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THE IMPACT OF FRIVOLOUS LAWSUITS ON DETERRENCE: DO
THEY HAVE SOME REDEEMING VALUE?*

Michael P. Stone^{**} & *Thomas J. Miceli*^{***}

INTRODUCTION

In economics literature, it is well settled that there is a divergence between the private and social incentives for persons to file suit. Beginning roughly thirty years ago, Steven Shavell described in a series of articles how plaintiffs do not fully internalize the social consequences of engaging in civil litigation.¹ In particular, Shavell identified two externalities—one negative and one positive²—from the use of the civil justice system. On one hand, when initiating suit, plaintiffs do not fully internalize the social costs of using the courts.³ Rather, plaintiffs only internalize their own litigation costs and neglect the costs of opposing parties and those of the public system generally.⁴ This negative externality suggests that there is an

* We wish to thank the participants of the 23rd Annual Meeting of the American Law and Economics Association, May 2013, for their insightful comments. We also wish to thank Verity Winship and the attendees of the 12th Annual Meeting of the Midwestern Law and Economics Association, October 2013.

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¹ See Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333, 333–34 (1982) [hereinafter Shavell, *Social Versus Private Incentive*]; Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575, 575 (1997) [hereinafter Shavell, *Fundamental Divergence*]; Steven Shavell, *The Level of Litigation: Private Versus Social Optimality of Suit and of Settlement*, 19 INT'L REV. L. & ECON. 99, 99–101 (1999). For a discussion on the topic by different authors, see, e.g., Louis Kaplow, *Private Versus Social Costs in Bringing Suit*, 15 J. LEGAL STUD. 371, 371 (1986); Peter S. Menell, *A Note on Private Versus Social Incentives to Sue in a Costly Legal System*, 12 J. LEGAL STUD. 41, 41 (1983); Susan Rose-Ackerman & Mark Geistfeld, *The Divergence Between Social and Private Incentives to Sue: A Comment on Shavell, Menell, and Kaplow*, 16 J. LEGAL STUD. 483, 483 (1987).

² A positive externality is one that imposes a benefit upon a third party. For instance, when one properly maintains one's home, it is likely that this behavior will increase (or at a bare minimum, not strictly decrease) the property values of neighboring homes. A negative externality imposes a cost upon a third party. A common example is pollution. By "internalizing an externality," we mean that a party's private losses (or gains) are identical to the social losses (or gains) associated with a particular externality. See BLACK'S LAW DICTIONARY 664 (9th ed. 2009).

³ Shavell, *Social Versus Private Incentive*, *supra* note 1, at 333.

⁴ Shavell, *Fundamental Divergence*, *supra* note 1, at 577–78.

excessive level of litigation.⁵ But on the other hand, plaintiffs do not consider a positive externality that may arise from litigation—namely, its deterrent effect upon potential injurers.⁶

Plaintiffs are driven by their own self-interest to seek compensation.⁷ Thus, when plaintiffs do not have the correct incentives to pursue a legal remedy, they may not file suit when it is otherwise socially beneficial for them to do so.⁸ In other words, plaintiffs do not take into account the possibility that litigation may induce future potential injurers to exercise greater care or precaution—a hallmark of the legal concept of deterrence.⁹ The failure to fully internalize this positive externality may possibly result in an insufficient level of litigation.¹⁰ Due to these competing externalities, there is a divergence between the private and social incentives for plaintiffs to file suit.

Despite this observation, few would advocate for an increase in the number of lawsuits. Indeed, there appears to be a widespread belief that there is excessive litigation generally, and that the civil justice system is plagued by frivolous lawsuits. Putting the normative questions pertaining to frivolous litigation aside, an unresolved descriptive issue is whether frivolous lawsuits are capable of exerting a positive externality upon persons or businesses engaged in risky activities. A proper positive evaluation of frivolous lawsuits therefore requires an examination of their impact on deterrence.

Economists have previously examined the deterrence externality under different liability rules—in particular, negligence and strict liability. Ordover found that negligence would result in some potential injurers exercising an insufficient, or suboptimal, level of care.¹¹ Indeed, if all potential injurers complied with the negligence standard of reasonable care under similar circumstances, then no plaintiffs would ever file a costly lawsuit.¹² But without the threat of suit, some potential injurers would not have the correct incentives to comply with the standard of care.¹³ The result is that some potential injurers must exercise suboptimal levels of care under negli-

⁵ Shavell, *Social Versus Private Incentive*, *supra* note 1, at 333. In other words, there are too many lawsuits from a social perspective.

⁶ *Id.* at 333–34.

⁷ Shavell, *Fundamental Divergence*, *supra* note 1, at 578.

⁸ See Shavell, *Social Versus Private Incentive*, *supra* note 1, at 334.

⁹ It is not necessarily true that the social deterrence benefit of suit *always* exceeds the private benefit. It is possible for the private benefit to exceed the social benefit. See *id.*

¹⁰ *Id.* This competing force has the potential to suggest that there are too few lawsuits from a social perspective.

¹¹ Janusz A. Ordover, *Costly Litigation in the Model of Single Activity Accidents*, 7 J. LEGAL STUD. 243, 243–45 (1978).

¹² See *id.* at 244.

¹³ *Id.* at 244–45.

gence.¹⁴ Hylton affirmed Ordovery's original negligence findings and extended the analysis of the deterrence externality to strict liability.¹⁵ He argued that potential injurers also exercise insufficient levels of care under strict liability since they do not fully internalize two social costs—the litigation costs of the plaintiffs they harm, and the magnitude of the harm suffered by those victims who did not have the correct incentives to file suit.¹⁶ Therefore, under strict liability with pure compensatory damages, potential injurers do not exercise the optimal level of care because they do not fully internalize all of the costs borne by accident victims.¹⁷ These two papers illustrate that there is generally a problem of underdeterrence in tort law.

The underdeterrence problem begets an analysis of appropriate corrective policies, but we ask a different question—namely, is it possible, despite the “bad press” they ordinarily receive, that frivolous lawsuits may sometimes actually serve to enhance deterrence? Put another way, as a positive (or descriptive) matter, can frivolous lawsuits potentially, though perhaps imperfectly, correct for the problem of underdeterrence? If so, they may have some redeeming social value. Having raised these questions, it is important to note at this juncture that we will not advocate for an increase in the frequency of frivolous litigation. Nor will we attempt to justify plaintiffs who file frivolous lawsuits. Our theoretical model, when properly interpreted, does not provide an adequate normative foundation to suggest that policymakers should enact rules to encourage (or at least not discourage) frivolous litigation. This is true because, practically speaking, it may be difficult to determine exactly when frivolous lawsuits induce beneficial deterrence.¹⁸ And in addition, we recognize that the existence of frivolous lawsuits may cause some to call into question the integrity of the civil justice system. As a result, our model only describes how, as a descriptive matter, frivolous lawsuits affect deterrence. Our conclusions therefore

¹⁴ *Id.* at 245.

¹⁵ Keith N. Hylton, *The Influence of Litigation Costs on Deterrence Under Strict Liability and Under Negligence*, 10 INT'L REV. L. & ECON. 161, 161–62 (1990).

¹⁶ *Id.* at 161. Note that victims will not file suit if expected court-ordered compensation is outweighed by the victim's cost of litigation.

¹⁷ On the topic of optimal deterrence, see Shavell, *Fundamental Divergence*, *supra* note 1, at 588 (arguing that optimal deterrence requires injurers to compensate victims for both their harm and litigation costs). Polinsky and Rubinfeld argue for an adjustment to the level of compensatory damages to ameliorate the problem of underdeterrence, though they allow for the possibility that injurers may exercise too much care from a social perspective. Their adjustment in the level of compensatory damages depends not only on the injurer's level of care relative to the social optimum, but also on the impact of litigation costs on a victim's incentives to file suit. A. Mitchell Polinsky & Daniel L. Rubinfeld, *The Welfare Implications of Costly Litigation for the Level of Liability*, 17 J. LEGAL STUD. 151, 151–53 (1988).

¹⁸ *But see infra* Part II.F for a numerical example demonstrating how frivolous lawsuits enhance deterrence in a socially valuable manner.

should not necessarily be interpreted as advocating for looser restrictions on the filing and litigating of frivolous claims.

With these considerations in mind, the remainder of the paper is organized as follows. In Part I, we describe how a certain subset of frivolous lawsuits can be characterized as “piggyback” lawsuits. Despite ambiguity regarding what constitutes a frivolous lawsuit, we observe that some frivolous claims piggyback on claims brought by legitimate accident victims. In Part II, we describe our theoretical model and provide numerical examples. There we show that under certain circumstances, frivolous lawsuits are capable of generating beneficial deterrence. In Part III, we focus on how the many legal regimes governing frivolous lawsuits impact deterrence. In particular, we discuss how these legal regimes may or may not increase social welfare in the presence of frivolous suits.

I. FRIVOLOUS LAWSUITS AS PIGGYBACK LAWSUITS

Different groups perceive frivolous lawsuits in different ways, and hence, there is some ambiguity with respect to defining, and correspondingly evaluating, frivolous suits. For instance, some personal injury lawyers may argue that frivolous lawsuits are infrequently initiated under contingency fee agreements because lawyers cannot expect to realize profits by representing clients with low-expected-value claims.¹⁹ Indeed, if a contingency fee arrangement exists between a lawyer and a particular client, then the lawyer’s willingness to represent the client may signal the case’s inherent level of merit.²⁰ Taking a different stance, some politicians have maintained that frivolous lawsuits pose a serious threat to the efficiency of the civil justice system.²¹ With the asserted goals of remedying judicial delay, mitigating a perceived litigation explosion, reducing excessive jury awards, and decreasing insurance premiums, some political platforms have focused on reducing the frequency of frivolous lawsuits (for example, by advocating

¹⁹ See, e.g., James D. Dana, Jr. & Kathryn E. Spier, *Expertise and Contingent Fees: The Role of Asymmetric Information in Attorney Compensation*, 9 J. L. ECON. & ORG. 349, 350 (1993) (arguing that rational lawyers will focus their efforts on meritorious claims as opposed to those cases with low expected returns). But see Thomas J. Miceli, *Do Contingent Fees Promote Excessive Litigation?*, 23 J. LEGAL STUD. 211, 212 (1994) (recognizing that frivolous lawsuits can be profitable under contingency fee agreements if defendants prefer settlement to trial).

²⁰ Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT’L REV. L. & ECON. 3, 26 (1990) (stating that “[t]he fact that an attorney is willing to take a percentage of a case as his compensation may be a good signal that the case has merit; accordingly, contingent fees may help to channel meritorious cases toward settlement, while screening out some frivolous claims”). Put another way, personal injury lawyers may serve as a screening mechanism.

²¹ See Robert S. Peck, *Violating the Inviolable: Caps on Damages and the Right to Trial by Jury*, 31 U. DAYTON L. REV. 307, 308 n.5 (2006).

various federal and state tort reform measures).²² In addition, the general public sometimes criticizes the assertion of fanciful or bizarre legal claims, including not only those that are adjudicated in favor of the defendant,²³ but also those that result in plaintiffs' verdicts.²⁴ Successful yet perhaps novel cases, including the infamous matter of *Liebeck v. McDonald's Restaurants*,²⁵ are occasionally considered by the public to be frivolous in nature.

These conjectured group-level views, however, differ from the manner in which frivolous lawsuits are treated under American jurisprudence. According to the United States Supreme Court, "a complaint, containing as it does both factual allegations and legal conclusions, is frivolous where it lacks an arguable basis either in law or in fact."²⁶ Similarly, Black's Law Dictionary defines the term "frivolous" as "[I]acking a legal basis or legal merit."²⁷ The Restatement (Third) of Law Governing Lawyers states, "A frivolous position is one that a lawyer of ordinary competence would recognize as so lacking in merit that there is no substantial possibility that the tribunal would accept it."²⁸ Based on these perspectives, we can conclude that certain extreme causes of action are clearly frivolous in nature. For instance, we would all agree that filing suit against Satan for deprivation of one's constitutional rights is a fanciful allegation, unfit to be heard by the courts.²⁹

²² *Id.*

²³ See, e.g., *Pearson v. Chung*, 961 A.2d 1067 (D.C. Cir. 2008). In this case, the plaintiff Pearson, an administrative law judge, sued the defendant owners of a dry cleaning business for allegedly losing a pair of the plaintiff's pants, which were left for alterations. *Id.* at 1069. Requesting punitive and injunctive relief, the plaintiff sought damages for as much as \$67 million (though later reduced) under theories of statutory unfair trade practices, common law fraud, conversion, and negligence. *Id.* at 1070, 1070 n.1. The trial court awarded judgment in favor of the defendants and the ruling was later affirmed on appeal. *Id.* at 1069. Unfortunately, to cover their defense costs, the defendants were forced to close two of their three dry cleaning shops. See *Lost Pants Case Exposes Scary Side of Legal System*, WASH. POST, Dec. 23, 2008, at B03; *\$54 Million 'Pant Suit' Runs Cleaners out of Business*, VIRGINIAN-PILOT, Sept. 20 2007, at A2. Third parties also had a fundraiser aimed at defraying more than \$100,000 in litigation costs incurred by the defendants. *He's No Santa Claus*, BISMARCK TRIBUNE, Sept. 21, 2007, at 7C.

²⁴ Rhode provides a brief overview of a number of novel, real-world cases—some frivolous, some not—to illustrate the inherent difficulty in distinguishing legitimate cases from frivolous ones. Deborah L. Rhode, *Frivolous Litigation and Civil Justice Reform: Miscasting the Problem, Recasting the Solution*, 54 DUKE L.J. 447, 447–49 (2004).

²⁵ *Liebeck v. McDonald's Rests., P.T.S., Inc.*, No. CV-93-02419, 1995 WL 360309 (N.M. Dist. Aug. 18, 1994).

²⁶ *Neitzke v. Williams*, 490 U.S. 319, 325 (1989). Fantastic or delusional factual allegations or indisputably meritless legal theories give rise to a complaint lacking an arguable basis. *Id.* at 327–28.

²⁷ BLACK'S LAW DICTIONARY 739 (9th ed. 2009).

²⁸ RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 110 cmt. d (2000).

²⁹ See generally *United States ex rel. Mayo v. Satan & His Staff*, 54 F.R.D. 282 (W.D. Pa. 1971) (dismissing the plaintiff's claims against Satan for failing to state a claim upon which relief could be granted, in addition to questioning whether personal jurisdiction and service of process were proper).

However, a determination of frivolity may not always be this easy to establish. For some cases, the dividing line between a frivolous and potentially unsuccessful lawsuit, *ex ante*, may be difficult to identify. It should therefore not be surprising that at least one court has recognized that the term “‘frivolous’ is incapable of precise determination,”³⁰ and accordingly, it may be the case that the lack of preciseness in defining the term “frivolous” has hampered scholarly analyses on the topic.³¹ In an effort to shed light on exactly what constitutes a frivolous lawsuit, we consider the reasonable possibility that frivolous lawsuits often “piggyback” on genuine claims—hence we label them as piggyback lawsuits—though we concede that there are other motivations for initiating lawsuits without merit.³²

Prior to justifying our treatment of frivolous lawsuits as piggyback lawsuits, we must first establish the incentives for plaintiffs to file frivolous lawsuits and for defendants to pay them off. A rational plaintiff will file a frivolous suit if and only if she expects to obtain a sufficiently large settlement offer prior to trial. Absent this expected settlement offer, a plaintiff will not have the proper incentives to file a frivolous lawsuit in the first place because she will inevitably lose (or be very likely to lose) at trial. As a result, the plaintiff’s (or plaintiff’s lawyer’s) motivation for filing a frivolous lawsuit must be to extract a positive settlement offer. But why do defendants pay off frivolous claims? At first blush, it appears that defendants ought to simply litigate all matters in an attempt to distinguish frivolous from genuine cases. However, as the model to be described below will illustrate, a policy of litigating all matters may not always be desirable from the defendant’s perspective.

Early attempts to explain the success of frivolous lawsuits in a rational agent model suggested that defendants offered positive settlement amounts to frivolous plaintiffs in an effort to avoid costly litigation. For instance, Rosenberg and Shavell argue that nuisance suits arise out of a divergence

³⁰ *De Vaux v. Westwood Baptist Church*, 953 So. 2d 677, 683 (Fla. Dist. Ct. App. 2007) (quoting *Wendy’s of N.E. Fla., Inc. v. Vandergriff*, 865 So. 2d 520, 524 (Fla. Dist. Ct. App. 2003)). It should be noted that there is some state court disagreement with respect to evaluating whether a lawsuit is frivolous. Keeling recognizes that the term “frivolous” is defined differently in different jurisdictions. Byron C. Keeling, *Toward a Balanced Approach to “Frivolous” Litigation: A Critical Review of Federal Rule 11 and State Sanctions Provisions*, 21 PEPP. L. REV. 1067, 1070–71 (1994). Some define it to imply subjective bad faith, while other states evaluate it according to an objective standard. *Id.*

³¹ In his article, Bone acknowledges that the “[o]ne obstacle [to developing a model of frivolous lawsuits] is the lack of a clear and generally accepted definition of a ‘frivolous suit,’” and uses a game theoretic approach to address this problem. Robert G. Bone, *Modeling Frivolous Suits*, 145 U. PA. L. REV. 519, 528 (1997).

³² In particular, our model does not consider the possibility that a frivolous lawsuit may be initiated simply to harass another person or entity, or that a frivolous lawsuit may be filed to further an ulterior motive in the context of antitrust law, i.e., sham litigation.

between plaintiffs' filing costs and defendants' litigation costs.³³ By incurring small filing costs in conjunction with the option to withdraw at a later time, frivolous plaintiffs are able to obtain positive settlement offers, since defendants recognize they will have to incur litigation costs in an effort to avoid default judgments.³⁴ Similarly, Cooter and Rubinfeld discuss nuisance suits in the context of an optimism model, where such suits arise out of asymmetric litigation costs borne by parties at trial.³⁵ In particular, defendants will pay positive settlements if they have higher trial costs than plaintiffs.³⁶ Both of these early attempts treated a suit as frivolous when the defendant knew that the plaintiff would be unwilling to pursue (or unable to succeed at) trial.³⁷ The defendant's incentive to settle was related to its inclination to steer clear of costly litigation.

Recent attempts to explain the behavior of parties to frivolous litigation assume a more realistic scenario of asymmetric information. P'ng finds that frivolous plaintiffs sometimes succeed in obtaining settlement offers when the *defendant* has private information regarding its own liability.³⁸ However, subsequent authors have pointed out that a frivolous plaintiff does not have a credible threat to reject a settlement offer and proceed to trial under P'ng's analysis because the defendant knows when a suit is frivolous.³⁹ In an effort to address the problem of threat credibility, Bebchuk assumes instead that it is the *plaintiff* who holds private information about the quality of a suit.⁴⁰ Treating frivolous lawsuits as negative

³³ See David Rosenberg & Steven Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3, 3 (1985) (considering a model allowing for the occurrence of such nuisance suits).

³⁴ *Id.*

³⁵ Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LIT. 1067, 1083–84 (1989).

³⁶ *Id.* at 1084.

³⁷ Rosenberg and Shavell define a frivolous lawsuit as one in which "the plaintiff is able to obtain a positive settlement from the defendant even though the defendant knows the plaintiff's case is sufficiently weak that he would be unwilling or unlikely actually to pursue his case to trial." Rosenberg & Shavell, *supra* note 33, at 3. Cooter and Rubinfeld state that "[a] nuisance suit can be defined as a suit that both sides recognize as having no merit, in which case the expected damage award is nil" Cooter & Rubinfeld, *supra* note 35, at 1083.

³⁸ Ivan P. L. P'ng, *Strategic Behavior in Suit, Settlement, and Trial*, 14 BELL J. ECON. 539, 540–41 (1983). P'ng's analysis supposed that the plaintiff did not know whether it put forth a genuine or frivolous claim. Only the defendant knew whether it was liable to the plaintiff. Therefore, under P'ng's model, the defendant held information that was not available to plaintiff. *Id.*

³⁹ See Lucian Arye Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437, 438 (1988) [hereinafter Bebchuk, *Settlement Offer*] ("[G]iven P'ng's assumptions, the defendant knows that it would not be in the plaintiff's interest to go to trial in the absence of a settlement; there is thus no reason for the defendant to believe that this would happen; and the defendant's best strategy is, therefore, to sit tight.").

⁴⁰ *Id.* at 440.

expected value (NEV) suits,⁴¹ Bebchuk's game theoretic model demonstrates that a frivolous plaintiff may succeed in obtaining a positive settlement offer due to uncertainty on the part of the defendant about whether a lawsuit is an NEV or a PEV (positive expected value) suit.⁴² In a follow-up article, Bebchuk widened the scope of his original model to consider the case where a defendant is reasonably certain that the plaintiff's suit is actually an NEV suit.⁴³ When this is the case, he argues that the divisibility of costs within the litigation process may still afford a plaintiff holding an NEV with the opportunity to extract a positive settlement offer.⁴⁴ Katz extended Bebchuk's original model by focusing on the plaintiff's incentive to file suit, in addition to the defendant's optimal settlement strategy.⁴⁵ In Katz's model, which is also based on asymmetric information on the part of the plaintiff, some frivolous lawsuits succeed in extracting a positive settlement in equilibrium.⁴⁶

Subsequent models have extended the previous insights and proposed remedies for the problem of frivolous suits. For example, Miceli identifies the conditions under which repeat defendants are able to establish credible threats to deter the initiation of frivolous lawsuits.⁴⁷ Farmer and Pecorino also utilize a reputation model in their analysis of frivolous lawsuits,⁴⁸ but they assume a plaintiff is able to obtain a positive settlement offer by establishing a reputation—i.e., a credible threat—to proceed to trial when a settlement offer is rejected.⁴⁹ Rosenberg and Shavell offer a different solution to frivolous lawsuits—permitting courts to prevent pretrial settlement.⁵⁰ Finally, Schwartz and Wickelgren find that the discovery process is capable of inducing frivolous plaintiffs to reduce their settlement offers or withdraw their cases.⁵¹

⁴¹ A NEV suit exists when the plaintiff's expected judgment at trial is less than its expected litigation costs. In other words, the plaintiff expects a negative net return by proceeding to trial. Lucian Arye Bebchuk, *A New Theory Concerning the Credibility and Success of Threats to Sue*, 25 J. LEGAL STUD. 1, 1 (1996) [hereinafter Bebchuk, *Threats to Sue*].

⁴² Bebchuk, *Settlement Offer*, *supra* note 39, at 440–41.

⁴³ Bebchuk, *Threats to Sue*, *supra* note 41, at 4.

⁴⁴ *Id.*

⁴⁵ Katz, *supra* note 20, at 26.

⁴⁶ *Id.* at 25.

⁴⁷ Thomas J. Miceli, *Optimal Deterrence of Nuisance Suits by Repeat Defendants*, 13 INT'L REV. L. & ECON. 135, 137–41 (1993).

⁴⁸ Amy Farmer & Paul Pecorino, *A Reputation for Being a Nuisance: Frivolous Lawsuits and Fee Shifting in a Repeated Play Game*, 18 INT'L REV. L. & ECON. 147, 147 (1998).

⁴⁹ *Id.* at 148–49.

⁵⁰ David Rosenberg & Steven Shavell, *A Solution to the Problem of Nuisance Suits: The Option to Have the Court Bar Settlement*, 26 INT'L REV. L. & ECON. 42, 42–43 (2006).

⁵¹ Warren F. Schwartz & Abraham L. Wickelgren, *Credible Discovery, Settlement, and Negative Expected Value Suits*, 40 RAND J. ECON. 636, 637 (2009).

In sum, most of the recent literature on the topic of frivolous, or nuisance,⁵² suits has focused on the defendant's optimal policy in choosing whether to settle or litigate particular claims. These models typically assume that there is some exogenous, or given, probability that a plaintiff is uninjured or barely injured. Without a trial, the defendant would be unable to discern genuinely injured from uninjured plaintiffs, but utilizing trial as a separating mechanism requires the defendant to incur litigation costs. While at first blush it appears that the defendant simply ought to litigate all matters, it can be shown that under certain conditions a defendant's optimal strategy is actually to settle with all plaintiffs—both legitimate *and* frivolous ones. As a result, previous literature on the topic of frivolous lawsuits suggests that in some cases defendants are unable to avoid paying off frivolous lawsuits. Settlement payoffs to frivolous plaintiffs are simply a fixed cost of engaging in a risky activity.

Contrary to the assertion that defendants are “defenseless” to frivolous lawsuits, it is apparent that potential injurers often *can* affect their incidence. Under standard economic models of torts, for instance, potential injurers cause accidents not only as a consequence of their choice of care, but also as a direct result of their activity level—how frequently they engage in the risky activity in question. Thus, in the extreme case, a particular (defendant) business could avoid frivolous lawsuits altogether by simply choosing not to engage in any activity at all, i.e., by shutting down. More generally, it presumably can reduce the threat of frivolous claims by reducing its activity level. For example, consider the hypothetical case of a supermarket owner who causes harm to a subset of customers who slip and fall on his premises.⁵³ The owner will face legal claims from customers who are genuinely injured as well as those customers who are either uninjured or suffered injuries caused by a different source. In this case, the success of frivolous claims in securing a pretrial settlement depends on the existence of genuinely injured customers. Absent genuinely injured customers, frivolous plaintiffs would not likely succeed in obtaining settlement, and hence, they would rarely (if ever) initiate a lawsuit. This scenario reflects the idea that frivolous lawsuits piggyback on legitimate lawsuits filed against individuals or businesses whose ordinary activity results in

⁵² For the purposes of our theoretical model, we view the terms “frivolous” and “nuisance” in the context of lawsuits as synonymous. However, at least one commentator has discussed a technical distinction between these two terms. See Lance P. McMillian, *The Nuisance Settlement “Problem”: The Elusive Truth and a Clarifying Proposal*, 31 AM. J. TRIAL ADVOC. 221, 222–23 (2007) (arguing that the two terms are not interchangeable, since a nuisance lawsuit implies a filing is made in bad faith, while a frivolous lawsuit does not). This dissimilarity is immaterial to our analysis.

⁵³ Katz also considers slip-and-fall accidents in his discussion of frivolous lawsuits. Katz, *supra* note 20, at 6.

some accidents.⁵⁴ We will often refer to this hypothetical scenario to stress important aspects of our theoretical model.

Consistent with the preceding logic, we formally define piggyback lawsuits to be those brought by the following:

(1) actual accident victims whose injuries were caused by someone other than the defendant (for example, negligence by another customer of the supermarket);

(2) actual accident victims whose injuries were caused by “nature” (for example, a fall caused by a sudden dizzy spell suffered by the victim); or

(3) uninjured plaintiffs (those feigning a fall).⁵⁵

This taxonomy of frivolous-as-piggyback lawsuits provides a straightforward definition upon which we can evaluate the impact of frivolous lawsuits on deterrence. In addition, it is consistent with the current jurisprudence governing frivolous lawsuits. Under our taxonomy, a defendant injurer is never liable at trial to a piggyback victim,⁵⁶ either because the defendant injurer did not factually cause the victim’s injuries or because the victim is truly uninjured. In other words, although the above categories consist of a mixture of genuinely injured and uninjured plaintiffs, as a matter of law they are all frivolous in the sense that, even under a rule of strict liability, the injurer would not be held liable for their damages in court.

This view is harmonious with how courts routinely interpret the many policies and procedures providing a remedy to defendants when fending off frivolous litigation.⁵⁷ Under American jurisprudence, for a case to be frivolous it must be meritless—meaning, according to the United States Supreme Court, “groundless or without foundation, rather than simply that the plaintiff has ultimately lost his case.”⁵⁸ Accordingly, courts are hesitant to provide a remedy for the filing of a frivolous lawsuit in cases that exhibit even an iota of merit. For instance, in *Tancredi v. Metropolitan Life Insurance Co.*,⁵⁹ the Second Circuit held that a finding of frivolity, which would trigger an award for attorney’s fees under the Civil Rights Attorney’s Fees

⁵⁴ Our treatment of frivolous lawsuits as piggyback lawsuits should not be confused with lawsuits that piggyback on governmental or regulatory investigations.

⁵⁵ Thomas J. Miceli & Michael P. Stone, “Piggyback” *Lawsuits and Deterrence: Can Frivolous Litigation Improve Welfare?*, 3 (Univ. of Conn. Dep’t of Econ. Working Paper Series No. 2013-16, July 2013), available at <http://www.econ.uconn.edu/working/2013-16.pdf>.

⁵⁶ That is, the probability of victory at trial for a piggyback victim is zero.

⁵⁷ See *infra* Part III for a discussion of the legal regimes that potentially affect the frequency of frivolous lawsuits.

⁵⁸ *Christiansburg Garment Co. v. Equal Emp’t Opportunity Comm’n*, 434 U.S. 412, 421 (1978) (in the context of interpreting Title VII of the Civil Rights Act of 1964).

⁵⁹ *Tancredi v. Metro. Life Ins. Co.*, 378 F.3d 220 (2d Cir. 2004).

Awards Act,⁶⁰ was improper when the original complaint was “very weak, but it was not completely without foundation.”⁶¹ Similarly, in *Hughes v. Rowe*,⁶² the United States Supreme Court held, again in the context of the Civil Rights Attorney’s Fees Awards Act, that attorney’s fees should not be awarded to the prevailing party when “[a]llegations that, upon careful examination, prove legally insufficient to require a trial are not, for that reason alone, ‘groundless’ or ‘without foundation’ The fact that a plaintiff may ultimately lose his case is not in itself a sufficient justification for the assessment of fees.”⁶³ Because courts are hesitant to treat cases with some merit as frivolous in nature, there is symmetry between our taxonomy and current jurisprudence. Under our taxonomy, all piggyback cases are wholly without merit in the sense that the defendant is never liable to a piggyback plaintiff under a rule of strict liability.

In the next section, we provide an overview of our theoretical model, which partially follows the model originally set forth by Katz.⁶⁴ However, our model extends Katz’s original analysis by grafting it onto a standard economic model of torts⁶⁵ to determine how defendants’ optimal strategy for dealing with piggyback lawsuits affects their prior choices of care and activity. In this way, we focus on how frivolous-as-piggyback lawsuits affect deterrence. We illustrate that, under certain conditions, these suits create incentives for potential injurers to engage in more efficient accident avoidance. That is, under a particular set of assumptions, piggyback lawsuits may actually enhance deterrence in a socially valuable way.

II. THEORETICAL FRAMEWORK FOR EVALUATING THE EFFECT OF PIGGYBACK LAWSUITS ON DETERRENCE

In this section, we set forth a theoretical model to illustrate how piggyback lawsuits affect accident avoidance. First, we provide a broad overview of the structure of the game, including its underlying assumptions. Next, we analyze the resulting settlement–trial equilibria. It is shown that due to the existence of information asymmetry, defendants face a dilemma when attempting to formulate a pretrial settlement policy. In particular, when defendants try to settle all cases, they permit piggyback plaintiffs to extract positive settlements, which result in increased settlement costs. However, when defendants litigate all cases, they avoid settling with piggy-

⁶⁰ 42 U.S.C. § 1988 (1976).

⁶¹ *Tancredi*, 378 F.3d at 230.

⁶² *Huges v. Rowe*, 449 U.S. 5 (1980).

⁶³ *Id.* at 15–16.

⁶⁴ See Katz, *supra* note 20, at 6–8 (enumerating the assumptions of the model).

⁶⁵ See, e.g., STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* (1987) (for an introduction to the economic analysis of tort law).

back plaintiffs, but they incur litigation costs which otherwise could have been avoided by settlement. This dilemma leads to the emergence of two distinct equilibria in the settlement–trial subgame. From these two equilibria, we then derive the prior care and activity choices of the defendant–injuror. We first show that piggyback lawsuits serve to enhance deterrence compared to a world without frivolous suits, and then go on to show that under certain conditions this enhanced deterrence is socially desirable. Finally, we provide a numerical example to illustrate the key conclusions of the analysis. Interested readers can find the formal details of the model in the Appendix.⁶⁶

A. *Structure of the Game and its Underlying Assumptions*

Our model is a sequential move game⁶⁷ consisting of two types of players: (i) an injurer who engages in a risky activity, and (ii) potential victims who are either legitimately injured (one such victim being labeled as a “genuine victim”), or are of the piggyback variety (one being a “piggyback victim”). There are four total periods. In the first period, the injurer chooses its activity level. In the context of our hypothetical scenario, the injurer’s activity level reflects the number of individual stores the supermarket owner wishes to operate. If the injurer’s activity level is positive—that is, if the owner operates at least one store—then the injurer also chooses its monetary expenditure in care per unit of activity. For instance, the supermarket owner takes steps to ensure that the aisles are clear of hazards and the floor is not slippery.

The injurer’s monetary expenditure on care directly influences its expected tort liability per unit of activity. Specifically, the probability of an accident is decreasing in care, meaning that as the injurer’s expenditure on care increases, the probability of an accident decreases. However, this does not imply that the injurer will necessarily find it desirable to invest in care to the point where the probability of an accident is zero. Care is costly and the rate by which it reduces the probability of an accident decreases as care increases.⁶⁸ Thus, an injurer will only increase its expenditure on care as long as the marginal benefit of care exceeds the marginal cost. Under strict liability, the injurer’s marginal benefit of care is the marginal reduction in expected tort liability per unit of activity. Thus, the injurer will continue to invest in care until the marginal reduction in liability equals the cost of the last unit of care (the marginal cost of care). In a simple model without liti-

⁶⁶ The appendix is based on the analysis in Miceli & Stone, *supra* note 55.

⁶⁷ Such a game permits sequential movement by players, i.e., one player moves first, then another chooses an action based on the first player’s observed action.

⁶⁸ This is a standard assumption under economic tort models. We particularly assume that the probability of an accident decreases as care increases, but at a decreasing rate.

gation costs, this level of care coincides with the socially optimal level of care. Under a more realistic scenario incorporating costly litigation, however, injurers will generally underinvest in care for the reasons noted in the Introduction. It is this underdeterrence that potentially makes piggyback suits socially desirable from an accident-cost perspective.

In addition to the number of genuine victims, which depends on the injurer's care level, we assume that there is an exogenous "supply" of piggyback victims per unit of the injurer's activity. The total number of potential plaintiffs facing the defendant, per unit of activity, is the sum of these two quantities.

Would-be victims—be they genuine or piggyback—move in the second period. Victims choose whether or not to file suit, which is costly. If a victim files suit, he becomes the plaintiff in a cause of action against the injurer, which is now the defendant. We assume that it is always in the interest of genuine plaintiffs to file suit, whether or not they expect subsequent bargaining with the defendant to result in a pretrial settlement. The decision of piggyback plaintiffs, however, depends on whether or not they expect the defendant to offer a positive settlement amount.

Once a victim (now a plaintiff) files suit, the defendant and plaintiff engage in a subgame involving the decision of whether to settle the dispute or proceed to trial. Thus, in the third period, the defendant makes a take-it-or-leave-it settlement offer (which could be zero) to the plaintiff, and then in the fourth period, the plaintiff either accepts or rejects this offer. If the plaintiff accepts, the parties settle and the game ends. However, if the plaintiff rejects the settlement offer, then the outcome of the game depends on whether the plaintiff is a genuine or a piggyback plaintiff. For simplicity, we assume that the prevailing legal rule is strict liability with pure compensatory damages, meaning the injurer will always be liable for a genuine victim's harm, since by assumption a genuine victim can prove causation in court. Thus, if the plaintiff is genuine, it will win at trial with certainty.⁶⁹ In contrast, a piggyback plaintiff cannot prove causation and will therefore lose at trial with certainty. Accordingly, only genuine plaintiffs ever proceed to trial, while piggyback plaintiffs who reject the defendant's offer (which only happens when the offer is zero) withdraw their claims.

The equilibrium of the preceding game is derived by backward induction,⁷⁰ which is the proper solution procedure for games in which players move sequentially. The Appendix provides a formal analysis of the model.

⁶⁹ Assuming that judges and juries do not commit errors.

⁷⁰ Backward induction requires us to first determine the optimal strategy for the last-moving players in time, i.e., the genuine and piggyback plaintiff's decisions of whether to accept or reject the defendant's take-it-or-leave-it settlement offer in period 4. Once we have ascertained both plaintiffs' optimal strategies in period 4, we work backwards in time to period 3 to identify the defendant's optimal take-it-or-leave-it settlement offer. With this information, we continue working backwards in time, first

B. *Settlement–Trial Subgame*

We begin by describing the outcome of the settlement–trial subgame, which begins at the point where a plaintiff files a lawsuit. Consider first the plaintiff’s decisions regarding whether to accept or reject the defendant’s take-it-or-leave-it settlement offer in the final period. If the plaintiff is genuine, it will only accept the defendant’s offer if it is at least as large as the expected value of trial. The expected value of trial is equal to the magnitude of the plaintiff’s damages less the plaintiff’s cost of trial.⁷¹ We assume that this is a positive amount, meaning that the plaintiff’s losses exceed the cost of trial.⁷² Any offer smaller than the plaintiff’s expected value of trial will cause a genuine plaintiff to reject the offer and proceed to trial. In contrast, piggyback plaintiffs, because they will lose at trial with certainty, will accept any positive settlement offer, and will drop the suit if offered zero.

We now move backwards in time to the point where the defendant makes its settlement offer. Since backward induction implies that the defendant has strategic foresight, it knows how the two types of plaintiffs will behave when faced with a given offer. Thus, if the defendant had perfect information and could distinguish genuine from piggyback plaintiffs, she would rationally offer genuine plaintiffs a settlement amount equal to their expected value of trial (as defined above), and zero to piggyback plaintiffs. When faced with these offers, genuine plaintiffs will accept the offer and settle, while piggyback plaintiffs will drop their suits—which is to say, they will accept the offer of zero. As a result, with perfect information, the defendant is able to avoid a costly trial with genuine plaintiffs via settlement, and to pay nothing to piggyback plaintiffs. And because rational plaintiffs will anticipate this outcome, only genuine plaintiffs will ever file suit.

The outcome will be quite different in the uncertainty case, however, because the defendant will not be able to distinguish between the two types of plaintiffs at the settlement stage and therefore must make a single offer. One possible strategy for the defendant is to offer the minimum amount that a genuine plaintiff will accept, in which case both types of plaintiffs will accept the offer, and no cases will ever go to trial. While this strategy saves on trial costs, it has the downside of paying off all piggyback suits as if they were genuine. And anticipating this, all potential piggyback plaintiffs will file suit. Alternatively, the defendant could offer zero to all plaintiffs—that is, refuse to settle any suits. While this strategy ensures that no piggyback

deriving whether plaintiffs will file suit in period 2, and finally concluding with the injurer’s optimal care and activity choices in period 1. The presumption here is that players have strategic foresight.

⁷¹ For example, suppose the plaintiff’s damages are \$100,000, and the cost of trial is \$20,000. Then, if the plaintiff goes to trial and wins, she will receive compensation of \$100,000, but will have to pay trial costs of \$20,000. Thus, the plaintiff will not settle for any amount less than \$80,000.

⁷² Note that the plaintiff’s filing costs do not matter for the settlement decision because, once the case has been filed, filing costs are a sunk expenditure.

plaintiffs would be able to extract a positive settlement amount—and hence would be deterred from filing suit—it would cause all genuine plaintiffs to opt for trial, thus requiring the defendant to incur litigation costs in addition to paying damages.

It is important to note that it will always be optimal for the defendant to make one of these two offers—either the minimum amount a genuine plaintiff will accept (equal to the genuine plaintiff's expected value of trial), or zero. It would obviously never pay for the defendant to offer more than a genuine plaintiff would accept (for both types would accept the lower amount), nor would it pay to offer an amount between zero and the minimum acceptable offer (for that offer would be rejected by genuine plaintiffs and would overcompensate piggyback plaintiffs).

The defendant's optimal choice between the two offers will depend on its beliefs about the likelihood that a given plaintiff is genuine or piggyback. Those beliefs will depend on three factors: (1) the level of care the defendant exercised (which determines the likelihood that a genuine accident will occur); (2) the total number of potential piggyback plaintiffs who might file suit (which we treat as exogenous);⁷³ and (3) the decision of piggyback plaintiffs about whether or not to file suit. If, taking all of these factors into account, the defendant perceives that the probability a plaintiff is genuine exceeds a certain threshold, then its optimal strategy will be to settle the claim—that is, to offer the minimum amount that a genuine plaintiff will accept. Although the defendant knows that by adopting this strategy there is a chance it will be paying off a piggyback plaintiff, the strategy is a worthwhile venture given the relatively high probability that the plaintiff is genuine and therefore would be willing to go to trial if offered nothing. Of course, potential piggyback plaintiffs will anticipate this behavior and will therefore file suit. Thus, in equilibrium, it must be the case that the total number of such plaintiffs is small relative to the number of genuine plaintiffs in order to fulfill the defendant's expectations. We will refer to this “pure strategy” equilibrium,⁷⁴ in which all potential piggyback plaintiffs file suit and the defendant settles all cases, as a Type 1 equilibrium.

Suppose alternatively that when all piggyback plaintiffs file suit, the defendant perceives a relatively low probability that a given plaintiff is genuine. In this case, one might suppose that the optimal strategy would be

⁷³ This number will depend on various factors, including the total number of persons with whom the defendant interacts when engaged in its activity, the ease with which they feign injury, and their inherent propensity to falsely file a lawsuit.

⁷⁴ A player adopts a pure strategy when it chooses a particular action with a probability of 1. In other words, a player chooses a single action with certainty. The intersection of players' pure strategies is a pure strategy equilibrium. For readers without a background in economics, see MARTIN J. OSBORNE, AN INTRODUCTION TO GAME THEORY 107–08 (Oxford Univ. Press 2004) (discussing the concept of a pure strategy and the resulting equilibrium briefly). In the context of our theoretical model, a Type 1 equilibrium is a pure strategy equilibrium because piggyback victims file suit with a probability of 1 and the defendant chooses to settle with a probability of 1.

for the defendant to refuse to settle any cases—i.e., to offer a zero settlement amount—as a way of inducing all piggyback plaintiffs to drop their cases. Of course, this would entail going to trial with genuine plaintiffs, but given the defendant’s initial beliefs, she calculates that this strategy is cheaper than paying off all of the piggyback plaintiffs. Piggyback plaintiffs will correctly anticipate this outcome and therefore will not file suit. But notice that this contradicts the defendant’s initial beliefs that piggyback plaintiffs constituted a relatively large fraction of all plaintiffs who actually file suit. If, in consequence, the defendant revises his beliefs to suppose that all plaintiffs are genuine, its optimal strategy would then be to settle all cases. But then all potential piggyback plaintiffs would be induced to file suit, and again the defendant’s beliefs would be contradicted.

This circular reasoning reveals that a pure strategy equilibrium in which the defendant offers a zero settlement amount to all plaintiffs cannot exist in this case. There does, however, exist a second type of equilibrium that involves “mixed strategies” by the defendant and piggyback plaintiffs. Generally speaking, a mixed strategy exists when a player randomly chooses between two or more pure strategy options.⁷⁵ In the current context, the defendant randomizes between offering a positive settlement amount and zero, while piggyback victims randomize between filing suit and not filing. (All genuine victims will file suit with certainty no matter what strategy they expect the defendant to play.) For these mixed strategies to constitute an equilibrium, it must be the case that defendants are indifferent between their two options, and piggyback victims are indifferent between their two options. Thus, the probabilities attached to each option for the two players must adjust to ensure that this is true.

As noted, this mixed strategy equilibrium in the settlement–trial subgame, which we will refer to as a Type 2 equilibrium, arises when the fraction of genuine plaintiffs in the population of all potential plaintiffs is below a threshold. In the resulting equilibrium, the defendant randomly settles with some plaintiffs and refuses to settle with the remaining ones (though remember, it cannot determine which plaintiffs are genuine), and piggyback victims randomly choose between filing and not filing suit. Among the piggyback plaintiffs who file, the ones who receive a positive settlement offer accept and settle, while the ones who receive an offer of zero are forced to withdraw their suits. At the same time, the defendant necessarily incurs some litigation costs when those genuine plaintiffs to whom she offers zero opt for trial.

In summary, the outcome of the settlement–trial subgame involves two equilibria. The first is a pure strategy equilibrium in which all piggyback victims file suit and the defendant settles with all plaintiffs—both genuine and piggyback. This Type 1 equilibrium emerges when the fraction of gen-

⁷⁵ *See id.*

genuine plaintiffs in the population of all plaintiffs is “sufficiently large.” The second is a mixed strategy equilibrium in which only some piggyback victims file suit, and the defendant settles a fraction of these cases. Among the cases that the defendant chooses not to settle—that is, to whom she makes a settlement offer of zero—genuine plaintiffs go to trial while piggyback plaintiffs drop their suits. This Type 2 equilibrium emerges when the fraction of genuine plaintiffs in the population of all plaintiffs is “sufficiently small.” Notice, however, that at least some piggyback plaintiffs succeed in obtaining settlements no matter which equilibrium emerges.

C. *Injurer’s Care and Activity Choices*

Now that we have identified the two equilibria that can arise from the settlement–trial subgame, we shift our attention to the injurer’s care and activity choices in the initial period. The injurer’s problem at this point is to maximize the net return from the activity in question. In terms of our example, the owner of a supermarket will choose the number of stores to operate, or equivalently, the number of hours to be open (its activity), and the amount of time and effort devoted to maintaining a safe environment (its care), to maximize profit. In making these choices, the injurer rationally anticipates the liability risk that it faces, which is reflected in the outcome of the settlement–trial subgame as just described. The injurer’s expected return will therefore incorporate the expected liability and litigation costs that emerge from that subgame.

We will examine the impact of the threat of piggyback suits on the injurer’s choice of activity and care in two ways. First, we will compare the injurer’s optimal choices in the model with piggyback suits (the imperfect information model) to its choices in a model of perfect information—that is, where the injurer can perfectly distinguish between genuine and piggyback plaintiffs. After that, we will compare the outcome in the imperfect information model to the socially optimal choices of activity and care—that is, the choices that a social planner would make.

D. *Comparison to the Perfect Information Model*

Recall that when the injurer has perfect information regarding the plaintiff’s type, it will rationally settle with all genuine plaintiffs and offer zero to any piggyback plaintiffs, who would then drop their cases. Thus, at the point where the injurer makes its care choice, the injurer expects to face only genuine plaintiffs, with whom it will settle for their expected value of trial. The injurer’s optimal care choice therefore minimizes the sum of the costs of care and expected liability, which equals the plaintiff’s expected value of trial multiplied by the probability of an accident.

In the model with imperfect information, the injurer's expected liability differs from that in the perfect information model because at least some piggyback plaintiffs succeed in obtaining settlements under either of the two equilibria of the settlement-trial subgame. Under the Type 1 (pure strategy) equilibrium, the defendant settles with all plaintiffs, and accordingly, the amount the defendant pays per suit is the same as in the perfect information model. However, because all piggyback plaintiffs file suit, the defendant faces more suits (or, what amounts to the same thing, a higher probability of a suit). It turns out, though, that the injurer's optimal care choice in this case is the same as in the perfect information model. The reason is that the injurer perceives the number of piggyback lawsuits to be fixed relative to its level of care, and so increasing that level would not reduce the number of such suits. In other words, the injurer only chooses care up to the point where the marginal reduction in liability costs from *genuine suits* equals the marginal cost of care. And since this is the same in the perfect and imperfect information models, the injurer chooses the same care level in the two cases.

The situation is different under the Type 2 equilibrium of the settlement-trial subgame. In this case, the injurer will choose a higher level of care as compared to the perfect information model. This is true because the injurer's expected liability now includes the possibility of trial costs when it defends claims brought by genuine plaintiffs. As a result, in an effort to avoid some costly trials, the injurer will exercise more care than it would under perfect information. Specifically, by exercising additional care, the injurer reduces the frequency of cases that end up at trial with genuine plaintiffs. Accordingly, the existence of piggyback lawsuits has the following impact on the care choice of injurers when compared to a world characterized by perfect information—injurers exercise the same amount of care under a Type 1 equilibrium, but they exercise *more* care under a Type 2 equilibrium. This demonstrates that the existence of piggyback lawsuits is capable of enhancing the care component of deterrence.

Let us now consider the impact of piggyback suits on the injurer's activity level. Under both type of equilibria, the number of piggyback plaintiffs is positively correlated with the injurer's activity. This is true, recall, because under both equilibria, at least some piggyback suits succeed in receiving settlements. Thus, as an injurer's activity level increases, the number of piggyback plaintiffs also increases. Furthermore, in the Type 2 equilibrium, the average liability per suit is higher because, as noted, some cases go to trial. For both of these reasons, the cost per unit of activity is higher in the imperfect information model. As a result, the injurer chooses a lower activity level compared to the perfect information model. This illustrates that piggyback lawsuits are *always* capable of enhancing the activity-level component of deterrence.

In conclusion, when compared to the equilibrium under perfect information, an injurer sometimes exercises more care and always decreases its

activity level given the threat of piggyback lawsuits under imperfect information. It remains to be seen, however, whether this enhanced deterrence is socially desirable. We address this question in the next section.

E. *Welfare Analysis*

To evaluate the social desirability of piggyback lawsuits, we first need to determine the care and activity levels that a perfectly informed benevolent social planner would choose. A benevolent planner's objective is to maximize the net value of the injurer's activity, taking into account all liability-related costs, including the filing costs of victims. We therefore take as given the need for accident victims to file suit in order to receive compensation for their losses. Given the need for suits, however, it is socially desirable for all of them to settle in order to avoid trial costs.

Based on this objective, we first note that injurers underinvest in care and overengage in the risky activity in the perfect information case compared to the social optimum; that is, even when injurers can distinguish between genuine and piggyback plaintiffs, there is underdeterrence. This occurs through two channels. First, the injurer does not internalize a genuine victim's filing costs, and second, the injurer is able to settle for less than the full amount of the victim's damages. (Recall that genuine plaintiffs will settle for an amount equal to their damages less their costs of trial.) Consistent with past literature on the topic, we see that when litigation is costly, strict liability results in underdeterrence, even when information is perfect.⁷⁶

The injurer's optimal care and activity choices will also generally diverge from the social optimum in the imperfect information case, but the direction of the divergence is ambiguous. Under a Type 1 equilibrium, the injurer will underinvest in care relative to the social optimum because, as in the perfect information case, it does not fully internalize the filing cost and damages suffered by a genuine victim. The filing cost is paid solely by the genuine victim, and as noted above, the injurer is able to exploit the plaintiff's litigation costs in making its settlement offer. With respect to its activity level, however, the injurer may overengage or underengage in the activity from a social perspective under a Type 1 equilibrium. The injurer may overengage in the activity because it does not internalize a genuine victim's filing cost, but it may underengage due to the costs of paying off piggyback plaintiffs. Given these two competing forces, the direction of the deviation from the social optimum with respect to the injurer's activity level in a Type 1 equilibrium is ambiguous.

With respect to a Type 2 equilibrium, the injurer may overinvest or underinvest in care, and overengage or underengage in activity, for roughly the same reasons. The injurer does not internalize a genuine victim's filing

⁷⁶ See, e.g., Hylton, *supra* note 15, at 161.

costs, nor does the injurer fully internalize a genuine victim's damages when settling a fraction of cases. This factor alone suggests that the injurer underinvests in care and overengages in activity. Working in the opposite direction, however, is the fact that the injurer incurs litigation costs for those cases filed by genuine plaintiffs that end up going to trial. Taken together, these factors show that, from a social perspective, it is unclear whether piggyback lawsuits induce, or fail to induce, beneficial deterrence under a Type 2 equilibrium.

In sum, the foregoing results suggest that piggyback lawsuits are *not* always undesirable from a social perspective. While the direction of the deviation relative to the social optimum is ambiguous in most cases, the existence of piggyback lawsuits generally results in more care and less activity relative to a world characterized by perfect information. Moreover, under certain conditions, they may actually serve to enhance deterrence in a socially valuable way. Now that we have described the theoretical model,⁷⁷ we present a numerical example to illustrate the preceding conclusions.

F. Numerical Example

For the purposes of this numerical example, we continue with our hypothetical situation of a supermarket owner who causes injuries to a subset of customers who slip and fall on the owner's premises. Suppose the supermarket owner is faced with the decision of whether to operate one, two, or three identical stores in a narrow geographic area. The owner's choice of how many stores to operate reflects a decision concerning his activity level. For the sake of argument, let the gross value per year of operating one, two, or three stores be \$150,000, \$200,000, and \$235,000, respectively. Notice that the supermarket owner's gross value is increasing in the number of stores, but at a decreasing rate, reflecting a diminishing marginal value. This might reflect the idea that the supermarket owner is attracting fewer new shoppers per store as he operates more stores in a narrow geographic area.

The supermarket owner knows that he will be held strictly liable to a subset of customers who suffer injuries from slip-and-fall accidents on his premises.⁷⁸ Recognizing this, suppose that the supermarket owner can choose one of three monetary expenditures on care per year to reduce the

⁷⁷ Under a well-functioning negligence rule, as opposed to strict liability, the presence of piggyback lawsuits will have no effect on deterrence. Changing the liability rule to one of negligence results in neither genuine nor piggyback plaintiffs filing suit. All injurers will comply with the negligence standard of due care under the circumstances. Miceli & Stone, *supra* note 55, at 18–20 (noting that all injurers will comply with the negligence standard of due care under the circumstances).

⁷⁸ For cases imposing strict liability for slip-and-fall accidents, see Steven D. Winegar, Comment, *Reapportioning the Burden of Uncertainty: Storekeeper Liability in the Self-Service Slip-and-Fall Case*, 41 UCLA L. REV. 861, 888–91 (1994).

probability of an accident. If he spends \$50,000—i.e., a high level of care—per store, he can hire a full-time employee to monitor the condition of the floors and to subsequently cure any defects. With a full-time employee, the probability that a customer will suffer injuries arising from a slip-and-fall accident at a particular store is 5% per year. Or, the supermarket owner can spend \$25,000—i.e., a medium level of care—per store to hire a part-time employee devoted to monitoring safety. In this case, the probability that someone will slip and fall at a particular store is 15% per year. Finally, the owner can spend \$10,000—i.e., a low level of care—per store to finance overtime pay for his current employees. In this case, the owner's employees work extra hours to share the burden of monitoring the floors, but because they are working longer hours, they are somewhat ineffective and the probability of an accident per year is 30%.⁷⁹ The supermarket owner's choice of his monetary expenditure on care will govern his decisions in each store which he operates, meaning, for instance, if he chooses a high level of care and operates three stores, then his total expenditures on care per year will be \$150,000—three full-time employees at \$50,000 each.

Finally, assume that when a customer suffers a slip-and-fall injury on the supermarket owner's premises, the victim's damages always amount to \$100,000. To file suit, the victim incurs a reasonable filing fee of \$500. And, when cases are brought to trial, both the plaintiff and the defendant incur identical litigation costs of \$20,000 each. The following tables summarize the relationship between the theoretical model's variables and the numerical values adopted for this example.

Table 1

Activity Level		Monetary Expenditure on Care		
	<i>Value per year</i>		<i>Cost</i>	<i>Probability of an accident</i>
<i>1 store</i>	\$150,000	<i>High level</i>	\$50,000	.05
<i>2 stores</i>	\$200,000	<i>Middle level</i>	\$25,000	.15
<i>3 stores</i>	\$235,000	<i>Low level</i>	\$10,000	.3

Table 2

Plaintiff's damages	\$100,000
Plaintiff's trial cost	\$20,000
Defendant's trial cost	\$20,000
Defendant's filing cost	\$500

⁷⁹ These conjectured values reflect the reasonable assumption that as care expenditures increase, they decrease the probability of an accident at a decreasing rate. See *supra* text accompanying note 68.

Consistent with the theory provided above, a benevolent social planner would induce the supermarket owner to choose a monetary expenditure on care and an activity level consistent with no piggyback victims filing suit, and all genuine victims filing suit but settling for their entire level of damages and filing costs prior to trial. A three-by-three matrix can be constructed to represent the net social value of operating the supermarket for each activity level–care combination. The combination that a social planner would choose corresponds to the highest net value resulting from these nine combinations. Table 3 presents all of the possible combinations.

Table 3

Social Planner ^a			
	<i>Care Expenditure</i>		
	<i>High level</i>	<i>Middle level</i>	<i>Low level</i>
<i>1 store</i>	\$94,975	\$109,925	\$109,850
<i>2 stores</i>	\$89,950	\$119,850	\$119,700
<i>3 stores</i>	\$69,925	\$114,775	\$114,550

^a Values correspond to: $V(z) - z[x + p(x)(L + k)]$
(see Appendix).

In the table, the activity level–care combination that maximizes the net value of activity for the supermarket is highlighted. It is evident that the supermarket owner's net value of activity is maximized from a social perspective when he chooses to operate two stores and exercises a middle level of care. All other combinations result in lower net values of operating the supermarket (that is, all other combinations exhibit a net value of less than \$119,850).⁸⁰ Put another way, the supermarket owner should hire two part-time employees at a cost of \$25,000 each, and he should place one part-time employee in each of his two stores. However, he should not operate a third store. This is the benchmark against which we will judge the social desirability of frivolous lawsuits.

We next ask, What are the supermarket owner's equilibrium choices of care and activity when he has perfect information regarding the plaintiff's type? Recall that when there is perfect information, the supermarket owner can distinguish piggyback plaintiffs from genuine plaintiffs and can settle with the latter but offer nothing to the former. Our theory above predicted that injurers overengage in activity and underinvest in care in this case rela-

⁸⁰ Notice, for example, that a social planner would *not* require the supermarket owner to exercise a high level of care. This reflects the idea that the social planner's objective is not to minimize the probability of an accident.

tive to the social optimum. To verify this result for our numerical example, Table 4 depicts the net value of activity to the supermarket owner for each activity–care combination when there is perfect information.

Table 4

Supermarket Owner Perfect Information^b			
	<i>Care Expenditure</i>		
	<i>High level</i>	<i>Middle level</i>	<i>Low level</i>
<i>1 store</i>	\$96,000	\$113,000	\$116,000
<i>2 stores</i>	\$92,000	\$126,000	\$132,000
<i>3 stores</i>	\$73,000	\$124,000	\$133,000

^b Values correspond to: $V(z) - z[x + p(x)(L - C_d)]$

Notice in particular that the supermarket owner’s net value of activity is maximized when he operates three stores and exercises a low level of care. (The maximized net value is again highlighted.) The supermarket owner is underdeterred in this example because, as we saw above, it is socially optimal for him to operate only two stores and invest in two part-time employees—i.e., a middle level of care. But with perfect information, he instead chooses to operate three stores and exercises a low level of care in each store.

Let us turn to the case of imperfect information by the supermarket owner regarding the plaintiff’s type. Recall that two equilibria potentially arise given asymmetric information. Suppose the probability that a piggyback victim arises per unit of activity is .02. This conjectured value for the potential number of such plaintiffs is so small that the supermarket owner will perceive a “sufficiently large” probability that a plaintiff’s claim is genuine.⁸¹ Table 5 identifies the net value to the supermarket owner under both possible equilibria when the probability a victim is a piggyback victim is .02 per unit of activity.

⁸¹ See *infra*, App. for details.

Table 5

Supermarket Owner							
Type 1 Equilibrium ^c				Type 2 Equilibrium ^d			
	Care Expenditure				Care Expenditure		
	High level	Middle level	Low level		High level	Middle level	Low level
1 store	\$94,400	\$111,400	\$114,400	1 store	\$94,000	\$107,000	\$104,000
2 stores	\$88,800	\$122,800	\$128,800	2 stores	\$88,000	\$114,000	\$108,000
3 stores	\$68,200	\$119,200	\$128,200	3 stores	\$67,000	\$106,000	\$97,000

^c Values correspond to: $V(z) - z\{x + [p(x) + q](L - C_\pi)\}$

^d Values correspond to: $V(z) - z[x + p(x)(L + C_\Delta)]$

Since the threat of piggyback victims is low relative to the probability of an accident for every care level, it should not be surprising that a Type 1 equilibrium emerges as optimal. Indeed, every activity level–care combination under a Type 1 equilibrium yields a higher net value than the corresponding activity level–care combination under a Type 2 equilibrium. Note that in this equilibrium, the supermarket owner chooses to operate two stores and to exercise a low level of care. (This maximized net value is highlighted in the left-hand panel of the above table.) When compared to the equilibrium under perfect information, the existence of piggyback plaintiffs results in beneficial deterrence with respect to the supermarket owner's activity level in the sense that the owner now operates two stores rather than three, which is the efficient level of activity. Notice, however, that the supermarket owner's level of care is unaffected by the presence of piggyback victims. This reflects the conclusion reached above that under a Type 1 equilibrium, the injurer exercises the same level of care as in the perfect information model, and too little care from a social perspective. This example illustrates the conclusion that piggyback lawsuits may imperfectly correct for the problem of underdeterrence.

Suppose instead that the probability a piggyback victim arises per unit of activity is much higher than in the previous example; specifically, suppose it is now .20. The following table depicts the net value of activity to the supermarket owner in this case.

Table 6

Supermarket Owner							
Type 1 Equilibrium				Type 2 Equilibrium			
	Care Expenditure				Care Expenditure		
	High level	Middle level	Low level		High level	Middle level	Low level
1 store	\$80,000	\$97,000	\$100,000	1 store	\$94,000	\$107,000	\$104,000
2 stores	\$60,000	\$94,000	\$100,000	2 stores	\$88,000	\$114,000	\$108,000
3 stores	\$25,000	\$76,000	\$85,000	3 stores	\$67,000	\$106,000	\$97,000

Given that the potential number of piggyback plaintiffs is relatively large, the supermarket owner will perceive a “sufficiently small” probability that the plaintiff’s claim is genuine. Therefore, it should not be surprising that a Type 2 equilibrium will emerge. As shown in the Table 6, the net values of activity for each activity level–care combination under a Type 2 equilibrium are higher than their Type 1 equilibrium counterparts. As the highlighted entry in the right-hand panel shows, the supermarket owner chooses to operate two stores and to exercise a middle level of care. Note that these choices correspond to the social optimum in this example, illustrating again how piggyback lawsuits are capable of enhancing deterrence in a socially valuable way.

Finally, consider a value that lies between the conjectured values we have utilized above. Suppose, in particular, that the probability a piggyback victim arises per unit of activity is .10. Table 7 depicts the net value of activity for each activity level–care combination under this scenario.

Table 7

Supermarket Owner							
Type 1 Equilibrium				Type 2 Equilibrium			
	Care Expenditure				Care Expenditure		
	High level	Middle level	Low level		High level	Middle level	Low level
1 store	\$88,000	\$105,000	\$108,000	1 store	\$94,000	\$107,000	\$104,000
2 stores	\$76,000	\$110,000	\$116,000	2 stores	\$88,000	\$114,000	\$108,000
3 stores	\$49,000	\$100,000	\$109,000	3 stores	\$67,000	\$106,000	\$97,000

From the table it is evident that the supermarket owner must compare the net values of activity under both equilibria—that is, some activity level–care combinations yield higher returns under a Type 1 equilibrium, while the remaining combinations yield a higher return under a Type 2 equilibrium. In this example, a Type 1 equilibrium in which the injurer operates two stores and exercises a low level of care turns out to be optimal. The

outcome is therefore the same as in the example where the probability a piggyback victim arose per unit of activity was .02.⁸²

The foregoing numerical examples illustrate the positive claim that piggyback lawsuits are sometimes capable of inducing beneficial deterrence. Although perhaps imperfect, piggyback lawsuits in these examples provide an incentive for the injurer to exercise levels of care and activity that, in some cases, are closer to the social optimum than those that would arise in a world characterized by perfect information (i.e., where piggyback suits are not a threat). We hasten to add, however, that these examples are only meant to be illustrative. We could just as easily have chosen values of the parameters to show that the threat of piggyback lawsuits can result in too much care and too little activity compared to the social optimum—that is, they could have resulted in overdeterrence. This, of course, obviates the usefulness of piggyback suits from a policy perspective. Still, an understanding of their impact on deterrence is important for properly evaluating the impact of policies that have been proposed for reducing frivolous litigation. That task is the purpose of the next section.

III. POLICY IMPLICATIONS

While the theoretical model and numerical examples suggest that piggyback lawsuits—or more broadly, frivolous lawsuits—are not always detrimental to social welfare, we have been unable to uncover any source of law that recognizes the potentially beneficial deterrence externality resulting from such suits. Rather, courts and policymakers alike share an interest in deterring plaintiffs from filing frivolous lawsuits. In particular, procedural rules, statutory law, and the common law of torts serve to protect parties—including private persons and even governments—from frivolous litigation. When these legal regimes are evaluated together, it is evident that they utilize two mechanisms (perhaps simultaneously) in an effort to reduce the frequency of frivolous litigation: (i) shifting the burden of the defendant's reasonable litigation costs and attorney's fees to the frivolous plaintiff, and (ii) claim-quality identification.⁸³ This section examines the

⁸² See *supra* Table 5.

⁸³ We do not discuss the impact of rules that do not provide a potential deterrent to the initiation of frivolous lawsuits. In his majority opinion in the infamous *Clinton v. Jones* case, Justice Stevens noted that “[m]ost frivolous and vexatious litigation is terminated at the pleading stage or on summary judgment, with little if any personal involvement by the defendant.” *Clinton v. Jones*, 520 U.S. 681, 708 (1997). FED. R. CIV. P. 12(b)(6), which permits dismissal of a complaint at the pleadings stage for failure to state a claim upon which relief can be granted, is capable of eliminating frivolous claims prior to the onset of discovery. Indeed, the current pleadings standard of plausibility, articulated by the United States Supreme Court in *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), may make it difficult for frivolous plaintiffs to succeed at surviving a Rule 12(b)(6) motion. See Adam Steinman, *The Pleading Problem*, 62 STAN. L. REV. 1293, 1300–10 (2010) (for a

positive implications of cost-and-fee shifting rules and claim-quality identification on accident avoidance in the presence of frivolous suits.

A. *Litigation Cost and Attorney Fee Shifting*

It is frequently argued that a switch from the American rule to the so-called English rule governing the allocation of attorney's fees will discourage the filing of frivolous lawsuits.⁸⁴ The common law rule in the United States is that each party bears its own attorney's fees at trial.⁸⁵ However, a number of legal regimes aimed at reducing the frequency of frivolous lawsuits abrogate this common law rule by authorizing the use of the English rule, which permits the victorious party to recover its attorney's fees from the losing party at trial. In addition, some legal regimes permit parties to recover reasonable litigation expenses, beyond those that would ordinarily be recoverable as taxable costs from frivolous plaintiffs.

For instance, Rule 11 of the Federal Rules of Civil Procedure deters the initiation of frivolous lawsuits by providing sanctions, including the imposition of attorney's fees and reasonable expenses.⁸⁶ Under Rule 11, a

discussion of the evolution of the pleadings standard from notice to plausibility). For lawsuits that survive the pleadings stage of litigation, summary judgment via FED. R. CIV. P. 56 permits parties to eliminate frivolous lawsuits without the necessity of trial. See Beverly Dyer, *A Genuine Ground in Summary Judgment for Rule 11*, 99 YALE L.J. 411, 411 (1989) (recognizing that the well-established standards for summary judgment are aimed at reducing frivolous lawsuits). However, neither Rule 12(b)(6) nor Rule 56 dismissal implies a finding of frivolity, and thus, these two procedural safeguards do not directly sanction, nor do they necessarily deter, the initiation of frivolous lawsuits. See, e.g., *Neitzke v. Williams*, 490 U.S. 319, 329 (1989) (stating "a failure to state a claim under Rule 12(b)(6) does not invariably mean that the claim is without arguable merit"). Nevertheless, these two rules of civil procedure have received some attention in the economics literature. Hylton provides an economic framework that considers dismissal at the pleadings stage, consistent with Rule 12(b)(6). Keith N. Hylton, *When Should a Case Be Dismissed? The Economics of Pleading and Summary Judgment*, 16 SUP. CT. ECON. REV. 39, 41 (2008). He argues that the standard for dismissal on the pleadings ought to fluctuate with evidentiary standards and litigation costs. *Id.* at 62. Kozel and Rosenberg argue for *mandatory* summary judgment prior to court enforcement of any settlement agreement as a solution to the nuisance-value settlement problem. Randy J. Kozel & David Rosenberg, *Solving the Nuisance-Value Settlement Problem: Mandatory Summary Judgment*, 90 VA. L. REV. 1849, 1853 (2004).

⁸⁴ Douglas C. Rennie, *Rule 82 and Tort Reform: An Empirical Study of the Impact of Alaska's English Rule on Federal Civil Case Filings*, 29 ALASKA L. REV. 1, 2 (2012).

⁸⁵ See generally John Leubsdorf, *Toward a History of the American Rule on Attorney Fee Recovery*, 47 LAW & CONTEMP. PROBS. 9 (1984) (discussing the emergence of the American rule in the United States).

⁸⁶ FED. R. CIV. P. 11(c)(2). For an overview of Rule 11 through its controversial amendments in 1983, see, e.g., Edward D. Cavanagh, *Frivolous Litigation: Developing Standards under Amended Rule 11 of the Federal Rules of Civil Procedure*, 14 HOFSTRA L. REV. 499 (1986); Robin J. Collins, Note, *Applying Rule 11 to Rid Courts of Frivolous Litigation without Chilling the Bar's Creativity*, 76 KY. L.J. 891 (1988); Neal H. Klausner, Note, *The Dynamics of Rule 11: Preventing Frivolous Litigation by Demanding Professional Responsibility*, 61 N.Y.U. L. REV. 300 (1986); Melissa L. Nelken, *Sanctions*

party is prohibited from filing a pleading, written motion, or other paper with the court that is “presented for any improper purpose, such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation.”⁸⁷ And, the legal arguments contained therein must be “warranted by existing law or by a nonfrivolous argument for extending, modifying, or reversing existing law or for establishing new law.”⁸⁸ While monetary Rule 11 sanctions are ordinarily paid to the court, under certain circumstances a court may require the violating party to compensate the aggrieved party for the costs of defending a frivolous claim.⁸⁹ Therefore, when warranted, Rule 11 may be viewed as a fee-shifting statute. In any event, as the Court aptly stated in *Lewis v. Casey*, since persons do not have a Constitutional right to file frivolous lawsuits,⁹⁰ “[d]epriving someone of a frivolous claim . . . deprives him of nothing at all, except perhaps the punishment of Federal Rule of Civil Procedure 11 sanctions.”⁹¹

Given the ability of Rule 11 to deter the initiation of frivolous lawsuits, it has received some attention in the literature. Kobayashi and Parker use a game theoretic model to criticize the “safe harbor” provision of Rule 11 by finding that it might increase the frequency of frivolous filings and the rate by which Rule 11 motions challenge such filings.⁹² Under a certain set of assumptions, the “safe harbor” provision “renders Rule 11 useless as a deterrent, consigning it either to fall into total disuse or to generate completely pointless satellite litigation.”⁹³ Polinsky and Rubinfeld provide a normative basis for utilizing Rule 11 sanctions as a deterrence mechanism.⁹⁴ Cooter and Rubinfeld develop a theoretical model where Rule 11 sanctions may be imposed for discovery abuse.⁹⁵ Bebchuk and Chang provide guidance on how courts ought to interpret the scope of Rule 11 in order to en-

Under Amended Federal Rule 11—Some “Chilling” Problems in the Struggle Between Compensation and Punishment, 74 GEO. L.J. 1313 (1986); William W. Schwarzer, *Rule 11 Revisited*, 101 HARV. L. REV. 1013 (1988); see also Keeling, *supra* note 30, at 1067 (discussing, in addition, the 1993 amendments to Rule 11).

⁸⁷ FED. R. CIV. P. 11(b)(1).

⁸⁸ FED. R. CIV. P. 11(b)(2).

⁸⁹ *Id.*; Fed. R. Civ. P. 11 advisory committee’s notes, 1993 amend., reprinted in 146 F.R.D. 401, 583 (1993). Compensation under Rule 11 is limited to reasonable, not actual, fees and victims have a duty to mitigate damages. For a discussion on this topic, see Nelken, *supra* note 86, at 1334–35.

⁹⁰ See *Bill Johnson’s Rests. v. NLRB*, 461 U.S. 731, 743 (1983).

⁹¹ *Lewis v. Casey*, 518 U.S. 343, 353 n.3 (1996).

⁹² Bruce H. Kobayashi & Jeffrey S. Parker, *No Armistice at 11: A Commentary on the Supreme Court’s 1993 Amendment to Rule 11 of the Federal Rules of Civil Procedure*, 3 SUP. CT. ECON. REV. 93, 101 (1993). The “safe harbor” provision permits a party to escape liability if it withdraws or corrects a frivolous paper within 21 days of service of a motion for Rule 11 sanctions. FED. R. CIV. P. 11(c)(2).

⁹³ *Id.* at 144.

⁹⁴ A. Mitchell Polinsky & Daniel L. Rubinfeld, *Sanctioning Frivolous Suits: An Economic Analysis*, 82 GEO. L.J. 397, 402 (1993).

⁹⁵ Robert D. Cooter & Daniel L. Rubinfeld, *Economic Model of Legal Discovery*, 23 J. LEGAL STUD. 435, 437 (1994).

sure that the “correct” plaintiffs bring suit.⁹⁶ They develop a formal model to show that Rule 11, as a two-sided fee-shifting statute, should be interpreted favorably to plaintiffs when litigation costs are high and the stakes of trial are low.⁹⁷ On the other hand, when litigation costs are low and the stakes of trial are high, courts should interpret Rule 11 favorably to defendants.⁹⁸ And, although tangential to their core topics, Cooper briefly notes that Rule 11 sanctions further a purpose of discovery—to determine whether there is a legitimate reason to sue⁹⁹—and Kaplow recognizes that sanctions, like Rule 11, affect a party’s incentive to litigate.¹⁰⁰

In addition to Rule 11, courts have an inherent equitable power to impose sanctions—such as the imposition of attorney’s fees—upon parties to litigation. Indeed, the Rules of Civil Procedure do not preclude a court from exercising its “inherent power”¹⁰¹ to punish when an attorney or a party has “acted in bad faith, vexatiously, wantonly, or for oppressive reasons,”¹⁰² insofar as such sanctions are not forbidden by Congress.¹⁰³ As the United States Supreme Court noted in *Chambers v. NASCO, Inc.*:

[W]hen there is bad-faith conduct in the course of litigation that could be adequately sanctioned under the Rules, the court ordinarily should rely on the Rules rather than the inherent power. But if in the informed discretion of the court, neither the statute nor the Rules are up to the task, the court may safely rely on its inherent power.¹⁰⁴

Thus, despite the common law American rule, the imposition of attorney’s fees is a permissible sanction under the inherent equitable power of the courts.¹⁰⁵

At the federal level, a common statutory remedy for the filing of a frivolous lawsuit is attorney’s fees. For instance, attorney’s fees are recoverable for frivolous, unreasonable, or meritless equal employment oppor-

⁹⁶ Lucian A. Bebchuk & Howard F. Chang, *An Analysis of Fee Shifting Based on the Margin of Victory: On Frivolous Suits, Meritorious Suits, and the Role of Rule 11*, 25 J. LEGAL STUD. 371, 371 (1996).

⁹⁷ *Id.* at 397–98.

⁹⁸ *Id.*

⁹⁹ Edward H. Cooper, *Discovery Cost Allocation: Comment on Cooter and Rubinfeld*, 23 J. LEGAL STUD. 465, 475 (1994).

¹⁰⁰ Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307, 363 (1994).

¹⁰¹ As Klausner recognizes, the “inherent power” of the courts extends to lawyers, their clients, or both. Klausner, *supra* note 86, at 312.

¹⁰² *Alyeska Pipeline Serv. Co. v. Wilderness Soc’y*, 421 U.S. 240, 258–59 (1975) (citations omitted).

¹⁰³ *Id.* at 259.

¹⁰⁴ *Chambers v. NASCO, Inc.*, 501 U.S. 32, 50 (1975).

¹⁰⁵ *See Roadway Express, Inc. v. Piper*, 447 U.S. 752, 765 (1980) (stating “[t]here are ample grounds for recognizing . . . that in narrowly defined circumstances federal courts have inherent power to assess attorney’s fees against counsel”).

tunity¹⁰⁶ and civil rights claims.¹⁰⁷ Indeed, under Title VII of the Civil Rights Act, attorney's fees may be awarded for the filing of a frivolous lawsuit, even if the lawsuit was not initiated in bad faith.¹⁰⁸ The Civil Rights Attorney's Fees Awards Act, codified at 42 U.S.C. § 1988, also provides for a remedy of attorney's fees.¹⁰⁹ This statute was enacted to "relieve defendants of the burdens associated with fending off frivolous litigation."¹¹⁰ In addition, frivolous patent actions permit the recovery of attorney's fees.¹¹¹ In the context of criminal law, the Hyde Amendment,¹¹² which punishes for vexatious, frivolous, or bad-faith forms of prosecutorial misconduct in criminal proceedings, permits a party to recover attorney's fees and court costs.¹¹³ These examples are not meant to be exhaustive, and fee shifting is not the only means by which the federal government may seek to reduce the frequency of frivolous litigation.¹¹⁴

In addition to the foregoing, the common law of torts has evolved to sanction the initiation of frivolous lawsuits. The common law doctrines of champerty and maintenance have been enveloped by the current torts of

¹⁰⁶ See Title VII of the Civil Rights Act, 42 U.S.C. § 2000e et seq. (2012).

¹⁰⁷ See Civil Rights Attorney's Fees Awards Act, 42 U.S.C. § 1988(b) (2012).

¹⁰⁸ *Christiansburg Garment Co. v. EEOC*, 434 U.S. 412, 421 (1978).

¹⁰⁹ See 42 U.S.C. § 1988(b) (2012).

¹¹⁰ *Fox v. Vice*, 131 S. Ct. 2205, 2215 (2011). Under this statute, a defendant may only recover the additional expenses, at the margin, from defending a frivolous claim. *Id.* at 2216. The United States Supreme Court has articulated a "but-for" test for the magnitude of recovery—a defendant may "receive only the portion of his fees that he would not have paid but for the frivolous claim." *Id.* at 2215.

¹¹¹ See 35 U.S.C. § 285 (2012). This statute reads, in pertinent part, that "[t]he court in exceptional cases may award reasonable attorney fees to the prevailing party." *Id.* Meritless patent actions are deemed "exceptional" under 35 U.S.C. § 285 (2012). *Beckman Instruments, Inc. v. LKB Produkter AB*, 892 F.2d 1547, 1551 (Fed. Cir. 1989) (citations omitted). Courts may award reasonable attorney's fees to the prevailing party in "exceptional" cases. *Id.* (citations omitted).

¹¹² 18 U.S.C. § 3006A (2012).

¹¹³ See *United States v. Capener*, 608 F.3d 392, 400 (9th Cir. 2010) (citations omitted). In this context, a frivolous prosecution is one that is groundless, such that the government's claims were foreclosed by binding precedent or obviously wrong. *Id.* at 401 (citation omitted).

¹¹⁴ For instance, the federal government has imposed substantial pleadings barriers to frivolous litigation in the context of class action securities fraud. See, e.g., 15 U.S.C. §§ 78u-4(b)(1), (2) (2012). The Private Securities Litigation Reform Act of 1995 was enacted, in part, "to curb frivolous, lawyer-driven litigation," *Tellabs v. Makor Issues & Rights*, 551 U.S. 308, 322 (2007), particularly through the abuse of securities fraud class action lawsuits, *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006). As the United States Supreme Court noted in *Tellabs*, "[p]rivate securities fraud actions . . . if not adequately contained, [could] be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law." *Tellabs*, 551 U.S. at 313. As a result, the Private Securities Litigation Reform Act of 1995 imposed barriers to litigating these suits, including heightened pleadings requirements, a limit on recoverable damages and attorney's fees, and sanctions for frivolous suits. *Merrill Lynch*, 547 U.S. at 81. Incidentally, this statute led to a widespread forum shift—plaintiffs began bringing class actions for securities fraud in state courts as opposed to federal court. See *id.* at 82. Hence, Congress enacted the Securities Litigation Uniform Standards Act in 1998 to preempt state law and ensure compliance with the objectives of the Private Securities Litigation Reform Act. *Id.*

abuse of process¹¹⁵ and malicious prosecution.¹¹⁶ However, the tort of abuse of process only applies after the wheels of litigation have been set in motion.¹¹⁷ Specifically, a cause of action must have already been initiated for an aggrieved party to obtain a remedy for abuse of process, and accordingly, the initiation of a known, meritless lawsuit will not necessarily afford the aggrieved party a remedy. In contrast, depending on the jurisdiction, the intentional tort of malicious prosecution may be employed to, in essence, abrogate the common law American rule when a party litigates a frivolous lawsuit. The United States Supreme Court has observed that “the gist of the tort [of malicious prosecution] is . . . commencing an action or causing process to issue without justification.”¹¹⁸ It exists when one maliciously and without probable cause¹¹⁹ initiates a civil or criminal legal proceeding which is later terminated against the plaintiff (in a civil proceeding) or the government (in a criminal proceeding).¹²⁰ The tort goes by different names in different jurisdictions,¹²¹ and sometimes the distinction between

¹¹⁵ Abuse of process involves, according to the United States Supreme Court, “misusing, or misapplying process justified in itself for an end other than that which it was designed to accomplish.” *Heck v. Humphrey*, 512 U.S. 477, 495 n.2 (1994) (citation omitted). This tort imposes liability upon a party for improperly utilizing the judicial system for a purpose for which it is not designed, *see, e.g.*, *Batten v. Abrams*, 626 P.2d 984, 988 (Wash. App. 1981); 1 AM. JUR. 2D *Abuse of Process* § 1 (2013); RESTATEMENT (SECOND) TORTS § 682 (1977), and accordingly, its objective is to deter parties from using the litigation process to achieve an undesired end. All states recognize the tort of abuse of process or some variant thereof. Jeffrey J. Utermohle, *Look What They’ve Done to my Tort, Ma: The Unfortunate Demise of “Abuse of Process” in Maryland*, 32 U. BALT. L. REV. 1, 7–8 (2002). Since the tort is a state-level construct, states tend to differ with respect to the essential elements of a successful abuse of process claim. *See id.* States use either a two-prong or three-prong test, with disagreement over the necessity of a showing of damages. *See id.* at 8 n.24. For a comprehensive state-by-state summary of the essential elements of a claim for abuse of process, *see id.* at 36–49.

¹¹⁶ *Allied Med. Assocs. v. State Farm Mut. Auto. Ins. Co.*, No. 08-02434, 2008 WL 4771850, at *9 n.6 (E.D. Pa. Oct. 30, 2008).

¹¹⁷ *See Batten*, 626 P.2d at 991 (stating “[t]he initiation of vexatious civil proceedings known to be groundless is not abuse of process There is no liability if nothing is done with the lawsuit other than carrying it to its regular conclusion”) (citation omitted). Therefore, the tort of abuse of process does not necessarily safeguard against the filing of a frivolous lawsuit. However, malicious prosecution remedies this defect.

¹¹⁸ *Heck*, 512 U.S. at 495 n.2 (1994) (alteration in original) (citation omitted) (internal quotation marks omitted).

¹¹⁹ Notice that this requirement is not an element of an abuse of process claim. Another substantial distinction between malicious prosecution and abuse of process is that in some states, attorneys are immune from liability for malicious prosecution when they act in good faith or perform a reasonable investigation of their clients’ claims. However, there is no blanket immunity for attorneys for abuse of process. *See* David W. Pollak, Comment, *Sanctions Imposed by Courts on Attorneys Who Abuse the Judicial Process*, 44 U. CHI. L. REV. 619, 639 (1977).

¹²⁰ 52 AM. JUR. 2D *Malicious Prosecution* § 1 (2013).

¹²¹ Wade recognizes that the tort of malicious prosecution has a muddled history, and today, identifying the proper name is jurisdiction-specific. John W. Wade, *On Frivolous Litigation: A Study of Tort Liability and Procedural Sanctions*, 14 HOFSTRA L. REV. 433, 437–38 (1986). Despite its inherent

the original cause of action (be it civil or criminal) is integral in identifying the appropriate cause of action for maliciously prosecuting an individual.¹²² Despite the lack of a concrete designation across jurisdictions, its purpose is clear—to provide a tort remedy that deters the initiation of unwarranted, baseless causes of action. The remedy for the tort of malicious prosecution also differs across jurisdictions, though a majority of states permit the recovery of reasonable attorney’s fees and even litigation expenses for aggrieved parties.¹²³

The existence of these legal regimes permitting cost and fee shifting raises the question of how they influence deterrence. Economic models tend to assume that a switch from the American rule to the English rule would permit a victorious party at trial to recover all of its litigation costs, including its expenses.¹²⁴ Consistent with this pattern, and as an extension to our original theoretical model, we assume that a switch to the English rule implies that a genuine plaintiff will be able to recover her trial and filing costs from the defendant if the case goes to trial, given that the plaintiff will win at trial with certainty under strict liability. As a result, a genuine plaintiff will only be willing to accept a settlement if the defendant offers an amount at least equal to the plaintiff’s damages plus her filing costs.¹²⁵

differences across states, he synthesizes the following five elements of a valid claim for malicious civil prosecution:

(1) the present defendant must have taken an active part in the initiation, continuation, or procurement of the original civil proceeding; (2) the original proceeding must have terminated in favor of the present plaintiff; (3) there must be damage of the type that the court regards as appropriate for an action of this nature; (4) there must be a lack of probable cause for the original action; and (5) there must have been ‘malice’ in the bringing of the original action.

Id. at 438. Due to the requirement that the original cause of action was terminated in favor of the present plaintiff, a separate cause of action is required to maintain a claim under this tort.

¹²² For instance, the Restatement (Second) of Torts uses “wrongful use of civil proceedings” or “wrongful institution of civil proceedings” to identify a claim originating under tort law, while the term “malicious prosecution” is reserved solely for criminal prosecutions. 52 AM. JUR. 2D *Malicious Prosecution* § 2 (2013) (citations omitted). Some states use the term “malicious use of process” when the original cause of action sounded in tort law. *Id.* (citations omitted).

¹²³ *Id.* at 442. It should be noted that a minority of states, particularly those following the English rule, require a showing of special damages. In these states, special damages include those incurred as a result of an arrest, interference with property, or those damages occurring in similar actions. Michael J. Philippi, *Malicious Prosecution and Medical Malpractice Legislation in Indiana: A Quest for Balance*, 17 VAL. U. L. REV. 877, 893 (1983). This requirement may render a remedy under malicious prosecution unavailable for certain causes of action. Wade, *supra* note 121, at 442.

¹²⁴ We recognize the divergence between the jurisprudential view of the English rule and its application to the theoretical model. In particular, a narrow interpretation of the English rule would only permit the victorious party at trial to recover its attorney’s fees, and not necessarily its litigation expenses.

¹²⁵ Return to the example, *supra* note 71, where the plaintiff’s damages are \$100,000 and her trial costs are \$20,000. Provided filing costs are \$500, if the plaintiff goes to trial and wins, she will receive compensation of \$100,000, and in addition, her trial and filing costs will be reimbursed. Thus, she will not settle for an amount less than \$100,500.

Under perfect information, where the defendant can distinguish piggyback from genuine plaintiffs, the defendant will offer the minimum acceptable settlement to all genuine plaintiffs and zero to all piggyback plaintiffs. Given the presence of the English rule, the defendant therefore fully internalizes all of the harm it causes in addition to the plaintiff's filing cost. No piggyback plaintiffs are induced to file suit, and accordingly, the injurer's objectives are identical to the social planner's objectives. As a result, the English rule induces the injurer to exercise the socially optimal levels of care and activity when there is perfect information.

Under imperfect information, the defendant's total costs under a Type 1 equilibrium will again be the same as in the perfect information case; that is, the costs will consist of the plaintiff's damages plus filing costs. In contrast, under a Type 2 equilibrium, the defendant will be required to compensate a genuine plaintiff for her litigation and filing costs. Thus, a trial now costs the defendant the amount of the plaintiff's damages, plus the trial costs of *both* parties and the plaintiff's filing costs (given that the plaintiff wins with certainty under strict liability). Therefore, the defendant's total costs under a Type 2 equilibrium are correspondingly adjusted upward compared to the perfect information model and the imperfect information model under the American rule. As a result, the injurer will exercise more care and less activity in both equilibria under the English rule as compared to the American rule.

Comparison with the social optimum further shows that under a Type 1 equilibrium, the injurer will exercise the socially optimal level of care but will underengage in activity. It underengages in activity (for instance, the supermarket owner will operate fewer stores) because it recognizes that it will settle with some piggyback plaintiffs, which raises its expected liability costs per unit of the activity (per store). Under a Type 2 equilibrium, the injurer will overinvest in care and underengage in activity. The injurer overinvests in care because it recognizes that trial is very costly under the English rule—not only will the injurer be liable for the plaintiff's damages, but it will also be liable for the plaintiff's litigation costs and filing cost (in addition to its own litigation costs). In comparison, a social planner would compel the injurer to fully internalize the plaintiff's damages and filing cost without the necessity of trial. The same intuition applies to the injurer's activity level in a Type 2 equilibrium, which is why the injurer will underengage in activity from a social perspective. These results suggest that a switch from the American rule to the English rule in the presence of frivolous suits will not necessarily enhance deterrence in a socially valuable way.

B. *Claim-Quality Identification*

We now shift our attention to the positive implications of bodies of law that further the objective of identifying claim quality prior to trial. The

legal regimes governing frivolous lawsuits are capable of providing defendants with some relevant information about the merit of a case upon its filing. Indeed, at least two general types of law serve to aid the defendant in his determination of whether a lawsuit is genuine or frivolous prior to trial. The first punishes attorneys for handling a frivolous matter, while the second makes information regarding filers of frivolous lawsuits publicly available.

As an extension of the literature regarding legal representation as a signal of merit, attorneys are deterred—either via personal liability or state-bar-level discipline—from litigating a frivolous matter. (Some of the previously discussed legal regimes governing cost and fee shifting—for example, Rule 11—may also further this end.) At the federal level, attorneys are *personally* liable for costs, expenses, and attorney’s fees arising from unreasonable or vexatious conduct under 28 U.S.C. § 1927.¹²⁶ Under this statute, sanctions may be imposed *only* against attorneys and not parties to a lawsuit.¹²⁷ The United States Supreme Court has held that liability under this statute will not be imposed for mere discourtesy to the court. Rather, the attorney must have acted intentionally or with reckless disregard to be liable under 28 U.S.C. § 1927.¹²⁸ Since a “multiplication of proceedings” must have occurred, initial pleadings are beyond the scope of 28 U.S.C. § 1927,¹²⁹ which suggests the penal nature of this statute has a similar effect to that of the tort of abuse of process.¹³⁰

Furthermore, attorneys have an ethical obligation to refrain from filing frivolous lawsuits.¹³¹ Under the Model Rules of Professional Conduct, “[a] lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modifica-

¹²⁶ 28 U.S.C. § 1927 (2012) reads,

Any attorney or other person admitted to conduct cases in any court of the United States or any Territory thereof who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys’ fees reasonably incurred because of such conduct.

For an in-depth examination of the elements required to satisfy this statute, see Pollak, *supra* note 119, at 623–29; see also Janet E. Josselyn, *The Song of the Sirens—Sanctioning Lawyers Under 28 U.S.C. 1927*, 31 B.C. L. REV. 477 (1990) (discussing the standards utilized by the circuit courts when evaluating whether an attorney has “unreasonably and vexatiously” multiplied proceedings).

¹²⁷ *Zaldivar v. City of Los Angeles*, 780 F.2d 823, 831 (9th Cir. 1986).

¹²⁸ *United States v. Ross*, 535 F.2d 346, 349 (6th Cir. 1976).

¹²⁹ *Zaldivar*, 780 F.2d at 831. See also Wade, *supra* note 121, at 472 (stating the statute’s “prime target is not the filing of a meritless action but multiplying “proceedings . . . unreasonably and vexatiously . . .”).

¹³⁰ See *supra* note 115 for a discussion of the tort of abuse of process. Notice again that abuse of process generally does not apply to the initiation of a frivolous lawsuit.

¹³¹ See generally 7 Am. Jur. 2d *Attorneys at Law* § 46 (providing an overview of an attorney’s ethical obligation to refrain from filing frivolous lawsuits).

tion or reversal of existing law.”¹³² Failure to comply with this ethical rule may lead to attorney discipline, including the possibility of disbarment.¹³³ While an attorney will ordinarily not be personally liable in negligence for breaching this ethical rule,¹³⁴ this state-level sanction ought to have the effect of deterring the initiation of frivolous lawsuits by attorneys.

Given the presence of 28 U.S.C. § 1927 at the federal level and the state-level ethical rules punishing attorneys for vexatious conduct, we expect that, all else equal, attorneys will exercise greater discretion in choosing whether to handle a frivolous claim. If anything, an attorney’s willingness to represent a particular client will be biased against claims asserted by frivolous plaintiffs. In terms of our theoretical model, these rules are aimed at reducing the probability that a potential piggyback victim arises per unit of activity. This suggests that conditioned on legal representation, the *ex ante* probability that a case is of the piggyback variety ought to be smaller given the existence of these rules. Put another way, the probability that a claim is piggybacking upon a genuine claim should be smaller when an attorney represents the matter. This line of thinking is consistent with the perception that legal representation is a signal of a case’s inherent merit (though note that this perception is not due to the presumption, asserted by economists, that attorneys will only accept cases that promise a positive expected return, but rather on the presumption that attorneys practice ethical discretion in their decisions regarding which cases to accept).

In addition to the legal regimes punishing attorneys for representing clients with frivolous claims, a few states have enacted statutes to “name and shame” filers of frivolous lawsuits. These states make the names of filers of frivolous lawsuits publicly available. If a person appears on one of these lists, extra burdens are imposed to file a lawsuit. Since 1991, California has maintained a Vexatious Litigant List.¹³⁵ To appear on this list, a litigant must satisfy at least one of many statutorily identified criteria, for example, by repeatedly filing frivolous motions or pleadings.¹³⁶ Under California law, any named vexatious litigant, when not represented by an attorney, must obtain court approval prior to filing a lawsuit. A trial court will only allow a vexatious litigant to proceed with a civil action if its purpose is

¹³² Rule 3.1 Meritorious Claims and Contentions, ANN. MOD. RULES PROF. COND. s. 3.1 (2011).

¹³³ 7 Am. Jur. 2d Attorneys at Law § 46 (citing Parler & Wobber v. Miles & Stockbridge, 756 A.2d 526 (D. Md. 2000)) (holding that violating Maryland’s Rules of Professional Conduct, “which prohibits the filing of frivolous suits, is grounds for attorney discipline and can lead to disbarment”).

¹³⁴ The common law of torts does not extend liability to an attorney for filing a frivolous lawsuit under a theory of negligence. As Wade describes, negligence actions are routinely unsuccessful when aimed at recovering damages for the filing of a frivolous lawsuit. Wade, *supra* note 121, at 452. This is even true when a negligence action relies on an attorney’s violation of a state-level ethical rule as evidence of negligence *per se*. *Id.* at 453.

¹³⁵ See *California’s Vexatious Litigant List*, ADMIN. OFFICE OF THE CA. COURTS (Nov. 1, 2013), <http://www.courts.ca.gov/documents/vexlit.pdf>.

¹³⁶ CAL. CIV. PROC. CODE § 391(b) (2013).

not to harass or delay, and even then, the vexatious litigant may be required to post security.¹³⁷ Texas has adopted similar legislation under Chapter 11 of its Civil Practice and Remedies Code.¹³⁸ Vexatious litigants in Texas are required to obtain permission to file suit¹³⁹ and are required to post security.¹⁴⁰ A number of other states have imposed rules restricting vexatious litigants from bringing suit, including at least Florida,¹⁴¹ Hawaii,¹⁴² Nevada,¹⁴³ Ohio,¹⁴⁴ and Utah.¹⁴⁵

These statutes provide some information regarding claim quality to defendants, particularly when a plaintiff is named on one of these lists and is required to obtain court approval, post security, or both. The overall impact of these vexatious litigant lists is that they ought to reduce the probability that a piggyback victim will arise per unit of activity, much like the legal regimes punishing attorneys for handling frivolous claims. In the context of the theoretical model, their presence also ought to decrease the potential number of piggyback suits.

Given the prediction that legal regimes aimed at claim-quality identification ought to decrease the probability a piggyback victim will arise, what can be said about their impact on deterrence? The decrease in potential piggyback suits that arguably results from these bodies of law should shift the state of the world towards that of perfect information. This implies that defendants will be less willing to go to trial, and as was demonstrated previously, injurers will tend to underinvest in care and overengage in activity. Even if these legal regimes result in *some* frivolous lawsuits being filed, it is more likely that a Type 1 equilibrium will emerge with all cases settling. As was demonstrated previously, the effect of a Type 1 equilibrium is that defendants underinvest in care and underengage or overengage in activity. The net effect on deterrence is therefore ambiguous. As a result, as a descriptive matter, it is unclear whether these legal regimes enhance social welfare, given the possibility that the success of some frivolous lawsuits in obtaining settlement may enhance deterrence in a socially desirable direction.

¹³⁷ CAL. CIV. PROC. CODE § 391.7(b) (2013).

¹³⁸ See *List of Vexatious Litigants*, TX. OFFICE OF COURT ADMIN. (Oct. 30, 2010), available at http://www.txcourts.gov/oca/Vexatious_Litigants.pdf.

¹³⁹ TEX. CIV. PRAC. & REM. CODE ANN. §§ 11.101–102 (2013).

¹⁴⁰ TEX. CIV. PRAC. & REM. CODE ANN. § 11.055.

¹⁴¹ FLA. STAT. § 68.093 (2013).

¹⁴² HAW. REV. STAT. § 634J (2013).

¹⁴³ NEV. SUP. CT. R. 9.5 (2013). See *Vexatious Litigant List*, ADMIN. OFFICE OF THE NEV. COURTS (Sept. 2013), available at <http://www.nevadajudiciary.us/images/vexatious%20litigant%20list100413.pdf>.

¹⁴⁴ OHIO REV. CODE ANN. § 2323.52 (West 2002); see also *Vexatious Litigators Under R.C. 2323.52*, SUP. CT. OF OHIO & OHIO JUD. SYS., available at <http://www.supremecourt.ohio.gov/Clerk/vexatious/> (last visited Aug. 1, 2013).

¹⁴⁵ UTAH R. CIV. P. 83.

CONCLUSION

In this paper, we have examined the impact of frivolous lawsuits on the care and activity choices of injurers. Specifically treating frivolous lawsuits as piggyback lawsuits, we showed that despite conventional wisdom on the topic, frivolous lawsuits are not necessarily detrimental to social welfare. Rather, under certain conditions, the existence of frivolous lawsuits may provide incentives for injurers to engage in more efficient accident avoidance. Despite this theoretical conclusion, we were unable to uncover any case or statutory law that seems to recognize the possible social value of frivolous lawsuits. This is understandable, given that most observers of the legal process would find the concept of an “optimal level of frivolous litigation” to be oxymoronic. And beyond that, even if one accepted the analysis in this paper, it would be impossible as a practical matter to identify the precise level of frivolous litigation that is socially desirable. The conclusions of the analysis contained herein nevertheless have relevance for evaluating policies aimed at reducing the level of frivolous litigation. To the extent that these policies succeed, they may have the unintended consequence of mitigating the deterrence benefits of the litigation process.

APPENDIX

This appendix lays out the details of the theoretical model described in the text. The following notation will be used:

z = level of the risky activity in which the injurer (defendant) engages;
 $V(z)$ = gross value of the activity, where $V(0)=0$, $V'>0$, and $V''<0$;
 x = dollar spending on care by the injurer per unit of the activity;
 $p(x)$ = probability of an accident per unit of the activity, where $p'<0$ and $p''>0$;
 q = probability of a “piggyback suit” being filed per unit of the activity;
 L = harm suffered by a genuine victim in the event of an accident;
 k = victim’s cost of filing suit;
 C_{π} = cost of a trial for victims (plaintiffs);
 C_{Δ} = cost of a trial for the defendant;
 S = settlement amount.

We first examine the outcome of the model when the defendant can perfectly distinguish genuine and piggyback plaintiffs (the perfect information model). We then turn to the model where the defendant cannot distinguish between the two types of plaintiffs (the imperfect information model).

The Perfect Information Model

We examine the players' decisions in reverse sequence of time. Thus, consider first the settlement-trial decision, assuming that both types of plaintiffs have filed suit. Under a rule of strict liability, genuine plaintiffs will win with certainty and be awarded compensation of L , but since they have to pay their own trial costs, the minimum amount they will accept to settle is $L - C_\pi > 0$. We therefore assume that the defendant will make a take-it-or-leave-it settlement offer of $S = L - C_\pi$ to all genuine plaintiffs, and they will accept this offer. As for piggyback plaintiffs, they will lose at trial with certainty, and so the defendant, who by assumption can perfectly distinguish them from genuine plaintiffs, will offer $S = 0$ and they will drop their suits rather than go to trial.

Now move back to the filing stage. Since all genuine plaintiffs expect to settle for $L - C_\pi$, they will only file suit if

$$L - C_\pi > k, \quad (\text{A1})$$

which we assume is true. Thus, all genuine plaintiffs will file. In contrast, no piggyback plaintiffs will file suit since they do not expect to receive a positive settlement offer.

Finally, consider the optimal care and activity choices of the injurer-defendant. Since the injurer anticipates that only genuinely injured plaintiffs will file suit and all will settle for $S = L - C_\pi$, the expected value of activity is given by

$$V(z) - z[x + p(x)(L - C_\pi)], \quad (\text{A2})$$

where the expression in square brackets is the total expected accident costs (care plus liability) per unit of risky activity. The injurer chooses care (x) and activity (z) to maximize this expression.

Consider first the injurer's choice of care. The first-order condition defining his optimal care level, denoted x_c^* , is

$$1 + p'(x)(L - C_\pi) = 0. \quad (\text{A3})$$

Note that x_c^* is independent of his level of activity because accident costs are assumed to be proportional to z . Given x , the injurer's optimal activity level, denoted $z_c^*(x)$, solves

$$V'(z) - [x + p(x)(L - C_\pi)] = 0, \quad (\text{A4})$$

where $z_c^* \equiv z_c^*(x_c^*)$.

The Imperfect Information Model

We now turn to the outcome of the model when the defendant cannot distinguish between genuine and piggyback plaintiffs. As above, we begin at the settlement–trial stage, where the defendant again chooses between two offers: $S=L-C_\pi$ and $S=0$. Note that the first is a “pooling” offer because it will induce both types of defendants to behave the same way—namely, to accept and settle. In contrast, the second is a “separating” offer because it will induce genuine plaintiffs to opt for trial while piggyback plaintiffs will drop their suits.¹⁴⁶ In choosing between these two offers, the defendant faces the following trade-off. On one hand, if she offers the higher amount, both genuine and piggyback plaintiffs will accept, so she avoids trial costs, but she ends up paying a positive amount to piggyback plaintiffs. On the other hand, if she offers zero, any piggyback plaintiffs who filed will drop their suits, but genuine plaintiffs will go to trial, costing the defendant $L+C_\Delta>L-C_\pi$.

In order to derive the equilibrium in this case,¹⁴⁷ we need to define two additional variables. Let

θ = probability that the defendant offers a settlement of $S=L-C_\pi$ rather than zero,

φ = the probability that a piggyback plaintiff files suit.

(The probability that a genuine plaintiff files suit is one, given (A1).) Note that in the perfect information model, $\theta=1$ and $\varphi=0$, but that outcome is not possible under imperfect information.

Consider first the defendant’s settlement strategy after a suit is filed by a plaintiff of unknown type. Using Bayes’ rule, she first calculates the conditional probability that the plaintiff is genuine to be

$$\hat{p}(x) = \frac{p(x)}{p(x)+\varphi q}, \quad (\text{A5})$$

which depends on his prior choice of care. Note that this expression ranges from $p(x)/(p(x)+q)<1$ when $\varphi=1$ (i.e., all piggyback plaintiffs file with certainty) to 1 when $\varphi=0$ (i.e., no piggyback plaintiffs file). Given (A5), if the defendant offers $S=0$, his expected cost per suit will be $\hat{p}(x)(L + C_\Delta)$ (because piggyback plaintiffs will drop), whereas if he offers

¹⁴⁶ Note that it would never make sense for the defendant to offer more than $L-C_\pi$ (since both types would settle for the lesser amount), nor would it make sense to offer an amount between 0 and $L-C_\pi$ (since genuine plaintiffs would reject it and go to trial, while piggyback plaintiffs would “accept” an offer of 0).

¹⁴⁷ The derivation of the equilibrium follows Katz, *supra* note 20.

$S=L-C_\pi$ his expected cost per suit will be $L-C_\pi$ (because all plaintiffs will settle). The defendant's optimal decision rule is therefore

$$\begin{aligned} \text{if } \hat{p}(x) &< \frac{L-C_\pi}{L+C_\Delta}, \theta = 0 \\ \text{if } \hat{p}(x) &> \frac{L-C_\pi}{L+C_\Delta}, \theta = 1 \\ \text{if } \hat{p}(x) &= \frac{L-C_\pi}{L+C_\Delta}, 0 \leq \theta \leq 1. \end{aligned} \quad (\text{A6})$$

Note that the first two lines represent pure strategies, while the third line constitutes a mixed strategy under which the defendant offers $L-C_\pi$ with probability θ and zero with probability $1-\theta$.

Now consider piggyback plaintiffs, who must decide between filing and not filing. Prior to filing, their expected return is $\theta(L-C_\pi)-k$, which is strictly positive if $\theta=1$ (by (A1)), and negative if $\theta=0$. Their decision rule is therefore

$$\begin{aligned} \text{if } \theta &< \frac{k}{L-C_\pi}, \varphi = 0 \\ \text{if } \theta &> \frac{k}{L-C_\pi}, \varphi = 1 \\ \text{if } \theta &= \frac{k}{L-C_\pi}, 0 \leq \varphi \leq 1, \end{aligned} \quad (\text{A7})$$

where the first two lines are pure strategies and the third is a mixed strategy.

It turns out that there are two types of equilibria of the settlement-trial subgame. The first (Type 1), occurs when

$$\frac{p(x)}{p(x)+q} > \frac{L-C_\pi}{L+C_\Delta}. \quad (\text{A8})$$

In this case, $\varphi=\theta=1$ is an equilibrium; that is, all piggyback plaintiffs file suit and the defendant settles all cases for $S=L-C_\pi$. This pure strategy equilibrium occurs when q , the probability of a piggyback suit, is small.

Alternatively, suppose that

$$\frac{p(x)}{p(x)+q} < \frac{L-C_\pi}{L+C_\Delta}. \quad (\text{A9})$$

In this case, if $\varphi=1$, the defendant's optimal strategy would be to set $\theta=0$ by the first line of (A6); that is, offer $S=0$. But then the optimal strategy of piggyback plaintiffs would be to set $\varphi=0$ (i.e., not file), in which case $\theta=1$ would be optimal for the defendant. Clearly, no pure strategy equilibrium exists in this case. There is, however, a mixed strategy equilibrium in which piggyback plaintiffs are indifferent between filing and not filing, and

defendants are indifferent between offering $S=0$ and $S=L-C_\pi$. From the third lines of (A6) and (A7), this implies that

$$\theta^* = \frac{k}{L-C_\pi} \quad (\text{A10})$$

and

$$\varphi^* = \frac{p(x)(C_\pi+C_\Delta)}{q(L-C_\pi)} \quad (\text{A11})$$

where the latter condition also makes use of (A5). This mixed strategy (Type 2) equilibrium occurs when q is relatively large.

Care and Activity Choices

The injurer's choice of care (x) and activity (z) will depend on which type of equilibrium he expects to arise in the settlement-trial subgame. If it is a Type 1 equilibrium in which all piggyback plaintiffs file suit and all cases settle, the injurer's problem is to choose x and z to maximize the following expected value of engaging in the activity:

$$V(z) - z[x+(p(x)+q)(L-C_\pi)] \quad (\text{A12})$$

The first-order conditions for x_1^* and $z_1^*(x)$, respectively, are

$$1 + p'(x)(L-C_\pi) = 0 \quad (\text{A13})$$

$$V'(z) - [x+(p(x)+q)(L-C_\pi)] = 0. \quad (\text{A14})$$

In contrast, if the expected equilibrium is of Type 2, all genuine plaintiffs and a fraction φ^* of piggyback plaintiffs will file suit. Of these suits, the defendant offers $S=L-C_\pi$ to a fraction θ^* , all of which settle, and $S=0$ to the remainder, of which only the genuine plaintiffs opt for trial. After making the appropriate calculations, it turns out that the defendant's expected costs in this case are equivalent to the cost he would incur if only genuine plaintiffs filed suit and all went to trial. Thus, his problem under a Type 2 equilibrium is to choose x and z to maximize the following expected value

$$V(z) - z[x+p(x)(L+C_\Delta)]. \quad (\text{A15})$$

The resulting first-order conditions for x_2^* and $z_2^*(x)$ are

$$1 + p'(x)(L+C_\Delta) = 0 \quad (\text{A16})$$

$$V'(z) - [x+p(x)(L+C_\Delta)] = 0. \quad (\text{A17})$$

Comparison of (A13) and (A16) shows that $x_1^* < x_2^*$, while comparison of (A14) and (A17) shows that $z_1^*(x) \underset{>}{\underset{<}{\geq}} z_2^*(x)$ for any x .

Given these results, we first ask how the defendant's equilibrium care and activity choices compare to those in the certainty model above. For care, comparison of (A3), (A13), and (A16) shows that $x_c^* = x_1^* < x_2^*$. Thus, the possibility of piggyback suits induces the defendant to take either the same or more care as compared to a world without such suits. For the activity level, comparison of (A4), (A14), and (A17) shows that for any x , $z_c^*(x)$ is larger than either $z_1^*(x)$ or $z_2^*(x)$. Thus, for any level of care, the possibility of piggyback suits reduces the defendant's activity level compared to a world without such suits.

Welfare Analysis

This section compares the defendant's equilibrium care and activity choices to the socially optimal choices—that is, the choices that a social planner would choose, assuming it could perfectly distinguish between genuine and piggyback plaintiffs. Since the planner would settle with all genuine plaintiffs, and no piggyback plaintiffs would file suit, the planner's objective function is

$$V(z) - z[x + p(x)(L+k)]. \quad (\text{A18})$$

Note that the planner accounts for the plaintiff's filing cost, k . The first-order conditions for x_s^* and $z_s^*(x)$, respectively, are

$$1 + p'(x)(L+k) = 0 \quad (\text{A19})$$

$$V'(z) - [x + p(x)(L+k)] = 0. \quad (\text{A20})$$

Consider first the choice of care. Comparing (A19) to the conditions for equilibrium care under the perfect information and imperfect information models implies that $x_s^* > x_c = x_1^*$, but $x_s^* \underset{>}{\underset{<}{\geq}} x_2^*$. Thus, the defendant takes less than the socially optimal level of care under the perfect information and Type 1 imperfect information models, but she may take too much or too little care under the Type 2 imperfect information model. (The comparison depends on the relative magnitudes of k and C_Δ .) As for the defendant's activity level, comparison of (A20) to the conditions for equilibrium activity under both models implies that $z_s^*(x) < z_c^*(x)$, but $z_s^*(x)$ may be larger or smaller than $z_1^*(x)$ and $z_2^*(x)$. Thus, the defendant overengages in the activity in the perfect information model compared to the social optimum, but she may overengage or underengage in the activity in the imperfect information model. These conclusions show that from a

pure deterrence perspective, the existence of piggyback suits is not necessarily socially undesirable.

Fee-Shifting Rules

A switch to the English rule for allocating legal costs, or the imposition of sanctions on frivolous suits that shifts the defendant's legal fees to the plaintiff, are often proposed as responses to the problem of frivolous litigation. In the context of the current model, these two responses have identical effects and therefore can be examined together under the heading of fee-shifting rules.

The first effect of such a rule on the model is to change the minimum amount that a genuine plaintiff will accept to settle to $S=L+k$. This is true because if the plaintiff wins at trial (which we assume will happen with certainty for a genuine plaintiff), the defendant will be responsible for both the plaintiff's trial costs and her (sunk) filing costs. As for piggyback plaintiffs, they will lose at trial and will therefore be responsible for the defendant's trial costs, which only reinforces their decision to drop their cases if presented with a settlement offer of zero. Thus, in the imperfect information model, the defendant's choice in the settlement-trial subgame is between offering $S=L+k$ and $S=0$, and the same two types of equilibria (pure and mixed strategies) exist. After working through the details, we calculate that the pure strategy (Type 1) equilibrium arises if the following condition holds

$$\frac{p(x)}{p(x)+q} > \frac{L+k}{L+C_{\pi}+C_{\Delta}+k} \quad (\text{A21})$$

and a mixed strategy (Type 2) equilibrium arises if

$$\frac{p(x)}{p(x)+q} < \frac{L+k}{L+C_{\pi}+C_{\Delta}+k}. \quad (\text{A22})$$

In the latter equilibrium, we have

$$\theta^* = \frac{k}{L+k} \quad (\text{A23})$$

and

$$\varphi^* = \frac{p(x)(C_{\pi}+C_{\Delta})}{q(L+k)} \quad (\text{A24})$$

as the equilibrium probabilities that the defendant offers a positive settlement amount, and that piggyback plaintiffs file suit, respectively. The resulting expected values of the activity to the defendant are

$$V(z) - z[x + (p(x)+q)(L+k)] \quad (A25)$$

under the pure strategy (Type 1) equilibrium, and

$$V(z) - z[x + p(x)(L+C_{\pi}+C_{\Delta}+k)] \quad (A26)$$

under the mixed strategy (Type 2) equilibrium. Comparing these expressions to those for the imperfect information model above (expressions (A12) and (A13)) shows that the injurer chooses more care and a lower activity level in both types of equilibria compared to the situation without fee shifting. Finally, comparing these expressions to the expression for social welfare in (A18), we further find that injurers invest in efficient care under the Type 1 equilibrium, and too much care under the Type 2 equilibrium, but they engage in too little activity under both equilibria. Generally, therefore, fee shifting results in overdeterrence compared to the social optimum.

NATURE ABHORS A VACUUM AND SO DO LOCAL GOVERNMENTS: BUT
VACANT PROPERTY ORDINANCES GO TOO FAR

*Michael M. Sandez**

Abstract

This article evaluates whether vacant property ordinances are a justifiable exercise of a municipality's police power. Most commentaries about vacant property ordinances reviewed by this author apparently assume the regulations are valid. This article does not make such an assumption, but rather takes a contrary view. The question of validity needs to be raised because hundreds of municipalities have enacted these types of ordinances, which, in this writer's opinion, will have a negative cumulative effect upon lenders' costs of doing business and borrowers' costs for new loans. Regulations are not a panacea for the country's mortgage and housing crises. The ordinances have yet to be tested in court, though they should be scrutinized before the government makes the economic situation worse. Enacted in response to the housing mortgage financial crisis, the regulations may not be valid if they were promulgated without substantial evidence that blight—a common justification—actually existed in the municipalities' respective jurisdictions. The type of ordinance discussed in this article rewrites the terms of mortgage loan agreements such that a borrower's contractual duties to maintain and keep secure the property are shifted to his mortgage lender and impose strict liability when the lender fails to comply. This article questions the wisdom of this impairment of contract because of the way fundamental aspects of the rule of law are undermined. Private parties cannot rely on the certainty and enforceability of lawful loan provisions that prescribe the private parties' division of duties and risks. As a consequence, confidence in the legal system will suffer. Without an adjudication of fault, local government bases the enactment on raw legislative fiat, not justice. Another issue involves the lack of clarity due to vague terms, which leaves the lender to guess at the meaning of the mandates and the timing of its compliance obligations. These ordinances must be tested for their vagueness. What is worse is that despite the borrower's voluntary commitment to personally maintain and keep secure the property, abandoned property ordinances encourage the borrower's irresponsibility by effectively releasing him from his loan obligations and the public nuisance regulatory scheme. If you are the borrower, what's not to like about such an ordinance? Nothing! Meanwhile, mortgage loan costs are sure to increase and are sure to be passed on to future borrowers. Moreover, it remains to be seen whether mortgage lenders will be able to recover some of

the expenses and fees they incur while complying with abandoned property ordinances.

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INTRODUCTION

A lot of attention has been given to the decline in real property prices that began in 2006 and the subsequent tidal wave of foreclosures, both of which were central to the catastrophic financial crisis in the U.S. economy.¹ With borrowers, lenders, Wall Street, and government-sponsored enterprises receiving one form of bailout or another, the group that has taken the biggest wallop has been the U.S. taxpayer.² A majority of officials, media, commentators, and the public blame mortgage lenders and Wall Street. It is not surprising that federal, state, and local governmental bodies rushed to “solve” the problems of the Great Recession by imposing more regulations on lenders.³ Too little has been said about how the federal government laid the foundation for the crisis through its policies and regulations, and through the pressure it applied against the mortgage lending industry.

As the crisis developed, the nation watched prices fall and defaults and foreclosures rise. The overwhelming majority of the foreclosures were the result of monetary defaults.⁴ The foreclosure fallout was exacerbated because of the dramatic decrease in housing prices, which left many borrowers with loans in excess of the property values, and a record number of foreclosures ensued.⁵ Many borrowers purchased homes with a variety of different (and sometimes misleading) loan products, but these borrowers should never have been approved for home loans in the first place. Many of these borrowers qualified with no or inadequate verification of ability to pay and yet obtained loans to purchase homes they later lost in foreclosure.⁶

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¹ THOMAS SOWELL, *THE HOUSING BOOM AND BUST*, 58–60 (Basic Books rev. ed. 2010) [hereinafter SOWELL].

² GRETCHEN MORGENSEN & JOSHUA ROSNER, *RECKLESS ENDANGERMENT: HOW OUTSIZED AMBITION, GREED, AND CORRUPTION LED TO ECONOMIC ARMAGEDDON* 40–42, 302–03 (2011) [hereinafter MORGENSEN & ROSNER].

³ *See id.* at 110.

⁴ *See, e.g.*, SOWELL, *supra* note 1, at 26, 62, 67.

⁵ *Id.* at 61–63, 65.

⁶ *See* SOWELL, *supra* note 1, at 18; MORGENSEN & ROSNER, *supra* note 2, at 283, 287; *see also* discussion *infra* Part II.

Other borrowers were unable to pay the higher interest rates when their mortgage rates adjusted upwards.⁷ The policy of home ownership for very-low- to moderate-income families and minorities stems from government intervention in the market, beginning with the Community Reinvestment Act of 1977.⁸ Additional federal legislation and regulation that entrenched and advanced the policy soon followed, as well as Fannie Mae's and Freddie Mac's participation in the real estate mortgage market through guarantees of loans and the purchase and sale of mortgages in the secondary market. The federal government, its agencies, government-sponsored enterprises, and certain community organizations were insistent on increasing the number of homeowners, whether or not they were qualified to purchase the home under traditional loan underwriting standards.⁹ Other borrowers defaulted on their payments because they lost their jobs due to the downturn in the economy and found it difficult to save their homes in a real estate market in tatters.

In 2007, the consequences of ill-advised public policy, dubious loan products, sharp loan practices, nonexistent or sloppy verification of borrowers' loan qualifications, and misinformation or misrepresentation by borrowers began to unfold. In response, the City of Chula Vista, a suburb of San Diego, California, enacted an ordinance that is becoming popular across the country.¹⁰ Essentially, Chula Vista's Abandoned Residential Property Registration Ordinance (CVAPO) changes the agreement made by mortgage lenders and borrowers regarding the maintenance and security of the real property that is the collateral for the loan.¹¹ Aside from loan payments, the typical loan terms obligate the borrower to occupy the property (at least for a specified period),¹² and to maintain, and not to commit waste at the property.¹³ The Chula Vista City Council, through legislative fiat, eliminated the lenders' contractual right to exercise their own discretion¹⁴ as to whether they would enter the property to maintain and secure the property. Thus, lenders—despite their lack of ownership and possessory rights—are now mandated to advance monies to maintain the property when, under the circumstances of particular loans, they might not otherwise do so.¹⁵ Notwithstanding the fact that the lenders' extension of credit provided an

⁷ SOWELL, *supra* note 1, at 18–21, 29.

⁸ Community Reinvestment Act of 1977, § 802 *et seq.*, as amended, 12 U.S.C. § 2901 *et seq.*

⁹ *See infra* Part II.

¹⁰ Benton C. Martin, *Vacant Property Registration Ordinances*, 39 REAL EST. L.J. 6, 19 (2010).

¹¹ *See infra* Part III.

¹² California-Single Family-Fannie Mae/Freddie Mac Uniform Instrument, Form 3005 01/01 § 6.

¹³ *Id.* at § 7.

¹⁴ CHULA VISTA, CAL., MUN. CODE § 15.60.040 ¶ 1.

¹⁵ CHULA VISTA, CAL., MUN. CODE § 15.60.040; *see also* *Neighborhoods: The Blameless Victims of the Sub-Prime Mortgage Crisis: Hearing Before the House Subcommittee on Domestic Policy*, 110th Cong. 101 (2008) (statement of Doug Leeper, Code Enforcement Manager for City of Chula Vista [hereinafter Testimony of D. Leeper]).

opportunity for borrowers to purchase homes, if the lenders fail to comply with the CVAPO, they face fines and the possibility of criminal misdemeanor prosecution and imprisonment.¹⁶ Other municipalities and counties across the country have enacted identical or similar regulations.¹⁷ This article, thus, critiques the CVAPO because it has become a model for many other regulations throughout the state of California and the country.¹⁸

Part II briefly reviews the historical background that led to the subprime mortgage fiasco.¹⁹ The focus of Part II is on the government policy to expand home ownership among the low- to moderate-income and minority communities, and the use of the home mortgage lending industry to implement the policy from the late 1970's to as recent as a few years before the mortgage meltdown. Given the magnitude of the Great Recession,²⁰ the CVAPO (and all others like it) must be considered in the context within which it was promulgated because it retains some of the same thinking found in the policy that led to the crisis. Just as lenders have been the government's vehicle to carry the home ownership policy forward, lenders are the abandoned property legislation's vehicle to carry the borrowers' contractual duty to maintain the collateral property. Lenders are seen as the industry obligated to mitigate the consequences of the financial crisis.²¹ Though this specific type of ordinance²² was first enacted in 2007 in response to the looming financial crisis, the core causes of the Great Recession were laid long before.²³ The historical context makes the critical point that government exercised poor judgment in the creation of a public policy that increased homeownership with little to no concern for the home purchaser's ability to pay, and implemented that policy through legislation,

¹⁶ CHULA VISTA, CAL., MUN. CODE § 15.60.090. "Violations of this chapter may be enforced in any combination as allowed in Chapters 1.20, 1.30, and 1.41 CVMC." Fines can be up to \$1,000 per violation per day; imprisonment can be for up to six months. *See also infra* notes 71–74 and related text.

¹⁷ *See* SAFEGUARD PROPERTIES, http://www.safeguardproperties.com/Resources/Code_Enforcement_Contacts.aspx (last visited July 1, 2013) (listing on excel spreadsheet code enforcement officers of local governments throughout the country). For a list of local governments that in May 2008 were interested in or were pursuing abandoned property ordinances, *see* Testimony of D. Leeper, *supra* note 15, at 103, 115; *see, e.g.*, FT. LAUDERDALE, FLA., MUN. CODE §§ 18-12.1 to 18-12.5; LAS VEGAS, NEV., MUN. CODE §§ 16.33.010–16.33.090.

¹⁸ For this reason, California case law and statutes will be referenced in the discussion of the various issues.

¹⁹ The historical background is brief but provides a context that may explain in part the push by local governments across the country to enact some version of vacant property ordinances.

²⁰ Some courts have taken to using the phrase "Great Recession" when referring to the financial collapse of 2007–2009. *See, e.g., In re Smith*, 435 B.R. 637, 643 (B.A.P. 9th Cir. 2010).

²¹ *See generally* Lea Deutsch, *Collateral Damage: Mitigating the Effects of Foreclosure in Communities*, 22 TEMP. POL. & CIV. RTS. L. REV. 203, 214–17 (2012).

²² The CVAPO has been called the "Chula Vista Model." Martin, *supra* note 10, at 11.

²³ *See infra* Part III.

regulation, and litigation that distorted the housing and lending markets to such an extent that it led to boom and bust cycles that devastated the national economy. One lesson that should be taken from the financial fiasco is that government ought to terminate the policy immediately and extricate itself in certain respects from the housing mortgage market.²⁴

Part III of this article provides a general description of the CVAPO's provisions and purpose and then examines whether the CVAPO satisfies constitutional standards. As explained in this part, the CVAPO works against the rule of law. If courts uphold abandoned property ordinances, their decisions will further entrench government's minimalist view of property rights, which already have receded extensively under court rulings. The CVAPO undermines the rule of law because local government's police power is expanded so it can impair private contracts and interfere with property rights without the accountability check of findings based on substantial empirical data that blight actually existed at the time of enactment.²⁵ The rule of law is weakened because an abandoned property ordinance exceeds valid police power authority in that the means to achieve the objective of public health and safety belie the core purpose of government, which is to wield its authority against wrongdoers. An abandoned property ordinance does not adjudicate wrongdoing; it does not concern itself with the finding of fault between a lender and a borrower. Instead, such an ordinance makes an economic choice that contradicts a requisite of the rule of law: the private parties' reliance on the certainty and enforceability of a lawful contract. Further, the ordinance rewrites a private contract. That is, the parties' lawful division of rights, duties, and risks is reversed so that a borrower is released from a significant contractual maintenance obligation and a lender becomes obligated, making public nuisance regulations superfluous in those instances when a borrower has defaulted on his mortgage loan and abandoned his property.²⁶ As a consequence, borrowers are encouraged to ignore their contractual and civic obligations regarding the property.

The rule of law is diminished because an abandoned property ordinance that is vague does not sufficiently define when a mortgage lender that has recorded a notice of default must start to maintain that property after the borrower abandons it. Nor does such an ordinance adequately define what the standard for maintenance is, once the lender begins that task. The ambiguity forces the lender to guess at definitions, making it vulnerable to a fine or prosecution.²⁷

²⁴ Obviously, government must remain involved in the regulation and prosecution of such things as fraudulent sales and lending practices, and the setting of capital requirements.

²⁵ See *infra* Part III.A.

²⁶ See *infra* Part III.B.

²⁷ See *infra* Part III.C.

The rule of law is defeated because an abandoned property ordinance is unfair and inequitable. Since fault is irrelevant, abandoned property ordinances disregard borrowers' default and abandonment. An ordinance of this type achieves its goal by creating a greater financial burden on lenders when local government should instead place the mandate to maintain and keep secure the property on the defaulting borrowers. Local officials have enacted an ordinance that is unfair because mortgage lenders are now exposed to the risk of claims by borrowers in addition to the risks of fines and prosecution under the ordinance.²⁸

Part IV examines the CVAPO in relation to some issues that arise in the context of California's nonjudicial foreclosure law. Part V offers recommendations and, finally, Part VI concludes the article.

II. BACKGROUND

So how did the subprime mortgage crisis come about? Government officials, the media, and the public in general primarily point to the lending industry and the financial sector as the cause of the financial crisis and the Great Recession. This opinion is so widespread that even international leaders are critical of the U.S. lending industry. José Manuel Barroso, the current President of the European Commission, identified the North American financial markets as the cause of the European financial crisis when, with diplomatic finesse, he stated, "This [European financial] crisis was not originated in Europe. [T]his crisis originated in North America, and many of our financial sectors were contaminated by, how can I put it, unorthodox practices from some sectors of the financial market."²⁹ Whether there was a direct causal link or not, European leaders such as Mr. Barroso are convinced that the financial crisis in Europe was caused not by the monetary policies and entitlement-program spending in Europe, but by the financial sector and the subprime mortgage fallout in the United States. Domestically, retired Congressman Barney Frank, the former Chairman of the House of Representatives' Committee on Financial Services who shielded the government-sponsored enterprises for years, stated that "[w]e are in a

²⁸ See *infra* Part III.D.

²⁹ Council of the European Union, *Joint Press Briefing: Van Rompuy & Barroso (Q&A)* (June 18, 2012), <http://tvnewsroom.consilium.europa.eu/event/g20-summit-june-2012/joint-press-briefing-van-rompuy-barroso-qa111/P12> (Pres. Barroso's response to a journalist's question at the G-20 Summit in Cabo San Lucas, Baja California, Mexico in June 2012); see also *Barroso: EU Needs No Economic Lessons*, UPI (June 19, 2012), http://www.upi.com/Top_News/World-News/2012/06/19/Barroso-EU-needs-no-economic-lessons/UPI-48321340092800/. While there certainly was a negative international economic impact as a result of the U.S. recession, see, e.g., SOWELL, *supra* note 1, at 64, the blame for it does not solely rest with the U.S. financial sector. See *id.* at 138–47, 179–82.

worldwide crisis now because of excessive deregulation” and “mortgages made and sold in the unregulated sector led to the crisis.”³⁰

The financial sector in the United States certainly had a significant role in the financial fiasco. Blame indeed can be laid at the feet of some front-line bank loan officers and mortgage brokers, but more specifically at the doors where corporate directives were set by some prime and subprime mortgage lenders, government-sponsored enterprises Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), investment bankers on Wall Street, and financial rating agencies.³¹ The traditional real property mortgage financing market, with its longstanding stringent qualification criteria for borrowers, was abandoned.³² Abuse or illegality by all actors became acceptable behavior. There is no doubt that there were individual persons and entities within the financial sector (from Main Street to Wall Street) and policy makers in Washington, D.C., that would be subject to liability if regulations already in place were enforced. To be sure, the financial sector and Wall Street contributed enormously to the subprime mortgage crisis, as well.³³ Countrywide, NovaStar and Fremont are three examples of the many lenders that exploited the easy-money opportunity created by the Federal Reserve Bank’s low interest rates and the easy borrower approval demanded by the federal government’s policy of more home ownership within low-income and minority communities.³⁴ This article will not recount all the details, but

³⁰ SOWELL, *supra* note 1, at 76 (citing WASH. POST, July 11, 2008, at A17).

³¹ *Id.* at 28; *see also supra* notes 23–24.

³² MORGENSON & ROSNER, *supra* note 2, at 1–7.

³³ SOWELL, *supra* note 1, at 271–85. For example, Wall Street investment bankers did not disclose to investors the number of subprime loans or the nature of the deficiencies in those loans that went in to the pool of loans that collateralized the mortgage-backed securities.

³⁴ A key relationship that led to the debacle involved Countrywide Financial, “an aggressive subprime mortgage lender,” and Fannie Mae. MORGENSON & ROSNER, *supra* note 2, at 10–11, 184–88. In 2004, Fannie Mae purchased 26 percent of its loans from Countrywide Financial. *Id.* at 190. In 2005, Fannie Mae purchased \$12.7 billion in subprime loans from Countrywide. *Id.* at 195. Countrywide Financial was known to alter borrowers’ applications in order to obtain approval of loans, engage in risky loan underwriting practices such as approval of loans that did not require documentation of borrowers’ income and assets, did not require down payments, and permitted high debt-to-income ratios. *Id.* at 182, 193, 195. From the heights to the depths of the industry, Countrywide nearly went bankrupt and was then purchased by Bank of America in 2007. *Id.* at 199–200. NovaStar Financial, formed as a real estate investment trust, was one of the subprime mortgage lenders that, along with others, produced the growth in this industry in the 1990’s and in to the next century. *Id.* at 100. NovaStar engaged in sharp lending practices and accounting fraud. *See id.* at 201–18. “[N]ovaStar was a microcosm of the nationwide home-lending assembly line that would lead directly to the credit crisis of 2008.” *Id.* at 208. It is no longer funding mortgage loans. *Id.* at 218. Fremont Investment & Loan obtained a line of credit from Goldman Sachs and other financiers in 2003 and rushed aggressively into the subprime mortgage loan business, primarily originating mortgage loans that used the property’s equity for cash payments to the borrowers and adjustable rate mortgage loans. *Id.* at 271–72. A significant portion of Fremont’s mortgages was known as “liar loans” which were expected to fail due to their material deficiencies. *Id.*

the role of mortgage lenders and investment bankers in the creation and bursting of the housing bubble is a fascinating yet sad illustration of how the various players in the financial sector willingly participated in the mandate to carry out the federal government's ill-advised policy.³⁵

Despite the fact that Mr. Barroso and Congressman Frank blamed only the financial sector for the worldwide crisis, the truth is that lenders are neither the beginning nor the end of the list of culpable parties. As if they were superheroes, Congressional politicians were quick to hold hearings and blame the evil lenders and Wall Street³⁶ and then passed more regulations that included money for loan modifications and foreclosure mitigation for borrowers.³⁷ There probably were some gaps in the regulation matrix that needed to be filled, but it is arguable that the housing bust would not have occurred had extant regulations been enforced and government agency oversight taken place—and, had the subprime home ownership policy never been implemented. To reinforce the perspective that the financial sector caused the debacle, legislators have written new laws that in nearly all instances favor the borrower and burden the lender.³⁸ Long before this crisis, however, government officials enacted legislation that promoted a policy of home ownership for unqualified borrowers and required lender compliance with the policy.³⁹ This policy had far more to do with the financial fiasco⁴⁰

at 287. Fremont's sharp lending practices and defective loans led to consequences it could not resolve and it filed for bankruptcy in 2008. *See id.* at 290–98.

³⁵ SOWELL, *supra* note 1, at 144.

³⁶ *Id.* at 72–78.

³⁷ Emergency Economic Stabilization Act, 12 U.S.C. §§ 5201–61 (2012), established the Troubled Asset Relief Program, *id.* §§ 5211–41. With these resources and legislation, the Making Home Affordable Program was created in an effort to combine the government mortgage assistance programs, including those of Treasury and the Department of Housing and Urban Development. *See Overview, DEP'T OF THE TREASURY* (last updated July 13, 2012), <http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/housing/Pages/Overview.aspx>. The Making Home Affordable Program includes the Home Affordable Modification Program (“HAMP”) and the Home Affordable Refinance Program (“HARP”). *See generally View All Programs, MAKING HOME AFFORDABLE* (last updated Mar. 8, 2013), <http://www.makinghomeaffordable.gov/programs/view-all-programs/Pages/default.aspx> (listing all programs in the Making Home Affordable Program). Mortgage loan restructuring was given special tax treatment by the Mortgage Forgiveness Debt Relief Act of 2007. 26 U.S.C. § 108(h) (Supp. I 2012). California also created the so-called “Homeowners’ Bill of Rights.” 2012 Cal. Stat. chs. 86–87 (codified in scattered sections of CAL. CIV. CODE. § 2920–24 (West 2013)).

³⁸ *See, e.g.*, 2012 Cal. Stat. chs. 86–87 (California’s “Homeowners’ Bill of Rights”).

³⁹ “It has now become evident that the regulatory pressures imposed by the government to ‘push’ lenders to extend more credit to higher-risk borrowers was simultaneously being met by Fannie Mae and Freddie Mac efforts to ‘pull’ lenders to issue more mortgages to high-risk borrowers.” Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 37 (2009).

⁴⁰ *See* SOWELL, *supra* note 1, at 72–78. Another commentator cites other causes for the financial crisis: “But the real issues of the crisis boil down to three different factors: state and local growth-management planning, the bond-ratings agencies, and banking reserve requirements.” RANDAL

than many officials care to admit, and only a few reluctantly have done so.⁴¹ The fact that elected officials and their relatives received low-cost loans, jobs, and campaign contributions also “persuaded” them to support their homeownership policy and protect the government-sponsored enterprises.⁴² There are some scholars and commentators, with an apparent sympathy for local government, who do not discuss the root cause of the crisis.⁴³ There are other commentators, however, whose works explain how government intervention through legislation and regulation, as well as inaction, distorted the housing and lending markets,⁴⁴ or suggest self-regulation by the mortgage loan industry,⁴⁵ or express concern about problems with vacant property ordinances.⁴⁶

Most people would agree with a general economic environment that promotes homeownership; after all, this is what enables the “American dream.” It is critical to keep in mind that the foundation for such an environment is the freedom to make personal economic choices that are based on private preferences and to accept the responsibility that obtains with such choices. The freedom to choose is inextricably intertwined with the possibility of failure. But when government policy interferes with the housing and mortgage markets through legislation and regulation,⁴⁷ it is foolish

O'TOOLE, AMERICAN NIGHTMARE: HOW GOVERNMENT UNDERMINES THE DREAM OF HOME OWNERSHIP 208 (Cato Inst. 2012).

⁴¹ See MORGENSON & ROSNER, *supra* note 2, at 40–41, 246–47, 250–51, 256–59, 303, 305 (detailing various officials' actions and later responses to the mortgage and lending crisis); SOWELL, *supra* note 1, at 48–52.

⁴² MORGENSON & ROSNER, *supra* note 2, at 68–69, 187–88; SOWELL, *supra* note 1, at 54.

⁴³ See, e.g., Creola Johnson, *Fight Blight: Cities Sue to Hold Lenders Responsible for the Rise in Foreclosures and Abandoned Properties*, 2008 UTAH L. REV. 1169, 1169 (2008); Benton C. Martin, *Vacant Property Registration Ordinances*, 39 REAL EST. L.J. 1, 1 (2010); Joseph Schilling, *Code Enforcement and Community Stabilization: The Forgotten First Responders to Vacant and Foreclosed Homes*, 2 ALA. L. REV. 101, 101 (2009).

⁴⁴ See, e.g., MORGENSON & ROSNER, *supra* note 2, at 31–45, 57, 77–93; SOWELL, *supra* note 1, at 121–26.

⁴⁵ See, e.g., M. Todd Henderson, *Self-Regulation for the Mortgage Industry* (Coase-Sandor Inst. for Law and Econ., Working Paper No. 638, 2013).

⁴⁶ See, e.g., Richard E. Gottlieb et al., *Reckless Abandon: Vacant Property Ordinances Create Legal Uncertainties*, 68 BUS. LAW. 669, 669 (2013); Keith H. Hirokawa & Ira Gonzalez, *Regulating Vacant Property*, 42 URB. LAW 627, 637 (2010).

⁴⁷ See, e.g., Community Reinvestment Act of 1977, 12 U.S.C. § 2901(b) (2012) (“encourage[ing] [financial] institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions”); Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. § 4501 (2012) (establishing Government Sponsored Enterprises' [GSE] role in loans to low and moderate-income earners); 12 U.S.C. § 4562 (2012) (establishing goals for purchase money and refinance loans by the GSEs to very-low- and moderate-income families); American Dream Downpayment Act of 2003, Pub.L. 108-186, 117 Stat. 2685; Low and Moderate Income Housing Goal, 24 C.F.R. § 81.12(a) (“Purpose of goal. This annual goal for the purchase by each GSE of mortgages on housing for low- and moderate-income families (“the Low- and Moderate-Income Housing Goal”) is intended to achieve increased purchases by the GSEs of such

to ignore the results of the policy after a financial crisis of the magnitude we have seen in the subprime mortgage fiasco.⁴⁸ A sober examination of the policy must take place notwithstanding the desire in some quarters for government to help low- and moderate-income families and minorities. While the inception of this subprime home ownership policy for low- and moderate-income families occurred in the late 1970s (if not earlier), the policy expanded and became reinforced through additional legislation and regulation in the 1990s.⁴⁹ An obscure section of a 1991 piece of legislation is perhaps the biggest act of government market intervention that has proven to be disastrous.⁵⁰ In response to the savings and loan crisis, Congress passed the Federal Deposit Insurance Corporation Improvement Act to impose tighter restrictions on lenders but also to expand government guarantees of loans.⁵¹ Commercial banks are members of the Federal Reserve Bank system and thus had the benefit of federal government assistance in a financial crisis; but under this Act, investment banks and insurance companies were given the assurance of taxpayer bailout.⁵² “Too big to fail” had been written into law. The tight restrictions on capital reserves and other similar requirements were later relaxed “under the guise of giving banks more flexibility or making them better able to compete in international markets.”⁵³ Deregulation facilitated the financial sector’s capacity to fund loans for nonqualified borrowers. An assurance of pay off upon borrower default emboldened lenders to write more loans.⁵⁴ Mortgage lenders, Fan-

mortgages.”); *see also* 42 U.S.C. § 12821 (2012) (Downpayment Assistance Initiative that appropriated \$800 million for assistance to low-income families for housing purchase down payments during the 2004 to 2007 period).

⁴⁸ MORGENSON & ROSNER, *supra* note 2, at 4 (“[T]he homeownership drive helped to plunge the nation into the worst economic crisis since the Great Depression.”); SOWELL, *supra* note 1, at 57 (“The development of lax lending standards, both by banks and by Fannie Mae and Freddie Mac standing behind the banks, came *not* from a lack of government regulation and oversight, but precisely as a *result* of government regulation and oversight, directed toward the politically popular goal of more ‘home ownership’ through ‘affordable housing,’ especially for low-income home buyers. These lax lending standards were the foundation for a house of cards that was ready to collapse with a relatively small nudge.”) (emphasis in original).

⁴⁹ *See* SOWELL, *supra* note 1, at 36–42. The Community Reinvestment Act of 1977 laid the foundation for all the legislation that relaxed requirements for loans to low and moderate-income borrowers and minorities. An example of a reduction in lending standards that advanced the home ownership policy occurred in 1995 when the Dept. of Housing and Urban Development relaxed the rules related to, among others, the elimination of the requirement to use appraisers who were independent of the lender. MORGENSON & ROSNER, *supra* note 2, at 57.

⁵⁰ MORGENSON & ROSNER, *supra* note 2, at 40–42.

⁵¹ Federal Deposit Insurance Corporation Improvement Act of 1991, Pub.L. 102-242, 105 Stat. 2236 (amended eleven times after enactment).

⁵² MORGENSON & ROSNER, *supra* note 2, at 40–42. Recall the taxpayer bailouts of Bear Stearns (an investment banker) and AIG (an insurance company). *Id.* at 148.

⁵³ *Id.* at 110.

⁵⁴ SOWELL, *supra* note 1, at 18.

nie Mae, Freddie Mac, and investment bankers on Wall Street were beneficiaries of this Act when, after they reaped the profits of their loan transactions, they received bailouts.⁵⁵ The Federal Deposit Insurance Corporation Improvement Act, of course, required the taxpayer to pay the bill.

Federal government regulatory agencies and elected officials certainly felt justified in the homeownership policy for low- and moderate-income families and minorities when the Boston Federal Reserve Bank in 1996 issued the results of its study and concluded that banks had engaged in discriminatory lending practices.⁵⁶ Upon later analysis, however, the study's flaws were discovered and exposed, and the primary author conceded the data to support that contention did not exist.⁵⁷ Nevertheless, government used the 1996 study to further expand the policy, even by force of litigation.⁵⁸ Quotas of loans for low-income and minority borrowers were established and lenders were held accountable to regulators, to a great extent through the policing efforts of community organizations such as the Association of Community Organizations for Reform Now (ACORN).⁵⁹

The policy and the crisis-driven relief, on balance, have proven to be ineffective and not helpful.⁶⁰ Such a policy should not be pursued because the U.S. Constitution does not authorize government to do what it has done in the name of a so-called right to home ownership.⁶¹ The notion of taxpay-

⁵⁵ Fannie Mae and Freddie Mac had an implied guarantee from the U.S. Government, though retired Congressman Barney Frank denied that such a guarantee existed. MORGENSON & ROSNER, *supra* note 2, at 152.

⁵⁶ See Alicia H. Munnell et al., *Mortgage Lending in Boston, Interpreting HMDA Data*, 86 AM. ECON. REV. 25-53 (1996) (concluding that race "played a significant role in the mortgage lending decision" in the greater Boston, MA area).

⁵⁷ MORGENSON & ROSNER, *supra* note 2, at 35-36; SOWELL, *supra* note 1, at 107-09.

⁵⁸ See, e.g., SOWELL, *supra* note 1, at 18, 39. The expansion of the policy occurred under the Clinton, Bush II, and Obama administrations. One commentator expressed the view that government's goal was not really the eradication of discrimination, but rather,

[t]he real goal was to achieve a more 'egalitarian distribution' of housing, period. So under the phony guise of 'fighting discrimination' the Fed, the Congress, Fannie Mae, Freddie Mac and myriad other federal government agencies forced, bribed, and extorted mortgage lenders of all kinds into making literally trillions of dollars in bad loans to unqualified borrowers.

Thomas DiLorenzo, *How Crackpot Egalitarianism Caused the Sub-Prime Mortgage Crisis*, LEWROCKWELL (Oct. 18, 2008), <http://www.lewrockwell.com/dilorenzo/dilorenzo154.html>.

⁵⁹ MORGENSON & ROSNER, *supra* note 2, at 22, 25, 34; SOWELL, *supra* note 1, at 116-18.

⁶⁰ Les Christie, *Borrowers in Obama housing program re-defaulting, watchdog says*, CNNMONEY (July 24, 2013; 12:08 AM) http://money.cnn.com/2013/07/24/real_estate/hamp-de-

[fault/index.html?section=money_topstories&utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+rss%2Fmoney_topstories+\(Top+Stories\)](http://money.cnn.com/2013/07/24/real_estate/hamp-de-fault/index.html?section=money_topstories&utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+rss%2Fmoney_topstories+(Top+Stories)) (last visited July 27, 2013) ("Those who have been in the program since 2009, are re-defaulting at a rate of 46%, the inspector general [Special Inspector General for the Troubled Asset Relief Program (SIGTARP)] found."); see also Zywicki & Adamson, *supra* note 39, at 4 ("Without an accurate understanding of the causes of the subprime bust, regulatory measures may be counterproductive, providing bailouts for reckless lenders and speculative borrowers while resulting in higher interest rates and less credit available for legitimate borrowers.")

⁶¹ See SOWELL, *supra* note 1, at 178-79.

er guarantees to fund an unrealistic, utopian policy when the financial actors—big or small, individual or corporate, private or public—default on loans or pursue illegal acts to obtain or to sell loans is outrageous.⁶² Despite the taxpayers' gargantuan indebtedness, the federal government continues to push the policy.⁶³ Through an objective analysis of the data and the devastating results, one can reasonably conclude that it is time to eliminate the policy. It is also time to extricate government from the residential loan business and its sponsorship of Freddie Mac and Fannie Mae.⁶⁴

Consistent with the subprime home ownership policy, government has granted a pass to borrowers for their role in the financial meltdown and has not sought to impose additional requirements on them. This is not to say that the owners, humans with dignity in their own right, were subprime, but that the government's intervention into the housing market with a policy that intentionally ignored commonsense standards for home purchases was subprime. Instead, in the policy makers' frame of mind the borrower is the victim, notwithstanding the significant number of "the all-popular liar loans that had so dominated the industry's . . . mortgage production."⁶⁵ Government compounded the problem by enacting various forms of loan modification and foreclosure mitigation legislation at the federal and state levels.⁶⁶ At the local level, city councils have enacted abandoned property ordinances of one variation or another—all of which benefit the borrower and impose greater financial burdens on lenders. Notwithstanding government officials' belief that they have taken saintly steps to solve the problem, the irony is that the very people government wants to protect will face higher mortgage loan costs when they obtain their next loan or when new home

⁶² *Id.* at 84–87, 160–64.

⁶³ Zachary A. Goldfarb, *Obama Administration Pushes Banks To Make Home Loans To People With Weaker Credit*, WASH. POST (Apr. 2, 2013), http://articles.washingtonpost.com/2013-04-02/business/38220144_1_housing-recovery-housing-market-housing-officials/2.

⁶⁴ With regard to the elimination of the federal government's sponsorship of Freddie Mac and Fannie Mae, Representatives Scott Garrett (R-NJ) and Jeb Hensarling (R-TX) have put forth a proposal known as the Protecting American Taxpayers and Homeowners ("PATH") Act. H.R. 2767, 113th Cong. (2013); *see also* John L. Ligon, *Hensarling Housing Finance Plan: A Welcome Step Toward Solving the Fannie and Freddie Mess*, HERITAGE FOUND. (July 22, 2013), http://www.heritage.org/research/reports/2013/07/hensarling-housing-finance-plan-welcome-step-to-solve-the-fannie-and-freddie-mess#_ftn1 (discussing and summarizing the PATH Act). Later, President Obama called for the elimination of Fannie Mae and Freddie Mac, but also mentioned other proposals that would further entrench government in the housing market. Jackie Calmes, *Obama Outlines Plans for Fannie Mae and Freddie Mac*, N.Y. TIMES (Aug. 6, 2013), http://www.nytimes.com/2013/08/07/us/politics/obama-fannie-mae-freddie-mac.html?_r=0.

⁶⁵ MORGENSON & ROSNER, *supra* note 2, at 287; *see also id.* at 283 ("Almost 45 percent of subprime loans made during this period were low-documentation or liar loans and as many as 60 percent overstated their incomes by at least half."). Despite their awareness that they did not need to produce documents for approval, many borrowers knew they could not afford the loans they obtained.

⁶⁶ *See supra* text accompanying note 37.

buyers obtain their first mortgage. Lenders will simply pass on regulatory costs to future borrowers.⁶⁷

Abandoned property ordinances have become the next layer of regulation imposed on mortgage lenders. Are such ordinances constitutional, in terms of whether they are a legitimate use of government's police power? Are public objectives truly met? Assuming affirmative answers, are such ordinances wise and helpful? These questions are taken up in the next section.

III. THE CHULA VISTA ABANDONED RESIDENTIAL PROPERTY ORDINANCE (CVAPO)

A. *General Description*

1. Inspection and Registration

In 2007, the City of Chula Vista, California, enacted the CVAPO.⁶⁸ The main thrust of the CVAPO mandates that mortgage lenders must undertake certain of the borrower's contractual obligations after there is a default and the lender has recorded a notice of default that initiates a non-judicial foreclosure.⁶⁹ Upon a borrower's "default"⁷⁰ and after the recording

⁶⁷ Lenders' costs will increase because of the need to comply with new regulations that have resulted in extended foreclosure processes, and—in the case of abandoned property ordinances—registration, inspection, and maintenance requirements. These latter costs would, of course, be justifiable *after* the foreclosure sale has occurred because at that point the lender (or third party bidder) has become the new fee simple owner.

⁶⁸ CHULA VISTA, CAL., MUN. CODE §§ 15.60.010–.120 (2013), available at http://www.codepublishing.com/CA/chulavista_PDF.html. Effective January 1, 2013, California law mandates maintenance of vacant residential property by owners that have purchased the property at a foreclosure sale or became owners pursuant to a deed of trust or mortgage, but expressly states that it does not preempt local ordinances and that a local government cannot impose fines and penalties under the state statute and the local ordinance. CAL. CIV. CODE § 2929.3 (West 2013).

⁶⁹ CHULA VISTA, CAL., MUN. CODE §§ 15.60.040–.060 (2013); *see also* Testimony of D. Leeper, *supra* note 15, at 101 ("Chula Vista's new ordinance compels the lender . . . exercise [sic] the abandonment clause in their contract.").

⁷⁰ "Default" is defined as "the failure to fulfill a contractual obligation, monetary or conditional." *Id.* at § 15.60.020. A default can be grounded on a borrower's failure to make loan payments (whether such payments are to consist of interest only, principal and interest, or principal, interest, taxes, and insurance) or a failure to satisfy any other contractual obligation imposed on the borrower by the underlying loan documents. Other contractual obligations in the typical deed of trust and promissory note generally obligate the borrower to maintain and keep the collateral property secure, not to abandon the property, and not to commit waste. Thus, the CVAPO encompasses any of these defaults, and does not distinguish between material and immaterial breaches that could be the basis for a default.

of a notice of default, a lender⁷¹ must “inspect”⁷² the “property.”⁷³ If the property is “vacant”⁷⁴ or shows “evidence of vacancy,”⁷⁵ it is “deemed abandoned” and the lender must register the property with the city’s director of development services department⁷⁶ and pay an “initial registration fee” within 10 days of the inspection.⁷⁷ Alternatively, the registration may

⁷¹ The provision actually states the inspection is to be conducted by “[a]ny responsible party/beneficiary or their designee.” *Id.* § 15.60.040. Section 15.60.020 defines “[r]esponsible party” as “the beneficiary that is pursuing foreclosure of a property subject to this chapter secured by a mortgage, deed of trust or similar instrument or a property that has been acquired by the beneficial interest at trustee’s sale.” *Id.* § 15.60.020. This paper shall use the term lender, throughout the CVAPO, to include the beneficiary/trustee of a deed of trust (whether corporation or individual), the assignee of the beneficiary/trustee (whether corporation or individual), and the beneficiary of a deed of trust that is the grantee of a trustee’s deed or a deed in lieu of foreclosure. *See id.* § 15.60.110 (declaring that “any person, firm and/or corporation” in violation of the CVAPO is subject to strict liability). Since recent California case law has upheld lenders’ use of Mortgage Electronic Registration Systems, Inc., (“MERS”) in deeds of trust, this article will use the term lender to include both the actual entity that originated the loan and the entity that fits the “responsible party” definition in the CVAPO, which may include MERS. *See, e.g.,* *Siliga v. Mortg. Elec. Registration Sys., Inc.*, 219 Cal. App. 4th 75, 83–84, (2013).

⁷² CHULA VISTA, CAL., MUN. CODE § 15.60.040 (2013); *see also id.* § 15.60.060 (“If the responsible party/beneficiary [i.e., lender] does not have a property preservation or real estate owned section/department, a field service provider or property manager shall be contracted to perform the inspection . . .”).

⁷³ *Id.* (setting out the registration and recording requirement). “Property” is defined as “any unimproved or improved real property, or portion thereof, situated in the city and includes the buildings or structures located on the property regardless of condition.” *Id.* at § 15.60.020. The CVAPO also includes a separate, narrower definition of “[r]esidential [property],” which is “any property . . . designed or permitted to be used for dwelling purposes . . .” *Id.* By implication, property includes all parcels whether zoned for residential, commercial, or industrial use. Interestingly, the city expressed a concern only for residential properties at the time of enactment. *See id.* § 15.60.010.

⁷⁴ “Vacant” is defined as “a building/structure that is not legally occupied.” *Id.* § 15.60.020. Neither “legally occupied” nor “occupied” are defined in the CVAPO.

⁷⁵ “Evidence of vacancy” is defined as “any condition visible from the exterior that on its own or combined with other conditions present would lead a reasonable person to believe the property is vacant. Such conditions include, but are not limited to, overgrown and/or dead vegetation; accumulation of newspapers, circulars, flyers and/or mail; past due utility notices and/or disconnected utilities; accumulation of trash, junk and/or debris; the absence of window coverings such as curtains, blinds and/or shutters; the absence of furnishings and/or personal items consistent with residential habitation; and statements by neighbors, passersby, delivery agents, or government employees that the property is vacant.” *Id.* Reference to “any condition” is ambiguous and subject to interpretations not contemplated by the city. For example, the city would likely apply the definition broadly, where even a borrower’s long vacation or extended travel for work could lead to the minimal conditions that suggest “vacancy” or “evidence of vacancy.” Under this scenario, the uncertainty of the meaning is not lessened by the definition’s express inclusion of examples such as “overgrown and/or dead vegetation,” etc. *Id.*

⁷⁶ *Id.* § 15.60.040.

⁷⁷ *See id.* §§ 15.60.040, .080. The amended CVAPO does not state the fee must be paid on an annual basis, as did the original CVAPO. *See id.*; *see also* CHULA VISTA, CAL., ORD. 3080 § 1 (2010), available at <http://lfweblink.chulavistaca.gov:27630/weblink8/0/doc/76878/Page1.aspx>.

be achieved by registration with a city-approved national database.⁷⁸ The lender's registration is valid for as long as the property is subject to the CVAPO, that is, while the "property remains abandoned."⁷⁹ After a property is the subject of a notice of default, "deemed abandoned," and registered with the city, the lender must maintain and keep secure the property.⁸⁰ These mandated duties also apply to completed foreclosures where title has transferred to the beneficiary of the deed of trust.⁸¹

On the other hand, if the initial inspection reveals that the borrower is in default and *occupies* the property, inspections are to continue on a monthly basis until the trustee (or other party) cures the default or the property is "deemed abandoned,"⁸² at which point property maintenance by the lender begins. The inspections are to continue as long as the "property remains abandoned."⁸³ This aspect of the CVAPO contemplates a series of inspections, and requires the lender or its agent "within 10 days of *that* inspection, [to] register the property as described above."⁸⁴

Fort Lauderdale, Florida, is an example of another jurisdiction that was hit hard by foreclosures. It enacted a similar abandoned property registration ordinance,⁸⁵ but unlike the CVAPO it imposes on the lender the inspection obligation upon default by the borrower *before* a notice of default has been issued.⁸⁶ Also distinct from the CVAPO, Fort Lauderdale imposes joint and several liability on the property owner and the lender.⁸⁷

Las Vegas, Nevada, has a similar regulatory scheme,⁸⁸ with the exception that the obligations under the ordinance are waived if the lender can demonstrate that the loan documents prohibit the lender from entering the collateral property *and* there is a "reasonable possibility" the borrower will

⁷⁸ CHULA VISTA, CAL., MUN. CODE § 15.60.040 (2013). The Chula Vista City Manager has approved the use of the Mortgage Electronic Registration Systems, Inc., registration system, along with the city's system. See Benton C. Martin, *Vacant Property Registration Ordinances*, 39 REAL EST. L.J. 6, 33 (2010).

⁷⁹ See CHULA VISTA, CAL., MUN. CODE § 15.60.040 (2013).

⁸⁰ *Id.* §§ 15.60.040–.060.

⁸¹ *Id.* § 15.60.040. When the lender obtains title at the foreclosure sale, there is every reason to expect the lender, as the fee simple absolute owner, to maintain the property and keep it secure.

⁸² *Id.*

⁸³ After the "property is deemed abandoned," the § 15.60.040 inspections stop, but the § 15.60.060 security inspections begin. See *id.* § 15.60.040, .060.

⁸⁴ *Id.* § 15.60.040 (emphasis added). Perhaps not as clear as it could be, this provision most likely refers to the specific inspection when the abandonment is discovered as the trigger that requires the start of maintenance. See *id.*

⁸⁵ FT. LAUDERDALE, FLA., MUN. CODE §§ 18-12.1 to 12.5 (2013), available at <http://library.municode.com/index.aspx?clientId=10787>.

⁸⁶ *Id.* § 18-12.1(a). To mandate lender inspections before a notice of default is recorded raises a number of issues that this article will not address.

⁸⁷ *Id.* § 18-12.5.

⁸⁸ LAS VEGAS, NEV., MUN. CODE §§ 16.33.010–.090 (2013), available at <http://library.municode.com/index.aspx?clientId=14787&stateId=28&stateName=Nevada>.

report the lender's entry as a trespass or will assert that the lender's entry is a breach of the loan documents or an illegal or unauthorized entry.⁸⁹ Also, this regulation declares that the regulation itself does not create a duty or obligation to anyone other than the city; does not create or imply a cause of action in favor of anyone other than the city; and that the acts of the lender do not create a duty or obligation to or a cause of action in favor of anyone other than the city.⁹⁰

These two cities' ordinances illustrate how the CVAPO does not account for situations in which the borrower may still assert rights against a lender because he is still the fee owner of the property, and further how it does not include a joint and several liability provision to reinforce the borrower's contractual commitments.

2. Maintenance and Security

A CVAPO inspection is intended to determine if the property is vacant⁹¹ or if there is evidence of vacancy.⁹² In the event either circumstance is found, the CVAPO declares the property is "deemed abandoned."⁹³ Upon discovery of an abandoned property, the CVAPO rewrites the property maintenance obligations in the deed of trust so that the borrower's maintenance obligations become the lender's obligations. The lender must undertake the duty to maintain and keep secure the property,⁹⁴ although no statement in the CVAPO expressly states the lender must complete these duties.⁹⁵ Maintenance and security measures are to be done according to the stated standards for maintenance and security⁹⁶ and the definition of "neighborhood standard."⁹⁷ Pursuant to § 15.60.070, the director of development services has the authority "to implement additional maintenance

⁸⁹ *Id.* § 16.33.070.

⁹⁰ *Id.* § 16.33.090.

⁹¹ CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013). The CVAPO defines "[v]acant" as "not legally occupied," but does not define this phrase. See *infra* Part III.C for the discussion of this term as used in the CVAPO.

⁹² *Id.* § 15.60.020 ("Evidence of vacancy" means any condition visible from the exterior that on its own or combined with other conditions present would lead a reasonable person to believe that the property is vacant.") See *supra* note 75 for the entire definition.

⁹³ *Id.* § 15.60.040, .020.

⁹⁴ *Id.* § 15.60.040 ¶ 9.

⁹⁵ See *generally id.* § 15.60 (describing the full breadth of the Abandoned Residential Property Registration section, in which specific duties to maintain and keep property are absent).

⁹⁶ *Id.* §§ 15.60.050, .060, .070.

⁹⁷ CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013) ("Neighborhood standard" means those conditions that are present on a simple majority of properties within a 300-foot radius of the subject property.').

and/or security measures.”⁹⁸ Maintenance and security obligations remain in place for as long as the property is abandoned.⁹⁹

3. Penalties

The city is authorized to enforce the requirements of the CVAPO and exact any remedy provided in its Municipal Code against a lender that fails to inspect, register, pay a registration fee, maintain, repair, keep secure, or hire a local property manager.¹⁰⁰ A lender can also be liable for the failure to complete additional measures required by the director of development services.¹⁰¹ According to § 15.60.110, a violation of the CVAPO “shall be treated as a strict liability offense regardless of intent.” The available remedies include fines of \$1,000 per violation per day, assessments, and even possible imprisonment for up to six months upon conviction for a misdemeanor.¹⁰² As of May 2008, the city chose to impose fines against non-compliant lenders.¹⁰³

4. Purpose and Means

While many of the regulations discussed in Part II had to do with government policy to increase home ownership for high-risk, unqualified borrowers, the CVAPO is a regulation that attempts to deal with the consequences of that policy. The least told part of the financial crisis story concerns the pressure imposed on lenders by the federal government and community organizations. The pressure, coupled with the lenders’ objective to earn profits, led to funded and securitized subprime mortgages in unprecedented numbers. Loans for home ownership by low- and moderate-income families and minorities increased because lenders ignored traditional underwriting standards and, to a certain extent, utilized exotic loan products to accomplish the goal. The expectations of an increase in home ownership were high and were being realized, but it was foreseeable that borrowers would default and lenders would foreclose.

⁹⁸ *Id.* § 15.060.070 (additional measures “include but not limited to securing any/all doors, windows or other openings, installing additional security lighting, increasing on-site inspection frequency, employment of an on-site security guard or other measures as may be reasonably required to arrest the decline of the property”).

⁹⁹ *Id.* § 15.60.040 ¶ 9.

¹⁰⁰ *Id.* § 15.60.090.

¹⁰¹ *Id.* § 15.060.070.

¹⁰² CHULA VISTA, CAL., MUN. CODE §§ 1.20.010, 1.30.180, 1.41.010–.180 (2013).

¹⁰³ Testimony of D. Leeper, *supra* note 15, at 98.

Chula Vista anticipated problems and in 2007 enacted the CVAPO. The city council expressly declared that the purpose of its regulatory scheme was to avoid blight.¹⁰⁴

It is the purpose and intent of the Chula Vista City Council, through the adoption of this chapter, to establish an abandoned residential property registration program as a mechanism to protect residential neighborhoods from becoming blighted through the lack of adequate maintenance and security of abandoned properties.¹⁰⁵

To achieve its purpose, the CVAPO “compels”¹⁰⁶ the lender to assume the borrower’s contractual obligation to maintain and secure the property.¹⁰⁷ The CVAPO completely eviscerates a provision in the standard deed of trust that grants the lender the contractual right to exercise its own discretion as to when to advance funds to secure and maintain the collateral property¹⁰⁸ by forcing the lender to undertake the borrower’s maintenance obligations without regard to the lender’s pre-loan-closing risk and cost analysis. This renders the deed of trust provision meaningless or, more accurately, the CVAPO rewrites this provision so that it reads the exact opposite of

¹⁰⁴ CHULA VISTA, CAL., MUN. CODE § 15.60.010 (2013).

¹⁰⁵ *Id.* (emphasis added).

¹⁰⁶ Testimony of D. Leeper, *supra* note 15, at 101.

¹⁰⁷ The typical deed of trust provision states in part,

7. Preservation, Maintenance and Protection of the Property; Inspections. *Borrower* shall not destroy, damage or impair the Property, allow the Property to deteriorate or commit waste on the Property. Whether or not *Borrower* is residing in the Property, *Borrower* shall maintain the Property in order to prevent the Property from deteriorating or decreasing in value due to its condition.

California-Single Family-Fannie Mae/Freddie Mae Uniform Instrument, Form 3005 01/01 § 7 (italics added).

¹⁰⁸ The relevant portion of the typical deed of trust provision reads in part,

7. . . . Lender or its agent *may* make reasonable entries upon and inspections of the Property. If it has reasonable cause, Lender *may* inspect the interior of the improvements on the Property. Lender shall give Borrower notice at the time of or prior to such an interior inspection specifying reasonable cause.

9. If (a) Borrower fails to perform the covenants and agreements contained in this Security Instrument, (b) there is a legal proceeding that might significantly affect Lender’s interest in the Property and/or rights under this Security Instrument (such as a proceeding in bankruptcy, probate, for condemnation or forfeiture, for enforcement of a lien which may attain priority over this Security Instrument or to enforce laws or regulations), or (c) Borrower has abandoned the Property, then Lender *may* do and pay for whatever is reasonable or appropriate to protect Lender’s interest in the Property and rights under this Security Instrument, including protecting and/or assessing the value of the Property, and securing and/or repairing the Property. . . . Securing the Property includes, but is not limited to, entering the Property to make repairs, change locks, replace or board up doors and windows, drain water from pipes, eliminate building or other code violations or dangerous conditions, and have utilities turned on or off. *Although Lender may take action under this Section 9, Lender does not have to do so and is not under any duty or obligation to do so. It is agreed that Lender incurs no liability for not taking any or all actions authorized under this Section 9.*

California-Single Family-Fannie Mae/Freddie Mae Uniform Instrument, Form 3005 01/01 §§ 7, 9 (emphasis added).

what the parties intended—the lender will now be responsible for what the borrower had agreed to do.

The following part of this article examines the question of whether the CVAPO is constitutionally valid as an application of police power. Is a local ordinance that impairs a contract under the justification of public health and safety valid when there is no data to establish that blight actually exists? Is a local ordinance that impairs a contract for the sake of public health and safety arbitrary and unreasonable when local government already has other alternatives, including a range of land use regulations applicable to the borrower to clean and repair property that is in poor condition?¹⁰⁹ An analysis of the issue of validity requires the classification of the CVAPO as a land use regulation concerned with blight or as a public nuisance ordinance primarily concerned with untidy and unsightly properties—because courts review these two types of regulations differently.¹¹⁰ Under this latter classification, it is important as well to evaluate whether the CVAPO is arbitrary and whether it is unconstitutionally vague.

B. *The Classification of the CVAPO and Its Validity*

The CVAPO could be classified as a regulation that seeks the prevention of blight because the CVAPO itself and city staff statements given to the city council repeatedly refer to concerns about blight. Typically, blight is spoken of in the context of a neighborhood that requires *extensive* clean up, so much so that the local government uses a redevelopment project to rehabilitate the neighborhood. Yet, the CVAPO does not involve a redevelopment plan and the testimony and information provided by city staff does not mention a redevelopment plan. From another perspective, the CVAPO appears to be tantamount to a public nuisance ordinance in that it emphasizes the elimination of property conditions and appearances that negatively affect the safety and values of the property and the neighborhood. Despite the stated purpose of blight prevention, the emphasis upon the condition of the property and the neighborhood indicates that the CVAPO is best classified as a general land use regulation that deals with public nuisances. Given these two possible classifications, the CVAPO will be examined under the standards for a regulatory scheme that deals with blight and the standards for a general land use regulation involving public nuisances.

¹⁰⁹ See *infra* note 153 and accompanying text.

¹¹⁰ This is the case at least in California, where statutes and case law treat these two types of regulations differently. Compare *supra* sources cited and text accompanying note 104 with *infra* sources cited and text accompanying note 112.

1. General Validity of Land Use Regulation

In general, land use regulations are constitutionally permissible under government's implied police power. The U.S. Supreme Court has declared that such power is understood to enable local government to protect the public health, safety, morals, and welfare.¹¹¹ The regulation must be substantially related to a legitimate government objective and cannot be arbitrary, capricious, or unreasonable.¹¹²

2. The Validity of the CVAPO as a Regulation to Eliminate Blight

California courts have upheld regulations with an objective to eliminate blight as a legitimate exercise of a government's police power.¹¹³ Such regulations must relate to and adopt a particular redevelopment plan as the means to eliminate blight in the area the project covers.¹¹⁴

For purposes of a municipality's redevelopment project, the California legislature defines a blighted area as one that consists of both a "predominantly urbanized" area and an area with a

combination of [physical and economic] conditions set forth in [California Health & Safety Code] Section 33031 [that] is so prevalent and so substantial that it causes a reduction of, or lack of, proper utilization of the area to such an extent that it constitutes a serious physical and economic burden on the community that cannot reasonably be expected to be reversed or alleviated by private enterprise or governmental action, or both, without redevelopment.¹¹⁵

¹¹¹ *Berman v. Parker*, 348 U.S. 26, 28–29 (1954); *Vill. of Euclid v. Ambler Realty Co.*, 272 U.S. 365, 392 (1926); *Mugler v. Kansas*, 123 U.S. 623, 659 (1887).

¹¹² *Nectow v. City of Cambridge*, 277 U.S. 183, 187–88 (1928); *Vill. of Euclid*, 272 U.S. at 395 (1926); *see also* *Kucera v. Lizza*, 59 Cal. App. 4th 1141, 1147 (1997) ("The constitutional measure by which we judge the validity of a land use ordinance assailed as exceeding municipal authority under the police power is whether it has a real or substantial relation to the public health, safety, morals or general welfare. Conversely, it is unconstitutional only if its provisions are clearly arbitrary and unreasonable, having no substantial relation to the public health, safety, morals, or general welfare.").

¹¹³ *E. Bay Mun. Util. Dist. v. Richmond Redevelopment Agency*, 93 Cal. App. 3d 346, 355–56 (1979).

¹¹⁴ *See infra* note 118. The financial crisis in California brought about a 2012 change in California law that eliminated local governments' redevelopment agencies and redirected funds held by such agencies to the state. This dramatic shift with the new legislation was motivated by the state's need to make up a substantial budget deficit and primarily dealt with the financing of redevelopment. *See* T. Brent Hawkins, *The Rise and Fall of Redevelopment in California*, 30 CAL. REAL PROP. J. 4, 4–8 (2012). Though it may be unclear how local government will finance local redevelopment in the future, the courts most likely will continue to rely on the underlying policies of accountability and limits on police power to require local government to justify a redevelopment plan with substantial evidence that there is in fact a blight problem.

¹¹⁵ CAL. HEALTH & SAFETY CODE § 33030(b)(1) (West 2011).

Briefly put, blight involves physical and economic *conditions*¹¹⁶ that are so prevalent and substantial that “a serious physical and economic *burden* on the community”¹¹⁷ is created.

When a redevelopment plan is under consideration to solve a blight problem, there must be a finding that “a project area is blighted in order to establish a redevelopment plan.”¹¹⁸ “[F]indings of blight must be supported by substantial evidence in the administrative record.”¹¹⁹ When the record lacks findings of blight, the ordinance that adopts a redevelopment plan will be invalidated.¹²⁰ This threshold requirement ensures that a local governmental ordinance that adopts the redevelopment plan to eliminate blight satisfies the state statute and passes constitutional muster in that the underlying data the local government relies upon establishes that the regulation is a “legitimate governmental function.”¹²¹

Accordingly, a vacant property registration ordinance enacted to prevent blight that might result from a high number of foreclosures must be based on substantial empirical data that establishes the existence of blight before such an ordinance can be valid. Since the ultimate objective of the CVAPO is to prevent blight, and by its ordinance the city employs an expansive reach of its police power, the CVAPO must also be held accountable to the threshold requirement of a finding of blight grounded on substantial empirical data.

The Chula Vista legislative body appears to have failed to provide substantial evidence of actual blight. The Recitals of the CVAPO and comments provided by city staff to the city council attempt to connect incidents of “risky financing arrangements” and an increase in foreclosures with the threat of blight in the city.¹²² However, the public records related to the public hearing for the CVAPO do not set forth the data that established that blight was a problem at the time of the passage of the CVAPO.¹²³ At the most, city personnel’s statements and information should be inter-

¹¹⁶ *Id.* §§ 33030 (b)(2), 33031 (a)–(b).

¹¹⁷ *Id.* § 33030 (b)(1) (emphasis added).

¹¹⁸ *County of Los Angeles v. Glendora Redevelopment Project*, 185 Cal. App. 4th 817, 832, 111 Cal. Rptr. 3d 104, 116–117 (2010) (explaining the criteria that must be found for there to be a finding of blight); *Boelts v. City of Lake Forest*, 127 Cal. App. 4th 116, 120, 136–37, 25 Cal. Rptr. 3d 164, 165–66, 178–80 (2005) (holding the city’s assertions were conclusory and failed to meet the definition of blight; city unsuccessfully argued there was blight because, among other reasons, a shopping center had antiquated design, twenty-three commercial vacancies, and signs of deterioration and deferred maintenance; the court pointed out that the city failed to show a connection between the project and health and safety problems, structural defects, or depreciation of property values); *Friends of Mammoth v. Town of Mammoth Lakes Redevelopment Agency*, 82 Cal. App. 4th 511, 560 (2000) (insufficient evidence to support the project even though 29% of buildings affected by deterioration and dilapidation).

¹¹⁹ *Beach-Courchesne v. City of Diamond Bar*, 80 Cal. App. 4th 388, 400 (2000).

¹²⁰ *Id.* at 391.

¹²¹ *E. Bay Mun. Util. Dist. v. Richmond Redevelopment Agency*, 93 Cal. App. 3d 346, 356 (1979).

¹²² *See infra* text accompanying notes 124–30.

¹²³ *Id.*

preted to mean that the volume of foreclosures *could* lead to blight. Thus, it is fair to ask whether Chula Vista was suffering “a serious physical and economic burden” as a result of “physical and economic conditions” before the ordinance was enacted in 2007. Without the data, it appears that the city council did not make a reasonably based finding of blight at the time of enactment.

The Recitals of Chula Vista Ordinance No. 3080 delineate in general terms the underlying concerns of the councilmembers. These concerns included: neighborhood decline, attractive public nuisance, lower property values, and reluctant purchasers, all of which were alleged to be the result of abandoned residences.¹²⁴ At a city council meeting, city building officials and the Code Enforcement Manager emphasized defaults and foreclosures that led to bank-owned homes, a lack of maintenance, and a difficulty in identifying such homes.¹²⁵ Such concerns led the director of planning and building to recommend to the city council that it adopt an “Abandoned Residential Property Registration Program as a means of ensuring that residential neighborhoods are *spared* the negative impacts associated with abandoned residential properties.”¹²⁶ The “Discussion” portion of the recommendation points to events that occurred in Chula Vista that must have reinforced the focus on lenders and trustees, but does not provide supportive data. According to the Planning and Building Department, new homes constructed during 2001 to 2005 were purchased with “risky financing arrangements offered by lenders specializing in sub-prime loans.”¹²⁷ In the effort to control the perceived future threat, the city council was convinced that lenders, not borrowers, should register and maintain the vulnerable properties, and voted on August 7, 2007, to enact Ordinance No. 3080, the CVAPO.¹²⁸

Significantly, the CVAPO Recitals do not cite or reference, and it appears that the council did not review, adopt, or incorporate, economic or

¹²⁴ CHULA VISTA, CAL., ORD. 3080 § 1 (2007).

¹²⁵ See generally BD. OF APPEALS AND ADVISORS OF CHULA VISTA, CAL., MINUTES OF A REGULAR MEETING (June 11, 2007); see also note 140 (regarding the number of bank-owned homes during the years 2006 to 2008).

¹²⁶ CITY OF CHULA VISTA, CITY COUNCIL AGENDA STATEMENT 15-1 (July 17, 2007) (emphasis added). The phrase suggests the negative impacts had not yet occurred.

¹²⁷ *Id.* at 15-2. As discussed in Part II of this article, lenders created “risky financing arrangements” to satisfy the pressure to meet quotas of loans for low-income and minority borrowers imposed by the federal government, the Federal Reserve Bank, Fannie Mae, and community organizations. MORGENSON & ROSNER, *supra* note 2, at 115–17; SOWELL, *supra* note 1, at 42–44; see also, Zywicki & Adamson, *supra* note 39, at 12, 25 (“But subprime lending has placed many people on the road to homeownership, and only a minority of subprime loans could be considered ‘predatory’ But foreclosure and delinquency do not necessarily indicate the presence of unaffordable loans, predatory loans, rising interest rates, or borrowers under duress.”).

¹²⁸ See CHULA VISTA, CAL., ORD. 3080 § 1 (2007). The CVAPO went into effect sixty days later and was amended in 2010.

crime data to support their concerns about blight. In addition, the Recitals, meeting minutes, and the city council agenda statement do not supply empirical data to support the findings and conclusions made by the city councilmembers. Without data, the councilmembers' conclusions were based primarily on general observations.¹²⁹ The testimony of city staff connected "risky financing arrangements" and foreclosures with the *potential* for blight in general terms, which is an insufficient basis for an ordinance that seeks to prevent blight.¹³⁰

When faced with a high volume of foreclosures that might lead to blight, a city ordinance ought to adhere to the same standard as an ordinance that adopts a redevelopment plan to eradicate blight because it is imperative that local governing bodies not enact legislation based on speculation. This speculative regulation significantly impacts contractual obligations and private property interests, just as condemnation impacts the landowners of the area targeted for redevelopment. When local authorities act on speculation, a community is worse off because such decision making ultimately diminishes the importance of legitimate private agreements and private property interests. The scrutiny of such speculative regulation is justifiably heightened so that the local governing body must first make the factual finding. Reliance upon speculation turns the regulation into an illegitimate governmental function.

If blight conditions did exist, they were not as severe as that spoken of in the state statute.¹³¹ There may have been particular lots and parcels that were in decline, but the 2008 written testimony of Doug Leeper, Code Enforcement Manager for City of Chula Vista, before a Congressional Subcommittee estimated that about 2100 homes were vacant in May 2008¹³² in the second largest municipality in San Diego County with a current population of nearly 250,000¹³³ and a population of 173,556 in 2000.¹³⁴ Other than

¹²⁹ See *infra* notes 132, 135–37. It is one thing if the City Council were to rely on a comprehensive study of the existence and consequences of "risky financing arrangements" that actually led to foreclosures and blight, but it is altogether different to rely solely upon observations made by city code enforcement officers who make their rounds but do not inquire into the details of the homeowners' purchase financing.

¹³⁰ *Beach-Courchesne v. City of Diamond Bar*, 80 Cal. App. 4th 388, 398–400 (2000); see also Zywicki & Adamson, *supra* note 39, at 12–35.

¹³¹ See *supra* notes 115–17 and accompanying text.

[T]rue blight is expressed by the kind of dire inner-city slum conditions described in the *Bunker Hill* case: unacceptable living conditions of 82 percent; unacceptable building conditions of 76 percent; crime rate of double the city's average; arrest rate of eight times the city's average; fire rate of nine times the city's average; and the cost of city services more than seven times the cost of tax revenues.

Beach-Courchesne, 80 Cal. App. 4th at 407 n.11 (emphasis in original).

¹³² Testimony of D. Leeper, *supra* note 15, at 104.

¹³³ See ABOUT THE CITY OF CHULA VISTA, CITY OF CHULA VISTA, <http://www.chulavistaca.gov/About/> (last visited Sept. 14, 2013).

¹³⁴ POPULATION CHANGE 1990–2000 INCORPORATED CITIES BY COUNTY, CAL. DEP'T OF FIN. DEMOGRAPHIC RESEARCH UNIT, *available at*

one specific instance,¹³⁵ Mr. Leeper spoke about blight only in general terms¹³⁶ and he acknowledged an improvement in the negative impacts.¹³⁷ Newspaper accounts during the relevant time period do not indicate there being widespread decline or that blight actually existed.¹³⁸

If blight did not exist in the municipality, it is an illegitimate use of police power to enact regulation that interferes with private property rights such as security lien interests. Under the appearance of preventing blight, the CVAPO forces private parties to undertake certain action contrary to private agreements in a way the parties would not otherwise consider.¹³⁹ Such a regulation would prematurely alter property interests today in the hope that blight does not occur in the future. If preemptive regulation that seeks to prevent blight before it starts were permitted, then constitutional validity is reduced to any language that merely provides a tenuous relationship between the controlling mandate and any problem that could possibly occur. Local government would not need to carry the burden of compiling and presenting the empirical data to support new regulations. Such a standard expands police power at the expense of the landowner's or lender's legitimate private property rights. The nature of government officials is to expand their power and control in order to lower the standard, justifying even earlier and more premature governmental intervention in other private contractual relationships to achieve other desired goals. But history proves such goals usually conflict with private property rights.

The city would undoubtedly contend that its police power permits it to prevent blight before it is created. In other words, the CVAPO is justifiable because it either prohibits conduct that could lead to blight or mandates conduct to prevent blight. But such an argument assumes that blight necessarily follows from "risky financial arrangements" and foreclosures. Foreclosures did increase in the lead up to the passage of the CVAPO in 2007 and over the next year,¹⁴⁰ but did blight actually occur? Property values did

http://www.dof.ca.gov/research/demographic/state_census_data_center/products-services/documents/table1.xls.

¹³⁵ Testimony of D. Leeper, *supra* note 15, at 97.

¹³⁶ *Id.* at 100, 102–03. Mr. Leeper did not cite any studies or statistics compiled by his department (other than those mentioned in his testimony and *supra* text accompanying note 132) or the local police department.

¹³⁷ *Id.* at 105.

¹³⁸ See Emmet Pierce, *Blight-prevention law emerges as a national model; Chula Vista forces lenders to maintain foreclosures*, SAN DIEGO UNION-TRIB. (Oct. 12, 2008), <http://legacy.utsandiego.com/news/metro/20081012-9999-1n12blight.html> (the article makes no reference to actual blight, but does refer to the ordinance as "blight-prevention"); see also Lori Weisberg, *Homeowners associations countywide are hit by foreclosure fallout and feeling the pinch of . . . Unpaid dues*, SAN DIEGO UNION-TRIB. (Nov. 1, 2007), http://www.utsandiego.com/uniontrib/20071101/news_1n1dues.html.

¹³⁹ See *infra* discussion at notes 172–73.

¹⁴⁰ RealtyTrac is an entity that compiles data regarding the number of notices of default, notices of trustee sale, and lenders' "real estate owned" (REO) properties. REALTYTRAC, INC., FORECLOSURE

decrease,¹⁴¹ but were the physical and economic conditions “so prevalent and so substantial” that “a serious physical and economic burden on the community” was created?¹⁴² No, the city would likely respond, because the enactment and enforcement of the CVAPO prevented such consequences. But this begs the question whether such preemptive measures by local government are permissible in the first place.¹⁴³ Without the empirical data, we do not know if blight existed at the time the CVAPO was enacted. “[F]indings of blight must be supported by substantial evidence in the administrative record,”¹⁴⁴ otherwise the enactment is not a legitimate governmental function.¹⁴⁵ In this instance, the record is inadequate.

Consequently, the CVAPO does not satisfy the requirement that it be based on a finding that statutory blight exists within the city. Thus, if the CVAPO were classified as one that concerns blight, it would be invalidated if challenged on this ground. Moreover, the rule of law is undermined because the local government has expanded its police power to control private contracts and interfere with property rights without the justification of findings based on substantial empirical data that blight actually exists.

3. The Validity of the CVAPO as a Public Nuisance Regulation

The CVAPO can be classified as a public nuisance regulation because of its emphasis on the eradication of nuisances that negatively impact the property and its value, as well as that of the surrounding neighborhood. As a charter city, Chula Vista has some latitude in promulgating regulations so long as the regulations reasonably relate to a legitimate objective that protects the public health, safety, morals, and welfare within its jurisdiction.¹⁴⁶ In the context of nuisances, a court will determine whether the regulation is

ACTIVITY REPORT FOR SAN DIEGO COUNTY 2005 (2ND QTR.)–2009 (1ST QTR.) (electronic spreadsheet compiled by RealtyTrac and licensed to author in August 2012) (on file with author). For 2006, its data states there were 1262 notices of default in the City of Chula Vista and of those, 33 (or 2.6%) became REO properties. *Id.* At the end of 2007—after the CVAPO was enacted in July 2007—there were 3,704 notices of default, of which 599 (or 16%) became REO properties. *Id.* In 2008, there were 4,381 notices of default and 2,598 (or 59.3%) became REO properties. *Id.*

¹⁴¹ SOWELL, *supra* note 1, at 58–60.

¹⁴² CAL. HEALTH & SAFETY CODE § 33030(b)(1) (West 2011).

¹⁴³ Such an argument is analogous to the contention that government costs have been reduced because there are no more auto accidents after government regulation made private ownership of autos illegal and confiscated all autos. It is still necessary to ask if such a regulation is constitutional. The means by which government seeks to achieve its intended objective is not justified merely by the achievement itself.

¹⁴⁴ *Beach–Courchesne v. City of Diamond Bar*, 80 Cal. App. 4th 388, 400 (2000).

¹⁴⁵ *E. E. Bay Mun. Util. Dist. v. Richmond Redevelopment Agency*, 93 Cal. App. 3d 346, 356 (1979).

¹⁴⁶ *Graham v. Kingwell*, 218 Cal. 658, 659 (1933); *Thain v. City of Palo Alto*, 207 Cal. App. 2d 173, 186 (1962).

an appropriate expression of a local government's police power as it asks "(1) whether the object of the ordinance is one for which the police power may be properly invoked and, if so, (2) whether the ordinance bears a reasonable and substantial relation to the object sought to be attained."¹⁴⁷ The courts recognize a presumption in favor of an ordinance's validity "if any rational ground exists for its enactment."¹⁴⁸ However, an ordinance will be held invalid if it is "palpably unreasonable, arbitrary or capricious, having no tendency to promote the public welfare, safety, morals, or general welfare."¹⁴⁹ When the findings of a local legislative body are fairly debatable, courts will not attack the findings and the ordinance will be upheld.¹⁵⁰ However, where "the physical facts show that there has been an unreasonable, oppressive, or unwarranted interference with property rights in the exercise of the police power," the courts will set aside a legislative body's decisions "as to matters of opinion and policy."¹⁵¹

a. A Public Nuisance Hybrid Regulation

An ordinance that prohibits, among other things, the accumulation of weeds, debris, and trash to protect public health and safety is considered within a city's police power.¹⁵² In *Thain*, a public nuisance ordinance was enacted to prevent the accumulation of weeds, debris, and trash on property within the city.¹⁵³ The ordinance also authorized the local authority to pursue summary abatement.¹⁵⁴ Since it is accepted in the law that a city "may enact ordinances the object of which is to abate or prevent nuisances," the court held the ordinance bore a reasonable and substantial relation to the object of protecting the public health and safety.¹⁵⁵ The court reasoned that since the accumulation of weeds, debris, and trash were readily considered a nuisance and that the ordinance sought to enable the local authority to remove or destroy the nuisance and charge the property owner when he failed to do it himself, the ordinance was a proper exercise of the municipality's police power.¹⁵⁶

¹⁴⁷ *Thain*, 207 Cal. App. 2d at 186 (citations omitted).

¹⁴⁸ *Id.* at 186 (citation omitted).

¹⁴⁹ *Id.* at 187.

¹⁵⁰ *Wilkins v. City of San Bernardino*, 29 Cal. 2d 332, 339 (1946) (citing *Zahn v. Bd. of Public Works*, 274 U.S. 325, 328 (1927)); *Skyline Materials, Inc. v. City of Belmont*, 198 Cal. App. 2d 449, 455–56 (1961).

¹⁵¹ *Skyline Materials, Inc.*, 198 Cal. App. 2d at 455 (citing *Lockard v. City of Los Angeles*, 33 Cal. 2d 453, 461 (1949)).

¹⁵² *Thain*, 207 Cal. App. 2d at 187.

¹⁵³ *Id.* at 177–78.

¹⁵⁴ *Id.* at 186.

¹⁵⁵ *Id.* at 187–88.

¹⁵⁶ *Id.*

The CVAPO is similar to the ordinance in *Thain* in that it requires the lender to remove weeds, debris, and trash as part of maintaining the property according to the neighborhood standard.¹⁵⁷ In addition, the CVAPO authorizes the city to abate nuisances and to charge the property owner,¹⁵⁸ as in *Thain*, but the city apparently has made no such effort. In these respects the CVAPO, being similar to the ordinance in *Thain*, would be upheld as an appropriate exercise of the police power because the regulation has a rational relation to the objective of protecting the public health and safety. But, as a hybrid regulation, the CVAPO does more.

b. A Public Nuisance Hybrid Regulation That Rewrites a Contract

The CVAPO rewrites a contract, which the ordinance in *Thain* does not. In contrast, the CVAPO, without sufficient warrant, unnecessarily shifts the duty of maintenance to lenders, while the ordinance in *Thain*, as with public nuisance ordinances in Chula Vista,¹⁵⁹ requires the property owner–borrower to clean up the weeds and maintain the property. This significant difference between the two types of ordinances requires an evaluation as to whether the CVAPO is arbitrary, capricious and unreasonable.

The city council arbitrarily chose lenders over borrowers as the party to maintain the property. The council considered the lenders' lien interest in the vacant property and the desire to protect that interest, but ignored the borrowers' superior fee interest in the property and the legal obligations imposed on them as owners. The legal obligations of the fee owner enable local government officials to wield their authority against the party who created the vacancy and threat of blight. To ignore the borrower is, in effect, to release him and to substitute the lender—though there has not been an adjudication of the lender's culpability in the loan transaction or some other factual finding that supports the borrower's release.

To shackle lenders with the mandate sidesteps the basic purpose of public nuisance regulation, which is to hold property owners accountable for the use (or rather in this case, nonuse) of their land. A local government's police power has been traditionally exercised to curb offensive uses by owners and tenants, who, through the dominion and control of the property, have exceeded their property rights to the point that their neighbors' property rights are affected.

¹⁵⁷ See CHULA VISTA, CAL., MUN. CODE §§ 15.60.040, .050, .070 (2013).

¹⁵⁸ To do so, the city must rely on other Chapters within the Municipal Code, which are incorporated by reference in to the CVAPO. See CHULA VISTA, CAL., MUN. CODE § 15.060.090 (2013), which incorporates Chapters 1.20, 1.30 and 1.41 of the Municipal Code.

¹⁵⁹ See CHULA VISTA, CAL., MUN. CODE §§ 1.030.030–.050 (2013) (using definitions and rules of construction from § 1.04.010).

But now, abandoned property ordinances are an expression of police power that is detached from a finding of fault.¹⁶⁰ The CVAPO ignores the question of whether a particular lender (or even a majority of lenders) committed fraud, engaged in sharp lending practices, or used loan documents with inconspicuous disclosures so as to trap borrowers in oppressive loans.¹⁶¹ As such, local government's moral authority to regulate in this manner is put into question. It is unreasonable to exercise core legislative and prosecutorial functions of government on a strict liability basis against a party when the facts that are known establish that another party is at fault. When local government makes such a choice, it presumes upon itself the authority to impose liability without evidence of fault. This necessarily detracts from the maxim that a nation is best governed by a legal regime that honors the rule of law through a careful adjudication of conduct before a penalty is imposed. When local government eschews a critical aspect of the rule of law for a pragmatic economic choice that rewards the party in default and burdens the nonbreaching party, the regulation does not serve the public welfare and public morals. This is the case in particular where mere speculation that severe harm exists is the putative justification.

The city council acted as if the borrower had no legal interest in or care for the property whatsoever. Regardless of what the borrower's attitude might have been, he remained the person immediately connected to the property both in right and duty. In this instance, the regulation hangs in midair without moral authority because its mandate is not based on fault. Lenders did not vacate the property or let it fall into disrepair. In fact, lenders required borrowers to make contractual commitments that seek the same objectives as public nuisance regulations.¹⁶² Local governments that enact vacant property ordinances in essence disregard this private effort to assist the public good and instead punish it. The benefit of private law became dispensable in the mind of the Chula Vista City Council. The fact that a

¹⁶⁰ See CHULA VISTA, CAL., MUN. CODE § 15.60.110 (2013) (a violation of the CVAPO is a strict liability offense). The principle that the law is to be used against those who have violated the law runs to the early Common Law.

[A]ccording to the common law interpretation of Chapter 29 of the Magna Carta, no person shall be deprived of his property or his livelihood, except when it is done in accordance with the law of the land. This protection requires three things: (1) the law which is alleged to have been violated must be existing and otherwise legitimate, (2) the law must be for a public and not private interest, and (3) *a judicial trial conforming to the requirements of due process must be held to determine if wrongdoing has occurred that warrants a deprivation.*

BERNARD H. SIEGAN, PROPERTY RIGHTS: FROM MAGNA CARTA TO THE FOURTEENTH AMENDMENT 16 (Soc. Philosophy & Policy Found. & Transaction Publishers 2001) (italics added).

¹⁶¹ See Testimony of D. Leeper, *supra* note 15. Code Enforcement Manager Doug Leeper claimed that lenders were the problem because of their failure and refusal to maintain the property that secures the loans. Mr. Leeper went on to state that his department faced extremely difficult challenges in efforts to locate the responsible lenders. *Id.* at 97, 100–01. At no point did Mr. Leeper indicate that he or his department pursued legal claims against lenders or make specific judgments about the validity of particular loan documents.

¹⁶² California-Single Family-Fannie Mae/Freddie Mac Uniform Instrument, Form 3005 01/01 § 7.

lender chooses not to enter the property when its borrower has vacated is not the functional or moral equivalent of an adjudication of fault. There may well be sound economic reasons for its choice, but even when it simply prefers for its own reasons (or for no reason) not to enter, its decision cannot be treated as if it were similar to the borrower's decision to abdicate his responsibilities. Nor is it satisfactory to enact such an ordinance based merely on the generalization that the city faces a host of bad lenders and bad loans. If violations of the law exist, the appropriate step is to file a court action instead of relying on speculation and generalizations.

Without proper justification, local government borders on immoral conduct when it relies on raw power to force its will on lenders and the mortgage loan market. In doing so, it has made a choice that is now law with a negative moral consequence—borrowers are effectively released from the loan agreement and the entire public nuisance regulatory scheme.¹⁶³ In fact, borrowers are encouraged to walk away. The city improperly wields its authority by the blunt force of law without the least bit of an effort toward a just determination of liability. Local government makes “winners” of borrowers and losers of lenders. The extent of arbitrariness of the abandoned property ordinances is shown by the fact that the city's pragmatic goal of maintained and secure properties could be achieved by enforcement of extant public nuisance law against the owner-borrower. Having brushed aside its moral authority, local government has no compunction in ignoring borrowers, but it goes further to ignore all other parties that have an interest in the subject property.

The council apparently did not consider whether other people or entities with vested or perfected property rights, who similarly want to protect their interests, would be more effective in the maintenance of the vacant property. A great number of the foreclosures occurred in a part of the city governed by homeowners' associations.¹⁶⁴ Such associations are a possible alternative for maintenance because the associations are mandated by their own recorded covenants to handle all of the maintenance, repairs, and landscaping in the common areas.¹⁶⁵ Also, junior lenders, lien creditors, and easement holders have a stake in the condition and value of the property. Tax agencies with liens certainly do, too. Nevertheless, the city's public record does not reflect the council's evaluation as to whether any of

¹⁶³ See *infra* Part III.B.4.

¹⁶⁴ A significant portion of the new housing construction (where a majority of the foreclosures occurred) was in the eastern part of Chula Vista where homeowners associations predominate. Lori Weisberg, *Homeowners associations countywide are hit by foreclosure fallout and feeling the pinch of . . . unpaid dues*, SAN DIEGO UNION-TRIB., Nov. 1, 2007.

¹⁶⁵ The developments in the eastern part of Chula Vista consist mainly of single-family residences and townhouses on relatively small lots with small private yards. The author points out that homeowners' associations could have been an alternative surrogate for the borrower rather than the lender, yet recognizes that the economic downturn would have affected the associations' revenue stream due to the lack of payment of association dues by homeowner members in loan default.

these other parties would be better suited to inspect, register, and maintain the vacant houses.¹⁶⁶ Any lender, or other party with an interest secured by an instrument recorded after the foreclosing lender's instrument, would be extremely concerned about such matters because their security interest would be eliminated upon foreclosure by the senior lender.

Without a finding of fault, local government has stripped itself of the moral authority to designate the lender as the party ultimately responsible for the property. This attenuates the relationship between the means and the objective of abandoned property ordinances. Therefore, the city's re-writing of the loan agreement transforms the CVAPO from a public nuisance ordinance to some other category of ordinance that has yet to be challenged in court. If tested, courts should consider that the rule of law is weakened because an abandoned property ordinance exceeds valid police power authority in that the means to achieve the objective of public health, safety, welfare, and morals belie the core purpose of government—to wield authority against faulty parties. An abandoned property ordinance does not adjudicate wrongdoing; it does not concern itself with fault finding between a lender and a borrower. Instead, such an ordinance makes an economic choice that contradicts a requisite of the rule of law: the private parties' reliance on the certainty and enforceability of an otherwise lawful contract.

c. A Public Nuisance Hybrid Regulation without Factual Support

Further, the CVAPO suffers from the lack of facts to support it. A trial court that faces an issue related to a public nuisance ordinance “may only consider whether there is any substantial competent and material evidence in the administrative record to sustain the findings and order attacked.”¹⁶⁷ Where the regulation involves aesthetic matters such as design plans, the regulation must be expressly or impliedly based on findings that the regulation is necessary for the general welfare.¹⁶⁸

As discussed above, when the CVAPO was enacted the city council did not make a finding based on substantial competent and material findings that the CVAPO was necessary for the city's general welfare.¹⁶⁹ Neither blight nor significant deterioration of property put the general welfare of the city in jeopardy. The code enforcement personnel may have sensed pressure from the increase in foreclosures and what that could portend for

¹⁶⁶ See *supra* notes 124–27 and related discussion.

¹⁶⁷ *Thain v. City of Palo Alto*, 207 Cal. App. 2d 173, 192–93 (1962).

¹⁶⁸ *Friends of Davis v. City of Davis*, 83 Cal. App. 4th 1004, 1012 (2000) (“To be valid, zoning regulations must be expressly or impliedly based upon a finding by the governing body of the municipality that such regulations are necessary for the general welfare of the community.”) (citation omitted).

¹⁶⁹ See *supra* Part III.B.2.

the city in general and for their department specifically, but having “a sense of things” is not the standard for such enactments. As happens all too often, the clouds may gather but the storm does not come.

Despite these deficiencies, in the end a court that classifies the CVAPO solely as a traditional public nuisance regulation would most likely rule that the CVAPO is valid, notwithstanding the lack of a substantial finding of blight because of the current broad interpretation of police power which permits the imposition of strict liability without an adjudication of fault. Under present day jurisprudence, the speculation of a threat such as blight likely would be sufficient to rule that the objective of blight-free homes and neighborhoods rationally relates to the CVAPO’s imposition of maintenance obligations on lenders as a reasonably necessary means for the general welfare.

4. The Validity of the CVAPO as a Land Use Regulation That Impairs Contracts

Typical public nuisance ordinances do not modify private agreements. Because the CVAPO significantly alters a contract that grants substantial property rights, it is necessary to ask: Is an ordinance that rewrites a contract provision to shift property maintenance obligations to the lender when the borrower defaults on the loan and abandons the property valid as the proper means to achieve the objective of preventing blight that might result from an increase in the volume of foreclosures without a finding by the local legislative body that blight actually exists? California courts have not had the opportunity to address this question.

Across the country there was an astonishing increase in the number of foreclosures at the time of the subprime mortgage fiasco.¹⁷⁰ Local government became concerned about the potential problems that might follow. For many, the focus became the prevention of blight.¹⁷¹ Government can respond, but only when it has been established that there is an existential crisis before it takes measures to alter private contracts. This section of the article will review the courts’ treatment of rent control ordinances because it provides guidance for abandoned property ordinances. Rent control price fixing, which was thought by some to be a good way to deal with housing shortages, interferes with private property rights of landlords and tenants, and alters private landlord–tenant agreements. Nonetheless, rent control ordinances are upheld in part because there is a substantial finding that a housing shortage actually exists.

¹⁷⁰ See generally Lea Deutsch, *Collateral Damage: Mitigating the Effects of Foreclosure in Communities*, 22 TEMP. POL. & CIV. RTS. L. REV. 203, 205–09, 210–17 (2012).

¹⁷¹ *Id.* at 214–15.

Just as ordinances that adopt a redevelopment plan to combat blight have been held valid,¹⁷² rent control ordinances have been upheld as constitutional.¹⁷³ Generally, redevelopment ordinances do not directly change private agreements. Rent control ordinances, on the other hand, directly change an agreement by setting the price of rent. A local rent control regulation is not made invalid merely because it intervenes in private contractual relationships that modify the private parties' arrangement of rights and obligations.¹⁷⁴ The focus of the analysis is not the urgency that may exist or the rent price that is set, but rather whether the ordinance reasonably relates to the legitimate governmental purpose.

[T]he United States Supreme Court's previously described enlargement of its view of the scope of the police power to regulate prices and its consequent repudiation of any 'emergency' prerequisite for price or rent controls find their parallels in our own decisions. It is now settled California law that legislation regulating prices or otherwise restricting contractual or property rights is within the police power if its operative provisions are reasonably related to the accomplishment of a legitimate governmental purpose and that the existence of an emergency is not a prerequisite to such legislation.¹⁷⁵

In *Birkenfeld v. City of Berkeley*, the California Supreme Court pointed to the fact that the city's charter amendment stated the conditions that connected the objective of the public health and welfare with the rent control regulation, which the court found to be within its police power.¹⁷⁶ For it to be a constitutional rent control regulation, the court ruled that the municipality was also required to make a finding of "a housing shortage and its concomitant ill effects of sufficient seriousness" before a rent control ordinance is considered a "rational" solution.¹⁷⁷ The *Birkenfeld* court viewed this requirement as a protection against local government actions that are arbitrary, capricious, and unreasonable.¹⁷⁸

A regulation may itself express its purpose to identify the relationship between the regulation and its objective of public health and welfare, but it is necessary for the local authority to do more. Under *Birkenfeld*, local government need not establish that an emergency exists, but it must make a finding that a serious problem actually exists.¹⁷⁹ Because rent control ordinances are analogous to the abandoned property ordinances in the way

¹⁷² *Boelts v. City of Lake Forest*, 127 Cal. App. 4th 116, 120, 136–37 (2005); *Friends of Mammoth v. Town of Mammoth Lakes Redevelopment Agency*, 82 Cal. App. 4th 511, 560 (2000) (holding that the town's proposal was not valid because there was no evidence showing that the area suffered from blight); *County of Los Angeles v. Glendora Redevelopment Project*, 185 Cal. App. 4th 817, 832 (2010).

¹⁷³ *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 135–36 (1976).

¹⁷⁴ *Id.* at 142–43.

¹⁷⁵ *Id.* at 158 (citations omitted).

¹⁷⁶ *Id.* at 160, n.28.

¹⁷⁷ *Id.* at 160; *see also Berman v. Downing*, 184 Cal. App. 3d Supp. 1, 4 (1986).

¹⁷⁸ *Birkenfeld*, 17 Cal. 3d at 161.

¹⁷⁹ *Id.* at 160.

they change contracts and interfere in property rights, a court is likely to rule that an abandoned property ordinance must satisfy the same criterion before it is found to be valid. Thus, a local government acts within its police power if it can show that its ordinance makes a finding of a serious problem that needs to be solved.

In accordance with this reasoning, the Chula Vista City Council stated the purpose of blight prevention in the subject ordinance itself.¹⁸⁰ But it also was required to make a finding that blight actually existed before the CVAPO was enacted. As detailed above, though, the Chula Vista councilmembers did not make a finding of blight,¹⁸¹ which makes the CVAPO invalid under the *Birkenfeld* reasoning.

Property owners and lenders retain rights that are unfortunately subject to the courts' expansive view of police power and local governments' expansive application of them. Extraordinarily broad police power is the current norm, but it has had detrimental affects, especially when a contract is rewritten to interfere with property rights.¹⁸² The lender-borrower loan agreement manifests the parties' bargained-for choices for the assignment of rights, duties, and risks. Abandoned property ordinances like that in Chula Vista ignore the standard provision that obligates the borrower, which states in part:

7. Preservation, Maintenance and Protection of the Property; Inspections. *Borrower* shall not destroy, damage or impair the Property, allow the Property to deteriorate or commit waste on the Property. Whether or not *Borrower* is residing in the Property, *Borrower* shall maintain the Property in order to prevent the Property from deteriorating or decreasing in value due to its condition.¹⁸³

The pertinent part of the typical trust deed provision that such ordinances rewrite states:

9. Protection of Lender's Interest in the Property and Rights Under this Security Instrument. If (a) Borrower fails to perform the covenants and agreements contained in this Security Instrument, (b) there is a legal proceeding that might significantly affect Lender's interest in the Property and/or rights under this Security Instrument (such as a proceeding in bankruptcy, probate, for condemnation or forfeiture, for enforcement of a lien which may attain priority over this Security Interest or to enforce laws or regulations), or (c) Borrower has abandoned the Property, then Lender may do and pay for whatever is reasonable or appropriate to protect Lender's interest in the Property and rights under this Security Instrument, including

¹⁸⁰ See CHULA VISTA, CAL., MUN. CODE § 15.060.010.

¹⁸¹ See *supra* Part III.B.2.

¹⁸² See generally *infra* note 190 and related text. In another case involving a real property guaranty agreement, the guarantor sought to "upset a judgment in favor of" the lender's successor, but the court, which affirmed the lower court's grant of a motion for summary judgment, stated: "We cannot rewrite contracts when the economy suffers a severe downturn." *Gray1 CPB, LLC v. Kolokotronis*, 202 Cal. App. 4th 480, 482 (2011).

¹⁸³ California-Single Family-Fannie Mae/Freddie Mae Uniform Instrument, Form 3005 01/01, § 7 (italics added).

protecting and/or assessing the value of the Property, and securing and/or repairing the Property Securing the property includes, but is not limited to, entering the Property to make repairs, change locks, replace or board up doors and windows, drain water from pipes, eliminate building or other code violations or dangerous conditions, and have utilities turned on or off. *Although Lender may take action under this Section 9, Lender does not have to do so and is not under any duty or obligation to do so. It is agreed that Lender incurs no liability for not taking any or all actions authorized under this Section 9.*¹⁸⁴

Abandoned property ordinances completely reverse the contractual maintenance and security obligations in a way that arbitrarily abrogates the parties' intent and encourages the borrower's disregard for contractual commitments. A borrower in default can walk away with what is in effect impunity; he is permitted to externalize a part of his home ownership costs onto lenders and future borrowers. This type of regulatory scheme undermines the concept of private contract law and freedom of contract. Vested contract and property rights are rendered less valuable because they are less certain; the holder of such rights cannot rely on legislatures or courts to protect his rights. Nor is it clear that a lender will achieve through foreclosure full recovery of the fees and costs it incurs under the obligations the ordinance transfers to it.¹⁸⁵ Perhaps worst of all, the CVAPO concentrates more control and power in government, rather than limiting government to the role of creating an environment in which private activity can flourish, albeit balanced by individual responsibility and accountability. Rather than regulation of land use, contract and property rights abuse is what demarks abandoned property ordinances like the CVAPO.

Curiously, the Recitals say nothing of the borrower as the source of the problem of abandoned residences and potential blight.¹⁸⁶ It is borrowers who vacate their homes in complete disregard of all contractual obligations to occupy, maintain, and secure their property. By giving the borrower a pass as if he has made no personal commitment to the lender, the CVAPO obliterates the protection granted to the lender by Cal. Civ. Code § 2929, which declares that a borrower shall not impair a mortgagee's security.¹⁸⁷ In fact, it is arguable that the city council created a defense for the borrower, who can now claim that in effect, the CVAPO releases the borrower of his contractual obligation to not impair the security notwithstanding the protection afforded a mortgagee under Cal. Civ. Code § 2929.¹⁸⁸ Chula Vista councilmembers bypassed the borrower and instead focused on "the

¹⁸⁴ *Id.* at § 9 (italics added).

¹⁸⁵ *See infra* Part IV.B.3.

¹⁸⁶ *See supra* notes 122–28.

¹⁸⁷ CAL. CIV. CODE § 2929 (West 2012) ("No person whose interest is subject to the lien of a mortgage may do any act which will substantially impair the mortgagee's security.").

¹⁸⁸ In contrast, the ordinance in Las Vegas expressly states that the regulation does not create or imply a cause of action in favor of any person other than the city, and adds that no act of the lender creates a duty or obligation to or creates a cause of action in favor of anyone other than the city. *See* LAS VEGAS, NEV., MUN. CODE §§ 16.33.090(A)–(B) (2013).

responsibility of out of area, out of state lenders and trustees” and their failure “to adequately maintain and secure” the property.¹⁸⁹

An apt quotation from *Hettinga v. United States*, captures the severity of the local government’s abandoned property ordinance:

First the Supreme Court allowed state and local jurisdictions to regulate property, pursuant to their police powers, in the public interest, and to “adopt whatever economic policy may reasonably be deemed to promote public welfare.” Then the Court relegated economic liberty to a lower echelon of constitutional protection than personal or political liberty, according restrictions on property rights only minimal review. Finally, the Court abdicated its constitutional duty to protect economic rights completely, acknowledging that the only recourse for aggrieved property owners lies in the “democratic process.” “The Constitution,” the Court said, “presumes that, absent some reason to infer antipathy, even improvident decisions will eventually be rectified by the democratic process and that judicial intervention is generally unwarranted no matter how unwisely we may think a political branch has acted.”

....

The hope of correction at the ballot box is purely illusory. In an earlier century, H.L. Mencken offered a blunt assessment of that option: “[G]overnment is a broker in pillage, and every election is a sort of advance auction sale of stolen goods.” And, as the *Hettingas* can attest, it’s no good hoping the process will heal itself. Civil society, “once it grows addicted to redistribution, changes its character and comes to require the state to ‘feed its habit.’” The difficulty of assessing net benefits and burdens makes the idea of public choice oxymoronic. Rational basis review means property is at the mercy of the pillagers. The constitutional guarantee of liberty deserves more respect—a lot more.¹⁹⁰

In *Hettinga*, a case about a regulation that forced dairy farmers who produced and distributed their own milk products to make payments to the government, Justice Brown accurately described the deterioration of property rights in her concurring opinion, which displayed her perspective in a spirited way.¹⁹¹ The hybrid land use regulation that is the abandoned property ordinance similarly shows the abusive application of police power authority used by local government against private property rights and the freedom of contract. Economic liberty is indeed deserving of more respect.

The rule of law becomes a false hope when an abandoned property ordinance rewrites a private contract to reverse the parties’ lawful division of rights, duties, and risks, releasing a borrower from the significant contractual obligation to maintain the property. Furthermore, a lender becomes obligated, rendering public nuisance regulations superfluous in those instances when a borrower has defaulted on his mortgage loan and abandoned his property.

¹⁸⁹ CHULA VISTA, CAL., ORDINANCE NO. 3080, Recitals ¶¶ 5–6 (2007).

¹⁹⁰ *Hettinga v. United States*, 677 F.3d 471, 480–81, 83 (D.C. Cir. 2012) (J., Brown, concurring) (citations omitted).

¹⁹¹ *Id.* at 480–83 (J., Brown, concurring).

C. *Are Abandoned Property Ordinances Void for Vagueness?*

Code enforcement personnel view property conditions through the CVAPO prism. The CVAPO, however, establishes criteria for a lender's conduct that is different than the relevant provisions in a loan agreement. As a result, mortgage lenders are put in a theoretical dilemma, if not a practical one. The rule of law is diminished because an abandoned property ordinance that is vague leaves a mortgage lender in the vulnerable position of guessing when it must begin to maintain property,¹⁹² putting it at risk of a fine or criminal prosecution.¹⁹³

In order to start the foreclosure process, the lender must make a good faith determination that the borrower is in default, and record a notice of default.¹⁹⁴ Upon recordation, the lender must inspect and register the property.¹⁹⁵ Upon inspection and the discovery of vacant property (i.e., "not legally occupied"), the lender must start to maintain the property.¹⁹⁶ If the property is found occupied but displays "evidence of vacancy,"¹⁹⁷ the lender must start to maintain the property regardless of the occupancy.¹⁹⁸ These steps raise a key question: Do the phrases "not legally occupied" and "evidence of vacancy" describe a sufficiently definitive point when a lender will know with certainty that its maintenance obligations begin?

A similar question arises after the maintenance obligations have begun. By what standard will the condition of the property and its maintenance be measured? The CVAPO declares the exterior of the property "shall be [maintained] in comparison to the neighborhood standard."¹⁹⁹ If there is landscaping, it "shall be maintained to the neighborhood standard at the time registration was required."²⁰⁰ "Neighborhood standard" is defined so that the properties within a 300-foot radius of the subject property are the determinative standard for the subject property's condition.²⁰¹ The director

¹⁹² See generally *Ross v. City of Rolling Hills Estates*, 192 Cal. App. 3d 370, 375 (1987).

¹⁹³ CHULA VISTA, CAL., MUN. CODE § 15.60.090, 110 (2007).

¹⁹⁴ What a lender cannot do under California foreclosure law is improperly and unfairly file a notice of default without a genuine default of the loan agreement terms. In re *Worcester*, 811 F.2d 1224, 1228, 1232 (9th Cir. 1987); *Whitman v. Transtate Title Co.*, 165 Cal. App. 3d 312, 323 (1985).

¹⁹⁵ See *supra* Part III.A.

¹⁹⁶ *Id.*

¹⁹⁷ CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013) ("Evidence of vacancy means any condition visible from the exterior that on its own or combined with other conditions present would lead a reasonable person to believe that the property is vacant."); see also *supra* note 75.

¹⁹⁸ CHULA VISTA, CAL., MUN. CODE § 15.60.040 (2013).

¹⁹⁹ CHULA VISTA, CAL., MUN. CODE § 15.60.050 ¶ 1 (2013).

²⁰⁰ *Id.* at ¶ 3.

²⁰¹ CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013). "Neighborhood standard" is defined as "those conditions that are present on a simple majority of properties within a 300-foot radius of the subject property. A property that is the subject of a neighborhood standard comparison, or any other abandoned property within the 300-foot radius, shall not be counted toward the simple majority." *Id.*

of development services has the authority to require additional maintenance and security measures, but the specific measures are left to the discretion of the director and thus are prone to be created and enforced subjectively.²⁰²

The phrases “not legally occupied,” “evidence of vacancy,” and “neighborhood standard” are vague and susceptible to multiple interpretations. The director of development services can impose additional requirements, but those requirements are not set out in the CVAPO so a lender would not know beforehand what it must do to satisfactorily maintain and keep secure the property. Without the necessary clarity, the CVAPO is void for its vagueness. The discussion below explains the confusion that is created by the CVAPO.

A vague ordinance is subject to attack based on the due process clauses of state and federal constitutions. The court in *Ross v. City of Rolling Hills Estates* set out the test for a due process attack:

It is well settled that “a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates the first essential of due process of law.” This principle applies not only to statutes of a penal nature but also to those prescribing a standard of conduct which is the subject of administrative regulation. *The language used in such legislation “must be definite enough to provide a standard of conduct” for those whose activities are prescribed as well as a standard by which the agencies called upon to apply it can ascertain compliance therewith.* Approved rules by which to judge the sufficiency of a statute in the premises have been applied in numerous decisions, i.e., the words used in the statute should be “well enough known to enable those persons within its purview to understand and correctly apply them.”²⁰³

The court went on to declare that “a standard fixed by language which is reasonably certain, judged by the foregoing rules, meets the test of due process ‘notwithstanding an element of degree in the definition as to which estimates might differ.’”²⁰⁴

An ordinance that preserves the features of property so as to protect its condition and value satisfies due process where its language describes the required conduct in a manner that is reasonably certain and does not require persons of common intelligence to guess at its meaning.²⁰⁵ In *Ross*, the plaintiff-landowners applied for a variance to enable them to construct a

²⁰² See *CHULA VISTA, CAL., MUN. CODE* § 15.60.070 (2013) (describing some examples of maintenance and security measures that may be required and providing the director the discretion to employ any “other measures as may be reasonably required to arrest the decline of the property”).

²⁰³ *Ross v. City of Rolling Hills Estates*, 192 Cal. App. 3d 370, 375 (1987) (italics in original) (citations omitted); see also *Friends of Davis v. City of Davis*, 83 Cal. App. 4th 1004 (2000) (holding a design review ordinance that authorized the local government to approve development project’s design was valid and not vague); *Briggs v. City of Rolling Hills Estates*, 40 Cal. App. 4th 637, 642–43 (1995) (holding a zoning ordinance that required building designs to “respect the existing privacy of surrounding properties” was not unconstitutionally vague).

²⁰⁴ *Ross*, 192 Cal. App. 3d at 375 (citations omitted in original).

²⁰⁵ *Id.*

two-story addition to their home.²⁰⁶ The local zoning commission denied the application pursuant to the municipality's view protection ordinance and the city council affirmed that decision.²⁰⁷ Plaintiff-landowners appealed to the trial court on the ground that various terms in the ordinance were vague and thus unconstitutional.²⁰⁸ The trial court denied the requested writ of mandate.²⁰⁹ The *Ross* court affirmed the lower court's judgment because the ordinance was not unconstitutionally vague.²¹⁰ It reasoned that, though the view protection ordinance was not a zoning ordinance, but like one, "[a] substantial amount of vagueness is permitted in California zoning ordinances' in order to permit delegation of broad discretionary power to administrative bodies."²¹¹ The court further found there was a sufficient finding that plaintiffs' proposed structure would adversely impact the views of neighboring properties.²¹²

Unlike the view protection ordinance in *Ross*, the CVAPO is vague because the term "vacant," defined as "not legally occupied," requires a lender to guess at its meaning.²¹³ This is significant because, once the notice of default is recorded, the lender's maintenance obligations begin as soon as the property is "vacant." Lenders and city personnel may come to different conclusions as to when a property is vacant, particularly when there is an occupant (whether the borrower or a tenant or some third party), but the occupancy is a breach of the loan agreement or a rental agreement, or in violation of federal, state or local law.

Since the CVAPO does not further define "vacant," its definition begs the question: When does a property become not legally occupied so that the maintenance obligations begin? Without guidance from the CVAPO,²¹⁴ occupancy must be evaluated for its lawfulness under federal, state, or local law, and under the loan's deed of trust or a rental agreement. The typical

²⁰⁶ *Id.* at 373.

²⁰⁷ *Id.*

²⁰⁸ *Id.* at 374. Plaintiff-landowners complained that the terms "needless," "discourage," "view," "impairment" and "significantly obstructed" were "unintelligible concepts."

²⁰⁹ *Ross v. City of Rolling Hills Estates*, 192 Cal. App. 3d 370, 373 (1987).

²¹⁰ *Id.* at 376, 379.

²¹¹ *Id.* at 376 (quoting *Novi v. City of Pacifica*, 169 Cal. App. 3d 678, 682 (1985)); *see also* *Briggs v. City of Rolling Hills Estates*, 40 Cal. App. 4th 637, 642–43 (1995) (holding that laws must be broad enough to allow substantial administrative discretion and not so rigid as to eliminate all differences of opinion).

²¹² *Ross*, 192 Cal. App. 3d at 377; *see also* *Friends of Davis v. City of Davis*, 83 Cal. App. 4th 1004, 1012 (2000) ("To be valid, zoning regulations must be expressly or impliedly based upon a finding by the governing body of the municipality that such regulations are necessary for the general welfare of the community.").

²¹³ CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013).

²¹⁴ Courts generally will not insert what has been omitted in an ordinance. *See In re Hoddinott*, 12 Cal. 4th 992, 1002 (1996); *Kleitman v. Superior Court*, 74 Cal. App. 4th 324, 334 (1999); *Herman v. L.A. Cnty. Metro. Transp. Auth.*, 71 Cal. App. 4th 819, 825–26 (1999); *see also* CAL. CODE CIV. P. § 1858 (2013).

residential deed of trust or mortgage requires owner occupancy (at least for a specified period) and prohibits abandonment of the property by the owner-borrower. A lender will determine whether a borrower has breached the deed of trust's occupancy provision,²¹⁵ and then decide whether to exercise its discretion to pursue a remedy.²¹⁶ During that decision-making process, a lender will certainly consider, in the context of California law, whether the borrower's absence from the property complies with the trust deed provision,²¹⁷ recognizing the borrower does not lose title until the foreclosure sale occurs.²¹⁸ In any case, the general rule is that a fee simple owner cannot abandon his title.²¹⁹ As it deliberates, the lender is aware that it is not in its interest to permit an extended vacancy because the property would fall into disrepair, affecting the property's value and the ultimate recovery at a foreclosure sale.

A few examples illustrate how the lender and code enforcement personnel could arrive at opposite conclusions. Examples of when property may not be legally occupied include: (1) a borrower literally abandons the property, leaving it empty in breach of the deed of trust; (2) a borrower moves out of the property to lease it to a tenant without the consent of the

²¹⁵ See California Single-Family-Fannie Mae/Freddie Mae Uniform Instrument, Form 3005 01/01, § 6 ("Occupancy. Borrower shall occupy, establish, and use the Property as Borrower's principal residence within 60 days after the execution of this Security Instrument and shall continue to occupy the Property as Borrower's principal residence for at least one year after the date of occupancy, unless Lender otherwise agrees in writing, which consent shall not be unreasonably withheld, or unless extenuating circumstances exist which are beyond Borrower's control.").

²¹⁶ See *id.* at § 9.

²¹⁷ For purposes of this article, the terms abandon, abandonment, and abandoned shall be used in their common usage; that is, the loan documents should be understood to mean that a borrower who leaves his residence is one who intends to permanently move out of and does physically depart from the residence. Generally, common law abandonment requires a showing of intent to abandon the property and actual abandonment of it. *Del Giorgio v. Powers*, 27 Cal. App. 2d 668, 679-80 (1938). Thus, it is reasonable to infer that borrowers abandon without giving any thought to how the departure will affect his fee title.

²¹⁸ See, e.g., *Jones v. Wagner*, 90 Cal. App. 4th 466 (2001) (discussing the sale of a foreclosed former partnership property); *Hohn v. Riverside Cnty. Flood Control & Water Conservation Dist.*, 228 Cal. App. 2d 605, 613 (1964).

²¹⁹ The strict legal rule of abandonment in California case law implicitly recognizes the typical borrower's lack of concern about title when it declares that an owner in fee simple absolute cannot abandon his fee title. *Gerhard v. Stephens*, 68 Cal. 2d 864, 884, 886 (1968) (holding that owner of a profit *a prendre* can abandon such a fee interest since it is an "incorporeal hereditament" which interest will return to the estate out of which it was carved, as distinguished from a "corporeal hereditament" (i.e., a fee simple absolute title that represents "the totality of the *possessory and corporeal* rights of ownership in real property"), which cannot be abandoned, because "the reason appears to be that society cannot tolerate voids in the ownership of land") (italics in original); *Hunter v. Schultz*, 240 Cal. App. 2d 24, 28 (1966); *Carden v. Carden*, 167 Cal. App. 2d 202, 209 (1959). *But see* *Del Giorgio v. Powers*, 27 Cal. App. 2d 668, 679-82 (1938) (recognizing the rule that one who holds an equitable title interest in a mining claim can abandon his interest).

lender;²²⁰ or, (3) a borrower is not in possession of the property, which is occupied by a tenant that abandons the premises before the lease term ends, a holdover tenant, an unapproved subtenant, a trespasser, an adverse possessor, or some other person without consensual occupancy. In scenarios (2) and (3) the properties are occupied, but there is a breach of the loan or rental agreement, or a violation of law.²²¹

This is not a question of whether there is a default since the lender has already filed a notice of default. The question is whether the property has since become vacant, because that is when the lender must start to maintain the property. Now, if the lender concludes the property is indeed vacant under hypotheticals (2) and (3) because the occupancy is not lawful, it will start its maintenance duties, which will surely please the city. However, if the lender determines the property is occupied and finds no breach of an agreement or violation of law, it will not begin maintenance. It is not unreasonable for a lender to draw this conclusion because a lender's inspection could indicate nothing is amiss with regard to occupancy, and may delay from taking any action because it is not satisfied that there is a legal basis to conclude there is an unlawful occupancy. It may conclude there is a default but it is an immaterial one, it may be in communication with the borrower, or it may need time to weigh its options. The code enforcement official may not agree, depending on the official's interpretation of the facts and personal discretion. Should that discretion be exercised against the lender, a fine or perhaps prosecution is sure to follow under the CVAPO's strict liability standard. This would be an unjust result.

Take a different example. Suppose the borrower continues to make his loan payments and remains in possession, but because of hard economic circumstances refuses to incur extra costs for gardening, landscaping, or repairs.²²² Instead, suppose that the borrower occupies the property but is such a bad steward that he allows weeds, debris, and other things to accu-

²²⁰ This example assumes the owner-occupied provision in the trust deed requires the lender's consent before the borrower vacates and leases the property or simply requires owner occupancy.

²²¹ There are a considerable number of permutations from these basic hypotheticals when it is kept in mind that the CVAPO applies to all zoning districts, covering residential and commercial property, as well as improved and unimproved property. Though the matters of vacancy and the condition of the subject property will have been resolved long before the end of the five-year statute of limitation when an action to quiet title can be filed, the example of an adverse possessor illustrates the ambiguity of the CVAPO—adverse possession of the property would be “not legally occupied” before the end of the statute of limitation but would be afterward. An adverse possessor must satisfy the common law elements of adverse possession, *California Maryland Funding, Inc. v. Lowe*, 37 Cal. App. 4th 1798, 1803 (1995) (actual possession that is open and notorious, continuous and uninterrupted for 5 years, hostile and adverse, and under either color of title or claim of right), and the statutory elements, CAL. CODE CIV. P. § 325 (2013), in order to obtain a judgment to quiet title in his name.

²²² Picture the all-too-frequent call to code enforcement personnel by the typical neighbor who complains about another's untidy property.

mulate.²²³ Debris and disrepair exist, yet the property is occupied. Is it “not legally occupied” because it is in violation of public nuisance law? Is it abandoned because it “shows evidence of vacancy”? A lender should not be faulted for its decision because it is reasonable to infer that the city’s definition of “abandoned” property²²⁴ is understood to make the private loan agreement the standard for what is legal occupancy and vacant property. Even so, the operative standard for the official remains the CVAPO. As a result, the respective interpretations may be at odds.

Further, the CVAPO is dissimilar to the ordinance in *Ross* in that the phrase “evidence of vacancy” is vague and leads to confusion. Here, a lender’s inspection could reveal the borrower or another occupies the property. As the lender conducts its monthly inspections, it could discover that the property has become untidy and unsightly. The question for the lender is whether these conditions are “evidence of vacancy” such that it must begin to maintain the property, notwithstanding the fact that there is an occupant.²²⁵ While the circumstances of disrepair in the CVAPO’s definition may indicate the property is vacant, they do not conclusively establish that it is.

Though the definition of the phrase delineates several examples of what suffices as evidence, the definition uses broad, general terms such as “overgrown” and “accumulation.”²²⁶ There is no indication of how overgrown the lawn, shrubs, trees, or vegetation must be or what amount of accumulated newspapers, circulars, mail, trash, junk, or debris must exist before the evidence is sufficient to deem the property abandoned. Unlike the disputed terms in *Ross*, the terms “overgrown” and “accumulation” are quantifiable. The CVAPO, however, provides no such descriptive guidance.²²⁷ In addition, “evidence of vacancy” can be shown by past due utility notices, but such notices that are mailed, not posted at the home, may not be visible because the notices are inside the house or in a mail box. Yet “evidence of vacancy” is defined as “any condition visible from the exterior,”²²⁸ which creates confusion as to what type of accumulated notices are “evidence” under the CVAPO. The definition of the phrase also includes

²²³ Code enforcement personnel certainly are aware that borrowers (or tenants) have different value systems and work ethic, making it a common occurrence that some occupants will allow weeds to grow, debris to accumulate, or structures and the property to fall into disrepair.

²²⁴ CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013) (“[A] property that is vacant and is under a current notice of default . . .”).

²²⁵ CHULA VISTA, CAL., MUN. CODE § 15.60.040 (2013) (“If the property is occupied but remains in default it shall be inspected by the responsible party/beneficiary, or their designee, monthly until (1) the trustor or another party remedies the default or (2) it is deemed abandoned.”). Property that is deemed abandoned is vacant or shows evidence of vacancy, *id.*, and must be maintained and kept secure, *id.* at §§ 15.60.050, 060.

²²⁶ CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013).

²²⁷ *Id.*

²²⁸ *Id.*

statements by certain persons (including passersby) that the property is vacant as evidence.²²⁹ While a statement might be understood on its face, it requires a lender to accept the statement blindly, without knowledge of underlying circumstances (such as the borrower's long term work assignment or vacation) or of the relationship between the person who makes the statement and the owner-borrower (that could be contentious) or of the speculation by the person who made the statement. The statement may not be reliable, but sufficient in the mind of the code enforcement official.

The phrase "neighborhood standard" in the CVAPO is distinguishable from the view protection ordinance in *Ross*. The neighborhood standard refers to properties located within a 300-foot radius of the subject property, but those properties may display disparate levels of maintenance, quality of construction and landscaping, and accumulation of papers, mail, trash, junk, and debris. This calls for a subjective categorization of the neighborhood properties based on subjective evaluations of "curb appeal," cleanliness, and aesthetic design features of the structure and landscape. The definition next requires a count of the number of properties in each category to determine which category is in the majority. The categorizing and counting are even more challenging when the 300-foot radius could include any combination of residential, commercial, improved, or unimproved properties. The lender and the city personnel could very well categorize and count the properties within the radius quite differently. Neither the subjective categorizing nor the counting is involved in the view protection ordinance in *Ross*.

Finally, the director of development services can impose additional maintenance and security requirements on the lender,²³⁰ but the lender is not informed what those might be until after it has approved and funded a loan that later falls into default. That is, it would be very difficult if not impossible for a lender to factor into its cost of doing business those additional, yet unknown potential expenses it may incur should the loan go in to default.²³¹ The CVAPO gives a short list of possible requirements, yet it leaves the list open-ended. Though it would be reasonable for an ordinance to give some flexibility to code enforcement personnel, it is equally reasonable for an ordinance that targets lenders to provide much more specificity. This is reasonable not because lenders are not sophisticated, but rather because they are heavily regulated and must account for the costs they incur to write loans, the costs they incur for poor and nonperforming loans, and the costs for administration of these details and reports to government regulators that

²²⁹ *Id.*

²³⁰ CHULA VISTA, CAL., MUN. CODE § 15.60.070 (2013).

²³¹ This is not a far-fetched concern in a state like California that has no qualms about enacting carbon gas emissions regulations regardless of the exorbitant price tag. Green regulations could be mandated for housing structures too. The CVAPO does make clear, however, that maintenance does not include the installation of landscaping if it did not previously exist. CHULA VISTA, CAL., MUN. CODE § 15.60.050 (2013).

disclose the percentage of poor and nonperforming loans within their portfolios. The more prudent step would be to delineate with more specificity what would be required of a lender that assumes the borrower's maintenance duties.

The vagueness creates opportunities for substantial differences of opinion and could result in a fine as well as criminal prosecution of a lender that measures the facts on the ground contrary to the conclusions of code enforcement officials. Such results could occur because, after a notice of default is recorded, a lender that guesses incorrectly about whether the property is "not legally occupied," shows "evidence of vacancy," or does not conform to the "neighborhood standard" will expose itself to such sanctions if it does not begin to maintain the property.²³² Moreover, the director could impose further maintenance and security requirements on the lender that further deepens the financial losses on the subject loan.²³³ Even in those instances where a lender responds promptly to a borrower's monetary default, it may draw a different conclusion about these critical trigger points and find itself the subject of a fine or prosecution, dependent upon the personal discretion of the code enforcement official.

Therefore, the CVAPO is likely to be declared void as unconstitutionally vague. The rule of law is diminished because mortgage lenders are made vulnerable to the imposition of fines and criminal prosecution over a rational difference of opinion about unlawful occupancy and the standard of maintenance.

D. *Are Abandoned Property Ordinances Fair and Equitable?*

As described in Part II, it was a variety of governmental agencies, officials, and government sponsored enterprises that had just as much (if not more) to do with creating the financial crisis and the volume of foreclosures as other participants in the financial sector.²³⁴ Abandoned property ordinances were not enacted to address the root causes of the financial crisis; rather, local legislatures had the opportunity to address and hold accountable a key factor—the borrower. In dealing with the fallout, such ordinances do not hold the borrower accountable, even though he most likely moved down the street and could be located without difficulty.²³⁵ Extant regula-

²³² CHULA VISTA, CAL., MUN. CODE § 15.60.090, 15.60.110 (2013).

²³³ *Id.* at § 15.60.070.

²³⁴ *See supra* Part II.

²³⁵ One does wonder what city councils around the country were thinking when borrowers received financial amnesty by legislative fiat. The question is asked with regard to the wisdom of the regulatory scheme, not as a matter of law. The courts do not ordinarily consider motive of the local legislature when it passes an ordinance. *Nat'l Indep. Bus. Alliance v. City of Beverly Hills*, 128 Cal. App. 3d 13, 22 (1982) (courts will not consider motive unless there is fraud or something on the face of an ordinance).

tions—building code, residential code, housing code, plumbing code, a public nuisance ordinance, and others²³⁶—provide the city with formidable tools and remedies with which to bring property owners²³⁷ in line with community standards for property conditions and value. Instead, abandoned property ordinances impliedly urge borrowers to be irresponsible since they will face no repercussions for abandoning *their* property. It is not wise public policy to further erode personal responsibility in a society that suffers extensively from individual irresponsibility as it is.²³⁸ It is necessary for citizens to evaluate the wisdom of abandoned property regulation.

The rule of law is defeated because an abandoned property ordinance is unfair and inequitable. Since fault is irrelevant, the sole function of such an ordinance is to achieve a pragmatic goal that the borrower could accomplish without a greater financial burden on lenders and subsequently on future borrowers, notwithstanding the fact that he is in default and has abandoned the property.

Are there no other means by which to assure that property maintenance obligations stay with the borrower? Would it not be more reasonable to craft legislation that reinforces the contract parties' division of rights, duties, and risks regarding the property, particularly when local government does not intend to use resources to adjudicate whether one party or the other has committed illicit acts or seeks a remedy with unclean hands?

Legislators that enact abandoned property ordinances can follow the example of other legislation that retains the responsibility of ownership on the owner himself. For example, regulation appropriately requires automobile owners to obtain periodic inspections to assure the vehicle satisfies standards of safety and to obtain auto liability insurance.²³⁹ The responsibility rests with the owner—not the lender—and the obligations of ownership do not change when there is an upward spike in auto accidents.

In recognition that the condition of property directly impacts its value, the CVAPO helps to ensure that property is maintained and kept secure. This tends to reinforce and even elevate community standards of ownership and good stewardship. Such benefits should and can be attained by reinforcing the owner–borrower's personal responsibility. Instead of promoting these positive traits, abandoned property ordinances interfere with a private contract and mandate property maintenance by lenders at the expense of

that indicates an improper motive when it was passed or inferable from its operation or effect of which a court can take judicial notice).

²³⁶ See CHULA VISTA, CAL., MUN. CODE TITLE 15, Ch. 15.04–.60 (2013).

²³⁷ That is, such property owners who hold a fee title interest rather than only a security interest.

²³⁸ A free society founded as a constitutional republic with an inextricable reliance on a people with sound moral character nonetheless faces the risk of individuals' abuse of that freedom. Government should not open the door further to the risk and encourage the abuse through regulation, however.

²³⁹ See, e.g., CAL. VEH. CODE § 16020 (2011) (financial responsibility for auto accident); CAL. VEH. CODE § 2814 (2011) (auto inspections).

indulging borrower irresponsibility so that borrowers externalize their costs onto lenders and future borrowers. The officials' top priority ought to be to reinforce the duties of all private property owners and contractual obligations, so as to reaffirm the law's preference for certainty and stability in the market.

Moreover, there is an absolute necessity to scrutinize and hold accountable government whenever it exercises its power to preemptively regulate the conduct of citizens. The necessity arises from the bedrock principles that the legislature's authority is limited, and must be closely scrutinized in those instances when regulation excessively interferes with lawful private economic conduct and private agreements between private parties. In his argument in support of a return to a more vigorous judicial review of legislative enactments restrictive of property rights, Professor Bernard Siegan stated:

Yet the judiciary is the branch of government to which those who are adversely affected by legislation must look for relief. Justices are not intended to be government agents, furthering the interests of the executive and legislative branches in their disputes with citizens. Thousands of people and billions of dollars are already devoted to this cause. A judicial system more concerned to protect the power of government than the freedom of the individual has lost its mission under the Constitution. In a society that extols private property and private enterprise, those who engage in economic activities in reliance on existing laws are entitled to be secure against arbitrary and confiscatory government actions. If at all possible, society should not penalize or punish people who observe the rules and commit no wrongs. This is one of the major reasons that we have a Supreme Court and that we grant it enormous power over lawmakers.²⁴⁰

As it is, individuals and businesses are subject to extensive regulation due to executive and legislative officials' incessant enactments that expand their power and control over ever-increasing areas of citizens' personal lives. With regard to the CVAPO, it is unwise and unfair to expand government control by way of a regulation that alters a private contract on the basis of speculation that blight *might* result.

It is not as if the local government, in its exercise of police power, will reduce the taxpayers' burden by shedding the code enforcement costs onto deep-pocket lenders²⁴¹ and then imposing fines on them for noncom-

²⁴⁰ BERNARD H. SIEGAN, *ECONOMIC LIBERTIES AND THE CONSTITUTION*, 6–7 (1980). Professor Siegan published a second edition of this book in 2006, but the quotation is taken from the first edition because he completely revised the organization and content of the second edition.

²⁴¹ See Zywicki & Adamson, *supra* note 39, at 4 (“Heightened protections for borrowers that increase the cost or risk of lending will raise the cost of lending and result in either higher interest rates for borrowers or reduced access to credit.”) (footnote omitted).

pliance.²⁴² The inevitable result will be that citizens will pay higher loan costs the next time they obtain a loan in locales that have enacted abandoned property ordinances. Very few people can purchase their home without a loan; consequently, the majority of citizens will have those local governments to thank when lenders pass on the costs of compliance with such ordinances through an increase in the cost of loans. What local government has done, then, is to make the burden on the taxpayer (soon to be borrower) heavier due to higher loan costs on top of taxpayer bailouts.²⁴³

The city council's choice to impose the regulation on lenders is not as effective as it would be if it was imposed on borrowers. As such, it is arbitrary, unreasonable, and unfair. The CVAPO regulatory scheme rests entirely on a lender's recordation of a notice of default against an owner-borrower who is in default. It is very possible that a lender will not record the notice of default;²⁴⁴ it will be reluctant to record because it must comply with a number of new statutes enacted to "solve" the financial crisis,²⁴⁵ including California's so-called Homeowners' Bill of Rights that requires, among other things, preforeclosure notice and consultation with the bor-

²⁴² Chula Vista City personnel cite as a measure of the success of the CVAPO the amount of registration fees and fines the City has recovered from lenders since enactment. *See* Testimony of D. Leeper, *supra* note 15, at 97, 104–05.

²⁴³ *See supra* text accompanying note 52.

²⁴⁴ Lenders may choose not to record for a variety of reasons. A lender may not proceed with foreclosure because it considers the borrower's absence from the property to not be a breach of the loan agreement at all. If the borrower is nonresponsive or cannot be found it may take months before the lender locates the borrower and discovers the facts on the ground. It is conceivable that a borrower (or tenant) can be on an extended business trip or vacation, but not make arrangements for property upkeep and not inform the lender. Also, the sheer volume of defaults and foreclosures on other loans outside the municipality may cause a long delay in the lender's response. For these reasons a notice of default is not recorded and the City's objective is not realized, but frustrated.

²⁴⁵ Federal legislation was enacted to assist borrowers in the aftermath of the subprime mortgage fiasco. *See supra* note 66. A federal court ruled that the Home Owners' Loan Act ("HOLA") of 1933, 12 U.S.C. §§ 1461 *et seq.* (2012), preempts California Civ. Code § 2923.5, a measure that mandates lenders to make a good faith effort to assess and explore loan modification with the borrower. *Rodriguez v. J.P. Morgan Chase*, 809 F. Supp. 2d 1291 (S.D. Cal. 2011). However, a recent California court decision ruled that HOLA did not preempt CAL. CIV. CODE § 2923.5 (West 2013). *Ragland v. U.S. Bank Nat'l Assn.*, 209 Cal. App. 4th 182, 201–02 (2012); *see also Skov v. U.S. Bank Nat'l Assn.*, 207 Cal. App. 4th 690, 702 (2012) (reversed judgment that sustained demurrer because there were factual issues regarding lender's compliance with sec. 2923.5, (citing the holding in *Mabry v. Superior Court*, 185 Cal. App. 4th 208 (2010) (federal law did not preempt sec. 2923.5))). The conflict has yet to be resolved. CAL. CIV. CODE § 2923.5 (2013) declares that a lender cannot file a notice of default until 30 days after it makes contact with the borrower or it satisfies due diligence through good faith efforts to do so; a lender must "assess the borrower's financial situation and explore options for the borrower to avoid foreclosure[]" before it records a notice of default. Section 2923.5 was incorporated into and amended by the "Homeowners' Bill of Rights," which became effective January 1, 2013. *See* 2012 Cal. Stat. ch. 86–87 (AB 278 and SB 900).

rower with a view toward loan modification.²⁴⁶ Without the recorded notice of default, the CVAPO does not apply and code enforcement personnel are left to maintain the property, frustrating the city's objective, unless of course it were to hold the borrower accountable. Even when a loan modification is not granted, there very well may be a long delay before the notice of default is recorded, and the objective of prompt inspection, registration, and maintenance will not be realized. Meanwhile, the typical borrower who has vacated the property but who is still the fee owner remains in the area and is still subject to the range of code enforcement provisions available to the city.

Notwithstanding the borrower's default and abandonment of the home, the typical borrower does not go into hiding. Many borrowers in default may have lost their jobs during the recession, but most likely remained in the area familiar to them and where their families and friends lived. Other borrowers who retained their jobs but vacated their homes also remained in the area. Local code enforcement personnel have the authority to obtain borrowers' change of address and post office box information, making it easier and more cost effective than locating a lender.²⁴⁷ While the borrower may have given up on his home to foreclosure, he nonetheless remained subject to all legal requirements attendant to fee ownership of the property.²⁴⁸ It would not be below his station to mow the lawn, clean the yard, pick up mail, paint over graffiti, and complete the tasks necessary to maintain and keep secure the property until title changes at the foreclosure sale.

The Chula Vista council ignored the party most responsible for the maintenance obligations and arbitrarily imposed them on lenders without any investigation as to whether a particular lender had defrauded or manipulated a borrower or whether there was another party better suited to maintain the property.²⁴⁹ This choice has enabled borrowers to skirt their personal commitment to care for the property they purchased, without any in-

²⁴⁶ 2012 Cal. Stat. ch. 86–87 (AB 278 and SB 900), amending, repealing and reenacting numerous provisions of the Civil Code, now found in CAL. CIV. CODE, §§ 2920, 2923.4, 2923.5, 2923.6, 2923.7, 2923.55, 2924, 2924.9, 2924.10, 2924.11, 2924.12, 2924.15, 2924.17, 2924.18, 2924.20 (West 2013). The “Bill of Rights” is due to expire on January 1, 2018 unless extended.

²⁴⁷ Names and addresses of individuals are available to local government agencies pursuant to 39 CODE OF FED. REG. § 266.4 subd. (b)(3), §§ 265.6 subd. (d)(1), (d)(4), (d)(5)(i) (2012). In addition, change of address information and post office box holder information is available pursuant to § 266.4 subd. (b)(1)(i) (individual provides written request for dissemination of his information) or § 266.4 subd. (b)(1)(ii) (individual grants written consent to U.S. Post Office to release his information). See also Testimony of D. Leeper *supra* note 15, at 97, 100, 101 (discussing the difficulty in locating originating lenders or assignees). What Mr. Leeper did not discuss in his testimony is the borrowers' primary responsibility for the property and did not indicate that it would be more difficult to locate the borrower than the lender (assuming Mr. Leeper is correct in his assessment about locating lenders).

²⁴⁸ Specifically, the borrower, as the fee owner, is subject to liability for violations of the loan agreement and public nuisance ordinances.

²⁴⁹ See *supra* Part III.B.3.b.

quiry as to whether a particular borrower was available to continue to maintain the property or was the victim of fraud or sharp lending practices.²⁵⁰

What makes the matter even more inequitable is the fact that there likely are instances when the defaulting borrower did not inform his lender that he does not occupy the property due to an extended work assignment or vacation, that he has not kept up the property for a long period of time, that another person occupies the property without keeping it up, or that there is an unlawful occupancy. If the lender is not aware and does not maintain the property, the CVAPO's strict liability provision would see to it that the lender incurs a fine that cannot be added to the borrower's debt. Neither the fine nor the lender's CVAPO-related costs would have occurred were it not for the borrower's default and failure to communicate. In spite of the borrower's liability for his breaches of the loan agreement, the lender is legislatively pronounced liable without any evidence the particular lender has breached the loan terms.²⁵¹ Though local government may hold the power to apply strict liability to lenders, such an enactment is inequitable. If the fine cannot be recovered as part of the debt through foreclosure, a lender will need to protect itself by periodic inspections for the life of the loan so that it is not caught unaware. Must this be done with every loan in the city? If not recoverable, lenders would be forced to take a loss or to fold the loss into higher loan costs. It is apparent that abandoned property ordinances can be applied in ways that are inequitable and unfair. The lack of justice in this way serves to further dilute the rule of law.

IV. THE CVAPO AND THE NONJUDICIAL FORECLOSURE

A. *Initial Considerations*

The critical predicate of this type of abandoned property ordinance enacted in Chula Vista and many other local jurisdictions is linked closely

²⁵⁰ The inquiry referred to here is not necessarily of each and every borrower, though that could be done once the borrower is located. Instead, this refers to a review of the data provided by such organizations as RealtyTrac or real estate and mortgage broker professional organizations regarding the number and types of loans, and identities of the lenders. Not all lenders applied the practices of Countrywide, Fremont, and others known for sharp lending practices. Nothing in the public record related to the passage of the CVAPO indicates there was any thought given to reinforcing the borrowers' obligations under the loan, which the data may have indicated as appropriate because of the significant number of legitimate loans. The sense of urgency due to the number of foreclosures, without sound data to show negative impact, does not justify the release of borrowers from their contractual obligations. Instead, the city undermined the principle of personal responsibility. Putting aside the political ramifications, it would be interesting to learn the results of a study that examined whether Chula Vista or any local government was as aggressive in the enforcement of its public nuisance ordinances against borrowers as it was with abandoned property ordinances against lenders during the financial crisis.

²⁵¹ CHULA VISTA, CAL., MUN. CODE § 15.60.110 (2013).

to the state's foreclosure statutory scheme in that the lender's inspection, registration, and maintenance duties follow after the lender records a notice of default.²⁵² If a notice of default is not recorded,²⁵³ the CVAPO is not applicable. The city's recourse is solely against the owner-borrower or the occupant, but not the lender.²⁵⁴ Due to the city's refusal to hold the owner-borrower accountable, the purposes of the CVAPO will be frustrated if the borrower does not maintain and keep secure the property.

A lender cannot in good faith record a notice of default unless it possesses factual support for a claim that the borrower has in fact defaulted on the loan.²⁵⁵ When it obtains the required information, the lender can proceed with the notice of default. If the borrower commits a monetary default, the lender is thus informed that it will need to take steps to meet the CVAPO obligations.

Given the definition of default in the CVAPO,²⁵⁶ the default could also be a breach of some other conditional promise in the loan agreement. Most deeds of trust include a residential borrower's covenants to occupy, maintain, and keep secure the property, as well as not to abandon²⁵⁷ or commit waste at the collateral property.²⁵⁸ A lender could initiate a foreclosure based upon a borrower's breach of one of these nonmonetary contractual promises.²⁵⁹ However, it is rare for a lender to record a notice of default under these circumstances. Moreover, borrowers that allow the property to fall into disrepair usually do not commit the type of acts that rise to the level of bad faith waste.

Lenders also analyze whether their borrowers are in breach of the loan agreement due to a violation of federal, state, or local law. If a borrower violates the law, a lender may initiate the foreclosure process when the vi-

²⁵² CHULA VISTA, CAL., MUN. CODE § 15.60.040 (2013).

²⁵³ A lender has discretion as to whether it will pursue its contractual remedy of foreclosure. See *supra* note 184, text regarding California-Single Family-Fannie Mae/Freddie Mae Uniform Instrument, Form 3005 01/01, § 9.

²⁵⁴ Lenders certainly want the collateral property to remain in good condition so that their security interest is protected, but poor market conditions and low property values may convince lenders to wait, or the lenders may do nothing simply because they are not aware of the situation at the property regarding its condition or occupancy.

²⁵⁵ What a lender cannot do under California foreclosure law is improperly and unfairly file a notice of default without a genuine default of the loan agreement terms. See, e.g., *Whitman v. Transtate Title Co.*, 165 Cal. App. 3d 312, 323 (1985); *In re Worcester*, 811 F.2d 1224, 1228, 1232 (1987).

²⁵⁶ The CVAPO defines a "default" as "the failure to fulfill a contractual obligation, monetary or conditional." CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013).

²⁵⁷ See *supra* note 214 and related text regarding vacancy. The CVAPO definition for "abandoned" states the property is "vacant" and the subject of a notice of default, which suggests default can be based on a breach of the owner-occupied, no-abandonment, or no-waste provisions of a deed of trust, and not necessarily because of a financial default. CHULA VISTA, CAL., MUN. CODE § 15.60.020 (2013).

²⁵⁸ See *supra* note 107 and related text regarding maintenance, security, and waste.

²⁵⁹ See *infra* note 260 and related text regarding the borrower's default.

olation of law is a default that creates an impairment of the security and exposes the property to a lien and forfeiture.²⁶⁰ Thus, a borrower who violates a public nuisance ordinance could be the subject of a foreclosure, but lenders infrequently proceed with a notice of default due to a nuisance violation, unless it is extreme.

Once the notice of default has been recorded, the focus turns to the inspection, registration, and maintenance duties under abandoned property ordinances. Code enforcement personnel will analyze whether a lender timely and properly inspects, registers, and maintains property according to the applicable abandoned property ordinance.²⁶¹ Lenders, on the other hand, must take into account the loan provisions, general legal requirements, and the CVAPO as they consider foreclosure. A conflict arises for lenders because the steps taken to satisfy abandoned property ordinances may lead to acts that interfere with the owner-borrowers' property rights or expose borrowers to extraordinary fees and costs that lenders later seek to recover through their credit bids at foreclosure sales. A borrower could claim that the lender's entry onto the subject property is without consent and is a trespass that interferes with his quiet use and enjoyment.²⁶² A borrower could also claim that the lender's maintenance and security expenditures are unreasonable and thus are not recoverable through the foreclosure bid.²⁶³ To discuss how this could come about requires a brief walk through the foreclosure statutory scheme.

B. *California's Nonjudicial Foreclosure Statutory Scheme*

A lender that encounters its borrower's monetary default will typically demand that the borrower cure the arrearages (plus accrued fees and costs lawfully authorized) but then pursue foreclosure if the loan is not brought current. It is reasonable to assume that in most financial defaults the borrowers continue to occupy the residence.²⁶⁴ To a certain extent, this yields a

²⁶⁰ The typical trustee deed provision states: “[Section] 11. . . . Borrower shall be in default if any action or proceeding, whether civil or criminal, is begun that, in Lender’s judgment, could result in forfeiture of the Property or other material impairment of Lender’s interest in the Property or rights under this Security Instrument.” California-Single Family-Fannie Mae/Freddie Mae Uniform Instrument, Form 3005 01/01, § 11.

²⁶¹ See *supra* Part III.C.

²⁶² Richard E. Gottlieb, Margaret J. Rhiew & Brett J. Natarelli, *Reckless Abandon: Vacant Property Ordinances Create Legal Uncertainties*, 68 BUS. LAW. 669, 672 (2013).

²⁶³ See *infra* Part IV.B.4.

²⁶⁴ Occupancy is a greater likelihood now that it is fairly common knowledge that government programs and regulations have provided relief for many borrowers. For many, it is a modern “no-fault” default with a “bonus” whereby the borrower’s default is minimized (despite non-qualification or incorrect information, or both) and is given a loan modification (dependent on qualification), while lenders ironically receives government funds to underwrite the modification or a guarantee despite the “risky

benefit to the lender in that it must inspect and register the property but need not maintain or keep it secure because the borrower—occupant presumably will perform those tasks. When abandoned, costs of monthly inspections, property managers, registration, and maintenance of the property, in addition to foreclosure costs,²⁶⁵ become significant given the length of time lenders need to analyze layers of federal and state regulation²⁶⁶ and then to determine whether a loan modification is feasible in light of the borrowers' personal circumstances. Such costs will inevitably increase due to the length of time for the foreclosure process.²⁶⁷

The CVAPO's requirements begin after lenders have recorded a notice of default.²⁶⁸ Before lenders concern themselves with the CVAPO requirements, lenders must carefully chart their course through the complexities of California foreclosure law. Also, it is incumbent on lenders to determine whether compliance with the CVAPO exposes them to potential liability for a borrower's claim and whether the expenses to comply with the CVAPO are recoverable in the foreclosure process.

1. Basic Foreclosure Law in California

When a borrower fails to make monthly payments,²⁶⁹ a lender is required to pursue its remedy only against the security in a *judicial* foreclosure²⁷⁰ suit under the "one form of action" rule.²⁷¹ But where the deed of trust grants a power of sale, a lender can pursue a *nonjudicial* foreclosure.²⁷² A lender may commence both judicial and nonjudicial foreclosures, but an

financing arrangements" some lenders offered. Thus, the irresponsible borrower's default enables him to externalize his costs onto taxpayers, who fund the government programs, and the next generation of borrowers in Chula Vista, who will pay higher loan costs. Even if the borrower vacates, it is usually after a period of time in the property during which the borrower makes no loan payments and probably saves the money for rent or purchase of the next residence.

²⁶⁵ It is estimated that on average a lender expends \$40,000 in fees and costs to complete a foreclosure. SOWELL, *supra* note 1, at 59.

²⁶⁶ See *supra* text accompanying note 66.

²⁶⁷ For example, a court may stay a foreclosure until it is determined whether the lender complied with the "assess and explore" duty under CAL. CIV. CODE § 2923.5 (2013). See *Mabry v. Superior Court*, 185 Cal. App. 4th 208, 214 (2010).

²⁶⁸ CHULA VISTA, CAL., MUN. CODE § 15.60.040 (2013).

²⁶⁹ Such a default may occur whether the loan requires payments of interest only, payments of principal and interest, or payments of principal, interest, taxes, and insurance.

²⁷⁰ A judicial foreclosure is authorized under CAL. CODE CIV. P. § 725(a) (West 2013).

²⁷¹ CAL. CODE CIV. P. § 726; see also *Krone v. Goff*, 53 Cal. App. 3d 191, 193 (1975). Actually, the rule involves two rules: the one form of action rule and the security-first rule.

²⁷² The power of sale is granted by the contractual covenants in the lender-borrower agreement, specifically the promissory note and the deed of trust.

election of remedies must be made by the lender,²⁷³ which most likely will pursue a nonjudicial foreclosure because of its lower cost, shorter time span, and the lack of a borrower's post-trustee sale redemption right (though there is a right to reinstate the loan²⁷⁴ and to pay the loan in full²⁷⁵ before the trustee sale), rather than the more costly judicial foreclosure that involves a lengthy lawsuit and provides a lengthy postjudgment period of redemption²⁷⁶ for the borrower.²⁷⁷

A lender may not obtain a deficiency judgment²⁷⁸ against the delinquent borrower when there is a purchase money loan²⁷⁹ or when the lender elects to foreclose by trustee sale.²⁸⁰ "Non-standard" purchase money loans can be an exception to the bar against deficiency judgments²⁸¹ and purchase money loan protection can be lost when such a loan is refinanced.²⁸² In fact, many of the foreclosures that occurred during the financial crisis were defaults of refinance loans in which borrowers paid off the existing loan and pulled out cash based on the equity they had in the property's value.²⁸³

After a lender has complied with all preforeclosure statutory requirements, the notice of default can be recorded ninety days later the notice of trustee's sale can be recorded,²⁸⁴ and the sale may be held no sooner than three months and twenty days later.²⁸⁵ Both the notice of default and the notice of trustee's sale must strictly follow the statutory requirements.

²⁷³ *Vlahovich v. Cruz*, 213 Cal. App. 3d 317, 321–22 (1989); *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35, 43 (1963).

²⁷⁴ CAL. CIV. CODE § 2924(c) subd. (a)(1) (West 2013).

²⁷⁵ CAL. CIV. CODE §§ 2903–2906 (West 2013).

²⁷⁶ CAL. CODE CIV. P. § 725(a), § 729.010 *et seq.* (2013).

²⁷⁷ CAL. CODE CIV. P. § 726 subd. (e) (2013); *Vlahovich*, 213 Cal. App. 3d at 321; 4 MILLER & STARR, CAL. REAL EST. § 10:180 (3d ed. 2002). For a comparison of non-judicial and judicial foreclosures, *see id.* § 10:221.

²⁷⁸ Deficiency judgment is generally defined as a judgment in favor of the lender in the amount of the balance of the debt after a foreclosure, "limited to the difference between the fair market value of the property and the amount for which it was sold." *Ghirardo v. Antonioli*, 14 Cal. 4th 39, 48 (1996) (citation omitted).

²⁷⁹ CAL. CODE CIV. P. § 580b (2013) ("No deficiency judgment shall lie in any event after a sale of real property . . . for failure of the purchaser to complete his or her contract of sale, or *under a deed of trust or mortgage given to the vendor to secure payment of the balance of the purchase price of that real property . . .*") (italics added); *see also Ghirardo*, 14 Cal. 4th at 49; *Krone v. Goff*, 53 Cal. App. 3d 191, 193 (1975).

²⁸⁰ CAL. CODE CIV. P. § 580d (2013).

²⁸¹ *See Spangler v. Memel*, 498 P.2d 1055, 1062, 7 Cal. 3d 603, 614 (1972); *Roseleaf Corp. v. Chierighino*, 378 P.2d 97, 100, 59 Cal. 2d 35, 41 (1963).

²⁸² *See DeBerard Props., Ltd. v. Lim*, 976 P.2d 843, 845, 20 Cal. 4th 659, 663 (1999) (citations omitted).

²⁸³ SOWELL, *supra* note 1, at 23.

²⁸⁴ *See* CAL. CIV. CODE §§ 2924(a)(2)–(3), 2924f(b)(1) (West 2013). The notice of trustee's sale must be posted, mailed, and recorded twenty days prior to the sale; it must also be published for three consecutive weeks.

²⁸⁵ CAL. CIV. CODE § 2924(a)(4) (West 2013).

California law authorizes a lender's automatic credit bid at the foreclosure sale in the full amount owed by the borrower, including trustee's fees and expenses.²⁸⁶ A lender may bid a lesser amount if it prefers.²⁸⁷ A prudent lender will be cautious with regard to the credit bid it submits because there are disadvantages to a full credit bid, including a bar to recovery of a deficiency judgment when, for example, there is a non-purchase money loan²⁸⁸ or when the borrower commits bad-faith waste.²⁸⁹ It is best to reserve the option to pursue a deficiency judgment for that occasion when the costs and fees attributable to compliance with the CVAPO are substantial and the subject loan is within an exception to the antideficiency rule. As a consequence, claims for deficiency judgments may become more common, although it is unlikely that a claim for bad faith waste would arise out of a borrower who merely allows the property to show "evidence of vacancy" as defined by the CVAPO since such acts of nuisance would rarely if ever rise to bad faith waste. If the underlying circumstances involve something less egregious than bad faith waste, the lender probably does not have the factual support to file a lawsuit in good faith to obtain a deficiency judgment and instead will limit itself to the remedy of the nonjudicial foreclosure. Either way, lenders and their counsel must evaluate whether California law would even support a deficiency judgment claim before they determine the optimum credit bid amount.

²⁸⁶ CAL. CIV. CODE § 2924h(b) (West 2013).

²⁸⁷ See *Cornelison v. Kornbluth*, 15 Cal. 3d 590, 607–08 (1975).

²⁸⁸ See *Goodyear v. Mack*, 159 Cal. App. 3d 654, 656–57 (1984). However, "there is no flat rule that the nature of a loan secured by a trust deed *never* changes in subsequent sales transactions. Instead, the proper inquiry is whether the facts are such that the purposes of the antideficiency statute will be advanced by applying it to a particular variation on a standard purchase money mortgage." *LaForgia v. Kolsky*, 196 Cal. App. 3d 1103, 1112 (1987).

²⁸⁹ See *Cornelison*, 15 Cal. 3d at 604–06 (affirming summary judgment in favor of defendant (purchaser's grantee who did not assume underlying debt) against cause of action for waste because plaintiff (seller-beneficiary of deed of trust) did not prove that defendant committed waste in bad faith, defined as reckless or malicious despoliation of the property). Thus, bad faith waste can be committed by the willful failure to irrigate, cultivate, fumigate, and fertilize an orchard that served as security for the loan, *Hickman v. Mulder*, 58 Cal. App. 3d 900, 908 (1976), the willful non-payment of real property taxes, *Nippon Credit Bank, Ltd. v. 1333 N. Cal. Boulevard*, 86 Cal. App. 4th 486 (2001), and possibly by the demolition of the building that secured the loan, *Fait v. New Faze Dev., Inc.*, 207 Cal. App. 3d 284, 299 (2012) (reversing summary judgment against lender's bad faith claim because genuine issue of material fact existed as to whether former owner and others committed bad faith waste by demolishing the building; broadly defining "'bad faith' waste [as that which] occurs *whenever* the owner's impairment of the value of the security is not caused by the economic pressures of a market depression, whether the owner acts recklessly, intentionally, maliciously, or with some other mental state").

2. Lender's Credit Bid Includes Loan Principal Balance, Interest, Fees, and Costs

The lender²⁹⁰ that pursues nonjudicial foreclosure of the property can submit at the trustee's sale a full (or partial) credit bid that will be the sum (or portion) of the outstanding loan principal, interest, fees, and costs.²⁹¹ The amounts of the delinquent loan principal and interest are of course calculated according to the loan documents and the borrower's payment history. Fees and costs related to prosecuting the foreclosure are rigidly regulated and limited by statutes that separate them into two categories, distinguished by the notice of default²⁹² and the notice of trustee's sale.²⁹³ As part of the statutory costs, expenses, and fees that are added to the principal amount owed by the borrower in a standard nonjudicial foreclosure, a lender can recover property taxes, assessments, insurance premiums or advances made by the lender in accordance with the terms of the deed of trust.²⁹⁴

3. Lender's Advances and Other Costs

Other expenses not directly related to the foreclosure, such as those incurred under the CVAPO mandate, present another category of lender ex-

²⁹⁰ In California, one appellate court has ruled that a party need not possess the promissory note to start a non-judicial foreclosure. *See* *Debrunner v. Deutsche Bank Nat'l Trust Co.*, 204 Cal. App. 4th 433 (2012).

²⁹¹ *See* CAL. CIV. CODE §§ 2924c, 2924d (West 2013).

²⁹² Once the lender records a notice of default, a lender can recover "all reasonable costs and expenses . . . which are actually incurred in enforcing the terms of the obligation." CAL. CIV. CODE § 2924c(a)(1)(C) (West 2013). Costs and fees are limited "to the costs incurred for recording, mailing, including certified and express mail charges, publishing, and posting notices required by Sections 2924 to 2924i, inclusive, postponement pursuant to Section 2924g not to exceed fifty dollars (\$50) per postponement and a fee for a trustee's sale guarantee or, in the event of judicial foreclosure, a litigation guarantee." CAL. CIV. CODE § 2924c(c) (West 2013). Attorney's fees are recoverable as well, but a schedule sets out in the statute limits the fees to a base amount plus a percentage of the unpaid principal balance, both of which are adjusted based upon the unpaid principal amount. CAL. CIV. CODE § 2924c(d) (West 2013).

²⁹³ *See* CAL. CIVIL CODE § 2924d(b) (West 2013) (when the notice of sale is recorded, "reasonable costs and expenses, to the extent allowed by subdivision (c) of Section 2924c, which are actually incurred in enforcing the terms of the obligation and trustee's or attorney's fees" are recoverable by a lender). Again, attorney's fees are set out in a schedule that limits the amount to a base amount and a percentage of the unpaid principal, both of which are adjusted depending on the unpaid principal amount. *See* CAL. CIV. CODE § 2924d(a) (West 2013). Attorney's fees authorized by § 2924d "shall be in lieu of and not in addition to those charges authorized by subdivision (d) of Section 2924c." *Id.*

²⁹⁴ CAL. CIV. CODE § 2924c(a)(1) (West 2013). Pursuant to the typical loan agreement, the borrower's payments for property taxes, assessments, and insurance premiums are combined into the monthly loan payments.

penses. There does not appear to be any California case that addresses the question of whether abandoned-property-ordinance-mandated costs incurred after a notice of default has been recorded are recoverable through the lender's credit bid at the foreclosure sale.

Advances paid by the lender on behalf of the borrower typically involve other expenses. Cal. Civ. Code §§ 2924c and 2924d set out the costs and expenses recoverable in a foreclosure, but "do[] not serve to define or limit the contractual obligation of the parties."²⁹⁵ Advances may be added to the debt owed by the borrower as long as the deed of trust contains a provision that permits the lender to make advances on behalf of the borrower to protect the security.²⁹⁶ Attorney's fees incurred to protect the security are like other advances paid by the lender under the terms of the deed of trust that can be added to the secured debt.²⁹⁷

Standard expenses to complete a nonjudicial foreclosure are authorized by §§ 2924c and 2924d.²⁹⁸ Because the CVAPO forces lenders to incur what appear to be nonforeclosure expenses to comply with its regulation, the question arises as to whether these expenses, together with related attorney's fees, are advances paid by the lender on behalf of the borrower to protect the security, and thus recoverable at the foreclosure sale.

One initial problem might occur when the lender inadvertently schedules the recording of a notice of default relative to preforeclosure efforts to communicate with the borrower and the timing of the lender's inspection, registration, and maintenance duties under the CVAPO. If the lender inspects and registers the property before or during the pre-notice of default thirty-day window, there may be a violation of Cal. Civ. Code § 2923.5 if the lender takes steps in pursuit of its foreclosure remedy prior to or during communication with the borrower.²⁹⁹ California courts have yet to rule on whether inspections, registration, payment of registration fees, or maintenance before or during the thirty-day window are a violation of § 2923.5. Nor has a court ruled that a lender's fees, costs, and advances that were incurred during the window can be included in or excluded from the lend-

²⁹⁵ See *Passinisi v. Merit-McBride Realtors, Inc.*, 190 Cal. App. 3d 1496, 1512 n.10 (1987) (holding "[t]hat [Civil Code § 2924d] provides amounts which may be claimed as reasonable costs and expenses of foreclosing upon the property, it does not serve to define or limit the contractual obligation of the parties") (citing *Buck v. Barb*, 147 Cal. App. 3d 920, 924-25 (1983)).

²⁹⁶ See *id.*; see also *Caruso v. Great W. Sav.*, 229 Cal. App. 3d 667, 676-77 (1991) (holding "the statutory schedule does not so restrict the attorney's fees in the present case"); *Bruntz v. Alfaro*, 212 Cal. App. 3d 411, 421 (1989) ("Under appropriate contract provisions, such expenses may be treated as collateral advances and added to the amount of the debt.").

²⁹⁷ See *Buck v. Barb*, 147 Cal. App. 3d 920, 924-25 (1983).

²⁹⁸ See *supra* notes 291-92 and accompanying text.

²⁹⁹ See *supra* notes 244-45 and accompanying text.

er's automatic credit bid at the foreclosure sale.³⁰⁰ However, this may not be a problem in San Diego County where a local federal district court—the venue where Chula Vista is located—has ruled that § 2923.5 is preempted by federal law.³⁰¹

These lender advances seem to fall into two categories. First, costs to inspect, maintain, and keep secure the property appear to be made on behalf of the borrower in that these costs directly relate to the trust deed covenants that obligate the borrower to maintain and keep secure the collateral property. It is certainly understood by the parties at the formation of the loan agreement that the borrower promises to maintain and keep secure the property he owns and possesses. If the lender must undertake these duties, it stands to reason that the expenses it incurs are for the borrower's account. Thus, the advances could be added to the borrower's debt.

Second, registration, the registration fee, and property management company non-inspection fees seem to primarily concern administrative duties. Since the CVAPO imposes these duties on the lender, it is arguable that the trust deed covenants pertaining to the borrower's maintenance, repair, and security obligations are not implicated. The duties are administrative in nature in that they enable the City to monitor the lender, as opposed to the substantive contractual obligations to keep secure the property. Further, the CVAPO defines the relationship between the municipality and the lender rather than that between lender and borrower, which relationship is defined by the loan agreement and its covenants. A borrower who faces a foreclosure may thus have the basis to challenge the advances paid by the lender for registration, the registration fee, and property management fees as administrative duties unrelated to the borrower's covenants to maintain and keep secure the property. This could become a major concern for the lender if the advances for the "administrative" category are substantial.

As for attorney's fees, it is reasonable to presume that an attorney will spend time to review the CVAPO beyond what would be the usual loan document review. Each borrower, property, and foreclosure involves particular circumstances that must be evaluated on a loan-by-loan basis. In that the lender is subject to strict liability for violations of the CVAPO,³⁰² legal counsel ought to thoroughly analyze the loan documents in light of the obligations under the CVAPO, and then advise the client accordingly. Consequently, the attorney's fees will be higher. While it appears such fees could be added to the debt owed by the borrower, that might not be the case, at least with regard to those fees attributable to analysis and advice

³⁰⁰ However, the Fourth District Court of Appeals, Division Three has held that where a lender violates Section 2923.5, the sole remedy for the borrower is additional time to discuss a resolution of the default. *See Mabry v. Superior Court*, 185 Cal. App. 4th 208, 214, 225 (2010).

³⁰¹ *See Rodriguez v. J.P. Morgan Chase & Co.*, 809 F. Supp. 2d 1291, 1295 (S.D. Cal. 2011). On the question of preemption, the cases are in conflict. *See supra* notes 244–45.

³⁰² CHULA VISTA, CAL., MUN. CODE § 15.60.110 (2013).

about the “administrative” duties imposed on the lender if a court accepts the two-category approach described above. If a borrower asserts the two-category approach, the issue becomes whether the advances to comply with the CVAPO, including attorney’s fees, can be made part of the amount owed by the borrower and recoverable through a foreclosure. If they are not recoverable, the CVAPO increases the lender’s losses for a nonperforming loan.

4. The Underlying Purpose of Lender’s Advances and Other Costs

“[A]side from the expenses of foreclosure, there are other costs, including legal fees, which [a creditor may incur while] protecting the security. Under appropriate contract provisions, such expenses may be treated as collateral advances and added to the amount of the debt.”³⁰³ In *Bruntz v. Alfaro*, where the lender was unsuccessful in the recovery of attorney’s fees because he refused to accept the borrowers’ tender of the correct amount to cure the default, the court concluded that “[w]hether a particular expense may be treated as an advance, or is subject to the limitations in Civil Code section 2924c, will depend upon the purpose for which the expense was incurred and the particular contractual terms involved.”³⁰⁴ Thus, the determination as to whether “other costs” are limited by the foreclosure statutory scheme or are advances that can become part of the debt turns on the purpose for the expense.

In *Walker v. Countrywide Home Loans, Inc.*, the subject deed of trust authorized the lender to “do and pay for whatever is necessary to protect the value of the Property and the Lender’s rights in the Property” to “make reasonable entries upon and inspections of the Property,” to enter “on the Property to make repairs,” and to include amounts disbursed, including attorney’s fees, to “become additional debt of Borrower.”³⁰⁵ Countrywide made thirteen separate “verify occupancy” inspections *prior* to its recording of a notice of default.³⁰⁶ The *Walker* court held that the lender’s charges for the actual cost of performing property inspections did not violate California’s unfair competition law based on its conclusion that “the deed of trust ‘unequivocally permits’ Countrywide to charge the Walkers with the reasonable cost of the property inspections.”³⁰⁷ The *Walker* opinion did not rule in the context of the foreclosure statutory scheme as to whether *post-*

³⁰³ *Bruntz v. Alfaro*, 212 Cal. App. 3d 411, 421 (1989).

³⁰⁴ *Id.*; *see also* *Caruso v. Great W. Sav.*, 229 Cal. App. 3d 667, 676–77 (1991) (“[T]he [trial] court failed to distinguish between [attorney] fees actually incurred as an expense of the foreclosure process, which fees are statutorily limited, and other fees incurred, such as those relating to the protection of the lender’s deed of trust, which are not so limited.”).

³⁰⁵ *Walker v. Countrywide Home Loans, Inc.*, 98 Cal. App. 4th 1158, 1165 (2002).

³⁰⁶ *Id.*

³⁰⁷ *Id.* at 1178–80.

notice of default inspections were recoverable under the deed of trust,³⁰⁸ but it did state that “[i]nspecting property after a default is an action that reasonably may be necessary to protect a lender’s security interest.”³⁰⁹

Advances paid in the form of inspection fees to protect a lender’s security can be added to the borrower’s debt and are recoverable through a nonjudicial foreclosure.³¹⁰ Pursuant to *Walker*, then, a lender that makes advances for *pre*-notice of default inspections in compliance with the CVAPO can add the cost to the amount owed by the borrower where the deed of trust authorizes inspections to protect the security. Unresolved by *Walker*, however, is whether inspections that take place *after* a notice of default is recorded can be added to the debt. As soon as the notice of default is recorded, monthly inspections conducted by lenders or by their local property management companies pursuant to the CVAPO will start and may continue for a lengthy, if not an indefinite, period of time. Thus, the amount of a lender’s advances for inspections could become substantial and obviously important to the lender.

The holding of the *Walker* court based the lender’s recovery of *pre*-notice of default inspection costs on the trust deed language.³¹¹ As described above, the inspections of the property in *Walker* was “to protect the value of the Property and the Lender’s rights in the Property.” Where the language of another trust deed is similar to that in *Walker*, the logic of the *pre*-notice of default inspection approved of in *Walker* would dictate that the purpose of the *post*-notice of default inspection allows recovery of those *post*notice inspection costs. Assuming lenders subject to the CVAPO use deeds of trust that contain the same or similar language, the *post*-notice of default inspection costs required by the CVAPO can be added to the debt owed by the borrower and recoverable through foreclosure sale proceeds because the purpose of the inspections to protect the value of the property and the lender’s security interest continue after the notice of default is recorded.

In *Buck v. Barb*, the defendant lender retained an attorney to determine whether the borrowers obtained fire insurance, as required by the loan agreement to protect the security.³¹² Because the plaintiff–borrower was uncooperative, the attorney expended time to eventually confirm that the insurance policy was indeed in place.³¹³ The court held that the deed of trust provisions regarding protection of the security and employment of

³⁰⁸ See *id.* at 1174 n.5.

³⁰⁹ *Id.* at 1178.

³¹⁰ See *id.* at 1178–80.

³¹¹ *Walker v. Countrywide Home Loans, Inc.*, 98 Cal. App 4th 1158, 1178–80 (2002).

³¹² *Buck v. Barb*, 147 Cal. App. 3d 920, 920 (1983).

³¹³ *Id.* at 924.

counsel authorized the lender to recoup the attorney's fees she incurred.³¹⁴ In *O'Connor v. Richmond Savings and Loan Association*, the lender employed a law firm "to advise the lender in connection with the entire loan transaction" after the borrower-developer became financially distressed, defaulted on the loan payments, and failed to pay carpenters and other sub-contractors.³¹⁵ To deal with recorded mechanics' liens, removal of materials and fixtures, and vandals, the law firm worked to secure the partially completed homes on seventeen different lots and initiated a nonjudicial foreclosure.³¹⁶ The *O'Connor* court held the lender was entitled to the attorney's fees it had advanced since the deeds of trust authorized the lender to incur and recover costs, including attorney's fees, to protect its security interest.³¹⁷ The court reasoned, "[t]he fees here are governed, not by the above code sections or by any other statute, but by the contract regarding attorney's fees, as set forth in the deeds of trust."³¹⁸

Just as *Buck v. Barb* upheld the recovery of attorney's fees to protect the security, a lender that incurs attorney's fees for review of and advice about compliance with the CVAPO can add those fees to the borrower's debt as long as the deed of trust authorizes such fees to protect the security.³¹⁹ A fire insurance policy, as existed in *Buck*, is one of many ways in which a property is kept secure and complements the tasks a lender must do under the CVAPO. As in *O'Connor*, attorney's fees for services that deal directly with the legal issues raised by the facts on the ground—as would be the case under the CVAPO—impact the level of protection of the security and should therefore be recoverable.

Attorney's fees do raise some questions though if the fees are construed to relate to the lender's "administrative" duties under the CVAPO rather than to protection of the security. "Administrative" duties under the CVAPO are the sole responsibility of the lender, a borrower would assert, and such duties were not within the contemplation of the parties at the time the loan agreement, with its covenants set forth in the trust deed, was formed. The duties cannot be delegated to the borrower because the express language of the CVAPO imposes the duties on the lender and declares the lender will be held strictly liable for violations.³²⁰ If a court were to accept the borrower's argument, the attorney's fees paid by a lender to review the CVAPO for its "administrative" aspects could not be added to the

³¹⁴ *Id.* at 925–26 (it appears all attorney's fees were incurred prior to the time the notice of default was recorded).

³¹⁵ *O'Connor v. Richmond Sav. & Loan Ass'n*, 262 Cal. App. 2d 523 (1968) (overruled on other grounds, *Garrett v. Coast & S. Fed. Sav. & Loan Ass'n*, 9 Cal. 3d 731 (1973)).

³¹⁶ *O'Connor*, 262 Cal. App. 2d 523, 526–27.

³¹⁷ *Id.* at 528–29. (It is not clear from the facts whether some of the attorney's fees were for services after the notice of default was filed).

³¹⁸ *Id.* at 528 (citation omitted).

³¹⁹ *Buck v. Barb*, 147 Cal. App. 3d 920, 925–26 (1983).

³²⁰ *See supra* note 71.

amount owed by the borrower and thus would not be recoverable through foreclosure. Acceptance of the “administrative” duties argument puts in jeopardy the recovery of not only the attorney’s fees, but also the registration fees and the property management non-inspection expenses since these expenditures relate to the municipality’s oversight of the lender’s management of the property.

The “administrative” duties argument misses two fundamental points, however. First, all of the duties imposed by the CVAPO relate to the security and the purpose of protecting it.³²¹ Even if administrative in nature, such duties are necessary tasks closely connected to the substantive efforts to maintain and keep secure the collateral property. Second, were it not for the borrower’s default and acts that led the property to be “not legally occupied” or to show “evidence of vacancy,” the lender would not have incurred any CVAPO related costs whatsoever and would not have retained counsel to review and give advice about the CVAPO. A reasonable reading of the typical language in a deed of trust regarding protection of the security would encompass registration, registration fees, property management, and related attorney’s fees as essential to the purpose of the protection of security.

Though no case has so ruled, the same reasoning as in the cases discussed above would allow the costs, expenses, and fees paid by a lender to comply with the CVAPO to be added to the borrower’s debt and recovered through foreclosure as long as the underlying deed of trust authorizes the lender to take such action for the purpose of protecting the security.³²² Accordingly, costs and fees for post-notice of default inspections, registration fees, retention of a property manager, and related legal fees are advances that would be recoverable at the trustee’s sale.

5. Foreclosure, the CVAPO, and Miscellaneous Issues

a. Lender’s Entry onto Borrower’s Property

As code enforcement officers “compel” lenders to maintain and keep secure the collateral property, the CVAPO raises the specter that the lender’s entry on to the owner–borrower’s property can expose the lender to tort liability or can be taken as a breach of the loan agreement due to an interference with the quiet use and enjoyment of the property, the failure to notify and obtain the consent of the borrower, or a trespass.³²³

³²¹ CHULA VISTA, CAL., MUN. CODE § 15.060.010.

³²² See generally *supra* notes 303–19 and accompanying text.

³²³ See generally 12 MILLER & STARR, CAL. REAL EST. §§ 36:1 *et seq.* (3d ed. 2002); see also Richard E. Gottlieb, Margaret J. Rhiew, Brett J. Natarelli, *Reckless Abandon: Vacant Property Ordinances Create Legal Uncertainties*, 68 BUS. LAW. 669 (2013).

A lender that enters the property to conduct inspections and maintenance could actually hand the borrower the factual bases for such claims. Despite the fact that his own actions put him in default, a borrower could argue that any action taken by the lender without the knowledge or consent of the borrower is a breach of the loan agreement that could potentially expose the lender to liability.³²⁴ The borrower could further contend that any fees or costs incurred by the lender under the CVAPO before or after the lender filed a notice of default cannot be a charge against the borrower that is added to the lender's foreclosure credit bid. For the lender that in the meantime works to confirm the property is "not legally occupied" but does not maintain the property out of caution so as to avoid such claims, there is the looming threat the city will apply fines or perhaps pursue prosecution of a criminal misdemeanor charge.

For insulation from liability, lenders could seek court appointment of a receiver, but this remedy would likely delay the start of inspections or maintenance and increase court costs and legal fees. A borrower, however, may argue that since the court-appointed receiver's costs and fees are to protect the lender from liability for its compliance with the CVAPO, such expenses are administrative and therefore not the same as those costs and fees related to foreclosure that can be added to the borrower's debt. The lender that does obtain a receiver could incur nonrecoverable costs, despite the fact that it was the borrower's default that initiated the problems.

Again, the borrower could contend that the expenses for registration, registration fees, property management companies, receivership fees, court costs, and perhaps others should be characterized as administrative in nature in that they concern the lender's compliance with local government's oversight of the lender, not the borrower. Under the borrower's construction, fees and costs of this nature are not authorized under the state's foreclosure statutory scheme. Therefore, the borrower would assert that the lender cannot add these expenses to the amount owed by the borrower.

Unlike the abandoned property ordinance in Las Vegas, Nevada,³²⁵ the CVAPO and others like it do not shield lenders and instead leave them vulnerable to legal attack from borrowers. It is evident by the shield set out in the Las Vegas ordinance that the prospect of unintended consequences was taken seriously. That consideration is absent from the public record in Chula Vista. Unfortunately, many abandoned property ordinances reflect local

³²⁴ See generally Richard E. Gottlieb, Margaret J. Rhiew, Brett J. Natarelli, *Reckless Abandon: Vacant Property Ordinances Create Legal Uncertainties*, 68 BUS. LAW. 669 (2013). This would, of course, depend on what the lender's actions were. Such claims by the borrower could conceivably include actions for forcible detainer, trespass, interference with quiet use and enjoyment, breach of the loan agreement, or indemnity if the lender's entry were to put the borrower, as a landlord, in breach of a rental agreement. Likewise, the borrower might be able to somehow use the lender's acts as a defense against a foreclosure. See generally 12 MILLER & STARR, CAL. REAL EST. §§ 36:1 *et seq.* (3d ed. 2002).

³²⁵ See *supra* text accompanying notes 88–90.

government's speculative, short-sighted approach to "risky financial arrangements" and foreclosures. Such ordinances let the lenders maintain the property regardless of the costs that will be passed on; regardless of the liability that lenders may face from borrowers; and, regardless of the irresponsibility the ordinance inexplicably encourages in borrowers notwithstanding the contractual promises and moral duties to which the borrower willingly assented.

b. Lender's Fees and Costs are Unreasonable

In the event that such expenses were not characterized as administrative, the borrower could still contend that these expenses are unreasonably high, which may be true given the extent of costly regulations and the current rates of property managers, receivers, general contractors, and others that would be hired to complete the tasks required of the lender. Courts may be open to this argument because the lender's recovery would not be enhanced since the average house value has dropped below the amount of the loan balance, and in any case the lender cannot pursue the borrower after the foreclosure sale due to the anti-deficiency judgment protection in California and other states.

c. Advances by a Junior Lender to a Senior Lender

Another issue raised by the CVAPO relates to advances made by a junior lender to reinstate the senior loan. Typically, when a junior lender, whose deed of trust is recorded after the senior lender's deed of trust, makes an advance pursuant to the junior deed of trust on behalf of the borrower to cure his default on the senior loan, the junior lender can commence its own foreclosure and add such advance to the amount owed on the junior loan.³²⁶ Since the CVAPO makes no distinction between senior and junior lenders in respect of the obligations under its regulatory scheme, the burden to comply falls on the lender that first records its notice of default.³²⁷ If the property is "not legally occupied" or shows "evidence of vacancy," only the lender that records a notice of default must inspect, register, and maintain the property.³²⁸ Where the senior lender records its notice of default, it must comply with the CVAPO. A junior lender must then evaluate whether it will protect its security interest and rights by advancing funds to cure the senior loan, and also consider the senior lender's and its own costs of com-

³²⁶ Such was the situation in *Passinisi v. Merit-McBride Realtors, Inc.*, 190 Cal. App. 3d 1496 (1987). See *supra* notes 294–95 and related text.

³²⁷ See generally *supra* Part III.A.

³²⁸ *Id.*

pliance with the CVAPO before it advances funds. That is, the junior lender must determine if the total sum of expenses for the advance to the senior, compliance with the CVAPO, and foreclosure exceed the balance due on the junior loan. Lenders, regardless of their priority position relative to other secured creditors, are experienced and competent in the deliberations regarding the advancement of funds on behalf of a borrower in default. Now, however, they must incorporate into their deliberations the issues raised by the new layer of regulations mandated by abandoned property ordinances.

It would not be a surprise if costs of junior loans go up even higher than senior loans due to the way local government has turned the lender–borrower deed of trust maintenance–security provision upside down. Mortgage lenders must recalibrate whether it is in their best interests to write loans for marginal borrowers given the costs that will be incurred upon default and abandonment. Abandoned property ordinances practically institutionalize subprime mortgage loans, which lenders presumably would provide at higher interest rates and closing costs.

V. RECOMMENDATIONS

Currently, the effects of the subprime mortgage fiasco are persistent, though there are fewer foreclosures³²⁹ and housing values appear to be on a modest upward climb in some areas.³³⁰ Yet the economy in general continues to sputter. Spending programs at all levels of government have not restored the economy, putting into doubt the wisdom of deficit spending and making taxpayers and future generations long term debtors. The spending and the programs may actually portend a worse economic disaster in the long run. In the meantime, new regulations that were meant to deal with the financial crisis continue to choke economic activity and the underlying freedom that is necessary for individuals and businesses to pursue their economic goals. In some ways we are witness to the modern version of the

³²⁹ Erik Anderson, *Mortgage Delinquencies Fall As Housing Market Bounces Back*, KPBS (Aug. 12, 2013), retrieved from <http://www.kpbs.org/news/2013/aug/12/mortgage-delinquencies-fall-housing-market-bounces/> (“The nation’s Mortgage Bankers Association said mortgage delinquencies have hit a five-year low.”); see also Erik Anderson, *California Foreclosures Fall As Home Prices Rise*, KPBS (July 23, 2013), available at <http://www.kpbs.org/news/2013/jul/23/california-foreclosures-fall-home-prices-rise/> (“Dataquick, which tracks the state’s housing market, said lenders issued just over 25,000 notices of default. That’s the first step in a long foreclosure process. That amount of notices is the second lowest quarterly number in seven years and well below the peak of more than 135,000 notices in the first quarter of 2009.”).

³³⁰ Lily Leung, *Home price gains in SD outpace U.S.*, THE SAN DIEGO UNION-TRIB. (Aug. 27, 2013), available at <http://www.utsandiego.com/news/2013/aug/27/san-diego-home-prices-real-estate-values-gains/> (“San Diego home prices in June rose 19 percent from a year ago, which marks its largest year-over-year hike since March 2005.”).

approach taken in the New Deal era—program after program were implemented with deficit spending to end the Great Depression, but the Depression was actually prolonged as a result of those economic policies.³³¹ Today, governments' new spending programs and new layers of regulations could very well be the reason the Great Recession continues. Rather than repeat the mistake of retaining restrictive legislation and costly programs, abandoned property ordinances ought to be repealed since foreclosures have tapered off and the risk of blight has subsided. The reasons that were given for abandoned property ordinances are no longer persuasive and do not justify their retention.

Local government should do its part to restore the deeper meaning of home ownership and the vitality of the home mortgage market by repealing abandoned property ordinances. Under the current regime of bailout programs and more regulation, home ownership is at the same time made cheaper and costlier. It is cheaper because the standards for ownership are so low that it has become nearly meaningless. Hard work, saving money, and sacrifice are not held out as virtues that produce a multiplicity of benefits. Borrowers from some communities were virtually given the loan to purchase a home and now face no consequences for default or abandonment.³³² Yet, home ownership is more costly because other sectors of society must bear the expense of more government control through regulation and more debt due to government deficit spending for subsidies. Socialization of home ownership is a bad idea, as can be seen from the fallout of the financial crisis and the underlying policies that fostered it.

The repeal of abandoned property regulations would not put municipalities at greater risk either because local government can enforce public nuisance ordinances and other regulations already on the books in such a way as to reinforce the owner-borrower's personal responsibility of home ownership. A borrower in default should not externalize his costs on his lender, future borrowers, or taxpayers. Borrowers should be given the message that ownership responsibilities run until he voluntary transfers title or involuntarily loses title. Moreover, *risks* of blight should be manageable given the fact that there are fewer foreclosures. If local legislators cannot compile the empirical data of serious blight problems to justify abandoned property ordinances, then such ordinances ought to be repealed. But if such ordinances remain, they should at a minimum be amended to require the borrower to take care of the property.

Borrowers fully understand that home ownership carries responsibility with it, even if they do not understand the details in the loan documents they sign.³³³ Accordingly, it is appropriate to ask the borrower to take steps

³³¹ AMITY SCHLAES, *THE FORGOTTEN MAN: A NEW HISTORY OF THE GREAT DEPRESSION* (2008).

³³² See generally *supra* Part II.

³³³ Even if the borrower does not know the details of a "risky" loan, he is aware that he has purchased a home that requires maintenance. This knowledge alone ought to be dispositive as to whether

to assure his lender and local authorities that the home will be maintained and kept secure after he moves out. As set out in one local ordinance, a borrower could be mandated to buy a bond that covers the costs of maintenance, repair, and security.³³⁴ Obviously, the borrower would be required to provide the bond at the time of purchase of the house. This type of requirement is sensible given the fact that continued government intervention would continue to restrict the lenders' use of traditional lending criteria.

Local officials could require a borrower to notify the city of his default or abandonment when he learns that he does not qualify under a loan modification program and cannot resolve his default. This requirement would make sense to a borrower who plans to move for nondefault reasons, since he would submit a change of address form to the U.S. Post Office at the time of his move. He need only provide one more form to the local official. The burden on the borrower would be minimal and the form submitted to the local official would disclose information similar to that in the publicly recorded notice of default or the change of address form. In addition, a borrower could be required to provide local officials with contact information and forwarding-address information, or grant consent to local officials to obtain such information from the U.S. Post Office. Federal regulation already authorizes local government to obtain certain mailing information.³³⁵ This requirement would enable officials to contact borrowers to notify them of the legal obligation to take care of the property.

Local officials enacted abandoned property ordinances as the means, at least in theory, for prompt and efficient responses to vacant property. The borrower is the person with the immediate connection to the property. Though he may have moved out, the great likelihood is that he is in the vicinity and is available to fulfill his ownership duties. On the other hand, the mortgage lender may not be as immediately available for any one of a number of reasons (as discussed above). An alternative party that could provide a prompt response is a homeowners' association. A homeowners' association has a secured interest in the property by virtue of the fact that its declaration of covenants, conditions, and restrictions is recorded and permits the association to enter onto the property under certain circumstances.³³⁶ In addition, the association is typically authorized to collect dues

the borrower should remain responsible for the maintenance, particularly since municipalities that have enacted abandoned property ordinances have chosen not to address the question of culpability in the underlying loan agreement.

³³⁴ *Easthampton Sav. Bank v. City of Springfield*, 874 F. Supp. 2d 25, 28–29 (D. Mass. 2012) (upholding local ordinance that requires the owner (defined to include mortgagors and mortgagees) to provide the local building commissioner a cash bond of no less than \$10,000 for maintenance and security).

³³⁵ *See supra* note 246.

³³⁶ A typical provision in a Declaration of Covenants, Conditions, and Restrictions authorizes “the subdivider or the Committee may enter upon the lands and remove the [nuisance] at the expense of the

with which it covers the expense to maintain common areas. Since it has a daily presence within the common interest community, the association can promptly respond to maintenance and security needs at a given property. It would be alerted to a possible vacant home when it no longer receives the owner–borrower’s payments of the association dues. Though the failure to pay dues would impact the association’s revenue to one degree or another, the association could still quickly discover whether the property is vacant, and then register with the city if it is. At that point, the city could contact the borrower through the U.S. Post Office and pursue its remedies under the standard public nuisance regulations. Moreover, the declaration provides procedural safeguards of notice and hearing when the association pursues its own remedies, including judgments and enforcement of liens.³³⁷

An obvious problem with this alternative is the fact that not all properties that will be the subject of a foreclosure are within a homeowners’ association. However, the close proximity of homeowners’ associations makes them the most immediately available party to respond to a vacant property, that is within the association. In Chula Vista the majority of foreclosures occurred in the area of the city that is made up almost entirely of homeowners’ associations.³³⁸ This likely occurred because the area is made up of new developments where purchasers paid higher prices and obtained larger loans, which made the purchasers more susceptible to defaults and foreclosures. Where the locus of a concentration of foreclosures is within a homeowners’ association, then the association is a viable option to quickly and cost-effectively inspect, register, and maintain the property, or at least determine the status of occupancy and notify the city if necessary.

At a minimum, the local governing body ought to amend abandoned property ordinances to provide lenders with a measure of protection against certain unintended consequences. These ordinances force lenders to enter onto the property to conduct inspections and maintain the property. Such entry and work may give rise to claims by borrowers against lenders. A provision can be added that is similar to the regulation in Las Vegas, which declares that no claim or duty is created in favor of any party except the city.³³⁹ Further, the local authorities could at least amend such ordinances

owner and such entry shall not be deemed a trespass.” LexisNexis® Forms: FORM 240-22.77 Statement of reservations and restrictive covenants-single family residential development ¶ 8.

³³⁷ Before the judgment sale occurs, an association would be required to provide notice to all parties with security interests in the subject property. CAL. CODE CIV. PROC. § 701.540 subd. (h).

³³⁸ Lori Weisberg, *Homeowners associations countywide are hit by foreclosure fallout and feeling the pinch of. . . Unpaid dues*, SAN DIEGO UNION-TRIB. (Nov. 1, 2007) (“Especially vulnerable are smaller condo-conversion projects and developments in more affordable areas, such as eastern Chula Vista, where first-time homeowners stretched themselves financially to buy, using loans with low teaser rates that have since reset upward.”).

³³⁹ See *supra* text accompanying notes 88–90.

to include a provision that imposes joint and several liability on the borrower, as has been done in Fort Lauderdale, Florida.³⁴⁰

If local government will not repeal such ordinances, which is virtually guaranteed under the currently popular government-fixes-all mentality, then the ordinances must be forced to withstand constitutional scrutiny. Local government ought to clarify such ordinances so that the circumstances that establish when property is “not legally occupied” or “shows evidence of vacancy” are not ambiguous and the standards to maintain and keep secure the property are clearly understood.

VI. CONCLUSION

The government’s subprime home ownership policy led to the subprime mortgage disaster. The policy is subprime primarily because the federal government mandated a system that enabled mortgage lenders, government-sponsored enterprises, and investment bankers to earn profits from mandated subprime mortgage loans and then to receive bailout money when the system collapsed. This government-inspired system provided bailout money (in the form of loan modification and other programs) for the borrowers too. Government callously turned to the taxpayer to pay the bill. There is nothing prime about this arrangement.

Another negative aspect of the subprime home ownership policy is the persistent belief in the notion that additional regulation will solve the problem *de jour*, or in this case, the crisis of an era. Local government continues this practice through the abandoned property ordinance. Such an ordinance erodes the rule of law in that it impairs a private contract between private parties by intentionally reversing the parties’ stated intent to assign in a lawful way the rights, duties, and risks of their contractual relationship. It is not as if the parties sought to violate the law or circumvent good economic practices when they agreed that the borrower was required to take care of the home he purchased. The rule of law is undermined because an abandoned property ordinance exceeds valid police power authority in that the means to achieve the objective of public health and safety belie the core purpose of government, which is to wield authority against wrongdoers. But, an abandoned property ordinance does not require the adjudication of wrongdoing and does not seek to find fault between a lender and a borrower. Instead, such a regulation holds lenders strictly liable, making an economic choice that contradicts a requisite of the rule of law: the private parties’ reliance on the certainty and enforceability of an otherwise lawful contract. Economic activity is just as much a core fundamental necessity and voluntary pursuit as any exercise of a right under the First Amendment of the U.S. Constitution. Thus, abandoned property ordinances ought to be

³⁴⁰ See *supra* text accompanying notes 85–87.

scrutinized under a standard higher than the current rational relation test with less deference by the courts.

The rule of law is also eroded in the way an abandoned property ordinance expands police power authority without findings that are based on substantial empirical data that blight actually exists. In the mind of code enforcement personnel, speculation that a serious problem might occur apparently is sufficient to justify releasing borrowers from a significant contractual obligation to care for his property, rendering public nuisance regulations superfluous in those instances when a borrower has defaulted on his mortgage loan and abandoned his property. Encouraging a borrower's irresponsibility toward his contractual obligations and binding a lender to property maintenance because of its deep pockets is unfair and inequitable, thus further eroding the rule of law.

An abandoned property ordinance that is vague is not constitutionally valid. The abandoned property ordinance does not sufficiently define when a mortgage lender that has recorded a notice of default must start to maintain that property after the borrower later abandons it. Moreover, the ordinance poorly defines what the standard for maintenance is once the lender begins that task. When mortgage lenders must guess at the meaning of certain critical terms in the ordinance and may suffer a fine or criminal prosecution if they guess incorrectly, the ordinance does not inform the lending industry of what is expected so that lenders have the opportunity to consider the cost of doing business. If a lender's mistake is overlooked, that would occur only because of the local official's sole discretion. The ordinance is thus arbitrary.

Further, the ordinance erodes the rule of law because at this point it is not clear if a foreclosing lender will obtain the remedy that it needs. A mortgage lender may not be able to recover its costs through its credit bid at the foreclosure sale. Where there is a wrong, there must be a remedy, unless we have arrived at the point where local government's police power now authorizes a regulation that mandates one party to a contract to pay for the other party's breach without reimbursement. This creates an inequitable turn of the contract terms.

The CVAPO and all other ordinances like it are not good legislation for the economy, the housing and lending markets, the virtue of personal responsibility, and the essential rule of law. Therefore, such ordinances ought to be repealed.



BETTING THE FARM: THE LIMITS OF GUARANTOR PROTECTION
UNDER THE SERVICEMEMBERS CIVIL RELIEF ACT

*Michael Rogers***

INTRODUCTION

After retiring from a career in the military, a husband, along with his wife, invested in a hardware business.¹ To support the business's operations, the husband and wife risked their home and the family farm as collateral for a \$700,000 loan from a local bank. Knowing that many small businesses fail,² the bank required a 10.25% interest rate on the loan. In addition, the bank required that the husband and wife execute a contract called a guaranty, whereby they, as guarantors, promised to personally pay the business's debt if the business failed to adhere to the terms of the loan. The hardware store turned a profit the first year but struggled to break even in the years that followed. While the business was struggling to stay afloat, the wife, a Navy reservist and the hardware store's vice president, was called into active military duty. Within ten months of the wife's call-up to military service, the hardware store finally failed and closed its doors for good. After liquidation of all the business's assets, the original \$700,000 loan had a remaining balance of over \$300,000. By the terms of the guaranty, the bank could seize the couple's home and farm as collateral if the remaining balance was not paid immediately—the couple had truly bet the farm on the success of the store.

This true story illustrates the difficulties faced by both small business owners and servicemembers, two constituencies critical to the welfare of the United States. President Obama recently described the importance of small business owners when he stated that “small businesses are the engine of economic growth in this country.”³ Similarly, President Obama empha-

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¹ These facts are taken from *Newton v. Bank of McKenney*, No. 3:11cv493-JAG, 2012 WL 1752407 (E.D. Va. May 16, 2012).

² *Frequently Asked Questions*, SMALL BUSINESS ASSOCIATION 1 (Jan. 2011), <http://www.sba.gov/sites/default/files/sbfaq.pdf> (showing that only half of new small businesses survive at least five years).

³ Barack Obama, U.S. President, Remarks at the College of Nanoscale Science and Engineering, State University of New York, (May 8, 2012), *available at* <http://www.whitehouse.gov/the-press-office/2012/05/08/remarks-president-albany-ny>.

sized the significance of servicemembers by stating, “[L]et us always stand united in support of our troops, who we placed in harm’s way. That is our solemn obligation.”⁴ That this husband and wife’s hardware store was one of 2.4 million veteran-owned firms, representing 9% of all firms conducting business in the United States, demonstrates how important servicemembers are in building and maintaining small businesses.⁵

Recognizing the plight of servicemembers in these situations, Congress has provided a set of protections and benefits for servicemembers in the Servicemembers Civil Relief Act (SCRA).⁶ Without the SCRA, the bank could seize the family’s farm while the wife is serving her country; with the SCRA, the bank cannot seize the wife’s nonbusiness assets⁷ nor obtain a default judgment against the wife while she is in active military service.⁸ While the servicemember would not need to worry about losing the family farm during her active military service, she may still have to worry about the potentially large interest payments that will accumulate because of the ambiguity of § 527 of the SCRA as to whether a guarantor can be liable for interest in excess of 6%.⁹ In fact, if she is liable for interest in excess of 6%, the amount for which she is personally liable could increase by over \$23,000 by the time her active military service ends.¹⁰ An additional liability of this amount could be the difference between keeping and losing the family farm.

Part I of this Comment provides the key background law necessary to address the issue of guarantor liability under the SCRA. This background begins in Part I.A with the statute itself, and then moves on to Part I.B, which focuses on § 527 to demonstrate the section’s lack of clarity regarding its limits on guarantor liability. Part I.C then discusses three recent district court cases addressing guarantor liability under the SCRA to further demonstrate that no court has yet directly addressed the specific question of guarantor liability under § 527.

Part II.A of this Comment analyzes the text of § 527, relevant SCRA case law, and the law of guaranty to argue that a court addressing the issue

⁴ Barack Obama, U.S. President, Remarks at the Commemoration Ceremony of the 50th Anniversary of the Vietnam War, (May 28, 2012), available at <http://www.whitehouse.gov/the-press-office/2012/05/28/remarks-president-commemoration-ceremony-50th-anniversary-vietnam-war>.

⁵ *Facts on Veterans and Entrepreneurship*, SMALL BUSINESS ADMINISTRATION, <http://www.sba.gov/about-offices-content/1/2985/resources/160491> (last visited Oct. 10, 2002). While the hardware store in this example was owned by both a veteran and an active duty servicemember, the SCRA applies only to active duty servicemembers.

⁶ 50 U.S.C. App. §§ 501-97b (2012).

⁷ *Id.* § 596.

⁸ *Id.* § 521.

⁹ *Id.* § 527; see *Newton v. Bank of McKenney*, No. 3:11cv493-JAG, 2012 WL 1752407 at *8 (E.D. Va. May 16, 2012) (leaving unanswered the question, “[C]an the servicemember be liable as a guarantor for corporate debt that accrues at a rate greater than 6%?”).

¹⁰ Pl.’s Mem. in Supp. of Summ. J. at 8, *Newton*, 2012 WL 1752407 (No. 3:11cv493-JAG).

of guarantor liability should find that a servicemember can be liable as a guarantor for debt that accrues at a rate greater than 6%. Finally, Part II.B of this Comment argues that the result of the technical legal analysis in Part II.A is sound policy because it is consistent with the legislative intent of the SCRA and actually serves to protect the servicemember's economic interests.

I. BACKGROUND

A. *The Servicemembers Civil Relief Act*

The purpose of the SCRA is “to provide for, strengthen, and expedite the national defense through protection extended . . . to servicemembers of the United States to enable such persons to devote their entire energy to the defense needs of the Nation.”¹¹ To achieve this purpose, the SCRA provides a number of procedural protections and substantive benefits to servicemember borrowers, as well as other protections and benefits not directly related to borrowing activities.¹² A servicemember under the SCRA is a “member of the uniformed services,” which includes the Army, Navy, Air Force, Marine Corps, Coast Guard, and the commissioned corps of the National Oceanic and Atmospheric Administration and the Public Health Service.¹³ Military service under the SCRA is defined as active duty and any period when a servicemember is lawfully absent from active duty.¹⁴ Military service for a member of the National Guard is defined as “a call to active service authorized by the President or Secretary of Defense for a period of more than 30 consecutive days.”¹⁵

The SCRA provides servicemembers in military service several key protections and benefits that have particular relevance to guarantors. First, a servicemember is entitled to a stay of proceedings in a civil action if her military service materially impacts her ability to appear at the proceed-

¹¹ 50 U.S.C. App. § 502 (2012).

¹² See generally THE JUDGE ADVOCATE GENERAL'S LEGAL CTR. & SCH., THE JUDGE ADVOCATE GENERAL'S SCHOOL GUIDE TO THE SERVICEMEMBERS CIVIL RELIEF ACT (2007) [hereinafter JAG GUIDE]; JOHN S. ODOM, JR. A JUDGE'S BENCHBOOK FOR THE SERVICEMEMBERS CIVIL RELIEF ACT (2011). Protections and benefits related to borrowing activity that are not directly relevant to this Comment include: protection from mortgage foreclosure, 50 U.S.C. App. § 533 (2012); protection from foreclosure on installment loans for purchase of real or personal property, *id.* § 532; and protection from an adverse credit report made as a result of a servicemember exercising her rights under the SCRA, *id.* § 518. Protections and benefits not directly related to borrowing activity include protections and benefits related to: insurance coverage and premiums, *id.* §§ 536, 541–47, 593–94; tolling of statute of limitations, *id.* § 526; taxation, *id.* §§ 570–571; and voting rights, *id.* § 595.

¹³ 50 U.S.C. App. § 511(1) (2012); see also 10 U.S.C. § 101(a)(5) (2012).

¹⁴ 50 U.S.C. App. § 511(2) (2012).

¹⁵ *Id.* § 511(2)(A)(ii).

ings.¹⁶ If, however, a servicemember fails to appear in a civil action and a default judgment is entered against her, the servicemember may reopen the default judgment if her ability to defend the action was materially impacted by her military service.¹⁷ Even if a servicemember's ability to appear or defend an action is not materially impacted by her military service, a lender may not seek the servicemember's nonbusiness assets in order to satisfy an obligation of the servicemember's business.¹⁸ If a court grants a servicemember relief in the form of a stay of proceedings or vacation of a default judgment, the court may grant the same relief to any party secondarily liable (including a guarantor) on the same civil obligation.¹⁹ Finally, a servicemember is entitled to have the interest rate on any obligation that existed prior to her military service reduced to 6%.²⁰

The Supreme Court requires courts to "liberally construe [the SCRA] to protect those who have been obliged to drop their own affairs to take up the burdens of the nation."²¹ While the SCRA was enacted in 2003, the current statute traces its origin directly back to the Soldiers' and Sailors' Civil Relief Act of 1940 (SSCRA) and indirectly back to civil relief statutes dating to the Civil War.²² The SCRA retains and builds upon the key concepts of the earlier legislation, and therefore the case law developed from this earlier legislation is still relevant in analysis of the current statute.²³

B. *Section 527 Does Not Address Guarantor Liability*

This comment examines the applicability of § 527 of the SCRA to a guarantor of corporate debt that accrues at an interest rate greater than 6%, and therefore a detailed examination of the text of § 527 is appropriate. The key provision of § 527 provides:

An obligation or liability bearing interest at a rate in excess of 6% per year that is incurred by a servicemember, or the servicemember and the servicemember's spouse jointly, before the servicemember enters military service shall not bear interest at a rate in excess of 6% (A) during the period of military service and one year thereafter, in the case of an obligation or

¹⁶ *Id.* § 522.

¹⁷ *Id.* § 521.

¹⁸ *Id.* § 596.

¹⁹ *Id.* § 513.

²⁰ 50 U.S.C. App. § 527 (2012) (2006); *see infra* Part I.B.

²¹ *Boone v. Lightner*, 319 U.S. 561, 575 (1943).

²² JAG GUIDE, *supra* note 12, at 1.

²³ JAG GUIDE, *supra* note 12, at 2 ("The SCRA strengthens, clarifies, and modernizes the older SSCRA. While there are significant changes, most key concepts, protections, and benefits remain. Thus, much of the older case law – examined in this volume – is as relevant as ever.").

liability consisting of a mortgage, trust deed, or other security in the nature of a mortgage; or (B) during the period of military service, in the case of any other obligation or liability.²⁴

Any interest in excess of 6% is forgiven, not merely postponed.²⁵ Creditors are required to reduce any required payment amount by the amount of interest that is forgiven and cannot increase the amount of principal due to maintain the same required payment amount that existed before any interest was forgiven.²⁶ To take advantage of § 527, the servicemember must provide written notice and a copy of her military orders to the creditor within 180 days of the end of the servicemember's military service.²⁷ Once a creditor is notified, the creditor must forgive all interest in excess of 6% that has accrued since the date the servicemember was called to military service.²⁸ A creditor may be exempt from the requirements of § 527 if it can demonstrate that the servicemember's ability to pay interest in excess of 6% is not materially impacted by the servicemember's military service.²⁹ The 6% interest rate cap applies to all types of liabilities, including student loans.³⁰

The text of § 527 does not differentiate between liability of a guarantor and a borrower; the 6% interest rate benefit simply applies to any "liability . . . incurred by a servicemember."³¹ While the text of § 527 does not directly address the question of whether a guarantor can be liable for interest that accrues at a rate greater than 6%, parsing the text provides a two-requirement framework that, depending on how courts construe each requirement, can provide different rules for guarantor liability.³² The first requirement of § 527 is that the servicemember incur a liability or obligation prior to entering military service.³³ The second requirement of § 527 is that a liability must accrue interest at a rate greater than 6% per year.³⁴ Exactly when and how a court determines each of these two requirements to have been satisfied will determine which of three potential rules for guarantor liability that court will adopt.³⁵

²⁴ 50 U.S.C. App. § 527(a)(1) (2012).

²⁵ *Id.* § 527(a)(2). *But cf. id.* § 513 (allowing a court to extend relief in the form of a stay, postponement, or suspension to a guarantor).

²⁶ 50 U.S.C. App. § 527(a)(3) (2012).

²⁷ *Id.* § 527(b)(1).

²⁸ *Id.* § 527(b)(2).

²⁹ *Id.* § 527(c); *In re Watson*, 292 B.R. 441, 444 (Bankr. S.D. Ga. 2003) ("The lender bears the burden of showing that the serviceman has the ability to pay at the original interest rate.").

³⁰ 20 U.S.C. § 1078(d) (2012).

³¹ 50 U.S.C. App. § 527(a)(1) (2012).

³² *See infra* Part II.A.

³³ 50 U.S.C. App. § 527(a)(1) (2012); *see also* *Shield v. Hall*, 207 S.W.2d 997, 1000 (Tex. Civ. App. 1948) (refusing to extend the SSCRA's interest rate benefit to a mortgage that was incurred while the servicemember was in military service).

³⁴ 50 U.S.C. App. § 527(a)(1) (2012).

³⁵ *See infra* Part II.A.

A court could determine that the first requirement is satisfied either when the guaranty is executed or when the loan's borrower defaults; if a court makes the latter determination and the borrower defaults after the guarantor enters military service, then the benefit of § 527 would not be available.³⁶ A court making the alternative determination—that a guarantor incurs liability when the guaranty is executed—could similarly make a determination that the *second* requirement—that the liability accrues interest in excess of 6%—is satisfied either when the guaranty is executed or when the loan's borrower defaults.³⁷ The benefit of § 527 would be available to the guarantor under either determination of when the second requirement is satisfied; however, a determination that the liability accrues interest in excess of 6% only after the borrower has defaulted would result in guarantor liability for interest in excess of 6% that accrued after the servicemember entered military service, *but before* the borrower defaulted.³⁸ This analysis of how a court could determine when and how each of the two requirements of § 527 is satisfied illustrates what this comment will refer to as the “two-requirement framework.”

A. *Recent Case Law Does Not Directly Address Guarantor Liability Under § 527*

No federal court at any level has directly addressed guarantor liability under § 527 of the SCRA.³⁹ Three district court cases since 2001 have addressed the applicability of the SCRA to corporations; however, in each case, the corporation had a servicemember owner who had personally guaranteed the corporation's debt.⁴⁰ While these cases do not explicitly apply the two-requirement framework, both *Cathey v. First Republic Bank* and *Newton v. Bank of McKenney* imply the first requirement by acknowledging the need to identify a liability incurred by a servicemember. In both these cases, it is clear that a *corporation* incurred a liability for a business loan; the court, however, focuses on whether a *servicemember* incurred a liability as required by § 527.⁴¹ The third case, *Linscott v. Vector Aerospace*, fails to apply the text of § 527 in reaching the conclusion that the benefits of the

³⁶ See *infra* Part II.A.3.

³⁷ See *infra* Part II.A.1–2.

³⁸ See *infra* Part II.A.2.

³⁹ See *Newton v. Bank of McKenney*, No. 3:11cv493-JAG, 2012 WL 1752407, at *7–8 (E.D. Va. May 16, 2012) (reviewing the available case law and acknowledging the unanswered question, “[C]an the servicemember be liable as a guarantor for corporate debt that accrues at a rate greater than 6%?”).

⁴⁰ *Cathey v. First Republic Bank*, No. 00-2001-M, 2001 WL 36260354 (W.D. La. July 6, 2001); *Linscott v. Vector Aerospace*, No. CV05-682-HU, 2006 WL 1310511 (D. Or. May 12, 2006); *Newton*, 2012 WL 1752407.

⁴¹ *Cathey*, 2001 WL 36260354, at *4; *Newton*, 2012 WL 1752407, at *7–8; see *supra* Parts I.C.1, 3.

SCRA extend to the servicemember's corporation.⁴² While these cases did not require the courts to decide the issue of guarantor liability,⁴³ their analysis and facts are useful to demonstrate how the issue can be addressed through applying the two-requirement framework; this application is the focus of Part II.A of this Comment.

1. Cathey v. First Republic Bank

In *Cathey v. First Republic Bank*, Stewart and Donna Cathey, together with their corporation, were comakers⁴⁴ of two construction loans intended to fund the construction of a gas station and convenience store.⁴⁵ Both loans provided that the borrower on the loans included both the corporation and the Catheys in their individual capacities.⁴⁶ In addition to signing the loan documents as borrowers, the Catheys executed personal guarantee agreements and pledged their home as collateral for the loans.⁴⁷ After the loans and guarantees had been executed, Mr. Cathey, a member of the United States Army Reserve, was called into active duty in Bosnia and sought to have the interest rate on the loans reduced to 6% as provided by the SSCRA.⁴⁸

In holding that the defendant was required to reduce the interest rate on the loan to 6%, the District Court for the Western District of Louisiana was careful to state that Mr. Cathey was entitled to the SSCRA benefits as a borrower on the loan and not as an owner of the corporation: "This is not a case where loans were executed by a corporation which happened to be owned in part by a serviceman. Rather, this case involves loans incurred by a serviceman."⁴⁹ The court did not base its holding on Mr. Cathey's status as a guarantor, but rather states simply that the guaranty was a "redundant requirement."⁵⁰

⁴² *Linscott*, 2006 WL 1310511, at *4; *see infra* Part I.C.2.

⁴³ *Cathey*, 2001 WL 36260354, at *4; *Linscott*, 2006 WL 1310511, at *4; *Newton*, 2012 WL 1752407, at *7–8; *see infra* Parts I.C.1–3.

⁴⁴ Comakers include cosigners and any party who participates jointly in the borrowing of money. BLACK'S LAW DICTIONARY 302 (7th ed. 1999).

⁴⁵ *Cathey v. First Republic Bank*, No. 00-2001-M, 2001 WL 36260354, at *1 (W.D. La. July 6, 2001).

⁴⁶ *Cathey*, 2001 WL 36260354, at *2–3.

⁴⁷ *Id.*

⁴⁸ *Id.* at *1. *Cathey* was decided in 2001 under the SSCRA of 1940, the legislation that preceded the 2003 enactment of the SCRA. The substance of § 526 of the SSCRA of 1940 for purposes of this Comment is identical to the substance of § 527 of the SCRA of 2003.

⁴⁹ *Id.* at *4–5.

⁵⁰ *Id.* at *4.

2. Linscott v. Vector Aerospace

While the *Cathey* court was careful to state the exact basis of the servicemember's ability to invoke the SSCRA's interest rate cap provision, the District Court of Oregon in *Linscott v. Vector Aerospace* extended the benefit to a corporation by misreading the *Cathey* holding.⁵¹ In *Linscott*, a helicopter repair company obtained a judgment against Jeffrey Linscott's corporation in a Canadian court based on the corporation's failure to pay for repairs that the helicopter repair company made to the corporation's helicopter engine.⁵² Mr. Linscott, an Air Force Reserve Major, had been on active duty for seven months between the dates when the defendant first invoiced Mr. Linscott's corporation for the repairs and when the judgment was entered.⁵³ The Canadian court ordered Mr. Linscott's corporation to pay \$106,074.90, representing the amount owed plus interest that had accrued at 18% per year.⁵⁴ Mr. Linscott was not a party to the action in Canadian court, but had personally financed the original purchase of the corporation's helicopter and had previously made assurances to the helicopter repair company that he would pay what his corporation owed if the repair company would return the helicopter engine to his corporation.⁵⁵ Before the defendant could register the judgment in the United States, Mr. Linscott and his corporation brought an action for violations of the SCRA.⁵⁶

The court, "persuaded by the reasoning of the court in *Cathey*," held that the protections of the SCRA extend to the servicemember's corporation, and granted a preliminary injunction preventing the defendant from registering the Canadian judgment because the 18% interest rate used to calculate the judgment amount violated § 527 of the SCRA.⁵⁷ The court interpreted *Cathey* as holding that "the protections extended to the servicemember by the Act extend to the servicemember's corporation, especially when, as in *Cathey* and as in this case, the corporation's obligations were personally guaranteed by the servicemember and the corporation 'depend[ed] on its owners' presence for profitability.'" ⁵⁸ This statement suggests that, despite the lack of any guaranty agreement between Linscott and the defendant, the court considered Linscott a guarantor of his corporation's

⁵¹ *Linscott v. Vector Aerospace*, No. CV05-682-HU, 2006 WL 1310511, at *4 (D. Or. May 12, 2006).

⁵² *Id.* at *2.

⁵³ *Id.* at *2.

⁵⁴ *Id.*

⁵⁵ *Id.* at *1-2.

⁵⁶ *Id.* at *1.

⁵⁷ *Linscott v. Vector Aerospace*, No. CV05-682-HU, 2006 WL 1310511, at *4 (D. Or. May 12, 2006).

⁵⁸ *Id.* (quoting *Cathey v. First Republic Bank*, No. 00-2001-M, 2001 WL 36260354, at *5 (W.D. La. July 6, 2001) (alteration in original)).

debt.⁵⁹ However, regardless of whether the court considered Linscott an actual guarantor or not, the court is clear that it based its holding on the theory that the benefits of § 527 of the SCRA extend to the servicemember's corporation, not on a theory that the benefits of § 527 extend to a guarantor of the corporation's debt.⁶⁰ Not only is it unclear whether the court considered Linscott a guarantor, the court is unclear when and how Linscott incurred a liability as required by the text of § 527.⁶¹ Although the court did not directly address the issue, by expanding the boundaries of the applicability of the SCRA beyond *Cathey*, it certainly suggested that it would extend the benefits of § 527 to a guarantor as well.

3. Newton v. Bank of McKenney

In *Newton v. Bank of McKenney*, the District Court for the Eastern District of Virginia agreed with this characterization of *Cathey* and *Linscott* while, in dicta, suggesting a resolution to the issue of guarantor liability for debt that accrues at a rate greater than 6%.⁶² In *Newton*, two corporations formed by Burl and Sharon Newton each executed a note that provided financing for a new hardware store.⁶³ While the Newtons executed personal guarantees for the notes, they were not parties to the notes in their individual capacities.⁶⁴ Ms. Newton was called into active duty in the Navy, and less than two years later the defendant foreclosed upon the corporations' assets in order to satisfy the unpaid debt on the notes.⁶⁵ In denying the Newtons' claims under § 533 of the SCRA,⁶⁶ the court rejected the *Linscott* court's incorrect interpretation of *Cathey* and refused to extend the benefits

⁵⁹ *Id.* at *4 (“[I]n this case . . . the corporation’s obligations were personally guaranteed by the servicemember . . .”).

⁶⁰ *Id.* (“[T]he protections extended to the servicemember by the Act extend to the servicemember’s family corporation . . .”); see also *Fifth Third Bank v. Schoessler’s Supply Room, L.L.C.*, 940 N.E.2d 608, 613 (Ohio Ct. App. 2010) (“In both the *Cathey* and *Linscott* decisions, the courts found that the protections afforded by the SCRA were applicable to the servicemembers’ companies.”).

⁶¹ In fact, the court fails to cite § 527 in its analysis. Also, the court incorrectly refers to the SCRA’s interest rate limitation provisions as arising out of § 526, *Linscott*, 2006 WL 1310511, at *3–4, whereas the 6% interest rate limitation had been enacted as § 527 of the SCRA on December 19, 2003. Servicemembers Civil Relief Act, Pub. L. No. 108-189, § 206-07, 117 Stat. 2862, 2844 (2003) (codified as amended at 50 U.S.C. App. §§ 526–27 (2006)); cf. *Newton v. Bank of McKenney*, No. 3:11cv493-JAG, 2012 WL 1752407, at *7 (E.D. Va. May 16, 2012) (noting that *Linscott* failed to acknowledge the language of § 596, 117 Stat. at 2865, also enacted in December 2003).

⁶² *Newton*, 2012 WL 1752407, at *7–8.

⁶³ *Id.* at *3.

⁶⁴ *Id.* at *3, *7.

⁶⁵ *Id.* at *3–4.

⁶⁶ 50 U.S.C. App. § 533 (2006) prohibits a lender from foreclosing upon any real property of a servicemember that is secured by a mortgage or similar instrument.

of the SCRA to a corporation.⁶⁷ In reaching this holding the court relied on the text of the SCRA and bedrock corporation law, which both recognize distinct rights of the servicemember and any corporate entity that she may own.⁶⁸

In addition to foreclosing on the corporation's assets, the defendant continued to assess interest at a rate in excess of 6% on one of the notes after Ms. Newton had requested an interest rate reduction in accordance with § 527.⁶⁹ This action by the defendant was supported by the Small Business Administration, who stated that the benefits of § 527 do not extend to the corporation of a servicemember.⁷⁰ In the end, the defendant credited all interest charged in excess of 6% back to the balance due on the note, rendering the Newtons' § 527 claim moot.⁷¹

Nonetheless, the court took the opportunity to distinguish the Newtons' liability as guarantors from the Catheys' liability as borrowers.⁷² In dicta, the court stated that the defendant had no obligation to lower the interest rate on the note because "[t]he guarantor on a note has a different liability than the maker—liability that only comes into existence when the maker defaults. As such, the Newtons incurred liability only when the corporation defaulted."⁷³ The court immediately thereafter states that it has not addressed the related question of whether the guarantor, having incurred liability due to the corporation's default, can be liable for debt that had accrued interest at a rate of greater than 6%.⁷⁴ This comment will now argue that the court had in fact answered the very question it purportedly left unanswered.

II. ANALYSIS

The text of the SCRA and the case law applying it leave open "a question the answer to which turns on a fine distinction"—can a servicemember guarantor be liable for interest greater than 6% under § 527?⁷⁵ The text of the SCRA and the case law do, however, provide a framework for analyz-

⁶⁷ *Newton*, 2012 WL 1752407, at *7.

⁶⁸ *Id.* at *5–6.

⁶⁹ *Id.* at *3.

⁷⁰ *See id.*; *see also* H.R. REP. NO. 108-81, at 53 (2003) ("The interest rate is not reduced to six percent . . . if the debt was incurred by the small legal entity . . . owned and operated by the individual who is called to active military service, and who is an essential employee of the business.") (quoting a letter from Hector Barreto, Administrator, Small Business Administration). The Small Business Administration was a co-guarantor of the Newtons' corporation's debt. *Newton*, 2012 WL 1752407, at *3.

⁷¹ *Id.* at *8.

⁷² *Id.* at *7–8.

⁷³ *Id.* at *8.

⁷⁴ *Id.*

⁷⁵ *Id.*

ing the issue through three potential rules. Part II.A of this Comment presents and analyzes these three rules in more detail, and argues that courts adopt the third rule because it aligns with the court's analysis in *Newton* and the principles of guaranty law. This third rule would hold that a servicemember guarantor incurs a liability that bears interest in excess of 6% when the corporation defaults and the guarantor becomes primarily liable for the debt. Practically, this results in a servicemember guarantor being unable to claim the benefit of § 527 for corporate debt whenever the corporation defaults after the servicemember has entered active military service. Part II.B of this Comment argues that this result, although arguably harsh, is sound policy because it aligns with the legislative intent of the SCRA and serves the long-run economic interest of servicemembers.

A. *Courts Should Find that a Guarantor Can Be Liable for Interest Greater than 6% Under § 527*

None of the three recent district court opinions to address § 527 directly analyze the question using the two-requirement framework provided by the text of § 527. The court in *Newton v. Bank of McKenney*, however, references the requirement that a servicemember incur a liability; this is the first requirement of this analytic framework. However, when discussing the liability incurred by a guarantor, the court in *Newton* does not address the unique nature of the guaranty relationship, where two separate liabilities are created. The second requirement, which entails the identification of a liability that bears interest in excess of 6%, provides a tool to analyze the applicability of § 527 to this unique relationship.

A guaranty relationship consists of two separate obligations. The first is the obligation of the borrower to the lender to adhere to the terms of the loan, and the second is the obligation of the guarantor to the lender to fulfill the first obligation if the borrower fails to adhere to terms of the loan.⁷⁶ When a guarantor agrees to fulfill the obligation of the borrower, he has incurred the second obligation. When the borrower defaults, the guarantor incurs the second obligation—he assumes the borrower's unconditional financial obligation to pay the loan.⁷⁷ It is at this point that the guarantor's liability is "fixed."⁷⁸ While the benefit of § 527 applies to an obligation or liability incurred by a servicemember, the text of § 527 does not specify how to treat a guarantor who incurs these two unique obligations at different times. However, analyzing § 527 using the two-requirement framework can address this ambiguity.

⁷⁶ 38 AM. JUR. 2D *Guaranty* §§ 1, 4 (2010).

⁷⁷ *Id.* at § 15.

⁷⁸ *Id.* Fixing a liability is synonymous with establishing a liability. See BLACK'S LAW DICTIONARY, *supra* note 44, at 626, 712.

The first requirement of the framework requires a court to identify the point in time when a servicemember incurs a liability. The second prong requires a court to identify the point in time when a liability bears interest in excess of 6% per year. Conceptually, these could occur at the same point in time—either when the guaranty is executed or when the borrower defaults—or the liability could begin bearing interest in excess of 6% after the liability is incurred.⁷⁹ The following parts of this comment will examine the analytic implications of these three potential rules.

1. *Rule 1: Guarantor Incurs Liability Bearing Interest in Excess of 6% When Guaranty is Executed*

Under this rule, a servicemember guarantor incurs a liability that bears interest in excess of 6% when the guaranty is executed, regardless of when the borrower defaults. Conceptually, the servicemember has incurred an obligation by promising to fulfill the borrower's obligation if the borrower defaults—this conditional obligation bears interest in excess of 6% because the underlying loan bears interest at a rate in excess of 6%.

For example, under the facts of *Newton*, a court determining whether Ms. Newton was entitled to the 6% interest rate benefit of § 527 would, under the first requirement, find that Ms. Newton had incurred a liability on July 6, 1998, when she executed the guaranty agreement.⁸⁰ Under the second requirement, a court would find that the guaranty obligation bore interest at a rate in excess of 6% because the underlying obligation, the loan agreement between the Newtons' corporation and the Bank of McKenney, had an interest rate of 10.25%.⁸¹ Therefore, the court would find that Ms. Newton is entitled to benefits of § 527 with respect to this obligation because the obligation, which bore interest in excess of 6%, had been incurred before she entered military service on June 13, 2005.⁸² Because the obligation would accrue interest in excess of 6% at all times during Ms. Newton's military service, the 6% interest rate limitation would apply to any interest accrued both before and after the corporation's default. While this result conforms to the Supreme Court's requirement that the SCRA be liberally construed to protect the interest of servicemembers,⁸³

⁷⁹ The opposite scenario, that a liability bears interest in excess of 6% before the liability is incurred, is implausible; a liability that does not exist cannot bear interest at any rate.

⁸⁰ Def.'s Mem. in Supp. of Summ. J. Ex. I, *Newton v. Bank of McKenney*, 2012 WL 1752407 (E.D. Va. May 16, 2012) (No. 3:11cv493-JAG).

⁸¹ Def.'s Mem. in Supp. of Summ. J. Ex. F, *Newton*, 2012 WL 1752407 (No. 3:11cv493-JAG).

⁸² *Newton*, 2012 WL 1752407, at *3.

⁸³ *Boone v. Lightner*, 319 U.S. 561, 575 (1943).

liberal construction does not require a court to rewrite the SCRA or insert language into the SCRA that does not exist.⁸⁴

The principal technical virtue of this rule is that it eliminates any potential arbitrary difference in treatments between various forms of guaranty, surety, and cosigner liability. For example, *Cathey* held that a cosigner of a loan is entitled to the benefit of § 527 of the SCRA because the cosigner has incurred liability on the loan in the same manner as the other borrower on the loan.⁸⁵ The purpose of the loan, however, was to fund the Catheys' corporation.⁸⁶ The corporation used the funds, the corporation was responsible for making payments on the loan, and, most importantly, the objective of the bank in requiring the Catheys to cosign the loan was to obtain their personal guarantees—"The Bank, however, candidly admits that without the personal guarantees of the Catheys that neither the Bank nor the Small Business Administration would have loaned money to the plaintiff's corporation."⁸⁷ Therefore, while the form of the Catheys' liability was undoubtedly that of a cosigner, the expectation of the parties was that the Catheys would pay only if the corporation could not.

While the servicemember in *Cathey* was a cosigner, the servicemember in *Newton* did not cosign the corporation's loan; she executed only a personal guaranty agreement.⁸⁸ While the court describes the technical distinction that exists in Virginia law between primary liability (such as that of a cosigner) and secondary liability (such as that of a guarantor), the practical effect of both forms of liability is the same—the individuals promise to pay the loan if the corporation does not.⁸⁹ The *Newton* court also draws an additional distinction between the liability incurred by a surety (primary liability) and a guarantor (secondary liability).⁹⁰ While these technical distinctions certainly exist in Virginia and other jurisdictions, the practical effect is the same regardless of how the relationship is labeled—the corporation is the party that ought to perform, but if the corporation does not perform, then the lender has recourse against the parties that have promised to perform if the corporation does not.⁹¹ In fact, the Restatement and some jurisdictions acknowledge that the distinction is, at most, tech-

⁸⁴ *Newton*, 2012 WL 1752407, at *6 ("[L]iberal interpretation does not allow the Court to insert language that does not exist, or to ignore language that does."). By refusing to "amend the definition of 'servicemember' to include closely-held corporations," the *Newton* court demonstrates that the Supreme Court's requirement of liberal construction does not require courts resolve all genuine questions of law under the SCRA in favor of the servicemember. *Id.*

⁸⁵ *Cathey v. First Republic Bank*, No. 00-2001-M, 2001 WL 36260354, at *4 (W.D. La. July 6, 2001).

⁸⁶ *Id.* at *1.

⁸⁷ *Id.* at *3.

⁸⁸ *Newton*, 2012 WL 1752407, at *7.

⁸⁹ *Id.* at *7–8.

⁹⁰ *Id.*

⁹¹ See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 (1996).

nical and of limited relevance to the overall nature of the relationship; in some cases the distinction is completely abolished.⁹² While § 527 of the SCRA is silent regarding any distinctions between these different relationships, the provisions of § 513 explicitly apply to “a surety, guarantor, endorser, accommodation maker, comaker, or other person who is or may be primarily or secondarily subject to the obligation,” suggesting that at least in the context of § 513 the distinction between these relationships is irrelevant.⁹³

While a court adopting this rule would eliminate the arguably arbitrary distinction between cosigner, surety, and guarantor liability suggested by *Cathey* and *Newton*, adoption of this rule would be incorrect. First, while the distinction between cosigner, surety, and guarantor may be arbitrary in some circumstances, these are in fact distinct relationships with distinct theories of liability. Even if the cosigner, surety, and guarantor all have the same intent—to pay if the borrower does not—the lender has distinct legal rights depending on which form has been chosen.⁹⁴ Crucially, a guarantor’s liability is distinct from the cosigner or surety’s liability because it is separate from the borrower’s liability, whereas a cosigner or surety is jointly liable along with the borrower.⁹⁵ A cosigner or surety is primarily liable jointly with the borrower and promises to make the same performance that the borrower does—to pay the loan according to its terms—while a guarantor, on the other hand, simply promises to perform if the borrower does not.⁹⁶ While the Supreme Court has stated that the SCRA is to be liberally

⁹² See *Souza v. Westlands Water Dist.*, 38 Cal. Rptr. 3d 78, 95 n.6 (Cal. Ct. App. 2006) (“A guarantor is a surety.”); *Marett v. Brice Bldg. Co.*, 603 S.E.2d 40, 42 (Ga. Ct. App. 2004) (“Contracts of suretyship and guaranty are indistinguishable.”); *Wooley v. Lucksinger*, 7 So. 3d 660, 664 (La. Ct. App. 2008) (“A contract of guaranty is equivalent to a contract of suretyship.”); 38 AM. JUR. 2D *Guaranty* § 10 (2010) (“There are many similarities between a guaranty and suretyship, centering on the fact that both the guarantor and the surety have promised to answer for the debt or default of a third person, and both are accessory contracts.”); RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 15 (describing guaranty, surety, and cosigner relationships all as involving “a secondary obligor who is subject to a secondary obligation . . .”). An accessory contract is a contract “entered into primarily for the purpose of carrying out a principal,” related contract. BLACK’S LAW DICTIONARY, *supra* note 44, at 366.

⁹³ 50 U.S.C. App. § 513 (2006) (providing that a court granting a servicemember relief in the form of a stay of proceedings or vacation of a default judgment may grant the same relief to any party secondarily liable on the same civil obligation); see also Robert H. Skilton, *The Soldiers’ and Sailors’ Civil Relief Act of 1940 and the Amendments of 1942*, 91 U. PA. L. REV. 177, 182 (1942) (describing that the 1942 amendments to the SSCRA extended the § 513 protections to “accommodation co-makers” in response to *In re Itzkowitz*, 30 N.Y.S.2d 336 (N.Y. Sup. Ct. 1941), which had drawn a distinction between a co-maker and a surety, guarantor, or endorser when applying § 513).

⁹⁴ 38 AM. JUR. 2D *Guaranty* § 10 (“A creditor may look to the surety for immediate payment on the debtor’s default, without first attempting to collect from the debtor, while the creditor must first seek payment from the debtor before going after a guarantor.”).

⁹⁵ See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 15; 38 AM. JUR. 2D *Guaranty* § 10.

⁹⁶ “[T]he guarantor promises to perform if the principal does not. By contrast, a surety promises to do the same thing that the principal undertakes.” *Mercy Med. Ctr., Inc. v. United Healthcare of the*

construed to accomplish its purpose, a court adopting this rule to avoid the distinction between cosigner, surety, and guarantor liability would be inserting language into the SCRA that is inconsistent with established law.⁹⁷

A second technical issue with this rule is that a court adopting this rule would allow a guarantor to receive the benefit of § 527 before the guarantor becomes liable to make any payment on the loan. Under this rule, a servicemember guarantor has incurred a liability bearing interest in excess of 6% when she executes the guaranty agreement and therefore would qualify for the benefit of § 527 when she enters military service. This result holds whether the corporate borrower has defaulted or not—for purposes of § 527, this rule holds that liability has already been incurred before default. Therefore, a court adopting this rule would allow a guarantor to request the 6% interest rate limitation for a loan that the corporation is still paying in accordance with the loan's terms, thereby allowing the corporation to receive the benefit of § 527.⁹⁸ This is precisely the result from *Linscott* that is criticized by the court in *Newton* as irreconcilable with the text of the SCRA and basic corporation law.⁹⁹

A rule recognizing that a liability bearing interest in excess of 6% is incurred when the guaranty agreement is executed has some appeal because it supports the purpose of the SCRA and eliminates a potentially arbitrary distinction between cosigner, surety, and guarantor liability. Courts should not adopt this rule, however, because it results in a corporation being able to take advantage of the SCRA and ignores the legal distinction between a cosigner or surety's primary liability and a guarantor's secondary liability.

2. *Rule 2: Guarantor Incurs Liability When Guaranty is Executed, but the Liability Bears Interest in Excess of 6% When Borrower Defaults*

Under this rule, a servicemember guarantor incurs a liability for purposes of § 527 when she executes a guaranty agreement, but that liability does not bear interest in excess of 6% until the borrower defaults and the guarantor is called on to satisfy the borrower's debt. Prior to the borrower's

Mid-Atlantic, Inc., 815 A.2d 886, 899 (Md. Ct. App. 2003) (alteration in original) (quoting Gen. Motors Acceptance Corp. v. Daniels, 492 A.2d 1306, 1310 (Md. 1985)); 38. AM. JUR. 2D *Guaranty* § 10.

⁹⁷ See *Newton v. Bank of McKenney*, no. 3:11cv493-JAG, 2012 WL 1752407, at *6 (E.D. Va. May 16, 2012) (“[L]iberal interpretation does not allow the Court to insert language that does not exist, or to ignore language that does.”).

⁹⁸ A court applying this rule would only have to inquire into whether and when the guaranty was executed and at what interest rate the loan accrued interest after the servicemember entered active military service. This analytic framework would require no inquiry into whether the lender had requested payment from the guarantor or whether the corporation had paid the loan in accordance with its terms.

⁹⁹ See *Linscott v. Vector Aerospace*, No. CV05-682-HU, 2006 WL 1310511, at *4 (D. Or. May 12, 2006); *Newton*, 2012 WL 1752407, at *6–7.

default, the guarantor has only a conditional obligation and no specific financial obligation that accrues interest; the interest is accruing to the separate obligation of the borrower. In fact, if the borrower makes payments sufficient to reduce the principal owed on the loan prior to defaulting, the guarantor's conditional liability accrues interest at a rate less than 0% because the amount of her liability is decreasing with each payment by the borrower that reduces the principal owed.¹⁰⁰

If a court examining the facts from *Newton* were to adhere to this rule, the court would find, as it would under Rule 1, that Ms. Newton incurred a liability when she executed the guaranty and that this occurred prior to her military service, as required by § 527.¹⁰¹ Unlike Rule 1, the court would find that Ms. Newton's liability did not begin to bear interest, at any rate, until her corporation defaulted and she became obligated to pay the loan. Section 527 would not apply to any interest accrued on the loan before the corporation defaulted because, prior to the default, Ms. Newton's liability did not bear interest in excess of 6%. However, Ms. Newton could claim the benefit of § 527 for any interest that accrued at a rate in excess of 6% after the corporation defaults because the liability that she incurred prior to her military service (when she executed the guaranty) would then be bearing interest in excess of 6%.

The primary virtue of this rule is the sensible result: it allows the servicemember guarantor to claim the 6% interest rate cap of § 527 for the interest that accrues after the borrower defaults, while having no effect on the interest that accrued before the borrower defaults. This result is consistent with the Supreme Court's requirement that the SCRA be liberally construed to the benefit of the servicemember.¹⁰² This is in contrast to the somewhat harsh alternative of barring an active-duty servicemember from claiming the benefit of § 527 even after her financial liability on the guaranty has been fixed by the borrower's default.¹⁰³

While this rule relies on an application of § 527 that is not grounded in case law, it does align with how other liabilities may be treated under § 527. Consider, for example, a servicemember who makes a purchase using a credit card prior to entering active military service. At the moment of purchase, the servicemember has incurred a liability to pay the credit card account according to its terms.¹⁰⁴ The terms of the account may include a

¹⁰⁰ See, e.g., N. Gregory Mankiw, *Maybe the Fed Should Go Negative*, N.Y. TIMES, Apr. 19, 2009, at BU7 ("Why not lower the target interest rate to, say, negative 3%? At that interest rate, you could borrow and spend \$100 and repay \$97 next year.").

¹⁰¹ *Newton*, 2012 WL 1752407, at *3; Def.'s Mem. in Supp. of Summ. J. Ex. I, *Newton*, 2012 WL 1752407 (No. 3:11cv493-JAG).

¹⁰² *Boone v. Lightner*, 319 U.S. 561, 575 (1943).

¹⁰³ See *supra* Part II.A.3.

¹⁰⁴ See, e.g., *Terms and Conditions of BankAmericard*, BANK OF AMERICA, <https://www.bankofamerica.com/credit-cards/credit-cards-terms-and-conditions.go?cid=2088696&po=R9> (last visited November 12, 2012) ("If you accept or use an account,

promotion where the interest rate on the purchase is 0% for some period of time.¹⁰⁵ If, after the promotion ends, the servicemember is called into active military service, absent the benefit of § 527 of the SCRA, the interest rate on that purchase may increase to some amount in excess of 6%.¹⁰⁶ In this case, § 527 will apply and, while the servicemember is in active military service, limit the interest rate that can be assessed to 6%.¹⁰⁷ In this scenario, similar to the guarantor scenario, § 527 applies because the servicemember incurred a liability before entering military service even though the liability did not begin bearing interest in excess of 6% until some later date. A similar scenario can occur when a liability accrues interest at a variable rate tied to some index rate.¹⁰⁸ The key analytic point of these examples is that the second requirement of the two-requirement framework—that a liability bear interest in excess of 6%—need not be satisfied before the servicemember enters military service; only the first requirement—that a liability be incurred—must occur prior to military service.

However, this rule for guarantor liability is difficult to reconcile with the text of § 527 of the SCRA. While the SCRA is to be construed liberally to accomplish its purpose, “liberal interpretation does not allow the Court to rewrite the Act.”¹⁰⁹ The 6% interest rate cap applies to “[a]n obligation or liability bearing interest at a rate in excess of 6% per year that is incurred by a servicemember . . . before the servicemember enters military service.”¹¹⁰ While this section can be liberally interpreted as applying to a liability that begins bearing interest in excess of 6% after the servicemember enters military service, no reasonable interpretation of this section would allow the two requirements to be satisfied by separate, legal-

you do so subject to the terms of this application, the ‘Details of Rate, Fee and Other Cost Information’ and the Credit Card Agreement, as it may be amended; you also agree to pay all charges incurred under such terms.”).

¹⁰⁵ See, e.g., *id.* (“0% Introductory APR for the first 15 Statement Closing Dates following the opening of your account.”).

¹⁰⁶ See, e.g., *id.* (“After [the promotion ends], your APR will be 10.99% to 20.99%, based on your creditworthiness when you open your account.”).

¹⁰⁷ See, e.g., *Rodriguez v. Am. Express*, no. CV F 03-5949 AWI LJO, 2006 WL 908613, at *8, *10 (E.D. Cal. Apr. 7, 2006) (describing that defendants Citibank and American Express complied with the requirements of § 527 by reducing the interest rate on plaintiff’s credit card accounts to 6% or lower without any discussion of what the interest rate on the accounts was at the time the plaintiff incurred liability).

¹⁰⁸ A variable interest rate is an interest rate “that varies at preset intervals in relation to the current market rate (usu. the prime rate).” BLACK’S LAW DICTIONARY, *supra* note 44, at 888. For example, an interest rate tied to the Bank Prime Loan rate would have increased from 4% on June 29, 2004, to 8.25% on June 29, 2006. *H.15 Release—Selected Interest Rates—Historical Data*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/releases/h15/data.htm> (last visited Nov. 17, 2012) (under “Bank Prime Loan,” click “Daily”).

¹⁰⁹ *Newton v. Bank of McKenney*, No. 3:11cv493-JAG, 2012 WL 1752407, at *6 (E.D. Va. May 16, 2012).

¹¹⁰ 50 U.S.C. App. § 527(a)(1) (2006).

ly distinct obligations. Specifically, under this rule the first requirement would be satisfied by the guaranty obligation, which is incurred when it is executed. The second requirement would be satisfied once the guarantor incurs the separate, primary obligation to pay the loan according to its terms, which occurs only when the borrower defaults. The language of § 527 cannot be interpreted as allowing each of the two requirements to be satisfied by separate obligations; it applies to “[an] obligation or liability,” not a set of related but distinct obligations or liabilities.¹¹¹ In contrast, the obligation in the credit card example is a single obligation that accrues interest at a different rate as time passes; there are no separate obligations as there are in the guarantor scenario.

Therefore, while a rule recognizing that a liability may be incurred before it begins to bear interest in excess of 6% has some practical appeal and can be technically justified through analogy to other liabilities, this rule is not reconcilable with the text of the SCRA and should therefore be rejected by the courts.

3. *Rule 3: Guarantor Incurs Liability Bearing Interest in Excess of 6% When Borrower Defaults*

Under this rule, the liability to which § 527 is to be applied is incurred by the guarantor when the borrower defaults, and the liability begins to bear interest at 6% at the same point in time. Conceptually, the occurrence of the borrower’s default condition in the guaranty agreement creates a distinct, new obligation of the guarantor to fulfill the borrower’s obligations under the original loan agreement. Upon this occurrence, an obligation is incurred by the servicemember, satisfying the first requirement of § 527. If this obligation bears interest at a rate greater than 6%, then the second requirement of § 527 is satisfied. While a liability bearing interest in excess of 6% has been incurred upon the corporation’s default, the 6% interest rate cap will not apply if default occurs after the servicemember guarantor enters active military service.

Applying this rule to the facts in *Newton* demonstrates this implication. There, Ms. Newton executed an agreement guaranteeing a loan to her corporation on July 6, 1998,¹¹² entered military service on June 13, 2005,¹¹³ and then became obligated to fulfill the terms of the loan on May 24, 2007, when her corporation defaulted.¹¹⁴ A court that adopts this rule would find that the servicemember guarantor incurred a liability that bears interest in excess of 6% on May 24, 2007. Since this liability was incurred after

¹¹¹ *Id.* § 527 (2006).

¹¹² Def.’s Mem. in Supp. of Summ. J. Ex. I, *Newton*, 2012 WL 1752407 (No. 3:11cv493-JAG).

¹¹³ *Newton*, 2012 WL 1752407, at *3.

¹¹⁴ *Id.* at *3 n.4.

Ms. Newton entered military service, Ms. Newton would not be entitled to the 6% interest rate limitation of § 527.

This result is consistent with the language used in dicta in *Newton*. There, the court described the guarantor's liability as secondary to the borrower's liability, with the guarantor's liability becoming primary when the corporate borrower defaulted.¹¹⁵ Using precisely the same language of "incurred liability" as is used in § 527, the court clearly intended this statement to be analyzed in the context of the text of § 527. The implication of this statement is plainly that because Ms. Newton had already entered active military service, the benefit of § 527 could not apply to this liability because, as the court specifically states, the liability had been incurred after Ms. Newton entered military service. Although the court concludes its dicta by stating that this key question of whether a guarantor can be liable for debt that accrues at a rate greater than 6% has not been answered, the court's unambiguous statement about when liability is incurred by a guarantor leaves little doubt that the court, if given the opportunity, would hold that the guarantor could be held liable for debt that accrues at a rate greater than 6%.¹¹⁶

This result is also consistent with the law of guaranty that holds that the guarantor's liability after the borrower's default is distinct from the liability before default. Prior to the borrower's default, the guarantor is secondarily liable and the borrower primarily liable; after the borrower's default, the guarantor becomes primarily liable.¹¹⁷ More specifically, after the borrower's default, the guarantor is no longer purely a guarantor; she becomes the debtor on the loan.¹¹⁸ Put differently, the liability of the guarantor becomes "fixed on default of the debtor."¹¹⁹ Regardless of the precise meaning of "fixed" in this context, it is clear that the guarantor has incurred a distinct liability upon the debtor's default. The debtor's liability has transferred to the guarantor; like a recently purchased used car, this liability is not new—but is new to the guarantor.

Courts should adopt this rule because it is most consistent with the *Newton* court's interpretation of § 527 and the principles of guarantor liability. However, as the timeline in *Newton* demonstrates, this rule leads to a potentially harsh result: not only would a servicemember guarantor be held liable for interest in excess of 6% that accrued on the corporate debt before the corporation's default, but also the servicemember would be unable to

¹¹⁵ *Id.* at *7–8; *see also* 38 AM. JUR. 2D *Guaranty* §§ 10, 15 (2010).

¹¹⁶ *Newton*, 2012 WL 1752407, at *8.

¹¹⁷ 38 AM. JUR. 2D *Guaranty* § 2 ("A guaranty creates a secondary obligation under which the guarantor promises to be responsible for the debt of another."); *id.* § 15 ("[T]he guarantor becomes primarily liable when the principal obligation has matured and is not performed.").

¹¹⁸ *Pollas v. Hardware Wholesalers, Inc.*, 663 N.E.2d 1188, 1190 (Ind. Ct. App. 1996) ("When the person or entity primarily liable for the debt defaults, the guarantor becomes the debtor.").

¹¹⁹ *State Bank of Burleigh Cnty. v. Porter*, 167 N.W.2d 527, 532 (N.D. 1969) (citing 38 AM. JUR. 2D *Guaranty*).

claim the 6% interest rate cap for interest that accrues on the debt after the corporation's default. While this result may be harsh, Part II.B of this Comment will demonstrate that this result is consistent with legislative intent and actually promotes servicemembers' long-run financial interests, even if they are liable for interest in excess of 6%.

B. *Permitting Guarantor Liability for Interest Greater than 6% Under § 527 is Sound Policy*

The rule proposed in Part II.A of this Comment would potentially saddle an active duty servicemember with liability for interest that has accrued at a rate in excess of 6%. Although this increases the financial liability of a person who is serving her country, after balancing all the relevant interests and consequences, the result is actually sound policy. First, this result is consistent with Congress's intent in passing the SCRA because it properly balances the interests of all the parties involved in the corporate loan transaction. Second, this result will provide servicemember small-business owners increased access to credit. Finally, this result will prevent the corporation's management from intentionally defaulting on their obligations in order to take advantage of the benefits of § 527.

1. *There Was No Legislative Intent to Extend § 527 to Guarantors*

Congress's purpose in passing the SCRA, provided in § 502, is "to provide for, strengthen, and expedite the national defense through protection extended by this Act to servicemembers of the United States to enable such persons to devote their entire energy to the defense needs of the Nation."¹²⁰ By this plain statement, it would seem that Congress intended the SCRA to provide servicemembers with every possible tool to enable them to ignore any potential distractions or pressures from their personal lives. Congress recognized and balanced the needs of the national defense, servicemembers and their families, and, critically for the analysis in Part II.B.2 of this Comment, "the needs of those who have dealt with and depend upon Servicemembers for fulfillment of their obligations."¹²¹ When assessing whether an interpretation of the SCRA is consistent with the legislative intent, the analysis is not as simple as determining whether the rule reduces the burden on the servicemember from her obligations at home.

¹²⁰ 50 U.S.C. App. § 502(1) (2006).

¹²¹ H.R. REP. NO. 108-81, at 51 (2003) (quoting *H.R. 5111, the Servicemembers' Civil Relief Act and H.R. 4017, the Solders' and Sailors' Civil Relief Equity Act, Hearings Before the H. Subcomm. on Benefits of the H. Comm. on Veterans' Affairs*, 107th Cong. 3-4 (2002) (statement of Craig Duehring, Acting Assistant Secretary of Defense, Reserve Affairs)).

For example, a rule that is beneficial for servicemembers, and therefore serves the national defense by making recruitment easier, is not necessarily consistent with the legislative intent without balancing the national defense interest against the impact on any counterparty to a servicemember's obligation.¹²²

In passing § 527, Congress recognized that one of the many potential impacts on servicemembers' personal lives is a decrease in income: "[This bill] springs from the inability of men who are in service to properly manage their normal business affairs while away. It likewise arises from the differences in pay which a soldier receives and what the same man normally earns in civil life."¹²³ Having recognized this potential impact, Congress sought through § 527 to provide some relief for high interest payments, which during World War II were as high as 3.5% per month.¹²⁴ Congress's intent for § 527 was not to eliminate required payments altogether, or to prevent new required payments; rather, the point of § 527 was to reduce existing required payments.¹²⁵

Applying this background to the question of whether a guarantor can be held liable for interest in excess of 6% under § 527, it is evident that either of the rules that would allow the guarantor to limit her interest rate to 6% would be in conflict with the legislative intent. First of all, prior to the default of the corporation the servicemember has no payment liability whatsoever, so reducing the interest rate to 6% cannot possibly support Congress's intent; the servicemember's payments remain at zero.¹²⁶ While the servicemember's corporation may receive some payment relief in this situation, the servicemember herself would not.¹²⁷ Also, providing the interest

¹²² *But see* Statement of Interest of the United States at 8, *Cathey v. First Republic Bank*, 2001 WL 36260354 (W.D. La. July 6, 2001).

¹²³ H.R. REP. NO. 108-81, at 33 (2003) (quoting 88 CONG. REC. H5368 (1942) (statement of Rep. Overton Brooks)).

¹²⁴ *See* Amy J. McDonough et al., *Crisis of the Soldiers' and Sailors' Civil Relief Act: A Call for the Ghost of Major (Professor) John Wigmore*, 43 MERCER L. REV. 667, 680 (1992) (quoting 88 CONG. REC. H5368 (1942) (statement of Rep. Overton Brooks)); James P. Pottorff, *Contemporary Applications of the Soldiers' and Sailors' Civil Relief Act*, 132 MIL. L. REV. 115, 130 (1991).

¹²⁵ H.R. REP. NO. 108-81, at 39 (2003) ("To resolve lingering questions about congressional intent, [§ 527] would clearly provide that interest above the 6 percent rate is to be forgiven, and that the amount of the monthly payment is to be reduced."); *see also* JAG GUIDE, *supra* note 12, at 106 ("The point is to have the servicemember's payment reduced else there is little benefit.").

¹²⁶ *See, e.g.*, *Newton v. Bank of McKenney*, No. 3:11cv493-JAG, 2012 WL 1752407, at *3 (E.D. Va. May 16, 2012) (describing the servicemember's corporation's payment history prior to default and that the bank only began requesting payment from the servicemember herself after the corporation's default).

¹²⁷ *See, e.g.*, Pl.'s Mem. in Supp. of Summ. J. at 8, *Newton*, 2012 WL 1752407 (No. 3:11cv493-JAG). The plaintiff's corporation would have been liable for \$23,676 less interest prior to the corporation's default if the 6% interest rate cap had applied to the corporation; this could have reduced the required payments the corporation was required to make, but could not reduce the servicemember's

rate benefit to the corporation in this way would not support Congress's intent because it would not reduce the servicemember's interest rate payment burden; it would only reduce the corporation's burden. Congress's intent in granting the 6% interest rate cap to servicemembers acknowledges that their incomes may be reduced; a rule that would allow the corporation to claim the 6% interest rate benefit would, in effect, result in *increased* income because the corporation would pass along the interest savings to its servicemember owners in the form of salary or dividends.¹²⁸

Second, after the corporation's default the servicemember guarantor's payment liability would jump from zero to some amount higher than zero—specifically, whatever payment liability the corporation had prior to default.¹²⁹ In this situation, limiting the interest rate on this obligation to 6% might reduce the payment required to some extent, but this slight relief would be minor relative to the overall increase in required payment that remains. For example, Ms. Newton's required payment jumped from \$0 to over \$300,000 because the lender had the right to call the entire balance due upon the borrower's default; there, the interest in excess of 6% that was forgiven by the bank was \$23,576.¹³⁰ Congress's intent with § 527 was to provide some relief for existing required payments, not to reduce the required payment on a newly incurred obligation by a mere 8%.

2. *Permitting Interest Greater than 6% Increases Servicemember Small Business Owners' Access to Credit*

If a court were to adopt a rule that allows a guarantor to claim the 6% interest rate benefit of § 527, that court may provide some marginal payment relief to the servicemember, but this impact could be overwhelmed by the resulting difficulty servicemember business owners will endure attempting to find affordable credit for their businesses. Insofar as § 527 is simply a limitation on the interest rate that lenders can legally charge a servicemember borrower, § 527 is essentially a type of usury law—"a law prohibiting moneylenders from charging illegally high interest rates."¹³¹ Such laws may benefit some borrowers in uncompetitive or imperfect mar-

payments because the servicemember was already making no payments because she was not liable for payments prior to the corporation's default.

¹²⁸ 18B AM JUR. 2D *Corporations* § 998 (2010) (corporation may distribute profits to its owners in the form of dividends); *id.* § 1661 (closely-held corporation may pay its managers a reasonable salary).

¹²⁹ *See, e.g.*, RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 (1996) (providing that a surety or guarantor "has a duty to effect, in whole or in part, the performance of the subject of the underlying obligation . . ." if the borrower does not perform his obligations).

¹³⁰ *See Newton*, 2012 WL 1752407, at *4; Pl.'s Mem. in Supp. of Summ. J. at 8, *Newton*, 2012 WL 1752407 (No. 3:11cv493-JAG).

¹³¹ BLACK'S LAW DICTIONARY, *supra* note 44, at 1685.

kets.¹³² However, basic economic theory demonstrates that a cap on possible interest rates will reduce the supply of money that is available for borrowing and therefore reduce the amount of credit that is available to the small businesses owned by servicemembers.¹³³ Because lenders will be less eager to lend to servicemember small-business owners (SSB Owners) due to the potential that the interest rate will be reduced to 6% under the SCRA in the future, lenders may choose not to lend to the servicemember-owned small businesses at all or may choose to charge a higher interest rate when the servicemember is not in active military service.¹³⁴ In either scenario, the servicemember is potentially better off without the benefit of § 527 because his business may otherwise have access to more or cheaper credit.

In order for a reduction in credit available to SSB Owners to occur, lenders would have to adjust their lending policies for SSB Owners to account for the impact of the SCRA. While this amounts to discrimination against servicemembers in lending decisions, there are no significant obstacles to such discrimination. The Equal Credit Opportunity Act does not outlaw discrimination in lending on the basis of a borrower being a servicemember.¹³⁵ A policy of unfavorable treatment for SSB Owners in lending decisions would likely be accompanied by significant public relations and political backlash against the lender, but behavior consistent with such a policy is not unprecedented. Despite the potential public relations and political toll, lenders have in the past targeted servicemembers for payday loans that accrue interest at rates well over 300%.¹³⁶

Applying the SCRA's 6% interest rate cap to corporate debt that is guaranteed by a servicemember is not necessarily bad policy simply because lenders would, as allowed by law, discriminate against SSB Owners and reduce the amount of credit available to them. For example, propo-

¹³² See generally Paul G. Hayeck, *An Economic Analysis of Justifications for Usury Laws*, 15 ANN. REV. BANKING L. 253, 253 (1996) (describing the justifications for usury laws as "(1) markets are non-competitive; (2) important social utility and distributional effects will otherwise be lost; (3) low interest rates encourage economic growth through increased borrowing; and (4) credit markets are characterized by imperfect information").

¹³³ See Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 301 (1995) (explaining that usury laws, which usually set an interest rate ceiling, tend to have the effect of reducing the availability of credit to the poor).

¹³⁴ See, e.g., Rudolph C. Blitz & Millard F. Long, *The Economics of Usury Regulation*, 73 J. POL. ECON. 608, 613 (1965) ("While the oft-stated purpose of usury legislation is to help that class of debtors which includes the landless peasants, poor urbanites, and very small businessmen, maximum rates are likely to affect them adversely by excluding them from the market.").

¹³⁵ 15 U.S.C. § 1691 (2006).

¹³⁶ Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: the Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653, 661 (2005). Congress responded to this practice by outlawing lending to servicemembers at interest rates in excess of 36%. 10 U.S.C. § 987. This prohibition only applies to consumer lending, and not commercial lending to small businesses. *Id.*

nents of traditional usury laws have argued that they are sound policy because the protection they offer low income and uninformed borrowers outweighs the marginal reduction in credit available to these borrowers.¹³⁷ However, the same cost-benefit analysis would not apply in the context of lending to SSB Owners at rates in excess of 6%. In this context, the usury law (the SCRA) does not provide protection to vulnerable borrowers, but rather protects all servicemember borrowers from some of the distraction of concerns at home.¹³⁸ The benefit of this protection is likely small and may not outweigh the cost of reduced credit available to SSB Owners.¹³⁹

3. *Permitting Interest Greater than 6% Reduces the Borrower's Incentive to Strategically Default*

A rule that limits servicemember liability as a guarantor for debt that accrues at a rate greater than 6% could create an incentive for corporate borrowers to take advantage of the benefits of § 527 through strategic default, a tactic unavailable to ordinary corporate borrowers.¹⁴⁰ Under such a rule, a corporate borrower obligated on a note guaranteed by a servicemember on active duty that is currently accruing interest at a rate in excess of 6% could strategically default on the note in order to shift liability for the note to the servicemember, who by law could not be liable for interest in excess of 6%.¹⁴¹

Such behavior by corporate management could lead to a number of undesirable outcomes. First, the servicemember guarantor would become responsible for payments on the loan at the exact time when the SCRA intends to reduce the servicemember's payment obligations.¹⁴² Second, the servicemember guarantor may willingly take on the shifted liability for the loan despite her military service because she is both the manager and guar-

¹³⁷ See generally Hayeck, *supra* note 132, at 253.

¹³⁸ See 50 U.S.C. App. § 502 (stating that the purpose of the SCRA is to enable servicemembers to "devote their entire energy to the defense needs of the Nation . . ."); H.R. REP. NO. 108-81, at 51 (2003) ("[This bill] springs from the inability of men who are in service to properly manage their normal business affairs while away.") (quoting *H.R. 5111, the Servicemembers' Civil Relief Act and H.R. 4017, the Solders' and Sailors' Civil Relief Equity Act, Hearings Before the H. Subcomm. on Benefits of the H. Comm. on Veterans' Affairs*, 107th Cong. 3-4 (2002) (statement of Craig Duehring, Acting Assistant Secretary of Defense, Reserve Affairs)).

¹³⁹ See *supra* Part II.B.1.

¹⁴⁰ *Newton v. Bank of McKenney*, No. 3:11cv493-JAG, 2012 WL 1752407, at *5-7 (E.D. Va. May 16, 2012).

¹⁴¹ A strategic default occurs when "borrowers who have the ability to repay . . . find it in their financial interests not to do so . . ." Curtis Bridgeman, *The Morality of Jingle Mail: Moral Myths About Strategic Default*, 46 WAKE FOREST L. REV. 123, 130 (Spring 2011) (discussing strategic default in the context of homeowners who owe more on their mortgage than the home is worth).

¹⁴² See *supra* Part II.B.1.

antor of the business she owns.¹⁴³ Under this scenario, the guarantor could make required payments, reduced by the amount of forgiven interest, using proceeds paid to her by the business. The business could funnel these proceeds to the servicemember either as dividends or salary.¹⁴⁴ Alternatively, the servicemember as guarantor could seek reimbursement from her business for the amount she has paid on the loan, an amount that has been reduced by the amount of interest forgiven under § 527.¹⁴⁵ While this scenario results in the servicemember having a net payment burden no greater than she would have if the strategic default had not occurred, this result is still undesirable because it indirectly allows the business to take advantage of § 527. This is a result that the text of the statute does not contemplate and that has been rejected by *Cathey* and *Newton*.¹⁴⁶ Third, if a guarantor were entitled to the benefit of § 527 and could require the lender to reduce the interest rate on the corporation's loan to 6%, corporations would have an incentive to seek out a servicemember guarantor for every loan.¹⁴⁷

There are several reasons why corporate management may not choose to strategically default, however. First, any default under the loan document may allow the lender to accelerate the payment due.¹⁴⁸ As in *Newton*, a servicemember guarantor is often unable to pay the entire amount due, in which case the lender may seek to foreclose on the servicemember's family farm in order to satisfy the debt.¹⁴⁹ Second, while the corporation may benefit from a reduced interest rate on the particular loan guaranteed by the servicemember, the strategic default would likely damage the corporation's credit rating, increasing the interest rate the corporation would be expected to pay on any future loans.¹⁵⁰

Even if the corporation chooses to strategically default to capture the benefit of § 527, the corporation may encounter additional legal challenges

¹⁴³ See, e.g., *Cathey v. First Republic Bank*, No. 00-2001-M, 2001 WL 36260354, at *4 (W.D. La. July 6, 2001) ("It is the plaintiffs whose labor and expertise was required to operate the corporation profitably so that its obligations could be met."); *Linscott v. Vector Aerospace*, No. CV05-682-HU, 2006 WL 1310511, at *1 (D. Or. May 12, 2006) ("Plaintiff Jeffrey Linscott owns and operates JLA . . ."); Def.'s Mem. in Supp. of Summ. J. Ex. Y, *Newton*, 2012 WL 1752407 (No. 3:11cv493-JAG) (joint owner of hardware store also served as the business's vice president).

¹⁴⁴ 18B AM. JUR. 2D *Corporations* § 998 (2010) (corporation may distribute profits to its owners in the form of dividends); *id.* § 1661 (closely-held corporation may pay its managers a reasonable salary).

¹⁴⁵ RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 22 (1996).

¹⁴⁶ *Cathey*, 2001 WL 36260354, at *4, *5; *Newton v. Bank of McKenney*, No. 3:11cv493-JAG, 2012 WL 1752407, at *5-7 (E.D. Va. May 16, 2012).

¹⁴⁷ Reply of Defs. to the Mot. for Partial Summ. J. of Pls. at 7, *Cathey*, 2001 WL 36260354 (No. 00-2001-M) ("Surely this is not what Congress intended.")

¹⁴⁸ Def.'s Mem. in Supp. of Summ. J. Ex. F, *Newton*, 2012 WL 1752407 (E.D. Va. May 16, 2012) (No. 3:11cv493-JAG).

¹⁴⁹ *Newton*, 2012 WL 1752407, at *4.

¹⁵⁰ See, e.g., *Western Union Misses Payments; Credit Rating Cut*, WALL ST. J., Dec. 2 1987, at 51 ("Western Union Corp. skipped more interest payments, prompting Standard & Poor's Corp. to downgrade to 'default' credit ratings on various company securities.")

to this strategy. First, the lender may choose to continue to pursue payment from the corporation before seeking to enforce the servicemember's guaranty.¹⁵¹ Second, the lender may be able to prove that the guarantor's ability to pay the obligation was not materially impacted as required under § 527.¹⁵² Additionally, the lender may be able to prove that the servicemember employing this strategy is abusing the corporate form, and therefore the court may pierce the corporate veil.¹⁵³ In any of these scenarios, a court may seek to block the corporation's strategy as an attempt to employ the SCRA as a weapon against legitimate creditors.¹⁵⁴

While these scenarios may suggest that a strategic default to take advantage of § 527 protection would rarely succeed, corporate management is certainly capable of exploiting and expanding any "loophole" in the law.¹⁵⁵ Any court confronted with the question of guarantor liability under § 527 should therefore slam the door on this strategy at the outset by holding that a servicemember guarantor can be liable for interest in excess of 6%.

CONCLUSION

Courts have not directly addressed the question of whether a servicemember who has guaranteed the debt of a corporation can be held liable for interest on that debt that accrues at a rate greater than 6%. While the text of the Servicemembers Civil Relief Act allows for at least three different interpretations, analysis of the statute's text, relevant case law, and the law of guaranty suggest that a rule that would allow a servicemember guarantor to be held liable for interest on corporate debt that accrues at a rate greater than 6% is correct. This result is also consistent with Congress's intent, maintains servicemember-owned corporations' access to credit, and eliminates the incentive for strategic default by these corporations.

¹⁵¹ See, e.g., *Newton*, 2012 WL 1752407, at *4 (bank foreclosing on corporate assets before enforcing the guaranty against servicemember).

¹⁵² 50 U.S.C. App. § 527(c) (2006).

¹⁵³ See 18 AM. JUR. 2D *Corporations* § 47 (2010).

¹⁵⁴ *Engstrom v. First Nat. Bank of Eagle Lake*, 47 F.3d 1459, 1462 (5th Cir. 1995) ("Although the act is to be liberally construed it is not to be used as a sword against persons with legitimate claims.").

¹⁵⁵ See, e.g., George J. Staibus, *Ethics Failures in Corporate Financial Reporting*, 57 J. BUS. ETHICS 5, 11 (2005) (describing how expansion in financial reporting rules has led "[a]uditors and client managers [to] work together to exploit every loophole . . .").

AN ECONOMIC PERSPECTIVE ON THE PRIVACY IMPLICATIONS OF DOMESTIC DRONE SURVEILLANCE

*Ian F. Rothfuss**

INTRODUCTION

A sixteen-hour standoff with police began after a suspect took control of six cows that wandered on to his farm and “chased police off his land with high powered rifles.”¹ Without the suspect’s knowledge, police used a Predator drone to locate and apprehend him on his 3,000-acre farm.² In addition to law enforcement, anyone may buy a handheld drone. The Parrot AR.Drone 2.0, for example, costs less than three hundred dollars and can fly up to 165 feet from its controller while recording and transmitting live high-definition video from the sky.³

Unmanned aerial vehicles (drones) have become essential to government surveillance overseas and are now being deployed domestically for law enforcement and other purposes. The ability of drones to conduct widespread domestic surveillance has raised serious privacy concerns. Both government and private actors may use drones. Given the proliferation of this new technology, Congress has recently directed the Federal Aviation Administration (FAA) to expedite the licensing process and open the domestic airspace to drones.⁴ Situations like the one described above will likely become more common in the near future.⁵ Domestic drones

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¹ Jason Koebler, *First Man Arrested with Drone Evidence Vows to Fight Case*, U.S. NEWS & WORLD REPORT (Apr. 9, 2012), <http://www.usnews.com/news/articles/2012/04/09/first-man-arrested-with-drone-evidence-vows-to-fight-case>.

² *Id.*

³ APPLE STORE, <http://store.apple.com/us/product/H8859ZM/A/parrot-ardrone-20> (last visited Jan. 18, 2012).

⁴ Harley Geiger, *Congress Demands Drones Over America*, CTR. FOR DEMOCRACY & TECH. (Feb. 9, 2012), <https://www.cdt.org/blogs/harley-geiger/0902congress-demands-drones-over-america>; FAA Modernization and Reform Act of 2012, Pub. L. No. 112-95, 126 Stat. 11 (2012).

⁵ The global drone market is predicted to total more than \$94 billion over the next decade. *Worldwide UAV market is to reach more that \$94 billion in ten years*, HOMELAND SEC. NEWS WIRE

have the potential to allow the government to effectively and efficiently monitor the activities of people across the nation. Part I of this Comment examines the capabilities of drones, discusses currently planned drone deployments, and examines recent developments that have brought the topic of domestic drone surveillance to the forefront of national security law discussions.

This comment concludes that current law does not adequately protect privacy interests from the widespread surveillance that could result from the unrestricted domestic use of drones. Part II discusses the sources of the right to privacy and examines the current state of the law.

Part III applies an economic perspective to determine the optimal level of domestic drone surveillance that the law should allow. This analysis is based upon a general economic model of surveillance developed by Andrew Song following the September 11, 2001 terrorist attacks.⁶ Economic analysis shows that the uncontrolled domestic deployment of drones would lead to an inefficient and unproductive loss of social utility. Prompt legislative action is therefore necessary to address the fundamental privacy challenges presented by the use of drones. Part IV concludes by proposing a legal framework to balance security and other interests while safeguarding the privacy rights of U.S. citizens. As discussed in this comment, such legislation should allow constructive use of the technology within a framework that protects individual privacy rights.

I. BACKGROUND: DOMESTIC DEPLOYMENT OF DRONES

Recent congressional legislation has directed the FAA to expedite its current licensing process and allow the private and commercial use of drones in U.S. airspace by October 2015.⁷ The FAA has streamlined the authorization process to “less than 60 days” for nonemergency drone operations.⁸ Among other requirements, the recent legislation directs the FAA to allow government agencies to operate small drones weighing less than 4.4 pounds.⁹ The use of drones can be expected to increase dramatically in the coming years.

(Apr. 12, 2012), <http://www.homelandsecuritynewswire.com/dr20120412-worldwide-uav-market-to-reach-more-than-94-billion-in-ten-years>.

⁶ Andrew Song, *Technology, Terrorism, and the Fishbowl Effect: An Economic Analysis of Surveillance and Searches* 3–22, (Harvard Law Sch. Pub. Law & Legal Theory, Working Paper No. 73, May 2003), available at <http://papers.ssrn.com/abstract=422220>.

⁷ Geiger, *supra* note 4; FAA Modernization and Reform Act of 2012, Pub. L. No. 112-95, 126 Stat. 11 (2012).

⁸ *Fact Sheet—Unmanned Aircraft Systems (UAS)*, FAA (Dec. 14, 2012), http://www.faa.gov/news/fact_sheets/news_story.cfm?newsId=14153 [hereinafter *Fact Sheet*].

⁹ *Id.*

The FAA has already authorized many police departments and other agencies to use drones.¹⁰ As of November 2012, the FAA oversaw 345 active Certificates of Waiver or Authorization that allow public entities to operate drones in civil airspace.¹¹ Customs and Border Protection uses Predator drones along the nation's borders "to search for illegal immigrants and smugglers"¹² and "[t]he FBI and Drug Enforcement Administration have used Predators for other domestic investigations."¹³ Predators owned by Customs and Border Protection and based at U.S. Air Force bases have been deployed on numerous occasions to assist local law enforcement.¹⁴ One law enforcement agency has even deployed a drone capable of being armed with lethal and non-lethal weapons.¹⁵

Drones also have applications beyond government law enforcement. Drones may be used to provide live video coverage of events without the need to use piloted helicopters and by paparazzi chasing after pictures of celebrities and other public figures.¹⁶ Individuals may use drones to spy on their neighbors, to keep an eye on their children, or to keep tabs on a potentially unfaithful spouse.¹⁷ The possibilities for corporate espionage and the theft of trade secrets are also endless.

Drones range in size from handheld units to units the size of large aircraft and have a wide variety of capabilities.¹⁸ Nearly fifty companies are reported to be developing an estimated 150 varieties of drone systems.¹⁹ Users of drones may include the military, federal and local law enforcement agencies, business entities, and private individuals. Drones have many diverse domestic uses including surveillance of dangerous disaster sites, patrolling borders, helping law enforcement locate suspects, monitoring traffic, crop dusting, aerial mapping, media coverage, and many others.²⁰

¹⁰ Somini Sengupta, *Who Is Flying Drones Over America?*, N.Y. TIMES BITS BLOG (Jul 14, 2012, 7:08 AM), <http://bits.blogs.nytimes.com/2012/07/14/who-is-flying-drones-over-america/>.

¹¹ *Fact Sheet*, *supra* note 8.

¹² Brian Bennett, *Police employ Predator drone spy planes on home front*, L.A. TIMES (Dec. 10, 2011), available at <http://articles.latimes.com/print/2011/dec/10/nation/la-na-drone-arrest-20111211>.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Harley Geiger, *How Congress Should Tackle the Drone Privacy Problem*, CTR. FOR DEMOCRACY & TECH. (Mar. 27, 2012), <https://www.cdt.org/blogs/harley-geiger/2703how-congress-should-tackle-drone-privacy-problem> (last updated May 4, 2012) (citing *Texas county police buys drone that can carry weapons*, HOMELAND SEC. NEWS WIRE (Oct. 31, 2011), <http://www.homelandsecuritynewswire.com/texas-county-police-buys-drone-can-carry-weapons>).

¹⁶ Mark Corcoran, *Rise of the Machines*, ABC NEWS (Apr. 9, 2012), <http://www.abc.net.au/foreign/content/2012/s3582815.htm>.

¹⁷ *Id.*

¹⁸ Andy Pasztor & John Emshwiller, *Drone Use Takes Off on the Home Front*, WALL ST. J. (Apr. 20, 2012), <http://online.wsj.com/article/SB10001424052702304331204577354331959335276.html>.

¹⁹ *Id.*

²⁰ Harley Geiger, *The Drones Are Coming*, CTR. FOR DEMOCRACY & TECH. (Dec. 21, 2011), <https://www.cdt.org/blogs/harley-geiger/2112drones-are-coming>.

Drones represent an unprecedented convergence of surveillance technologies that could lead to increased security but could also jeopardize the privacy of U.S. citizens. Drones may be equipped with a variety of technologies including high-resolution cameras,²¹ face-recognition technology,²² video-recording capability,²³ heat sensors,²⁴ radar systems,²⁵ night vision,²⁶ infrared sensors,²⁷ thermal-imaging cameras,²⁸ Wi-Fi and communications interception devices,²⁹ GPS,³⁰ license-plate scanners,³¹ and other systems designed to aid in surveillance. Drones will soon be able to recognize faces and track the movement of subjects with only minimal visual-image data

²¹ Neal Gomba, *New spy drone has 1.8 gigapixel camera*, EXTREMETECH (Dec. 28, 2011), <http://www.extremetech.com/extreme/110873-new-spy-drone-has-1-8-gigapixel-camera>.

²² Geiger, *supra* note 4 (citing Noah Shachtman, *Army Tracking Plan: Drones That Never Forget a Face*, WIRED (Sep. 28, 2011), <http://www.wired.com/dangerroom/2011/09/drones-never-forget-a-face/> (discussing the ability of drones to utilize facial recognition technology to track subjects)).

²³ Joe Pollicino, *Parrot unveils AR.Drone 2.0 with 720p HD camera, autonomous video-recording, we go hands-on*, ENGADGET (Jan. 8, 2012), <http://www.engadget.com/2012/01/08/parrot-unveils-ar-drone-2-0-with-720p-hd-camera-autonomous-vid/> (discussing the video recording capability of drones).

²⁴ *Drones in U.S.: More Unmanned Aircraft Will Be Flying in Domestic Airspace by 2015*, HUFFPOST LIVE (Sep. 19, 2012, 11:42 AM), http://www.huffingtonpost.com/2012/09/19/drones-unmanned-aircrafts-us-airspace_n_1896839.html (discussing the use of heat sensors on drones).

²⁵ C.E. Schwartz et al., *A Radar for Unmanned Air Vehicles*, 3 LINCOLN LAB. J. 1 (1990), available at http://www.ll.mit.edu/publications/journal/pdf/vol03_no1/3.1.6.radarUAV.pdf (discussing a radar system designed for drones).

²⁶ Ian Drury, *The 7oz helicopter that could help beat the Taliban: \$35,000 device enables soldiers to look at enemy territory without risk of being killed*, MAIL ONLINE (Aug. 2, 2012), <http://www.dailymail.co.uk/sciencetech/article-2182916/The-7oz-helicopter-help-beat-Taliban--20-000-device-enables-soldiers-look-enemy-territory-risk-killed.html> (discussing the night vision capability of drones).

²⁷ *Developing Commercial UAV Applications, Imaging Sensors and Data Collection*, UAV MARKETSPACE <http://www.uavm.com/uavsubsystems/imagingdatasensors.html> (last visited Oct. 7, 2013) (discussing infrared sensors available for drones).

²⁸ Geiger, *supra* note 4 (citing Draganfly Innovations Inc., *DraganFlyer X6*, <http://www.draganfly.com/uav-helicopter/draganflyer-x6/features/flir-camera.php> (last visited Oct. 7, 2013)) (discussing a thermal infrared camera that enables drones to locate “individuals based on body heat”).

²⁹ *Id.* (citing Gary Mortimer, *Wi-Fi Aerial Surveillance Platform, WASP drone*, SUAS NEWS (Aug. 15, 2010), <http://www.suasnews.com/2010/08/587/wi-fi-aerial-surveillance-platform-wasp/>); Kim Zetter, *DIY Spy Drone Sniffs Wi-Fi, Intercepts Phone Calls*, WIRED (Aug. 4, 2011), <http://www.wired.com/threatlevel/2011/08/blackhat-drone> (discussing the ability of drones to access wireless networks and intercept communications)).

³⁰ Lynetta Bowen, *GPS-Guided Drones Present Privacy and Security Concerns*, ROCKY MOUNTAIN TRACKING DAILY GPS NEWS (Sept. 6, 2012), <http://www.rmtracking.com/blog/tag/drones/> (discussing the GPS capability of drones).

³¹ Geiger, *supra* note 4 (citing Kris Gutiérrez, *Drone Gives Texas Law Enforcement Bird's-Eye View on Crime*, FOXNEWS.COM (Nov. 16, 2011), <http://www.foxnews.com/us/2011/11/16/drone-gives-texas-law-enforcement-birds-eye-view-on-crime/#ixzz1dw9bVOh8/>) (discussing the use of drones with license plate reading technology).

obtained from aerial surveillance.³² Drones have the ability to break into wireless networks, monitor cell-phone calls, and monitor entire towns while flying at high altitude.³³ These rapid technological advancements present privacy challenges that were not contemplated when our existing laws were developed.

II. BACKGROUND—PRIVACY AND LEGAL FRAMEWORK

Since courts have yet to specifically address drone surveillance, we must begin by examining the constitutional and common law sources of the right to privacy.

A. *The Right to Privacy*

The right to privacy is an old concept. It was famously traced back to the development of the common law and viewed as an evolution from the existing common law.³⁴ From this beginning, four common law privacy torts evolved: (1) intrusion upon seclusion³⁵; (2) publicity placing person in false light³⁶; (3) appropriation of name or likeness³⁷; and (4) publicity given to private life.³⁸ The tort of intrusion upon seclusion provides a cause of action against “one who intentionally intrudes, physically or otherwise, upon the solitude or seclusion of another or his private affairs or concerns . . . if the intrusion would be highly offensive to a reasonable person.”³⁹ The tort of publicity placing a person in false light offers a cause of action against one who gives publicity to a matter concerning another that places the other before the public in a false light . . . if, (a) the false light . . . would be highly offensive to a reasonable person, and (b) the actor had knowledge of or acted in reckless disregard as to the falsity of the publicized matter.⁴⁰

³² Shachtman, *supra* note 22.

³³ Andy Greenberg, *Flying Drone Can Crack Wi-Fi Networks, Snoop on Cell Phones*, FORBES (July 28, 2011), <http://www.forbes.com/sites/andygreenberg/2011/07/28/flying-drone-can-crack-wifi-networks-snoop-on-cell-phones/>; Ellen Nakashima & Craig Whitlock, *With Air Force's Gorgon Drone 'we can see everything'*, WASH. POST (Jan. 2, 2011, 12:09 AM), <http://www.washingtonpost.com/wp-dyn/content/article/2011/01/01/AR2011010102690.html>.

³⁴ Samuel D. Warren & Louis D. Brandeis, *The Right to Privacy*, 4 HARV. L. REV. 193, 193 (1890).

³⁵ RESTATEMENT (SECOND) OF TORTS § 652B (1977).

³⁶ *Id.* § 652E.

³⁷ *Id.* § 652C.

³⁸ *Id.* § 652D.

³⁹ DANIEL J. SOLOVE & PAUL M. SCHWARTZ, INFORMATION PRIVACY LAW 80 (4th ed. 2011) (quoting RESTATEMENT (SECOND) OF TORTS § 652B).

⁴⁰ *Id.* at 205–06 (quoting RESTATEMENT (SECOND) OF TORTS § 652E).

Also, the tort of appropriation of name or likeness provides a common law cause of action for “invasion of privacy” against “one who appropriates to his own use or benefit the name or likeness of another.”⁴¹ Finally, the tort of publicity given to private life provides for a cause of action for “invasion of privacy” against “one who gives publicity to a matter concerning the private life of another . . . if the matter publicized is of a kind that (a) would be highly offensive to a reasonable person, and (b) is not of legitimate concern to the public.”⁴² The tort of intrusion upon seclusion is the most likely to be implicated by the domestic use of drones. A claim of publicity given to private life would require a publication action and would not accrue simply because of surveillance.⁴³

In addition to the common law right to privacy, U.S. citizens have a constitutional right to privacy.⁴⁴ Although not directly enumerated in the Constitution, the right to privacy is derived from several Amendments in the Bill of Rights to the U.S. Constitution⁴⁵:

[T]he right to privacy is nowhere specifically mentioned in the U.S. Constitution or in the Bill of Rights. Nevertheless, because privacy flows from the general concept that there are certain freedoms beyond the power of [the] government to restrict, many view the federal Bill of Rights as a firm judicial mandate empowering the courts to protect both enumerated and unenumerated rights.⁴⁶

The First Amendment guarantees that Congress “shall make no law respecting an establishment of religion, or prohibiting the exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.”⁴⁷ Accordingly, the First Amendment protects an individual’s right to privacy regarding speech, assembly, and religion.⁴⁸ The First Amendment potentially applies to domestic drone use since widespread drone surveillance may have a chilling effect on protected activities.

In addition to the First Amendment, the Third Amendment provides for the privacy of an individual’s home by holding that “no soldier shall, in time of peace be quartered in any house, without the consent of the Owner.”⁴⁹ The Fourth Amendment expands this privacy right by providing that

⁴¹ *Id.* at 220 (quoting RESTATEMENT (SECOND) OF TORTS § 652C).

⁴² *Id.* at 109–10 (quoting RESTATEMENT (SECOND) OF TORTS § 652D).

⁴³ RESTATEMENT (SECOND) OF TORTS § 652D (2012).

⁴⁴ See DAVID M. O’BRIEN, *PRIVACY, LAW, AND PUBLIC POLICY* 35–169 (1979).

⁴⁵ See RICHARD A. GLENN, *THE RIGHT TO PRIVACY: RIGHTS AND LIBERTIES UNDER THE LAW* 21–44 (2003).

⁴⁶ *Id.* at 35.

⁴⁷ U.S. CONST. amend. I.

⁴⁸ JOHN T. SOMA & STEPHEN D. RYNERSON, *PRIVACY LAW IN A NUTSHELL* 58 (2008); see also O’BRIEN, *supra* note 44, at 138–76.

⁴⁹ SOLOVE & SCHWARTZ, *supra* note 39, at 34; U.S. CONST. amend. III.

[t]he right of the people to be secure in their persons, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.⁵⁰

Lastly, the Fifth Amendment promotes privacy by protecting a citizen's right to not be "compelled in any criminal case to be a witness against himself."⁵¹ Of these amendments, the most applicable to drone surveillance is the Fourth Amendment; however, the Fifth Amendment has potential applicability if drones use electronic surveillance to uncover inculpatory information that an individual is concealing. The First, Fourth, and Fifth Amendments, along with the majority of the Bill of Rights, have been incorporated into the Due Process clause of the Fourteenth Amendment and made applicable to the states.⁵²

The next section will examine how current laws protect the privacy rights of U.S. citizens from surveillance.

B. *Current Legal Framework*

Courts have not yet addressed the issue of drone surveillance; therefore, the best way to assess the current legal framework is to review the jurisprudence on related surveillance methods to determine how a court would likely rule.

The starting place is the development of modern wiretap law, which began with *Olmstead v. U.S.*⁵³ In *Olmstead*, the Supreme Court held wiretapping to be constitutional on the grounds that there was "no seizure" since the conversations were only heard and there was no physical entry into the defendant's property.⁵⁴ The Court reasoned that "the intervening [telephone] wires are not part of [the defendant's] house or office, any more than are the highways along which they are stretched."⁵⁵ Almost forty years later, in *Katz v. U.S.*, FBI agents monitored phone calls placed from a public phone booth by attaching a device to the exterior of the booth.⁵⁶ The Supreme Court held that "the Fourth Amendment protects people, not places" and reasoned that "what a person knowingly exposes to the public, even

⁵⁰ SOLOVE & SCHWARTZ, *supra* note 39, at 34; U.S. CONST. amend. IV; *see also* O'BRIEN, *supra* note 44, at 35–31.

⁵¹ SOLOVE & SCHWARTZ, *supra* note 39, at 35; U.S. CONST. amend. V; *see also* O'BRIEN, *supra* note 44, at 89–137.

⁵² JOSHUA DRESSLER & GEORGE C. THOMAS, III, *CRIMINAL PROCEDURE INVESTIGATING CRIME* 47 (5th ed. 2012) (quoting *Duncan v. Louisiana*, 391 U.S. 145, 147–48 (1968)).

⁵³ *Olmstead v. U.S.*, 277 U.S. 438, 464 (1928).

⁵⁴ *Id.*

⁵⁵ *Id.* at 465.

⁵⁶ *Katz v. U.S.*, 389 U.S. 347, 348 (1967).

in his own home or office, is not a subject of the Fourth Amendment protection.”⁵⁷ The Court deviated from the “trespass doctrine” of *Olmstead* and other decisions to hold that it was constitutionally insignificant whether the listening device actually physically penetrated the phone booth.⁵⁸

Justice Harlan’s concurring opinion in *Katz* articulated a two-part test for evaluating a person’s expectation of privacy: (1) “a person” must exhibit “an actual (subjective) expectation of privacy,” and (2) “the expectation” of privacy must “be one that society is prepared to recognize as ‘reasonable.’”⁵⁹ This test is the primary standard for determining whether an individual has an expectation of privacy protected by the Fourth Amendment.⁶⁰ Specifically, a reasonable expectation of privacy does not exist in information shared with third parties, such as the numbers dialed from a telephone since this information is routinely shared with the telephone company in the “ordinary course of business.”⁶¹

In response to the Supreme Court’s decisions, Congress enacted the Federal Communications Act of 1934 (FCA) and subsequently the Electronic Communications Privacy Act (ECPA) to protect the privacy of communications.⁶² The ECPA included the Wiretap Act, the Stored Communications Act, and the Pen Register Act.⁶³

The Wiretap Act protects wire, oral, and electronic communications from interception and disclosure.⁶⁴ Under the Wiretap Act, “to ‘intercept’ a communication means to acquire its contents through the use of any ‘electronic, mechanical, or other device.’”⁶⁵ The Wiretap Act requires a judicial order before the government may intercept communications.⁶⁶ In addition, the Wiretap Act contains an exclusionary rule that allows a party to “move to suppress the contents of any wire or oral communication intercepted . . . or evidence derived therefrom.”⁶⁷ The exclusionary rule does not apply to electronic communications, which include all forms of communication other than wire or oral communications, including email.⁶⁸

The Stored Communications Act prevents service providers from disclosing the content of stored communications and the Pen Register Act requires a court order before a device that tracks phone numbers may be uti-

⁵⁷ *Id.* at 351.

⁵⁸ *Id.* at 353.

⁵⁹ *Id.* at 361. (Harlan, J., concurring).

⁶⁰ SOLOVE & SCHWARTZ, *supra* note 39, at 269.

⁶¹ *Smith v. Maryland*, 442 U.S. 735, 743–46 (1979).

⁶² SOLOVE & SCHWARTZ, *supra* note 39, at 315–22.

⁶³ *Id.* at 315.

⁶⁴ *Id.* at 317; 18 U.S.C. §§ 2510–22 (2012).

⁶⁵ SOLOVE & SCHWARTZ, *supra* note 39, at 317 (quoting 18 U.S.C. § 2510(4) (2012)).

⁶⁶ *Id.* at 318.

⁶⁷ *Id.* at 318 (quoting 18 USC § 2518(10)(a) (2012)).

⁶⁸ *Id.* at 316–18.

lized.⁶⁹ The USA PATRIOT Act passed after the September 11, 2001 terrorist attacks made changes to the ECPA, including adding a provision allowing the government to delay notice of a search if the court determined that there was “‘reasonable cause’ that immediate notice would create an ‘adverse result.’”⁷⁰

Turning to aerial surveillance, the Supreme Court has applied the *Katz* two-part test to hold that it is “unreasonable . . . to expect . . . [constitutional protection] from being observed with the naked eye from an altitude of 1,000 feet.”⁷¹ The Supreme Court also held that “aerial photographs of an industrial plant complex from navigable airspace” do not constitute a search that violates the Fourth Amendment.⁷² The expectation of privacy granted for the curtilage of a home does not extend to the open areas of an industrial plant.⁷³ While the degree of vision enhancement achieved by the particular aerial photography did not raise constitutional concerns, the Court left open the question of the constitutionality of higher degrees of vision enhancement.⁷⁴ The Court specifically stated that serious constitutional questions would be raised by electronic surveillance that could penetrate a building to “hear and record confidential discussions.”⁷⁵ In addition, a reasonable expectation of privacy does not exist against surveillance conducted by a helicopter operating at an altitude of 400 feet, since a member of the public could legally operate a helicopter at that altitude.⁷⁶

In *Kyllo*, the Supreme Court held that the Fourth Amendment requires a warrant any time that the Government uses a device that is not in general public use to reveal details of a home that would not otherwise be known without physically entering the home.⁷⁷ There is no legitimate privacy interest in the possession of contraband.⁷⁸ Accordingly, a dog sniff that only reveals the existence of contraband without physically trespassing on private property would not likely be found to be a search in violation of the Fourth Amendment.⁷⁹ Therefore, drones would potentially violate a legiti-

⁶⁹ *Id.* at 320–21.

⁷⁰ *Id.* at 332 (quoting 18 U.S.C. § 3103a(b) (2012)).

⁷¹ *California v. Ciraolo*, 476 U.S. 207, 215 (1986).

⁷² *Dow Chem. Co. v. United States*, 476 U.S. 227, 239 (1986).

⁷³ *See id.*

⁷⁴ *Id.* at 238–39.

⁷⁵ *Id.*

⁷⁶ *Florida v. Riley*, 488 U.S. 445, 451–52 (1989).

⁷⁷ *Kyllo v. United States*, 533 U.S. 27, 40 (2001).

⁷⁸ *Illinois v. Caballes*, 543 U.S. 405, 408 (2005) (holding that “governmental conduct that *only* reveals the possession of contraband ‘compromises no legitimate privacy interest’”) (quoting *United States v. Jacobsen*, 466 U.S. 109, 123).

⁷⁹ *See Florida v. Jardines*, 133 S. Ct. 1409, 1417 (applying a property-based trespass approach, the Court held that a search in violation of the Fourth Amendment occurred when police physically intruded on private property with trained police dogs).

mate expectation of privacy if used to reveal anything in a private home other than contraband.

Drones may also be used like tracking beepers and GPS tracking devices to track suspects. The Supreme Court has held that attaching a tracking beeper to a drum of chloroform did not violate the Fourth Amendment rights of the eventual purchaser.⁸⁰ Similarly, the Court has held that “[a] person travelling in an automobile on public thoroughfares has no reasonable expectation of privacy in his movements from one place to another” and that the use of a tracking beeper is analogous to following a vehicle and tracking through visual surveillance.⁸¹ However, the Supreme Court held that the use of a tracking beeper to reveal information that law enforcement “could not have obtained by observation from outside the curtilage of the house” constituted a search in violation of the Fourth Amendment.⁸² In *U.S. v. Jones*, the Supreme Court considered the Fourth Amendment implications of a GPS tracking device.⁸³ Building upon the previous tracking-beeper jurisprudence, the Court applied a property-based trespass approach to the Fourth Amendment and held that the Government conducted a search under the Fourth Amendment when it physically trespassed on private property to install the GPS tracking device.⁸⁴ The Court did not address whether the search could have been considered reasonable given the circumstances.⁸⁵

The Supreme Court has not directly addressed drone surveillance; however, the technology is analogous to the other forms of surveillance discussed above. While the Fourth Amendment jurisprudence protects the privacy of an individual’s home, there is little constitutional privacy protection outside of the home.⁸⁶ If drones become commonly used by the public, that could significantly affect the Fourth Amendment analysis under the test established in *Kyllo*.⁸⁷

⁸⁰ *United States v. Knotts*, 460 U.S. 276, 278–79, 285 (1983).

⁸¹ *Id.* at 281.

⁸² *United States v. Karo*, 468 U.S. 705, 715 (1984).

⁸³ *United States v. Jones*, 132 S. Ct. 945, 948 (2012).

⁸⁴ *Id.* at 949–53.

⁸⁵ *Id.* at 954.

⁸⁶ For further discussion of drone surveillance and the Fourth Amendment, *see generally*, Joseph J. Vacek, *Big Brother Will Soon Be Watching—Or Will He? Constitutional, Regulatory, and Operational Issues Surrounding the Use of Unmanned Aerial Vehicles in Law Enforcement*, 85 N.D. L. REV. 673, 679–84 (2009) (discussing the limits of police UAV surveillance); Travis Dunlap, comment, *We’ve Got Our Eyes on You: When Surveillance by Unmanned Aircraft Systems Constitutes a Fourth Amendment Search*, 51 S. TEX. L. REV. 173, 183–92 (2009) (exploring Fourth Amendment violation tests in the context of requiring police warrants for aerial surveillance); Paul McBride, comment, *Beyond Orwell: The Application of Unmanned Aircraft Systems in Domestic Surveillance Operations*, 74 J. AIR L. & COM. 627, 639–51 (2009) (exploring the evolution of warrantless surveillance activities and modern jurisprudence).

⁸⁷ *Kyllo v. United States*, 533 U.S. 27, 40 (2001).

According to the Restatement (Second) of Torts, an aircraft may be liable for trespass “if, but only if, (a) it enters into the immediate reaches of the air space next to the land, and (b) it interferes substantially with the . . . use and enjoyment of [the] . . . land.”⁸⁸ While the courts have not yet determined whether this rule applies to “space rockets, satellites, missiles, and similar objects,”⁸⁹ it is reasonable to believe that any flying drone, regardless of its size, could be considered an aircraft. Accordingly, this comment proceeds under that assumption.

The Restatement view is based on a 1946 Supreme Court opinion that “had the effect of making the upper air, above the prescribed minimum altitudes of flight, a public highway.”⁹⁰ The Supreme Court “preserve[d] the action of trespass as a remedy where the ‘immediate reaches’ are invaded by flight” by holding that “if the landowner is to have full enjoyment of the land, he must have ‘exclusive control of the immediate reaches of the enveloping atmosphere,’ and ‘invasions of it are in the same category as invasions of the surface.’”⁹¹ The term “‘immediate reaches’ of the land has not been defined as [of] yet, except to mean that ‘the aircraft flights were at such altitudes as to interfere substantially with the landowner’s possession and use of the airspace above the surface.’”⁹² The Restatement authors suggest that “flight within 50 feet” would be within the “‘immediate reaches,’” while flight above 500 feet would not be.⁹³ Flight at altitudes in between 50 and 500 feet would likely “present a question of fact.”⁹⁴

While the trespass doctrine provides a potential cause of action for drones flying close to the ground, the doctrine of nuisance could potentially apply to drones flying at higher altitudes.⁹⁵ In general, a cause of action for nuisance may exist when there is an intentional and unreasonable “invasion of another’s interest in the private use of enjoyment of land.”⁹⁶ Accordingly, an individual must reasonably demonstrate that high-altitude drone surveillance interferes with the use and enjoyment of their land to have a valid cause of action.

Given the current state of the law, which is pieced together from constitutional and tort law, new laws will be necessary to address the deployment of domestic drones. The next section discusses the economic perspective of privacy to establish an economic framework that may be used to evaluate potential new laws and policies.

⁸⁸ RESTATEMENT (SECOND) OF TORTS § 159 (1965).

⁸⁹ *Id.*

⁹⁰ *Id.* § 159 cmt. i; *see generally* United States v. Causby, 328 U.S. 256 (1946) (case discussed by the restatement authors).

⁹¹ RESTATEMENT (SECOND) OF TORTS § 159 cmt. j (1965) (quoting *Causby*, 328 U.S. at 264–65).

⁹² *Id.* § 159 cmt. l.

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.* at § 159 cmt. m.

⁹⁶ RESTATEMENT (SECOND) OF TORTS § 822 (1979).

III. ANALYSIS: AN ECONOMIC PERSPECTIVE

In the absence of current legislation and settled law, economic analysis provides a cogent framework to analyze the societal effects of the domestic use of drones. This section discusses the economic view of privacy and explains Song's economic model of surveillance, which may be used to analyze potential legal and policy alternatives regarding domestic drone surveillance.

A. *Economic Model of Surveillance*

Economic models may be used to analyze the utility and costs of surveillance to assist in determining the socially optimal amount of surveillance.⁹⁷ These models are predicated on the assumption that individual citizens are "rational economic agents" who will "seek to maximize their 'self-interest'" when making decisions about their own behavior, privacy, and other activities.⁹⁸

Utility may be directly and indirectly derived from privacy.⁹⁹ Direct utility from privacy includes the intrinsic value that individuals and society place on privacy, including intimacy and seclusion.¹⁰⁰ Indirect utility of privacy results when individuals or society "value privacy because it facilitates other benefits," such as "avoid[ing] sanctions for socially undesirable conduct."¹⁰¹

While utility is generated by privacy, surveillance may also generate social utility by promoting security.¹⁰² Surveillance promotes security through a combination of prevention and deterrence of harm.¹⁰³ Prevention includes law enforcement interventions that prevent crime and interventions that enhance public safety, such as preventing swimmers from drowning or

⁹⁷ See, e.g., Song, *supra* note 6 (developing a model for finding the optimal privacy protections for both accounting for both the benefits of privacy and the benefits of deterrence); Hugo M. Mialon & Sue H. Mialon, *The Economics of the Fourth Amendment: Crime, Search, and Anti-Utopia* (July 4, 2004), available at <http://ssrn.com/abstract=591667> (using a game theoretic model to determine the conditions where the protections of the Fourth Amendment are likely to produce positive results).

⁹⁸ HENRY N. BUTLER & CHRISTOPHER R. DRAHOZAL, ECONOMIC ANALYSIS FOR LAWYERS 5 (2d ed. 2006); see generally Alessandro Acquisti, *The Economics of Personal Data and the Economics of Privacy*, ¶¶ 7–24 (Working Party for Info. Sec. and Privacy & Working Party on the Info. Econ., Background Paper No. 3, 2010), available at <http://www.oecd.org/sti/interneteconomy/46968784.pdf> (presenting and critiquing several economic theories of privacy, particularly the Chicago School).

⁹⁹ Song, *supra* note 6, at 8.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 9.

¹⁰² See *id.* at 3.

¹⁰³ *Id.* at 6–7.

children from being hit by cars.¹⁰⁴ Surveillance has a deterrent effect since the information gathered increases the probability of punishment for criminals.¹⁰⁵ Assuming the presence of surveillance is known, potential criminals will be less likely to commit crimes since they know authorities are observing the criminals' activities.¹⁰⁶

What Song refers to as "privacy disutility" results as individuals lose privacy and the associated utility.¹⁰⁷ Song identifies the three main causes of "privacy disutility" as losing informational, attentional, or physical privacy.¹⁰⁸ Informational privacy is lost if information that an individual desires to be kept private is exposed.¹⁰⁹ Attentional privacy is lost due to mere unwanted attention, even if nothing is actually exposed.¹¹⁰ Physical privacy is lost from the presence of a third party in a location where seclusion or intimacy is expected.¹¹¹

Privacy and security are competing externalities.¹¹² A desire for security leads to increased surveillance and the need for others to sacrifice privacy.¹¹³ A desire for increased privacy would potentially lead to less surveillance and decreased security for other members of society. Applying the Coase theorem, if transaction costs are zero, the higher valuing user of information should be able to compensate the owner of the information for any externality caused by the value-maximizing activity.¹¹⁴ Whether information is disclosed will depend upon the value the owner places on keeping the information private relative to the value that other users place on obtaining the information.¹¹⁵ Surveillance would then prevail when the value of increased societal security is greater than the perceived value of increased individual privacy. As discussed above, this value calculation will depend on the utility and disutility associated with specific activities and types of information. This would be true if the transaction costs were zero; however, the transaction costs of bargaining for the privacy of information will likely be substantial. Given these high transaction costs, there will be a significant loss of utility if private information is revealed by increased surveillance.

¹⁰⁴ *Id.*

¹⁰⁵ Song, *supra* note 6, at 6–7.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 7.

¹⁰⁸ *Id.* at 7–8.

¹⁰⁹ *Id.* at 7.

¹¹⁰ *Id.* at 7–8.

¹¹¹ See Song, *supra* note 6, at 8 (discussing the privacy disutility created by the presence of a dog on an intimate date).

¹¹² Kathleen Wallman, *The Tension Between Privacy and Security: An Analysis Based on Coase and Pigou*, 3 J. TELECOMM. & HIGH TECH. L. 397, 397–408 (2005).

¹¹³ *Id.* at 404.

¹¹⁴ See *id.* at 403–04.

¹¹⁵ Acquisti, *supra* note 98, at 4.

Since individuals behave rationally¹¹⁶ and seek to maximize utility, it is logical that individuals will look for ways to minimize privacy disutility.¹¹⁷ Individuals may respond by “avoid[ing] the behavior altogether due to the lack of privacy” or employing defensive measures.¹¹⁸ An individual will likely focus on her private marginal utility and rationally decide “not to engage in an activity if the marginal privacy disutility outweighs the [private] marginal utility from engaging in the activity.”¹¹⁹ However, since there may be “external benefits to engaging in the activity,” “the social marginal benefit from the activity may be greater than the private marginal utility to the individual.”¹²⁰ Therefore, social costs of avoidance will result if individuals choose not to participate in socially beneficial activities due to a loss of privacy from surveillance.¹²¹ Imperfect information regarding surveillance may increase social costs of avoidance since people may not perform socially beneficial activities since they think they are being watched.¹²² In addition, “social costs from avoidance will generally increase as the area subject to surveillance encompasses more activities.”¹²³

Instead of completely avoiding activities impacted by surveillance, individuals may choose to engage in defensive measures.¹²⁴ While defensive measures, such as encryption of data or privacy fences, are costly, the use of defensive measures will “reduce [the] overall social costs of surveillance” since rational “individuals will [only] take defensive measures to protect their privacy . . . if the cost of the defensive measure is less than or equal to their privacy disutility or private benefit forgone from avoidance.”¹²⁵

In addition, surveillance results in administrative costs in the form of “collection costs” and “processing costs.”¹²⁶ These costs are incurred by the party undertaking the surveillance and are related to the means and scope of the surveillance undertaken.¹²⁷ Accordingly, “the surveillance actor has the socially optimal incentive to minimize” these costs.¹²⁸ As technology low-

¹¹⁶ BUTLER & DRAHOZAL, *supra* note 98, at 5.

¹¹⁷ Song, *supra* note 6, at 11.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² *See id.* at 12–13 (discussing example of teenager who fails to use birth control since she feels that she is being watched and miscalculates the risks).

¹²³ Song, *supra* note 6, at 14.

¹²⁴ *Id.* at 15–16.

¹²⁵ *Id.* at 15.

¹²⁶ *Id.* at 16.

¹²⁷ *Id.* at 16–17.

¹²⁸ *Id.* at 17.

ers the cost of surveillance, the socially optimal amount of surveillance will likely increase.¹²⁹

Song completes his economic model of surveillance by suggesting an “economic interpretation of [the] ‘reasonable’ expectation of privacy.”¹³⁰ He suggests that the classic Learned Hand Formula for negligence liability may be applied to determine when a level of surveillance is in the best interest of society.¹³¹ Specifically, the formula may be applied to analyze where probable cause or a reasonable expectation of privacy exist as an economic basis for determining when a search or method of surveillance is in the best interest of society.¹³²

Song believes that the reasonable expectation of privacy “should depend on the degree of harm that the government is trying to prevent or deter [and] . . . the effectiveness of the method of surveillance in deterring or preventing harm.”¹³³ Rather than have courts make these reasonableness determinations in each case, Song proposes three categories of scrutiny: (1) heightened scrutiny for protected areas; (2) minimal scrutiny for unprotected areas; and (3) intermediate scrutiny for areas in between protected and unprotected.¹³⁴ To determine the appropriate level of scrutiny, courts should consider three factors to measure the potential social costs and privacy disutility from proposed surveillance action: “[1] the number of different activities that take place in the area subject to surveillance, [(2)] the nature of those activities, and [(3)] the social benefits conferred by those activities.”¹³⁵ Communicative activities should always be given heightened scrutiny since “the social costs from avoidance are likely to be greater due to the external benefits from the dissemination of information and imperfect information when seeking information.”¹³⁶

In addition to the type of activity, Song differentiates between “[g]eneral-purpose forums’ . . . in which many different activities take place . . . and ‘[s]pecial-purpose forums’ . . . that are limited to a few activities or even designated for a certain kind of activity.”¹³⁷ General-purpose forums should receive heightened scrutiny since the greater number of activities will likely lead to a higher level of social costs from avoidance due to surveillance.¹³⁸

¹²⁹ Song, *supra* note 6, at 17.

¹³⁰ *Id.* at 19–20.

¹³¹ *Id.*

¹³² *Id.*; see also Craig S. Lerner, *The Reasonableness of Probable Cause*, 81 TEX. L. REV. 951, 1019–22 (2003).

¹³³ Song, *supra* note 6, at 20.

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.* at 20–21.

¹³⁷ *Id.* at 21–22.

¹³⁸ *Id.*

Each level of scrutiny would require the government actor to demonstrate a differing level of interest.¹³⁹ Heightened scrutiny would require “a compelling state interest,” “intermediate scrutiny would require a ‘substantial’ state interest, and minimal scrutiny would merely require a legitimate government interest.”¹⁴⁰ In addition, the heightened and intermediate levels of scrutiny would require documentation that no viable alternative that would be less restrictive on privacy exists.¹⁴¹ By requiring the government to demonstrate a specified level of governmental interest and that no less intrusive alternatives are available, society can be protected from surveillance that is not socially beneficial.¹⁴²

The next section will specifically apply these economic perspectives of surveillance to domestic drone surveillance.

B. *Economic Analysis of Drone Surveillance*

Song’s general economic model of surveillance may be applied to analyze domestic drone surveillance. Drones provide a very effective means to accomplish widespread, general, persistent surveillance. The optimal amount of drone surveillance will occur where the marginal social benefit of surveillance equals or exceeds the marginal social cost or disutility of the surveillance.¹⁴³ Therefore, the costs and benefits resulting from drone surveillance must be identified and analyzed. As a result of the availability of efficient widespread surveillance, increased domestic drone surveillance will generate utility in the form of increased security from crime and terrorism.

Drones may remain airborne for long periods of time without onboard pilots and are very efficient at providing persistent, widespread surveillance. As a result, the societal utility and disutility caused by the drone surveillance may be compounded. The socially optimal amount of surveillance may increase because drones have the ability to significantly reduce the cost of widespread surveillance.¹⁴⁴ The benefit of this increased security will come at the cost of individual privacy. Given the widespread and pervasive nature of potential domestic drone surveillance, the marginal cost of uncontrolled drone surveillance will likely exceed the marginal benefit of the surveillance. Therefore, such widespread surveillance will be unproductive and inefficient for society.

¹³⁹ Song, *supra* note 6, at 20.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *See generally id.* (proposing three factors courts should consider in determining the correct level of scrutiny).

¹⁴³ *Id.* at 20.

¹⁴⁴ *Id.* at 17.

The law must strive to allow the optimal amount of drone surveillance. If drone surveillance is restricted too much, allowing less than the optimal level, then society will not realize the full benefit that the surveillance can provide in the form of prevention, deterrence, and security.¹⁴⁵ At the same time, if the limits are not strong enough, too much drone surveillance will lead to significant disutility resulting from the loss of privacy. Therefore, the law should be structured to allow drone surveillance up to the point where the social benefit of the surveillance exceeds or equals the marginal social cost or disutility.

Following the insights gained from Song's economic model of surveillance, legal rules may be developed to efficiently implement domestic drone surveillance while minimizing disutility and social costs of avoidance. The government should be required to justify the use of domestic drone surveillance to ensure that it is deployed in a manner that benefits society. Drones should only be used when the government is able to satisfy the required levels of scrutiny described in Song's model.¹⁴⁶ Doing so will ensure that the societal benefits to be gained from drone surveillance will outweigh the privacy disutility and social costs that may result from the loss of privacy.

The next section will apply this conclusion to analyze the current legislative and policy recommendations for drone surveillance to determine the optimal course of action.

IV. LEGISLATIVE AND POLICY RECOMMENDATIONS

This section discusses the current policy and legislative recommendations regarding drone surveillance and applies economic analysis to recommend an optimal way forward. Developing new laws and policies to address the privacy threats presented by domestic drone surveillance will involve the difficult balancing of many special interests and the individual privacy rights of U.S. citizens.¹⁴⁷ Therefore, in drafting a legal framework for domestic drone surveillance, Congress should consider economic factors and establish a framework which allows the use of drones with constraints to protect the privacy interests of U.S. citizens. As an objective methodology, these economic perspectives should lead lawmakers and pol-

¹⁴⁵ See generally Song, *supra* note 6 (offering an economic analysis of privacy with respect to surveillance and searches, and proposing why privacy should be protected).

¹⁴⁶ *Id.* at 20.

¹⁴⁷ See generally PRISCILLA M. REGAN, LEGISLATING PRIVACY: TECHNOLOGY, SOCIAL VALUES, AND PUBLIC POLICY (1995) (examining Congressional policy making related to computerized databases, wiretapping, and polygraph testing, and determining that the legislation has an unbalanced stance in favor of benefitting those with a vested interest in new technology).

icymakers to enact rules that will efficiently maximize utility while protecting privacy interests.

The new framework should address the privacy concerns arising out of the domestic use of drones, while still allowing society to realize the technological benefits. Congress must consider many factors when determining how to best integrate drones into U.S. airspace.¹⁴⁸ In addition, the proposed policies should be compared with the policies in countries such as the United Kingdom, where general surveillance is more commonplace.¹⁴⁹

In July 2012, the Association for Unmanned Vehicle Systems International (AUVSI) issued a code of conduct that attempted to address concerns associated with the deployment of drones.¹⁵⁰ Among other elements, the code of conduct requires industry members to “respect the privacy of individuals” and “comply with all federal, state, and local laws, ordinances, covenants, and restrictions.”¹⁵¹ The code of conduct has been viewed as insufficient since it only lists broad topics, does not discuss specific privacy concerns, and does not elaborate on how the provisions will be enforced.¹⁵²

Current recommendations address a number of concerns regarding the widespread deployment of drones in the United States. Among these are recommendations from the American Civil Liberties Union (ACLU)¹⁵³ and legislation currently pending in both houses of Congress.¹⁵⁴ The first group of recommendations to consider is usage restrictions. It is generally accepted that drones and other means of surveillance may be used when a warrant has been issued because probable cause exists. Therefore, the focus of

¹⁴⁸ See generally BART ELIAS, CONG. RESEARCH SERV., R42718, PILOTLESS DRONES: BACKGROUND AND CONSIDERATIONS FOR CONGRESS REGARDING UNMANNED AIRCRAFT OPERATIONS IN THE NATIONAL AIRSPACE SYSTEM (2012) (discussing Congress’s response to UAV and challenges faced by the FAA in implementing the FAA Modernization and Reform Act); RICHARD M. THOMPSON II, CONG. RESEARCH SERV., R42701, DRONES IN DOMESTIC SURVEILLANCE OPERATIONS: FOURTH AMENDMENT IMPLICATIONS AND LEGISLATIVE RESPONSES (2013) (assessing drone use and the Fourth Amendment, as well as Congressional measures restricting the use of drones at home).

¹⁴⁹ See generally LAURA K. DONOHUE, THE COST OF COUNTERTERRORISM: POWER, POLITICS, AND LIBERTY 182–272 (2008) (comparing United States drone use with that of surveillance in the UK).

¹⁵⁰ *Drone Group Issues Code of Conduct*, WALL ST. J., Jul. 3, 2012, at B4; *AUVSI Releases “Code of Conduct” for Unmanned Aircraft Systems Operations*, ASS’N FOR UNMANNED VEHICLE SYS. INT’L (July 2, 2012), <http://www.auvsi.org/AUVSI/News#COC>.

¹⁵¹ *Unmanned Aircraft System Operations Industry “Code of Conduct,”* ASS’N FOR UNMANNED VEHICLE SYS. INT’L, <http://www.auvsi.org/conduct> (last visited Oct. 20, 2013).

¹⁵² Jaikumar Vijayan, *Drone industry’s Code of Conduct disappoints*, COMPUTERWORLD (July 12, 2012), <http://blogs.computerworld.com/privacy/20685/drone-industrys-code-conduct-disappoints>.

¹⁵³ AM. CIVIL LIBERTIES UNION, PROTECTING PRIVACY FROM AERIAL SURVEILLANCE: RECOMMENDATIONS FOR GOVERNMENT USE OF DRONE AIRCRAFT 15–16 (Dec. 2011), available at <https://www.aclu.org/files/assets/protectingprivacyfromaerialsurveillance.pdf> (the American Civil Liberties Union (ACLU) published recommendations regarding domestic government use of drones, which included usage restrictions, image retention restrictions, public notice, democratic control, and auditing effectiveness tracking).

¹⁵⁴ S. 1016, 113th Cong. (2013); H.R. 972, 113th Cong. (2013); H.R. 1262, 113th Cong. (2013).

pending legislation and policy recommendations is on when the use of drones should be allowed without a warrant, if at all. The ACLU proposes that drone use should be limited to three purposes: (1) “where there are specific and articulable grounds to believe that the drone will collect evidence relating to a specific instance of criminal wrongdoing or, if the drone will intrude upon reasonable expectations of privacy, where the government has obtained a warrant based on probable cause;”¹⁵⁵ (2) “where there is a geographically confined, time-limited emergency situation in which particular individuals’ lives are at risk;”¹⁵⁶ or (3) “for reasonable non-law enforcement purposes . . . where privacy will not be substantially affected.”¹⁵⁷ Similarly, both the House and Senate versions of the Preserving Freedom from Unwanted Surveillance Act of 2013 provide for three exceptions to the warrant requirement: (1) “patrol of borders”; (2) “exigent circumstances”; and (3) “high risk” of terrorist attack, as determined by the Secretary of Homeland Security.¹⁵⁸ The definition of exigent circumstances differs in the two bills. The Senate bill defines exigent circumstances to only include action necessary to “prevent imminent danger to life,”¹⁵⁹ while the House bill uses a broader definition that also includes “serious damage to property, or to forestall the imminent escape of a suspect, or destruction of evidence.”¹⁶⁰ The broader definition of exigent circumstances in the House of Representatives version of the bill¹⁶¹ is appropriate since it will give law enforcement more latitude to protect the American people in addition to providing for civil liability¹⁶² as a check against improper use of this authority.

The next recommendation is to consider whether there should be an exclusionary rule that would make any evidence gathered without a warrant or other legal authorization inadmissible in a criminal proceeding. The Senate bill also includes an exclusionary rule that would prohibit evidence collected in violation of the Act from being used in criminal prosecution.¹⁶³ Exclusionary rules can overdeter criminal investigations.¹⁶⁴ Therefore, unless a compelling case can be made as to why it is necessary, it would be more efficient not to include an exclusionary rule in the legislation.

Another consideration is whether drones operating in the United States should be allowed to carry weapons like drones operating overseas which

¹⁵⁵ AM. CIVIL LIBERTIES UNION, *supra* note 154, at 15–16.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ S. 1016, 113th Cong. § 4 (2013); H.R. 972, 113th Cong. § 3 (2013).

¹⁵⁹ S. 1016, 113th Cong. § 4 (2013).

¹⁶⁰ H.R. 972, 113th Cong. § 3 (2013).

¹⁶¹ *Id.*

¹⁶² H.R. 972, 113th Cong. § 4 (2013).

¹⁶³ S. 1016, 113th Cong. § 6 (2013).

¹⁶⁴ RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 956–57 (8th ed. 2011) (discussing the overdeterrence of criminal investigations resulting from the exclusionary rule).

are used to target enemy combatants. One recommendation is to prohibit law enforcement from arming drones.¹⁶⁵ Drones have the ability to conduct remote precision strikes on suspects, but due process concerns and the dangers resulting from armed unmanned aircraft preclude the viability of this option within the United States. Therefore, domestic drones should be prohibited from carrying weapons of any kind.

Congress should enact rules to govern domestic drone use. One recommendation is that Congress should require the Department of Transportation to conduct a Privacy Impact Assessment of the operation of drones domestically.¹⁶⁶ Pending legislation proposes amending the FAA Modernization and Reform Act of 2012 to address drone privacy concerns.¹⁶⁷ With the proper focus on privacy concerns, drones may be deployed domestically while still protecting the privacy of American citizens.

In addition, Congress should require a warrant for “extended surveillance of a particular target.”¹⁶⁸ As discussed earlier, the Fourth Amendment would not necessarily require a warrant in these situations. Even so, such a requirement extending warrant protections makes sense and will provide a valuable check against law enforcement abuse of the new technology.

Congress should require authorization from an independent official for generalized surveillance that collects personally identifiable information such as facial features and license plate numbers.¹⁶⁹ This recommendation would apply to situations where a warrant was not required but personally identifiable information was still being gathered, such as surveillance at a public event. This recommendation should be enacted as a safeguard of the public’s privacy interests. To adequately protect privacy interests, Congress should direct that the independent official, vested with decision-making power on applications for general surveillance, be a neutral and detached magistrate who is completely separated from any law enforcement or intelligence agency.

As discussed in the previous section, legislation should be crafted to maximize the social utility from the domestic use of drones. The legislation should be structured according to the three levels of scrutiny proposed by Song to ensure that the governmental interest in the surveillance outweighs the disutility or social cost that will result from the loss of privacy.¹⁷⁰ The neutral and detached magistrate discussed above could determine when a sufficient government interest exists to warrant allowing generalized drone surveillance.

¹⁶⁵ Geiger, *supra* note 16.

¹⁶⁶ *Id.*

¹⁶⁷ H.R. 1262, 113th Cong. (2013).

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *See* Song, *supra* note 6, at 20.

Additional policy recommendations include an image retention restriction¹⁷¹ and a requirement to file a data collection statement to obtain a FAA license to operate a drone.¹⁷² These recommendations should be incorporated into the legislation. Congress should require a data collection statement with applications for a FAA license to operate a drone. A key element of the required data collection statement should address the retention of images and other data obtained.¹⁷³ Such a restriction would mandate that all images and other sensory data gathered through surveillance be deleted unless the information serves a valid, legal purpose that requires retention.¹⁷⁴ This restriction is necessary to prevent the government or any other entity from amassing an essentially limitless database of information on the activities of U.S. citizens without a valid and specified purpose.

Collectively, enacting these recommendations would prevent widespread, general drone surveillance while allowing drones to be utilized domestically when reasonably warranted to maintain security or protect the interests of American citizens. Therefore, these recommendations would adequately protect the privacy interests of American citizens while allowing law enforcement and other entities to utilize drones to protect our country and serve other worthwhile endeavors.

CONCLUSION

U.S. citizens want to be safe from terrorist attacks and other threats, but not at the expense of their privacy rights. Therefore, a delicate balance must be achieved between privacy and security interests. Drones represent a surveillance technology advancement that threatens to dramatically alter the balance between these interests. As discussed in this comment, the current legal framework does not adequately protect privacy from the widespread surveillance that will likely result from the unrestricted domestic use of drones. Therefore, prompt legislative action is necessary to address the fundamental privacy challenges presented by the use of drones. Such legislation should allow for constructive use of drones within a framework that contains restrictions to protect individual privacy rights. While widespread general surveillance could make the nation safer from crime and terrorism, such extensive surveillance will ultimately be inefficient. The surveillance that could result from the domestic use of drones would detract from individual privacy and cause individuals to reduce productive activities and invest in countermeasures. Such “privacy disutility” will outweigh the societal benefits unless domestic drone surveillance is restricted. Therefore,

¹⁷¹ AM. CIVIL LIBERTIES UNION, *supra* note 153, at 15.

¹⁷² Geiger, *supra* note 16.

¹⁷³ *Id.*

¹⁷⁴ *Id.*

without legislative action we may soon live in a world where “every time we walk out of our front door we have to look up and wonder whether some invisible eye in the sky is monitoring us.”¹⁷⁵

¹⁷⁵ Catherine Herridge, *Privacy concerns as US government rolls out domestic drone rules*, FOXNEWS.COM (May 14, 2012), <http://www.foxnews.com/politics/2012/05/14/privacy-concerns-as-us-government-rolls-out-domestic-drone-rules/print##ixzz20oLm15dB> (quoting Jay Stanley, Senior Policy Analyst, American Civil Liberties Union).

SHOULD WE BEWARE OF DOG OR BEWARE OF BREED? AN ECONOMIC COMPARISON

*Meagan Dziura**

INTRODUCTION

When Charlotte Williams arrived home at 8:15 PM she found her husband, Charles Hagerman, unresponsive with injuries to his neck.¹ Their two pit bulls, Scrappy and Scrappy's son, stood nearby.² As authorities investigated the scene, Mrs. Williams reportedly just sat and stared in shock saying, "The dog killed my husband."³ Mrs. Williams's son, Daryl, reported that his parents had raised their pit bull from when he was a puppy and had taken in Scrappy's son only a year and a half before Daryl's father was found mauled to death by the dogs.⁴ Daryl said the dogs were friendly with all members of the family including small children; however, he also said that Mr. Williams was prone to seizures, which may have frightened the dogs into attacking.⁵ It is these kinds of seemingly unprovoked attacks that leave the public angry and frightened when it comes to the dogs designated as pit bulls.⁶ However, pit bulls are not the only dog breed associated with unprovoked attacks.⁷ In fact, since 1975, dogs belonging to more than thirty breeds have been responsible for fatal attacks on humans.⁸ The boom in the population of the breeds and breed mixes that make up the category of pit bull,⁹ combined with the media's portrayal of the breed as an aggressive

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¹ Maudlyne Iherjirika, Police: South Side man killed in pitbull attack at his home, CHICAGO SUN-TIMES (Aug. 15, 2012), <http://www.suntimes.com/news/metro/14519676-418/police-south-side-man-killed-in-pitbull-attack.html>.

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ Larry Cunningham, *The Case Against Dog Breed Discrimination by Homeowners' Insurance Companies*, 11 CONN. INS. L.J. 1, 6 (2004–2005).

⁷ Jeffery J. Sacks et. al., *Breeds of Dogs Involved in Fatal Human Attacks, 1979–1998*, 217 J. AM. VET. MED. ASS'N 836, 839 (2000).

⁸ *Id.*

⁹ <http://www.petfinder.com/index.html> (select type "dog" and enter "pit bull Terrier" in the breed box and restrict the search to within 100 miles of zip code 22201; do the same restrictions with "German Shepherd"). A simple search for "pit bull Terrier" on September 19, 2012 at 5:35pm on the pet adoption

fighting machine,¹⁰ has contributed to a public outcry for legislation restricting or banning these types of dogs.¹¹

There are two main approaches to solving the problem of dog attacks and fatalities by companion dogs.¹² The first approach is Breed Specific Legislation, which regulates the sale, transport, or ownership of particular breeds of dogs under the auspices that these types of dogs are inherently dangerous.¹³ These regulations range from mandatory sterilization to an outright ownership ban.¹⁴ The second approach is the implementation of Dangerous Dog Laws that focus on restricting and regulating owners and their dogs after the individual dog has been deemed dangerous due to past behavior.¹⁵

This comment will provide an economic comparison of these two approaches, ultimately concluding that greater enforcement of current Dangerous Dog Laws combined with community education is the more efficient way to lessen the number of dog bites in the United States and prevent dog attacks. Part I presents the statistics of dog bites and dog attacks in the United States and discusses the unreliability of the most-often-quoted statistics. Part II provides a cost-benefit analysis of Breed Specific Legislation (BSL) and Dangerous Dog Laws (DDL). Part III provides a cost-benefit analysis of which approach is the best choice for communities and offers recommendations to decrease the instances of dog bites.

website “Petfinder” pulled up 1,322 dogs up for adoption compared to 289 dogs when searched for the term “German Shepherd.” See also Kristen E. Swann, *Irrationality Unleashed: The Pitfalls of Breed-Specific Legislation*, 78 U. MO. KAN. CITY L. REV. 839, 854 (2010) (discussing the town of Tijeras, N.M. where a number of attacks by pit bulls caused a public outcry which led to a breed ban, and how before the ban 25% of the households in Tijeras owned a pit bull).

¹⁰ Jamey Medlin, *Pit Bull Bans and the Human Factors Affecting Canine Behavior*, 56 DEPAUL L. REV. 1285, 1302 (2007).

¹¹ Karyn Grey, *Breed-Specific Legislation Revisited: Canine Racism or the Answer to Florida’s Dog Control Problems?*, 27 NOVA L. REV. 415, 418 (2003).

¹² Safia Gray Hussain, *Attacking the Dog Bite Epidemic: Why Breed Specific Legislation Won’t Solve the Dangerous Dog Dilemma*, 74 FORDHAM L. REV. 2847, 2854 (2006).

¹³ *Id.*

¹⁴ *Alabama Breed-specific Laws*, DOGSBITE.ORG (July 31, 2012, 10:13 PM), <http://www.dogsbite.org/legislating-dangerous-dogs-alabama.php> (declaring pit bulls “inherently dangerous” in some counties and banning ownership outright in others); see also *California Breed Specific Laws*, DOGSBITE.ORG (July 31, 2012, 10:13 PM), <http://www.dogsbite.org/legislating-dangerous-dogs-california.php> (mandating that all pit bulls be sterilized in twelve counties).

¹⁵ Hussain, *supra* note 12, at 2854–62; see also Cynthia A. Meneely & Sarah A. Lindquist, *Dangerous Dog Laws: Failing to Give Man’s Best Friend a Fair Shake at Justice*, 3 J. ANIMAL L. 99, 112 (2007) (listing of the types of restrictions mandated to the owners of dogs that have been deemed dangerous).

I. BACKGROUND INFORMATION ON DOG BITE STATISTICS, BSL, AND DDL

A. *Dog Bite Statistics*

When a dog attacks a person, and more shockingly, when a dog kills a person, the public outcry is understandably strong.¹⁶ It is in the best interest of the public and the government to understand why these attacks happen, and which breeds cause the most bites—if this is in fact possible to determine. Many statistics attempt to quantify dog attacks and pinpoint which breeds cause the most attacks; however, there are many problems with the resulting statistics.¹⁷ It is hard for experts to come up with national statistics on dog bites and attacks because there is no national reporting system.¹⁸ Each locality has its own animal control or humane law enforcement and each operation has its own system. Even if each state was able to track all reported dog bites, there is no way to ensure that all dog bites would be reported. The following statistics attempted to remedy the discrepancy in reporting by relying on newspapers and other sources for dog bite numbers.

In 1997, the Center for Disease Control (CDC) conducted a study on dog bites, collecting data from the Humane Society of the United States and media reports concerning dog bite fatalities.¹⁹ Table 1 shows results of this study for a few specific years.²⁰

¹⁶ Cunningham, *supra* note 6.

¹⁷ *Id.* at 17–27.

¹⁸ *Id.* at 30.

¹⁹ CTRS. FOR DISEASE CONTROL, *Dog Bite Related Fatalities—United States, 1995–1996*, in 46 MORBIDITY & MORTALITY WKLY. REP. 463 (1997).

²⁰ *Id.*

Table 1

Biting Breeds	1991-1992	1993-1994	1995-1996	Total
Breed				
Pit Bull	6	5	3	14
Rottweiler	3	10	10	23
German Shepherd	2	0	2	4
Husky	2	1	2	5
Alaskan Malamute	3	1	0	4
Doberman Pinscher	1	0	0	1
Chow Chow	3	0	2	5
Great Dane	0	1	1	2
St. Bernard	0	0	0	0
Akita	1	2	0	3

This CDC report found that the majority of the dogs that attack humans are larger and more powerful breeds.²¹ From the years 1991–1996, pit bulls were responsible for fourteen attacks on humans, whereas Rottweilers were responsible for a total of twenty-three.²² While these statistics seem convincing, the results are problematic.²³ The CDC reported that these results uncovered only approximately 74% of dog bite-related fatalities.²⁴ Problems specifically concerning the interpretation of narrative studies concern the lack of narrative when publishing the numerical results. For example, a study using data collected from hospital emergency departments included the following accounts: a young girl bitten when she attempted to take away a dog's food, a man bitten when trying to break up fighting dogs, and a woman bitten by her own dog after the dog had been hit by a car and had become disoriented.²⁵ These stories illustrate the discrepancy between the numerical outcome and the actual situation.²⁶

Furthermore, most of the studies do not distinguish between an aggressive attack, an unprovoked attack, a confused and scared bite, or an accidental nip.²⁷ The result of this skewed reporting results in unreliable statistics, causing problems for advocates both for and against BSL.

²¹ *Id.*

²² *Id.*

²³ Sacks et. al., *supra* note 7.

²⁴ CTRS. FOR DISEASE CONTROL, *supra* note 19.

²⁵ Cunningham, *supra* note 6, at 21.

²⁶ *Id.*

²⁷ Kenneth M. Phillips, *The Problem with Statistics*, DOG BITE LAW, <http://dogbitelaw.com/dangerous-vicious-dogs/the-problem-with-statistics.html> (last visited Sept. 21, 2012).

In another narrative study, Lee E. Pinckney and Leslie A. Kennedy from the University of Texas Southwestern Medical School attempted to gather statistics solely using newspaper reports concerning dog attacks.²⁸ They sent requests to major United States newspapers for all of published dog attack fatality stories between 1966 and 1980.²⁹

Table 2

Dog Breed	Deaths between 1966 and 1980
German Shepherd	16
Husky	9
Saint Bernard	8
Pit Bull	6
Great Dane	6
Malamute	5
Doberman pinscher	2
Chow Chow	1
Golden Retriever	3
Collie	2

The number of fatalities for the breeds listed in Table 2 between 1966 and 1980 totaled fifty-eight.³⁰ German shepherds caused the most attacks with sixteen, whereas pit bulls (referred to as a “Bullterrier” in this study) caused only six.³¹ However, because this study relied solely on newspapers to respond to the researchers’ requests, the responses were limited, and only 48% of the newspapers responded.³² This means that these results are unreliable.

Another study—shown in Table 3³³—conducted by doctors at the CDC attempted to narrow the scope of the data to focus the results, but because the original set of data was flawed, the CDC’s data is also suspect.³⁴ First, they selected dog bite cases from incidents reported to Denver Municipal Animal Shelter (the Denver animal control) in 1991.³⁵ The results were

²⁸ Lee E. Pinckney & Leslie A. Kennedy, *Traumatic Deaths From Dog Attacks in the United States*, 69 PEDIATRICS 193, 193 (1982).

²⁹ *Id.*

³⁰ *Id.* at 194.

³¹ *Id.*

³² *Id.* at 193.

³³ Kenneth A. Gershman et. al., *Which Dogs Bite? A Case-Control Study of Risk Factors*, 93 PEDIATRICS 913, 914 (1991).

³⁴ *Id.* at 913.

³⁵ *Id.*

limited to those dogs that had bitten a nonhousehold member and whose victim sought medical attention for the bite.³⁶

Table 3

Breed	Number of Biting Dogs
Akita	5
Chihuahua	2
Chow Chow	31
Cocker Spaniel	8
Collie	8
Doberman Pinscher	6
German Shepherd	34
Golden Retriever	2
Labrador Retriever	9
Standard Poodle	4
Scottish Terrier	3
Shetland Sheepdog	2
All other breeds	46

In these initial findings, the animal control reported far more German Shepherds and Chow Chows biting humans than any other dog breed, with thirty-four and thirty-one dogs respectively.³⁷ Pit bulls are not listed in this study because pit bulls had officially been banned in the City of Denver since August of 1989.³⁸ Despite the pit bull ban being in effect for two years, there were still a total of 160 bites requiring medical attention.³⁹ The researchers then broke the statistics down further by asking more specific questions about the situation surrounding the dog bite, such as the age of the dog and whether the dog had been chained in the yard, had been to obedience class, had been bought at a pet store, or had been taken in as a stray.⁴⁰

Though this study is far more thorough than other studies of its kind, it still has limitations. The researchers found that only half of potentially suitable dog owners were reached by phone.⁴¹ Also, because the study was

³⁶ *Id.*

³⁷ *Id.* at 914.

³⁸ Colo. Dog Fanciers, Inc. v. City & Cnty. of Denver, 820 P.2d 644, 646 (Colo. 1991).

³⁹ Gershman, *supra* note 33, at 914.

⁴⁰ *Id.* at 915.

⁴¹ *Id.* at 914.

limited to those victims who sought medical attention, the results are not representative of all bites.⁴² Pit bulls and pit bull breeds are obviously not accounted for because of the ban existing in Denver at the time; however, the breed may still have been represented in the “all other breeds” category. Other results, such as the number of dogs that had been disciplined using “takedowns” or “string-ups,” may not be indicative of all of the dogs that had been disciplined with those harsh methods⁴³ as the owners may have been hesitant to report disciplining their dogs in a manner similar to abuse.

Ultimately, the researchers concluded that, despite the multiple factors they asked dog owners about, their study required further analysis, such as determination of each dog’s breed and an analysis of the victim’s behavior in each bite situation.⁴⁴ The most important result that the researchers say readers should take from the study is that owners “may be able to reduce the likelihood of owning a dog that will eventually bite” through owner behavior and breed selection based on owner lifestyle.⁴⁵

Though experts in the dog industry have generally deemed statistics on attacks unreliable,⁴⁶ there is still a public outcry for the banning or restriction of specific dog breeds.⁴⁷ This can be attributed to the high publicity that dog attacks receive, especially when they are perpetrated by a controversial dog breed, and because of the astounding amount of dogs we share our lives with today.⁴⁸ In 2011, it was estimated that there were 46.3 million American households that owned dogs; this amounts to 78.2 million dogs living as pets in the United States.⁴⁹ As it is with any species living in extremely close quarters with another species, there can be conflicts.⁵⁰

⁴² *Id.* at 915.

⁴³ Marc Bekoff, *Did Cesar Millan Have to Hang the Husky?*, PSYCHOL. TODAY (Apr. 12, 2012), <http://www.psychologytoday.com/blog/animal-emotions/201204/did-cesar-millan-have-hang-the-husky> (explaining that many animal experts feel that techniques such as “string-ups” are overly harsh and unnecessary for disciplining even strong dog breeds).

⁴⁴ Gershman, *supra* note 33, at 916.

⁴⁵ *Id.* at 916.

⁴⁶ See Phillips, *supra* note 27 (describing general problems with dog bite statistics); see also Cunningham, *supra* note 6, at 17–27 (discussing several different studies related to dog bites and the statistical limitations of each).

⁴⁷ Swann, *supra* note 9, at 854.

⁴⁸ Linda S. Weiss, *Breed Specific Legislation in the United States*, ANIMAL LEGAL & HIST. WEB CTR. (2001), <http://www.animallaw.info/articles/aruslweiss2001.htm>.

⁴⁹ *Breakdown of Pet Ownership in the United States According to the 2011–2012 APPA National Pet Owners Survey*, AM. PET PROD. ASS’N, http://www.americanpetproducts.org/press_industrytrends.asp (last visited Sept. 21, 2012).

⁵⁰ Ronald Bailey, *North America’s Most Dangerous Mammal: How Best to Deal with the Menace of Bambi*, REASON (Nov. 21, 2011), <http://reason.com/archives/2001/11/21/north-americas-most-dangerous>. On average, there are 1.5 million deer/vehicle collisions annually, resulting in 29,000 human injuries and more than \$1 billion in insurance claims in addition to the death toll. *Id.*; see also *Boehm v. City of Philadelphia*, 59 Pa. Super. 441, 444 (1915) (upholding an ordinance banning pigs from residing in the City of Philadelphia as it conflicted with the comfort and health of the community).

The popularity of certain dog breeds also skews statistics. The Humane Society gives a good example of the problem with statistics based on breed: If there is a study citing five attacks by golden retrievers and ten attacks by pit bulls, it would appear that pit bulls are the more dangerous of the two dogs.⁵¹ However, if when looking at the total population of the two breeds the study shows that there are fifty golden retrievers and five-hundred pit bulls, then statistically speaking, pit bulls are the safer breed as the pit bull's bite rate would be two percent to the golden retriever's ten percent.⁵² Though these numbers are not based on a real study, the popularity of pit bulls compared to other dogs is in reality quite high⁵³ and could account for skewed results and the seemingly higher incidents of pit bull attacks.

B. Breed Specific Legislation

Because of the millions of dogs living as pets in the United States,⁵⁴ and the high publicity given to dog attacks on humans, legislators must decide how to best address this issue. The two most common ways legislatures address this problem is through Breed Specific Legislation or through Dangerous Dog Laws.

Breed Specific Legislation is a highly contested approach to solving the dog bite problem in the United States. There are several types of restrictions these laws can impose, including labeling certain breeds as "vicious," mandatory sterilization, outright ownership bans, mandatory muzzling, or restraining only specific dog breeds.⁵⁵ However, the commonality with this type of legislation is that it singles out certain dog breeds and attributes society's dog bite problem to solely those breeds.⁵⁶ A number of breeds have been targeted by restrictions, including Rottweilers, American Staffordshire Terriers (pit bulls), Chow Chows, German Shepherds,

⁵¹ Public Memorandum from Stephanie Shain, Dir. of Outreach for Companion Animals, The Humane Soc'y of the U. S. (Mar. 2003) (on file with author).

⁵² *Id.*

⁵³ Weiss, *supra* note 48; Swann, *supra* note 9, at 851–52 (discussing the town of Tijeras, N.M. where a number of attacks by pit bulls caused a public outcry which led to a breed ban, and how pre-ban 25% of the households in Tijeras owned a pit bull).

⁵⁴ AM. PET PROD. ASS'N, *supra* note 49.

⁵⁵ See, e.g., DES MOINES, IOWA, CODE OF ORDINANCES § 18-41(6)–(9) (2001) (defining as vicious, "Staffordshire terrier breed of dog; The American pit bull terrier breed of dog; The American Staffordshire terrier breed of dog; or Any dog which has the appearance and characteristics of being predominately of the breeds of Staffordshire terrier, American pit bull terrier, American Staffordshire terrier."); MIAMI-DADE CNTY., FLA., CODE OF ORDINANCES § 5-17.6(b) (1992) (an outright ban of newly acquired pit bulls, under penalty of civil violation and "humane destruction" of the dog); SAN FRANCISCO, CA., HEALTH CODE § 43.1 (2005) (mandating the mandatory sterilization of all pit bulls).

⁵⁶ Weiss, *supra* note 48.

Doberman Pinschers, and Akitas.⁵⁷ This kind of BSL is not a new concept. The first law of its kind targeting dogs was enacted in 1980 in Hollywood, Florida.⁵⁸ Today, almost 650 cities in the United States have enacted some form of BSL, and ten states and the District of Columbia have upheld the constitutionality of statewide BSL.⁵⁹ For example, in San Francisco, California, the law requires the mandatory spaying and neutering of pit bulls,⁶⁰ and the city requires a permit to breed, sell, or transport pit bulls or pit bull puppies.⁶¹ Prince George's County, Maryland, also has BSL that consists of an outright ban of ownership of pit bulls within the county limits.⁶²

With the lack of information on dog bites and definitive data showing which breeds cause the most bites, why do legislators insist on passing laws discriminating against one specific type of breed? For the most part, it is due to misinterpretation of studies, such as the CDC's two studies discussed above.

Cities and counties have spent millions of dollars attempting to enforce these laws, and many have failed.⁶³ There are many cities that have discussed repealing, or have actually repealed, BSL after realizing the enforcement was too costly and that the banning of certain breeds was not effectively curbing dog bites.⁶⁴ The Prince George's County, Maryland pit bull ban has been in effect since 1996.⁶⁵ However, in 2003 the county put together a Task Force to conduct a study to determine whether the current

⁵⁷ MANHATTAN, KAN., CODE OF ORDINANCES § 6-25(c) (1987) (defining as inherently "dangerous," American Pit Bull Terrier, American Staffordshire Terrier, Argentine Dogo, Cane Corso, Chow, Dogue de Bordeaux, Doberman Pinscher, Fila Brasileiro, German Shepherd, Perro de Presa Canario, Rottweiler, Staffordshire Bull Terrier").

⁵⁸ Weiss, *supra* note 48.

⁵⁹ *BSL State-by-State*, DOGSBITE.ORG, <http://www.dogsbite.org/legislating-dangerous-dogs-state-by-state.php> (last visited Oct. 12, 2012).

⁶⁰ S.F., CAL., HEALTH CODE § 43.1 (2008).

⁶¹ *Id.* at § 44.

⁶² PRINCE GEORGE'S CNTY., MD., MUN. CODE, § 3-185.01 (1997).

⁶³ Sandy Miller, *The High Cost of Breed Discriminatory Legislation*, BEST FRIENDS NETWORK (May 29, 2009, 3:58 PM), <http://network.bestfriends.org/11240/news.aspx>.

⁶⁴ VICIOUS ANIMAL TASKFORCE REPORT, PRINCE GEORGE'S CNTY., MD. DEP'T OF ENVTL. RES. Attachment J (2003) [hereinafter VICIOUS ANIMAL TASKFORCE REPORT] (citing other jurisdictions that repealed BSL and have opted for "more responsible ownership" and "better enforcement of generic law"); see, e.g., *Proposed Amendments to the Code of the City of Topeka, Kansas § 6.05.010: Before the council chamber of Topeka, KS* (Sept. 28, 2010), available at <http://www.topeka.org/pdfs/AnimalControlDraft.pdf> (proposing to Topeka, Kansas that BSL is too costly and should be repealed); Justin Michaels, *Pit Bulls Not Considered Vicious Under Cleveland Ordinance Change*, NEWS CHANNEL 5 (June 6, 2011), http://www.newsnet5.com/dpp/news/local_news/cleveland_metro/pit-bulls-no-longer-considered-vicious-by-the-city-of-cleveland-after-ordinance-change (discussing the repeal of the mandatory labeling of pit bulls as "vicious" in Cleveland); *Pit Bulls Freed From Muzzles*, WIDBEY NEWS-TIMES (Nov. 6, 2009, 3:43 PM), <http://www.whidbeynewstimes.com/news/69420532.html> (discussing the repeal of the pit bull BSL in Widbey, Washington).

⁶⁵ PRINCE GEORGE'S CNTY., MD., MUN. CODE, § 3-185.01 (1997).

BSL was in fact working or whether the county should return to the previously enforced Dangerous Dog Laws.⁶⁶ The Task Force noted many initial reasons they opposed BSL. They indicated their worry that the current BSL punishes good dog owners, whereas law should hold the irresponsible dog owner responsible for dog attacks.⁶⁷ The task force also found that BSL was hard to enforce and created a backlog of Animal Control Commission cases.⁶⁸

Other counties have indicated that BSL banning certain dog breeds is just not working. Despite having an outright ban of pit bulls since 1989,⁶⁹ for example, Denver, Colorado authorities estimate that there are still 4,500 pit bulls residing within the city limits.⁷⁰ Also, in Miami-Dade County, Florida an outright ban of pit bulls has been in place since 2003,⁷¹ yet authorities estimate that there are still 50,000 pit bulls residing within the city limits.⁷² Many counties are beginning to realize that BSL is not a quick fix to the dog bite problems plaguing their citizens. In addition to the ineffectiveness of this type of legislation, counties are finding it far more costly than expected.

C. *Dangerous Dog Laws*

The ability of the state to regulate dog ownership began when dog owners attempted to recover for the loss of their dog when the dog was killed.⁷³ The constitutionality of regulating dog ownership established, cities and counties began to impose regulations on the number of dogs a person can own and the acceptable behavior for those dogs.

The history of liability and legislation of dog bites began with the common law assertion that an owner was “under no obligation to guard against injuries which he has no reason to expect on account of some disposition of the individual animal different from the species generally, unless he has notice of such disposition.”⁷⁴ The common law was more of a “one-

⁶⁶ VICIOUS ANIMAL TASKFORCE REPORT, *supra* note 64, at 1–2.

⁶⁷ *Id.* at 3.

⁶⁸ *Id.*

⁶⁹ DENVER, COLO., CITY COUNCIL BILL NO. 434 (1989).

⁷⁰ Medlin, *supra* note 10, at 1312.

⁷¹ MIAMI-DADE CNTY., FLA., CODE OF ORDINANCES § 5-17.6(b) (2003).

⁷² Medlin, *supra* note 10, at 1312.

⁷³ *Sentell v. New Orleans & Carrollton R.R.*, 166 U.S. 698, 702 (1897) (considering dogs as “properly falling within the police powers of the several states”).

⁷⁴ *Domm v. Hollenbeck*, 102 N.E. 782, 783 (Ill. 1913) (“The owner or keeper of a domestic animal of a species not inclined to mischief, such as dogs, horses, and oxen, is not liable for any injury committed by it to the person of another, unless it be shown that the animal had a mischievous propensity to commit such an injury, and the owner had notice of it, or that the injury was attributable to some

bite rule” (instead of a strict liability rule), requiring the plaintiff to prove owner negligence in order to recover for injuries caused by a pet dog.⁷⁵ By 1953, states like California had added sections to their civil code, making dog owners at least partially liable to injuries caused by their dogs “regardless of the former viciousness of the dog or the owner’s knowledge of such viciousness.”⁷⁶ This has developed into today’s dangerous dog laws, which often vary from state to state and municipality to municipality.

Dangerous Dog Laws commonly contain four sections: (1) a definition of a “dangerous dog” or “vicious dog”; (2) a procedure for officially declaring a dog dangerous; (3) restrictions applicable to those dogs officially declared dangerous; and (4) penalties for violating the restrictions.⁷⁷ For example, the District of Columbia has non-breed-specific dog laws that designate a dog as a “Dangerous Dog” or a “Potentially Dangerous Dog” based upon whether the animal causes either a serious injury to a person or domestic animal without provocation, or chases or menaces a person or domestic animal in an aggressive manner.⁷⁸ Once a dog has been declared “Dangerous” or “Potentially Dangerous,” based on the facts of the situation where the dog was acting in a vicious manner, the owner must comply with the regulations imposed by the city.⁷⁹ These regulations include additional security or care requirements established by the governing office, mandatory spaying or neutering, microchipping, current vaccinations, additional annual fees, and posting a warning sign on the owner’s property alerting people that there is a dangerous dog on the premises.⁸⁰ The penalties for noncompliance or repeat offenders include the destruction of the dog, a fine of up to \$10,000, and imprisonment.⁸¹

II. COST–BENEFIT ANALYSIS OF BSL AND DDL

A. *Breed Specific Legislation*

The cost of Breed Specific Legislation on the community is high. By singling out one breed as a problem, the message sent to residents is that wholesale removal of the breed deemed offensive will solve all of the dog bite problems, even if an outright ban has not been issued by the legislature.

other neglect on his part. If the owner of a vicious animal knows its character and disposition to commit injury to mankind he is liable for all injuries it may inflict.”).

⁷⁵ *Janis v. Graham*, 946 N.E.2d 983, 987 (Ill. App. Ct. 2011).

⁷⁶ CAL. CIV. CODE § 3342(a) (1953).

⁷⁷ *McNeely & Lindquist*, *supra* note 15, at 112.

⁷⁸ D.C. CODE § 8-1901 to -05 (1988).

⁷⁹ *Id.*

⁸⁰ *Id.* § 8-1904.

⁸¹ *Id.* § 8-1906.

The consequences of this limited approach can be far-reaching. Because the term “pit bull” can describe a variety of terrier breed and breed mixes, it can be hard for owners to know whether their dog falls under the local BSL.⁸² Despite many companies offering DNA testing for dogs,⁸³ these tests are not always accurate and only contain a limited number of dog breeds under which the tested dog can fall.⁸⁴ This ambiguity can result in suits brought against the local government by the owners of restricted or banned breeds challenging the vagueness of the laws.⁸⁵ Challenges to BSL have also included challenges to their constitutionality, citing violations to the owners’ Due Process and Equal Protection rights,⁸⁶ and challenges to the reach of the government’s police power.⁸⁷ When municipal or state laws are challenged, the administrative costs are high because these challenges clog up the court system and force the city or county to use funds to defend the city when these funds could be used toward stopping abusive and irresponsible dog ownership. Other negative costs can include a public outcry for a vigilante-style justice that only leads to a further need for enforcement,⁸⁸ the creation of a black market for dogs that are labeled as dangerous or vicious by legislatures,⁸⁹ and lowering the chance of recovery by dog bite victims.⁹⁰

The inability of dog bite victims to receive compensation is particularly troubling as it undermines the legislature’s ability to compensate the community for dog bites. Without BSL, a dog owner has incentives to pay for proper dog training, to properly care for their dog, and to prevent it from

⁸² Swann, *supra* note 9, at 840–41.

⁸³ WISDOM PANEL: CANINE GENETIC ANALYSIS, <http://www.wisdompanel.com/> (last visited Nov. 14, 2012); HAPPY DOG DNA, <http://www.happydogdna.com/> (last visited Nov. 14, 2012); *Animal DNA Testing*, DDC VETERINARY, <http://www.vetdnacenter.com/canine.html> (last visited Nov. 14, 2012).

⁸⁴ Paula Szuchman, *Beagle or Bichon, Can Drool Provide Insight?*, WALL ST. JOURNAL (Sept. 18, 2009), <http://online.wsj.com/article/SB10001424052970204518504574416810535466706.html>.

⁸⁵ See generally Devin Burstein, *Breed Specific Legislation: Unfair Prejudice & Ineffective Policy*, 10 ANIMAL L. 313, 318 (2004) (explaining that these cases generally challenge the constitutionality of Breed Specific Legislation alleging vagueness and violations of due process); see also *State v. Peters*, 534 So. 2d 760, 762 (Fla. Dist. Ct. App. 1988) (challenging a statute regulating pit bulls for vagueness).

⁸⁶ *Colo. Dog Fanciers, Inc. v. City & Cnty. of Denver*, 820 P.2d 644, 647 (Colo. 1991) (holding that the ordinance did not violate the owner’s due process though the owner was not given a hearing prior to the impounding of his dog).

⁸⁷ *Vanater v. Village of South Point*, 717 F. Supp 1236, 1242 (S.D. Ohio 1989) (holding that though dogs are individual property, they are still subject to the police power of the state).

⁸⁸ Tim Omarzu, *‘Kill a Pitbull Day’ Sparks Online Fire*, TIMES FREE PRESS (Sept. 21, 2012), <http://www.timesfreepress.com/news/2012/sep/21/kill-a-pitbull-day-sparks-online-fire-chattanooga/?local>. Someone wrote a Facebook post declaring Halloween night as “Kill-a-Pitbull Night” instructing people to use “baseball bats, knives, bricks, poisons . . . hot dog soaked in radiator fluid.”

⁸⁹ Jonathan R. Shulan, *Animal Law-When Dogs Bite: A Fair, Effective, and Comprehensive Solution to the Contemporary Problem of Dog Attacks*, 32 U. ARK. LITTLE ROCK L. REV. 259, 278 (2010).

⁹⁰ Hilary M. Schwartzberg, *Tort Law in Action and Dog Bite Liability: How the American Legal System Blocks Plaintiffs From Compensation*, 40 CONN. L. REV. 845, 866 (2008).

developing aggressive behavior toward others.⁹¹ These incentives can take the form of tort lawsuits, nuisance fines, or the impounding of the dog. In order for the incentives to work, the cost of the fine or lawsuit from a potential dog bite victim must be more than the cost of training and care for dog owners to be willing to train, sterilize, and properly care for their dog.⁹² However, because BSL places the blame on the breed of dog, and not the owner's behavior, BSL disincentivizes positive owner behavior. As Heather Mizeur, representative of Montgomery County, Maryland, in the Maryland House of Delegates indicated, owner accountability is a problem with BSL, as "everyone should get the same legal protection whether they're bitten by a Chihuahua, a Saint Bernard, or a pit bull."⁹³ Laws must be successful in targeting negligent owners, or dog attacks will not be curbed.

Another cost to society is the inability of certain breed owners to purchase a home.⁹⁴ Homeowners' insurance companies will often not write policies for owners of pit bulls, making getting a mortgage, and therefore buying a house, almost impossible.⁹⁵ This leaves the law-abiding owners of banned breeds with few options other than giving up their beloved pet, living outside the limits of local BSL, or attempting to rent a home. Limiting homeownership may have adverse effects on a community with a BSL. Homeownership has been shown to increase the community's desirability.⁹⁶ According to Habitat for Humanity, homeowners are more likely than renters to be politically active (especially in local politics), more likely to invest in solving local problems, more likely to improve the community's appearance, and more likely to belong to local organizations.⁹⁷

Renting a home can also prove difficult to owners of dogs deemed dangerous by BSL. Even if BSL does not exist in a particular community, because of the hype surrounding dogs like pit bulls, many apartment buildings have banned pit bulls and other breeds that are frequently targeted by BSL.⁹⁸ Limiting tenants to non-pet owners can be costly to rental communities as well. In a survey of renters and landlords conducted by the Founda-

⁹¹ *Id.*

⁹² *Id.*

⁹³ *The Kojon Nnamdi Show: Pit Bulls in Maryland*, WAMU RADIO (July 25, 2012), transcript available at <http://thekojonnamdishow.org/shows/2012-07-25/pit-bulls-maryland/transcript>.

⁹⁴ Cunningham, *supra* note 6, at 3 (explaining his struggle with buying a home for him and his Chow Chow mix and Rottweiler in a city where there were breed restrictions on those two breeds).

⁹⁵ *Id.*

⁹⁶ *Benefits of Homeownership*, HABITAT FOR HUMANITY—N.Y.C. 1, 3, <http://www.habitatnyc.org/pdf/Toolkit/homewonership.pdf>.

⁹⁷ *Id.*

⁹⁸ *Pet Policy*, WINDSOR COMMUNITIES, <http://www.windsorcommunities.com/apartments/northern-va/shirlington/floor-plans#pets> (last visited Nov. 16, 2012) (restricting renters from owning breeds such as pit bulls and Rottweilers despite a state law in Virginia prohibiting BSL).

tion for Interdisciplinary Research and Education Promoting Animal Welfare (FIREPAW), researchers found that tenants with pets stayed an average of twenty-six months longer than renters without pets.⁹⁹ The researchers also found that the vacancy rates for pet-friendly rentals were much lower than rentals that allowed no pets or significantly restricted them.¹⁰⁰

An increase in BSL also increases the amount of money spent on impounding and euthanizing members of the banned breed. In cities where pit-bull-targeted BSL exists, or existed in the case of counties in Ohio,¹⁰¹ shelters see a high kill rate with pit bulls.¹⁰² In Franklin County, Ohio, 2,291 pit bulls were euthanized out of the 5,225 dogs total.¹⁰³ Experts say that the high kill rate of pit bulls is attributed to the Ohio state law (now repealed) requiring pit bulls to be labeled as inherently vicious.¹⁰⁴ Though this state law did not require counties to enact ordinances along the same lines as the State law, most county shelters still did.¹⁰⁵

The cost of euthanasia alone is not the only cost associated with impounding a banned or “vicious” dog. Prince George’s County, Maryland, found that while they had BSL against pit bulls, it cost the county on average \$235,824 to run the BSL program for an average of 829 pit bulls throughout the entire process of impounding, appeal, and possible euthanasia.¹⁰⁶ The following chart shows the cost associated with the impounding and euthanasia of pit bulls in Prince George’s County.¹⁰⁷

⁹⁹ Pamela Carlisle-Frank et al., *Companion Animal Renters and Pet-Friendly Housing in the U.S.*, FOUND. FOR INTERDISCIPLINARY RES. & EDUC. PROMOTING ANIMAL WELFARE 1, 10 (2005), <http://www.firepaw.org/CompanionAnimalRentersPetFriendly.pdf>.

¹⁰⁰ *Id.* (finding the vacancy rates for rentals that did not allow pets was 14% whereas vacancy rates for pet-friendly housing was at only 10%).

¹⁰¹ Catherine Candisky, *Ohio won't Label Pit Bulls 'Vicious' but Bexley Still Can*, THE COLUMBUS DISPATCH, (Feb. 9, 2012, 5:42 AM), <http://www.dispatch.com/content/stories/local/2012/02/09/ohio-wont-label-pit-bulls-vicious-but-city-still-can.html> (repealing the labeling of pit bulls as “vicious” after BSL had existed for twenty-five years in the state of Ohio and enacting Dangerous Dog Laws; this ruling will not require local ordinances from repealing their specific rules on pit bulls).

¹⁰² Mary Beth Lane, *Kill Rates Vary Widely at Ohio Dog Shelters*, THE COLUMBUS DISPATCH, (Oct. 21, 2012, 9:02 AM), <http://www.dispatch.com/content/stories/local/2012/10/21/kill-rates-vary-widely-at-ohio-dog-shelters.html>.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ VICIOUS ANIMAL TASKFORCE REPORT, *supra* note 64, at Attachment F.

¹⁰⁷ *Id.*

Table 4

Total Cost of Impounding Pit Bulls in 2001	
Revenues for the County	Dollar Amount
Registration of Pit Bull	4,350
Pit Bull tag	3,697
Bond Amount upon impound of dog	7,514
Total Revenue from Pit Bull Owners	15,561
County Expenses	Dollar Amount
Cost to euthanize Pit Bulls	707
Boarding Costs	175,117
Labor Costs related to enforcement	60,000
Total Expenses	235,824

The amount of money received in pit bull licensing and registration, and the bond paid upon impounding the dog, is supposed to cover the costs associated with management of dogs in the county.¹⁰⁸ However, in 2001 the county received only \$15,561 from pit bull registration but spent \$235,824 in the enforcement of BSL.¹⁰⁹ Prince George's County also cited extra loss of income associated with dog ownership, such as income to veterinarians and pet supply stores.¹¹⁰

The benefits of BSL are not enough to outweigh the costs. Many respected animal advocates assert that pit bulls are the dog of choice for criminals such as drug dealers and pimps.¹¹¹ People for the Ethical Treatment of Animals (PETA) is of the opinion that laws that mandate bans, euthanization, or sterilization of pit bulls will eliminate the number of pit bulls that are trained as weapons.¹¹² Even if a pit bull is not trained to be an aggressive dog, they are stronger than many other breeds. A spokesperson for PETA rightfully relayed this concern: "[A]n unpredictable Chihuahua is one thing, an unpredictable [pit bull] another."¹¹³ Though this is true, BSL is a quick and expensive pseudo-solution that does not get to the root of the problem, especially when there are many other large breeds that are not

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ VICIOUS ANIMAL TASKFORCE REPORT, *supra* note 64, at 3.

¹¹¹ Ingrid Newkirk, *Controlling an Animal as a Deadly Weapon*, DOG BITE LAW, <http://dogbitelaw.com/breed-specific-laws/arguments-for-and-against-breed-specific-laws.html> (last visited Jan. 8, 2013).

¹¹² *Id.*

¹¹³ *Id.*

widely targeted by BSL. Overall, the costs of BSL are too high and the laws too ineffective and inefficient to stop the dog bite problem in the United States.

B. *Dangerous Dog Laws*

In theory, dogs classified by the county or state should have actually demonstrated aggressive and dangerous behaviors pursuant to the statute, but this is not always the case.¹¹⁴ For example, though a dog may be guilty of running at large, but not of displaying dangerous behavior, with enough complaints it could be deemed dangerous by the county or state.¹¹⁵ This is because the launch of an investigation into a potentially dangerous dog usually relies on complaints from members of the public or bite victims.¹¹⁶ It is also often difficult to appeal once a dog has been classified as dangerous.¹¹⁷ This appeal process can be costly and lengthy, requiring animal control officers or humane law enforcement officers to question multiple witnesses and impound the potentially dangerous dog for a long period of time.¹¹⁸ Once a dog has been declared dangerous, the owner may be required to obtain insurance for up to \$100,000 to cover their dog's potential bite victims.¹¹⁹ The owner's homeowner's insurance may also increase or be cancelled completely.¹²⁰

The length of the declaring process is a problem in itself as it can give more time for an aggressive dog to continue its aggressive behavior as the "diagnosis [of dominance aggression] cannot be made on the basis of a one-time event."¹²¹ If an owner has an aggressive dog that has not actually bitten someone, it could take many complaints by neighbors and visits by the local animal law enforcement before the city can start the process to declare the dog dangerous.¹²² This can leave ample time for a dog to actually attack someone before the owner is required to restrict the dog's behavior.

In addition, some states are attempting to change their culpability standards for dog owners from the traditional "one-bite" rule to a strict lia-

¹¹⁴ Mcneely & Lindquist, *supra* note 15, at 116.

¹¹⁵ *Id.* at 129.

¹¹⁶ Hussain, *supra* note 12, at 2882.

¹¹⁷ Mcneely & Lindquist, *supra* note 15, at 124 (demonstrating the difficulty of the appeal process).

¹¹⁸ *Id.* at 115.

¹¹⁹ *Id.* at 116.

¹²⁰ *Id.* at 115.

¹²¹ *Id.* at 106.

¹²² Cynthia A. Mcneely & Sarah A Lindquist, *Dangerous Dog Laws: Failing to Give Man's Best Friend a Fair Shake at Justice*, 3 J. ANIMAL L. 99, 121–22 (2007). A case study in Florida demonstrated that it could take over two months to go through the administrative process to have a dog declared "dangerous" leaving ample time for an attack to occur. *Id.*

bility rule for all dog owners regardless of whether the dog has bitten someone in the past.¹²³ By owning a dog that is frequently “running at large,” or that has been declared “potentially dangerous” or “dangerous,” an owner is put on notice of their liability, and comparative negligence cannot be used as a defense to any resulting dog bite.¹²⁴ In this situation, the owner would be strictly liable for all damages if his dog attacks someone even if the dog’s only past crime was running loose in the neighborhood and therefore was mistakenly deemed “dangerous.”

Dangerous Dog Laws are often hard to enforce due to the lack of uniformity with animal control databases.¹²⁵ An owner may have had a dog declared “dangerous” in the past and have been deemed unfit to own a dog, but if the owner moves to a new city, with a different system of tracking, then the owner could merely obtain a new dog and the same dog behavior could begin again.

There are many similar costs to society with Dangerous Dog Laws as there are with BSL. The process of declaring a dog as “dangerous” may take a long time—time in which cost continues to grow.¹²⁶ In addition, government fees are associated with the appeal process, whether it be in front of a board, city manager, or a panel of experts.¹²⁷ In one case, the process of declaring a woman’s show dogs as “dangerous” took over two months and required a number of administrative hearings and visits to the owner’s property by animal control officers.¹²⁸

Other costs include the normal operations of animal control divisions or humane law enforcement divisions such as euthanasia costs, impounding costs, and the cost of defending appeals from owners whose dogs have been impounded.¹²⁹ Despite the drawbacks of Dangerous Dog Laws to society, especially through the administrative appeal process, they are still far less problematic than BSL. Dangerous Dog Laws do not discriminate against specific types or breeds of dogs and focus instead on owner behavior, making the owner culpable for the dog’s behavior. Because owner behavior is

¹²³ Cynthia Hodges, *Table of Dog Bite Strict Liability Statutes*, ANIMAL LEGAL AND HISTORICAL CTR. (2012), <http://animallaw.info/articles/State%20Tables/tbusdogbite.htm> (last visited Nov. 16, 2012). Georgia, New York, North Carolina, Tennessee, and West Virginia all have laws that make an owner of a previously declared “dangerous” or “vicious” dog strictly liable. *Id.*

¹²⁴ *Id.* In some states, “provocation” by the victim is the only defense available to owners residing under strict liability laws. *Id.*

¹²⁵ Safia Gray Hussain, *Attacking the Dog Bite Epidemic: Why Breed Specific Legislation Won’t Solve the Dangerous Dog Dilemma*, 74 *FORDHAM L. REV.* 2847, 2875 (2006).

¹²⁶ Mcneely & Lindquist, *supra* note 15, at 118 (describing the type of fees that were associated with one case in which an owner appealed its dog’s classification as “dangerous”).

¹²⁷ *Id.* at 115 (explaining the lack of uniformity between the types of panels that declare dogs as “dangerous” or “potentially dangerous”; in one panel in Florida, there is a minister to address “spiritual matters”).

¹²⁸ *Id.* at 122–25.

¹²⁹ See *supra* notes 106–07 and accompanying text.

something that can be punished and regulated by the community, it is far more logical to make an owner responsible for their dog than make a dog's breed responsible for the dog's behavior.

III. BREED SPECIFIC LEGISLATION OR DANGEROUS DOG LAWS: AN ANALYSIS OF THE SOLUTION

A. *Breed Specific Legislation: Not the Solution*

Enacting BSL and enforcing the removal of an entire breed of dogs from a given locality are far more costly than Dangerous Dog Laws as it does not get to the root of the dog bite problem and ultimately the majority of dog bite problems will still exist.

The biggest argument against BSL is the monetary cost to the community. As shown by the Prince George's County Task Force report, the maintenance of just a single dog throughout the process of impounding, appeal, and eventual euthanasia costs \$68,000.¹³⁰ Other costs directly attributed to BSL that are not attributed to Dangerous Dog Laws are the false sense of safety that the public is lulled into.¹³¹ Similar to the problem with the lack of tort recovery with BSL, the blame is placed on the dog breed itself and not the owner. If the owner does not have to take responsibility for their dog, they can blame any dog bites on the breed and not their own negligence. The government then must bear the costs of the owner's lack of culpability—by taking the dog and eventually destroying it.

Unlike the community costs associated with BSL, the costs associated with Dangerous Dog Laws rest predominately on the dog owner. With Dangerous Dog Laws, the owner is fined and must go through several costly processes to continue ownership of their dog; however, these costs are placed on the owner and not the state. Though greater enforcement of Dangerous Dog Laws may require more funds for stricter enforcement of licensing and cruelty violations, as indicated by the Prince George's report, the violation fines should balance out the enforcement costs.¹³²

Under BSL, even if an owner takes his dog to obedience class, always properly restrains his dog pursuant to the local leash laws, and the dog happens to be a pit bull, or look like one, an animal control officer can seize the dog and ask the owner to relocate the animal to outside the jurisdiction of

¹³⁰ Memorandum from the Office of Audits and Investigations, Prince County, Md. to Assoc. Dir. of Animal Mgmt. Div., Prince County, Md. (Mar. 5, 2003) (on file with author).

¹³¹ Hussain, *supra* note 12, at 2872.

¹³² Memorandum from the Office of Audits and Investigations to Assoc. Dir. of Animal Mgmt. Div., *supra* note 130, at 1.

the BSL.¹³³ This absolute enforcement of breed discrimination disincentivizes responsible ownership. In a BSL community, the potentially responsible pit bull owner has no incentive to train the dog, as the dog will be targeted and restricted—and possibly euthanized—regardless of behavior. Likewise, a beagle owner, in a BSL community where pit bulls are targeted, has no incentive to train his dog, as the community is so worried about pit bulls that the beagle can become aggressive and misbehave without the same consequences as a targeted breed. Dangerous Dog Laws, on the other hand, are far less likely to punish compliant and responsible dog owners. If a pit bull owner neglects to train and properly restrain his dog pursuant to the local leash laws, and that pit bull bites someone, then that owner is held responsible, fined, and, if necessary, the dog is euthanized. The same situation would happen if the guilty dog were a beagle. Regardless of breed, the dogs and owners would go through the same process, and the dogs past behavior would be evaluated along with the owner's past behavior.

BSL also gives insurance companies the opportunity to discriminate against the owners of certain dogs. As homeowner's insurance is essential to obtaining a mortgage, which is usually essential to buying a home, BSL can stop people from buying homes in the community. This can have disastrous effects on the community,¹³⁴ especially if rental properties can also discriminate against certain breeds.¹³⁵ With Dangerous Dog Laws, owners of dogs that have been declared "dangerous" due to past behavior may also find themselves limited in their housing options.¹³⁶ However, the possibility of losing homeowner's insurance, or the possibility of needing greater liability insurance, only acts as further incentive for dog owners to be responsible owners by training, socializing, and sterilizing their dog.

The most concerning consequence of BSL, a consequence practically nonexistent with Dangerous Dog Laws, is the dog owner's fear that their dog will be the next one legislated against.¹³⁷ The Doberman pinscher used to be considered one of the most dangerous dog breeds in America; similarly, the Presa Canario breed was almost unheard of when two of them fatally

¹³³ See VICIOUS ANIMAL TASKFORCE REPORT, *supra* note 64, at 3; SHERWOOD, ARK., ORDINANCE No. 1776 § 5B (2008), available at <http://www.animallaw.info/local/lousarsherwoodbsl.htm> ("Residents who are unaware of the Prohibited breed ban and house an animal within the corporate limits of the City of Sherwood are advised of the ordinance. If the resident has a secure location to confine their pet, a written warning is issued giving them a fifteen (15) day grace period to allow time to relocate the animal outside of the city limits.").

¹³⁴ See Cunningham, *supra* note 6, at 57.

¹³⁵ *Id.* at 2 n.2. See also HABITAT FOR HUMANITY—N.Y.C., *supra* note 96, at 1–5 (describing the benefits brought to the community by an increase in home ownership).

¹³⁶ McNeely & Lindquist, *supra* note 15, at 115–16.

¹³⁷ *Why Breed Specific Legislation Doesn't Work*, THE HUMANE SOCIETY OF THE U.S. (Jan. 9, 2013), http://www.humanesociety.org/issues/breed-specific-legislation/fact_sheets/breed-specific-legislation-flaws.html.

attacked a woman in California.¹³⁸ Now legislatures have begun adding Presa Canarios to existing BSL that had already banned pit bulls, and in some cases, Doberman pinschers.¹³⁹ However, any dog can be trained, neglected, or abused to create an aggressive animal. Recently, in Houston, Texas, police reported a German shepherd escaped a fenced enclosure and attacked a ten-year-old child as she walked to her mailbox.¹⁴⁰ In May 2012, in Culpepper, Virginia, a Jack Russell terrier was left alone with an infant, bit off the baby's ear, and delivered thirty more bites to the baby's body before it was discovered and restrained.¹⁴¹ If an irresponsible dog owner wants to create a vicious dog, the dog breed does not matter. Therefore, if a community rids itself of a so-called vicious dog breed such as the pit bull, there is sure to be another breed that will soon top the list as the most aggressive and dangerous dog in the United States.

B. *Recommendations*

A horrifying news story was published in 1983 where a child was mauled to death by his family's pet pit bull.¹⁴² The community became enraged and urged legislators to ban pit bulls in the City of Cincinnati.¹⁴³ It was later discovered that a local teenager had actually stolen the dog, perhaps hoping to train it for dog fighting, and had sold it on the street to the mauled boy's father.¹⁴⁴ The boy's father bought the unsterilized dog and kept it chained in the yard, in hopes that it would mate with their already chained-up female dog.¹⁴⁵ A ban on pit bulls would not have prevented this incident.¹⁴⁶ There needs to be a different and broader approach to solving dog bite issues.¹⁴⁷ Most importantly, there must be stronger enforcement of

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ Sherry Williams, *Friendswood PD: Girl Attacked by German Shepherd; Charges Pending Against Dog-Owner*, KHOU 11 NEWS (Mar. 29, 2012, 6:00 PM), <http://www.khou.com/news/Friendswood-police-Girl-attacked-by-German-shepherd-charges-pending-against-dog-owner-144932825.html>.

¹⁴¹ Donnie Johnston, *Jack Russell Terrier Bites Off Infant's Ear*, FREDERICKSBURG.COM (May 2, 2012, 10:34 AM), <http://blogs.fredericksburg.com/newsdesk/2012/05/02/jack-russell-terrier-bites-off-infant%E2%80%99s-ear/>.

¹⁴² Medlin, *supra* note 10, at 1285.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *See id.* at 1310–11 (discussing the Cyclical Effect of Irresponsible Human Behavior and how this type of incident can happen with any other strong breed of dog).

¹⁴⁷ *See generally Position Statement on Breed-Specific Legislation*, AM. SOC'Y FOR THE PREVENTION OF CRUELTY TO ANIMALS, <http://www.aspc.org/about-us/aspc-policy-and-position-statements/position-statement-on-breed-specific-legislation> (last visited Sept. 24, 2013) (giving a brief overview of better ways to curb dog on human attacks); *Why Breed Specific Legislation Doesn't Work*,

Dangerous Dog Laws that are already in place.¹⁴⁸ Greater enforcement, combined with a policy of strict liability for dog owners whose dogs are running loose and bite someone causing injury or death,¹⁴⁹ would incentivize owners to follow leash laws and ensure that fences and enclosures are inescapable by their dogs.¹⁵⁰ This will also allow for greater criminal liability for owners of dogs that have been declared “dangerous” by prior behavior.¹⁵¹

The most important first step is the stricter enforcement of regular dog licensing laws.¹⁵² However, the majority of people do not license their pets.¹⁵³ When dogs lack proper registration, there is no way to keep track of how many dogs are in the city or who owns the dogs, making it harder to pinpoint culpability when the dog attacks someone.¹⁵⁴ Once licensing is in place, there can be proper dog bite reporting for allocation of scarce resources and for better pinpointing what kinds of preventive strategies are working in which communities.¹⁵⁵ Increased dog licensing regulations would also help curb the problem of dogs running at large in the community, as authorities could more easily determine an owner and therefore issue a citation. This would also decrease dog bites, as many dog-on-human attacks occur while the dog is running off its owner’s property.¹⁵⁶

Studies have shown that aggressive behavior in dogs can be traced back to six categories of behavior¹⁵⁷: (1) humans encouraging aggressive behavior in larger, stronger dogs by reinforcing aggressive behavior by their dogs toward other animals and humans;¹⁵⁸ (2) humans abusing or neglecting larger, stronger dogs by limiting socialization;¹⁵⁹ (3) dogs protect-

supra note 137 (providing a brief overview of why the organization is against Breed Specific Legislation and the more effective ways to curb dog on human attacks).

¹⁴⁸ See Hussain, *supra* note 12, at 2886.

¹⁴⁹ *Maryland House Gives Initial Approval to Dog Bite Bill*, ABC 7 NEWS (Aug. 14, 2012, 5:39 PM), <http://www.wjla.com/articles/2012/08/maryland-house-gives-initial-approval-to-dog-bite-bill-78831.html>.

¹⁵⁰ Hussain, *supra* note 12, at 2884.

¹⁵¹ See *id.* at 2876.

¹⁵² *Id.* at 2884 (reporting that Calgary, Canada, halved the number of aggressive dog incidents by stricter enforcement of their licensing laws).

¹⁵³ *Breed-Specific Law FAQ*, DOGSBITE.ORG, <http://www.dogsbite.org/legislating-dangerous-dogs-bsl-faq.php> (last visited Sept. 25, 2013).

¹⁵⁴ See *id.*

¹⁵⁵ See Task Force on Canine Aggression and Human-Canine Interactions, *A Community Approach to Dog Bite Prevention*, 218 J. AM. VETERINARY MED. ASS’N 1732, 1738–39 (2001).

¹⁵⁶ Sacks et al., *supra* note 7, at 836.

¹⁵⁷ McNeely & Lindquist, *supra* note 15, at 107.

¹⁵⁸ *Id.* See also Medlin, *supra* note 10, at 1298 (“For the past 20 years, [p]it [b]ulls have been subjected to cruelty, abuse and mistreatment to a degree and on a scale that no other breed in recent history has ever had to endure.”) (citing KAREN DELISE, *FATAL DOG ATTACKS: THE STORIES BEHIND THE STATISTICS* 85 (2002)).

¹⁵⁹ McNeely & Lindquist, *supra* note 15, at 107.

ing food or family members;¹⁶⁰ (4) dogs that are ill;¹⁶¹ (5) dogs allowed to chase moving objects;¹⁶² and (6) dogs who have not been spayed or neutered and are looking for a mate.¹⁶³ These six factors can all be attributed to human behaviors and many of them are considered animal cruelty or neglect under various state and federal statutes.¹⁶⁴ However, better anticruelty laws are still needed in general.¹⁶⁵ For example, chaining of dogs should be included under all anticruelty laws as it breeds isolation and makes the dogs more territorial and more prone to aggressiveness.¹⁶⁶

Because most canine aggression can be traced to human behavior, especially cruel behavior, people already convicted of animal abuse should be banned from owning dogs in the future. States should enact animal abuse registries similar to one proposed in New York City.¹⁶⁷ The registry would contain people convicted of “animal fighting, abandonment, aggravated cruelty, and failure to provide proper sustenance.”¹⁶⁸ The bill proposing the registry would mandate that the abusers would be on the registry for five years after the first conviction and ten years after an additional conviction, and those on the list would be prevented from obtaining any new pets.¹⁶⁹

Dog fighting is also a major contributor to dangerous dog behavior. As dog-fighting sports evolved in England from bull and bear baiting to the cheaper dog-on-dog combat, fighting dogs were bred to be stronger and to have greater endurance for longer—and therefore more profitable—fights.¹⁷⁰ When dog fighting came to the United States in the mid-1850’s, the promoters of dog fighting had bred the ultimate fighting dog, the American pit bull terrier.¹⁷¹ Though dog fighting has been outlawed in all fifty

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ See, e.g., MINN. STAT. § 343.40 (2012) (banning the keeping of dogs outdoors without proper shelter and protection against the elements); N.C. GEN. STAT. § 14-36061 (2012) (criminalizing cruelty to animals); VA. CODE ANN. § 3.2-6570 (2008) (criminalizing cruelty to animals).

¹⁶⁵ See Hussain, *supra* note 12, at 2875–76.

¹⁶⁶ Mcneely & Lindquist, *supra* note 15, at 108.

¹⁶⁷ *Animal Abuser Registry Bill Proposed by New York City Council Members*, HUFFINGTON POST N.Y. (Sept. 19, 2012, 1:44 PM), http://www.huffingtonpost.com/2012/09/19/animal-abuse-registry-bill-new-york-city-council_n_1897209.html?utm_hp_ref=new-york; see also Charles Rabin & Patricia Mazzei, *Miami-Dade Commission Signs Off on Online Dangerous-dog Registry*, THE MIAMI HERALD (Oct. 2, 2012), <http://www.miamiherald.com/2012/10/02/3029298/miami-dade-commission-meets-tuesday.html> (Miami legislatures have approved an online dangerous dog registry that will include any registered dangerous dogs’ pictures along with the owners’ home address).

¹⁶⁸ HUFFINGTON POST N.Y., *supra* note 168.

¹⁶⁹ *Id.*

¹⁷⁰ Monica Villavicencio, *A History of Dogfighting*, NPR (July 19, 2007), <http://www.npr.org/templates/story/story.php?storyId=12108421>.

¹⁷¹ *Id.*

states, and is a felony in all but Idaho and Wyoming,¹⁷² the Humane Society estimates that there are about 40,000 dog fighters in the United States and 100,000 “street fighters” (amateur dog fighters) as well.¹⁷³ High-stakes dog fighting is a profitable industry that incentivizes the continued breeding of aggressive, fighting dogs.¹⁷⁴ The most worrisome outcome of underground dog fighting is the profitability of “backyard” breeders, who are unregistered and unskilled, and breed dogs that are aggressive towards humans.¹⁷⁵ The unrestricted breeding of fighting dogs has caused the overpopulation of a breed that many consider a symbol for power, tenacity, and aggression.¹⁷⁶

Though dog fighting is banned in all fifty states,¹⁷⁷ the penalties need to be stronger for those spectating, participating, and training dogs for competition in this heinous activity.¹⁷⁸ The first step is making sure that dog fighting is a felony in all fifty states, and not just a misdemeanor.¹⁷⁹ There should also be a restriction of ownership, specifically laws prohibiting those previously convicted of a felony from owning certain types of dogs.¹⁸⁰ However, it is not just the actual dog fighting that must be legislated against; laws should prohibit the steps leading up to dog fighting, such as stealing other pets for “bait” animals to train future fighting dogs to kill.¹⁸¹ States should follow Arizona’s example and make stealing a dog for the purpose of dog fighting a felony regardless of the value of the dog.¹⁸² If the authorities are notified when the dog is stolen, the investigation begins earlier and the likelihood of discovering a dog-fighting ring, or a purveyor of dog fighting, becomes higher.¹⁸³

¹⁷² *Rankings of State Dog Fighting Laws*, THE HUMANE SOC’Y OF THE U.S. (June 2011), http://www.humanesociety.org/assets/pdfs/animal_fighting/dogfighting_statelaws.pdf.

¹⁷³ Hanna Gibson, *Dog Fighting Detailed Discussion*, ANIMAL LEGAL & HISTORICAL CTR. (2005), <http://www.animallaw.info/articles/ddusdogfighting.htm> (last visited Sept. 21, 2012).

¹⁷⁴ *Dogfighting a Booming Business, Experts Say*, CNN.COM (July 19, 2007, 9:32 PM), <http://www.cnn.com/2007/US/07/18/dog.fighting/index.html>.

¹⁷⁵ Gibson, *supra* note 174.

¹⁷⁶ Medlin, *supra* note 10, at 1298; Richard, *supra* note 10, at 13–15.

¹⁷⁷ THE HUMANE SOC’Y OF THE U.S., *supra* note 173.

¹⁷⁸ *Id.* (spectating at a dogfight is only classified as a misdemeanor in twenty-four states and legal in two. Possessing dogs for dog fighting is still only a misdemeanor in four states).

¹⁷⁹ *Id.*

¹⁸⁰ 720 ILL. COMP. STAT. 5 / 12 (2013) (prohibiting felons from owning unspayed and unneutered dogs); OHIO REV. CODE ANN. § 955.54 (LexisNexis 2012) (banning felons from owning unspayed and unneutered dogs).

¹⁸¹ Maryann Mott, NAT’L GEOGRAPHIC NEWS (Feb. 18, 2004), http://news.nationalgeographic.com/news/2004/02/0218_040218_dogfighting.html.

¹⁸² *Bringing All Appropriate Charges*, AM. SOC’Y FOR THE PREVENTION OF CRUELTY TO ANIMALS FOR PROF’LS, <http://www.aspcapro.org/bringing-all-appropriate-charges.php> (last visited Sept. 21, 2012).

¹⁸³ *Id.*

Spaying and neutering pets can decrease aggression and territorial behavior especially when male dogs smell a nearby female in heat.¹⁸⁴ Owners and potential owners should be educated on the benefits to spaying and neutering their dogs. Providing low-cost access to spay and neuter services by animal rescue and advocacy organizations may encourage dog owners to spay and neuter their pets since the high cost of these procedures may be a deterrent to owners.¹⁸⁵

Education is a major element to curb dog attacks. This includes not just education for those desiring to own dogs, but community education as well.¹⁸⁶ Dogs communicate with other dogs and humans in very different ways than humans communicate with other humans.¹⁸⁷ Children are often overly enthusiastic with their canine friends, especially when interacting closely with a dog for the first time.¹⁸⁸ As children between the ages of five and nine are the most likely dog bite victims,¹⁸⁹ young children need to be educated about dog behavior and how to appropriately interact with dogs.¹⁹⁰ In Sydney, Australia, 197 children, ages seven to eight, were selected to complete a thirty-minute school lesson on how to both recognize different dog behaviors and how to safely interact with dogs.¹⁹¹ Ten days after the lesson the children were surprised to see a dog tethered in their playground, sitting five meters from its owner.¹⁹² Of the 197 children who participated in the lesson, only 9% attempted to pet or play with the dog while 79% of the students in the control group, students who were not given the lesson, attempted to play with or pet the dog.¹⁹³ Though this experiment was only done with a small group of children, the results were astounding. Though all of these elements together seem costly, they are actually just utilizing

¹⁸⁴ *Top Ten Reasons to Spay and Neuter Your Pet*, AM. SOC'Y FOR THE PREVENTION OF CRUELTY TO ANIMALS, <http://www.asPCA.org/pet-care/spayneuter/spay-neuter-top-ten.aspx> (last visited Sept. 21, 2012).

¹⁸⁵ *Spaying and Neutering*, ANIMAL WELFARE LEAGUE OF ARLINGTON, <http://www.awla.org/spay-neuter-program.shtml> (last visited Sept. 21, 2012); see also *ASPCA Mobile Spay/Neuter Clinics*, AM. SOC'Y FOR THE PREVENTION OF CRUELTY TO ANIMALS, <http://www.asPCA.org/asPCA-nyc/mobileclinic/> (last visited Sept. 21, 2012) (offering \$5 spay and neutering services to those receiving public assistance and free spay and neutering services to pit bulls and pit bull mixes).

¹⁸⁶ Mcneely & Lindquist, *supra* note 15, at 104.

¹⁸⁷ *Id.* (explaining the five categories of canine auditory communications).

¹⁸⁸ Bruce A. McKenna, *Breed Discrimination Laws: So Wrong in so Many Ways*, FED. LAWYER, June 2011, at 4–5 (recalling a memory of attending a ten-year-old's birthday party and seeing the birthday boy hug his brand new puppy-present so hard that the dog bit him).

¹⁸⁹ *Home and Recreational Safety: Dog Bite Prevention*, CTRS. FOR DISEASE CONTROL AND PREVENTION (Oct. 25, 2013), <http://www.cdc.gov/homeandrecreationalafety/dog-bites/biteprevention.html#mostatrisk>.

¹⁹⁰ Medlin, *supra* note 10, at 1309.

¹⁹¹ Simon Chapman, et. al., *Preventing Dog Bites in Children: Randomised Controlled Trial of an Educational Intervention*, 320 BRIT. MED. J. 1512 (2000).

¹⁹² *Id.*

¹⁹³ *Id.*

organizations and services already available in the community. For example, most animal shelters and adoption programs require potential owners to spay or neuter their new dog, or the organization provides the surgery using the adoption fee.¹⁹⁴ Other rescue organizations offer free behavior and training classes for families that adopt.¹⁹⁵

CONCLUSION

In a way, dogs are one of humanity's greatest experiments, effectively proving that nurture can overcome nature. Over thousands of years, we have worked as a species to take an element of wild nature and create our greatest companion. Dogs embody our rise as a species and our ability to shape and adopt our surroundings. It is the great tragedy of dogs, then, that we, their creators, are also their abusers. When individuals abuse and neglect their dogs, the betrayal is greater than just between the owner and the pet. The community is also affected in the form of aggressive, antisocial, and unmanageable dogs, which are at best a nuisance and at worst a danger to other members of the community.

There is no denying that the cost to society for dog bites is high. Total losses to society in dog bites and treatments of bites alone may be higher than \$1 billion per year.¹⁹⁶ However, the answer to this danger is not to pinpoint a breed and attribute all of society's problems to that breed. Breed Specific Legislation fails to address the root of the problem with dog attacks. Not only are BSL too costly to society, but they are also ineffective.¹⁹⁷ Instead, the answer to dog attacks is a broad and preemptive approach including greater enforcement of licensing laws, greater penalties for abusers and violators of criminal statutes, more education for owners and their children, and a swift and sure process of compensation for dog bite victims. With the Dangerous Dog Law approach to the dog-bite problem, society will see an eventual decrease in enforcement costs and a decrease in actual dog attacks on humans.

¹⁹⁴ *Adoption Process*, LOST DOG & CAT RESCUE FOUND., <http://lostdogrescue.org/adoptions/adoption-policies-procedures> (last visited Jan. 7, 2013).

¹⁹⁵ *Behavioral and Training Help: Charm School*, ANIMAL WELFARE LEAGUE OF ALEXANDRIA, http://awla.convio.net/site/PageServer?pagename=petowners_trainingtips (last visited Jan. 7, 2013).

¹⁹⁶ John K. Bini et. al., *Mortality, Mauling, and Maiming by Vicious Dogs*, 253 ANNALS SURGERY 791, 796 (2011).

¹⁹⁷ Medlin, *supra* note 10, at 1312.



KEEPING UP WITH THE TIMES: INTEGRATING INNOVATIONS IN
CRIMINAL COPYRIGHT INFRINGEMENT INTO THE FEDERAL
RULES OF CRIMINAL PROCEDURE

*Crystal Yi**

INTRODUCTION

U.S. laws must continue to evolve and adapt to advancing crimes. Nevertheless, in an increasingly interconnected and online society, innovations in criminal acts may be evolving too quickly for stagnant rules to keep pace. In the world of criminal copyright infringement, some foreign corporations may have found a technical loophole by way of the “service requirement” of Rule 4(c)(3)(C) of the Federal Rules of Criminal Procedure. The rule requires that (1) a summons be delivered to an agent of the corporation who is legally authorized to receive service of process, and (2) a copy of the summons be mailed to the corporation’s last known address *in the United States*.¹ First, effecting service in a foreign country for a criminal case may be difficult as the United States government must acquire the permission of the foreign nation to effect service, and this often means playing by the foreign nation’s rules of service. Second, although a corporation or its subsidiaries will generally have an address in the United States if it conducts business in the country, because of the increasing prevalence of online companies, foreign corporations can now conduct business with Americans without ever establishing a physical presence in the United States. Thus, if a foreign corporation has never had a physical address or principal place of business in the United States, Rule 4(c)(3)(C) seems to ensure the foreign corporation immunity from prosecution for criminal acts committed within the United States because of a mere technicality.² These unintended consequences starkly contradict the long-held principle in criminal jurisprudence that “a man, who outside the country willfully puts in

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¹ FED. R. CRIM. P. 4(c)(3)(C).

² Opp’n of the U.S. to Mot. of Specially Appearing Def. Megaupload Ltd. to Dismiss Indictment for Lack of Personal Jurisdiction at 1, *United States v. Dotcom*, No. 1:12-cr-3, 2012 WL 4788433 (E.D. Va. Oct. 5, 2012) (No. 117), 2012 WL 2885906 [hereinafter *Opp’n of Mot. to Dismiss*].

motion a force to take effect in it, is answerable at the place where the evil is done.”³

Although there are potential solutions to the problem of serving individuals and corporations outside of the United States in civil cases, such as piercing the corporate veil or international agreements,⁴ these options are not applicable to criminal cases because of the specific wording of Rule 4(c)(3)(C), which states that a copy of a summons must be mailed to an organization’s address *in the United States*.⁵ Rule 4(c)(3)(C) seems to tie the hands of the government, perhaps simply because the drafters of that rule did not anticipate the increasing importance of the Internet or the advancement of copyright infringement in cyberspace. As the stakes rise and increasing numbers of copyright holders are injured by online copyright infringement, the implications of allowing foreign online corporations to be immune from domestic criminal prosecution may be devastating, especially to music, movie, and other media industries. As Senator Leahy has expressed,

Intellectual property is just as vulnerable as it is valuable. The Internet has brought great and positive change to all our lives, but it is also an unparalleled tool for piracy. The increasing inter-connectedness of the globe, and the efficiencies of sharing information quickly and accurately between continents, has made foreign piracy and counterfeiting operations profitable in numerous countries. Americans suffer when their intellectual property is stolen.⁶

The Federal Rules of Criminal Procedure should not act as an obstacle to achieving justice against known criminals. Because online activities will likely only continue to advance in the future, it is time to adapt the technical rule to the Internet Age so that the rules are applicable to the crimes being committed in cyberspace.

Part I of this Comment will discuss criminal copyright infringement and Rule 4 of the Federal Rules of Criminal Procedure generally. It will also discuss relevant case law that has acknowledged, but has failed to provide an answer to, the mailing requirement problem. Part II will then examine potential solutions to the mailing requirement problem that are available to civil cases and discuss the difficulties of applying those same rules to criminal cases. Finally, in Part III, this Comment will argue that, to keep up with criminal ingenuity and allow the government the means to counteract the vast harms caused by criminal copyright infringement where the United States already has jurisdiction, Congress should amend the Federal

³ *Ford v. United States*, 273 U.S. 593, 623 (1927) (quoting 2 JOHN BASSETT MOORE, LL. D., A DIGEST OF INTERNATIONAL LAW 244 (1906)). The Supreme Court went on to say, “And the methods which modern invention has furnished for the performance of criminal acts in that manner has made this principle one of constantly growing importance and of increasingly frequency of application.” *Id.*

⁴ Discussed *infra* Part II.B.

⁵ FED. R. CRIM. P. 4(c)(3)(C).

⁶ 154 CONG. REC. S9583-02 (Sept. 26, 2008).

Rules of Criminal Procedure to provide for alternate methods to fulfill the mailing requirement when there is no address within the United States.

I. BACKGROUND

A. *The Problem of Criminal Copyright Infringement Generally*

In the Copyright Clause, the Constitution of the United States provides that Congress has the power to “Promote the Progress of Science and Useful Arts.”⁷ Copyright law is designed to “foster the production of creative works and the free flow of ideas by providing legal protection for creative expression.”⁸ Yet, with constantly developing technologies, Congress has struggled with balancing the protection of copyrights and promoting creativity in science and the arts.⁹

One court observed, “The future of the nation depends in no small part on the efficiency of industry, and the efficiency of industry depends in no small part on the protection of intellectual property.”¹⁰ A study reported that copyrights added \$932 billion to the U.S. economy in 2010 alone and that 5.1 million Americans are employed by copyright industries.¹¹ However, the infringement of those copyrights taxes the U.S. economy, and the losses are substantial.¹² Representative Berman has said that the results of the “[r]ampant counterfeiting and piracy of U.S. products” around the world has had a “devastating impact on our economy.”¹³ In 2008, Representative Blackburn stated that music and entertainment industries are “suffering from rampant theft of their intellectual property online, and in marketplaces around the world to the tune of \$58 billion each year.”¹⁴

While criminal copyright infringement has emerged as a serious problem with real consequences, some violations are considered “in the public interest.”¹⁵ Moreover,

⁷ Note, *The Criminalization of Copyright Infringement in the Digital Era*, 112 HARV. L. REV. 1705, 1705 (1999) [hereinafter *Criminalization*] (citing U.S. CONST. art. I, § 8, cl. 8).

⁸ DEPARTMENT OF JUSTICE, PROSECUTING INTELLECTUAL PROPERTY CRIMES 3 (3d ed. 2006).

⁹ See *Criminalization*, *supra* note 7, at 1705.

¹⁰ Rockwell Graphic Sys., Inc. v. DEV Indus., Inc., 925 F.2d 174, 180 (7th Cir. 1991).

¹¹ John M. Owen, *Graduated Response Systems and the Market for Copyrighted Works*, 27 BERKELEY TECH. L.J. 559, 562 (2012) (citing STEPHEN E. SIWEK, INT’L INTELL. PROP. ALLIANCE, COPYRIGHT INDUSTRIES IN THE U.S. ECONOMY: THE 2011 REPORT 4 (2011), available at <http://www.iipa.com/pdf/2011CopyrightIndustriesReport.pdf>).

¹² *Id.*

¹³ 154 CONG. REC. H3075 (May 6, 2008).

¹⁴ 154 CONG. REC. E2141-01 (Sept. 28, 2008).

¹⁵ *Criminalization*, *supra* note 7, at 1705–06; see also ROBERT A. GORMAN & JANE C. GINSBURG, COPYRIGHT FOR THE NINETIES 548 (1993) (discussing the fair use doctrine as codified at 17 U.S.C. § 107 (1994)).

it simply is not cost effective to sue each end user for copyright infringement [S]uing even a fraction of the end users could bankrupt the content industries. It is also generally considered bad for public relations to sue your customers, and most people engaged in illegal file sharing also buy music legally.¹⁶

Thus, rather than holding millions of individual end users accountable, the government sues the service provider or the file-sharing website, such as Megaupload.¹⁷

The Digital Millennium Copyright Act (DCMA), enacted in 1998, was an attempt to adapt copyright law to the Internet Age.¹⁸ It was largely a response to “user-driven media” and websites such as YouTube.¹⁹ The DCMA “created a safe harbor for websites from copyright infringement claims when they acted as a mere conduit distributing content posted by others.”²⁰ So long as the service provider acts “expeditiously to remove, or disable access to” known copyrighted material once it has received written notice of the infringement by the copyright owner, the service provider avoids liability.²¹ Criminal penalties are reserved for those who willfully engage in copyright infringement for profit.²²

B. *Evolving Modes of Copyright Infringement*

Because of new developments in technology, penalizing copyright infringement has become more difficult.²³ File-sharing programs allow users to share music, movies, and other files over the Internet. Although file-sharing programs are legitimate in and of themselves, they can facilitate the widespread, unauthorized distribution of copyrighted material.²⁴ Two innovations in file-sharing technology that Internet users have adopted in copy-

¹⁶ “It may cost as much as \$250,000 for a copyright owner to take even a low-stakes copyright case to trial and final judgment.” Mark A. Lemley & R. Anthony Reese, *Reducing Digital Copyright Infringement Without Restricting Innovation*, 56 STAN. L. REV. 1345, 1376 (2004).

¹⁷ *Id.* at 1377.

¹⁸ *Copyrights in Cyberspace: A Roundup of Recent Cases*, 12 J. HIGH TECH. L. 106, 113 (2011) [hereinafter *Roundup*].

¹⁹ *Roundup*, *supra* note 18, at 114–15. YouTube allows users to upload videos onto its servers, making the videos available to anyone who visits the website. *Copyright Infringement Pushin’: Google, YouTube, and Viacom Fight for Supremacy in the Neighborhood that may be Controlled by the DCMA’s Safe Harbor Provision*, 51 IDEA 607, 621 (2011) [hereinafter *Pushin’*]. By 2008, YouTube users uploaded more than 400,000 videos per day, and YouTube estimated that seventy percent of the most popular material uploaded on its site was copyrighted material. *Id.* at 622.

²⁰ *Roundup*, *supra* note 18, at 115.

²¹ *Id.*

²² *See Criminalization*, *supra* note 7, at 1705.

²³ *See id.*

²⁴ *Arista Records LLC v. Lime Grp. LLC*, 784 F. Supp. 2d 398, 410 (S.D.N.Y. 2011).

right-infringing activities are peer-to-peer systems and “cloud-computing.”²⁵

1. Peer-to-Peer

Peer-to-peer (P2P) systems allow users to share files with other users who are simultaneously logged onto a common network.²⁶ P2P systems are advantageous because they provide faster file transfers, conserve bandwidth, and reduce or eliminate the need for the central storage of files.²⁷ For example, Napster, the pioneer P2P file-sharing service, connected users who were logged onto the network through a central indexing server, enabling them to share music files.²⁸ As a result, users could access copyrighted music files virtually free of charge.²⁹ Thus, P2P technology can also violate a copyright holder’s exclusive rights of distribution and reproduction when users share copyrighted music files.³⁰ Subsequent P2P systems have further decentralized the file-sharing process³¹ by eliminating the need for even the central indexing server upon which Napster relied and substituting it with supernodes, or mini-indexing servers, throughout the network.³² P2P technologies continue to advance and resolve inefficiency problems from which earlier P2P models suffered.³³

On one hand, P2P systems are beneficial because they lower the costs of sharing content.³⁴ On the other hand, P2P systems provide uncontrolled

²⁵ See Deborah Platt et. al, *Peer-to-Peer file-Sharing Technology: Consumer Protection and Competition Issues*, 2005 WL 154111, at *2 (F.T.C.) [hereinafter *Peer-to-Peer*]; Sascha Segan, *What is Megaupload?*, PCMAG.COM (Jan. 20, 2012, 10:43 AM), <http://www.pcmag.com/article2/0,2817,2399133,00.asp>.

²⁶ *Pushin*, *supra* note 19, at 619.

²⁷ *Peer-to-Peer*, *supra* note 25, at *2. Rather than storing files in a central server to which users must connect to retrieve files, P2P allows users to share directly with other users. As a result, P2P also allows for faster file transfers and conservation of bandwidth. *Id.* at *4.

²⁸ See Annemarie Bridy, *Is Online Copyright Enforcement Scalable?*, 13 VAND. J. ENT. & TECH. L. 695, 699 (2011); *Pushin*, *supra* note 19, at 618.

²⁹ Other examples of P2P systems include Limewire and μ Torrent.

³⁰ *Pushin*, *supra* note 19, at 619.

³¹ In P2P systems, “files are not uploaded to a provider’s server; they remain instead on the users’ own systems, from which other users directly retrieve them.” Bridy, *supra* note 28, at 717. This decentralization makes it difficult to regulate under the DCMA’s safe harbor provisions because the act only covers (1) transitory digital network communications, (2) system caching, (3) storage on behalf of users, and (4) information location. *Id.* at 716–17.

³² *Id.* at 699–704. For example, the problem of free riding was solved through the introduction of a BitTorrent file-sharing protocol that made it impossible for any user on the network to “take without giving.” *Id.* at 701.

³³ *Id.* at 699.

³⁴ *Peer-to-Peer*, *supra* note 25, at *22 (“[P2P systems] reduce the marginal costs of distributing digital content to zero or near-zero.”).

access to digital content, some of which may be copyright-protected.³⁵ As a result, such systems can have detrimental effects on the incentive for innovation and creativity.³⁶ If the exclusive rights of distribution and reproduction of artists, musicians, and other copyright holders are not protected, they would have little incentive to create new works or to share them with the public.

2. Cloud Computing” and Online File-Hosting Services

P2P systems have continued to evolve, but users are also turning to other sources of media sharing.³⁷ According to the National Institute of Standards and Technology, cloud computing

is a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.”³⁸

With “cloud computing” file-hosting, “everyday processes and information that are typically run and stored on local computers—email, documents, calendars—can be accessed securely anytime, anywhere, and with any device through an Internet connection.”³⁹

In addition, recent file-hosting services such as Megaupload⁴⁰ allow users to upload files to a centralized server and allow anyone else to download the file by using a unique link.⁴¹ RapidShare is another file-hosting service and works very similarly to Megaupload. Its servers “automatically generate a unique download link (a URL) for each uploaded file and send

³⁵ *Id.*

³⁶ *Id.*

³⁷ Bridy, *supra* note 28, at 704.

³⁸ Peter Mell & Timothy Grace, *The NIST Definition of Cloud Computing (Special Publication 800-145)*, NAT'L INST. OF STANDARDS AND TECH. 2 (Sept. 2011), available at <http://csrc.nist.gov/publications/nistpubs/800-145/SP800-145.pdf>.

³⁹ Ilana R. Kattan, Note, *Cloudy Privacy Protections: Why the Stored Communications Act Fails to Protect the Privacy of Communications Stored in the Cloud*, 13 VAND. J. ENT. & TECH. L. 617, 622 (2011) (quoting *ECPA Reform and the Revolution in Cloud Computing: Hearing Before the Subcomm. on the Constitution, Civil Rights, and Civil Liberties of the H. Comm. on the Judiciary*, 111th Cong. 2 (2010) (statement of Richard Salgado, Sr. Counsel, Law Enforcement and Information Security, Google, Inc.)). Cloud computing also eliminates the need for a user to be tethered to a desktop computer. William Jeremy Robison, Note, *Free at What Cost?: Cloud Computing Privacy Under the Stored Communications Act*, 98 GEO. L.J. 1195, 1199 (2010).

⁴⁰ Other examples of cloud file-sharing websites include MediaFire, RapidShare, and Dropbox.

⁴¹ Segan, *supra* note 25.

that link to the user who uploaded the file.”⁴² The user can then share the link, and others can access the file from RapidShare’s servers.⁴³ Megaupload and RapidShare are examples of online file-hosting services known as “cyberlockers” or Direct Download Links.⁴⁴

Like P2P systems, cloud computing and online file-hosting services have legitimate uses that are beneficial to users sharing information online. File-hosting services provide a mechanism for sharing files—with little or no transaction costs—that users can access “anytime, anywhere,” and that protects users from data loss due to hardware malfunctions.⁴⁵ Furthermore, unlike P2P systems, services such as RapidShare do not “index user materials and [do] not allow users to search for specific files.”⁴⁶ However, users may still share copyrighted material using the unique link to their uploaded file, whether by sharing the link through email or by posting it on a website, thereby violating copyright holders’ exclusive rights to distribute and reproduce their works.⁴⁷

C. *Evolving Interpretations of the Rules: Expanding the Application of the Federal Rules*

Technology has continued to evolve, and as a result, the criminal activities that those technologies facilitate have also evolved. Accordingly, procedural jurisprudence has adapted to remain relevant to advancing crimes. For instance, in an increasingly interconnected world, the notion of an American court’s personal jurisdiction has expanded to confront the realities of foreign activities that are directed to and have an effect in the geographical boundaries of the United States.⁴⁸ However, in some aspects, American procedural rules are still lagging behind criminal innovations. Such legal vulnerabilities leave an opening for criminal opportunism.

⁴² Luke M. Rona, *Off With the Head? How Eliminating Search and Index Functionality Reduces Secondary Liability in Peer-to-Peer File-Sharing Cases*, 7 WASH. J. L. TECH. & ARTS 27, 41–42 (2011) (quoting *Perfect 10, Inc. v. RapidShare*, No. 09-CV-2596 H, at *2 (S.D. Cal. May 18, 2010)).

⁴³ *Id.* at 42.

⁴⁴ Bridy, *supra* note 28, at 705.

⁴⁵ See Kattan, *supra* note 39, at 622; Segan, *supra* note 25. For example, these services can be used to permit shareware and freeware developers or independent musicians who otherwise may not be able to afford the cost of bandwidth to share their work. Segan, *supra* note 25.

⁴⁶ Rona, *supra* note 42, at 41–42.

⁴⁷ *Pushin’*, *supra* note 19, at 619.

⁴⁸ See discussion *infra* Part I.C.1.

1. Personal Jurisdiction in the Internet Age

In the American legal system, a court must have personal jurisdiction over the parties.⁴⁹ Personal jurisdiction can be either general or specific. General jurisdiction applies when a defendant's contacts with the forum are systematic and continuous, and thus, the defendant could reasonably anticipate defending a claim there.⁵⁰ Specific jurisdiction exists when the defendant has "certain minimum contacts [with a forum state], such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'"⁵¹ Minimum contacts can be established if the defendant purposefully availed himself of the privilege of conducting business in the forum by creating "continuing relationships and obligations with citizens of another state."⁵² Alternatively, if a defendant purposefully directs his acts toward a forum state, and those acts are expected to have an effect within the state, the defendant could reasonably anticipate defending a claim there.⁵³

However, in the Internet age, geographically-based principles of jurisdiction are difficult to apply.⁵⁴ Because websites can be accessed from wherever there is an Internet connection, and because information travels through cyberspace, there is not necessarily a physical jurisdiction that covers an Internet address.⁵⁵ Nevertheless, courts have found jurisdiction to exist in cases based on minimum contacts with a forum state through an Internet website. In *Zippo Manufacturing Co. v. Zippo Dot Com Inc.*,⁵⁶ the court used a "sliding scale" to measure specific personal jurisdiction based on Internet activity.⁵⁷ An Internet website could be (1) passive, (2) interactive, or (3) integral to the defendant's business.⁵⁸ Passive websites are only informational and do not provide a means to interact with the site owner.⁵⁹ Courts do not ordinarily exercise personal jurisdiction for such sites.⁶⁰ An interactive website allows viewers to communicate with the site owner, whether by telephone, mail, or email.⁶¹ Depending on the level of interac-

⁴⁹ Generally, a defendant can be sued under copyright law where there is personal jurisdiction. See Symposium, *Copyright Disputes Involving Online Activities*, 717 PLI/PAT 299, 311 (2002) [hereinafter *Copyright Disputes*].

⁵⁰ See *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 318 (1945).

⁵¹ *Id.* at 316.

⁵² *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 473 (1985).

⁵³ *Calder v. Jones*, 465 U.S. 783, 789 (1984).

⁵⁴ *Copyright Disputes*, *supra* note 49, at 321.

⁵⁵ *Id.*

⁵⁶ *Zippo Mfg. Co. v. Zippo Dot Com, Inc.*, 952 F. Supp. 1119, 1124 (W.D. Pa. 1996).

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

tivity and the commercial nature of the site, courts may or may not exercise personal jurisdiction for such sites.⁶² Finally, sites that are integral to the defendant's business are those that are actively used to conduct transactions with persons in the forum state.⁶³ Such sites generally fall under the specific jurisdiction of the forum state.⁶⁴

2. Rule 4(c)(3)(C) of the Federal Rules of Criminal Procedure

Another facet of American procedural laws can be found in the service of process requirement. The United States Court of Appeals for the Fourth Circuit has described service of process as the "procedure by which a court having venue and jurisdiction of the subject matter of the suit asserts jurisdiction over the person of the party served."⁶⁵ A federal court must fulfill the service of process requirement before asserting personal jurisdiction over a party.⁶⁶ According to the Supreme Court, "[s]ervice of process, under longstanding tradition in our system of justice, is fundamental to any procedural imposition on a named defendant."⁶⁷ Both service of process and personal jurisdiction must be satisfied before a suit can go forward. Although they are "inextricably intertwined, since service of process constitutes the vehicle by which the court obtains jurisdiction,"⁶⁸ they are also "distinct concepts that require separate inquiries."⁶⁹

Rule 4(f) of the Federal Rules of Civil Procedure provides means for serving an individual in a foreign country:

Unless federal law provides otherwise, an individual . . . may be served at a place not within any judicial district of the United States:

(1) by any internationally agreed means of service that is reasonably calculated to give notice, such as those authorized by the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents;

⁶² *Zippo Mfg. Co.*, 952 F. Supp. at 1124.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Harding v. Williams Prop. Co.*, 1998 U.S. App. LEXIS 21268, at *12 (4th Cir. Aug. 31, 1998) (quoting *Miss. Publ'g Corp. v. Murphree*, 326 U.S. 438, 444-45 (1946)).

⁶⁶ *Id.*

⁶⁷ *Murphy Bros., Inc. v. Michetti Pipe Stringing, Inc.*, 526 U.S. 344, 350 (1999); *see also Harding*, 1998 U.S. App. LEXIS 21268, at *12 ("In the absence of service of process (or waiver of service by the defendant) a court ordinarily may not exercise power over a party the complaint names as defendant.").

⁶⁸ *United States v. Chitron Elecs. Co.*, 668 F. Supp. 2d 298, 304 (D. Mass. 2009) (quoting *Miss. Publ'g Corp. v. Murphree*, 326 U.S. 438, 444-45 (1946)).

⁶⁹ *Peay v. BellSouth Med. Assistance Plan*, 205 F.3d 1206, 1209 (10th Cir. 2000).

(2) if there is no internationally agreed means, or if an international agreement allows but does not specify other means, by a method that is reasonably calculated to give notice:

(A) as prescribed by the foreign country's law for service in that country in an action in its courts of general jurisdiction;

(B) as the foreign authority directs in response to a letter rogatory or letter of request; or

(C) unless prohibited by the foreign country's law, by:

(i) delivering a copy of the summons and of the complaint to the individual personally; or

(ii) using any form of mail that the clerk addresses and sends to the individual and that requires a signed receipt; or

(3) by other means not prohibited by international agreement, as the court orders.⁷⁰

The same rules apply for foreign corporations.⁷¹ As distinct from civil cases, a summons for an individual in a criminal case can only be served "within the jurisdiction of the United States or anywhere else a federal statute authorizes an arrest."⁷² Rule 4(c)(3)(C) of the Federal Rules of Criminal Procedure provides that, for corporations,

[a] summons is served on an organization by delivering a copy to an officer, to a managing or general agent, or to another agent appointed or legally authorized to receive service of process. A copy must also be mailed to the organization's last known address within the district or to its principal place of business elsewhere in the United States.⁷³

Thus, the criminal rules provide none of the means to serve an individual or corporation in a foreign country that are available in civil cases. However, it does impose an additional mailing requirement.

D. *Limited Case Law Recognizes the Problem, but Does Not Provide a Solution*

The issue of integrating Rule 4(c)(3)(C) into situations involving a foreign party's activity in the United States absent a physical presence is

⁷⁰ FED. R. CIV. P. 4(f).

⁷¹ FED. R. CIV. P. 4(f).

⁷² FED. R. CRIM. P. 4(c)(2).

⁷³ FED. R. CRIM. P. 4(c)(3)(C).

still relatively new. District courts that are confronted with the problem seem quick to point out the deficiency of service, but struggle to provide a solution to the problem. Some courts have provided for creative means for fulfilling the service requirement that are not generally available in the civil context.⁷⁴ Some merely defer the issue, while expressing doubt that any alternate methods will provide the necessary solution to fulfilling the service requirement.⁷⁵

1. *United States v. Johnson Matthey PLC*⁷⁶

In this case, the court quashed service when the government attempted to serve a criminal summons on a foreign corporate defendant by mailing a copy of the summons to the last known address of the wholly-owned subsidiary of the defendant within the United States.⁷⁷ The defendant never had an address or place of business in the United States, so the court ruled that the government failed to satisfy the mailing requirement of Rule 4 of the Federal Rules of Criminal Procedure.⁷⁸ Although the court quashed service in this case, it did not instruct the parties as to how service could be properly met.⁷⁹ The court only suggested that the parties turn to the mutual legal assistance treaty between the United Kingdom and the United States for guidance.⁸⁰

2. *United States v. Chitron Electronics Co.*⁸¹

In this case, the court found that service of process on the president of the defendant's subsidiary company located in the United States was sufficient to satisfy service on the parent corporation in China.⁸² Generally, in a civil context, service of process on a wholly-owned subsidiary does not satisfy proper service requirements.⁸³ However, in this case, because the subsidiary in the United States (1) “[had] minimum contacts with the fo-

⁷⁴ See discussion *infra* Part I.D.2–3.

⁷⁵ See discussion *infra* Part I.D.1.

⁷⁶ *United States v. Johnson Matthey PLC*, No. 2:06-CR-169 DB, 2007 WL 2254676 (D. Utah Aug. 2, 2007).

⁷⁷ *Id.* at *2.

⁷⁸ *Id.*

⁷⁹ See *id.*

⁸⁰ *Johnson Matthey*, 2007 WL 2254676, at *2; see generally Treaty Between The United States and United Kingdom and Northern Ireland on Mutual Legal Assistance on Criminal Matters, U.S.–U.K., Jan. 6, 1994, T.I.A.S. No. 96-1202, available at <http://commcns.org/13Jvyw0>.

⁸¹ *United States v. Chitron Elecs. Co.*, 668 F. Supp. 2d 298 (D. Mass. 2009).

⁸² *Id.* at 306.

⁸³ *Id.* at 304–05.

rum” and (2) acted as a “mere conduit for the activities of its parent,”⁸⁴ the court allowed the government to pierce the corporate veil⁸⁵ and serve the parent corporation.⁸⁶

3. *United States v. Public Warehousing Co.*⁸⁷

In this case, as in *Chitron*, the court recognized that “there is no litmus test for determining whether a subsidiary is the alter ego⁸⁸ of its parent. Instead, [the Court] must look to the totality of the circumstances.”⁸⁹ The court interpreted the silence of Rule 4 of the Federal Rules of Criminal Procedure regarding the alter ego, alongside the spirit of Rule 2 of the Federal Rules of Criminal Procedure,⁹⁰ to find that service was proper when the government served the president of the defendant parent corporation’s subsidiary within the United States.⁹¹ In this case, the court determined that the defendant parent corporation had sufficient notice of the indictment against it, and by serving the president of its subsidiary at its office in the United States, it was “reasonable to assume that [the managing agent] would transmit notices to [the parent corporation].”⁹²

4. *United States v. Alfred L. Wolff GmbH*⁹³

In this case, the court quashed service when the government attempted to serve the attorneys of the defendant corporation’s subsidiary in the United States.⁹⁴ The court held that unlike the circumstances in *Chitron* and *Public Warehousing Co.*, the government failed to demonstrate that the

⁸⁴ *Id.* at 305 (quoting *Stanley Works v. Globemaster, Inc.*, 400 F. Supp. 1325, 1332–35 (D. Mass. 1975)).

⁸⁵ For a further discussion of piercing the corporate veil, see *infra* Part II.A.2.

⁸⁶ *Chitron*, 668 F. Supp. 2d at 306.

⁸⁷ *United States v. Pub. Warehousing Co.*, No. 1:09-CR-490-TWT, 2011 WL 1126333 (N.D. Ga. Mar. 28, 2011).

⁸⁸ For further information on the alter-ego doctrine, see *infra* Part II.A.2.

⁸⁹ *Pub. Warehousing*, 2011 WL 1126333, at *6 (alteration in original) (quoting *United Steelworkers of America v. Connors Steel Co.*, 855 F.2d 1499 (11th Cir.1988)).

⁹⁰ Rule 2 of the Federal Rules of Criminal Procedure provides that “[t]hese rules are to be interpreted to provide for the just determination of every criminal proceeding, to secure simplicity in procedure and fairness in administration, and to eliminate unjustifiable expense and delay.” FED. R. CRIM. P. 2.

⁹¹ *Pub. Warehousing*, 2011 WL 1126333 at *7.

⁹² *Id.* at *5 (quoting *Heise v. Olympus Optical Co.*, 111 F.R.D. 1, 6 (N.D. Ind. 1986)); see *id.* at *8.

⁹³ *United States v. Alfred L. Wolff GmbH*, No. 08 CR 417, 2011 WL 4471383 (N.D. Ill. Sept. 26, 2011).

⁹⁴ *Id.* at *1.

subsidiary was the alter ego of the parent corporation.⁹⁵ The government failed to articulate a sufficient relationship between the parent and subsidiary with, for example, the extensive daily interactions and several financial entanglements found between the subsidiary and parent in *Public Warehousing Co.*⁹⁶

E. *Pending Cases are Stuck on the Issue, Searching for Plausible Solutions*

Three recent cases, still in district court, have presented the service of process dilemma. The district courts have considered such alternatives as using international agreements or the alter-ego doctrine,⁹⁷ but are struggling with establishing a viable means by which the government can effectuate service in difficult circumstances where foreign corporations are directing criminal activities to and having effects in the United States.

1. *United States v. Dotcom*⁹⁸

The U.S. District Court for the Eastern District of Virginia is struggling with this issue in *United States v. Dotcom*. In January 2012, the government indicted Kim Dotcom, along with seven other individuals, in one of “the largest criminal copyright cases ever brought by the United States.”⁹⁹ Dotcom founded Megaupload, a file-sharing website, and has used the website for profit by distributing massive amounts of pirated files.¹⁰⁰ Although the file-sharing site can be used for legitimate purposes, many of the files being shared are copyrighted material, the distribution of which is not authorized by the copyright owners.¹⁰¹ Dotcom and the other defendants are charged with being part of a massive, worldwide organization engaged in criminal copyright infringement that has caused more than an estimated \$500 million in damages to copyright holders.¹⁰²

Megaupload is a Hong Kong corporation with no U.S. offices or agents. Among others, one issue in this case is whether the government can

⁹⁵ *Id.* at *7.

⁹⁶ *Id.*

⁹⁷ See *infra* Part II.A.2.

⁹⁸ *United States v. Dotcom*, No. 1:12-cr-3, 2012 WL 4788433 (E.D. Va. Oct. 5, 2012).

⁹⁹ *Justice Department Charges Leaders of Megaupload with Widespread Online Copyright Infringement*, DEP’T OF JUSTICE, (Jan. 19, 2012), <http://www.justice.gov/opa/pr/2012/January/12-crm-074.html>.

¹⁰⁰ Superseding Indictment at ¶¶ 1–5, *United States v. Dotcom*, No. 1:12-cr-3, 2012 WL 4788433 (E.D. Va. Oct. 5, 2012), 2012 WL 602594.

¹⁰¹ *Id.* ¶ 7.

¹⁰² *Id.* ¶¶ 1–2.

properly serve the corporation with process when the corporation has no U.S. offices or even subsidiaries in the United States. Regarding the Megaupload case, District Judge Liam O’Grady has said, “I frankly don’t know that we are ever going to have a trial in this matter.”¹⁰³

2. *United States v. Pangang Group Co.*¹⁰⁴

United States v. Pangang Group Co. appeared before the U.S. District Court for the Northern District of California. In this case, the court quashed service, explaining that the “only way for the [g]overnment to show that it has complied with the mailing requirement, is to show that [its subsidiary] is the alter-ego” of the defendant in this case.¹⁰⁵ The court concluded that the government failed to show that the subsidiary was the alter ego of the defendant.¹⁰⁶ The court also acknowledged that a mutual legal assistance agreement may not be a viable alternative and that the government may be without a means to effect service on the defendant.¹⁰⁷ The case has not yet been decided.

3. *United States v. Kolon Indus., Inc.*¹⁰⁸

The United States District Court for the Eastern District of Virginia is dealing with yet another corporation that does not have a last known address or principal place of business in the United States. Although both parties agree that the delivery requirement must be fulfilled before the court can have jurisdiction over the case, the court struggled over whether the United States government could possibly comply with the mailing requirement.¹⁰⁹ The court suggested that the mailing requirement is but an additional mechanism for providing notice of service effected in satisfaction of the service requirement, and is not a necessary prerequisite of valid service or exercising jurisdiction.¹¹⁰ In this case, the court quashed the United

¹⁰³ Joe Coscarelli, *Megaupload Founder Kim Dotcom Might Never Go to Trial*, NYMAG.COM (Oct. 13, 2012, 5:02 PM), <http://nymag.com/daily/intel/2012/04/megaupload-founder-kim-dotcom-might-never-go-to-trial.html>.

¹⁰⁴ *United States v. Pangang Grp. Co.*, 879 F. Supp. 2d 1052 (N.D. Cal. 2012).

¹⁰⁵ *Id.* at 1066.

¹⁰⁶ *Id.* at 1066–69.

¹⁰⁷ *Id.* at 1069.

¹⁰⁸ *United States v. Kolon Indus., Inc.*, No. 3:12cr137-01, 2013 BL 49906 (E.D. Va. Feb. 22, 2013).

¹⁰⁹ *See id.* at *3–4, *23.

¹¹⁰ *Id.* at *5–6. The court stated, “It is doubtful that Congress would stamp with approval a procedural rule permitting a foreign corporate defendant to intentionally violate the laws of this country [thereby causing harm to its citizens], yet evade the jurisdiction of United States’ courts by purposefully

States government's initial attempts at service of process, but left open the possibility that service could be effected via a mutual legal assistance treaty with South Korea, where the corporation is located.¹¹¹

II. ANALYSIS

A. *Potential Solutions to the Service of Process Problem*

This section discusses potential alternatives to facilitate the service requirement. These alternatives are generally available in the civil context. However, these alternatives are not always a perfect fit for the criminal context and do not necessarily guarantee a practical solution to the delivery and mailing requirement problems of Rule 4(c)(3)(C).

1. Waiving Service

If the defendant cannot be properly served, then the case may never be brought before the court.¹¹² Thus, to effectuate the judicial process in sometimes impractical situations, Rule 4 of the Federal Rules of Civil Procedure provides a means for waiving service. Rule 4(d) provides that "an individual, corporation, or association . . . has a duty to avoid unnecessary expenses of serving the summons. The plaintiff may notify a defendant that an action has been commenced and request that the defendant waive service of a summons."¹¹³ Unlike Rule 4 of the Federal Rules of Civil Procedure, Rule 4 of the Federal Rules of Criminal Procedure does not provide for waiver of service of process, perhaps to preserve the guarantee of due process in criminal cases through an arrest warrant or summons.¹¹⁴ Even if the defendant could waive service of process, it is not likely that he would. Not only is this option unfair to the defendants, who are entitled to due process of law, but it provides the defendants no incentive to waive service.

failing to establish an address here." *Id.* at *6 (quoting *United States v. Dotcom*, No. 1:12-cr-3, 2012 WL 4788433, at *1 (E.D. Va. Oct. 5, 2012)).

¹¹¹ *Id.* at *23.

¹¹² Mem. of Law in Support of Mot. of Specially Appearing Def. Megaupload Ltd. to Dismiss Indictment for Lack of Personal Jurisdiction at 7 n.3, *United States v. Dotcom*, No. 1:12-cr-3, 2012 WL 4788433 (E.D. Va. Oct. 5, 2012) (No. 115), 2012 WL 2885911.

¹¹³ FED. R. CIV. P. 4(d)(1).

¹¹⁴ FED. R. CRIM. P. 4(a).

2. Service on Agents: Alter-Ego Doctrine or Piercing the Corporate Veil

Rule 4(h)(1) of the Federal Rules of Civil Procedure allows a “managing agent” of the corporation to receive service.¹¹⁵ However, in some cases,

a court may disregard a corporate entity and pierce the veil of limited liability where the corporation is merely the alter ego or business conduit of another person or entity. This doctrine fastens liability on the individual or entity that uses a corporation merely as an instrumentality to conduct that person’s or entity’s business.¹¹⁶

Although originally a state law concept, courts have tried to apply this so-called alter-ego doctrine to federal common law.¹¹⁷ The court in *Automotriz Del Golfo de Cal. S.A. v. Resnick* applied a two-part test in determining whether there was a nexus sufficient to conclude that a corporation was merely an “alter-ego” of another person or entity.¹¹⁸ The court considered the (1) “unity of interest and ownership” and (2) inequity involved in a particular case.¹¹⁹ Generally, “the first prong may be satisfied by a showing of domination and control of the corporation, which occurs most often in the context of a parent–subsidiary relationship.”¹²⁰ Some federal courts have modified the first prong to “reflect the type and degree of control over a corporate defendant required by the policy of the applicable federal statute.”¹²¹ The degree of control a court might require depends on the remedy sought.¹²² Some courts have also adapted the second prong to “mean the use of the corporate form to violate or evade federal law.”¹²³ In such cases, courts must determine whether a corporation or subsidiary was created for a “legitimate business purpose or primarily for evasion of federal policy or statute.”¹²⁴

¹¹⁵ *Bridgeport Music, Inc. v. Rhyme Syndicate Music*, 376 F.3d 615, 623 (6th Cir. 2004) (“A managing agent is one authorized to transact all business of a particular kind at a particular place and must be vested with powers of discretion rather than being under direct superior control.”).

¹¹⁶ *Peetoom v. Swanson*, 334 Ill. App. 3d 523, 527 (Ill. App. Ct. 2002) (internal citations omitted).

¹¹⁷ *Piercing the Corporate Law Veil: The Alter Ego Doctrine Under Federal Common Law*, 95 HARV. L. REV. 853, 866 (1982) [hereinafter *Alter Ego*].

¹¹⁸ *Automotriz Del Golfo de Cal. S.A. v. Resnick*, 306 P.2d 1, 3 (Cal. 1957).

¹¹⁹ *Id.*

¹²⁰ *Alter Ego*, *supra* note 117, at 854.

¹²¹ *Id.* at 866.

¹²² *Id.* at 867. A court may be less likely to pierce a veil when monetary damages are sought, but more likely in cases “when a cease-and-desist order has already issued against a corporation.” *Id.* at 866.

¹²³ *Id.*

¹²⁴ *Id.*

The Federal Rules of Criminal Procedure do not explicitly provide for this alternative to service of process.¹²⁵ The court in *United States v. Public Warehousing Co.* interpreted this omission alongside the spirit of Rule 2 of the Federal Rules of Criminal Procedure¹²⁶ to find that service was proper when the government effectuated service on the president of the defendant parent corporation's subsidiary within the United States.¹²⁷ However, the mailing requirement problem persists in cases where the foreign parent corporation does not have a subsidiary within the United States. For example, in *United States v. Dotcom*, Megaupload does not have a subsidiary located in the United States, so the government would not be able to pierce the corporate veil to reach the foreign corporation. It is possible that the government could argue that Dotcom is the alter ego of Megaupload and potentially serve him upon his entry into the United States. However, as Dotcom's extradition proceedings continue to be delayed in New Zealand, it is uncertain whether Dotcom will ever be held responsible for his criminal acts.¹²⁸ Moreover, because Dotcom is not the sole executive of Megaupload, the government would need to establish "unity of interest and ownership."¹²⁹

3. Letters Rogatory, Mutual Legal Assistance Treaties (MLATs), and Memoranda of Understanding (MOUs)

The Federal Rules of Civil Procedure explicitly allow for service "by any internationally agreed means of service that is reasonably calculated to give notice, such as those authorized by the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents."¹³⁰ One such means is a letter rogatory.¹³¹ A letter rogatory is a "medium, in effect, whereby one country, speaking through one of its courts, requests another country, acting through its own courts and by methods of court procedure peculiar

¹²⁵ See FED. R. CRIM. P. 4.

¹²⁶ Rule 2 of the Federal Rules of Criminal Procedure provides that the "rules are to be interpreted to provide for the just determination of every criminal proceeding, to secure simplicity in procedure and fairness in administration, and to eliminate unjustifiable expense and delay." FED. R. CRIM. P. 2.

¹²⁷ *United States v. Pub. Warehousing Co.*, No. 1:09-CR-490-TWT, 2011 WL 1126333 (N.D. Ga. Mar. 28, 2011).

¹²⁸ Extradition procedures, first delayed to March 25, 2013, are now being delayed further to August 2013, with a possibility for further delay if the Supreme Court of New Zealand decides to hear Dotcom's appeal. See Nick Perry, *Indicted Megaupload founder Kim Dotcom plans website reboot while fighting extradition*, YAHOO.COM (Oct. 11, 2012), <http://news.yahoo.com/indicted-megaupload-founder-kim-dotcom-plans-website-reboot-062016159.html>; *U.S. Government Wins Appeal in Kim Dotcom Extradition Battle*, TORRENTFREAK (Mar. 1, 2013), <http://torrentfreak.com/u-s-government-wins-appeal-in-kim-dotcom-extradition-battle-120301/>.

¹²⁹ *Automotriz Del Golfo de Cal. S.A. v. Resnick*, 306 P.2d 1, 3 (Cal. 1957).

¹³⁰ FED. R. CIV. P. 4(f)(1).

¹³¹ The letter rogatory is codified in 28 U.S.C. § 1781.

thereto and entirely within the latter's control, to assist the administration of justice in the former country."¹³² Letters rogatory may be used for "providing notice, serving summons, locating individuals, [and] examining both voluntary and involuntary witnesses."¹³³ Because letters rogatory allow foreign countries to use their own judicial officers to effectuate service, foreign governments may be more willing to comply than with other measures of effectuating personal service abroad.¹³⁴

An MLAT is another potential internationally agreed-upon means of service. MLATs "impose a treaty obligation on [each party's] law enforcement to assist . . . prosecutors and to provide representatives on their behalf in local courts."¹³⁵ MLATs merely supplement existing international agreements and are designed to provide a direct link between the law enforcement agencies of different countries.¹³⁶ Thus, they can be more effective than letters rogatory, which must often travel through numerous bureaucratic channels.¹³⁷ Although courts may not use them directly because MLATs are in the "province of the executive branch,"¹³⁸ they are available for use by prosecutors.¹³⁹

Finally, an MOU is a bilateral agreement that can expressly provide for mutual assistance in such matters as investigations of copyright infringement violations.¹⁴⁰ MOUs are generally not legally binding in courts, but like MLATs, are binding on a political level in the realm of internation-

¹³² *The Signe*, 37 F. Supp. 819, 820 (E.D. La. 1941).

¹³³ Bruce Zagaris & Jessica Resnick, *The Mexico–U.S. Mutual Legal Assistance in Criminal Matters Treaty: Another Step Toward the Harmonization of International Law Enforcement*, 14 ARIZ. J. INT'L & COMP. L. 1, 8 (1997).

¹³⁴ Harry Leroy Jones, *International Judicial Assistance: Procedural Chaos and a Program for Reform*, 62 YALE L.J. 515, 537 (1953).

¹³⁵ Robert Neale Lyman, *Compulsory Process in a Globalized Era: Defendant Access to Mutual Legal Assistance Treaties*, 276 VA. J. INT'L L. 261, 276 (2006). As of 2012, the United States has fifty-six MLATs in force with the following countries: Antigua & Barbuda, Argentina, Australia, Austria, the Bahamas, Barbados, Belgium, Belize, Brazil, Canada, Cyprus, the Czech Republic, Dominica, Egypt, Estonia, France, Germany, Greece, Grenada, Hong Kong, Hungary, India, Ireland, Israel, Italy, Jamaica, Japan, Latvia, Lichtenstein, Lithuania, Luxembourg, Malaysia, Mexico, Morocco, the Netherlands, Nigeria, Panama, the Philippines, Poland, Romania, Russia, St. Lucia, St. Kitts & Nevis, St. Vincent & the Grenadines, South Africa, South Korea, Spain, Sweden, Switzerland, Thailand, Trinidad & Tobago, Turkey, Ukraine, the United Kingdom (including the Isle of Man, Cayman Islands, Anguilla, British Virgin Islands, Montserrat and Turks, and Caicos), Uruguay, and Venezuela. *2012 International Narcotics Control Strategy Report: Treaties and Agreements*, U.S. DEP'T OF STATE (Mar. 7, 2012), <http://www.state.gov/j/inl/rls/nrcrpt/2012/vol2/184110.htm>.

¹³⁶ Bruce Zagaris, *Developments in International Judicial Assistance and Related Matters*, 18 DENV. J. INT'L L. & POL'Y 339, 352 (1990).

¹³⁷ *Id.*

¹³⁸ Lyman, *supra* note 135, at 276. "[U]ltimately, MLATs are intended to facilitate law enforcement cooperation, not to expand the power of courts." *Id.*

¹³⁹ *Id.* at 282.

¹⁴⁰ Pamela Jimenez, *International Securities Enforcement Cooperation Act and Memoranda of Understanding*, 31 HARV. INT'L L. J. 295, 298 (1990).

al relations.¹⁴¹ They are advantageous because they “promote international cooperation by providing a mutually acceptable method” for exchanging information.¹⁴² MOUs also allow for the (1) detailed creation of procedures in specific areas of interest, (2) establishment of timetables in handling requests for information, and (3) cooperation of two countries without the need for formal ratification procedures.¹⁴³

Rule 4 of the Federal Rules of Criminal Procedure does not explicitly authorize overseas service by international agreement.¹⁴⁴ However, as with piercing the corporate veil, if viewed in the spirit of Rule 2 of the Federal Rules of Criminal Procedure, international agreements such as letters rogatory, MLATs, and MOUs may facilitate service in foreign countries in criminal cases. Nevertheless, these methods also have their drawbacks.

The use of letters rogatory can be restrictive. First, the process of sending a letter rogatory is slow.¹⁴⁵ Therefore, the execution of the request may not be completed within the timeline of a trial. Second, “execution of letters [of] rogatory by the foreign government is entirely a matter of comity.”¹⁴⁶ Thus, there is no guarantee that a foreign government will execute it, especially if the foreign government is sympathetic to the criminal.¹⁴⁷ Third, although in the United States, “assistance in response to letters rogatory is unlimited,”¹⁴⁸ a “foreign country can only honor requests which fall within its court’s procedures and control.”¹⁴⁹ In other words, the foreign court must have the power to execute the act that the United States wants the foreign court to perform.¹⁵⁰ As a result, there are few, if any, cases where service has been effected through letters rogatory.¹⁵¹

MLATs may provide a more direct means of interacting with foreign governments, but similar timeliness and legal jurisdiction problems still

¹⁴¹ William Thomas Worster, *Between a Treaty and Not: A Case Study of the Legal Value of Diplomatic Assurances in Expulsion Cases*, 21 MINN. J. INT’L L. 253, 289 (2012).

¹⁴² Jimenez, *supra* note 140, at 311.

¹⁴³ Harvey L. Pitt, David B. Hardison & Karen L. Shapiro, *Problems of Enforcement in the Multi-national Securities Market*, 9 U. PA. J. INT’L BUS. L. 374, 435 (1987) (quoting S. REP. NO. 461, 100TH CONG. 2 (1988)).

¹⁴⁴ See Rebuttal Mem. of Law in Further Support of Mot. of Specially Appearing Def. Megaupload Ltd. to Dismiss Indictment for Lack of Personal Jurisdiction at 17-18, *United States v. Dotcom*, No. 1:12-cr-3, 2012 WL 4788433 (E.D. Va. Oct. 5, 2012) (No. 118), 2012 WL 3070963 [hereinafter Rebuttal in Supp.].

¹⁴⁵ Lyman, *supra* note 135, at 273.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ Mark K. Gyandoh, *Foreign Evidence Gathering: What Obstacles Stand in the Way of Justice?*, 15 TEMP. INT’L & COMP. L.J. 81, 86 (2001).

¹⁵⁰ *Id.*

¹⁵¹ See, e.g., *Sayles v. Pac. Eng’g & Constructors, Ltd.*, No. 08-CV-676S, 2009 WL 791332, at *3-4 (W.D.N.Y. 2009) (granting plaintiff’s motion for the issuance of a letter rogatory, only to have the Taiwanese defendants agree to waive service of process defenses).

exist. In *DeJames v. Magnificence Carriers, Inc.*, the court held service to be invalid when the service was effectuated in a manner inconsistent with the Federal Rules but through an international treaty.¹⁵² The court stated,

[T]he purpose and nature of the treaty demonstrates that it does not provide independent authorization for service of process in a foreign country. The treaty merely provides a mechanism by which a plaintiff authorized to serve process under the laws of its country can effect service that will give appropriate notice to the party being served and will not be objectionable to the country in which that party is served.¹⁵³

Thus, service through MLATs must be effectuated in a manner consistent with both American procedural rules and the foreign country's procedural rules. Although courts may have suggested through dicta the possibility of using MLATs as a solution to the service requirement problem, courts have never held that service of summons through an MLAT treaty satisfies the Rule 4 mailing requirement.¹⁵⁴ In fact, in *United States v. Pangang Group Co.*, the court recognized that an MLAT may not even be a viable alternative to service of process on a foreign corporation.¹⁵⁵

The terms of the MLAT between the United States and Hong Kong in *United States v. Dotcom* seem to reinforce the inapplicability of MLATs in such cases. The MLAT provides in relevant part that "[t]he Requested Party may affect service of any document by mail or, if the Requesting Party so requests, in any other manner required by the law of the Requesting Party that is not prohibited by the law of the Requested Party."¹⁵⁶ In other words, the United States would be limited to the procedural rules of the foreign country, which are often insufficient to fulfill the requirements of American procedural rules.¹⁵⁷ Furthermore, the defendants in *Dotcom* insisted that the MLAT between the United States and Hong Kong did not purport to expand the personal jurisdiction of the courts of this country or otherwise alter the express terms of the Federal Rules.¹⁵⁸ It is merely a mechanism to serve documents extraterritorially *where U.S. law already*

¹⁵² See *DeJames v. Magnificence Carriers, Inc.*, 654 F.2d 280, 287–290 (3d Cir. 1981).

¹⁵³ *Id.* at 288.

¹⁵⁴ Rebuttal in Supp., *supra* note 145, at 3.

¹⁵⁵ *United States v. Pangang Grp. Co.*, 879 F. Supp. 2d 1052, 1066 (N.D. Cal. 2012).

¹⁵⁶ Mutual Legal Assistance Treaty, U.S.–H.K., art. 15(3), 1997, U.S.T. LEXIS 115.

¹⁵⁷ See, e.g., Harry Leroy Jones, *International Judicial Assistance: Procedural Chaos and a Program for Reform*, 62 *YALE L.J.* 515, 537 (1953) (explaining that foreign process servers may be reluctant to swear an oath in regards to the service of process procedure, and because American procedural rules require the verification of proof of service, such unverified foreign service may be deemed insufficient by some American courts).

¹⁵⁸ [Proposed] Supp. Mem. of Law in Further Support of Mot. of Specially Appearing Def. Megaupload Ltd. to Dismiss Indictment for Lack of Personal Jurisdiction, *United States v. Dotcom*, No. 1:12-cr-3, 2012 WL 478843 (E.D. Va. Oct. 5, 2012) (No. 120-1), 2012 WL 4788433 [hereinafter Supp. Mem. for Mot.].

*authorizes extraterritorial service.*¹⁵⁹ Thus, if U.S. law does not permit extraterritorial service, as is true of Rule 4(c)(3)(C) of the Federal Rules of Criminal Procedure, the MLAT does not apply.¹⁶⁰

Finally, regardless of how beneficial MOUs may be for international diplomacy, they are essentially aspirational agreements. Thus, it is difficult to predict whether a nation will practically fulfill its obligations after agreeing to an MOU.¹⁶¹ This problem can be especially evident when the institutional structures and political attitudes of foreign nations with regard to intellectual property crime are not necessarily consistent with those of the United States, which has stricter rules than most foreign nations.¹⁶² For example, provided with “a chance for improved trade relations between China and the U.S.,”¹⁶³ China agreed to a 1995 MOU with the United States by which the parties agreed to take action to crack down on Chinese violations of intellectual property rights.¹⁶⁴ However, because of fundamental cultural differences, attitudes towards copyright infringement in China are more relaxed than in the United States.¹⁶⁵ Furthermore, because of nondeterrent sanctions, inefficient enforcement of copyright rules, and an ineffective judiciary, the task of cracking down on copyright infringement is still difficult in China.¹⁶⁶

Even assuming that letters rogatory, MLATs, and MOUs are viable options for service in the foreign country in criminal cases,¹⁶⁷ the mailing requirement problem persists because letters rogatory and MOUs do not supersede domestic laws. As described above, letters rogatory and MOUs must operate through the already-existing procedural rules of each country. In the United States, then, fulfilling the mailing requirement through inter-

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 3.

¹⁶¹ William Thomas Worster, *Between a Treaty and Not: A Case Study of the Legal Value of Diplomatic Assurances in Expulsion Cases*, 21 MINN. J. INT'L L. 253, 289 (2012).

¹⁶² See Geoffrey T. Willard, *The Protection of Computer Software in the People's Republic of China: Current Law & Case Developments in the "One-Copy" Country*, 14 J. MARSHALL J. COMPUTER & INFO. L. 695, 712–16 (1996).

¹⁶³ *The 1995 Agreement Regarding Intellectual Property Rights Between China and the United States: Promises for International Law or Continuing Problems with Chinese Piracy?*, 4 TULSA J. COMP. & INT'L L. 169, 177 (1996) [hereinafter *Agreement*].

¹⁶⁴ *Id.* at 173. As part of this agreement, China enacted new regulations which would allow Chinese trademark officials not only to protect trademarks by Chinese people, but those of foreigners, as well. *Id.* at 174.

¹⁶⁵ Glenn R. Butterson, *Pirates, Dragons and U.S. Intellectual Property Rights in China: Problems and Prospects of Chinese Enforcement*, 38 ARIZ. L. REV. 1081, 1107–08 (1996).

¹⁶⁶ *Agreement*, *supra* note 164, at 173.

¹⁶⁷ The MLATs between the United States and foreign countries obligate the requested state to serve a subpoena, but some MLATs do not require the requested state to serve a subpoena. Bruce Zagaris & Jessica Resnick, *The Mexico–U.S. Mutual Legal Assistance in Criminal Matters Treaty: Another Step Toward the Harmonization of International Law Enforcement*, 14 ARIZ. J. INT'L & COMP. L. 1, 51–52 (1997).

national agreements is not even available for criminal cases because Rule 4(c)(3)(C) requires that a copy of the summons must be mailed to a corporation's last known address in the United States. Moreover, Rule 4 of the Federal Rules of Criminal Procedure, a federal law, can override an MLAT if Rule 4 is later in time.¹⁶⁸ If a treaty and a rule cannot be reconciled, courts observe the long-standing principle that whichever was enacted later in time is deemed controlling.¹⁶⁹ Because Rule 4 of the Federal Rules of Criminal Procedure was last amended in 2011, and the last amendment to the specific provision of Rule 4(c)(3)(C) occurred in 2002, Rule 4 of the Federal Rules of Criminal Procedure would likely supersede most MLATs, including the one in *United States v. Dotcom*.

B. *Implications*

Obviously, U.S. courts cannot simply ignore the customs of international diplomacy regarding service of process in foreign nations at the risk of blatantly impinging on the territorial autonomy of foreign nations. Neither can courts completely disregard the mailing requirement provided in Rule 4(c)(3)(C), thereby potentially suggesting that courts may simply set aside inconvenient procedures and regulations enacted by Congress.¹⁷⁰ Yet, to interpret Rule 4(c)(3)(C) as making service of process impossible by requiring that a copy of the summons be mailed to the defendant at a U.S. address, without alternatives, would produce unintended consequences. A strict interpretation of the rule would allow online companies such as Megaupload to elude prosecution for online piracy in the United States by merely avoiding the establishment of a U.S. address at which it can be served with a copy of the summons. Although a corporation once required a physical presence in a country to conduct business with the people of that country, with the advent of the Internet, a corporation can now "transact business world-wide in a matter of minutes"¹⁷¹ without ever stepping into the territorial boundaries of that country. The resulting policy would frustrate the enforcement of criminal copyright laws, tying the hands of the government as foreign corporations freely facilitate the infringement of

¹⁶⁸ Supp. Mem. for Mot., *supra* note 159, at 1–2. See 28 U.S.C. § 2072 ("All laws in conflict with [U.S. procedural] rules shall be of no further force or effect after such rules have taken effect."); *Whitney v. Robertson*, 124 U.S. 190, 194 (1888) ("By the constitution, a treaty is placed on the same footing, and made of like obligation, with an act of legislation.").

¹⁶⁹ See *Cook v. United States*, 288 U.S. 102, 119 (1933); *Whitney*, 124 U.S. at 194; *Vorhees v. Fischer & Krecke*, 697 F.2d 574, 575–76 (4th Cir. 1983); see also 28 U.S.C. § 2072(b) (2006) (explaining laws in conflict with changed law are of no further force).

¹⁷⁰ See Rebuttal in Supp., *supra* note 145, at 2.

¹⁷¹ Laura H. Bak–Boychuk. *Internet Gambling: Is Avoiding Prosecution in the United States as Easy as Moving the Business Operations Offshore?*, 6 SW. J.L. & TRADE AM. 363, 364 (1999).

movie, music, and other industries' copyrighted works.¹⁷² The United States alone is already losing billions of dollars to copyright infringement, and the losses are growing exponentially.¹⁷³ Allowing foreign corporations to implement copyright infringement from outside the United States without the prospect of effective criminal sanctions would only aggravate the growing problem.

The United States needs more than mere defensive mechanisms of controlling copyright infringement through online activity. The United States government could potentially control copyright infringement by blocking certain websites and, thus, affecting the flow of visitors to websites that are likely conducting illegal activities.¹⁷⁴ Alternatively, the government could require foreign corporations to waive service requirements in criminal prosecution or agree to alternative means of service in order to operate within the United States and service American users.

However, not only is the notion of government censoring of websites reminiscent of a tragic infringement of the American spirit of citizens' rights and liberty, but the costs of monitoring all websites created that could potentially be participating in copyright infringement are simply too high.¹⁷⁵ Moreover, a corporation could easily launch a new website, as they often do, if a prior one is shut down or blocked by the government. For example, Dotcom could easily create, and in fact, already has created, a new file-sharing website and continue his infringing practices in the United States if he is not prosecuted due to the government's inability to satisfy the delivery and mailing requirements.¹⁷⁶ In addition, as described above, many of these file-sharing websites have legitimate uses as well as potentially infringing ones. It would be immensely difficult to filter out only the illegal uses, thereby balancing the benefits of continued creativity and international exchange, and the risk of copyright infringement practices. Thus, the United States requires a proactive method of prosecuting foreign criminals who affect American users in order to safeguard the economy and those incentives for creativity that copyright infringement destroys.

¹⁷² Opp'n of Mot. to Dismiss, *supra* note 2, at 7.

¹⁷³ 154 CONG. REC. E2141-01 (Sept. 28, 2008).

¹⁷⁴ Laura H. Bak-Boychuk, *supra* note 172, at 371.

¹⁷⁵ *Id.* at 371-72.

¹⁷⁶ See, Lanier Saperstein, Comment, *Copyrights, Criminal Sanctions and Economic Rents: Applying the Rent Seeking Model to the Criminal Law Formulation Process*, 87 J. CRIM. L. & CRIMINOLOGY 1470, 1587 (1997). On January 19, 2013, Dotcom launched Mega, his new cloud storage website. In the early stages following the launch, the website was reported to have crashed because of the sheer volume of uploads on the website. *Kim Dotcom's Mega fileshare site struggles under massive demand*, CBS NEWS (Jan. 22, 2013, 10:45 AM), http://www.cbsnews.com/8301-205_162-57565135/kim-dotcoms-mega-fileshare-site-struggles-under-massive-demand/. In fact, Dotcom garners the support of many users of file-sharing sites such as Megaupload.com and has become somewhat of a cult hero. See Jonathan Hutchison, *Mogul Goes from Shady to Admired*, N.Y. TIMES, July 4, 2012, at B1.

Perhaps, then, it is time for Congress to provide criminal procedure with a means to catch up with criminal innovations. These innovations in cyberspace are pushing criminal activities beyond the traditional boundaries of criminal activity. The drafters of Rule 4 likely did not anticipate such advancement of online criminal activities. Nevertheless, Rule 2 of the Federal Rules of Criminal Procedure provides that the “rules are to be interpreted to provide for the just determination of every criminal proceeding, to secure simplicity in procedure and fairness in administration, and to eliminate unjustifiable expense and delay.”¹⁷⁷ Thus,

[the Rules] are merely the means and the instruments by which the purpose of the administration of justice is achieved. The safeguards that surround a defendant are not intended to constitute obstacles and hurdles against conviction of the guilty, but are designed to prevent the possible conviction of an innocent person, or a person whose guilt has not been satisfactorily established beyond a reasonable doubt.¹⁷⁸

Surely, legislators did not intend the procedural rules to be an obstacle to prosecuting foreign corporations that commit criminal acts within the United States over the Internet without a physical U.S. address.

Regardless of the current effectiveness of such mechanisms as letters rogatory, MLATs, and MOUs (and perhaps they will become more effective with use), as it stands, Rule 4(c)(3)(C) closes off even the *possibility* of using those avenues to effectuate service in the future. Criminalizing copyright infringement requires the ability to enforce criminal sanctions through the courts. Criminal sanctions work to deter criminal copyright infringement that civil remedies alone are insufficient to prevent.¹⁷⁹ In fact, corporations might regard civil damages as merely another calculable cost of business.¹⁸⁰ The ability to prosecute criminal copyright infringers provides the additional protection of incarceration of guilty individuals, preventing them from quickly reentering the market to continue infringing activities as offenders like Dotcom intend to do. Without the ability to enforce criminal sanctions, the effect of the criminalization of offenses would be severely debilitated. Government protestations against copyright infringement by foreign corporations like Megaupload would be all bark and no bite. So long as the government remains unable to reach serious criminal copyright infringers and enforce criminal sanctions for their offenses because of a technical deficiency, the United States will be signaling to foreign copy-

¹⁷⁷ FED. R. CRIM. P. 2.

¹⁷⁸ *United States v. Mihalopoulos*, 228 F. Supp. 994, 1012 (D.D.C. 1964); *see also* *United States v. Young*, 14 F.R.D. 406, 407 (D.D.C. 1953) (“One of the purposes of the new rules was to abrogate the technicalities which all too often had led to dismissal of indictments and to reversals of convictions on grounds that had no connection with the guilt or innocence of the defendant.”).

¹⁷⁹ Saperstein, *supra* note 176, at 1507.

¹⁸⁰ *Id.*

right infringers that they may continue their infringing activities from outside the United States without repercussions from its courts.

Thus, to facilitate those criminal proceedings and sanctions that are already available, perhaps Congress should adopt a means of enforcement, such as those delineated in the Federal Rules of Civil Procedure, to the ever-advancing world of criminal behavior. After all, the question in the relevant pending cases is not necessarily of jurisdiction, but whether the service requirements, specifically the mailing requirement, can be effectuated. The United States can already establish jurisdiction in most cases where there are minimum contacts with the forum state.¹⁸¹ This “effects doctrine,” provides that

a foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case . . . in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that causes a direct effect in the United States.¹⁸²

What bars the prosecution of known criminal copyright infringers such as Dotcom is the seemingly administrative matter of serving the corporation with a copy of the summons.

Therefore, perhaps the Legislature should explicitly provide for the effectuation of service through internationally agreed means of service or the alter-ego doctrine as it does in the Federal Rules of Civil Procedure. This would alleviate the effect of the strict “in the United States” language of the mailing requirement in Rule 4(c)(3)(C) of the Federal Rules of Criminal Procedure. Of course, removing the “in the United States” language completely would provide another solution. This way, it might at least be possible to surpass the administrative hurdle of sending a copy of the summons where the United States already has jurisdiction over the defendant. Because these methods of using letters rogatory, MLATs, and MOUs are already available in the civil context, it would not be a much further step to extend them to the criminal context. After all, even the civil means require an agreement between countries, so the change would not be attempting to impose any further obligations on foreign countries that they would not agree to impose on themselves.

These changes would merely open doors to facilitate the prosecution of a growing international problem that already causes vast economic losses all over the world.¹⁸³ The alternative means of service may not provide a practically easy solution in each case, but the current “in the United States”

¹⁸¹ See *supra* Part I.C.1.

¹⁸² Laura H. Bak-Boychuk, *supra* note 172, at 372 (quoting 18 U.S.C. § 1605 (2006)).

¹⁸³ For example, in 1995 alone, China experienced losses of at least \$1.8 billion due to online piracy. Butterton, *supra* note 165, at 1093.

language precludes all possible alternatives. Thus, although it is not a full solution, modifying the text of Rule 4(c)(3)(C) would act to combat criminal opportunism abroad and promote international cooperation against copyright infringement.

CONCLUSION

In an era in which individuals can be connected instantaneously and simultaneously with millions of other individuals around the world, the implications of even this seemingly minor loophole in the Federal Rules of Criminal Procedure can be devastating. The drafters of the Federal Rules of Criminal Procedure may not have anticipated such innovation in the criminal sphere through the use of cyberspace, but especially in recent years, the effects have been catastrophic. In the face of international criminal copyright infringement, policymakers must open new avenues to prevent administrative requirements from becoming insurmountable hurdles to criminal prosecution. As it currently stands, Rule 4(c)(3)(C) acts as an administrative obstacle that may prevent obtaining justice against criminal corporations and their executives. Criminal copyright infringement has already cost the United States economy billions of dollars and promises only to further devastate music and entertainment industries worldwide.

CALLING FROM PRISON: ECONOMIC DETERMINANTS OF INMATE PAYPHONE RATES

*Maxwell Slackman**

INTRODUCTION

Prior to August 9, 2013, Winston Holloway could only make two or three phone calls per month.¹ Each fifteen-minute collect call cost his family \$10.70.² In contrast, Natalie Bolds pays \$3.50 for each fifteen-minute collect call to her fiancé.³ Holloway is an inmate in an Arkansas state prison, while Bolds's fiancé resides in a California state prison. The difference in phone rates results from the unique pricing policies in state and federal prison payphone services.

Security concerns inherent in penal facilities necessitate reliance on expensive call monitoring and blocking systems, differentiating inmate payphone systems from standard public carriers.⁴ In addition, several states require monetary commissions from telephone providers.⁵ Site commissions are payments from the service provider back to the state, usually a set percentage of the provider's revenues from the facilities.⁶ Before the Federal Communications Commission ("FCC") intervened, the costs of providing commissions to states were incorporated into consumer pricing, resulting in higher costs for recipients of collect calls made from prison.⁷

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¹ Peter R. Shults, *Calling the Supreme Court: Prisoners' Constitutional Right to Telephone Use*, 92 B.U. L. REV. 369, 369 (2012).

² Brief of Appellant at 4–5, *Holloway v. Magness*, 666 F.3d 1076 (8th Cir. 2012) (No. 11-1455), 2011 WL 1554810.

³ Letter from Natalie Bolds, to Marlene H. Dortch, Sec'y, FCC, CC Docket No. 96-128 at 1 (Filed June 3, 2009).

⁴ *In re* Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, 17 F.C.C.R. 3248, 3252 (Feb. 21, 2002) [hereinafter 2002 Order and NPRM] (“[I]nmate calling services, largely for security reasons, are quite different from the public payphone services that non-incarcerated individuals use.”).

⁵ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-893, BUREAU OF PRISONS: IMPROVED EVALUATIONS AND INCREASED COORDINATION COULD IMPROVE CELL PHONE DETECTION 13 n.a (2011) [hereinafter GAO Report].

⁶ Paul R. Zimmerman & Susan M.V. Flaherty, *Location Monopolies and Prison Phone Rates*, 47 Q. REV. OF ECON. & FIN. 261, 262 (2007).

⁷ Justin Carver, *An Efficiency Analysis of Contracts for the Provision of Telephone Services to Prisons*, 54 FED. COMM. L. J. 391, 398 (2002) (written prior to the FCC intervention and noting that

Many inmates believe that these commissions and resulting prices were unreasonable, unjust, and violated their First Amendment rights.⁸ However, the Supreme Court granted deference to correctional institutions due to the expertise, planning, and commitment of resources required to administer these facilities.⁹

Prison payphones arguably represent the purest form of state-controlled “captive customer”¹⁰ markets. Inmates claim that exorbitant state commissions unduly increase prices, tax the poorest segments of the population, and reduce inmate connection with the outside world, resulting in higher incidence of recidivism.¹¹ In contrast, state governments and telecommunications companies contend that monetary commissions support the prison infrastructure and reduce recidivism by providing better facilities, education, and reintegration assistance.¹²

On August 9, 2013, the FCC passed an order that sets maximum rates at \$0.21 per minute for calls placed using a debit system and \$0.25 per minute for collect calls.¹³ By greatly reducing these per minute rates, this order promises to make prisoner calling more affordable and, through this, to reduce recidivism.

However, this article argues that the FCC, via the powers granted to it through the Telecommunications Act of 1996,¹⁴ should revisit its ruling and instead mandate a tiered pricing system for inmate payphone rates based on facility size and commission payouts. While the current order takes needed steps to limit rates and increase inmate communication with the outside world, these rate caps¹⁵ do not reflect operation costs and may discourage

most “admit that the kickbacks they receive from the service provider do increase the cost of the calls for the consumer”).

⁸ *Holloway v. Magness*, 666 F.3d 1076, 1078 (8th Cir. 2012), *cert. denied*, 133 S. Ct. 130 (U.S. 2012).

⁹ *Turner v. Safely*, 482 U.S. 78, 84–85 (1987).

¹⁰ A captive customer is reluctant or unable to “substitute one product or vendor with another, because of the high cost (in terms of discomfort, effort, and/or money) involved in switching.” *Captive Customer Definition*, BUSINESSDICTIONARY.COM, <http://www.businessdictionary.com/definition/captive-customer.html> (last visited Jan. 12, 2013).

¹¹ DREW KUKOROWSKI, PRISON POLICY INITIATIVE, *THE PRICE TO CALL HOME: STATE-SANCTIONED MONOPOLIZATION IN THE PRISON PHONE INDUSTRY 1–2* (2012), *available at* <http://www.prisonpolicy.org/phones/report.html>.

¹² Letter from Cherie R. Kiser, Counsel to Global Tel*Link Corp., to Marlene H. Dortch, Sec’y, FCC, CC Docket No. 96-128, attach.1, at 8 (filed on Oct. 3, 2012) [hereinafter *Global Tel*Link Oct. 3 Ex Parte Letter*].

¹³ Press Release, FCC, *FCC Bars High Rates for Long Distance Phone Calls in Jails and Prisons Nationwide* (Aug. 9, 2013) [hereinafter *FCC Press Release*] *available at* http://transition.fcc.gov/Daily_Releases/Daily_Business/2013/db0809/DOC-322749A1.pdf.

¹⁴ *Verizon Commc’ns Inc. v. Trinko*, 540 U.S. 398, 405–07 (2004).

¹⁵ The term “price cap” is colloquial for “price ceiling,” a “legally established maximum price that sellers may charge.” HENRY N. BUTLER & CHRISTOPHER R. DRAHOZAL, *ECONOMIC ANALYSIS FOR LAWYERS* 513 (2d ed. 2006). The FCC and inmate payphone stakeholders use the term “cap” when

service provision to small, high-cost facilities. Low rate caps may also disincentivize heightened security precautions and create large administrative burdens on the FCC as facilities individually petition for cost-based relief from the caps. The FCC must review its single rate caps in light of the various economic and legal arguments for and against the current system.

Part I of this Comment will investigate and analyze the technical, economic, and social background of inmate payphones and facility commissions. Part II of this Comment will analyze the FCC's power to regulate payphone rates and corresponding state commissions under 47 U.S.C. § 201(b) and caselaw. Court precedent and the Telecommunications Act of 1996 empower the FCC to directly regulate commissions or set benchmark price caps on consumer rates.¹⁶ Finally, Part III will analyze the FCC's price cap order and investigate the most effective regulatory policy that incentivizes efficient pricing and proper use of potential percentage commissions.

I. BACKGROUND

The United States prison population has rapidly increased in the last thirty years, expanding from 320,000 inmates in 1980 to 2.27 million in 2010.¹⁷ This expansion necessitated larger investments in the country's penal infrastructure.¹⁸ Today, the United States invests more than \$60 billion per year in state and federal penal systems and operates more than 5,000 adult prisons and jails.¹⁹ These investments also expanded the market for prison services.²⁰ The prison telephone industry benefited from these investments and has grown into a \$1.2 billion industry.²¹ As the prison telephone industry matured, its effects on inmate recidivism expanded.

describing possible price ceilings of inmate payphone rates. This article follows the industry standard and uses "price cap" in place of "price ceiling."

¹⁶ *Trinko*, 540 U.S. at 406–07.

¹⁷ Steven J. Jackson, *Ex-Communication: Competition and Collusion in the U.S. Prison Telephone Industry*, 22 *CRITICAL STUD. IN MEDIA COMM.* 263, 266 (2005); LAUREN E. GLAZE, BUREAU OF JUSTICE STATISTICS, *CORRECTIONAL POPULATION IN THE UNITED STATES*, 2011, 8 (2012), <http://bjs.ojp.usdoj.gov/content/pub/pdf/cpus11.pdf>.

¹⁸ Carver, *supra* note 7, at 392.

¹⁹ JOHN J. GIBBONS & NICHOLAS DE B. KATZENBACH, *CONFRONTING CONFINEMENT, A REPORT OF THE COMMISSION ON SAFETY AND ABUSE IN AMERICA'S PRISONS* 11 (2006), available at http://www.vera.org/download?file=2845/Confronting_Confinement.pdf. This data combines both federal and state penal systems.

²⁰ Carver, *supra* note 7, at 392.

²¹ Todd Shields, *Prison Phones Prove Captive Market for Private Equity*, BLOOMBERG (Oct. 4, 2012), available at <http://www.bloomberg.com/news/2012-10-04/prison-phones-prove-captive-market-for-private-equity.html>.

A. *Inmate Recidivism and the Phone*

Inmate access to payphones plays an important role in reducing recidivism. Regular communication between inmates and their families reduces recidivism and facilitates a successful transition back into society.²² Regular communications also benefit the 2.7 million children who have at least one parent in state or federal custody.²³

Inmates are routinely imprisoned in remote, unpopulated areas frequently located far from their families.²⁴ Additionally, to alleviate overcrowding and cut costs, eleven states transfer inmates to other states.²⁵ These practices often make in-person visitations difficult, time consuming, and costly.²⁶ Letters between prisoners and their families are insufficient because letters often fail to convey the emotional support of the families.²⁷ Additionally, written communication is ineffective for illiterate prisoners and families.²⁸ Hence, many corrections-system stakeholders believe that telephones play an integral role in maintaining communication between prisoners and their families.²⁹

There is significant bipartisan support for prisoner phone access, which often focuses on the benefits of lowering recidivism. The 2012 Republican Party Platform calls for “the institution of family-friendly policies . . . [to] reduce the rate of recidivism, thus reducing the enormous fiscal and social costs of incarceration.”³⁰ Similarly, the 2012 Democrat Party Platform “support[s] . . . initiatives to reduce recidivism.”³¹

²² *Housing D.C. Code Felons Far Away From Home: Effects on Crime, Recidivism, and Reentry*, H. Oversight and Gov’t Reform Subcomm. on Fed. Workforce, Postal Serv. & D.C., 111th Cong. 2–3 (2010) (statement of Nancy G. La Vigne, Director, Justice Policy Center, The Urban Institute), available at <http://www.urban.org/UploadedPDF/901346-housing-dc-felons.pdf>; Nancy G. La Vigne et al., *Examining the Effect of Incarceration and In-Prison Family Contact on Prisoners’ Family Relationships*, 21(4) J. CONTEMP. CRIM. JUST. 314, 316 (2005) [hereinafter *Examining the Effect of Incarceration*].

²³ FCC Press Release, *supra* note 13, at 1.

²⁴ Madeleine Severin, *Is There A Winning Argument Against Excessive Rates for Collect Calls from Prisoners?*, 25 CARDOZO L. REV. 1469, 1474 (2004).

²⁵ *Id.*; Michael Montgomery, *Moving more inmates out of state raises new questions*, CALIFORNIA WATCH (June 14, 2011), <http://californiawatch.org/dailyreport/moving-more-inmates-out-state-raises-new-questions-10787> (last visited Oct. 11, 2012) (stating that, in California, “[c]urrently, more than 10,000 offenders are serving sentences in private prisons outside California, in four states. That number could grow to 15,000 by 2013”).

²⁶ Severin, *supra* note 24, at 1474.

²⁷ *Id.* at 1474–75.

²⁸ *Id.*

²⁹ GIBBONS & KATZENBACH, *supra* note 19, at 36–37.

³⁰ KUKOROWSKI, *supra* note 11, at 1 (quoting REPUBLICAN PARTY PLATFORM 38 (2012), <http://www.gop.com/wp-content/uploads/2012/08/2012GOPPlatform.pdf> (last visited Sept. 4, 2012)).

³¹ *Id.* (quoting DEMOCRATIC NATIONAL PLATFORM (2012), <http://assets.dstatic.org/dnc-platform/2012-National-Platform.pdf> (last visited Sept. 7, 2012)).

Many prisoners communicate and stay attached to the outside world via phone calls. This attachment reduces recidivism, benefitting society and prisoners alike. The Republican and Democrat platforms both support reducing recidivism, acknowledging the need to lower barriers between inmates and their families. However, the unique security and payment structure of prison payphone systems increases connection barriers between the prisoners and their families.

B. *The Unique Structure of Prisoner Phone Systems*

Global Tel*Link, Securus Technologies (Securus), and CenturyLink are the three largest prison payphone providers.³² Nearly 90% of prisoners residing in state prisons use services provided by these companies.³³ Securus serves more than 2,200 facilities and holds state, county, and local contracts serving 850,000 inmates.³⁴ Global Tel*Link, the largest of the three major providers, maintains contracts for thirty-three state correctional departments and serves 1.11 million inmates in 1,900 facilities.³⁵ CenturyLink provides payphone services to 300,000 inmates across the country.³⁶ Though these are the three largest and most prolific payphone services, local companies also bid for service contracts.³⁷

For security reasons, most inmate calls must be made on a collect, prepaid, or debit basis.³⁸ Phone calls are typically limited to fifteen minutes in length.³⁹ Before connecting to the intended recipient, calls are routed to centralized systems where parties are identified and verified against an ap-

³² KUKOROWSKI, *supra* note 11, at 2. The Bureau of Prisons, military, and state prison payphone rates also vary dramatically.

³³ *Id.*

³⁴ Letter from Stephanie A. Joyce, Attorney for Securus, to Marlene H. Dortch, Sec'y, FCC, CC Docket No. 96-128, attach.1 at 2 (filed on Aug. 22, 2012) [hereinafter Securus Aug. 22 *Ex Parte* Letter].

³⁵ Global Tel*Link Oct. 3 *Ex Parte* Letter, *supra* note 12, at attach.1, at 2.

³⁶ CenturyLink Aug. 31, 2009 Comments, WC Docket No. 09-144, Securus Technologies, Inc. Petition for Declaratory Ruling at 1.

³⁷ Other inmate service providers identified as competitors are: Unisys, Telmate, Legacy Long Distance International, Combined Public Communications, Talton Communications, Inmate Calling Solutions, Pay-Tel Communications, Infinity Networks, Inmate Communications Corporation, and Network Communications International Corporation. Global Tel*Link Oct. 3 *Ex Parte* Letter, *supra* note 12, at attach.1.

³⁸ 2002 Order and NPRM, *supra* note 4, at 5. Increasingly, prisoner payphone providers offer debit-based calling options. Letter from Stephanie A. Joyce, Attorney for Securus, to Marlene H. Dortch, Sec'y, Federal Communications Commission, CC Docket No. 96-128, at 2 (filed on July 2, 2012) [hereinafter Securus July 2 *Ex Parte* Letter]; Evercom and T-Netix May 21, 2007 Comments, Docket No. P-999, DI-07-204 to Minn. Pub. Utils. Comm'n. at 3 [hereinafter Evercom May 21 Comments].

³⁹ GAO Report, *supra* note 5, at 6.

proved phone number list.⁴⁰ After verification, calls are connected to the end party.⁴¹ The service provider then monitors and records the call.⁴² These security measures increase the installation and operational costs of inmate calling, which is partially responsible for the increased per-minute pricing of inmate calling.

Additionally, the Bureau of Prisons (BOP) and many state facilities require that prison payphone providers furnish hardware and software capable of recognizing inmate voices, monitoring calls, recording calls automatically, restricting calls to verified numbers on the inmates' contact lists, restricting access to telephones as determined by the correctional facilities, and terminating calls when security issues arise.⁴³ These restrictions are designed to prevent prisoners from engaging in illegal activities while incarcerated.⁴⁴ Preapproving phone numbers ensures that prisoners cannot harass witnesses, police officers, judges, or prosecutors.⁴⁵ Call monitoring and recording increases the difficulty of running drugs, ordering "hits," and conducting phone scams from prison phones.⁴⁶ However, these security measures also increase the operational costs of inmate payphone systems, which are transferred to inmates and further raises per-minute charges.

For regulatory purposes, inmate calls are treated as collect calls, allowing service providers to only charge for the call once the party accepts it.⁴⁷ However, only 40% of inmate calls are successfully connected.⁴⁸ Each call must be filtered through the phone company's security system before acceptance.⁴⁹ This creates substantial initial connection costs, even for the 60% of prisoner calls that are never successfully accepted and thus not billable. These additional costs are shifted to the prisoners and their families whose calls are successful.

Most prison facilities only offer collect-call services where call recipients, typically the prisoners' families, are responsible for the calls' cost.⁵⁰

⁴⁰ Securus July 2 *Ex Parte* Letter, *supra* note 39, at attach.1.

⁴¹ Final connection is accomplished by sending the signal to either local or long-distance Local Exchange Carrier (LEC) switches. *Id.*

⁴² *Id.*

⁴³ GAO Report, *supra* note 5, at 6–7; Evercom May 21 Comments, *supra* note 39, at 3.

⁴⁴ Other safeguards include individual phone and phone group control by administrators (controlling duration and time of usage), automated voice prompts validating acceptance of the collect call and warning prisoners of time limits, personal identification numbers allowing administrators to track each prisoner separately, and reporting of penological or administrative infractions directly to prison administrators. Zimmerman & Flaherty, *supra* note 6 at 263 n.7.

⁴⁵ *Id.* at 262.

⁴⁶ *Id.*

⁴⁷ Letter from Stephanie A. Joyce, Attorney, Securus, to Marlene H. Dortch, Sec'y, FCC, CC Docket No. 96-128 at 5 (May 23, 2008) [hereinafter Securus May 23 *Ex Parte* Letter].

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *In re* Amendment of Policies & Rules Concerning Operator Serv. Providers & Call Aggregators, 10 F.C.C. Red. 1533, 1535 (1995) [hereinafter 1995 NPRM and Notice]; GAO Report, *supra* note

Since many prisoners are from low-income households and communities, these heightened costs create substantial financial barriers to communication, resulting in fewer calls to relatives.⁵¹

C. Monetary Commissions Made Inmate Calling Exorbitantly Expensive

Though payphones represent the most efficient method of maintaining prisoner–community relations, prisoner telephone rates are historically more expensive than comparable calls made from payphones outside the facilities. FCC Commissioner Mignon Clyburn believes that “[t]he cost of calling from prisons is over and above the basic monthly phone service families of prisoners already pay, and in many cases families will spend significantly more for receiving calls from prison.”⁵² These heightened rates necessitated FCC intervention.

Prior to the latest FCC order, initial connection fees for prison callers typically ranged from \$3 to \$4 per call and interstate long distance charges were as high as \$0.89 per minute.⁵³ One fifteen-minute interstate phone call cost as much as \$17.⁵⁴ Some families paid \$34 per month to speak to prisoners for thirty minutes.⁵⁵ Many families could not afford this additional cost.⁵⁶ One Illinois study found that the cost of phone calls was one of the greatest barriers to prisoner–family contact.⁵⁷

Payphone rates also varied dramatically between states, even when different states contracted with the same prison phone provider.⁵⁸ For example, a fifteen-minute, long-distance phone call from a Massachusetts state prison was only \$2.36, while a similar call made from a Georgia state

5, at 6. Recently, the Bureau of Prisons has moved towards a mix of collect calling and direct-dial, where the prisoners are charged directly for the call, options. *Id.* The GAO believes that direct dial options emphasize prisoner responsibility and reduce the burden of high charge calls on the outside community. *Id.*

⁵¹ See generally BRUCE WESTERN, PUNISHMENT AND INEQUALITY IN AMERICA 85–107 (2006) (discussing the economic trends and inequalities of the penal population).

⁵² Press Release, FCC, Statement of FCC Commissioner Mignon L. Clyburn on Meeting Petitioners Martha Wright and Ulandis Forte and Screening the Award-Winning Film *Middle of Nowhere* (Sept. 24, 2012) [hereinafter Clyburn Press Release], available at <http://www.fcc.gov/document/commissioner-clyburn-stmt-mtg-petitioners-wright-and-forte-and-film>.

⁵³ *Id.*

⁵⁴ *Id.* For example, in Georgia state penitentiaries, fifteen minute prisoner calls cost \$17. GEORGIA DEPARTMENT OF CORRECTIONS, INMATE TELEPHONE SYSTEM: GLOBAL TEL*LINK CUSTOMER USER GUIDE 4, http://www.dcor.state.ga.us/pdf/GDC_GTL_user_manual.pdf (last visited on Oct. 13, 2012).

⁵⁵ Clyburn Press Release, *supra* note 52, at 1.

⁵⁶ *Id.*

⁵⁷ *Examining the Effect of Incarceration*, *supra* note 22, at 316.

⁵⁸ KUKOROWSKI, *supra* note 11, at 2. The Bureau of Prisons, military, and state prison payphone rates also vary dramatically.

prison was \$17.⁵⁹ This disparity resulted primarily from varying mandates stipulating that service providers give the state a percentage of profits extracted from the per minute rates.⁶⁰ These monetary commissions ranged from 15% to 60% of per minute revenue.⁶¹

Many states relied heavily on commissions to cover costs of prison services and inmate opportunities. The Idaho Department of Corrections estimates that losing commission revenue will result in a shortfall of \$1.086 million.⁶² In contrast, several states, such as Nebraska and Missouri,⁶³ banned commissions altogether prior to the FCC ruling.⁶⁴

States that mandated commissions prior to the FCC ruling used the revenues in dramatically different ways. Alabama and Arkansas used commissions to support general state law enforcement, while Massachusetts deposited commissions into a general state fund.⁶⁵ Virginia used its commissions to fund the Victim Information Network, which notifies victims of prisoner parole reviews.⁶⁶ Texas mandated a 40% or greater commission, with half of the proceeds going to victim compensation and the other half going to a general revenue fund.⁶⁷

Some commissions, paid for by the prisoners' families, supported state functions that do not directly benefit the prisoners. Initiatives like Virginia's Victim Information Network, as well as general state funding, arguably should be funded by state legislatures. Under these programs, the loss of commissions will not impact recidivism because the funded initiatives do not benefit prisoners.

D. *History of the FCC Price Cap Order*

In 2000, Martha Wright brought a class action suit against several prison phone companies alleging that payphone contracts and state com-

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² T-Netix and Evercom June 20, 2007 Reply Comments, CC Docket No. 96-128, DA 03-4027 at 7 [hereinafter T-Netix June 20 Reply Comments].

⁶³ IOWA LEGISLATIVE FISCAL BUREAU, ISSUE REVIEW, DEP'T OF CORRS.: TEL. REBATE FUND 4 (2001), http://www.prisonphonejustice.org/includes/_public/rates/Missouri/MO_prison_phone_rates_and_revenues_2001.pdf.

⁶⁴ *See, e.g.*, Contract to provide inmates with access to telecommunications services in a correctional facility or jail; conditions, N.M. STAT. ANN. § 33-14-1 (2011) (New Mexico banned commissions in 2001).

⁶⁵ Global Tel*Link Oct. 3 *Ex Parte* Letter, *supra* note 12, at attach.1, at 7.

⁶⁶ *Id.* at attach.1, at 8.

⁶⁷ *Id.* at attach.1, at 7.

missions violated antitrust law.⁶⁸ The district court deferred her complaint to the FCC, noting that the agency had primary jurisdiction over the regulation of tariffed phone providers.⁶⁹ Wright petitioned the FCC in 2001 and, via her 2007 revised proposal, requested that the FCC impose telephone calling price caps at \$0.20 to \$0.25 per minute with no connection costs for interstate long-distance rates.⁷⁰ These rates mirrored those provided by the BOP.⁷¹

Wright's \$0.20–\$0.25 price caps coincided with early Congressional attempts to regulate prison payphone rates. In 2007, Representative Bobby Rush introduced the Family Telephone Connection Protection Act of 2007.⁷² This now defunct bill actively affirmed the FCC's power over inmate payphone rates and mandated that the FCC implement sound and reasonable price caps.⁷³

On August 9, 2013, the FCC enacted price caps similar to the Wright proposal.⁷⁴ The FCC set rate caps at \$0.21 per minute for debit calls and \$0.25 per minute for prepaid calls.⁷⁵ The FCC believes that this will decrease inmate call rates from \$17 per fifteen-minute call to \$3.75 and \$3.15 for debit and prepaid calls, respectively.⁷⁶ The FCC also created safe-harbor rates, stating that \$0.12 per minute for debit and prepaid calls and \$0.14 per minute for collect calls was presumptively reasonable and cost based.⁷⁷ Additionally, the FCC chose to prohibit monetary commissions.⁷⁸

⁶⁸ CTR. FOR CONSTITUTIONAL RIGHTS, *Martha Wright v. Corrections Corporation of America* (FCC Petition), <http://ccrjustice.org/Wright-v-CCA> (last visited on Oct. 15, 2012).

⁶⁹ *Id.*

⁷⁰ Petitioner's Alternative Rulemaking Proposal at 5, *In re* Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996 Petition for Rulemaking or, *in the Alternative, Petition to Address Referral Issues In Pending Rulemaking*, DA 03-4027 (2007), (No. 96-128), [hereinafter Wright 2007 Proposal].

⁷¹ KUKOROWSKI, *supra* note 11, at 4.

⁷² Family Telephone Connection Protection Act of 2007, H.R. 555, 110th Cong. § 1 (2007), available at <http://www.govtrack.us/congress/bills/110/hr555/text>.

⁷³ *Id.* at § 2(16). Representative Rush introduced a second, nearly identical bill in 2009 that was also never enacted. Family Telephone Connection Protection Act of 2009, H.R. 1133, 111th Cong. (2009), available at <http://www.govtrack.us/congress/bills/111/hr1133>.

⁷⁴ FCC Press Release, *supra* note 13, at 1.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.* at 2.

E. *Third-Party Beneficiary Status of Inmates in Contract Bidding Necessitated Regulation*

Each state's department of corrections allots the majority of their prison payphone contracts through a bidding process.⁷⁹ Bids tend to encompass multiple state penal institutions.⁸⁰ The winning bidder gains an exclusive service contract for all penal facilities under the department's control, thereby gaining a monopoly in each of the contracted facilities.⁸¹

Prisoners were third-party beneficiaries in these negotiations, receiving pricing determined by the facility authority and the service providers.⁸² Due to their incarceration, inmates have no choice in telephone providers and must use the services determined by the state.⁸³ As no close, legal substitutes exist, and alternatives such as letters and visitations are often ineffective or costly, the resulting inmate demand for this service is inelastic.⁸⁴

Under a typical government bidding process for monopoly contracts, the selected contract should result in efficient and secure services similar to the competitive market, providing the lowest possible cost to the prisoner.⁸⁵ However, the potential for monetary commissions changed state incentives. Instead of negotiating for the cheapest services, states negotiated for contracts that resulted in higher monetary gains through commissions.⁸⁶

The FCC noted that competition during the negotiation process does not create downward pressure on consumer rates.⁸⁷ Even when commission rates were determined on a state level, outside of the bidding process, individual facilities benefited by negotiating for per-minute pricing higher than otherwise expected.⁸⁸

Commissions on per-minute revenues were rarely negotiated during the bidding process and were usually set by the facility or statute.⁸⁹ Telecom providers believed that monetary commissions resulted from local policy decisions and that the telephone providers could not affect the percentages during the bidding process.⁹⁰ Nonetheless, increased costs due to monetary commissions ensured that phone providers had little incentive to

⁷⁹ Zimmerman & Flaherty, *supra* note 6, at 262.

⁸⁰ Letter from Melissa Newman, Vice President, Federal Regulatory Affairs for CenturyLink, to Marlene H. Dortch, Sec'y, FCC, CC Docket No. 96-128, at 1 (filed on Oct. 12, 2012).

⁸¹ Zimmerman & Flaherty, *supra* note 6, at 262.

⁸² Carver, *supra* note 7, at 392.

⁸³ 2002 Order and NPRM, *supra* note 4, at 6.

⁸⁴ KUKOROWSKI, *supra* note 11, at 1.

⁸⁵ Carver, *supra* note 7, at 395.

⁸⁶ KUKOROWSKI, *supra* note 11, at 1.

⁸⁷ 2002 Order and NPRM, *supra* note 4, at 6.

⁸⁸ Carver, *supra* note 7, at 392, 418.

⁸⁹ Evercom and T-Netix May 2, 2007 Comments, CC Docket No. 96-128, DA 03-4027 at 7 [hereinafter Evercom May 2 Comments].

⁹⁰ Securus Aug. 22 *Ex Parte* Letter, *supra* note 34, at 2.

offer lower pricing during bidding. As a result, prisoners were often incentivized to use cheaper, illegal prison payphone substitutes.

F. *FCC Regulation Disincentivizes the Use of Illegal Prison Payphone Substitutes*

The FCC has noted that prison payphone contracts, and resulting price structures, are not bound by typical phone provider rules due to exceptional security and penological circumstances.⁹¹ Providers block certain types of calls, such as call forwarding (where callers choose their call provider by routing their call through a third-party provider) and third-party conference calling.⁹² To ensure that the provider is able to restrict certain numbers and calling services, the FCC allows companies to block prohibited call diversion attempts (where calls are redirected through third-party providers to unidentified end callers).⁹³ However, due to the heightened pricing created by monetary commissions, prisoners were incentivized to illegally circumvent the payphone systems.

1. Call Diversion

The Government Accountability Office (GAO) reported that higher priced, long-distance calls are decreasing while local calls are increasing, resulting in a drop in commission revenue.⁹⁴ The BOP contends that this shift reflects the increased prevalence of call-diverter companies.⁹⁵ Call diversion provides local numbers to call recipients who would otherwise qualify as long-distance recipients.

After clearance by the payphone provider's centralized system, these calls are rerouted to the call diverter's Voice over Internet Provider ("VoIP") router.⁹⁶ The VoIP router then sends the number to the unknown third party. As a result, recipients are able to save the difference in costs between local and long-distance charges, sometimes accounting to 70% savings.⁹⁷

The GAO estimates that call diversion lowered the costs for 84% of inmate calls.⁹⁸ However, call diversion makes it impossible for the service

⁹¹ 1995 NPRM and Notice, *supra* note 50, at 1534.

⁹² Evercom May 2 Comments, *supra* note 89, at 3.

⁹³ *Id.* at 4; 2002 Order and NPRM, *supra* note 4, at 6.

⁹⁴ GAO Report, *supra* note 5, at 11 fig.1 (showing rates of long-distance calls are decreasing as local minutes are increasing, resulting in smaller revenues from facility commissions).

⁹⁵ *Id.* at 15.

⁹⁶ Securus July 2 *Ex Parte* Letter, *supra* note 38, at attach.1 at 2.

⁹⁷ GAO Report, *supra* note 5, at 15.

⁹⁸ *Id.*

provider to accurately validate the recipient's identity. As such, call diversion may assist prisoner calls to unauthorized individuals and bypass the telephone provider's security system.

The BOP believes that new technologies, such as Internet-based messaging systems, may lessen the popularity of call diversion.⁹⁹ The BOP recently launched electronic messaging systems with pricing set at \$0.05 per minute.¹⁰⁰ Consumption of this substitute doubled between 2009 and 2010, and the BOP foresees demand increasing dramatically in the near future.¹⁰¹ Similarly, the rate of cell phone smuggling has increased in recent years. Further, now that the FCC has implemented pricing regulation, fewer inmates will find it economically viable to utilize call diverters in lieu of legal payphone systems. Hopefully, the FCC regulation will stem the growing popularity of call diversion and incentivize the majority of inmates to use sanctioned payphone communications.

2. Ties to Cell Phone Smuggling

Between 2008 and 2010, the BOP confiscated 8,656 smuggled cell phones.¹⁰² During this time, eight states collectively confiscated nearly 50,000 smuggled cell phones.¹⁰³ Prisoners claim that the price and risk of prosecution from using smuggled cell phones were less costly than using the payphone system.¹⁰⁴

However, smuggled cell phones are also used to coordinate identity-theft rings, threaten public officials and their families, and order assassinations.¹⁰⁵ In response, Congress passed the Cell Phone Contraband Act, which added cell phones to the prohibited prison contraband list under 18 U.S.C. § 1791.¹⁰⁶ The bill increased the punishment for possessing smuggled cell phones to up to one-year imprisonment,¹⁰⁷ pushing many prisoners to use prison payphones instead.

Despite the increased penalties, detection and prevention of smuggled cell phones are constrained by resource issues and prisoners continue to use

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.* at 20 tbl.3.

¹⁰³ These states were California, Florida, Maryland, Mississippi, New Jersey, New York, South Carolina, and Texas. See GAO Report, *supra* note 5, at 22 tbl.4.

¹⁰⁴ Erin Fitzgerald, *Cell "Block" Silence: Why Contraband Cellular Telephone Use in Prisons Warrants Federal Legislation to Allow Jamming Technology*, 2010 WIS. L. REV. 1269, 1278 (2010).

¹⁰⁵ GAO Report, *supra* note 5, at 23–24.

¹⁰⁶ Cell Phone Contraband Act, 2010, Pub. L. No. 111-225, 125, 124 Stat. 2387, 18 U.S.C. § 1791(d)(1)(F) (2012).

¹⁰⁷ 18 U.S.C. § 1791(b)(4).

cell phones as a payphone substitute.¹⁰⁸ The FCC's regulation of the inmate telephone industry will add an additional incentive, ensuring that price-sensitive inmates use prisoner payphones in lieu of smuggled cell phones.

II. ANALYSIS OF RELEVANT CASE LAW

Previous cases suggest increased per minute costs do not violate inmates' First Amendment rights and that the service contracts fall under state immunity from antitrust laws. However, court precedent holds that the FCC, which was granted specific power to regulate payphones under the Telecommunications Act of 1996, may regulate payphone contracts otherwise protected from antitrust claims.¹⁰⁹

A. *Inmate Payphone Reform is not Based on First Amendment Rights*

Constitutional challenges to prison payphone rates typically argued that excessive rates violated First Amendment rights to free speech and Fourteenth Amendment rights to equal protection and due process.¹¹⁰ However, established court precedent holds that prisons may create reasonable limitations on prisoner rights in light of legitimate penological or administrative concerns.¹¹¹

While it is uncontested that prisoners have a right to communicate with their families, it is unclear whether this right extends to an affirmative duty on the part of the prison facility to provide such services.¹¹² Under Sixth and Ninth Circuit precedent, the First Amendment creates an affirmative obligation to provide telephone services to inmates.¹¹³ However, the First and Seventh Circuits have held that no affirmative obligation exists.¹¹⁴ The First and Seventh Circuits agree that prisoners have a First Amendment right to speech, but split from the Sixth and Ninth Circuits in refusing to extend this right to electronic communication.¹¹⁵

Despite some circuit holdings that prisons have an affirmative duty to provide contact with the outside world, no court precedent requires low

¹⁰⁸ Fitzgerald, *supra* note 104, at 1282–84.

¹⁰⁹ Verizon Commc'ns Inc. v. Trinko, 540 U.S. 398, 406–07 (2004).

¹¹⁰ Severin, *supra* note 24, at 1512–13.

¹¹¹ *Id.* at 1514.

¹¹² Holloway v. Magness, 666 F.3d 1076, 1079 (8th Cir. 2012), *cert. denied*, 133 S. Ct. 130 (U.S. 2012).

¹¹³ Holloway v. Magness, 2011 WL 204891, 6–7 (E.D. Ark. Jan. 21, 2011) (citing Johnson v. California, No. CV95–1192–RG, 1996 WL 34442602 (C.D. Cal. July 15, 1996)); Washington v. Reno, 35 F.3d 1093, 1099–100 (6th Cir. 1994).

¹¹⁴ *Id.*

¹¹⁵ *Id.*

payphone pricing or that prisons provide other forms of electronic communication, such as email and instant messaging.¹¹⁶ Many courts have also held that the contractual system of monetary commissions and state-sanctioned monopolies does not infringe upon prisoners' First Amendment rights.¹¹⁷

Courts maintain that because inmates have access to some form of alternate communication through mail and visitation, the high cost for telephone communication does not constitute an absolute denial of free speech rights.¹¹⁸ Consequently any hardship alleged by prisoners is not a "constitutionally significant curtailment of the right of the free speech . . . particularly given the limited nature of that right in prison settings."¹¹⁹ When prisoners' First Amendment complaints have failed to provide pricing relief, inmates turned to economic arguments against excessive payphone rates.

B. *Antitrust Review by Courts Was Unsuccessful and Necessitated FCC Action*

In the 2001 decision of *Arsberry v. Illinois*, Judge Posner analyzed and dismissed antitrust claims against prison payphone rates.¹²⁰ Judge Posner based his decision on the belief that it was impossible for the telephone companies to horizontally collude.¹²¹ After *Arsberry*, prisoner advocates abandoned collusion arguments and focused instead on barriers to entry claims, which require a different economic analysis under the Sherman Act.¹²²

Mirroring Judge Posner's *Arsberry* holding, in *Miranda v. Michigan* the Eastern District Court of Michigan—like many courts after it—found that long-distance telephone carriers were immune from antitrust liability arising out of their exclusive dealing agreements with states when contracting for prisoner call services.¹²³ The court believed that state law gave pris-

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 8.

¹¹⁸ *Id.* at 10.

¹¹⁹ *Holloway v. Magness*, 2011 WL 204891 at 10 (quoting *Walton v. N.Y. State Dep't of Corr. Servs.*, 921 N.E.2d 145, 155 (N.Y. 2009)).

¹²⁰ *Arsberry v. Illinois*, 244 F.3d 558, 565–66 (7th Cir. 2001).

¹²¹ *Id.* at 566.

¹²² Section 2 of the Sherman Act makes it illegal to "monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States." 15 U.S.C. § 2 (2012).

¹²³ *Miranda v. Michigan*, 141 F. Supp. 2d 747, 750 (E.D. Mich. 2001).

ons authority to create anticompetitive rules that limit supply.¹²⁴ The court held that state immunities covered telecommunications companies.¹²⁵

An underlying rationale of courts is that prison payphone monopolies are state-sponsored and thus fall under the Parker Immunity Doctrine. Under *Parker v. Brown* and subsequent cases, local government entities and the private entities they contract with are exempt from federal antitrust laws if the anticompetitive actions are clearly articulated, affirmatively indicated as state policy, and actively overseen by the state.¹²⁶ State governments limit competition via laws and regulations that set prices, create barriers to entry, and limit outputs.¹²⁷ In *Parker*, the Supreme Court reasoned that, if this immunity did not extend to private actors, “a state would be unable to implement programs that restrain competition among private parties” because “[a] plaintiff could frustrate any such program merely by filing suit against the regulated private parties, rather than the state officials who implement the plan.”¹²⁸ The contract bidding, monetary commissions, and resulting prison payphone monopolies fall under Parker Immunity. Thus, lawsuits alleging Sherman Act violations fail under the state-immunity doctrine.

However, the Parker Immunity Doctrine does not exempt state and private agents from federal oversight when congressional legislation is enacted to preempt state laws.¹²⁹ The Telecommunications Act of 1996 granted the FCC regulatory power over telecommunications providers operating as tariff aggregators—companies that provide telephones “to the public or to transient users of [a] premises for interstate calling.”¹³⁰ Therefore, the FCC may decide any form of applicable regulation regardless of Parker Immunity.

For interstate calling, the Filed Rate Doctrine, which mandates that regulated telecommunications carriers file rates with the FCC, also prevents suits against prison payphone providers but allow for direct FCC regulation.¹³¹ The Second Circuit posits that “legislatively appointed regulatory bodies have institutional competence to address rate-making issues . . . [while] the interference of courts in the rate-making process would

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ Keith A. Rowley, *Immunity from Regulatory Price Squeeze Claims: From Keogh, Parker, and Noerr to Town of Concord and Beyond*, 70 TEX. L. REV. 399, 416–18 (1991).

¹²⁷ ANDREW I. GAVIL, WILLIAM E. KOVACIC, JONATHAN B. BAKER, *ANTITRUST LAW IN PERSPECTIVE: CASES, CONCEPTS AND PROBLEMS IN COMPETITION POLICY* 1064 (Thomson/West, 2d ed.).

¹²⁸ *S. Motor Carriers Rate Conference, Inc. v. United States*, 471 U.S. 48, 56–57 (1985).

¹²⁹ *Parker v. Brown*, 317 U.S. 341, 350 (1943) (“Occupation of a legislative ‘field’ by Congress in the exercise of a granted power is a familiar example of its constitutional power to suspend state laws.”).

¹³⁰ 47 U.S.C. § 226(a)(2), (h)(4)(A) (2012).

¹³¹ *Miranda v. Michigan*, 141 F. Supp. 2d 747, 757–58 (E.D. Mich. 2001); *Arsberry v. Illinois*, 117 F. Supp. 2d 743, 744–45 (N.D. Ill. 2000).

subvert the authority of rate-setting bodies and undermine the regulatory regime.”¹³² As a result, even if Sherman Act allegations fail in court, the FCC may still regulate prison payphone providers.

This case history suggests that inmates will almost always be unsuccessful when suing prison payphone providers on First Amendment and antitrust theories.¹³³ However, while Parker Immunity protects payphone providers from direct antitrust suits, the Filed Rate Doctrine grants the FCC discretion to regulate telecommunications providers.¹³⁴ Through the Telecommunications Act, the FCC is legally competent to set prison payphone price caps on otherwise protected providers.

C. *The FCC Has the Power to Regulate Pricing via 47 U.S.C. § 201*

In 1998, the FCC chose not to impose benchmark rates on inmate payphone providers because it was concerned that regulation would stifle competition.¹³⁵ However, because competition over consumer rates did not develop as expected,¹³⁶ the FCC recently set general price caps and restricted funding of state commissions through payphone pricing.¹³⁷

In *Verizon v. Trinko*, the Supreme Court found that antitrust claims were unsuitable mechanisms for arguing telecommunication policy.¹³⁸ Instead, the Court held that the FCC, armed with the Telecommunications Act of 1996, was a more appropriate forum for debating regulation of telecommunications markets.¹³⁹ In 1999, the Supreme Court ruled that deference must be given to the FCC’s interpretation of the Telecommunications Act.¹⁴⁰ Accordingly, the FCC has original jurisdiction to regulate telecommunications industries and is not tied to the fate of previous antitrust claims.¹⁴¹

The Supreme Court and Eighth Circuit have also held that Congress gave the FCC general jurisdiction to create and implement preemptive regu-

¹³² Fax Telecomunicaciones Inc. v. AT&T, 138 F.3d 479, 489 (2d Cir. 1998) (internal citations omitted).

¹³³ *Arsberry*, 244 F.3d at 565–66; *Miranda*, 141 F. Supp. 2d at 750.

¹³⁴ *Miranda*, 141 F. Supp. 2d at 757–58.

¹³⁵ *Billed Party Preference for InterLATA 0+ Calls, Second Report and Order and Order on Reconsideration*, 13 F.C.C.R. 6122 (1998) [hereinafter 0+ Second Report].

¹³⁶ See 2002 Order and NPRM, *supra* note 4, at 6.

¹³⁷ Aug. 9 FCC Press Release, *supra* note 13 at 1–2.

¹³⁸ See *Verizon Commc’ns Inc. v. Trinko*, 540 U.S. 398, 406–07 (2004).

¹³⁹ See *id.*

¹⁴⁰ *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 397 (1999) (citing *Chevron v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842–43 (1984) (indicating that deference is due to the regulating agency when interpreting the legislative statute granting the agency power to regulate)).

¹⁴¹ JONATHAN E. NUECHTERLEIN & PHILIP J. WEISER, *DIGITAL CROSSROADS: AMERICAN TELECOMMUNICATIONS POLICY IN THE INTERNET AGE* 418–19 (2005).

lation over local competition.¹⁴² In *Iowa Utilities Board v. FCC*, the Eighth Circuit relied heavily on § 201(b) of the Telecommunications Act, which grants the FCC rulemaking authority to include the regulation of local competitors.¹⁴³ In 1999, the Supreme Court also relied on § 201(b) in *AT&T Corp. v. Iowa Utilities Board*, where it ruled that Congress had implicitly given general jurisdiction to the FCC.¹⁴⁴ These cases abolished the traditional separation of interstate and intrastate regulation and urged the FCC to work cooperatively with states on policies relating to local telecom competition.¹⁴⁵

As confirmed by both *Iowa Utilities Board* cases, the FCC has exclusive power to regulate excessive telephone rates under 47 U.S.C. § 201(b), which mandates that “practices, classifications, and regulations for and in connection with such [interstate wire] communications service, shall be just and reasonable, and any such charge, practice, classification, or regulation that is unjust or unreasonable is hereby declared to be unlawful.”¹⁴⁶ Under § 201(b), the FCC may regulate common carriers if rates are deemed unjust and unreasonable. In the past, the FCC did not extend typical carrier regulation to prisoner payphone providers due to exceptional security and penological concerns.¹⁴⁷

The FCC first considered rate capping prisoner phone services in 1996 but found that the complex security requirements resulted in market-specific facilities and costs.¹⁴⁸ Hence, the FCC found that inmate phone calls necessarily cost more than calls made from outside the prison system.¹⁴⁹ However, the FCC also stated that “the recipients of collect calls from inmates . . . require additional safeguards to avoid being charged excessive rates from a monopoly provider.”¹⁵⁰ For example, the FCC requires that prisoner payphone providers inform call recipients of their right to demand pricing quotes before being charged.¹⁵¹

However, FCC price cap authority is limited by 47 U.S.C. § 276, which grants the agency authority to only promulgate regulations that “establish a per call compensation plan to ensure that all payphone service providers are fairly compensated for each and every completed intrastate

¹⁴² *Id.* at 86.

¹⁴³ *See* *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 804–06 (8th Cir. 1997).

¹⁴⁴ *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 367 (1999).

¹⁴⁵ NUCHESTERLEIN & WEISER, *supra* note 141, at 86.

¹⁴⁶ 47 U.S.C. § 201(b) (2012).

¹⁴⁷ 1995 NPRM and Notice, *supra* note 50, at 1534.

¹⁴⁸ *Miranda v. Michigan*, 141 F. Supp. 2d 747, 759–60 (E.D. Mich. 2001).

¹⁴⁹ *Id.* at 760.

¹⁵⁰ 0+ Second Report, *supra* note 135, at 6123.

¹⁵¹ *Hang up on High Public Pay Phone Rates*, FCC, <http://www.fcc.gov/guides/hang-high-public-pay-phone-rates> (last visited Sept. 13, 2013). Consumers can receive these quotes by pressing no more than two digits or staying on the line. *Id.*

and interstate call using their payphone.”¹⁵² The FCC must examine its price caps to ensure that service providers in the most costly facilities are still adequately compensated.

III. ANALYSIS AND COMPARISON OF ECONOMIC ARGUMENTS

FCC pricing regulation ensures that rates provided in prison phone contracts are constrained close to the costs of implementing and maintaining the telephone systems. Cost regulation is necessary in the inmate payphone industry because payphone services have no close, legal substitutes, inmate demand is inherently inelastic, and the inmates’ position as third-party beneficiaries incentivizes higher monetary commissions instead of lower end-user prices.¹⁵³

Price regulation is also necessary to curb the use of illegal and potentially harmful substitutes. Inmate petitioners believe that lower payphone costs will incentivize purchasers of smuggled cell phones to use legitimate communication instead.¹⁵⁴ In addition, call diversion by inmates who seek lower cost alternatives will shift back to legal payphone purchases as rates become more affordable. Inmates using these substitutes for illegal purposes are not affected by cheaper pricing of legitimate options. Under ideal FCC rate regulation, only inmates participating in criminal enterprises within the prison would be incentivized to continue using call diversion and smuggled cell phones. Thus, under ideal FCC rate regulation, penal institutions and state legislatures could increase punishments for illegal communication without overcriminalizing individuals who are simply attempting to affordably communicate with their families.

While the FCC’s August 9th, 2013 rate caps closely parallel attempted legislation and the Wright petition, they may undercompensate service providers of small, costly facilities because the order assumes that the efficiencies and economies of scale found in larger facilities are present in all facilities. These rate caps may unduly burden payphone providers of small, inefficient prison facilities that cannot take advantage of the relative efficiencies present in larger prison facilities.

Additionally, the FCC chose to prohibit monetary commissions.¹⁵⁵ However, this blanket prohibition will reduce the effectiveness of beneficial, prisoner-related projects funded through the commissions and may stifle innovation of new projects aimed at reducing prisoner recidivism.

¹⁵² 47 U.S.C. § 276(b)(1)(A) (2012).

¹⁵³ Zimmerman & Flaherty, *supra* note 6, at 266 n.15.

¹⁵⁴ Letter from Lee Petro, Counsel for Martha A. Wright, to Marlene H. Dortch, Sec’y, FCC, CC Docket No. 96-128, at 1 (filed July 3, 2012).

¹⁵⁵ Aug. 9 FCC Press Release, *supra* note 13, at 2.

The FCC should review its price-cap order and instead utilize an open, tiered rate structure. Such a system would allow phone providers to take advantage of varying efficiencies and economies of scale while reducing the FCC's administrative burdens.

A. *The FCC's Current Rate Caps Are Untenable*

The FCC's rate caps may fail to provide adequate cost recovery as mandated by 47 U.S.C. § 276.¹⁵⁶ Section 276(b)(1)(A) requires that the FCC regulate payphone services so that per-call compensation plans adequately compensate for each call's cost.¹⁵⁷ The FCC's nationwide price caps could result in losses from calls originating in small, high-cost facilities that mandate higher security requirements.¹⁵⁸

The FCC has stated that prices partially vary due to costs of different security standards.¹⁵⁹ Forcing payphone providers to suffer shortfalls from facilities that mandate costly security procedures would violate 47 U.S.C. § 276. Though the FCC has not defined § 276's "fair compensation" for these services, the FCC's current rate caps may ultimately prove unfair.¹⁶⁰

Securus, one of the largest inmate payphone providers, contends that the initial setup of a call is the most expensive step because the service provider must make up for principal costs of the service, "including software development, database management, [and] high-speed data connectivity. . . ."¹⁶¹ Including software development costs in initial call setup fees is logical due to the variety and divergence of state security concerns and requirements. Consequently, price caps that do not allow connection costs must account for these initial costs by ensuring that the per-minute benchmarks are set slightly higher than the marginal cost of delivery once the system is installed. Thus, even where the FCC's price caps cover basic marginal costs of the calls, they may still undercompensate the service provider.

Advocates of the FCC's current price caps also argue that, because the BOP operates at rates similar to the FCC mandated rates, state programs can survive at similar rates.¹⁶² While the BOP successfully operates at the rates proposed by the FCC order, it is composed of many large, similar facilities and thus may benefit from economies of scale not existing in smaller

¹⁵⁶ Comments of Global Tel*Link at 11, *in re* Implementation of the Pay Tel. Reclassification & Compensation Provisions of the Telecomm. Act of 1996, Report and Order, 11 FCC Rcd. 20,541 (1996) (No. 96-128) [hereinafter Global Tel*Link May 2 Comments].

¹⁵⁷ 47 U.S.C. § 276(b)(1)(A) (2012).

¹⁵⁸ Global Tel*Link May 2 Comments, *supra* note 156, at 13.

¹⁵⁹ 2002 Order and NPRM, *supra* note 4, at 11.

¹⁶⁰ *Id.* at 7-11 (asking stakeholders to comment on numerous definitions of "fairly compensated").

¹⁶¹ Securus May 23 *Ex Parte* Letter, *supra* note 47, at 5.

¹⁶² See Wright 2007 Proposal, *supra* note 70, at 18.

state systems. The BOP has standard security requirements for its inmate payphones.¹⁶³ Payphone service providers need only present a stock security suite during bidding for any BOP contract.¹⁶⁴ This allows providers to efficiently develop technology and facilities to take advantage of the single level of security. Similar efficiencies do not exist for state payphone providers because security requirements vary among states and localities.¹⁶⁵ As a result, successful bidders of state contracts may be required to develop unique security systems for different facilities.

Proponents of the FCC's price caps may also argue that, because the regulation limits resources dedicated to research and development, service providers will be incentivized to standardize security systems among multiple facilities. However, security standards vary between high- and low-security facilities and among states. These standards may be set at the state legislative level through legislation and budgeting preferences. A convergence of security standards is thus unlikely to ever occur. Price caps that limit resources for the development of new security systems may instead reduce competition to serve high-security facilities.

1. The FCC's Current Rate Caps Do Not Consider Differences in Costs

The FCC's rate caps do not recognize economies of scale at play in the prisoner telephone market. Securus contends that costs fluctuate based on inmate numbers, call volume, and other site-specific costs, resulting in varying costs when supplying the market.¹⁶⁶ Call volume may also differ due to facility payphone policies that limit the number of calls per day and the total minutes of calls per month.

State contracts range from five-bed local jails to 3,300-bed state prisons, requiring entirely different payphone structures.¹⁶⁷ Securus primarily

¹⁶³ GAO Report, *supra* note 5, at 6–7.

¹⁶⁴ Inmate phone vendors provide stock hardware and software to BOP personnel, who operate a standard system called TRUFONE. *Id.* at 6. Unlike state contracts, the BOP personnel operate the security system and follow a standardized list of security procedures. *See id.* at 6–7. TRUFONE uses voice recognition to identify inmates, provides each inmate with personal access codes, checks inmate funds, records all calls, restricts calls to only an inmates' verified contact list, and terminates calls if security issues arise. *Id.*

¹⁶⁵ Zimmerman & Flaherty, *supra* note 6, at 262–63 n.7.

¹⁶⁶ Securus May 23 *Ex Parte* Letter, *supra* note 47, at 2; *see also* Evercom May 2 Comments, *supra* note 89, at 6–7 (explaining that the inmate telephone industry substantially lacks economies of scale because secure calling platforms for inmate services are necessarily provided based on the individual requirements of each correctional facility served).

¹⁶⁷ Securus May 23 *Ex Parte* Letter, *supra* note 47, at 2.

contracts for small, county-level facilities.¹⁶⁸ These small facilities comprise 80% of its client base.¹⁶⁹ Due to the need to install, operate, and maintain payphone facilities, the marginal costs associated with providing secured calling solutions to small facilities may be much higher than those associated with larger facilities.

In contrast to Securus's client base, the Wright petition—the basis for the FCC's latest rulemaking—claims that payphone providers' contracts average 1,743 beds per facility.¹⁷⁰ The FCC order bases its price caps on the efficiencies available in these larger contracts.¹⁷¹ It is difficult for smaller facilities, like those that Securus contracts for, to be as cost-efficient as larger facilities, and the upfront costs are nearly equivalent. If the rates fall below these larger costs, few payphone providers will bid for small, high-cost facilities. This may result in less competition for these facilities and may result in limiting access to payphones.¹⁷²

Prison payphone providers also reject the Wright petition's claim that providers have profit margins of 85%.¹⁷³ Service providers claim that, if this were true, more competition would exist and several providers would not have left the market.¹⁷⁴ Securus states that it only makes a profit of 2.28% after recovery of costs.¹⁷⁵

Service providers may petition the FCC for an exemption from the price caps.¹⁷⁶ However, this will create tremendous administrative burdens on the agency. Each service provider may be incentivized to petition for exemptions by artificially inflating costs, possibly through cross subsidization of tangentially related operations. While most faulty petitions will be denied by the FCC, submitting petitions is relatively low cost compared to the administrative resources needed to accurately assess them. The current FCC order may result in an influx of hundreds of petitions, corresponding to the large number of localities with unique, cost-varying facilities. This inundation may make it administratively infeasible for the FCC to adequately assess each petition under the current order.

To combat this administrative burden, the FCC could create a heightened presumption against petitions. The order already mandates a data-collection program where prison telephone providers must annually re-

¹⁶⁸ *Id.*; see also Global Tel*Link May 2 Comments, *supra* note 156, at 2 (explaining that Global Tel*Link "serves all types of correctional facilities, ranging from municipal and county jails that house fewer than ten inmates to state correctional systems that house tens of thousands of inmates").

¹⁶⁹ Securus May 23 *Ex Parte* Letter, *supra* note 48, at 2; see also Global Tel*Link May 2 Comments, *supra* note 156, at 2.

¹⁷⁰ Securus May 23 *Ex Parte* Letter, *supra* note 48, at 2.

¹⁷¹ *Id.*

¹⁷² Global Tel*Link May 2 Comments, *supra* note 156, at 12.

¹⁷³ *Id.* at 14.

¹⁷⁴ *Id.*

¹⁷⁵ Securus May 23 *Ex Parte* Letter, *supra* note 47, at 4.

¹⁷⁶ See Aug. 9 FCC Press Release, *supra* note 13, at 2.

port facility costs to the FCC.¹⁷⁷ However, the costs of collecting, analyzing, and reporting each facility's ongoing operational costs will be inefficient and impose greater costs on the service providers, which are already being undercompensated.

2. Lack of Prior Data Will Increase the Probability of a Successful Court Appeal

While the FCC has mandated annual cost reports in other dockets, these orders are usually continuations of prior Notices of Proposed Rulemaking ("NPRM") data collection requirements. In his dissent from the FCC's Current Order, FCC Commissioner Ajit Pai ("Commissioner Pai") suggested that the FCC had not collected sufficient data on payphone installation and service costs, stating that the price caps were arbitrarily set and did not rely on sufficient data.¹⁷⁸ Berin Szoka of TechFreedom described the recent price cap vote as following a "Ready, Fire, Aim" mentality by imposing burdensome regulations before gathering essential facts.¹⁷⁹

Both Commissioner Pai and Mr. Szoka believe that there is a lack of supporting evidence and that the price caps will not withstand court inspection.¹⁸⁰ This sentiment was mirrored by several commentators prior to the price cap decision.¹⁸¹ Additionally, Commissioner Pai believes that the price caps were not contemplated by the FCC's prior inmate NPRMs and that the record contains overwhelming evidence that the caps are set too low, opening the agency to accusations of arbitrary and capricious decision making.¹⁸²

Section 706(2)(A) of the Administrative Procedure Act (APA) states that reviewing courts shall "set aside agency action, findings and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."¹⁸³ The lack of supporting evidence in the record, the FCC's decision to mandate data collection after imposing strict price caps, and Commissioner Pai's dissent may provide opponents of pris-

¹⁷⁷ *Id.*

¹⁷⁸ Press Release, FCC, Dissenting Statement of Comm'r Ajit Pai as Delivered at the August 9, 2013 Open Agenda Meeting (Aug. 9, 2013) [hereinafter Pai Dissent], http://transition.fcc.gov/Daily_Releases/Daily_Business/2013/db0809/DOC-322749A4.pdf.

¹⁷⁹ Press Release, TechFreedom, FCC Botches Prison Payphone Reform with Price Controls Unlikely to Survive in Court (Aug. 9, 2013) [hereinafter TechFreedom], available at <http://techfreedom.org/publications/fcc-botches-prison-payphone-reform-price-controls-unlikely-survive-court>.

¹⁸⁰ Pai Dissent, *supra* note 178, at 3; TechFreedom, *supra* 179.

¹⁸¹ Notice of Proposed Rulemaking at 9, *in re* Rates for Interstate Inmate Calling Services, FCC 13-113 (2012), (No. 12-375).

¹⁸² Pai dissent, *supra* note 178, at 2-3.

¹⁸³ Administrative Procedure Act, 5 U.S.C. § 706 (2012).

oner payphone reform sufficient evidence to derail the FCC's regulation. If the FCC is unable to explain its decision-making process and provide sound data supporting the low caps, the court system may remand the decision, further slowing needed reform and regulation of the inmate payphone industry.

The FCC should preempt this appeal by reviewing the order on its own terms. To avoid accusations of arbitrary and capricious rulemaking, the FCC should evaluate existing data in the record that contradicts the validity of the current price caps. The FCC should consider the concerns of the service providers and consider implementing a tiered rate cap framework in lieu of the current price caps.

B. *The FCC Should Reexamine its Blanket Prohibition of Monetary Commissions*

The FCC order also mandates that monetary commissions may not be supported in the per-minute charges.¹⁸⁴ While blanket prohibition will ensure that states and localities are not able to take advantage of inmates and their families by shifting general expenses onto per-minute rates, the FCC's order also prohibits monetary collections that fund inmate-focused projects and amenities. A tradeoff exists between efficiently protecting inmates from abusive commissions and funding programs that directly benefit inmates and reduce recidivism. The FCC should examine these tradeoffs to ensure that its decision to prohibit all commission fees is justified.

1. Limiting Commissions May Be Justified Due to Abuse

Some supporters of monetary commissions argue that these payments are necessary to support the state prison structure. For example, a Florida sheriff stated that eliminating or curtailing commissions "would have a negative impact on the inmates as phone companies and jails will be left with no option but for removal of the phones."¹⁸⁵ This argument does not survive close scrutiny. Costs associated with the installation and operation of payphones are borne by the payphone provider.¹⁸⁶ While the elimination of monetary commissions will negatively impact state projects, such as victim compensation and notification systems, it will have no impact on the viability of payphones in prisons.

¹⁸⁴ Aug. 9 FCC Press Release, *supra* note 13, at 2.

¹⁸⁵ Letter from Jack Parker, sheriff, Brevard County, to Marlene H. Dortch, Sec'y, FCC, FCC Docket No. 96-128, 1 (filed on Oct. 30, 2008).

¹⁸⁶ Carver, *supra* note 7, at 392.

The FCC's prohibition on state commissions reduces the profitability of inmate payphone contracts for states. However, the costs of inmate calls will not shift to the states. For example, New York, Florida, and Washington all restrict or waive monetary commission rates without losing prisoner payphone services.¹⁸⁷ Similarly, the incentives of payphone providers to enter into contracts and provide calling systems will not be adversely affected solely by blanket prohibition of monetary commissions.

In reality, prohibition of monetary commissions may incentivize payphone providers to extend their services by allowing them to recoup more revenue from per-minute rates. Without the need to share revenue with the states, payphone providers can lower consumer prices and still capture a portion of the revenues previously given to the states—assuming price caps are not set below costs. In future contract bidding, competition may push prices closer to payphone providers' marginal costs and may eventually make FCC price caps unnecessary.

2. Blanket Prohibition of Commissions Will Defund Beneficial Inmate Programs

The previous rationale suggests that the FCC's blanket prohibition of monetary commissions will solve the high costs of inmate payphone rates without creating an administrative burden on the FCC. However, not all commissions are designed to take advantage of captive consumers. Monetary commissions are often used to fund projects that directly benefit inmates by increasing their quality of life while reducing recidivism. A few prison systems use monetary commission revenue to fund prison amenities otherwise unsupported by the state legislatures.

The BOP's trust fund exemplifies how low monetary commissions can benefit prison systems.¹⁸⁸ In 1999, the BOP created a trust fund account for all revenues derived from payphone commissions and used the money to provide inmates with certain amenities and activities not supported through the appropriations system.¹⁸⁹ The trust fund provides for inmate wages, recreational activities, family programs, psychological assistance, and reading programs.¹⁹⁰ Unlike Army and Marine Corps prisons, which use payphone commissions to fund projects for the entire base, the BOP uses its excess funds to provide special amenities and more employment, education, and recreational opportunities.¹⁹¹ The GAO believes that, under systems

¹⁸⁷ Wright 2007 Proposal, *supra* note 70, at 3–4.

¹⁸⁸ GAO Report, *supra* note 5, at 7.

¹⁸⁹ *Id.* at 6, 17 n.37.

¹⁹⁰ *Id.* at 17, tbl.2. Nearly 75% of the trust fund's 2010 profits were generated through the payphone system. *Id.* at 7–8.

¹⁹¹ *Id.*

similar to the BOP trust fund, lowering call rates and prohibiting monetary commissions will force facilities to cut inmate amenities, wages, and activities.¹⁹²

Though the prohibition of state commissions will lower per-minute rates, the reduction in employment, recreational, and education programs will increase inmate idleness.¹⁹³ This increased idleness may correspond to increased violence, escape attempts, and other disruptions within the correctional facilities.¹⁹⁴ Recreational and educational activities also help inmates assimilate back into society, thereby reducing recidivism.¹⁹⁵ A blanket prohibition against funding similar projects via per-minute charges may also make prisons more expensive because the funds underwrite lower inmate wages for janitorial, electrical, and laundry jobs in lieu of contracting out to expensive third parties.¹⁹⁶

The FCC should investigate direct rate regulation of monetary commissions instead of blanket prohibition. Under direct FCC regulation of commission rates, inmate payphones can be a source of inmate project funding without overtaxing inmate families. The GAO reports that the federal prison system, even operating under a commission system, charges significantly less than its state counterparts.¹⁹⁷ The BOP charges \$0.06 per minute for local calls and \$0.23 per minute for long distance calls.¹⁹⁸ Under these lower prices, commissions still generated \$34 million for the trust fund, with long-distance calls contributing 90% of the trust fund's funding.¹⁹⁹

While the BOP's trust fund benefits from the large number of federal prisoners and significant economies of scale, state funds need not be large to be effective. Under a system similar to the BOP's trust fund, monetary commission funding can correlate directly to the number of state prisoners. If states only use monetary commissions to provide prisoner amenities, the smaller funds can adequately cover the smaller costs of providing services to smaller populations. However, directly regulating commission levels and designating what these funds may be used for presents enormous administrative challenges that may either result in overregulation of nonobvious, beneficial projects or be too burdensome on the FCC.

¹⁹² *Id.* at 12.

¹⁹³ GAO Report, *supra* note 5, at 12, 18.

¹⁹⁴ *Id.*

¹⁹⁵ *Id.* at 18.

¹⁹⁶ *Id.*

¹⁹⁷ IDAHO STATE LEGISLATURE: OFFICE OF PERFORMANCE EVALUATIONS, *Inmate Collect Call Rates and Telephone Access: Opportunities to Address High Phone Rates* at 14 (Jan. 2001), available at <http://idahodocs.contentdm.oclc.org/cdm/compoundobject/collection/p15100coll7/id/1028/rec/10>.

¹⁹⁸ Global Tel*Link Oct. 3 *Ex Parte* Letter, *supra* note 12, at attach.1, at 7–8.

¹⁹⁹ GAO Report, *supra* note 5, at 14.

States use monetary commissions to fund a variety of unique and creative operations. Although a few states, such as Virginia and Texas,²⁰⁰ use monetary commissions to fund programs that do not directly benefit the inmates or their families, completely prohibiting monetary commissions would also deter the funding of new, creative projects that do not facially benefit inmates. For instance, it is not obvious whether psychological therapy between inmates and victims reduces recidivism.²⁰¹ A bright-line rule against funding projects via per-minute commissions could hamper the research, development, and funding of projects like this. Thus, the FCC should reexamine its strict prohibition against small state commissions and weigh any potential benefits created by these programs against the increases in per-minute payphone rates.

C. A Tiered Benchmark Structure is Efficient and Administratively Feasible

The FCC should reevaluate its single price cap and instead adopt a different system. Blanket prohibition of monetary commissions may be untenable because it could harm prisoner-focused programs that would not otherwise be supported by prison budgets. Additionally, single per-minute rates may disincentivize advanced security procedures and lower the quality and quantity of payphones in small, inefficient jails. In contrast, a tiered system allows prisoner payphone providers to benefit from efficiencies and economies of scale while ensuring that prisoners pay reduced rates.

FCC pricing regulation via tiered price caps would ensure that states are not incentivized to take advantage of their inmates' sequestered nature and inability to choose substitute goods. A tiered pricing structure would also allow inmate telephone providers of smaller, less efficient prisons to charge at higher cap rates to ensure that the service providers are adequately compensated via 47 U.S.C. § 276²⁰² and that these facilities are not underserved. Finally, an open, tiered system, which automatically places prisons into separate pricing bands based on size efficiencies, would greatly decrease the administrative burdens of monitoring and responding to initial pricing petitions.

²⁰⁰ Global Tel*Link Oct. 3 *Ex Parte* Letter, *supra* note 12, at attach.1, at 7–8.

²⁰¹ Restorative Justice is an alternative to prison sentences that utilizes face-to-face meetings among all parties connected to a crime. LAWRENCE W. SHERMAN & HEATHER STRANG, THE SMITH INSTITUTE, RESTORATIVE JUSTICE: THE EVIDENCE at 4 (2007), available at http://www.sas.upenn.edu/jerrylee/RJ_full_report.pdf; see also Global Tel*Link Oct. 3 *Ex Parte* Letter, *supra* note 12, at 7–8 attach.1 (demonstrating that several UK studies suggest restorative justice reduced recidivism more than prisons while also reducing victims' post-traumatic stress symptoms).

²⁰² 47 U.S.C. § 276 (2012).

Securus calls for a tiered system based on facility size and allowable call length.²⁰³ Under an open, tiered rate structure, the FCC could set de facto rate benchmarks based on facility size. The Wright petitioners acknowledge that a tiered rate system would be effective.²⁰⁴ Under this framework, facilities serving small prisons would automatically charge at the highest price caps. Companies that specialize in serving facilities with fewer than twenty-five beds, higher marginal costs, and no economies of scale would be incentivized to continue serving these prisons. Under this tiered framework, facilities containing between 25 and 250 prisoners should be benchmarked at an intermediate price.²⁰⁵ The largest facilities, which benefit from the highest traffic volumes, economies of scale, and the lowest marginal service costs, can be benchmarked at pricing similar to that offered by the BOP and current FCC order.

While marginal costs also vary based on differing security requirements of each state, incorporating this variable into rate benchmarks creates an enormous administrative burden on the FCC. Provided that the FCC sets benchmarks above marginal costs, ignoring this variable does not inherently violate prison phone providers' rights to fair compensation under 47 U.S.C. § 276. Thus, for expediency and to avoid additional administrative burdens, a tiered price cap framework should only focus on one variable—facility size.

It is also possible that, if benchmarks are set too low, payphone providers could be disincentivized from investing in research and development of cheaper and more secure services. However, telephone providers are already engaged in strong competition to provide new, more secure technology offerings during the bidding process.²⁰⁶ So long as benchmarks are set above marginal costs, competition for contracts will ensure that payphone providers are incentivized to continue developing security systems.

Under such a framework, facilities could still petition the FCC for rate-cap relief by making a showing of heightened costs due to higher security standards and other unique variables. The accommodating nature of this framework would ensure that the number of legitimate petitions is lower than those created by the FCC's current rate caps. This would ensure that administrative burdens created by the regulation are minimized, allowing for more efficient utilization of FCC resources.

An FCC regulation mandating a tiered rate framework on the prison payphone industry would limit telecommunications providers to the rate cap designated for their facility's size. This would ensure that service pro-

²⁰³ Securus July 2 *Ex Parte* Letter, *supra* note 37, at 1.

²⁰⁴ Letter from Lee G. Petro, Attorney for Martha Wright, to Marlene H. Dortch, Sec'y, FCC, CC Docket No. 96-128 at Ex. A, 2 (filed Oct. 24, 2012).

²⁰⁵ *Id.*

²⁰⁶ *E.g.*, Global Tel*Link offers biometric caller verification of voice-analysis instead of typical call number identification. Global Tel*Link Oct. 3 *Ex Parte* Letter, *supra* note 12, at 4 attach.1.

viders of the smallest jails with the largest costs are justly compensated. A tiered rate cap would also constrain per-minute pricing at larger, more efficient prisons by subjecting them to lower price caps. This framework would ensure that service providers operating under different conditions are able to meet their varying operational costs while efficiently constraining attempts to extract monopoly profits from inmates and their families.

CONCLUSION

Prisoners like Winston Holloway and Natalie Bolds's fiancé are captive consumers of a monopoly. Prior to the latest FCC ruling, state governments, the trustees of prisoners' interests in payphone contracts, were frequently captured by monetary commissions that raised revenues by taxing the poorest segments of the community. High inmate telephone pricing had a direct effect on the well-being of the larger community. Recidivism is directly correlated with the frequency and quality of inmate communication with the outside world. By limiting communication through prohibitive pricing, states increased the probability that prisoners will be unable to successfully transition back into society. These commissions also resulted in unpredictable rates among states.

The FCC regulated these unjust and unreasonable payphone rates by implementing rate caps under 47 U.S.C. § 201(b). Although the new regulation is beneficial insofar as it standardizes and decreases prison payphone rates, it does not account for the varying costs of providing phone services in differently sized facilities. The FCC's order also prohibits all monetary commissions, failing to consider the possible benefits of low monetary commissions.

Therefore, the FCC should reevaluate its August 9th, 2013 order and instead implement an open, tiered rate structure. Under a tiered rate system, prisoners would enjoy lower rates while payphone providers would benefit from efficiencies unrealized under the current rate caps. If the FCC chooses to repeal its blanket prohibition of monetary commissions and set direct rates, states could still reap the benefits of sensible commissions. Additionally, a tiered rate framework would incentivize heightened competition and negotiations for lower per-minute pricing. This regulation would fully compensate service providers, ensure that prisoners like Holloway and Natalie Bolds's fiancé are able to connect with their families, reduce recidivism, and thereby benefit society as a whole.