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## JUST COMPENSATION FOR THE TAKING OF MORTGAGE LOANS

*Katherine A. Pancak\**  
*Thomas J. Miceli\*\**

### INTRODUCTION

A number of cities across the country have considered helping homeowners who owe more on their mortgage loans than their homes are worth by using their power of eminent domain to take those negative-equity or so-called “underwater” mortgage loans and forcibly refinancing them.<sup>1</sup> Such an approach has never been used before so there are many questions as to whether using eminent domain to take underwater mortgage loans would be legally and practically viable.<sup>2</sup> However, that has not stopped local governments in San Bernardino County, San Francisco, Chicago, and

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<sup>1</sup> The locality to first consider this plan was San Bernardino County, California. See Mario Anzuoni, *Governments Mull Radical Solutions to Underwater Mortgages*, NBC NEWS (Aug. 16, 2012, 5:02AM), [http://economywatch.nbcnews.com/\\_news/2012/08/16/13301668-governments-mull-radical-solution-to-underwater-mortgages-seize-them](http://economywatch.nbcnews.com/_news/2012/08/16/13301668-governments-mull-radical-solution-to-underwater-mortgages-seize-them). However, it appears that San Bernardino County has decided not to pursue such action as of January 2013. See Alejandro Lazo, *San Bernardino County Abandons Eminent Domain Mortgage Plan*, LA TIMES (Jan. 24, 2013), <http://articles.latimes.com/2013/jan/24/business/la-fi-mo-eminent-domain-20130124>. Other cities are now considering the plan including larger cities such as San Francisco and Chicago, medium sized cities such as Richmond, California, and smaller cities such as Brockton, Massachusetts. See, e.g., Kevin Du, *Seizing Mortgages New Cities Show Interest in Richmond's Eminent Domain Plan*, THE PREEMINENT DOMAIN (July 16, 2014), <http://thepreeminentdomain.com/seizing-mortgages-new-cities-show-interest-in-richmonds-eminent-domain-plan>; Jon Prior, *Chicago Considers Eminent Domain to Seize Underwater Mortgages*, HOUSING WIRE (July 7, 2012), <http://www.housingwire.com/articles/chicago-considers-eminent-domain-seize-underwater-mortgages>; Simon Van Zuylen-Wood, *Eminent Domain for Mortgages: Brockton, Other Cities Consider Novel Idea*, COMMONWEALTH MAG. (Jan. 15, 2013), <http://commonwealthmagazine.org/economy/001-eminent-domain-for-mortgages>; *New York Eyes Hockett's Eminent Domain Approach to Underwater Mortgage Debt*, CORNELL UNIV. L. SCH. SPOTLIGHTS (July 3, 2014), <http://www.lawschool.cornell.edu/spotlights/NY-Hockett-Underwater-Mortgage-Debt.cfm>. As of the third quarter of 2014, 16.9% of all homeowners in the United States with a mortgage—approximately 8.7 million homeowners—were underwater. Stan Humphries, *Negative Equity Down By Almost Half Since 2012 Peak, But There's Still a Ways to Go*, ZILLOW (Dec. 16, 2014), <http://www.zillow.com/research/negative-equity-2014-q3-8532>.

<sup>2</sup> Andrew Peace, *Coming Up for Air: The Constitutionality of Using Eminent Domain to Condemn Underwater Mortgages*, 54 B.C. L. REV. 2167, 2197 (2013).

other cities from exploring the possibility.<sup>3</sup> The City of Richmond, California went so far as to take the first step in an eminent domain proceeding by offering to buy loans held by residential mortgage-backed security trusts.<sup>4</sup> Two trust companies—Wells Fargo and Bank of New York Mellon—then sued Richmond on the grounds that the city’s proposed mortgage loan taking was unconstitutional for numerous reasons.<sup>5</sup> A federal district court dismissed the claims as being unripe because the loans had not actually been taken yet.<sup>6</sup> While this initial case concluded without a ruling on constitutional issues, there is the potential for future judicial activity in cities wishing to secure debt relief for underwater residents and alleviate high foreclosure rates.<sup>7</sup> As recently as February 2016, Newark, New Jersey officials stated that they are considering taking underwater mortgage loans through eminent domain in an attempt to redevelop areas of the city with high foreclosure rates that have “become havens for squatters and drug dealers.”<sup>8</sup>

After the financial crisis, cities got involved in attempting to cure the problem of underwater mortgage loans out of frustration that the private market and federal programs have been unsuccessful at providing widespread mortgage loan principal reduction.<sup>9</sup> While voluntary renegotiation of an underwater mortgage loan is typically less costly for a lender than allowing a loan to default, the practice of creating mortgage-backed securities (“MBS”) out of pools of individual loans, especially the more risky loans held in private-label mortgage-backed securities (“PLS”),

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<sup>3</sup> See references *supra* note 1.

<sup>4</sup> Laura Flanders, *Meet the Mayor Who’s Using Eminent Domain to Fight Foreclosure*, THE NATION (Nov. 20, 2013), <http://www.thenation.com/article/meet-mayor-whos-using-eminent-domain-fight-foreclosure/>.

<sup>5</sup> Complaint for Declaratory and Injunctive Relief at 9-15, *Wells Fargo Bank v. City of Richmond*, No. CV-13 -3663-CRB (N.D. Cal. Aug. 7, 2013); Amended Complaint for Declaratory and Injunctive Relief at 2-7, *Bank of New York Mellon v. City of Richmond*, 2013 WL 5955699 (N.D. Cal. Aug. 9, 2013) (No. C 13-03664 CRB).

<sup>6</sup> Order Granting Defendants’ Motion to Dismiss and Denying Plaintiffs’ Motion for a Preliminary Injunction, *Wells Fargo Bank, National Association, et al. v. City of Richmond*, No. 13-03663-CRB (N.D. Cal. Sept. 16, 2013). Thereafter, Wells Fargo and Bank of New York Mellon appealed the decision to the Ninth Circuit, but both later voluntarily filed to dismiss the appeal.

<sup>7</sup> For example, in March 2014, the Irvington, New Jersey Municipal Council approved a resolution to use eminent domain to take underwater mortgages. Eunice Lee, *Irvington Moves a Step Closer to Using Eminent Domain to Fight Foreclosure*, THE STAR-LEDGER (NJ) (Mar. 30, 2014 11:05 AM),

[www.nj.com/essex/index.ssf/2014/03/irvington\\_moves\\_a\\_step\\_closer\\_to\\_using\\_power\\_of\\_eminent\\_domain\\_to\\_stem\\_foreclosure\\_crisis.html](http://www.nj.com/essex/index.ssf/2014/03/irvington_moves_a_step_closer_to_using_power_of_eminent_domain_to_stem_foreclosure_crisis.html). See also references *supra* note 1.

<sup>8</sup> Dan Ivers, *Snow Plows Take Back Seat to Crime, Foreclosures in Newark*, NJ ADVANCE MEDIA (Feb. 4, 2016, 12:18 PM), [http://www.nj.com/essex/index.ssf/2016/02/blizzard\\_takes\\_back\\_seat\\_to\\_crime\\_foreclosures\\_at.html](http://www.nj.com/essex/index.ssf/2016/02/blizzard_takes_back_seat_to_crime_foreclosures_at.html).

<sup>9</sup> See references *supra* note 1.

is viewed as an impediment to loan write-downs.<sup>10</sup> The MBS pooling and servicing agreements often require a supermajority vote of the security investors before an individual loan can be modified, which arguably is unmanageable given the numbers of investors and their geographic dispersion.<sup>11</sup> More particularly, it has been claimed that the complex legal and financial agreements governing MBS trustees prevent and/or create incentives against wide-scale voluntary loan principal write-downs, even when such write-downs would be in a typical lender's best interest.<sup>12</sup> Furthermore, the U.S. Federal Housing Finance Agency prohibits Fannie Mae and Freddie Mac (government-sponsored enterprises that buy, guarantee, and securitize residential mortgage loans to provide liquidity to the mortgage markets) from unilaterally reducing the principal balance of loans that they guarantee.<sup>13</sup> Therefore, local governments are contemplating using eminent domain as a creative and revenue-neutral way to provide homeowners with relief from underwater mortgage debt.

The taking of mortgage loans by eminent domain presents a myriad of constitutional issues, including whether a mortgage loan is 'property' that can be taken by eminent domain, whether the taking of underwater mortgage loans serves a 'public use,' and how 'just compensation' should be determined.<sup>14</sup> Legal commentators have provided lengthy analysis on the first two issues, but very little attention has been focused on the actual determination of the amount of just compensation and there is no directly relevant precedent.<sup>15</sup> However, the amount of just compensation is critical in considering whether city proposals would in fact be revenue-neutral, and whether takings in this context would positively or negatively affect

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<sup>10</sup> Robert Hockett & John Vlahoplus, *A Federalist Blessing in Disguise: From National Inaction to Local Action on Underwater Mortgages*, 7 HARV. L. & POL. REV. 253, 260 (2013) (discussing that many of the PLS loan pooling and servicing agreements prohibit or otherwise prevent the trustee or loan servicer from modifying or selling underwater loans in sufficient number, and that changing the rules could be limited by income tax considerations).

<sup>11</sup> *Id.* See also Robert Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt*, 19 CURRENT ISSUES ECON. & FIN., no. 5, 2013, at 3. [hereinafter Hockett, *Paying Paul*] (discussing supermajority voting required by pools and other structural impediments to write-downs).

<sup>12</sup> See Robert Hockett, *It Takes a Village: Municipal Condemnation Proceedings and Public/Private Partnerships for Mortgage Loan Modification, Value Preservation, and Local Economic Recovery*, 18 STAN. J. L. BUS. & FIN. 121, 138-142 (2012) [hereinafter Hockett, *It Takes a Village*].

<sup>13</sup> The Federal Housing Finance authority instituted a one-time limited principal reduction program in 2016, estimating that 33,000 borrowers would be eligible. *FHFA Announces Principal Modification Program and Further Enhancements to NL Sales Requirements* (April 4, 2016), <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-PRM-Program-and-Further-Enhancements-to-NPL-Sales-Reqts.aspx>.

<sup>14</sup> Thomas J. Miceli & Katherine A. Pancak, *Using Eminent Domain to Write-Down Underwater Mortgages: An Economic Analysis*, 24 J. HOUS. RES. 221, 223-25 (2015).

<sup>15</sup> See *infra* notes 18 and 43.

mortgage markets.<sup>16</sup> This article contributes to the current nationwide discussion by examining the appropriate measure of compensation for a mortgage loan taking. Both legal and economic analyses point to possibilities that range from less than the value of the loan collateral to the mortgage loan debt outstanding, depending on whether the mortgage loan is performing or nonperforming, and, if performing, whether that status is likelihood of default in the future.<sup>17</sup>

We begin in the next section by briefly reviewing the elements of the overall general scheme of using eminent domain to provide relief to homeowner-borrowers who owe more on their mortgage loans than their homes are currently worth. We specifically examine the mortgage loan property right that would be taken, as this particular type of property interest has not been the subject of past eminent domain proceedings. Part II looks at current discussions surrounding Fifth Amendment protections. Part III then analyzes approaches for determining just compensation based on case law and judicial holdings in related contexts. Part IV then supplements the legal discussion with an economic perspective on the determination of compensation, including whether the contemplated use of eminent domain could be revenue-neutral.

## I. MORTGAGE LOAN TAKING PROPOSAL

All of the cities that have contemplated using eminent domain to provide relief to homeowners who are underwater on their mortgage loans followed the general structure set forth and advocated in a number of writings by Professor Robert Hockett (this general structure is hereinafter

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<sup>16</sup> Miceli & Pancak, *supra* note 14 at 223-25, argue that the taking of mortgage loans would most likely withstand judicial review as long as just compensation is paid; however, the question as to the legally required amount of just compensation is not clear. From an economic perspective, the takings could have a negative impact on mortgage markets if the amount of just compensation is too low; however, the plan is not revenue-neutral if the amount of just compensation is too high. Therefore they found a trade-off between the immediate benefits of avoiding current mortgage defaults and longer-term increased costs of financing, with the weighings of the trade-off being directly impacted by the determination of just compensation.

<sup>17</sup> See *infra* Part III. A nonperforming loan is generally considered a loan where the borrower has not made required loan payments in the past 90 days, whereas a performing loan is a loan where the borrower has made payments in the last 90 days. *What is a Nonperforming Loan*, INVESTOPEDIA, <http://www.investopedia.com/terms/n/nonperformingloan.asp>. A borrower is said to be in 'default' on a loan when the borrower has not met the legal obligations under the loan agreement, including making required loan payments.

In our analysis, we recognize that the taking of an underwater mortgage loan may be of a performing or nonperforming loan. In other words, whether the loan is performing or not does not impact whether the loan can be taken by eminent domain. However, the valuation of an underwater mortgage loan and therefore just compensation for taking may be dependent on whether the loan is performing or nonperforming.

referred to as the “Plan”).<sup>18</sup> Basically, the Plan calls for a government (city, town, or county) to use its power of eminent domain to seize an underwater mortgage loan from its current mortgage lender (or subsequent mortgage holder), to reduce the outstanding mortgage loan debt amount, and to refinance the new lower mortgage loan debt.<sup>19</sup> The intent is to convert homeowners who were previously underwater to above-water status on their loans.<sup>20</sup> The Plan would primarily target performing mortgage loans that are secured by single family, owner-occupied residences and whose borrowers could qualify for new high loan-to-value loans.<sup>21</sup> Note that the underlying real estate (the house itself) would *not* be the subject of the eminent domain proceeding (i.e., there is no taking of homes *per se*); rather, the proposal is to take the mortgage loan—the mortgage note plus the mortgage lien—from the lender (or subsequent holder such as a PLS trust).<sup>22</sup> Specific implementation details of the Plan, such as selection of the loans to be taken, refinancing process and participants, and homeowner engagement, would be decided by the city involved and could differ between cities.<sup>23</sup>

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<sup>18</sup> See generally Hockett & Vlahoplus, *supra* note 10; Hockett, *It Takes a Village*, *supra* note 12; Hockett, *Paying Paul*, *supra* note 11; Robert Hockett, “*We Don’t Follow, We Lead*”: *How New York City Will Save Mortgage Loans by Condemning Them*, 124 YALE L.J. 131 (2014) [hereinafter Hockett, *We Don’t Follow*].

<sup>19</sup> Hockett, *We Don’t Follow*, *supra* note 18, at 136. Hockett provides an overview of the Plan as it relates to proposed takings in New York City, explaining why he believes using eminent domain is necessary and the basic mechanics.

<sup>20</sup> *Id.* Our analysis focuses on the mortgage loan (note and lien) being taken from the mortgage lender or holder. We assume that the mortgage borrower would be a willing participant in such a taking, given that it would result in reduction in the amount of principal owed by the borrower. The taking of a mortgage loan that could potentially have adverse consequences on the borrower is beyond the scope of this paper.

<sup>21</sup> See Hockett, *It Takes a Village*, *supra* note 12, at 154-55.

<sup>22</sup> The Plan also intends to primarily target loans held in PLS trusts, since PLS have not allowed for widespread mortgage loan principal reduction. *Id.* at 155.

<sup>23</sup> Hockett, *We Don’t Follow*, *supra* note 18, at 138-39. Detailed information about the specifics of the Richmond, California approach to the Plan are alleged in the Amended Complaint for Declaratory and Injunctive Relief, *Bank of New York Mellon v. City of Richmond*, *supra* note 5. Paragraph 28 identifies Mortgage Resolution Partners (“MRP”) as a for-profit company hired to (1) raise funds to refinance the seizures, (2) identify mortgage loans to be acquired by eminent domain, and (3) arrange for the loan refinancing. MRP was to receive a fee of \$4,500 for each loan taken and refinanced. MRP’s investors would receive a profit between the seizure price and the price of the new loan, as well as net of expenses. The agreement between the City of Richmond and MRP is set out in Exhibit I. The City Council minutes indicating approval are set out in Exhibit J. The Plan itself was described in Exhibits G and H, and explained that homeowners could opt into the Plan but would need to be able to qualify for the new refinanced loan. Letters to the trustees of the loan pools offering to purchase the loans intended to be taken (a first step in an eminent domain proceeding) are set out in Exhibits D, E, and F. The offer letters attached a list of approximately 624 mortgage loans, identified in a number of ways, including loan ID, parcel number, and street address. For each individual loan, there was a price offered at a value determined by the Mortgage Industry Advisory Corporation, a private appraisal firm.

The key financial assumption of the Plan is that the compensation for the taking of a loan would be less than the current market value of the loan collateral (and significantly less than the loan debt outstanding).<sup>24</sup> The Plan suggests that compensation for a performing loan would be 85% or less of the value of the collateral, or approximately the net foreclosure recovery amount.<sup>25</sup> As we discuss in Part III, however, the value of a mortgage loan is an open legal question and is potentially dependent on a number of factors.

For illustration purposes, suppose a homeowner bought a home for \$210,000 and borrowed \$200,000 for the purchase (a 95% initial loan to collateral value ratio or initial “LTV” ratio). After the financial crisis of the late 2000s, many homes experienced a reduction in value. In our example, let’s assume that the home that was once worth \$210,000 has now depreciated and currently has a market value of \$140,000. After making amortized loan payments for ten years, the borrower’s outstanding mortgage debt is now \$168,000, with a current LTV ratio of 120%.<sup>26</sup> This would be a classic example of an underwater loan, where the homeowner owes more than the home is worth.<sup>27</sup>

According to the Plan, a city would “take” the mortgage loan—both the mortgage note and mortgage lien—from the lender. The Plan contemplates that just compensation would be 85% of the market value of the collateral; in this example then, compensation paid to the lender would be no more than \$119,000 (or, the \$140,000 current real estate value multiplied by .85). The city would then issue a new mortgage loan to the homeowner in an amount up to 95% LTV ratio; in this case that would be \$133,000 (or, the \$140,000 current real estate value multiplied by .95).<sup>28</sup>

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Loan balance and price offered as a percentage of loan balances was also identified, with percentages ranging widely from approximately seven percent to ninety-four percent. No mention of the value of the underlying collateral was made in the letters or any basis for the amounts offered.

<sup>24</sup> See Hockett, *It Takes a Village*, *supra* note 12, at 155.

<sup>25</sup> *Id.* The Mortgage Bankers Association reports that average lender foreclosure costs are over \$50,000 per loan, and as much as 30-60% of the outstanding loan balance. MORTGAGE BANKERS ASSOCIATION, *Lenders’ Cost of Foreclosure 2* (May 28, 2008), <http://dcwintonlaw.com/wp-content/uploads/2010/06/Lenders-Cost-of-Foreclosure.pdf>.

<sup>26</sup> Assuming a fully amortized mortgage loan with an interest rate of 6.14% for a 30-year term, made 10 years ago: monthly payments would be \$1,217 and the remaining loan balance would be \$167,993. Anytime the LTV ratio is above 100%, the loan amount outstanding is greater than the value of the collateral, meaning the loan is underwater. The higher the LTV ratio is above 100%, the deeper the loan is underwater.

<sup>27</sup> The definition of underwater mortgages and problems faced by homeowners with underwater mortgages is explained at Amy Loftsgordon, *What is an Underwater Mortgage*, NOLO.COM, [www.nolo.com/legal-encyclopedia/what-is-underwater-mortgage.html](http://www.nolo.com/legal-encyclopedia/what-is-underwater-mortgage.html).

<sup>28</sup> Hockett, *It Takes a Village*, *supra* note 12 at 154-55. Intuitively, the fact that the value of the mortgage loan to the government taker is greater than the just compensation paid to the mortgage lender it is taken from is initially troubling, even without further legal or economic analysis. In *Kimball Laundry Co. v. United States* the Supreme Court noted that it would be difficult to justify compensation

Theoretically, there would be no cost to the city or other government entity seizing the mortgage loan, making the Plan revenue-neutral.<sup>29</sup> The homeowner would no longer be underwater, with the new debt payable having been reduced by \$35,000 (or, the \$168,000 outstanding debt on original loan minus \$133,000 new loan amount). The \$14,000 difference between the just compensation of \$119,000 (85% of the house value) and the refinanced balance of \$133,000 (95% of the house value) would notionally cover the condemnation costs, refinance costs, and profit to the investor backing the Plan. The previous lender would have absorbed most of the property price decline, experiencing a net debt loss of \$49,000 (or, the \$168,000 outstanding debt on original loan minus \$119,000 just compensation payment).

The Plan recognizes that compensation will have to be paid to the original lender for the taking of the mortgage loan, so the question of whether the execution of the Plan is a taking that requires compensation is not a disputed point.<sup>30</sup> What will likely be a hotly contested question is the *amount* of compensation. As noted, in order for the taking under the Plan to be cost-neutral for the government, the compensation paid to the lender must be less than the current market value of the real estate that secures the loan.<sup>31</sup> However, the government entity taking the property does not set the level of just compensation; that would be up to the courts.<sup>32</sup> Whether compensation for the taking of a mortgage loan would be based on the value of the collateral or another measure such as the amount of debt still owed is an interesting legal question. With no previous precedent on this exact issue, we need to look at court decisions in similar cases for guidance.

We start our inquiry by explicitly describing the property that would be taken. A residential mortgage loan consists of two distinct parts that are legally evidenced by two separate documents.<sup>33</sup> The first is the actual

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payment to a property owner that is less than the value of the property to the taker, stating that “[i]t would be equally difficult to deny compensation for value to the taker in excess of value to the owner.” *Kimball Laundry Co. v. United States*, 338 U.S. 1, 13 (1949).

<sup>29</sup> A significant assumption and advantage of the Plan to a municipality is that there would be no cost to the municipality (that assumption, however, is greatly dependent on the determination of just compensation). It is difficult to think of any other alternative approaches a municipality could pursue to provide relief to constituent borrowers that would be cost-neutral, which obviously makes the Plan particularly attractive to local governments.

<sup>30</sup> *Hockett, It Takes a Village*, *supra* note 12, at 150-51. There are, however, other relevant points, such as whether such a taking meets the public purpose test.

<sup>31</sup> *See id.* at 155.

<sup>32</sup> *Monongahela Navigation Co. v. United States*, 148 U.S. 312, 327 (1893) (“The legislature may determine what private property is needed for public purposes-- that is a question of a political and legislative character; but when the taking has been ordered, then the question of compensation is judicial.”).

<sup>33</sup> CHARLES F. FLOYD & MARCUS T. ALLEN, *REAL ESTATE PRINCIPLES* 329-32 (10th ed. 2011). It is important to point out that a mortgage loan consists of both the debt, as evidenced by the note, and the lien, as evidenced by the mortgage deed. There are some commentators that are confused on this point

mortgage loan debt, which is the borrower's promise to repay the mortgage loan with interest. This legally enforceable promise is created when the borrower signs a promissory note (mortgage note), which provides evidence of the mortgage loan debt.<sup>34</sup> Just like a bond, it promises the lender or subsequent note holder a stream of payments over a period of time.<sup>35</sup> If the borrower does not repay this monetary obligation, the lender can sue the borrower for repayment based on the legal obligation of the mortgage note.<sup>36</sup>

Unique to a mortgage loan is the second document that supplements the mortgage note. To protect the lender against the borrower's possible failure to pay, the borrower pledges his or her house as collateral.<sup>37</sup> The document that provides evidence of the pledge of collateral is referred to as a mortgage (mortgage lien).<sup>38</sup> This gives the lender a second option to collect the debt owed. If the borrower does not repay, the lender can foreclose on the house and the proceeds from sale can be used to pay off the money that the borrower still owes the lender.<sup>39</sup> If the net proceeds from foreclosure exceed the debt owed under the mortgage note, the borrower is reimbursed the difference. If, however, the proceeds from foreclosure do not fully pay off the debt owed, whether the lender can sue the borrower for the difference depends on whether the state where the property is located allows or prohibits the collection of a deficiency judgment.<sup>40</sup>

The property that the Plan proposes to take is the complete mortgage loan, consisting of both the mortgage note and the mortgage lien, thus fully discharging the debt owed from the borrower to the lender and

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and analyze the issue as if just the mortgage lien was being seized. *See, e.g.*, Anthony F. DellaPelle, *Eminent Domain and Underwater Mortgages: Is the Concept Still Afloat*, NEW JERSEY L.J. (March 18, 2015), <http://www.njlawjournal.com/id=1202720914137?slreturn=20170402141608> (“[N]o proponent of the plan has ever explained how a homeowner will be substantially helped if he is relieved of the burden of his mortgage, but is still liable on the underlying debt . . .”).

<sup>34</sup> FLOYD & ALLEN, *supra* note 33.

<sup>35</sup> Because mortgage notes are considered a type of investment, some types are traded in the secondary mortgage market and are pooled together and packaged as part of mortgage-backed securities. In fact, the Plan is targeting individual mortgage loans owned by private label securitization (“PLS”) trusts, and identifies the structure of PLS trusts as an impediment to loan write-downs. Hockett, *It Takes a Village*, *supra* note 12, at 139-40, 155.

<sup>36</sup> This is true unless the note is non-recourse, meaning that the lender only has the option of foreclosing on the property.

<sup>37</sup> FLOYD & ALLEN, *supra* note 33, at 331-32.

<sup>38</sup> *Id.* Because the homeowner gives the collateral and the lender receives the collateral in the purchase property, the homeowner is referred to as the “mortgagor” and the lender is referred to as the “mortgagee.” In title theory jurisdictions, the mortgage conveys a defeasible fee to the lender that ends upon repayment of the loan, and the actual document is typically called a mortgage deed. In lien theory jurisdictions, the mortgage creates a lien on the real estate, and the actual document is called a mortgage lien. For ease of wording, we will refer to the pledge of collateral as a “mortgage lien.”

<sup>39</sup> *Id.* at 332.

<sup>40</sup> *Id.*

extinguishing the lender's right to foreclose on the house.<sup>41</sup> The taking, therefore, is of both the borrower's promise to repay principal and interest (mortgage note) and the collateral interest in the borrower's house (mortgage lien). Past court cases have discussed the taking of mortgage liens, but not a taking of a complete mortgage loan consisting of both the mortgage note and the mortgage lien.<sup>42</sup> Therefore, it appears that just compensation for the taking of a mortgage loan would be a case of first impression in the courts.<sup>43</sup>

## II. FIFTH AMENDMENT PROTECTIONS

Eminent domain is the power of a government to take private property without the owner's consent.<sup>44</sup> The Fifth Amendment to the U.S.

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<sup>41</sup> The Plan refers to the taking of "mortgage loans and liens." See Hockett, *It Takes a Village*, *supra* note 12, at 151.

<sup>42</sup> See *infra* Part III. Eminent domain is not limited to the taking of real property, and can be used to take mortgage interests as discussed in Part III and other types of intangible contract rights, as long as the public purpose and just compensation requirements are met. See, e.g., *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1 (1977) (contract rights); *Armstrong v. United States*, 364 U.S. 40 (1960) (mechanic's lien); *Offield v. New York, New Haven & Hartford R.R. Co.*, 203 U.S. 372 (1906) (shares of stock); *City of Oakland v. Oakland Raiders*, 32 Cal.3d 60 (1982) (sports franchise).

<sup>43</sup> For relevant discussion focusing on just compensation for the taking of underwater mortgage loans, see generally Raymond H. Brescia & Nicholas Martin, *The Price of Crisis: Eminent Domain, Local Governments, and the Value of Underwater Mortgages*, 24 TEMP. POL. & CIV. RTS. L. REV. 1 (2014) (discusses difficulties in valuing intangible assets; points to valuing a mortgage loan based on what it would sell for in the open market, but does not distinguish between performing and nonperforming loans) and Emily C. Cory, *Richmond: Take My Mortgage, Please!*, 34 ST. LOUIS U. PUB. L. REV. 181 (2014) (recognizing that just compensation should be different for loans that are not likely to default versus loans that are likely to default). For discussion on the constitutionality of underwater mortgage taking in general, see generally Marissa Schaffer, *Stemming the Tide of Foreclosure: Evaluating the Use of Eminent Domain to Relieve Underwater Homeowners*, 2014 COLUM. BUS. L. REV. 215 (2014); Katharine Roller, *The Constitutionality of Using Eminent Domain to Condemn Underwater Mortgage Loans*, 112 MICH. L. REV. 139 (2013); Peace, *supra* note 2; Joel M. Langdon, *The Importance of a Promise: Underwater Mortgages and a Municipal Rescue Attempt through Eminent Domain*, 45 URB. LAW. 571 (2013).

<sup>44</sup> Eminent domain is the legal procedure by which a government entity can forcibly acquire land owned by a private person. See PHILIP NICHOLS, ET AL., NICHOLS LAW OF EMINENT DOMAIN § 1.11 (3d ed. 2006). See generally *United States v. Jones*, 109 U.S. 513, 518 (1883); *Boom Co. v. Patterson*, 98 U.S. 403, 406 (1878). The power of eminent domain is not limited to the taking of real property. See, e.g., *Cincinnati v. Louisville & Nashville R.R. Co.*, 223 U.S. 390, 398 (1912) (discussing the condemnation of a right of way). In particular, if a contract has been held to constitute property within the meaning of the Fifth Amendment, it can therefore be taken. See, e.g., *Lynch v. United States*, 292 U.S. 571, 579 (1934) ("The Fifth Amendment commands that property be not taken without making just compensation. Valid contracts are property. . ."). Further, eminent domain has been used to condemn not only contract rights, but also securities. See, e.g., *Offield v. New York, New Haven & Hartford R.R. Co.*, 203 U.S. 372, 375 (1906) (involving shares of stock that were condemned to enable the company to improve a section of railroad).

Constitution limits this power by requiring that the taking must be for a “public use” and the government must pay “just compensation.”<sup>45</sup> Consequently, to be a valid exercise of eminent domain, the taking of a mortgage loan for the purpose of refinancing and transference to a private investor must meet both the “public use” and “just compensation” requirements.<sup>46</sup> These two requirements are meant to provide a balance between the needs of the public and the rights of private property owners.<sup>47</sup>

The public use inquiry has been the primary focus of recent legal debate on the constitutionality of mortgage takings.<sup>48</sup> Advocates of the Plan

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<sup>45</sup> U.S. CONST. amend. V (“[N]or shall private property be taken for public use, without just compensation.”). While the Fifth Amendment applies to actions by the federal government, the Fourteenth Amendment extends the Takings Clause to eminent domain actions by the states. *See Chicago, Burlington & Quincy R.R. Co. v. Chicago*, 166 U.S. 226, 241 (1897) (“[A] judgment of a state court, even if it be authorized by statute, whereby private property is taken for the State or under its direction for public use, without compensation made or secured to the owner, is . . . wanting in the due process of law required by the Fourteenth Amendment . . .”). In addition, state constitutions typically contain similar language. *See, e.g.*, CAL. CONST. art. I, § 19, cl. a (“Private property may be taken or damaged for a public use and only when just compensation, ascertained by a jury unless waived, has first been paid to, or into court for, the owner.”); CONN. CONST. art. I, § 11 (“The property of no person shall be taken for public use, without just compensation therefor.”); N.Y. CONST. art. I, § 7, cl. a (“Private property shall not be taken for public use without just compensation.”).

<sup>46</sup> There are also other potential legal challenges to the use of eminent domain to take mortgage loans. *See references supra* note 43. Further, there are practical challenges to the viability of the Plan. In particular, the 2015 and 2016 federal appropriations bills prevent federal government involvement in the refinancing of mortgage loans taken by eminent domain, both restricting the Federal Housing Administration, the Government National Mortgage Administration, or the Department of Housing and Urban Development from using funds “to insure, securitize, or establish a Federal guarantee of any mortgage or mortgage backed security that refinances or otherwise replaces a mortgage that has been subject to eminent domain condemnation or seizure, by a state, municipality, or any other political subdivision of a state.” Consolidated Appropriations Act of 2016, PUB. L. NO. 1114-113, § 232, 129 STAT. 2896 (2015); Consolidated and Further Continuing Appropriations Act of 2015, PUB. L. NO. 113-235, § 236, 128 STAT. 2758 (2014). For 2015 and 2016 (and possibly subsequent years if the same language is passed in future year appropriation bills), this means that local governments would have to rely on private sources of refinance funding. Further, the Federal Housing Finance Authority (FHFA) has expressed concern over the use of eminent domain to restructure mortgage loans and has stated that it may initiate legal challenges to any locality that uses eminent domain in this way. *See* Federal Housing Finance Authority, FHFA Statement on Eminent Domain (Aug. 8, 2013). In response, the American Civil Liberties Union and the Center for Popular Democracy filed a lawsuit under the Freedom of Information Act to compel the FHFA to provide details about the agency’s relationship with the financial industry and its efforts to block this use of eminent domain. *See ACLU and Center for Popular Democracy File FOIA Lawsuit Over Efforts to Limit Municipalities’ Foreclosure Prevention Options*, ACLU (Dec. 5, 2013), <https://www.aclu.org/news/aclu-and-center-popular-democracy-file-foia-lawsuit-over-efforts-limit-municipalities>.

<sup>47</sup> *San Diego Gas & Elec. Co. v. City of San Diego*, 450 U.S. 621, 656 (1981) (Brennan, J. dissenting) (discussing the equitable theory underlying the just compensation clause and explaining that it “was designed to bar the government from forcing some individuals to bear burdens which, in all fairness, should be borne by the public as a whole.”).

<sup>48</sup> *See infra* Part III.

believe that the taking of mortgage loans meets the public use threshold given that the purpose of the taking is to stabilize local housing markets, prevent foreclosures, and stop blight caused by foreclosures in residential neighborhoods.<sup>49</sup> Some opponents argue that the taking of mortgage loans is not a public use because the loans will be transferred to private investors for the primary purpose of enriching the investors.<sup>50</sup> In particular, the Securities Industry and Financial Markets Association (“SIFMA”) has argued that the public use requirement is not satisfied, contending that no courts have allowed a local government to “seize private property and redistribute it to others for the general purpose of improving local economic conditions.”<sup>51</sup> Further, SIFMA has posted a memo on its website stating that “[i]t is hardly clear that seizure of performing loans is necessary to avoid blight, given that these borrowers have demonstrated that they will pay their mortgages even if their balances exceed the appraised value of their homes.”<sup>52</sup> Since mortgage loans selected under the Plan will be performing loans where borrowers are current on their payments, the Plan’s proposal addresses only future, or possible, blight.<sup>53</sup>

Contrary to the arguments of those opposing the Plan, there is U.S. Supreme Court precedent that the government’s attempt to correct a housing failure falls within the scope of the public use requirement.<sup>54</sup> In *Hawaii Housing Authority v. Midkiff*, the Court held that a state could take land from private landowners, with just compensation, and give it to the private tenants occupying the land for the public purpose of correcting a failure in the housing market caused by concentrated land ownership that “was responsible for skewing the State’s residential fee simple market, inflating land prices, and injuring the public tranquility and welfare.”<sup>55</sup> The Court found that Hawaii’s land redistribution was rationally related to a conceivable public purpose, and that debates over the wisdom of takings were best carried out by legislatures, not by federal courts.<sup>56</sup> The fact that

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<sup>49</sup> See references *supra* note 18.

<sup>50</sup> The Securities Industry and Financial Markets Association (“SIFMA”) is a vocal opponent of the Plan. Its position related to taking of underwater mortgages is available at <http://www.sifma.org/news/news.aspx?id=8589940215>.

<sup>51</sup> See *O’Melveny & Myers, LLP: Memorandum-San Bernardino Eminent Domain Proposal*, at 5, SIFMA (July 16, 2012), [http://www.sifma.org/uploadedfiles/issues/capital\\_markets/securitization/eminent\\_domain/memorandumfromo'melvenymyerstosifmaresanbernardinoeminentdomainproposal071612.pdf](http://www.sifma.org/uploadedfiles/issues/capital_markets/securitization/eminent_domain/memorandumfromo'melvenymyerstosifmaresanbernardinoeminentdomainproposal071612.pdf) [hereinafter “SIFMA Memo”].

<sup>52</sup> *Id.* at 5.

<sup>53</sup> *Id.*

<sup>54</sup> Schaffer, *supra* note 43, at 253; Roller, *supra* note 43, at 150-51; Peace, *supra* note 2, at 2194-96 (“the Plan would almost certainly satisfy the public use prong of the Takings Clause”).

<sup>55</sup> *Hawaii Hous. Auth. v. Midkiff*, 467 U.S. 229, 232 (1984) (correcting market failure in land market is a legitimate public purpose).

<sup>56</sup> *Id.* at 243.

the property taken was transferred to private beneficiaries did not mean that the taking violated the public use requirement of the Constitution.<sup>57</sup>

The circumstances and holding in *Midkiff* are analogous to the current situation of taking of underwater mortgages from pools of mortgage-backed securities.<sup>58</sup> In *Midkiff*, the concentrated land ownership was viewed as problematic to the State of Hawaii's housing market.<sup>59</sup> The landowners chose to lease rather than sell their property, primarily due to the significant federal tax liabilities they would incur upon sales.<sup>60</sup> To overcome this impediment to land sales, the Hawaii Legislature enacted a law that would accomplish the transfer of ownership from landowners to tenants through eminent domain, thereby making the federal tax consequences less severe.<sup>61</sup> In the case of underwater mortgages, loan principal write-downs could be a better financial option for a loan holder than allowing a loan to go into default and incurring the costs of foreclosure.<sup>62</sup> However, there may currently be impediments to efficient decision-making in the mortgage markets due to the difficulties of effectuating mortgage principal write-downs for loans held in MBS.<sup>63</sup> Given the *Midkiff* precedent, if this impediment is skewing residential housing markets, there is a strong argument to be made that taking a mortgage from a private mortgagee, with just compensation, and giving it to a private investor that will write down the principal and refinance the loan is related to a conceivable public purpose.<sup>64</sup>

Beyond *Midkiff*, legal commentators have also pointed to the more recent U.S. Supreme Court holding of *Kelo v. City of New London* as substantiation that the Plan's proposal to condemn underwater mortgages satisfies the federal public use requirement.<sup>65</sup> *Kelo* made it clear that public use is a broad concept that encompasses any economic development that promises a conceivable public purpose.<sup>66</sup> In *Kelo*, the promise of enhanced tax revenues and jobs for the community was the public purpose that met the public use threshold; in the mortgage-taking context, the goals of creating a healthier local housing market and preventing blight that

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<sup>57</sup> The Court noted that the role courts play in reviewing a government's judgment of what constitutes a public use "is 'an extremely narrow' one." *Midkiff*, 467 U.S. at 240 (citing *Berman v. Parker*, 348 U.S. 26, 32 (1954)).

<sup>58</sup> Schaffer, *supra* note 43, at 253.

<sup>59</sup> *Midkiff*, 467 U.S. at 232.

<sup>60</sup> *Id.* at 233.

<sup>61</sup> *Id.*

<sup>62</sup> See Janice Eberly & Arvind Krishnamurthy, *Efficient Credit Policies in a Housing Debt Crisis*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY 73 (2014) ("[L]enders who bear the credit default risk have a direct incentive to partially write down debt and avoid a full loan loss due to default.").

<sup>63</sup> See *supra* notes 10-12 and accompanying text.

<sup>64</sup> Schaffer, *supra* note 43, at 253.

<sup>65</sup> Peace, *supra* note 2, at 2194-95.

<sup>66</sup> *Kelo v. City of New London*, 545 U.S. 469, 484, 490 (2005).

neighborhood foreclosures could create arguably fulfills the requirement.<sup>67</sup> Similar to *Midkiff*, the *Kelo* case also dealt with the issue of a so-called private-to-private transfer—in the case of the taking of a mortgage loan, whether a loan could be taken from one private lender and transferred to another private lender.<sup>68</sup> *Kelo* broadly construed the concept of public use to allow condemned property to be transferred to a private party for development purposes if it created spillover benefits.<sup>69</sup>

At the federal constitutional level then, it appears that the taking of underwater mortgage loans under the Plan would withstand the public use test. However, given the backlash after the *Kelo* decision, many states have revised their state constitutions or statutes to make it harder to seize property through eminent domain and then transfer that property to a private party.<sup>70</sup> Therefore, the viability of the Plan's public use argument could differ depending on state specific law. For example, California passed Proposition 99 in 2008, prohibiting state and local governments from acquiring owner-occupied homes for the purpose of conveying the property to other persons, with certain listed exceptions.<sup>71</sup> By definition, this California eminent domain law limitation would not apply to seizing mortgage loans, since the property right being seized is not the equivalent of taking an owner-occupied home.<sup>72</sup> On the other hand, Florida would most likely prohibit the taking of mortgage loans under the Plan since state eminent domain law now prohibits condemnation for the purpose of abating or eliminating blight conditions, and only allows private property that is taken to be transferred to a private entity 10 years after condemnation.<sup>73</sup> In New York, New Jersey, and Massachusetts, the states and cities have been considering using eminent domain to take mortgages but have not enacted any post-*Kelo* legislation that would limit takings.<sup>74</sup>

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<sup>67</sup> *Id.* at 483-84. The concurring opinion in the *Kelo* case sets out a more detailed standard for judicial review of economic development takings than that found in the majority opinion. The concurrence forwarded the idea that the purpose of government takings should only be subjected to minimal scrutiny and need only bear a rational relation to a legitimate government purpose. *Id.* at 490-91 (Kennedy, J., concurring).

<sup>68</sup> *Id.* at 477.

<sup>69</sup> *Id.* at 485-86. See also *Midkiff*, 467 U.S. at 232-33.

<sup>70</sup> The Institute for Justice reports that “43 states have passed either constitutional amendments or statutes that reformed their [state] eminent domain laws” in response to the *Kelo* case, with 34 of those states banning takings for economic development purposes. *Five Years After Kelo: The Sweeping Backlash Against One of the Supreme Court's Most-Despised Decisions*, INSTITUTE FOR JUSTICE (June, 2010), <http://ij.org/report/five-years-after-kelo/>.

<sup>71</sup> Proposition 99 amended Section 19 of Article I of the California Constitution. CAL. CONST. art. I, § 19.

<sup>72</sup> For detail on state law changes in the wake of the *Kelo* case, see *50 State Report Card: Tracking Eminent Domain Reform Legislation since Kelo*, CASTLE COALITION (Aug. 2007), <http://castlecoalition.org/50-state-report-card> [hereinafter CASTLE COALITION].

<sup>73</sup> FLA. STAT. §§ 73.014, 73.013(1)(g) (2016).

<sup>74</sup> See CASTLE COALITION, *supra* note 72.

Given that the federal public use issue appears to be, for the moment at least, a settled issue, we suggest that the legal discussion on mortgage takings needs to more fully explore the “just compensation” requirement.<sup>75</sup> Although mortgage loan takings proposals contemplate paying just compensation, little focus has been given to the determination of the correct measure of just compensation in this context. The Plan contends that just compensation for underwater mortgages will be less than the current market value of the mortgage lien collateral.<sup>76</sup> SIFMA points out that there should be a distinction between the value of the mortgage lien collateral and the value of the mortgage loan itself, especially for borrowers of performing loans who are unlikely to default.<sup>77</sup> The correct measure of just compensation will determine if the Plan is revenue-neutral, and therefore financially feasible, for cities. Therefore, we explore this issue in the next section.

### III. MEASURES OF JUST COMPENSATION

The Fifth Amendment’s guarantee that private property shall not be taken for a public use without just compensation was “designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.”<sup>78</sup> The purpose of this constitutional protection is therefore to shift the financial burden of a taking of property for public use from the property owner to the public.<sup>79</sup> In the case of mortgage loan takings, that would mean shifting the burden of stabilizing housing markets from mortgage lenders to the public.

The Supreme Court has adopted the concept that just compensation means the “full monetary equivalent of the property taken.”<sup>80</sup> In other

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<sup>75</sup> For a discussion of the importance of the just compensation requirement, *see generally* James Geoffrey Durham, *Efficient Just Compensation as a Limit on Eminent Domain*, 69 MINN. L. REV. 1277 (1985) (the just compensation requirement acts to deter government from inefficient takings); Marisa Fegan, *Just Compensation Standards and Eminent Domain Injustices: An Underexamined Connection and Opportunity for Reform*, 6 CONN. PUB. INT. L.J. 269 (2007) (courts and commentators have paid less attention to just compensation than public purpose when analyzing eminent domain; this has to switch after the *Kelo* decision).

<sup>76</sup> Hockett, *It Takes a Village*, *supra* note 12, at 155.

<sup>77</sup> SIFMA Memo, *supra* note 51, at 6.

<sup>78</sup> *Armstrong v. United States*, 364 U.S. 40, 49 (1960). For a discussion of the measure of government takings in general, *see* Katrina M. Wyman, *The Measure of Just Compensation*, 41 U.C. DAVIS L. REV. 239 (2007).

<sup>79</sup> *Armstrong*, 364 U.S. at 49.

<sup>80</sup> A good discussion of the measure of just compensation can be found in *United States v. Reynolds*, 397 U.S. 14, 16 (1970). For discussion on just compensation issues, *see* Durham, *supra* note 75; Marisa Fegan, *Just Compensation Standards and Eminent Domain Injustices: An Underexamined Connection and Opportunity for Reform*, 6 CONN. PUB. INT. L.J. 269 (2007); Abraham Bell & Gideon Parchomovsky, *The Hidden Function of Takings Compensation*, 96 VA. L. REV. 1673 (2010).

words, the owner of the taken property theoretically has to be put in the same position monetarily as if the property had not been taken.<sup>81</sup> While there could be various ways to approach the calculation of this amount, the Court early on adopted the measure of “fair market value.”<sup>82</sup> Fair market value has been further defined as the objective value that the marketplace puts on the property in question, and does not include any subjective value the owner places on the property,<sup>83</sup> or speculative value,<sup>84</sup> and is not measured by what a replacement property would cost.<sup>85</sup> To provide more clarity, the Court has said that market value is “what a willing buyer would pay in cash to a willing seller.”<sup>86</sup> In Part IV, we ask whether fair market value actually achieves the objective of leaving a lender as well off as if the property had not been taken. However, in the remainder of this section, we consider different measures of market value for mortgage takings.

The determination of market value of a mortgage loan has not been previously examined by the courts, and therefore, the interpretation of the correct level of just compensation for the taking of a mortgage loan is still an open legal question.<sup>87</sup> Determining market value is relatively

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<sup>81</sup> Property owners are compensated for objective monetary value, not subjective personal value of property taken. *Infra* note 83. Although we assume that owners of mortgage loans have no personal attachment to the loans *per se*, they may have such an attachment to the underlying property. This possibility plays an important role in our economic analysis in Part IV.

<sup>82</sup> *United States v. Chandler-Dunbar Water Power Co.*, 229 U.S. 53, 80-81 (1913). In again dissecting the actual words, the Court noted that the word ‘fair’ doesn’t add much to the words of ‘market value,’ but does indicate that it is “market value, fairly determined.” *United States v. Miller*, 317 U.S. 369, 374 (1943).

<sup>83</sup> *Kimball Laundry Co. v. United States*, 338 U.S. 1, 5 (1949). However, after the Supreme Court’s decision in *Kelo*, allowing for homes to be taken for private development, a handful of states have revised their compensation requirements to attempt to compensate for the difficulty of measuring loss of personal value. At least five states have revised their requirements for the payment of just compensation. *See, e.g.*, CONN. GEN. STAT. § 8-129(a)(2) (125% of average appraised value if property acquired by a development agency); IND. CODE ANN. § 32-24-4.5-8 (2)(A) (requires 150% of fair market value if a person’s primary residence is taken).

<sup>84</sup> *See United States v. Fuller*, 409 U.S. 488 (1973) (permits to use adjacent grazing land were deemed speculative and therefore not compensable); *Almota Farmers Elevator & Warehouse Co. v. United States*, 409 U.S. 470 (1973) (renewal of a land lease was not deemed speculative).

<sup>85</sup> *See United States v. 50 Acres of Land*, 469 U.S. 24, 35 (1984) (just compensation for a town dump does not factor in the cost of replacing the dump).

<sup>86</sup> *Miller*, 317 U.S. at 374. *See also 50 Acres*, 469 U.S. at 35; *United States v. 564.54 Acres of Land*, 441 U.S. 506 (1979); *Almota*, 409 U.S. at 473. The Supreme Court has recognized that factual situations may call for an exception to the market value rule, in particular when market value is too difficult to determine or when market value is so less than actual costs as to be manifestly unjust. *50 Acres*, 469 U.S. at 29-30.

<sup>87</sup> For accounting purposes, a performing mortgage loan held as an investment (as opposed to for sale) is reported at amortized cost, which is the equivalent of the unpaid loan principal. Any loan where the lender will be unable to collect the principal and interest due is referred to as an impaired loan. Impairment is a judgment about the borrower’s likelihood to repay, not necessarily about whether the value of the collateral is less than the loan amount outstanding, although that could be one of the

straightforward with the types of mortgage loans that have readily observable market prices. When residential mortgage loans are originated, they are regularly sold off in the secondary market.<sup>88</sup> There is even a secondary market for seasoned loans.<sup>89</sup> However, the price paid for a mortgage loan when it was originally sold in the secondary mortgage market is not relevant to the discussion of current market value of the mortgage loan if conditions related to the loan have changed since the sale. Back to our illustrative example where a homeowner borrowed \$200,000 for the purchase of a \$210,000 home; time has gone by and the home is now worth \$140,000 and the outstanding mortgage debt is \$168,000. Whereas originally the LTV ratio was 95%, it is now 120%, and the loan is considered to have negative equity and be underwater. Given the underwater status of the loan, it is now more risky, and therefore would not be worth what it originally sold for in the secondary mortgage market compared to when it was not underwater. In particular, the current market value of the collateral for seasoned loans eligible for sale in the secondary market cannot be less than the collateral's original value, meaning that a seasoned loan cannot be sold in the traditional secondary mortgage market if it is underwater.<sup>90</sup> Therefore, there is currently no observable trading market for performing underwater mortgage loans by which a market comparison approach could be used to determine the value of a specific mortgage loan.

There is a thin trading market for nonperforming underwater loans, with a handful of observable transactions. In 2010, the U.S. Department of Housing and Urban Development began selling pools of defaulted FHA-held single family mortgage loans.<sup>91</sup> The loans are sold at deep discounts because of their nonperforming status. For example, the pool of loans in

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indications. ACCOUNTING BY CREDITORS FOR IMPAIRMENT OF A LOAN, *Statement of Fin. Accounting Standards No. 114*, at 7 (Fin. Accounting Standards Bd. 1993) [hereinafter FAS 114]. FAS 114 instructs financial institutions to estimate the amount of loss by looking at the present value of estimated cash flows or estimated market price if that is readily observable. If a loan is impaired and collateral dependent (where repayment is expected to be provided solely by the underlying value of the collateral), measurement is based on the value of the collateral less costs.

<sup>88</sup> For a description of the dynamics of the primary and secondary mortgage markets, see Tristan Igualada, *Primary and Secondary Mortgage Rate Trends in Today's Economy*, INTERACTIVE DATA FIXED INCOME ANALYTICS, <http://www.interactivedata.com/uploads/File/Primary%20and%20Secondary%20Mortgage%20Rates.pdf>.

<sup>89</sup> FANNIEMAE, *Selling Guide: B2-1.4-02: Mortgage Loan Eligibility*, (June 28, 2016), <https://www.fanniemae.com/content/guide/selling/b2/1.4/02.html#Seasoned.20Mortgages>. Seasoned mortgage loans are defined as mortgages loans that are more than one year old.

<sup>90</sup> *Id.*

<sup>91</sup> Aimee M. Cummo & Michael A. Calandra, Jr., *The HUD Non-Performing Mortgage Loan Juggernaut*, BLOOMBERG BNA (May 6, 2014). See also U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, *Asset Loan Sales Information*, [portal.hud.gov/hudportal/HUD?src=/program\\_offices/ho\\_using/comp/asset/hsgloan](http://portal.hud.gov/hudportal/HUD?src=/program_offices/ho_using/comp/asset/hsgloan).

the Housing and Urban Development (“HUD”) Single Family Home Loan Sale 2015-1 sold for 67.62% of the pool’s unpaid principal balance.<sup>92</sup> These HUD asset sales do provide some information about the discount to loan balance outstanding for pools of nonperforming loans, which would provide a starting point for analyzing the value of nonperforming loans. However, and more importantly for the Plan, these sales do not necessarily provide comparable market data that can be used to value a performing mortgage loan. Therefore, just compensation needs to be based on other available data and/or on a value established by calculation.<sup>93</sup>

There are three types of past eminent domain court cases that may shed some light on the appropriate assumptions to be made, or the best approach to use, to determine compensation for the taking of an underwater mortgage loan. First, if there is a mortgage lien on a house, and the house is taken by eminent domain, the mortgage lien is wiped out in the condemnation proceedings. Previous court cases have discussed the amount of compensation owed to a mortgage lender for the taking of a mortgage lien. Second, during the Depression, laws were enacted to help bankrupt farmers who were underwater on their farm mortgage loans. In a handful of cases, the Supreme Court discussed the compensation to be paid for a regulatory taking of mortgage liens. Note that analysis under these first two perspectives is admittedly problematic, since they are not directly on point and refer to what may be considered as dicta. However, they do deal with the question of just compensation for the taking of mortgage-related interests, so they need to be discussed. We conclude that they provide the lower and upper bounds for mortgage loan compensation generally. Third, courts have recognized that the market value of future revenue can be determined by calculating the capitalized value of the future cash flows. This helps us more precisely understand compensation for a specific mortgage loan within the prescribed bounds. In the following sections, we look at these types of court cases, and refer back to our original example to determine the appropriate level of just compensation under each.

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<sup>92</sup> U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, SINGLE FAMILY LOAN SALE 2015-1 (‘SFLS 2015-1’), at 1-4 (2015), <http://portal.hud.gov/hudportal/documents/huddoc?id=SFLS2015-1resultsummary.pdf>. We mention this information on pool sale price for the purpose of identifying that there has been some type of secondary market for nonperforming loans. Pools of loans are not identical, however, and therefore it is not necessarily appropriate to arrive at valuation measure that could be used to value another pool or a specific loan without understanding the pool variables. When understanding the pool variables, there may be some value in using this information to determine the appropriate discount rate to be used in determining the capitalization of future income. See, *infra* Part III, Section C.

<sup>93</sup> *United States v. Miller*, 317 U.S. 369, 374 (1943) (“Where, for any reason, property has no market resort must be had to other data to ascertain its value . . .”).

A. *Taking of Mortgaged Real Estate: The Undivided Fee Rule*

When the government uses its power of eminent domain to take real estate in which more than one person or entity has interests (e.g. owner of property along with tenant, lender, or easement holder), there is typically only one award of compensation based on the market value of the real estate without regard to the various interests.<sup>94</sup> This is known as the *undivided fee rule*, whereby the value of separate interests in a parcel of real estate cannot exceed the worth of the whole.<sup>95</sup> Most states have codified this rule in their state eminent domain statutes.<sup>96</sup> That means that for mortgaged property, just compensation cannot exceed the fair market value of the property, even if the amount of debt owed to the lender exceeds that value.

Once just compensation is determined, the award is then apportioned among the persons having an interest in the property according to contractual agreement, state statute, or judicial determination.<sup>97</sup> In the case of a mortgaged property, state law typically provides that mortgage lenders will be paid the amount of mortgage debt outstanding, up to the amount of condemnation award.<sup>98</sup> Mortgage lien documents also typically have “condemnation clauses” that echo state statutes, providing that the entire condemnation award will be applied to repayment of the mortgage debt first.<sup>99</sup> In any case of apportionment of the condemnation award, if the value of the real estate is less than the debt amount outstanding, the most that the mortgage lender will receive is the value of the real estate.

Therefore, with the taking of real estate that extinguishes a mortgage lien, the lender is entitled to the full amount of debt outstanding, up to the

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<sup>94</sup> See *A.W. Duckett & Co. v. United States*, 266 U.S. 149, 151 (1924) (“Ordinarily an unqualified taking in fee by eminent domain takes all interests and as it takes the res is not called upon to specify the interests that happen to exist.”). See also *United States v. 14.02 Acres of Land*, 547 F.3d 943, 956 (9th Cir. 2008); *United States v. 1.377 Acres of Land*, 352 F.3d 1259, 1269 (9th Cir. 2003).

<sup>95</sup> The undivided fee rule is also known as the “unit rule.” A handful of states do not follow the undivided fee rule, but instead value each property interest separately, so that the sum of the parts could theoretically exceed the value of the undivided fee. See generally, Victor P. Goldberg, Thomas W. Merrill & Daniel Unumb, *Bargaining in the Shadow of Eminent Domain: Valuing and Apportioning Condemnation Awards Between Landlord and Tenant*, 34 UCLA L. Rev. 1083 (1986).

<sup>96</sup> See, e.g., MASS. GEN. LAWS ch. 79, § 29 (2015) (“[T]here shall first be found and set forth the total amount of damages sustained by the owners of such property, estimating the same as an entire estate and as if it were the sole property of one owner in fee simple . . .”). See generally, Jill S. Gelineau, *Landlord/Tenant Apportionment Issues in Eminent Domain*, PRAC. R. E. LAW (Sept. 2014).

<sup>97</sup> See *14.02 Acres of Land*, 547 F.3d at 956; *1.377 Acres of Land*, 352 F.3d at 1269.

<sup>98</sup> See, e.g., CONN. GEN. STAT. § 48-21 (2015) (“[T]he amount due any such mortgagee, lienor or other encumbrancer, not exceeding the amount to be paid for such property, shall be paid to him according to priority of claims, before any sum is paid to any owner of such property.”).

<sup>99</sup> *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 596 (1935) (“If a part of the mortgaged property were taken by eminent domain, a mortgagee would receive payment on a similar basis.”).

value of the real estate. Depending on state law, if the lender's condemnation award is less than the outstanding debt, the lender would then become an unsecured creditor for the remainder of the debt after partial repayment of the debt and have the ability to sue the property owner for the deficiency.<sup>100</sup> If a state does not allow for a deficiency judgment, or if the borrower is in bankruptcy, the lender will be limited to compensation equal to the value of the real estate.

Referring back to our original example, recall that the homeowner bought a home for \$210,000 and borrowed \$200,000 for the purchase, but after ten years the home has a market value of \$140,000 and an outstanding loan balance of \$168,000. If the government were to take the home by eminent domain, the government would take all of the property rights associated with the home, including the lender's mortgage lien. The undivided fee rule dictates that a single value of just compensation must be calculated, which is equal to the market value of the property. In the example, that amount is \$140,000. In other words, as far as the government is concerned, extinguishing a mortgage lien through eminent domain requires no more compensation than the current market value of the property. This would be the case regardless of whether the loan is performing or nonperforming. However, this does not extinguish the mortgage note, and the borrower may still be liable for the difference between the condemnation award and the amount of debt outstanding—\$28,000 in our example. But the lender attempting to collect on a mortgage note without a mortgage lien would have to pursue this amount directly from the borrower, assuming that state law allows for deficiency judgments.

#### B. *Regulatory Taking of a Mortgage Lien: The New Deal Cases*

The above section looked at the circumstance when the mortgage lien is taken, but the mortgage note is left in place. A situation closer to the taking of a complete mortgage loan (mortgage note and mortgage lien) involve cases where the mortgage lien is taken and the mortgage note is or will be extinguished in bankruptcy. Certain mortgage note debt can be restructured or discharged in a bankruptcy proceeding, but not the mortgage lien, meaning that a bankrupt borrower can be excused from repaying a note, but the lender can still foreclose on the pledged real estate collateral.<sup>101</sup>

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<sup>100</sup> For a comparison of state laws on mortgage deficiencies, see James Orlando, *Comparison of State Laws on Mortgage Deficiencies and Redemption Periods*, CT OLR RES. REP. (July 29, 2010), <https://www.cga.ct.gov/2010/rpt/2010-R-0327.htm>.

<sup>101</sup> Note that current bankruptcy law provides a special protection to home mortgage lenders, in that a bankrupt mortgage borrower that wishes to keep his or her principal residence must pay the full amount of debt outstanding during the 5-year period under a Chapter 13 bankruptcy repayment plan. 11 U.S.C. § 1322(b)(2) (2006). For a discussion of this bankruptcy provision, the problems it is causing homeowners after the financial crisis, and recommendations for changes, see generally Adam J. Levitin,

During the Depression, however, federal laws were enacted to prevent bankrupt farmers from losing their farms through foreclosure of mortgage liens.<sup>102</sup> Lenders challenged these laws as regulatory takings requiring the payment of just compensation.<sup>103</sup> Three Supreme Court cases examining these laws illustrate the standard, rationale, and potential difficulty in determining just compensation for mortgage loan-related takings.<sup>104</sup> None of the cases ruled on just compensation *per se*; rather, they examined whether a law was invalid because it amounted to a regulatory taking of property rights without any compensation. In all of the cases, the mortgage borrower was bankrupt, and thus repayment of debt related to the mortgage note was or would be discharged in bankruptcy court.<sup>105</sup> Therefore, while only the mortgage lien was being taken by the change of law, the practical effect was that the lender had lost both the mortgage lien and mortgage note. While not exactly on point, the cases present relevant discussion related to eminent domain and government relief for underwater borrowers.

In *Louisville Joint Stock Land Bank v. Radford*, in a unanimous opinion, the Court held that a law that restructured a mortgage lien without just compensation to the lender violated the Fifth Amendment takings clause.<sup>106</sup> In that case, Louisville Joint Stock Land Bank (“the Bank”) made two mortgage loans totaling \$9,000 to a farmer (“Radford”) to be repaid over 34 years at 6% interest.<sup>107</sup> The mortgage note was secured by a mortgage lien on Radford’s 170-acre Kentucky farm, which was worth about \$18,000 at the time of the loan.<sup>108</sup> Ten years later, Radford defaulted on the repayment of principal and interest (and also defaulted on his requirement to pay taxes and insurance).<sup>109</sup> At that point, the farm was worth about \$4,445, meaning that Radford had an underwater mortgage loan.<sup>110</sup> As provided for under Kentucky law, the Bank attempted to foreclose on the mortgage lien and to have the proceeds from a foreclosure

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*Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WISC. L. REV. 565 (2009).

<sup>102</sup> See *infra* notes 116, 118, and 137.

<sup>103</sup> See *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278 (1940); *Wright v. Vinton Branch*, 300 U.S. 440, 458 (1937); *Radford*, 295 U.S. at 602.

<sup>104</sup> *Id.* These cases reflect the purpose of the current Plan of refinancing underwater mortgages. “Its avowed object is to take from the mortgagee rights in the specific property held as security; and to that end ‘to scale down the indebtedness’ to the present value of the property.” *Radford*, 295 U.S. at 594.

<sup>105</sup> “Under the bankruptcy power Congress may discharge the debtor’s personal obligation, because, unlike the states, it is not prohibited from impairing the obligations of contracts . . . . But the effect of the act here complained of is not the discharge of Radford’s personal obligation.” *Radford*, 295 U.S. at 589.

<sup>106</sup> 295 U.S. at 602.

<sup>107</sup> *Id.* at 573.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 573-74.

<sup>110</sup> *Id.* at 577.

sale applied to the repayment of the mortgage loan debt.<sup>111</sup> The Bank also offered to take the farm in satisfaction of the debt, which at the time was about \$9,205.<sup>112</sup>

Radford filed for bankruptcy and relied on a new provision of federal bankruptcy law called the Frazier-Lemke Farm-Mortgage Act (“Frazier-Lemke Act” or “Act”),<sup>113</sup> which was passed to relieve bankrupt farmers who were underwater and in default on their mortgage loans.<sup>114</sup> The Act only applied to existing mortgages.<sup>115</sup> It allowed bankrupt farmers to suspend foreclosure proceedings on their farms through one of two alternative ways.<sup>116</sup> First, if the lender agreed, a bankrupt farmer could buy back his mortgage lien under a low-percentage, low-interest, six-year payment plan at the farm’s then appraised value.<sup>117</sup> If the lender refused the purchase option, the foreclosure proceedings would be stayed by the bankruptcy court for five years, with the bankrupt farmer paying rent to the court to be distributed to both secured and unsecured creditors.<sup>118</sup> At the end of five years, the bankrupt farmer could buy back his mortgage lien for the appraised value at the time of the bankruptcy filing or the reappraised value in five years, and the farmer’s mortgage loan debt would be discharged.<sup>119</sup> This meant that a lender would be deprived of the right to foreclose on the property or in any way to immediately recover the current appraised value of the property.<sup>120</sup>

The Court struck down the Act on Fifth Amendment constitutional grounds, finding that it amounted to a transfer of a bank’s valuable mortgage lien rights in the farm from the bank to Radford without just

<sup>111</sup> *Id.* at 574.

<sup>112</sup> *Radford*, 295 U.S. at 575, 577.

<sup>113</sup> Frazier-Lemke Farm-Mortgage Act, 48 Stat. 1289 (1934) (expired 1949). For information on farm failures during the Depression and the government’s response, see Randal R. Rucker & Lee J. Alston, *Farm Failures and Government Intervention: A Case Study of the 1930’s*, 77 AM. ECON. REV. 724 (1987).

<sup>114</sup> *Radford*, 295 U.S. 555.

<sup>115</sup> It’s interesting to note that this Act passed in the House of Representatives as applying to both existing and future mortgages, but then the Senate amended it before passing to apply only to existing mortgages, because it was pointed out that if it applied to future mortgages, farmers’ future mortgage credit would be destroyed. *Radford*, 295 U.S. at 595, fn 26, referring to Conference Report, June 18, 1934, 73d Cong., 2d Sess., 78 Cong. Rec., pp. 12,074-75.

<sup>116</sup> *Radford*, 295 U.S. at 575-76.

<sup>117</sup> *Id.* at 575 (“By paragraph 3, the bankrupt may, if the mortgagee assents, purchase the property at its then appraised value, acquiring title thereto as well as immediate possession, by agreeing to make deferred payments as follows: 2 ½ per cent. within two years; 2 ½ per cent. within three years; 5 per cent. within four years; 5 per cent. within five years; the balance within six years. All deferred payments to bear interest at the rate of 1 per cent. per annum.”).

<sup>118</sup> *Id.* at 575-76.

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

compensation.<sup>121</sup> Before the Act, the bank's property right in the collateral consisted of a bundle of rights, including the right to insist on full payment of the mortgage loan, the right to foreclose the mortgage lien, the right to decide the timing of the foreclosure sale, the right to bid at the foreclosure sale, and the right to control the property and collect rent after default.<sup>122</sup> The Court found that the Act took those rights from the Bank, and that such a takings required just compensation.<sup>123</sup> The Court stated that "[n]o instance has been found, except under the Frazier-Lemke Act, of either a statute or decision compelling the mortgagee to relinquish the property to the mortgagor free of the lien *unless the debt was paid in full*."<sup>124</sup> The Court fully recognized that the country was in difficult financial times and the Act's purpose was to keep farmers on their farms, but it still sounded the legal alarm that "statutes for the relief of mortgagors, when applied to preexisting mortgages, have given rise, from time to time, to serious constitutional questions."<sup>125</sup>

Given that *Radford* was a regulatory taking case, the Court did not directly rule on the *amount* of just compensation, and some commentators have noted that any discussion about compensation could be considered dicta.<sup>126</sup> However, it can be inferred from the holding that the option to receive the current appraised value of the mortgage collateral over time through a payment plan was not considered sufficient.<sup>127</sup> In *Radford*, recall that at the time the Bank attempted to foreclose, the outstanding mortgage debt was \$9,205 and the value of the real estate was \$4,445.<sup>128</sup> The Act had

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<sup>121</sup> *Id.* at 601. The Court observed that allowing farmers to stay on their farms and thus restricting the ability of mortgagees to foreclose was clearly shown by the legislative history of the Act. *Id.*

<sup>122</sup> *Id.* at 594 ("Under Kentucky law, the Bank had a property right in the farm as mortgage collateral, which included the right was to insist on full payment of the mortgage loan before giving up his mortgage lien on the farm. The Supreme Court held that the Act as applied took property rights from the mortgagee bank. The property rights taken were defined as:

- (a) The right to retain the mortgage lien until the mortgage loan was paid
- (b) The right to foreclose the mortgage lien
- (c) The right to determine when a foreclosure sale would be held (subject only to discretion of the court)
- (d) The right to protect its interest in the property by bidding at a foreclosure sale, and therefore to have mortgaged property proceeds devoted primarily to the satisfaction of the mortgage loan
- (e) The right to control the property during default and collect rents.")

<sup>123</sup> *Id.* at 579.

<sup>124</sup> *Id.* (emphasis added).

<sup>125</sup> *Id.* at 581.

<sup>126</sup> James S. Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 981-82 (1983).

<sup>127</sup> Theoretically the bank in this case would have potentially received more than the current appraised value of the collateral, as the bank would then have become an unsecured creditor for the remaining mortgage loan debt in the Bankruptcy Court proceeding. *Radford*, 295 U.S. at 577.

<sup>128</sup> *See id.* The Court does not say why the mortgage debt at the time was greater than the original mortgage loan, but it may be because taxes and insurance were also unpaid and due. *Id.*

the effect of replacing the Bank's property right in the mortgage lien with the option of either receiving (1) \$4,445 (value of the real estate) to be paid over 6 years at a low interest rate, or (2) rent of \$325 per year for five years (fixed by the court, to be shared with other creditors, with no provision for maintenance payments of taxes and insurance), plus a payment at the end of five years of \$4,445 (current value of real estate) or the reappraised value of the property.<sup>129</sup> The Court recognized that even if all payments were made on time over six years and there was no risk that Radford would not default again, money to be received in the future is not the same as money today.<sup>130</sup> Therefore, the application of the time value of money actually made the total payment scheme less than the current appraised value of the property. In other words, the so-called option for the Bank to be paid the current appraised value of the property more accurately amounted to relinquishment of the right to possess the property for six years, with an unsecured promise to purchase at the end of the period for a price less than appraised value.<sup>131</sup>

While the Court did not specifically consider what amount of compensation would be just, the two options under the Act for compensation—current appraised value under a six year payment plan or appraised value in five years—left the Bank without all of a mortgagee's rights under state law (the rights to be paid in full on the debt, foreclose immediately, bid at the foreclosure sale, or to control the farm after default) and was therefore deemed inadequate.<sup>132</sup> The often-quoted statement by the Court that “[t]his right of the mortgagee to insist upon *full payment* before giving up his security has been deemed the essence of a mortgage,” appears to declare that full repayment of a mortgage loan debt would be the only compensation that would meet the Constitutional requirements.<sup>133</sup> The Court examined previous statutes for the relief of lenders and noted that such statutes have only been sustained when the lender had still maintained the right to repayment of the mortgage note through foreclosure of the mortgage lien.<sup>134</sup>

After the holding in *Radford*, Congress immediately responded by enacting a revised version of the Frazier-Lemke Act known as the Farm Mortgage Moratorium Act of 1935 (“Revised Act”).<sup>135</sup> The Revised Act provided for a stay of foreclosure for three years, with a provision that the

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<sup>129</sup> *Id.*

<sup>130</sup> *Id.* at 592.

<sup>131</sup> *Id.* at 592-93.

<sup>132</sup> *Id.* at 575. To further complicate the fact pattern of this case, the Bank had offered to accept a deed in lieu of foreclosure in full satisfaction of the loan. This is in keeping with the practice of lienholders to bid up the outstanding debt at a foreclosure proceeding.

<sup>133</sup> *Id.* at 580 (emphasis added).

<sup>134</sup> *Id.* at 581 (citing *W.B. Worthen Co. v. Kavanaugh*, 295 U.S. 56 (1935)); *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934).

<sup>135</sup> Farm Mortgage Moratorium Act of 1935, 48 Stat. 929 (1935).

bankruptcy court could shorten the period if circumstances called for it. During the stay, a bankrupt farmer was required to pay rent, which went to farm upkeep and taxes, with any remainder going to the lender. At the end of three years, the bankrupt farmer could buy back the mortgage lien and have the mortgage note debt discharged in bankruptcy by paying the appraised value of the property at the time of bankruptcy, less any principal paid during the three years. The lender also had the right to ask that the farm be sold at public auction and could then bid up to the amount of debt at the sale; the bankrupt farmer had the right to redeem after the sale, but only by paying the amount of the winning bid.

Legal scholars have pointed out that it is difficult to comprehend how the changes made in the Revised Act were sufficiently different from the original Act that it was no longer a regulatory taking without just compensation, given that a lender still lost the right to be paid in full on the debt and foreclose immediately.<sup>136</sup> However, two years after the *Radford* case, the Supreme Court upheld the Revised Act in *Wright v. Vinton Branch of Mountain Trust Bank of Roanoke* (“*Wright 1937*”).<sup>137</sup> The Court stressed that *Radford* did not require that a lender’s entire bundle of property rights had to be maintained for a law to be constitutional, and the rights to request a public auction and bid at the auction were maintained.<sup>138</sup> The Court continued to discuss the constitutionality of the Revised Act in *Wright v. Union Central Life Insurance Company* (“*Wright 1940*”).<sup>139</sup> In that case, a lender exercised its option under the Revised Act to ask that a bankrupt farmer’s farm be sold at public auction.<sup>140</sup> The Court held that the bankrupt farmer had the right to redeem his property at the current value of the property after the lender requested a public sale but before the court ordered the public sale (and before the lender could bid the amount of debt at the sale, thus causing the right of redemption to be at the higher amount).<sup>141</sup> In discussing the rationale, the Court noted that the Revised Act preserved the right of the lender to receive the value of the collateral, and as far as the

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<sup>136</sup> Rogers, *supra* note 126, at 979-81. See also John Hanna, *New Frazier Lemke Act*, 1 MO. L. REV. 1, 19 (1936) (written after the passage of the Revised Act but before it was challenged at the U.S. Supreme Court level, noting that lower courts were holding it was still unconstitutional and concluded that it was still unconstitutional).

<sup>137</sup> *Wright v. Vinton Branch of Mountain Tr. Bank of Roanoke*, 300 U.S. 440 (1937).

<sup>138</sup> The Revised Act was found to adequately preserve the following property rights in a mortgage, which had not been protected in *Radford*: (a) the right to retain the mortgage lien until the mortgage debt was paid; (b) the right to foreclose; and (c) the right to protect the mortgagee’s interest in the property by bidding at a foreclosure sale. *Id.* at 458.

<sup>139</sup> *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273 (1940). There was also an intervening Supreme Court case discussing and ruling that the provision in the Revised Act that extended the period of redemption after foreclosure was constitutional. *Wright v. Union Cent. Life Ins. Co.*, 304 U.S. 502 (1938).

<sup>140</sup> *Wright*, 311 U.S. at 278.

<sup>141</sup> *Id.* at 279.

mortgage lien was concerned, the value of the collateral was the full amount that a lender was constitutionally entitled to.<sup>142</sup>

As to bankruptcy proceedings, all three New Deal era cases established the legal precedent that secured creditors have the right to have the value of a mortgage lien preserved in bankruptcy.<sup>143</sup> The cases did not rule directly on the actual value of a mortgage lien. The language in *Radford* seemed to imply that the value of a mortgage lien is equal to the value of the mortgage debt. Referring back to our original example where a home has a current market value of \$140,000 and mortgage debt of \$168,000, that case then suggests that the appropriate amount of just compensation is \$168,000. However, *Wright 1937* and *Wright 1940* clarified that some, but not all, of a mortgage lender's rights in a mortgage lien could be extinguished or restructured without amounting to a constitutional taking, and the most important mortgage lien right, at least in the case of a non-performing loan, is that the lender maintains the right to the value of the collateral.<sup>144</sup> In our example that would be \$140,000.

Besides trying to decipher the monetary value of a mortgage lien, it is useful to reflect on the rationale used by the Court. In all three cases, the Court examined the rights that a lender had as a holder of a mortgage lien. All of the rights focused entirely on the mortgage lien and included only rights associated with the collateral.<sup>145</sup> The Court did not need to examine the rights that the lender had as a holder of a mortgage note, as the debt was being dealt with separately in bankruptcy. If the discussion was not just of a mortgage loan lien, but rather of a mortgage loan note and lien, the discussion would have to be expanded to include the rights of a lender as a holder of a mortgage note. Recall that a mortgage note obligates the borrower to pay the lender the loan amount with interest. As the Court recognized that the essential right of a mortgage lien is related to the value of the collateral, the reasoning in the New Deal era cases could lend itself to the argument that a mortgage lender has the right to retain a mortgage note until the mortgage loan debt is paid.<sup>146</sup>

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<sup>142</sup> See *id.* at 278-79 (“Safeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property.”).

<sup>143</sup> Rogers, *supra* note 126, at 981.

<sup>144</sup> *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278–79 (1940); *Wright v. Vinton Branch of Mountain Tr. Bank of Roanoke*, 300 U.S. 440, 458 (1937).

<sup>145</sup> *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 594-95 (1935) . See *supra* note 122 for the rights enumerated.

<sup>146</sup> Current bankruptcy law does not allow for restructuring or discharge of primary residence mortgage loan debt. See *supra* note 101. So even in the case of bankruptcy, a borrower could not keep his or her house without paying the full amount of loan debt outstanding.

### C. *Capitalization of Future Income*

While intangible property such as securities and contracts have been taken by eminent domain, we have found no discussion about the amount or appropriate measure of just compensation.<sup>147</sup> In the case of condemnation of tangible real estate, courts do not typically take into account income generated by the real estate being condemned when determining just compensation, but rather, prefer to use a market comparison approach (looking at comparable properties that have recently sold). However, using an income approach has been allowed in select circumstances.<sup>148</sup>

In general, income from a business located on property being taken by eminent domain is not taken into account when determining market value of property; this is known as the “business profits rule.”<sup>149</sup> There is an exception to this rule when the property is a special use without relevant comparable property sales to compare to, and the revenue is derived from the property itself rather than a business located on the property.<sup>150</sup> For example, *Ozark Gas Transmission Systems v. Barclay* concerned an easement for a pipeline that was being taken from the owners of a pick-your-own apple and peach orchard.<sup>151</sup> The property owner’s appraiser could not use the market comparison approach to determine the value of the orchard because there was only one other orchard in the county and none had ever been sold before.<sup>152</sup> Looking at other comparable sized properties was meaningless, since too many fact-specific adjustments would need to be made to take into account the specifics of the orchard and trees.<sup>153</sup> Therefore, the court allowed fair market value of the orchard to be determined by capitalizing the anticipated income from each acre of orchard over the recognized life expectancy of the trees.<sup>154</sup> The court held that this approach fit the exception to the general business profits rule,

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<sup>147</sup> See *supra* note 42.

<sup>148</sup> Richard Duvall & David Black, *Methods of Valuing Properties Without Compare: Special Use Properties in Condemnation Proceedings*, 68 APPRAISAL J. 1, 6 (2000):

The “income approach” can be used for valuing special use properties that generate revenue for the owner. Stated simply, the method involves estimating the annual net income likely to be produced by the property and the number of years over which the owner could reasonably expect this level of income. The present value of this income stream is calculated by applying a capitalization rate, which is intended to approximate the net rate of return on investment reasonably expected by the owner. When the entire property is taken, the present value of the property’s future income stream is offered as evidence of the owner’s damages.

<sup>149</sup> See, e.g., *Denver Urban Renewal Auth. v. Cook*, 526 P.2d 652 (1974) (profits of a sporting goods store was deemed tied to the management and administration of the business and therefore not considered in determining value of the property in an eminent domain proceeding).

<sup>150</sup> *Ozark Gas Transmission Sys. v. Barclay*, 662 S.W. 2d 188, 191 (Ark. Ct. App. 1983).

<sup>151</sup> *Id.*

<sup>152</sup> *Id.* at 190.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.* at 191.

given that the revenue was derived from the property itself rather than from a business operating on the property.<sup>155</sup>

It appears obvious that the exception to the business profits rule would apply to the taking of mortgage loans, since the property being taken is not tangible real estate but rather an intangible stream of future income. In fact, the only value a mortgage loan has to a mortgage lender (or subsequent holder) is as an investment that generates future income.<sup>156</sup> In finance, the value of an investment such as a bond is based on the capitalization of future income, which is calculated by determining the present value of future cash flows discounted back to the date of the valuation by an appropriate discount rate.<sup>157</sup>

Future revenue has also been allowed to be considered when determining just compensation in the taking of property that included mineral or other underground deposit rights that could potentially generate royalty payments. In *United States v. 103.38 Acres of Land*, the United States Court of Appeals for the Sixth Circuit addressed the question of royalty capitalization for mineral deposit.<sup>158</sup> That case involved a tract of unimproved land that was leased by the landowners to a mining company at a specified royalty rate. Before actual mining operations started, the property was condemned as part of a flood control project.<sup>159</sup> Because there were no true comparable sales to the specific property because of its mineral deposits, the landowners argued that compensation should be based on the hypothetical cash flows that would have been obtained through the mining royalty revenue.<sup>160</sup>

The Court prefaced its discussion of just compensation by recognizing that a comparable sales analysis was the preferred method for establishing a property's fair market value.<sup>161</sup> In the absence of true comparable property sales; however, the Court recognized that other valuation methods could be used. In this case, the Court noted the difference between high quality coal

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<sup>155</sup> *Id.*

<sup>156</sup> Given that some of the loans may be part of a mortgage backed security, the question arises whether not only would just compensation need to pay fair market value of the mortgage taken, but also whether any loss due to the reduction in value of the securitized pool. In takings of only a portion of a single tract, courts have held that the owner should also be compensated for any loss of value of the remaining tract. However, if an owner owns a couple of separate adjoining tracts and only one of those tracts is taken, courts do not require compensation for the any consequential damages to other properties. *United States v. Miller*, 317 U.S. 369, 376 (1943).

<sup>157</sup> See Amy Gallo, *A Refresher on Net Present Value*, HARV. BUS. REV. (Nov. 19, 2014), <https://hbr.org/2014/11/a-refresher-on-net-present-value>. See also Jay Guo, *Fair Valuation of Residential Whole Loans*, INTERACTIVE DATA (May 2011), <http://www.interactivedata.com/uploads/File/2011-Q2/prd/TSLearningCurves2011.pdf>.

<sup>158</sup> *United States v. 103.38 Acres of Land*, 660 F.2d 208 (6th Cir. 1981).

<sup>159</sup> *Id.* at 209.

<sup>160</sup> *Id.* at 210.

<sup>161</sup> *Id.* at 211.

on the subject property and inferior quality coal on the comparable properties meant that the comparable sales method would not be an appropriate measure of the fair market value of the subject property.<sup>162</sup> Therefore, the Court allowed a cash flow analysis that consisted of the multiplication of a royalty rate by the estimated recoverable tonnage of coal in place.<sup>163</sup> The Court rejected the government's contention that a cash flow analysis for unmined coal was too speculative because of the impossibility of determining how much coal a tract contains and whether it could be mined profitably, recognizing that in the absence of certainty some speculation is required to determine fair market value of a mineral-bearing property.<sup>164</sup>

Given that capitalization of future cash flows has been deemed an acceptable method for determining fair market value in takings cases, we explore what that would mean in the case of a mortgage loan taking. For a mortgage loan, future cash flows consist of either the contractual or expected cash flows from the loan.<sup>165</sup> For a performing loan, revenue is the contractual future principal and interest payments made for the remainder of the loan term.<sup>166</sup> Default probabilities for a performing loan are not taken into account when projecting cash flows, but rather, are accounted for when determining the appropriate discount rate.<sup>167</sup> For a non-performing loan, estimated revenue is the expected net foreclosure value and any deficiency judgment proceeds.<sup>168</sup>

A critical variable in estimating the value today of a specific residential mortgage loan is the discount rate to be used.<sup>169</sup> Basically, discount rates are made up of both a benchmark interest rate component and a risk premium component.<sup>170</sup> The benchmark rate reflects current market conditions and can be observed in the marketplace by looking at the interest rate on newly issued mortgage loans.<sup>171</sup> The benchmark rate therefore reflects the *average* risk of default. The difficult part on determining the correct interest rate is deciding the premium that should be added to the benchmark rate to take into account the *loan-specific risks* associated with both the borrower repayment under the terms of the note and the worth of the collateral if the borrower should default. Estimating a specific risk

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<sup>162</sup> *Id.*

<sup>163</sup> *Id.* at 213.

<sup>164</sup> *103.38 Acres of Land*, 660 F.2d at 213.

<sup>165</sup> John Tschirhart, et al., *Bank Commercial Loan Fair Value Practices*, FED. RES. BD., 10 (June 2007), <http://www.federalreserve.gov/pubs/feds/2007/200729/index.html>.

<sup>166</sup> *Id.* at 10.

<sup>167</sup> *Id.* at 11.

<sup>168</sup> *Id.*

<sup>169</sup> See Guo, *supra* note 157 at 3.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

premium for discounting a particular mortgage loan would be one of the most challenging steps in the capitalization valuation process.<sup>172</sup>

Given this difficulty, the indicated market value of a loan using this approach may be the same as, greater than, or less than the amount of the principal outstanding.<sup>173</sup> Returning to our example, if the \$200,000 mortgage carried an interest rate of 6.14% for a 30-year term with monthly payments of \$1,217, then after ten years the remaining loan balance would be about \$168,000. If the appropriate discount rate is equal to the interest rate on the mortgage loan (i.e., the risk of default is average), then the present value of the contractual cash flows from the loan is equal to the loan balance outstanding.<sup>174</sup> However, if the discount rate is more or less than the stated interest rate on the mortgage loan, the capitalized value will be different than the outstanding loan balance.

Note that performing a capitalization of future cash flows does involve some level of speculation—speculation whether a future loan will continue to be performing, if a loan goes into default what price the property would sell for at a foreclosure sale, and the appropriate discount rate to use in finding present values of future projected cash flows. In *103.38 Acres of Land*, the Court recognized that determining just compensation using any type of cash flow approach does require “some speculation,” and therefore there is no set numbers or general formula that can be used, but rather, compensation would be dependent on the circumstances of each particular case.<sup>175</sup> In that case, the court accepted expert witness speculation about the amount and quality of unmined coal on a specific property.<sup>176</sup> Likewise for a mortgage takings case there would need to be testimony about borrower and loan collateral characteristics. Specifically, estimation of a loan-specific discount rate would need to incorporate fact-specific forecasts for default probabilities and recovery amounts in the event of default.<sup>177</sup>

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<sup>172</sup> *Id.* See *infra* Part IV for a discussion of empirical analysis that analyze factors that increase the risk of default for an underwater performing loan.

<sup>173</sup> Basic accounting standards also apply a discount to the face value of the note when the current appropriate risk adjusted discount rate is different than the stated interest rate on the mortgage loan mortgage note. *Interest on Receivables*, APB Op. No. 21. (Fin. Accounting Standards Bd. 1971). Note that accounting principles sometimes provide for a write-down in the value of a loan, but rarely provide for a write-up.

<sup>174</sup> When the discount rate is exactly the same as the interest rate being paid on the mortgage loan, the present value of future payments will be the same as the principal amount outstanding on the mortgage loan; in other words, the fair market value of the loan will be the amount of the loan outstanding.

<sup>175</sup> *United States v. 103.38 Acres of Land*, 660 F.2d 208, 213 (6th Cir. 1981).

<sup>176</sup> *Id.*

<sup>177</sup> *United States v. Commodities Trading Corp.*, 339 U.S. 121, 126-27 (1950) (discussing the role forward looking calculations of future value play in requisitioning pepper during WWII when price ceilings were in place).

Getting into the quantitative mechanics of capitalization, if the appropriate discount rate is less than the interest rate on the mortgage loan (i.e., the loan-specific risk of default is less than average), the present value of the future cash flows would be above the value of the mortgage debt outstanding.<sup>178</sup> For instance, given a benchmark interest rate of 4% for a 30-year mortgage loan, if there is no additional default risk associated with the performing loan, there would be no loan-specific risk premium added to this base rate. At 4%, the present value of the future cash flows of the mortgage loan in our example is \$200,850, which is above the loan balance outstanding of \$168,000.<sup>179</sup> Conversely, if the appropriate discount rate is more than the interest rate on the mortgage loan, the present value of the cash flows would be below the value of the mortgage debt outstanding. Again, starting with a benchmark interest rate of 4%, suppose there is high risk that the borrower in question would default. Assuming a loan-specific risk premium of, say, 6%, and hence a discount rate of 10%, the present value of the future loan cash flows is \$126,128. At a discount rate of 20%, the present value of the future loan cash flows would be \$71,647. In order for the present value of the cash flows to equal 85% of the value of the collateral in our example (corresponding to the assumed compensation of \$119,000 under the Plan), the discount rate would have to be 10.86%.

This approach illustrates yet another way to think about a condemnation award for a mortgage loan. The higher the prevailing interest rate under the original loan and the lower the chance of default or prepayment, the higher the value of the loan to the lender, and vice versa. Therefore, under this approach, there is a range of possible values to a mortgage loan, related to the specific facts of the loan, which could range from below the value of the mortgaged real estate to above the value of the outstanding debt. If a loan is non-performing or likely to be in default, the value is closer to the value of the collateral; if the loan is performing and not likely to default, the value is closer to the amount of the outstanding debt. The problem, of course, is establishing the probability of default, which is discussed more thoroughly in Part IV.

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<sup>178</sup> This is the same principal that explains why bonds increase in value when risk-adjusted market interest rates go down below a bond's stated interest rate and decrease in value when market interest rates go up. As an example, if a publicly traded bond pays a higher interest rate than similar bonds in the market, that bond will be a more attractive investment, and therefore have a higher market value than a similar bond with a lower interest rate, all else remaining equal.

<sup>179</sup> Note that the present value of the cash flows is actually worth more than the loan debt outstanding because the interest rate on the loan amount outstanding is higher than can be currently obtained in the market, and the loan is performing but can't be refinanced because it is underwater (similar to a premium bond). See *What is a Premium Bond*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/premiumbond.asp>.

#### D. *Summary of Measures of Just Compensation*

The analyses in this section have shown that the determination of a just compensation for a mortgage loan taking can be determined from previous case law in which the taking was either of a mortgage lien, or of the investment value of the mortgage loan (debt and lien). When a performing or nonperforming mortgage lien is extinguished as part of the taking of the underlying collateral, the value the lien is viewed as the amount of the debt outstanding up to the value of the collateral. Regulatory changes impacting a nonperforming mortgage loan lien do not constitute a taking as long as the lender retains the right to receive the value of the collateral. It is important to point out that the value of the mortgage note was not discussed in either types of mortgage lien takings cases. The income approach that uses cash flow capitalization modeling depends on whether the loan is performing or nonperforming, as well as estimates about riskiness of receiving contractual or expected cash flows.

#### IV. DETERMINING VALUE: AN ECONOMIC PERSPECTIVE

This section uses economic theory to shed further light on the amount of just compensation for mortgage takings.<sup>180</sup> From an economic perspective, we ask what measure leaves lenders no worse off than if a taking had not occurred based on the rational behavior of borrowers. If lenders are no worse off than if a taking had not occurred, the use of eminent domain should not have an adverse impact on mortgage markets and future lending activity. Note that this analysis basically employs the same type of risk premium required by the capitalization approach discussed in the previous section, and therefore could help courts in determining the appropriate discount rate to be used when implementing that approach. Based on this determination of just compensation, we can then assess whether the level of compensation could potentially be revenue-neutral for cities as contemplated by the Plan.

In order to properly examine the likely effect of the Plan on the mortgage market, it is important to recognize that the value of a mortgage loan is heavily dependent on whether the loan is performing or nonperforming, and if performing, whether the borrower will repay or default. Specifically, if an underwater mortgage loan were non-performing or highly likely to default, the value of the mortgage loan to the mortgage lender equals the value of the underlying collateral less the transactions costs associated with default (assuming that the lender would not seek

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<sup>180</sup> See generally THOMAS MICELI, *THE ECONOMIC THEORY OF EMINENT DOMAIN: PRIVATE PROPERTY, PUBLIC USE* (2011) (discussing economic theories related to eminent domain).

and/or be able to obtain a deficiency judgment against the borrower). Therefore, the minimum amount of compensation that would leave lenders no worse off than a defaulting loan is equal to the current market value of the underlying real estate, less the transaction costs that lenders would have to incur in reselling it. In the example where the outstanding loan balance is \$168,000, but the property's market value is \$140,000, the value of the mortgage loan to the lender is some amount less than \$140,000. Notice, therefore, that it is possible that the assumed 85% of collateral value compensation rate under the Plan may reasonably approximate the value of the collateral in a foreclosure situation. The taking of these types of loans would be revenue-neutral for a city, if in fact the borrower had sufficient income to qualify for a new lower principal but high LTV ratio loan.

Conversely, for underwater mortgages that would not likely default, the value of the mortgage is closer to the value of the outstanding debt, or \$168,000. In this situation, if lenders receive less than the debt to be repaid to them, they are effectively subsidizing those borrowers who would not have defaulted. This will in turn cause an increase in the mortgage interest rate because lenders will have to charge a premium for all mortgages at their origination so as to ensure that, on average, they yield a competitive return.<sup>181</sup> For these types of loans, the compensation amount is higher than the assumed 85% of collateral value compensation rate under the Plan; taking of these types of loans would be not be revenue-neutral for a city.

In general, there are two theories about why a residential mortgage loan borrower would default: the ability-to-pay theory and the equity theory.<sup>182</sup> The ability-to-pay theory posits the risk of default increases when a borrower cannot make the monthly loan payments due to loss of employment, divorce or other income-related reasons.<sup>183</sup> The equity theory focuses on the amount of equity in the house, looking at the current value of the property as compared to the loan amount outstanding.<sup>184</sup> No borrower with significant positive equity would ever default, even if the borrower were unable to make monthly loan payments, since the borrower could sell the house and pay off the loan.<sup>185</sup> However, in the case of negative equity, i.e. an underwater loan, default may occur even if the borrower has the ability to repay.<sup>186</sup>

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<sup>181</sup> Another factor not considered here is whether the introduction of a forced refinancing plan discourages borrowers and lenders from voluntarily renegotiating underwater mortgages. Presumably, at least some loans that would have resulted in default would be renegotiated, which one expects is less costly than forced renegotiation.

<sup>182</sup> Terrence Clauretie & G. Stacy Sirmans, *REAL ESTATE FINANCE*, 316-318 (2009).

<sup>183</sup> *Id.* at 316.

<sup>184</sup> *Id.*

<sup>185</sup> *Id.* at 317.

<sup>186</sup> *Id.* The equity theory of default is also called the "put option theory"; whenever the value of the house is less than the value of the loan, it makes the most financial sense for the borrower to give ("put to") the lender the property rather than repay the loan.

Whether an underwater borrower that has the ability to repay and actually continues to pay or defaults would be largely due to the borrower's "subjective value." Subjective value is defined to be the amount that the borrowers value the property in excess of its market value, reflecting, for example, the borrower's attachment to the house or neighborhood.<sup>187</sup> Economists recognize that this is a real economic value because it reflects the minimum price that the owner of a piece of property would accept to sell it in a consensual transaction, referred to as his or her "reservation price." Specifically, the difference between an owner's reservation price—the amount that would leave him or her truly indifferent between selling and not selling—and the fair market value of the property is therefore the owner's subjective value.<sup>188</sup>

To illustrate the effect of subjective value on the default decision, suppose that in our example the borrower has a subjective value of the property equal to \$50,000. Then, the minimum amount he or she would accept to sell the property is \$190,000 (or, the \$140,000 current market value plus \$50,000 subjective value), which exceeds the outstanding loan balance of \$168,000. Thus, although the loan is underwater, the borrower would not voluntarily choose to default.<sup>189</sup> Borrowers with subjective values less than \$28,000, in contrast, would be willing to default because the outstanding balance exceeds their true reservation price.<sup>190</sup> The tricky thing about subjective value and other perceptions about default costs is that it is private information of the borrower, and therefore, his or her reservation price is not observable to the market. As a consequence, individual assessment about subjective value and default costs makes it difficult to determine which underwater but performing loans would result in default.

The challenge this creates for the proposed Plan is twofold. First, if the purpose of any local eminent domain taking is to prevent the harms to the housing market that defaults and foreclosures create, then the goal should be to take those performing underwater mortgages that would eventually default so as to prevent foreclosure. Second, as we have determined under the legal analysis, the possible just compensation from a legal perspective ranges from the net value of the collateral to the

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<sup>187</sup> For a discussion of the concept of subjective value, see MICELI, *supra* note 180, at 57-59.

<sup>188</sup> See, e.g., Jack L. Knetsch & Thomas E. Borchering, *Expropriation of Private Property and the Basis for Compensation*, 29 U. TORONTO L. J. 237 (1979); WILLIAM A. FISCHER, *REGULATORY TAKINGS: LAW, ECONOMICS, AND POLITICS* (1995) (relating subjective value to the "offer-ask" disparity).

<sup>189</sup> This example focuses on voluntary or discretionary defaults only, as opposed to involuntary defaults where the borrower simply lacks the resources to pay the mortgage, regardless of its market value.

<sup>190</sup> See Jan K. Brueckner, *Mortgage Default with Asymmetric Information*, 20 J. REAL EST. FIN. & ECON. 251 (2000) (subjective value also accounts for the impaired credit incurred by the borrower in the event of default).

outstanding loan balance. Where in that range actual just compensation for a specific loan would be heavily dependent on the likelihood of default of the loan, given the goal of leaving lenders no worse off than if the taking had not occurred. Therefore, there needs to be the ability to distinguish between performing underwater borrowers who would default from those who would not, so that all underwater mortgage loans would not be treated the same.

A central question then becomes, at what point an underwater borrower walks away from his or her house? Academic studies have empirically analyzed this question, and found that the probability of default was most consistently explained by the equity theory; in other words, negative equity increases the probability that a borrower will default.<sup>191</sup> Studies also tested the ability-to-pay theory; while finding a relationship between some trigger events such as unemployment rates and default, many empirical findings proved inconclusive.<sup>192</sup> However, more recent studies have concluded that a borrower that is underwater on his or her mortgage is more likely to default if the borrower has experienced an income shock that impacts his or her ability to repay.<sup>193</sup> Studies surveyed also found that borrower attributes played a secondary role relative to loan characteristics in explaining default rates.<sup>194</sup> Lastly, the threat of recourse in states that allow deficiency judgments were found to greatly reduce the probability of default.<sup>195</sup>

A Federal Reserve study examining mortgage loans after the financial crisis found that the odds of default increased as borrowers fell deeper underwater.<sup>196</sup> Their data revealed that borrowers who were just a little underwater, with equity between -1 and -9 percent, were not likely to default.<sup>197</sup> Default when a borrower was only slightly underwater was almost entirely accounted for by some type of negative income shock to the borrower.<sup>198</sup> As borrowers became deeper underwater, the probability of default increased significantly; in fact the default probability more than

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<sup>191</sup> Timothy Jones & G. Stacey Sirmans, *The Underlying Determinants of Residential Mortgage Loan Default*, 23 J. REAL ESTATE LIT. 169, 172 (2015) (reporting on a survey of nearly 100 empirical and theoretical studies related to mortgage default).

<sup>192</sup> *Id.*, at 180-81.

<sup>193</sup> Christopher Foote, Kristopher Gerardi & Paul Willen, *Negative Equity and Foreclosure: Theory and Evidence*, 64 J. URB. ECON. 234, 237 (2008).

<sup>194</sup> Jones & Sirmans, *supra* note 191, at 181-83.

<sup>195</sup> *Id.* at 186-87.

<sup>196</sup> Neil Bhutta, Jane Dokko & Hui Shan, *The Depth of Negative Equity and Mortgage Default Decisions* (Fin. & Econ. Disc. Series, Fed. Res. Bd., FEDS Working Paper No. 2010-35 (2010)) (examined borrowers from Arizona, California, Florida, and Nevada, who purchased homes in 2006 with 100 percent financing; the loan sample consisted of 133,281 purchase loans observed from January 2006 to September 2009).

<sup>197</sup> *Id.* at 20.

<sup>198</sup> *Id.* at 21.

doubled when equity was below -60 percent.<sup>199</sup> In other words, slightly underwater was not a sufficient condition for default, a borrower also needs to experience some type of income shock. As concluded, however, the deeper a borrower becomes underwater, the less important a negative income shock is to determining default probability.<sup>200</sup>

Importantly, the Federal Reserve study was able to empirically distinguish between defaults induced by job losses and other income shocks and those induced purely by negative equity.<sup>201</sup> It found that the median mortgage borrower that has not experienced an income shock does not default on an underwater mortgage loan until the principal outstanding on the borrower's loan is 62% more than the value of the borrower's house.<sup>202</sup> In other words, only half of the borrowers in the study defaulted by the time their equity reached -62 percent of the house value. To put this in perspective, a borrower with a \$168,000 loan amount outstanding reaches -62 percent equity when the value of his house is \$103,703, or said another way, 162% current LTV ratio. Obviously then, the study presents empirical evidence that not all underwater mortgage borrowers default. One of the conclusions that the study draws from this is that many underwater mortgage borrowers either have high subjective values or perceive high costs to default.

In summary, the correct measure of just compensation for a performing mortgage must therefore reflect the two types of performing underwater mortgages in the population: those that would have resulted in default, and those that would not have. For loans that are only slightly underwater, the question becomes whether the borrower has experienced an income shock. With no income shock, the probability that a borrower would default is very small, thus putting the measure of compensation at the value of the mortgage loan outstanding. At this amount, the Plan is not financially feasible, in that a city would not be able to pay just compensation and refinance the mortgage loan in a revenue-neutral way. In our example, the just compensation would be \$168,000. The mortgage loan could then only be refinanced with 95% of the current property value of \$140,000, which equates to \$133,000. The difference then of \$35,000 (\$168,000 just compensation and \$133,000 refinanced loan) plus takings and refinance costs would have to be borne by the city.

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<sup>199</sup> *Id.* at 20.

<sup>200</sup> *Id.* at 19-21. As with the previous literature, the Federal Reserve study also found that the probability of default increased with other variables, such as unemployment and credit card default statistics, low FICO scores, and living in a non-deficiency judgment state.

<sup>201</sup> *Id.* at 19.

<sup>202</sup> *Id.* at 2, 20. The study classifies a borrower as having defaulted if he is 90+ days delinquent for two consecutive months, even though practically default on a mortgage occurs the moment that the borrower stops paying. *Id.* at 11.

For loans that are only slightly underwater, but where the borrower has experienced some type of negative income shock, the probability of default becomes much greater. How much greater may be able to be determined by looking at borrower-specific measures of default probability, such as borrower FICO score and whether the property is located in states that allow for deficiency judgments. However, anytime the borrower has experienced a negative income shock, the Plan may not be financially feasible if the borrower has insufficient income to qualify for refinancing at the higher new LTV ratio.

For loans that are deeply underwater, the probability of default is much greater, thus putting the measure of compensation somewhere between the net value of the collateral and the amount of the loan outstanding (in our example, a range between \$140,000 less projected foreclosure costs to \$168,000). For deeply underwater loans where the borrower has experienced a negative income shock, again the Plan may not be financially feasible, if the borrower has insufficient income to qualify for refinancing. For deeply underwater loans where the borrower has not experienced a negative income shock, the closer the just compensation rate is to the lower end of the range, meaning that the Plan may be financially feasible. As predicted by the Plan, compensation could potentially be 85% of the value of the property (\$119,000). The loan could be refinanced at 95% of the value of the property (\$133,000). The positive difference between just compensation and refinance amount (\$14,000) could cover costs of implementing the Plan, thus making it revenue-neutral.

Therefore, the Plan may only be financially feasible in cases of deeply underwater mortgage loans where the borrower has sufficient income to repay the refinanced loan amount. However, it is most likely not financially feasible for only slightly underwater mortgage loans or when the borrower has experienced such a negative income shock that he or she would not be able to qualify for the refinanced loan. Therefore, the Plan does not likely help the homeowners that have experienced the double economic hardship of both being underwater on their mortgage loans and having endured a negative impact to their income.

As long as lenders are not worse off with the taking than without the taking, there should be minimal long-term implications for mortgage markets. If just compensation is based on a range of values depending on likelihood of default so that the amount is closer to net collateral value for those loans likely to default, and closer to the loan amount outstanding for those loans less likely to default, this should not destabilize mortgage markets, and should in fact not be much different than the risk already recognized as part of the possibility of default and/or prepayment already.

## CONCLUSION

This paper has examined the proper amount of just compensation for the taking of underwater mortgage loans, an issue that has not yet been directly addressed by the courts, but which is central for a city to understand in order to determine whether this novel approach to foreclosure prevention is financially feasible. Our analysis has been two-pronged. We first looked at existing legal precedent regarding the computation of just compensation in related case law. Since individual seasoned underwater mortgage loans do not have readily observable market prices, the determination of just compensation needs to be based on other information or calculation. Case law related to the taking of mortgage liens indicates the value of a mortgage loan's ranges, from the net value of the real estate collateral to the amount of mortgage loan debt outstanding. Where specifically in this range it should be set can be based on capitalization of anticipated future loan cash flows to the lender. The more deeply a performing loan is underwater, the more likely it is to default, and therefore value is closer to net collateral value. A loan that is not deeply underwater is less likely to default, and therefore the value is closer to the loan amount outstanding. This approach suggests a possible range of values (depending on whether the loan is performing or nonperforming) from the amount of debt outstanding to some amount less than the value of the collateral.

Next, we used an economic perspective for guidance on the application of the law, explicitly accounting for the behavior of performing mortgage borrowers who find themselves underwater. A key insight here is that not all such underwater borrowers will in fact default because of the value they attach to the real estate above its market value—what economists refer to as subjective value. Those mortgage loans that would have defaulted are worth the net foreclosure value of the collateral, whereas those that would not have defaulted are worth the value of the outstanding debt. The proper measure of compensation therefore falls somewhere in the range of values suggested by the legal analysis, but exactly where depends on observable and unobservable factors. Previous econometric studies have shown that slightly underwater borrowers are not likely to default unless the borrower also experiences a negative income shock; the more deeply a mortgage loan becomes underwater the greater probability that loan will default with or without an income shock. Therefore, both the extent of negative equity and status of the borrower impact the probability of default, which impacts just compensation, which then ultimately determines the financial feasibility of using eminent domain to force a refinancing of the mortgage loan. We conclude that, in most cases, the Plan is not financially feasible and therefore unworkable given that it cannot be both revenue-neutral and leave lenders no worse off than if a taking had not occurred.







## THE LAW AND ECONOMICS OF CONCEALING HEALTH AND SAFETY INFORMATION<sup>†</sup>

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### INTRODUCTION

Since at least the 1970s, substantial mass tort cases involving such products as Methyl tert-butyl ether (“MTBE”), tobacco, lead-based paint, underground storage tanks, and asbestos have been a prominent part of complex civil litigation in the United States. The allegation that producers concealed the unsafe nature of their products has been a defining characteristic of such suits and billions of dollars have been at stake.<sup>1</sup>

Mass tort cases lie at the intersection of the law and economics of antitrust, the environment, and tort liability, because plaintiffs commonly allege that: (1) defendants failed to disclose<sup>2</sup> or intentionally concealed the truth about the pollution or health risks generated by the production and sale of allegedly unsafe products,<sup>3</sup> either individually, in a concerted

<sup>†</sup> The views and opinions expressed in this article are our own and do not necessarily reflect the official policy of the USPTO or any agency of the U.S. government. All views, and analyses (and especially, any errors) contained in this article are the responsibility of the authors.

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<sup>1</sup> For various historical accounts of mass tort cases and discussions of their current relevance, *see generally* Deborah R. Hensler, *Has the Fat Lady Sung? The Future of Mass Toxic Torts*, 26 REV. LITIG. 883 (2007); Deborah Hensler, *A Brief History of Asbestos Litigation in the United States*, 826 NEW BUS. L. 28 (2006); Robert F. Blomquist, *American Toxic Tort Law: An Historical Background, 1979-87*, 10 PACE ENVTL. L. REV. 85 (1992); Robert L. Rabin, *A Sociolegal History of the Tobacco Tort Litigation*, 44 STAN. L. REV. 853 (1992).

<sup>2</sup> A substantive distinction arguably exists between strict liability and negligence-based failure-to-warn as grounds for toxic tort liability claims. However, the subtle distinction between these two claims is not emphasized here as it is immaterial to advance the arguments made. It suffices to note that numerous toxic tort cases have been argued under the failure-to-warn theory. *See, e.g.*, *Glassner v. R.J. Reynolds Tobacco Co.*, 223 F.3d 343, 346 (6th Cir. 2000); *Tompkin v. Am. Brands*, 219 F.3d 566, 568 (6th Cir. 2000); *Carel v. Fibreboard Corp.*, 74 F.3d 1248 (10th Cir. 1996); *Olivo v. Owens-Illinois, Inc.*, 895 A.2d 1143, 1149 (N.J. 2006).

<sup>3</sup> Courts impose a more stringent burden of proof on plaintiffs who allege intentional misrepresentation as a cause of action. Despite these constraints, plaintiffs often allege that the defendant has fraudulently concealed material information in a toxic tort claim. While some courts find

action,<sup>4</sup> or as part of a conspiracy;<sup>5</sup> (2) defendants generated false information about the safety of their products;<sup>6</sup> and (3) defendants suppressed information about the existence of and innovation in safer alternatives, and unilaterally or collusively failed to adopt those safe alternatives.<sup>7</sup>

This article uses economic analysis to explore the conditions under which firms may find it in their interest to conceal innovation or adverse health and safety information. The analysis yields critical insights

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that plaintiffs do in fact have a cause of action based on the defendant's fraudulent concealment in toxic tort cases (*see, e.g.*, *Keywell Corp. v. Weinstein*, 33 F.3d 159, 165 (2d Cir. 1994); *Albertson v. Richardson-Merrell, Inc.*, 441 So. 2d 1146, 1147 (Fla. Ct. App. 1983)), others have dismissed such cases on summary judgment stating that plaintiffs have failed to establish reasonable reliance on the defendant's misrepresentation. *See, e.g.*, *Glassner*, 223 F.3d at 353-54; *Tompkins v. R.J. Reynolds Tobacco Co.*, 92 F. Supp. 2d 70, 82-83 (N.D.N.Y. 2000). *See also* Tucker S. Player, *After the Fall: The Cigarette Papers, the Global Settlement, and the Future of Tobacco Litigation*, 49 S.C. L. REV. 311, 321-22 (1998) (explaining that fraudulent misrepresentation claims garnered drastic relevance in the third wave of tobacco litigation in the US).

<sup>4</sup> *See Hymowitz v. Eli Lilly & Co.*, 539 N.E.2d 1069, 1074 (N.Y. 1989) (internal citations omitted), *cert. denied*, 493 U.S. 944 (1989), (the court dismissed defendant's summary judgment motion while also rejecting application of the concert of action theory on the grounds that there is no evidence that defendants were in any "agreement, tacit or otherwise, to market DES for pregnancy use without taking proper steps to ensure the drug's safety"). *See Marshall v. Celotex Corp.*, 691 F. Supp. 1045, 1048 (E.D. Mich. 1988) (defendants' motion for summary judgment was granted on the grounds that the plaintiff failed to show that defendants' concerted action caused decedent's asbestos based injury). In numerous other toxic tort cases in which the plaintiff failed to specifically identify a defendant who caused the harm, courts have predominantly rejected plaintiff's use of concert of action theory. *See, e.g.*, *Kraus v. Celotex Corp.*, 925 F. Supp. 646, 652 (E.D. Mo. 1996); *Hurt v. Phila. Hous. Auth.*, 806 F. Supp. 515, 531-32 (E.D. Pa. 1992); *Santiago v. Sherwin-Williams Co.*, 794 F. Supp. 29, 33 (D. Mass. 1992) *aff'd*, 3 F.3d 546 (1st Cir. 1993); *In re DES Cases*, 789 F.Supp. 552, (E.D.N.Y. 1992); *Morton v. Abbott Labs.*, 538 F. Supp. 593, 596-97 (M.D. Fla. 1982); *Chavers v. Gatke Corp.*, 132 Cal. Rptr. 2d 198, 205-06 (Ct. App. 2003); *Bichler v. Eli Lilly & Co.*, 436 N.E.2d 182, 188 (N.Y. Ct. App. 1982). *But see In re Methyl Tertiary Butyl Ether Prods. Liab.*, 379 F. Supp. 2d 348, 437, 441 (S.D.N.Y. 2005) (court dismissed all 12(b)(6) motions by defendant as it related to plaintiffs' collective liability, including concert of action, claims).

<sup>5</sup> *See, e.g.*, *In re Methyl Tertiary Butyl Ether Prods. Liab.*, 379 F. Supp. at 441; *Tuttle v. Lorillard Tobacco Co.*, 377 F.3d 917, 926 (8th Cir. 2004); *Spain v. Brown & Williamson Tobacco Corp.*, 363 F.3d 1183, 1201 (11th Cir. 2004); *Waterhouse v. R.J. Reynolds Tobacco Co.*, 270 F. Supp. 2d 678, 685-86 (D. Md. 2003); *Hearn v. R.J. Reynolds Tobacco Co.*, 279 F. Supp. 2d 1096, 1117 (D. Ariz. 2003); *Sackman v. Liggett Grp., Inc.*, 965 F. Supp. 391, 393 (E.D.N.Y. 1997); *In re N.D. Pers. Injury Asbestos Litig. No. 1*, 737 F. Supp. 1087, 1096 (D. N.D. 1990); *Lewis v. Lead Indus. Framework - 35 Ass'n*, 793 N.E.2d 869, 879 (Ill. App. Ct. 2003); *Nicolet v. Nutt*, 525 A. 2d 146, 147 (Del. 1987).

<sup>6</sup> In toxic tort cases, plaintiffs often allege both fraudulent concealment and fraudulent misrepresentation simultaneously. *See Sackman*, 965 F. Supp. at 393; *Nicolet*, 525 A. 2d at 147 (recognizing both causes of action). *But see Glassner*, 223 F.3d at 345-46; *Tompkin v. Am. Brands*, 219 F.3d 566, 567 (6th Cir. 2000) (granting summary judgment based on a plaintiff's failure to establish a cause of action on either fraudulent concealment or fraudulent misrepresentation claims).

<sup>7</sup> *See United States v. Philip Morris USA, Inc., et al.*, 449 F. Supp. 2d 1, 26-27 (D.D.C. 2006).

regarding firms' incentives to conceal information either unilaterally or, in the context of a cartel or conspiracy, jointly.

Specifically, this article analyzes a firm's costs and benefits from illegally concealing relevant safety information about its products. This article also explores the incentives to collude with other firms to more effectively sustain the concealment of such information. Then, the article presents the legal claims made in a mass tort case and provide the economic framework for a more efficacious analysis of these claims. In that respect, the dynamic nature of the market for information also suggests necessary conditions under which a firm might rationally engage in these tortious activities.

Failure-to-warn is often a cause of action in products liability cases, both under negligence and strict liability. By contrast, the focus in this article is on cases in which plaintiffs allege intentional misrepresentation by defendants, which includes an element of *scienter*.<sup>8</sup> Fraudulent misrepresentation claims, while having less stringent statute of limitation constraints,<sup>9</sup> provide plaintiffs the additional possibility of recovering punitive damages. In some cases, plaintiffs fail to muster the scrutiny that courts impose on proving fraudulent misrepresentation "by clear and convincing evidence."<sup>10</sup> In fact, toxic tort cases in which a plaintiff alleges fraudulent misrepresentation have been dismissed on summary judgment based on the plaintiff's failure to provide sufficient support for at least one element of fraud.<sup>11</sup> This article explains how a look at a firm's behavior through the lens of its dynamic optimization problem may provide some guidance to the court's evaluation of fraudulent intent.

It should be further noted that in a fraudulent misrepresentation claim, a plaintiff may also allege that defendants acted in concert or tortiously conspired against a plaintiff. If proven, such allegations may lead to treble damages under a theory of joint and several liability. Thus, such collective action theories may enable a plaintiff to recover even in the event that the damages cannot be specifically attributed to an individual defendant.<sup>12</sup> To succeed in either of these claims, however, a plaintiff has the burden of proving every element of concert of action<sup>13</sup> or civil conspiracy.<sup>14</sup> Most

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<sup>8</sup> For our purposes, *scienter* refers to a defendant's knowledge of his or her statement being a fraudulent misrepresentation.

<sup>9</sup> In an intentional misrepresentation case, the clock starts ticking for statute of limitation purposes only when the plaintiff is on notice of the defendant's fraudulent behavior.

<sup>10</sup> See *Adams v. NVR Homes, Inc.*, 135 F. Supp. 2d 675, 690 (D. Md. 2001).

<sup>11</sup> See, e.g., *Glassner*, 223 F.3d at 353 (dismissing on summary judgment a fraudulent misrepresentation allegation on the grounds that the plaintiff failed to show justifiable reliance on tobacco companies' misrepresentation of their products).

<sup>12</sup> Furthermore, the showing of defendants' engagement in any coordinated effort may provide some evidence in proving *scienter*.

<sup>13</sup> See RESTATEMENT (SECOND) OF TORTS § 876 (AM. LAW INST.1977).

importantly, in both of these collective liability cases, the plaintiff must show a knowing agreement or *meeting of the minds* between the defendants.<sup>15</sup>

However, when there is an allegation of a conspiracy to conceal information among producers, the proverbial "smoking gun" evidence of a collective understanding and intentional agreement is rarely available to the finder of fact. Although conspiracies may sometimes be uncovered as a result of conspirators' sloppiness or negligence, conspiratorial conduct is by its very nature self-concealing. Most courts recognize this constraint in obtaining direct evidence of intentional engagement in a civil conspiracy.<sup>16</sup> Accordingly, courts frequently accept information regarding the conduct of the alleged co-conspirators and the nature of non-conspiratorial market outcomes in the industry in question as being sufficient circumstantial evidence to state a claim.<sup>17</sup>

There is a substantial economic literature regarding conspiracies under the economic concept of "collusion." The factors of the economic environment upon which this literature focuses include market-power, alignment of incentives, and ability to enforce compliance. However, due to its inherently dynamic characteristics, an alleged conspiracy to control the generation and dissemination of information raises specific issues that go beyond the standard economic analysis of collusion. Consideration of these issues would provide a court with a more comprehensive guide to evaluating the economic evidence in alleged conspiracies in mass tort litigation. This article discusses the theoretical economic framework as would be relevant to the court's consideration.

The remainder of this article is organized as follows. In Part I, the article provides a brief account of mass tort litigation in the U.S. and the claims made by plaintiffs who allege that defendants have materially misrepresented the products they sell. In Part II, the article presents an economic theory based analysis that a firm would make in measuring the costs and benefits of concealing information; the revelation of which can be materially damaging to the firm. In Part III, the article provides a similar discussion on a firm's cost and benefit analysis in deciding whether to conspire or collude with other firms within its industry to conceal damaging information. In Part IV, the article applies these economic theories to two industries that have been defendants in mass tort cases in the U.S., i.e. MTBE and Tobacco industries. This article concludes by suggesting directions for future work.

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<sup>14</sup> See, e.g., *Blackmon v. Am. Home Prods. Corp.*, 346 F. Supp. 2d 907, 921 (S.D. Tex. 2004); *In re N.D. Pers. Injury Asbestos Litig.* No. 1, 737 F. Supp. 1087, 1096 (D.N.D. 1990).

<sup>15</sup> See *Am. Tobacco Co. v. United States*, 328 U.S. 781, 810 (1946).

<sup>16</sup> See *United States v. Fox*, 902 F.2d 1508, 1515 (10th Cir.), *cert. denied*, 498 U.S. 874 (1990).

<sup>17</sup> See, e.g., *Beard v. Worldwide Mortg. Corp.*, 354 F. Supp. 2d 789, 816 (W.D. Tenn. 2005); *Hearn v. R.J. Reynolds Tobacco Co.*, 279 F. Supp. 2d 1096, 1117 (D. Ariz. 2003).

A. *Mass Tort Litigation And Allegations of Concealing Safety Information*

A “mass tort” lawsuit can be defined as involving “tortious misconduct associated with a mass-marketed product that affects large numbers of people nationwide by way of recurring patterns of injury that may remain latent for years or decades.”<sup>18</sup> Industries embroiled in mass tort litigation in recent decades include asbestos, tobacco, lead paint, chrome, and underground storage tank producers. Mass tort litigation has become an important part of the civil litigation landscape in the United States and allegations that defendants have concealed relevant health and safety information has been a prime component of this litigation.<sup>19</sup> Substantial damages have often been at stake. For example, asbestos liabilities have triggered widespread bankruptcies among users and producers of asbestos products,<sup>20</sup> as billions of dollars have been paid to resolve damage claims and related costs.<sup>21</sup> More recently, in a landmark suit, the U.S. government unsuccessfully sought \$289 billion in health care costs from major tobacco companies,<sup>22</sup> in addition to the over \$10 billion per year the industry had already agreed to pay to 46 states in perpetuity in a Master Settlement Agreement.<sup>23</sup>

Generally, mass tort lawsuits share common themes. Among products liability theories, plaintiffs frequently allege that firms concealed information under negligent failure-to-warn<sup>24</sup> and fraudulent misrepresentation<sup>25</sup> claims. In the former types of a cause of action, the

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<sup>18</sup> Richard A. Nagareda, *Autonomy, Peace, and Put Options in the Mass Tort Class Action*, 113 HARV. L. REV. 747, 750 (2002).

<sup>19</sup> See generally Blomquist, *supra* note 1, at 163 (discussing various toxic tort cases with fraudulent misrepresentation claims). See also Rabin, *supra* note 1, at 866 (indicating the point at which courts began to accept fraud as viable claims in tobacco tort cases); PAUL BRODEUR, *OUTRAGEOUS MISCONDUCT: THE ASBESTOS INDUSTRY ON TRIAL* 142-44 (1985) (outlining asbestos producing companies' calculated cover-up of their products negative health consequences to humans).

<sup>20</sup> See Robert Jones, *The Manville Bankruptcy: Treating Mass Tort Claims in Chapter 11 Proceedings*, 96 HARV. L. REV. 1121, 1121 (1983).

<sup>21</sup> Paul Brodeur, *The Cruel Saga of Asbestos Disease*, L.A. TIMES, (Feb. 18, 2005).

<sup>22</sup> See *United States v. Phillip Morris USA, Inc., et al.*, 449 F. Supp. 2d 1, 28 (D.D.C. 2006) (finding that major tobacco companies have defrauded the American people and have violated racketeering laws but failing to award damages due to restrictions imposed on financial remedies based on civil RICO law violations).

<sup>23</sup> See NATIONAL ASSOCIATION OF ATTORNEYS GENERAL, *Master Settlement Agreement*, <http://www.naag.org/assets/redesign/files/msa-tobacco/MSA.pdf>.

<sup>24</sup> See, e.g., *Tompkin v. Am. Brands*, 219 F.3d 566, 568 (6th Cir. 2000); *Carel v. Fibreboard Corp.*, 74 F.3d 1248 (10th Cir. 1996); *Borel v. Fibreboard Paper Prods. Corp.*, 493 F.2d 1076, 1081 (5th Cir. 1973); *In re Methyl Tertiary Butyl Ether Prods. Liab. Litig.*, 175 F. Supp. 2d 593, 599-600, 625 (S.D.N.Y. 2001).

<sup>25</sup> See, e.g., *Glassner v. R.J. Reynolds Tobacco Co.*, 223 F.3d 343, 353 (6th Cir. 2000); *Keywell Corp. v. Weinstein*, 33 F.3d 150, 160 (2d Cir. 1994); *Tompkins v. R.J. Reynolds Tobacco Co.*, 92 F.

plaintiff must prove that the product at issue “is defective because of inadequate instructions or warnings when the foreseeable risks of harm posed by the product could have been reduced or avoided by the provision of reasonable instructions or warnings . . . and the omission of the instructions or warning renders the product not reasonably safe.”<sup>26</sup> Furthermore, the plaintiff must show that the defendant owed him a duty to warn.<sup>27</sup> In a fraudulent misrepresentation case, a plaintiff has the more burdensome task of proving to the court that the defendant (1) intentionally made (2) false representation,<sup>28</sup> with the (3) intent to induce the plaintiff to act or refrain from acting, and that the plaintiff (4) justifiably and (5) detrimentally relied on the false representation.<sup>29</sup>

Plaintiffs also often bring lawsuits under a collective liability theory alleging a concert of action or conspiracy by industry participants to conceal the adverse health consequences of industry products.<sup>30</sup> Perceived benefits to plaintiffs from raising a collective liability claim include a potential for obtaining joint and several liability from defendants, the possibility of asserting jurisdiction over a non-resident defendant, and the possibility of extending the statute of limitations.<sup>31</sup> Perhaps because of these perceived benefits, civil conspiracy allegations have been raised in toxic mass tort cases against numerous industries. Examples include MTBE, tobacco, lead-based paint, hydrochloric acid, asbestos, and chrome.<sup>32</sup>

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Supp. 2d 70, 83 (N.D.N.Y. 2000); *Albertson v. Richardson-Merrell, Inc.*, 441 So. 2d 1146, 1147 (Fla. App. Ct. 1983).

<sup>26</sup> See RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 2(c) (AM. LAW INST. 1998).

<sup>27</sup> See RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 2 cmt. i. (AM. LAW INST. 1998).

<sup>28</sup> Communication orally or in writing, a sample or model, action, or inaction are all possible forms of representation.

<sup>29</sup> See RESTATEMENT (SECOND) OF TORTS § 525 (AM. LAW INST. 1977).

<sup>30</sup> See *Tuttle v. Lorillard Tobacco Co.*, 377 F.3d 917, 926 (8th Cir. 2004); *Spain v. Brown & Williamson Tobacco Corp.*, 363 F.3d 1183, 1201 (11th Cir. 2004); *In re Methyl Tertiary Butyl Ether Products Liab.*, 379 F. Supp. 2d 348, 440 (S.D.N.Y. 2005); *Hearn v. R.J. Reynolds Tobacco Co.*, 279 F. Supp. 2d 1096, 1117 (D. Ariz. 2003); *Waterhouse v. R.J. Reynolds Tobacco Co.*, 270 F. Supp. 2d 678, 685-86 (D. Md. 2003); *Sackman v. Liggett Group, Inc.*, 965 F. Supp. 391, 394-95 (E.D.N.Y. 1997); *Kraus v. Celotex Corp.*, 925 F. Supp. 646, 652 (E.D. Mo. 1996); *Hurt v. Phila. Hous. Auth.*, 806 F. Supp. 515, 531-32 (E.D. Pa. 1992); *Santiago v. Sherwin-Williams Co.*, 794 F. Supp. 29, 33 (D. Mass. 1992); *In re DES Cases*, 789 F.Supp. 552, (E.D.N.Y. 1992); *Morton v. Abbott Labs.*, 538 F. Supp. 593, 596-97 (M.D. Fla. 1982); *In re N.D. Pers. Injury Asbestos Litig. No. 1*, 737 F. Supp. 1087, 1096 (D. N.D. 1990); *Marshall v. Celotex Corp.*, 691 F. Supp. 1045, 1046 (E.D. Mich. 1988); *Chavers v. Gatke Corp.*, 132 Cal. Rptr. 2d 198, 205-06 (Ct. App. 2003); *Lewis v. Lead Indus. Framework - 35 Ass'n*, 793 N.E.2d 869, 878 (Ill. App. Ct. 2003); *Nicolet v. Nutt*, 525 A. 2d 146, 147 (Del. 1987); *Hymowitz v. Eli Lilly & Co.*, 539 N.E.2d 1069, 1074 (N.Y. 1989); *Bichler v. Eli Lilly & Co.*, 436 N.E.2d 182, 188 (N.Y. Ct. App. 1982).

<sup>31</sup> See Richard Ausness, *Conspiracy Theories: Is There a Place for Civil Conspiracy in Products Liability Litigation?*, 74 TENN. L. REV. 383, 392-96, 407-08 (2007); Thomas L. Leach, *Civil Conspiracy: What's the Use?*, 54 U. MIAMI L. REV. 1, 1-14 (1999).

<sup>32</sup> See *supra* note 30.

Under the concert of action theory, a defendant is found to be vicariously liable to a plaintiff if he: (a) does a tortious act in concert with the other or pursuant to a common design with him, or (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.<sup>33</sup> Similarly, a civil conspiracy necessitates an element of scienter that shows a meeting of the mind between co-conspirators. Although the necessary elements of a "civil conspiracy" can differ by state, the claim commonly requires the following five elements: (1) two or more persons, (2) an objective to commit an unlawful act or commit a lawful act by unlawful means, (3) a meeting of minds on the objective or activity (4) an overt act done for the purpose of furthering the conspiracy, and (5) damage to another resulting from the conspiracy.<sup>34</sup>

Economic theory of a firm's incentive to conceal information, individually or in collusion with other firms within the industry, can give courts much guidance in assessing the validity of such mass toxic tort claims and the application of collective liability theories. The next Section provides an economic theory based analytic framework that helps identify the elements necessary to incentivize firms to engage in the tortious activities of information concealment.

## II. THE COSTS AND BENEFITS OF CONCEALING INFORMATION

### A. *Markets For Information*

In order to assess the costs and benefits to firms of concealing safety information, it is first important to consider the economics of markets for information. Economists often define "market" as the organizational or institutional forum that facilitates interactions between buyers and sellers who determine prices and quantities exchanged.<sup>35</sup> Markets can exist for essentially anything of economic value—including products, services and financial assets.

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<sup>33</sup> See RESTATEMENT (SECOND) OF TORTS § 876 (AM. LAW INST. 1977).

<sup>34</sup> See Ausness, *supra* note 31, at 390. See also *Sonnenreich v. Philip Morris, Inc.*, 929 F. Supp. 416, 419, (S.D. Fla. 1996); *Nicolet*, 525 A.2d at 149-50; *Jay Edwards, Inc. v. Baker*, 534 A.2d 706, 709 (N.H. 1987).

<sup>35</sup> See ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 7 (8th ed. 2012).

Information plays a central role in modern economic analysis.<sup>36</sup> Economic actors are normally assumed to follow their incentives as they understand them, and thus their behavior can depend on the information that is available to them, and also their beliefs about the information that might be available to others. Information can be thought of as a commodity that is produced and exchanged in a market for information. Economists have extensively studied markets for information in a variety of contexts, such as financial assets and biotechnology.<sup>37</sup> There is also a large literature on the economics of personal information and privacy.<sup>38</sup> Many tools and principles of economic analysis can be directly applied to information markets.<sup>39</sup> Just as in ordinary markets, information markets have a variety of participants, including generators of information, disseminators of information, and consumers of information.<sup>40</sup> These information market participants are, *prima facie*, assumed to be acting in ways that reflect their own understanding of their own self-interest.<sup>41</sup> Furthermore, while markets for information have their own idiosyncrasies, they share several characteristics with other forms of markets for goods and services.<sup>42</sup>

In markets for goods or services, for instance, antitrust principles can be used to delineate distinct and separate markets. An antitrust market can be defined as the smallest set of products such that a hypothetical monopolist supplying that set could profitably maintain a small but significant and non-transitory increase in price (“SSNIP”) through the period in which entry could normally be expected to occur.<sup>43</sup> Thus, market definition is related to the degree of substitutability.<sup>44</sup> Products that are good substitutes for the product in question are normally in the same market, since competition from substitutes tends to limit the profitable

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<sup>36</sup> Issues related to information tend to permeate economics textbooks and journals. *See, e.g.*, DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 448 (4th ed. 2004); *see also*, PINDYCK & RUBINFELD, *supra* note 35 at 631.

<sup>37</sup> *See, e.g.*, Massimo Massa, *Financial Innovation and Information: the Role of Derivatives When a Market for Information Exists*, 15 *REV. FIN. STUD.* 927 (2002); Edna F. Emsiedel, *The Market for Credible Information in Biotechnology*, 21 *J. OF CONSUMER POL’Y* 405 (1998).

<sup>38</sup> *See, e.g.*, Kai-Lung Hui & Ivan P.L. Png, *Handbooks in Information Systems, in THE ECONOMICS OF PRIVACY*, 1 (T. Hendershott ed., 2006).

<sup>39</sup> *See, e.g.*, Joseph E. Stiglitz, *The Contributions of the Economics of Information to Twentieth Century Economics*, 115(4) *Q. J. ECON.* 1441 (2000) [hereinafter *Stiglitz Contributions*]; Joseph E. Stiglitz, *Information and Economic Analysis: A Perspective*, 95 *ECON. J.* 21 (1985).

<sup>40</sup> *See, e.g.*, George J. Stigler, *The Economics of Information*, 69(3) *J. POL. ECON.* 213 (1961); George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84(3) *Q. J. ECON.* 488 (1970).

<sup>41</sup> *Id.*

<sup>42</sup> *See Stiglitz Contributions, supra* note 39 at 1446.

<sup>43</sup> *See* U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, *HORIZONTAL MERGER GUIDELINES* § 4.1 (2010) [hereinafter 2010 GUIDELINES].

<sup>44</sup> *Id.*

exercise of monopoly power.<sup>45</sup> On the other hand, a monopolist is not constrained by products or services that cannot serve as a substitute for the monopolist's wares, and such products will not be in the same market.

Similarly, distinct markets for different kinds of information can coexist simultaneously in the economy. Each market is likely to differ in terms of market participants, market dynamics, and the nature of the information that is produced and exchanged. For example, the market for information about presidential candidates is likely to differ substantially from the information market related to new automotive technologies.

Furthermore, a basic property of a market equilibrium is that participants have no incentive to deviate from their current behavior.<sup>46</sup> Accordingly, a market for information can be thought of as being in equilibrium when no market participant wants to change their behavior in generating, disseminating, or consuming information.<sup>47</sup> However, similar to other types of markets, the notion of equilibrium need not imply the existence of consensus among the market participants nor a proportional control over the market for any given information.

In a market for goods or services, a firm has market power when it has the ability to profitably "raise price, reduce output, diminish innovation, or otherwise harm customers as a result of diminished competitive constraints or incentives."<sup>48</sup> In other words, a firm has effective control of the market equilibrium. Market power can often be a matter of degree and depends on the responses of both current as well as potential competitors. Accordingly, antitrust authorities normally set threshold tests of market power<sup>49</sup> in which a firm would be said to have market power if it could profitably maintain a small but significant price increase through the period in which entry could normally be expected to occur.<sup>50</sup> In order to exercise market power in this way, a firm must therefore be relatively unconstrained by the profit-seeking incentives of its current and potential competitors, as well as by buyers' incentives to seek cheaper substitutes.

Similarly, in the case of a market for information, a market participant can be said to have market power when it has the ability to profitably control the equilibrium of the informational market. Just as in ordinary markets, one must be relatively unconstrained by the incentives and abilities of other participants to seek their own advantages by their

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<sup>45</sup> *Id.*

<sup>46</sup> See Huw Dixon, *Equilibrium and Explanation*, in JOHN CREEDY, FOUNDATIONS OF ECONOMIC THOUGHT 356, 358 (1990).

<sup>47</sup> 2010 GUIDELINES, *supra* note 43 at §2.3.

<sup>48</sup> See *Id.* at § 1.

<sup>49</sup> Such as the SSNIP test often used by the U.S. Department of Justice and the Federal Trade Commission (DOJ/FTC).

<sup>50</sup> See 2010 GUIDELINES, *supra* note 43 at § 4.1.

generation, dissemination, or consumption choices, in order to exercise market power in an information market.

However, there exists a key difference between markets for information and other forms of markets for goods and services. Namely, the behavior of participating agents in the former is substantially more dependent on dynamic considerations. A firm's decision whether to conceal information about its products and whether to engage in a conspiracy to do so will heavily depend on the current exclusivity and materiality of the information as well as how these are expected to evolve. Next, we consider how these dynamic considerations of the market for information affect a rational agent's incentive to conceal safety information. Then, we will explain how such an analysis would give a framework within which a court could effectively evaluate the validity of a plaintiff's information concealment allegations.

## B. *Evaluating The Costs and Benefits of Information Concealment*

### 1. What Information Should be Revealed?

In assessing the costs and benefits to firms of health and safety information "concealment," it is also necessary to establish what health and safety information the law should be concerned with. Allegations of concealment of health and safety information in mass tort litigation have commonly entailed claims of fraudulent concealment, failure-to-warn, or both.<sup>51</sup> From an economics perspective, we are concerned with health and safety information about a product that, once revealed, will cause a substantial decline in the demand for that product. This decline in demand can come through a change in consumer preferences, new legislation or regulation, or a combination of these.

Many large firms obtain new information of various types on the health and safety of their products on a daily or near daily basis, and sometimes many times a day.<sup>52</sup> It would obviously be too onerous an economic burden to require such firms to publicly reveal every bit of

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<sup>51</sup> See, e.g., *In re Methyl Tertiary Butyl Ether Prods. Liab.*, 379 F. Supp. 2d 348, 440 (S.D.N.Y. 2005); *In re Methyl Tertiary Butyl Ether Prods. Liab.*, 175 F. Supp. 2d 593 (S.D.N.Y. 2001); *Castano v. American Tobacco Co.*, 84 F. 3d 734 (5<sup>th</sup> Cir. 1996); see also Exhibit D of NATIONAL ASSOCIATION OF ATTORNEYS GENERAL, *Master Settlement Agreement*, <http://www.naag.org/assets/redesign/files/msa-tobacco/MSA.pdf>, where a list of lawsuits related to the master settlement are provided.

<sup>52</sup> See J. Collier & I. Iheanacho, *The Pharmaceutical Industry as an Informant*, 360 LANCET 1405, 1405-06 (2002); Jennifer Couzin, *Gaps in the Safety Net*, SCIENCE, (Jan. 14, 2005), at 196. For a detailed account of safety testing costs and how forced disclosure of data gathered may affect research incentives, see Thomas O. McGarity & Sidney A. Shapiro, *The Trade Secret Status of Health and Safety Testing Information: Reforming Agency Disclosure Policies*, 93 HARV. L. REV. 837, 848-49 (1980).

information they compile on their products on a continual basis and is likely to have little or no social value. Also, some information on a product's safety and health consequences can be incomplete, inaccurate or both. The revelation of such information could even have detrimental effects since it could cause irrational overreaction by regulators who might restrict the use of the product when it is socially undesirable to do so. For example, the EPA once banned the use of Alar, a chemical compound used by apple growers, although no other country banned this product and no scientific evidence existed that the product entailed a significant risk of causing cancer.<sup>53</sup> Thus, when referring to the concealment of information for the purpose of our discussion in this article, we do not include information that, once revealed, would cause an irrational decrease in the demand or supply of a product.

## 2. Costs and Benefits of Concealing Information

With the above economic framework of markets for information and a category for the relevant safety information, we are now ready to discuss the economic analysis a firm considers in deciding whether to reveal information potentially detrimental to the valuation of its product. A revelation of new information that a product being sold is unsafe will obviously reduce the demand and expected profitability of that product.<sup>54</sup> Thus, the expected benefits to a firm from successfully concealing information that its product is unsafe for any given time period would be equal to the amount of reduced profits of this firm if this information was revealed. On the other hand, any firm selling an unsafe product faces the prospect that the nature of the product will be discovered and the fraudulent concealment proven. Consequently, the firm will face litigation costs, including the possibility of punitive damages, and harm to reputation. This difference between the benefits of concealment and potential litigation costs is the cost of concealing information, and the amount of that cost is dependent on the probability that the nature of the product will be uncovered over time and whether there is sufficient evidence showing that the producer intentionally concealed this material information.

Therefore, total net benefits to concealing information are equal to the present discounted value of the difference between future expected

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<sup>53</sup> David Vogel, CTR. FOR ANALYSIS OF RISK AND REGULATION, LONDON SCH. ECON. & POL. SCI., *The New Politics of Risk Regulation in Europe* 1 (2001), <http://eprints.lse.ac.uk/35984/1/Disspaper3.pdf>.

<sup>54</sup> The information allegedly concealed in mass tort lawsuits can be related to safety, pollution, health, or a combination of these. For analytical simplicity we will place all of these information categories into the basket of "safety" information when discussing the costs and benefits of concealment.

incremental profits of selling an unsafe product and future expected litigation and reputational costs. Concealing safety information is only rational if the total net benefits of concealment are positive.

Thus, the critical factors that a firm will consider in determining whether there are any net benefits derived from concealing information about an unsafe product are: (1) the decline in profitability of the firm selling this product if safety information is revealed, (2) the probability that the unsafe nature of the product will be uncovered, (3) the probability that a plaintiff can prove that the defendant fraudulently concealed this information, and (4) the litigation and reputational costs that will be incurred by firms concealing information if this information is subsequently uncovered.<sup>55</sup> As explained below, each of these factors change over time due to dynamic elements internal and external to the firm. Therefore, the incentive for concealing information is initially dependent on the expected trajectory of these changes and is also likely to be dynamically updated along with the changing market for information.

First, consider the decline in product profitability that will occur if information is revealed. Other things equal, firms are unlikely to find it in their interest to conceal information about an unsafe product unless the profits of this product are high enough to offset the expected litigation and reputational costs incurred upon the future revelation of such information. For instance, if firms sell an unsafe product in a competitive market where there will be a low or no margin of profit, it is unlikely that they will derive net benefits from concealing information about the safety faults of its product. Thus, it would be irrational for a firm to conceal information about an unsafe product if it does not have market power or does not expect to be able to sustain the market power it currently possesses. Thus, long-term concealment of health hazards commonly alleged in mass torts litigation is difficult to maintain in industries characterized by increasing competition.

Alternative safer versions of the product at issue and the potential development of such alternatives should also be considered in a firm's assessment of whether there are additional profits to be made by concealing information. Firms will not have an incentive to conceal information about an unsafe product if there is an alternative product that brings profits that are at least nearly as great as the unsafe product but without the risk of future litigation costs and reputational harm. Thus, when there is a relatively low cost ability to develop alternative products not marred by safety concerns, then it is unlikely that firms will find it in their interest to conceal information and sell the product.<sup>56</sup>

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<sup>55</sup> The rate at which the firm discounts future costs and benefits can be important as well.

<sup>56</sup> Here, we are assuming that the availability and potential marketability of an alternative product is immediately apparent as the firm becomes aware of the damaging information. Otherwise, it could be the case that a firm that has concealed information before the discovery or development of safer

The profitability potential of alternative products also has important dynamic implications. Industries characterized by high rates of innovation are, in general, not susceptible to a concealment of safety information.<sup>57</sup> If a firm contemplating concealing information about an unsafe product, or one that is actively concealing such information, develops a competing product that is expected to yield profits close to or above those of the unsafe product, then this firm will often find it in its interest to reveal the detrimental information and sell its safer product. In addition to being able to stop incurring possible damages from selling products known to be unsafe, such information revelation could, in fact, enable the firm to effectively promote its new safer product. This is particularly true for new entrants capable of selling a competing and safer version of the product at issue.

Second, consider the probability that any concealed information will be uncovered over time. Working backwards from the potential of product safety information being revealed in the future, it can be shown that the incentives to conceal information in the present—and the ability to obtain a consensus to do so—can deter concealing information.<sup>58</sup> Firms will be unlikely to behave in ways that would expose them to significant expected litigation and reputational costs if they expect the profits from selling an unsafe product will be short lived.

Firms will not expect to profit from concealing information unless this concealment is expected to be successful at least through a period long enough that the expected incremental profits to firms from selling the unsafe product overcome expected future costs. That is, profits must be higher than the expected future litigation plus the reputational costs firms incur from concealing safety information and selling the product.<sup>59</sup> Otherwise, the discounted present value of future penalties may be sufficient to deter concealing information today. On the other hand, if a firm concealing information is shortsighted, it may effectively ignore the likelihood that what they have concealed will become known in the future,

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products may decide to continue the concealment in perpetuity in order to avoid litigation of certain causes of actions that are less constrained by statute of limitations.

<sup>57</sup> See Appendix D Part I-A *Individual Characteristics of Mass Torts Case Congregations: A report to the Mass Torts Working Group* FEDERAL JUDICIAL CENTER (1999), listing personal injury mass tort cases by product category.

<sup>58</sup> See, e.g., Masahiro Okuno-Fujiwara, Andrew Postlewaite & Kotaro Suzumura, *Strategic Information Revelation*, 57(1) REV. ECON. STUD. 25, 32 (1990). Although applied in a different context, the paper provides the theoretical model necessary to show how an agent can be deterred from concealing information.

<sup>59</sup> An antitrust conspiracy that ultimately falls apart need not be associated with any litigation costs or reputational effects as, unlike a conspiracy to conceal information, the end of an agreement will not necessarily imply that any adverse information is revealed to the public. Hence, conspirators attempting to raise price may only need to reach consensus at the present point in time and may not need to be ensured of the duration of the agreement.

after a latency period. If so, then the perceived enforcement-related "costs" of the concealment are likely to occur in the future, if at all, but the benefits accrue in the present, and the incentive to conceal information may be enhanced.

In order to successfully prevent safety information from being uncovered, and thereby control markets for information and innovation, firms attempting to conceal information must—at minimum—achieve the difficult task of controlling the dissemination of information of substantial market participants. In other words, these firms need to have at least the potential to be substantial generators of information or innovation. Even then, it is highly unlikely that a conspiracy over information or innovation could succeed without including all substantial participants in the product market.

The generators and disseminators of information that are capable of preventing a successful attempt to conceal such information are not limited to the future and current product market participants. Regulators, academics, and scientists, as well as producers of substitutes and complements for the product whose safety or innovation information has been suppressed may have both the incentive and the ability to either undercut or support an attempt to conceal such information. For example, information about the health risks associated with smoking was generated by a myriad of sources, and disseminated by a wide variety of agents. Tobacco industry participants constitute a small subset of these generators and disseminators, which included: academic and medical researchers; the American Cancer Society; Reader's Digest, which was the most widely read publication in the United States during the 1950s and 60s; and, of course, the Surgeon General along with the mandatory health warnings which were added to cigarette packaging and advertising.<sup>60</sup> Similarly, many entities outside the tobacco industry sought to commercialize innovations that were aimed at controlling or mitigating such risks.

To the extent a firm is effective at suppressing innovation and information about the risks of the current generation of the industry's products, a new entrant may find it increasingly profitable to carve out a niche in the market by competing on the basis of safety. This is because the new entrant in the industry will be unencumbered by past history of conspiracy and cover-up. As it is faced with this likely demand for a safer product, the firm will also have an incentive to publicly highlight the relatively less safe properties of the existing incumbent products. Thus, new entry is an important factor to consider when assessing the probability that safety information will be uncovered.

Third, greater expected litigation and reputational costs from concealing information reduce the expected profitability of concealing

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<sup>60</sup> Roy Nott, *Cancer by the Carton*, READER'S DIGEST, Dec. 1952; U.S. DEP'T OF HEALTH, EDUCATION, AND WELFARE, SMOKING AND HEALTH (1964).

information. These expected litigation and reputational costs are also likely to vary over time; such changes, in turn, alter the incentives of a firm to conceal information. In some instances, technological improvements may reduce the damages incurred by selling what was an unsafe product. For example, improvements in medicine may reduce the health consequences of a product or improvements in environmental clean-up may reduce the costs of remediating a spill of a toxic substance. Other things equal, when the damages incurred by concealing information and continuing to sell an unsafe product are reduced in this way, then firms have an increased incentive to conceal information. This is because the costs of concealing information and selling an unsafe product have been reduced but the benefits have not been impacted.

Finally, it should also be noted that a firm concealing information may have a greater incentive to continue the practice compared to initiating information concealment in the first place. This occurs for two reasons. First, any participant in an industry selling an unsafe product may be incurring increasingly large legal liabilities due to the continuing cover-up either unilaterally or as part of a conspiracy.<sup>61</sup> If there is a possibility that industry participants may be able to permanently avoid these legal liabilities, they will have an increasing incentive to continue to conceal information due to these escalating potential legal liabilities. Second, firms considering concealing information may face future costs that do not compound over the duration of concealment.<sup>62</sup> Such costs have a deterrent effect only until information concealment has begun.

### III. CONSPIRACIES TO CONCEAL INFORMATION

Mass tort litigation commonly involves not only a claim that information was concealed but that a conspiracy took place between multiple firms to conceal this information. Above, we considered the determinants of whether a firm will find it in its own unilateral self-interest to conceal information. Assessing whether or not a group of firms will be able to reach and maintain a conspiratorial agreement to conceal information requires an extension of this analysis. When examining the individual behavior of alleged conspirators who concealed information, one considers the possibility that firms concealed information based on their own individual incentives and not due to an agreement. However, in a market with multiple producers, one should further consider the ability of firms within the industry to reach and maintain an agreement. To that end,

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<sup>61</sup> See Al H. Ringleb & Steven N. Wiggins, *Liability and Large-Scale, Long Term Hazards*, 98(1) J. POL. ECON. 574, 577-78 (1990).

<sup>62</sup> For instance, harm to reputation is such a cost that will be incurred due to information concealment but the effect of which is not related to the duration of concealment.

traditional economic tools on the economics of collusion applied in an antitrust context are instructive. But, as we explain below, these tools must also be adapted to properly evaluate an alleged agreement to conceal information.

A. *Distinguishing Conspiracy From Unilateral Behavior*

As explained above, under certain conditions, firms may have an incentive to conceal the unsafe nature of a product they are selling. However, if each firm with information about the safety of a product finds it profitable to conceal this information, no agreement between firms will be necessary, as each firm will find it in its individual self-interest to do so. Thus, it is not usually possible to infer a conspiratorial agreement based on parallel conduct alone. Consistent with this, courts have rejected civil conspiracy claims based solely on evidence of parallel behavior.<sup>63</sup>

The need for firms to rationally enter into a civil conspiracy arises only if at least one firm has a unilateral incentive to disclose this information. This incentive must be overcome through some form of payments made by conspirators whose unilateral incentive is to conceal information. Thus, when the plaintiff's claim is simply that firms have not revealed information in their possession, it should be noted that an intra-industry agreement to conceal is necessary only in the event that at least one firm's silence need to be bought. Furthermore, in some instances, plaintiffs claim that defendants conspired to generate false information. Contrary to such an allegation, it could be the case that the defendant firms do not have an incentive to conspire to achieve an outcome which is inconsistent with unilateral incentives, but instead may collaborate to ensure that the goals that each individual firm shares are achieved more efficiently. For example, resources may be shared in joint generation of information that may help ensure a consistent message across firms.

B. *Traditional Economic Analysis of Collusion*

Economists typically evaluate conspiratorial agreements in the context of agreements to reduce competition and raise prices by using the terms "conspiracy," "collusion" or "collusive agreement" interchangeably.<sup>64</sup> There is a broad consensus in the economic literature as to the minimum

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<sup>63</sup> See Ausness, *supra* note 31 at 397-99.

<sup>64</sup> Sometimes economists also use the word "cartel" to describe a collusive organization.

economic prerequisites for such collusive agreements to reduce competition actually having an effect in the marketplace.<sup>65</sup>

The first test of an economic analysis of collusion is: could the alleged conspiracy have succeeded? From an economic point of view, that test encompasses the following essential elements:

1. Participants must be able to effectively *control the object* of the alleged conspiracy.<sup>66</sup>
2. Participants must be able to *align* their possibly disparate *incentives* and *reach and maintain consensus* as to the objectives and means of the alleged conspiracy.<sup>67</sup>
3. Participants must be able to *monitor* each other's behavior in order to detect "cheating," and to *punish* cheating when it is detected.<sup>68</sup>

From an economic point of view, each of these prerequisites of an effective collusive agreement has implications for the kinds of economic activities and outcomes one would expect to observe in the marketplace. For example, when alleged conspirators' incentives tend to diverge, substantial balancing payments or other compensating incentives may be

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<sup>65</sup> There is a large volume of literature analyzing and explaining the structural conditions of such a market. See, e.g., U.S. DEP'T OF JUST. AND THE FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES (1992) [hereinafter 1992 GUIDELINES]; Margaret C. Levenstein & Valerie Y. Suslow, *What Determines Cartel Success?*, 44 J. ECON. LIT. 43, 44 (2006); Andrew Dick, *When are Cartels Stable Contracts?*, 39 J.L. & ECON. 241, 249-50 (1996); Peter Asch & Joseph Seneca, *Characteristics of Collusive Firms*, 23 J. IND. ECON. 223, 223-25 (1975); Thomas Ross, *Cartel Stability and Product Differentiation*, 10 INT. J. IND. ORG. 1, 3-4 (1992); John Haltiwanger & Joseph E. Harrington, *The Impact of Cyclical Demand Movements on Collusive Behavior*, 22(1) RAND J. OF ECON. 89, 93-97 (1991); CARLTON & PERLOFF, *supra* note 36, at Chapter 5.

<sup>66</sup> This is analogous to the presumption of the 1992 Merger Guidelines: mergers that do not create or enhance market power are unlikely to have potential adverse effects on competition. In the case of pricing, the Merger Guidelines define market power as the "ability profitably to maintain prices above competitive levels for a significant period of time", 1992 GUIDELINES, *supra* note 65, at 2. In the context of a market for information, this definition needs to be modified as discussed in detail below.

<sup>67</sup> "[T]he terms of coordination may be imperfect and incomplete . . . and still result in significant competitive harm. At some point, however, imperfections cause the profitability of abiding by the terms of coordination to decrease and, depending on their extent, may make coordinated interaction unlikely in the first instance." 1992 GUIDELINES, *supra* note 65, at 20.

<sup>68</sup> "Where market conditions are conducive to timely detection and punishment of significant deviations, a firm will find it more profitable to abide by the terms of coordination than to deviate from them. Deviation from the terms of coordination will be deterred where the threat of punishment is credible . . . Where detection and punishment likely would be rapid, incentives to deviate are diminished and coordination is likely to be successful . . . By contrast, where detection or punishment is likely to be slow, incentives to deviate are enhanced and coordinated interaction is unlikely to be successful." 1992 GUIDELINES, *supra* note 65, at 20-21.

needed before the conspirators can reach consensus.<sup>69</sup> Similarly, in order to monitor and punish, the conspirators need to utilize an organizational and institutional framework that permits the transmission of information about individual conspirator's actions and credibly facilitates the metering out of punishments.<sup>70</sup>

### 1. Control

The requirement that the conspirators control the object of the collusion is tantamount to requiring that the conspirators have market power in a cognizable market. Otherwise, the conspiracy would have no effect on the marketplace, no matter how capable the conspirators were in organizing and coordinating their behavior.

For example, suppose a set of erstwhile competitors get together and agree to set a minimum selling price that lies strictly above the price currently prevailing in the marketplace. If the conspirators do not have market power, then such price-fixing efforts are likely to fail. If prices rise to an artificially high level, then the excess profits available at those prices will attract entry into the industry and stimulate competition from non-colluding parties. It is precisely this competition or the threat thereof that maintains competitive pricing even in the face of attempted collusion. By contrast, in the citric acid and lysine price fixing cases, often cited as examples of recent collusive agreements, Archer Daniels Midland ("ADM") and its competitors in those industries had market power in hard-to-enter industries.<sup>71</sup> As such, it is more likely that their market division and price-fixing efforts could have had a significant effect on market outcomes.

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<sup>69</sup> Such a diversion is observed, for instance, when there are significant differences in the size of firms or the extent to which they compete in different geographic or functional regions of the market.

<sup>70</sup> "For example, the extent of information available to firms in the market, or the extent of homogeneity, may be relevant to both the ability to reach terms of coordination and to detect or punish deviations from those terms." 1992 GUIDELINES, *supra* note 65, at 19. Arguably, the market conditions that determine both 'the extent of information' and the homogeneity of incentives can be endogenous to the conspiracy. Indeed, to the extent that the organizational and institutional structure of the marketplace does not facilitate reaching an agreement as to the terms of coordination or permit monitoring and/or punishment, then in order to succeed, the conspiracy must create such organizational or institutional conditions—else the conspiracy is doomed to fail.

<sup>71</sup> See, e.g., John M. Connor, *The Global Citric Acid Conspiracy: Legal-Economic Lessons*, 14 AGRIBUSINESS 435, 438 tbl.1 (1998); John M. Connor, *The Global Lysine Price-Fixing Conspiracy of 1992-1995*, 19 REV. AGR. ECON. 412, 413 (1997).

## 2. Consensus and Coordination

Conspirators often have conflicting incentives. In fact, the need for a conspiratorial agreement arises only in the event that disparity exists in incentives among firms who wish to align their actions within the market. Thus, in order for a successful collusive agreement to be established, putative conspirators must find a way of aligning these incentives in the form of an agreement that is acceptable to each of the parties involved. If the firms cannot coordinate their activities by reaching an agreement that is acceptable to all, then a successful conspiracy is not possible.

Disparities in incentives will often occur when putative conspirators operate at different levels of a vertical distribution chain. For example, manufacturers selling a product that is used as an input into a final product will likely prefer that the price of that input be high. However, other firms using that input to produce and sell a final product will likely prefer a lower price on that input.<sup>72</sup> In order to reach an agreement between manufacturers and the firms selling the final good, the incentives of the manufacturers, who desire a higher price on the input, must be aligned somehow with the incentives of the firms, who prefer a lower price on the input, selling the final good. If these incentives cannot be aligned, then a successful agreement is impossible.

There are several questions that must be addressed when assessing whether or not firms have an ability to reach an agreement when they have divergent incentives. How disparate are the incentives? For any disparity in incentives between parties, how will this disparity be resolved? An agreement that aligns the incentives of putative conspirators also requires an organizational apparatus that is capable of implementing it.

As an example, in the lysine conspiracy, ADM had substantial excess capacity, relative to its competitors.<sup>73</sup> Therefore, ADM had at least a plausible incentive to increase its market share by reducing price. This would have been in ADM's interest but against the interests of its co-conspirators. In this case, however, ADM used this plausible incentive to credibly threaten to flood the market if the other conspirators failed to agree to the division of the market that ADM advocated. Apparently this was one way that ADM was able to enforce consensus with its co-conspirators.<sup>74</sup>

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<sup>72</sup> Even while these firms at the higher end in the chain of production are aiming for a higher price on the final good.

<sup>73</sup> See William Kolasky, U.S. Dep't of Justice, Antitrust Compliance Programs: The Government Perspective, Address Before the Corporate Compliance 2002 Conference (July 12, 2002) at 11.

<sup>74</sup> Connor, *supra* note 71, at 418.

### 3. Monitoring and Punishment

Cartel agreements to reduce competition can be quite difficult to maintain because there are economic forces such as the difficulty of monitoring adherence to an agreement that exert pressure against them. Hence, the economic history of cartels is characterized by instability and a tendency toward intermittent or permanent failure. For example, there have been a number of natural-resource cartels whose effects have been non-transient, including cartels in coal, rubber, tea, oil, and uranium.<sup>75</sup> Because many of these cartels (especially those in existence prior to World War II) were government-sponsored and therefore legal, it was substantially easier to operate the cartel—for example, meetings could be held openly. Notwithstanding this feature, even government-sponsored cartels can and do fail.

In a price-fixing conspiracy, because individual cartel members have incentives to “cheat”—to produce more than the agreed-to output, thereby undermining the conspiratorial price—conspirators need to monitor each other’s outputs. This can be surprisingly difficult. And punishing cheating, while relatively easy to execute, can force the punishing participant to incur significant costs. Normally punishments are “in kind”: cheating is deterred by the threat, usually from one or more substantial cartel members, to expand output and reduce prices.

One example is the role played by ADM in the citric acid and lysine cartels.<sup>76</sup> As part of its investigation, the FBI taped meetings and conversations between the conspirators.<sup>77</sup> From the evidence gathered in the case, it was in fact determined that ADM threatened to use its superior capacity to flood the market unless the other conspirators adhered to the cartel output limits.<sup>78</sup>

Consider also the case of OPEC. Even though OPEC is a legal cartel, it has been generally unsuccessful in maintaining monopoly prices for oil.<sup>79</sup> The reason is that the cartel members have substantial difficulty in monitoring each other’s output, and many of the member countries therefore apparently cheat on the cartel’s agreed-to output restrictions. To punish cheating, in the past, Saudi Arabia resorted to ‘flooding’ the market

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<sup>75</sup> See David J. Teece, David Sunding & Elaine Mosakowski, *Natural Resource Cartels*, in *HANDBOOK OF NATURAL RESOURCE AND ENERGY ECONOMICS* 1131-1166 (Allen V. Kneese and James L. Sweeney eds., 1993).

<sup>76</sup> See Kolasky, *supra* note 73, at 11.

<sup>77</sup> See Connor, *supra* note 71 at 419.

<sup>78</sup> The cartel not only set an overall limitation on output, but also allocated output to each conspirator. See Kolasky, *supra* note 73 at 11. See also, Connor, *supra* note 71 at 419.

<sup>79</sup> See, e.g., Griffin, James M. & Weiwen Xiong, *The Incentive to Cheat: An Empirical Analysis of OPEC*, 40 *J. LAW ECON.* 289, 298-99, 306 (1997).

by greatly increasing its own production.<sup>80</sup> This action had the predictable effect of driving down prices, sometimes at a significant cost also to the punishing party.<sup>81</sup>

### C. *Applying the Traditional Framework of Collusion*

Mass tort conspiracies and antitrust conspiracies are both aimed at suppression. However, an antitrust conspiracy seeks to suppress competition while a mass tort conspiracy seeks to conceal information about safety risks of using certain products and to suppress innovation that could alleviate them. This fundamental difference between what the firms are trying to suppress raises unique issues when attempting to apply the traditional economic framework of evaluating collusion to an alleged conspiracy to conceal information.

Furthermore, compared to the suppression of competition, which is the hallmark of antitrust conspiracies, the successful suppression of information has important additional dynamic requirements that are further compounded and complicated by the fundamental latency that is the defining characteristic of alleged mass tort conspiracies. This idiosyncratic dynamic element that influences a firm's decision about whether to conceal information is at the root of this article's novel contribution. We discuss it in detail below within the context of each of the three prerequisites (i.e. control, consensus and coordination, and monitoring and punishment) of an effective collusive agreement that we already identified.

#### 1. Control

The dynamic elements and the intertwined nature of innovation and information imply that normally, civil conspiracies over information will have broader control requirements than antitrust conspiracies.

Antitrust conspiracies do not require that participants control the object of the conspiracy in the past. That is, the conspirators collectively need market power in the product market in the present solely to successfully fix today's prices. Whether the conspirators collectively had market power in the past is essentially irrelevant to today's success of a price-fixing conspiracy. At best, information about the past market power of conspirators can give immaterial signals about the likely duration of a successful collusion.

The control requirement of a conspiracy to conceal information is fundamentally different from a conspiracy to suppress competition. Prior

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<sup>80</sup> *Id.* at 308.

<sup>81</sup> *Id.*

revelation that a product is unsafe makes a conspiracy to conceal the safety of the product impossible while prior price competition between firms does not hinder their ability to limit competition over price today.

In other words, innovation and information evolve in only one direction: once in the public domain, information cannot be erased, and scientific discovery and innovation do not display retrograde motion. In this sense, the existing environment determined by past generation and dissemination of information and innovations strictly constrain the ability of conspirators today to control the object of the conspiracy. In this respect, the past may affect the ability of conspirators to reach consensus today. These past flows of information and innovation, of course, were determined in part by the participants of the product market, as well as the actions and efforts of all other information disseminators and generators who operate outside the normal confines of the product market. Thus, unlike a collusive agreement to suppress competition, a successful conspiracy to conceal information is dependent not only on the industry's incentives to do so but also on the information set already accessible to participants whose incentives are not necessarily aligned with those of the industry.

Furthermore, as already noted, if the benefits of concealing information detrimental to the product's demand do not exceed the expected future litigation and reputational costs, a rational agent will not have the incentive to engage in a conspiracy to conceal any information. That is, the conspiracy is not feasible when the discounted present value of future penalties exceeds the expected benefits from the conspiracy. Thus, in addition to the importance of the past, the expected ability to control information flows in the future is also important for both the likelihood of achieving an initial conspiracy and the likelihood of maintaining that conspiracy.

## 2. Consensus and Coordination

In order for firms to reach a consensus on an agreement to conceal certain information, it must be the case that each firm participating in that agreement finds it more profitable to conceal said information under an agreement rather than to reveal it. It must also be the case that at least one firm would find it in its interest to reveal the information, absent the existence of an agreement. The joint increased expected profits for the firms who find it in their interest to conceal the information must exceed the expected decrease in profits from the firm or firms who would otherwise unilaterally opt to reveal it. Moreover, in addition to reaching a consensus, participants must also coordinate and execute payment transfers from the firms who would profit from concealment to the firm or firms who would not.

Because latency periods can be quite long—for example, it could take 20 to 30 years of smoking to get lung cancer—the consensus requirement of

a conspiracy to conceal health and safety information can be quite demanding.<sup>82</sup> As the period of time during which participants must confine themselves to the stipulation of the agreement increases, the uncertainty of the future market dynamic makes reaching a consensus on all aspects of the concealment and the corresponding transactions particularly challenging. For example, economists have found that even for the category of what one may consider successful price-fixing conspiracies, only 20%-30% have had a lifespan exceeding a decade.<sup>83</sup> Furthermore, a number of these were government-sponsored cartels that operated under the auspices and protections of the law. On the other hand, a typical mass tort conspiracy involving information concealment does not avail itself of such governmental protections in addition to being faced with the challenges of particularly long latency periods.

However, in some ways it may be easier to achieve consensus in a toxic tort conspiracy as compared to an antitrust conspiracy. In a price-fixing conspiracy, for example, individual firms must act in ways that are contrary to their individual self-interest. That is, in order to achieve and maintain an artificially elevated cartel price, each firm must sell less than it would otherwise unilaterally prefer. Thus, in the price-fixing example, the conspiracy is intended to solve the “prisoner’s dilemma” that competitors in the marketplace normally face. The decision not to deviate from the agreement is sustained not because the participant’s market share or profits would be harmed but because of the punishment costs a firm would potentially suffer if it cheated. Thus, as noted before, the efficacy and sustainability of the cartel is dependent on the effectiveness of the monitoring and punishment mechanisms at the disposal of the participants.

On the other hand, in principle, participants in a mass torts conspiracy typically do not want the public to learn of the true safety properties of its products. Nor does such a conspirator want to reveal to the public the nature of those products that have been collusively kept from the marketplace. In this case, the unilateral incentives of each firm correspond with the aims of the concealment conspiracy overall. In order to avoid any potential liability based on the revelation of damaging information, all participants have an incentive to keep concealed information hidden in

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<sup>82</sup> For a detailed study and account of the latency period for cigarette smoking to cause lung cancer, see Michael J. Thun et al., *Age and the Exposure-Response Relationships Between Cigarette Smoking and Premature Death in Cancer Prevention Study II* in *SMOKING AND TOBACCO CONTROL MONOGRAPH 8* 383, 394-97 (DM Burns, L Garfinkel and JM Samet eds.,1997).

<sup>83</sup> See, e.g., James Griffin, *Previous Cartel Experience: Any Lessons for OPEC?*, in *ECONOMICS IN THEORY AND PRACTICE: AN ECLECTIC APPROACH* 179, 183 (Lawrence R. Kleing & Jamie Marquez eds., 1989) (showing that, of 32 cartels studied, 19 had a life expectancy of only 6.6 years while the other 13 had a shorter life expectancy); PAUL LEE ECKBO, *THE FUTURE OF WORLD OIL* 28, 30-32 (1976); Valerie Suslow, *Stability in International Cartels: An Empirical Survey* (Hoover Institution, Working Paper No. E-88-7, 1988); Richard A. Posner, *A Statistical Study of Antitrust Enforcement*, 13 J. L. & ECON. 365, 402 (1970).

perpetuity. Accordingly, no participant would have an incentive to unilaterally deviate and disclose information that it has previously conspired to conceal.

### 3. Monitoring and Punishment

Monitoring and punishing cheating is an important function in a typical antitrust conspiracy since the typical conspiratorial conduct normally would not be in the unilateral interest of individual conspirators. However, despite the fact that all conspirators are known to each other, monitoring proves to be difficult. In some price-fixing conspiracies, for example, cheating is fundamentally a private affair between an individual conspirator and an individual buyer, which imposes a significant obstacle to monitoring. Incentives to cheat are also often large. Profits can be increased by making additional sales slightly below the fixed price and there are likely to be many buyers willing to pay something between the cartel price and the competitive price. However, punishment is often relatively easy once cheating is detected. For example, in a price-fixing conspiracy, a cheater can be punished by being faced with low prices. Similarly, in a bid-rigging conspiracy or customer allocation conspiracy, a cheater can be disciplined by being deprived of their normal allotment of business.

Conspiracies to conceal information are fundamentally different. Information can only evolve in one direction. Once information is in the public domain, it cannot be erased. The same is true for the state of innovation in an industry. This means that if cheating does occur, unlike other conspiracies, the source of the information is unlikely to remain hidden. On the other hand, punishment is relatively difficult. Once the information is revealed, the relationship within the conspiracy collapses, obviating any means of punishment. This is very much unlike a price-fixing conspiracy, in which prices could be lowered temporarily to discipline any wayward firms and then raised later once all conspirators had fallen back into line.

Also, by contrast with an antitrust conspiracy, once a conspiracy to conceal information has been underway for some period of time, there may be a reduced incentive to cheat. As explained above, this reduced incentive to deviate from the agreement and cheat can be explained by the mounting potential liability as well as the corresponding reputational or litigation cost that has accumulated during the period of concealment.

The state of the information market, the number of conspirators and their scope of involvement, as well as the possibility of other constituents producing and disseminating relevant information in the past, present, and future are all material considerations that influence the decision to engage in an information concealment conspiracy. Accordingly, in a mass tort litigation, the consideration of a defendant's intent to conspire would be

significantly better informed by analyzing the evolution of these factors in the information market.

#### IV. EXAMPLES AND APPLICATIONS: TOBACCO AND MTBE

##### A. *The Alleged Conspiracy By the Tobacco Industry To Dupe And Poison Smokers With Cigarettes*

It is undoubtedly the case that producer firms in the tobacco industry—including but not limited to the major cigarette companies such as Philip Morris and RJR—collectively have market power in the product market.<sup>84</sup> However, over time, the number and significance of obviously non-colluding entities (e.g., the U.S. Surgeon General and a host of academic researchers) who “entered” the market for information indicates that the tobacco companies have lost the requisite dynamic control of the market for information about cigarette risks and safety.<sup>85</sup> Nor, for the same reason, did tobacco companies have dynamic control of the market for cigarette safety innovation.

There is a substantial tally of the history of safety-related innovations on cigarettes, both inside and outside the tobacco industry.<sup>86</sup> This record should be interpreted, however, in light of the fact that commercializing safety innovations—by an incumbent firm or a new entrant—is difficult in the tobacco industry. This is not only because of incumbent firms’ market power but because of regulations that limit the ability of new brands to be launched in an advertising marketplace and that prohibit tobacco companies from competing on the basis of safety.<sup>87</sup>

Thus, in the case of the tobacco industry, the allegations of information concealment should be evaluated in light of the regulatory and political environment that shaped the set of information-producing agents, as well as the path of safety innovation.

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<sup>84</sup> See CENTER FOR DISEASE CONTROL AND PREVENTION, SMOKING & TOBACCO USE, ECONOMIC TRENDS IN TOBACCO, [http://www.cdc.gov/tobacco/data\\_statistics/fact\\_sheets/economics/econ\\_facts/](http://www.cdc.gov/tobacco/data_statistics/fact_sheets/economics/econ_facts/) (noting that while the share of market power among the tobacco companies has changed significantly, the major powers in the industry have remained the same). For an example to compare 1991 and 2011 tobacco company market share.

<sup>85</sup> See SMOKING AND HEALTH: REPORT OF THE ADVISORY COMMITTEE TO THE SURGEON GENERAL OF THE PUBLIC HEALTH SERVICE, which contains the first comprehensive report released by the Surgeon General in 1964 based on over 7,000 scientific articles on the subject.

<sup>86</sup> See Robert F. Lanzillotti, *Schumpeter, product innovation and public policy: the case of cigarettes*, 13 J. EVOL. ECON. 469, 473 (2003).

<sup>87</sup> See generally James Langenfeld & Brad Noffsker, *Economic Analysis of Allegations in Cigarette Litigations and the Impact of FTC Regulation*, in RESEARCH IN LAW AND ECONOMICS, VOL. XXV 129 (Richard O. Zerbe & John B. Kirkwood, eds., 2012).

B. *The Alleged Conspiracy By the Oil Industry To Dupe And Poison Water Supplies With MTBE*

First, in the MTBE litigation, some defendants produced and sold MTBE while others did not. This would lead to different incentives for industry use of MTBE. Accordingly, consensus can be difficult to achieve when alleged participants differ in their business operations and therefore may differ in their preferences for the outcome of any agreement. The involvement of a large number of participants makes reaching consensus more difficult, other things being equal. For instance, at least one of the MTBE suits contained over fifty named Defendants.<sup>88</sup>

Furthermore, in considering the ability to maintain consensus, one should consider the possibility that the incentives of the alleged conspirators changed over time, thereby potentially limiting the ability to maintain an agreement. Defendants in MTBE were alleged to maintain an agreement for many decades, and during that period, the oil industry went through enormous organizational and corporate changes. With a large number of participants, as in the MTBE defendants, this dynamic element inhibiting consensus is further aggravated.

Second, firms in the ethanol industry (a potential substitute for MTBE as an additive for gasoline) had strong incentives to provide information on potential groundwater effects of MTBE to the public and the EPA. Thus, another consideration is that non-defendants, who offer a product competing with that of attempted conspirators, can have an incentive to discover and provide any information on adverse health consequences of the attempted conspirators' product. Also important in considering the ability to control the object of a conspiracy to suppress information is that the EPA or other government agencies can have an incentive and ability to uncover information. The EPA had an ability to obtain information on the health effects and contamination risks of MTBE, for example, through the Toxic Substances Control Act.<sup>89</sup> It also instituted a regulatory negotiation ("Reg Neg") in which interested parties had an opportunity to discuss any potential adverse consequences of allowing MTBE as a gasoline additive.<sup>90</sup>

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Again, in the MTBE cases, the changes in the characteristics of the participating agents dynamically play a significant role in determining the

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<sup>88</sup> See *In re Methyl Tertiary Butyl Ether Prod. Liab. Litig.*, 447 F. Supp. 2d 289, 303 (S.D.N.Y. 2006).

<sup>89</sup> 15 U.S.C. § 2603 (a)(1) (2016).

<sup>90</sup> See Ellen Siegler, *Regulatory Negotiations and Other Rulemaking Processes: Strengths and Weaknesses from an Industry Viewpoint*, 46 DUKE L.J. 1429, 1432 (1997).

<sup>91</sup> See Senate Hearing 105-879 on the use of MTBE in gasoline before the Committee on Environment and Public Works of the U.S. Senate.

market for information and, consequently, the decisions to conceal information and innovation.

#### CONCLUSIONS AND DIRECTIONS FOR FUTURE WORK

Claims of fraudulent information concealment and civil conspiracy have become primary causes of action for prominent cases in the area of toxic tort litigation. In these cases, plaintiffs have commonly alleged that defendants have suppressed truthful information about the risks and safety of their products and have suppressed safer alternatives. Defendants and their attorneys often suggest that plaintiffs add conspiracy claims to their complaints in order to obtain potential litigation benefits: the possibility of holding defendants jointly and severally liable; the enhanced ability to assert jurisdiction over a non-resident defendant; and the possibility of extending the statute of limitations.<sup>92</sup>

Lessons from the economic study of markets for information and collusion are highly instructive in analyzing such claims, albeit only the starting point. As in any market, the possibility of segmentation and the existence of a stable equilibrium are characteristics of markets for information. Thus, a participant's incentive to conceal information can be analyzed within this framework. Furthermore, as is true for any type of conspiracy, participants in a toxic torts conspiracy must be able to reach consensus and control the object of the conspiracy.

However, there are also substantive elements that make information concealment in a toxic tort case and conspiracies to do so particularly unique due to participants' need to incorporate dynamic considerations into their decisions. Unlike in traditional markets, participants must include current and future expected information dissemination in the public sphere in evaluating their incentive to engage in any tortious acts of information concealment. Furthermore, in a mass torts conspiracy, the three elements of consensus, control, and monitoring take on a dynamic character that is fundamentally unlike the expression of these same requirements in an antitrust context. Thus, unlike an antitrust conspiracy, while participants require continued control over the market, sustaining consensus and the need to monitor compliance is less cumbersome.

This is a result of the fundamental properties of information and innovation—as compared to, say, prices—and also, the fundamental latency properties of concealing information. Accordingly, courts can benefit from acknowledging this idiosyncrasy and applying the instructive economic frameworks of analysis discussed above in evaluating the validity of a plaintiff's allegation in a mass toxic tort case. In future work, we aim to

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<sup>92</sup> See Ausness, *supra* note 31 at 408. See also, Thomas L. Leach, *Civil Conspiracy: What's the Use?*, 54 U. MIAMI L. REV. 1 (1999).

apply these frameworks to consider ways in which regulatory measures could be used to better align participants' incentive not to engage in the tortious acts of information concealment and conspiracy.





A FREE MARKET APPROACH TO THE RIDESHARE  
INDUSTRY AND WORKER CLASSIFICATION: THE  
CONSEQUENCES OF EMPLOYEE STATUS AND A  
PROPOSED ALTERNATIVE

*Easton Saltsman\**

INTRODUCTION: THE AGE OF THE SHARING ECONOMY – INNOVATION  
LEADING TO LEGAL OBSTACLES

Although we now live in the age of the sharing economy, the definition of this market is as murky as the laws and regulations that surround it. The sharing economy grew out of the popularity of social networking and e-commerce, and it “mobilizes technology, markets, and the ‘wisdom of crowds’ to bring strangers together.”<sup>1</sup> Although the sharing economy encompasses a variety of different businesses, the typical business model is app-driven and connects an aggregation of individuals to share or trade underutilized assets.<sup>2</sup> Not only has the sharing economy been a part of a disruptive force that is breaking down the corporate structure of the twentieth century, but this new economy is also breaking down outdated regulations and laws.

Many new start-ups, from peer-to-peer fashion to Airbnb’s lodging services, are fighting to classify their companies under the broad range of digital platforms that comprise the sharing economy.<sup>3</sup> The rideshare sector of the sharing economy has been highly successful thus far and provides the best demonstration of the uneasy relationship between new technology and traditional legal concepts that threaten its continued expansion. The rideshare industry has been highly successful in disrupting the taxi service

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\* J.D., George Mason University School of Law, 2017.

<sup>1</sup> See Juliet Schor, *Debating the Sharing Economy*, GREAT TRANSITION INITIATIVE, Oct. 2014, at 1, 7.

<sup>2</sup> Robert Sprague, *Worker (Mis)Classification in the Sharing Economy: Trying to Fit Square Pegs in Round Holes*, 31 A.B.A. J. LAB. & EMP. L. 53, 54 (2015) (“The always-connected, app-driven U.S. economy of the early twenty-first century fostered development of a new online business model: people with underutilized assets—time, particular skills, vehicles, household goods, spare bedrooms, or even home-cooked meals—connect with other people or businesses seeking those assets.”); Christopher Koopman, Matthew Mitchell, & Adam Thierer, Mercatus Center, Comment Letter on Sharing Economy Workshop, Project No. P15-1200, 1, 3 (May 26, 2015), <https://www.mercatus.org/publication/sharing-economy-issues-facing-platforms-participants-and-regulators>.

<sup>3</sup> See Schor, *supra* note 1, at 1; Sarah Cannon & Lawrence H. Summers, *How Uber and the Sharing Economy Can Win Over Regulators*, HARV. BUS. REV. (Oct. 13, 2014), <https://hbr.org/2014/10/how-uber-and-the-sharing-economy-can-win-over-regulators/>.

industry because of its low fixed-cost model.<sup>4</sup> As Emily Isaac explains, “[t]his distinction between ‘tech company’ and taxi business is incredibly important to Uber because it is what allows them to operate in a sort of ‘legal void’ in which they provide all the services of a taxi but are exempt from the extensive and costly taxi regulations. . . .”<sup>5</sup>

Although companies like Uber and Lyft have been very successful and have expanded their operations to more than a thousand cities across four continents, they have seen waves of lawsuits and legal challenges from local regulators.<sup>6</sup> Moreover, the ability to classify their drivers as independent contractors instead of employees, one of the key features of the rideshare industry’s success, is an ongoing legal battle that Lyft and Uber face, which could threaten to destroy their entire business model. The rideshare industry skirts a majority of the employment-related federal acts by classifying its drivers as independent contractors and allows the companies to maintain low fixed-costs because they need not pay certain taxes and benefits, provide overtime compensation, or reimburse work-related expenses.<sup>7</sup> Some critics compare Uber to running a sweatshop and call for new worker protection measures for employees in the sharing economy.<sup>8</sup>

This Comment argues that courts will most likely find that rideshare drivers are employees rather than independent contractors. However, this Comment maintains that an employee classification will actually hurt drivers, not benefit them. At this early stage in the rideshare experiment, it is not readily apparent that drivers need worker protection regulations because they are thriving as independent contractors. However, as lawmakers learn more about worker experience and find it necessary to protect drivers, a third employment classification should be considered. Although most legal commentators suggest the introduction of a dependent contractor classification to fix the newly created employment problems of

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<sup>4</sup> See Emily Isaac, *Disruptive Innovation: Risk-Shifting and Precarity in the Age of Uber 2* (Berkeley Roundtable on the Int’l Econ., Working Paper 2014-7, 2014) (“Uber’s success, which can be attributed to a low fixed-cost model that provides ride-seekers a faster and more reliable alternative to the traditional taxi and promises drivers a higher hourly earning through the avoidance of costly regulations, has severely disrupted the taxi service industry.”).

<sup>5</sup> *Id.* at 9.

<sup>6</sup> Cannon & Summers, *supra* note 3.

<sup>7</sup> See David Bauer, *The Misclassification of Independent Contractors: The Fifty-Four Billion Dollar Problem*, 12 RUTGERS J. L. & PUB. POL’Y 138, 144-45 (2015); Catherine Lee Rassman, *Regulating Rideshare without Stifling Innovation: Examining the Drivers, the Insurance “Gap,” and Why Pennsylvania Should Get on Board*, 15 PITT. J. TECH. L. & POL’Y 81, 87 (2014).

<sup>8</sup> See Antonio Aloisi, *Commoditized Workers: Case Study Research on Labor Law Issues Arising From a Set of “On-Demand/Gig Economy” Platforms*, 37 COMP. LAB. L. & POL’Y J. 653, 670 (2015) (“A good description of what ‘uberizing’ actually means is ‘trapping’ a set of innovative procedures – geo-location, online payments, workforce management, and distribution – into an ‘app-accessible service’ or a ‘sweatshop,’ according to its critics, with lower entry barriers because people monetize resources they already own.”).

the sharing economy, this classification would likely not be applicable to workers in the sharing economy since they are not economically dependent on a single firm. Instead, lawmakers should create a third classification based upon a franchise relationship because the rideshare industry's business model closely resembles trademark franchising.

Part I of this Comment provides a brief overview of the complex legal puzzle of employment classification as defined by the federal and state governments. Part II discusses the recent California Uber cases, which have found that drivers are employees, not independent contractors. Part III examines relevant taxi and FedEx case law that courts most likely will use to assist in classifying rideshare drivers as employees. Part IV analyzes the economic consequences of an employee classification. Part V discusses two alternatives to the classic independent contractor-employee classification distinction.

## I. THE FORTY-EIGHT-FACTOR EMPLOYMENT TEST

Nearly every industry incorporates the use of independent contractors into some aspect of business.<sup>9</sup> Although a specific definition of an independent contractor is dependent on the context of the job, Jeffrey Eisenach finds that “in general [independent contractors] are workers who either work at multiple projects simultaneously or move frequently from project to project, exercise significant autonomy relative to their ‘client,’ are compensated in a way that allows them to earn a profit, and often bring their own tools or equipment to the project.”<sup>10</sup> The use of independent contractors has substantially increased over the past two decades because a firm can significantly reduce the cost of its workforce and the state and federal governments have not strictly enforced the distinction between the employment classifications.<sup>11</sup> Some of the economic and business advantages for employers using independent contractors are as follows: (1) employers are not mandated to withhold taxes or make Social Security and Medicare contributions; (2) they are not required to pay unemployment and workers' compensation premiums; (3) they are not required to pay the minimum wage or overtime pay; (4) health insurance need not be accounted for under the Affordable Care Act; (5) federal labor laws concerning

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<sup>9</sup> Independent contractors are also “sometimes referred to as freelancers, consultants, per diems, 1099ers, contractors, project workers, temps, specialists and the like. . . .” RICHARD J. REIBSTEIN, LISA B. PETKUN & ANDREW J. RUDOLPH, PEPPER HAMILTON LLP, THE 2015 WHITE PAPER ON INDEPENDENT CONTRACTOR MISCLASSIFICATION: HOW COMPANIES CAN MINIMIZE THE RISKS 1 (2015), [http://www.pepperlaw.com/uploads/files/icmisclassification\\_minimizerisk\\_04\\_2015.pdf](http://www.pepperlaw.com/uploads/files/icmisclassification_minimizerisk_04_2015.pdf).

<sup>10</sup> JEFFREY A. EISENACH, NAVIGANT ECONOMICS, THE ROLE OF INDEPENDENT CONTRACTORS IN THE U.S. ECONOMY 1 (2010), [http://www.aei.org/wp-content/uploads/2012/08/-the-role-of-independent-contractors-in-the-us-economy\\_123302207143.pdf](http://www.aei.org/wp-content/uploads/2012/08/-the-role-of-independent-contractors-in-the-us-economy_123302207143.pdf).

<sup>11</sup> See REIBSTEIN, PETKUN & RUDOLPH, *supra* note 9, at 2.

unionization do not apply; (6) independent contractors cannot sue companies for discrimination, and individuals injured by independent contractors generally cannot recover against the firm that retains the independent contractor; and (7) firms can easily expand or contract their workforces to accommodate workload fluctuations.<sup>12</sup>

Not all employee misclassifications are due to the great economic benefits to firms, but also a significant amount of businesses simply do not understand the law because of the vast multitude of both federal and state tests and laws.<sup>13</sup> Some legal scholars do not find this confusion to be a surprise because the employment classification tests are different “not only at the federal level and between states, but sometimes [they are different] within a single state—and that the same language found in a statute in one state is often interpreted differently by the courts and administrative agencies in another state.”<sup>14</sup> More than forty-eight different factors were used in 2009 to determine independent contractor status, thus the tests are often subjective and differ between jurisdictions.<sup>15</sup> Most federal and state tests, however, focus on an employer’s right to control a worker, although the control does not need to be exercised.<sup>16</sup>

## II. THE CALIFORNIA UBER CASES

Courts and agencies in eight states have issued rulings that classify Uber drivers as independent contractors: California, Colorado, Georgia, Illinois, Indiana, New York, Pennsylvania, and Texas.<sup>17</sup> However, in May

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<sup>12</sup> *See id.*

<sup>13</sup> *Id.* at 2 (“[T]he overwhelming number of businesses that misclassify employees as independent contractors has simply paid insufficient attention to the legal requirements or do not understand the laws in this area, either because they have mistaken conceptions of the laws or because they are confused by the array of different laws at the federal and state levels.”).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 3 (“Our 2009 review of the factors used by the courts and by various state and federal agencies revealed that, collectively, far more than 48 factors were used by different decision-making bodies in determining independent contractor status—and, in the years since, dozens of additional factors have been considered.”).

<sup>16</sup> *See* Bauer, *supra* note 7, at 151 (“In general, the basic test [of determining employee/independent contractor] looks at factors relating to the employer’s right to control the worker.”); REIBSTEIN, PETKUN & RUDOLPH, *supra* note 9, at 2 (“One of the few constants in most federal and state tests for independent contractor versus employee status is whether a business has the ‘right to control the manner and means’ by which a worker accomplishes the end product of his or her work.”); DENISE CHENG, FUTURE OF WORK PROJECT, IS SHARING REALLY CARING? A NUANCED INTRODUCTION TO THE PEER ECONOMY 12 (2014), <http://static.opensocietyfoundations.org/misc/future-of-work/the-sharing-economy.pdf>; EISENACH, *supra* note 10, at 5.

<sup>17</sup> Andrew Nusca, *Uber Loses Another Legal Round in the Employee vs. Contractor Debate*, FORTUNE (Sept. 10, 2015), <http://fortune.com/2015/09/10/uber-california-employee/>; Mike Isaac & Natasha Singer, *California Says Uber Driver is Employee, Not a Contractor*, N.Y. TIMES (June 17,

2015, the Florida Department of Economic Opportunity was the first to find that a former driver, Darrin McGillis, was an employee of Uber, and thus able to collect unemployment insurance.<sup>18</sup> Following Florida's lead several months later, the California Labor Commissioner's Office found that an Uber driver was an employee, although the same Office in 2012 found that an Uber driver was an independent contractor.<sup>19</sup> Despite rulings in several states, there are two 2015 California Uber cases (*O'Connor* and *Berwick*) that are the most significant because they are the first cases in which officials have formally crafted arguments concerning the issue.

A. *O'Connor v. Uber Technologies, Inc.*

In *O'Connor*, the plaintiff Uber drivers filed a putative class action lawsuit against Uber and claimed they were eligible for various statutory protections for employees because they were misclassified as independent contractors.<sup>20</sup> The court laid out California's two-stage test for employment: (1) the plaintiff worker establishes a *prima facie* case that he is an employee after he offers evidence that he provided services to the employer, and (2) if the plaintiff establishes a *prima facie* case, the burden is now on the employer to prove that the worker is an independent contractor.<sup>21</sup>

Uber argued that the presumption of employment did not apply in the case because the drivers did not provide Uber a service.<sup>22</sup> Uber's primary argument was that the company was merely a neutral technological platform that connected drivers and passengers, rather than a company in the transportation industry.<sup>23</sup> The Court disagreed, however, and found that Uber's software was merely one element in a very expansive business.<sup>24</sup> The Court stated, "Uber does not simply sell software; it sells rides."<sup>25</sup> Relying on Uber's own marketing materials, the Court found that Uber held

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2015), [http://www.nytimes.com/2015/06/18/business/uber-contests-california-labor-ruling-that-says-drivers-should-be-employees.html?\\_r=0](http://www.nytimes.com/2015/06/18/business/uber-contests-california-labor-ruling-that-says-drivers-should-be-employees.html?_r=0).

<sup>18</sup> Douglas Hanks, *For Uber, Loyal Drivers and a New Fight for Benefits*, MIAMI HERALD (May 21, 2015), <http://www.miamiherald.com/news/business/article21599697.html>.

<sup>19</sup> See Sarah McBride & Dan Levine, *In California, Uber Driver is Employee, Not Contractor: Agency*, REUTERS (June 18, 2015), available at <http://www.reuters.com/article/us-uber-california-idUSKBN0OX1TE20150618>.

<sup>20</sup> *O'Connor v. Uber Techs., Inc.*, 82 F. Supp. 3d 1133, 1135 (N.D. Cal. 2015).

<sup>21</sup> *Id.* at 1138 (citing *Narayan v. EGL, Inc.*, 616 F.3d 895, 900-01 (9th Cir. 2010)).

<sup>22</sup> *Id.* at 1141.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* ("Uber engineered a software method to connect drivers with passengers, but this is merely one instrumentality used in the context of its larger business.")

<sup>25</sup> *Id.*

itself out as a transportation service, not merely as a technology company.<sup>26</sup> The Court explained,

Uber is no more a ‘technology company’ than Yellow Cab is a ‘technology company’ because it uses CB radios to dispatch taxi cabs, John Deere is a ‘technology company’ because it uses computers and robots to manufacture lawn mowers, or Domino Sugar is a ‘technology company’ because it uses modern irrigation techniques to grow its sugar cane.<sup>27</sup>

Moreover, the court determined that the drivers were performing a service for Uber because Uber “would not be a viable business entity without its drivers.”<sup>28</sup> Because Uber depends on the drivers’ services to obtain revenue, it exercises a significant amount of control over the drivers.<sup>29</sup> For instance, Uber unilaterally sets the fares drivers can charge riders.<sup>30</sup> Furthermore, Uber acts like a transportation company and not a technology company because Uber exercises control over the qualification of the drivers through its application process, which includes background checks, city knowledge exams, vehicle inspections, and personal interviews.<sup>31</sup>

The California District Court held that as a matter of law, the plaintiffs were Uber’s presumptive employees, and thus, the burden shifted to Uber to disprove an employment relationship.<sup>32</sup> However, the court found that this issue presented a mixed question of law and fact that must be resolved by a jury, and denied Uber’s summary judgment motion.<sup>33</sup> On the same day and in the same court as *O’Connor*, a similar ruling was ordered against Lyft.<sup>34</sup> These class actions are presently still active.

#### B. *Berwick v. Uber Technologies, Inc.*

The plaintiff, ex-Uber driver Barbra Ann Berwick, filed a suit against Uber claiming compensation for various work-related expenses<sup>35</sup> that she did not receive because she was misclassified as an independent contractor

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<sup>26</sup> *O’Connor*, 82 F. Supp. at 1141-42 (“Uber’s own marketing bears this out, referring to Uber as ‘Everyone’s Private Driver’, and describing Uber as a ‘transportation system’ and the ‘best transportation service in San Francisco.’”).

<sup>27</sup> *Id.* at 1141.

<sup>28</sup> *Id.* at 1142.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *O’Connor*, 82 F. Supp. at 1145.

<sup>33</sup> *Id.* at 1135.

<sup>34</sup> *Cotter v. Lyft, Inc.*, 60 F.Supp. 3d 1067, 1070 (N.D. Cal. 2015).

<sup>35</sup> *Berwick v. Uber Techs. Inc.*, 11-46739 EK, at 1 (Cal. Mar. 10, 2015) (Santa Clara Law Digital Commons).

rather than an employee of Uber.<sup>36</sup> The Labor Commissioner's Office wrote that there is a presumption of employment, and that Uber had the burden of proving that Berwick was an independent contractor.<sup>37</sup> Quoting *Borello*, the Labor Commissioner's Office found that, "[t]he modern tendency is to find employment when the work being done is an integral part of the regular business of the employer, and when the worker, relative to the employer, does not furnish an independent business or professional service."<sup>38</sup>

Berwick and others drivers are integral to the transportation services in which Uber provides because, without drivers, Uber does not have a business.<sup>39</sup> The court found that, in reality, Uber is "involved in every aspect of the operation."<sup>40</sup> Furthermore, the California Labor Commissioner's Office found that Uber exercised a substantial amount of control when it vetted applicant drivers, regulated the maximum age of the cars used, terminated drivers that received less than 4.6 stars, and accepted money from the passengers, which it then used to pay the drivers.<sup>41</sup>

The California Labor Commissioner's Office ordered Uber to reimburse Barbara Ann Berwick \$4,152.20 in expenses and other costs for the eight weeks she worked as a driver.<sup>42</sup> However, the ruling does not apply beyond Berwick to other drivers and the ruling could be altered if Uber's appeal succeeds.<sup>43</sup>

### III. DRIVER CLASSIFICATIONS IN RELATED MARKETS

Courts across the United States will likely look to precedent in related markets to determine if rideshare drivers are employees due to the lack of case law pertaining specifically to the rideshare industry. In these instances, case law pertaining to taxi companies and FedEx will be the most relevant in aiding courts to come to a decision on rideshare driver classification.

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<sup>36</sup> *Id.* at 6.

<sup>37</sup> *Id.* at 8.

<sup>38</sup> *Id.* (quoting *S.G. Borello & Sons, Inc. v. Dept. of Industrial Relations*, 48 Cal.3d 341, 357 (1989)).

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 9.

<sup>41</sup> *Berwick*, 11-46739 EK at 9.

<sup>42</sup> *Id.* at 11-12.

<sup>43</sup> Isaac & Singer, *supra* note 17.

### A. *The FedEx Cases*

Some commentators believe that the recent FedEx cases could have major repercussions for companies in the sharing economy, like Uber and Lyft.<sup>44</sup> In the mid-2000s, FedEx ground package delivery service drivers began filing lawsuits against the company claiming that they were employees misclassified as independent contractors. Most courts have relied on the right to control issue in the FedEx cases and have found that drivers are employees, not independent contractors.<sup>45</sup>

The court in *Slayman* found that the plaintiff drivers were employees as a matter of law.<sup>46</sup> Oregon's right-to-control test requires courts to weigh four factors: (1) direct evidence of the right to, or exercise of, control; (2) the furnishing of tools and equipment; (3) the method of payment; and (4) the right to fire.<sup>47</sup> The court found that factors two through four were neutral or slightly favored FedEx, thus the court's decision primarily rested on the right to control factor.<sup>48</sup>

Although rideshare companies exert fewer controls over its drivers than FedEx, courts using a rule similar to Oregon's right-to-control test will most likely find that the factors heavily favor rideshare drivers. The court in *Slayman* found that FedEx heavily controlled the appearances of its drivers when it told drivers what to wear from their "hats down to their shoes and socks" and required drivers to have neat hair and shaven faces.<sup>49</sup> Rideshare companies do not directly regulate and mandate that drivers wear specific articles of clothing or present themselves in a certain way like FedEx does. However, through the rating system, rideshare companies indirectly control what drivers wear. If passengers complain about professionalism concerning how the driver is dressed or about bad hygiene, the rideshare companies will alert the drivers of these complaints and it will affect their ratings, which can lead to deactivation. Even if there is some control exerted by rideshare companies, drivers have greater latitude in deciding what they will wear, and presumably riders will only give a poor rating for appearance when the situation is an outlier and is extremely

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<sup>44</sup> See Patrick Hoge, *Independent Contractor Ruling on FedEx Drivers Could Affect "Sharing Economy,"* SAN FRANCISCO BUS. TIMES (Aug. 28, 2014), <http://www.bizjournals.com/sanfrancisco/blog/techflash/2014/08/independent-contractor-ruling-fedex-uber-lyft.html>.

<sup>45</sup> See generally *Alexander v. FedEx Ground Package Sys., Inc.*, 765 F.3d 981, 996 (9th Cir. 2014); *Wells v. FedEx Ground Package Sys., Inc.*, 979 F. Supp. 2d 1006, 1036 (E.D. Mo. 2013); *Craig v. FedEx Ground Package Sys., Inc.*, 335 P.3d 66, 92 (Kan. 2014); *Estrada v. FedEx Ground Package Sys., Inc.*, 64 Cal. Rptr. 3d 327, 330 (Cal. Ct. App. 2007).

<sup>46</sup> *Slayman v. FedEx Ground Package Sys., Inc.*, 765 F.3d 1033, 1041 (9th Cir. 2014).

<sup>47</sup> *Id.* at 1042.

<sup>48</sup> *Id.* at 1046.

<sup>49</sup> *Id.* at 1042.

offensive. In addition, FedEx controlled the appearance of its drivers' vehicles far beyond federal regulations because it has to be painted a specific shade of white, a FedEx decal must be attached, and the vehicle must be clean and presentable.<sup>50</sup> Although rideshare companies force drivers to put a decal on their car indicating that they drive for them and have standards to maintain clean and orderly cars, the companies do not require uniformity of paint color. Each rideshare company does have standards setting a minimum year of how old the car can be, but this requirement is far less intrusive to drivers than painting their car a certain shade of white.

FedEx also far surpasses the control of rideshare companies in daily operations. For instance, although FedEx does not set specific working hours for each driver, the workloads are structured to take 9.5 to 11 hours to complete for every business day.<sup>51</sup> Additionally, FedEx tells drivers what packages to deliver and when to deliver the package.<sup>52</sup> Rideshare drivers do not have a work schedule or set number of hours. Although rideshare drivers are not required to accept every passenger request, Uber, for example, tracks the acceptance rate of rides.<sup>53</sup> Many believe that Uber uses this data as a determinate in deactivating drivers, thus, in a way, the company may be controlling what rides drivers choose.<sup>54</sup>

While rideshare drivers have more latitude in control than FedEx drivers, rideshare companies exercise a significant amount of control over the driver's actual work. First, the hiring process demonstrates an exercise of significant control because rideshare companies thoroughly vet applicants by issuing background checks, city knowledge exams, vehicle inspections, and personal interviews.<sup>55</sup> Second, rideshare companies unilaterally set fare rates and collect the money, then pay the fares to the drivers.<sup>56</sup> Lastly, and most importantly, rideshare companies indirectly control every driver's action through the use of the rider rating system. This system has considerable influence over drivers' decision-making because if drivers receive an aggregate rating under a certain threshold, such as 4.6 stars, then they are deactivated from using the app.<sup>57</sup> It does not matter whether the control is located in the hands of a few powerful executives or in the hands of the masses, the driver's behavior is still significantly affected due to the control that others wield.

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<sup>50</sup> *Id.* at 1043.

<sup>51</sup> *Id.*

<sup>52</sup> *Slayman*, 765 F. 3d at 1043.

<sup>53</sup> See James Cook, *Uber's Internal Charts Show How Its Driver-Rating System Actually Works*, BUS. INSIDER (Feb. 11, 2015), <http://www.businessinsider.com/leaked-charts-show-how-ubers-driver-rating-system-works-2015-2?r=UK&IR=T>.

<sup>54</sup> *Id.*

<sup>55</sup> *O'Connor v. Uber Techs., Inc.*, 82 F. Supp. 3d 1133, 1142 (N.D. Cal. 2015).

<sup>56</sup> *Berwick v. Uber Techs. Inc.*, 11-46739 EK, at 9 (Cal. Mar. 10, 2015).

<sup>57</sup> *Id.*

One of the few courts that have found FedEx drivers to be independent contractors rather than employees, the D.C. Circuit Court, applied the common law agency test to determine the classification of a worker.<sup>58</sup> The Court found, “both this court and the Board, while retaining all of the common law factors, ‘shift[ed the] emphasis’ away from the unwieldy control inquiry in favor of a more accurate proxy: whether the ‘putative independent contractors have “significant entrepreneurial opportunity for gain or loss.””<sup>59</sup>

Although rideshare drivers are similar to the FedEx drivers in many respects, such as discretion in choosing hours, means of carrying out the job, and other performance details, most courts would still not find that rideshare drivers satisfy the common law agency test in determining independent contractor status. There was substantial evidence that FedEx drivers had ample entrepreneurial opportunity because more than 25 percent of drivers hired employees to assist in the delivery routes.<sup>60</sup> FedEx drivers are allowed to sell and trade routes to others, and the Court found that there was a significant profit opportunity since the average profit from a route ranged from \$3,000 to nearly \$16,000.<sup>61</sup> Although rideshare companies might tout that drivers make a profit, the profit is merely from keeping a larger share of the fare than a traditional taxi company as opposed to owning an asset, a rideshare profile, that a driver could sell to others. It would be ridiculous to say that a waitress is not an employee of a restaurant, solely because she has an entrepreneurial opportunity for gain or loss by the quality of her service, which determines her tip. Similarly, retaining a larger portion of the fare is hardly significant entrepreneurial opportunity for gain or loss. Regardless, the National Labor Relations Board rejected the D.C. Circuit Court’s analysis anyways, and found that the driver was an employee.<sup>62</sup>

### B. *The Taxi Cases*

It is very difficult to find a consensus of whether courts considered taxi drivers to be employees or independent contractors because many companies have drastically different business models. Fredrickson believes that many taxi drivers are considered independent contractors and are denied many of the same workplace protections as Uber drivers.<sup>63</sup>

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<sup>58</sup> See *FedEx Home Delivery v. N.L.R.B.*, 563 F.3d 492, 496 (D.C. Cir. 2009).

<sup>59</sup> *Id.* at 497 (quoting *Corp. Express Delivery Sys. & Teamsters Local 886*, 332 N.L.R.B. 1522 (2000)).

<sup>60</sup> *Id.* at 499.

<sup>61</sup> *Id.* at 500.

<sup>62</sup> See Sprague, *supra* note 2, at 65.

<sup>63</sup> See Caroline Fredrickson, *It’s Not Just Uber: Why the Taxi Industry Needs an Overhaul*, AMER. PROSPECT (Sept. 14, 2015), <http://prospect.org/article/its-not-just-uber-why-taxi-industry-needs->

However, a great number of courts have found that taxi companies possess the requisite amount of control over drivers in order for drivers to be considered employees, and not independent contractors.<sup>64</sup>

The *Purvis* court found that solely the right of control does not distinguish an employee from an independent contractor.<sup>65</sup> Rather, the “relevant and determinative distinction lies in the right to control the means and methods chosen to accomplish the result.”<sup>66</sup> Although drivers could work whenever they wanted to, set their own hours, and refuse any fare, the court still held that the driver was an employee because the cab company had to the right to control and did control the method and means of the work the driver performed.<sup>67</sup> The Cab company provided a list of rules that the drivers must follow, such as: the length of breaks while on the clock, cab maintenance, preventing the drivers from picking up fares off the street without permission, and the drivers' relationship with the dispatcher.<sup>68</sup> The list of rules that most rideshare companies give drivers in manuals far surpasses the rules in *Purvis*.

Rideshare companies possess a significant amount of control because they retain the right to deactivate a driver for receiving an aggregate rating under a certain threshold. In *Yellow Cab*, that taxi dispatcher could terminate leases to a car due to insubordination or based on complaints by passengers.<sup>69</sup> The *Yellow Cab* court held, “[l]iability to discharge for disobedience or misconduct is strong evidence of control.”<sup>70</sup> Uber, for instance, does not have a clear deactivation policy that warns drivers

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overhaul (“Taxi drivers, just like Uber drivers, are independent contractors and are similarly denied minimum wage, overtime pay, protection from discrimination, are not covered by health and safety laws, can’t bargain collectively and don’t get workers compensation or unemployment insurance.”).

<sup>64</sup> See generally *C & H Taxi Co. v. Richardson*, 461 S.E.2d 422 (W. Va. 1995) (Taxi company owned and maintained the cabs and controlled the right to terminate or not renew the lease of the cab); *Walls v. Allen Cab Co., Inc.*, 903 S.W.2d 937 (Mo. Ct. App. 1995) (Driver set his own hours, maintained and repaired his cab, and collected fares); *Bowdoin v. Anchor Cab*, 643 So.2d 42 (Fla. Dist. Ct. App. 1994) (Taxi company controlled the maximum fares and prohibited drivers from working for other companies); *Yellow Cab Co. v. Jones*, 464 N.E.2d 1079 (Ill. App. Ct. 1984) (Taxi company required the drivers to dress in uniform; could terminate or not renew any cab lease as well as prevent driver from subleasing a cab; repaired cabs and radios; required drivers to buy gas from their garage and report mileage); *Shinuald v. Mound City Yellow Cab Co.*, 666 S.W.2d 846 (Mo. Ct. App. 1984) (Taxi company required certain dress, cabs to be fueled at Yellow Cab pumps, set rates for fares, and trained drivers).

<sup>65</sup> *Purvis v. Porter Cabs, Inc.*, 568 S.E.2d 424, 427 (Va. Ct. App. 2002).

<sup>66</sup> *Id.* (quoting *Cty. of Spotsylvania v. Walker*, 487 S.E.2d at 274, 277 (Va. Ct. App. 1997)).

<sup>67</sup> *Purvis*, 568 S.E.2d at 430.

<sup>68</sup> *Id.* at 429.

<sup>69</sup> See *Yellow Cab Coop., Inc. v. Workers’ Comp. Appeals Bd.*, 277 Cal. Rptr. 434, 441 (Cal. Ct. App. 1991).

<sup>70</sup> *Id.*

upfront of fireable offenses.<sup>71</sup> Drivers only receive warnings of misconduct once they have already committed the alleged offense.<sup>72</sup> Courts will most likely view this powerful and unclear deactivation policy as strong evidence of control over drivers.

Even when courts have found that a company retained a significant amount of control, some courts take the analysis a step further and inquire if the service falls outside the normal business conduct of the employer.<sup>73</sup> In *Kubinec*, Top Cab's sole business activity provided radio dispatch and communication services to its lessees of taxi radio equipment for a fixed fee.<sup>74</sup> Although Top Cab did exercise great control over some of the driver's daily operations, the Court concluded that drivers still maintained a significant amount of autonomy to continue to be classified as an independent contractor.<sup>75</sup> Much like rideshare companies, Top Cab forced drivers to maintain the performance and cleanliness of his vehicle, or the driver would be subject to termination.<sup>76</sup> Additionally, the Court in *Kubinec* noted that on Top Cab's website, the company boasted that it provides taxi transportation services, much like the *O'Connor* Court noted about Uber.<sup>77</sup>

However, the Court also found that Top Cab provided a communication and referral service, and was not engaged in transportation services.<sup>78</sup> Top Cab's sole stream of revenue was the fixed fee it charged drivers for leasing radio equipment.<sup>79</sup> Thus, although Top Cab might have received an incidental benefit from drivers providing rides to passengers, Top Cab received the same amount of income each month even if none of the drivers provided any rides.<sup>80</sup> However, rideshare companies would not satisfy this exception. A rideshare company's stream of revenue results from a commission per ride, not from a fixed fee. As drivers give more rides, the company directly benefits from the services.

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<sup>71</sup> Ellen Huet, *How Uber's Shady Firing Policy Could Backfire on the Company*, FORBES (Oct. 30, 2014, 10:00AM), <http://www.forbes.com/sites/ellenhuet/2014/10/30/uber-driver-firing-policy/>.

<sup>72</sup> *Id.*

<sup>73</sup> See *Kubinec v. Top Cab Dispatch, Inc.*, 2014 WL 3817016, \*1 (Mass. Super. June 25, 2014).

<sup>74</sup> *Id.* at \*10.

<sup>75</sup> *Id.* at \*15.

<sup>76</sup> *Id.* at \*2.

<sup>77</sup> *Id.* at \*5 ("Website touts that Top Cab: has the largest taxi fleet in the greater Boston area; can provide a passenger a taxi in two to four minutes; is family-owned and operated; has a 'mission to ensure that [customers] enjoy traveling in our taxis'; and has 'over 500 Ford Crown Victorias, Chevy Impalas, Dodge Grand Caravans, Toyota Sienna[s], Ford Windstar[s], and Toyota Camry Hybrid' taxis running twenty-four hours a day."). Compare *O'Connor*, 82 F. Supp. 3d at 1141-42 ("Uber's own marketing bears this out, referring to Uber as 'Everyone's Private Driver', and describing Uber as a 'transportation system' and the 'best transportation service in San Francisco'").

<sup>78</sup> *Kubinec*, 2014 WL 3817016 at \*11.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

### C. *The Verdict*

It is clear that most courts in the future will find that rideshare drivers are employees. In October 2015, Oregon's Bureau of Labor and Industries was the first entity to follow California's rationale and find that Uber drivers were employees based on the degree of control by the company.<sup>81</sup> Similarly, case law concerning related business entities such as FedEx and taxi companies has found most of the time that the drivers are employees, not independent contractors.<sup>82</sup> Most courts operate under the presumption that "a service provider is presumed to be an employee unless the principal affirmatively proves otherwise."<sup>83</sup> With the current political and legal climate, Uber and other rideshare companies will have a difficult time classifying drivers as independent contractors through litigation. However, Uber and Lyft have not shown an eagerness to litigate challenges to their operations and, on the contrary, have sought to engage in regulatory capture. If the rideshare companies are going to maintain the driver independent contractor classifications, they will have to "avoid costly litigation and instead work to develop a cooperative regulatory climate."<sup>84</sup> Uber has already successfully lobbied North Carolina, Arkansas, and Indiana state legislators to pass a regulatory scheme that classifies its drivers as independent contractors.<sup>85</sup>

## IV. THE CASE AGAINST EMPLOYEE STATUS: AN ECONOMIC ANALYSIS OF THE RIDESHARE INDUSTRY

There is a rhetoric problem in America concerning jobs. The public cries for more jobs, and so politicians and journalists scold corporations for exporting jobs from the United States to Mexico or China. Meanwhile, people continue to criticize companies like Wal-Mart, McDonalds, and Uber, that collectively employ millions of American workers, for exploiting cheap labor. There is increasing language that jobs and employment are

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<sup>81</sup> Malia Spencer, *In Setback for Uber, Oregon Labor Department Says Drivers are, in Fact, Employees*, PORTLAND BUS. J. (Oct. 14, 2015, 1:00PM), <http://www.bizjournals.com/portland/blog/techflash/2015/10/in-setback-for-uber-oregon-labor-departmentsays.html>.

<sup>82</sup> See *E.g. Slayman*, 765 F.3d 1033; *FedEx Home Delivery*, 563 F.3d 492; *Kubinec*, 2014 WL 3817016; *Purvis*, 568 S.E.2d 424.

<sup>83</sup> *Yellow Cab Coop., Inc.*, 277 Cal. Rptr. 434, 438 (Cal. Ct. App. 1991).

<sup>84</sup> Boris Bindman, *Keep on Truckin', Uber: Using the Dormant Commerce Clause to Challenge Regulatory Roadblocks to TNCs*, 72 WASH. & LEE L. REV. 136, 144 (2015).

<sup>85</sup> Allison Griswold, *Three US States Have Already Blessed Uber's Independent Contractor Employment Model*, QUARTZ (Dec. 10, 2015), <http://qz.com/571249/three-us-states-have-already-blessed-ubers-independent-contractor-employment-model/>.

economic goods in and of themselves, when in reality they are merely an input or a means to achieve an end.<sup>86</sup>

Although legal analysis of existing employment classification laws favor a finding of employee status for rideshare drivers, an economic analysis tends to disfavor employee status. First, this section will demonstrate that most rideshare drivers do not fit the general demographics of a typical employee of a company. Second, this section will explore that it is economically efficient for rideshare companies to shift risk onto drivers, because drivers can most easily avoid the risk. Moreover, classic worker protection regulations, although possibly relevant for other industries, are not needed in the rideshare industry. This section concludes with a thought-provoking question: Why are workers rushing to drive for rideshare companies if their labor is being exploited?

#### A. *Would Employee Status Benefit Drivers?*

Many critics of the rideshare industry claim that drivers are forced into these jobs that provide little financial certainty out of economic desperation caused by high unemployment rates from the stagnant American economy.<sup>87</sup> Stanley Aronowitz, director of the Center for the Study of Culture, Technology, and Work at the Graduate Center of the City University of New York, states, “[t]hese [Uber driver positions] are not jobs, jobs that have any future, jobs that have the possibility of upgrading; this is contingent, arbitrary work.”<sup>88</sup> Mr. Aronowitz might be correct that there is not a future for drivers in the rideshare industry because there is no ability to grow in the company, but are drivers even seeking a permanent job in the rideshare industry? The answer for most drivers is no.

Most Uber drivers joined the company when they had other employment arrangements and only 8% were unemployed at the time they were hired.<sup>89</sup> Hall and Krueger report that around 53% of hired drivers were employed full-time, 27% employed part-time, 7% were students, 3% were retired, and 2% were stay-at-home parents.<sup>90</sup> That means 80% of Uber employees already possessed the stability and predictability of employment, and simply desired to supplement his or her income by driving for Uber.

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<sup>86</sup> See Walter Block, *How the Market Creates Jobs and How the Government Destroys Them*, at 1, FREE MARKET, May 1, 1988.

<sup>87</sup> See generally Isaac, *supra* note 4; Natasha Singer, *In the Sharing Economy, Workers Find Both Freedom and Uncertainty*, N.Y. TIMES (Aug. 16, 2014), [http://www.nytimes.com/2014/08/17/technology/in-the-sharing-economy-workers-find-both-freedom-and-uncertainty.html?\\_r=0](http://www.nytimes.com/2014/08/17/technology/in-the-sharing-economy-workers-find-both-freedom-and-uncertainty.html?_r=0).

<sup>88</sup> Singer, *supra* note 87.

<sup>89</sup> Jonathan Hall & Alan Krueger, *An Analysis of the Labor Market for Uber's Driver-Partners in the United States*, 2 (Princeton Univ. Indus. Relations Section, Working Paper No. 587, 2015).

<sup>90</sup> *Id.* at 10.

Additionally, this unique working arrangement has enticed students, retirees, and stay-at-home parents, who normally would not desire to enter into an employment arrangement, to utilize their labor as a resource. In August of 2014, *The New York Times* published a story of a stay-at-home mom, Jennifer Guidry, who was having difficulties supporting her family even though she was working for multiple sharing economy services due to price cuts by those sharing economy companies.<sup>91</sup> Articles like this fail to realize that employers have an incentive to exert more control over workers if they have to provide a wide variety of employment benefits. Thus, if drivers were to become employees, Uber would most likely eliminate the flexibility of the job and set more standard hours for the drivers. This would eliminate Ms. Guidry's ability to work and obtain an income while raising a family.

It is extremely costly to change the status of rideshare drivers for the benefit of the 8% who are unemployed and to the detriment of the 92% of drivers, who are either employed elsewhere or merely desire a flexible job to earn a little money. However, not all of the unemployed drivers would benefit from the change in employment classification. These unemployed individuals are coming from a variety of different careers and backgrounds, and may not desire a future with driving for Uber, but want to find a job in their respective industry.<sup>92</sup> The flexibility that Uber and other rideshare companies provide for these unemployed individuals is that they can search for another job, while still bringing in some income from driving.<sup>93</sup> Temporary, short-term jobs that have low barriers to entry, such as driving for Uber, have positive economic effects on the economy as a whole because it reduces the costs of structural and frictional unemployment.<sup>94</sup> By receiving an income and working flexible hours, drivers seeking other employment can wait longer to find a full-time job that best suits their skills and interests, instead of being forced to take the first job they are offered, which might not be a good fit. Also, the rideshare industry allows workers to go back to school to receive further education that will help them find a job in the rapidly changing economic climate.

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<sup>91</sup> See generally Singer, *supra* note 87.

<sup>92</sup> A New Jersey Uber driver seeking employment in technology sales stated, "In some ways it's saving me while I search for other employment." See Lauren Weber & Rachel Emma Silverman, *On-Demand Workers: 'We Are Not Robots'—Is Technology Liberating or Squeezing the New Class of Freelance Labor?*, WALL ST. J. (Jan. 27, 2015), <http://www.wsj.com/articles/on-demand-workers-we-are-not-robots-1422406524>.

<sup>93</sup> See Hall & Krueger, *supra* note 89, at 12 ("Another aspect of the flexibility that Uber provides is that spending time on the platform can help smooth the transition to another job, as driver-partners can take off time to prepare for and search for another job at their discretion.").

<sup>94</sup> Frictional unemployment is the unemployment resulting from the time an individual takes to search for the right employment between jobs. N. GREGORY MANKIW, *MACROECONOMICS* 167 (7th ed. 2014). Structural unemployment is caused by a divide between workers' actual skills and education that they can offer, and the skills and education that are required for certain job positions. *Id.* at 169.

Even Elie Gurfinkel, a named plaintiff in *O'Connor*, saw the immense benefits in driving for Uber under an independent contractor model. Gurfinkel was employed full-time by ADL Embedded Solutions as a ‘fulfillment and project manager’ when he began driving for Uber.<sup>95</sup> After two months of driving for Uber, Gurfinkel left his full-time job at ADL Embedded Solutions to drive full-time for Uber.<sup>96</sup> Economic analysis presumes that all individuals are rational wealth-maximizing players in the market.<sup>97</sup> A wealth-maximizing individual would not leave a managerial position at a company if the benefits of working for Uber did not outweigh the opportunity cost of his former job. Although Gurfinkel sought even more employee benefits in his suit against Uber, economic analysis supposes that he was in a better economic position driving with Uber than having a full-time job as a manager at ADL.

In totality, the evidence indicates that rideshare drivers enjoy the flexibility over their schedules and the additional income from the unique employment arrangement the sharing economy has provided.<sup>98</sup> An Indiana Uber driver states, “[t]he whole reason I do it is because I need the flexibility of not being locked into a set schedule as an employee. If I wanted that, I’d get a part time job with set hours.”<sup>99</sup> It is also apparent that drivers for rideshare companies should not be considered employees because 86% of Uber drivers chose to drive for less than 35 hours a week and more than 50% chose to drive for less than 15 hours a week.<sup>100</sup> The independent contractor model not only benefits employers and certain workers, but also solves many market problems. There are several economic efficiencies that an independent contractor model provides, such as firm’s ability to respond to short-run changes in demand, better evaluate worker performance, and base payment on output rather than fixed periods of time.<sup>101</sup>

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<sup>95</sup> *O'Connor*, 82 F. Supp. 3d at 1136.

<sup>96</sup> *Id.*

<sup>97</sup> See JULES L. COLEMAN, *MARKETS, MORALS, AND THE LAW* 105-06 (Oxford U. Press 1998).

<sup>98</sup> See Hall & Krueger, *supra* note 89, at 2-3. *But see* Weber & Silverman, *supra* note 92 (“‘Many people are really liberated by the income they are able to earn and the flexibility over their schedules,’ says Shelby Clark, the chief executive of Peers, a membership organization of roughly 250,000 independent contractors for on-demand firms. ‘At the same time, working in the sharing economy can feel isolating and confusing.’”).

<sup>99</sup> Harry Campbell, *Do Uber Drivers Even Want to be Employees?*, FORBES (Apr. 22, 2015), <http://www.forbes.com/sites/harrycampbell/2015/04/22/do-uber-drivers-even-want-to-be-employees/>.

<sup>100</sup> Hall & Krueger, *supra* note 89, at 18.

<sup>101</sup> EISENACH, *supra* note 10, at 29.

### B. *Shifting Risks to the People Who Can Minimize Them*

Critics of Uber suggest that it is a “digital middleman” that shifts risk from the corporation to workers.<sup>102</sup> Principals and agents both make decisions to optimize benefits and reduce costs, but usually, the agent has more knowledge than the principal. This gives rise to the moral hazard problem, in which the agent takes more risks or increases costs because someone else bears the burden of those risks.<sup>103</sup>

Therefore, risk should be placed on the parties that are in the best position to avoid the risk and lower costs.<sup>104</sup> For instance, if two drivers made the exact fares and took the exact same routes, they have provided the exact same service for the rideshare company. But if driver A drove a Toyota Prius and driver B drove a truck, the company would have to reimburse driver B much more for gas. Even in the way that drivers operate their cars, if the rideshare company paid for all the gas, then they would not have an incentive to reduce the cost. However, by placing the cost of maintenance and gasoline on the drivers, the risks are closer associated with the individuals that can most easily avoid the costs and it incentivizes the drivers to reduce costs.

### C. *Worker Protection Regulations*

Congress has enacted several major worker protection statutes, such as the Fair Labor Standards Act, Internal Revenue Code, the National Labor Relations Act, the Civil Rights Act of 1964, and numerous worker compensation laws, but they only cover employees, not independent contractors.<sup>105</sup> Steven Hill suggests “the accelerated use by employers of the 1099/independent contractor loophole has in turn begun causing a rapid erosion of the safety net for workers and families—indeed of the New Deal social contract that was forged across many decades.”<sup>106</sup> Progressive era legislation sought to protect workers from workplace hazards and working a considerable amount of hours, while subsequent legislation decades later sought to protect minority workers from discrimination and provide a minimum wage for all workers. As discussed below, although these

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<sup>102</sup> Isaac, *supra* note 4, at 16. See also Sprague, *supra* note 2, at 56..

<sup>103</sup> See Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531 (1968).

<sup>104</sup> See JOSEPH A. HUSE, UNDERSTANDING AND NEGOTIATING TURNKEY AND EPC CONTRACTS 484 (2d. 2002).

<sup>105</sup> Isaac, *supra* note 4, at 12.

<sup>106</sup> Steven Hill, *New Economy, New Social Contract: A Plan for a Safety Net in a Multiemployer World*, at 5, NEW AM. (Aug. 4, 2015), <https://www.newamerica.org/economic-growth/new-economy-new-social-contract/>.

regulations might have been needed at the time, these same concerns do not plague rideshare company drivers.

a. Occupational Safety, Maximum Number of Hours, and Discrimination

*The Jungle*, by Upton Sinclair, depicts the harsh working conditions and exploitation of labor in the America meatpacking industry that generalizes the backdrop of Progressive Era occupational safety legislation.<sup>107</sup> These same factory conditions do not analogize well with the rideshare industry's business model because drivers do not come into an office or place of business owned by the company. Whereas workers in factories in the early 1900s might have been exposed to dangerous machinery, toxic chemicals, and other unsafe working conditions, drivers in the rideshare industry in essence create their own working conditions. In regards to occupational safety, the make and model of the driver's car, as well as a driver's driving habits, will determine his safety on the job.

Legislators also wanted to reduce workers' hours from the typical eighty-hour workweek for the family's physical and mental wellbeing.<sup>108</sup> Similarly, drivers in the rideshare industry have complete control over their hours worked. They are not forced to work eighty-hour workweeks for Uber or Lyft, and can pick their own hours. By giving the power to drivers to regulate their own working conditions, traditional employee protection regulations are inconsequential in the rideshare industry.

Because Uber and the other rideshare companies can fire drivers without cause, some fear that drivers could potentially be fired due to race, gender, ethnicity, or religion.<sup>109</sup> Although the rideshare company may not fire a driver because of his race or religion, the rider-feedback system could be biased against minority groups. Brishen Rogers, states, "Passengers may give bad reviews to racial-minority drivers, whether out of implicit or explicit bias."<sup>110</sup> This may require drivers belonging to a minority group to engage in "emotional labor" to form a relationship with passengers to overcome a certain preconception.<sup>111</sup> Although it is more than plausible that passengers may rate drivers based on implicit or explicit bias, there is not any factual proof that this is happening. In 2014, Uber claimed that only two to three percent of its drivers were in the danger zone of deactivation,

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<sup>107</sup> See generally UPTON SINCLAIR, *THE JUNGLE* (Doubleday 1906).

<sup>108</sup> See generally STEVEN L. PIOTT, *DAILY LIFE IN THE PROGRESSIVE ERA* (Randall M. Miller et al. eds. 2011).

<sup>109</sup> See Isaac, *supra* note 4, at 14.

<sup>110</sup> Brishen Rogers, *The Social Costs of Uber*, 82 U. CHI. L. REV. DIALOGUE 85, 95 (2015).

<sup>111</sup> *Id.* at 97.

with an average rating below 4.6.<sup>112</sup> Also, Uber statistics show that rider complaints are three times more likely to be about a driver's lack of city knowledge than the driver's poor attitude or disrespect.<sup>113</sup> These numbers tend to show that not many drivers are at risk for deactivation, and for the ones that are at risk, it is most likely due to them taking bad routes or lacking knowledge of the area rather than criteria, such as attitude, which could be subject to bias against minority groups.

b. The Minimum Wage

Uber executives have sole control of fare pricing, which has led some legal scholars to believe that there is a "race to the bottom" in regards to pricing.<sup>114</sup> Although fare prices have dropped, this is most likely due to market conditions of increased supply of drivers rather than a race to the bottom. Even with the reduction in fare prices, in a study of sixteen of the available Uber markets, the average earnings per hour, after discounting costs, such as depreciation, gas, and insurance, exceed the hourly wage of chauffeurs and taxi drivers.<sup>115</sup>

Although a majority of rideshare drivers earn far above minimum wage, and even more than taxi drivers, who also earn more than minimum wage, some drivers may be earning less than minimum wage.<sup>116</sup> Even though rideshare executives control fare pricing, drivers have a great amount of control over their hourly wage by when and where they decide to work.<sup>117</sup> One of the principal strengths of the rideshare business model is how it takes advantage of local knowledge. Thus, Uber or Lyft do not coordinate with drivers and tell them when and how to work. Instead, self-interested drivers use their expertise of local markets to capitalize on specific places during certain periods of time when the demand for a car service is high. Much like an entrepreneur that opens a business, the drivers that have the most knowledge about local demand will be rewarded with high hourly wages, while drivers that lack knowledge earn a lower wage. Thus, drivers who are earning less than the minimum wage per hour should be forced out of the market. This is how markets work. Drivers need these signals to exit a market because their labor is more valuable elsewhere.

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<sup>112</sup> See Cook, *supra* note 53.

<sup>113</sup> See *id.*

<sup>114</sup> See Isaac, *supra* note 4, at 13.

<sup>115</sup> See Hall & Krueger, *supra* note 89, at 23.

<sup>116</sup> See Maya Kosoff, *Uber Drivers Speak Out: We're Making A Lot Less Money Than Uber is Telling People*, BUS. INSIDER (Oct. 29, 2014), <http://www.businessinsider.com/uber-drivers-say-theyre-making-less-than-minimum-wage-2014-10>.

<sup>117</sup> See generally *id.* See also Weber & Silverman, *supra* note 92; Singer, *supra* note 87.

Critics, however, describe this process as forcing workers to bid against each other to cut their own wages.<sup>118</sup> Although this statement is said as a negative, it is not, in fact. This is competition. Ideally, workers' hourly earnings will be reduced to match their opportunity cost. This ensures that consumers are receiving a low price and labor is being distributed to its highest valued use.

#### D. *Workers Do Not Typically Flock to Inferior Working Conditions*

Drivers have thrived under the current business model that classifies them as independent contractors. The role of independent contractor classifications is very important in the American economy when a "traditional employment relationship is either impractical or uneconomic for the worker, the client, or both."<sup>119</sup> It is a general maxim that if a large number of consumers buy a product, then the popularity of the product demonstrates that it has a greater marginal value for most people compared to the next best alternative. Similarly, it can be assumed that a rapid increase in wanting to work as a driver for a rideshare company demonstrates that value derived from working for a rideshare company is greater than the next best available job. In 2012, there were almost zero Uber drivers, but that number has escalated to over 160,000 drivers in just two years.<sup>120</sup> For the past two years, the number of new Uber drivers has more than doubled every six months.<sup>121</sup> Hall and Krueger also report that 71% of Uber drivers have increased their overall income since joining the company and "fifteen times as many driver-partners said Uber had made their lives better, rather than worse, by giving them more control over their schedule."<sup>122</sup> Roughly one-third of the 8,500 San Francisco taxi drivers quit their driver job for a registered cab company to work for rideshare companies.<sup>123</sup> Not only have the benefits of working for the rideshare industry enticed people to quit their other driving jobs, but people are even quitting their non-driving jobs.

Classifying drivers as employees would destroy the business model of the rideshare industry. Currently, rideshare companies can save up to 40%

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<sup>118</sup> Sprague, *supra* note 2, at 57.

<sup>119</sup> EISENACH, *supra* note 10, at 2.

<sup>120</sup> Hall & Krueger, *supra* note 89, at 1.

<sup>121</sup> *Id.* at 13.

<sup>122</sup> *Id.* at 11. *See also id.* at 12 ("Partnering with Uber appears to have affected driver-partners in other positive ways as well. Nine times as many said Uber had improved, rather than hurt, their sense of confidence (56% versus 6%); nearly six times as many said that it had made better, rather than worse, their overall quality of life (58% versus 10%); and more than five times as many said that it had strengthened, rather than weakened, their sense of financial security (61% versus 11%).").

<sup>123</sup> Isaac, *supra* note 4, at 5.

by classifying drivers as independent contractors.<sup>124</sup> However, if rideshare companies provided drivers the same benefits as its full-time employees, drivers would “receive paid holidays and health care benefits worth an average of \$5,500 a year, plus thousands more in mileage reimbursement.”<sup>125</sup> Despite the benefits to drivers, giving drivers an employee classification would hurt the rideshare industry by raising the costs and therefore the interests of drivers. Customers would also be affected because reducing the supply of drivers while consumer demand remains constant would lead to increased fares and longer wait times.

## V. ALTERNATIVES TO THE STANDARD EMPLOYMENT CLASSIFICATIONS

Rideshare drivers or other app-enabled workers in the sharing economy do not fit into the molds of traditional employees or independent contractors and are left in a legal void. As Judge Chhabria stated in *Cotter v. Lyft*, “the jury in this case will be handed a square peg and asked to choose between two round holes.”<sup>126</sup> Judge Chhabria recognized that Lyft drivers do not seem like employees because they supervise themselves, work irregular hours, and many drivers treat working for Lyft as merely a side job to earn extra income.<sup>127</sup> However, Lyft drivers also do not seem like independent contractors since independent contractors usually have a special skill concerning a discrete task for a limited period of time.<sup>128</sup> The definitions and employment tests that courts utilize are rooted in twentieth century concepts that appear to be outdated for twenty-first century employment questions. Part A of this section will explore the dependent contractor classification that many other countries utilize. After determining that the dependent contractor classification would not be suitable for the needs of the sharing economy, Part B will explore an existing legal alternative, the franchise relationship. This section will conclude by recommending that a third employment classification should be based on the franchise relationship.

### A. *The Dependent Contractor*

Designating all drivers as employees would negatively affect both drivers and rideshare companies. However, the independent contractor

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<sup>124</sup> Lucas E. Buckley, Jesse K. Fishman & Matthew D. Kaufman, *The Intersection of Innovation and the Law*, 38 WYO. LAW. 36, 38 (2015).

<sup>125</sup> Jeffrey Chu, *Uber Drivers Would Earn \$5500 Per Year in Benefits if Paid as Employees*, TIME (Aug. 21, 2015), <http://time.com/money/4005662/uber-drivers-earnings-employee-benefits/>.

<sup>126</sup> *Cotter v. Lyft, Inc.*, 60 F.Supp. 3d 1067, 1070 (N.D. Cal. 2015).

<sup>127</sup> *Id.* at 1069.

<sup>128</sup> *See id.*

model might buck some worker protection laws that society has deemed necessary for a minimum standard of living. Therefore, it seems as if both parties could compromise and find a middle ground between these two extremes where workers would get some, but not all of the employee benefits, it would allow the workers to retain some of their independence. Political commentators and legal scholars have suggested that a dependent contractor would be the ideal classification for workers in the sharing economy where workers are less dependent on the intermediary employer, yet the employer still retains a significant amount of control.<sup>129</sup> H.W. Arthurs is credited for coining the term “dependent contractor” in a 1965 article commenting on Canadian employment law.<sup>130</sup> He considered self-employed truck drivers, peddlers, taxicab operators, farmers, fishermen, and service station lessees to be dependent contracts since they were in an economically vulnerable position due to a powerful monopoly buyer or seller, or because of disorganized market conditions.<sup>131</sup>

Labor commissions and legislatures in Canada have implemented Arthurs’s ideas and created a variance of the dependent contractor classification. The main benefit that dependent contractors receive, that their independent contractor counterparts do not receive, is a severance package if terminated.<sup>132</sup> Most Canadian Labour Relations Boards follow the 80% rule in determining whether a worker is a dependent contractor, meaning that 80% of an individual’s income must be earned from a quasi-employer.<sup>133</sup> However, the Ontario Board uses a different rule and analyzes the eleven *Algonquin Tavern* factors: (1) the right to use substitute workers; (2) ownership of tools and supply of materials; (3) evidence of entrepreneurial activity; (4) the selling of one's own services in the market generally; (5) economic mobility or independence—the freedom to refuse a job; (6) evidence of variation in fees charged; (7) organizational integration; (8) degree of specialization, skill, expertise, and creativity; (9) control in the manner of performance of work; (10) magnitude of the contract and manner

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<sup>129</sup> See generally ALOISI, *supra* note 8; Roberto Cruz, *A Class of Their Own? Independent Contractors Causing a Conundrum*, WORKFORCE (Sept. 1, 2015), <http://www.workforce.com/2015/09/01/a-class-of-their-own-independent-contractors-causing-a-conundrum/>; Aarti Shahani, *Service Jobs, Like Uber Driver, Blur Lines Between Old Job Categories*, NPR (June 26, 2015), <http://www.npr.org/2015/06/26/417675866/service-jobs-like-uber-driver-blur-lines-between-old-job-categories>.

<sup>130</sup> H.W. Arthurs, *The Dependent Contractor: A Study of the Legal Problems of Countervailing Power*, 16 U. TORONTO L.J. 89, 89 (1965) (“Because the choice of either legal designation—“employee” or “independent contractor”—in effect prejudices the issue of their right to bargain collectively, a new term is needed: “dependent contractor”).

<sup>131</sup> *Id.* at 110.

<sup>132</sup> Shahani, *supra* note 129.

<sup>133</sup> See Elizabeth Kennedy, *Freedom from Independence: Collective Bargaining Rights for Dependent Contractors*, 26 BERKELEY J. EMP. & LAB. L. 143, 154 (2005).

of payment; and (11) the rendering of services under the same conditions as employees.<sup>134</sup> Besides Canada, Germany and Spain also use the dependent contractor classification.<sup>135</sup>

A third classification is a common-sense approach to the classification problem because great masses of workers fall in between the two extremes of employee or independent contractor statuses. However, a third classification, or at least the dependent contractor classification, might muddle the classifications distinctions even more.

First, the *Algonquin Tavern* eleven-part test is essentially an expanded test that some American courts currently use for employee classification.<sup>136</sup> Not only are eleven-part tests impractical to use because of the difficulty to balance an abundance of factors, but another classification type would make distinctions even more difficult. Whereas now courts decide between merely an employee and an independent contractor, adding a third classification would force courts to choose between an employee, an independent contractor, and a dependent contractor. Tests with a large number of factors provide employers little guidance in making classification decisions and provide courts with greater discretion to follow the judges' personal beliefs.

Second, a rule where workers have to reach some threshold of total earnings from a single firm, such as Canada's 80% rule or Germany and Spain's lower standards, might have undesirable effects in the market. Many drivers work for Uber, Lyft, and Sidecar as well as for other companies in the sharing economy, such as Airbnb and TaskRabbit.<sup>137</sup> This threshold-type rule may not work in the sharing economy since workers are not solely dependent on a single firm, but on a handful of different firms. This rule could have unintended consequences, such as drivers only working for one company. Drivers would flock to the industry leader, which is Uber, and firms like Lyft and Sidecar would lose drivers. This would create a chain reaction, in which the second tier rideshare companies would keep losing riders due to a lack of supply of drivers, and Uber would become more dominant as more drivers switch to its network. This would further decrease competition and force the second tier rideshare companies out of the market. It would also create enormous barriers to entry since firms could not build an expansive base of drivers to compete with the industry leader.

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<sup>134</sup> C.L.C., *Local 1689 v. Algonquin Tavern*, 3 Can. L.R.B.R. 337, ¶ 64 (Ont. 1981).

<sup>135</sup> Cruz, *supra* note 129.

<sup>136</sup> Sec'y of Labor, *United States Dep't of Labor v. Lauritzen*, 835 F.2d 1529, 1535-38 (7th Cir. 1987) (evaluating worker status based on (1) control, (2) profit and loss, (3) capital investments, (4) degree of skill required, (5) permanency, (6) importance to a particular business, and (7) dependence of the workers).

<sup>137</sup> Singer, *supra* note 87 ("[M]any workers toggle among multiple services").

Not only would quality decrease as prices are raised for riders, but drivers also would not benefit from working for just one company. Many drivers work for multiple ridesharing companies because they can maximize their earnings and reduce risk.<sup>138</sup> Also, rideshare companies currently must compete to build their driver base. Uber and Lyft frequently battle each other by offering drivers promotional incentives to drive for their companies.<sup>139</sup> Drivers have significant bargaining power with rideshare companies because the companies know that if they are not treated well, the drivers will merely switch to another platform. If drivers were forced to choose only one rideshare company to drive with, these incentives would no longer exist, and thus, drivers would lose much of their bargaining power.

### B. *The Franchise Business Model*

The driver-company relationship in the rideshare industry may be more similar to a franchise than an employment relationship.<sup>140</sup> First, this sub-section will outline the general economic tenants of a franchise relationship. Second, this sub-section will detail the federal legal requirements of being classified as a franchise. Lastly, this sub-section will conclude by exploring the effects of this model on the parties involved.

#### a. The Economics of a Franchise

Franchising is a practice whereby an owner of a trademark (franchisor) sells the non-exclusive rights of the trademark to a local distributor (franchisee) for a payment.<sup>141</sup> Franchising can also be seen as an “interorganizational form that creates a contractual alliance between two firms to generate and allocate a productive benefit.”<sup>142</sup> Most franchises have three elements in common: (1) a trademark is licensed to a franchisee;

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<sup>138</sup> *See id.*

<sup>139</sup> *See* Brian Fung, *Why Drivers are Winning the Labor War Between Uber and Lyft*, WASH. POST (Mar. 3, 2015), <https://www.washingtonpost.com/news/the-switch/wp/2015/03/03/why-drivers-are-winning-the-labor-war-between-uber-and-lyft/>.

<sup>140</sup> Maselli and Giuli first proposed that Uber’s business model may be a form of franchising, but no other legal scholars have tackled this issue yet. *See* Ilaria Maselli & Marco Giuli, *Uber: Innovation or Déjà vu?*, CENTER FOR EUROPEAN POLICY STUDIES COMMENTARY, at 2 (Feb. 25, 2015) (“Uber is not at all innovative since it is just a form of franchising.”).

<sup>141</sup> *See* Steve Spinelli & Sue Birley, *Toward a Theory of Conflict in the Franchise System*, 11 J. BUS. VENTURING 329, 330 (1996) (“[O]rganizational form structured by a long-term contract whereby the owner, producer, or distributor of a service or trademarked product (franchisor) grants the non-exclusive rights to a distributor for the local distribution of the product or service (franchisee).”).

<sup>142</sup> *Id.*

(2) the franchisor provides a marketing plan to the franchisee; and (3) the franchisee pays the franchisor a fee for the services provided.<sup>143</sup> McDonald's is the quintessential example of a franchise due to its success of regulating intimate details of the daily operations that create product uniformity.<sup>144</sup>

The various definitions of franchising are usually broad and encompass a variety of different business models. The structure and operations of the rideshare market functions like a trademark franchise whereby a franchisor owns a trademark or manufactures a product that they allow the franchisee to distribute downstream to the consumers.<sup>145</sup> Uber and Lyft do not provide a direct service to consumers, but they created and own the technology that connects riders and drivers. Rideshare companies most likely have no desire to engage in downstream production and distribution of taxi rides because it is expensive. Franchising can be viewed as a means to distribute a product. Local franchisees have greater knowledge of market conditions and have relatively lower search costs compared to the franchisor.<sup>146</sup> Klein states that the economic rationale behind franchising is that "it permits transactors to achieve whatever benefits of large scale may be available in, for example, brand name development and organizational design, while harnessing the profit incentive and retailing effort of local owners."<sup>147</sup> This allows firms to expand their business rapidly without the need of raising capital.<sup>148</sup>

The focal point of the transaction between the franchisor and the franchisee is the purchase of the trademark. The trademark is a valuable asset because it acts as a signal to consumers and conveys information about price and quality.<sup>149</sup> Franchisors have an incentive to strongly monitor and control the franchisee. The free rider problem plagues franchises because the marginal cost is greater to the franchisor than the franchisee for bad service. Thus, a wealth maximizing franchisee would

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<sup>143</sup> See David Gurnick, *Franchise Law*, 14 *COMPLEAT LAW* 33 (1997).

<sup>144</sup> See Alanson P. Minkler, *Why Firms Franchise: A Search Cost Theory*, 148 *J. INST. & THEORETICAL ECON.* 240, 245 (1992).

<sup>145</sup> See Alan Felstead, *The Social Organization of the Franchise: A Case of 'Controlled Self-Employment'*, 5 *WORK, EMP. & SOC'Y* 37, 39 (1991) ("The franchisor typically provide some advertising, management assistance and training, but the franchisee generally conducts business as an independent distributor acquiring the identity of the franchisor through the product/trade mark."); see also Minkler, *supra* note 144, at 241.

<sup>146</sup> See Minkler, *supra* note 144, at 240 ("Franchising might exist because franchisees have superior knowledge about local markets and enjoy low search costs relative to the franchisor").

<sup>147</sup> Benjamin Klein, *The Economics of Franchise Contracts*, 2 *J. CORP. FIN.* 9, 10 (1995).

<sup>148</sup> See Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 *J. L. ECON.* 223, 225 (1978) ("A common explanation for the franchising of independent firms, rather than reliance on expansion by wholly owned subsidiaries, is that franchising is a method used by the franchisor to raise capital. Thus, it is argued, the franchisor is able to expand his business more quickly than would otherwise be the case.").

<sup>149</sup> *Id.* at 228.

reduce the quality of service because he would receive all the savings benefits, but the franchisor would experience a loss in the value of the trademark. To reduce the effects of the free rider problem, the franchisor most likely will exert significant control over the franchise by regulating standards, the means of production, and intimate details of the daily operations through operating manuals.<sup>150</sup>

The franchisor-franchisee relationship is akin to an employer-employee relationship because of the significant amount of control the franchisor has over the behavior of the franchisee.<sup>151</sup> Although franchisees report as self-employed, they are dependent on the franchisor, and thereby share many similarities with employees.<sup>152</sup> Felstead suggests, “[t]he worker-employer relationship is replaced by one based on *firm-supplier* lines.”<sup>153</sup>

#### b. The Legal Requirements of a Franchise

The Federal Trade Commission (FTC) and seventeen states have laws governing franchise relationships.<sup>154</sup> Most states follow the FTC’s Franchise Rule in defining what constitutes a franchise.<sup>155</sup> The FTC’s Franchise Rule consists of three main elements: (1) substantial association between the franchisee and the trademark; (2) the franchisor has a significant amount of control over franchisee’s operation; (3) payment of a fee to the franchisor.<sup>156</sup>

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<sup>150</sup> See Felstead, *supra* note 145, at 40.

<sup>151</sup> Paul H. Rubin, *supra* note 148, at 225.

<sup>152</sup> See Felstead, *supra* note 145, at 42.

<sup>153</sup> *Id.*

<sup>154</sup> See Gurnick, *supra* note 143, at 34 (The 17 states are California, Florida, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Texas, Utah, Virginia, Washington State, and Wisconsin).

<sup>155</sup> See Susan A. Grueneberg & Jonathan C. Solish, *Franchising 101*, ABA BUS. L. TODAY (2010), <http://apps.americanbar.org/buslaw/blt/2010-03-04/grueneberg-solish.shtml>.

<sup>156</sup> See FTC Franchise Rule, 16 C.F.R. § 436.1 (2007) (“*Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that: (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark; (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation; and (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.”).

1. Substantial association between the franchisee and the trademark

There is no national test to determine whether a substantial association between the franchisee and the trademark exists, but most jurisdictions look for a license to use a franchisor's name.<sup>157</sup> There is a significant amount of case law from Connecticut, more so than from any other jurisdiction, which defines and interprets the substantial association required to form a franchise. Connecticut courts review the following four factors: (1) the percentage of the franchisee's sales that come from the trademark; (2) the use of the trademark; (3) the degree to which the public associates the trademark with the franchisee; and (4) the extent of the financial harm to the franchisee if the franchisor terminated the right to use the trademark.<sup>158</sup>

Many states, including Connecticut, have determined that the percentage of the franchisee's sales factor is the most important determinative that a substantial association exists.<sup>159</sup> The Second Circuit found that a substantial association between a franchisee and the trademark exists because the franchisee sold only the franchisor's products.<sup>160</sup> Similarly the *Spear-Newman* court found that 23% of the franchisee's sales being associated with the franchisor's trademark was sufficient to find a substantial association, although in *Grand Light*, 3% was not enough.<sup>161</sup> Drivers perform services under various rideshare platforms. Although most drivers tend to only drive for the industry leaders, Uber and Lyft, there are a number of other rideshare platforms. If a driver belongs to four or five different rideshare platforms, he may not meet the minimum percentage of the franchisee's sales to have a substantial association with the franchisor rideshare company. However, in jurisdictions such as the Seventh Circuit, a franchisee must show that more than 50% of its business results from a relationship with the franchisor.<sup>162</sup> It would be difficult to fulfill the

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<sup>157</sup> See Grueneberg & Solish, *supra* note 155.

<sup>158</sup> See Daniel J. Oates, Shannon L. McCarthy & Douglas C. Berry, *Substantial Association with a Trademark: A Trap for the Unwary*, 32 FRANCHISE L.J. 130, 131 (2013). See generally *Petereit v. S.B. Thomas, Inc.*, 63 F.3d 1169 (2d Cir. 1995); *Spear-Newman, Inc. v. E.I. du Pont de Nemours & Co.*, 1991 WL 318725 (D. Conn. 1991); *B&E Juices, Inc. v. Energy Brands, Inc.*, 2007 WL 3124903 (D. Conn. 2007); *Contractors Home Appliance, Inc. v. Clarke Distribution Corp.*, 196 F. Supp. 2d 174 (D. Conn. 2002); *Rudel Mach. Co., Inc. v. Giddings & Lewis, Inc.*, 68 F. Supp. 2d 118 (D. Conn. 1999); *Chem-Tek, Inc. v. Gen. Motors Corp.*, 816 F. Supp. 123 (D. Conn. 1993); *Hartford Elec. Supply Co. v. Allen-Bradley Co., Inc.*, 736 A.2d 824 (Conn.1999).

<sup>159</sup> See Oates, McCarthy & Berry, *supra* note 158, at 131.

<sup>160</sup> *Petereit*, 63 F.3d at 1180-81.

<sup>161</sup> *Spear-Newman*, 1991 WL 318725 at 10. Compare *Grand Light & Supply Co., Inc. v. Honeywell, Inc.*, 771 F.2d 672, 677 (2d Cir. 1985).

<sup>162</sup> See *Echo, Inc. v. Timberland Mach. & Irr., Inc.*, 661 F.3d 959, 966 (7th Cir. 2011) ("As demonstrated above, TMI failed to show that more than 50 percent of its business resulted from its relationship with Echo.").

substantial association requirement in jurisdictions that have a bright line 50% rule, but rideshare companies could require drivers to drive exclusively for its company in those jurisdictions. However, in most other jurisdictions, such as Connecticut, drivers would easily exceed the lower standards put in place by the courts.

Drivers' use of the rideshare company's trademark weighs in favor of a substantial association. In *Spear-Newman*, the court found that the franchisee was linked to a franchisor's trademarked name through advertising, franchisee's business cards, use of trademark in name of franchisee's business, and franchisee's trucks displayed the trademark.<sup>163</sup> Furthermore, the *Chem-Tek* court noted that a franchisee holding himself out to the public as a representative of the franchisor showed a substantial association.<sup>164</sup> Not only do rideshare drivers have to attach a sticker to his or her car indicating that they drive for Uber or Lyft, but also riders can only come into contact with drivers through the company's trademarked app. After a driver accepts to give a ride through the app, the driver's name, face, make and model of their car, and license plate number appear to the rider. Only an agent of Uber can appear on Uber's app and only an agent of Lyft can appear on the Lyft app. Thus, the use of the trademark demonstrates a substantial association between the franchisee-driver and the franchisor-company.

There is not a substantial association where a franchisee presents no evidence to demonstrate that customers closely associate the franchisee's business with the franchisor.<sup>165</sup> The *Rudel* court also noted, "[t]he duration of a commercial relationship does not appear to be a significant factor in the substantial association inquiry."<sup>166</sup> Much like the second factor, the degree to which the public associates the trademark with the franchisee is easily shown by the fact that riders can only request an Uber driver through the Uber app. There is no mistake that a driver works for either Uber or Lyft because the rider must request that driver through the proper rideshare platform.

There is a substantial association between the franchisee and the trademark when the franchisee's business would fail without the

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<sup>163</sup> *Spear-Newman*, 1991 WL 318725 at 10. *Compare Contractors Home Appliance*, 196 F. Supp. 2d at 179 (holding that no substantial association was shown where the only use of trademark was in window stickers and on company sign).

<sup>164</sup> *See Chem-Tek*, 816 F.Supp. at 129.

<sup>165</sup> *See Contractors Home Appliance*, 196 F. Supp. 2d at 180.

<sup>166</sup> *Rudel Mach. Co., Inc. v. Giddings & Lewis, Inc.*, 68 F. Supp. 2d 118, 127 (D. Conn. 1999). *Compare Hartford Elec. Supply v. Allen-Bradley Co., Inc.*, 736 A.2d 824, 839 (Conn.1999) (noting that evidence that franchisee was a widely recognized distributor of franchisor's products for fifty years supported finding of substantial association).

trademark.<sup>167</sup> Drivers drive for multiple rideshare platforms to reduce risk and take advantage of the numerous promotions and benefits each platform offers. For instance, if Uber cuts ties with a driver, the driver could work for any of the other rideshare platforms, and not experience a drop off in revenue. However, drivers in smaller markets, where the lower-tiered platforms have not been established, are subject to greater failure since there are fewer alternatives to turn to if a driver is let go by either Uber or Lyft.

In summary, a rideshare driver would most likely fulfill Connecticut's four-factor test to determine whether a substantial association exists between a franchisee and the franchisor's trademark. Not every driver would meet all the criteria because some jurisdictions have more stringent tests and drivers in different markets face different circumstances.

## 2. The Franchisor Has a Significant Amount of Control Over Franchisee's Operation

The FTC's Franchise Rule Compliance Guide states, "to be deemed 'significant,' the control or assistance must relate to the franchisee's overall method of operation—not a small part of the franchisee's business."<sup>168</sup> The FTC has included the following as significant controls: appearance requirements, hours of operation, accounting practices, and area of operation.<sup>169</sup> Significant types of assistance include: offering formal business training programs, furnishing marketing materials, selecting site locations, maintaining a website, and creating a detailed operating manual.<sup>170</sup>

Tanya Woker from the University of KwaZulu-Natal, states, "[i]t is clear . . . that if entrepreneurs develop marketing plans or manuals that are given to those using their trade marks, the relationship will constitute a franchise, even if no further assistance is provided."<sup>171</sup> From an examination of the FTC's Compliance Guide, only a modest showing of control or assistance is needed to prove a franchise relationship.<sup>172</sup> The FTC even found that a discount buying club, the International Consumer

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<sup>167</sup> See *Hartford Elec. Supply*, 736 A.2d at 839. Compare *B&E Juices*, 2007 WL 3124903 at 42 (holding that franchisee's business was not substantially associated with trademark where termination of franchise would not cause franchisee's business to fail).

<sup>168</sup> FTC, FRANCHISE RULE COMPLIANCE GUIDE, 2 (2008).

<sup>169</sup> *Id.* at 3.

<sup>170</sup> *Id.*

<sup>171</sup> Tanya Woker, *Establishing When a Franchise is Actually A Franchise—'If it Looks Like a Duck, Smells Like A Duck and Quacks Like A Duck, it is Usually A Duck'*, 22 S. AFR. MERCANTILE L.J. 12, 18 (2010).

<sup>172</sup> *Id.* at n. 26.

Club, was a franchise because the franchisor provided money-making ideas, sample directories, sample contracts, and supplied membership cards.<sup>173</sup>

Rideshare companies far surpass the minimum requirement of providing drivers with merely a manual. Not only does Uber, for example, distribute manuals to its drivers, but the California Labor Commissioner's Office even found that Uber is involved in every aspect of the driver's operation.<sup>174</sup> To be hired by a rideshare company like Uber, the company vets applicant drivers, regulates the maximum age of the cars used, runs background checks, gives city knowledge exams, and requires personal interviews. Once an applicant becomes a driver, they must maintain a certain level of cleanliness in their car and follow Uber grooming requirements. Although Uber does not set hours or make drivers work at certain times, Uber's handbook states that drivers will be investigated and potentially terminated if they reject too many trips.<sup>175</sup> Furthermore, Uber drivers can only give rides to customers requesting rides from the Uber app and Uber unilaterally sets the fare price without the driver's input. Uber even receives the fare money, not the driver, through its payment system and subsequently gives the driver his share. It is clear from hiring to firing that Uber and other rideshare companies retain and exercise a substantial amount of control over drivers.

### 3. Payment of a Fee to the Franchisor

Lastly, the FTC Rule requires that the franchisor receive a payment from the franchisee for the use of the trademark, but the payment does not need to be labeled a franchise fee in the agreement.<sup>176</sup> Thus, an initial fee for the trademark, a commission royalty, consulting fee, or training fee is sufficient, as long as the fee is in furtherance of the right to operate the business.<sup>177</sup> Uber and other rideshare companies make a majority of its revenue from commission fees per ride.<sup>178</sup> This commission or royalty payment satisfies the Rule's payment requirement because the fee is for the use of being affiliated with the rideshare company's brand.

Under the FTC Rule's payment requirement, a franchisee is required to pay at least \$500 within the first six months after starting the business relationship for it to be considered a franchise.<sup>179</sup> Rideshare drivers

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<sup>173</sup> *Id.* at 18-19.

<sup>174</sup> *Berwick v. Uber Technologies Inc.*, 11-46739 EK, at 9 (Cal. Mar. 10, 2015).

<sup>175</sup> *See O'Connor v. Uber Technologies, Inc.*, 82 F. Supp. 3d 1133, 1149 (N.D. Cal. 2015).

<sup>176</sup> *See Grueneberg & Solish, supra* note 155.

<sup>177</sup> *See id.*

<sup>178</sup> *See Ellen Huet, Uber Tests Taking Even More From Its Drivers With 30 Percent Commission*, FORBES (May 18, 2015), <http://www.forbes.com/sites/ellenhuet/2015/05/18/uber-new-uberx-tiered-commission-30-percent/>.

<sup>179</sup> *See Grueneberg & Solish, supra* note 155.

working an average of 5 hours per week should easily meet this requirement. Assuming that rideshare drivers make an average hourly wage of \$19.04 per hour after a 20 % commission is taken out, it would take drivers four hours per week for six months to reach the \$500 threshold.<sup>180</sup> Even assuming a much lower hourly wage of \$12 per hour, it would still only take six and half hours per week for six months to exceed \$500.<sup>181</sup>

### c. No Party Wants a Franchise Relationship

Critics of this Comment may find fault in classifying rideshare drivers as franchisees because neither rideshare companies nor drivers necessarily desire their relationship with each other to be considered a franchise. Rideshare companies have worked with state and city governments to legalize ridesharing services to skirt the strict taxi service licensing requirements. In September 2013, California became the first state to create a new distinct legal category, the Transportation Network Company (TNC), for rideshare companies.<sup>182</sup> Other states and cities, such as Colorado, Illinois, D.C., Seattle, Chicago, Austin, New York City, and Houston, have followed California's example and created a TNC category for rideshare companies.<sup>183</sup> The TNC distinction is based on the rideshare company's ability to use an app-based platform to connect passengers with drivers.<sup>184</sup> If rideshare companies were considered franchisors, they in essence would be doing more than just connecting passengers with drivers, and thus it might ruin their TNC status. Furthermore, federal and state franchise laws, which often conflict, could make it very costly for a rideshare company to operate. On the other hand, drivers, or other critics of the current independent contractor business model, would also be dissatisfied with a franchise relationship because the drivers would still not

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<sup>180</sup> Drivers would pay the rideshare company \$4.16 commission if they netted \$19.04 after commission payments. See Jacob Davidson, *Uber Reveals How Much Its Drivers Really Earn . . . Sort Of*, TIME (Jan. 22, 2015), <http://time.com/money/3678389/uber-drivers-wages/>.  $6$  (number of months)  $\times$   $4.3$  (number of weeks in a month)  $\times$   $4.16$  (commission)  $\times$   $N$  (number of hours worked) =  $500$ . Thus,  $N$  would equal 4.07 hours.

<sup>181</sup> Drivers would pay the rideshare company \$3 commission if they netted \$12 after commission payments. See Rachel Gillett, *Here's How Much You Could Make as an Uber or Lyft Driver in 20 Major US Cities*, BUS. INSIDER (July 20, 2015), <http://www.businessinsider.com/how-much-uber-drivers-make-in-each-city-2015-7>.  $(6 \times (\text{number of months}) \times 4.3 (\text{number of weeks in a month}) \times 3 (\text{commission}) \times N (\text{number of hours worked}) = 500$ . Thus,  $N$  would equal 6.45 hours).

<sup>182</sup> Rassman, *supra* note 7, at 91.

<sup>183</sup> See Jordan Ferguson, *Shifting Landscapes: Regulatory Challenges Stemming from Emerging Technologies*, 38 PUB. L.J. 22, 23 (2015); Sheena Goodyear, *Uber vs. the World: How Cities are Dealing with Ride-hailing Technology*, CBC NEWS (Oct. 2, 2015), <http://www.cbc.ca/news/business/uber-versus-the-world-1.3252096>.

<sup>184</sup> See Cal. Pub. Util. Code § 5431 (West 2015).

receive greater benefits and protections. The primary legal benefits franchisees receive from a franchisor are certain disclosures that the franchisor must make.<sup>185</sup> Although rideshare drivers would not be compensated for expenses or offered paid vacation days under a franchise relationship, the rideshare companies would be required to disclose estimated costs of the business.<sup>186</sup> Even though under a franchise relationship a rideshare driver would not receive tangible financial benefits, the disclosure requirements may aid drivers in conducting a more accurate cost-benefit analysis of deciding whether or not to drive.

### C. *The Recommendation*

The rideshare industry, in many respects, embodies the essence and principles of the free market. In the relatively short amount of time that rideshare companies have been operating, the data suggests that drivers, riders, and the companies are benefitting from this innovative business model. In a process that has already been started, the taxi lobby and the media are portraying the rideshare industry as the poster child for the evils of unfettered free markets because of the supposed worker rights violations. However, politicians, regulators, and judges should be hesitant about asserting a presumption that workers are employees. If anything, the rideshare experiment has proven that firms like Uber can reach better economic outcomes for drivers, compared to its heavily regulated counterparts, the taxi industry. As Koopman, Mitchell, and Thierer write, “[w]hen market circumstances change dramatically—or when new technology or competition alleviate the need for regulation—then public policy should evolve and adapt to accommodate these new realities.”<sup>187</sup> Take for instance the rideshare insurance issue, which is embedded in the employee-independent contractor distinction. Many part-time, and even probably a majority of full-time rideshare drivers would not be able to afford commercial-grade auto insurance at a price tag of a couple thousand dollars over private insurance coverage. Thus, Uber started to offer a \$1 million insurance policy for all Uber rides, but only when a passenger is in the vehicle.<sup>188</sup> Then in January of 2015, insurance companies began to offer

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<sup>185</sup> See Jeff Elgin, *How the Government Protects Franchisees*, ENTREPRENEUR (Oct. 14, 2002), <http://www.entrepreneur.com/article/56218>.

<sup>186</sup> *Id.*

<sup>187</sup> CHRISTOPHER KOOPMAN, MATTHEW MITCHELL & ADAM THIERER, MERCATUS CTR., *THE SHARING ECONOMY AND CONSUMER PROTECTION REGULATION: THE CASE FOR POLICY CHANGE 3* (2014).

<sup>188</sup> Kristen Bahler, *Here's What You Need to Know About Insuring Yourself with Uber*, TIME (Sep. 12, 2016).

a new grade of insurance to rideshare drivers at a nominal additional fee.<sup>189</sup> Given the appropriate amount of time for the market to adjust, it solves problems without the need of ex post remedies. Koopman, Mitchell, and Thierer explain, “[b]y trying to head off every hypothetical worst-case scenario, preemptive regulations actually discourage many *best-case* scenarios from ever coming about.”<sup>190</sup>

I propose that, in the absence of evidence suggesting driver abuse, legislatures and regulators should stick with the status quo. If actual, persistent worker abuses in the rideshare industry surface in the future, or if government officials succumb to political pressure, a third employment classification should be developed to preserve the immense benefits of the rideshare industry, but provide drivers with some minimum protections. Although both drivers and rideshare companies might not be incentivized to advocate for a legally recognized franchise relationship, the franchise analysis is important in many respects. First, the analysis shows that the current employment classification system is not completely broken because other contractual relationships exist, outside of the employment context, that would best describe the classification of a rideshare driver. Most importantly, however, a third category of employment status could be based off of a franchise relationship. Many legal scholars and regulators have faced difficulties comprehending the rideshare industry’s business model and exactly what service the company is providing. Viewing this relationship as a franchise can help politicians and regulators understand the nuances of the rideshare industry. An employment classification based on the franchise relationship could provide the flexibility for rideshare companies to operate with low costs, but ensure that drivers receive increased protections.

There will always be criticism of a classification that does not afford workers the same benefits as employee status. However, legislatures and regulators need to balance the immense economic benefits this sector of the economy provides to all parties with the rights of the worker. As discussed in this Comment, most rideshare drivers are thriving under the current independent contractor model, and only a small minority of drivers are experiencing subpar working conditions, such as earning below the minimum wage due to personal car expenses or unpredictable firings. A third classification based on a franchise relationship is the least intrusive alternative that will help the minority of rideshare drivers that are experiencing problems in this sector of the economy without burning down the entire business model. This alternative would help drivers because the disclosure requirements under a franchise relationship would force rideshare companies to explicitly state the estimated costs associated with

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<sup>189</sup> See Nerd Wallet, *Rideshare Insurance for Drivers: Where to Buy, What I Covers* (Mar. 21, 2017), <https://www.nerdwallet.com/blog/insurance/best-ridesharing-insurance/>.

<sup>190</sup> CHRISTOPHER KOOPMAN, MATTHEW MITCHELL & ADAM THIERER, *supra* note 187 at 18.

driving and the potential causes of termination. The disclosure requirements would fix the asymmetric information that exists currently between the rideshare companies and drivers, and provide potential drivers with more accurate information to decide if the benefits of driving for a rideshare company outweigh the costs.

## CONCLUSION

The impracticality of the current employment status test is causing substantial difficulties for businesses because they make employers choose between two extremes. Misclassification of independent contractors could be devastating for a company, and they may be liable for: (1) unpaid federal, state and local income tax withholdings and Social Security and Medicare contributions; (2) unpaid unemployment insurance taxes, both to the federal government and to state governments; (3) unpaid workers' compensation premiums; (4) unpaid overtime compensation and/or minimum wages; (5) unpaid work-related expenses; and (6) unpaid sick and vacation pay.<sup>191</sup> Until the distinction between an independent contractor and an employee is made clear, or a third type of employment classification is created, this problem could stifle innovation not only in the sharing economy, but also in the economy as a whole. For business models that rely heavily on the independent contractor distinction, like Uber and Lyft, there is too much uncertainty for these firms to continue to innovate and grow.

Inevitably, legislators or courts will classify drivers as employees, despite immense economic benefits for all parties under an independent contractor classification. It is too soon to decide if the independent contractor model is oppressing the rights of rideshare drivers. Despite news reports every other day concerning Uber and Lyft taking advantage of its drivers, more and more drivers are leaving traditional employment arrangements and joining the rideshare industry.<sup>192</sup> If change is in fact needed in employment classification law concerning the rideshare industry, politicians and regulators should consider a franchise relationship. Even if the courts or regulators do not view rideshare drivers legally as franchisees, it may still be a helpful model in creating a new employment classification that fits the needs of the sharing economy.

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<sup>191</sup> See REIBSTEIN, PETKUN & RUDOLPH, *supra* note 9, at 4.

<sup>192</sup> See Hall & Krueger, *supra* note 89, at 2.

## DOES THE FEDERAL TRADE COMMISSION'S SECTION 5 STATEMENT IMPOSE LIMITS ON THE COMMISSION'S UNFAIR METHODS OF COMPETITION AUTHORITY?

*Lindsey M. Edwards\**

### INTRODUCTION

Section 5 of the Federal Trade Commission Act (“FTC Act”) prohibits “unfair methods of competition in or affecting commerce.”<sup>1</sup> More than one hundred years after Congress created the Federal Trade Commission (“FTC” or “Commission”) and gave it broad authority to prohibit “unfair methods of competition,” the FTC had yet to define what constituted an unfair method of competition. On August 13, 2015, a bipartisan majority of the FTC ended this century-long failure and adopted a statement of principles concerning how it will exercise its standalone Section 5 authority.<sup>2</sup> The Commission’s Statement of Enforcement Principles Regarding “Unfair Methods of Competition” (“Section 5 Statement” or “Statement”) announced that the FTC will be guided by three principles when deciding whether to bring a standalone Section 5 claim: (1) promotion of consumer welfare as that term is generally understood in antitrust precedent, (2) focus on harm to competition or the competitive process while accounting for procompetitive benefits when evaluating commercial practices, and (3) reluctance to rely on a standalone Section 5 theory if the Sherman Act or Clayton Act is sufficient to address the competitive concern at issue.<sup>3</sup>

The Section 5 Statement, while considered a substantial improvement and significant milestone in FTC history by some,<sup>4</sup> was met with skepticism

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<sup>1</sup> 15 U.S.C. § 45(a)(1) (2012). All references herein to “Section 5” relate to its prohibition of “unfair methods of competition” and not to its prohibition of “unfair or deceptive acts or practices.”

<sup>2</sup> FED. TRADE COMM’N, STATEMENT OF ENFORCEMENT PRINCIPLES REGARDING “UNFAIR METHODS OF COMPETITION” UNDER SECTION 5 OF THE FTC ACT (2015), [https://www.ftc.gov/system/files/documents/public\\_statements/735201/150813section5enforcement.pdf](https://www.ftc.gov/system/files/documents/public_statements/735201/150813section5enforcement.pdf) [hereinafter SECTION 5 STATEMENT].

<sup>3</sup> *Id.*

<sup>4</sup> See Edith Ramirez, Chairwoman, Fed. Trade Comm’n, Remarks at the Competition Law Center at George Washington University Law School 1 (Aug. 13, 2015) (referring to the SECTION 5 STATEMENT as “an important milestone in the Commission’s application of its founding statute”);

and criticism by others.<sup>5</sup> The primary question motivating the debate over the value of the Statement is whether it places new constraints upon the

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Joshua D. Wright & Angela M. Diveley, *Interpreting Section 5 Unfair Methods of Competition After the 2015 Commission Statement*, ANTITRUST SOURCE, Oct. 2015, at 13 (“We are confident that the flexible framework articulated in the Statement, by bounding the previously unbounded, and by adopting the same methodological commitments to an economically informed rule of reason, will lead to an improvement in the development of Section 5 competition law.”); Jared Bona, *Section 5 of the FTC Act and Commissioner Joshua Wright: Mission Accomplished?*, THE ANTITRUST ATTORNEY BLOG (Sept. 16, 2015), <http://www.theantitrustattorney.com/2015/09/16/section-5-of-the-ftc-act-and-commissioner-joshua-wright-mission-accomplished/> (“In my opinion, the answer is that the Section 5 guidelines are an important mission accomplished.”); Richard Epstein, *A Tribute to Joshua Wright*, TRUTH ON THE MARKET (Aug. 24, 2015), <https://truthonthemarket.com/2015/08/24/a-tribute-to-joshua-wright/> (“This short policy statement sets matters in the right direction when it treats unfair methods of competition as a variation on the basic theme of monopoly, and notes that where the antitrust laws do apply, the FTC should be reluctant to exercise its standalone jurisdiction. It is a tribute to Ramirez and Wright that they could come to agree on the statement, so that a set of sound principles has bipartisan support.”); Geoffrey Manne, *FTC Commissioner Joshua Wright gets his competition enforcement guidelines*, TRUTH ON THE MARKET (Aug. 13, 2015), <https://truthonthemarket.com/2015/08/13/ftc-commissioner-joshua-wright-gets-his-competiton-enforcement-guidelines/> (“[T]he Statement brings UMC law into the world of modern antitrust analysis. This is a huge achievement.”).

<sup>5</sup> See *Dissenting Statement of Commissioner Maureen K. Ohlhausen*, FTC ACT SECTION 5 POLICY STATEMENT 1 (Aug. 13, 2015), [https://www.ftc.gov/system/files/documents/public\\_statements/735371/150813ohlhausendissentfinal.pdf](https://www.ftc.gov/system/files/documents/public_statements/735371/150813ohlhausendissentfinal.pdf) [hereinafter *Ohlhausen Dissent*]; *FTC Issues Statement of Enforcement Principles Interpreting “Unfair Methods of Competition” Under Section 5 of the FTC Act*, CAHILL GORDON & REINDEL LLP 1 (Aug. 21, 2015), [https://www.cahill.com/publications/firm-memoranda/10130384/\\_res/id=Attachments/index=0/CGR%20Memo%20-%20FTC%20Issues%20Statement%20of%20Enforcement%20Principles%20Interpreting%20Unfair%20Methods%20of%20Competition%20Under%20Section%205%20of%20the%20FTC%20Act.pdf](https://www.cahill.com/publications/firm-memoranda/10130384/_res/id=Attachments/index=0/CGR%20Memo%20-%20FTC%20Issues%20Statement%20of%20Enforcement%20Principles%20Interpreting%20Unfair%20Methods%20of%20Competition%20Under%20Section%205%20of%20the%20FTC%20Act.pdf) (“It is notable for being the first, albeit laconic, articulation of the FTC’s interpretation of the unfair competition clause of Section 5, but it likely does not portend significant changes in enforcement priorities.”). See also *Federal Trade Commission Issues Policy Statement on Unfair Methods of Competition*,

CROWELL & MORING 2 (Aug. 14, 2015), <https://www.crowell.com/NewsEvents/AlertsNewsletters/all/Federal-Trade-Commission-Issues-Policy-Statement-on-Unfair-Methods-of-Competition/pdf> (“It offers little that the Commission has not stated previously in the context of enforcement actions brought over the past decade.”); *FTC Issues Statement on “Unfair Methods of Competition” Prohibited by Section 5 of the FTC Act*, KING & SPALDING 2 (Aug. 18, 2015), <http://www.kslaw.com/imageserver/KSPublic/library/publication/ca081815.pdf> (“At bottom, the FTC seems to have missed an opportunity to provide businesses with meaningful guidance in a controversial area of its enforcement authority.”); *FTC Issues Policy Statement on the Reach of Section 5 of FTC Act*, at 1 (Aug. 17, 2015), KIRKLAND & ELLIS LLP 1, <https://www.kirkland.com/siteFiles/Publications/081715.pdf> (“For businesses concerned about the potential for an activist FTC to apply Section 5 in novel ways, this statement provides little comfort.”); *Key Take-Aways from the FTC’s New Section 5 Statement*, MORRISON & FOERSTER LLP 2 (Aug.

24, 2015), <http://www.mondaq.com/unitedstates/x/422104/Antitrust+Competition/Key+TakeAways+From+the+FTCs+New+Section+5+Statement> (“The Statement . . . does not disappoint those who expected little guidance.”); *FTC Issues Unprecedented but Vague Guidance on Unfair Methods of Competition*, NIXON PEABODY LLP 1 (Aug. 20, 2015), [http://www.nixonpeabody.com/FTC\\_guidance\\_on\\_unfair\\_methods\\_of\\_competition](http://www.nixonpeabody.com/FTC_guidance_on_unfair_methods_of_competition); *After Long Debate, FTC Issues Only General Principles Regarding Section 5*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP 1 (Aug. 21, 2015),

FTC's Section 5 authority or merely restates widely agreed upon existing enforcement principles. Commissioner Maureen K. Ohlhausen, a critic of the Statement and the only Commissioner to vote against its issuance, claims that the Statement does not impose any new limits on the FTC and, in fact, potentially expands its Section 5 authority.<sup>6</sup> Other critics doubt not only the ability of the Statement to constrain the Commission, but also its ability to provide meaningful guidance.<sup>7</sup>

This Article addresses whether the Section 5 Statement places a meaningful constraint on the FTC's discretion over its unfair methods of competition ("UMC") authority. By evaluating the agency's Section 5 enforcement record under the standard articulated in the Statement, this Article demonstrates that the Statement does in fact constrain agency discretion and that the aforementioned criticisms miss their mark. Part I of this Article discusses briefly the history of the Commission's standalone Section 5 authority. Part II summarizes the elements of the Statement and discusses the praises and criticisms for each. Part III reviews the Commission's standalone Section 5 enforcement record, identifying four categories of conduct that the Commission has conventionally prosecuted using that authority. Part IV applies the Statement's standard to the facts of the cases discussed in Part III, illustrating that under the announced standard the Commission will not be able to challenge at least some conduct that it has previously prosecuted under Section 5 and thus that the Statement can be expected to constrain the FTC's enforcement authority.

## I. BACKGROUND

Congress enacted the FTC Act in 1914.<sup>8</sup> With this statute, Congress created the Commission and delegated to it the authority to enforce Section 5, which houses the central provision of the original statute: a prohibition on "unfair methods of competition."<sup>9</sup> While the Commission may invoke Section 5 to prohibit acts or practices that violate the Sherman or Clayton Acts, it may also invoke its "standalone" Section 5 authority to prohibit conduct that does not violate the traditional antitrust laws but otherwise constitutes an unfair method of competition.<sup>10</sup> Congress left to the

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<https://www.skadden.com/insights/after-long-debate-ftc-issues-only-general-principles-regarding-section-5> ("Those anxious for guidance, however, will not find the FTC's statement on Section 5 wholly satisfying.").

<sup>6</sup> *Ohlhausen Dissent*, *supra* note 5, at 1-2.

<sup>7</sup> *See supra* note 5.

<sup>8</sup> Federal Trade Commission Act, 15 U.S.C. §§ 41-51 (2012).

<sup>9</sup> Congress added a prohibition on "unfair or deceptive acts or practices" in 1938. Wheeler-Lea Act, Pub. L. No. 75-447, 52 Stat. 111 (1938) (codified as amended at 15 U.S.C. §§ 41, 44, 45 & 52-58 (2012)).

<sup>10</sup> 15 U.S.C. § 45(a)(1) (2012).

Commission, an agency “with broad business and economic expertise,” the task of defining “unfair.”<sup>11</sup> It took until 2015 for the Commission, through the Statement, to commit to a single, coherent standard applicable to enforcement of its standalone Section 5 authority.

The 101-year gap between the enactment of the FTC Act and the issuance of the Section 5 Statement holds a number of improvements for antitrust law generally. However, the Commission’s input in establishing a reliable standard for its standalone Section 5 authority is less than impressive.<sup>12</sup> While the antitrust laws have evolved considerably to reflect improved techniques for evaluating competitive harms and benefits, the gap between Section 5 theory and practice has been called “one of the [FTC]’s most significant failures,” leaving businesses unable to predict the type of conduct that would constitute a Section 5 violation.<sup>13</sup> A number of creative interpretations of the FTC’s standalone authority—each of which diverges significantly from the traditional goal of protecting consumer welfare—have been posited from inside the agency.<sup>14</sup>

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<sup>11</sup> E. I. Du Pont de Nemours & Co. v. FTC, 729 F.2d 128, 136 (2d Cir. 1984); James C. Cooper, *The Perils of Excessive Discretion: The Elusive Meaning of Unfairness in Section 5 of the FTC Act*, 3 J. ANTITRUST ENFORCEMENT 87, 88 (2015).

<sup>12</sup> William E. Kovacic & Marc Winerman, *Competition Policy and the Application of Section 5 of the Federal Trade Commission Act*, 76 ANTITRUST L.J. 929, 933, 944 (2010) (“In practice, the FTC’s application of Section 5 has played a comparatively insignificant role in shaping U.S. competition policy.”). See Joshua D. Wright, Comm’r, Fed. Trade Comm’n, *What’s Your Agenda?*, Remarks at the Antitrust Section of the American Bar Association Spring Meeting (Apr. 11, 2013), [https://www.ftc.gov/sites/default/files/documents/public\\_statements/whats-your-agenda/130411abaspringmtg.pdf](https://www.ftc.gov/sites/default/files/documents/public_statements/whats-your-agenda/130411abaspringmtg.pdf) (“What does a frank assessment of the 100 year record of Section 5 tell us about its contribution to the competition mission? Or as I might put it, has Section 5 lived up to its promise of nudging the FTC toward evidence-based antitrust? I believe the answer to that question is a resounding ‘no.’”).

<sup>13</sup> Wright & Diveley, *supra* note 4, at 1.

<sup>14</sup> See Rambus, Inc., F.T.C. No. 011-0017 (2006) (Leibowitz, Comm’r, concurring) (opining that “actions that are ‘collusive, coercive, predatory, restrictive, or deceitful,’ or *otherwise oppressive*” can constitute unfair methods of competition (emphasis added)); Robert H. Lande, *Revitalizing Section 5 of the FTC Act Using “Consumer Choice” Analysis*, ANTITRUST SOURCE, Feb. 2009, at 2 (“The choice framework would impose a threshold requirement that every Section 5 antitrust violation significantly impairs the choices that free competition brings to the marketplace . . . [and] that every Section 5 consumer protection violation significantly impairs consumers’ ability meaningfully to choose from among the options the market provides.”); Michael Pertschuk, Remarks before the Annual Meeting of the Section on Antitrust and Economic Regulation, Association of American Law Schools (Dec. 27, 1977) (unpublished speech on file with the Wayne Law Review) (“[N]o responsive competition policy can neglect the social and environmental harms produced as unwelcome by-products of the marketplace: resource depletion, energy waste, environmental contamination, worker alienation, the psychological and social consequences of producer-stimulated demands.”); J. Thomas Rosch, Comm’r, Fed. Trade Comm’n, *The Great Doctrinal Debate: Under What Circumstances Is Section 5 Superior to Section 2?*, Remarks at New York State Bar Association Annual Antitrust Conference 9 (Jan. 27, 2011) (“Congress believed the Commission would be an expert agency and, as such, could identify the sort of ‘one-off’ or ‘out-of-round’ conduct that Section 5 should reach.”).

The antitrust community has not been silent on the failure of the agency to define its Section 5 authority. Congress,<sup>15</sup> businesses,<sup>16</sup> the antitrust bar,<sup>17</sup> academics,<sup>18</sup> and even commissioners have demanded guidance.<sup>19</sup> The Commission finally answered the call on August 13, 2015

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<sup>15</sup> See *Oversight of the Enforcement of the Antitrust Laws: Hearing Before the Subcomm. on Antitrust Competition Policy and Consumer Rights of the S. Comm. on the Judiciary*, 113th Cong. 11-13 (2013) (questions for the record for Chairwoman Edith Ramirez) [hereinafter 2013 Hearing]; *Oversight of the Antitrust Enforcement Agencies: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 114th Cong. 4 (2015) (statement of Bob Goodlatte, Chairman, H. Comm. on the Judiciary) (statement of Tom Marino, Chairman, Subcomm. on Regulatory Reform, Commercial & Antitrust Law, H. Comm. on the Judiciary) [hereinafter 2015 Hearing].

<sup>16</sup> A. Douglas Melamed, Comments to the Federal Trade Commission, Workshop on Section 5 of the FTC Act as a Competition Statute (Oct. 14, 2008), [https://www.ftc.gov/sites/default/files/documents/public\\_comments/section-5-workshop-537633-00004/537633-00004.pdf](https://www.ftc.gov/sites/default/files/documents/public_comments/section-5-workshop-537633-00004/537633-00004.pdf).

<sup>17</sup> See Jan M. Rybnicek & Joshua D. Wright, *Defining Section 5 of the FTC Act: The Failure of the Common Law Method and the Case for Formal Agency Guidelines*, 21 GEO. MASON L. REV. 1287 (2014). See also Joe Sims, *Section 5 Guidelines: Josh Wright as the New King of Corinth?*, CPI ANTITRUST CHRONICLE (Sept. 17, 2013), <https://www.competitionpolicyinternational.com/section-5-guidelines-josh-wright-as-the-new-king-of-corinth/>; Susan A. Creighton & Thomas G. Krattenmaker, *Some Thoughts on the Scope of Section 5, Remarks at Workshop on Section 5 of the FTC Act as a Competition Statute* (Oct. 17, 2008), [https://www.ftc.gov/sites/default/files/documents/public\\_events/section-5-ftc-act-competition-statute/screighton.pdf](https://www.ftc.gov/sites/default/files/documents/public_events/section-5-ftc-act-competition-statute/screighton.pdf); Tad Lipsky, *Lessons From the Section 2 Context*, TRUTH ON THE MARKET (Aug. 2, 2013), <http://truthonthemarket.com/2013/08/02/tad-lipsky-on-lessons-from-the-section-2-context/> (“The FTC’s struggle to provide guidance for its enforcement of Section 5’s Unfair Methods of Competition (UMC) clause . . . could evoke a much broader long-run issue.”).

<sup>18</sup> See Thom Lambert, *Guidelines for the FTC’s UMC Authority: What’s Clear and What’s Not?*, TRUTH ON THE MARKET (Aug. 1, 2013), <http://truthonthemarket.com/2013/08/01/thom-lambert-on-guidelines-for-the-ftcs-umc-authority-whats-clear-and-whats-not/>; Geoffrey Manne, *The Importance of Sensible Guidance for UMC Enforcement*, TRUTH ON THE MARKET (Aug. 1, 2013), <http://truthonthemarket.com/2013/08/01/geoffrey-manne-on-the-importance-of-sensible-guidance-for-umc-enforcement/>; Tim Wu, *Section 5 Guidelines Would Make the FTC Stronger and Better*, TRUTH ON THE MARKET (Aug. 1, 2013), <http://truthonthemarket.com/2013/08/01/tim-wu-on-section-5-guidelines-would-make-the-ftc-stronger-and-better/>.

<sup>19</sup> See Kovacic & Winerman, *supra* note 122, at 930 (“Among other steps, we see a need for the Commission, as a foundation for future litigation, to issue a policy statement that sets out a framework for the application of Section 5”); Robert Bosch GmbH, A Corp., F.T.C. No. 121-0081 (2012) (Ohlhausen, Comm’r., dissenting) (“Before invoking Section 5 to address business conduct not already covered by the antitrust laws (other than perhaps invitations to collude), the Commission should fully articulate its views about what constitutes an unfair method of competition.”); Julie Brill, Comm’r, Fed. Trade Comm’n, Remarks at POLITICO Pro’s P2012 Policy and Politics Technology Luncheon (Dec. 13, 2012) (stating that although difficult, “it would be a great idea” to develop guidance as to the contours of Section 5); Jon Leibowitz, Comm’r, Fed. Trade Comm’n, “Tales from the Crypt” Episodes ‘08 and ‘09: The Return of Section 5, Remarks at Workshop on Section 5 of the FTC Act, as a Competition Statute at 4 (Oct. 17, 2008) (“If we do use Section 5—and I strongly believe we should—it is essential that we try to develop a standard”); Joshua D. Wright, Comm’r, Fed. Trade Comm’n, Section 5 Revisited: Time for the FTC to Define the Scope of Its Unfair Methods of Competition

by issuing the Section 5 Statement, which sets forth the principles that will guide the Commission in exercising its standalone Section 5 authority.<sup>20</sup>

The primary thrust of the Statement is to link the interpretation of the FTC's Section 5 authority to the traditional antitrust laws—the Clayton Act and the Sherman Act—to take advantage of the more economically sophisticated development of those laws.<sup>21</sup> Indeed, in its Statement of the Federal Trade Commission On the Issuance of Enforcement Principles Regarding “Unfair Methods of Competition” Under Section 5 of the FTC ACT (“Commission Statement”), the Commission explicitly incorporates by reference the rule of reason as understood under the traditional antitrust laws.<sup>22</sup> In addition to analyzing conduct under the rule of reason, the Section 5 Statement declares that the Commission will be guided by the promotion of consumer welfare in deciding whether to challenge conduct under its standalone Section 5 authority.<sup>23</sup> Further, the Statement announces that the Commission is less likely to use its Section 5 authority when either the Sherman or Clayton Act is sufficient to address the conduct.<sup>24</sup> This “anti-circumvention” prong of the Statement has been said to be a useful limiting principle because it restricts the Commission from avoiding the significantly more demanding standards of proof necessary under the Sherman and Clayton Acts.<sup>25</sup>

There has been substantial debate over whether the Statement has any bite—that is, will its faithful application limit the Commission's Section 5 agenda? This Comment will answer this question by analyzing how prior

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Authority, Remarks at Symposium on Section 5 of the Federal Trade Commission Act (Feb. 26, 2015) [hereinafter Wright, Section 5 Revisited]; Joshua D. Wright, Comm'r, Fed. Trade Comm'n, Section 5 Recast: Defining the Federal Trade Commission's Unfair Methods of Competition Authority, Remarks at Executive Committee Meeting of the New York State Bar Association's Antitrust Section (June 19, 2013) [hereinafter Wright, Section 5 Recast].

<sup>20</sup> SECTION 5 STATEMENT, *supra* note 2.

<sup>21</sup> See FED. TRADE COMM'N, STATEMENT OF THE FEDERAL TRADE COMMISSION ON THE ISSUANCE OF ENFORCEMENT PRINCIPLES REGARDING “UNFAIR METHODS OF COMPETITION” UNDER SECTION 5 OF THE FTC ACT 1 (Aug. 13, 2015) [hereinafter COMMISSION STATEMENT] (“Our statement makes clear that the Commission will rely on the accumulated knowledge and experience embedded within the ‘rule of reason’ framework developed under the antitrust laws over the past 125 years—a framework well understood by courts, competition agencies, the business community, and practitioners.”).

<sup>22</sup> *Id.*

<sup>23</sup> SECTION 5 STATEMENT, *supra* note 2.

<sup>24</sup> *Id.*

<sup>25</sup> See Richard Epstein, *When Bureaucrats Do Good*, HOOVER INSTITUTION (Aug. 17, 2015), <http://www.hoover.org/research/when-bureaucrats-do-good> (“The presumption against using the standalone authority when either the Sherman or Clayton Act ‘is sufficient to address’ some competitive harm is a useful limiting principle.”); Wright & Diveley, *supra* note 4, at 10 (“This third, ‘anti-circumvention’ prong . . . implicitly acknowledges that using Section 5 to evade the more rigorous standards of proof required by the traditional antitrust laws is inappropriate, and sets forth a limiting principle concerning the scope of Section 5.”).

cases brought under the FTC's standalone Section 5 authority would be decided under the standard announced in the Section 5 Statement. Prior decisions are the best baseline from which to determine whether the Statement signifies a constraint on the FTC's definition, and thus enforcement, of Section 5. Analyzing these cases under the standard articulated in the Statement provides a method to determine whether the FTC's Section 5 authority will be constrained in a way the agency has not heretofore been constrained.

## II. THE FTC'S SECTION 5 STATEMENT

A bipartisan Section 5 policy statement would have been considered highly unlikely at any point over the past two decades. Many agency chairs and commissioners had identified the agency's UMC authority as a potential target for policy reform. Several went so far as to propose that the Commission consider new guidelines. Chairman William Kovacic, in particular, made Section 5 a priority by holding a public workshop to examine the agency's history with its UMC authority and to determine whether it remained a useful tool.<sup>26</sup> Additionally, Chairman Jon Leibowitz, who called upon the agency to rely upon Section 5 more frequently, hired high-profile legal scholar and Columbia Law Professor Tim Wu to tackle the problem of new guidelines.<sup>27</sup> When Chairman Leibowitz's term came to an end without new guidelines, Section 5 reform became far less likely during Chairwoman Edith Ramirez's tenure.

Shortly after Commissioner Joshua D. Wright began his term at the FTC, he announced that the issuance of a Section 5 policy statement would be the most important goal of his tenure.<sup>28</sup> Nonetheless, a policy statement still seemed highly unlikely. In April 2013, he announced that he would soon release a proposed policy statement to begin the discussion.<sup>29</sup> That same week, Chairwoman Ramirez was questioned before the Senate Judiciary's Subcommittee on Antitrust, Competition Policy and Consumer Rights about the lack of useful enforcement guidance in regards to Section 5 and whether the Commission planned to issue formal guidance.<sup>30</sup> Between June and July of 2013, Commissioner Wright and Commissioner Ohlhausen each released proposed policy statements that discussed what they believed to be the appropriate scope and role of Section 5.<sup>31</sup> After over

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<sup>26</sup> William E. Kovacic, Chairman, Fed. Trade Comm'n, Remarks at the Workshop on Section 5 of the FTC Act as a Competition Statute 19 (Oct. 17, 2008).

<sup>27</sup> Ben James, *Columbia Law Professor Picked As FTC Senior Adviser*, LAW360 (Feb. 8, 2011).

<sup>28</sup> See Wright, *supra* note 12.

<sup>29</sup> *Id.*

<sup>30</sup> See 2013 Hearing, *supra* note 15, at 12.

<sup>31</sup> Maureen K. Ohlhausen, Comm'r, Fed. Trade Comm'n, Section 5: Principles of Navigation, Remarks Before the U.S. Chamber of Commerce (July 25, 2013); Joshua D. Wright, Comm'r, Fed.

a year and a half of discussion, Commissioner Wright announced in a speech in February 2015 that he would be putting “three principal definitions for how to define [UMC] up for a vote by the Commission.”<sup>32</sup> Soon thereafter, in May 2015, Chairwoman Ramirez was questioned by the House Judiciary’s Subcommittee on Regulatory Reform, Commercial and Antitrust Law, where she was urged strongly to issue guidance on the FTC’s Section 5 authority and to work with Commissioner Wright to that end.<sup>33</sup> On August 13, 2015, a bipartisan majority of the Commission adopted the Section 5 Statement by a 4-1 vote, with Commissioner Ohlhausen dissenting.<sup>34</sup>

The Section 5 Statement has three key substantive elements. Most fundamentally, it establishes the promotion of consumer welfare as that term is generally understood in antitrust precedent as the exclusive goal of Section 5 enforcement. The Statement also expresses a methodological commitment—that is, it commits the FTC to account for both competitive harm and any countervailing efficiencies or other cognizable business justifications when assessing whether conduct constitutes an unfair method of competition. Finally, the Statement acknowledges that the FTC should be reluctant to rely on a standalone Section 5 theory if the traditional antitrust laws are sufficient to address the competitive concern at issue.

Like the Sherman Act, the Statement is short. While its brevity has been the focus of some criticisms of its potential to limit expansive interpretations of Section 5, it also enables the Statement to rely expressly upon the accumulated knowledge of the antitrust laws. Indeed, through the use of terms of art and concepts developed under the traditional antitrust laws, the Statement incorporates by reference the prevailing economic foundations of the modern antitrust laws and over a century of antitrust jurisprudence.<sup>35</sup> This Article now turns to discussing the merits of the arguments in favor of and against each of the three prongs of the Statement individually.

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Trade Comm’n, Proposed Policy Statement Regarding Unfair Methods of Competition Under Section 5 of the Federal Trade Commission Act (June 19, 2013).

<sup>32</sup> Wright, Section 5 Revisited, *supra* note 19, at 14.

<sup>33</sup> See 2015 Hearing, *supra* note 15, at 61.

<sup>34</sup> SECTION 5 STATEMENT, *supra* note 2; Press Release, Fed. Trade Comm’n, FTC Issues Statement of Principles Regarding Enforcement of FTC Act as a Competition Statute (Aug. 13, 2015).

<sup>35</sup> Wright & Diveley, *supra* note 4, at 4 (“The Statement is short at only one page in length, but by incorporating terms of art and concepts developed under the Sherman and Clayton Acts, their *prima facie* simplicity provides antitrust practitioners with 125 years’ worth of antitrust jurisprudence upon which to assess the competitive effects, and therefore the lawfulness, of challenged business conduct.”).

A. *The Promotion of Consumer Welfare, as Understood by the Antitrust Laws, Will Guide the Commission in Enforcing Section 5*

“[T]he Commission will be guided by the public policy underlying the antitrust laws, namely, the promotion of consumer welfare.”<sup>36</sup>

A fundamental question concerning the FTC’s Section 5 authority that has vexed the Commission, individual Commissioners, and the antitrust community more broadly, has been whether Section 5 can and should be applied to achieve non-competition goals or instead only to promote consumer welfare. Perhaps the most fundamental contribution to antitrust doctrine from the economic revolution of the 1970s and 1980s was the narrowing of its domain to welfare-based economic concerns.<sup>37</sup> While modern antitrust law reflects those insights, the FTC has used its standalone Section 5 authority to reach non-competition goals in the past.<sup>38</sup> Indeed, before the Statement’s issuance, the Commission had never rejected interpretations of Section 5 that would reach non-competition goals.

There is no debate that the Statement rejects interpretations of Section 5 that the Commission has embraced in recent history. Critics of the Statement have claimed, however, that this prong does not accomplish or change contemporary Section 5 enforcement because the Commission has, over the past two decades, arguably been guided by the promotion of consumer welfare in its Section 5 enforcement endeavors.<sup>39</sup> These critics argue that in light of this recent and relatively restrained performance, there is no real reason for the Commission to issue a policy statement that explicitly constrains its modern interpretations of Section 5 to the goal of promoting consumer welfare.

These criticisms appear to implicitly concede that eliminating interpretations of Section 5 that embrace non-economic interpretations would be beneficial to modern antitrust enforcement. Assuming that is correct, the real question appears to be the magnitude of the benefit. One cannot properly conclude the benefit derived is zero unless one discounts to

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<sup>36</sup> SECTION 5 STATEMENT, *supra* note 2.

<sup>37</sup> See William E. Kovacic & Carl Shapiro, *Antitrust Policy: A Century of Economic and Legal Thinking*, 14 J. ECON. PERSP. 43 (2000); Joshua D. Wright & Douglas H. Ginsburg, *The Goals of Antitrust: Welfare Trumps Choice*, 81 FORDHAM L.R. 2405 (2013).

<sup>38</sup> Pertschuk, *supra* note 14 (“[N]o responsive competition policy can neglect the social and environmental harms produced as unwelcome byproducts of the marketplace: resource depletion, energy waste, environmental contamination, worker alienation, the psychological and social consequences of marketing-stimulated demands.”); Rosch, *supra* note 14, at 9 (“Congress believed the Commission would be an expert agency and, as such, could identify the sort of ‘one-off’ or ‘out-of-round’ conduct that Section 5 could reach.”); see also Wright & Diveley, *supra* note 4, at 5 (“Non-competition goals have historically been well within the reach of Section 5 both as a matter of theory and in practice.”).

<sup>39</sup> *Ohlhausen Dissent*, *supra* note 5, at 2.

zero the probability that more expansive interpretations of Section 5 impact Commission enforcement. In the last decade alone, former Chairman Leibowitz has suggested that Section 5 should cover “‘collusive, coercive, predatory, restrictive, or deceitful,’ or *otherwise oppressive*” conduct,<sup>40</sup> Professor Robert Lande has called for a Section 5 interpretation that incorporates the issuance of consumer choice,<sup>41</sup> and Professors Jonathan Baker and Steven Salop have called on the Commission to use Section 5 to seek to eliminate income inequality.<sup>42</sup> Assuming that restricting Section 5 to the promotion of consumer welfare is beneficial, then these contemporary efforts to use the Commission’s standalone UMC authority for non-competition goals counsels in favor of the Statement’s constraining effect.<sup>43</sup>

The Section 5 Statement provides an answer to the threshold question of whether the Commission’s Section 5 authority bears a family resemblance to American antitrust law or is properly thought of as a different species. The first prong of the Statement specifies that, consistent with the traditional antitrust laws, consumer welfare, to the exclusion of non-economic goals, will guide the Commission in enforcing Section 5.<sup>44</sup> Commissioner Wright and Angela Diveley have noted that “[i]n light of the historical context of Section 5 as well as modern calls to expand its interpretation, the Statement’s exclusion of non-competition goals from the FTC’s Section 5 analysis is not only necessary but also plays a critical role in modernizing Section 5 enforcement” by aligning it with the traditional antitrust laws.<sup>45</sup>

## B. *The Section 5 Statement Adopts the Rule of Reason*

“[T]he act or practice will be evaluated under a framework similar to the rule of reason, that is, an act or practice challenged by the Commission must cause, or be likely to cause, harm to competition or the competitive process, taking into account any associated cognizable efficiencies and business justifications.”<sup>46</sup>

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<sup>40</sup> Leibowitz, *supra* note 14, at 15.

<sup>41</sup> Lande, *supra* note 14, at 2 (“The choice framework would impose a threshold requirement that every Section 5 antitrust violation significantly impairs the choices that free competition brings to the marketplace [and] that every Section 5 consumer protection violation significantly impairs consumers’ ability meaningfully to choose from among the options the market provides.”).

<sup>42</sup> See Jonathan B. Baker & Steven C. Salop, *Antitrust, Competition Policy, and Inequality*, 104 GEO. L.J. 1, 23 (2015) (“The FTC could conclude that monopoly pricing or price discrimination targeted at less advantaged consumers can be an unfair practice in violation of Section 5 . . . even if the market power was legitimately obtained.”).

<sup>43</sup> See Epstein, *supra* note 25.

<sup>44</sup> SECTION 5 STATEMENT, *supra* note 2.

<sup>45</sup> Wright & Diveley, *supra* note 4, at 6.

<sup>46</sup> SECTION 5 STATEMENT, *supra* note 2.

The Commission Statement, released in conjunction with the Section 5 Statement, makes clear that “the Commission will rely upon the accumulated knowledge and experience embedded within the ‘rule of reason’ framework developed under the antitrust laws over the past 125 years.”<sup>47</sup> As all antitrust lawyers know, the rule of reason can mean many different things depending upon the setting in which it is applied. Two important questions that have arisen with regard to analyzing UMC under Section 5 are whether the rule of reason applies when analyzing business conduct alleged to constitute an unfair method of competition and, if so, what variation of the rule of reason should be applied. Should anticompetitive effects be analyzed differently under Section 5 than the traditional antitrust rule of reason? What about procompetitive efficiencies? These fundamental questions were unanswered prior to the Section 5 Statement.

Several Commissioners offered their own proposed answers to these questions in the period leading up to the Statement’s adoption that no doubt influenced discussion within the agency and among the Commissioners with respect to the merits of a policy statement. For example, Chairwoman Ramirez has pointed to the modern-day rule of reason to decide whether conduct violates Section 5. In her view, the Commission is required to show that the harm to competition is not outweighed by the cognizable efficiencies before bringing a Section 5 claim.<sup>48</sup> Commissioner Ohlhausen, however, has advanced the position that the harm to competition be disproportionate to any cognizable efficiencies in order for the Commission to bring a Section 5 claim.<sup>49</sup> Commissioner Wright proposed an even more restrictive approach where Section 5 would apply only where the allegedly unfair method of competition was devoid of cognizable efficiencies and the balancing approach embraced by the rule of reason would be left to govern claims concerning business conduct where competitive harms and benefits were simultaneously present.<sup>50</sup>

The Section 5 Statement answers directly the central questions of whether the rule of reason should be applied and whether Section 5’s application of the rule of reason requires special modification for treatment of competitive harms and efficiencies. In short, the Statement creates an identity between the mode of antitrust applied to analyze business conduct under the traditional antitrust laws and under Section 5. The Commission makes this identity clear by explicitly incorporating by reference the rule of

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<sup>47</sup> COMMISSION STATEMENT, *supra* note 21, at 1.

<sup>48</sup> See Edith Ramirez, Chairwoman, Fed. Trade Comm’n, Unfair Methods and the Competitive Process: Enforcement Principles for the Federal Trade Commission’s Next Century, Keynote Address at the George Mason Law Review and Law & Economics Center Antitrust Symposium: The FTC: 100 Years of Antitrust and Competition Policy (Feb. 13, 2014).

<sup>49</sup> See Ohlhausen, *supra* note 31.

<sup>50</sup> See Wright, Section 5 Revisited, *supra* note 19, at 16.

reason well understood by practicing antitrust lawyers, judges, and scholars.<sup>51</sup> The Commission Statement accompanying the Section 5 Statement cites as authority the relevant section in the leading treatise on antitrust law to underscore the point that the type of balancing contemplated by the Statement is precisely the sort of balancing that has been common to the antitrust enterprise for decades under the modern rule of reason.<sup>52</sup> Further, in a speech given the day the Statement was released, Chairwoman Ramirez emphasized that the framework referred to in the Statement was the broad, modern rule of reason:

I wish to stress, however, that we are using the term “rule of reason” in its broad, modern sense. As the Supreme Court has explained, the rule of reason does not “necessarily . . . call for the fullest market analysis” in all cases; “[w]hat is required, rather, is an enquiry meet for the case,” depending on “whether the experience of the market has been so clear, or necessarily will be, that a confident conclusion about the principal tendency of a [practice] will follow from a quick (or at least quicker) look, in place of a more sedulous one.” That observation applies as much to standalone Section 5 theories of liability as to any other antitrust claim.<sup>53</sup>

The rule of reason contemplated by the Statement is less restrictive than the methods of analysis Commissioner Wright and Commissioner Ohlhausen proposed in the sense that it rejects both forms of “special” treatment for efficiencies proposed by each of them. However, the Statement aligns the framework used to analyze UMC with that of the traditional antitrust laws in terms of defining, identifying, and evaluating antitrust harms and benefits.<sup>54</sup> By linking the Statement to the traditional antitrust laws, the Commission presumably limited the types of harm that may be considered cognizable under Section 5 since not all forms of consumer harm result in cognizable antitrust injury.<sup>55</sup> Further, the Statement specifies that the Commission will take into account “any associated cognizable efficiencies *and* business justifications.”<sup>56</sup> Following

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<sup>51</sup> Critics of the Section 5 Statement were quick to point out that the statement refers to a framework *similar to* the rule of reason. Commissioner Wright announced in a paper interpreting the Section 5 Statement that the Commission refers to a framework “similar to” the rule of reason due to a concern that the traditional rule of reason could not reach invitations to collude. The use of “similar to” is “intended to preserve the Commission’s ability to reach invitations to collude and, importantly, to provide an analytical framework that includes consideration of this type of expected harm to competition.” See Wright & Diveley, *supra* note 4, at 7-8.

<sup>52</sup> COMMISSION STATEMENT, *supra* note 21, at 1.

<sup>53</sup> Ramirez, *supra* note 4, at 8.

<sup>54</sup> Wright & Diveley, *supra* note 4, at 7.

<sup>55</sup> *Id.* at 8-9.

<sup>56</sup> SECTION 5 STATEMENT, *supra* note 2 (emphasis added). The terms “cognizable efficiencies” and “business justifications” are legal terms of art in antitrust jurisprudence. The 2010 Horizontal Merger Guidelines define cognizable efficiencies as “merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service.” U.S. DEP’T OF JUSTICE AND FED. TRADE COMM’N, HORIZONTAL MERGER GUIDELINES 30 (2010). Business justifications are

the logic that linking the Statement to the traditional antitrust laws restricts the types of harms that may be challenged under Section 5, commentators have interpreted the Statement to require the Commission to “consider efficiencies and business justifications in a manner consistent with the development of the traditional antitrust laws.”<sup>57</sup>

C. *The Commission Is Less Likely to Use Its Section 5 Authority Where Existing Antitrust Laws Address the Act or Practice*

“[T]he Commission is less likely to challenge an act or practice as an unfair method of competition on a standalone basis if enforcement of the Sherman or Clayton Act is sufficient to address the competitive harm arising from the act or practice.”<sup>58</sup>

The third prong of the Statement announces that the Commission will use the traditional antitrust laws where possible.<sup>59</sup> Commentators and scholars have pointed to this restriction as a useful limiting principle because it constrains the Commission’s ability to avoid the more arduous standards of proof necessary under the Sherman and Clayton Acts.<sup>60</sup> The view that the Commission had used Section 5 to evade the consumer injury proof requirements of the traditional antitrust laws has given rise to significant criticism of UMC enforcement actions, including *Intel*, *N-Data*, and *Google*.<sup>61</sup> The anti-circumvention prong is a somewhat remarkable concession by the Commission in light of the agency’s consistent rejection of the proposition that the scope of the traditional antitrust laws, determined by generalist Article III judges, should limit the boundaries of Section 5.

Despite the Commission’s historical rejection of the proposition, the antitrust community has largely recognized that the Commission’s use of Section 5 where the conduct at issue falls within the reach of the traditional

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often discussed in Section 2 cases, and more generally in cases involving unilateral conduct. For a more detailed discussion about the differences between and application of cognizable efficiencies and business justifications in the context of analyzing unfair methods of competition under the Statement, see Wright & Diveley, *supra* note 4, at 9-10.

<sup>57</sup> Wright & Diveley, *supra* note 4, at 10 (“To the extent the defendants burden to establish cognizable efficiencies or business justifications sufficient to rebut the Commission’s prima facie burden vary across Section 1 and Section 2, it is clear that Section 5 analysis should be faithful to those differences.”).

<sup>58</sup> SECTION 5 STATEMENT, *supra* note 2.

<sup>59</sup> *Id.*

<sup>60</sup> See Epstein, *supra* note 25 (“The presumption against using the standalone authority when either the Sherman or Clayton Act ‘is sufficient to address’ some competitive harm is a useful limiting principle.”); Wright & Diveley, *supra* note 4, at 10 (“This third, ‘anti-circumvention’ prong . . . implicitly acknowledges that using Section 5 to evade the more rigorous standards of proof required by the traditional antitrust laws is inappropriate, and sets forth a limiting principle concerning the scope of Section 5.”).

<sup>61</sup> These cases are discussed in detail below in Part III.

antitrust laws is more likely to chill procompetitive conduct and is inappropriate.<sup>62</sup> Indeed, critics of the Statement respond to the anti-circumvention prong by arguing that it does not go far enough, because the Statement does not have the force of law in precluding the Commission from enforcing Section 5 when the traditional antitrust laws apply. However, by that standard, no informal guidelines promulgated by the agency over its 100-year history are capable of imposing any constraining force upon the agency. The appropriate question is not whether the anti-circumvention prong imposes any constraints upon the agency—it does—but rather, how much force that constraint will have in real-world cases.

To understand the degree of constraint the anti-circumvention prong might impose upon the Commission, it is critical to understand the nature of the potential constraining force. “Hard constraints,” such as legal preclusion from bringing a Section 5 claim when the traditional antitrust laws apply to conduct at issue, are only one possible constraint. However, there are other sources of constraints. Indeed, Professor Gus Hurwitz, an administrative law scholar and former antitrust attorney for the Department of Justice, has observed that while the Statement does not legally constrain the Commission from exercising its Section 5 authority where the traditional antitrust laws apply, it does create “powerful soft constraints” in that it “substantially increases the stakes the Commission faces should it needlessly make use of its UMC authority.”<sup>63</sup> Former Commissioner Wright, a principle drafter of the Statement, acknowledges this soft constraint as a powerful one because it “provides recourse to commissioners, litigants, judges, and even Congress, if the Commission abuses its authority.”<sup>64</sup> In a paper with Angela Diveley, they explain:

[T]he anti-circumvention prong of the Statement provides parties the ability, in litigation, to call attention to the fact that the conduct being litigated is covered by the traditional antitrust laws, and thus a less appropriate target for Commission action according to its own standards. While the Statement does not absolutely preclude the Commission from pursuing such a case, it would do so at substantial risk of losing the litigation at hand, of harming its own reputation by creating a perception that it is seeking to evade the more rigorous burden of proof under the traditional antitrust laws, and of providing an environment ripe for judicial interpretation of Section 5 that would further constrain its authority.<sup>65</sup>

Additionally, Chairwoman Ramirez, while discussing the anti-circumvention prong in a speech announcing the Statement, explained that “the Commission benefits from drawing on the same 125-year body of

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<sup>62</sup> Wright & Diveley, *supra* note 4, at 10.

<sup>63</sup> Gus Hurwitz, *Will the FTC's UMC Policy Statement Save the Commission from Itself?*, TECH POLICY DAILY (Aug. 18, 2015, 6:00AM), <http://www.techpolicydaily.com/technology/ftc-umc-policy-statement/>.

<sup>64</sup> Wright & Diveley, *supra* note 4, at 12.

<sup>65</sup> *Id.*

Sherman Act precedent that has evolved organically through both public and private litigation” when anticompetitive conduct that threatens consumer welfare falls within the scope of the Sherman Act.<sup>66</sup> By implicitly acknowledging that using Section 5 when the traditional antitrust laws apply is inappropriate, the Commission limited the scope of its standalone Section 5 authority.<sup>67</sup>

### III. CONVENTIONAL UNFAIR METHODS OF COMPETITION CASES

The Commission’s modern Section 5 enforcement efforts can be usefully divided into four categories of conduct: invitations to collude, facilitating practices, patent hold-up, and exclusionary conduct. The Commission has a long history of using its standalone Section 5 authority to reach facilitating practices and exclusionary conduct. Over the past twenty years, the Commission has sought to expand its Section 5 authority through settlements in cases involving invitations to collude and patent hold-up.<sup>68</sup>

#### A. *Invitations to Collude*

The Commission has pursued invitations to collude under Section 5 for over two decades. Invitations to collude are “generally understood to be unilateral solicitations to enter into unlawful horizontal price-fixing or market-allocation agreements.”<sup>69</sup> Since the challenged conduct is a solicitation rather than formation of a “contract, combination . . . or conspiracy” required by Section 1 or attempted monopolization under Section 2 absent sufficient market power, invitations to collude fall short of the reach of the Sherman Act.<sup>70</sup> The FTC first challenged an alleged invitation to collude under Section 5 in 1992.<sup>71</sup> The early cases brought by the Commission involved private communications with competitors interpreted as solicitations to enter into price-fixing or market allocation agreements.<sup>72</sup> The Commission alleged in those cases that the “invitation, if accepted, was likely to result in higher prices, reduced output, and injury to

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<sup>66</sup> Ramirez, *supra* note 4, at 8.

<sup>67</sup> Wright & Diveley, *supra* note 4, at 10.

<sup>68</sup> See Cooper, *supra* note 11, at 89.

<sup>69</sup> Larry Fullerton, *FTC Challenges to “Invitations to Collude”*, 25 ANTITRUST 30 (2011).

<sup>70</sup> 15 U.S.C. § 1 (2012).

<sup>71</sup> Complaint, Quality Trailer Products, 115 F.T.C. 994 (1992).

<sup>72</sup> See Complaint, MacDermid, Inc., F.T.C. No. 991-0167, 1999 FTC LEXIS 191 (Dec. 21, 1999); Complaint, Stone Container Corp., 125 F.T.C. 853 (1998); Complaint, Precision Moulding Co., 122 F.T.C. 104 (1996); Complaint, YKK (U.S.A.) Inc., 116 F.T.C. 628 (1993); Complaint, A.E. Clevite, Inc. 116 F.T.C. 389 (1993).

consumers.”<sup>73</sup> As the cases below demonstrate, the Commission later began challenging public communications as invitations to collude under Section 5.

In 2006, the Commission brought a case against Valassis Communications, Inc., one of the two main companies that published advertising inserts for newspapers.<sup>74</sup> Valassis cut prices in an effort to regain its former market share after a failed attempt to raise prices.<sup>75</sup> Valassis’s competitor did the same, and prices dropped dramatically.<sup>76</sup> Valassis’s CEO announced in a quarterly earnings call that Valassis would make necessary price cuts to retain its current market share, but would not bid below a specific price floor for new business. That price floor was higher than the prevailing market rate, and the CEO also announced that Valassis would monitor its competitor’s reaction for “concrete evidence” of reciprocity.<sup>77</sup> The Commission alleged that Valassis had made an invitation to collude and, in doing so, had violated Section 5 of the FTC Act.<sup>78</sup>

In 2010, the Commission challenged U-Haul International Inc. for inviting its main competitors to collude.<sup>79</sup> U-Haul’s CEO sent memoranda to its regional managers commanding them to raise prices and to invite their competitors to do the same.<sup>80</sup> The CEO also announced during a quarterly earnings call that U-Haul was raising prices and advocated that its competitors follow suit.<sup>81</sup> After competitors in at least one regional market raised prices, the Commission brought a case under Section 5 alleging an invitation to collude.<sup>82</sup>

## B. *Facilitating Practices*

The Commission has also used its standalone Section 5 authority to attack facilitating practices in oligopolistic industries against firms that implement practices that facilitate anticompetitive effects. Facilitating practices are defined as “activities that tend to promote interdependence by reducing rivals’ uncertainty or diminishing incentives to deviate from a coordinated strategy, and thus increase the likelihood of tacit coordination among oligopolists that would not otherwise occur, or occur so often, or so

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<sup>73</sup> Complaint, Stone Container Corp., 125 F.T.C. 853, ¶ 7 (1998).

<sup>74</sup> Valassis Commc’ns, Inc., F.T.C. No. 051-0008 (Apr. 28, 2006).

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> U-Haul Int’l, Inc., F.T.C. No. 081-0157 (July 20, 2010).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

completely.”<sup>83</sup> As indicated below, the Commission has identified facilitating practices to include advance announcements of price increases, most-favored buyer clauses, and base point pricing systems, as well as other unilaterally adopted practices.

In *FTC v. Sperry & Hutchinson Co.*,<sup>84</sup> Sperry & Hutchinson (S&H) manufactured stamps and sold them to retail stores, which in turn gave them to customers as a bonus on their purchases. Customers could then redeem the stamps with S&H for additional merchandise.<sup>85</sup> Third parties opened independent trading stamp exchanges that permitted customers to trade one brand of stamps for another.<sup>86</sup> This process undermined S&H's goodwill because customers lost motivation to return to stores offering its stamps, instead completing their stamp books through the independent stamp exchanges.<sup>87</sup> S&H commenced a program to suppress the stamp exchanges by claiming to retain title to the stamps and litigating against all exchanges that traded those stamps without authorization.<sup>88</sup> All parties agreed that this conduct did not violate the letter or the spirit of the antitrust laws.<sup>89</sup> The Commission nonetheless found that S&H's action constituted an unfair method of competition under Section 5 on a theory that it was unfair to destroy an entire collateral industry like the exchanges.<sup>90</sup> The Fifth Circuit reversed, stating that Section 5 would only reach conduct that violated the letter or spirit of the antitrust laws.<sup>91</sup> The Supreme Court reversed again, holding that the Commission, “like a court of equity,” could consider “public values beyond simply those enshrined in the letter or encompassed in the spirit of the antitrust laws.”<sup>92</sup>

In *Boise Cascade Corp. v. FTC*,<sup>93</sup> the Commission challenged plywood manufacturers for adopting a base point pricing system to compute delivery prices. The Commission alleged that by adopting an industry-wide “artificial freight factor” to equalize delivery prices across the country, southern and western plywood manufacturers undermined price competition in violation of Section 5.<sup>94</sup> The Ninth Circuit concluded that “none of the delivered pricing cases support a finding of a section 5 violation for the bare existence of an industry-wide artificial freight

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<sup>83</sup> Kevin J. Arquit, *The Boundaries of Horizontal Restraints: Facilitating Practices and Invitations to Collude*, 61 ANTITRUST L.J. 531, 536-37 (1999).

<sup>84</sup> *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 236 (1972).

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.* at 237-238.

<sup>89</sup> *Id.* at 239.

<sup>90</sup> *Sperry & Hutchinson Co.*, 405 U.S. at 239.

<sup>91</sup> *FTC v. Sperry & Hutchinson Co.*, 432 F.2d 146, 150 (5th Cir. 1970).

<sup>92</sup> *Sperry & Hutchinson Co.*, 405 U.S. at 244.

<sup>93</sup> *Boise Cascade Corp. v. FTC*, 637 F.2d 573 (9th Cir. 1980).

<sup>94</sup> *Id.* at 574-75.

factor.”<sup>95</sup> Because the Commission could not produce evidence that plywood manufacturers had actually colluded or that their pricing system negatively affected prices in the plywood industry, the court held that the parties had not violated Section 5.<sup>96</sup> The court further explained that upholding the Commission’s finding of a Section 5 violation “on a theory that the mere widespread use of a practice makes it an incipient threat to competition would be to blur the distinction between guilty and innocent commercial behavior.”<sup>97</sup>

In *E.I. Du Pont de Numours v. FTC (“Ethyl”)*,<sup>98</sup> the Commission challenged the leading manufacturers of antiknock compounds used in gasoline. The Commission alleged that the manufacturers used uniform delivered pricing to geographically dispersed buyers, advanced notice of price increases, and most-favored buyer contract terms.<sup>99</sup> The Commission concluded that these actions facilitated parallel pricing at levels higher than would have existed in a competitive market.<sup>100</sup> Like the Ninth Circuit in *Boise Cascade*, the Second Circuit overturned the Commission’s finding that the pricing practices at issue violated Section 5.<sup>101</sup> The court explained that because the challenged practices were adopted unilaterally and the Commission had not introduced sufficient evidence to prove that competition was substantially lessened, the practices did not constitute unfair methods of competition.<sup>102</sup> The Second Circuit cautioned against excessive use of Section 5, stating that standards for determining whether conduct falls within the “elusive concept” of unfairness “must be formulated to discriminate between normally acceptable business behavior and conduct that is unreasonable or unacceptable” in order to prevent the Commission from arbitrarily or capriciously employing Section 5.<sup>103</sup> The court explained that there must be “at least some indicia of oppressiveness . . . such as (1) evidence of anticompetitive intent or purpose on the part of the producer charged, or (2) the absence of an independent legitimate business reason for its conduct.”<sup>104</sup>

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<sup>95</sup> *Id.* at 576-77.

<sup>96</sup> *Id.* at 582.

<sup>97</sup> *Id.*

<sup>98</sup> *E.I. Du Pont de Numours v. FTC*, 729 F.2d 128 (2d Cir. 1984).

<sup>99</sup> *Id.* at 133-34.

<sup>100</sup> *Id.* at 136.

<sup>101</sup> *Id.* at 142.

<sup>102</sup> *Id.* at 141-42.

<sup>103</sup> *Id.* at 138.

<sup>104</sup> *E.I. Du Pont de Numours*, 729 F.2d at 139.

### C. *Patent Hold-Up*

The Commission began using Section 5 to address patent hold-up issues in 1996.<sup>105</sup> However, like invitations to collude, most of the patent hold-up cases brought under Section 5 have ended in consents. Patent hold-up is a term that has been used by the Commission and others to describe several different types of conduct in the standard setting context. Accordingly, it is useful to draw some distinctions between the three primary theories of competitive harm often described as patent hold-up.

The first theory of patent hold-up involves a company acting deceptively in the standard setting context to get its patented technology adopted by the standard, thus acquiring monopoly power it would not have otherwise had. The typical allegation in these cases involves the patent holder intentionally failing to disclose its standard essential patent (“SEP”) to the standard setting organization (“SSO”) or affirmatively deceiving the SSO by claiming it does not have essential patents that read on the standard. In this first scenario, patent hold-up occurs when the patent holder’s technology is adopted by the SSO, after which the patent holder uses its SEP to exclude rival technologies and charge supracompetitive royalties.

*In the Matter of Dell Computer Corporation*<sup>106</sup> is a case that embodies this first theory of patent hold-up. Dell participated in the Video Electronics Standards Association (“VESA”), which asked its members to “certify whether they had any patents, trademarks, or copyrights that conflicted with [a proposed standard].”<sup>107</sup> Dell maintained that it did not have a patent, but after VESA adopted the standard Dell “sought to enforce its patent against firms planning to follow the standard.”<sup>108</sup> The Commission concluded that Dell violated Section 5 because there was evidence that VESA “adopted the standard—based, in part, on Dell’s certification— . . . [and] would have implemented a different non-proprietary design had it been informed of the patent conflict during the certification process.”<sup>109</sup> In other words, because Dell’s deception led VESA to adopt its technology and resulted in Dell acquiring monopoly power it would not have otherwise gained, its conduct violated Section 5.

The second theory of patent hold-up occurs when a SEP holder breaches a commitment made to the SSO to license its SEP on fair, reasonable, and non-discriminatory (“FRAND”) terms. In this case, the patent holder’s technology is not selected upon the basis of a deceptive claim or omission. Patent hold-up occurs in this scenario when the patent

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<sup>105</sup> Dell Comput. Corp., 121 F.T.C. 616 (1996).

<sup>106</sup> *Id.* at 624.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

holder breaches the FRAND commitment and charges licensees supracompetitive royalty rates.

The Commission's action in *In the Matter of Negotiated Data Solutions LLC ("N-Data")*<sup>110</sup> illustrates the second theory of patent hold-up. In that case, the Commission challenged Negotiated Data Solutions LLC ("N-Data") for defaulting on a licensing commitment to an SSO.<sup>111</sup> The Commission alleged that N-Data violated Section 5 by opportunistically breaking the licensing commitment after the technology subject to the commitment was adopted by the industry.<sup>112</sup> The Commission distinguished renegeing on a previous licensing commitment generally from doing so during the standard-setting process.<sup>113</sup> While merely departing from a prior licensing commitment is generally unlikely to violate Section 5, the Commission explained that the Supreme Court "has not hesitated to impose antitrust liability on conduct that threatens to undermine the standard-setting process."<sup>114</sup>

The third theory of patent hold-up is a special case of the second category—that is, it also involves a SEP holder breaching a contractual commitment made with an SSO after its technology has been adopted. In this last scenario, the SEP holder seeks to enjoin implementers of the technology from its use in a patent infringement lawsuit and leverages the injunction to negotiate higher royalty rates. Some commentators contend, and some courts have held, that the FRAND commitment itself contractually binds the SEP holder from seeking an injunction.<sup>115</sup> In other words, some have interpreted the FRAND commitment as a promise by the SEP holder to accept monetary damages as adequate for patent infringement rather than injunctive relief. Thus, this third category of patent hold-up, like the second, involves a claim that the SEP holder has breached its FRAND obligation.

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<sup>110</sup> See Complaint, Negotiated Data Sols. LLC, F.T.C. No. 051-0094 (Sept. 22, 2008).

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> Analysis of Proposed Consent Order to Aid Public Comment, at 6, Negotiated Data Sols. LLC, F.T.C. No. 051-0094 (Jan. 23, 2008).

<sup>114</sup> *Id.*

<sup>115</sup> See *Apple, Inc. v. Motorola, Inc.*, 869 F. Supp. 2d 901, 914 (N.D. Ill. 2012) ("By committing to license its patents on FRAND terms, Motorola committed to license [its technology] to anyone willing to pay a FRAND royalty and thus implicitly acknowledged that a royalty is adequate compensation for a license to use that patent."). See also Joseph Farrell, John Hayes, Carl Shapiro & Theresa Sullivan, *Standard Setting, Patents, and Hold-Up*, 74 ANTITRUST L.J. 603, 638 (2007) ("Our interpretation implies that a patent holder that has made a commitment to license on a FRAND basis should not be able to get (or threaten) an injunction against the use of the technology to comply with the standard."); Douglas H. Ginsburg, Taylor M. Owings & Joshua D. Wright, *Enjoining Injunctions: The Case Against Antitrust Liability for Standard Essential Patent Holders Who Seek Injunctions*, ANTITRUST SOURCE, Oct. 2014.

This last theory of patent hold-up is exhibited by *In the Matter of Motorola Mobility LLC & Google Inc.*<sup>116</sup> The Commission asserted that by seeking injunctions and exclusion orders against allegedly “willing licensees” for patent infringement of their SEPs, Google and Motorola Mobility violated Section 5.<sup>117</sup> The Commission claimed that seeking an injunction constituted an unfair method of competition because Google and Motorola Mobility had agreed to license the SEPs on FRAND terms.<sup>118</sup> In a consent agreement, the Commission required the parties to provide a potential licensee with a written offer containing all material license terms necessary to license its SEPs, as well as an offer of binding arbitration to determine any license terms that are not agreed upon, before seeking an injunction or exclusion order for infringement of FRAND-encumbered SEPs.<sup>119</sup>

#### D. *Exclusionary Conduct*

The conduct that the Commission has most often pursued under Section 5 is exclusionary conduct. Similar to invitations to collude, exclusionary conduct often falls outside of the reach of the Sherman Act. Exclusionary conduct cannot be challenged under Section 1 because it involves unilateral conduct. Additionally, the challenged firms typically do not possess the requisite market power that the Commission would need to prove to succeed under Section 2.

In *FTC v. R.F. Keppel & Bro., Inc.*,<sup>120</sup> the Supreme Court considered the propriety of a plan for marketing children’s penny candy. Under the plan, a certain percentage of the candies were packaged with a penny inside the wrapper and buyers who happened to pick those pieces received their purchase for free.<sup>121</sup> The elements of chance in this plan proved irresistible to children and Keppel accordingly expanded its market share at the expense of competitors who did not adopt the same technique.<sup>122</sup> The Court condemned the marketing scheme and held it an unfair method of competition.<sup>123</sup> It held that the gambling features of the plan were contrary

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<sup>116</sup> Decision and Order, *Motorola Mobility LLC & Google Inc.*, F.T.C. No. 121-0120 (July 24, 2013).

<sup>117</sup> Complaint, *Motorola Mobility LLC & Google Inc.*, F.T.C. No. 121-0120 (July 24, 2013).

<sup>118</sup> *Id.*

<sup>119</sup> Decision and Order, *Motorola Mobility LLC & Google Inc.*, F.T.C. File No. 121-0120 (July 24, 2013).

<sup>120</sup> *FTC v. R. F. Keppel & Bro., Inc.*, 291 U.S. 304 (1934).

<sup>121</sup> *Id.* at 307.

<sup>122</sup> *Id.* at 307-08.

<sup>123</sup> *Id.* at 313.

to public policy, and that the Commission was empowered to halt the scheme under Section 5.<sup>124</sup>

In 2009, the Commission challenged Intel for engaging in “a number of unfair methods of competition . . . to block or slow the adoption of competitive products and maintain its monopoly to the detriment of consumers.”<sup>125</sup> The Commission alleged the loyalty discounts offered by Intel to computer original equipment manufacturers (“OEMs”) foreclosed its rivals from purchases by OEMs.<sup>126</sup> Additionally, the Commission asserted that design changes to Intel’s software were implemented solely to reduce the performance of competing central processing units (“CPUs”) relative to its own CPUs and that Intel had induced suppliers of complementary products to eradicate their support of competing CPU products.<sup>127</sup>

#### IV. ANALYZING CONVENTIONAL UNFAIR METHODS OF COMPETITION CASES UNDER THE FTC’S SECTION 5 POLICY STATEMENT

Recent Commission UMC decisions are the best available predictors of the types of cases the Commission is likely to bring under Section 5 in the future for at least two reasons. First, recent UMC decisions represent areas that the Commission has identified as enforcement priorities. Second, as discussed, the Commission’s Section 5 priorities have been relatively stable over the past 20 years, indicating that a dramatic change of course is unlikely. Evaluating the merits of this sample of potential Section 5 cases against the Statement provides a framework to answer important questions about the Statement’s likely impact. Most importantly, analyzing the prior cases under the Statement makes it possible to determine whether the Statement constrains agency discretion, as some have argued, or whether it lacks the specificity and substance to make a difference. If the Commission is unable to challenge conduct under the Statement that it has previously charged as an unfair method of competition, it can safely be said that the Statement limits the Commission’s historically broad Section 5 authority. The application of the Statement to the conventional Section 5 cases introduced in Part III are discussed below.

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<sup>124</sup> *Id.* at 313.

<sup>125</sup> Complaint, Intel Corp., F.T.C. No. 061-0247 (Dec. 16, 2009).

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

### A. *Invitations to Collude*

Invitations to collude have generally been accepted as a relatively uncontroversial example of an unfair method of competition in violation of Section 5.<sup>128</sup> The Commission has a history of challenging both private and public communications as invitations to collude. While both cases discussed below involve invitations to collude alleged to arise from public communications, there is no significant and systematic difference between the analysis of invitations arising from public and private communications under Section 5. I turn to analyzing representative examples of the Commission's recent invitation to collude cases under the Statement.

Invitations to collude like the ones in *Valassis* and *U-Haul* survive the first prong of the Section 5 Statement. These cases involve a representative of a firm announcing an intention to raise prices and inviting competitors to do the same. Invitations to collude, if accepted, result in the formation of a cartel, which nearly always reduce competition and consumer welfare. Thus, an invitation to collude generates a risk of competitive harm and can be condemned as such rather than relying upon non-economic concerns.

Invitations to collude also survive the second prong of the Statement. The harm flowing from invitations to collude is cognizable in a rule of reason analysis. As discussed, an invitation to collude, if accepted, forms a cartel that would otherwise constitute a per se violation of the antitrust laws. Thus, the invitation to collude itself creates a risk of competitive harm. While some invitations are more serious—and more likely to be accepted—than others, causing the risk of competitive harm to vary across invitations, it is clear that the offer to enter into a conspiracy itself creates some likely harm.

In determining whether an invitation to collude is likely to harm competition, the Commission must determine the magnitude and probability of the alleged harm to competition using of economic analysis rather than mere speculation. This can be done from an ex ante perspective similar to any other antitrust analysis under the rule of reason evaluating future harm. In terms of cognizable efficiencies, invitations to collude very rarely possess any legitimate business justification. Of course, in the case of public invitations to collude, one can imagine arguments about potentially legitimate business justifications for communications about prices, but those justifications were not present in *Valassis* or *U-Haul*. Thus, in invitation to collude cases, like those the Commission has focused on thus far in its recent enforcement history, the second prong of the Statement would likely be satisfied.

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<sup>128</sup> See Cooper, *supra* note 11, at 99-100; Rybnicek & Wright, *supra* note 17, at 1310; Wright & Diveley, *supra* note 4, at 3.

Section 5 enforcement actions against at invitations to collude also survive the third prong of the Statement because such conduct typically cannot be reached under the traditional antitrust laws. An invitation to collude does not constitute a violation of Section 1 of the Sherman Act because it is a solicitation rather than the formation of an agreement in restraint of trade. It is possible that an invitation to collude could constitute attempted monopolization under Section 2 if the firm extending the invitation has the requisite market power. However, most of the firms the Commission has challenged for inviting competitors to collude do not meet that criteria. Thus, as a general matter, invitations to collude satisfy the third prong because the enforcement of the traditional antitrust laws are not “sufficient to address the competitive harm arising from the act or practice.”<sup>129</sup>

Because invitations to collude pose a tremendous threat to competition with arguably no social benefit and may not be condemned under the traditional antitrust laws, the Commission is permitted under the Statement to challenge this type of conduct using its standalone Section 5 authority.

#### B. *Facilitating Practices*

Facilitating practices are not outside the reach of the Commission’s Section 5 authority under the Section 5 Statement to the extent that the challenged conduct involves economic harm to consumers. This standard, however, does rule out some cases in the Commission’s recent Section 5 history. For example, the Statement precludes the Commission from bringing cases like *Sperry & Hutchinson* where the challenged conduct is contrary to public policy but does not threaten consumer welfare. The first prong makes clear that the Commission will be guided by the economic goals of the antitrust laws. By incorporating the promotion of consumer welfare into the Statement, the Commission acknowledged that Section 5 is not the proper vehicle to challenge conduct that, while contrary to public policy, does not result in actual or likely anticompetitive effects.

Like invitations to collude, many of the Commission’s Section 5 facilitating practices cases do invoke concerns with economic harms consistent with the antitrust laws, but remain outside of their reach. Unless the challenged firm possesses suitable market power and may be condemned under an attempted monopolization theory, these practices cannot be reached under the Sherman Act absent an actual agreement.<sup>130</sup> However, unlike invitations to collude, facilitating practices may advance legitimate business activities and benefit consumers in some cases.

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<sup>129</sup> See SECTION 5 STATEMENT, *supra* note 2.

<sup>130</sup> See PHILLIP E. AREEDA, ANTITRUST LAW ¶ 1436, at 248 (1st ed. 1986) (noting that facilitating practices should not transform an otherwise immune oligopoly into a conspiracy).

Whether or not the Commission should challenge facilitating practice with legitimate business justifications depends on if the conduct would survive the rule of reason analysis required under the second prong of the Statement.

The Statement also limits the Commission's ability to use its Section 5 authority to challenge cases like *Boise Cascade* that involve conduct that has been addressed and determined not to be an antitrust violation Sherman Act. The Statement does not absolutely preclude the Commission from using Section 5 to challenge conduct that the traditional antitrust laws govern. However, the importance of the soft constraint created by the third prong of the Statement is that it gives challenged parties something to present in court should the Commission attempt to abuse its discretion by bringing a case under Section 5 in an attempt to evade the higher standard of proof required under the traditional antitrust laws.

Most facilitating practices cases will turn on the second prong of the Statement. Rather than focusing solely on the actual or potential anticompetitive effects, the Commission must now exam cognizable efficiencies and legitimate business justifications when determining whether conduct constitutes an unfair method of competition. Practices like uniform delivered pricing and most-favored nation clauses, which the FTC challenged in *Ethyl*, are widely used in both monopoly and competitive markets and may offer countervailing competitive benefits.<sup>131</sup> Most-favored nation clauses "may be useful to buyers who wish to ensure that they can acquire production inputs on terms at least as good as those offered to their rivals . . . and permit[] smaller buyers to receive the same treatment as larger, more powerful buyers who might otherwise be able to secure more favorable terms."<sup>132</sup>

The Commission is still able to condemn facilitating practices as unfair methods of competition under the Section 5 Statement if the challenged conduct involves some economic harm and the firm does not possess suitable market power to be condemned under Section 2 of the Sherman Act. When a facilitating practice caused, or is likely to cause, anticompetitive harm that is not outweighed by cognizable efficiencies or legitimate business justifications, it is still within the scope of the Commission's Section 5 authority.

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<sup>131</sup> Donald S. Clark, *Price-Fixing Without Collusion: An Antitrust Analysis of Facilitating Practices After Ethyl Corp.*, 1983 WIS. L. REV. 887, 932 (1983). See also Michael G. Vita, *Fifteen Years After Ethyl: The Past and Future of Facilitating Practices* 68 ANTITRUST L.J. 991 (2001).

<sup>132</sup> Clark, *supra* note 131, at 932.

### C. *Patent Hold-Up*

Patent hold-up cases have been an important component of the Commission's UMC enforcement portfolio. Indeed, the Commission has made more liberal use of its Section 5 authority in patent hold-up cases as it has expanded its enforcement and policy presence at the intersection of intellectual property and competition policy generally. While deception-based patent hold-up cases remain within the scope of the Sherman Act under existing monopolization doctrine, patent hold-up is now generally outside the scope of the Commission's standalone Section 5 authority under the Statement. Thus, patent hold-up represents one critical area where the Statement will constrain likely future targets of the Commission's UMC enforcement efforts.

Recall that there are three general variants of patent hold-up cases: (1) when a company acts deceptively in the standard setting context to get its patented technology adopted by the SSO, thus acquiring monopoly power it would not have otherwise had; (2) when a SEP holder breaches a commitment made to the SSO to license its SEP on FRAND terms; and (3) when the SEP holder breaches the contractual commitment made with the SSO after its technology has been adopted.<sup>133</sup> Each of these categories of patent hold-up cases likely would survive the first prong of the Statement because all three theories contemplate risk of economic harm rather than relying upon non-competition concerns to justify imposing antitrust limits on patent licenses and negotiations. Whether a particular patent hold-up allegation survives the second and third prongs of the Statement will depend upon the specific theory alleged by the Commission and, of course, the individual facts of the case. The application of the Statement to variants of patent hold-up theory are discussed below.

#### 1. Deception-Based Patent Hold-Up Cases

The Commission is not precluded from challenging patent hold-up cases involving deception by a SEP holder in the standard setting process under the first prong of the Section 5 Statement. When a SEP holder deceives an SSO, thereby persuading it to adopt its patented technology, and proceeds to use its SEP to exclude rival technologies and charge supracompetitive royalties, there is a clear economic threat to consumer welfare arising from the patent holder's wrongful acquisition of newfound market power. Accordingly, it is relatively straightforward that the first prong of the Statement would not limit the Commission from bringing a deception-based patent hold-up claim.

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<sup>133</sup> See *supra* Part III.C.

The second prong of the Statement presents a more substantial obstacle. Whether a deception-based patent hold-up theory survives the second prong depends upon whether the SEP holder already possessed monopoly power and its deception merely allowed it to increase price without excluding rivals. In this scenario, the deceptive conduct was not the cause of the SEP holder's market power and thus did not exclude rival technologies. The Supreme Court held in *NYNEX Corp. v. Discon, Inc.*<sup>134</sup> that a lawful monopolist that engages in deceptive conduct that enables it to evade pricing constraints is immune from antitrust liability.<sup>135</sup> In other words, the Supreme Court has held that deception-based patent hold-up by a SEP-holder with previously acquired monopoly power is not a cognizable antitrust harm. On the other hand, a traditional antitrust claim is likely to succeed if the patent holder employs deception to gain monopoly power that it could not have otherwise obtained. Thus, when the SSO would not have included the SEP holder's technology in the standard without the patent holder acting deceptively, "the acquisition and exercise of monopoly power warrants an antitrust sanction."<sup>136</sup>

Cases like *Dell*, where deception was necessary for the patent holder to obtain and exercise monopoly power, survive the second prong of the Statement. Under the rule of reason, this conduct is likely to harm competition and lacks any countervailing efficiencies or business justifications. In *Rambus Inc. v. FTC*,<sup>137</sup> the D.C. Circuit explained that "if [the firm's] more complete disclosure would have caused [the SSO] to adopt a different (open, non-proprietary) standard, then its failure to disclose harmed competition and would support a monopolization claim."<sup>138</sup> In cases where the SSO would have adopted a different standard but for the deception, the patent holder could not be said to have lawfully obtained monopoly power prior to the deception since adoption of its SEP was dependent on something other than competition on the merits. The subset of deception-based patent hold-up cases that satisfy the causation requirement in *Rambus*—that is, where the deception is the but-for cause of the SSO selecting the patented technology for the standard—can generate

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<sup>134</sup> *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128 (1998).

<sup>135</sup> *Id.* at 135. See also Bruce H. Kobayashi & Joshua D. Wright, *The Limits of Antitrust and Patent Holdup: A Reply to Cary et al.*, 78 ANTITRUST L.J. 505, 519 (2012) ("NYNEX immunizes a firm from antitrust liability if the firm (1) first lawfully acquired monopoly power and (2) then committed fraud or engaged in other deceptive conduct (3) that allowed it to evade pricing constraints to the detriment of consumers.").

<sup>136</sup> See Kobayashi & Wright, *supra* note 135, at 519 ("NYNEX would not immunize a firm that (1) committed fraud and (2) thereby acquired market power (3) that it exercised in the form of evading a RAND commitment."); Wright & Diveley, *supra* note 4, at 9 (discussing the holdings of *Broadcom Corp. v. Qualcomm Inc.*, 501 F.3d 297 (3d Cir. 2007) and *Rambus Inc. v. FTC*, 522 F.3d 456 (D.C. Cir. 2008)).

<sup>137</sup> *Rambus Inc. v. FTC*, 522 F.3d 456 (D.C. Cir. 2008).

<sup>138</sup> *Id.* at 463.

significant competitive harm and lack procompetitive virtues. Thus, these cases are likely to survive rule of reason analysis and consequently, do not run afoul of the second prong of the Section 5 Statement.

The third prong of the Statement, however, provides a basis upon which to disfavor Section 5 enforcement in cases like *Dell*. Deception that results in a SSO adopting a technology that would not have otherwise been chosen is a clear violation of Section 2 of the Sherman Act.<sup>139</sup> As discussed above, the Commission could theoretically still challenge this variation of patent hold-up under Section 5 as it is not legally precluded from doing so.<sup>140</sup> However, it would do so at the risk of appearing to attempt to evade the burden of proof required by the Sherman Act since federal courts have decided cases with facts nearly identical to *Dell*.<sup>141</sup> Further, because the Commission announced in the Section 5 Statement that it is less likely to bring cases under Section 5 when the traditional antitrust laws apply, challenged parties have something to present in court should the Commission attempt to abuse its discretion.

In sum, the Section 5 Statement will effectively constrain the Commission from challenging deception-based patent hold-up under Section 5. Though the first two prongs of the Statement do not preclude the Commission from exercising its standalone Section 5 authority in cases like *Dell*, the soft constraints associated with the third prong will likely prevent the Commission from bringing an action under Section 5 rather than the Sherman Act.

## 2. Breach of Contract-Based Patent Hold-Up Cases

The Commission is not likely to be able to employ its Section 5 authority to challenge a SEP holder that has breached a commitment to an SSO to license its patent on FRAND terms under the Statement. As with deception-based patent hold-up theories, the first prong of the Statement is satisfied because breach of contract patent hold-up cases involve potential economic harm. However, the second prong is a significant obstacle in cases involving breach of FRAND terms. A SEP holder that breaches, renegotiates, or defaults on a commitment to license the patent on FRAND terms illustrates a lawful monopolist's charging of supracompetitive prices and does not violate the antitrust laws.<sup>142</sup>

Consider cases like *N-Data* where no deceptive conduct is alleged but the SEP holder has defaulted on a FRAND commitment. The theory of harm that is asserted under this patent hold-up theory is that a firm with

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<sup>139</sup> See generally *Broadcom*, 501 F.3d at 297; *Rambus*, 522 F.3d at 456.

<sup>140</sup> See *supra* Part II.C.

<sup>141</sup> See generally *Broadcom*, 501 F.3d at 297; *Rambus*, 522 F.3d at 456.

<sup>142</sup> Wright & Diveley, *supra* note 4, at 9.

lawfully acquired monopoly power has used the threat of an injunction to induce licensees to pay supracompetitive royalty rates. The second prong of the Statement calls for analyzing whether this alleged breach violates the rule of reason—that is, the Commission must determine whether the challenged conduct is likely to cause anticompetitive harm after considering associated cognizable efficiencies and business justifications, as those terms are understood under the traditional antitrust laws.

Because a lawful monopolist is permitted to raise prices without incurring liability under the antitrust laws, cases resembling *N-Data* fail the rule of reason analysis contemplated by the Statement. The traditional antitrust laws have clearly held, in precisely this context, that any competitive harm from supracompetitive pricing associated with the lawful exercise of monopoly power is presumptively lawful under the antitrust laws.<sup>143</sup> In *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*,<sup>144</sup> the Supreme Court explained that because the “mere possession of monopoly power, and the concomitant charging of monopoly prices . . . is an important element of the free-market system,” a lawful monopolist that raises price does not do so in violation of the antitrust laws. Established precedent and the economic logic of the antitrust laws “have determined the consumer welfare benefits associated with enhanced incentives to innovate attributable to the ability to charge the monopoly price outweigh the static efficiency losses resulting from temporary monopoly pricing.”<sup>145</sup>

SEP holders with lawful monopoly power who would have been chosen by the SSO anyway—perhaps because of the strength of their patent or the high caliber of their technology—do not violate the antitrust laws by exercising their lawfully acquired monopoly power. In *NYNEX*, the Supreme Court drew a distinction between unlawful acquisition or exercise of monopoly power and an attempt to evade pricing constraints.<sup>146</sup> The Court held that a firm with lawfully acquired monopoly power that engages in deceptive conduct which permits it to evade pricing constraints and harm consumers is immune from antitrust liability.<sup>147</sup>

To the extent that the Commission finds that these cases otherwise satisfy the first two prongs of the policy statement, the third prong of the statement provides an additional reason to refrain from utilizing Section 5 enforcement. The existing antitrust laws have answered the question of whether breaching FRAND terms constitutes a violation of Section 2 in the

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<sup>143</sup> See *Broadcom*, 501 F.3d at 315; *Rambus*, 522 F.3d at 466.

<sup>144</sup> *Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004).

<sup>145</sup> *Wright & Diveley*, *supra* note 4, at 9.

<sup>146</sup> *NYNEX*, 525 U.S. at 135 (1998). See also *Kobayashi & Wright*, *supra* note 135, at 519 (“*NYNEX* thus rejects the notion that a monopolist’s evasion of a constraint on pricing—even when it involves bad conduct and results in higher prices—is sufficient to state a monopolization claim.”).

<sup>147</sup> 525 U.S. at 135.

negative.<sup>148</sup> Consequently, the Statement will effectively constrain the Commission from using its standalone Section 5 authority to challenge patent hold-up cases involving breach of FRAND terms.

### 3. Injunction-Based Patent Hold-Up Cases

Under the Statement, the Commission will not likely be able to use its standalone Section 5 authority to challenge the conduct of a SEP holder seeking to enjoin implementers of the technology from using it as a means to negotiate higher royalty rates. This patent hold-up theory is an extension of the breach of contract patent hold-up theory discussed above. In this manifestation, however, rather than merely threatening to bring an infringement action to induce the licensee to pay supracompetitive royalty rates, the SEP holder actually and affirmatively seeks an injunction. As with the breach of contract theory of patent hold-up, the first prong of the Statement requiring economic harm is satisfied. However, cases alleging patent hold-up in the form of seeking an injunction are similarly likely to run afoul of the second and third prongs of the Statement.

Recall that in *N-Data*, a classic breach of contract theory patent hold-up case, the Commission alleged that the relevant unlawful conduct—that is, the unfair method of competition—was N-Data’s *reneging* on its FRAND commitment by charging and receiving what the Commission deemed to be non-FRAND royalty rates. In other words, the allegedly unfair method of competition was renegotiating a higher price than initially agreed upon. The crux of the unlawful behavior, the Commission argued, was the violation of the original FRAND commitment by receiving a different price.

The theory of harm in the injunction cases is related, but slightly different. In *Google/MMI*, for example, the Commission alleged that the SEP holder “breached its FRAND obligations by seeking to enjoin and exclude implementers of its SEPs.”<sup>149</sup> Note that the allegedly unlawful conduct is not the successful extraction of a higher royalty rate, as in *N-Data*, but rather the seeking of the injunction itself. The threat of an injunction, of course, is the mechanism by which the patent holder is able to extract a higher royalty rate. Cases like *N-Data* fail a rule of reason analysis because this extraction of a higher price, without more, is simply the exercise of lawfully acquired monopoly power. If those cases fail, the mere threat of an injunction in order to facilitate the extraction of a higher royalty rate must also fail. Thus, *Google/MMI* and similar cases would likely run afoul of the second prong of the Statement because, just as a lawful monopolist is permitted to charge supracompetitive prices under the

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<sup>148</sup> *Broadcom*, 501 F.3d at 315; *Rambus*, 522 F.3d at 462.

<sup>149</sup> Complaint, Motorola Mobility LLC & Google Inc., F.T.C. No. 121-0120, at 5 (July 24, 2013).

antitrust laws, seeking an injunction is not a cognizable antitrust harm. Therefore, challenging a SEP holder for seeking an injunction on a FRAND-encumbered SEP would not survive the required rule of reason analysis.

The key insight for understanding the implications of patent hold-up theories for the third prong of the Statement is that the injunction-based theory is simply an extension of the breach of contract-based patent hold-up theory. As discussed, the traditional antitrust laws unequivocally reject a cause of action based upon the exercise of lawfully obtained monopoly power.<sup>150</sup> This concept is sufficiently robust to extend to both breach of contract based theories where a higher price is negotiated, such as *N-Data*, and claims attacking the threat of injunction itself, as in *Google/MMI*. The contrary and mistaken view, discussed above, requires the view that the antitrust laws condemn all attempts to evade pricing constraints. That view is mistaken.<sup>151</sup>

Finally, it is worth observing that the *Noerr-Pennington* doctrine provides another basis upon which to disfavor challenging this theory of patent hold-up.<sup>152</sup> To the extent that an antitrust claim is based on petitioning activity, such as seeking an injunction on a FRAND encumbered SEP, the *Noerr-Pennington* doctrine would likely preclude the suit.<sup>153</sup> While the *Noerr-Pennington* doctrine is applicable to the Sherman Act rather than Section 5, the Statement linked Section 5 enforcement to the traditional antitrust laws. Therefore, the Commission would be less likely to bring claims of this nature under its Section 5 authority since it would be precluded from doing so under the Sherman Act.

#### D. *Exclusionary Conduct*

Exclusionary conduct is still within the scope of the Commission's standalone Section 5 authority under the Statement. It is important for the Commission to be able to challenge conduct that is likely to harm competition and lacks sufficient countervailing efficiencies that cannot be

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<sup>150</sup> *Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004).

<sup>151</sup> *See NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128, 135 (1998).

<sup>152</sup> *See generally* *E. R.R. Presidents Conf. v. Noerr Motor Freight, Inc.*, 365 U.S. 127 (1961); *United Mine Workers v. Pennington*, 381 U.S. 657 (1965). *See also* *Apple, Inc. v. Motorola Mobility, Inc.* 886 F. Supp. 2d 1061, 1066 (W.D.W. 2012) (“[T]he *Noerr-Pennington* doctrine provides Motorola immunity from Apple's antitrust and unfair competition claims premised on Motorola's patent infringement litigation and from Apple's claims for declaratory judgment, to the extent that those claims are premised on a theory of antitrust or unfair competition.”).

<sup>153</sup> *See A.D. Bedell Wholesale Co. v. Phillip Morris Inc.*, 263 F.3d 239, 251 (3d Cir. 2001) (“If . . . conduct constitutes valid petitioning, the petitioner is immune from antitrust liability whether or not the injuries are caused by the act of petitioning or are caused by government action which results from the petitioning.”).

reached under the traditional antitrust laws. However, the Statement imposes important constraints on the Commission's ability to pursue cases like *Keppel* under non-competition goals, as well as cases like *Intel* when the challenged firm has sufficient market power and could be condemned under the traditional antitrust laws.

The Statement precludes the Commission from bringing cases like *Keppel* where the challenged conduct is contrary to public policy but does not threaten consumer welfare. The first prong makes clear that the Commission will be guided by the economic goals of the antitrust laws. By incorporating the promotion of consumer welfare into the Statement, the Commission acknowledged that Section 5 is not the proper vehicle to challenge conduct that is contrary to public policy.

The Statement also limits the Commission's ability to use its Section 5 authority to challenge cases like *Intel* that involve a dominant actor in the market engaging in exclusionary conduct since it could challenge the conduct under Section 2 of the Sherman Act. The Statement does not absolutely preclude the Commission from using Section 5 to challenge conduct that the traditional antitrust laws govern. However, the importance of the soft constraint created by the third prong of the Statement is that it gives challenged parties something to present in court should the Commission attempt to abuse its discretion by bringing a cases under Section 5 in an attempt to evade the higher standard of proof required under the traditional antitrust laws.

## CONCLUSION

After analyzing prior cases the Commission brought using its Section 5 authority under the Section 5 Statement it is clear that the Statement imposes legitimate constraints on the Commission. The first and third prongs of the Statement limit the types of conduct the Commission may challenge as an unfair method of competition. The second prong of the Statement will force the Commission to consider whether or not conduct that survives the first and third prongs and appears to be anticompetitive on its face has redeeming efficiencies before condemning it under Section 5.

Going forward, the antitrust community will be better able to predict the type of conduct the Commission will challenge under Section 5. In aligning the Commission's Section 5 authority with the traditional antitrust laws, the Statement provides practitioners and judges the guidance necessary to counsel clients and adjudicate cases involving conduct alleged to be an unfair method of competition. Importantly, parties will likely be less willing to settle cases than they were before the Statement when it was anybody's guess as to how the Commission determined whether conduct constituted an unfair method of competition.

A final and powerful quality of the Statement is that it provides aggrieved parties with something to point to if the Commission oversteps

the boundaries it defined for itself in the Statement. The Commission ended a century-long failure by issuing the Section 5 Statement and finally defining how it will exercise its standalone Section 5 authority. The Statement can be expected to have a practical effect in shaping competition policy by constraining enforcement authority and is a significant milestone in the Commission's history.