of friends could be argued to be the "online equivalent" of a social circle tolerated by the Act. The broadcast should reasonably exceed that of a "normal circle" and approach more of an "indiscriminate circle" of friends. This can be argued for users that have thousands of "friends" and easily held for users whose "friend lists" are less "actual friends" and more "followers" or fans; in which case the user would be a celebrity or person with online following. Finally, the user should include commentary to induce and/or invite his friends to view the content. The stronger the language the user uses, the more he will fall under the inducement doctrine as held in *Grokster*.[92]

Assuming the above requirements are met, the liability should also be considered under the *Perfect 10* holding. Under the server test, the user who shares the content, and whose name appears within the "in-line frame," would not be liable since he is not storing the content and transmitting the content to the viewer. However, this case is easily distinguished from the case in *Perfect 10.* There, the court was faced with the "actions" done by Google's search engine which is controlled by a mathematical algorithm in reaction to the input that users give it; whereas, in this case the user actively seeks the content and shares it. The active steps taken by the user and the inducing conduct should determine infringement by linking not under the

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[90] Since users are not akin to what Sony was in the Betamax case (i.e. the producer of the article of commerce), the "Sony Defense" will not be available to them. *See* Gershwin Pub. Corp. v. Columbia Artists Management, Inc., 443 F.2d 1159 (2d Cir. 1971)..

[91] 17 U.S.C. § 504(c)(2) (2009).

[92] Metro-Goldwyn-Mayer Studios v. Grokster, Ltd., 545 U.S. 913 (2005).

Perfect 10 holding, but under the holding in *Intellectual Reserve, Inc.*[93] Without the benefit of the server test, the user would be liable for contributory infringement either by inducement or by the more general doctrine described in *Gershwin*.[94]

B. Compulsory Licensing: Solution?

Although my argument is that secondary infringement is occurring, as we speak, at a high volume on Facebook, the solution should not be a redub of the failed Motion Picture Association of America/Recording Industry Association of America lawsuits against college students and surprised grandmothers. Rather, copyright owners should accept the fact that this kind of infringement will only become more common and prevalent given the ease with which it can be done and the appearance of legitimacy that it involves in the eyes of the users. Furthermore, as social networks evolve and as our technology and "online status" becomes more and more omnipresent in our lives, I suggest a solution much derided by the Copyright Office: a compulsory license.[95]

Congress can legislate the creation of a collective society that can impose a levy on Internet Service Providers, which can then be distributed among the artists and owners in a way similar to the Audio Home Recording Act and the Alliance of Artists and Recording Companies do with the private copy levy. This would ensure that artists and owners receive compensation they would otherwise not receive. It would also, contrary to what the Copyright Office argues, foment creativity and expression since the rapid spread of web content over social networks leads to more awareness of the artists or the work, and to new expressions in response to said work.[96] The RIAA lawsuits proved that going after individuals only made a difference to those who get sued, just as well as going after individual Facebook users will not produce positive results. Instead, artists and owners should seek to avoid the deadly mistake they did with Napster, and find a solution that works

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[93] Intellectual Reserve, Inc. v. Utah Lighthouse Ministry, Inc., 75 F. Supp. 2d 1290 (D. Utah 1999) (holding that a user who posted the hyperlink addresses of infringing content he was asked to remove on his website was liable for copyright infringement).

[94] Furthermore, although individual profiles resemble a "web portal" more and more these days, neither them nor the users fit the definition of a service provider under the DMCA since they do not provide transmissions or services for digital online communication. *See* 17 U.S.C.A. § 512(k)(1); Gershwin Pub. Corp. v. Columbia Artists Management, Inc., 443 F.2d 1159 (2d Cir. 1971).

[95] "A compulsory license mechanism is in derogation of the rights of authors and copyright owners." *Copyright Webcasting Programming on the Internet: Hearing Before the Subcommittee on Courts and Intellectual Property of the Committee on the Judiciary House of Representatives* 106th Cong. 66-178 (2000) (statement by Copyright Register, Marybeth Peters).

[96] This is particularly common in the case of political messages and content.

within the system while, at the same time, flagging and removing copyrighted content on video-sharing sites while continuing to support legal video hosting sites such as Hulu.com. [97]

Web 2.0, as social networks tend to be called by some, will only continue to expand and users will continue to share content regardless of the "flavor of the month" site that is being used. As such, infringing content will continue to be distributed via linking that may or may not be "in-line framed," but that will be exponentially broadcasted as more users see it, and "share it forward." This is the direction technology and its users are moving towards. Authors and artists should work with this tide and exploit the free distribution that comes with it, and together, help steer the tide away from unauthorized content and towards sites that provide users with the same content, but sponsored by the artists who produce it.

[97] Hulu.com is a joint venture, owned by NBC Universal, FOX Entertainment Group, Disney-ABC Television Group and Providence Equity Partners. It is operated by an independent team, and is dedicated to the online streaming of television shows and movies. For more information, visit http://www.hulu.com/about.

SHARING MEDIA ON SOCIAL NETWORKS: INFRINGEMENT BY LINKING?

JEAN G. VIDAL FONT*

I. INTRODUCTION

Social networking sites such as Facebook, MySpace, and Twitter have become so popular that they are now used as verb tenses in the same way Google is used to describe an online search.[1] Facebook, for one, claims over 901 million monthly active users.[2] One of the most popular features that Facebook has is the "share" feature, which allows users to "post" web content

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[1] As in "I *facebooked* you but I couldn't find you," "Did you *twitter* about it?", etc.

[2] FACEBOOK, http://newsroom.fb.com/content/default.aspx?NewsAreaId=22 (last updated Mar. 2012).

on their profiles.[3] By posting web content on their profiles, the user's "friends" (or people whom the user authorizes to see his/her profile) can see the web content that the user posted. Also, they can be invited to access it. Facebook boasts that over 30 billion pieces of content are shared every month.[4] This content includes, but is not limited to, Internet links, videos, web pages, photos, and any other content that a user can find on the Internet. To take a single act as the basis for the question posed here, and to serve also as an illustrative example; a user can go to YouTube, select a video, which the user knows (or should know) that is infringing of the artist's rights, and "shares" it on his[5] profile.[6] In a simple sequence of acts that can take less than ten seconds, the user has now made the link available to possibly hundreds (or even thousands) of his or her "friends."[7] Assuming now that the content being shared is infringing, is the user who "shares" it guilty of contributory infringement?

This paper will analyze a situation in which millions of users find themselves doing each day: sharing web content on their social networking profiles. Part II of this paper will discuss the exclusive rights that the Copyright Act affords authors and the remedies those authors have to protect their rights, including but not limited to the two prevailing theories of secondary infringement, namely (1) contributory infringement and (2) vicarious infringement, as well as a more recent development known as infringement by inducement. Part III will discuss the *Perfect 10 v. Google*[8] decision by the Ninth Circuit and its relevance to the situation before us, since said case deals with "in-frame linking," a feature which is crucial to the Facebook "share" feature. Part IV will analyze the "sharing" feature in light of the doctrines discussed and determine if sharing content on a profile is akin

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[3] This article will not discuss the "video" feature found on Facebook. The "video" feature allows users to upload (onto the Facebook servers) their own videos, thereby embedding them onto their profiles. This feature is different than the "sharing" feature in regards to the possible liability the user might incur since, if the video were to be infringing, the user would be liable for direct infringement. This paper focuses on the possible contributory infringement liability that the user might incur when he "shares" preexisting content that is uploaded/hosted by an unrelated third party.

[4] FACEBOOK, http://www.facebook.com/applications/Posted_Items/2309869772#/press/ info.php?statistics (last updated Dec. 2011).

[5] Throughout the article I will refer to the user as a "he" since a gender neutral term results in confusing language given the many references I make to an individual user's actions.

[6] YouTube is a user-generated video portal that is owned by Google, Inc. Users can upload their own videos onto YouTube and they are available for anyone to see.

[7] Facebook has since lifted the limit it used to impose on the maximum number of "friends" a user could have. It was previously set to 5,000 users but has since been lifted. *See* Michael Arrington, *Facebook To Lift 5,000 Friends Limit*, TECHCRUNCH (Friday, May 9th, 2008) http://techcrunch.com/2008/05/09/facebook-to-lift-5000-friends-limit/ (last accessed on April 14th, 2012).

[8] Perfect 10 v. Google, Inc., 416 F. Supp. 2d 828 (C.D. Cal. 2006).

to distributing or making available, and if the user's actions fall under one of the secondary liability doctrines developed by the courts. Part V will conclude that, in some cases, when a user shares content that is visibly infringing to a large number of "friends," he could be liable under the doctrine of secondary liability.

II. Rights and Remedies

A. Exclusive Rights in Copyright

Congress, pursuant to Article I Section 8 of the Constitution, affords copyright owners a set of exclusive rights to exploit in regards to their works.[9] The Copyright Act of 1976[10] (hereinafter "the Act") lists those six exclusive rights and the scope of their extent.[11] The Act gives the owner of a copyright the right to: (1) reproduce copies; (2) prepare derivative works; (3) distribute copies; (4) publicly perform; (5) display the work; and (6) the right to the digital public performance of the underlying sound recording.[12] The mentioned rights are the key for this analysis given that infringement can only be found when any of the said rights are violated and secondary liability can only be determined if direct infringement is found. This article will be limited to discussing only those rights that are primarily (and possibly) affected by the "sharing" feature found in Facebook.

1. Reproduction

Section 106(1) of the Copyright Act affords the owner of the work the exclusive right to reproduce the copyrighted work in copies or phonorecords. Copies and phonorecords, as used in the Act, consist of material objects in which the work is fixed and it is only the reproduction of those material objects that is included in the reproduction right.[13] The copy in question must be one that can be perceived, reproduced or otherwise communicated for a period of more than a transitory duration.[14] Furthermore, it is not required to distribute or sell the copy in order to violate the exclusive right. The mere unauthorized (and presumably not protected under the fair use doctrine) reproduction of the work is enough ground for infringement of the reproduction right.[15]

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[9] U.S. CONST. art. I, § 8.
[10] Copyright Act of 1976, 17 U.S.C. §§ 101-810.
[11] 17 U.S.C. § 106 (2009).
[12] *Id.*
[13] NIMMER, NIMMER ON COPYRIGHT 8-31, (2010).
[14] 17 U.S.C. § 101 (2009); NIMMER, *supra* note 13 at 8-32.
[15] NIMMER, *supra* note 13 at 8-35.

In the computer world, courts have found that the copying of computer software to the random access memory ("RAM") constitutes "copying" for the purpose of the reproduction right in Section 106 of the Act.[16] In *Mai Systems Corps. v. Peak Computers,* the court, recognizing its own limitations, held:

> However, it is generally accepted that the loading of software into a computer constitutes the creation of a copy under the Copyright Act. . . . We recognize that these authorities are somewhat troubling since they do not specify that a copy is created regardless of whether the software is loaded into the RAM, the hard disk or the read only memory ("ROM"). However, since we find that the copy created in the RAM can be "perceived, reproduced, or otherwise communicated," we hold that the loading of software into the RAM creates a copy under the Copyright Act.[17]

RAM copying is the more traditional form in which a work can be copied into a computer, be it by the user's specific command or by the operation of a computer program. In the context of Internet browsing, "caching" is the most common form of reproducing or copying objects or data that is later used by the Internet browser.[18] The Digital Millennium Copyright Act (DMCA) recognizes the reproduction (and hence, violation) caused by "caching" by exempting Internet Service Providers from infringing under the "System Caching Safe Harbor."[19] Websites such as Youtube and most online streaming media work on the user's computer by caching the media in an unknown folder (to the user), and storing it there until the browser deletes the "cache". However, armed with a little technical knowledge and a quick search on Google, users can easily access the cache folder and the media stored in it, therefore making the copies accessible and perceivable to the user. Moreover, many users nowadays are "permanently" connected to the

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[16] *See* MAI Systems. Corp. v. Peak Computer, Inc. 991 F.2d 511, 518 (9th Cir. 1993).

[17] *Id.* at 519 (internal citations omitted); *see* NIMMER, *supra* note 13 at 8-131 (Nimmer agrees with the ruling, and points out that the U.S. Copyright Office is also in agreement with the ruling).

[18] Matthew Fagan, *Can you do a Wayback on that? "The Legal communities use of cached web pages in and out of trial,"* 13 B.U. J. Sci & Tech. L. 46, 50 (2007) (stating "In the Internet context, caching similarly means "the storing of copies of content [that subscribers wish to see most often] at locations in the network closer to subscribers than their original sources .. . . in order to provide more rapid retrieval of information." Web browsers like Firefox and Internet Explorer store cached web pages at the location closest to the user (the local computer itself), while Internet service providers ("ISPs") cache web pages on proxy servers in order to provide streamlined access to the most popular pages among a large group of users. In this way, users get their copies from the proxy server instead of the site owner's server, which is likely to be slower and more congested than the proxy server.").

[19] 17 U.S.C. § 512(b) (2009).

Internet through their home networks, high speed cellular networks, and office networks, thus, the "streaming copy" needs to be viewed under today's use and how accessible it is to the user. This last point will be discussed in greater detail in Part V.

2. The Right to Distribute

Section 106(3) of the Act affords copyright owners the exclusive right to "distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending."[20] The right does not apply to any distribution of copies but only such distributions that are made to the public.[21] In order to have a valid claim under a violation of Section 106(3), the owner must prove ownership of the right and prove an actual dissemination of either copies or phonorecords.[22] The term "dissemination" has not been without controversy, and there seems to be a disagreement over its reach between two Circuit Courts.

The Ninth Circuit affirmed the holding of the district court in *Perfect 10 v. Google*; it held that public distribution in the Internet context requires the actual transfer of the file from one user to the other.[23] However, the Fourth Circuit held in *Hotaling v. Church of Jesus Christ* that a violation to the right to distribute is found when the alleged infringer makes the work available to the public, regardless of the public's acceptance of that offer.[24] In that same case, the court distinguished the right of the owner of a legally acquired copy of a work to lend or lease said copy without violating the author's 106(3) right from the distribution of unlawful copies, the latter being a violation of the right to distribute.[25] The difference between the two circuits seems to lie in what constitutes distribution. The Fourth Circuit holds that *making available is enough to constitute distribution* while the Ninth Circuit requires the *actual dissemination* of the work (in the context of the Internet).[26] Although the "black letter law" might be unclear, what is clear, though, is that it remains the sole right of the copyright owner to control the distribution of his work to the public.

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[20] 17 U.S.C. §106(3) (2002).
[21] NIMMER, *supra* note 13 at 8-148.
[22] *Id.*, citing National Car Rental Sys. Inc. v. Computer Assoc., 991 F.2d 426, 434 (8th Cir. 1993).
[23] Perfect 10 v. Google, Inc., 416 F. Supp. 2d 828, 844 (C.D. Cal. 2006).
[24] Ahern v. County of Nassau, 118 F. 3d 119 (4th Cir. 1997).
[25] *Id.* at 203.
[26] Robert Kasunic, *Making Circumstantial Proof of Distribution Available*, 18 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 1145,1153-1154 (2008).

3. The Right to Display and Perform

Sections 106(4) and 106(5) grant the owner the exclusive right to publicly perform and/or display his work, so long as it is within the scope of the right. Sections 106(4) and (5) state that:

> (4) [I]n the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;
>
> (5) [I]n the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly.[27]

Therefore, it is only in the enumerated works that the above-mentioned rights will apply. The display and performance rights only protect the public performance/display of such. In contrast, the Act defines a public performance or display as:

> (1) [T]o perform or display it at a place open to the public or at any place where a substantial number of persons outside of a normal circle of a family and its social acquaintances is gathered; or
>
> (2) to transmit or otherwise communicate a performance or display of the work to a place specified by clause (1) or to the public, by means of any device or process, whether the members of the public capable of receiving the performance or display receive it in the same place or in separate places and at the same time or at different times.[28]

The phrase "open to the public" has not been without debate, but a clear expression was found in *Columbia v. Aveco.*[29] The court held, and so far it has not been overruled, that a public space need not be crowded with people for a public performance (or display) to take place just as long as the space is, in fact, open to the public.[30] Whereas this provided a clear guidance in traditional settings, it is less clear on how it applies to the Internet and social networking sites, which are, in essence, *de facto* public spaces.

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[27] 17 U.S.C. § 106 (4)-(5)
[28] *Id.* at § 101.
[29] Columbia Pictures Industries, Inc. v. Aveco, Inc., 800 F.2d 59 (3rd Cir. 1986).
[30] *Id.*

The Act defines displaying as "to show a copy of it, either directly or by means of a film, slide, television image, or any other device or process or, in the case of a motion picture or other audiovisual work, to show individual images nonsequentially."[31] The right, similar to the right of distribution, affords the owner of a lawfully made copy the right to display it publicly, yet the same privilege is not conferred to those who obtain unlawfully made copies.[32] A Congressional House Report, published soon after the enactment of the 1976 Act, stated that the privilege is also limited when the work is performed or displayed by transmissions. This Report elaborated that the owner cannot transmit the display to members of the public who are located in a different place where the work is held, whereas he can display it (via transmission) to the public as long as they are in the same place where the work is held.[33] In other words, the owner of a work cannot transmit the display (and presumably, the performance) of the work through the Internet to users who are located outside the physical location of where the work is being held.

The Act defines a performance as "to recite, render, play, dance, or act it, either directly or by means of any device or process or, in the case of a motion picture or other audiovisual work, to show its images in any sequence or to make the sounds accompanying it audible."[34] Although similar, the rights apply to different means of communicating the work. In the matter that concerns this article, users are "performing" the work when they open audiovisual media clips that are usually scenes (if not the entire work) of movies, television shows or music videos, and are usually "displaying" the work when they open images or display a literary piece on their computer monitors.

Although the rights so far discussed are not all the rights that appear under the Act, they are, however, the rights that seem to be in play as far as the rights which are affected the most in "in-frame" linking posts on social networking sites. Having thus constructed a clear frame of which rights are in play and their scope, we now turn to the remedies that are afforded to copyright owners to protect said rights.

B. Remedies

Section 501 of the Act states that copyright owners have the power to enforce their rights against those who directly infringe on their exclusive rights.[35] Generally, the Act allows the owner to recover actual damages

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[31] 17 U.S.C.§ 101.
[32] NIMMER, *supra* note 13 at 8-285.
[33] H. R,. . No. 94-1476, at 79-80 (1976).
[34] 17 U.S.C. § 101.
[35] 17 U.S.C. § 501.

and/or statutory damages as defined in sections 504(b) and 504(c).[36] Moreover, what is important is that copyright owners can enforce their right on two distinct groups, those who directly infringe on their rights, and those who contribute or are vicariously responsible to the direct infringement of another person.

Direct infringement is aimed at the person who directly infringes on the exclusive rights afforded by the Act whereas secondary infringement is aimed not at the principal culprits, but at those who facilitate said infringement. On one hand, in order to prevail on direct infringement, the plaintiff must prove ownership of the alleged infringed material and must demonstrate that the alleged infringer has violated at least one exclusive right of the plaintiff's copyright.[37] On the other hand, the courts have developed the doctrine of secondary liability in two strands: (1) vicarious infringement (liability); and (2) contributory infringement.

1. *Vicarious Liability*

Vicarious liability for copyright infringement, like contributory infringement, was developed by jurisprudence rather than by statute. Vicarious liability was the result of a series of decisions of the Second Circuit as "an outgrown of the agency principles of *respondent superior.*"[38] In *Gershwin Publishing v. Columbia Artists Management, Inc.*,[39] the Second Circuit created the test that would become the "standard test" for vicarious liability. The court held, "even in the absence of an employer-employee relationship one may be vicariously liable if he has the right and ability to supervise the infringing activity and also has a direct financial interest in such activities."[40] Given the requisite of "direct financial interest" for the finding of vicarious liability, one may conclude that most Facebook users would not be liable under this doctrine since there is no financial interest in "sharing" web content with their friends on the social network. However, the same cannot be said for contributory infringement, since this doctrine does not require a direct financial interest.

2. *Contributory Infringement*

In *Gershwin Publishing v. Columbia*, the Court of Appeals for the Second Circuit summed the concept of contributory infringement, stating that "[s]imilarly, one who, with knowledge of the infringing activity, induces,

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[36] 17 U.S.C. § 504(b)-(c).
[37] Perfect 10 v. Google, 508 F.3d 1146, 1159 (9th Cir. 2007).
[38] Fonovisa v. Cherry Auctions, Inc., 76 F.3d 259, 261-262 (9th Cir. 1996).
[39] Gershwin Pub. Corp. v. Columbia Artists Management, Inc., 443 F.2d 1159 (2d Cir. 1971).
[40] *Id.* at 1162.

causes or materially contributes to the infringing conduct of another, may be held liable as a 'contributory' infringer."[41] The Supreme Court addressed this issue in the *Sony-Universal City* case, holding that copyright law had to "strike a balance between a copyright holder's legitimate demand for effective-not merely symbolic-protection of the statutory monopoly, and the rights of others freely to engage in substantially unrelated areas of commerce."[42] Contributory infringement, unlike vicarious, can occur in settings in which no financial benefit is being transferred between the parties, but where a party is directly infringing at the inducement or encouragement of another. The development of this doctrine, beginning with the Supreme Court's decision in *Kalem v. Harper Brothers* up to their most recent decision in *Metro-Goldwyn v. Grokster*,[43] is worth tracing in order to understand not only what is held to be contributory liable, but also what defenses can a party bring against it.

In *Kalem v. Harper Brothers*,[44] Harper Brothers brought suit against Kalem for the alleged infringement of the copyright in General Lew Wallace's *Ben Hur* by the exhibition of moving pictures of the incidents told in the book. Kalem was in the business of producing moving-picture films, one of them being the object of litigation in the suit. Although the Court found Kalem liable for copyright infringement, it did express what would later become the "staples of commerce" doctrine. The Court distinguished between the merchant who sells his product, capable of being used in illegal activities, without knowing it would be used for said activities against the seller who sells it with a view to the illegal resale. In this case, Kalem not only produced the machines, but also advertised the use of his film for dramatic reproduction. It was not until 1984, in the *Sony-Universal City* case, that the Court elaborated on this holding.

In *Sony Corporation v. Universal City*, the Court debated whether Sony could be held liable for any infringement done by consumers with their Betamax video recorders. The Court distinguished this case from *Kalem*, holding that whereas in *Kalem* the producers "did not merely provide the 'means' to accomplish an infringing activity, the producers supplied the work itself", Sony did not supply Betamax consumers with the "respondents' works".[45] The Court, in seeking to determine what responsibility, if any rested on Sony, turned to patent law. More specifically, they turned to the "staples of commerce" doctrine. This doctrine holds that "[u]nless a commodity 'has no use except through practice of the patented method' . . . the patentee has no right to claim that its distribution constitutes

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[41] *Id.*
[42] Sony Corp. v. Universal City, 464 U.S. 417, 442 (1984).
[43] Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd., 545 U.S. 913 (2005).
[44] Kalem Co. v. Harper Bros., 222 U.S. 55 (1911).
[45] *Sony Corp.* 464 U.S., at 446.

contributory infringement."[46] The Court, mindful of the differences between patent and copyright law, sought to strike a balance between the copyright holder's legitimate demand for effective, not merely symbolic, protection of the statutory monopoly, and the rights of others freely to engage in substantially unrelated areas of commerce."[47]

As such, the Court held that the sale of articles of commerce will not constitute contributory infringement if the product is "widely used for legitimate, unobjectionable purposes. Indeed, it may merely be capable of substantial non-infringing uses."[48] The "Sony Rule" would not be revisited by the Supreme Court until 2005, and even then, the Court made it clear that it was not changing said Rule.

In 2005, the Supreme Court held, by unanimous vote, that Grokster was to be liable for copyright infringement by using a doctrine known as "inducement" which, just like the Sony rule, had its origins in patent law. In *Metro-Goldwyn-Mayer Studios v. Grokster*,[49] the Court faced a *de facto* successor to the popular file-sharing program called Napster. Grokster was a similar file sharing program but, unlike Napster, it did not hold a centralized server. It did, however, rely on a technology called "Peer to Peer" which uses the users' computers as "mini routers" to connect to other users.[50] The Ninth Circuit had affirmed the District Court's finding in that Grokster was not liable for secondary liability for its users direct infringement under the "Sony Betamax" doctrine, holding that Grokster was a commercial product capable of substantial non-infringing use.[51] In reversing the Ninth Circuit's decision, the Supreme Court refused to discuss Grokster's responsibility under the staples of commerce doctrine, choosing instead to hold Grokster responsible under the "inducement doctrine."

The Court, citing *Oak Industries Inc. v. Zenith Electronics*,[52] described the "inducement doctrine," as evidence of active steps taken to encourage direct infringement, "such as advertising an infringing use or instructing how to engage in an infringing use . . . overcomes the law's reluctance to find liability when a defendant merely sells a commercial product suitable for

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[46] *Id.* at 441.
[47] *Id.* at 442.
[48] *Id.*
[49] Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd., 545 U.S. 913 (2005).
[50] A&M Records, Inc. v. Napster, 239 F.3d 1004 (9th Cir. 2001) (holding that Napster, an online file-sharing service that had centralized servers, was liable for vicarious and contributory copyright infringement for the direct infringement that its users were committing. The court recognized that Napster had significant non-infringing use, but the degree of control that Napster had over its servers and the volume of infringing material that passed through its network outweighed the use of the "Betamax" defense).
[51] Metro-Goldwyn-Mayer Studios, Inc. v. Grokster Ltd. . 380 F.3d 1154 (9th Cir. 2004).
[52] Oak Industries, Inc. v. Zenith Electronics Corp., 697 F. Supp. 988, 992 (N.D. Ill. 1988).

some lawful use."[53] Finally, the Court, adopting the doctrine the same way it adopted the staple-article doctrine of patent law in Sony, held "that one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties."[54] The Court distinguished between "mere knowledge of infringing potential or of actual uses" (which would not be actionable) and "purposeful, culpable expression and conduct" (which would be actionable).

However, it is not clear if the Court treats infringement by inducement as a separate doctrine of secondary liability or if it is a "type" of contributory liability. Furthermore, there is legitimate concern with the degree to which the courts could take the "inducement rule" in every day scenarios, thus applying it to "almost anyone whose behavior regularly supports infringement by others."[55] However, given its distinct requirements when compared to contributory infringement, I would argue that it is a third doctrine of secondary liability which we will treat separately for our analysis.[56] This brings us to what courts held (prior to *Perfect 10*) on what contributory responsibility might befall on websites that "link" to infringing material.

3. Infringement By Linking

Prior to the *Perfect 10* case, one of the cases that best dealt with "infringement by linking"[57] was an Indiana District Court case, *Batesville Services v. Funeral Depot.*[58] In *Batesville*, the defendant, Funeral Depot, operated a website through which it sold caskets which included the brand name caskets sold by Batesville. Funeral Depot was not an authorized reseller of Batesville caskets, but they had arrangements with other authorized dealers in order sell the caskets to the customers. The copyright issue arose from Funeral Depot's use of Batesville images, which were hosted on third party servers (which were authorized dealers). Funeral Depot would display a thumb-nail sized image on their website of a Batesville casket. The user would click on the thumbnail and a bigger picture would appear. The larger image was hosted on a reseller's website but it would display Funeral Depot's phone number. The website would also tell the user that the

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[53] *Grokster, Ltd.*, 545 U.S. at 915, (citing Water Technologies Corp. v. Calco, 850 F.2d 660, 668 (C.A. Fed. 1988)).
[54] *Id.* .
[55] Alfred C. Yen, *Third-Party Copyright Liability After Grokster*, 91 MINN. L. REV. 184, 231 (2006).
[56] This view is also shared by some in academia, such as Professor Alfred Yen, *See id.* at 239.
[57] By "linking" I refer to hyper linking within a website to a different site or file which is hosted in an independent server from the one hosting the website being viewed.
[58] Batesville Services, Inc. v. Funeral Depot, Inc., 2004 WL 2750253 (S.D. Ind. 2004).

displayed image was shown through the authorized reseller and not through Funeral Depot. Batesville alleged that Funeral Depot was not authorized to use their copyrighted photographs and that the fact that they were hosted on a different server did not affect the copyright liability that Funeral Depot had accrued.

Although the controversy in the case dealt with various issues, the relevant issue here was the court's discussion on linking. Funeral Depot argued that linking can never amount to a copyright violation.[59] In support, they cited two district court opinions from California.[60] The holding in those two cases did not, however, convince the court. The court concluded that the two cases that Funeral Depot cited showed "that it may be difficult to prove copyright infringement or contributory infringement from the use of hyperlinks, indeed, hyperlinks are essential to the operation of the Internet for a host of legitimate purposes."[61] However, the court refused to embrace Funeral's argument, that the district cases embraced a "sweeping per se rule" that linking did not constitute infringement. The court instead referred to a district court opinion from Utah in which the court upheld an injunction against a defendant who was providing addresses of websites containing infringing material he had previously hosted and was ordered to remove.[62] The court found that Funeral Depot acted more like the defendant in *Intellectual Reserve, Inc. v. Utah Lighthouse Ministry, Inc.,* than the defendant in *Ticketmaster* or *Bernstein* since Funeral Depot did not "casually" link the images owned by Batesville, but created the pages and links, paid for them and still controlled them.[63]

Batesville, as well as the cases cited by the court, demonstrate the "gray area" in which the courts in *Perfect 10 v. Google* had to engage and decide. On one hand, the person who "links" the material is not hosting nor creating the material, since it is already there due to the work of a third party. On the other hand, the person who "links" is directing traffic and giving a third party site more publicity than it previously had, therefore increasing the number of people who visit it and contributing to the infringing activity. None of the cases prior to *Perfect 10* engaged in depth this issue, particularly the discussion over the combination of linking and "in-frame linking".

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[59] *Id.* at 11.
[60] Ticketmaster v. Tickets.com, 2000 WL 525390 (C.D. Cal.); Bernstein v. JC Penney, 1998 WL 906644 (C.D. Cal.).
[61] *Batesville Services, Inc.*, 2004 WL at 11.
[62] Intellectual Reserve, Inc. v. Utah Lighthouse Ministry, Inc., 75 F. Supp. 2d 1290 (D. Utah 1999).
[63] *Batesville Services*, *Inc.*, 2004 WL at 12.

III. PERFECT 10 AND IN-FRAME LINKS

A. The Case at the District Court

The plaintiff in this case is a publisher of adult magazines known as "Perfect 10" and the operator of a subscription website under the same name. Plaintiffs owned the copyright on all the images of the models that they used in their publications and websites. Perfect 10 exploited these images and derived profits from the sale of their publications and the subscriptions to their websites. Perfect 10 grew concerned with the distribution and unauthorized reproductions of their images on a variety of websites. Aware of the violation to their exclusive rights under the Act, they naturally proceeded to go against the infringing parties. Their search led them to the defendant, Google. Google operates a well-known search engine (www.google.com), which also includes an "image search" engine. Google's engine would "crawl" the Internet (thus indexing websites and their content) in order to provide the user with search results. Among those websites indexed were the websites who were infringing on Perfect 10's copyright over the images. When a user searched for images, he would be shown several thumbnail images, which Google hosted. The user would then click on the thumbnail and would be taken to that party's website. However, Google would "frame" the third party's website within their own website, so the user would see Google's frame in the upper part of their browser, with the third party's website beneath the frame. This could give the user the impression that he was still navigating within Google's search engine; when in fact, he was not.[64]

Perfect 10 filed suit against Google in the Central California District Court asserting both copyright and trademark claims.[65] Among the copyright claims, Perfect 10 alleged direct copyright infringement, vicarious copyright infringement, and contributory copyright infringement. Perfect 10 alleged that Google's thumbnails of images belonging to Perfect 10 were a direct copyright violation, while Google's linking to websites containing infringing material were both a vicarious infringement (due to Google's revenue deriving from advertisements) and a contributory infringement. In their part, Google claimed a fair use defense against the direct copyright claim (and succeeded on those merits) and argued that it bore no responsibility for the infringing content to which it linked.

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[64] *See* Perfect 10 v. Google, Inc., 416 F. Supp. 2d 828, 833 (C.D. Cal. 2006). (defining the term "Framing" as " . . . a method of "combin[ing] multiple pages in a single window so that different content can be viewed simultaneously, typically so that one 'frame' can be used to annotate the other content or to maintain a link with an earlier web page").

[65] *Id.* at 828.

The court discussed several issues that are of particular importance here, namely whether an "in-line link" constituted a display and which test should be applied to make that determination. Perfect 10 alleged that Google was violating their display right by displaying the infringing site framed within Google's page since the display was the "mere act of incorporating content into a webpage that is then pulled by the browser" under a test called the "Incorporation Test."[66] Under this test the entity who hosts the webpage which incorporates the infringing material is the entity who displays said image. Google, however, argued for a "server test" which would define a "display" as "the act of serving content over the web, i.e. physically sending ones and zeroes over the Internet to the user's browser."[67] Under this definition, the party that hosts the data and transmits it is the entity who displays the image. The court then recognized the dangers that an absolute adoption of either test could have. On one hand, the server test would shield a user who created a website with the clear intent to facilitate infringing content without actually hosting any of it, while the incorporation test could cause a chilling effect on a core aspect of the Internet, its capacity to link to other sites.[68]

The court acknowledged the lack of precedents on this matter and highlighted several decisions that had dealt with contributory infringement and linking while, at the same time, dismissing Perfect 10's reliance on an opinion by the Ninth Circuit in *Kelly v. Arriba*,[69] which was withdrawn in a subsequent opinion by the same court. However, this court, lacking a binding precedent on which to determine the case, decided to adopt the server test for several reasons. First, it concluded that the test is an accurate reflection of what happens "at the technological level as users browse the web and thus, reflects the reality of how content" travels over the Internet.[70] Second, the court concluded that the server test did not invite infringement by a search engine nor preclude liability for direct infringement while maintaining a test which website operators can easily understand and the courts can apply with ease. Finally, the court concluded that the server test recognizes the third parties as the direct infringers, and not the search engine while, at the same time, maintaining a delicate balance for which copyright strives to maintain between technology and creativity.[71] Applying the test, the court held that Google did not directly infringe on Perfect 10's display rights.

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[66] *Perfect 10*, 416 F. Supp. 2d at 839.
[67] *Id.*
[68] *Id.* at 840.
[69] Kelly v. Arriba Soft Corp. 280 F.3d 934 (9th Cir. 2002) *withdrawn by* Kelly v Arriba Soft Corp., 336 F.3d 811 (9th Cir. 2003). (First citation is Kelly I and the second citation is Kelly II).
[70] *Perfect 10*, 416 F. Supp. 2d at 843.
[71] *Id.*

The court then focused on the secondary liability alleged by Perfect 10. It determined that Google lacked the *actual* or *constructive* knowledge necessary for contributory liability to exist. Google could not monitor all the websites it "crawled" and indexed since its operation is controlled by mathematical algorithms and not by direct human input. Google, the court concluded, did not materially contribute to the infringement done by third parties since it only facilitated searches directed by the user, in contrast to Napster, which dedicated itself to helping users locate infringing audio files on their servers. The court distinguished Google from the defendants in *Columbia Pictures v. Redd Horne*,[72] in that Google did not conduct all the advertising and promotional work for the alleged infringers. Google provides advertisement based on the normal use of their search engines but not on the particular infringing work. As such, the court determined that Perfect 10 did not meet the burden necessary to succeed on their injunctions based on contributory infringement. Finally, the court held there was no merit to Perfect 10's claim of vicarious infringement since Google lacked the "right and ability to control" the infringing activity of others as required under the doctrine of vicarious liability.[73] Predictably, Perfect 10 appealed the decision to the Ninth Circuit Court.

B. Court of Appeals

The Ninth Circuit Court began its opinion by reiterating the working definitions for the two technological features in the case; the "in-line linking" and the "framing" feature as used by Google. "In-line linking" was described as the process by which the webpage directs a user's browser to incorporate content from different computers into a single window, whereas framing refers to the process by which information from one computer appears to frame and annotate the in-line linked content from another.[74] The in-line linking allowed Google to display an image search result which could include an infringing copy of a picture owned by Perfect 10, within the "Google search frame" but without Google itself making a copy of it; instead directing the user to the alleged infringer's website.

The court addressed two issues on appeal: (1) the claim on direct infringement (based on the display right and the distribution right) and (2) the claim on secondary liability. With regards to the direct infringement, the court began with the claim on the display right. The court distinguished the display of the thumb-nail sized pictures that Google hosted and the full size pictures that Google linked to, adding "in sum, based on the plain language of the statute, a person displays a photographic image by using a computer to

[72] Columbia Pictures Industries, Inc. v. Redd Horne, Inc. 749 F.2d 154 (3rd Cir. 1984).
[73] *Perfect 10*, 416 F. Supp. 2d at 858.
[74] Perfect 10 v. Google, 508 F.3d 1146, 1156 (9th Cir. 2007).

fill a computer screen with a copy of the photographic image fixed in the computer's memory."[75] The court, thus, held that Perfect 10 had made a *prima facie* case that Google had directly infringed its display right in regards to the thumbnail images.[76] The court determined since the full size image was hosted on a different website, direct liability could not be found.

Perfect 10 argued that merely making images available infringed the copyright owner's distribution rights. They relied on *Hotaling v. Church of Jesus Christ*,[77] holding that an owner of a collection of works who makes them available to the public may be deemed to have distributed copies of the works. The court rejected Perfect 10's argument, and held that the "deemed distribution" rule did not apply to Google since they do not own Perfect 10's copyrighted work and they (Google) do not communicate these images to the users that use Google's search engine. The court distinguished the case against Google from the holding in *Napster* and *Hotaling* in so much as Google did not own the Perfect 10 images nor did they communicate those images to the people using Google's search engine. The court held against Perfect 10 on the likelihood of success in the injunction sought.

Turning then to the issue of contributory infringement, the court began by stating that their test for contributory infringement was consistent with the rule set forth in *Grokster*[78] and in *Gershwin*.[79] The court emphasized that the infringer must be found to "induce, cause or materially contribute to the infringing conduct of another" with knowledge of the infringing activity.[80] The Circuit Court held that "a computer system operator can be held contributorily liable if it 'has actual knowledge that specific infringing materials is available using its system' and can 'take simple measures to prevent further damage' to copyrighted works, yet continues to provide access to infringing works."[81] The Circuit Court determined that the district court did not analyze the facts surrounding the notice or knowledge that Google may have over the existence of infringing pictures in their search engine, adding "[a]pplying our test, Google could be held contributorily liable if it had knowledge that infringing Perfect 10 images were available using its search engine, could take simple measures to prevent further damage. . . and failed to take such steps."[82] The court remanded to the district to resolve the factual disputes over the adequacy of Perfect 10's notices and Google's

[75] *Id.* at 1160.
[76] The court would later on determine that Google was not liable due to a fair use defense.
[77] Hotaling v. Church of Jesus Christ of Latter-Day Saints 118 F.3d 199 (4th Cir. 1997).
[78] Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd., 545 U.S. 913 (2005).
[79] Gershwin Pub. Corp. v. Columbia Artists Management, Inc., 443 F.2d 1159 (2d Cir. 1971).
[80] *Perfect 10*, 508 F.3d at 1171 (citing Gershwin Publishing Corp. v Columbia Management, Inc., 443 F.2d 1159, 1162 (2d Cir. 1971)).
[81] *Id.* at 1172 (citing A&M Records v. Napster, 239 F.3d 1004, 1022 (9th Circ. 2001) *and* Religious Tech Center v. Netcom, 907 F. Supp. 1361, 1375 (N.D. Cal. 1995)).
[82] *Id.*

response to these notices. The court then discussed the vicarious liability, if any, incurred by Google, concluding that Perfect 10 did not show a likelihood of success at establishing Google's ability to stop or limit the content. This showing was necessary to prove vicarious liability. Finally, the court instructed the district court to determine if Google could qualify for immunity under Title II of the Digital Millennium Copyright Act for service providers.[83]

In sum, *Perfect 10* holds that linking and in-frame displays do not produce an absolute responsibility, nor does it completely shield from responsibility. Incidentally, it must also be pointed out, had the court ruled against Google, search engines as a whole could have been detrimentally affected and with that, the flow of information on the Internet could have been dramatically impacted. Furthermore, Google lacked direct control over how its algorithm produced any given search result in a way similar to the one Napster had under its centralized servers. However, although the court reaffirmed the use of the server test as the more "technologically appropriate" test, its application has yet to be seen to the new wave of user generated websites which actively link to third party infringing content.

IV. FACEBOOK, IN-FRAME LINKING, AND USER INDUCEMENT: SECONDARY LIABILITY?

A. Background on Facebook and the "Share" Feature

1. Facebook: What is it?

Facebook is a social network (arguably the largest) in which users can connect to other users and communicate with each other, share and upload pictures, videos, notes, information, and embed web content, among many other features. Although users can control their levels of privacy, the default settings allow for any update a user makes to their profile to be displayed in the "news feed." The "news feed" is the "home page" that every user sees when they first log in to their account. Users, when logging in to their home page, will then see all their friends' "feeds", or updates, on their "news feed." In other words, every time a user updates his page, Facebook proceeds to "publish" his update to the "news feed." When a user shares web content, said "posting," is then broadcasted to his friends, who will see a thumbnail version of the content posted on their news feed. Although the update does not get directed at any one person in particular (although this is an available option), the fact that said update is shown on the home page of the other users is hard to ignore. Furthermore, users are likely to open the web content posted by their friend, since it is being posted for the sole reason of "sharing it" with said friends. The user who posts the content also has the option of

[83] 17 U.S.C. § 512 (2009).

placing a caption or message with the post. Usually the caption will be an invitation to see the content.

When the other users see this posting, and open it, Facebook directs the user to the source website. Facebook does not make a copy of the content, but merely links to it by using an "in-line linking" within a frame, much like Google uses in its image search. Take for example, the posting of a YouTube video clip. The posting user (the poster) finds the video while browsing YouTube, he clicks on his web browser's toolbar, and selects a button, installed by Facebook, to "share." The browser opens a new window, in which it logs into the user's Facebook account, and asks the user if he wants to "post it to his profile" or "send as a message" to another user. The window also allows the poster to write a caption or message that will be displayed with the posted content. The poster decides that the video is funny and could include a caption such as "Great video, a must see!" Once the poster selects the "post" button, the content is then displayed as a thumbnail on his profile. Later, his friends, when they log on to see his profile page, will immediately see the thumbnail and caption of the content on the profile. Alternatively, they will see the preview of the content on their "news feed" when they log in. Upon seeing it, they could click on the thumbnail, which will direct the web browser to open a new window, displaying the page in which the content originally located. However, Facebook frames the page by maintaining a horizontal bar on top of the page (which the user can remove) in which Facebook allows the user to "comment" on the content or to "share" it, thus allowing the user to "repost" the content on his own profile.

2. *Shared Content: How Can It Be Seen and Controlled?*

Now assume that the content posted is clearly infringing; it could be a clip from the rock band Metallica, uploaded by an individual user. The poster has taken a video clip, which is infringing, and has made it available to a multitude of users known as "friends." Those users will now have access to an infringing clip that they may have otherwise never found. If the poster has a copious friend list, it could mean that hundreds or thousands of users are now aware of this video clip and could, in theory, access it. The end result is that infringing content is propagated and distributed across the Facebook network by means of linking and embedding. This web content could be displayed on the profiles of hundreds, or dozens of thousands of people as can be the case with popular celebrities or "Internet stars" who can now have unlimited friends. Now, the user can control where his "shared content" is distributed to, since they could alter the privacy settings so that it does not "broadcast" on their friends "news feed", in which case it would only appear on their profile. Under this scenario, their friends would not be alerted of the shared content whereas in the more typical scenarios, all friends are alerted.

Given that the user can customize his Facebook "presence" and "broadcasting" in a variety of ways and degrees, we will focus on the most general type of setting, which is the default setting that all users get when they sign up, and the one that a user who seeks to purposely "reach" many people would have.

B. Where is the Infringement?

For a user to be held contributory liable, there needs to be a direct infringement by another.[84] Therefore, for the user to be liable, it must be true that the content they are sharing is, by itself, infringing. This question is easily answered with multimedia content such as audiovisual clips hosted on video-sharing sites (such as Youtube), and to an extent, images. Assuming the clip is an unauthorized reproduction or adaptation of a protected work, direct infringement can be rapidly determined. Both audiovisuals and images are reproduced on the site hosting them (to which the site can refute a secondary liability claim if it complies with the requirements of the DMCA) and are perceivable to the public. Upon "playing" the video, display rights and performance rights are infringed since the performance/display is occurring over a transmission to the public which can number anywhere from a dozen to several million viewers at any given time. Furthermore, once the video is uploaded, it is indexed in the respective video-sharing site. It is usually available via a simple Internet search engine since the video is both available by index and is also being "transferred" from the host site to the user every time it is accessed, it violates the distribution right both under the *Hotaling*[85] holding as well as the *Perfect 10*[86] holding. The "open" and public manner in which most video hosting sites operate also likens them to a space "open to the public," thus under *Columbia v. Aveco,*[87] the performance of these audiovisual clips would be a public performance and display (when appropriate).

Having established the initial direct infringement, the first prerequisite for contributory infringement to exist is met. The question now turns to the end user who views the uploaded media content; who is allegedly infringing. Are the end users who open and view the infringing clip actually infringing? In *A&M Records, Inc. v. Napster,*[88] the Ninth Circuit acknowledged the district court's assertion that the Napster users were directly infringing both when they uploaded music files and when they

[84] *Gershwin*, 443 F.2d at 1159.
[85] Hotaling v. Church of Jesus Christ of Latter-Day Saints, 118 F.3d 199 (4th Cir. 1997).
[86] Perfect 10 v. Google, Inc., 416 F. Supp. 2d 828, 833 (C.D. Cal. 2006).
[87] Columbia Pictures Industries, Inc. v. Aveco, Inc., 800 F.2d 59 (3rd Cir. 1980).
[88] A&M Records, Inc. v. Napster, Inc., 239 F.3d 1004 (9th Cir 2001) (stating "Napster users who download files containing copyrighted music violate plaintiff's reproduction rights.").

downloaded said files. It could be argued that Youtube users differ from Napster users in a crucial way. Youtube users do not download a copy on to their computer, which they could easily access at any time.

This argument, although on its face seemingly true, does not conform to the way users access data nowadays. It used to be; now it is not the only way. With the advent of broadband and Wi-Fi networks, including public Wi-Fi and smart phones capable of accessing the Internet, there is less need for users to physically host data when streaming the same data is just as seamless. Users today have the same access to files they had with Napster, only they need not download a physical file since they can stream it from a variety of places at any time. Furthermore, as was explained in Part II, computers do make a copy of the work being streamed even though it is not readably available to the user. However, even if the cached copy is held not to be a reproduction under the Act, the fact is that users now have "virtual copies" they can download on demand anywhere they are. The "copy" thus, need not be on the user's hard drive, but merely at the user's fingertips. Therefore, the end users who view an audiovisual clip from Youtube, for example, can be infringing in the same manner that the Napster end users were when they downloaded the copyrighted file. Both users have succeeded in being able to access unauthorized copies of copyrighted works "on demand" and can perform them whenever they wish. With direct infringers at both ends of the line, we now look at the role of the Facebook user who shares the content, facilitating the initial infringement of one to the subsequent infringement of the other.

V. Linking Content: When Sharing Becomes Infringing and What Can Be Done

A. Secondary Liability by Linking

A person is held to contributory infringe when they induce, cause, or materially contribute to the infringing conduct of another.[89] In this scenario, it is the "middle man," the Facebook user who finds the infringing content and "shares" it with his group of friends; which is essentially a distribution list. It is that user who not only finds the content and broadcasts it on his profile page and on the page of the friends he is connected with but the one who can also induce them to view it by adding suggestive comments on the link. It is my conclusion that contributory infringement liability should be found when the users satisfiy four requirements: (1) they must share content that a reasonable person would find to be infringing (such as a music video uploaded by someone who is clearly not the artist or label); (2) their "privacy settings" should be such that would "broadcast" the posting of the content to all their "friends"; (3) their "friends" should be a number that reasonably

[89] *Gershwin*, 443 F.2d at 1159.

exceeds the "normal circle of family and social acquaintances" standard; and (4) the user must include suggestive or enticing comments on the link as to invite their friends to open it.[90]

My conclusion begins with requiring that the content be one that would make a reasonable person believe it is not authorized. Although liability is not waived by the infringing acts of a user who "had no reason to believe that his or her acts constituted an infringement,"[91] contributory infringement requires active knowledge of infringing activity. Second, the user must, upon "posting" the content, broadcast it so that the posting appears on all his "friends" news feed, therefore maximizing the reach of his broadcast and allowing the content to reach his friends without them having to access his profile first. If the user's privacy settings are set so that it does not "broadcast" his posting, the content will not be accessible to his friends unless they go to his profile and actively seek his posted content. It is important that the content be published on his friend's pages, so as to maximize the user's active steps to share and distribute the media. Third, a modest amount of friends could be argued to be the "online equivalent" of a social circle tolerated by the Act. The broadcast should reasonably exceed that of a "normal circle" and approach more of an "indiscriminate circle" of friends. This can be argued for users that have thousands of "friends" and easily held for users whose "friend lists" are less "actual friends" and more "followers" or fans; in which case the user would be a celebrity or person with online following. Finally, the user should include commentary to induce and/or invite his friends to view the content. The stronger the language the user uses, the more he will fall under the inducement doctrine as held in *Grokster*.[92]

Assuming the above requirements are met, the liability should also be considered under the *Perfect 10* holding. Under the server test, the user who shares the content, and whose name appears within the "in-line frame," would not be liable since he is not storing the content and transmitting the content to the viewer. However, this case is easily distinguished from the case in *Perfect 10.* There, the court was faced with the "actions" done by Google's search engine which is controlled by a mathematical algorithm in reaction to the input that users give it; whereas, in this case the user actively seeks the content and shares it. The active steps taken by the user and the inducing conduct should determine infringement by linking not under the

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[90] Since users are not akin to what Sony was in the Betamax case (i.e. the producer of the article of commerce), the "Sony Defense" will not be available to them. *See* Gershwin Pub. Corp. v. Columbia Artists Management, Inc., 443 F.2d 1159 (2d Cir. 1971)..

[91] 17 U.S.C. § 504(c)(2) (2009).

[92] Metro-Goldwyn-Mayer Studios v. Grokster, Ltd., 545 U.S. 913 (2005).

Perfect 10 holding, but under the holding in *Intellectual Reserve, Inc.*[93] Without the benefit of the server test, the user would be liable for contributory infringement either by inducement or by the more general doctrine described in *Gershwin*.[94]

B. Compulsory Licensing: Solution?

Although my argument is that secondary infringement is occurring, as we speak, at a high volume on Facebook, the solution should not be a redub of the failed Motion Picture Association of America/Recording Industry Association of America lawsuits against college students and surprised grandmothers. Rather, copyright owners should accept the fact that this kind of infringement will only become more common and prevalent given the ease with which it can be done and the appearance of legitimacy that it involves in the eyes of the users. Furthermore, as social networks evolve and as our technology and "online status" becomes more and more omnipresent in our lives, I suggest a solution much derided by the Copyright Office: a compulsory license.[95]

Congress can legislate the creation of a collective society that can impose a levy on Internet Service Providers, which can then be distributed among the artists and owners in a way similar to the Audio Home Recording Act and the Alliance of Artists and Recording Companies do with the private copy levy. This would ensure that artists and owners receive compensation they would otherwise not receive. It would also, contrary to what the Copyright Office argues, foment creativity and expression since the rapid spread of web content over social networks leads to more awareness of the artists or the work, and to new expressions in response to said work.[96] The RIAA lawsuits proved that going after individuals only made a difference to those who get sued, just as well as going after individual Facebook users will not produce positive results. Instead, artists and owners should seek to avoid the deadly mistake they did with Napster, and find a solution that works

[93] Intellectual Reserve, Inc. v. Utah Lighthouse Ministry, Inc., 75 F. Supp. 2d 1290 (D. Utah 1999) (holding that a user who posted the hyperlink addresses of infringing content he was asked to remove on his website was liable for copyright infringement).

[94] Furthermore, although individual profiles resemble a "web portal" more and more these days, neither them nor the users fit the definition of a service provider under the DMCA since they do not provide transmissions or services for digital online communication. *See* 17 U.S.C.A. § 512(k)(1); Gershwin Pub. Corp. v. Columbia Artists Management, Inc., 443 F.2d 1159 (2d Cir. 1971).

[95] "A compulsory license mechanism is in derogation of the rights of authors and copyright owners." *Copyright Webcasting Programming on the Internet: Hearing Before the Subcommittee on Courts and Intellectual Property of the Committee on the Judiciary House of Representatives* 106th Cong. 66-178 (2000) (statement by Copyright Register, Marybeth Peters).

[96] This is particularly common in the case of political messages and content.

within the system while, at the same time, flagging and removing copyrighted content on video-sharing sites while continuing to support legal video hosting sites such as Hulu.com. [97]

Web 2.0, as social networks tend to be called by some, will only continue to expand and users will continue to share content regardless of the "flavor of the month" site that is being used. As such, infringing content will continue to be distributed via linking that may or may not be "in-line framed," but that will be exponentially broadcasted as more users see it, and "share it forward." This is the direction technology and its users are moving towards. Authors and artists should work with this tide and exploit the free distribution that comes with it, and together, help steer the tide away from unauthorized content and towards sites that provide users with the same content, but sponsored by the artists who produce it.

[97] Hulu.com is a joint venture, owned by NBC Universal, FOX Entertainment Group, Disney-ABC Television Group and Providence Equity Partners. It is operated by an independent team, and is dedicated to the online streaming of television shows and movies. For more information, visit http://www.hulu.com/about.

USO DE LAS REDES SOCIALES: ¿JUSTA CAUSA PARA DESPIDO?

RINA G. DÍAZ NOTA*

"As employers gain access to increasingly sophisticated technology, new legal issues seem destined to suffuse the workplace."

Vega Rodríguez v. Puerto Rico Telephone Co., 110 F.3d 174 (1st. Cir. 1997).

"The Internet is the first thing that humanity has built that humanity does not understand, the largest experiment in anarchy that we have ever had."

Eric Schmidt – Presidente de Google

I. INTRODUCCIÓN

Son las seis de la mañana y Mónica[1] actualiza nuevamente su cuenta de *Facebook.* En su comentario más reciente avisa a sus contactos que se encuentra de camino al "infierno", refiriéndose a su lugar de trabajo. En respuesta, recibe muestras de solidaridad de algunos compañeros de trabajo y de uno que otro conocido y familiar. Todos sus contactos saben, o pueden conocer a través de su perfil, el nombre de la empresa descrita esa mañana como el "infierno". Como en ocasiones anteriores, los comentarios despectivos publicados por Mónica son parte de la agenda de asuntos discutidos por la gerencia. Argumentos como: "Mónica está afectando nuestra reputación", "es una empleada desleal" y "ya hemos hablado con ella" se ponderan. Días más tarde, Mónica es despedida y, posteriormente, radica una demanda por despido injustificado. ¿Existe justa causa para este despido?

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[1] "Mónica" es el nombre asignado a un personaje para propósitos ilustrativos.

Esta y otras preguntas son las que se plantean en este escrito. ¿Cuál es la norma en Puerto Rico para atender este caso? ¿Se trata de mirar únicamente la Ley 80 de 1976 (En adelante, "Ley 80")?[2] ¿Qué consideraciones debe evaluar el patrono para crear normas sobre el uso de cuentas personales en redes sociales?

El propósito de este trabajo es realizar un análisis que sirva para establecer una guía o lista de cotejo al momento de evaluar un escenario de esta naturaleza que pudiera conllevar una acción de despido en Puerto Rico. Particularmente, se atenderá el escenario donde la red social ha sido utilizada por el empleado en su carácter personal, fuera del lugar de trabajo y/o en su tiempo libre.

Este análisis iniciará con la presentación de estadísticas del uso de las redes sociales y su impacto en la relación obrero–patronal, seguido de un examen del memorando más reciente publicado por la Junta Nacional de Relaciones del Trabajo y su postura en los casos relacionados con despidos por el uso de redes sociales.[3] A su vez, se examinará su posible aplicación en nuestro ordenamiento dentro de los parámetros que impone la Ley 80,[4] así como consideraciones de índole constitucional que apuntan a las figuras del patrono, empleado y sus respectivos derechos.

II. REDES SOCIALES: SU USO Y ALCANCE

Escenarios como el ejemplo anterior surgen, en parte, como consecuencia del fenómeno del uso de las redes sociales como extensión de nuestra interacción social. Las redes sociales han llegado para quedarse y su evolución las ha convertido en más que una moda.[5] Ahora, la inclusión de amistades, conocidos, familiares o, sencillamente, personas con las que se comparte algún tipo de interés, han transformado las relaciones interpersonales de muchos, impactando las dinámicas sociales en el mundo.

En Puerto Rico y a nivel mundial, la red social más popular es *Facebook,*[6] con una participación de un 83.4% del total de usuarios de

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[2] Ley de indemnización por despido sin justa causa, Ley Núm. 80 de 30 de mayo de 1976, según enmendada. 29 LPRA §§ 185a–185m (2009).

[3] NATIONAL LABOR RELATIONS BOARD, MEMORANDUM OM 11-74 (September 2011).

[4] 29 LPRA §§ 185a–185m.

[5] Para conocer la historia y el desarrollo de las redes sociales, véase Danah M. Boyd & Nicole B. Ellison, *Social Network Sites: Definition, History and Scholarship*, 13 J. COMPUTER-MEDIATED COMM., no. 1 (2007), disponible en http://jcmc.indiana.edu/vol13/issue1/boyd.ellison.html (consultado el 14 de noviembre de 2011). En este artículo, las autoras explican cómo, a partir del año 1997, comenzaron a desarrollarse las redes sociales y brindan una buena explicación de su funcionamiento.

[6] *The State of the Internet Now!*, STATE OF THE INTERNET NOW (Nov. 21, 2011), http://www.onlineschools.org/state-of-the-internet/soti.html; *Top 15 Most Popular Social Networking Sites: March 2012*, EBIZMBA RANK - THE EBUSINESS KKNOWLEDGEBASE SURVEY (Nov. 21, 2011), http://www.ebizmba.com/articles/social-networking-websites.

Internet.[7] A pesar de que han surgido controversias en relación a los controles de privacidad,[8] *Facebook* se ha mantenido en una tendencia de crecimiento constante. A principios del año 2011 contaba con cerca de 500 millones de usuarios. En comparación, a finales de marzo de 2012, el mismo contaba con más de 901 millones de usuarios activos.[9] De éstos, más del 50% acceden a su cuenta a diario y, en promedio, cada uno tiene cerca de 130 *amigos*. Además de *Facebook*, los usuarios de Internet, ya sea desde sus celulares, computadoras portátiles o tabletas, utilizan distintos recursos o portales que permiten una experiencia interactiva.

Las páginas conocidas como *blogs* permiten que cualquier persona publique su opinión en relación a cualquier tema. Son también un modo accesible de satisfacer la necesidad de muchos de sentirse escuchados y se consideran análogos a un diario virtual donde el autor registra sus reflexiones y preocupaciones.[10] Se estima que existen cerca de 152 mil millones de *blogs*.[11] Su accesibilidad pudiera presentar una desventaja en comparación con el recurso literario tradicional, que pasa por un gran escrutinio para cuidar que la publicación no traspase barreras legales, por ser escritos bajo la emoción y sin la debida reflexión sobre las posibles consecuencias.[12]

Las posibilidades no se limitan al medio escrito, pues se extienden a momentos grabados en fotografías y en videos. Páginas como *YouTube* permiten que los usuarios publiquen y compartan con el mundo videos creativos, educativos o simplemente de eventos que presenciaron. Se estima que treinta y cinco (35) horas de video son publicados en *YouTube* a cada minuto.[13]

El alcance de todos estos medios mencionados y muchos otros trasciende la utilidad de mero entretenimiento. Si bien permiten y facilitan la interacción, representan un arma poderosa para impactar opiniones y auspiciar movimientos constructivos y destructivos. El movimiento exitoso

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[7] *Estudios de comportamiento sobre el uso de medios digitales y móviles*, ESTUDIOS TÉCNICOS (14 de noviembre de 2011), http://www.estudiostecnicos.com/news.php?news=Estudio_de_comportamiento_sobre_el_uso_de_medios_digitales_y_m%C3%B3viles_&news_id=90&start=4&category_id=0&parent_id=0&arcyear=Y&arcmonth=M&.

[8] Julia Angwin, Shayndi Raice & Spencer E. Ante, *Facebook Retreats on Privacy - Social Network Nears Settlement on Charges it Misled Users About Their Data*, THE WALL STREET JOURNAL, Nov. 11, 2011, http://online.wsj.com/article/SB10001424052970204224604577030383745515166.html.

[9] *Facebook's latest news, announcements and media resources – Fact Sheet – Facebook,* FACEBOOK (May 25, 2012), http://newsroom.fb.com/content/default.aspx?NewsAreaId=22.

[10] Bijal J. Patel, *Myspace or Yours: The Abridgement of the blogosphere at the hands of at-will-employment*, 44 HOUS. L. REV. 777, 782 (2007).

[11] *The State of the Internet Now!*, *supra* nota 6.

[12] Paul S. Gutman, *Say What? Blogging and Employment Law in Conflict*, 27 COLUM. J.L. & ARTS 145, 153 (2003).

[13] *The State of the Internet Now!*, *supra* nota 6.

del pueblo de Egipto ante la dictadura de Hosni Mubarak es tan solo una muestra histórica del poder y del alcance de las redes sociales. En varios medios de comunicación se reseñó cómo las redes sociales fueron una herramienta clave que permitió a los egipcios lograr un consenso en torno a sus manifestaciones y que facilitó la coordinación de su lucha.[14]

III. La relación obrero-patronal y las redes sociales

El uso de las redes sociales también ha modificado el modo en que se perfecciona la relación contractual obrero-patronal desde el proceso de reclutamiento, durante la relación de empleo, como lo es en términos de su productividad, y en la etapa del desenlace por un despido. Cada una de estas etapas pudiera ser evaluada detenidamente, en especial el periodo de reclutamiento y el modo y tipo de información sobre los candidatos a la cual los patronos están accediendo a través de las redes sociales. El campo que nos ocupa en este escrito es la etapa del despido.

Si bien el uso de las redes puede ser constructivo, es cierto que hay quienes las utilizan para ocasionar daño en distintos modos.[15] No necesitamos un gran esfuerzo para imaginar el alcance y consecuencias que pueden tener un escrito o un video en la reputación de una persona o empresa. Celebridades, políticos, ejecutivos y compañías han tenido que responder al público e, inclusive, desaparecer de los medios o renunciar a sus cargos luego de haber protagonizado un escándalo originado en las redes sociales. Es precisamente este potencial de agravio a la imagen de las empresas la justificación primordial que presentan los patronos para tomar medidas disciplinarias contra empleados que publican comentarios despectivos en relación a sus empleos.[16]

Es una noción popular en extinción la cual postula lo siguiente: lo que uno haga en su carácter personal y posteriormente *postée* en una red social de ninguna manera afectará su empleo. Recientemente hemos visto los titulares en medios noticiosos sobre despidos de empleados por comentarios publicados en una red social.[17] Por la misma razón, como la interacción social

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[14] Catharine Smith, *Egypt's Facebook Revolution: Wael Ghonim Thanks The Social Network*, THE HUFFINGTON POST, Feb. 11, 2011, http://www.huffingtonpost.com/2011/02/11/egypt-facebook-revolution-wael-ghonim_n_822078.html.

[15] JAY E. GRENIG & JEFFREY S. KINSLER, DISCOVERY OF ELECTRONICALLY STORED INFORMATION, HANDBOOK OF FEDERAL CIVIL DISCOVERY AND DISCLOSURE, § 14:18 (2nd ed.).

[16] Patel, *supra* nota 10, a la pág. 782. El autor hace referencia en la nota 28 al artículo *MyEmployerSucks.com: Why You Need a Blogging Policy*, VA. EMP. L. LETTER, July 2005, a la pág. 4, donde se discute y se alerta cómo comentarios publicados en *blogs* por empleados molestos pueden ser desastrosos para las empresas debido al gran alcance de la audiencia en el Internet de manera instantánea.

[17] Se dice que el caso de Heather Armstrong fue uno de los primeros casos notorios sobre el despido por el uso de redes sociales de una empleada que fue despedida luego de publicar

es una que permite accesibilidad global, en ocasiones surge confusión del modo en que se deben atacar y resolver estos casos; además, se tiene que ver el alcance de ciertos derechos en relación con la jurisdicción en donde se encuentran los protagonistas de los mismos. Un empleado puede ver una noticia en una red social sobre un obrero que ha hecho exactamente lo mismo en otro país y ha salido airoso, pero ese no es necesariamente su escenario por la distinción en la aplicación de las normas de acuerdo al foro. Además, la duda también permea en la gerencia de las empresas, la cual tampoco tiene una respuesta simple y clara para manejar efectivamente posibles ataques a su imagen y reputación por parte de su personal, y por lo tanto pierde de perspectiva las actividades que pudieran ser consideradas como protegidas.

Consecuentemente, en distintas jurisdicciones y foros, las cortes han fallado a favor y en contra del empleado, al amparo de distintas normas y el contexto de cada situación.[18] Ante esta realidad, los patronos deben detenerse a ponderar con cautela el verdadero impacto que tuvo o tiene el comentario. En fin, según comenta Nancy Cleeland, portavoz de la Junta Nacional de Relaciones del Trabajo, esto es un "territorio nuevo".[19] Es por ello que este tipo de escenario presenta un reto para patronos, empleados y abogados.[20] A pesar de que el uso de las redes es cotidiano, su norma y la respuesta ante posibles escenarios aún no lo es.

IV. MEMORANDO OM 11-74 – JUNTA NACIONAL DE RELACIONES DEL TRABAJO

El pasado 18 de agosto de 2011, la Junta Nacional de Relaciones del Trabajo (en adelante, "la Junta") emitió el Memorando OM 11-74 (en adelante, el "Memorando del 2011"), en el cual resume su postura ante las reclamaciones recientes relacionadas a acciones disciplinarias y despidos por uso de las redes sociales.[21] Aunque el resultado de estos casos no es norma vinculante, el Memorando del 2011 es una buena herramienta que los patronos pueden utilizar para asegurarse de que sus actuaciones y normas se

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las frustraciones generadas por su empleo y empresa en su *blog*, www.dooce.com. Desde entonces, el término *dooced* es utilizado en inglés para referirse al hecho de ser despedido por comentarios publicados en *blogs*. *Véase* Sprague, *Fired for Blogging,* 9 U. PA. J. LAB. & EMP. L. 355 (2007).

[18] Kashmir Hill, *When You Can and Can't Fire Employees for Social Media Misbehavior*, FORBES, Aug. 25, 2011, http://www.forbes.com/sites/kashmirhill/2011/08/25/when-you-can-and-cant-fire-employees-for-social-media-misbehavior/.

[19] Dave Jamieson, *Facebook Firings: Feds, Managers Navigate "New Territory" in Employment*, THE HUFFINGTON POST, Aug. 2, 2011, http://www.huffingtonpost.com/2011/08/02/facebook-firings-new-territory_n_915520.html.

[20] Steven C. Bennett, *Civil Discovery of Social Networking Information*, 39 SW. L. REV. 413, 415 (2010).

[21] NATIONAL LABOR RELATIONS BOARD, *supra* nota 3.

aparten de prácticas ilícitas.[22] Además de servir como guía, es importante que los patronos se mantengan actualizados en cuanto al desarrollo de estos casos. La postura de la Junta se aparta del Memorando publicado en el año 2009[23] en cuanto a las normas empresariales consideradas como ilícitas, de manera que aquellos patronos que formularon sus normas a la luz de las recomendaciones anteriores, deberían revisar el contenido y hacer los ajustes correspondientes. Veamos los asuntos atendidos en el documento.

A. Actividades protegidas y concertadas

La mayoría de los casos que discute el Memorando atiende reclamaciones al amparo de la sección 157 y 158 de la Ley Nacional de Relaciones del Trabajo,[24] y fácilmente pudiéramos agruparlos en aquellos casos en que se discute la definición de una actividad protegida y concertada y en las consideraciones que hace la Junta en relación a la validez y alcance de las normas empresariales.

La sección 157 de la Ley Nacional de Relaciones del Trabajo concede unos derechos a los trabajadores, como el derecho a participar en actividades protegidas y concertadas.[25] Este tipo de actividades consiste en aquellas en que participa un grupo de trabajadores que procuran modificar el sueldo o las condiciones de trabajo. En varias ocasiones, la Junta ha ido explicando y definiendo el alcance de este concepto. Muestra de esto es precisamente el Memorando OM 11-74. La sección 158(a)(1) de dicha Ley prohíbe a los patronos "interferir con, refrenar, o coaccionar a los empleados en el ejercicio de los derechos relacionados a organizar, formar, hacerse miembro de o ayudar a una organización obrera con el fin de negociaciones colectivas, o participar en actividades concertadas, o abstenerse de cualquier actividad parecida".[26]

La Junta hace referencia a los factores enumerados en el caso de *Meyers* o mejor conocido como la *prueba Meyers*, cuando evalúa si una

[22] National Labor Relations Act, 29 U.S.C. § 151-169 (2006).

[23] NATIONAL LABOR RELATIONS BOARD, MEMORANDUM 18-CA-19081 (Dec. 2009).

[24] 29 U.S.C. §§ 157–158(a). Derechos de los empleados: "a organizarse, a constituir, afiliarse o ayudar a organizaciones obreras, a negociar colectivamente a través de representantes seleccionados por ellos mismos, y a dedicarse a otras actividades concertadas con el propósito de negociar colectivamente u otro fin de ayuda o protección mutua…". Del mismo modo, la seccion 158 define las prácticas ilícitas del patrono y de las organizaciones sindicales. En la sección 158(a) define como práctica ilícita del patrono el "intervenir en, restringir, o coaccionar a sus empleados en el ejercicio de los derechos garantizados en la sección 157", esto es, entre otras, la participación de actividades protegidas y concertadas. (Traducción suplida).

[25] *Id.*

[26] *Id.*

actividad se considera como protegida o concertada.[27] A tales efectos, más allá de revisar que la actividad procure modificar el sueldo o las condiciones de trabajo, considera también si la misma se llevó a cabo en o con la autoridad de otros empleados, y no únicamente en representación del empleado que la ejercitó. También considera aquellas circunstancias en las que empleados, de manera individual, persiguen iniciar o inducir a otros a hacerlo o buscan prepararse para una acción grupal; de la misma manera, si el empleado, de modo individual y como excepción a la norma que protege actividades concertadas, presenta un reclamo del grupo a la gerencia.[28]

No obstante, no toda actividad o conducta se considera protegida. En su evaluación, la Junta utiliza los criterios esbozados en el caso de *Atlantic Steel*.[29] Para ello va a tomar en consideración y hará un balance entre la naturaleza del comentario, el lugar donde hizo, el contexto en que se realizó y si estaba relacionado o si fue provocado por una práctica injusta del patrono.

1. *Casos no considerados como actividad protegida o concertada*

La Junta no extendió la protección a la conducta de un empleado que fue despedido luego de publicar en su perfil de *Facebook* una queja, en su carácter individual, sobre una de las normas de su empleo, cuando ésta no surge ni busca inducir a una actividad concertada.[30] Este fue el caso de un *bartender* que publicó comentarios en su perfil relacionados a la política de propinas del restaurante en el que trabajaba en una conversación con uno de sus contactos, que en este caso era un familiar y no un compañero de trabajo.[31]

El contenido del comentario hacía referencia a la frustración que sentía por no haber recibido un aumento en un periodo de cinco (5) años y que, a pesar de que él hacía el trabajo de los meseros, no podía recibir propinas debido a las estipulaciones de las normas. En específico y a la luz de los factores mencionados, la Junta concluyó que, a pesar de que el comentario publicado en la red social estaba relacionado a una norma empresarial que impactaba su sueldo y condiciones de trabajo, no había evidencia de que se perseguía una actividad concertada. Los participantes del comentario no

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[27] Meyers Industries (Meyers I), 268 NLRB 493 (1984); Meyers Industries (Meyers II), 281 NLRB 882 (1986). Ambos casos son citados en el MEMORANDO OM 11-74, *supra* nota 3, a la pág. 4.

[28] *Véase* Nancy J. King, *Labor Law for Managers of Non-Union Employees in Traditional and Cyber Workplaces,* 40 AM. BUS. L.J. 827, 833 (2003) (discusión de las justificaciones por las quejas individuales no tienen la misma protección que una actividad concertada).

[29] Atlantic Steel Co., 245 NLRB 814, 816-817 (1979) (citado en NATIONAL LABOR RELATIONS BOARD, *supra* nota 3, a la pág. 5).

[30] NATIONAL LABOR RELATIONS BOARD, *supra* nota 3, a la pág. 14.

[31] *Véase* JT's Porch Saloon & Eatery, Ltd., Case No. 13-CA-46689, 2011 NLRB GCM LEXIS 24 (July 7, 2011).

eran compañeros de trabajo, ya que eran personas ajenas al patrono, y en ningún momento el empleado compartió su queja con la gerencia. Esto nos pudiera llevar a concluir que, de haber participado algún compañero de trabajo o de haberse realizado un acercamiento al patrono, es posible que la decisión hubiesen sido distinta. Sin embargo, en este caso, el *bartender* también utilizó un lenguaje peyorativo para referirse a los clientes del restaurante. El empleado comentó que deseaba que éstos "se asfixiaran con el trago mientras conducían ebrios", razón primordial que utilizó el patrono para despedirlo.

Otro escenario que no fue considerado como una actividad protegida o concertada fue el caso de un empleado que escribió en el perfil de un Senador de su respectivo estado para expresarse en desacuerdo con el manejo de los servicios de emergencias a nivel estatal; entre ellos, el modo en que operaba su patrono, ya que entendía que éste no estaba colaborando para mejorar la situación del estado.[32] En su comentario, incluyó detalles de la operación de respuesta a llamadas de emergencia, la cantidad limitada de camiones disponibles y un evento en que uno de sus compañeros no tenía el conocimiento para brindar resucitación adecuadamente.

En ningún momento se demostró que el empleado presentó estas preocupaciones al patrono o que las discutió con otros compañeros de trabajo. La justificación de su despido fue hacer comentarios despectivos de la empresa y por revelar información confidencial sobre una llamada de servicio; por lo tanto, sus comentarios constituían una violación a las normas de conducta de la compañía. La Junta concluyó que, bajo la *prueba Meyers,* su comentario no podía considerarse como una actividad protegida o concertada ya que no había discutido sus preocupaciones con ningún compañero de trabajo, tampoco las había informado a la gerencia y, además, admitió que no esperaba una acción en específico por parte del Senador, pues su intención era dar publicidad a la situación.

En otro caso, el patrono, una tienda de ventas al detal, disciplinó a un empleado que describió su ambiente de trabajo como una tiranía y además, alertó la posible renuncia de varios compañeros si la situación no cambiaba.[33] En este caso, algunos compañeros de trabajo sí participaron en la conversación, pero no se demostró que perseguían iniciar algún tipo de acción grupal; al contrario, los comentarios se limitaban a brindarle apoyo moral. En respuesta a sus compañeros, el empleado utilizó lenguaje soez y muy despectivo para describir a la asistente de gerente con la que había tenido una discusión por haberse extraviado unos materiales. La Junta, aplicando la *prueba de Meyers,* nuevamente concluyó que el acto de refunfuñar individualmente las frustraciones por las actuaciones de un

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[32] *Véase* Rural Metro, Case No. 25-CA-31802, 2011 NLRB GCM LEXIS 30 (June 29, 2011).
[33] *Véase* Wal-Mart, Case No. 17-CA-25030, 2011 NLRB GCM LEXIS 34 (July 19, 2011).

gerente, cuando sus actos no son prácticas ilícitas, no es una actividad protegida o concertada.

2. Casos considerados como actividad protegida o concertada

En uno de los casos, la Junta determinó que un patrono, un establecimiento de venta de vehículos lujosos, incurrió en una violación a la sección 158(a)(1)[34] al despedir a unos empleados que publicaron unos comentarios y fotografías en *Facebook* en los que criticaban y se mofaban de un evento de la empresa.[35]

De acuerdo con los hechos de este caso, una persona que conducía un vehículo de otro de los negocios del patrono se estrelló contra el establecimiento. Mientras se encontraban en horas laborables, uno de los empleados, junto a sus compañeros, se acercó a observar lo ocurrido y tomó unas fotografías. Días siguientes, el patrono auspició un evento para la introducción de uno de sus nuevos modelos lujosos. En reuniones previas al evento, uno de los gerentes comunicó a los vendedores que, como parte del evento, servirían a los clientes embutidos, galletas, otras meriendas y agua. Uno de los empleados le comunicó al gerente su preocupación en cuanto a la opción de la bebida y la comida. También, luego de la reunión, algunos compañeros discutieron su frustración y desilusión, ya que entendían que enviaba un mensaje equivocado a sus clientes y que ello impactaría sus comisiones.

Durante la actividad, los empleados sacaron fotografías posando con la comida y las bebidas frente a los letreros de la actividad, las cuales fueron publicadas en *Facebook* días más tarde por uno de los empleados. Las imágenes fueron acompañadas con comentarios que se referían *al gran esfuerzo que hizo el patrono* en el evento importante, al servir este tipo de refrigerios. También incluyó las fotografías del carro que se había accidentado la semana anterior.

Uno de los *amigos* que comentó en las fotografías en *Facebook* era compañero de trabajo de estos y le comentó al patrono respecto al incidente. El patrono revisó el perfil del empleado y le solicitó remover las imágenes, lo cual éste hizo de inmediato. Días después se reunieron para discutir el asunto de las fotos y le expresaron que sus actuaciones habían sido una vergüenza para la empresa, sus fundadores y presidente, y se le indicó que quedaba suspendido. Posteriormente, fue despedido y, meses más tarde, el patrono le indicó que lo había despedido por publicar las fotos del accidente, por el cual entendía que se estaba burlando de un accidente serio.

[34] 29 U.S.C. § 158 (a)(1).

[35] *Véase* Karl Knauz Motors, Inc. d/b/a Knauz BMW v. Robert Becker, Case No. 13-CA-46452 (July 21, 2011).

La Junta concluyó dos cosas: 1) la conducta ciertamente fue despectiva; y 2) no fue en respuesta a una práctica ilícita. A pesar de esto, la conducta exhibida no fue lesiva al punto de perder la consideración de una actividad protegida y concertada por el hecho de que la preocupación de la calidad del evento respondía al impacto que ello tendría en sus comisiones. Además y cónsono con lo anterior, los empleados habían llevado el planteamiento a la atención de la gerencia previo al evento. La Junta, por su parte, decidió aplicar el estándar de *Jefferson*, el cual se utiliza cuando un empleado ha manifestado frente a terceros comentarios despectivos de su patrono o de sus productos.[36] Bajo este estándar, el planteamiento es si el comentario guarda relación con alguna disputa laboral subyacente, y si no se trata de un acto desleal, temerario o de un comentario maliciosamente falso que perdiera la protección. Al aplicar el estándar, la Junta determinó que en este caso el comentario no fue desleal ni en menosprecio a la calidad del producto del patrono, y encontró irrelevante el hecho de que los comentarios publicados sobre las fotos no mostraban expresamente la preocupación de las comisiones, porque entendió que los comentarios eran en sí un reflejo de la frustración previamente planteada en relación a la selección de comida del patrono.

B. Normas empresariales

Distinto al Memorando anterior, en el Memorando del 2011 se discute y se aclara que una política que restrinja o prohíba que los empleados realicen *cualquier comentario* que sea despectivo a cerca de la empresa en cualquier medio, incluyendo el internet, sin la autorización previa del patrono, o que prohíba *cualquier publicación de fotografías* en las que apareciera el logo o imagen corporativa es una violación a la sección 158(a)(1),[37] porque se presta para prohibir que los empleados participen en una actividad concertada. De acuerdo con la postura de la Junta, y el ejemplo que mencionan a la luz de esta interpretación, el lenguaje de una norma de esta naturaleza prohibiría que un empleado publicara una foto de un piquete que incluya el logo de la empresa o que un empleado tome y publique fotos de una manifestación en la que está vistiendo alguna camisa que lo identifique como empleado de la empresa cuando dicha manifestación o protesta es en relación a las condiciones de empleo.

En el mismo caso, la Junta también atiende y evalúa el lenguaje de la norma que prohíbe que se emitan comentarios despectivos sobre la empresa, sus supervisores, compañeros de trabajo o sus competidores. En este particular, la norma establecía que los estándares de conducta de la empresa

[36] NLRB v. Electrical Workers Local 1229, 346 U.S. 464 (1963) (citado en NATIONAL LABOR RELATIONS BOARD, MEMORANDO OM 11-74, *supra* nota 3, a la pág. 9).
[37] 29 U.S.C. § 158(a)(1) (2006).

prohibían *todo tipo de lenguaje o acción* que fuera *inapropiada o generalmente ofensiva* y cualquier comportamiento rudo o descortés hacia los clientes y/o compañeros de trabajo. La Junta concluyó que estos términos eran muy abarcadores y que, al no definir adecuadamente la conducta inapropiada o incluir una aclaración que indicara que con ello no estaban restringiendo el ejercicio de sus derechos conforme a la sección 157, era una práctica ilícita.

V. ALCANCE DE LAS RECOMENDACIONES DEL MEMORANDO EN PUERTO RICO

Como parte de sus funciones, la Junta realiza investigaciones y otorga remedio en casos de querellas por prácticas ilícitas de patronos y sindicatos privados. A pesar de que su alcance es reconocido mayormente en aquellas empresas en las que existen sindicatos, en ocasiones la Junta ha invocado la Ley de Relaciones del Trabajo para así atender casos de empresas sin sindicatos en situaciones donde se han disciplinado empleados por violaciones a las políticas patronales que se alegan que son prácticas ilícitas.[38]

Es importante recalcar que en la evaluación de estos casos, distinto a como ocurre en Puerto Rico, rige la norma del empleo a voluntad o *employment-at-will*. Esta doctrina, propia de las jurisdicciones de la mayoría de los estados de los Estados Unidos, permite al patrono contratar empleados por un término indeterminado y despedirlos libremente, aunque ciertamente se han reconocido excepciones de índole estatutaria, como lo son las protecciones anti-discriminatorias,[39] las actividades protegidas y concertadas,[40] aquellas reconocidas jurisprudencialmente en las que el empleado actúa en beneficio del interés público; como por ejemplo, cuando un empleado se niega a participar en una actividad ilegal o cuando es despedido por actuar en el ejercicio de un derecho o de una obligación civil, y en aquellos casos en que un empleado ha reportado alguna infracción.[41]

De modo que aún en el caso de la mayoría de los estados, los patronos, además de velar por no incurrir en aquellas excepciones a la doctrina del empleo a voluntad, deben asegurarse de que tanto la razón del despido como sus políticas empresariales no interfieren con aquellas actividades reconocidas como protegidas y concertadas. Sin embargo, el caso de Puerto Rico es más complicado.

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[38] NLRB v. Northeastern Land Servs., Ltd., 645 F.3d 475 (1st Cir. 2011).
[39] Civil Rights Act of 1964, Title VI, 42 U.S.C. § 2000e–2000e-15 (2006).
[40] 29 U.S.C. § 157 (2006).
[41] Patel, *supra* nota 10, a la pág. 780.

VI. UN VISTAZO A LA LEY 80

Según se mencionó anteriormente, en Puerto Rico, distinto a la doctrina del empleo a voluntad, existe legislación protectora que sanciona al patrono que despide a su empleado o empleada salvo que demuestre una causa justificada.[42] El artículo 2 de la Ley 80, define justa causa para despido como sigue:

> [S]e entenderá por justa causa para el despido de un empleado de un establecimiento: (a) Que el obrero siga un patrón de conducta impropia o desordenada. (b) La actitud del empleado de no rendir su trabajo en forma eficiente o de hacerlo tardía y negligentemente o en violación de las normas de calidad del producto que se produce o maneja por el establecimiento. (c) Violación reiterada por el empleado de las reglas y reglamentos razonables establecidas para el funcionamiento del establecimiento siempre que copia escrita de los mismos se haya suministrado oportunamente al empleado...[43]

El Tribunal Supremo de Puerto Rico ha servido de marco para la interpretación de la Ley 80 y ha expresado que, como regla general, no favorece el despido como sanción a la primera falta, pero que dicha regla no es absoluta.[44] Así lo reiteró recientemente en *Feliciano Martes v. Sheraton Old San Juan*. Para que un empleado sea despedido como sanción a una primera falta, "ésta tiene que ser de tal seriedad o naturaleza, tan grave, tan lesiva a la paz y al buen orden de la empresa, que resulte imprudente tener que esperar su reiteración para destituir al empleado".[45] La Ley 80 no favorece el despido como sanción a una primera falta, pero ello no "excluye de la sanción o despido en primera o única ofensa aquella falta cuya intensidad de agravio así lo requiera en protección de la buena marcha de la empresa y la seguridad de las personas que allí laboran".[46]

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[42] Ley de indemnización por despido sin justa causa, Ley Núm. 80 de 30 de mayo de 1976, según enmendada. 29 LPRA §§ 185a–185m (2009).

[43] 29 LPRA § 185b (2009).

[44] Feliciano Martes v. Sheraton Old San Juan, 2011 TSPR 97. El Tribunal expresa y reitera que la ley no favorece el despido como sanción a la primera falta, pero reconoce que pudiera considerarse como una sanción justificada si no hacerlo pudiera poner en riesgo la seguridad, el orden o la eficiencia que constituyen el funcionamiento del negocio y, por tanto, constituiría una imprudencia esperar que ocurra nuevamente para despedirlo. Este caso se apoya en casos anteriores: Rivera Torres v. Pan Pepín, Inc., 161 DPR 681 (2004); Delgado Zayas v. Hospital Interamericano de Medicina Avanzada, 137 DPR 643 (1994) y Secretario del Trabajo v. I.T.T., 108 DPR 536 (1979).

[45] Rivera Torres v. Pan Pepín, Inc., 161 DPR 681(2004).

[46] *Feliciano Martes*, 2011 TSPR 97.

Otro factor importante para que exista justa causa es la existencia de la norma o reglamento empresarial y que éstos se le hayan entregado al empleado. No podemos olvidar que las normas empresariales forman parte sustantiva del contrato de empleo entre el patrono y el empleado y que el patrono está sujeto a cumplirlas. No se trata de unas exigencias atribuibles únicamente al empleado de un modo arbitrario. En *Santiago v. Kodak Caribbean,* el Tribunal así lo expresó:

> [E]l manual de una empresa que contiene las reglas y los reglamentos del trabajo y que establece las normas, los beneficios y los privilegios que disfrutará el empleado forman parte del contrato de trabajo. . . . Sin embargo, la ausencia de razonabilidad de estas normas podría convertir el despido en uno caprichoso o arbitrario, y por lo tanto injustificado. De otra parte, los beneficios y privilegios allí establecidos constituyen derechos del empleado y un despido en violación a éstos también resultaría en un despido injustificado.[47]

Por otra parte, se ha reconocido que no todo posible acto o conducta puede incluirse de modo específico en un manual. En *Secretario Del Trabajo v. G.P. Industries Inc.*,[48] el Tribunal Supremo de Puerto Rico resolvió, al evaluar un despido por conducta adulterina que no era parte de la conducta prohibida en el manual, que "un patrono tiene derecho a despedir un empleado cuya conducta amenaza la paz y la seguridad en el trabajo, incluso si dicho comportamiento no está específicamente prohibido por las reglas de disciplina del patrono".[49] En estos casos, al igual que en aquellos en donde el despido sea la sanción a una primera ofensa, el criterio rector es el impacto al buen y normal funcionamiento de la empresa.

Como hemos visto en el caso de Puerto Rico, los patronos, más allá de velar y asegurarse de que no están incurriendo en una práctica ilícita, al interferir con una actividad que pudiera considerarse como protegida o concertada, según ilustra el Memorando del 2011, el cual fue creado por la Junta, tienen que también plantearse el requisito de la justa causa.

VII. OTRAS: CONSIDERACIONES CONSTITUCIONALES

A continuación se mencionarán brevemente consideraciones constitucionales muy relevantes a este escrito. Hay quienes plantean que en Puerto Rico, a la luz del alcance más extenso de nuestra Constitución, la

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[47] Santiago v. Kodak Caribbean, 129 DPR 763, 775-76 (1992).

[48] Srio. del Trabajo v. G.P. Inds., Inc., 153 DPR 223 (2001).

[49] International Shipping Agency v. Unión de Empleados de Muelles de PR, Negociado de Conciliación y Arbitraje del Departamento del Trabajo y Recursos Humanos A-11-05, 12 de julio de 2011 (Fuentes Félix, F.).

intervención que pueden tener los patronos en la participación de sus empleados en las redes sociales o el uso de la información publicada en éstas es un asunto de índole constitucional, más allá del aspecto laboral que conlleva un despido. Como norma general, para levantar un asunto de índole constitucional se requiere una acción estatal. No obstante, nuestro ordenamiento ha reconocido que el derecho a la intimidad se puede invocar ante patronos privados,[50] pero no así el derecho a la libertad de expresión.

En aquellas instancias en que se puede invocar la garantía constitucional del derecho a la intimidad frente a un patrono, el empleado tiene que demostrar que las actuaciones del patrono "fueron intencionales, arbitrarias, caprichosas e irrazonables y que fueron originadas por un motivo ajeno al legitimo interés del patrono de salvaguardar el efectivo desempeño en el empleo". [51]

El argumento que muchos expresaron es que tienen una percepción de que, en su tiempo libre y en la intimidad de su hogar o donde sea que hacen uso de las redes sociales fuera de horas laborables y en equipos que no son provistos por el patrono, cada cual es libre de decir lo que quiera.[52] El hecho de que una comunicación esté publicada en el perfil de una persona, ¿significa que se trata de una conducta privada? En un caso presentado ante la corte de apelaciones de las Fuerzas Armadas se estipuló que un perfil en el Internet es el equivalente moderno a pararse en el medio de la calle con un uniforme militar y gritar a viva voz: "Soy militar y soy racista y extremista".[53] Por lo tanto, ¿cuál es la expectativa de privacidad que debe tener un empleado por los comentarios publicados en una red social?

Si bien es cierto que la red es pública, no es una avenida abierta para que el patrono intervenga con ésta. Habrá que evaluar cómo obtuvo el acceso a la información y si se trataba de un perfil público o si el usuario publicaba su información bajo la creencia de que su audiencia era limitada por haber seleccionado las opciones de privacidad, por ejemplo, una contraseña de acceso al foro. Sin embargo, hay quien piensa que no es necesario hacer esta distinción pues aquél que publica información en el *Internet* lo hace a sabiendas de que esa información pudiera caer en manos de un tercero.

En un caso de New Jersey, la corte de Distrito concluyó que el patrono violó la Ley federal de Comunicaciones Grabadas (SCA, por sus siglas en

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[50] Arroyo v. Rattan Specialties, 117 DPR 35 (1986).

[51] Segarra Hernández v. Royal Bank de Puerto Rico, 145 DPR 179 (1998).

[52] Hago una distinción cuando el equipo es provisto por el patrono, o se hace uso en los predios o en horas laborables. Para una discusión del derecho propietario del patrono a la administración de su negocio y de la expectativa de privacidad del empleado, *véase* Vega Rodríguez v. Puerto Rico Telephone Company, 110 F.3d 174 (1997) (se justifica el uso de vigilancia con cámaras de seguridad, por el interés apremiante de la seguridad).

[53] U.S. v Wilcox, 66 M.J. 442 (C.A.A.F. 2008), *citado en* AELE Law Enforcement Legal Ctr, *Online Networking, Texting and Blogging by Peace Officers Part One – Impeachment, Policy & First Amendment Issues*, 2010 (4) AELE MONTHLY JOURNAL 201, 202 (April 2010).

inglés)[54] a la vez que violaba la Ley estatal de Comunicaciones Grabadas,[55] la cual prohibía acceder a información grabada electrónicamente de manera intencional sin autorización o excediendo esa autorización, de haberla. [56] En este caso, el patrono despidió a unos empleados luego de tener acceso a unas discusiones grupales realizadas en un foro que requería una contraseña. Los empleados utilizaban este foro para discutir asuntos relacionados al trabajo, pero también compartían comentarios de índole sexual en relación a los clientes del restaurante y a la gerencia, sobre el uso de sustancias controladas e información confidencial del patrono. Inicialmente, el patrono tuvo acceso al foro por medio de un empleado que, a iniciativa suya, le mostró a su supervisor el contenido de las conversaciones. No obstante, más adelante, otro de los supervisores le solicitó la contraseña del foro al empleado, quien testificó que compartió la información por temor a que el patrono tomara represalias en su contra. La corte impuso responsabilidad al patrono y le ordenó el pago de penalidades por las violaciones al estatuto de New Jersey y a la SCA.

En cuanto a una posible invocación al derecho a la libertad de expresión, habrá que esperar a que, en su día, el Tribunal Supremo lo evalúe. Por el momento, es sabido que no es una garantía que puede invocarse en relaciones obrero-patronales privadas, pero hay quien piensa que las publicaciones en las redes sociales sirven como una gran aportación y que, por ser de alto interés público, merecen ser protegidas frente a cualquier tipo de represalia por parte de un patrono.[57]

En un artículo que propone la ampliación de las excepciones de la doctrina del empleo a voluntad,[58] Patel considera que publicar un *blog* es un ejercicio de libertad de expresión al amparo de la Primera Enmienda de la Constitución de los Estados Unidos.[59] Si bien atiende que el derecho constitucional se puede invocar frente a una acción estatal y que no estaría disponible a los empleados del sector privado, Patel argumenta que la actividad debería estar protegida en beneficio del mejor interés público de

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[54] El "Stored Communications Act (SCA)" fue promulgada en el año 1986 como parte de la Ley de Privacidad de Comunicaciones Electrónicas, 18 U.S.C. § 2701(a)(1) que se extiende a la aplicación de la intervención del patrono, si accede de modo ilegal al perfil de un usuario. La SCA define como una ofensa el acceder de modo intencional, y sin autorización, algún recurso que contenga información electrónica grabada). Además, *véase* Konop v. Hawaiian Airlines, Inc., 302 F.3d 868, 879 (9th Cir. 2002). En este caso se discute la aplicación de la SCA cuando un patrono accede al *blog* personal de uno de sus empleados.

[55] N.J. Stat. § 2A:156A-27 (2012).

[56] Pietrylo v. Hillstone Rest. Group, 2009 WL 3128420 (D.N.J. 2009).

[57] Patel, *supra* nota 10, a la pág. 779.

[58] Patel, *supra* nota 10, a la pág. 805.

[59] "El Congreso no hará ley alguna con respecto a la adopción de una religión o prohibiendo el libre ejercicio de dichas actividades; o que coarte la libertad de expresión o de la prensa, o el derecho del pueblo para reunirse pacíficamente, y para solicitar al gobierno la reparación de agravios", U.S. CONST. amend. I.

promover este nuevo recurso de comunicación.[60] Otro argumento es que las empresas, al estar en una mejor posición económica que los individuos, pueden financiar campañas para rehabilitar su imagen, además de que pueden, como cualquier persona, comentar en las páginas y responder a comentarios que laceren su reputación.[61]

VIII. Conclusión

Atendiendo la pregunta del caso ficticio de Mónica, no conocemos todos los elementos que indujeron a la empleada a publicar reiteradamente comentarios despectivos sobre su empresa ni cómo el patrono tuvo acceso a los mismos, entre otros. Sin embargo, a la luz de las consideraciones mencionadas, nuestra recomendación es realizar un análisis concienzudo de la totalidad de las circunstancias en cada caso evaluando, además de lo enmarcado en la Ley 80 y su jurisprudencia interpretativa, los siguientes aspectos:

1. Norma empresarial
    a. ¿Existe una norma empresarial razonable que prohibiera este tipo de conducta?
    b. De existir una norma, ¿se entregó copia escrita al empleado?
    c. ¿Se ha revisado el lenguaje de la norma para asegurar que no se interprete como una práctica ilícita o se ha incluido alguna aclaración de que no se restringe el ejercicio de los derechos de los trabajadores?
    d. En ausencia de una norma que atienda la conducta específica del empleado, ¿es la ofensa de tal gravedad que tiene un impacto en el buen funcionamiento y seguridad de la empresa y sus empleados?
2. Naturaleza de la publicación o comentario
    a. ¿Se trata de una actividad protegida o concertada o por lo menos, perseguía serlo? En lo relevante, se debe aplicar los escrutinios de *Meyers, Atlantic Steel* y *Jefferson*, según el caso.
        i. ¿Tenía el patrono conocimiento de las preocupaciones del empleado en cuanto a las condiciones de trabajo?
        ii. ¿Participaron en la comunicación compañeros de trabajo con miras a iniciar una actividad protegida o concertada o por lo menos perseguía ese fin?
        iii. ¿Surge esta acción en respuesta a una práctica ilícita del patrono?
    b. ¿Se trata de la primera ofensa?

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[60] Patel, *supra* nota 10, a la pág. 805.
[61] Lyrissa Barnett Lidsky, *Silencing John Doe: Defamation & Discourse in Cyberspace*, 49 DUKE L.J. 855, 857 (2000).

   c. ¿Cuál es el impacto de esta conducta o posible consecuencia?
   d. ¿Es una ofensa de tal gravedad e impacto al buen funcionamiento de la empresa, ya sea en la reputación o en el ambiente de trabajo?
3. Medio de acceso a la información publicada por el patrono
   a. ¿Cómo el patrono tuvo acceso a la publicación o perfil del usuario?
   b. ¿Se trata de un perfil o foro privado del empleado?
   c. El acceso a la información: ¿fue presentada voluntariamente por un tercero al patrono? ¿Se obtuvo de forma arbitraria, caprichosa e intencional o fue con un interés legítimo en salvaguardar el buen funcionamiento de la empresa?

Si bien coincidimos con las expresiones de Patel, en el sentido de que el Internet es un recurso de comunicación muy valioso que debería fomentarse, también somos creyentes de la importancia de la lealtad de los empleados hacia su empresa. En una parte apoyamos los derechos de los empleados a manifestarse y a protestar para luchar por los derechos adquiridos y por las condiciones de empleo, pero imponerle una carga económica a las empresas para que tengan que defender su imagen de sus propios empleados es, en cierto modo, apoyar un sabotaje. La justificación más común de los patronos a un despido, sobre todo cuando se trata de una primera ofensa, es el impacto lesivo en su reputación.[62] No sólo se impacta el funcionamiento de una empresa, también se afecta la imagen del producto. Otros argumentos se apoyan en el riesgo de que empleados compartan secretos corporativos o asuntos confidenciales de la empresa, sobre todo cuando se trata de autores anónimos,[63] y que los comentarios tengan un impacto negativo en el ambiente de trabajo como consecuencia del contenido de esas expresiones.

Ciertamente, la imagen de la empresa se lacera cuando, en lugar de ser un cliente, es el mismo empleado quien la menosprecia. Dicha conducta pudiera ser censurable y suficiente justa causa para un despido si es que el patrono logra demostrar: (1) un impacto o potencial impacto al buen funcionamiento de la empresa; (2) que existía una norma lícita y razonable que prohibiera dicha conducta; (3) que la misma se entregó al empleado; (4) que el acceso a la información se obtuvo de un modo lícito; y (5) para salvaguardar la seguridad y el orden de la empresa. Pero, a pesar de ello,

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[62] Para una discusión en relación al modo en que los *blogs* pueden agravar la reputación de las empresas, *véase* Albert J. Solecki, Jr. & Melissa G. Rosenberg, *Employee Blogging*, 13 EMP. L. STRATEGIST, no. 7, Nov. 2005, a la pág. 1.

[63] Konrad Lee, *Anti-Employer Blogging: Employee Breach of the Duty of Loyalty and the Procedure for Allowing Discovery of a Blogger's Identity Before Service of Process is Effected*, 2006 DUKE L. & TECH. REV. 2.

hemos visto que en aquellos casos en que la conducta del empleado es en respuesta a una práctica ilícita del patrono, el balance se ha inclinado a favor del empleado a pesar de que la naturaleza de su comentario sea uno de gran menosprecio.

Una gran herramienta para los patronos es contar con una norma empresarial elaborada, que sea realista y razonable. Además, debe tomarse en consideración lo expresado por la Junta en cuanto a la posible vaguedad en el lenguaje, al incluir frases como *conducta inapropiada,* o que sea tan restrictivo que pudiera considerarse como una práctica ilícita en sí misma por interferir con los derechos y actividades protegidas de los empleados. A tono con lo establecido en el Memorando del 2011, sugerimos que en el caso de las normas existentes que restringen el uso de la imagen empresarial en los medios se incluya una nota que aclare que la excepción al uso de la imagen y fotografías es en el ejercicio de aquellas actividades protegidas conforme a la Ley, sin descartar la inclusión de la norma.

Aún no sabemos el potencial de evolución que las redes sociales alcanzarán y cómo ello impactará nuestro ordenamiento jurídico. Ante la ausencia de jurisprudencia que nos arroje luz en cuanto al tratamiento que dará nuestro Tribunal Supremo a estas situaciones noveles, el Memorando del 2011 nos ofrece una señal que nos sirve para tomar las medidas cautelares para hacer una recomendación legal informada o para manejar una posible reclamación de esta índole con un cliente. Como hemos visto, en Puerto Rico, para prevalecer no bastará con que la empresa demuestre que no incurrió en una práctica ilícita o en alguna de las excepciones de la doctrina del empleo a voluntad, como en la mayoría de los estados de Estados Unidos. También deberá demostrar que el despido es uno justificado a base de nuestra legislación protectora, que debe analizarse a la luz de los eventos y circunstancias específicas de cada caso.

TRADEMARKS AND POLITICAL SPEECH

ANABELLE TORRES COLBERG, ESQ.*

I. INTRODUCTION

A slogan is a phrase used to advertise or promote a product, service, political candidate, or organization. Political candidates rely on slogans to promote themselves as the better choice against their opponents, and they frequently use previously trademarked slogans in order to advance their message. However, when a trademark holder's phrase or slogan becomes the repeated catchphrase associated with a candidate or political cause, that trademark holder may rightly become concerned.[1]

In most cases involving political use of trademarked slogans, courts repeatedly have ruled in favor of politicians. The courts have stated that politicians used the trademark in a noncommercial manner and, thus, their

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[1] *See* John D. Shakow, *Just Steal It: Political Sloganeering and the Rights of Trademark Holders*, 14 J.L & POL.199 (1998).

use maintains the value of free speech and the marketplace of ideas. Along similar lines, the courts have also denied trademark protection for political slogans created by politicians during a campaign. These slogans are seen as expressive phrases, detached from commercial means, and consequently are disqualified from trademark protection. That distinction is not correct and should be re-evaluated. The use of trademarks by politicians in their speeches, as well as the creation of original slogans during the course of their campaigns, correspond to the use of marketing strategies that look for the support needed for a certain politician to prevail in a particular election. The relationship between trademarks and political speech is clearly a tense one because trademark holders do not get the protection needed in the political scenario.

Courts have acted in accordance to the belief that the Constitution prohibits any restriction on political speech, unless a party can prove a compelling state interest to the contrary. However, this philosophy assumes that political speech has inherent democratic value that advances the principles of government and of the democratic process.[2] By extending First Amendment protection to incidental speech in support of the democratic process, courts must consider the way it interprets First Amendment rights.[3] Courts have not confronted a major struggle in their restriction of obscene, libelous, scandalous, or misleading political speech, since these types of speech cause harm more often than good. Said reasoning should also be applied to trademark plagiarism in political speech.[4] It is not the same to occasionally use a known trademark to express a particular idea, as it is to use it as a promotional slogan for a politician. By repeatedly using it as a catchphrase, people will associate the trademark with the politician and seeing that the motivation behind the use is purely commercial, it should not be awarded with the overwhelming First Amendment protection.

Another view states that political slogans are commercial speech rather than political discourse. It presumes that political slogans have minimal informational value and that politicians choose to adopt a commercial mark for its associative and market power rather than for its content.[5] In fact, many politicians seek trademark protection for their original slogans so that they may obtain the legal means by which to market them as a product that warrants consumer support.

In cases of political trademarks, courts have applied First Amendment considerations too broadly. They have not restricted political speech in relation to trademarks because of their emphasis on freedom of political speech; they have not considered the notion that the current political speech

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[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*

is not the one the Constitution intended to protect. The use of trademarks in political speech corresponds to political marketing strategies, and the courts currently do not invoke the Lanham Act to give trademark holders the resources needed to act against infringers.[6] Due to the fact that politicians have now begun to claim trademark protection as a result of the positive impact these slogans have had and because of their commercial value to their campaigns, the law should consider granting trademark protection to political speech. There is a risk that the courts may see political speech as immune to corruption since almost all speech could be considered political. However, protecting all types of political speech could open the door to an outright ban on any law that limits speech, which could dangerously disable government and society.[7] In that sense, courts should differentiate each particular type of political speech in order to distinguish the purpose of the issue in question and to see whether any restrictions should be applied, if any, and in what circumstances.

This article will discuss two (2) related issues concerning political speech. First, this article will consider the use of trademarked slogans in political speech. Second, it will examine the lack of trademark protection for original political slogans. In the second part of this work, we will discuss the background of these two issues and of the laws surrounding them. In the third part, we will discuss, in depth, the arguments in favor and against the maintenance of current laws, which include First Amendment considerations and the distinctions between commercial and noncommercial speech. In the fourth part, on the other hand, we will examine the differences between political campaigns and advertising campaigns, the application of trademark law, and the proposal of possible changes in these laws. Moreover, the remaining part of this work will be dedicated to explaining the necessity to change current laws and to set forth our conclusions summing up our main theses.

The purpose of the political slogan, as well as the commercial slogan, is trying to sell a product, the politician himself. The distinction made between the two types of speeches is artificial, since both the politician and the business are competing for people's support. Both sell and offer services. The politician sells his talents and ideas, and people support him in the same way that they buy Adidas tennis shoes.

[6] Lanham Act (U.S. Trademark Act), 15 U.S.C. §§ 1051-1141.
[7] Shakow, *supra* note 1.

II. BACKGROUND

A. The Problem of Trademark Usage in Political Speech

The courts have constantly resolved that politicians' use of trademarks in their speeches does not constitute infringement. For example, the conservative interest group Concerned Woman for America (CWA) registered its "Putting Families First" slogan in 1995, and sought to enjoin the Democratic National Committee (DNC) from using "Families First" in brochures and speeches during the 1996 National Convention.[8] CWA argued that the DNC's use of their phrase diluted the impact of the brand and confused voters.[9] However, the court denied the injunction and stated that the DNC's use created little likelihood of confusion and was, therefore, not actionable under federal law.[10] Additionally, the federal anti-dilution policy specifically excludes noncommercial speech.[11]

In another example of trademark law, MasterCard International sued then presidential candidate, Ralph Nader, for copyright and trademark infringement based on Nader's use of an ad similar to MasterCard's "Priceless" campaign.[12] The court ruled that Nader's ad was sufficiently transformative from MasterCard's ads, and that the ad had in fact "a political noncommercial purpose." [13]

Similarly, when an Ohio gubernatorial candidate borrowed the "AFLAC duck" in order to portray his opponent in a negative light in an Internet campaign, the court denied the preliminary injunction sought against him.[14] The court stated that even though the public may associate the candidate's cartoon with the trademarked AFLAC duck, the cartoon, as a political message, is shielded by both the Constitution and the statutory exemption.[15]

During the 1980s, the Reagan administration Strategic Defense Initiative became known as "Star Wars." When the creator of the *Star Wars* film franchise sued the defendants, the court ruled that the plaintiff's trademark was only protected against those who sought to attach the words to products or services that competed with the plaintiff in the marketplace, or against those who diluted the value of the words by engaging in a non-

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[8] Benjamin Sheffner, *The Democrats Can Put "Families First," Judge Rules*, ROLL CALL, Aug. 26, 1996.
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] MasterCard Int'l Inc. v Nader 2000 Primary Comm., Inc., 2004 WL 434404, 2004 U.S. DIST. LEXIS 3644 (S.D.N.Y. 2004).
[13] *Id.*
[14] American Family Life Insurance Co. v. Hagan, 266 F. Supp. 2d 682(N.D. Ohio 2002).
[15] *Id.*

competing trade.[16] Since the defendants had not affixed the plaintiff's trademark to any goods or services for sale, and since they were not in competition with plaintiff, they were not penalized for infringement.[17] However, if the politician's objective is to sell his image and to obtain support from the citizens; then, in this case, Reagan and George Lucas were both competing for the same thing: the attention and support of the public.

In addition to these examples, many other infringement cases have been brought against political candidates. Trademark holders do not often oppose the sporadic use of their trademarked material in politicians' communications; however, when a trademark holder's property, in the form of a phrase or slogan, becomes the repeated catchphrase associated with a candidate or political cause, trademark holders become concerned.[18] In a world controlled by the media, a politician's sloganeering is the most important part in his or her campaign.[19] As the message spreads, there is a possibility that it can cause great harm to the politician and to the trademarked material, unless the politician has control of the message.[20] Corporations routinely invest a fortune into crafting a positive corporate image, slogans, and *persona*.[21] Politicians seek to capitalize on this value when they take someone else's slogan for their own use.[22]

Candidates are attracted to well-known trademarks in large part because these slogans inspire goodwill.[23] Politicians use known slogans or trademarks in their efforts to connect with the electorate. The popularity and effectiveness of these slogans among the public will continue to motivate their incorporation in politicians' campaigns. Notwithstanding, courts should evaluate the use given to a particular slogan by the politician, so it can determine if it should be restricted in order to protect a trademark holder.

B. Insufficient Trademark Protection of Original Political Slogans

The Lanham Act defines a trademark as "any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured or sold by others."[24] Slogans can be divided into two main

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[16] Lucasfilm, Ltd. v. High Frontier, 622 F. Supp. 931 (1985).
[17] *Id.*
[18] Shakow, *supra* note 1.
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] 15 U.S.C. § 1127 (Supp. I 1995).

categories: political slogans and commercial slogans.[25] A political slogan is designed to influence the political opinions of the public and to steer them towards a certain candidate or policy. In contrast, a commercial slogan serves to remind the consumer of a specific brand and to influence his or her future purchases. While the specific persuasive goals may be different in these two (2) categories, the purpose of both slogans is to inspire a certain response from the audience. A slogan is considered a mark when it reminds consumers of its producer rather than the product that is being advertised.[26] Political slogans fit into this mold because their objective is to remind people, not only of a particular message of the politician, but also of the politician himself. In that sense, the politician is using the slogan to market himself, to get the support needed to prevail in the election, and to obtain the economic support needed to finance the campaign.

In many instances, slogans are short sentences or phrases that capture the brand essence, personality, and positioning of a company, distinguishing them from their competitors. Similarly, political slogans capture the essence, viewpoint, and message of a politician and serve to distinguish him from his competitors. Marketing experts know that the best way for a product or a candidate to be remembered is through a slogan or platform that is succinct and easy to remember.[27] A great slogan can also be trademarked for use on products such as clothing, mugs, and other campaign articles. With the evolution of media and political campaigns, future candidates must decide whether or not to seek trademark protection for their original slogans.[28] Not only may candidates use these slogans for their products, but also to prevent the use of variations on a good slogan by other candidates.[29] Marketing strategies apply to both political and commercial speech due to the fact that their goal is to generate a commercial transaction; one, by the profit that his or her ideas generate by prevailing in the election, and the other, by experiencing an increase in sales.

Political slogans can boost the involvement of citizens in a political movement. The accessibility and prevalence of these slogans in the media can make it easier for the electorate to become motivated and involved in the political process because they feel as if they are a part of the campaign. In a democratic process as well as in any marketing campaign, it is very important for the majority to feel passionate and to identify with a spirit of

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[25] Lisa P. Ramsey, *Intellectual Property rights in advertising*, 12 MICH. TELECOMM. TECH. L. REV. 189 (2006).
[26] *Id.*
[27] Sebastian Gibson, *The Marketing of Candidates Using Trademarks and Campaign Slogans in California and the U.S.*, (Oct. 17, 2008), http://www.articlesbase.com/intellectual-property-articles/the-marketing-of-candidates-using-trademarks-and-campaign-slogans-in-california-and-the-us-607721.html.
[28] *Id.*
[29] *Id.*

involvement and support. Without this feeling of investment, the electorate would be overcome by apathy, which would consequently lead to lower political participation and to a greater sense of detachment among the public.

Political slogans are very important to the campaigning process. Aside from acting as a source identifier for the politician, they also serve as a tool to finance the campaign itself. The economic structure of a campaign relies upon contributions; that is, people donate to a campaign when they identify with its message, which is promoted through a slogan. This slogan can motivate people to contribute to the campaign and to buy certain goods that serve to advertise the slogan. Without these messages, people would not get involved, and as a result, not finance the candidate's campaign.

The law does not currently permit candidates to trademark their slogans, because of the First Amendment considerations previously discussed. But, political slogans are part of the economy and they are a commercial expression that is needed to finance a campaign. A political campaign is analogous to a commercial campaign because both are constructed in accordance to marketing strategies. The political slogan, like the commercial slogan, is trying to sell a product, in this case, the politician.

III. The Usual Explanations For Maintaining the Status Quo

A. First Amendment Considerations

The First Amendment prohibits the creation of any law that seeks to restrict speech.[30] In determining whether a law unduly restricts speech, courts have balanced the interests of the speaker against the interests of the government.[31] The courts' rulings have shown that trademark rights do not entitle the owner to quash the unauthorized use of a mark by another who is communicating ideas or expressing a point of view.[32] When an unauthorized use of another's mark is part of a message and does not serve to identify a source, the protection of the First Amendment applies completely. However, is a slogan not a source identifier, attached to an ideological content that makes the consumer think of the producer or the promoter?

In *Rogers v. Grimaldi*, the Court of Appeals for the Second Circuit determined that the interest in preventing consumer confusion outweighed the concern of free expression alleged by the filmmakers.[33] The court noted that the expressive element of film titles, portraying Rogers' name, even when she was not in the movie, generally afforded them more protection than ordinary commercial labels, but held that a misleading title with

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[30] Shakow, *supra* note 1.
[31] *Id.*
[32] *Id.*
[33] Rogers v. Grimaldi, 875 F.2d. 994 (2d Cir. 1989).

absolutely no artistic relevance cannot be justified as a protection of free expression.[34]

However, because political speech is considered to be at the core of the First Amendment and has traditionally been awarded with the greatest amount of protection, courts must apply the strictest scrutiny when balancing the rights of the parties involved. In that sense, to acquire trademark protection for a political slogan and to consider the use of trademarked material in political speech to be infringement, the party must demonstrate that there is a compelling state interest that justifies a restriction of speech. Courts have not distinguished between all kinds of political speech; they have simply made a broad interpretation dictating that almost anything political should be awarded First Amendment protection without evaluating the individual circumstances. If they evaluate each circumstance, in order to see if the First Amendment protection fully applies, the practice of politicians appropriating another's slogan to promote themselves *commercially* should not be one of those circumstances when one acknowledges that the use employed by the politician relates to marketing strategies and not to the dissemination of ideas.

The principle that gives the broadest protection to political speech responds to the view that political speech forwards the democratic process and is relevant to self-government purposes.[35] However, to include a speech that is antithetical to the democratic process within the protection of the First Amendment contradicts the principles upon which the Amendment is based.[36] For example, incidental speech, which encourages people to violate existing laws, should not be protected. In this sense, not all political speech should be immune from the trademark holders' rights, particularly when the use of the trademark is related to speech that does not represent the ideals that the Constitution intended to protect.[37] As mentioned above, courts have restricted obscene political speech, libelous political speech, and even misleading political speech against First Amendment arguments. Therefore, plagiarism of political speech should similarly not be awarded protection under the First Amendment.[38]

In *Tomei v. Finley*, the District Court for the Northern District of Illinois issued a preliminary injunction because of the strong likelihood of confusion resulting from the use of a political party of an acronym designed to deceive voters into thinking the candidate belonged to the opposing political party.[39] According to this decision, cases must be analyzed based on

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[34] *Id.*
[35] Shakow, *supra* note 1.
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] Tomei v. Finley, 512 F. Supp. 695 (N.D. Ill. 1981).

the possible harm to the parties involved, instead of the type of speech. When the harm experienced by trademark holders outweighs the use of the trademark in the speech, the argument of free speech should yield and the restriction must be permitted. Our point is that the duplicity in political slogans, due to its lack of trademark protection, would lead to confusing people, creating an unnecessary burden on them when trying to differentiate between campaigns.

In *San Francisco Arts & Athletics, Inc. v. US Olympic Committee*, the Supreme Court prohibited the use of the word "Olympic" by a gay rights advocacy group, began to promote an international "Gay Olympic Games" in order to enhance the image of the gay community.[40] In order to finance the games, the group started selling paraphernalia which contained the word "Olympic Games".[41] The U.S. Olympic Committee (U.S.O.C.) attempted to block any use of the term "Olympic" because Congress had granted them the exclusive rights to use the word.[42] The court asserted that the gay group's use of the term "Olympic" could harm the U.S.O.C. by dulling the distinction and commercial value of the mark, and they also argued that the use of the word was intended to convey a political message.[43] This case established that the expressive use of a word cannot be separated from its commercial value.[44] This means that the courts have been willing to protect the rights of trademark holders against infringement, even when the infringer attempts to convey a political message.[45]

What the court recognized in *San Francisco Arts & Athletics*, is what we are trying to argue in relation to the unrestricted political use of another's trademark. The expressions made by the politicians using the trademark may harm the commercial value of the slogan; as mentioned earlier, it is difficult to detach the expressive part from the commercial value especially when the politician rests on the reasoning that he is using the trademark for communicational purposes when in reality he is using it to take advantage of the market power of the trademark.

There are circumstances in which First Amendment considerations should prevail, such as when the use of the trademark comprises the sole mean of political expression. However, it is difficult to identify a circumstance when the use of a well-known slogan, as "Just Do It", is the only way the politician is able to communicate his message.[46] Therefore, we reiterate our position that when a trademark becomes the campaign slogan

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[40] San Francisco Arts & Athletics, Inc. v. United States Olympic Comm., 483 U.S. 522 (1986).
[41] *Id.*
[42] *Id*,
[43] *Id.*
[44] Shakow, *supra* note 1.
[45] *Id.*
[46] *Id.*

of a politician, the harm caused by the trademark infringement should trump the First Amendment protection.

B. Noncommercial Speech against Commercial Speech

The Lanham Act defines "use in commerce" as "the bona fide use of a mark in the ordinary course of trade, and not made merely to reserve a right in a mark."[47] Congress drafted the "use in commerce" definition narrowly to include only uses likely to establish a connection between a mark and a product or service in the minds of consumers.[48] This is exactly what a politician does by creating a slogan that will help people identify him or her. The Supreme Court has held that "core" commercial speech is a speech that does "no more than propose a commercial transaction."[49] However, some messages simultaneously propose a commercial transaction and address social, political or other issues of public interest and may be deemed "commercial speech" so that they are subjected to lesser First Amendment protection.[50] The courts have devised a three-part test to be applied in cases of mixed messages in commercial speech: "(1) whether the communication is an advertisement; (2) whether it refers to a specific product or service; and (3) whether the speaker has an economic motivation for the speech. If all three factors are present, there is 'strong support' for the conclusion that the speech is commercial."[51] If the primary purpose of the speech is "informational," as opposed to "commercial," full First Amendment protection applies.[52] However, in this test the court does not consider that even the purest political expression could suffice it.

The Supreme Court has recognized that books, movies, religious literature, and even political speech need to generate money in order to disseminate, but that the rights of the speaker are not lost merely because compensation is received. Political speech has traditionally been perceived as noncommercial; therefore, because the Lanham Act requires the infringer to have used the mark "in commerce," the courts have repeatedly resolved that the use of trademark in political speech does not constitute infringement. This principle is based on the view that a commercial trademark holder would have difficulty demonstrating that the use of the trademarked slogan

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[47] 15 U.S.C. § 1127 (Supp. I 1995).
[48] Stacey L. Dogan and Mark A. Lemley, *Grounding Trademark Law through Trademark Use*, 92 IOWA L. REV. 1669 (2007).
[49] Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. 748 (1976).
[50] *Id.*
[51] Procter & Gamble v. Amway Corp., 242 F.3d 539 (5th Cir. 2001) (summarizing factors to determine whether speech is commercial originally presented in Bolger v. Youngs Drug Prods. Corp., 463 U.S. 60, 67 (1983)).
[52] *Id.*

by the politician is likely to cause confusion or to deceive the consumers.[53] The principle that establishes that political speech is noncommercial also proves problematic for politicians seeking trademark protection on their own original slogans. But, as explained, the repeated use of a well-known trademark in political speech may harm its commercial value. Consumers may get confused when seeing or hearing the slogan. Should they think of the politician or the business? With the confusion of the consumer, the trademark could lose its distinctiveness, which was one of the reasons it received protection in the first place.

Use of the commercial trademarks in political speech responds to the intent of the politician to gain support based on the popularity of the slogan. Politicians do not appropriate a popular slogan because of the expressive content of the slogan; on the contrary, they do so for the market power of the slogan. In that sense, the infringement of the politician on another's trademark is purely commercial. Therefore, consequences must be accordingly applied. In a sense, an invisible line of comparison is drawn between this kind of political speech and commercial speech. This kind of political speech responds to market demands; therefore, the distinction made between political and commercial speech becomes arbitrary and confusing. As previously discussed, this kind of political speech is not the type of speech that the Constitution intended to protect. Plagiarism of another's trademark for commercial consideration should be restricted in order to show respect to the rights given by law to the trademark holders. Again, this assumes that the politician uses a well-known commercial trademark as the slogan in his or her campaign in order to take advantage of the goodwill and brand identity associated with that trademark, and to sell him or herself as the product people want to support.

Political slogans in a campaign are a good example of hook marketing because the most deserving ones work. Politicians often seek trademark protection for their logos and slogans in order to give the campaign an "exclusive right to use the mark for those goods and services listed."[54] These goods range from baby bottles, mouse pads, and lapel pins to "political fund-raising services."[55] Many campaigns view the sale of these items as an important component of their fund-raising. Plus, with the rise of the Internet, these products can make campaigns more easily identifiable.[56] "The advent of the Internet means that there is a greater volume of fraudulent activity going on that victimizes campaigns," since anyone "with an e-mail list and a blast server can essentially steal money from the donors and the

[53] Shakow, *supra* note 1.
[54] Sarah Wheaton, *Vote for Me ™*, THE CAUCUS: THE POLITICS AND GOVERNMENT BLOG OF THE TIMES (Oct. 18, 2007), http://thecaucus.blogs.nytimes.com/2007/10/18/vote-for-metm/.
[55] *Id.*
[56] *Id.*

campaign."[57] In that sense, the main reason to have a good slogan is economic, rather than expressive. The slogan helps people associate a particular politician with a particular message, and gives people an opportunity to make an informed decision as to which campaign they would rather support.

The efficacy and purpose of a political slogan is no different than that of a commercial slogan, so each should qualify for the same trademark protection. After all, the politician sells his or her own *persona* and cause as a product. A merchant earns a living by merchandising a product and by gaining the support of the consumers; the politician earns his or her way in politics by gaining the support of their constituents. By not giving trademark protection to original political slogans, the politician loses the means to fulfill his or her objectives to be distinguished among opponents by promoting his or her product.

IV. New Alternatives

A. Is a Commercial Campaign a Better Analogy for a Political Campaign?

As previously discussed, considering the commercial aspect of political speech led to a comparison between political and commercial campaigns. Political campaigns use the same powerful tools as businesses to build enduring relationships, raise money, track news, and organize campaigns.[58] Moreover, political campaigns are embracing the same trends as businesses; they are harnessing the power of the Business Web in order to deepen relationships, among other strategies.[59]

Similarly, political candidates work hand–in-hand with advertisement agencies in order to construct an effective media campaign to promote themselves as a product. The principles employed in a campaign are those that have proven their effectiveness in the market. These marketing strategies are implemented in accordance with the objective of merchandising the politician. They serve to emphasize his or her strengths, to outline his or her campaign platform, to weaken political opponents and to enhance his or her public image. These marketing strategies are mostly employed during the political season, when the media becomes saturated with political and commercial advertising. As time passes, the success of a

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[57] *Id.* (citing interviewee Marc Elias).

[58] *Salesforce.com Introduces Campaignforce, New Salesforce Political Campaigns Edition* , MANAGING AUTOMATION, (May 16, 2007), http://www.managingautomation.com/maonline/news/product/read/Salesforcecom_Introduces_Campaignforce_New_Salesforce_Political_Campaigns_Edition_28774?page=1.

[59] *Id.*

political candidate depends more and more upon the effectiveness of his or her media campaign.

The distinction between political speech and commercial speech should be re-evaluated according to the previously mentioned conditions. The law has fallen behind in comparison to the progress that society and marketing have made. The important role played by the media in political campaigns could raise concern insofar the political process is becoming more and more a battle of advertisements instead of a battle of ideas. Nevertheless, the political process has always been that way in one way or another. The market forces of advertisements and promotion have always guided it. The problem is that nowadays, people are more aware of it, as a consequence of the proliferation of the media. Notwithstanding all these, courts are still in denial of reality and keep maintaining the difference between political and commercial speech. Even in a free market system, there is no such thing as a speech containing only ideas, because whether we like it or not, ideas always have economic content behind them and by not recognizing this, the system is basing itself on a fantasy instead of reality.

B. Application of Trademark Law in Political Context

Trademark laws establish that the producer of a commercial product has the right to prevent others from using his or her product in order to take advantage of the quality and goodwill acquired as a consequence of the loyalty and support of its consumers. Additionally, the anti-dilution statutes protect trademarks from any use that would diminish the distinguishing quality of the mark.[60]

1. Trademark Use in Political Speech

If Bob Dole had been elected and used "Just Don't Do It" throughout the term of his administration, the public would have likely stopped associating "Just Do It" uniquely with Nike and its shoes.[61] Instead of thinking of Nike immediately, consumers may picture Dole or Tiger Woods when they hear the popular slogan.[62] This means that Nike's trademark is losing value as it becomes blurred.[63]

A trademark may also become diluted if it is tarnished.[64] If an infringer associates a mark with something unwholesome or that somehow undermines the positive image of a trademark, the original trademark value

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[60] *See* Lanham Act (U.S. Trademark Act), 15 U.S.C. §§ 1051-1141.
[61] *Id.*
[62] Shakow, *supra* note 1.
[63] *Id.*
[64] 15 U.S.C. § 1125.

has been reduced.[65] By reducing the commercial appeal of the mark, the infringer may not have confused the public, but he or she has certainly caused its owner some damage. This is clearly applicable to political candidates as well. Association with some political philosophies, when forced on a commercial actor, may hurt the commercial prospects of the actor's goods.[66] For example, if Nike's phrase had become associated in the consumers' minds with teenage drug abuse due to repeated references in Dole's speeches, Nike's sales may have suffered. Certainly, the return on Nike's investment in "Just Do It" would be diminished.[67] However, while dilution can be stopped by a lawsuit in a commercial case, the law does not currently have a resource to enact consequences against the dilution of a political slogan.

As discussed above, when politicians co-opt commercial trademarks and transform them into slogans, it is because of the associative and market power of the mark.[68] Even when the intent of the politicians may not be to harm the mark, their intent is clearly to take advantage of and benefit from it. They want to attract voters by associating the well-known slogan with their own *persona*, and that should be considered a trademark violation. The politician seeks a specific public response through the use of another's slogan.

In this sense, even when the law does not recognize the use of a trademark slogan or mark in political speech as commercial, the principles that apply to trademark law do not coincide with the actual application of the law. People do not necessarily know the specifications of the law and they do not analyze whether the trademarks are used in a commercial or noncommercial way; they simply associate the known trademarked slogan with the message conveyed by the politician. The law has drawn a line between political and commercial speech which in reality does not exist. Consequently, it is not in accordance to the perception of the consumer what trademark law intends to address. By association, people could reasonably presume that the owner of the mark is sponsoring the politician's campaign. As a result, if the business' consumers disagree with the politician's message, they could stop supporting the brand and buying their products. Even when the use of a trademark by a particular politician does not fall under the definition of infringement of the Lanham Act, the trademark holder can still suffer the damages that trademark law intends to prevent. Politicians have many tools to express their views and messages; they do not need to use a specific slogan to accomplish their objective, nor is the public served by ignoring the rights of a trademark owner.

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[65] Shakow, *supra* note 1.
[66] *Id.*
[67] *Id.*
[68] Shakow, *supra* note 1.

Courts should not continue to categorize the use of trademarks as commercial or noncommercial, because the average person cannot recognize the difference between the two (2) categories. The law should respond in accordance to the damages inflicted, and should create a balance between the interests of the parties involved. The law should prevent and protect against possible damages, and in this case it can actually cause more harm than good.

2. Trademark Protection for Political Slogans

A political slogan is the way in which a politician reminds voters of his or her particular message. The purpose of the slogan is no different than that of a commercial slogan. In both cases, its purpose is to gain the sponsorship and loyalty of the public, to distinguish the product from its competitors, to remind the consumer or voter of a specific brand or politician, and to influence the audience in their future purchases or votes.

The Lanham Act rejects a slogan if its first use was not in commerce, and the Act does not consider that political slogans are used in commerce.[69] However, the politician uses the slogan to market him or herself and to sell the goods by using the slogan for his or her campaign, meaning that the slogan is, in fact, being used in commerce. Many commercial slogans were first heard in other contexts and did not acquire trademark status until the producer of a commercial good decided to attach the phrase to a product or brand. Political slogans are also used on a variety of commercial products (*e.g.* shirts, mugs, etc.) as a source identifier. By allowing others to merchandise goods with the political slogan of a particular politician, the law allows others to gain profit at the expense of the popularity of said politician. People purchase commercial items that contain the political slogan to show support for the politician, his or her message, and the campaign.

Lack of political trademarks also leads to public confusion in relation to the political message. In the case of *United We Stand for America*, the court ruled that if different organizations were permitted to employ the same trade name when endorsing candidates, voters would be unable to derive any significance from an endorsement because they would not know whether the endorsement came from the organization whose objectives they shared or from another organization using the same name.[70] This reasoning should be extended to political slogans. The same potential confusion could result from two (2) opposing candidates who use the same slogan in a campaign; voters would not understand the different positions and would have trouble identifying the candidate they want to support.

In the recent mayoral election of San Francisco, one of the candidates used the slogan "Together We Can," which seems like a harmless enough

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[69] Lanham Act (U.S. Trademark Act), 15 U.S.C. §§ 1051–1141.

[70] United We Stand Am., Inc. v. United We Stand, Am. N.Y., Inc., 128 F.3d 86 (1997).

slogan.[71] However, when formulating the slogan, the candidate considered that San Francisco voters were fed up with divisions within the board of supervisors, with clamorous disputes between the board and the mayor, and with the city's homeless problem, which some have called insoluble.[72] The other candidate was presenting himself as a leftist, and was often portrayed as a creator of divisions and political factions. Each word in the slogan targets something in the political landscape; for example, "together" suggests that the other candidate is divisive.[73] What if the other candidate, aware of his reputation, decided to use the same "Together We Can" slogan in order to get more votes? Would the current trademark law be fair to those voters who may get confused by the similar slogans?

In many instances, a political slogan serves not just as a marketing tool but also as a representation of a politician's ideals. Thus, the slogan becomes vital to the politician because it is his or her beliefs, platform, and legacy. The use of those political slogans does not end with the campaign; their relevancy lasts, at least, throughout the career of the politician.[74] After all, politics do not end when a campaign ends. In America, governing is just as political as running for office.[75] Lawmakers and executives must constantly garner votes, build coalitions, and muster public support.[76] A politician must be everywhere at once; similarly, some slogans demonstrate their strength through expansion and saturation.[77] When this strength is shown in a way that the only thing associated with the slogan is the politician, it means that the slogan has acquired the sufficient status, or a secondary meaning, to be considered for trademark protection.

The constant lack of restrictions on political slogans by the media could cause distortion and change in the message that identifies a politician and his campaign, thus confusing the supporters of the politician while hurting his or her reputation and career. Since the slogan functions as a source identifier, the political message correlates directly with the politician. Protecting political slogans is a way of granting individuals exclusive rights to their property. Slogan infringement deprives the owner of his or her right to control the message. In addition, it creates unfair competition, as profits can be diverted from their rightful owner as a result of slogan plagiarism on merchandise and as an impetus for donations.

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[71] Tamim Ansary, Do Slogans Matter? (Originally published in the political column section of- the now extinct- MSN Encarta encyclopedia, on file with the University of Puerto Rico Business Law Journal).
[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.*

C. Possible Changes to the Law

1. Use of Another Trademark in Political Speech

If a politician appropriates another's trademark, it should be viewed as infringement. As noted above, a politician's motivations to incorporate a trademark into his or her campaign does not necessarily serve a democratic purpose. As a result, First Amendment protection should not apply in certain cases. The use of the trademark by the politician must be viewed as analogous to a commercial trademark. In other words, the politician must use the trademarked slogan as the slogan of the campaign in order for the use to qualify as an infringement. The politician could use the trademark as incidental to his speech, but should not be able to use it as the main slogan that represents his or her political message. The power and influence that trademarks have acquired over the years could not have been imagined when drafting the Constitution; in this case, the law must evolve along with society. The electorate is not well served when a politician intends to benefit, not from his own creativity, but from the popularity of a well-known mark. Therefore, just as the courts recognize that obscene, libelous, or misleading political speech should be restricted, so should political speech that infringes upon a trademark belonging to another.

Taking this into consideration, the legal sanction to penalize the politician's infringement should be economic. In that sense, even when the use of a trademarked slogan may confuse people, the debate will not be censored. The penalty will be issued after the debate, not before, which will be the case if an injunction is used to prohibit the use of the slogan in the speech.

2. Trademark Protection for Political Slogans

The United States Patent and Trademark Office (U.S.P.T.O.) has strict regulations regarding whether or not a slogan can become a registered mark. In its simplest format, the decision depends upon whether the slogan is being used in the same manner as the mark, or whether the slogan is inherently distinctive and has developed what the law refers to as a "secondary meaning."[78] These laws could be adjusted in order to allow politicians to seek trademark protection for their slogans under certain circumstances. A politician should not necessarily be allowed to get trademark protection for the multiple slogans he or she intends to use throughout a campaign. In order to acquire trademark protection, the politician must prove that the slogan has acquired a secondary meaning. He or she must be able to demonstrate that the slogan has instant and universal association with the campaign; if

[78] 15 U.S.C. § 1127 (Supp. I 1995).

the slogan is thus used as a source identifier, it deserves to be rewarded with the protection. The politician must prove the strength of his or her slogan in order to demonstrate that its relevance would transcend the electoral period, because of the overwhelming association that people have made with the slogan. By acquiring trademark protection for the slogans, the politician should have access to the resources granted by the Lanham Act in order to seek legal action against infringers. The politician should also own exclusive rights to sell commercial merchandise containing the slogan; it should not be permitted that others enrich themselves at the expense of the politician's popularity.

For example, if Hillary Clinton or John McCain had attempted to use the "Yes We Can" slogan in their campaigns, President Obama would have been granted the economic remedies provided by law for trademark infringement. This is a slogan that, in accordance to the principles outlined above, should deserve trademark protection. "Yes We Can" is easily and instantly identified with Obama, and other people should not be able to benefit from Obama's popularity by using his slogan. However, if an opponent started to use "No We Can't," that should be considered a tolerable use as part of a political debate. This example constitutes circular reasoning; the opponent alludes to Obama's slogan in order to establish his or her own campaign in opposition to Obama. Voters would not be confused, because they would understand that the contradicting slogans belonged to different candidates.

V. Do We Really Need a Change?

It is important to begin enacting changes in trademark law in order to address the problems outlined above. Courts have blindly ruled in favor of political speech, without considering whether they should define the kinds of political speech that merit First Amendment protection. If political speech continues to be wholly and absolutely protected against any kind of attack, and if political speech is not subject to any limitation, then political exception could easily become the new rule.[79] Almost all speech could be considered political, but most of that political speech could also be commercial. Protecting political speech entirely could lead to an outright ban on any law that limits speech, which would be dangerous to both government and society.[80] If the ultimate goal of free political speech is the discovery of political truth, and if not, arguably, every example of political speech contributes to this discovery, then not all political speech needs to be protected in order to further the objectives of the First Amendment.[81]

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[79] Shakow, *supra* note 1.
[80] *Id.*
[81] *Id.*

There is a strong public interest in protecting trademarks because investments in trademarks made by private companies help lower costs for the consumer.[82] In today's information-saturated society, the function of effective and exclusive use of trademark is enormously valuable. Consumers can distinguish between producers, identify the products and services with which they have had positive relationships in the past, and maintain associations with products whose trademarks reflect those positive relationships.[83] Trademarked slogans are not political discourse, they are political nicknames; the vigilant protection of trademark would impose only an incidental and indirect restriction on political speech.[84]

The United States has a strong public policy regarding intellectual property. A person's creations are often some of his or her most valuable assets, and the country has always acknowledged the importance of the ownership rights over these creations. We must, therefore, continue to safekeep those rights. People invest many resources in the development of their work, and these efforts ultimately benefit the economy at large. The United States should further prioritize the protection of rights to intellectual property, including trademarks, and should not permit that these trademarks lose value as a result of infringement. If current trademark laws do not change, trademarks could then lose value to both the individual and the national economy. Additionally, the infringement of political trademarks could result in voter disenfranchising and political alienation as a result of a confused electorate.

The protection of intellectual property rights should also expand in order to protect political slogans. These aspects of political speech constitute an area of intellectual property that is currently unprotected by both copyright law and trademark law.

VI. Conclusion

The objective of this work is to create a debate and to question a treatment of law that has long been taken for granted: the view that political speech deserves the greatest amount of protection, even when it behaves more analogous to commercial speech; or that the commercial content should not be present in the political speech. This article intended to demonstrate that the fundamentals on the actual treatment of the law do not correspond to the reality of the political world and should therefore be re-examined.

We argue that the First Amendment could tolerate restrictions in the political scenario. To this end, the current law is unfair to those trademark

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[82] *Id.*
[83] *Id.*
[84] *Id.*

holders whose rights are infringed by politicians who appropriate their trademarks in order to take advantage of their market power. This type of trademark use should be seen as commercial, not political, because the politician uses the slogan to market him or herself as a product in order to gain consumer loyalty.

In the same way, the denial of trademark protection to original political slogans responds to an arbitrary distinction between this kind of political speech and commercial speech. The process surrounding political slogans is analogous to that of commercial slogans, and follows marketing and economic principles. A political slogan is a marketing tool used to promote the politician; since the slogan serves as a source identifier, trademark law should also apply in this context.

The law should change according to the needs and development of society. The proliferation of the media increases the necessity to protect intellectual property, by both protecting a trademark from political infringement and by granting trademark protection to original political slogans. The United States has long been an active promoter of intellectual property; these intellectual property rights should extend to this kind of political speech.

PUERTO RICO HOUSING INCENTIVES POLICY: ANALYZING GOVERNMENT SPONSORED HOUSING INCENTIVES IN PUERTO RICO FROM 2007 TO 2011

CARLOS INFANTE GUTIÉRREZ*

I. THE STATE OF PUERTO RICO'S REAL ESTATE MARKET

Puerto Rico's economy has been on a steady decline since 2007. The island's real Gross Domestic Product (GDP) growth rate has declined from 0.05% in 2006 to -5.8% in 2010.[1] This negative growth is expected to continue throughout 2011. The more optimistic expect this situation to turn around in 2012.[2] As expected, the financial, real estate, and construction sectors have been severely affected by the island's poor economic

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[1] *The World Fact Book*, CENTRAL INTELLIGENCE AGENCY 2011, https://www.cia.gov/library/publications/the-world-factbook/geos/rq.html (follow "Economy"). (negative estimates for GDP growth though the period -1.2% in 2007, -2.8% in 2008, -3.7% in 2009).

[2] Carlos Marquez & Jose L. Carmona, *Puerto Rico is Now Ready for Growth Finally*, CARIBBEAN BUSINESS, March 10, 2011 (citing GDP President Juan Carlos Battle who expects the economy to report positive economic growth in the 2012 fiscal year).

performance over recent years. Furthermore, the global economy collapsed in 2008, dealing another serious blow to the local economy. At that point, Puerto Rico's public debt was already growing at a higher rate than its economic growth, forcing the government to undertake massive budget cuts in 2009 to prevent the island's bonds from reaching junk bond status.[3] All these factors had major effects on virtually every economic sector. For instance, the economy contracted as a result of a steady increase in the unemployment rate and a reduction in capital investments. Local economists have dubbed this local recession as the "Recesión Criolla".

Before Puerto Rico's recession started, the construction and real estate markets seemed to thrive by posting strong sales numbers. As a result, new construction developments flourished and people rushed to take advantage of extremely accessible and attractive financing offers in order to make a seemingly "safe" and profitable investment. Speculation in the market led to increases in property values and homebuyers were more than happy to spend as much as 50% of their household incomes on housing expenses as they expected to capitalize on their property's appreciation in value.[4] However, after peaking in 2006, this speculative appreciation of property values came to a screeching halt by year's end. As property values rose to unattainable levels, housing market developments that were usually sold before completion started to accumulate in unprecedented amounts. Developers and their financial partners faced a huge problem as the current economic climate and their poor forecasting decisions led them to a dead end.[5]

Due to an increase in the cost of materials, the Federal minimum wage, and a long bureaucratic permit process amongst other factors during the aforementioned time period, developers of new properties chose to focus on mid to high price range properties in order to obtain profit margins that would justify undertaking such projects. The increase in construction and other development costs forced developers to steer away from low income housing projects despite the availability of government subsidies and instead focus on higher priced projects with greater profit margins.[6] Therefore, although the demand for low income housing units existed, low profitability and market risk scared developers from constructing these types of

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[3] *See* The Special Act to Declare a Fiscal Emergency and to Establish a Fiscal Stabilization Plan to Salvage the Credit of Puerto Rico, Act. No. 7 of March 9, 2009, P.R. LAWS ANN. tit. 3, §§ 8791-8810 (2009). (Puerto Rico's bonds had been downgraded by credit rating agencies to BBB- and where closely monitoring the islands actions).

[4] *See* Graham A. Castillo, *Situation and Outlook of the Housing Market*, 18th Housing Congress, Estudios Técnicos, Inc., August 18, 2010.

[5] Castillo, *supra* note 4 (it is estimated that there is an existing inventory surplus of 19,841 new housing units of which 97% have been on the market for more than 18 months).

[6] HOUSING AND URBAN DEVELOPMENT COMMISSION POSITIVE REPORT ON P. DE LA C. 1577, Legis. Assemb. 16-1577, 1st Sess., at 3-8 (P.R. June 16, 2009).

properties. The difference between the increase in real estate prices and household income created an oversupply of mid to high-end properties and a lack of supply of lower priced properties.[7] This, along with stricter lending guidelines adopted by banks due to the global financial crisis, led to a drastic reduction in new home sales, constructions, and loans originated by local financial institutions. Unlike the situation in the United States, the island's housing problems were not necessarily due to sub-prime mortgage lending practices as economic hardship, foreclosures, and distressed properties were substantial problems as individual's struggled to fulfill their financial obligations.[8]

The problem in Puerto Rico was not lack of demand but lack of adequate housing supply for the market's needs.[9] Developers and financial institutions ignored key economic variables[10] and saturated the market with mid to high income housing units and developments which offered the highest profit margins. This had the effect of undersupplying the mid to low income housing market, which in turn had limited viable housing options to choose from. The most undersupplied segment consisted of potential buyers with moderate income who did not qualify for public housing benefits, because of their income, but could not afford to buy houses due to high asking prices and limited financing options.[11] Due to the importance of the construction industry's multiplying effect in the economy,[12] since 2007 it has been the acting government's priority to reduce the inventory of properties available for sale in order to encourage new capital investments by developers and provide liquidity to the financial institutions tied to these developments. Consumers were supposed to benefit from the government's efforts to stimulate the real estate market, as they would obtain different types of incentives such as tax exemptions and bonuses which could be used as down payments or to cover closing costs. We now proceed to analyze these strategies established by the acting government in response to the collapse of the real estate market.

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7 Castillo, *supra* note 4 (of the existing inventory surplus of 19,841 reported as of June 2010, only 5,560 units were priced under $150,000 and 6,136 were priced over $300,000).

8 *Id.* (delinquency rates on home mortgages have reportedly increased from 2.8% in 2006 to 13.5% in 2010 and personal bankruptcies have spiked 10.2% and commercial bankruptcies climbed to 30.3% as of June 2010).

9 DEPARTMENT OF HOUSING IN THE HOUSING AND URBAN DEVELOPMENT COMMISSION FINAL REPORT ON R. DE LA C. 238, Legis. Assemb. 16-238, 1st Sess., at 6 (P.R. May 13, 2009).

10 Such as unemployment rate, median income, population increases/decreases and general economic health of the island.

11 FINAL REPORT R. DE LA C. 238, *supra* note 9, at 6.

12 My New Home Program, Act No. 209 of December 29, 2009, P.R. LAWS ANN. tit. 17, § 1034 (2009). (estimated at 165 according to the Statement of Motives).

II. HOUSING INCENTIVES LAUNCHED IN PUERTO RICO SINCE 2007

A. The Newly Built and Existing Housing Acquisition Tax Credit Programs

The first attempt to stimulate the real estate market was launched in 2007 in the form of Act No. 197 of December 14, 2007 ("Act 197") also known as the "Newly Built Housing Acquisition Tax Credit Program and Existing Housing Acquisition Tax Credit Program." Act 197's Statement of Motives acknowledges that the sale of newly built housing units is an important activity that generates financial activity on the island and provides revenue to the state.[13] It states that increased unemployment, cost of living expenses, and the costs of doing business in Puerto Rico have led to an economic slowdown specific to the island which contrasts to the growth experienced by other neighboring economies.[14] As a result of this slowdown, sales of newly built housing units had reportedly dropped by more than 50%.[15] Proposed as a job creating measure that would encourage new investment in the construction industry, Act 197 provided a tax credit that ranged from $10,000 to $25,000 to financial institutions that financed newly built pre-designed housing and existing housing units sold.[16] However, these credits would have to be applied towards the balance of the obligation assumed by the buyer, effectively subsidizing the purchase. The incentives provided under this Act had a cap of $220 million dollars, regardless of the number of qualified candidates.[17]

This legislation offered three different types of incentives depending on the type of property the buyer intended to purchase and the use it would be destined for. Since the main purpose of the legislation was to reduce the inventory of newly built housing units, the highest incentives were offered to buyers of new properties, especially those who intended to use them as primary residences.[18] Such buyers could qualify for a 20% credit off the purchase price with up to a maximum of $25,000 applied towards the purchase price.[19] Buyers of newly built housing units intended for use as

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[13] The Newly Built Housing Acquisition and Existing Housing Acquisition Tax Credit Programs, Act No. 197 of December 14, 2007, P.R. LAWS ANN. tit. 13, §§ 8044(K)-8044(L), 8514 (2007).
[14] *Id.*
[15] *Id.* (Act 197 adds section 1040K, section 1040L and sub clause (G) to clause (l) of subsection (b) to the Puerto Rico Internal Revenue Code of 1994).
[16] *Id.*
[17] *Id.* § 1(h).
[18] *Id.* § 1(a)(8). ("Qualified Residence" is defined as a newly built housing unit owned and used by the acquirer as his/her main residence for a term of not less than three years as of its acquisition. Although this three-year limit may not apply under certain circumstances and may not have the effect of invalidating the credit).
[19] *Id.* § 1(b)(2).

second homes or investment properties, could in turn qualify for a 10% credit off the purchase price up to a maximum of $15,000.[20] Finally, buyers of existing housing units, regardless of the intended use of the housing unit, could qualify for a 10% credit off the purchase price, up to a maximum of $10,000.[21] This latter group was limited to a maximum of 1,500 existing housing units.[22] These different alternatives were intended to provide benefits to financial institutions with tied up capital who couldn't afford to offer new commercial lending by reducing their risk on new loans. Two other goals of Act 197 were to provide buyers with opportunities to buy a primary residence which in turn would reduce the new housing inventory and, to a lesser degree, to offer buyers of second homes or investment properties and buyers of existing homes in the secondary market benefits and cost saving opportunities. This way all market participants, regardless of the type of housing (existing, pre-built, or new), would benefit from government sponsored incentives previously unavailable for such a wide spectrum of candidates.[23]

Financial institutions that wanted to take advantage of the tax benefits offered by Act No. 197, were required to register the property with the Puerto Rico Department of Treasury ("Hacienda") and the seller had to register with the Department of Consumer Affairs or "DACO" (Spanish acronym), which would keep an inventory of qualifying units and available credits.[24] The original expiration date on the tax credits was June 30, 2008, but it was subject to the availability of funds and a maximum number of existing properties to which the credits would be applied (for existing housing units). However, there were some initial complications and confusion that caused the original deadline to be extended to December 31, 2008.[25] At this point, the market was still desperate for a reduction in its inventory and there were still funds available from the original $220 million designation. However, existing housing unit sales quickly reached the maximum number of units allowed to benefit from the legislation incentives. Act No. 61 of May 12, 2008 ("Act 61") was thus passed to amend Act No. 197

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[20] *Id.* § 1(b)(1).
[21] *Id.* § 2(b)(1).
[22] *Id.* § 2(h).
[23] Qualification was not limited by traditional factors such as income or other social variables. The incentives were available for all home buyers purchasing a qualifying residence in a new construction or a pre-existing residence as long as they followed the guidelines set forth in Act 197 in order to register the project or property for the incentive program.
[24] The Newly Built Housing Acquisition and Existing Housing Acquisition Tax Credit Programs, Act. No. 197 of December 14, 2007, §§ 1(c)(i) & 2(c)(i). P.R. LAWS ANN. tit. 13, §§ 8044(K)-8044(L), 8514 (2007).
[25] Act. No. 61 of May 12, 2008, § 3(a)(8), P.R. LAWS ANN. tit. 13, §§ 8040(G), 8040(K)-8040(L) (2011).

in order to extend the number of existing housing units available for a maximum credit of $10,000 from 1,500 to 3,500 units.[26] Nevertheless, this increase in the maximum number of units would still be subject to the original funding limits of $220 million allotted for the stimulus program. The government hoped these incentives would encourage skeptical investors who were hesitant to purchase properties.

In order to provide homebuyers with credits without sacrificing the operating budget for fiscal year, Act No.197 provided financial institutions the aforementioned credits in three installments, to be collected on consecutive tax years starting on June 30, 2009.[27] The actual total amount of disbursements was higher than the credit amount allotted for the subsidies in order to account for interest and to compensate for opportunity costs and risk incurred by financial institutions.[28]

It is important to note that Act 197 did not identify where the funds to finance the credits would come from. In other words, the tax credits granted would simply be a pure reduction of taxes collected since no corresponding revenue generating source matched the tax credits identified. This revenue reduction would consequently affect the Government's operating budget for the next three fiscal years.

By December 31, 2008, Hacienda had processed a total of 11,518 applications for the credits set forth in Act 197 and Act 61.[29] The total amount of credits granted by the government amounted to $219,923,549, just under the assigned $220 million. Thus, the government would have a decrease in earnings throughout the extension of the tax credits equal to the $219,923,549 awarded plus interest.[30] Hacienda warned that the tax credits would have a negative impact on the central government's income and revenue generating capabilities since taxpayer obligations would be reduced by the same amount of the credits.[31] As such, these credits would substantially reduce Puerto Rico's general operating fund during the years corresponding to the credit installments. Hacienda went on to state that it would not recommend another incentive package aimed at the housing sector without first identifying alternative sources of income to compensate for the loss of revenue resulting from the tax credits.[32]

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[26] *Id.* § 4 (h)

[27] The Newly Built Housing Acquisition and Existing Housing Acquisition Tax Credit Programs, Act. No. 197 of December 14, 2007, §§ 1(d) & 2(d). P.R. LAWS ANN. tit. 13, §§ 8044(K)-8044(L), 8514 (2007).

[28] *See* Exhibit 2.

[29] *See* Exhibit 3 for distribution of credits in units and dollar amounts.

[30] Which will actually be a greater amount considering interest on the three credit installments. *See* Exhibit 2.

[31] FINAL REPORT R. DE LA C. 238 *supra* note 9.

[32] *Id.* at 4.

B. The Puerto Rican Economic Stimulus Plan

In May 2008, shortly after the enactment of Act No. 61, the global economy collapsed. Puerto Rico, already experiencing a difficult time dealing with its internal economic problems, was now being affected by a global recession which severely limited investment opportunities in both the public and private sectors. This situation would further affect the housing market since financial institutions would forcedly establish stricter financing requirements and availability of funding options would be limited. The events taking place did very little to bolster consumer confidence in the housing sector; the housing bubble had burst and the market was inevitably going into a price correction phase. This was terrible news for Puerto Rico's unsold inventory of new housing units and also for sellers of existing housing units. Increased delinquencies on mortgage payments, which resulted in increased foreclosures by lending institutions, resulted in an additional influx of properties into the market. These foreclosed properties would also affect the value of comparable properties, since financial institutions usually auction off or sell these properties for much less than their initial market value in order to get rid of the liability. In hopes of continuing the efforts set forth by the previous housing stimulus, the newly elected New Progressive Party government passed Act No. 9 of March 9, 2009 ("Act 9"), known as the "Puerto Rican Economic Stimulus Plan" in an attempt to boost the struggling Puerto Rican economy which was expected to continue its contraction.[33] This stimulus plan was part of the newly elected government's denominated "Economic and Fiscal Reconstruction Plan" which aimed to control and reduce government spending, raise additional resources for the general fund, promote the creation of Public Private Partnerships, and offset the recessionary impact of fiscal control measures to be implemented[34]

Pursuant to Act 9, $500 million would be disbursed through several programs in order to stimulate the overall economy,[35] of which a total of $54

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[33] The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009, P.R. LAWS ANN. tit. 12, §§ 142-155 (2009). (the Statement of Motives alludes to a budgetary deficit that is equal to 40% of the Government's recurring revenues and to the precarious state of the overall economy It refers to Puerto Rico's economy as being in a recession since 2007, when it experienced a contraction of 1.9%, followed by a 2.5% contraction in 2008, and an expected contraction for 2009 and 2010 of 3.4% and 2.0% respectively, which turned out to be too optimistic. At the time it was expected that the recession would last until 2011. It also points out the necessity to "restore fiscal health, improve its credit ratings and promote economic recovery.").

[34] *Id.* at 5.

[35] The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009 § 2. P.R. LAWS ANN. tit. 12, §§ 142-155 (2009). (such funds would be under the administration of the Government Development Bank for Puerto Rico ("GDB"), which would utilize the funds of the Puerto Rico Economic Stimulus Fund created by virtue of § 6 of Act No. 91 of May 13, 2006, as amended).

million would be allotted to measures directed towards the real estate market.[36] Of the $54 million assigned to help address the real estate market situation, $30 million would be assigned to establish a program to assist families struggling with their mortgages payments[37] and $24 million would be assigned towards homebuyer incentives. While acknowledging the government's attempt to implement a comprehensive plan to stimulate the real estate market (and the overall economy), for the purposes of this work we will focus on the "Homebuyer Stimulus Aid" set forth in § 5 of Act 9 which established a $25,000 or $10,000 credit towards the down payment of newly built or existing housing unit purchases, respectively. This bonus towards the down payment of a homebuyer's purchase would be provided by placing a second mortgage over the house for the appropriate amount in the name of the Puerto Rico Housing Financing Authority ("PRHFA").[38] This second mortgage would not be payable for 10 years, after which the homebuyer would have to start paying back the principal along with a fixed interest rate.[39] This interest rate could never be greater than the prevailing interest rate on the market plus one fourth percent (1/4 %) upon closing of the sale.[40]

The $30 million assigned to assist families pay their mortgages through the "Protecting Your Home Program", was aimed at decreasing mortgage loan delinquencies and foreclosures. This program had strict requirements and benefited lower income households which had recently gone through financial troubles and could not pay their mortgages. The program offered qualified participants up to eighteen months-worth of

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[36] The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009 § 12. P.R. LAWS ANN. tit. 12, §§ 142-155 (2009). (another $500,000 were assigned to the Regulations and Permits Administration in order to cover expenses related to the implementation of an interim procedure in order to create a more efficient permit and endorsement application procedure. One of the main purposes of the Interagency Permits and Endorsements Committee created by Executive Order OE-2009-6, is to expedite the bureaucratic nature of obtaining necessary permits and endorsements, in hopes of stimulating investing including Real Estate Developments, however, due to its administrative nature and applicability to other industries it was not included in the amount assigned towards the Real Estate Market in this work).

[37] The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009 § 4. P.R. LAWS ANN. tit. 12, §§ 142-155 (2009). (which allowed the Puerto Rico Housing Authority to provide a surety equal to 25% of the principal of a mortgage for eligible homes. Although this program would provide distressed homeowners with alternatives in order to avoid foreclosure on their homes and help reduce risk and increase liquidity in financial institutions, for the purpose of this work we will focus on incentives geared towards the purchase of new and existing housing units).

[38] *Id.* § 5.

[39] *Id.* § 5.

[40] Act. No. 28 of June 8, 2009, P.R. LAWS ANN. tit. 12 § 145, *amending* Act. No. 9, § 5 (in order to establish the applicable interest rate for the second mortgage originated from the "Homebuyer Stimulus Aid").

subsidies, up to a maximum amount of $20,000, in order to complement the mortgage payment.[41] These subsidies helped families who were at risk of losing their homes and also helped financial institutions by avoiding unnecessary foreclosures. In order to benefit from these payment guarantees, financial institutions were required to waive any late fees and other administrative charges incurred up to that point. This was intended to reduce the influx of distressed properties and corresponding depreciation of property values associated with this situation.

C. My New Home Program Act

Just 9 months after the approval of the Puerto Rican Economic Stimulus Plan, Act No. 209 of December 29, 2009, also known as the "My New Home Program Act" ("Act 209") was enacted. The purpose of this Act was to grant subsidies to lower income families for the purchase of their own property. Previous incentives were aimed at reducing the newly built housing inventory. However, most of these properties were simply not accessible to most market participants, whose options were very limited. As such, this program would favor individuals with low to moderate income levels, disabilities, the elderly, and public servants whose duties are essential to society.[42] Qualifying housing units could not exceed the maximum limits set by Federal Housing Authority ("FHA") loans. However, the PRHFA could raise previously preset price limits in order to reasonably cover purchasers' needs and market demand.[43] The incentives provided by Act 209 would provide qualifying participants a voucher for 5% of the sale price or appraised value of the property for a minimum of $5,000 and a maximum of $10,000.[44] This subsidy would have to be matched by the project's developer or the financial institution that financed the project.[45] In this way, the government hoped to reduce the amount of subsidies financed with public funds while allowing the private sector to contribute in order to provide homebuyers with a considerable incentive. Participating developers would benefit from this program by hopefully boosting stagnant sales and by not having to reduce property prices. To qualify for the "My New Home Program", the homebuyer would have to use the voucher for closing related

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[41] *Id.* (as defined, a qualified participant would have to be at least 3 months late on their mortgage payments, have suffered a 20% loss of income or more, have a maximum family income of $48,000 and have an outstanding debt on their mortgage worth less than $200,000),

[42] My New Home Program, Act No. 209 of December 29, 2009, P.R. LAWS ANN. tit. 17, § 1034 (2009).

[43] *Id.* § 1, *amending* Act No. 124 of December 10, 1993 (this price limit could be ignored if the Permits for Use have been valid for a period in excess of 18 months, as provided therein).

[44] *Id.* § 1.

[45] *Id.* § 1.

costs,[46] use the unit as his or her main residence, be a first time beneficiary of the program, have an annual income below $125,000, and be purchasing a home with a price below $300,000.[47] This program allowed for participants to benefit from other programs or incentives in addition to those offered by Act. 209.[48]

In order to sell a property without any penalties, program participants would need to keep the property for a minimum 10 year term. If the purchased property were to be sold within the 10 year term, the benefits obtained by the program participant would have to be returned in proportion to the remainder of the term.[49]

The funds allocated for Act 209 would be administered by PRHFA according to the rules and regulations adopted by the authority as provided by the Act.[50] Act. No. 122 of August 6, 2010, known as the "My New Home Financing Program", would set forth the source of funding for this new subsidy. As per Act 122, PRHFA would be assigned a recurrent source of funding obtained from the transfer of unclaimed liquid funds being held by financial and insurance institutions along with future assignments as approved by the legislature.[51] PRHFA could also dispose additional funds to this program by means of internal cost saving measures or budget redistribution as it deemed pertinent.[52]

D. The Puerto Rico Real Property Market Stimulus Act

Upon the expiration of Act 9, property inventories were still at unacceptable high levels. This forced the Government to pass its most expansive attempt yet to stimulate the real estate market in the form of Act No. 132 of September 2, 2010 ("Act 132"), also known as the "Real Property Market Stimulus Act." Once again, the government's purpose was to promote the sale of new and existing housing units through the adoption of a new

[46] As defined in the Puerto Rico Housing Financing Authority's Procedural Guidelines for the My New Home Program, § 4(V) (including lawyer's fees, realtor commissions, loan origination fees, cancelation fees and other related costs).
[47] *Id.* § 5.
[48] My New Home Program, Act No. 209 of December 29, 2009 §4. P.R. LAWS ANN. tit. 17, § 1034 (2009).
[49] *Id*, § 1.
[50] *Id*, § 1.
[51] My New Home Program Financing Plan, Act No. 122 of August 6, 2010, P.R. LAWS ANN. tit. 7, §2105 (2010). (This law would propose an amendment to Act No. 36 of June 28, 1989, Art. 6 (a)(2), in order to reduce the ten year holding period that financial and insurance institutions would have to wait in order to revert unclaimed liquid assets to the state to three years).
[52] *Id.* § 4.

incentive package.[53] This package consisted of real property tax exemptions, capital gains tax exemptions, income tax exemptions from the leasing of residential properties, and exemptions from transaction fees and duties. Act 132 was passed in response to projections which had newly built housing unit sales dropping by as much as 30% in comparison to the previous year.[54] This time, qualification requirements were loosened even more in order to allow for maximum participation in the program. Prospective buyers of high priced homes could now potentially qualify. Since the main purpose was to sell new housing units, restrictive requirements such as those based on the intended use of the property were eliminated. Like previous programs, pre-designed houses and existing housing units would also be included in the program. However, in contrast to the previous packages, the rental market and the non-residential real estate market were included in the package to create a more comprehensive effect on the overall market and the economy. This would provide alternatives for developers and sellers that are unable to sell properties and for consumers that are not able to purchase a property right now.

There were three different types of beneficiaries eligible for Act 132 benefits. The first type of beneficiary were purchasers of "newly built properties" as defined by the Act,[55] would receive the most benefits, since reducing this type of inventory was the stimulus package priority. Under this scenario, total net long-term capital gain obtained from the sale of a new residential unit purchased under Act 132 would be exempted from state income tax obligations.[56] Buyers of new property under Act 132 would not have to pay income tax on capital gains upon the sale of the property in the future.[57] Buyers of new properties under Act 132 would also be exempt from the payment of real property taxes for five years[58] and exempt from paying the "Special Real Property State Tax"[59] approved in 2009 as a measure to

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[53] The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010, P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2010).

[54] *Id.* (only a total of approximately 5,000 newly built housing units were sold in 2009 and only 1,726 units were sold for the first semester of 2010, for an estimated total amount of around 3,500 units sold for the year for an expected 30% decline in sales).

[55] *Id.* §1(a)(1-2) ("newly built residential property which is suitable for family living and has not been occupied." It also includes predesigned housing units acquired from approved developers).

[56] *Id.* § 3(b)(1).

[57] *Id.* § 3(c)(2). (such benefits would only be available to first time purchasers of the property, not to any other subsequent transfers).

[58] *Id.* § 5. (pursuant to Act No. 83 of August 30, 1991 and/or Act No. 71 of Jul 2, 2010. Commencing on Jan 2, 2011).

[59] *Id.* § 6.

increase the government's revenue stream.[60] Furthermore, all parties involved in a new property sale were exempted from incurring in any internal revenue stamp or voucher expense as required by law for the execution, filing, and recording of public documents.[61]

The second group of beneficiaries was composed of those who acquired a "qualified property." This included any existing residential or non-residential property whose sale price did not exceed $3 million.[62] The seller of a "qualified property" during the validity of Act 132 was fully exempted from state income taxes concerning the long term capital gains associated with the sale.[63] As was the case with new properties, those who bought a "qualified property" before the expiration date of the Act, would also obtain a tax benefit upon the future sale of their property. However, instead of the 100% exemption granted to sellers of "newly built properties", the seller of a "qualified property" would obtain a 50% exemption on the net long-term capital gains generated from the future sale of their property.[64] Acknowledging the devaluation of properties during recent years which forced sellers to sell their homes for less than the value of their mortgage loans, Act No. 132 included provisions to reduce losses on sales of "qualified property." As such, a taxpayer who is a natural person was allowed to deduct a $5,000 capital loss against his or her personal income, thus increasing the current capital loss limit allowed against regular income.[65] The carry-over of such losses was allowed to be carried over to a maximum of 15 years, as opposed to the 5 years previously allowed.[66] Sellers of a "qualified property" also received a 50% exemption from charges related to internal revenue stamps and other vouchers required by law for the execution, filing, and recording of public documents.[67] Sellers were also fully exempted for the same purposes regarding the cancelation of any mortgage burdening the property.[68] Also, the buyer of a "qualified property" would be exempted from 50% of the costs of internal revenue stamps and vouchers as required by law for execution, filling and registration purposes with respect to the purchase and mortgage of the property.[69]

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[60] The Special Act to Declare a Fiscal Emergency and to Establish a Fiscal Stabilization Plan to Salvage the Credit of Puerto Rico, Act. No. 7 of March 9, 2009, P.R. LAWS ANN. tit. 3, §§ 8791-8810 (2009).
[61] The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010, § 7. P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2010).
[62] *Id.* §1(c)(1)(2).
[63] *Id.* § 3(a)(1).
[64] *Id.* § 3(b)(2).
[65] *Id.* § 4 (a).
[66] *Id.* § 4(b).
[67] *Id.* § 7.
[68] *Id.*
[69] *Id.*

The final group of eligible beneficiaries was composed of "eligible lessors" of any residential property.[70] Under Act 132, any income earned from the rental or leasing of any residential property would be fully exempted from all applicable state income taxes[71] for a period of 10 taxable years commencing on January 1, 2011.[72] This alternative hoped to provide new options for home sellers and developers who were not able to sell their units and to provide a more accessible rental market for those looking to purchase homes but who were not able to do so due to strict lending conditions and inaccessible inventory alternatives. In theory, this program would also provide the lessor with additional income to meet his obligations and invest or consume in other economic areas. Financial institutions or individual sellers tied to these developments would hopefully benefit from increased account receivables collections, less bankruptcies, and less foreclosures.

III. Effect of Incentives in the Housing Market

Governments can intervene in the housing markets in five major ways: (1) by defining and enforcing property rights; (2) by taxation; (3) by the granting of subsidies; (4) through housing regulations; and (5) by direct public provisions.[73] Governments implement these measures in order to balance the different interests that affect a variety of important issues inextricably tied to housing. The majority of the provisions included in the real estate incentives discussed herein concern subsides implemented by altering applicable tax provisions, altering property rights, and plain cash incentives. An exemption from a regulation, which has an identifiable benefit to society similar to its cost, is treated as a subsidy.[74] Reductions, which do not yield corresponding benefits, are treated as pure cost reductions.[75] Although market interventions by governments may seek different purposes, it is useful to apply a cost/benefit analysis in order to gauge the economic effects of implementing such measures. The purpose of a cost/benefit analysis is to determine if the investment in such an incentives program was effective and worth implementing.

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[70] *Id*. §1(b) (whereby "eligible lessor" is defined as any individual, succession, corporation, partnership or trust that leases new or existing housing units).
[71] *Id.* § 2(a).
[72] *Id.* § 2(b).
[73] Deniz Baharoglu, Lawrence M. Hannah & Stephen Malpezzi, *Getting Housing Incentives Right in Turkey* 14 (University of Wisconsin-Madison working papers 97-03, May 30, 1997), *available* at the University of Wisconsin Center for Urban Land Economic Research.
[74] Getting the Incentives Right, URBAN NOTES Vol. 1, No. 1 (April 1989) Published by the Urban Development Division of PPR, at 2.
[75] *Id.*

The various stimulus packages promoted by the Puerto Rican Government directly affected four groups: (1) property buyers and sellers; (2) developers; (3) the government; and (4) the local economy.[76] The ideal scenario is one where all four groups benefit from the stimulus packages. However, because of the nature of the incentives and the variability of the factors that affect the housing market, most often some groups will benefit while others bear the measures' cost burden. We will now explore the effects of the incentives implemented by the Puerto Rican government, as well as other foreign governments, in order to gauge the effectiveness of these strategies in improving the real estate market situation.

A. Effects of Incentives in Home Prices During their Validity

Governments establish incentive packages with certain expectations and to fulfill specific purposes. However, studies show that on many occasions the results of such incentives prove to be counterproductive towards the achievement of said purposes or have other related unexpected effects, which offset the benefits provided. In theory, consumer subsidies increase a purchaser's buying power, artificially increasing demand and in turn raising prices. With most goods, manufacturers would respond by increasing supply, which would bring costs back down. Nevertheless, some goods, such as housing, face constraints to new supply due to various factors like construction time and pre-construction requisites.[77] Moreover, increasing supply would not make sense in Puerto Rico's case, considering the current overstock of housing. In practice, housing subsidies have the unwanted lateral side effect of increasing property prices.[78] Subsidies simply end up getting capitalized into housing prices, which by definition would increase prices, therefore potentially affecting affordability and limiting access to the market.[79]

The International Monetary Fund ("IMF") has found that first home buyer grants, variable rates mortgages, and capital gains tax concessions all serve to destabilize housing markets.[80] Furthermore, according to the IMF: "[s]ubsidies to first time home buyers are shown to both amplify house

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[76] See Exhibit 7, in order to view factors considered in a cost/benefit analysis for housing market participants.

[77] Jack Hough, *Why the US Doesn't Need Any More Home–Buyer Perks*, SMART MONEY, A WSJ ONLINE MAGAZINE (October 30, 2009), http://www.smartmoney.com/invest/markets/why-us-does-not-need-more-home-buyer-perks/.

[78] Miguel-Angel López García, *Precios de la vivienda e incentivos fiscales a la vivienda en propiedad en España*, 12 REVISTA DE ECONOMÍA APLICADA 39 (1996).

[79] *Why Housing Incentives Must Go*, MACROBUSINESS (February 27, 2011), http://www.macrobusines.com.au/2011/02/why-housing-incentives-must-go/.

[80] David Uren, *Incentives Hurting Housing Market*, THE AUSTRALIAN, April 11, 2011, *available at* 2011 WLNR 6938715.

prices, swings in the upturn and lead to deeper subsequent busts."[81] Similarly, "tax deductibility of capital gains tends to both amplify the boom and exacerbate the bust."[82] Some, like former Australian Treasury chief Ken Henry, believe that first time home buyer grants only result in prices being bid higher and that buyers leverage the government grants in order to spend more.[83] All of these incentives were implemented in Puerto Rico but none of the previously described potentially negative long run effects were considered. The implementation of housing incentives in Puerto Rico has been solely based on short run statistics with no mention of future implications or unintended consequences.

The impact of the incentives varies depending on the chosen strategies. New and existing properties are in most cases perfect substitutes.[84] Incentives that are applied towards the purchase of both new and existing properties maintain their respective prices unaltered in relation to each other.[85] However, if the two types of properties were to be treated differently by incentivizing one more than the other, relative prices between them would have to be modified.[86] This different treatment would lead to a new valuation process that would result in a decreased price for the properties not receiving the equal incentives (usually the existing properties).[87] Some studies show that "savings incentives" have a positive effect on pricing in the long run and, in the short run, results in the increase of prices being capitalized by all the existing properties.[88] This would entail that all properties would equally increase in value by the amount of the incentive. These same proponents argue that "investing incentives" have a negative long-term effect on property prices and also have an adverse effect on existing home prices upon their implementation.[89] Therefore, investing incentives would also have the effect of increasing demand, while controlling price increases because of the corresponding depreciation of existing properties. In other words, the increase in new property prices due to the capitalization of incentives would be counter-balanced by the decrease in prices of existing properties, thus effectively controlling the overall increase in prices. As described herein, Puerto Rico's focus has been primarily on new housing units' sales and, to a lesser degree, existing housing units sales, thus qualifying as an investment incentive.

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[81] International Monetary Fund, *Housing Finance and Stability-Back to Basics*?, GLOBAL FINANCIAL STABILITY REPORT, April 2011.
[82] Uren, *supra* note 80.
[83] *Id.*
[84] *Id.* at 2.
[85] *Id.* (referred to as "Savings Incentives").
[86] *Id.* (referred to as "Investing Incentives).
[87] *Id.* at 3.
[88] *Id.*
[89] *Id.*

Incentives granted are usually justified as a way to provide buyers with more access to the market; nonetheless, in many ways these incentives do the complete opposite. A secondary purpose of these incentives, considering the dramatic decline in home values, may be to prevent a free-fall of home prices by injecting confidence into the market. Goldman Sachs estimated that government support boosted house prices by 5% (or kept them from falling that much more) in the United States in 2009 by means of the Federal housing stimulus program.[90] Therefore, once a program like this expires, it is possible that homes would drop in value by that same 5% in addition to any further drop in value related to other factors in the market. Economists believe that temporary incentives mostly convinced people who were already considering buying a property to do so sooner rather than later, before the incentive programs expire. This means that upon the expiration of the incentives, a sudden drop in the number of buyers and housing prices could suddenly take place.[91] It is estimated that of the American Recovery and Reinvestment Act ("ARRA") beneficiaries, only 15% would not have purchased their home if they were not offered the $8,000 incentive.[92] Therefore, in order to determine if these incentives were worth the investment, we must examine the market's behavior upon their expiration.

B. Effect on Property Values after Incentive Expiration

Puerto Rico is not the only country facing a real estate crisis, although the underlying reasons for each country's situation may differ. However, many other countries have turned to incentives as an option to reverse their situations. Countries that have implemented similar stimulus packages have found out that the expiration of these packages have brought adverse unintended consequences. For instance, the month after the expiration of the $8,000 Federal incentive program,[93] the Mortgage Bankers Association reported a 27% decline in mortgage applications.[94] Existing home sales dropped by 10% in February of 2011 to their lowest point in 9 years, 40% of which are estimated to have been distressed property sales. Since the expiration of the homebuyer incentive program new housing sales have decreased 22% and existing home sales have decreased 6% in the United

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[90] Jack Hough, *Shopping for a House? Consider Waiting Nine Months*, SMART MONEY, A WSJ ONLINE MAGAZINE (January 29, 2010), http://www.smartmoney.com/invest/markets/shopping-for-a-house-consider-waiting-6-months/.

[91] *Id.*

[92] Hough, *supra* note 77.

[93] American Recovery and Reinvestment Act of 2009, 26 U.S.C. §§ 36(b) (2012). (which was extended from its original expiration date to April, 2010).

[94] Ana González Ribeiro, *New Home Buyer Incentives Replace Government Tax Credit*, MINT.COM (May 20, 2010), http://www.mint.com/blog/goals/home-buyer-credit-05202010/.

States,[95] while $26 billion in state sponsored subsidies has been incurred by the government.[96] In the United States, homebuyers have lost almost twice what they received as government cash incentives to property price decline. Since the expiration date of the federally sponsored program, median home values fell from $185,000 to $170,000. Thus, program beneficiaries obtained $8,000 but on average lost $15,000.[97] In places like Australia, it is argued that first time-home buyer incentives proved to be a boon for home sellers instead of homebuyers as was originally intended.[98] In Spain, after the end of a tax incentive proposed to stimulate property sales, sales dropped significantly, again suggesting a negative backlash directly attributable to the expiration of incentives.[99] The goals of these programs were similar to those of the programs established in Puerto Rico: incentivizing home purchases within an established time period so as to hopefully create a sense of urgency and boost the economy through property sales while decreasing inventories. Although Puerto Rico's incentives programs have yet to expire and have been extended for the fourth time throughout 2012,[100] property values have decreased from a median price of $250,000 in 2009 to $215,000 in 2011, suggesting that once the programs have concluded prices could experience a free-fall and possibly at a faster rate as demand decreases.

C. Private Sector Incentives

Due to the desperation created by stagnant sales, developers have had to create and implement an unprecedented number of creative strategies in order to sell properties. Accordingly, developers and financial institutions have teamed up in order to provide further incentives in addition to those offered by the government. These incentives are intended to provide additional benefits that could be considered cost reductions for buyers but do not affect the selling price of the homes. Developers and their creditors try to avoid reducing selling prices since this would affect consumer confidence and would certainly enrage recent homebuyers in those same projects (not

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95 Jack Hough, *How the $8,000 Tax Credit Cost Home Buyers $15,000*, SMART MONEY, A WSJ ONLINE MAGAZINE (May 10, 2011), http://www.smartmoney.com/spend/real-estate/how-the-8000-tax-credit-cost-home-buyers-15000-1304981110838/?zone=intromessage.

96 *Id.*

97 *Id.*

98 *The Impact of First-Home Buyer Stimulus*, TOMORROW: A HOME LOANS BLOG (June 9, 2011), http://www.tomorrowfinance.com.au/blog/the-impact-of-first-home-buyer-stimulus/.

99 *El fin de deducción por comprar casa comienza a mostrar su cara negativa en el Mercado,* EL MUNDO, November 5, 2011 9:06am, http://www.elmundo.es/elmundo/2011/05/11/suvivienda/1305097617.html?a=4b5c0d087d59965c7588b6734aca0685&t=1310248396. (citing data from the Spanish Instituto Nacional de Estadísticas (INE)).

100 Joanisabel González, *Otro salvavida a vivienda*, EL NUEVO DÍA (June 9, 2012), http://www.elnuevodia.com/otrosalvavidasalavivienda-1275181.html.

to mention reduce profit margins and capacity to meet obligations). Also, by preventing a further drop in home values, buyers would be less hesitant to wait to purchase a home for fears of declining values. Buyers perceive they are getting more value for their purchase and are enjoying costs savings. Some examples of such increasingly creative incentives granted by developers are: free upgrades, vouchers for home appliances, customizations, and attractive project specific financing options.[101] Some argue that the use of rebates actually makes the real estate market look healthier than it actually might be by preventing price reductions.[102] However, savvy homebuyers are increasingly looking at pure price reductions as the only acceptable incentive because other incentives cannot guarantee that home prices would not decline in the near future resulting in their loan becoming "under water."[103] Also, some buyers would rather use these savings to purchase what they really need without being limited by incentive options and restrictions.[104] Developers continue to re-evaluate alternatives in order to adapt to this new economic reality. More and more projects are being redesigned in order to reduce the price and size of developments in an attempt to serve the demands of the market and not add to the un-sellable high-priced inventory surplus.

D. Why Stimulate the Housing Market through Incentives?

Despite the negative effects of incentivizing home purchases, why have so many countries turned to incentive based policies in order to help mitigate the effects of the real estate market crisis?

First, governments have faced harsh pressures to act in order to stabilize their respective economies due to the financial crisis. By incentivizing the real estate market, governments hope to stimulate the economy along with a series of other measures so as to stop the "bleeding". In Puerto Rico, the real estate and construction industries have a considerable multiplying effect on the economy, helping to stimulate related industries. Buyers of existing houses spend in repairs, new appliances, legal fees, and sales commissions amongst other expenditures. Buyers of new homes have an even greater impact, since these units had to be built and therefore would contribute to the economy with construction jobs, materials purchased, permit and impact assessment fees, and other regulatory and

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[101] *See* Exhibit 8 for a more expansive list of incentives.

[102] Jessica Saunders, *Home Buyer Incentives Another Sign Housing Boom is Over*, THE SAN FRANCISCO BUSINESS TIMES (September 10, 2006), http://www.bizjournals.com/eastbay/stories/2006/09/11/story2.html?page=all.

[103] Common term used to describe a loan, usually a home mortgage loan, with a higher balance than the value of the home.

[104] Such as brand or store specific vouchers, limited upgrade options, or financing offers tied to a specific institution.

administrative fees. Both types of purchases generate a post-closing economic chain where real estate brokers, notaries, engineers, architects, appraisers, moving companies, hardware stores, electronic stores, and other sectors of the economy benefit.[105] All of these incidental transactions generate revenue for the State through collections of sales taxes and other applicable taxes. Homeowners also pay property taxes and other special taxes which are based on estimated home values. These taxes generate considerable income for both the State and Municipal Governments. It is therefore clear that a decrease in home values would mean a corresponding decrease in taxes collected. By maintaining or increasing property values, assuming that these values are constantly revised, the State can prevent a further reduction of revenue collections. In the best-case scenario, the increase in the amount of taxes collected as a result of the stimulus effect of the incentives on the economy would be greater than the amount of subsidies granted by the State.

Some incentives are also aimed at promoting new developments. A drop in the development of new projects also decreases revenues for the State due to reduced building permits, hookup fees, impact assessment fees, titling taxes and inscription fees. Sales taxes collected would also decline due to lower sales of building materials, household appliances, and other related goods. According to the Nelson A. Rockefeller Institute of Government Tax, the amount of state taxes collected in the United States in 2010 was 17% below the amount collected in 2008.[106] Although, this drop in tax collections may not be solely attributable to real estate, construction and other related industries, it is certainly a significant part of the equation.

In order to free some tied up capital from financial institutions and investors, the new housing unit inventory must be reduced. This inventory ties up investors' and financial institutions' opportunities to undertake new projects and pursue new opportunities. Existing properties also affect financial institutions which provide and service mortgage loans. Therefore, property sales are crucial in order to increase liquidity for local banks so that they may lend to consumers and make commercial investments. Through incentives, it is hoped that inventories will be reduced and the capacity to make new investments will increase.

Furthermore, a struggling global economy and an extended local recession have hit the job market in Puerto Rico particularly hard. Naturally, considering the state of the real estate market, construction jobs have disappeared at an alarming rate. It is estimated that 60,000 construction

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[105] The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010. P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2010).

[106] John E Petersen, *The Housing Markets Effect on Government Finance*, GOVERNING (November, 2010), http://www.governing.com/columns/public-finance/effects-housing-market-government-finance.html.

related jobs have been lost since 2004.[107] In the United States, approximately 2 million construction jobs had been lost as of mid-2010.[108] It is estimated that every on-site construction job generates roughly two other off-site jobs.[109] This could represent a total loss of approximately 180,000 construction related jobs in Puerto Rico and around 6 million in the United States. In order to turn the economy around it is crucial that job opportunities are created and a healthy construction sector would certainly help to that effect.

E. Other Factors to Consider

To fully comprehend the extension of government sponsored incentives we must briefly discuss other types of subsidies. As described, Puerto Rico's housing inventory surplus consists, in its vast majority, of medium to high-priced units. Throughout our history, several programs have been established, using both state and federal funds, to promote the development of low-income housing units and provide low-income families with proper housing alternatives. Most recently, in an attempt to reduce low-income housing development costs, a bill has been proposed by the state senate to impose a three-year moratorium regarding the payment of impact assessment fees, which can amount to 25% of the costs of developing low-income projects.[110] This would hopefully motivate developers to provide more low income housing to meet market demand without forcing the government to fund such projects exclusively with public funds. However, as discussed, subsidies do not necessarily cancel out taxes and other regulatory costs.[111] Thus, it would be questionable to assume that they would translate into lower prices for buyers or motivate developers to undertake low-income projects.

In order to qualify for subsidies to produce low-income housing units, developers are imposed pricing controls by the government in order to guarantee the affordability of the units for buyers. These controls restrict developers' profits which are supposed to be mitigated by the granted subsidies. However, studies have shown that in most cases the costs of regulatory and pricing restrictions outweigh the subsidies and regulatory exemptions provided to developers. Administrative processes and regulatory

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[107] The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010. P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2010). (as of the approval date of the Act).
[108] Petersen, *supra* note 106.
[109] *Id.*
[110] S. 16-1447, 5th Sess. (P.R. October 25, 2011).
[111] Stephen Malpezzi & Stephen K. Mayo, *Getting Housing Incentives Right: a Case Study of the Effects of Regulation, Taxes, and Subsidies on Housing Supply in Malaysia*, LAND ECONOMICS, Vol. 73 No. 3, (Aug. 1997), *available at* http://info.worldbank.org/etools/docs/library/156603/housing/pdf/Hannah_handout.pdf

requirements add risk to any development project and delays caused by regulatory procedures tie up capital and increase risk.[112] These delays add further uncertainty and cost to developments which depend on the prompt completion of such procedures in order to fulfill expected projections. This is a well-documented subject matter that is critical when analyzing the profitability and/or viability of any new real estate development.[113] Puerto Rico is significantly affected by this problem. Some argue that the current permit approval process is the riskiest factor in investing in Puerto Rico.[114] The IMF ranks Puerto Rico as the 151 out of 183 economies with respect to dealing with construction permits as of 2011.[115] This ranking does not motivate investors to do business in Puerto Rico and adds uncertainty to investors who do. The average time to undertake construction projects in Puerto Rico is estimated to be 5 to 7 years from initiation to completion.[116] However, these projections should be altered in order to include the additional time it takes to sell a finished property in the current economy, thus adding further costs to the bottom line. The burdensome approval process increases risk and the "hurdle rate", that developers require before proceeding with projects.[117] Some of these requirements have legitimate public interests which justify their existence such as security, acceptable living standards, and urban planning necessities. These priorities need to be balanced out in order to develop an expedite, cost effective process that guarantees proper land use. It is therefore imperative that this issue be addressed properly to improve efficiency, reduce costs, promote investments and also prevent an unchecked growth in inventory.

IV. CONCLUSION

The real estate market in Puerto Rico has been going through an unprecedented negative slump since 2007. Pressured to act, incumbent political leaders were forced to create various incentive based packages in order to confront this crisis. The urgency and magnitude of the problem, along with outside pressures from various lobbyist groups, have caused decision makers to enact legislation focusing on short run strategies without fully examining the collateral and long term effects of their decisions. The collapse of the global economy did little to improve the situation and to this

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112 Getting the Incentives Right, *supra* note 74.

113 *Id.*

114 HOUSING AND URBAN DEVELOPMENT COMMISSION POSITIVE REPORT ON P. DE LA C. 1577, *supra* note 6, at 1.

115 *Ease of Doing Business in Puerto Rico*, THE DOING BUSINESS PROJECT BY THE INTERNATIONAL MONETARY FUND, (2011), http://www.doingbusiness.org/data/exploreeconomies/puerto-rico#dealing-with-licenses.

116 Alexander Lopez, *Home Sour Home*, CARIBBEAN BUSINESS, June 2, 2010 at 17.

117 Malpezzi & Mayo, *supra* note 111.

day we are still struggling to come up with solutions to a problem that, in spite of all efforts, has become worse. Sales of new and existing homes have decreased, property values have plummeted, and new properties are being foreclosed adding a further influx of properties to the already alarmingly overstocked housing inventory. Due to increased weakness in capital gains outlook, investors are deserting the market.[118] Moreover, considering the most recent extension of the current stimulus package until December 31, 2012,[119] Puerto Rico has had an almost ongoing subsidy of the market for three years and is yet to face the aftermath of a definite change in policy. Although the diminishing property sales numbers cannot be completely attributable to an inadequate incentives policy, the results on the market after the incentives expire and the effect these incentives have on those who chose to take advantage of them can.

The main problem in Puerto Rico, as explained, consists of an oversupply of mid to high-end properties and an undersupply of low-end properties desired by the market. Developers and financial institutions looking to profit on what had been a lucrative industry gave in to speculation and failed to take into account the reality of the market's needs.[120] As a result, what had once been profitable job-generating enterprises became a huge burden for the economy as bankruptcies, delinquencies, layoffs, and reduced associated government tax collections added to the already distressed state of affairs in Puerto Rico. The capital tied up to these developments prevents the promotion of new investment opportunities as financial institutions struggle to stay afloat amidst the crisis.

Every single one of the legislations examined emphasized the importance of providing homebuyers with an opportunity to have access to the real estate market through incentives. The logic behind the implementation of such programs was that homebuyers could not afford to buy or were not inclined to buy without incentives. Buyers could benefit in two ways: by buying a desired property at a lower price or by having access to a higher priced property which they could not previously afford. The Housing Department argued that these types of incentives were positive for

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118 Uren, *supra* note 80.

119 Act No. 115 of July 11, 2011, *amending* The Puerto Rico Real Property Market Stimulus Act, Act. No. 132 of September 2, 2010, P.R. LAWS ANN. tit. 13, §§ 10691-10700 (2011). (extending Act 132 benefits until October 31, 2011); *see also Extienden beneficios gubernamentales al comprar primera casa*, PRIMERA HORA (June 8, 2012), http://www.primerahora.com/extiendenbeneficiosgubernamentalesalcomprarprimeracasa-657870.html.

120 Alexander Lopez, *supra* note 116, at 18 (quoting Banco Popular Executive Vice President Silvio López: "the Census Bureau reported in 2006 that 85.3% of households earn less than $50,000 and 62.7% earn less than $25,000. On 2006, of the 13,500 new properties sold of which 57% were units under $200,000. Currently, 60% of new properties are priced over $300,000.").

homebuyers by reducing purchase prices and making homes more affordable. However, as previously explained, these incentives have the opposite effect, inflating housing prices by the value of the incentives, thus preventing them from reaching their true market value. This would have the effect of keeping property prices at unattainable levels for those who were supposed to benefit from the incentives. Promoting home ownership through subsidies has induced many buyers to borrow more than they can afford in order to buy a house, using the incentives to leverage their purchases for bigger and more expensive properties. This may add to future loan delinquencies and possible foreclosures. At a time when properties are still declining in value and are expected to continue a downward trend, buyers are paying premium prices for homes which will more than likely be worth less in the very near future, erasing any possible benefit obtained through the subsidies. Incentives gave buyers a false sense of value and were therefore adversely affected by the stimulus program. Consequently, buyers would have benefited more by the natural correction of prices without government intervention. The homebuyer would have potentially bought the same home at a lower price and at less cost to the government if no incentives had been implemented. Because of this, the incentive programs implemented have failed to accomplish the goals set out with respect to benefiting homebuyers.

The investment incentives granted, as previously mentioned, have a negative long-term effect on prices and help create price speculation. Thus, it is difficult to comprehend how one of the causes of the problem could be viewed as a viable solution to the real estate crisis. Moreover, when treating new and existing properties differently, the difference in the subsidy means that while new properties are capitalizing the value of the higher incentive, existing properties are losing value for the same amount. This would not only depreciate existing home values for homeowners but also decrease property tax collections in proportion to the lost value of these properties which, in turn, greatly outnumber new housing units. Therefore, the government has spent taxpayer dollars in order to subsidize a limited group and has collected fewer taxes as a result. Furthermore, with new and existing properties being perfect substitutes in most cases, it would be difficult to assume that new properties will sell at a higher rate when comparable, cheaper alternatives (existing properties) are available as a result of the incentives policy. If the bargaining possibilities that exist in the existing property market are taken into account, which are certainly limited when dealing with new developments, price differences could be even greater between these two alternatives effectively harming the new properties market.

Another reason given to justify incentive programs is that they inject confidence into the market. However, buyers seem reluctant to enter the market as they are confused by mixed signals. If the market were healthy, would it need to be stimulated by incentives? On one hand, there are attractive interest rates, lower prices and incentives, while on the other hand there are prohibitive lending practices, increased foreclosures, and high unemployment rates.[121] In the United States, it is estimated that as much as a third of homeowners owe more than their homes are worth,[122] something which will not appease potential buyers looking to buy now. Celia Chen, a housing market analyst at Moody's Analytics, states that "many are reluctant to purchase a home even if they have the means because of the uncertainties in the economy."[123]

It would be difficult to estimate what would have happened to the real estate market and the local economy without the incentives created. It is very likely that without government intervention home sales would have been lower and the resulting effect on the post transaction chain would have affected other sectors of the economy. This would have amplified the struggles of the local economy, but it would also have cost the taxpayers a considerably lower amount of public funds in the form of subsidy assignments and tax exemptions. Financial institutions and developers have benefited from the government intervention by reducing their inventory, albeit not at expected rates, and increasing their liquidity. These two groups have hailed the results of the incentives and argued that although the market is still struggling, it would be much worse off without the incentives. Recently, sales have slightly increased but not at a considerable rate considering the horrible comparable numbers of years past and the influx of new properties into the market. These sales numbers could also have been adversely affected by conditioning buyers to expect subsidies when making their purchases. As the incentives expire, this may cause buyers to wait until the next set of incentives to buy. Additionally, it could be argued that the incentives program has drained the market of potential homebuyers, since the pool of first time homebuyers was not increased by the stimulus package. This would bring about terrible consequences for future sales, especially as incentives expire.

Home ownership incentives may also distort investment decisions in the economy towards housing and away from more productive business investments.[124] As reported by the GDB, construction only contributes 1.7% to the GDP of Puerto Rico (although other sectors are also affected by this

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[121] Unemployment rate has reached 16.2% according to the most recent statistics reported by the GDB. *Puerto Rico Economic Indicators*, GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO (June 22, 2011), http://www.bgfpr.com/economy/documents/PREI062211.pdf

[122] Michelle Conlin, *Home Sellers Pull Out All the Stops to Attract Wary Buyers*, USA TODAY (March 27, 2011), http://www.usatoday.com/money/economy/housing/2011-03-27-spring-home-buying.htm.

[123] *Id.*

[124] Why Housing Incentives Must Go, *supra* note 79.

industry), so in order to stimulate the economy, public funds may have been put to better use through other incentives or investments. The high subsidies accruing to the few current beneficiaries drain scarce public resources and commit future earnings at a time when the government is struggling to find new sources of income. It is also worth noting that due to the nature of incentives, the rest of the taxpaying population is bearing the costs of these incentives and/or receiving less public services than before for their tax dollars. In effect, a privileged group enjoys special treatment while other property owners' tax obligations are doubled through special legislation in order to increase revenues to finance the aforementioned special treatment. Furthermore, a considerable amount of future revenue generating potential has been compromised in order to finance the subsidies granted.[125] Through these incentives, the government has foregone most of its related revenue generating alternatives for years to come, relying on sales tax and other incidental revenues to make up for this loss of income.

In order to reduce inventories, developers will need to ultimately reduce prices drastically and develop radical new strategies to attract buyers.[126] It has come to a point where cutting losses may be a better strategy than holding on and expecting things to change. Nonetheless, it will take a joint long term effort from the private and public sectors in order to stabilize the market. The government should focus its efforts towards preventing further foreclosures which affect lending institutions and have a negative impact on the market as property values plummet and inventory levels rise.[127] The demand for the "Protecting Your Home Program" was such that its funds almost expired before they were available with the government being forced to inform the public that it would not be accepting further applications just three days after it starting accepting them. This reflects the critical fiscal situation that many households are going through and the huge demand for these types of programs. Such programs also help financial institutions by increasing their revenues and preventing further delinquencies.

The government should also focus its efforts on job creation since, regardless of the magnitude of the incentives, if people do not have have a steady income they won't be able to buy a home or qualify for any loan. Considering the limited space and resources of Puerto Rico, due to its geographical size, the government can no longer rely on the construction

[125] Such as the opportunity cost of the ten year interest and principal exemption for the second mortgages granted by The Puerto Rico Economic Stimulus Plan, Act No. 9 of March 9, 2009, P.R. LAWS ANN. tit. 12, §§ 142-155 (2009).
[126] Such as no reserve auctions, new property rentals, the promotion of properties to foreign markets as vacation homes, the promotion of fractional ownerships amongst others.
[127] López, *supra* note 116, at 17 (reports show that a foreclosed property on average reduces the value of nearby homes by 27%).

industry to help move the economy. Instead, it should shift its focus to other more sustainable industries in order to move forward. Puerto Rico has to set its economic development priorities in areas that maximize its current capabilities and expertise. Although new development projects create jobs, they do little to transition Puerto Rico's economy towards a more competitive, less labor-intensive economy. With a decreasing and aging population, the government should study the overall need for housing in Puerto Rico. It should also analyze the overall effects of the incentives once they have expired in order to reassess strategies and establish a forward looking policy that will increase the competitiveness of Puerto Rico and its construction and real estate markets.

V. EXHIBITS

Exhibit 1: Timeline of Real Estate Market Stimulus Plans Sponsored by Puerto Rico's Central Government

Act No.	Popular Name	Date
Act. No. 197	Newly Built and Existing Housing Acquisition Tax Credit	December 14, 2007.
Act No. 61	Newly Built and Existing Housing Acquisition Tax Credit Deadline Extension	May 12, 2008
Act. No. 9	Puerto Rican Economic Stimulus Plan	March 9, 2009.
Act. No. 209	My New Home Program	December 29, 2009
Act. No. 122	Funds for My New Home Program	August 6, 2010
Act. No. 132	The Puerto Rican Real Property Market Stimulus Act	September 2, 2010
Act No. 115	Extension of Benefits of the Puerto Rican Real Property Market Stimulus Act	July 11, 2011

Exhibit 2: *Actual Credits Granted by the Government Including Interest under Act No. 197*[128]

Example 1: Maximum credit allowed of 15,000 for new housing units

1st. Payment	$5,200	34.37% of total credit

[128] As provided by Act. No. 197, §§ 1(9)(ii)(b)1-2, 2(b)(1)

2nd. Payment	$5,500	36.67% of total credit
3d. Payment	$5,800	38.37% of total credit
Total	$16,500	109.41% of total credit or 10% interest.

Example 2: Maximum credit allowed of 25,000 for new housing units used as primary residence.

1st. Payment	$8,800	35.2% of total credit
2nd. Payment	$9,200	36.8% of total credit
3d. Payment	$9,600	38.4% of total credit
Total	$27,600	110.4% of total credit.

Example 3: Maximum Credit Allowed for Existing housing units.

1st. Payment	$3,500	35% of total credit
2nd. Payment	$3,600	36% of total credit
3d. Payment	$3,800	38% of total credit
Total	$10,900	109% of total credit or 9% interest.

Exhibit 3: Number of Credit Applications Successfully Processed by the Treasury Department under Act. No. 197[129]

Type of Credit	Credits Processed	Dollar Amount of Credits
Existing Housing Unit Credits	3,416	$32,905,512
New Housing Unit Credits	7,919	$183,329,088
Pre-designed Housing Unit Credits	183	$3,688,940
Total	11,518	$219,923,540

Exhibit 4: Second Mortgage Participation under Act No. 9[130]

Units Sold by Month

Month	2009	2010	2011
Jan		118	135
Feb		162	225
Mar		246	233
Apr	1	127	265
May	2	154	
Jun	20	144	
Jul	41	224	
Aug	53	133	
Sep	48	132	
Oct	84	194	
Nov	205	183	
Dec	205	236	
Total	659	2053	858
Total Units Sold:	**3570**		

Value of Units Sold by Months ('000)

Month	2009	2010	2011
Jan		$18,543	$20,219

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129 Housing and Urban Development Commission, H.R. Res. 238 16th Leg. (1st. Sess. 2009), May 13, 2009 (Final Report by Pedro I. Cintrón Rodríguez Housing and Urban Commission President).

130 *According to data provided by the PR Financial Institutions Commission (as of Aril 30, 2011)

Feb		$25,199	$30,893
Mar		$36,913	$36,491
Apr	$150	$18,596	$35,240
May	$738	$23,434	
Jun	$4,148	$20,947	
Jul	$7,142	$32,890	
Aug	$7,455	$19,162	
Sep	$10,648	$20,569	
Oct	$19,163	$28,191	
Nov	$30,469	$28,177	
Dec	$31,991	$36,338	
Total	$111,904	$308,959	$122,843
Total Dollar Value of Units Sold:	**$543,706**		

Exhibit 5: Down Payment and Closing Cost Bonus Participation (under Act No. 209)[131]

New and Existing Housing Units Sold by Month

Month	2010	2011
Jan	513	759
Feb	887	794
Mar	938	1067
Apr	652	1089
May	594	
Jun	842	
Jul	510	
Aug	754	
Sep	721	
Oct	883	
Nov	807	
Dec	912	
Total	9013	3709
Total units:	**12722**	

[131] *Id.*

Value of Incentives Granted (in ‘000)

Month	2010	2011
Jan	$2,761	$4,602
Feb	$4,743	$4,965
Mar	$5,191	$7,033
Apr	$3,643	$7,222
May	$3,367	
Jun	$4,491	
Jul	$2,513	
Aug	$3,726	
Sep	$4,368	
Oct	$5,514	
Nov	$4,955	
Dec	$5,467	
TOTAL	$50,739	$23,822
Total 2010 and 2011: $74,561		

Exhibit 6: Real Property Market Stimulus Participation (Act No. 132)[132]

New Housing Units Sold			Existing Housing Units Sold		
Month	**2010**	**2011**	**Month**	**2010**	**2011**
Jan		249	Jan		745
Feb		260	Feb		844
Mar		299	Mar		901
Apr		370	Apr		1182
May			May		
Jun			Jun		
Jul			Jul		
Aug			Aug		
Sep	211		Sep	559	
Oct	337		Oct	1131	
Nov	262		Nov	791	
Dec	298		Dec	815	
Total	1108	1178	Total	3296	3672
Total Units: 2286			**Total Units: 6968**		

[132] *Id.*

New Units Sold in Dollars (‘000)			**Existing Units Sold in Dollars (‘000)**		
Month	**2010**	**2011**	**Month**	**2010**	**2011**
Jan		$57.2	Jan	$119.0	$109.3
Feb		$50.3	Feb	$110.3	$122.6
Mar		$62.0	Mar	$103.4	$132.9
Apr		$73.2	Apr	$118.9	$173.3
May			May		
Jun			Jun		
Jul			Jul		
Aug			Aug		
Sep	$40.5		Sep	$202.4	
Oct	$73.6		Oct	$169.5	
Nov	$61.7		Nov	$120.0	
Dec	$73.8		Dec	$126.6	
TOTAL	$249.6	$242.7	TOTAL	$618.5	$538.1
Total $: $492.3			**Total $: $1,156.6**		

Total Units Combined: 9,254 **Total $ Combined (‘000): $1,648.9**

Exhibit 7: Cost Benefit Analysis[133]

The Economy

(Market Value of Unit) – (Resource Cost to the Economy)= (Net Economic Cost /Benefit)

If the economic cost/benefit is positive the unit is efficient.

The Developer

[(Land Subsidy) + (Infrastructure subsidy) + (Construction Subsidy) + (Sales Price)]

— [(Resource Cost of the Economy) + (Cost of Land Use and Building Reg.) + (Land Acquisition) + (Other Taxes)]

= Net Financial Cost/Benefit to the Developer

If the developer’s cost/benefit is positive a supply response will be observed.

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133 Stephen Malpezzi & Stephen K. Mayo, *Getting Housing Incentives Right: a Case Study of the Effects of Regulation, Taxes, and Subsidies on Housing Supply in Malaysia*, 73 LAND ECONOMICS 3 (Aug. 1997), at 372 – 391.

House Purchasers

[(Market Value of Unit) + (Recurrent Infrastructure Subsidies) + (End Use Financial Subsidies)]

— [Sales price) + (Registration Taxes) – (Property Taxes) – Extra Cost of Program Participations)]

= Net Financial Cost/Benefit to the Developer

If the purchaser's cost/benefit is positive analysis there will be demand for the unit.

The Government

[(Taxes) + (User Fees & Admin Charges)]

— [(Subsidies Paid Out) + Opportunity Costs of Implicit Subsidies)]

= Net Financial Cost/Benefit

If the Government's cost/benefit is positive there will be a positive effect on the treasury.

Exhibit 8: Examples of Private Sector Incentives for Homebuyers[134]

- Rolled back pricing
- No payment for six months
- 100% financing
- Payment of closing costs and other buying costs
- Free pools
- Home Owners Association fees paid for a determined amount of time
- Free landscaping
- Free upgrades and customization options
- Interest rate buy down
- Vouchers for as much as $50,000 for appliances and other equipment
- Payment of property taxes
- Free Vacation packages
- Free Cars
- Low introductory interest rates for a determined amount of time

[134] In Puerto Rico and the United States.