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A RADICAL ROUTE TO FUNDING URBAN REVITALIZATION:
PROFITABLE PHILANTHROPY THROUGH LIMITED LIABILITY
COMPANIES AND A MARKET-BASED RETURN ON INVESTMENTS

*Roger M. Groves**

The issue posed in this article is simple. Why should we restrict the return on investment of those we beg to invest in charitable causes? The answer is far more complicated.

INTRODUCTION

The Basic Economics of the Urban Investing Landscape

A, B, and C, are three people alone on an island. The only available food is the fish they catch. The islanders are reduced to subsistence living because it takes each person all day to catch one fish since there is no fishing equipment. One day, A decides that he will build a net because he believes it will allow him to catch his one fish quicker, thereby giving him the opportunity to catch more fish, if he so chooses. B and C say A is crazy because A will starve to death if it takes a week to make the net, which may not even work. A agrees it will take him at least a day to make the net, but believes that making it is worth the risk. A makes the net in a day and goes to bed very hungry but uses the net to catch five fish the next morning. That same day, four new people find the island and buys A's fish. A then uses the money to construct a stronger, larger, and more efficient net. A catches more fish. He sells the fish to newer islanders in exchange for concrete and other useful items, which A then uses to build a net manufacturing plant and a house.

A created a capital asset (the net) to increase production because he believed the net would bring a return on his investment (more fish) that was greater than what he risked and the cost to make the net (i.e., his labor and a single day of hunger).¹ In a similar hypothetical, an economist called the

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¹ PETER D. SCHIFF & ANDREW J. SCHIFF, HOW AN ECONOMY GROWS AND WHY IT CRASHES 2-9 (2010).

net-caught fish “spare production[, which] is the lifeblood of a healthy economy.”²

In America, our economy is healthiest when money-lenders conclude, as A did, that making an investment is worth the risk because it will bring a return greater than its cost.³ The investor or the bank makes a capital investment into A’s net-production business. The net, which is more efficient than catching fish by hand, facilitates increased economic activity, including consumer spending, which then grows the economy. Indeed, roughly three-fourths of the United States’s economic activity is consumer spending.⁴ Businessperson A uses the proceeds to repay investors and hires people to build his home and business. Those builders and laborers receive money they can spend on goods and services, all of which contributes to economic growth.

Consider A’s enterprise as one of many small businesses, which comprise the majority of American businesses. According to the U.S. Census Bureau, in 2006, 5.38 million of the 6.02 million firms in the U.S. had less than twenty employees.⁵ The following passage illustrates the rationale when many of these small businesses are financed: “A bank officer authorizes a \$100,000 loan to a small-business man—a judgment that the businessman’s future earnings will be sufficient to repay the loan, that his enterprise would create real value in the future, which would justify the risk and the creation of the additional money.”⁶ However, this process is less prevalent in low-income communities.⁷ In too many instances, a small business in a low-income area has an anemic financial statement, which leads to doubt as to whether the expected return on investment in the small business is worth the risk. Often, this doubt occurs because the investor believes there is insufficient demand for the small business’s goods or ser-

² *Id.*

³ *Id.*

⁴ See Lucia Mutikani, *Economy Expands as Consumer Spending Picks Up*, REUTERS, Apr. 30, 2010, <http://www.reuters.com/article/idUSTRE63F2NT20100430>. Specifically, this economic activity is a reference to the country’s gross domestic product (GDP), which is the gross market value of all production. See *GDP Per Capita (Current US\$)*, THE WORLD BANK, <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD> (last visited Mar. 18, 2011).

⁵ SMALL BUS. ADMIN., OFFICE OF ADVOCACY, THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 99 (2009), http://sba.gov/sites/default/files/files/sb_econ2009.pdf.

⁶ WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 59 (1987).

⁷ See, e.g., Letter from Julie L. Williams, Acting Comptroller of the Currency, to Chief Executive Officers of all National Banks, Department and Division Heads, and all Examining Personnel (July 15, 1998), <http://www.occ.gov/static/news-issuances/memos-advisory-letters/1998/advisory-letter-1998-9.pdf> (discussing various barriers to access for minority businesses in low-income communities).

vices in its relevant geographic market. As a result, many small businesses in low-income areas do not receive the financing they need.⁸

Without a change in the status quo, we appear doomed for more of the same—undercapitalized small businesses struggling to survive in a struggling community.⁹ Each denial of equity capital is a lost opportunity for America to have its healthiest economy. How do we change the seemingly perpetual urban poverty? This article attempts to provide one piece of the answer to that question.

Americans are driven by more than just profit.¹⁰ In the above hypothetical, assume A no longer has to worry about making a living. Thus, he changes his focus to improving the quality of life for others, even if he foregoes profits to do so. In America, private foundations may serve this purpose. For example, a private foundation was formed to help businesses in low-income communities receive equity capital and identify the issues facing these businesses:¹¹ without a new profit-like investment, the foundation's projects would fail for lack of investment capital because private investors would view the risk versus return ratio as too high.¹²

That reality is ever present across urban landscapes in America, thus the question: given that the state of investment in urban America is so inadequate, how will it change? This article explores an investment model designed with a philanthropic paradigm to increase equity investments in

⁸ See, e.g., I.R.S. Priv. Ltr. Rul. 199943044 (Oct. 29, 1999) (investor claims that small businesses in low-income areas will not be able to receive the financing they need because of the risk versus return ratio is too high).

⁹ Hope springs eternal for more aggressive incentive programs that may increase private equity investor confidence beyond the charitable organizational setting discussed in this article. One such program is the recent American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. No. 111-5, 123 Stat. 115 (2009), which was enacted on February 17, 2009. The ARRA added § 54AA to the Internal Revenue Code, under which state and local governments may issue Build America Bonds as taxable governmental bonds with Federal subsidies for a portion of their borrowing costs. I.R.C. § 54AA (2009). Bond holders may receive federal tax credits or refundable tax credits paid to state and local governmental issuers of the bonds. See I.R.S. Notice 2009-26, 2009-16 I.R.B. 833 (Apr. 3, 2009), available at www.irs.gov/pub/irs-drop/n-09-26.pdf. But various other programs already exist to remedy the ills of low-income urban communities. See *infra* note 14 for examples of such programs. However, as long as urban residents remain economically distressed, the palpable investment risk and resultant hesitancy of potential investors is understandable.

¹⁰ Forty wealthy families and individuals joined Microsoft Corporation co-founder, Bill Gates, and billionaire investor, Warren Buffett, to pledge at least half of their wealth to charity. Carol J. Loomis, *The \$600 Billion Challenge*, FORTUNE, July 5, 2010, at 82, 85. In what they term the "giving pledge," Gates and Buffett estimate amassing as much as \$600 billion in charitable giving. *Id.* at 86. The pledgees include: Oprah Winfrey; TBS Network and former Atlanta Braves owner, Ted Turner; and New York City Mayor, Michael Bloomberg. *Id.* at 88. See also THE GIVING PLEDGE, <http://www.givingpledge.org> (last visited Mar. 18, 2011).

¹¹ The foundation made its case before the IRS, reported in a private letter ruling. I.R.S. Priv. Ltr. Rul. 199943044 (Oct. 29, 1999).

¹² *Id.* The target area to be served was designated by a state as economically depressed, with high rates of unemployment particularly among recent immigrants. *Id.*

small businesses in low-income communities. In doing so, it advocates modifying existing tax laws, so they enable, rather than tax, such ventures in profitable philanthropy.

Reformulating the Incentives Model to Allow Market-Based Returns

Congress has recognized an increasing need to infuse private equity investment into cities' decaying urban cores.¹³ The U.S. historically used its tax laws not only to generate revenue, but also to provide incentives for charitable ventures to help cure urban ills.¹⁴ Those incentives have mostly been confined to tax benefits and primarily in the forms of deductions and credits.¹⁵ This article suggests that private investors are far more interested in cash returns on their investments rather than tax deductions. Therefore, a cash incentive would increase equity investments in financially risky projects more effectively than tax deductions and credits. This argument implies the market-based risk and reward analysis should be incorporated more robustly into U.S. tax policy. Investors in charitable projects should not have to choose between a low return on a high-risk venture and not investing at all. Charitable investors should have the opportunity, in certain narrowly defined circumstances, to gain a high reward for high-risk ventures, just like the private sector does. In essence, this charitable investor would be participating in "profitable philanthropy."¹⁶ It is also wise tax policy to increase private equity investments for such cases, as they may correspondingly decrease the need for public subsidies.¹⁷

While it may be a radical approach to provide a double benefit of tax exemption *and* market returns, there are many justifications. The policy reason, noted above, suggests that the goal of a healthy America is para-

¹³ See, e.g., America's Private Investment Companies Act, S. 1565, 106th Cong. (1999) ("The purposes of this Act are to: (1) license *private* for profit *community* development entities that will focus on making *equity* and credit *investments* . . .") (emphasis added).

¹⁴ Tax incentives for economically distressed communities include new markets tax credits (totaling 39% of qualified equity investments over seven years, i.e., 5% of the investment for the first three years and 6% for the remaining four years of the credit allowance period; see I.R.C. § 45D (2010)); tax exempt bond financing for enterprise zones (where 95% of the net proceeds are used for enterprise zone facilities; see I.R.C. § 1394(a) (2002)); and, more recently, recovery zone economic development bonds and credits (for designated recovery zones due to the sub-prime mortgage housing and banking crisis; see I.R.C. § 1400U-2 (2009) (added by the American Recovery and Reinvestment Act, Pub. L. No. 111-5, 123 Stat. 115 (2009)).

¹⁵ For a comprehensive list of such incentives, see JAMES EDWARD MAULE, TAX INCENTIVES FOR ECONOMICALLY DISTRESSED AREAS, TAX MANAGEMENT PORTFOLIO SERIES 597 (2005).

¹⁶ This article defines "profitable philanthropy" as the activity of investing for primarily charitable purposes while also gaining market returns on the assets invested.

¹⁷ For a discussion of the tax policy benefits of broadening the private equity base, see Roger M. Groves, *More Private Equity, Less Government Subsidy, and More Tax Efficiency in Urban Revitalization: Modeling Profitable Philanthropy and Investment Incentives*, 8 FLA. ST. U. BUS. REV. 93 (2009).

mount. Taxation and related incentives are means to help achieve that goal. This article proposes a theory of “tax benefit reciprocity,” where the extra benefit of market returns is limited because it accrues only to the extent the entity lessens the government’s burden. One should not be left with the impression that the narrow circumstance this article advocates somehow robs the U.S. Treasury or creates a destructive tax shelter. Rigorous statutes providing for unrelated business income tax and excise tax regulations, safeguard against abuses of tax exemption status.¹⁸ This article also asserts that for low-income projects that are viewed as high-risk investments, incentivizing a large number of investors to contribute smaller amounts of money increases equity investments more effectively than relying on a few investors to contribute very large amounts. This strategy is especially advantageous where conventional financing with market-based rates of return is unavailable.¹⁹ This article challenges the presumption that charitable ventures should not be profitable. Investors taking on high-risk ventures to assist disadvantaged communities should be allowed to let typical market forces operate; rather than being forced into a high-risk, low-return venture, investors should have the option to engage in a high-risk, high-return venture. To this end, U.S. tax laws can facilitate such an approach.

Current tax laws and Internal Revenue Service (IRS) pronouncements raise serious doubt as to whether tax-exempt private foundations can make a substantial profit when jointly venturing with for-profit entities in a genuinely charitable project. In select circumstances, there is a blurring of an otherwise bright line between nonprofit organizations, focused only on charitable causes, and companies whose primary goal is earning a net return for its investors. The idea that charitable “giving” must mean relegating the entity to a break-even economic existence without material economic re-

¹⁸ Taxation of exempt organizations for revenue unrelated to their exempt activities totaled approximately \$226 million in 2001. See STAFF OF J. COMM. ON TAXATION, 109TH CONG., HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 6 (Comm. Print 2005).

¹⁹ The scope of this article involves amendments to existing tax law. A forthcoming article in progress, entitled *Venture Capital and Philanthropic LLCs: The Future Financing Vehicle of Choice for Urban Frontiers*, models urban financing techniques and strategies more precisely. Specifically, this article suggests the careful correlation between risk and return through an investment model so that non-profits undertaking high-risk ventures receive a correspondingly high return without jeopardizing exempt status when jointly financing the venture. To avoid comingled investment risk between the exempt members and the for-profit members, the capital investment can be separated into a separate tranche so that the charitable project is undiluted. As the profit entity gains market returns, the non-profit continues under constrained circumstances or leaves the venture, liquidating its interests at fair market value. If the venture continues to fulfill primarily charitable objectives, the non-profit member can continue in the venture only if he maintains control to maintain the charitable purposes. If the charitable purpose is converted to primarily profit purposes, the non-profit member must liquidate his interests or risk a recapture of benefits and penalties for failing to timely disclose the conversion. This model also includes factors and schedules to add clarity and predictability to determining the limits of a non-profit’s return on investment, and to ascertain when the profit conversion occurs.

turn, needs exceptions. Indeed, exceptions exist, but they are primarily obscured in individual, unpublished IRS private letter rulings (PLR).²⁰ This article advocates encouraging the business relationships between tax-exempt foundations and for-profit entities that joint venture through limited liability companies to invest in charitable ventures.

Part I of this article discusses how certain tax-exempt, charity-based corporations (public charities) may joint venture with for-profit entities through a limited liability company (LLC), and that the investments made by the LLC in charitable projects are authorized by law.²¹ Part II introduces the rationale for extending the exemption status of joint venture investments beyond public charities to include private foundations.

Part III argues that the investment returns by the private foundation and the LLC should match the customary risk–reward experience in the private marketplace. The argument is two-fold: first, the underlying purpose for the restrictions generally placed on private foundations (to prevent unfair competition) should not apply to philanthropic LLCs; second, the flexibility of the prudent investor standard provides opportunities for the LLC manager to operate without violating the spirit of the tax laws.

Part IV advocates an expanded definition for the type of program-related investments (PRIs) that qualify as “special allocations” for investment income. It explores the unique advantages of using the LLC operating agreement in lawfully distributing those special allocations. Part V proposes amendments to existing IRS regulations to overcome three major restrictions on special allocations, so that investors of philanthropic LLCs can receive investment incentives through allocated tax benefits with greater certainty.

Part VI examines the various excise taxes that could be imposed as penalties against the philanthropic LLC. It calls for a statutory remedy that adds certainty to the law and avoids a chilling effect on investment by assuring investors that taxes will not be imposed if certain other requirements are met. A study on the effect of excise taxes on charitable giving by private foundations concluded that a required annual tax based on net investments can disincentivize increased investment and can have “countervailing effects on foundation behavior.”²² A recent congressional bill sought to simplify and reduce the amount of that same tax, in recognition of the ad-

²⁰ Tax law practitioners have access to the PLRs through traditional online sources. Yet there is currently no evidence that indicates that private equity investors rely on such PLRs. Investors are more likely to ascertain the investment risk for a particular investment without reliance on PLRs, which are only responsive to individual circumstances before the IRS and expressly without precedent for any other transactions.

²¹ The LLC is sometimes referred to as a philanthropic LLC that makes “mission-based investments” because its mission is charitable in nature.

²² See COUNCIL ON FOUNDS., SIMPLIFY THE EXCISE TAX ON PRIVATE FOUNDATIONS (S. 676/H.R. 4090) (2010), available at www.cof.org/templates/311.cfm?ItemNumber=16095.

verse effect that a higher tax rate can have on charitable giving.²³ These taxes add to the risk that investors and joint venture financiers must consider.²⁴

Part VII explores the benefits of allowing greater investment returns and encouraging private equity investors to contribute mission-related investments. It introduces a theory of tax benefit reciprocity, where the benefit the philanthropic entity receives is proportionate to the benefit it provides the government by lessening its burden of assisting disadvantaged communities.

I. JOINT VENTURE OPPORTUNITIES FOR NONPROFIT CORPORATIONS THROUGH LLCs—WITHOUT RETURN ON INVESTMENT LIMITATIONS

This article focuses on joint ventures because status quo investments have not transformed the neediest areas of major American cities. Joint ventures represent an “innovative and increasingly important part of business strategy”²⁵ that are valuable for all stages of a project’s development for a wide array of business sectors, including start-ups, or fledgling businesses, in low-income areas.²⁶ Joint ventures also provide transactional advantages and flexibility for shared risks and allocations of burdens, which are beneficial for risky ventures like those serving low-income areas.²⁷ The Joint Committee on Taxation recognized this connection between joint venture opportunities and charitable projects when it cited a leading commentator, who stated:

Joint ventures continue to play an increasingly important role for exempt organizations faced with the challenge of operating in a difficult economic environment. They offer a way for nonprofits to successfully shape their own destiny. . . . These arrangements, assuming they are structured properly, provide an alternative, viable way for exempt organizations to accomplish their missions, eliminating the need for total reliance on the more traditional sources of funding.²⁸

²³ S. 676, 111th Cong. (2009). The bill was co-sponsored by three Democrat and four Republican senators. The bill sought to amend I.R.C. § 4940, so that the two-tiered annual tax would be replaced with a single revenue-neutral tax at a lesser rate.

²⁴ In addition to the study and proposed legislation, this article relies on the logic that investors are less likely to invest in high-risk projects if the return is low and the penalty is substantial.

²⁵ Yves Brulard & Romain Sabatier, *Exit Clauses Applicable to Joint Ventures under Belgian Law*, 28 COMP. L. Y.B. INT’L BUS. 131, 131 (2007).

²⁶ See ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, COMPETITION POLICY AND JOINT VENTURES 22-24 (1986).

²⁷ *Id.*

²⁸ STAFF OF J. COMM. ON TAXATION, 109TH CONG., HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 115

In a difficult economic environment, conventional sources of funding for philanthropic projects that serve low-income urban communities are sparse. Hence, fostering these arrangements between nonprofits and for-profit entities may bring about radical, pragmatic change.

Entities within the target low-income communities are often those types of businesses in need of investment capital. This article also examines capital pooling among the entity's investors into a fund for investing in a start-up or fledgling entity.²⁹ As such, the entities at the center of this article are akin to venture capital firms with a venture capital fund.³⁰

Revenue Ruling 98-15 is the primary authority allowing a federally tax-exempt § 501(c)(3) organization to joint venture with a for-profit entity and retain its exempt status, even though both are members of an LLC.³¹ There, the nonprofit entity was an acute care hospital exempt from federal income tax under § 501(c)(3) of the Internal Revenue Code (IRC).³² The for-profit member was a hospital that owned and operated numerous hospitals.³³ The nonprofit contributed all of its operating assets, primarily its hospital, to the LLC; the for-profit hospital also contributed assets to the LLC.³⁴ The LLC's income would then flow back to these members in proportion to their contributions to the LLC.³⁵

A. *The Aggregate Principle—Treatment of the LLC as a Partnership*

In determining whether the nonprofit could retain its exempt status, the IRS first examined whether the type of activities the LLC undertook were the type authorized for exempt entities.³⁶ While promoting health through a hospital can be "charitable" under § 501(c)(3), a hospital owned and operated for profit by private owners is not "charitable."³⁷ That principle led the IRS to scrutinize the relationship between the exempt entity and any for-profit entity it conducted business with. The IRS synthesized several prior

(Comm. Print 2005) (quoting MICHAEL I. SANDERS, *JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS*, 2004 CUMULATIVE SUPPLEMENT ix (2d ed. 2004)).

²⁹ A. DAVID SILVER, *UP FRONT FINANCING: AN ENTREPRENEUR'S GUIDE* 25 (1982) (explaining that a start-up company is one that has essentially no revenues).

³⁰ *Id.* at 30 ("[M]ost private venture capital funds have a strong preference for start-ups" because their superior industry and market acumen provide an opportunity to control the venture).

³¹ See Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94.

³² *Id.*; I.R.C. § 501(c)(3) (2010) (exempting from federal income tax entities organized and operated exclusively for charitable, scientific, or educational purposes as long as no part of the net earnings inures to benefit any private shareholders or individuals).

³³ Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *2.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at *18-*20.

³⁷ *Id.* at *23.

tax court opinions where an exempt entity was in a partnership or limited partnership with a for-profit entity.³⁸

In what it termed the “aggregate principle,” the IRS relied on a case in which the tax court allowed a partner to take a business bad-debt deduction for a loan he made to the partnership because the partner, “by reason of being a partner,” was entitled to receive a tax benefit from his association with the partnership.³⁹

In another case, a charitable organization retained exempt status though it raised funds to produce a play through creating a limited partnership, where limited partners included private individuals and a for-profit corporation.⁴⁰ In these cases, the IRS applied the aggregate principle, where individual partner benefits were aggregated rather than separated for tax purposes.⁴¹ When the partnership operations primarily furthered the non-profit purposes, and the for-profit entities had no control over those operations, the partnership was afforded exempt status and the nonprofit partner retained its exempt status.⁴² Conversely, if the for-profit members used the nonprofit entity as an “instrument” to further their for-profit purposes, the partnership did not qualify as a § 501(c)(3) organization, and therefore, is not exempt.⁴³ The IRS looked to these relevant rulings in analyzing whether § 501(c)(3) status would attach to an LLC.⁴⁴

The question the IRS considered was whether the nonprofit hospital continues to be exempt when it forms an LLC with a for-profit corporation

³⁸ *Id.* at *12-*17.

³⁹ Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *13 (citing *Butler v. Comm’r*, 36 T.C. 1097, 1106 (1961) (holding that a partner can take a business bad debt for a loan he made to the partnership because the partner, “[b]y reason of being a partner,” was entitled to receive a tax benefit from his association with the partnership)).

⁴⁰ *Id.* at *13-*14 (citing *Plumstead Theatre Soc’y, Inc. v. Comm’r*, 74 T.C. 1324, 1333-34 (1980) (exempt status was retained though the exempt partnership raised funds to produce a play by creating a limited partnership, where limited partners included private individuals and a for-profit corporation but the limited partners had no control over the operations), *aff’d*, 675 F.2d 244 (9th Cir. 1982)).

⁴¹ *Id.* at *13 (citing *Butler v. Comm’r*, 36 T.C. 1097, 1106 (1961) (holding that a partner can take a business bad debt for a loan he made to the partnership because the partner, “[b]y reason of being a partner,” was entitled to receive a tax benefit from his association with the partnership)).

⁴² *See id.* at *13-*14 (citing *Plumstead Theatre Soc’y, Inc. v. Comm’r*, 74 T.C. 1324, 1333-34 (1980) (exempt status was retained though the exempt partnership raised funds to produce a play by creating a limited partnership, where limited partners included private individuals and a for-profit corporation but the limited partners had no control over the operations), *aff’d*, 675 F.2d 244 (9th Cir. 1982)); *Broadway Theatre League of Lynchburg, Va., Inc. v. United States*, 293 F. Supp. 346, 355 (W.D. Va. 1968) (exempt status was retained though the exempt partner hired a for-profit booking agent for its theatrical performances because the exempt partner retained ultimate control of the activities).

⁴³ Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *15-*16 (citing *Est of Hawaii v. Comm’r*, 71 T.C. 1067, 1082 (1979) (a company is not exempt when it is merely an instrument to fund a for-profit corporation)).

⁴⁴ *Id.*

and the nonprofit hospital contributes the bulk of its assets to the LLC.⁴⁵ The IRS relied on two sources: the cases embodying the aggregate principle and the IRC sections referring to taxation of a partnership with trade or business income unrelated to its otherwise exempt activity.⁴⁶ Under IRC § 512(c), the partner (or in this case an LLC member) must include its share of the partnership's gross income as part of its own unrelated business income when computing its individual income taxes.⁴⁷ The IRS stated that if the LLC, like a partnership, furthers nonprofit purposes and only incidentally benefits for-profit members, the LLC could achieve or retain § 501(c)(3) exempt status.⁴⁸ Similarly, the nonprofit LLC member can be exempt, even if it executes a management contract with a for-profit entity, so long as the for-profit entity is subject to reasonable compensation and terms, and does not use the nonprofit entity as an instrument for for-profit purposes.⁴⁹

As applied to the facts presented, the IRS examined the LLC's articles of organization and the operating agreement (governing documents).⁵⁰ Two factors appeared to have primary importance: first, the LLC board had the affirmative duty to operate in furtherance of the charitable purposes of the nonprofit LLC member; second, if conflicts arose between nonprofit goals

⁴⁵ *Id.* at *1.

⁴⁶ *Id.* at *8-*13. As will be discussed in detail later, an entity may retain § 501(c)(3) status but still have tax liability for income received from a trade or business unrelated to its exempt activities. See I.R.C. § 512(c) (2010), which is specific to partnerships.

⁴⁷ I.R.C. § 512(c)(1).

⁴⁸ Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *17-*18. The Ruling did not have to face an issue of whether an LLC can be treated as a partnership for tax purposes. The regulations already provide that a business entity that is not classified as a corporation can elect its status and that partnership status is attained by default under what are termed "check-the-box" regulations. Treas. Reg. § 301.7701-3(a)-(b)(2) (as amended in 2006).

⁴⁹ Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *13-*14 (citing *Plumstead Theatre Soc'y, Inc. v. Comm'r*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982); *Broadway Theatre League of Lynchburg, Va., Inc. v. United States*, 293 F. Supp. 346 (W.D. Va. 1968)).

⁵⁰ *Id.* at *2-*3. A more comprehensive summary of significant aspects of management follows:

1. The LLC must operate the hospital only in a manner that furthers the charitable purposes.
2. The charitable purposes must promote health for a broad cross-section of the community.
3. The majority of the managing board is chosen by the exempt entity (3 of the 5 board members).
4. A majority of the board must have decision-making authority over important operating matters of the LLC including, but not limited to, the following:
 - a. Annual capital budgets and operating budgets;
 - b. Earnings distributions;
 - c. Selection of key executives;
 - d. Facilities acquisitions or dispositions;
 - e. Contracts beyond a threshold level; and
 - f. Renewal or termination of management contracts.
5. The exempt entity has veto power over any attempt by a profit member to amend the governing documents.

Id. at *3.

and for-profit goals, the governing documents made clear that the exempt purposes would govern.⁵¹ Since the governing documents prioritized charitable purposes in the LLC's operation and governance, the IRS concluded that the LLC would operate primarily for exempt purposes and that any benefits to its for-profit member were incidental.⁵² Accordingly, the non-profit member retained its exempt status.⁵³

B. *No Limit on the Return on Investment*

Significantly, the IRS did not specifically limit the return on investment (ROI) of the LLC's tax-exempt member, despite its joint operation of the hospital with a for-profit entity. Whether the ROI was above a certain threshold, beyond that of the for-profit member, or greater than the market-based return of other for-profit entities, did not affect the determination of exempt status. Instead, the IRS authorized income from the LLC operations to be returned in proportion to the members' respective asset contributions. To illustrate, if no other statutes or rules applied, and the nonprofit member contributed \$20 of assets, and the for-profit contributed \$10, the IRS would authorize the nonprofit to receive twice the amount of income as the for-profit entity because it contributed twice the assets to the LLC. As long as the income accrued while the LLC was operating in furtherance of the exempt purposes and significant operating control resided in the nonprofit member, the amount of income generated was not a basis for eliminating exempt status for the nonprofit member.⁵⁴

In Revenue Ruling 98-15, the IRS dealt with a tax-exempt hospital under § 501(c)(3) as opposed to a private foundation. The ruling clarified that the exemption was allowed even though the entity was not a private foundation.⁵⁵ As discussed below, Revenue Ruling 98-15 should also apply to private foundations.⁵⁶

⁵¹ *Id.* at *3-*4.

⁵² *Id.* at *18-*20.

⁵³ *Id.* The IRS also noted facts under which the exemption status would be lost. Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *20-*23. In what it termed "situation 2," the same general circumstance existed where a nonprofit § 501(c)(3) hospital forms an LLC with a for-profit hospital provider. *Id.* The differences were that each member had equal representation on the managing board, both members had the right to veto major document revisions and must jointly approve major decisions regarding budgets and earnings distributions, and day-to-day management was provided by a wholly owned subsidiary of the for-profit member. *Id.* Under this scenario, the IRS concluded that the nonprofit hospital member would lose its § 501(c)(3) exemption for its failure to establish that the LLC would operate for sufficiently exempt purposes. *Id.*

⁵⁴ There are, however, other restrictions under the tax code that impair, chill, or otherwise penalize ROI that were not at issue in that Revenue Ruling.

⁵⁵ Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *22-*23.

⁵⁶ *See infra* Part II.

II. THE EXTENSION OF REVENUE RULING 98-15 TO PRIVATE FOUNDATIONS—MEETING THE REQUIREMENTS FOR PROGRAM-RELATED INVESTMENTS

A. *The Public Charity—Private Foundation Distinction*

The rules governing nonprofits are not uniform. Varying exemption rules apply; the types of investments nonprofits can make differ depending on the nonprofit, and the amount of return the nonprofit can receive from those investments varies as well. This article focuses on the private foundation investments, particularly the economic return they derive from those investments.

In Revenue Ruling 98-15, the nonprofit hospital was an entity exempt from federal income tax under § 501(c)(3).⁵⁷ To clarify the rule, the IRS stated the hospital was not a private foundation, which is in a separate subcategory of exempt entities.⁵⁸ The § 501(c)(3) hospital's governing documents declared that the hospital relied on the general public for its financial support and qualified as a public charity under the IRC.⁵⁹ This designation is legally distinct from a private foundation, which derives contributions primarily from a narrow group of contributors or from its own funds.⁶⁰

The source of the contributed funds is therefore the most important factor distinguishing public charities and private foundations. As their name implies, public charities derive their support primarily from the general public and the government.⁶¹ More specifically, to be classified as a public charity, an entity must receive more than one-third of its support from "gifts, grants . . . or membership fees" and less than one-third of its support from investment income.⁶² Private foundations, on the other hand, are exempt under § 509 of the IRC, outside of the public charity definition found in § 501(c)(3).⁶³ Entities receiving funding from major philanthropists most often qualify as private foundations because such funding is not a

⁵⁷ Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *1-*2.

⁵⁸ *Id.* A § 501(c)(3) corporation can avoid private foundation status under § 509(a) of the Code when it has the principal purpose of providing hospital care under I.R.C. § 509(a)(1) (2006), which incorporates by reference hospitals under I.R.C. § 170(b)(1)(A)(iii) (2010). *Id.*

⁵⁹ *Id.* at *18-*20.

⁶⁰ For the public support requirements, see I.R.C. § 501(c)(3) (2010). The private foundation exemption is found in I.R.C. § 509.

⁶¹ I.R.C. § 170(b)(1)(A)(i)-(iv) (2010) (including churches, schools, hospitals, and governmental units as public charities).

⁶² I.R.C. § 509(a)(2).

⁶³ Section 509(a) defines a private foundation as an organization qualifying as a 501(c)(3) but that does not receive more than one third of its support from public sources such as gifts, grants, membership fees, and gross receipts from admissions or less than one-third of its support each year from gross investment income. I.R.C. § 509(a)(2)(A)(i)-(B)(i).

result of general public solicitations.⁶⁴ Moreover, major philanthropists may wish to designate and control where and to whom those funds are donated.⁶⁵ As such, these entities most likely qualify as private foundations for their charitable entity.

Since a private foundation has the ability to self-direct a donor's funds, the donor may invest those funds according to her self-interest. As a result, the danger of abuse is ostensibly greater with a private foundation than with a public charity. Accordingly, the IRS has compelling grounds for discriminating as to the types of investments a private foundation can make. This consideration is problematic for the interpretation that Revenue Ruling 98-15 covers private foundations. The ruling only concerned the public charity, which unlike a private foundation lacks the potential for self-interest. Therefore, one can argue that the ruling does not extend the continued § 501(c)(3) exempt status it gave the joint venture with a for-profit member.

B. *Program-Related Investments as a Qualifier and Gatekeeper*

It is logically and legally consistent for the IRS to impose more stringent rules for private foundations to ensure that foundation investments and activities are sufficiently tied to truly exempt purposes.⁶⁶ IRC § 4944 accomplishes this objective by requiring the private foundation's investment in a for-profit venture to qualify as a program-related investment (PRI).⁶⁷ Section 4944 provides that investments must: (1) be primarily designed to accomplish charitable purposes, (2) have "no significant purpose" to produce "income or appreciation of property," and (3) have no purpose that furthers substantial legislative or political activities.⁶⁸ Failure to conform to those requirements jeopardizes the exempt status of the private foundation; entities violate the mandate by investing "in such a manner . . . [that] jeopardize[s] the carrying out of any of its exempt purposes."⁶⁹ The conse-

⁶⁴ See generally Victoria B. Bjorklund, *Current Developments For Charitable Giving to Donor-Advised Funds and Supporting Organizations*, REPRESENTING & MANAGING TAX-EXEMPT ORGS. (Geo. U. L. Ctr. Continuing Legal Educ., Washington, D.C.), Apr. 29, 2004, at 97, available at 2004 WL 2800516 (describing different donors' attempts to control their gifts and the government's responses); see also Roger M. Groves, *More Private Equity, Less Government Subsidy, and More Tax Efficiency in Urban Revitalization: Modeling Profitable Philanthropy and Investment Incentives*, 8 FLA. ST. U. BUS. REV. 93, 101 (2009).

⁶⁵ See generally Bjorklund, *supra* note 64; see also Groves, *supra* note 64.

⁶⁶ See *supra* Part II.A.

⁶⁷ See I.R.C. § 4944(c) (2006).

⁶⁸ *Id.* (explaining the exceptions for PRIs); Treas. Reg. § 53.4944-3(a)(1) (as amended in 2009) (giving more details for PRI tax exceptions).

⁶⁹ I.R.C. § 4944(a)(1) (2006).

quences for that failure are grave, subjecting the private foundation to excise taxes, penalties, and potential revocation of exempt status.⁷⁰

III. MARKET-BASED INVESTMENT RETURNS

Investment returns by the foundation and the LLC should be broadened to match risk-reward experience customary in the private marketplace. The current limitation is implicit, but is nonetheless an elephant in the meeting room of investors. In Private Letter Ruling 2006-10-020, the IRS did not find a jeopardizing investment when below market rates were the investors' expectation, and no conventional financing was available.⁷¹ The IRS's determination left the possibility of an opposite finding given opposite facts: where the investors expect market returns and there is available conventional financing, investments would be considered jeopardizing.⁷² If the jeopardizing investment exists, the heavy penalties from the excise taxes would likely chill investment.⁷³

An additional disincentive for risky philanthropic investing involves limitations on the types of entities in which the philanthropic LLC invests funds. For example, the IRS determined that if a private foundation invests in a for-profit small business investment company, exempt status is jeopardized even if the purpose is to create employment opportunities in high-unemployment areas.⁷⁴ In one case, a nonprofit's investment in a horse-racing facility was not program-related, and therefore likely subject to excise taxes.⁷⁵ This was true even though the facility employed people who would otherwise be unemployed, and the track had an "erratic earnings history consisting mostly of losses" with no feasible prospects for sale on the open market.⁷⁶ Although the IRS has not directly stated in these instances that market or above-market returns are categorically forbidden, it has placed restrictions on where to invest, when the investment arguably has charitable benefits, even where there have been historic losses and questionable marketability to the investment.⁷⁷ These rulings provide an uncertain legal landscape that discourages philanthropic ventures. Congressional intent to impose restrictions on private foundations generally does not apply to the philanthropic LLC.

⁷⁰ I.R.C. §§ 4944(a)(1)–(b)(2) (2006) (explaining that there is an initial excise tax of 5% of the invested sums for each year, imposed on the private foundation and some managers).

⁷¹ I.R.S. Priv. Ltr. Rul. 200610020 (Mar. 10, 2006).

⁷² *Id.*

⁷³ See *infra* Table A, for the comprehensive list of those excise taxes and associated penalties.

⁷⁴ I.R.S. Priv. Ltr. Rul. 7742062 (1977).

⁷⁵ I.R.S. Priv. Ltr. Rul. 8201050 (Oct. 7, 1981).

⁷⁶ *Id.*

⁷⁷ I.R.S. Priv. Ltr. Rul. 8201050 (Oct. 7, 1981).

A. *Foundational Relevance of the Unrelated Business Income Tax and the Principle of Unfair Competition*

The rationale for limiting the economic ROI for tax exempt entities and other related restrictions on the use of those investments is rooted in the principle of unfair competition. Before the IRC's enactment, President Truman requested that Congress revise the tax laws.⁷⁸ His initiative to improve the U.S. tax system included closing tax loopholes "which enable some few to escape their share of the cost of government at the expense of the rest of the American people."⁷⁹ The President stated:

[S]ome tax loopholes have . . . developed through the abuse of the tax exemption accorded educational and charitable organizations . . . [E]xemption[s] intended to protect educational activities [have] been misused . . . to gain *competitive advantage* over private enterprise through the conduct of business and industrial operations entirely *unrelated* to educational activities.⁸⁰

President Truman also decried instances where charitable trust funds used their exempt status "as a cloak for speculative business ventures and the funds intended for charitable purposes, buttressed by tax exemption, [were] used to acquire or retain control over a wide variety of industrial enterprises."⁸¹ He noted that the appropriate congressional committee "ha[d] already undertaken to correct this situation . . ."⁸² By 1954, the IRC imposed an unrelated business income tax (UBIT) on federally tax-exempt organizations and certain exempt trusts.⁸³

The UBIT rationale underpinning the regulation of exempt organizations' investment income requires updating to meet the current urban crisis and conditions. The unfair competition rationale is not at issue when competition does not exist. In numerous circumstances, nonprofits invest in ventures that the private sector would not, in large part because the objective is tied to benevolence as opposed to maximum profitability. If a for-profit entity would not pursue the project, then there is no competition and thus no compelling reason to prohibit the nonprofit from creating any risk-reward dynamic the market will bear. The result should be no different if

⁷⁸ HARRY S. TRUMAN, REVISION OF THE TAX LAWS, H.R. DOC. NO. 81-451 (1950). The document was referred to the Committee on Ways and Means.

⁷⁹ *Id.* at 3.

⁸⁰ *Id.* at 5 (emphasis added).

⁸¹ *Id.*

⁸² *Id.*

⁸³ Internal Revenue Code of 1954, ch. 736, 68A Stat. 3, 169-70 (1954) (current version at I.R.C. §§ 511-12 (2010)).

the nonprofit exempt entity joint ventures with a for-profit entity so long as the joint venture's primary purpose is charitable.⁸⁴

In the latter circumstance, the for-profit partner may desire to invest, but will only do so if a joint venture partner incurs the greater risk. In other circumstances, the for-profit entity would invest in a project only if the other joint venture partner provides financing or tax benefits that flow to the for-profit entity (i.e., gap financing or transferrable tax benefits or credits). Under either of these two scenarios, but for the nonprofit's investment, the for-profit entity would not have sufficient incentive to initiate the project. The entities are not competing for the same opportunity. Instead, they are cooperating in order to bring the project to fruition, simultaneously enhancing the for-profit partner's goal of raising revenue. Additionally, rather than losing a business opportunity, the for-profit entity may pursue a dual goal—profitability and philanthropy rather than focusing solely on profitability. This dual goal may create fiduciary duty issues for the corporate board of directors, but those issues are beyond the scope of this article.⁸⁵

A related reason for allowing private investment exemption rules is rooted in tax policy. If government programs continue to be the primary means of rehabilitating urban and rural America, then those expenditures will continue to drain the Treasury. If, however, increased return from investing spurs greater investor activity, private sector funds may supplant government expenditures. Therefore, allowing profit incentives would stimulate the economy by increasing private equity investments and reducing the governmental subsidy over time. Beyond raising revenue, allowing the government to reduce expenditures in this area leaves more funds for other purposes. The result is a net gain to the Treasury because rather than simply raising revenue, the Treasury keeps more of what it raises.⁸⁶

⁸⁴ The downside of creating additional tax benefits is that it creates the opportunity for unintended tax shelter consequences. As noted throughout this article, existing definitions and procedures already provide adequate safeguards.

⁸⁵ A for-profit entity has a primary duty to its shareholders and/or partners to pursue profitability for the entity. See *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919). Nonetheless, there are methods of gaining shareholder approval/ratification that could authorize this dual bottom line, including executing shareholder agreements that govern the making of distributions. See MODEL BUS. CORP. ACT § 7.32(a)(2) (2008). Voting rights may be afforded to some shareholders and not others through voting trusts, which may enhance approvals of philanthropic ventures by the entity. *Id.* § 7.30(a). The shareholders may elect board members specifically because of their social philanthropic ideals. There are even statutory provisions that have become increasingly popular authorizing a board of directors to consider the effects of their decisions on communities in which the business is located. See Pennsylvania Business Corporation Act, 15 PA. CONS. STAT. § 1715(a)(1) (2010). For more comprehensive discussion of corporate social responsibility, see ROBERT W. HAMILTON, JONATHAN R. MACEY & DOUGLAS K. MOLL, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 504-14 (11th ed. 2010).

⁸⁶ This theory is admittedly steeped in optimism as it posits a net financial benefit. The author discusses the disincentives if the project incurs losses in the second paragraph of section F, involving capital account deficits.

President Truman articulated another principle that is just as valuable now as it was in 1950: the need to balance the revenue requirements with the need to incentivize and increase the number of charitable organizations. “It has properly been the policy of the Federal Government since the beginning of the income tax to encourage the development of these organizations. That policy should not be changed. But the few glaring abuses of the tax-exemption privilege should be stopped.”⁸⁷

Instead, the Federal Government should adopt an updated and more efficient policy to encourage the development of charitable organizations through joint ventures between exempt and for-profit entities in an LLC. The investments made in that form can be subject to certain safeguards.⁸⁸ The investments must further the exempt purposes, instead of being used to gain a competitive advantage over taxable entities or to acquire or control industrial enterprises for their own pecuniary interests. This structure would retain the balance President Truman sought. Although tax laws must exist to prevent exemption abuses, those rules should be amended without, as President Truman said, “jeopardizing the basic purposes of those organizations which should rightly be aided by tax exemption.”⁸⁹ Because unfair competition concerns motivated Congress to create restriction policies, those restrictions should be lifted where the unfair competition threat is nonexistent or already mitigated.

In sum, the primary benefits of uncapped investment returns may be three-fold: (1) increased investment returns should stimulate more private equity investment in target low-income communities; (2) the additional investments, when coupled with existing investments, may eclipse what would otherwise be accomplished without the prospect of higher returns; and (3) the private investment can become an increasing share of the total cost of urban revitalization as it lessens the government’s burden.⁹⁰ These advantages stem from the premise that greater financial returns will spur investment beyond the amount that would occur if government restrictions severely impair the investor’s entrepreneurial motivations.

This premise is not novel. Profit theorists have long maintained that entrepreneurs will not contribute to a venture and assume the risks associated with it “without the expectation of a compensation in excess of the actu-

⁸⁷ HARRY S. TRUMAN, REVISION OF THE TAX LAWS, H.R. DOC. NO. 81-451, at 5 (1950).

⁸⁸ The joint venture investments must qualify as program-related investments under § 4944 of the Code. I.R.C. § 4944(c) (2006).

⁸⁹ HARRY S. TRUMAN, REVISION OF THE TAX LAWS, H.R. DOC. NO. 81-451, at 5 (1950).

⁹⁰ Benefits (1) and (2) are hopes, not empirically established. The third benefit of uncapped returns is addressed in more detail as part of the “tax benefit reciprocity” discussion. A second argument against an uncapped investment return could be that it would allow the donor to distribute less to the intended charitable target. This author asserts that existing regulations against undistributed income and excess business holdings are well designed to curb that abuse, but modifications are necessary to sufficiently incentivize private investors to meet the current urban crisis.

arial value of the risk.”⁹¹ An “inducement” is required to assume such a risk, namely the “prospect of a surplus over and above *all* costs.”⁹² Therefore, the more comfortable the entrepreneur is with the prospects of compensation beyond the costs and risk, the more likely he or she will invest in the venture. In the context of this article, all costs include tax liability and governmental restrictions on the entrepreneur’s investment return. This article posits that the investor’s motivations are a mix of philanthropy and profitability, making this type of investor a social entrepreneur.⁹³ The profitability motivations are part of the equation, which must be addressed anew if we are to move beyond the status quo of charitable investment in urban America.

The above-referenced surplus is less likely to materialize if the return on an investment is restricted and if the investor is restricted to below-market ROI. Through IRS regulations and other pronouncements, the government leaves significant doubt as to whether it will allow market-based returns for charitable investments. The discussion below illustrates this problem by examining IRS regulations and PLRs.

The most instructive regulation provides various examples interpreting § 4944 and the PRI exception in particular.⁹⁴ In one instance, a private foundation provided a loan to a business designed to increase economic opportunities for low-income residents and prevent community deterioration.⁹⁵ The loan was made “at an interest rate below the market rate for commercial loans of comparable risk.”⁹⁶ The IRS stated the loan “would not have been made *but for* such relationship between the loan and [the private foundation’s] exempt purpose.”⁹⁷ The IRS concluded that the loan had no significant purpose for income production and therefore the loan was a PRI.⁹⁸ Presumably, though not directly stated, the IRS reasoned that if the entity makes a loan at below-market rates, it must not have made that investment primarily for income production.

The IRS would also grant PRI status to a private foundation’s below-market financing when conventional financing was unavailable, thereby filling a gap in a venture’s capital needs.⁹⁹ A private foundation made a loan at below-market interest rates to induce a financially secure, publicly

⁹¹ Israel M. Kirzner, *The Nature of Profits: Some Economic Insights and Their Ethical Implications*, in *PROFITS & MORALITY* 29 (Robin Cowan & Mario J. Rizzo eds., 1995).

⁹² *Id.*

⁹³ Roger M. Groves, *Time To Step Up: Modeling the African American Ethninvestor for Self-Help Entrepreneurship in Urban America*, 13 *MICH. J. RACE & L.* 99, 111 (2007).

⁹⁴ Treas. Reg. § 53.4944-3 (as amended in 2009).

⁹⁵ Treas. Reg. § 53.4944-3(b), ex. (4) (as amended in 2009).

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ Treas. Reg. § 53.4944-3(b), ex. (5) (as amended in 2009).

traded business to build a new plant in a deteriorated urban area.¹⁰⁰ A significant fact the IRS cited was that the business “would be unwilling to establish [the plant] absent such inducement.”¹⁰¹ If the business declared that it envisioned a sufficient return without the inducement, the question becomes: would the IRS conclude income production was one of the business’s significant purposes? If so, the excise taxes associated with the investments would apply. Equally logical would be that the IRS is willing to conclude that no significant income production purpose exists, only if the foundation provides less desirable below-market financing for risky ventures, which banks or other conventional sources would not finance. This uncertainty could easily make an investor uncomfortable about investing in such projects for fear that PRI status would disappear or be denied, subjecting the investor to additional excise tax liability.

Conventional lenders for loans to these ventures will likely use time-honored methods to ascertain the degree of risk and return and overall worthiness of investment capital. Such methods include debt–equity ratios, present value and future income projections based on capitalization rates, cash flows, and expense normalization.¹⁰² Traditionally, upon reviewing such data, a typical bank would not make a loan to support a PRI. The IRS would only grant PRI status to a private foundation if it essentially ignores established investment criteria and makes the loan or stock purchase nonetheless.

The IRS looked favorably on a foundation’s loan that was interest-free so that an economically disadvantaged individual could attend college.¹⁰³ If an entity has no return on the investment, the loan was not principally made for income production. This example, like the rest of the IRS’s regulations and examples, provides guidance as to how the IRS would rule on similar facts. In none of the examples, however, did the IRS grant PRI status to an investment where the loan or stock purchase was provided at a market-based return based on conventional financing criteria. Rejecting market-based investment criteria and rate of return expectations should not be necessary in order to remain exempt or prevent substantial excise taxes.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* The IRS concluded the loan was still a program-related investment even though the loan was made to a large established entity, because it still provided employment opportunities for low-income persons at the new plant. *Id.*

¹⁰² See generally ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS: ESSENTIAL TERMS AND CONCEPTS 161-98 (3d ed. 2002) (discussing the various techniques used to value an enterprise). In particular, new entities are subject to heightened scrutiny of projected cash flows and a calculation of an internal rate of return compared to the cost of capital. *Id.* at 178.

¹⁰³ Treas. Reg. § 53.4944-3(b), ex. (9) (as amended in 2009).

B. *Flexible Investment Parameters Under the Prudent Investor Standard*

The only guidance provided by the IRS on retaining PRI status for an investment is that risky below-market loans are acceptable when the conventional criteria would suggest rejection of the investment. At the same time, the foundation must make investment decisions using a “prudent investor” standard.¹⁰⁴ An investment jeopardizes the exempt status of the foundation if the investment manager fails to exercise ordinary business care and prudence in making the investment.¹⁰⁵ The prudent investor standard should be interpreted broadly enough to allow an investment manager significant decision-making discretion, allowing market returns and uncapped investment income while maintaining PRI status.

The IRS suggests that managers analyze the two primary elements of return and risk when making investments on behalf of the entity. Specifically, in one of its most explanatory PLRs, the IRS stated:

In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital) the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return).¹⁰⁶

Additionally, the IRS provides a four-part rule of potential benefit to the foundation manager:

(1) There are no investments that are per se jeopardizing, though certain categories of investment will be closely scrutinized¹⁰⁷

(2) The determination of whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes is made on a case by case, i.e., investment by investment basis¹⁰⁸

(3) But in each case taking into account the foundation’s “portfolio as a whole”¹⁰⁹; and

(4) The determination is only made “as of the time that the foundation makes the investment and not subsequently on the basis of hindsight.”¹¹⁰

¹⁰⁴ Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 2009).

¹⁰⁵ *Id.*

¹⁰⁶ I.R.S. Priv. Ltr. Rul. 9237035 (June 16, 1992).

¹⁰⁷ “No category of investments shall be treated as a per se violation of § 4944.” *Id.* The categories given close scrutiny are: “Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells. The purchase of ‘puts’ and ‘calls,’ and ‘straddles,’ the purchase of warrants, and selling short.” *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

A reasonable interpretation of this rule is that it allows significant discretion and flexibility in investment decisions. This interpretation is supported by two key facts. First, no investment will automatically jeopardize the exempt status or lead to the imposition of excise taxes. Second, determinations of the prudence of an investment rely solely on the information reasonably available to the manager at the time of the investment, even if the investment did not turn out well. Additionally, the IRS reaffirmed that it will follow this rule when scrutinizing foundation investments, stating, “[O]nce it has been ascertained that an investment does not jeopardize the carrying out of a foundation’s exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation *subsequently realizes a loss*.”¹¹¹

Furthermore, the no-hindsight rule should also apply to investments that realize a gain, rather than just a loss. The IRS should refrain from reading in a requirement that requires the manager to forecast a loss when making an investment decision. An investment decision should still be prudent when the investment manager remains focused on the twin goals of philanthropy and profitability. At the time of making an investment, a manager could easily be unsure of whether a certain investment will be profitable, given that each goal may compromise the other. If the investment decision remains prudent, it should still qualify as a PRI, and the entity should not have to avoid the investment for fear of jeopardizing its exempt status or incurring substantial excise taxes.

In sum, the standard and four-part rule suggests that the prudent investor standard should be interpreted broadly enough to allow a market-based, risk-reward analysis and allow high-level returns on high-risk ventures, without second-guessing a manager’s investment decision. However, the regulations and PLRs discussed above leave considerable uncertainty as to whether the IRS will interpret the prudent investor standard so broadly.

The current state of uncertainty has caused some foundations, or their related philanthropic LLCs, to make individualized requests to the IRS for PLRs. As noted above, the IRS has most often, if not exclusively, authorized PRI status for ventures that anticipated below-market investment return. In PLR 199943044, a private foundation provided seed money for start-up and struggling businesses to promote economic development in economically disadvantaged areas.¹¹² The foundation faced a typical investment problem: “The project [was] unable to raise investment capital, probably because private investors viewed the risk versus return ratio as too high.”¹¹³ As seen in the regulation examples, if the foundation made the investment when a bank would not have invested, based on an analysis of

¹¹¹ I.R.S. Priv. Ltr. Rul. 9237035 (June 16, 1992).

¹¹² I.R.S. Priv. Ltr. Rul. 199943044 (Oct. 29, 1999).

¹¹³ *Id.*

conventional investment criteria, the IRS would likely conclude that the foundation made the investment without a significant purpose of income production, and the investment would qualify as a PRI.

But what if, at the time of the investment, the manager had information that suggested the investment's potential for a huge return despite a huge risk? Since the investment is judged when it's made, being at best a fifty-fifty gamble, the investment should be a PRI even if the huge return is subsequently realized. Additional evidence of an income-production purpose should be required to justify a refusal of PRI status. Such evidence may come from Board of Director minutes stating: "while the community would benefit from this addition, our stakeholders' financial interests are paramount, and we are mindful that if they do not achieve a return consistent with other investments they may withdraw their capital. Accordingly, this investment will not be made." Absent such expressions of financial prioritization at the expense of the charitable mission, the IRS should make clear that if a foundation manager states that there is a potential for a substantial return on this venture, the investment will still qualify as a PRI.

Including the above scenario as an example in the regulations would clarify the IRS's process for determining PRI status. As a result, exempt entities and their for-profit co-venturers would be more inclined to make equity capital investments in low-income communities. Thus, helping communities in need would not require the sacrifice of profitability potential.

Although Congress has a policy to encourage such mission-related investments, the current uncertainty concerning the IRS's PRI status rulings (absent an individualized PLR) clouds the ability of social entrepreneurs and private investors to see the requisite surplus to invest. However, the IRS is clear that an entity does not jeopardize its exempt status or become subject to excise taxes solely by generating significant amounts of income from its investments.¹¹⁴ While this regulation provides a basis of hope, there is no guidance from statutes or the IRS as to what other facts are sufficient to classify a significant income-generating investment as a PRI rather than for the purpose of income production. Without clarification, tax laws bypass an opportunity to instill investor confidence, which would bring an increase in the equity investments sorely needed in the target communities.

¹¹⁴ Treas. Reg. § 53.4944-3(a)(2)(iii) (as amended in 2009).

IV. HARMONIZING PRIS WITH LLC FLEXIBILITY

A. *Expanding “Special Allocations” of Tax Benefits Through the LLC Operating Agreement*

The above authorities allow the private foundations to engage in certain investments through an LLC. Yet there is little discussion, and even less clarity, in nonprofit tax jurisprudence about how much freedom this type of LLC manager should be afforded when allocating profits from those charitable mission-related investments. This section discusses harmonizing and expanding the tax law with the statutory authority given to an LLC. A foundation that is a manager of an LLC should, through what are termed “special allocations,” be able to provide unique and customized incentives for private investors and the foundation. The hopeful result is an increase in the use of this LLC model and infusion of more equity capital into worthy projects for urban redevelopment.

B. *LLC Flexibility*

One of the benefits of an LLC is the flexibility of self-governance under its governing documents, particularly its operating agreement. This flexibility has the muscularity to trump even non-mandatory provisions of a statute. Such strength is illustrated frequently by reference to *Elf Atochem North America, Inc. v. Jaffari*,¹¹⁵ in which a Delaware LLC executed an operating agreement requiring any dispute between members to be arbitrated in California. Although Delaware statutes clearly authorized arbitration, the Delaware court held that the arbitration clause was effective because of the legislature’s stated policy within the statute to maximize the contractual freedom of the LLC.¹¹⁶

The LLC is well suited for this article’s model LLC joint venture because of statutory flexibility in management and profit distribution. Regarding management, the LLC members determine whether to manage the entity through a single manager or any agreed configuration of a group of members, regardless of respective ownership interests.¹¹⁷ Furthermore, the managers do not need to have any particular amount of ownership interest.¹¹⁸ Under the PLRs and regulations, the foundation must have primary

¹¹⁵ *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286 (Del. 1999).

¹¹⁶ *Id.* at 296.

¹¹⁷ The relevant provision of the Delaware Code states: “A limited liability company agreement may provide for classes or groups of managers having such relative rights, powers and duties as the limited liability company agreement may provide” DEL. CODE ANN. tit. 6, § 18-404(a) (2006).

¹¹⁸ The relevant provision of the Delaware Code states: “Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its mem-

authority to ensure that the amounts invested by members into a fund are distributed consistently with the foundation's charitable and educational purposes.¹¹⁹ Under the Delaware LLC statutes, the foundation can be the manager by whatever terms are established in the operating agreement.¹²⁰

Regarding distributions, the LLC operating agreement may govern the allocation of profits among members even if that allocation is different from the pro-rata ownership of the entity.¹²¹ The Delaware LLC Act's policy is "to give the maximum effect to the principle of freedom of contract and to the enforceability of [LLC] agreements."¹²² The Supreme Court of Delaware noted, "Commentators observe that only where the agreement is inconsistent with mandatory statutory provisions will the members' agreement be invalidated."¹²³ Thus, foundations and for-profit members should have flexibility to adjust their respective profits and other tax benefits to meet the complex requirements of the excise tax statutes and regulations in order to retain PRI status for the foundation's investments and the LLC distributions.

C. "Special Allocations" of LLC Income

The combination of the LLC's ability to "maximize" the freedom of contract principles under *Jaffari* and the LLC's qualification as a partnership under the IRC as interpreted by Revenue Ruling 98-15 creates advantages when the LLC desires to creatively spread economic benefits among the members.¹²⁴ Specifically, under IRC § 7704, an LLC is taxed as a partnership unless it elects to be taxed as a corporation.¹²⁵ Furthermore, § 704 provides that a partner's distributive share of "income, gain, loss,

bers in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members." *Id.* § 18-402 (emphasis added).

¹¹⁹ Bjorklund, *supra* note 64, at 116.

¹²⁰ See DEL. CODE ANN. tit. 6, §§ 18-402, 18-404 (2006).

¹²¹ See *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d at 290 (stating that the Delaware LLC statute allows for great freedom of contract in creating and structuring an LLC). There is no statutory mandate in Delaware that LLCs divide their profits in exact accord with the ownership interests of the members. See also *Synopsis—partnership allocation rules*, [2011] 10 Stand. Fed. Tax Rep. (CCH) ¶ 25,124.01 (2010) (regarding partnership allocation rules). Corporations, however, must allocate on a pro rata basis according to a shareholder's ownership interests. *Id.*

¹²² *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d at 291 (quoting DEL. CODE ANN. tit. 6, § 18-1101(b)).

¹²³ *Id.* at 292.

¹²⁴ See PHILLIP L. JELSMAN & PAMELA EVERETT NOLLKAMPER, *THE LIMITED LIABILITY COMPANY* ¶ 12:240, at 12-20 (2009).

¹²⁵ I.R.C. §§ 7704(a), (g) (2008). See also Treas. Reg. §§ 301.7701-1–301.7701-16 (as amended in 2009), which is termed the "check-the-box" regulation.

deduction, or credit” shall be determined “by the partnership agreement.”¹²⁶ The LLC equivalent of the partnership agreement is typically the operating agreement, which articulates the contractual relationship among members, internal operation, and day-to-day management of the entity.¹²⁷ The contractual relationship necessarily includes the process of income and profit distribution which the “partners may allocate . . . among themselves in any manner they choose.”¹²⁸

Thus, the IRC allows an LLC, taxed as a partnership, to allocate tax items either in conformance with ownership interests or instead to choose special allocations where an item such as income or a deduction is disproportionately allocated to a member or partner in greater or lesser proportion than his ownership percentages.¹²⁹ These special allocations are of prime importance in the context of this article since the philanthropic LLC model contemplates the allocation of profits and losses between the exempt foundation and for-profit members. The allocations of losses are particularly relevant since investors may view ventures in low-income communities as having a greater potential for losses than profits. Therefore, allocations that mitigate those losses or distribute them for a unique, philanthropic benefit may incentivize private investors to contribute equity capital into these often risky ventures.

D. *The Twin Requirements of Substantial Economic Effect—Overview*

While an LLC is generally free to allocate a distributive share of tax items among members, the IRC establishes limits on this allocation. The IRC states: “A partner’s distributive share of income, gain, loss, deduction, or credit shall, *except as otherwise provided in this chapter*, be determined by the partnership agreement.”¹³⁰ For instance, if an allocation under a partnership agreement attempts to vary the allocation so that the partner with 20% ownership interest receives 40% of the distributable income, the IRC provides that such an allocation from a partnership agreement must

¹²⁶ I.R.C. § 704(a) (2004). If the partnership agreement does not so allocate those items, the determination is made “in accordance with the partner’s interest in the partnership (determined by taking into account all facts and circumstances) . . .” I.R.C. § 704(b)(1) (2004).

¹²⁷ See, e.g., FLA. STAT. § 608.402(24) (2002). The operating agreement, not customarily required by statute, sets forth the relationships between the members, describes entity interests, but cannot unreasonably restrict access to records or eliminate the duty of loyalty. See § 608.4101 (2002) (records); § 608.4225 (2006) (duty of loyalty).

¹²⁸ *Synopsis—partnership allocation rules*, [2011] 10 Stand. Fed. Tax Rep. (CCH) ¶ 25,124.01 (2010).

¹²⁹ Treas. Reg. § 1.704-1(a) (as amended in 2008). See also *Synopsis—partnership allocation rules*, [2011] 10 Stand. Fed. Tax Rep. (CCH) ¶ 25,124.01 (2010). This is a particular advantage that partnerships and LLCs have over corporations, which must allocate those tax items on a pro rata basis. *Id.*

¹³⁰ I.R.C. § 704(a) (2004) (emphasis added).

have a “substantial economic effect” (SEE) or else the allocation must be in accordance with the partner’s ownership interests.¹³¹ The treasury regulations provide the most illumination, and are designed to:

[E]nsure that the members’ distributive shares of tax items conform to their shares of the economic consequences of those items . . . a balance between allowing special allocations of partnership tax items to accommodate legitimate business concerns while avoiding the exploitation that would be permitted by complete freedom in making tax allocations.¹³²

The regulations require (1) the allocation to “be consistent with the *underlying* economic arrangement of the partners” and (2) a correlation between the allocation and the non-tax benefit or burden received from the allocation.¹³³

If the partnership agreement states the partners will share the risk of loss in a partnership property equally, an allocation that grants all deductions for cost recovery (from that same risk) to only one partner is inconsistent with the underlying economic arrangement of the partners.¹³⁴ The IRS will instead require the cost recovery deductions to be reallocated based on the partners’ respective ownership interests.¹³⁵

The Treasury regulations explain that for an allocation to have a SEE, the allocation must (1) have an economic effect and (2) be substantial (the substantiality test).¹³⁶

E. *Economic Effect*

An allocation can only have the requisite economic effect if it is consistent with the “underlying economic arrangement” of the partners—in this case, LLC members.¹³⁷ The actual economic consequences among the LLC members must be reflected in the members’ capital accounts. These accounts follow certain accounting rules that track items relevant to income, gain, liabilities and contributions to the entity.¹³⁸ Generally, an LLC operat-

¹³¹ I.R.C. § 704(b)(2) (2004). *See also* Treas. Reg. § 1.704-1(b)(2)(i).

¹³² JELSMAN & NOLLKAMPER, *supra* note 124, at 12-20.

¹³³ Treas. Reg. § 1.704-1(b)(2)(ii)(a) (as amended in 2008).

¹³⁴ Treas. Reg. § 1.704-1(b)(1), (5) ex. 1(i).

¹³⁵ Treas. Reg. § 1.704-1(b)(5), ex. 1(i). There are rules that mandate certain allocations apart from the pro rata ownership interests and not eligible for special allocations by the members/partners. For example, there are rules governing: 1) allocations in family partnerships, I.R.C. § 704(e) (2004); 2) contributions of property or services where gain is allocated to the party who contributed the item, § 704(c) (2004); and 3) changes in partnership interests, § 706(d) (1998).

¹³⁶ Treas. Reg. § 1.704-1(b)(2)(i).

¹³⁷ Treas. Reg. § 1.704-1(b)(2)(ii).

¹³⁸ Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended in 2008). Each member’s capital account is increased by her cash or property contribution to the entity, minus liabilities assumed by the partnership.

ing agreement that authorizes special allocations must follow the required capital account formulation to satisfy this economic effect element.¹³⁹

Further, this element requires compliance with three criteria known as the safe harbor rules, all of which involve the capital account referenced above. The LLC's operating agreement must provide that:

1. Capital accounts will be maintained during the full term of the LLC existence.¹⁴⁰

2. Firm proceeds upon liquidation will be allocated according to the *positive* capital account balances by the end of the tax year or ninety days after liquidation, and

3. After liquidation of entity ownership interests, the member is unconditionally obligated to restore any *deficit* balance in his capital account.¹⁴¹

Consistent with the IRS's intent to deter use of allocations to avoid or evade tax, the safe harbor prevents perpetual capital account deficits caused by special allocations. However, there should be two narrow exceptions for philanthropic LLCs with legitimate PRIs.

F. *Exceptions to Cure Capital Account Deficits*

Treasury regulations place an unconditional obligation on the LLC to restore a deficit balance to a member's capital account upon liquidation of a partner's interest. The capital balance of each LLC member is increased by (1) the amount of money that is part of his contribution to the partnership, (2) the fair market value of property he contributes to the entity, and (3) partnership income and gain, even if the income or gain is otherwise exempt from tax.¹⁴² Conversely, the member's capital account is decreased by amounts of money the partnership distributed to him and allocations of partnership losses.¹⁴³ A philanthropic LLC investing in a charitable project, like an elderly home and attached clinic for sickle cell patients, that has losses exceeding the combined contributions of cash, property, and LLC income, will have a deficit balance. If the LLC attempts to liquidate the LLC or any member's interests in light of those losses, any special allocation apart from the existing corresponding allocation among the members

Id. The capital account is decreased by the cash or property distributed to the member from the LLC minus liabilities assumed therewith by the member. *Id.*

¹³⁹ *See id.* This is stated as a general rule because the regulations allow alternatives to the capital accounts element. A few of those alternatives involve qualified income offsets. Treas. Reg. § 1.704-1(b)(2)(ii)(d) (as amended in 2008). *See also* discussion *infra* Part V.A.

¹⁴⁰ Treas. Reg. § 1.704-1(b)(2)(iv)(a) (as amended in 2008).

¹⁴¹ Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2)-(3) (as amended in 2008).

¹⁴² Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended in 2008).

¹⁴³ *Id.*

would not be recognized due to the failure to restore the deficit—that is, failing to meet the economic effect element.¹⁴⁴ Until the member is obligated to restore the capital account to a positive balance by the end of that LLC’s taxable year or within ninety days of the liquidation, there will not be an economic effect to an attempted special allocation—such as an allocation that rewards a particular member with a high marginal tax rate in need of the losses in greater proportion than his ownership units.¹⁴⁵

The risk of losses in excess of revenue is more likely when investing in low-income communities where conventional financing is unavailable. If investors consider such a charitable investment in those high-risk areas then subsequently realize the losses are likely to cause a deficit capital account balance, the investor would not be entitled to a special allocation and there would be a disincentive to invest in that project. If, instead, investors could gain customized tax benefits to offset the losses themselves, sufficient incentives may exist to spur additional equity investment.

The regulations make an allowance when the LLC operating agreement contains a qualified income offset.¹⁴⁶ This exception is an attempt for flexibility in the regulation. The regulation attempts to reach an allocation’s substance, even when the form used is noncompliant (i.e., not following the book accounting requirements of capital account balances). Consistent with this codified flexibility is the need to incorporate the underlying reasons for the safe harbor provisions. As noted above, Congress and the IRS imposed these provisions to balance legitimate business reasons for allocating tax items among the owners while avoiding the exploitation that would be permitted by complete freedom in making tax allocations.¹⁴⁷ These rules intended to prevent tax evasion by sophisticated allocation schemes.¹⁴⁸

The philanthropic LLC model presents a type of “legitimate” business interest not taken into account under the existing regulations. It is that legitimacy that should be balanced against the potential tax evasion considerations when determining the appropriate basis to excuse deficit restoration of capital accounts in meeting the economic effects element. It is also important to recognize that tax avoidance is legal, but tax evasion is illegal. That rule should be equally applicable to all entities whether they are for-profit or nonprofit. By contrast, for-profit entities have a fiduciary duty to their respective members to pursue profitability as a primary activity. Naturally, the investments are means to attain profitability; they should be made

¹⁴⁴ See Treas. Reg. § 1.704-1(b)(2)(ii)(b) (as amended in 2008).

¹⁴⁵ See Treas. Reg. § 1.704-1(b)(2)(ii)(c) (as amended in 2008).

¹⁴⁶ Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3) (as amended in 2008). Recommended amendments to this “qualified income offset” are described later in this article. See discussion *infra* Part V.A.

¹⁴⁷ See JELSMAN & NOLLKAMPER, *supra* note 124, at 12-20.

¹⁴⁸ See S. REP. NO. 94-938(I), at 100 (1976), reprinted in 1976 U.S.C.C.A.N. 3438, 3536 (providing legislative history to the Tax Reform Act of 1976 and Congress’s intent in enacting § 1.704-1(b)(2)).

with profitability as the priority.¹⁴⁹ That pursuit of profitability understandably puts foundation managers of the LLC first in line as potential manipulators of allocation rules to avoid tax. The less tax they pay, the more revenue hits the bottom line. The philanthropic LLC ties its legitimacy to a different source: its charitable causes and attendant mission-related investments.

When an entity already qualifies as a tax-exempt organization and has PRIs, it needs alternatives to deficit restoration. The result of the allocation should not be as narrow as that contemplated for the for-profit entities. The allocation should allow some tax advantages to members. Such a policy would encourage for-profit entities to increase their investments in charitable ventures. The investors' desire to sacrifice some profitability makes them contribute capital to such ventures. The balance should weigh more favorably for those who pose a lesser risk of the ills the law attempts to prevent.

Additionally, the allocation rules include the statutory requirement to consider "*all* facts and circumstances" in determining whether to respect the LLC's own special allocation.¹⁵⁰ Congress, therefore, obligates the IRS to incorporate this requirement into its analysis.

In support of the public policy reasons for the proposed amendments that follow, and as part of the facts and circumstances test, the circumstances should take into account that Congress has enacted many other statutes designed to encourage private investors to contribute capital into philanthropic ventures.¹⁵¹ While there is value in keeping tax considerations in proper context and categories, there should still be an overall congruent tax policy. There should be defined goals for tax statutes and the regulations that implement those laws. Part of U.S. policy and statutory scheme involves using tax benefits as incentives to encourage certain activities. These activities include charitable investing by joint ventures between nonprofit and for-profit entities in economically disadvantaged communities.¹⁵²

Congress authorized such ventures to gain tax-exempt financing, non-recognition and exclusion of gross income, bond credits, tax credits, ex-

¹⁴⁹ See *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919). The Michigan Supreme Court stated that business is organized primarily for profit, and that it is unlawful for the Board of Directors to refuse to issue dividends to benefit non-shareholders or otherwise make profit purposes incidental. The court required a distribution to shareholders because it viewed Mr. Ford's refusal to do so part of an arbitrary scheme to share company profits with the public.

¹⁵⁰ I.R.C. § 704(b)(2) (2004).

¹⁵¹ For example, a federally sponsored, multi-billion dollar tax credit program (New Markets Tax Credit) provides incentives to lure investors into projects designed to revitalize urban communities in America. I.R.C. § 45D (2010). See also Roger M. Groves, *The De-Gentrification of New Markets Tax Credits*, 8 FLA. TAX REV. 213, 218 (2007).

¹⁵² James Edward Maule, *Tax Incentives for Economically Distressed Areas*, 597 TAX MGMT. PORTFOLIO, at III-K (2005).

pense deductions, and favorable depreciation rates.¹⁵³ The aggregation of those benefits has often been the missing piece that allows the venture to make economic sense—essentially, filling the gap for this type of financing.¹⁵⁴

From a policy perspective, recognizing the relationship between exempt entities and governmental costs benefits this discussion. Every entity and person should contribute to the costs of government since everyone benefits from the government's provisions.¹⁵⁵ Congress recognized this relationship over forty years ago when it first enacted the jeopardizing investment laws requiring foundations that violated the new law to make a "contribution, a tax . . . of their investment income, toward the cost of government."¹⁵⁶ Those taxes "may be viewed as being, in part, a user fee."¹⁵⁷ The logical corollary is that exempt entities that relieve, rather than increase the governmental burden, should be afforded customized benefits. The role of a private foundation in governmental relief is "tax-benefit reciprocity" and can be a formulaic part of an allocation of tax benefits among philanthropic investors that furthers the LLC's exempt purposes.

An amendment to the regulations would strategically eliminate the obligation of a member of a philanthropic LLC to restore a deficit capital account under narrowly established circumstances. This opens up the flexibility in an operating agreement for special allocations of losses, which can increase the incentive for these investments by members in need of those losses. This opportunity would only be available to those willing to invest charitably. The amendment would change the existing restoration provision by providing:

"If requirement (1) of paragraph (b)(2)(ii)(b) of this section is satisfied, a partner's obligation to restore the deficit balance in his capital account to the partnership may be eliminated or reduced as of the end of a partnership taxable year to the extent the partnership has established program-related investments as defined in the Code and _ percent of any liquidated interests distributed or percent of any tax benefit from the allocation beyond the benefit otherwise allowed if the deficit had been restored while a deficit balance exists shall be redirected to an alternate charitable cause,

¹⁵³ For a comprehensive list of tax incentives for such projects, see *id.* at IV.

¹⁵⁴ *Id.* at III-K.

¹⁵⁵ The legislative history for the laws that created the current restrictions on private foundation investments states, "[S]ince the benefits of government are available to all, the costs should be borne, at least to some extent, by all of those able to pay. Your committee believes that this is true for private foundations as it is for taxpayers generally This tax, then, may be viewed as being in part a user fee." H.R. REP. NO. 91-413, pt. 4, at 19 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645 (legislative history on the Tax Reform Act of 1969). The Act was considered the most substantive and comprehensive reform of the income tax laws since its initial passage in 1954. *Id.*

¹⁵⁶ H.R. REP. NO. 91-413, pt. 1, at 4 (1969).

¹⁵⁷ H.R. REP. NO. 91-413, pt. 4, at 19 (1969).

including but not limited to charitable contributions to existing federally tax exempt organizations under § 501(c)(3) of the Code.”

In no event, shall the extent of the non-charitably transferred benefit exceed to the investor.

Under this proposed amendment, the IRC maintains charitable continuity without using the provision for profiteering under the cover of a charitable vehicle. This formulation provides a basis for limiting the extent of the tax benefit through measuring it by the difference between an allocation if the deficit were restored and the allocation actually made without restoration. Dividing the benefits in a percentage split gives the investor and a successor in interest access to the charitable benefit, allowing a shared benefit. The charitable benefit to the subsequent entity can be made through tax credits to a charitable venture, in similar fashion to the new markets tax credits. It is an unproven line that protects against abuse but is still a sufficient incentive to encourage additional investment of private equity funds. A final safeguard would be a cap on the tax benefit to the investor, regardless of the percentage split between the investor and the successor charity.

V. OTHER REGULATORY AMENDMENTS INCLUDING TAX BENEFIT RECIPROCITY

An amendment to existing regulation providing special allocation for the philanthropic LLC should include a justification. Below is an attempt to codify the principle that tax policy should provide incentives for private equity contributions to charitable ventures:

(i) Where the partnership has qualified program-related investments pursuant to applicable treasury pronouncements, and the return on those investments continues to be used by the partnership for exempt purposes, the partnership may specially allocate a partner’s distributive share of any item or class of items of income, gain, loss, deduction, or credit in such a way that is reasonably designed to perpetuate or accelerate investments by partners in ventures that further the exempt purpose, subject to the limitations of subsection (ii).

(ii) The extent of the tax benefit shall be limited to _____ percent beyond the amount of tax benefit otherwise calculated under this section, unless the partnership establishes tax benefit reciprocity where the extent of community value reasonably appears to replace or reduce existing governmental subsidies to the target community.¹⁵⁸

¹⁵⁸ This percentage would be the product of Congressional debate much like any other numerical tax standard. The marginal income tax rates and capital gains rates, for example, have fluctuated to accommodate forecasted revenue needs weighed against philosophical issues of what groups of taxpayers should bear a heavier burden. See ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND

(iii) The determination of whether sufficient tax benefit reciprocity exists shall be determined by the Commissioner, or his delegated agency, on a case-by-case basis under regulations specifically designed for such a determination.

(iv) This subsection also applies to items of allocation that are by definition incapable of having economic effect for the lack of economic equivalents under this section, since equivalents in this subsection include community benefits determined under the tax-benefit-reciprocity regulations.

Subsection (iii) recognizes the need to measure and quantify tax benefits. This article therefore suggests a new regulation that incorporates factors already used in a comparable context. In the waning years of the Clinton administration, the 106th Congress amended the IRC¹⁵⁹ to give “new market tax credits” (NMTC) for investing in low-income communities.¹⁶⁰

There are several similarities between the NMTC scheme and the philanthropic LLC model proposed in this article. The NMTC program provides tax credits as incentives for laudable projects in low-income communities.¹⁶¹ In the philanthropic LLC context, the incentives are the allocations of income, gain, loss, deduction, or credit.¹⁶² The NMTC determines “qualified equity investments” for the tax credit using a detailed and comprehensive list of factors under statutory guidelines, including community benefit to be achieved by the project.¹⁶³ Similarly, under the proposed subsection (i), the philanthropic LLC must have PRIs. That would require the IRS’s best practices to prevent tax-exempt entities from abusing PRIs as a mere instrumentality for profitability.

MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 132-33 (9th ed. 2005).

¹⁵⁹ On May 23, 2000, President Clinton and Speaker of the House, Dennis Hastert, publicly announced an agreed upon proposal that led to the introduction of the Community Renewal and New Markets Act of 2000, H.R. 4923, 106th Cong. (2000). Robert W. Oast, Jr., *Incentives for Economic Development in Underserved Communities and for Affordable Housing: A Selective Look at the Legislative Initiatives in the 106th Congress*, 33 URB. LAW. 793, 795 (2001). What emerged from the conference deliberations of both chambers was the Community Renewal Tax Relief Act of 2000 (CRTRA), H.R. 5662, 106th Cong. (2000). *Id.* at 795. Despite its complexity and permutations, the bill was introduced December 14, 2000, and voted and passed on the same day. *Id.* at 795; Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 26 U.S.C.). The CRTRA was signed into law on December 21, 2000, tucked away into obscurity within the massive appropriations act. Consolidated Appropriations Act of 2001, Pub. L. No. 106-554, § 1 & app. G, 114 Stat. 2763, 2763A-1, 2763A-587 to -651 (2000). Thus, it received little fanfare or public attention beyond those already in the know. Actual legislative history is equally obscure.

¹⁶⁰ I.R.C. §§ 45D(a)–(b) (2010).

¹⁶¹ The credit is in the amount of 39% of a taxpayer’s equity investment over a seven-year period. See I.R.C. § 45D(a)(2)(A)–(B) (2010).

¹⁶² I.R.C. § 704(a) (2004).

¹⁶³ I.R.C. § 45D(a)(1) (2010). For a discussion of the twenty-five point system, see *infra* p. 42 and note 161.

In the NMTC program, the tax credit is measured as a flat percentage of the equity investment.¹⁶⁴ The proposed allocation regulation also sets a flat percentage basis, but there is a two-tiered measurement system. In Section V of this article, the author proposes a regulation that incorporates his theory of tax benefit reciprocity. Under that theory, the regulation would initially cap the LLC's tax benefit (Tier 1). The regulation would then have a second tier analysis. If the LLC's venture generates a community value that replaces or reduces government subsidies, then a special allocation of tax benefits beyond the initial cap is allowed. This is what the author terms a "super-benefit allocation". There is a super-benefit if the LLC provides a super benefit under tax benefit reciprocity factors. Again, the NMTC factors qualify tax subsidies where an equity investment fulfills Congressional intent to help disadvantaged communities.

The NMTC scheme evaluates applications using the following four criteria: business strategy, capitalization strategy, management capacity, and community impact. Each has a maximum of twenty-five points. Each applicant receives a numeric score and rank.¹⁶⁵ "Priority points" are awarded in business strategy if the applicant (1) has a record of providing capital or technical assistance to disadvantaged businesses or communities or (2) intends to funnel substantially all of its cash investment to low-income businesses.¹⁶⁶

The proposed philanthropic LLC regulation would require the LLC to apply for the super-benefit allocation. The agency would use a modified form of the NMTC factors related to community benefit such as "community impact" and "priority points." These factors would quantify the government aid that the project would displace. Currently the NMTC community impact points are awarded based on the following:

- (1) targeting areas of high distress;
- (2) prior performance;
- (3) economic development impacts;
- (4) community development impacts; and
- (5) other community benefits.¹⁶⁷

The agency would use these factors to list the government aid currently directed to the target communities. Then LLC applicants could present an apples-to-apples comparison with its own alleged benefits. The LLC would need to establish how its venture reduced the governmental burden using the agency's guidelines on causation and correlation. Success in this context does not require that the LLC receive huge economic returns from

¹⁶⁴ I.R.C. §§ 45D(f)(1)(A)-(D) (2010). These sections specifically provide for a credit of 5% of the equity investment for the first three years, followed by a 6% credit for the remaining four years.

¹⁶⁵ Notice of Allocation Availability, 69 Fed. Reg. 49,947, 49,951 (Aug. 12, 2004).

¹⁶⁶ *Id.* at 49,951-52.

¹⁶⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-536, NEW MARKETS TAX CREDIT: MINORITY ENTITIES ARE LESS SUCCESSFUL IN OBTAINING AWARDS THAN NON-MINORITY ENTITIES 14 (2009).

the investment. Rather, the basis for allowing the expanded benefits in the allocation process is success in reducing or supplanting a governmental cost or burden.

The proposed regulation could also add certainty—a welcomed attribute for determining what allocations can or cannot be made for specific types of entities. Under the proposed regulation, the philanthropic LLC would already have some certainty as a threshold benefit from the allocation. Currently, the LLC only has the expensive options of receiving a legal opinion, receiving a PLR based on a drafted attorney's request, or simply taking a chance that the substantial excise tax liabilities and exemption loss do not occur.

The complexity and variations that bring unforeseen issues will require some flexibility in the regulatory scheme. Under the proposed subsection (iii), the Commissioner or his delegated agency would make case-by-case determinations. Similarly, in the NMTTC program an agency analyzes each applicant under specific factors and qualification guidelines.¹⁶⁸ Before awarding a for-profit member with additional income or deductions, the LLC would have to show that it provided a greater community benefit and that the benefit was reasonably correlated to a long-term reduction in government subsidies.

For example, a philanthropic LLC claims that it provided start-up capital for a new health care clinic that specializes in a disease disproportionately affecting Hispanics or African Americans in a particular community. The LLC provides statistics revealing that the clinic reduced Medicaid costs in that community. The LLC could also show that, by hiring previously unemployed residents in the area, it reduced spending for unemployment benefits. The designated agency may have difficulty quantifying the government savings attributed to the LLC's activities. However, if the insurance industry can quantify worker's compensation benefits for a lost limb based on actuarial tables, then a benefits analysis can be created for tax benefits reciprocity as well.

Finally, subsection (iv) is meant to clarify whether certain items precluded from having economic effect by inherent definition are within this relaxed standard. Since "equivalence" is expanded beyond traditional economic benefits, the basis for the preclusion disappears. For example, tax credits lack economic equivalents and therefore must be allocated based on a partner's ownership interests.¹⁶⁹ For administrative convenience, it is preferable to apply the fixed percentage from the subsection rather than

¹⁶⁸ The U.S. Treasury delegated the responsibility for tax credit distribution and administration of the program to the Community Development Financial Institutions Fund. 12 C.F.R. § 1805.600–.701 (2005).

¹⁶⁹ *Partner's Distributive Share: Partnership Items Without Economic Effect: Partnership Items Deemed to Lack Economic Effect, in General*, [2010] 10 Stand. Fed. Tax Rep. (CCH) ¶ 25,124.028 (2010).

calculating the extent of tax benefit reciprocity in every case, since tax benefits only flow from the partner's ownership interest.

These principles lay the groundwork for recommended modifications of two other existing allocation rules discussed below. Both are part of the IRS's attempt to find flexible alternate tests that determine economic effect under atypical circumstances. The philanthropic LLC that is fortunate enough to receive market or above-market returns on a risky joint venture is such an atypical circumstance that it deserves its own regulation.

A. *The Qualified Income Offset*

Much of the current authority from the IRS leaves uncertain whether market or above-market returns will jeopardize a private foundation's exempt status or result in significant excise tax liability. Allowing the entity to receive market-based returns and then use distributable income as a qualified income offset (QIO) with forgiveness of remaining deficits in capital accounts thereafter would yield better long-term benefit. Forgiveness would be based on private-sector factors that the banking industry has successfully used for decades.

Generally, the current safe-harbor provisions will not respect a special allocation if an LLC member has a deficit account balance upon liquidation of his entity interests.¹⁷⁰ The member can avoid this outcome by restoring the deficit to the entity by the end of that tax year or within ninety days after the liquidation.¹⁷¹ Without the restoration, the item will be allocated according to the member's ownership interests in the partnership.¹⁷² Therefore, if an investor made a substantial contribution to a charitable venture that unexpectedly fails, the loss to the entity results in a deficit capital account balance. The regulation is clear that the member must be "unconditionally obligated to restore the amount of such deficit."¹⁷³

To mitigate this harsh provision, a separate regulation allows an LLC operating agreement to contain a QIO.¹⁷⁴ Under that section, a contribution from the entity to offset the deficit gives the allocation economic effect to bring it within the safe harbor.¹⁷⁵ Limited partners often benefit from this as they are not contractually obligated to contribute to the entity's ventures.¹⁷⁶ For example, assume a for-profit member of the LLC contributes \$10,000 but is not required to provide additional capital for the LLC ventures. The

¹⁷⁰ Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 2008).

¹⁷¹ Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (as amended in 2008).

¹⁷² Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 2008).

¹⁷³ Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (as amended in 2008).

¹⁷⁴ Treas. Reg. § 1.704-1(b)(2)(ii)(d)(3) (as amended in 2008).

¹⁷⁵ *Id.*

¹⁷⁶ *Partner's Distributive Share: Partnership Allocation Rules: Alternative Tests for Economic Effect*, [2010] 10 Stand. Fed. Tax Rep. (CCH) ¶ 25,124.0225 (2010).

general safe harbor provisions limit his allocation of deductions, losses, etc., to \$10,000 since that is the extent of his economic risk. But if the member receives an unexpected distribution of cash causing a deficit balance for his capital account, the partnership agreement can require the partnership to allocate gross income items to cure the deficit.

Under the philanthropic LLC model, the vast majority of current decisions from the IRS would only be characterized as PRIs if the anticipated ROI was below market, conventional financing was unavailable, and the venture was highly risky. If the risky venture brings extraordinary returns, let it be. The returns that become distributable to LLC members should be allowed into the capital accounts to restore deficits if necessary. The extent of investment returns should not be reduced because LLCs have the advantage of contractual freedom in framing operating agreements, tax policies and statutes encourage for-profit joint ventures for charitable causes, and government burden may decrease. Those returns operate as effective incentives through amended deficit restoration of capital accounts and QIOs to further our nation's tax policy perspectives.

B. *Substantiality and Amendment of the De Minimis Rule*

The regulations require that a philanthropic LLC's economic effect be substantial.¹⁷⁷ Substantiality depends on the reasonable possibility that the dollar amounts the partners receive is substantially affected, when looked at as of the time the allocation becomes part of the LLC or partnership agreement.¹⁷⁸ The substantiality of the allocation is independent of the tax consequences of the allocation.¹⁷⁹

The IRS customized a provision to allow exemptions for deserving circumstances. Exemptions, at their root, involve tax policy decisions. Indeed, the progressive income tax system of the U.S. is a policy decision, requiring those with more income to pay a higher percentage of tax than those with less income.¹⁸⁰ The IRS's exemption from the safe harbor allocation rules applies to those with lesser ownership interests, similar to tax exemptions for those with low income.¹⁸¹ The regulations apply to partners that directly or indirectly own less than 10% of the capital and profits of a partnership, and receive less than 10% of the allocable items; such partners

¹⁷⁷ Treas. Reg. § 1.704-1(b)(2) (as amended in 2008).

¹⁷⁸ Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2008).

¹⁷⁹ *Id.*

¹⁸⁰ For example, corporations with taxable income over \$50,000 and no more than \$75,000 are taxed at a marginal rate of 25% on that income for 2010. Corporations with taxable income over \$75,000 and up to \$100,000 pay a higher 34% tax. See ROBERT W. HAMILTON, JONATHAN R. MACEY & DOUGLAS K. MOLL, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 7 tbl.1 (11th ed. 2010).

¹⁸¹ Treas. Reg. § 1.704-1(b)(2)(iii)(e) (as amended in 2008).

may not have the allocation's tax attributes considered "the *de minimis* rule."¹⁸² Presumably, this policy-based exemption attempts to show reasonableness by exempting members with small ownership interests from the restrictions applied to other LLC members.

The exemption to philanthropic LLC modeled entities should be expanded. The policy's goal is to not hold an LLC, which is only trying to help others with qualified PRIs, to the same restrictions as LLCs seeking to maximize profits. The most effective way to encourage private investment of capital through such entities is to simply increase the *de minimis* percentage for entities with qualified PRIs that are used in allocating benefits to LLC members. Congress and the IRS would determine the exact amount of that ownership percentage through the political process. Particularly, if there is a second-tier finding that the LLC actually provides tax benefit reciprocity, the ownership interests of the LLC member could be tiered progressively higher according to the reduced burden of the government.

Regulatory allocations should be expanded to allow philanthropic LLCs greater ability to allocate tax items to further their exempt purposes. This would encourage for-profit investors to joint venture with tax-exempt private foundations for projects designed primarily to help low-income communities. For such a scheme to work, high-risk ventures must be able to yield high economic returns without government caps. If the regulations allow the LLC to allocate tax items in a way that atypically benefits investors *because* of the mission-based investment, the regulation will encourage such investments.

This proposal expands the SEE definition for this particular type of LLC. Rather than restricting the allocation so that the benefits of tax items are ignored, the benefits are allowed even if distributed differently from ownership interests. Because the LLC's philanthropic purposes consist of more than pure economic return, this proposal seeks to incorporate a broader consideration of the value of philanthropy into the equation. For this type of LLC, the analysis is not just about the "allocations that reflect the actual economic arrangement of the partners."¹⁸³ These partners voluntarily sacrificed purely economic returns to prioritize the charitable venture and should receive the tax benefits that a more flexible allocation scheme would allow.

Thus, under Revenue Ruling 98-15, the operating agreement could provide a formula that specifically authorizes a significant ROI for whichever members benefit from the allocation the most, whether they are the for-profit member or the nonprofit foundation, even if the allocation benefits a member disproportionately from ownership interests. The restrictions

¹⁸² *Id.*

¹⁸³ *Synopsis—partnership allocation rules*, [2011] 10 Stand. Fed. Tax Rep. (CCH) ¶ 25,124.01 (2010) (stating that one way to allocate taxable items to each partner is by their share of ownership in the partnership).

from Revenue Ruling 98-15 still apply—the activities that generated the return must still further the exempt purposes. The for-profit entity may not use the exempt member as an instrument to shield the for-profit member. The proposed amendments to the allocation regulations have sufficient safeguards against tax evasion or perversion of congressional intent. The amendments to the safe harbor rules would be applicable to a narrow group of entities that pass rigorous qualifications as factor-tests administered by a Treasury agency.

VI. EXCISE TAX CONSIDERATIONS AND A CALL FOR CODIFICATION

With these proposed amendments,¹⁸⁴ the LLC operating agreement can be carefully crafted to allow the foundation and the for-profit member to adjust the profits and other tax items without violating the IRC § 4944 jeopardy investment regulation or the IRC § 704 allocation laws and regulations. In both cases, the proposals increase the flexibility of the managing member. One benefit of increased flexibility is the managing member can more easily navigate ways to prevent unintended liability for other excise taxes that the IRS may potentially impose on the LLC's investments. IRC §§ 4940–4945 present a complex array of companion regulations that are cause for very careful analysis before a foundation invests jointly with for-profit ventures.¹⁸⁵ The investment decision is a high-risk game.

Table A depicts the various excise taxes and potential penalties, respectively.¹⁸⁶ An exempt private foundation or its LLC cannot avoid a net-investment income tax if it loses, or fails to qualify for, tax exemption.¹⁸⁷ Additionally, it cannot avoid an excise tax for self-dealing between the private foundation and the foundation manager, or other foundation contributors.¹⁸⁸ The private foundation cannot avoid paying an excise tax if it fails to distribute a minimum amount of its investment return toward the philanthropic mission.¹⁸⁹ The LLC cannot avoid a separate excess business holdings tax if the private foundation holds stock or other interests in an enterprise it otherwise would be required to divest.¹⁹⁰

¹⁸⁴ See *supra* Part V.

¹⁸⁵ There is a tax on: the private foundation's net investment income; see I.R.C. §§ 4940(a)–(b) (2007); each act of self-dealing between any foundation manager or certain other foundation contributors and the private foundation; see I.R.C. § 4941(a) (2006); undistributed income; see I.R.C. §§ 4942(a)–(c) (2007); excess business holdings; see I.R.C. §§ 4943(a)–(c) (2006); investments which jeopardize a charitable purpose; see I.R.C. § 4944 (2006); and spreading propaganda; see I.R.C. §§ 4945(a)–(h) (2006).

¹⁸⁶ See *infra* Table A.

¹⁸⁷ I.R.C. § 4940(b) (2007).

¹⁸⁸ I.R.C. §§ 4941(a)(1)–(2) (2006).

¹⁸⁹ I.R.C. §§ 4942(a)–(e) (2007).

¹⁹⁰ I.R.C. §§ 4943(a)–(c) (2006).

Table A reveals that philanthropic organizations may be subject to a very significant amount of potential tax liability,¹⁹¹ which chills equity investments in risky charitable ventures. A high-risk investment with low anticipated returns and a high potential for substantial tax liability is unlikely to attract investors. If investors can avoid such tax liability by investing under the incentive-laden model proposed in this article, equity capital for target communities would increase. This result is consistent with the long-stated policy of balancing revenue generation and increasing equity participation.

Once an investment qualifies as a PRI under IRC § 4944(c), it is excluded from the category of jeopardy investment which would subject the entity to excise taxes under that section.¹⁹² Importantly, the IRS has often concluded that if a tax-exempt private foundation meets the PRI qualification, the foundation avoids other excise taxes as well. In PLR 199943044, the IRS not only found that the private foundation's acquisition of stock in the for-profit business was a PRI, and therefore not a jeopardizing investment subject to the excise tax under IRC § 4944,¹⁹³ it also concluded that the investment was a qualifying distribution and not subject to tax on undistributed income under IRC § 4942, or excess business holdings under IRC § 4943.¹⁹⁴

Unfortunately for the philanthropic LLC, the Chief of Exempt Organizations, a technical branch within the IRS, wrote that PLR.¹⁹⁵ By its own terms, a PLR is "directed only to the organization that requested it" and "may not be used *or cited* as precedent."¹⁹⁶ The only statutory means of making a PLR precedential is for the IRS to establish it as a regulation.¹⁹⁷ There are no statutory triggers to force the IRS into action on such an issue.

The IRS provided regulations designed to give taxpayers and exempt entities notice of relevant interpretations and authority they can rely on regarding PRIs, but no such guidance is codified in a single source for navigating the excise alligators discussed above. If an exempt entity cannot cite PLRs or receive reasonable clear direction from the IRS on tax outcomes, the entity might not undertake a risky joint venture in a low-income community with a for-profit entity.

To remedy that malady, Congress should incorporate IRS rulings and pronouncements into statute, which are otherwise obscure to the general public. Codification results in certainty. This way counsel to private foundations and potential for-profit joint venture partners would know the state

¹⁹¹ See *infra* Table A.

¹⁹² I.R.C. § 4944(c) (2006).

¹⁹³ I.R.S. Priv. Ltr. Rul. 199943044 (Oct. 29, 1999).

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*; see also I.R.C. § 6110(k)(3) (2007) (discussing the statutory precedent prohibition).

¹⁹⁷ I.R.C. § 6110(k)(3).

of the law, and their clients would have more information in determining whether such ventures are worth the investment risk. The process and statutory mandate should also include extraordinary public notice to those who meet the profile of the private equity pool. Informing the public of this investment opportunity is a matter of congressional will, not resources. Congress can break the cycle of perpetual poverty and governmental dependence in America by codifying PLRs.

As applied, the PRI statute should include a subsection that provides greater clarity and certainty, as many safe-haven provisions do in complicated or otherwise ambiguous areas of tax law.¹⁹⁸ This safe-harbor provision should state the following:

An organization recognized as exempt under § 501(c)(3) of the Internal Revenue Code, or related entity that carries on the exempt purposes of said organization, that meets the requirements of this section for program-related investments and therefore have no excise tax as a jeopardy investment under this section, shall have a rebuttable presumptive exemption from the other excise taxes in §§ 4940–4945 of the Internal Revenue Code. The exemption may be rebutted by the Commissioner or delegated agency on any basis authorized under the Code for assessment of taxes, penalties, and interest. The Secretary of the Treasury shall establish regulations to provide adequate guidance as to the types of facts and circumstances that may likely cause imposition of any of the above-referenced excise taxes.

Such a statutory provision and any eventual interpretive regulations would provide potential equity investors and their legal advisors with a more stable basis when making decisions. If investors can better anticipate a lower risk of significant tax liability, they can factor in tax savings reliably. Investors may also benefit by gaining a better understanding of how much to invest, what type of return to expect absent the excise tax liability, whether to joint venture, and if so, what rate of return fulfills each investor's risk appetite.

Congress has not provided a mandate as to when PLRs must become statute, presumably due to the vicissitudes of the political process.¹⁹⁹ But there should be some guidance for Congress, especially when tax revenues are at stake. For example, Congress could include a triggering event to the effect of: "when the federal deficit reaches X point, Congress shall conduct

¹⁹⁸ One such safe harbor is where the IRS attempts to clarify through numerous examples what types of allocations of income, credits, gains, and deductions a partnership or LLC may provide to its partners (or its LLC members taxed as partnerships) that are disproportionate from their respective ownership interests. See I.R.C. § 704 (2004); Treas. Reg. § 1.704-1(2)(b) (as amended in 2008).

¹⁹⁹ One potential adverse byproduct of codification could be a trend by the IRS to issue fewer PLRs for fear that those customized pronouncements may become statutory for all taxpayers. Also, perhaps some taxpayers or tax-exempt entities prefer the customized benefit they incur in receiving a PLR that others cannot use as precedent. However, the benefits of transparency, clarity, predictability, and precedential benefit for taxpayers, or well-intentioned non-profits, as a whole should be a higher priority and worth the trade off.

public hearings through an appropriate joint committee to ascertain whether prior pronouncements from the Treasury have such revenue-generating potential that they should become statutes with extraordinary notice and opportunity for public input.” Such specific congressional guidance would give charitable organizations proper direction for investment purposes.

VII. POLICY CONSIDERATIONS

A. *Uncapping ROI as an Economic Stimulant Tempered by Tax Benefit Reciprocity*

Another justification for uncapping the ROI for private foundations is based on tax policy and economics. The debates of the 1950 UBIT legislation evidence that President Truman sought to spur economic growth. When foundations see an opportunity for a greater ROI, they will invest more capital into those businesses, permitting the businesses to hire more employees and to buy and sell more goods and services. If increased capital and labor force produces a higher quality product, more customers should be attracted. Both the enhanced LLC and increased consumers of the goods or services add to a more robust economy. These activities create taxable events that generate tax revenues to federal, state, and local treasuries. In turn, such a beneficial system would promote a more efficient use of previously underused resources, such as employing the previously unemployed, resulting in an economic net gain.

There is a multiplier effect to the positives flowing from the LLC’s investment capital into a business. If a single foundation invests in a business, the investment should generate more indirect tax revenue than the revenue the government would directly receive in excise taxes from the foundation.

No rational tax policy should view tax or revenue benefits only flowing in one direction to the continual benefit of one and the detriment of another. If a private foundation is already exempt from paying income tax, it should not receive even greater returns on investment without a corresponding benefit to the public fisc. There should be some basis, beyond taxes, for measuring the extent of a private foundation’s contribution to society. The government has the burden to provide a basic standard of living for our most needy citizens. The philanthropic LLC’s reward for its contribution should consist of more than the imposition of excise taxes or an unrelated business income tax. This concept is well rooted in historic economic principles.

Adam Smith established a fundamental principle for tax-related contributions.²⁰⁰ According to Smith, “the greater part of the members of any society should contribute to the public revenue in proportion to their respective expense.”²⁰¹

What then is the philanthropic LLC’s proportionate expense to the U.S. Treasury? Theoretically, an entity should not have to contribute to the Treasury if the entity does not benefit from it.²⁰² One must consider revenue demands and comparative fairness among entities. But, as an underlying principle, an LLC’s justification for greater tax benefits should be in proportion to the reduction it causes in government expenses. Smith’s proportionality model translates into a theory of tax-benefit reciprocity. The model illustrates that the government should determine the amount of an entity’s tax benefit by measuring the advantage the tax entity confers on the government.

One may further trace such a theory to Aristotle’s notion that people should “be rewarded in accordance with their merits.”²⁰³ This ancient principle relates to modern theories of distributive justice to the extent that the state has an obligation to provide a certain level of material means to all its citizens. If those threshold benefits are not provided, “the state may need to redistribute goods to correct for market imperfections.”²⁰⁴ Implicit in the distributive justice theory is the need for society and its human capital to contribute; in other words, the market has a role in creating and distributing the benefits shared by all.²⁰⁵ Aristotelian thought also furthers the notion that on a project-by-project basis, one’s contribution to a project is the

²⁰⁰ For general information on Adam Smith, see Thurman W. Arnold, *The Preservation of Competition, in THE FUTURE OF DEMOCRATIC CAPITALISM* 1, 3-4 (1950). Smith was also termed “the first economist” by celebrated economist John Kenneth Galbraith. JOHN KENNETH GALBRAITH, *THE AGE OF UNCERTAINTY* 15 (1977). Smith may or may not appreciate being called an economist since he was a professor of logic, and then moral philosophy. *Id.* Yet his seminal publications examine causes of wealth on a comparative basis between Great Britain, the American colonies, and beyond. See ADAM SMITH, *THE WEALTH OF NATIONS* 953 (Modern Library 2000) (1776).

²⁰¹ SMITH, *supra* note 200, at 953.

²⁰² It is difficult to quantify and value the extent of a charitable quid pro quo to measure in this context. But it is no more daunting a task than business appraisers faced when first attempting to quantify intangible assets such as goodwill or the going concern value of a business. There are now well-established valuation methods for both.

²⁰³ See SAMUEL FLEISCHACKER, *A SHORT HISTORY OF DISTRIBUTIVE JUSTICE* 5 (2004).

²⁰⁴ See *id.* at 4. Distributive justice is also termed “economic justice” or “social justice.” *Id.* at 1. While Aristotle did not give birth to the name “distributive justice,” he did opine about resource allocation and rewarding people based on merit. *Id.* at 1-2. Fleischacker attempts to connect Aristotle’s theories to modern concepts of distributive justice. He also admits that “the history of ideas is a messy affair, and there is neither universal agreement today on what ‘distributive justice’ means nor a neat time line in the past by which the premises . . . for modern distributive justice came, one by one, into wide acceptance.” *Id.* at 15-16.

²⁰⁵ See *id.* at 4.

proper basis for determining that person's allocation of the project's benefit.²⁰⁶

If a society is obligated to take care of its least fortunate and most needy, then government and the more fortunate should share this obligation. Tax exemptions for philanthropic organizations should be merit-based. Measuring the private foundations' and philanthropic LLCs' ROI should include the benefits bestowed on others through their mission-based investments. The extent of benefits they receive should reflect their investment outcomes.

What philanthropic organizations deserve under the tax benefit reciprocity principle is therefore correlated with the amount of reciprocal benefit they provide to the government. If their investment provides societal benefits that relieve part of the government's burden, then the extent of the benefit and contribution fits within the Aristotelian sense of merit-based compensation. A corporation should receive tax benefits as a function of the value it confers on its community government. Tax-benefit reciprocity incorporates Aristotelian concepts and a trading of values, which the law has commoditized through the language of tax benefits.

Congress has promoted this rationale for granting exemptions. A 1939 House of Representatives Committee Report stated:

The exemption from taxation . . . devoted to charitable . . . purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from the financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of the general welfare.²⁰⁷

Current regulations reiterate this concept in defining charity to include an organization that "lessen[s] . . . the burdens of Government."²⁰⁸ This confluence of tax benefits and burdens gives rise to a dialogue between the LLC and the government. For example, the LLC may offer capital to businesses serving those with otherwise unmet needs, capital that would be unavailable under other conditions to the LLC. If the government also subsidizes needy programs and businesses, then the governmental burden lessens as philanthropic LLCs' capital provisions increase.

An LLC should retain the benefits of tax exemption and PRI status only if its mission-based investments provide a corresponding benefit to the tax system. As every tax exemption results in lost tax revenue, the remain-

²⁰⁶ FLEISCHACKER, *supra* note 203, at 4-5.

²⁰⁷ H.R. REP. NO. 75-1860, at 19 (1938).

²⁰⁸ *See, e.g.*, Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008). Recent Congresses have found these historical underpinnings important. For instance, in 2005, the Joint Committee on Taxation recited these concerns when it provided a comprehensive analysis of exemptions. *See generally* STAFF OF J. COMM. ON TAXATION, 109TH CONG., HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS (Comm. Print 2005).

ing non-exempt taxpayers must make up for that lost revenue. To justify the lost revenue, the tax-exempt entity should reduce the burden on the non-exempt taxpayers. Therefore, it is wise tax policy to incentivize the infusion of private equity into businesses that serve needy areas, especially since this is where private investment can provide the greatest relief to the government safety net. More private equity should result in more tax efficiency.²⁰⁹

At bottom, all tax benefits contain an element of incentives. When an entity earns certain qualified income through charitable investing without incurring tax liability, that entity is more inclined to make larger charitable investments. Moreover, the entity would have even more incentive if the return on charitable investments would have a broader qualification without a cap on profits. It is necessary to delineate the limits on such a return to minimize abuses. Still, the underlying principle remains.

It is important to recognize that these proposed regulations do not dilute the most vital reasons for the tax treatment of a foundation's investment income. Appropriately, Congress sought to eliminate an incongruity in tax benefits when it amended the tax law in 1969. Prior to the 1969 amendments, a private foundation could invest in assets, accrue income from those assets, and receive substantial tax benefits from making the investment.²¹⁰ The charity, however, would receive no immediate benefit because the law did not require any immediate distributions from the foundation to the charity.²¹¹ A key feature of the 1969 amendments was to penalize a foundation's undistributed income through a tax.²¹² However, Congress has more to do in order to equitably balance the goal of providing immediate cash infusions to donation recipients with the need to incentivize investors.

CONCLUSION

If there is to be serious change in the status quo of economic development in under-resourced communities, the investment-incentive paradigm for charitable investments in urban America must change. Federal regulations should reward market-based investments in high-risk philanthropic ventures if a philanthropic LLC makes investments that are true to its chari-

²⁰⁹ See generally Roger M. Groves, *More Private Equity, Less Government Subsidy, and More Tax Efficiency in Urban Revitalization: Modeling Profitable Philanthropy and Investment Incentives*, 8 FLA. ST. U. BUS. REV. 93 (2009) (arguing that as a matter of tax policy, increasing the private sector contribution to charitable projects should reduce the need for governmental subsidies, and the preferred method of increasing investor participation is to increase the amount of investment return rather than focus on tax deductions).

²¹⁰ H.R. REP. NO. 91-413, at 25.

²¹¹ *Id.*

²¹² *Id.*

table purposes and qualify as PRIs. Accordingly, this article proposes various amendments to federal tax regulations to increase the investor's ROI, thereby increasing private equity contributions. This increase would generate more equity capital for the communities in greatest need of economic revitalization. Existing excise tax regulations may prevent abuse of exempt investment income effectively, but they are shortsighted in that they do not promote Congress's goal of increasing private equity capital into disadvantaged areas.²¹³

It is wiser tax policy to uncap the return on investment for mission-based investments of LLCs that otherwise meet the safeguards contained in the PRI provisions. In the long run, this policy would create an overall net gain to tax revenues. The law's current state leaves serious doubt as to whether the philanthropic LLCs' ROI can be at or above market value. This doubt chills private investment in such joint ventures. Congress should amend existing regulations concerning market-based returns to incentivize investors to facilitate those desirable outcomes. This amendment would encourage private investment.

Realistically, the government must balance the threat of abuse with the desire to incentivize investors to enter into ventures in needy communities. Congress must retain regulations that curb abuse and amend certain provisions to further incentivize philanthropic organizations. We must remain cognizant that such organizations must balance their mission with profitability in determining how to best allocate their resources. The law should incentivize investors to make many nets for the underprivileged so that islands of underinvestment, otherwise known as urban low-income communities, can be defined by their prosperity, not their poverty.

²¹³ While this article concerns the high profile I.R.C. § 4944, which jeopardizes investment regulation, there are additional hurdles to overcome through regulations that were not designed for philanthropic investors that nonetheless chill transformative investments.

TABLE A. POTENTIAL EXCISE TAXES FOR A PRIVATE FOUNDATION ON ITS INVESTMENTS

Type	1 ST TIER Calculation	2 ND TIER Calculation	Manager Joint & Severable Liability?
Net Investment Income on Nonexempt Private Foundations (§ 4940)	Gross Investment + Capital Gain – Deductions x 2%	None	No
Self-Dealing (§ 4941)	<ul style="list-style-type: none"> • 10% on Self-Dealer • 5 % on Manager (20K cap) 	<ul style="list-style-type: none"> • 200% on Self Dealer • 50% on Manager (20K cap) 	No
Undistributed Income (§ 4942)	30% of undistributed amount	100% of undistributed amount	No
Excess Business Holdings (§ 4943)	10 % of excess holdings	200% of excess holdings	No
Jeopardizing Investments (§ 4944)	<ul style="list-style-type: none"> • 10% on Foundation • 10% on Manager (10K cap) 	<ul style="list-style-type: none"> • 20% on Foundation • 5% on Manager (20K cap) 	Yes
Taxable Expenditures (§ 4945)	<ul style="list-style-type: none"> • 20% on Foundation • 5% on Manager (10K cap) 	<ul style="list-style-type: none"> • 100% on Foundation • 50% on Manager (20K cap) 	Yes

U.S. HEALTH CARE REFORM: COMPREHENSIVE INSURANCE OR AFFORDABLE CARE?

*Don W. King**

INTRODUCTION

The United States leads the world in scientific discovery and medical innovation,¹ and recent studies suggest that for many types of cancer, U.S. patients have outcomes superior or equivalent to those in other industrialized countries.² However, U.S. health insurance and medical care are expensive,³ and Americans may be spending more on health care than necessary to achieve the highest quality.⁴ While there are undoubtedly many reasons why health insurance and medical care are expensive, present federal and state policies appear to be important factors.⁵

* The author would like to thank Steve Balla, Greg Conko, Joe Cordes, Susan Dudley, and Tevi Troy for their very helpful comments.

¹ See ECONOMIC REPORT OF THE PRESIDENT, together with THE ANNUAL REPORT OF THE COUNCIL OF ECONOMIC ADVISORS, H. Doc. No. 108-145, at ch. 10 (2004), available at http://www.gpoaccess.gov/usbudget/fy05/pdf/2004_erp.pdf.

² Because of differences among countries in disease registries and early disease detection, comparison studies must be interpreted with caution. Nevertheless, recent studies suggest that in treating some types of cancers, U.S. outcomes are superior to, or equivalent to, outcomes in other advanced countries. See Milena Sant et al., *Breast Carcinoma Survival in Europe and the United States: A Population Based Study*, 100 *CANCER* 715 (2004); Arduino Verdecchia et al., *Recent Cancer Survival in Europe: a 2000-02 Period Analysis of EUROCARE-4 Data*, 8 *LANCET ONCOLOGY* 784 (2007); June E. O'Neill & Dave M. O'Neill, *Health Status, Health Care and Inequality: Canada vs. the U.S.* (Nat'l Bureau of Econ. Research, Working Paper No. 13429, 2007).

³ See Gerard F. Anderson et al., *It's the Prices Stupid: Why the United States Is So Different From Other Countries*, 22 *HEALTH AFF.*, no. 3, at 89 (2003). Between 1960 and 2009, prices for medical care increased at a greater rate than the Consumer Price Index (CPI) (author's calculation). *Databases, Tables, and Calculators by Subject, All Urban Consumers (Current Series)*, BUREAU OF LAB. STAT., <http://www.bls.gov/data/>. Similarly, between 1988 and 2007, premiums for employer-sponsored insurance increased at a greater rate than the CPI. See THE KAISER FAMILY FOUND. ET AL., *EMPLOYER HEALTH BENEFITS: 2007 ANNUAL SURVEY 19* (2007) (Exhibit 1.1: Average Percentage Increase in Health Insurance Premiums Compared to Other Indicators), available at <http://www.kff.org/insurance/7672/upload/76723.pdf>.

⁴ See Jonathan Skinner, Elliott S. Fisher & John E. Wennberg, *The Efficiency of Medicare* (Nat'l Bureau of Econ. Research, Working Paper No. 8395, 2001); Elliott S. Fisher et al., *The Implications of Regional Variations in Medicare Spending, Part 2: Health Outcomes and Satisfaction with Care*, 138 *ANN. INTERN. MED.* 288 (2003). See also Willard G. Manning, et al., *Health Insurance and the Demand for Health Care: Evidence from a Randomized Experiment*, 77 *AM. ECON. REV.* 251 (1987).

⁵ Part I of this paper discusses a number of ways in which current federal and state policies contribute to high prices for health insurance and medical care.

In 2010, Congress passed the Patient Protection and Affordable Care Act (PPACA).⁶ PPACA reflects an approach to health care reform that focuses on the importance of insurance⁷ as a means to assure access to care. Under this approach, legislation is designed to extend comprehensive, third-party coverage to a larger percentage of the population.⁸ Because a third party pays for most care, cost control is achieved primarily by the third party (e.g., by providing incentives for patients, professionals, or facilities to use fewer resources or by negotiating lower payment rates with physicians and hospitals).

Since World War II, Congress and state legislators have often taken this approach, attempting to increase access to care by increasing the prevalence of comprehensive, third-party coverage among various segments of the population.⁹ However, for many years, real prices for health insurance and medical care have increased,¹⁰ and health care expenditures as a percentage of gross domestic product (GDP) have increased as well.¹¹

Proponents of universal, comprehensive insurance envision universal access to high-quality care—a worthy goal. However, economic theory and many data suggest that legislative attempts to achieve universal, comprehensive insurance will have major unintended consequences. These include

⁶ Patient Protection and Affordable Care Act, Pub. L. 111-148, 124 Stat. 119 (2010). Congress later amended PPACA with the Health Care and Education Reconciliation Act of 2010. Pub. L. 111-152, 124 Stat. 1029 (2010).

⁷ For health insurance to efficiently spread the risk of loss, the loss must be uncertain, measurable, and large. In addition, insurance premiums must be based on the insured's risk, and the risk pool must consist of a large number of insured. See JOHN A. BONI ET AL., *THE HEALTH INSURANCE PRIMER: AN INTRODUCTION TO HOW HEALTH INSURANCE WORKS* 3 (2000). Today, most U.S. health plans contain a component of true insurance, as well as a large component of "prepaid benefits" that cover small, expected expenses. Instead of indemnifying individuals for their loss, most plans now pay physicians and hospitals directly, and to some extent, "manage" the care (e.g., some plans employ physicians and operate facilities, while many plans contract with physicians and hospitals concerning methods of payment, payment rates, and other items). For a discussion of these arrangements, see 2 PAUL STARR, *THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE* 60-79 (1982); CHARLES E. PHELPS, *HEALTH ECONOMICS* ch. 11 (3d ed. 2003); Thomas Rice, *Financial Incentives as a Cost-Control Mechanism in Managed Care*, in *THE PRIVATIZATION OF HEALTH CARE REFORM* 99 (M. Gregg Bloche ed., 2003). Finally, self-insured employee benefit plans and public programs pay for medical care for many Americans. In this paper, "health insurance" refers to the various forms of payment for medical care that include a component of true insurance.

⁸ For reform proposals that use this approach, see DAVID M. CUTLER, *YOUR MONEY OR YOUR LIFE* 114-124 (2004); TIMOTHY STOLZFUS JOST, *HEALTH CARE AT RISK: A CRITIQUE OF THE CONSUMER-DRIVEN MOVEMENT* 189-204 (2007).

⁹ Part I discusses federal and state attempts to increase coverage among various segments of the population.

¹⁰ See references cited *supra* note 3.

¹¹ See Table 1: *National Health Expenditures Aggregate, Per Capita Amounts, Percent Distribution, and Average Annual Percent Growth, by Source of Funds: Selected Calendar Years 1960-2009*, CTRS. FOR MEDICARE & MEDICAID SERVS., <http://www.cms.gov/NationalHealthExpendData/downloads/tables.pdf>.

higher prices, larger expenditures, and potentially less access to medical care.

This paper recommends an alternative approach: one that focuses on the importance of individuals owning the funds used for their health care, and choosing both health insurance and medical care from a wide variety of options.¹² To increase individual ownership, Congress and state legislators will need to repeal or decrease incentives that favor third-party payment over direct payment for health insurance and medical care. To facilitate a wider variety of options, Congress and state legislatures will need to repeal or decrease the stringency of many regulations presently governing both health insurance and medical care. Because individuals would be better able to pay directly for their health insurance and medical care, individuals, often in consultation with their physician, would be primarily responsible for cost control.

This article is divided into four parts. Part I provides an overview of present federal and state policies, reviewing their effects on prices, expenditures, and prevalence of health insurance. Part II reviews the likely effects of PPACA provisions designed to extend comprehensive third-party coverage to a larger percentage of the population. Part III outlines a series of alternative reforms designed to increase individual ownership of health care funds and to increase each person's options for health insurance and medical care. Part IV describes how these alternative reforms should lead to greater access to care for low-income, high-risk,¹³ and older Americans.

I. EFFECTS OF FEDERAL AND STATE POLICIES ON U.S. HEALTH CARE¹⁴

This Part reviews the effects that present policies have on U.S. health care under six categories: (1) tax incentives for health insurance and medical care; (2) public programs that pay for medical care (public insurance); (3) administrative regulation of private health insurance; (4) administrative regulation of professional and medical facility care; (5) administrative regulation of pharmaceuticals and devices; and (6) liability for medical malprac-

¹² For reform proposals that use this approach, see JOHN F. COGAN ET AL., *HEALTHY, WEALTHY, AND WISE: 5 STEPS TO A BETTER HEALTH CARE SYSTEM* ch. 2 (2005); MICHAEL F. CANNON & MICHAEL D. TANNER, *HEALTHY COMPETITION: WHAT'S HOLDING BACK HEALTH CARE AND HOW TO FREE IT* 1-17 (2d ed. 2007).

¹³ For the purpose of this paper, a high-risk individual is one who, because of a genetic variation, chronic disease, or other condition, is more likely than the general population to incur large medical expenses.

¹⁴ The policies described in this section represent only a small portion of the statutes, administrative regulations, and case law governing health care. Arguably, they do represent the most important federal and state policies that influence prices, expenditures, prevalence of health insurance, and access to care.

tice. Each subpart provides a brief description of representative policies, a discussion of their benefits and costs, and a brief review of selected data.

A. *Tax Incentives for Health Insurance and Medical Care*

1. Exclusion of Employer-Sponsored Insurance

In 1943, the Internal Revenue Service (IRS) ruled that employees could exclude the value of employer-sponsored insurance (ESI) from gross income when calculating their income tax. In 1954, Congress incorporated this exclusion into the tax code.¹⁵ However, the exclusion does not apply if an individual purchases insurance independent of an employer (IPI) or pays for medical expenses directly. As a result, there is a strong incentive for individuals to obtain health insurance through their employer and to choose comprehensive insurance with minimal cost sharing.

Allowing employers to fund ESI with pre-tax dollars increases access to medical care for many people. Also, ESI may have benefits for employees independent of tax advantages.¹⁶ For example, employment can be a good means of pooling risk, and ESI may decrease employees' bargaining and administrative costs. Conversely, employers may offer insurance that does not meet a specific employee's needs, and ESI is usually not portable from one employer to another.

In addition, the disparate tax treatment of ESI, IPI, and out-of-pocket expenses increases prices for health insurance and medical care. First, the ESI exclusion allows employees to pay for insurance with pre-tax dollars. For those employees, health insurance is less "costly" than their other expenses.¹⁷ Second, because an employer is paying for an employee's insurance, the employee may be unaware of the cost of the insurance. Finally, the tax exclusion policy makes health insurance less costly for an employee than if the employee were paying for medical care out-of-pocket. Each of these factors increases the demand for both health insurance and medical care, and greater demand for any good or service usually results in higher prices and larger expenditures.¹⁸ While higher prices are costly for all, they

¹⁵ 26 U.S.C. § 106(a) (2006). See also TOM MILLER, JOINT ECON. COMM., HOW THE TAX EXCLUSION SHAPED TODAY'S PRIVATE HEALTH INSURANCE MARKET (Dec. 17, 2003), available at http://www.aei.org/docLib/20070222_Millerarticle.pdf.

¹⁶ For example, see David A. Hyman & Mark Hall, *Two Cheers for Employment-Based Health Insurance*, 2 YALE J. HEALTH POL'Y L. & ETHICS 23 (2001).

¹⁷ A person who pays for health insurance with pre-tax dollars forgoes fewer benefits than one who pays the same price with post-tax dollars.

¹⁸ In a 1973 study, Martin Feldstein showed that under the conditions present at that time, hospital prices and the demand for health insurance were mutually reinforcing (i.e., an increase in the price of hospital care resulted in an increase in the demand for health insurance, and vice versa). He also showed that greater average coinsurance rates would result in substantial welfare gains. See Martin S.

are especially costly for individuals who do not have ESI and who must pay for insurance and medical care with after-tax dollars.

Third-party payment for most medical care has other costs. Because individuals do not own the funds that pay for their care, they may have less ability to use the funds in the best way for their particular situation. For example, a person's health plan may cover care that an individual does not need, but not cover care that the individual does need. Also, a third party cannot be present during the millions of patient-physician interactions that occur each day. As a result, there may be costly disputes concerning whether a service is covered or whether the service was necessary for a particular condition. For the same reason, third-party payment may lead to fraud.

Finally, third-party payment affects the professionals and medical facilities that provide care. When a third party is paying, both professionals and medical facilities serve two masters: a patient and a third-party payer. Although all professionals and facilities attempt to provide the best possible care for each patient, third-party payment decreases both the incentive and the flexibility to provide the most cost-effective care possible.

In 2009, ESI covered 169.7 million people, or 55.8% of the population.¹⁹ Between 1988 and 2007, premiums for ESI increased at a greater rate than the consumer price index (CPI).²⁰ In 2010, the average price for single coverage ESI was \$5,089 per year, and the average price for family coverage ESI was \$13,770 per year.²¹ The Centers for Medicare and Medicaid Services (CMS) estimated that in 2009, Americans spent \$2.486 trillion on health care, approximately 17.6% of the GDP.²²

2. Additional Tax Incentives

Since excluding ESI from gross income, Congress and the IRS have created additional incentives that partially equalize the disparate tax treatment of ESI, IPI, and direct payment for medical care. For example, self-employed persons, who meet certain criteria, may deduct the cost of health insurance from gross income when calculating their personal income

Feldstein, *The Welfare Loss of Excess Health Insurance*, 81 J. POL. ECON. 251, 261-265, 275-277 (1973).

¹⁹ See CARMEN DENAVAS-WALT, BERNADETTE D. PROCTOR & JESSICA C. SMITH, U.S. CENSUS BUREAU, P6O-238, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2009 22-24 (2010), available at <http://www.census.gov/prod/2010pubs/p60-238.pdf>.

²⁰ Between 1999 and 2007, the average annual increase in premiums for ESI was 9.6% (author's calculation). EMPLOYER HEALTH BENEFITS: 2007 ANNUAL SURVEY, *supra* note 3, at 19.

²¹ See THE KAISER FAMILY FOUND. ET AL., EMPLOYER HEALTH BENEFITS: 2010 ANNUAL SURVEY 20 (2010), available at <http://ehbs.kff.org/pdf/2010/8085.pdf>.

²² See CTRS. FOR MEDICARE & MEDICAID SERVS., *supra* note 11.

tax.²³ Flexible spending accounts (FSA)²⁴ and health reimbursement arrangements (HRA)²⁵ allow some employees to purchase individual insurance or pay out-of-pocket expenses with pre-tax dollars. Similarly, health savings accounts (HSA) allow persons who meet certain criteria to pay out-of-pocket expenses with pre-tax dollars.²⁶

An HSA is an account established with a financial institution, into which an individual can place pre-tax dollars and later withdraw these funds, tax free, to pay for medical expenses.²⁷ HSA funds can be invested, carried over from year to year to pay for future expenses, and left to one's heirs. However, there are annual limits to HSA contributions: an HSA owner cannot purchase his or her primary health insurance policy with HSA funds, and an owner must maintain a high-deductible health plan (HDHP).

The primary benefit of an HSA is that it allows an individual to use pre-tax dollars to pay for out-of-pocket medical expenses. Because HSA owners pay directly for much of their care, owners have both the incentive and flexibility to choose care based on quality and price. Similar to the tax preference for ESI, the use of an HSA provides greater benefits for a high-income than for a low-income earner, and it decreases federal tax revenue. However, the lost revenue resulting from HSA contributions is small compared to the lost revenue resulting from the tax exclusion of ESI.²⁸

As of January, 2010, 10 million Americans were covered by an HDHP associated with an HSA.²⁹ One study found that for covered employees, 2008 premiums for HSA-qualified HDHPs were 35% to 40% less than premiums for other types of plans.³⁰

²³ 26 U.S.C. § 161 (2006).

²⁴ 26 U.S.C. § 125 (2006). *See also* IRS Employee Benefits—Cafeteria Plans, 72 Fed. Reg. 43,938 (proposed Aug. 6, 2007) (to be codified at 26 C.F.R. pt. 1); J.P. Wieske, *Benefiting Cities: How Cafeteria Plans Enhance City Benefits While Saving Taxpayer Money*, CAHI ISSUES & ANSWERS (Council for Affordable Health Ins., Alexandria, Va.), July 2008, available at http://www.cahi.org/cahi_contents/resources/pdf/n149Section125Plans.pdf.

²⁵ *See* I.R.S. Notice 2002-45, available at www.irs.gov/pub/irs-drop/n-02-45.pdf; I.R.S. Bulletin, 2002-28 I.R.B. (July 15, 2002), available at www.irs.gov/pub/irs-irbs/irb02-28.pdf.

²⁶ *See* 26 U.S.C. § 223 (2006).

²⁷ *Id.*

²⁸ The Joint Committee on Taxation estimated that in 2010, the lost revenue associated with the exclusion of employer contributions for health care, including insurance premiums, was \$105.7 billion. The lost revenue associated with HSA contributions was \$0.9 billion. *See* STAFF OF THE JOINT COMM. ON TAXATION, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2010-2014, 47-48 (Comm. Print 2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3718>.

²⁹ AHIP CTR. FOR POLICY & RESEARCH, JANUARY 2010 CENSUS SHOWS 10 MILLION PEOPLE COVERED BY HSA/HIGH-DEDUCTIBLE HEALTH PLANS 3 (2010), available at <http://www.ahipresearch.org/pdfs/HSA2010.pdf>.

³⁰ *See* Benjamin Zycher, *HSA Health-Insurance Plans After Four Years: What Have We Learned?*, MED. PROGRESS REP. (Manhattan Inst., New York, N.Y.), Feb. 2009, at 9. Since HSA plans have higher deductibles, total health care expenses may be greater for some HSA owners.

B. *Public Programs That Pay for Medical Care (Public Insurance)*

To increase access to medical care for seniors and low-income persons, Congress created Medicare and Medicaid in 1965.³¹ Medicare is a federal program that pays for medical services and products for Americans sixty-five years of age and older, for disabled persons, and for persons with end-stage renal disease.³² Medicaid, jointly funded by the federal and state governments, pays for medical services and products for low-income persons who meet certain criteria.³³ In 1997, Congress created the State Children's Health Insurance Program (S-CHIP).³⁴ S-CHIP pays for medical services and products for certain low-income children who are not eligible for Medicaid.

As with the tax exclusion of ESI, the primary benefit of public insurance is that it increases access to care for many persons who otherwise may not have access. In addition, providing public insurance may decrease the amount of uncompensated care,³⁵ cost shifting between uninsured and insured patients,³⁶ and inappropriate use of emergency departments.³⁷ However, because of low payment rates and other factors, some physicians do not accept public insurance beneficiaries,³⁸ and public insurance often "crowds out" private insurance.³⁹ Individuals who replace private insurance

³¹ Social Security Amendments of 1965, Pub. L. 89-97, 79 Stat. 286 (1965).

³² For a general discussion of Medicare, see THE HENRY J. KAISER FAMILY FOUND., *MEDICARE: A PRIMER* (2010), available at <http://www.kff.org/medicare/upload/7615-03.pdf>.

³³ For a general discussion of Medicaid, see THE KAISER COMM'N ON MEDICAID & THE UNINSURED, *MEDICAID: A PRIMER* (2010), available at <http://www.kff.org/medicaid/upload/7334-04.pdf>.

³⁴ See THE KAISER COMM'N ON MEDICAID & THE UNINSURED, *STATE CHILDREN'S HEALTH INSURANCE PROGRAM (SCHIP) AT A GLANCE* (2007), available at <http://www.kff.org/medicaid/upload/7610.pdf>.

³⁵ It is estimated that total U.S. uncompensated care in 2008 was \$54.3 billion, 2.2% of total health care spending. See JACK HADLEY ET AL., THE KAISER COMM'N ON MEDICAID & THE UNINSURED, *COVERING THE UNINSURED IN 2008: A DETAILED EXAMINATION OF CURRENT COSTS AND SOURCES OF PAYMENT, AND INCREMENTAL COSTS OF EXPANDING COVERAGE 18-19* (2008), available at <http://www.kff.org/uninsured/upload/7809.pdf>.

³⁶ Hadley et al. estimated that the amount of cost shifting from uninsured patients to privately insured patients in 2008 was less than 1% of total private health insurer costs. See HADLEY ET AL., *supra* note 35, at 52-53.

³⁷ In a recent review of the existing literature, Newton et al. reported that more uninsured individuals were seen in emergency departments than in the past, but the rate of increase was similar to that seen in insured persons. See Manya F. Newton et al., *Uninsured Adults Presenting to US Emergency Departments*, 300 JAMA, no. 16, Oct. 2008 at 1914.

³⁸ See Peter Cunningham & Jessica May, *Medicaid Patients Increasingly Concentrated Among Physicians*, TRACKING REP. (Ctr. for Studying Health Sys. Change, Wash. D.C.), Aug. 2006, at 1, available at <http://www.hschange.com/CONTENT/866/866.pdf>.

³⁹ See David M. Cutler & Jonathan Gruber, *Does Public Insurance Crowd Out Private Insurance?*, 111 QUART. J. ECON. 391 (1996); Lara Shore-Sheppard, Thomas C. Buchmueller & Gail A.

with public insurance may have less access to care than they had prior to enrolling in public insurance.

There are other costs. Public insurance is inherently subject to political influence. Types of care covered, payment rates, and other items are determined by Congress, a state legislature, or an administrative body—all of which are subject to political influence. Similar to the tax preference for ESI, public insurance increases the demand for care, and the greater demand usually leads to higher prices and larger expenditures.⁴⁰

Finally, public insurance requires public funding, and the taxation necessary to support public insurance entails costs to society in addition to the cost of the funds collected. For example, taxation costs include the federal or state agency cost to collect taxes, taxpayer costs to comply with the tax code,⁴¹ and less visible costs resulting from incentives engendered by the tax code.⁴²

Data suggest that becoming eligible for Medicaid increases the likelihood that a newly eligible beneficiary will see a physician,⁴³ and some data

Jensen, *Medicaid and Crowding Out of Private Insurance: A Re-examination Using Firm Level Data*, 19 J. HEALTH ECON. 61 (2000); Anthony T. LoSasso & Thomas C. Buchmueller, *The Effect of State Children's Health Insurance Program on Health Insurance Coverage* (Nat'l Bureau of Econ. Research, Working Paper No. 9405, 2002); Jonathan Gruber & Kosali Simon, *Crowd-out Ten Years Later: Have Recent Public Insurance Expansions Crowded Out Private Health Insurance?*, 27 J. HEALTH ECON. 201, 209-213, 216 (2008).

⁴⁰ In a recent study, Finklestein estimated that the enactment of Medicare in 1965 increased hospital spending by approximately 37% between 1965 and 1970, and that Medicare may have been responsible for over 50% of the growth of hospital spending during those years. See Amy Finklestein, *The Aggregate Effects of Health Insurance: Evidence from the Introduction of Medicare*, 122 Q. J. ECON. 22 (2007).

⁴¹ Moody et al. estimated that Americans would spend \$265.1 billion complying with the income tax code in 2005, \$148 billion for businesses, \$111 billion for individuals, and \$7 billion for non-profit organizations. See J. Scott Moody, Andy P. Warcholik & Scott A. Hodge, *The Rising Cost of Complying with the Federal Income Tax*, SPECIAL REP. (Tax Found., Wash. D.C.), Dec. 2005, available at <http://www.taxfoundation.org/files/sr138.pdf>.

⁴² Feldstein described three types of costs resulting from incentives produced by increasing the U.S. tax rate on labor income: (1) the loss of labor input resulting from a decreased incentive to invest in education, training, or longer hours of work; (2) the loss of value to an employee who takes compensation in a form the employee would not otherwise choose, e.g., health insurance benefits; and (3) the loss of value to an employee who spends income on tax-deductible items the employee would not otherwise choose, e.g., interest payments on a home mortgage. Using IRS data from 2000, Feldstein estimated that the "deadweight loss" of these three costs, resulting from a 1% increase in marginal income tax rates, would be 76% of the revenue obtained. Thus, in addition to IRS agency costs, taxpayer compliance costs, and the cost to taxpayers of the revenue obtained, there may be additional costs of up to \$ 0.76 for every additional dollar of revenue. See Martin A. Feldstein, *The Effect of Taxes on Efficiency and Growth* (Nat'l Bureau of Econ. Research, Working Paper No. 12201, 2006).

⁴³ See Janet Currie & Jonathan Gruber, *Health Insurance Eligibility, Utilization of Medical Care, and Child Health*, 111 Q. J. ECON. 431 (1996); Laurence C. Baker & Anne Beeson Royalty, *Medicaid Policy, Physician Behavior, and Health Care for the Low-Income Population*, 35 J. HUM. RESOURCES 480 (2000).

suggest that becoming eligible for Medicaid improves health.⁴⁴ On the other hand, less than 60% of U.S. physicians accept all new Medicaid patients.⁴⁵ While most data suggest that the physician acceptance rate for Medicare beneficiaries is equivalent to that of privately insured individuals,⁴⁶ beneficiary access to primary care is limited in some locations.⁴⁷

Studies show that the crowd-out rate for Medicaid and S-CHIP is large.⁴⁸ One study found that for every 100 newly eligible persons who enrolled in public insurance after eligibility expansion, 60 fewer persons were enrolled in private insurance.⁴⁹

In 2009, Medicare Part A covered almost 46 million beneficiaries, and total Medicare expenditures were \$509 billion.⁵⁰ In 2009, the Medicare Boards of Trustees estimated that if Medicare law were to remain the same, by 2083, Medicare expenditures would represent 11.4% of the GDP.⁵¹

In the 2009 fiscal year, federal and state expenditures for Medicaid and S-CHIP were \$384.3 billion.⁵² In 2010, CMS investigators estimated that by 2015, Medicaid expenditures would reach \$627.5 billion.⁵³ This estimate does not include the cost of taxation necessary to generate the funds.

⁴⁴ See Cutler & Gruber, *supra* note 39. See also Helen Levy & David Meltzer, *The Impact of Health Insurance on Health*, 29 ANN. REV. PUB. HEALTH 399 (2008). On the other hand, Finklestein and McKnight found that the enactment of Medicare did not affect overall mortality among persons 65 and older during the first ten years of its existence. See Amy Finklestein & Robin Mcknight, *What Did Medicare Do? The Initial Impact of Medicare on Mortality and Out of Pocket Medical Spending*, 92 J. PUB. ECON. 1644, 1647-1653 (2008).

⁴⁵ See Cunningham & May, *supra* note 38.

⁴⁶ See Peter Cunningham, Andrea Staiti & Paul B. Ginsburg, *Physician Acceptance of New Medicare Patients Stabilizes in 2004-05*, TRACKING REP. (Ctr. for Studying Health Sys. Change, Wash. D.C.), Jan. 2006, at 1, available at <http://www.hschange.com/CONTENT/811/811.pdf>.

⁴⁷ See ROSYLAND FRAZIER & MARK FOSTER, UNIV. OF ALASKA ANCHORAGE, HOW HARD IS IT FOR ALASKA'S MEDICARE PATIENTS TO FIND FAMILY DOCTORS? (2009), available at http://www.iser.uaa.alaska.edu/Publications/researchsumm/UA_RS14.pdf.

⁴⁸ See references cited *supra* note 39.

⁴⁹ See Gruber & Simon, *supra* note 39, at 18-22.

⁵⁰ See BARBARA S. KLEES, CHRISTIAN J. WOLFE & CATHERINE A. CURTIS, BRIEF SUMMARIES OF MEDICARE & MEDICAID: TITLE XVII AND TITLE XIX OF THE SOCIAL SECURITY ACT 21 (2010), available at <http://www.cms.gov/MedicareProgramRatesStats/Downloads/MedicareMedicaidSummaries2010.pdf>.

⁵¹ See THE BDS. OF TRS. OF THE FED. HOSP. INS. & FED. SUPPLEMENTARY MED. INS. TRUST FUNDS, 2009 ANNUAL REPORT 4 (2009), available at <http://www.cms.hhs.gov/reportstrustfunds/downloads/tr2009.pdf>.

⁵² See KLEES, WOLFE & CURTIS, *supra* note 50, at 29-30.

⁵³ *Id.*

C. *Administrative Regulation of Private Health Insurance*

In 1974, Congress passed the Employee Retirement Income Security Act (ERISA).⁵⁴ ERISA provides a uniform regulatory structure for multi-state employers that provide welfare benefit plans for their employees. Under ERISA, if an employer self-insures for medical care, (i.e., assumes the risk and pays directly for care), the employer's plan is governed by ERISA instead of by a state's insurance regulations.⁵⁵

To facilitate continuing coverage for persons leaving employment, Congress passed the Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1985.⁵⁶ COBRA requires employers with twenty or more employees to offer a terminating employee up to eighteen months of continuation coverage at 102% of the cost of coverage for a similarly situated continuing employee.⁵⁷

At least partially to facilitate new coverage for persons leaving employment, Congress in 1996 enacted the Health Insurance Portability and Accountability Act (HIPAA).⁵⁸ HIPAA limits the ability of group health plans to exclude coverage for preexisting illnesses,⁵⁹ and it prohibits group plans from discriminating based on health status.⁶⁰ HIPAA also requires insurers in the individual market to make insurance available to certain populations⁶¹ and to guarantee renewal to all policyholders.⁶²

States regulate private health insurance if it is not governed by ERISA. Some states restrict the ability of insurers to underwrite (the process of determining the risk of an applicant, whether to offer insurance, and the premium to be charged). For example, some states require insurers to issue health insurance to all applicants regardless of health status, a requirement known as "guaranteed issue."⁶³ Some states require insurers to charge all insured individuals the same price regardless of their risk of incurring med-

⁵⁴ Employee Retirement Income Security Act, Pub. L. No. 93-406, 88 Stat. 829 (1974).

⁵⁵ 29 U.S.C.A. §§ 1144(a), (b)(2)(A), (b)(2)(B) (West 2006).

⁵⁶ Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 82 (1986).

⁵⁷ 29 U.S.C.A. § 1161 (West 2010); 29 U.S.C. §§ 1162(1), (2)(A)(ii), (3)(A) (West 2010).

⁵⁸ Health Insurance Portability and Accountability Act, Pub. L. No. 104-191, 110 Stat. 1936 (1996).

⁵⁹ 29 U.S.C.S. § 1181(a) (LexisNexis 2011).

⁶⁰ 29 U.S.C.S. § 1182(a)(1)(A) (LexisNexis 2011).

⁶¹ 42 U.S.C.S. § 300gg-41 (LexisNexis 2011).

⁶² 42 U.S.C.S. § 300gg-42 (LexisNexis 2011).

⁶³ See MERRILL MATHEWS, VICTORIA C. BUNCE & JP WIESKE, COUNCIL FOR AFFORDABLE HEALTH INS., STATE HEALTH INSURANCE INDEX 2006: A 50-STATE COMPARISON OF THE NATION'S HEALTH INSURANCE MARKET (2006), available at http://www.cahi.org/cahi_contents/resources/pdf/StateIndex.pdf (in 2006, ten states required some form of guaranteed issue in the individual insurance market).

ical expenses, a requirement known as “community rating.”⁶⁴ Because community rating without guaranteed issue may result in the exclusion of high-risk persons, states that require community rating usually require guaranteed issue as well. In addition, all states require insurers to either offer or include certain benefits in the policies they sell (mandated benefits).⁶⁵ For example, some states require insurers to offer or include coverage for *in vitro* fertilization or for chiropractic treatment.

The primary benefit of guaranteed issue plus community rating is that it allows high-risk persons to obtain health insurance at a more affordable price than they otherwise would. However, guaranteed issue, combined with community rating, increases prices for others. First, insurers may incur compliance costs. More importantly, because high-risk persons are likely to incur more medical expenses, average claims costs increase. Because larger claims costs increase insurance prices, low-risk persons may not purchase insurance until they become sick. As a result, guaranteed issue plus community rating may lead to a risk pool skewed to high-risk persons, further increasing prices.

The primary benefit of mandated benefits is that they increase the value of health insurance for persons who need the care for which coverage is mandated. However, many of these mandates lead to higher insurance prices for others.⁶⁶ Mandated benefits may increase insurance prices for several reasons. First, insurers may incur compliance costs. More importantly, because insurers must include additional benefits, average claims costs increase. Third, similar to guaranteed issue plus community rating, individuals who do not benefit from the mandates are more likely to forgo purchasing insurance, potentially skewing the risk pool toward patients who require the specified care. Finally, most mandates result in a third party paying for a greater proportion of a person’s care. As a result, there is an increased risk that some people will be less careful concerning their own health⁶⁷ and a greater incentive for patients and physicians to use resources, even if the expected benefits are small.

⁶⁴ *Methodology*, COUNCIL FOR AFFORDABLE HEALTH INS. (2006), http://www.cahi.org/cahi_contents/resources/pdf/StateIndexMethodology.pdf. Under pure community rating, insurers may not vary premiums. Under modified community rating, insurers may vary premiums based on factors such as age, but not health status. In 2006, seven states required some form of community rating in the individual insurance market. *Id.*

⁶⁵ See VICTORIA C. BUNCE & JP WIESKE, COUNCIL FOR AFFORDABLE HEALTH INS., HEALTH INSURANCE MANDATES IN THE STATES 2010 3 (2010), available at http://www.cahi.org/cahi_contents/resources/pdf/MandatesintheStates2010.pdf.

⁶⁶ See, e.g., MICHAEL J. NEW, HERITAGE FOUND., THE EFFECT OF STATE REGULATIONS ON HEALTH INSURANCE PREMIUMS: A REVISED ANALYSIS 5 (2006).

⁶⁷ See, e.g., Jonathan Klick & Thomas Stratmann, *Subsidizing Addiction: Do State Health Insurance Mandates Increase Alcohol Consumption?*, 35 J. LEG. STUD. 175, 193 (2006); Jonathan Klick & Thomas Stratmann, *Diabetes Treatments and Moral Hazard*, 50 J.L. & ECON. 519, 536 (2007).

Studies show that guaranteed issue at community-rated prices increases the prevalence of health insurance among high-risk persons, but increases prices⁶⁸ and decreases prevalence among the general population.⁶⁹ In one study, investigators estimated that within the individual health insurance market, the net effect was a lower overall insurance prevalence of 6% to 7.4%.⁷⁰

Data concerning the effects of mandated benefits are mixed. Some studies of the individual market suggest that mandated benefits increase insurance prices⁷¹ and decrease insurance prevalence.⁷² However, a recent study suggests that some mandates increase premiums, while other mandates decrease them.⁷³ One study of the small-group market suggests that mandates decrease the probability that an employer will offer insurance to employees,⁷⁴ while another suggests that mandated benefits have little effect on health insurance coverage.⁷⁵

D. *Administrative Regulation of Professional and Facility Care*

During the latter half of the nineteenth century, states began licensing physicians,⁷⁶ and in the latter half of the twentieth century, states began licensing and developing scope of practice rules for a number of relatively new health professions.⁷⁷ Today, states regulate professional care in three

⁶⁸ See Amanda E. Kowalski, William J. Congdon & Mark H. Showalter, *State Health Insurance Regulations and the Price of High-Deductible Policies*, 11 F. FOR HEALTH ECON. & POL'Y, no. 2, 2008 at 1, 10-12.

⁶⁹ See, e.g., Amy Davidoff, Linda Blumberg & Len Nichols, *State Health Insurance Market Reforms and Access to Insurance for High-Risk Employees*, 24 J. HEALTH ECON. 725 (2005); Bradley Herring & Mark V. Pauly, *The Effect of State Community Rating Regulations on Premiums and Coverage in the Individual Health Insurance Market* 19 (Nat'l Bureau of Econ. Research, Working Paper No. 12504, 2006), available at <http://www.nber.org/papers/w12504.pdf>.

⁷⁰ See Herring & Pauly, *supra* note 69, at 19.

⁷¹ See, e.g., NEW, *supra* note 66, at 5.

⁷² See, e.g., Frank A. Sloan & Christopher J. Conover, *Effects of State Reforms on Health Insurance Coverage of Adults*, 35 INQUIRY 280, 288 (1998).

⁷³ See Tracey A. LaPierre et al., *Estimating the Impact of State Health Insurance Mandates on Premium Costs in the Individual Market*, 27 J. INS. REG. 3, 31 (2009).

⁷⁴ See Gail A. Jensen & Michael A. Morrissey, *Small Group Reform and Insurance Provision by Small Firms, 1989-1995*, 36 INQUIRY 176, 183 (1999).

⁷⁵ See Jonathan Gruber, *State-mandated Benefits and Employer-provided Health Insurance*, 55 J. PUB. ECON. 433, 458-59 (1994).

⁷⁶ See STARR, *supra* note 7.

⁷⁷ See, e.g., SHARON CHRISTIAN, CATHERINE DOWER & ED O'NEILL, UNIV. OF CAL., S.F., OVERVIEW OF NURSE PRACTITIONER SCOPES OF PRACTICE IN THE UNITED STATES—DISCUSSION 14-15 (2007) (in general, states have gradually increased the practice authority of mid-level practitioners; however, some states continue to have fairly restrictive scope of practice rules); Richard A. Cooper, Tim Henderson & Craig L. Dietrich, *Roles of Nonphysician Clinicians as Autonomous Providers of Patient Care*, 280 J. AM. MED. ASS'N 795 (1998) (explaining how different states look at the roles and practices

primary areas: (1) entry requirements that establish the minimal qualifications for one to practice a profession; (2) scope of practice rules that establish what a professional is allowed to do; and (3) disciplinary rules for professionals who violate either ethical or competence standards.⁷⁸

To promote high quality care for Medicare beneficiaries, the federal government directly regulates hospitals and other medical facilities. For example, to receive payment for treating Medicare beneficiaries, hospitals and other facilities must meet certain “conditions of participation” and sign provider agreements, both of which entail extensive facility regulation.⁷⁹ In the late 1980s, Congress enacted additional legislation authorizing comprehensive regulation of skilled nursing facilities⁸⁰ and clinical laboratories.⁸¹

Because of increasing expenditures for hospital care, some states in the late 1960s and early 1970s required hospitals and other facilities to obtain a certificate of need (CON) before expanding facilities or purchasing major equipment.⁸² In 1974, Congress passed the National Health Planning and Resources Development Act (NHPDA), conditioning federal funds on the establishment of CON programs.⁸³ Congress repealed the NHPDA in 1986.⁸⁴ However, thirty-six states and the District of Columbia continue to maintain CON programs for certain types of facility expansion.⁸⁵

Finally, to protect the confidentiality of personal health information, Congress in 1996 authorized the Department of Health and Human Services (HHS) to issue regulations concerning the security and privacy of personal health information.⁸⁶ Compliance with the Privacy Rule,⁸⁷ which applies to professionals, medical facilities, and others who come in contact with personal health information, was required in April 2003.⁸⁸

of nonphysician clinicians); Gary L. Gaumer, *Regulating Health Professionals: A Review of the Empirical Literature*, 62 MILBANK MEMORIAL FUND Q., HEALTH & SOC'Y 380 (1984).

⁷⁸ See BARRY R. FURROW ET AL., HEALTH LAW ch. 3 (2d ed. 2000).

⁷⁹ 42 U.S.C.S. § 1395cc (LexisNexis 2011); see *id.* at 536, 547-51.

⁸⁰ Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1988).

⁸¹ Clinical Laboratory Improvement Amendments of 1988, Pub. L. No. 100-578, 102 Stat. 2903 (1988).

⁸² See Patrick J. McGinley, *Beyond Health Care Reform: Reconsidering Certificate of Need Laws in a “Managed Competition” System*, 23 FLA. ST. U. L. REV. 141, 147 (1995) (A source of historical information about CON laws).

⁸³ National Health Planning and Resources Development Act, Pub. L. No. 93-641, 88 Stat. 2225, 2246 (1975).

⁸⁴ Pub. L. No. 99-660.

⁸⁵ *Certificate of Need*, AM. HEALTH PLAN. ASS'N, <http://www.ahpanet.org/copn.html> (last visited May 13, 2011).

⁸⁶ See Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1936 (1996).

⁸⁷ Civil Money Penalties: Procedures for Investigations, Imposition of Penalties, and Hearings, 68 Fed. Reg. 18,895, 45 C.F.R. pt. 160 (2003).

⁸⁸ See Don W. King, *Federal Health Care Regulation*, MERCATUS POL'Y SERIES, no. 2, 2006 at 66, available at

Most regulations involving professional and facility care were designed to improve the quality of professionals or the quality of care they provide; their primary benefit is that they may result in higher quality care (e.g., fewer injuries from substandard care). A few regulations were designed to control costs (e.g., Medicare's utilization review requirements and CON rules). The primary benefit of the Privacy Rule is that there may be fewer infringements on the confidentiality of patient information.

However, there are also costs to these regulations. Compliance with most regulations increases the cost of providing a good or service. For example, preparing CON applications requires personnel time and, at times, legal assistance. Compliance with the Privacy Rule may require additional computer equipment or a change in billing operations.

In addition, some regulations provide barriers to entry and thus decrease market competition. For example, stringent licensing and scope-of-practice rules may prevent qualified personnel from providing certain types of care, and CON rules may prevent qualified facilities from obtaining the equipment needed to provide certain types of care. Fewer competitors decrease the supply of care, and a smaller supply usually results in higher prices. Finally, many of these regulations decrease the flexibility of professionals and medical facilities to develop more innovative ways to provide both high-quality and cost-effective care.

A number of studies show that strict licensing and scope-of-practice rules increase professional wages,⁸⁹ other studies show these rules increase prices for professional care,⁹⁰ and at least one of these studies suggests that strict rules do not increase quality.⁹¹ In addition, many studies suggest that nurse practitioners are able to provide high-quality care in both primary care and low-risk labor and delivery settings.⁹²

During the 1980s, the Federal Trade Commission conducted a series of studies of CON programs. These studies showed that CON rules do not

http://www.mercatus.org/uploadedFiles/Mercatus/Publications/20060511_Federal_Health_Care_Regulation_King_April_2006_Final_as_Posted.pdf.

⁸⁹ See, e.g., William D. White, *The Impact of Occupational Licensure of Clinical Laboratory Personnel*, 13 J. HUM. RES. 91, 101 (1978); FRANK A. SLOAN & BRUCE STEINWALD, HOSPITAL LABOR MARKETS 46 (1980).

⁹⁰ See, e.g., Lawrence Shepard, *Licensing Restrictions and the Cost of Dental Care*, 21 J.L. & ECON. 187, 189 (1978); Deborah Haas-Wilson, *The Effect of Commercial Practice Restrictions: The Case of Optometry*, 29 J.L. & ECON. 165, 183 (1986).

⁹¹ See, e.g., Deborah Haas-Wilson, *supra* note 90.

⁹² See, e.g., Judith Rooks et al., *Outcomes of Care in Birth Centers: The National Birth Center Study*, 321 NEW ENG. J. MED. 1804 (1989); A. Mark Durand, *The Safety of Home Birth: The Farm Study*, 82 AM. J. PUB. HEALTH 450, 451-52 (1992); OFFICE OF TECH. ASSESSMENT, OTA-HCS-37, NURSE PRACTITIONERS, PHYSICIAN ASSISTANTS, AND CERTIFIED NURSE-MIDWIVES: A POLICY ANALYSIS 19 (1986); Sue Horrocks, Elizabeth Anderson, & Chris Salisbury, *Systemic Review of Whether Nurse Practitioners Working in Primary Care Can Provide Equivalent Care to Doctors*, 324 BRIT. MED. J. 819, 821 (2002).

decrease hospital costs, but in some cases increase them.⁹³ Studies of the effects of CON laws on quality of care are mixed. Most studies suggest that CON laws have no effect on quality.⁹⁴ However, some studies suggest CON laws improve quality,⁹⁵ and others suggest they decrease quality.⁹⁶

One investigator estimated in 2004 that the annual expected benefits of professional quality regulation were \$5.7 billion, while the expected costs were \$7.7 billion.⁹⁷ In the same study, he estimated that the annual expected benefits of facility quality regulation were \$4 billion, while the expected costs were \$21.8 billion.⁹⁸

E. *Administrative Regulation of Pharmaceuticals and Devices*

In 1962, Congress amended the Federal Food, Drug, and Cosmetics Act (FFDCA), for the first time requiring pharmaceutical companies to obtain approval from the U.S. Food and Drug Administration (FDA) before releasing a new drug to the U.S. market.⁹⁹ To gain approval, a pharmaceutical company must demonstrate, based on controlled studies, that a new drug is both safe and effective for at least one clinical indication. Subsequently, the FDA developed detailed regulations governing all aspects of new drug development.¹⁰⁰

⁹³ See, e.g., KEITH B. ANDERSON & DAVID J. KASS, BUREAU OF ECON., CERTIFICATE OF NEED REGULATION OF ENTRY INTO HOME HEALTH CARE 92 (1986); DANIEL SHERMAN, BUREAU OF ECON., THE EFFECT OF STATE CERTIFICATE-OF-NEED LAWS ON HOSPITAL COSTS (1988) (finding that an increase “in CON review thresholds and repealing CON programs would not lead to increased hospital costs.”). See also C.J. Conover & F.A. Sloan, *Does Removing Certificate-of-Need Regulations Lead to a Surge in Health Care Spending?*, 23 J. HEALTH POL. POL’Y & L. 455 (1998) (finding that when CON was removed costs did not rise); FED. TRADE COMM’N & DEP’T OF JUSTICE, IMPROVING HEALTH CARE: A DOSE OF COMPETITION Ch. 8, at 6 (2004) (finding that most CON programs do not contain health care costs).

⁹⁴ See, e.g., J.L. Robinson, D.B. Nash, E. Maxey, et al., *Certificate of Need and the Quality of Cardiac Surgery*, 16 AM. J. MED. QUAL. 155 (2001); Iona Popesu, Mary S. Vaughan-Sarrazin, & Gary Rosenthal, *Certificate of Need Regulations and Use of Coronary Revascularization after Acute Myocardial Infarction*, 295 JAMA 2141, 2146 (2006) (finding that Certificate of Need regulations did not affect the mortality rate of patients after an acute myocardial infarction).

⁹⁵ See, e.g., Mary S. Vaughan-Sarrazin et al., *Mortality in Medicare Beneficiaries Following Coronary Artery Bypass Graft Surgery in States with and without Certificate of Need Regulation*, 288 JAMA 1859, 1864-65 (2002).

⁹⁶ See, e.g., S.M. Shortell & E.F. Hughes, *The Effect of Regulation, Competition, and Ownership on Mortality Rates Among Hospital Inpatients*, 318 NEW ENG. J. MED. 1100 (1988).

⁹⁷ CHRISTOPHER J. CONOVER, *Health Care Regulation: A \$169 Billion Hidden Tax*, 527 POL’Y ANALYSIS (Cato Inst., Wash. D.C.), Oct. 4, 2004, at 12.

⁹⁸ *Id.* at 10.

⁹⁹ See Drug Amendments of 1962, Pub. L. No. 87-781, 76 Stat. 780 (1962) (The FFDCA was enacted under Pub. L. No. 75-717, 52 Stat. 1040 (1938)).

¹⁰⁰ See, e.g., King, *supra* note 88, at 43-44.

The primary benefit of requiring pharmaceutical companies to obtain approval before marketing a new drug is that there may be fewer injuries caused by medications. Also, by avoiding the use of drugs that would not have been effective, patients and insurers may make fewer unnecessary expenditures.

Costs include the FDA cost to develop governing regulations and to evaluate applications for approval. In addition, pharmaceutical companies incur large compliance costs,¹⁰¹ and there may be other costs that are difficult to quantify. For example, under the requirement for prior approval, a safe and effective drug may not be approved, it may be delayed, or it may be less affordable because large compliance costs led to higher prices. If requiring prior approval prevents use of a drug by a patient for whom it would have been safe and effective, there may be greater morbidity or even mortality.

In a 2003 study, investigators estimated that for each new drug approved between 1990 and 2001, pharmaceutical companies had a capitalized research and development cost of \$802 million (in 2000 dollars).¹⁰² In a more recent study, two of these investigators estimated that biopharmaceutical firms had a capitalized research and development cost of \$1.24 billion (2005 dollars) for each new biopharmaceutical approved.¹⁰³ While the research and development necessary to bring a new drug to the market is costly even without the requirement for prior approval, regulatory compliance is an important component of total cost.¹⁰⁴ Finally, one investigator estimated in 2004 that the annual expected benefits of pharmaceutical and medical device regulation were \$7.1 billion, while the expected costs were \$49.0 billion.¹⁰⁵

¹⁰¹ See Joseph A. Dimasi, Ronald W. Hansen & Henry G. Grabowski, *The Price of Innovation: New Estimates of Drug Development Costs*, 22 J. HEALTH ECON. 151, 180 (2003) (estimating that the capitalized research and development cost for each new drug approved was \$802 million); Christopher P. Adams & Van V. Brantner, *Estimating the Cost of New Drug Development: Is It Really \$802 million?*, 25 HEALTH AFF. 420, 427 (2006) (finding that a research and development cost of \$802 million is probably an underestimate); Joseph A. Dimasi & Henry G. Grabowski, *The Cost of Biopharmaceutical R & D: Is Biotech Different?*, 28 MANAGERIAL & DECISION ECON. 469, 477 (2007) (estimating that the research and development cost of biopharmaceuticals is higher than the cost of traditional pharmaceuticals).

¹⁰² See Dimasi, Hansen & Grabowski, *supra* note 101, at 180.

¹⁰³ See Dimasi & Grabowski, *supra* note 101, at 475-476. In this study, the investigators also updated their estimate of the time-adjusted research and development cost for each new pharmaceutical approved, estimating the cost to be \$1.32 billion in 2005 dollars.

¹⁰⁴ Adams & Brantner, *supra* note 101, at 426-27. The FDA approved many of the drugs used to treat HIV infection under less stringent regulatory requirements. When compared to other new drugs, these drugs had relatively low pre-approval costs.

¹⁰⁵ CONOVER, *supra* note 97, at 14-15.

F. *Liability for Medical Malpractice*

Medical malpractice law allows a patient who has suffered an injury caused by a physician or other professional to recover damages from the professional who caused the injury. Because most diagnostic and therapeutic actions carry a risk of injury, courts hold physicians liable only if the physician acted below a customary or “reasonable” standard of care.¹⁰⁶

Throughout American history, the incidence of malpractice lawsuits has varied.¹⁰⁷ However, beginning around 1960, the number and monetary value of both malpractice lawsuits and damage awards increased,¹⁰⁸ especially during the mid-1970s, mid-1980s, and the first decade of the twenty-first century.¹⁰⁹

Economic benefits of malpractice liability include the value of damage awards received by patients injured by substandard care and the value of injuries prevented by malpractice law’s incentives for safer care. Costs include the cost for both patients and physicians to prepare and defend cases and the cost to physicians of damage awards to patients.

In addition, there may be costs resulting from other incentives engendered by malpractice law. Defensive medicine refers to two types of physician actions. To avoid a lawsuit, physicians may use resources they otherwise would not use (e.g., they may order additional diagnostic tests or perform additional procedures). Also to avoid a lawsuit, physicians may limit their practice (e.g., discontinue labor and delivery care).

Although studies of malpractice law are subject to error, the best available data suggest that most patients who suffer injuries resulting from substandard care do not sue, and many patients who sue have not been injured by substandard care.¹¹⁰ Most studies suggest that in those cases in which a lawsuit is filed, there is a relationship between substandard care

¹⁰⁶ See Philip G. Peters, Jr., *The Quiet Demise of Deference to Custom: Malpractice Law at the Millennium*, 57 WASH. & LEE L. REV. 163, 164 (2000).

¹⁰⁷ See KENNETH ALLEN DEVILLE, *MEDICAL MALPRACTICE IN NINETEENTH-CENTURY AMERICA* 1-65, 187-224 (1990). See also PAUL C. WEILER, *MEDICAL MALPRACTICE ON TRIAL* 1-16 (1991).

¹⁰⁸ WEILER, *supra* note 107, at 1-16.

¹⁰⁹ See David M. Studdert, Michelle M. Mello & Troyen A. Brennan, *Medical Malpractice*, 350 NEW ENG. J. MED. 283 (2004).

¹¹⁰ For example, in two controlled studies, less than 3% of patients injured by substandard care brought suit. See A. Russell Localio et al., 325 NEW ENG. J. MED. 245, 247 (1991); David M. Studdert et al., *Negligent Care and Malpractice Claiming Behavior in Utah and Colorado*, 38 MED. CARE 250, 254-55 (2000). In the Studdert et al. study, less than 25% of patients who brought suit had been injured by substandard care. In both of these studies, investigators used retrospective physician chart review to determine which adverse events were caused by substandard care and which were not. Determining whether adverse events are the result of substandard care is subject to both dispute and error, whether determination is made by physician chart review or by a jury. As a result, one must use caution in interpreting these studies.

and outcome of the suit.¹¹¹ However, at least one study suggests no such relationship,¹¹² and other studies report many cases in which outcomes are not concordant with the merits of the claim.¹¹³ Finally, some data suggest that reforms that decrease the expected payout of damage awards (e.g., caps on total or noneconomic damages) result in less resource use¹¹⁴ and greater physician supply.¹¹⁵

Each year, Towers Perrin estimates the cost of malpractice awards, physician compliance, and malpractice insurance, but not the cost of defensive medicine. Perrin estimated that 2008 costs were approximately \$29.8 billion.¹¹⁶ One investigator estimated in 2004 that the annual expected benefits of state medical tort law were \$33 billion while the expected costs, including the cost of defensive medicine, were \$113.7 billion.¹¹⁷ In a recent study, other investigators estimated that the annual cost of the medical liability system was \$55.6 billion.¹¹⁸

¹¹¹ See, e.g., F.W. Cheney et al., *Standard of Care and Anesthesia Liability*, 261 JAMA 1599, 1601 (1989); Henry S. Farber & Michelle J. White, *Medical Malpractice: An Empirical Examination of the Litigation Process*, 22 RAND J. ECON. 199, 204-05 (1991); Mark I. Taragin et al., *The Influence of Standard Care and Severity of Injury on the Resolution of Medical Malpractice Claims*, 117 ANNALS INTERNAL MED. 780, 781-82 (1992); Ralph Peeples et al., *The Process of Managing Medical Malpractice Cases: The Role of Standard of Care*, 37 WAKE FOREST L. REV. 877, 892 (2002); David Studdert et al., *Claims, Errors, and Compensation Payments in Medical Malpractice Litigation*, 354 NEW ENG. J. MED. 2024, 2029 (2006).

¹¹² T.A. Brennan et al., *Relation Between Negligent Adverse Events and the Outcome of Medical-Malpractice Litigation*, 335 NEW ENG. J. MED. 1963, 1965 (1996).

¹¹³ For example, Cheney et al. found that physicians made payments in 42% of cases in which the standard of care was met. See Cheney et al., *supra* note 111, at 1601. Similarly, Studdert et al. found that 27% of patients injured by substandard care did not receive compensation, and 28% of patients whose injuries were not the result of substandard care received compensation. See Studdert et al., *supra* note 110, at 2027-2028.

¹¹⁴ See Daniel Kessler & Mark McClellan, *Do Doctors Practice Defensive Medicine?*, 111 Q.J. ECON. 353, 383 (1996); Daniel Kessler & Mark McClellan, *Malpractice Law and Health Care Reform: Optimal Liability Policy in an Era of Managed Care*, 84 J. PUB. ECON. 175, 178 (2002).

¹¹⁵ See Daniel P. Kessler, William M. Sage & David J. Becker, *Impact of Malpractice Reforms on the Supply of Physician Services*, 293 JAMA 2618, 2620-21 (2005).

¹¹⁶ TOWERS PERRIN, *2009 Update on U.S. Tort Cost Trends*, 1, 10 (2009), http://www.towersperrin.com/tp/getwebcachedoc?webc=USA/2009/200912/2009_tort_trend_report_12-8_09.pdf.

¹¹⁷ See CONOVER, *supra* note 97 at 15-18.

¹¹⁸ See Michelle M. Mello et al., *National Costs of the Medical Liability System*, 29 HEALTH AFF. 1569, 1574 (2010).

G. *Discussion—Effects of Present Policies on U.S. Health Care*

1. Demand, Supply, Expenditures, and Medical Care

The demand for a good or service is the quantity of the good or service a person or group of persons is willing to purchase at a given price.¹¹⁹ Factors that influence demand include the number of people who want to purchase the item, the tastes and preferences of the purchasers, the income or wealth of the purchasers, and the number and price of substitutes or alternatives to the good or service.

The supply of a good or service is the quantity of the good or service a person or group of persons is willing to sell or provide at a given price.¹²⁰ Factors that influence supply include the number of people offering the item or service, the state of technology needed to produce the good or service, the cost of providing the good or service, and the number and price of substitutes or alternatives.

With respect to medical care, however, there are several additional factors that influence demand and supply. For example, the demand for care is usually not based on a person's tastes and preferences, but instead on one's medical condition, the severity of that condition, and what one's physician recommends (e.g., whether to have a diagnostic test performed or whether to take a medication). Also, the demand for care is influenced by the extent to which third parties pay for care.

Similarly, the supply of care is influenced by ethical considerations. For example, many physicians provide care for persons who are unable to pay at either no charge or at a discounted rate. Despite the fact that different factors influence demand and supply, data suggest that medical care does follow basic economic principles, including the law of demand and the law of supply.¹²¹

Finally, greater demand and large health care spending are not necessarily problems. Because maintaining one's health is very important to most people, one would expect that as people become wealthier, they would

¹¹⁹ See generally EDGAR K. BROWNING & MARK A. ZUPAN, MICROECONOMICS: THEORY & APPLICATIONS, 16-20 (7th ed. 2002).

¹²⁰ See *id.* at 20-22.

¹²¹ See, e.g., Manning et al., *supra* note 4, at 259-267. In this randomized, controlled experimental study, individuals who were assigned to health plans with large co-insurance payments had significantly fewer outpatient expenditures than persons assigned to plans with small or no co-insurance payments. These data suggest that the extent of third-party payment does influence the demand for care. In this study, there were no differences in health outcomes for persons with mean characteristics. However, low-income persons who had high blood pressure or visual impairment and no co-insurance payments had better outcomes than similar persons who had co-insurance payments. This latter finding will be discussed in Part IV.

spend a larger percentage of their income on health-related items.¹²² In addition, data suggest that much of the growth in U.S. expenditures over the past fifty years is responsible for improvements in health and wellbeing.¹²³

However, data also suggest that some portion of health care spending may have little effect on health outcomes.¹²⁴ When a third party pays for most care, there are few constraints on the demand for care, and the excess demand may lead to expenditures that have relatively few benefits. Since large expenditures decrease the resources available for other items (e.g., food, housing, education, or retirement savings), policies that result in fewer expenditures are desirable, provided they lead to equivalent or superior health outcomes.

2. Summary of Effects on Private Health Insurance

The exclusion of ESI from gross income increases the prevalence of private health insurance and undoubtedly increases access to care for many people. However, the differential nature of the exclusion increases the demand for health insurance, specifically the demand for comprehensive insurance with minimal cost sharing. Greater demand usually results in higher prices and larger expenditures. In addition, because the exclusion has led to the situation in which employers pay for most private health insurance, some people may not be able to choose the type of insurance best suited to their particular situation.

Underwriting restrictions increase the prevalence of health insurance among high-risk persons, and mandated benefits increase the value of health insurance for certain populations. However, most of these requirements increase average claims costs and decrease the coverage options from which others may choose. Higher costs and fewer options decrease the supply of insurance, and a smaller supply usually leads to higher prices. In addition, underwriting restrictions and mandated benefits prevent insurers from developing less expensive and more innovative forms of insurance for persons who desire them.

¹²² For a discussion of the effects of income on health care expenditures, see Uwe E. Reinhardt, Peter S. Hussey & Gerard F. Anderson, *Cross-National Comparisons of Health Systems Using OECD Data*, 21 HEALTH AFF., no. 3, May/June 2002, at 169.

¹²³ See generally David M. Cutler & Mark McClellan, *Is Technological Change Worth It?*, 20 HEALTH AFF., no. 5, Sept./Oct. 2001, at 11. See also Frank R. Lichtenberg, *Sources of U.S. Longevity Increase, 1960-1997* (Nat'l Bureau Econ. Research, Working Paper No. 8755, 2002).

¹²⁴ See references cited *supra* note 4.

3. Summary of Effects on Medical Services and Products

Both the tax preference for ESI and public insurance increase access to care for many people. However, both policies increase the demand for medical care, and greater demand usually results in higher prices and larger expenditures. Also, these policies contribute to the situation in which most patients do not own the funds that pay for their care. As a result, some persons may not be able to use their health care funds in the best way for their particular situation.

Most administrative regulations involving professional care, facility care, and pharmaceuticals have benefits. However, even beneficial regulations increase costs, and some decrease the entry of competitors. Similarly, the potential for malpractice liability increases the cost of providing care and may cause physicians to restrict their practices. Both higher costs and restricted entry decrease the supply of care, and a smaller supply usually leads to higher prices. Additionally, some of these regulations prevent professionals and facilities from developing more innovative ways to provide high quality, cost-effective care.

II. EFFECTS OF PPACA PROVISIONS DESIGNED TO INCREASE COVERAGE

Congress recently passed the Patient Protection and Affordable Care Act (PPACA),¹²⁵ which it later amended with the Health Care and Education Reconciliation Act of 2010.¹²⁶ PPACA contains a number of provisions designed to extend comprehensive, third-party coverage to a larger percentage of the population. This section discusses these provisions under the following categories: (1) additional regulations involving health insurance; (2) mandate and tax credit for individuals to purchase private insurance; (3) assessment on large employers if an employee receives a tax credit; and (4) expansion of eligibility for Medicaid.

A. *Additional Regulations Involving Health Insurance*

PPACA places a number of new requirements on health insurers. For example, PPACA prohibits group health plans and insurers in both the group and individual markets from imposing a “preexisting condition exclusion” and from establishing rules for individual eligibility based on

¹²⁵ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).

¹²⁶ Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010).

health status.¹²⁷ In addition, PPACA prohibits insurers in the small group and individual markets from basing premiums on health status,¹²⁸ and it prohibits insurers in both the group and individual markets from rejecting an employer or individual applicant for health insurance and from refusing to renew coverage for either plan sponsors or individuals.¹²⁹

Finally, PPACA requires health plans to provide an “essential health benefits package” equal to the scope of benefits in a typical employer plan,¹³⁰ authorizes the Secretary of Health and Human Services to specify what is required in an essential benefits package,¹³¹ and restricts cost sharing.¹³²

The primary benefit of PPACA’s underwriting restrictions is that they will allow high-risk individuals to obtain health insurance at lower prices than they otherwise would. However, these restrictions will likely increase insurance prices for others.¹³³ Similarly, the requirement for insurers to cover a comprehensive package of benefits will increase the value of insurance for those who need the types of care the package covers. However, requiring a specific benefit package will prevent individuals from purchasing less expensive alternatives. Finally, both types of requirements will prevent insurers from developing less expensive and more innovative types of insurance.

The Congressional Budget Office (CBO) estimated that PPACA will increase 2016 premiums in the individual insurance market by 10% to 13% over what they otherwise would be.¹³⁴

B. *Mandate and Tax Credit for Individuals to Purchase Insurance*

PPACA requires most Americans, beginning in January 2014, to maintain health insurance or pay a penalty (individual mandate).¹³⁵ An individual who will be required to pay more than 8% of household income will be

¹²⁷ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1201, 124 Stat. 119, 154 (2010).

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1302(a)-(b), 124 Stat. 119, 163-65 (2010).

¹³¹ *Id.*

¹³² Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1302(c), 124 Stat. 119, 165 (2010).

¹³³ See Kowalski, Congdon & Showalter, *supra* note 68.

¹³⁴ Letter from Douglas W. Elmendorf, Director, Congressional Budget Office, to the Honorable Evan Bayh (Nov. 30, 2009) available at <http://www.cbo.gov/ftpdocs/107xx/doc10781/11-30-Premiums.pdf>.

¹³⁵ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1501(b), 124 Stat. 119, 244 (2010).

exempt. In 2016, the penalty amount will be the larger of 2.5% of household income or \$695 per year.¹³⁶ After 2016, the amount will be adjusted for inflation. The mandate is similar to a 2006 Massachusetts law that requires most Massachusetts residents to purchase health insurance or pay a penalty.¹³⁷

To make the required insurance more affordable, PPACA provides a refundable tax credit—a form of subsidy—to individuals whose household income is between 100% and 400% of the federal poverty line.¹³⁸ In 2009, 400% of federal poverty guidelines for a family of four in the forty-eight contiguous states was \$88,200.¹³⁹

Potential benefits of requiring all individuals to purchase health insurance include a higher prevalence of health insurance, greater access to care for some persons, and a larger percentage of the population over which to spread risk. The primary benefit of a public subsidy over public insurance is that it allows a recipient to choose among more varied insurance options.

However, there are several costs. By preventing individuals from refusing to purchase health insurance, the mandate will increase the demand for insurance, and greater demand will likely lead to higher prices. Also, because the federal government will determine the type and amount of insurance each person must maintain, advocacy groups, professional organizations, or facility organizations may lobby Congress or HHS to increase minimum benefit levels or further restrict cost sharing. Additional requirements will likely lead to higher prices.

More importantly, an individual mandate represents a significant infringement on individual freedom. Given health insurance prices in the U.S., PPACA's individual mandate will require many individuals to pur-

¹³⁶ *Id.*; Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 10106(b)(1), 124 Stat. 119, 909 (2010); Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1002(a)(1)-(2), 124 Stat. 1029, 1032 (2010).

¹³⁷ See Jonathan Gruber, *The Massachusetts Health Care Revolution: A Local Start for Universal Access*, 36 HASTINGS CENTER REP. 14, 16 (2006); David A. Hyman, *The Massachusetts Health Plan: The Good, the Bad, & the Ugly*, POL'Y ANALYSIS (Cato Inst., Wash. D.C.), June 28, 2007, at 2.

¹³⁸ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1401(a), 124 Stat. 119, 213 (2010); Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1001(a), 124 Stat. 1029, 1030 (2010).

¹³⁹ Annual Update of HHS Poverty Guidelines, 74 Fed. Reg. 4199 (Jan. 23, 2009).

chase an item for which the expected benefits are much less than the cost.¹⁴⁰ In addition, PPACA's individual mandate may be unconstitutional.¹⁴¹

Finally, a subsidy extended to such a large percentage of the population will require large public funding. The additional taxation necessary to fund the subsidies will have economic costs in addition to the cost of the funds collected,¹⁴² and these subsidies will increase the unfunded liability for health care presently faced by both the federal and state governments.¹⁴³

Because the Massachusetts reform was enacted in 2006 and consisted of many components, there are few data concerning the specific effects of an individual mandate.¹⁴⁴ Since enacting reform, health insurance prevalence in Massachusetts has increased,¹⁴⁵ and the increase has occurred among private group insurance, private individual insurance, publicly subsidized private insurance, and Medicaid.¹⁴⁶ However, Massachusetts insur-

¹⁴⁰ A mandate requiring an individual to purchase insurance made more expensive by underwriting restrictions and required benefits seems especially unfair to young, healthy individuals. Prior to the passage of PPACA, a young, healthy taxpayer was required to pay federal payroll taxes to support Medicare, federal income taxes to support Medicare, Medicaid, and S-CHIP, and state income or state sales taxes to support Medicaid and S-CHIP. PPACA will require this same person to support federally subsidized private insurance for middle class people and to purchase health insurance, the expected benefits of which may be much less than the cost.

¹⁴¹ See Randy Barnett, Nathaniel Stewart & Todd Gaziano, *Why the Personal Mandate to Buy Health Insurance is Unprecedented and Unconstitutional*, LEGAL MEMORANDUM (Heritage Found., Wash. D.C.), Dec. 9, 2009.

¹⁴² See discussion and references cited *supra* notes 41-42.

¹⁴³ See generally, THE BDS. OF TRS. OF THE FED. HOSP. IN. & FED. SUPPLEMENTARY MED. INS. TRUST FUNDS, *supra* note 51.

¹⁴⁴ Prior to reform, Massachusetts required guaranteed issue plus community rating. The 2006 reform expanded eligibility criteria for Medicaid, created an insurance exchange for private health insurance, required employers to provide insurance or pay a small penalty fee, required individuals to maintain insurance or pay a large penalty fee, and provided direct subsidies to purchase private insurance to individuals who earn up to 300% of the federal poverty level. See Gruber, *supra* note 137, at 16; Hyman *supra* note 137, at 3.

¹⁴⁵ See Sharon K. Long, *On the Road to Universal Coverage: Impacts of Reform in Massachusetts at One Year*, 27 HEALTH AFF. w270, w274 (2008); JOHN HOLOHAN & LINDA BLUMBERG, URBAN INST., MASSACHUSETTS HEALTH REFORM: SOLVING THE LONG-RUN COST PROBLEM 2 (2009); RACHEL NARDIN, DAVID HIMMELSTEIN & STEPHIE WOOLHANDLER, PHYSICIANS FOR A NAT'L HEALTH PROGRAM & PUB. CITIZEN, MASSACHUSETTS' PLAN: A FAILED MODEL FOR HEALTH CARE REFORM 6 (2009); Michael Tanner, *Massachusetts Miracle or Massachusetts Miserable: What the Massachusetts Model Tells Us about Health Care Reform*, CATO BRIEFING PAPERS (Cato Inst., Wash. D.C.), June 9, 2009, at 3.

¹⁴⁶ See HOLOHAN & BLUMBERG, *supra* note 145, at 1; NARDIN, HIMMELSTEIN & WOOLHANDLER, *supra* note 145, at 6.

ance prices, which were the highest in the nation prior to reform,¹⁴⁷ have continued to increase at a greater rate than the national average.¹⁴⁸

Since enactment of the Massachusetts reform, access to care has improved for some individuals, but may have worsened for others. One study found that more low-income residents reported seeing a physician in 2007, as compared to 2006, and more reported having a place they could go for medical care.¹⁴⁹ However, in this same study, more residents reported difficulty obtaining a physician appointment.¹⁵⁰

A 2009 survey found that average physician appointment wait times among five specialties was 49.6 days in Boston, compared to 27.0 days in Philadelphia (the second longest), and an average of 20.5 days in the fifteen major metropolitan areas surveyed.¹⁵¹ While wait times decreased in most metropolitan areas compared to 2004, they increased in Boston in three of the four specialties with comparison data.¹⁵²

The Centers for Medicare and Medicaid Services (CMS) Office of the Actuary estimated that PPACA-authorized federal spending for individual premium and cost-sharing subsidies will be \$506.5 billion in years 2014 through 2019.¹⁵³

C. *Assessment on Employers If an Employee Receives a Tax Credit*

Beginning in January 2014, employers with fifty or more full-time equivalent employees must pay an assessment if one of their full-time employees (defined as one who works at least thirty hours per week) receives a credit to purchase insurance.¹⁵⁴ If the employer does not offer coverage, the penalty amount is \$2,000 multiplied by thirty fewer than the number of

¹⁴⁷ See AM.'S HEALTH INS. PLANS CTR. FOR POL'Y & RESEARCH, *INDIVIDUAL HEALTH INSURANCE 2006-2007: A COMPREHENSIVE SURVEY OF PREMIUMS, AVAILABILITY, AND BENEFITS* 7-9 (2007).

¹⁴⁸ See Tanner, *supra* note 145, at 4. See also John F. Cogan, R. Glenn Hogan & Daniel Kessler, *The Effect of Massachusetts' Health Reform on Employer-Sponsored Insurance Premiums*, 13 F. FOR HEALTH ECON. & POL'Y, no. 2, 2010 at 1-4.

¹⁴⁹ See Long, *supra* note 145, at 277.

¹⁵⁰ *Id.*

¹⁵¹ MERRITT HAWKINS & ASSOCS., 2009 SURVEY OF PHYSICIAN APPOINTMENT WAIT TIMES 14 (2009).

¹⁵² *Id.* at 4-9.

¹⁵³ Under PPACA, subsidies to purchase private insurance will begin in 2014, increase annually from 2014 through 2019, and continue to increase annually after 2019. Memorandum from Richard S. Foster, Chief Actuary, Ctrs. for Medicare & Medicaid Servs. Office of the Actuary, *Estimated Financial Effects of the "Patient Protection and Affordable Care Act," as Amended* 4-5, tbl. 1 (Apr. 22, 2010), available at http://www.cms.gov/ActuarialStudies/Downloads/PPACA_2010-04-22.pdf.

¹⁵⁴ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1513(a), 124 Stat. 119, 253 (2010).

full-time employees.¹⁵⁵ If the employer offers coverage, but the employee would have to pay more than 8% of income for the coverage, the penalty is the lesser of \$3,000 multiplied by the number of full-time employees who receive a tax credit or \$2,000 multiplied by thirty fewer than the number of full-time employees.¹⁵⁶

Since 1975, Hawaii has required employers to provide health insurance to employees who work more than twenty hours per week,¹⁵⁷ and beginning in 2007, Massachusetts required employers with eleven or more employees who work at least twenty hours per week to provide health insurance or pay a penalty of \$295.¹⁵⁸

Similar to the individual mandate, the employer assessment will likely increase the prevalence of health insurance and may increase access to care for some persons. However, the employer assessment will increase the demand for insurance, and the greater demand will likely lead to higher insurance prices. More importantly, requiring an employer to either provide insurance or pay an assessment will affect an employer's cost of labor. In a competitive market, an employer cannot absorb higher costs without decreasing other costs. As a result, higher health benefit costs will likely be offset by lower wages, fewer benefits other than health insurance, or fewer employees.

Because Hawaii's employer mandate has a number of exemptions and excludes dependents from required coverage, it has had relatively little effect on the prevalence of health insurance or employment.¹⁵⁹ Following implementation of the mandate, Hawaii had an increase in health insurance prevalence compared to the rest of the country, but the increase was small.¹⁶⁰ In addition, Hawaii had a larger increase in wages than the rest of the country, but the increase was smaller in the industries most affected by the mandate.¹⁶¹ Finally, compared to other states, Hawaii had an increase in workers who worked less than twenty hours per week.¹⁶²

¹⁵⁵ *Id.*; Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1003(a)-(b), 124 Stat. 1029, 1033 (2010).

¹⁵⁶ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1513(a), 124 Stat. 119, 253 (2010); Health Care Reconciliation Act of 2010, Pub. L. No. 111-152, § 1003(a)-(b), 124 Stat. 1029, 1033 (2010).

¹⁵⁷ CAL. HEALTHCARE FOUND., STATE EMPLOYER HEALTH INSURANCE MANDATES: A BRIEF HISTORY 3 (2004).

¹⁵⁸ See Gruber, *supra* note 137; Hyman, *supra* note 137, at 2.

¹⁵⁹ See Andrew W. Dick, *Will Employer Mandates Really Work? Another Look at Hawaii*, 13 HEALTH AFF. 343 (1994).

¹⁶⁰ *Id.* See also Norman K. Thurston, *Labor Market Effects of Hawaii's Mandatory Employer-Provided Health Insurance*, 51 INDUS. & LAB. REL. REV. 117, 118-19 (1997).

¹⁶¹ See Thurston, *supra* note 160, at 126-29.

¹⁶² *Id.*

D. *Expansion of Eligibility for Medicaid*

Beginning in 2014, PPACA extends Medicaid benefits to all individuals whose household income does not exceed 138% of the federal poverty level.¹⁶³ The primary advantage of expanding Medicaid eligibility is that some individuals will gain access to care they otherwise would not have.¹⁶⁴ In addition, extending coverage to a larger percentage of the low-income population may decrease the inappropriate use of emergency departments¹⁶⁵ and decrease cost shifting between uninsured and insured patients.¹⁶⁶

However, as noted previously, there are several costs. For example, Medicaid may provide less than ideal access to care,¹⁶⁷ expansion of Medicaid eligibility often crowds out private insurance,¹⁶⁸ and Medicaid is subject to political influence and fraud.¹⁶⁹ Finally, expanding Medicaid will require public funding, and the taxation required to fund the expansion will have its own inherent costs.¹⁷⁰

The CMS Office of the Actuary estimates that PPACA will increase federal spending for Medicaid and S-CHIP by \$410 billion during years 2014 through 2019.¹⁷¹ These estimates do not include the cost of taxation needed to generate the funds or the additional Medicaid costs that states will incur.

¹⁶³ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 2001(a)(1), 124 Stat. 119, 271 (2010); Health Care Reconciliation Act of 2010, Pub. L. No. 111-152, § 1004(e), 124 Stat. 1029, 1036 (2010).

¹⁶⁴ See, e.g., Currie & Gruber, *supra* note 43; Baker & Royalty, *supra* note 43.

¹⁶⁵ See Newton et al., *supra* note 37.

¹⁶⁶ See HADLEY ET AL., *supra* note 35.

¹⁶⁷ See Cunningham & May, *supra* note 38.

¹⁶⁸ See references cited *supra* note 39.

¹⁶⁹ One federal investigator recently testified, “[A]pproximately 65,000 Medicaid beneficiaries in the five states investigated visited six or more doctors to acquire prescriptions for the same type of controlled substances during fiscal years 2006 and 2007. These individuals incurred approximately \$63 million in Medicaid costs for these drugs . . .” U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-057, MEDICAID: FRAUD AND ABUSE RELATED TO CONTROLLED SUBSTANCES IDENTIFIED IN SELECTED STATES 7 (2009). See also *A Prescription for Waste: Controlled Substance Abuse in Medicaid: Hearing Before The Fed. Fin. Mgmt., Gov’t Info., Fed. Servs. & Int’l Sec. Subcomm. of the Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. 40 (2009) (statement of Gregory D. Kutz, Managing Director Forensic Audits and Special Investigations). While all insurers are subject to fraud, public insurers may be more so than private insurers. In general, private insurers use resources to investigate and determine whether claims are valid prior to paying them. In contrast, for most beneficiaries, public insurers pay claims when received, investigating after the fact if there is a suspicion of fraud or abuse. See MERRILL MATHEWS, THE COUNCIL FOR AFFORDABLE HEALTH INS., MEDICARE’S HIDDEN ADMINISTRATIVE COSTS: A COMPARISON OF MEDICARE AND THE PRIVATE SECTOR 5 (2006).

¹⁷⁰ See *supra* notes 41-42 and accompanying text.

¹⁷¹ See Memorandum from Richard S. Foster, *supra* note 153, at 4. Under PPACA, expenditures for Medicaid and S-CHIP expansion will begin in 2014, increase annually through 2019, and continue to increase annually after 2019.

E. *Discussion—Effects of PPACA Provisions Designed to Increase Coverage*

1. Summary of Effects on Private Health Insurance

PPACA's individual mandate, tax credit, and employer assessment will increase the prevalence of private health insurance and should increase access to care for some people. However, each of these provisions will increase the demand for private insurance, and the greater demand will likely lead to higher prices and larger expenditures.

PPACA's underwriting restrictions will increase the prevalence of health insurance among high-risk persons and PPACA's required comprehensive benefits will increase the value of health insurance for those persons who presently have less comprehensive benefits. However, these features will increase average claims costs, decrease insurance options, and likely lead to higher insurance prices. In addition, these requirements will prevent insurers from developing less expensive and more innovative types of insurance.

2. Summary of Effects on Medical Services and Products

PPACA's individual mandate, tax credit, employer assessment, and Medicaid expansion will increase the prevalence of comprehensive coverage and should increase access to care for some people. However, each of these features will increase the demand for medical care, and the greater demand will likely lead to higher prices and larger expenditures. In addition, because these features will lead to greater third-party payment, they may decrease the ability of some persons to use their health care funds in the most appropriate way for their clinical circumstances and decrease both the incentive and flexibility of physicians and facilities to develop more cost-effective ways to provide care.

III. ALTERNATIVE APPROACH TO HEALTH CARE REFORM

As described in Part I, some federal and state policies favor third-party payment over paying directly for both health insurance and medical care. Other policies in effect limit one's options for insurance or care. Although most of these policies have benefits, together they contribute to high prices and large expenditures. As described in Part II, PPACA expands incentives for third-party payment and further restricts insurance options. Although these provisions will make comprehensive coverage more prevalent, they will likely lead to even higher prices and larger expenditures.

In contrast, reforms that put health care funds in the hands of individuals and reforms that increase options for both health insurance and medical care should lead to lower prices and fewer expenditures.¹⁷² To increase individual ownership of health care funds, Congress and state legislators will need to repeal or decrease present incentives that favor third-party payment over paying directly for both health insurance and medical care. To increase the available options, Congress and state legislators will need to repeal or relax many of the regulations that presently govern health insurance, medical and facility care, and pharmaceuticals. In addition, states will need to ensure that liability for medical malpractice does not limit access to care.

Because present policies represent decisions made over many years by Congress, state legislators, and federal and state executive officials, ideal reform will likely require many separate actions. Also, because a sudden policy change may be disruptive to care for some people, policymakers may need to phase in these reforms gradually. Finally, because present policies and patterns of practice vary among states, there may be different, equally effective ways to achieve reform.

The alternative reforms can be organized under seven categories: (1) repeal provisions of PPACA that increase third-party payment for care; (2) equalize the tax treatment of funds used to pay for health care; (3) replace public insurance with public subsidies and private, voluntary support; (4) repeal or decrease underwriting restrictions and mandated benefits; (5) liberalize the regulations governing professional and medical facility care; (6) decrease restrictions on access to pharmaceuticals; and (7) reform liability for medical malpractice. Each subpart provides a brief description of potential reforms and briefly describes their benefits and costs.

A. *Repeal Provisions of PPACA and the Reconciliation Act*

To increase individual ownership of health care funds, Congress should consider repealing PPACA's individual mandate, employer assessment, and Medicaid expansion. Repealing the individual mandate and employer assessment would prevent a large increase in demand for health insurance and should prevent a large increase in insurance prices. Similarly, repealing the individual mandate, employer assessment, and Medicaid expansion would prevent a large increase in the demand for medical services and products and a likely increase in prices for medical care.

To increase individual options for health insurance, Congress should consider repealing each of PPACA's health insurance regulations. Repealing the underwriting restrictions, required benefit package, and cost-sharing restrictions would prevent a large decrease in the supply of health insurance

¹⁷² Part III discusses how these reforms should lead to lower prices and fewer expenditures.

and should prevent an associated increase in insurance prices. In addition, repeal of each of these requirements would allow insurers to continue offering less expensive insurance options.

To prevent a large increase in public funding for health care, Congress should consider repealing PPACA's tax credit to purchase health insurance and PPACA's Medicaid expansion.¹⁷³ In addition, repealing each of the provisions described in Part II will be necessary for many of the provisions described below to be effective.

B. *Equalize Tax Treatment of Funds Used for Health Care*

To increase individual ownership of health care funds, Congress should consider equalizing the tax treatment of ESI, IPI, and out-of-pocket expenses. More equal tax treatment would decrease the incentive for employees to choose ESI over IPI and to choose comprehensive health plans with minimal cost sharing. Some people would continue to choose ESI plans with minimal cost sharing, while others would purchase insurance independent of their employer or choose insurance with fewer benefits or more cost sharing. Over time, there likely would be a shift to more direct payment for both health insurance and medical care, and more direct payment should result in lower prices and fewer expenditures.¹⁷⁴

Congress could partially equalize the tax treatment of health care expenses in one or more of the following ways: (1) provide a standard tax

¹⁷³ Patient Protection and Affordable Care Act, Pub. L. 111-148, § 2001(a)(1), 124 Stat. 119, 271 (2010); Health Care Reconciliation Act of 2010, Pub. L. 111-152, § 1004(e), 124 Stat. 1029, 1036 (2010).

¹⁷⁴ Many data suggest that direct payment for care would lead to lower prices and fewer expenditures. For example, most people pay directly for cosmetic surgery and LASIK surgery. Whereas inflation-adjusted prices for general medical care have increased during the past ten to fifteen years, inflation-adjusted prices for both cosmetic surgery and LASIK surgery have decreased. See Devon M. Herrick, *Health Care Entrepreneurs: The Changing Nature of Providers*, POL'Y REP. (Nat'l Ctr. of Pol'y Analysis, Wash. D.C.), Dec. 2008. In addition, centers that cater to individuals who pay directly, e.g., "medical tourist" destinations in both foreign countries and the United States, charge considerably less than do most U.S. medical centers for the same procedures. *Id.* See also DELOITTE CTR. FOR HEALTH SOLUTIONS, *MEDICAL TOURISM: CONSUMERS IN SEARCH OF VALUE* (2008). Finally, most Singaporeans own the funds used to pay for their care and pay directly for most care. See Rob Taylor & Simon Blair, *Financing Health Care: Singapore's Innovative Approach*, PUB. POL'Y FOR THE PRIVATE SECTOR (The World Bank Group, Wash. D.C.), May 2003. In 2005, health care expenditures in Singapore were \$944 dollars per capita (3.5% of GDP), much lower than in any other advanced country. WORLD HEALTH ORG., *WORLD HEALTH STATISTICS 2008* 88, available at http://www.who.int/whosis/whostat/EN_WHS08_Full.pdf. Although there are few data comparing quality of care for specific conditions, Singapore's neonatal mortality rates are among the lowest in the world, while its life expectancy rates are among the highest. *Id.* at 42.

credit for health insurance; (2) provide a standard deduction for health insurance; or (3) decrease restrictions on health savings accounts.¹⁷⁵

1. Provide a Standard Tax Credit for Health Insurance

First, Congress could enact a standard individual tax credit for health insurance.¹⁷⁶ Because a standard credit would be a specified annual amount, regardless of the type of insurance purchased, there would be less incentive to choose ESI over IPI. In addition, the purchaser would have less incentive to choose a comprehensive health plan over more limited insurance. Unlike the exclusion for ESI, and unlike PPACA's tax credit, a standard credit would provide an equal benefit for all taxpayers, regardless of one's income or marginal tax rate. If Congress made the credit refundable, a credit would serve as a direct subsidy for a low-income person to purchase insurance.

2. Provide a Standard Deduction for Health Insurance

Congress could also allow taxpayers to deduct from gross income a standard amount for health insurance.¹⁷⁷ Similar to a standard credit, a standard deduction would remove the preference for ESI over IPI and lessen the incentive to choose a comprehensive health plan with minimal cost sharing. Unlike a tax credit, but similar to the exclusion of ESI, a standard deduction would provide more direct benefit for a high-income than for a low-income person.

¹⁷⁵ When enacting a standard tax credit or a standard deduction, Congress could replace the present preference for ESI with the reform or allow an individual to choose between present law and the recommended reform. Replacing present law may be more economically efficient. However, repealing present law may disrupt care for some people, and it may not be politically possible. As a result, this section discusses these two reforms as though the law would allow an individual to choose between employer-provided tax preferences and the tax preference provided by the reform. Because these reforms would not allow an individual to exclude health care expenses from gross income for payroll tax purposes, these reforms do not completely equalize the tax treatment of health care expenses.

¹⁷⁶ See, e.g., Sue A. Blevins, *Restoring Health Freedom: The Case for a Universal Tax Credit for Health Insurance*, POL'Y ANALYSIS (Cato Inst., Wash. D.C.), Dec. 12, 1997, at 18-20.

¹⁷⁷ See, e.g., *Fact Sheet: Making Private Health Insurance More Affordable for Low-Income Americans*, WHITE HOUSE PRESIDENT GEORGE W. BUSH (Feb. 23, 2007), <http://georgewbush-whitehouse.archives.gov/news/releases/2007/02/print/20070223-4.html>.

3. Decrease Restrictions on Health Savings Accounts

Congress could also reduce restrictions on health savings accounts (HSAs).¹⁷⁸ For example, Congress could increase the annual contribution limit, allow HSA owners to purchase their primary health insurance with HSA funds, or allow a person to establish an HSA regardless of whether he or she purchases an HDHP, another type of insurance, or no insurance.

Similar to a standard credit or deduction, fewer HSA restrictions would decrease the incentive to choose comprehensive ESI with minimal cost sharing and should result in both lower insurance prices¹⁷⁹ and a larger insurance prevalence.¹⁸⁰ Also, fewer HSA restrictions would increase each person's incentive to save for future health care expenses. Finally, if individuals paid directly for more of their care, professionals and medical facilities would have more incentive and more flexibility to develop cost-effective ways to provide individualized care.

Fewer HSA restrictions would result in less federal revenue. However, the lost revenue resulting from larger HSA contributions would be small compared to the lost revenue presently associated with the tax preference for ESI.¹⁸¹

C. *Replace Public Insurance with Public Subsidies and Private Support*

To increase individual ownership of health care funds, Congress and the states should consider replacing public insurance with public subsidies and private, philanthropic support. A public subsidy could be a defined amount distributed in advance of care that a beneficiary could use to purchase insurance or pay directly for care. The amount of the subsidy could be based on one's income, on one's risk of incurring medical expenses,¹⁸² or both. Private support could take the form of an individual contributing to organizations that support the care of those who need assistance or contributing to professionals and medical facilities that provide care at either no charge or a discounted rate.¹⁸³ Finally, private support could take the form

¹⁷⁸ See, e.g., Michael F. Cannon, *Large Health Savings Accounts: A Step Toward Tax Neutrality for Health Care*, 11 F. FOR HEALTH ECON. & POL'Y, no. 2, 2008 at 1-27.

¹⁷⁹ See Zycher, *supra* note 30.

¹⁸⁰ AHIP reported that 27% of new enrollees in HSA/HDHP plans in the individual market were previously uninsured. AHIP CTR. FOR POLICY & RESEARCH, JANUARY 2007 CENSUS SHOWS 4.5 MILLION PEOPLE COVERED BY HSA/HIGH-DEDUCTIBLE HEALTH PLANS 1 (2007). Fewer restrictions should make HSAs even more attractive to uninsured persons.

¹⁸¹ See *supra* note 28 and accompanying text.

¹⁸² For a discussion of risk adjustment, see Robert Kuttner, *The Risk-Adjustment Debate*, 339 NEW ENG. J. MED. 1952 (1998).

¹⁸³ There are a number of ways present laws may inhibit private, philanthropic support for medical care. First, public provision of social services may crowd out private contributions to social services.

of in-kind contributions by professionals and medical facilities that provide care at either no charge or a discounted rate.¹⁸⁴

A public subsidy offers a number of advantages over public insurance. First, a subsidy in advance of care would allow a beneficiary to choose insurance and care tailored specifically to the individual's needs. Second, because some physicians do not accept public insurance beneficiaries, a subsidy that allows one to purchase private insurance or pay directly should increase access for many beneficiaries. Third, because a beneficiary would own the subsidy funds, a subsidy may provide an incentive for insurers to develop less expensive forms of insurance and for professionals and facilities to develop innovative ways to provide less expensive care.

A potential disadvantage of a subsidy in advance of care is that some low-income persons may not seek the care they need.¹⁸⁵ As a result, it may be better to provide some recipients with a subsidy at the point of care,¹⁸⁶ or require some recipients to purchase a comprehensive health plan. Also, replacing public insurance with a subsidy to purchase private insurance would increase the demand for private insurance and may lead to higher insurance prices. Finally, a public subsidy requires public funding. However, because there would be fewer administrative costs, and because funding would not be open-ended, replacing public insurance with a public subsidy of a defined amount would allow both the federal and state governments to better control their expenditures.

See, e.g., Daniel M. Hungerman, *Are Church and State Substitutes? Evidence from the 1996 Welfare Reform*, 89 J. PUB. ECON. 2245 (2005); Jonathan Gruber & Daniel M. Hungerman, *Faith-Based Charity and Crowd-Out During the Great Depression*, 91 J. PUB. ECON. 1043 (2007); Daniel M. Hungerman, *Crowd-Out and Diversity*, 93 J. PUB. ECON. 729 (2009). Second, the threat of a malpractice lawsuit may prevent some physicians from providing discounted care to low-income persons. Finally, high tax rates decrease personal wealth that individuals would otherwise be able to contribute to those who need assistance. Accordingly, decreasing public assistance, reforming medical malpractice law, and decreasing marginal income tax rates may significantly increase private support for care.

¹⁸⁴ The National Association of Free Clinics estimates that free clinics provide up to \$3 billion of care annually for low-income patients. *See* Letter from Bonnie A. Beavers, Exec. Dir., Nat'l Assoc. of Free Clinics, to Members of the Citizens Health Care Working Group (Aug. 28, 2006), available at <http://govinfo.library.unt.edu/chc/recommendations/orgs/nafc.pdf>. *See also* K. Kelleher, *Free Clinics: A Solution That Can Work Now*, 266 JAMA 838 (1991); Stephanie Geller, Buck M. Taylor & H. Denman Scott, *Free Clinics Helping to Patch the Safety Net*, 15 J. OF HEALTH CARE FOR THE POOR & UNDERSERVED 42 (2004); Mohan M. Nadkarni & John T. Philbrick, *Free Clinics: A National Survey*, 330 AM. J. MED. SCI. 25 (2005). Free clinics often have arrangements with local physicians and hospitals to provide specialist care, laboratory and imaging studies, and hospital care at either no charge or a discounted rate. Many professionals and hospitals that are not associated with free clinics also provide care for low-income patients at either no charge or a discounted rate.

¹⁸⁵ In the study described *supra* note 121, low-income individuals who had high blood pressure or visual impairment, and who also had large co-insurance rates, experienced poorer health outcomes than did low-income persons who had no co-insurance payments. *See* Manning et al., *supra* note 4.

¹⁸⁶ Singapore subsidizes medical care for low-income persons by providing the subsidy at the time care is provided. *See* Taylor & Blair, *supra* note 174.

Private support offers additional advantages. Because private support is usually made at the local level and is not legally required, it tends to be more flexible than public funding and more adaptable to each individual's needs. Private support is also less subject to political influence, costly disputes, and fraud. Finally, because it is voluntary and does not entail taxation costs,¹⁸⁷ private support is less costly to society than either public insurance or a public subsidy. It is possible that over time, private support could replace public subsidies.¹⁸⁸

D. *Decrease Underwriting Restrictions and Mandated Benefits*

To increase health insurance options, Congress and state legislators should consider relaxing present restrictions on health insurance underwriting. For example, to decrease the price of ESI, Congress could eliminate the requirement for COBRA continuation coverage.¹⁸⁹ To decrease the price of small group and individual insurance, Congress could eliminate HIPAA's requirements for guaranteed issue and guaranteed renewal.¹⁹⁰ For individuals who live in states that have enacted guaranteed issue and community rating laws, the state could eliminate or decrease the stringency of these requirements.¹⁹¹

Similarly, Congress and state legislators could eliminate or decrease mandated benefits. For example, Congress could repeal or decrease the requirement that insurers provide the same annual and lifetime limits for

¹⁸⁷ See *supra* notes 41-42 and accompanying text.

¹⁸⁸ Studies suggest that public spending for social services has a crowd-out effect on philanthropic spending for social services. See references cited *supra* note 183. One study suggests that as involuntary transfers of wealth increase, the crowd-out effect on voluntary transfers increases. See Kenneth S. Chan, Rob Godby & Stuart Mestelman, *Crowding-Out Voluntary Contributions to Public Goods*, 48 J. ECON. BEHAV. & ORG. 305 (2002). Finally, by decreasing prices for insurance and care and by increasing patient and donor income, over time the recommended reforms may decrease the need for public spending on health care.

¹⁸⁹ Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 82 (1986). In effect, COBRA continuation coverage is a form of guaranteed renewal plus community rating. Data suggests that terminating employees who choose COBRA continuation coverage incur more medical expenses than continuing employees on the same plan. See Stephen A. Huth, *COBRA Costs Continue to be High, Erratic*, 52 EMP. BENEFIT PLAN REV. 36 (1997). These data suggest that required continuation coverage may result in higher insurance prices for remaining employees.

¹⁹⁰ Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1998 (1996).

¹⁹¹ Two investigators estimated that repealing New York's guaranteed issue and community rating laws would result in up to a 37% reduction in the number of uninsured. See Stephen T. Parente & Tarren Bragdon, *Healthier Choice: An Examination of Market-Based Reforms for New York's Uninsured*, MED. PROGRESS REP. (Manhattan Inst. for Policy Research, New York, N.Y.), Sept. 2009, at 13-14.

mental health benefits as for medical/surgical benefits.¹⁹² States could eliminate requirements for insurers to pay for the treatment of alcoholism or for the treatment provided by a particular type of professional.¹⁹³ Finally, using its constitutional authority to regulate interstate commerce, Congress could exempt insurers regulated by their home state from the underwriting restrictions and mandated benefits imposed by a purchaser's state.¹⁹⁴

The primary benefit of each of these reforms is that each should lead to lower insurance premiums. Also, these reforms would allow insurers to offer more innovative types of insurance. Finally, decreasing barriers to purchasing insurance across state lines may encourage states to develop more flexible regulatory policies. The primary cost to these reforms is that high-risk persons and others who benefit from these requirements may be required to pay higher insurance prices. However, as discussed in Part IV, there are other ways Congress or state legislators can facilitate high-risk access that do not significantly increase insurance prices for others.

E. *Liberalize Regulations Governing Professional and Facility Care*

To increase one's options for medical care, Congress and state legislators should consider repealing or decreasing the stringency of many of the regulations presently governing professional and facility care. For example, states could repeal or relax the stringency of their CON rules¹⁹⁵ or their licensing and scope of practice rules for mid-level practitioners.¹⁹⁶ Similarly, Congress could repeal or decrease the stringency of the Privacy Rule.

Each of these reforms would decrease the cost of providing care and would likely lead to lower prices. In addition, fewer requirements would increase the flexibility of professionals and medical facilities to develop more innovative ways to provide care. Finally, less stringent rules regarding patient privacy may encourage patients, professionals, and medical facilities to develop a contractual method for protecting patient health information that would more effectively protect patient privacy.

Potential costs include less quality, higher costs, or less confidentiality of personal health information. However, many data suggest that stringent

¹⁹² 29 U.S.C. § 1185a (a) (2009).

¹⁹³ See, e.g., MATTHEWS, BUNCE & WIESKE, *supra* note 63.

¹⁹⁴ See Health Care Choice Act of 2007, H.R. 4460, 110th Cong. § 1-4 (2007). Two investigators estimated that allowing New York residents to purchase insurance from insurers in Pennsylvania and Connecticut may decrease New York's uninsured rate by 17%. See Parente & Bragdon, *supra* note 191.

¹⁹⁵ See, e.g., Joint Statement of the Antitrust Div. of the U.S. Dep't of Justice and the Fed. Trade Comm'n Before the Ill. Task Force on Health Planning Reform (Sept. 15, 2008), available at http://www.justice.gov/atr/public/press_releases/2008/237153a.pdf.

¹⁹⁶ See, e.g., Julie A Fairman et al., *Broadening the Scope of Nursing Practice*, 364 NEW ENG. J. MED. 193 (Jan. 20, 2011).

rules governing licensing,¹⁹⁷ scope of practice,¹⁹⁸ and facility expansion¹⁹⁹ increase costs, but there are few data suggesting they improve quality. Also, by increasing the process of discovery that occurs under greater competition,²⁰⁰ fewer restrictions may lead to more innovation and potentially to higher quality. A complete assessment of benefits and costs can help both legislators and agency officials determine if a regulation should be retained, decreased, or repealed.

F. *Decrease Restrictions on Access to Pharmaceuticals*

To increase one's access to beneficial drugs, Congress should consider reforming the new drug approval process. This subpart discusses four possible ways. First, Congress could allow private drug-certifying bodies to perform many of the functions presently carried out by the FDA.²⁰¹ Private certifying bodies have been used successfully for medical devices in Europe and as a pilot program in the U.S.²⁰² Competing private entities may be able to discover more effective and less costly ways to assure safety and efficacy.

Second, Congress could create a dual-track approval process that would allow a patient and experimental drug sponsor to contract for the purchase of an unapproved drug that has completed Phase 1 safety trials, provided the patient and patient's physician are informed about the drug's safety and efficacy data.²⁰³ A dual-track approval process would be especially beneficial for patients with serious, life-threatening illnesses, for which there are few approved options.

Third, Congress could maintain the FDA's safety and efficacy requirements, but eliminate the prior approval requirement. A regulatory or law enforcement agency can enforce risk reducing regulations in two primary ways—by monitoring products in the marketplace and removing those products that do not meet the regulatory standard, or by requiring a

¹⁹⁷ See references cited *supra* note 89.

¹⁹⁸ See references cited *supra* note 90.

¹⁹⁹ See references cited *supra* note 93.

²⁰⁰ See Friedrich A. Hayek, *Competition as a Discovery Procedure*, 5 Q.J. AUSTRIAN ECON. 9 (2002). This article is an English translation of a lecture delivered in German by Professor Hayek in 1968.

²⁰¹ For example, Congress could maintain the FDA's authority for final approval, but allow drug certifying bodies to evaluate a pharmaceutical company's research data and recommend for or against approval. See HENRY I. MILLER, *TO AMERICA'S HEALTH: A PROPOSAL TO REFORM THE FOOD AND DRUG ADMINISTRATION* ch. 5 (2000).

²⁰² *Id.*

²⁰³ See Bartley J. Madden, *A Dual Track System To Give More-Rapid Access to New Drugs: Applying a Systems Mindset to the U.S. Food and Drug Administration (FDA)*, 72 MED. HYPOTHESES 116, 116 (2009).

product's sponsor to obtain approval before releasing a new product to the market.²⁰⁴ Monitoring and removal is less costly for a product sponsor²⁰⁵ and was used successfully by the FDA before the 1962 requirement.²⁰⁶

Fourth, Congress could maintain the safety requirement but eliminate the efficacy requirement.²⁰⁷ At present, physicians are allowed to prescribe approved drugs for conditions other than that for which the drug was initially approved, a practice sometimes called "off-label" use. In effect, the FDA is now allowing the use of drugs to treat conditions for which they have not been demonstrated to be effective. Removing the efficacy requirement may allow safe and effective drugs to reach the market sooner and at less expense.²⁰⁸

The primary benefit of each of these reforms is that patients should have greater access to pharmaceuticals at lower prices, and greater access may decrease morbidity and mortality. In addition, liberalizing the prior approval process may allow pharmaceutical companies to develop safe and effective drugs that cannot be developed cost-effectively under the present regulatory framework. The primary cost is that patients may incur more injuries from unsafe drugs. However, each of the recommended reforms maintains a safety requirement that could be made more stringent if necessary.

G. *Reform Liability for Medical Malpractice*

To increase the availability of medical care, states should consider reforming their medical malpractice law. This subpart discusses two possible ways.²⁰⁹ First, for situations in which a contract has not been formed in advance of care, states could place a cap on noneconomic damage

²⁰⁴ See Peter Huber, *Exorcists vs. Gatekeepers in Risk Regulation*, AEI J. ON GOV'T & SOC'Y (Cato Inst., Wash. D.C.), Nov./Dec. 1983, at 23, 32.

²⁰⁵ *Id.*

²⁰⁶ See MILLER, *supra* note 201, at ch. 1.

²⁰⁷ See Daniel B. Klein & Alexander Tabarrok, *Who Certifies Off-Label?*, 27 REGULATION 60, 63 (2004).

²⁰⁸ Even without a requirement for efficacy, a safety standard could be adjusted based on intended use and expected benefits.

²⁰⁹ While common law solutions are usually more flexible than legislative solutions, Hayek points out that the common law sometimes evolves in an undesirable direction that is not easily corrected by means of additional case law. Under these circumstances, corrective legislation may be necessary. See FRIEDRICH A. HAYEK, *RULES AND ORDER* 72, 88 (1973). For a review of proposals to reform state malpractice law, see Studdert, Mello & Brennan, *supra* note 109. Federal proposals for substantive reform of malpractice law are likely unconstitutional and are not recommended. See Michael I. Krauss & Robert A. Levy, *Can Tort Reform and Federalism Coexist?*, POL'Y ANALYSIS (Cato Inst., Wash. D.C.), Apr. 14, 2004, at 1.

awards.²¹⁰ Noneconomic damages are inherently subjective, and capping them would not alter a person's fundamental right of redress against one who injures him or her. Because economic damages are not inherently subjective and may be necessary to assure that an injured patient receives both medical care and income replacement, limiting caps to noneconomic damages seems more desirable than placing caps on total damages.

Second, states could require courts to enforce contracts for malpractice protection made between patients and physicians in advance of care.²¹¹ Contracting in advance of care would allow patients and physicians to choose the type of protection that best meets the needs of each particular situation.

Both types of malpractice reform should decrease the cost of providing care, and may increase physician willingness to provide care. A larger physician supply should result in lower prices and greater access. In addition, allowing patients and physicians to contract in advance of care may lead to both safer care and better compensation of injured patients.

Potential costs include less compensation of negligently injured patients and more injuries resulting from a diminished threat of malpractice liability. However, the presently available data suggest that a large majority of patients injured by substandard care are not presently being compensated²¹² and that malpractice law is having little, if any, deterrent effect.²¹³

²¹⁰ See COGAN ET AL., *supra* note 12, at ch. 2. For a review of the effects that damage caps have on costs and physician supply, see Michelle M. Mello, *Medical Malpractice: Impact of the Crisis and Effect of State Tort Reforms*, SYNTHESIS PROJECT REP. (Robert Wood Johnson Found., Princeton, N.J.), May 2006, at 24.

²¹¹ Several scholars have proposed allowing patients and physicians to contract in advance of care for malpractice protection. For a discussion relating contracting in advance of care, see PATRICIA M. DANZON, *MEDICAL MALPRACTICE: THEORY, EVIDENCE, AND PUBLIC POLICY* ch. 12 (1985); Richard A. Epstein, *Medical Malpractice: the Case for Contract*, 1 AM. B. FOUND. RES. J. 87 (1976); Richard A. Epstein, *Medical Malpractice, Imperfect Information, and the Contractual Foundation for Medical Services*, 49 L. & CONTEMP. PROBS. 201 (1986); Clark C. Havighurst, *Private Reform of Tort-Law Dogma: Market Opportunities and Legal Obstacles*, 49 L. & CONTEMP. PROBS. 143 (1986); Michael I. Krauss, *Restoring the Boundary: Tort Law and the Right to Contract*, POL'Y ANALYSIS (Cato Inst., Wash. D.C.), June 3, 1999; Michelle M. Mello & Troyen A. Brennan, *Deterrence of Medical Errors: Theory and Evidence for Malpractice Reform*, 80 TEX. L. REV. 1595 (2002); Jeffrey O'Connell, *Neo-No-Fault Remedies for Medical Injuries: Coordinated Statutory and Contractual Alternatives*, 49 L. & CONTEMP. PROBS. 125 (1986); PAUL H. RUBIN, *TORT REFORM BY CONTRACT* ch. 2 (1993). For a review of this topic, see generally Don W. King, *Contract as a Means of Medical Malpractice Reform*, POL'Y RESOURCE (Mercatus Ctr., Arlington, Va.), Mar. 2007.

²¹² See *supra* note 110 and accompanying text.

²¹³ The Harvard Medical Practice Study attempted to determine whether state malpractice law was having a deterrent effect on medical injuries. There was a trend suggesting that patients cared for by physicians who faced greater malpractice risk had fewer injuries from substandard care, but the results were not statistically significant. See PAUL C. WEILER ET AL., *A MEASURE OF MALPRACTICE* ch. 6 (1993). On the other hand, Hyman pointed out that malpractice lawsuits and increasing malpractice premiums were one reason the American Society of Anesthesiology initiated a safety program that resulted in a decrease in anesthesia-related injuries. See David M. Hyman, *The Poor State of Health*

H. *Discussion—Effects of Alternative Approach to Reform*

1. Summary of Effects on Private Health Insurance

Equalizing the tax treatment of ESI, IPI, and out-of-pocket expenses would decrease the incentive for employees to choose ESI over IPI and to choose comprehensive health plans with minimal cost sharing. As more individuals choose less expensive insurance, insurance prices and health care expenditures should decline. Also, more equal tax treatment would increase the ability of many persons to choose insurance targeted to their specific needs. Finally, replacing public insurance with a public subsidy in advance of care would allow public beneficiaries to choose from the same insurance options now available to non-beneficiaries.

Fewer underwriting restrictions and fewer benefit mandates should lead to lower claims costs and to more varied insurance options. A larger insurance supply, including a larger supply of low-cost alternatives, should lead to lower prices. Also, fewer requirements would allow insurers to develop less expensive and more innovative forms of insurance that may better meet many persons' needs.

2. Summary of Effects on Medical Services and Products

Equalizing the tax treatment of ESI, IPI, and out-of-pocket expenses and replacing public insurance with public subsidies or private support would lessen the incentive for individuals to pay for medical care through a third party. As more individuals choose to pay for care with their own funds, prices for care and excess expenditures should decline. Also, because more individuals would own the funds used for their care, individuals would have greater ability to choose care specific to their clinical circumstances.

Less stringent regulation of professional care, facility care, and pharmaceuticals would decrease the cost of providing care and lead to more varied of options for care. Similarly, medical malpractice reform would decrease professional costs and may increase physician willingness to provide care. Both types of reform would increase the supply of care, and a larger supply would likely lead to lower prices. Finally, less stringent regulations would allow professionals and medical facilities to develop more innovative ways to provide high-quality and cost-effective care.

Care Quality in the U.S.: Is Malpractice Liability a Part of the Problem or a Part of the Solution?, 90 CORNELL L. REV. 893 (2005).

3. Summary of Effects on Individual Ability to Pay

Congress and state legislators could facilitate more affordable health insurance and medical care in two primary ways: (1) by enacting policies that result in lower prices; or (2) by enacting policies that increase one's ability to pay. As just described, each of the recommended reforms should result in lower prices for either health insurance or medical care.

In addition, some of these reforms would increase the ability of many persons to pay. For example, allowing a standard tax credit or a standard deduction for health insurance, decreasing restrictions on HSAs, or replacing public insurance with a public subsidy would increase the after-tax personal income of millions of Americans. Additional personal income would allow more individuals to pay for their own care and more persons to contribute to the care of those who need assistance.

IV. APPLICATION OF REFORMS TO SPECIFIC POPULATIONS

While greater individual ownership and more options should increase access to care for most people, it is important to consider how these reforms would affect low-income, high-risk, and older individuals. Part IV discusses application of the recommended reforms to these populations.

A. *Application to Low-Income Persons*

Prior to the mid-twentieth century, much of the care received by low-income Americans was provided privately. Philanthropic and religious organizations built hospitals for low-income Americans.²¹⁴ Fraternal organizations built hospitals and hired physicians to care for members and their families.²¹⁵ Both employers and unions hired physicians to provide care for their employees and members, respectively, as well as their families.²¹⁶ In addition, many physicians and hospitals charged low-income patients at a discounted rate,²¹⁷ and some continue to do so. Finally, during the last thirty years, philanthropic and religious groups have established "free clinics," most of which serve uninsured patients at little to no charge.²¹⁸

²¹⁴ See STARR, *supra* note 7, at 145.

²¹⁵ See DAVID T. BEITO, FROM MUTUAL AID TO THE WELFARE STATE: FRATERNAL SOCIETIES AND SOCIAL SERVICES 1890-1967, at 109, 161, 181 (2000).

²¹⁶ See STARR, *supra* note 7, at 199.

²¹⁷ See *id.* at 147-48.

²¹⁸ See *supra* note 184 and accompanying text.

During the nineteenth and early twentieth centuries, cities and counties built dispensaries, clinics, and hospitals for low-income persons;²¹⁹ and during the latter half of the twentieth century, Congress created Medicaid and S-CHIP to pay for low-income care. Since the creation of Medicaid, Congress and state legislatures have attempted to increase low-income access primarily by expanding eligibility for Medicaid or S-CHIP. Although expanding eligibility does increase access for some individuals,²²⁰ Medicaid often provides less than ideal access to care,²²¹ crowds out private insurance,²²² and requires public funding.

Each type of alternative reform should result in lower prices for health insurance, medical care, or both. Lower prices would be especially beneficial for low-income persons. While a standard deduction or fewer HSA restrictions would provide less direct benefit for a low-income person, either reform would increase the personal income of many Americans. Greater personal income would help low-income persons on the margin to better afford both health insurance and medical care, and greater income would increase the ability of middle and high-income persons to contribute to low-income care.

Two types of reform may be especially beneficial. First, Congress and state legislatures should consider decreasing both underwriting restrictions and required benefits.²²³ While these requirements increase access for some persons, they prevent others from choosing less expensive insurance to cover large, unexpected expenses. Allowing low-income persons to purchase relatively inexpensive insurance should increase both health insurance prevalence and access to care among the low-income population.

Second, states should consider decreasing restrictions on nurse practitioner care.²²⁴ For many low-income persons, primary care is the point of entry to preventive care, treatment of many conditions, and referral to specialists. Some states have fairly restrictive scope-of-practice rules (e.g., some require nurse practitioners to have on-site supervision, and some require physician review for each prescription).²²⁵ Allowing nurse practitioners to provide care to the full extent of their training should make primary care more available to low-income persons. Similarly, fewer restrictions on

²¹⁹ See STARR, *supra* note 7, at 150, 182.

²²⁰ See Currie & Gruber, *supra* note 43, at 431; Baker & Royalty, *supra* note 43, at 481.

²²¹ See Cunningham & May, *supra* note 38, at 1; Cunningham, Staiti & Ginsburg, *supra* note 46, at 1.

²²² See Gruber & Simon, *supra* note 39, at 202.

²²³ See e.g., Parente & Bragdon, *supra* note 191.

²²⁴ See Joint Statement, *supra* note 195.

²²⁵ See CHRISTIAN, DOWER & O'NEILL, *supra* note 77, at 1; SHARON CHRISTIAN, CATHERINE DOWER & EDWARD O'NEILL, UNIV. OF CAL., S.F., CHART OVERVIEW OF NURSE PRACTITIONER SCOPES OF PRACTICE IN THE UNITED STATES 3-4 (2007). See also Cooper, Henderson & Dietrich, *supra* note 77, at 795.

nurse–midwife care may result in greater access to low-risk labor and delivery care.

For low-income individuals who do need assistance, a public subsidy should be more effective than public insurance at increasing access to care. A subsidy in advance of care would allow a recipient to choose from the same options for health insurance and medical care available to others. Also, because a subsidy would entail fewer administrative costs, a subsidy should be less costly for federal and state governments. Finally, because private support is more flexible and more adaptable to specific needs, and because it entails no taxation costs, private support offers the possibility of even greater low-income access at less cost to society.

B. *Application to High-Risk Persons*

Beginning in the 1970s, some states established high-risk pools to provide health insurance for high-risk individuals.²²⁶ Individuals who purchase insurance from these pools pay premiums, but premiums are limited to 125% to 200% of the premium required of average-risk persons. To keep premiums within the required range, states provide subsidies to these pools.

Other states have attempted to assure high-risk access by requiring guaranteed issue at community-rated prices.²²⁷ While guaranteed issue plus community rating increases insurance prevalence among the high-risk population, it decreases prevalence among the average-risk population,²²⁸ and it may result in a net decrease in insurance prevalence.²²⁹

Each of the recommended reforms should result in lower prices for either health insurance or medical care. Because high-risk persons often require more care, lower prices would be especially beneficial for them. Also, high-risk persons are not necessarily low-income. A standard deduction or less restrictive HSAs would directly increase the ability of some high-risk persons to pay for their health insurance and medical care, and both reforms would increase the ability of middle and high-income persons to contribute to the care of high-risk individuals who need assistance.

Two types of reform may be especially beneficial. First, Congress and state legislatures should consider decreasing the number of mandated benefits. Some high-risk individuals do not benefit from these mandates, and

²²⁶ For a discussion of high-risk pools, see LORI ACHMAN & DEBORAH CHOLLET, THE COMMONWEALTH FUND, *INSURING THE UNINSURABLE: AN OVERVIEW OF STATE HIGH-RISK POOLS* (2001); Austin Frakt et al., *Insuring the Uninsurable: The Growth in High-Risk Pools*, (Abt Assocs. Inc., Working Paper No. 12, 2002); *High-Risk Health Insurance Pools*, ISSUE BRIEF (Families USA, Wash. D.C.), May 2006.

²²⁷ See Davidoff, Blumberg & Nichols, *supra* note 69, at 727; Herring & Pauly, *supra* note 69, at 3.

²²⁸ See Herring & Pauly, *supra* note 69, at 20.

²²⁹ See *id.*

eliminating or decreasing them should result in lower insurance prices. Fewer mandates may also lead to the development of more innovative types of insurance, including insurance designed for persons with specific chronic illnesses.

States also should consider decreasing restrictions on facility expansion and equipment purchase.²³⁰ High-risk patients often require care from specialized centers that treat large numbers of patients with related disorders. Some data suggest that patients who obtain care from physicians and hospitals that treat a large volume of patients with the same condition have better outcomes than those who obtain care from low-volume physicians and hospitals.²³¹ Also, these centers are often able to provide care at very low cost.²³²

Repealing or decreasing the stringency of CON laws should decrease the cost of developing these centers, potentially lowering prices for specialized care. By paying directly for care at low-cost centers and purchasing insurance to cover large, unexpected expenses, some high-risk persons may be better able to afford care than by purchasing comprehensive health plans and obtaining care from traditional full-service facilities.

There also are reasons to think that some high-risk persons may be able to obtain affordable insurance in an unregulated market. For example, most people are able to obtain guaranteed renewal as a feature of their insurance policy.²³³ Voluntary guaranteed renewal allows one to pay extra when one is young and healthy in return for guaranteed renewal at a rate similar to one's rating class if one later becomes ill. Similarly, health-status insurance would allow a low-risk person to purchase insurance to cover the cost of future premiums if one later becomes high-risk.²³⁴ Finally, most individuals who are moderately high-risk are able to obtain insurance at rates only slightly higher than average-risk persons.²³⁵ As a result, it may not be necessary to subsidize all persons who are high-risk.

²³⁰ See e.g., Joint Statement, *supra* note 195.

²³¹ See Ethan A. Halm et al., *Is Volume Related to Outcome in Health Care? A Systematic Review and Methodologic Critique of the Literature*, 137 ANNALS INTERN. MED. 511, 511 (2002). See also John D. Birkmeyer et al., *Surgeon Volume and Operative Mortality in the United States*, 349 NEW ENG. J. MED. 2117, 2117 (2003).

²³² For example, Duke University's congestive heart failure program is a specialized program that produces excellent outcomes at low cost. See David J. Whellan et al., *The Benefit of Implementing a Heart Failure Disease Management Program*, 161 ARCHIVES INTERN. MED. 2223, 2228 (2001).

²³³ Pauly reported that prior to HIPAA's requirement for guaranteed renewal, up to 80% of individuals in the individual market had voluntary guaranteed renewal as a feature of their insurance policy. See Mark V. Pauly, *Regulation of Bad Things That Almost Never Happen, But Could: HIPAA and the Individual Insurance Market*, 22 CATO J. 59, 64 (2002).

²³⁴ For a description of health-status insurance, see John H. Cochrane, *Health-Status Insurance: How Markets Can Provide Health Security*, POL'Y ANALYSIS (Cato Inst., Wash. D.C.), Feb. 18, 2009.

²³⁵ See Herring & Pauly, *supra* note 69, at 21.

For severely high-risk persons who are unable to obtain insurance in an unregulated market, a public subsidy or private support should be more satisfactory than requiring guaranteed issue plus community rating. A public subsidy could be a subsidy to a high-risk pool, a risk-adjusted subsidy to an insurer, or a risk-adjusted subsidy to an individual to purchase insurance in the open market. The primary benefit of a subsidy over underwriting restrictions is that a subsidy does not increase insurance prices for low and average-risk persons. The primary cost is that subsidies require public funding. As with low-income persons, private, philanthropic support for high-risk care offers the possibility of even greater access to care at less cost to society.

C. *Application to Medicare Beneficiaries*

Since Medicare's inception in 1965, Congress has attempted to increase access for seniors primarily by increasing Medicare payment rates to physicians and medical facilities.²³⁶ Higher payment rates are necessary to maintain beneficiary access to care. However, Medicare payment rates are in effect a form of fixed prices, and fixed prices cannot adjust to the rapid changes in the demand for and supply of specific types of care. As a result, Medicare's payment rates may result in surpluses or shortages of some types of care.²³⁷

Each type of recommended reform should result in lower prices for either health insurance or medical care. Because Medicare beneficiaries tend to require more care, and because Medicare contains a number of cost-sharing features, reforms that lead to lower prices should increase access for most beneficiaries.

Congress also should consider replacing traditional Medicare with a subsidy that a beneficiary could use to purchase private insurance or pay directly for care. A subsidy could be income-based, risk-adjusted, or both. The primary advantage of a subsidy over traditional Medicare is that it would allow a beneficiary to choose from the same health insurance and medical care options available to others. Also, if beneficiaries owned the funds used for their care, insurers would have an incentive to develop innovative types of insurance for seniors, and professionals and facilities would have an incentive to develop more cost-effective ways to provide senior care. Replacing Medicare insurance with a subsidy of a defined amount

²³⁶ In most years, Congress increases payment rates for physician care.

²³⁷ Above market payment rates may lead to excess procedures performed, and below market payment rates may lead to a shortage of certain types of care. For example, low Medicare payment rates may lead to a shortage of primary care physicians in some locations. See FRAZIER & FOSTER, *supra* note 47.

would also allow the federal government to better control both its present expenditures and long-term liabilities.

Finally, Congress should consider allowing younger Americans to opt out of Medicare, placing their Medicare payroll taxes and other contributions into personal accounts to pay for retirement medical expenses.²³⁸ By converting Medicare payroll taxes into savings for health care, it is possible that over time, both Medicare insurance and public subsidies could be eliminated.²³⁹ Low-income and high-risk seniors could be eligible for the same public subsidies and private, philanthropic support described earlier for younger low-income and high-risk individuals.

CONCLUSION

During the twentieth century, Congress and state legislators enacted laws that favor third-party payment over paying directly for both health insurance and medical care. Both also enacted laws authorizing extensive regulation of private health insurance, professional care, and medical facility care. In addition, Congress required pharmaceutical companies to gain approval before releasing a new drug to the U.S. market, and state medical malpractice lawsuits increased. While each of these developments has had benefits, together they have contributed to high prices for health insurance, high prices for medical care, and large health care expenditures.

Congress recently passed legislation designed to extend comprehensive third-party coverage to a larger percentage of Americans. While greater insurance coverage will provide benefits for some individuals, it will likely lead to even higher prices, larger expenditures, and potentially less access for others.

In contrast, reforms that increase individual ownership of health care funds and reforms that result in a wider variety of options should lead to lower prices for both health insurance and medical care. In addition, these reforms should lead to fewer excess expenditures, greater innovation, and potentially higher quality. Finally, these reforms may be more effective than universal insurance at increasing access to care for low-income, high-risk, and older Americans.

²³⁸ See, e.g., Martin Feldstein, *Prefunding Medicare*, 89 AM. ECON. REV. 222, 224 (1999).

²³⁹ Since 1984, Singapore has required individuals to save 6% to 8% of their wages to pay for health care, and most Singaporeans now pay directly for much of their care. See Taylor & Blair, *supra* note 174, at 3.

THE STUDENT LOAN CRISIS AND THE RACE TO PRINCETON LAW SCHOOL¹

*William S. Howard**

INTRODUCTION

In 2010, the 111th Congress passed and President Obama signed the Health Care and Education Reconciliation Act (the Act).² Within the Act are provisions of the Student Aid and Fiscal Responsibility Act that will change the way students pay for higher education.³ At the heart of the bill is a provision that removes private banks as “middlemen”⁴ in the loan process, which will allegedly save the United States Government \$68 billion over the next eleven years.⁵ The purpose of the Act is to make college affordable in the midst of the rising tide of college tuition; there is no denying that the cost of higher education and concomitant student borrowing is booming. For instance, “two-thirds of American students borrow money to pay for their college education.”⁶ In the 2008–2009 academic year, the

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¹ Princeton Law School does not exist. This paper uses the term as a metaphor for the race to the top of legal rankings and the conspicuous consumption and inelastic-based market forces that inflate the cost of higher tuition, specifically at law schools.

² Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010).

³ Student Aid and Fiscal Responsibility Act of 2009, H.R. 3221, 111th Cong. (2009); see *Student Aid and Fiscal Responsibility Act (SAFRA)*, NAT’L ASS’N FOR C. ADMISSION COUNSELING, <http://www.nacacnet.org/LegislativeAction/LegislativeNews/Pages/SAFRA.aspx> (last visited Apr. 24, 2011).

⁴ Private banks will no longer lend money directly to students with subsidies from the U.S. Government and protection against default by the full faith and credit of the U.S. Government. Instead, private banks will be relegated to servicing the loans. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §§ 2201-05, 124 Stat. 1029, 1074-75 (2010).

⁵ Tracey D. Samuelson, *Student Loan Reform: What Will It Mean for Students?*, THE CHRISTIAN SCI. MONITOR (Mar. 30, 2010), <http://www.csmonitor.com/Business/2010/0330/Student-loan-reform-What-will-it-mean-for-students>. Furthermore, “[l]oan payments will be capped at 10 percent of a student’s disposable income (it’s currently 15%) and any debt remaining after 20 years will be forgiven (the current threshold is 25). For public servants—including teachers, nurses, or members of the armed forces—that cap is 10 years. But, those repayment terms are only applicable for loans signed after July 1, 2014, and will not be retroactive, nor do they apply to private loans.” *Id.*

⁶ Tamar Lewin, *House Passes Bill to Expand College Aid*, N.Y. TIMES (Sept. 17, 2009), http://www.nytimes.com/2009/09/18/education/18educ.html?_r=1.

amount of money students borrowed grew to \$75.1 billion, which is nearly a 25% increase over the previous year.⁷

Many would argue that this borrowing binge is justified due to the rising cost of education. For instance, from 2002 through 2007 the cost of attending a public undergraduate university jumped 35%.⁸ The median undergraduate tuition and fees for the 2007–2008 school year in 2009 dollars was \$14,461 for in-state students at public universities, \$27,383 for out-of-state students at public universities, and \$33,042 for students at private universities.⁹ The increase is even more pronounced at law schools, which are viewed as “cash cows” by universities, who use law school tuition to fund other parts of their campuses.¹⁰ Between 1987 and 2005, the average public law school tuition increased by 448%.¹¹ In 1986, in-state law school tuition and fees averaged \$2,063, which adjusted for inflation is about \$4,000 today.¹² In 2008, in-state tuition at public law schools aver-

⁷ Anne Marie Chaker, *Students Borrow More Than Ever For College: Heavy Debt Loads Mean Many Young People Can't Live Life They Expected*, WALL ST. J. (Sept. 4, 2009, 11:24 AM), <http://online.wsj.com/article/SB10001424052970204731804574388682129316614.html>. This is a startling statistic because 2008-2009 was in the midst of a recession, a time when most consumers were deleveraging, but the amount of money borrowed by students far surpassed previous years in which the rate of increase in borrowing ranged from as low as 1.7% in the 1998-1999 school year to almost 17% in 1994-1995. *Id.*

⁸ *Id.* It is probably true that students are more willing to go back to school in the midst of a recession, but why are students willing to dig themselves so far into debt? The answer is probably that many are making their decisions based on college and post-graduate schools' advertised employment and salary statistics that are backwards looking, and perhaps dishonest. However, these statistics are based on a pre-recession economy. What if the post-recession economy is really a new global economy in which Americans are to expect a stagnate standard of living, perhaps temporarily declining, while the rest of the world catches up in comparative salary and spending power? The next ten years could see a dramatic stagnation, perhaps even drop, in white collar salaries as white collar workers soon learn that globalization and free trade in an economy as technologically advanced as the global economy is today does not merely mean that blue collar jobs will search the globe looking for a lowest cost of labor, but white collar jobs will also. In fact, with the current technology, the start-up cost of shipping white collar jobs overseas is probably much less than shipping blue collar jobs overseas. White collar workers who are digging themselves into debt based on backward looking employment statistics could be in for a rude and, maybe, crippling awakening.

⁹ Debra Cassens Weiss, *GAO Puts Blame on US News Rankings for High Law School Tuition*, A.B.A. J. (Oct. 27, 2009, 8:13 AM), http://www.abajournal.com/news/article/why_you_can_blame_us_news_instead_of_the_aba_for_high_law_school_tuition/. See also U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-20, HIGHER EDUCATION: ISSUES RELATED TO LAW SCHOOL COST AND ACCESS (2009).

¹⁰ David Franklin, *Trials of Socrates*, SLATE (July 31, 1997), <http://www.slate.com/id/3133/>.

¹¹ William Henderson & Andrew Morriss, *Commentary: Law Schools Have Only Themselves to Blame for Power of 'U.S. News' Rankings*, LAW.COM (June 22, 2007), <http://www.law.com/jsp/article.jsp?id=1182330351869>.

¹² Lauren Streib, *Law School Racket: Faculties Up 40% Over Last Ten Years, Forces Costs & Ranks Up*, BUS. INSIDER (Mar. 10, 2010), <http://www.businessinsider.com/law-school-racket-faculties-up-40-over-last-ten-years-forces-costs-and-ranks-up-2010-3>.

aged \$16,836.¹³ At the uppermost end of the tuition scale was Yale University, charging \$50,140 for its law school tuition.¹⁴

Based on estimates by the Office of Management and Budget, the balance of all outstanding U.S. student loans was \$730 billion as of 2010.¹⁵ The problem is reaching a tipping point particularly in the aftermath of the most recent recession, as many students financed expensive educations under the assumption that the post-graduation jobs and average salaries advertised by schools and school ranking magazines would be available to them.

Despite identifiable market forces that cause natural increases in the price of education, the predominant reason for the dramatic acceleration in the cost of higher education is the vicious inflation cycle created by politicians who seek to “make college affordable” simply by making more loans available and affordable.¹⁶ When confronted with the increasing cost of education, the policy response is to myopically create programs that pour more leverage into an already over-leveraged system. The result of these actions is no different from the housing bubble, and their consequences may be just as disastrous.

This article will first briefly examine the recent housing bubble to highlight the public and private sector forces that created excessive inflation and the bubble in the housing market. Under this paradigm, one can examine similar forces that drive inflation in higher education. Next, it will examine the U.S. student loan program to illuminate how increasing the money supply in the student loan market exacerbates, rather than solves, the problem of out-of-control, rising education prices. Finally, it will briefly address any possible and feasible solutions to America’s rising tuition problem.

¹³ *Id.*

¹⁴ Weiss, *supra* note 9.

¹⁵ Anya Kamenetz, *\$830 Billion in Student Loans: The New Mortgage Bubble*, THE HUFFINGTON POST (Aug. 11, 2010, 11:58 PM), http://www.huffingtonpost.com/anya-kamenetz/830-billion-in-student-lo_b_679497.html (citing ANYA KAMENETZ, *DIY U: EDUPUNKS, EDUPRENEURS, AND THE COMING TRANSFORMATION OF HIGHER EDUCATION* (2010)). The figure might be closer to \$830 billion, as estimated by Mark Kantrowitz. *Id.* See Mary Pilon, *Student-Loan Debt Surpasses Credit Cards*, WALL ST. J. (Aug. 9, 2010, 1:13 PM), <http://blogs.wsj.com/economics/2010/08/09/student-loan-debt-surpasses-credit-cards/>.

¹⁶ See Libby Quaid & Justin Pope, *Obama Would Spend More to Make College Affordable*, SEATTLE TIMES (Feb. 26, 2009, 3:26 PM), http://seattletimes.nwsourc.com/html/politics/2008789299_apobamabudgeteducation.html. Another valid comparison is the political desire to make college affordable for everyone irrespective of if they should go to college. Like the housing bubble, the political drive was to “create an ownership society” by essentially making risky loans to people who were not qualified to pay them back and in essence were not qualified to be home-buyers. Likewise, by a similar logic, many people probably should not be going to college, and still others should not be going at inflated prices.

I. THE HOUSING BUBBLE

An eerie conceptual analogy to the student loan crises can be found in the American housing market in the first decade of the new millennium. The paradigms are: (1) specific identifiable market forces cause both the housing market and the higher education market to inflate faster than the “normal” rate of inflation; (2) politicians respond by creating short-sighted programs that loan money to consumers who can then buy these “goods” at the inflated prices instead of identifying the inflation’s root causes; and (3) these programs inject excessive leverage into the markets and exacerbate the problem by turning the market’s homeostasis regulation mechanism into a vicious inflationary cycle.¹⁷

This article proffers that government regulations, improperly implemented and abused, caused much of the problems in the housing market. It is imperative to underscore at the outset that it was not too much regulation or too little regulation that caused the problem—it was both. Bad regulation driven by both liberal and conservative ideologies caused the American housing crisis. The combination of the liberal policy that all Americans deserve to own a home as if it were a natural and inalienable right, and the conservative belief that free markets are self-regulating as if this were an unassailable natural law, led to the housing bubble. Even though we pretend to have learned from the recent housing crisis, politicians and pundits repeatedly call for the need to make college affordable, much like how they called for policies to make housing affordable. Thus, it is clear that the student loan crisis is following the same inflationary path as the housing crisis.

A. *Preliminary Causes of Housing Inflation*

As Thomas Sowell thoroughly documents in his book, *Housing Boom and Bust*, America’s housing crisis began with abnormally rising “housing” prices in certain parts of America in the 1970s.¹⁸ In fact, by the peak of the housing crises in 2005, a quarter acre of land was worth about \$140,000 in

¹⁷ The leverage provided by student loans is not the only reason for runaway tuition prices, nor does the spigot merely need to be turned off. The problems are more complicated. For a detailed examination of many of the reasons for the runaway tuition prices at the “selective” undergraduate universities, see RONALD G. EHRENBURG, *TUITION RISING: WHY COLLEGE COSTS SO MUCH* (2000). However, even Ehrenberg’s thoroughly exhaustive book does not mention the upward pressure on prices caused by the excessive leverage from the Federal Government. This article contends that if that issue is not addressed, the problem will continue regardless of how many other ways a university tweaks the details to cut costs and lower tuition.

¹⁸ THOMAS SOWELL, *THE HOUSING BOOM AND BUST* 10 (2010). “Housing” needs to be in quotes because, as Sowell points out, the cost of housing was not increasing, what was increasing was the price of land. *Id.*

Chicago and \$700,000 in San Francisco.¹⁹ Many politicians and bureaucrats had a rational explanation for the abnormal inflation in the housing market in these parts of the country, such as rising incomes and population growth.²⁰ However, as Sowell points out, even though San Francisco's population increase in the 1970s was 11.9%, 0.4% higher than the national population growth, its housing prices skyrocketed, far outpacing the rest of the nation.²¹

The real reason why housing prices began to rise in California in the 1970s, however, is because the decade saw the rapid spread of laws severely restricting the use of land, such as "smart growth" and "open space" policies meant to protect the environment.²² These laws severely restricted citizens from buying land, and this artificial restriction on the supply of land drastically increased the price of the land. For instance, more than half the land in San Mateo County, California is now "preserved."²³ Compare California to Houston, Texas, which never utilized housing restrictions or "smart growth" regulations, and therefore, never had a shortage of land or housing, nor skyrocketing housing prices.²⁴ Today, a \$155,000 house in Houston, Texas costs \$1 million in San Jose, California.²⁵ Nonetheless, even though land restriction laws explained the rising cost of housing in some parts of the country, politicians and pundits ignored this fact and declared that the market failed to produce affordable housing and that the government needed to intervene and make housing affordable.

B. *The Liberal Ideologies*

The first example of how an ideology stripped bare from economic reality caused the housing bubble was the politicization and over-involvement of the two major Government Sponsored Entities (GSEs) in the housing market. The government established the Federal National Mortgage Association (Fannie Mae) during the Great Depression, followed by the Federal Home Loan Mortgage Corporation (Freddie Mac) in the 1970s.²⁶

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at 14.

²³ SOWELL, *supra* note 18, at 13-14. These laws were enacted by the current residents whom saw the value of their houses increase dramatically after the law was passed. Of course, the residents supported policies that kept out new residents, preserved their right to open land, and most importantly, caused the value of the land which they owned to artificially inflate in value.

²⁴ *Id.* at 14.

²⁵ *Id.*

²⁶ Darrell Issa, *Unaffordable Housing and Political Kickbacks Rocked the American Economy*, 33 HARV. J.L. & PUB. POL'Y 407, 407-08 (2010).

Before the creation of Fannie Mae and Freddie Mac, and even during their tenure as healthy institutions, the conventional procedure by which one would buy a home was that a lender would require a 20% down payment, a verified stream of income, and a very good credit score, to protect against the homeowner defaulting on the loan. When a borrower tied up 20% of her own money in an investment, she tended to not default on the terms of the investment agreement; furthermore, the down payment gives the bank a cushion in case of default or a drop in price.²⁷ These are normal risk regulation mechanisms for a creditor, and are the only way lending and leveraging can work in a healthy market—the lender must take a risk, which causes the lender to carefully screen and select those to whom she will lend.

Of course, this process results in less lending and thus less home ownership than politicians desired. Therefore, the two GSEs were created to make home ownership more available and affordable to Americans.²⁸ The GSEs do so by buying the mortgage loans that banks made to borrowers, thereby instantly infusing the banks with liquid cash without having to wait thirty years for the payments, which in turn, the banks can then lend again to another home buyer.²⁹ The GSEs' involvement began removing risk from the system; banks knew they could sell a mortgage to a GSE, thereby diminishing the banks' concern about borrowers' credit default risk. The only limit to safeguard against absolute frivolous lending was the GSEs' concern for credit risk and potential default. Freddie Mac and Fannie Mae both placed strict requirements on lenders regarding the level of risk they would accept in a loan that they purchased. But then things changed.

During the last forty years, American politicians began to create programs to make housing more affordable, especially for those Americans that were least likely to qualify for a traditional home loan. For instance, Congress passed the Community Reinvestment Act (CRA)³⁰ in 1977, which required banks to make a quota of loans to low and moderate-income borrowers.³¹ The CRA's regulations required the use of "innovative and flexible financing," and the Department of Housing and Urban Development (HUD) began to bring lawsuits against banks that declined a greater portion of minority applicants compared to white applicants *regardless of credit-worthiness*.³² Furthermore, in 1992, HUD became Fannie Mae and Freddie Mac's regulator and set quotas for affordable housing and for pushing sub-prime loans.³³ In 1995, Fannie Mae and Freddie Mac began receiving "af-

²⁷ SOWELL, *supra* note 18, at 8.

²⁸ National Housing Act, 12 U.S.C. § 1716 (1992).

²⁹ SOWELL, *supra* note 18, at 93.

³⁰ Community Reinvestment Act of 1977, 12 U.S.C. § 2901 (2010).

³¹ SOWELL, *supra* note 18, at 39.

³² *Id.* at 40 (emphasis added).

³³ *Id.* at 43.

fordable housing credits” for buying subprime securities from banks in the secondary market.³⁴ These changes were all made pursuant to a political ideology that championed homeownership for all Americans, as if it were a fundamental positive right, regardless of the laws of economics. This ideology was not exclusively a liberal one, as the Bush Administration also joined in the race to put everyone in a home by passing the American Dream Downpayment Act in 2003.³⁵ All of these regulations reduced the risk of making loans, leading to more loans being made to more people who could not pay them back.

C. *The Conservative Ideologies*

Contributing to this vicious cycle was the private sector, large banks, and certain free market ideologies that rose to the level of divine revelation just as the “make housing affordable” mantra had, regardless of the pragmatic concerns. Specifically, although not exclusively, the following free market ideologies contributed to the housing bubble³⁶: (1) the repeal of the Glass-Steagall Act of 1933,³⁷ (2) the Federal Reserve’s interest rate policy under Alan Greenspan, (3) the lack of derivative regulation, and (4) the relaxation of the SEC’s Net Capital Rule.³⁸

In 1999, President Bill Clinton signed into Law the Gramm-Leach-Bliley Act,³⁹ which repealed part of the Glass-Steagall Act of 1933.⁴⁰ The Glass-Steagall Act reduced the separation between commercial banks and investment banks. Commercial banks differ from investment banks because commercial banks make retail and commercial loans in a conservative manner and hold citizens’ and companies’ checking and savings accounts. Investment banks, on the other hand, feature a more risk-taking culture.⁴¹ The Gramm-Leach-Bliley Act allowed the traditional risk-taking institutions to mingle assets of everyday depositors and increase both the risk and liquidity in the system.⁴² Although many have argued that the

³⁴ Carol D. Leonnig, *How HUD Mortgage Policy Fed The Crisis*, WASH. POST (June 10, 2008), <http://www.washingtonpost.com/wp-dyn/content/article/2008/06/09/AR2008060902626.html>.

³⁵ American Dream Downpayment Act, S. 811, 108th Cong. (2003) (enacted); SOWELL, *supra* note 18, at 42.

³⁶ The following four ideologies fit the paradigm of an ideology governing regulation that, in turn, caused excessive leverage in the system.

³⁷ Glass-Steagall Act, Pub. L. No. 73-66, 48 Stat. 162 (1933) (repealed 1999).

³⁸ Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 17 C.F.R. pts. 200 and 240 (2004).

³⁹ Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

⁴⁰ Cyrus Sanati, *10 Years Later, Looking at Repeal of Glass-Steagall*, N.Y. TIMES (Nov. 12, 2009, 2:24 PM), <http://dealbook.nytimes.com/2009/11/12/10-years-later-looking-at-repeal-of-glass-steagall/>.

⁴¹ *Id.*

⁴² *Id.*

mingling of assets did not have a role in the bursting of the housing bubble, the fact remains that by 2007 too many banks in America were “too big to fail” and thus needed to be bailed out by the federal government’s Troubled Asset Relief Program.⁴³ The increased size of the Wall Street banks resulting from the repeal of the Glass-Steagall Act created a moral hazard, as investors knew the federal government could never let these banks fail. This adherence to ideology removed the natural risk mechanisms of default and failure from the system and precipitated the crises.⁴⁴

The second “conservative” policy that precipitated the housing bubble was the Federal Reserve Board’s interest rate policy. Individuals primarily pay for houses with borrowed money. Buyers calculate how expensive of a house they can afford not based on the price of the house, but on their monthly mortgage payments. Therefore, if a person can afford a total monthly payment of \$2,000, the person might qualify for a \$200,000 loan at an interest rate of 10%; however, if the interest rate is brought down to 4%, the same person could qualify for a loan of roughly \$380,000 and still retain a monthly payment of \$2,000.⁴⁵ Under Alan Greenspan, the Federal Reserve kept interest rates low to stimulate the economy after the bursting of the dot-com bubble, dropping interest rates from 6.5% to 1%.⁴⁶ This easy money policy dramatically increased the supply available to purchase a home, which dramatically increased the prices of homes.⁴⁷ As Milton Friedman said: “Inflation is always and everywhere a monetary phenomenon.”⁴⁸ Only in this case it was industry specific. The Federal Reserve’s interest rate policy was motivated by faith in an ideology of self-regulating markets, instead of pragmatic, moderate policymaking.⁴⁹

Another conservative ideology that greatly contributed to the housing bubble was Congress’s enactment of the Commodity Futures Modernization Act in 2000,⁵⁰ which allowed for self-regulation of the over-the-counter derivatives market, such as credit default swaps (CDS) and mortgage

⁴³ The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

⁴⁴ The entire concept that institutional investors are considered sophisticated people who understand the trades they are entering is simply an antiquated concept in a world of derivatives of derivatives and should be re-evaluated. See MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2011).

⁴⁵ SOWELL, *supra* note 18, at 6.

⁴⁶ *Open Market Operations*, FED. RESERVE, <http://www.federalreserve.gov/fomc/fundsrate.htm> (last updated Jan. 26, 2010).

⁴⁷ SOWELL, *supra* note 18, at 6-7.

⁴⁸ MILTON FRIEDMAN, *MONEY MISCHIEF* 49 (1992).

⁴⁹ *Greenspan Admits ‘Mistake’ that Helped Crisis*, MSNBC (Oct. 23, 2008) <http://www.msnbc.msn.com/id/27335454/>.

⁵⁰ The Consolidated Appropriations Act for FY2001, Pub. L. No. 105-554, 114 Stat. 2763 (2000).

backed securities (MBS).⁵¹ The volume of CDS outstanding increased 100-fold from 1998 to 2008.⁵² Although Fannie Mae and Freddie Mac began the policy of buying mortgages from lenders, it was not until Wall Street learned how to package these derivatives in creative and obscure ways that the housing bubble really took off.⁵³

A final example of conservative ideology trumping pragmatic analysis was when the Securities and Exchange Commission (SEC) voted unanimously in 2004 to permit the largest broker-dealers to apply for exemptions from the established Net Capital Rule.⁵⁴ This change permitted the five largest investment banks to dramatically increase their financial leverage and aggressively expand their issuance of mortgage-backed securities, thus pumping more liquidity into the housing market and removing practical risk considerations from the financial industry.⁵⁵ The SEC recently admitted this decision was a major contributor to the increase in risk taking and liquidity in the market.⁵⁶

These free market policies flooded the financial system with liquidity and removed many of the traditional risk mechanisms that make for healthy credit markets. With these free market policies in place, the rest of the system and its actors can act rationally within the system and still cause chaos, which is exactly what happened.⁵⁷ By the peak of the housing bubble, consumers purchased two-thirds of all mortgages from the secondary market, half of which were purchased by Fannie Mae and Freddie Mac.⁵⁸ This zeal to infuse increasingly more liquidity into the housing market resulted in the median sale price of a single-family home rising 33% from \$143,600 in 2000 to \$219,600 in 2005.⁵⁹ In some parts of the U.S., prices rose even more dramatically with increases of 110% in Los Angeles, California and 127% in San Diego, California.⁶⁰ In 2007, after the housing bubble burst,

⁵¹ Stephen Figlewski et al., *Geithner's Plan for Derivatives*, FORBES (May 18, 2009, 10:00AM), <http://www.forbes.com/2009/05/18/geithner-derivatives-plan-opinions-contributors-figlewski.html>.

⁵² *Id.*

⁵³ Proponents of credit default swaps argue that it is a necessary tool to hedge the risk of a loan default. However, if this were true, the hedge should be built into the interest rate, with a riskier loan getting a higher rate. Instead, the CDS gave banks the ability to lend to institutional clients at lower rates than the risk picture would demand because the bank could insure that risk with a CDS.

⁵⁴ See U.S. GEN. ACCOUNTING OFFICE, GAO-04-896, MAJOR RULE REPORT: ALTERNATIVE NET CAPITAL REQUIREMENTS FOR BROKER-DEALERS THAT ARE PART OF CONSOLIDATED SUPERVISED ENTITIES (2004).

⁵⁵ *See id.*

⁵⁶ Stephen Labaton, *SEC Concedes Oversight Flaws*, N.Y. TIMES (Sept. 27, 2008), http://www.nytimes.com/2008/09/27/business/27sec.html?_r=1&em.

⁵⁷ There were many other causes of the housing bubble, including problems with the credit rating agencies and large fund managers buying securities they did not understand.

⁵⁸ SOWELL, *supra* note 18, at 3.

⁵⁹ Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 COLO. L. REV. 1, 35 (2009).

⁶⁰ SOWELL, *supra* note 18, at 1.

Fannie Mae and Freddie Mac had to be placed into conservatorship, having amassed \$2 trillion in mortgage debt.⁶¹

This was the essence of the housing bubble. Each actor made decisions that seemed to be rational and benefit them financially, but *in toto* the result was disastrous. Now the same ideological blindness is poisoning the student loan industry. Government officials and the private players who benefit from the government's actions are acting in tandem resulting in the increased costs of education. These players are harkening that the cost of education is rising too quickly, therefore, we need to make college affordable by making more loans to more people, thus propelling the vicious cycle and inflating the cost of higher education in the same manner as the housing market.

II. THE STUDENT LOAN INDUSTRY

A very similar mechanism is at work in the student loan market. It starts with factors that lead to a natural inflation in the price of education that outpaces normal inflation. In response to higher prices, politicians sound the clarion call to make college affordable and do so by enacting programs that infuse leverage into the market and eviscerate all natural risk mechanisms, as was done in the housing market. This, of course, exacerbates the problem and sends the process into a vicious cycle of rising prices, more loans, rising prices, more loans, *ad infinitum*.

A. *History of Student Loans & Public Policy*

Federal funding of education originated at the height of the Cold War, as the United States saw the importance of educating and training its citizens so as to not fall behind the Soviets, who were already sending satellites into space.⁶² Shortly after the launch of Sputnik, the United States Government created several federal loan programs in response to the demand to educate more American citizens. Such programs included: the Health Professions Education Assistance Act of 1963,⁶³ which provided loans to medical and health program students; the College Work-Study Program,⁶⁴ now called the Federal Work-Study Program, allowed the federal government to

⁶¹ SOWELL, *supra* note 18, at 52, 75.

⁶² Gareth Marples, *The History of Student Loans—Financial Aid for Economic Competition*, FIN. SHOPPER NETWORK, http://www.financial-shopper-network.com/history_of_student_loans.htm (last visited Mar. 24, 2011).

⁶³ Health Professions Educational Assistance Act of 1963, Pub. L. No. 88-129, 70 Stat. 717 (1963).

⁶⁴ Economic Opportunity Act of 1964, Pub. L. No. 88-452, 78 Stat. 508 (1964) (codified at 42 U.S.C. §2701).

fund most of students' wages earned while working at on-campus jobs; and the Middle Income Student Assistance Act,⁶⁵ which made student loans available to middle-class families, without an income limit on federal aid programs.

While Congress passed numerous bills to respond to the "need" to send more citizens to college, this article focuses on the Higher Education Act of 1965⁶⁶ because it provides the lion's share of the federal funding for student loans through programs such as: the Educational Opportunity Grant Program, which targeted low-income students who could not afford college; the Guaranteed Student Loan Program, now called the Federal Stafford Loan Program, which provided additional loans through banks or lending agencies to offset rising education costs; and the Parent Loans for Undergraduate Students Program (PLUS loans), which allowed upper-income families to obtain student loans, but at much higher interest rates.⁶⁷

President Lyndon Johnson signed the Higher Education Act of 1965 (HEA) into law in 1965 as part of his Great Society. Title IV of the HEA established the Stafford Loan Program, which provides for subsidized and unsubsidized loans that are guaranteed by the U.S. Department of Education.⁶⁸ Until 1993, a public-private consortium generally administered the loans: private banks would make the loans to students, and the federal government would subsidize the interest payments and guarantee the loans against defaults.⁶⁹ If a parent or student defaulted, the private lender was reimbursed by the government for its losses.⁷⁰ In 1993, the Budget Reconciliation Act formed the William D. Ford Federal Direct Loan Program, which allowed students to bypass private lenders by borrowing directly from participating schools who, in turn, got funds directly from the U.S. Department of Education.⁷¹ From 1993 through 2010, the Stafford Federal Stafford loan program had two channels: the William D. Ford Federal Direct Loan Program and the traditional Federal Family Education Loan Program (FFELP).⁷² The FFELP, which represents the original public-private consortium, still accounts for 80% of all new federal student loans.⁷³ However, a provision in the Health Care and Education Reconciliation Act of 2010 eliminates the FFELP program in favor of expanding the Ford Pro-

⁶⁵ Middle Income Student Assistance Act, Pub. L. No. 95-566, 92 Stat. 2402 (1978).

⁶⁶ Higher Education Act of 1965, Pub. L. No. 89-329, 79 Stat. 1219 (1965).

⁶⁷ Marples, *supra* note 62.

⁶⁸ 20 U.S.C. §§ 1071-87-4.

⁶⁹ *Stafford Loans, SCHOLARSHIPS*, <http://www.scholarships.com/financial-aid/student-loans/stafford-loans/> (last visited Mar. 19, 2011).

⁷⁰ *Obama Calls for Elimination of Subsidies to Student Loan Providers*, ORGANIZING FOR AM. (May 15, 2007), http://www.barackobama.com/2007/05/15/obama_calls_for_elimination_of.php.

⁷¹ *Direct Loan Page for Students*, U.S. DEP'T OF EDUC., <http://www2.ed.gov/offices/OSFAP/DirectLoan/student.html> (last updated Mar. 3, 2011).

⁷² *Id.*

⁷³ *Id.*

gram.⁷⁴ The intention of the reform is to reap the savings that were being paid to the banks in subsidies and guarantees and redirects them to fund grants based on need, such as Pell Grants.⁷⁵

Even though the impetus behind the drive to put more American students into college was to win the Cold War, the campaign to put more students into the college system continued and became a cause in itself even after the Cold War ended. Many benefit monetarily from herding so many students through higher education institutions who may have little motivation to bring down the cost of tuition. These interested parties rarely make arguments for measures to reduce the cost of tuition. Instead, they advocate increasing the amount of money students are allowed to borrow and funnel into the system.

B. *Student Loan Market Forces: An Inelastic Market*

The desire to send more students to college and the subsequent creation of student loan programs inflated the cost of higher education, just as mortgage loan programs drove the housing bubble. However, inflation in both the housing and student loan markets did not solely result from cheaper loans. Like land restriction laws in the housing market, there are other external forces at work in the student loan market which cause the cost of higher education to increase.

There are many reasons why educational institutions cannot cut costs the way a normal corporation can. For instance, universities do not measure value by economic profit and cost cutting; like nonprofit organizations, universities have little concern for profit. Instead, they are concerned with spending as much money as they can get in an effort to increase their rankings.⁷⁶

Additionally, inelastic demand has driven up the price of education. The law of demand applies in normal elastic supply–demand relationships: consumer demand for a good decrease as its price increases. However, in an inelastic supply–demand relationship, demand does not decrease as the price of a good or service increases; in some cases, demand may even increase. The law school market is a good example: in-state law school tuition plus fees averaged \$2,063 in 1986, which adjusted for inflation is about \$4,000 today; however, in-state tuition alone at public law schools averaged \$16,836 in 2008.⁷⁷ Given the rising cost of education above inflation rates,

⁷⁴ *Obama Calls for Elimination of Subsidies to Student Loan Providers*, *supra* note 71.

⁷⁵ *Id.*

⁷⁶ EHRENBERG, *supra* note 17, at 11.

⁷⁷ Streib, *supra* note 12. The same phenomena is seen for undergraduate colleges. For example, in 2000, Ursinus College in Collegeville, Pennsylvania, boosted tuition and fees by 17.6% and the following year the school received nearly 200 more applications than the year before, and within eight

the demand for law school should abate or stabilize, as it does for any good or service exhibiting normal elastic demand.⁷⁸ Thereafter, tuition would eventually stop rising as students cut back enrollment. Like a manufacturer of goods or provider of services, colleges would then be forced to cut costs or compete against entrepreneurs who flood the market with lower-cost alternatives.⁷⁹ However, in the market for higher education, especially in the market for legal education, is inelastic demand—the demand, as measured by applications, has increased even though cost has increased.⁸⁰

Higher education, especially law school, exhibits an inelastic demand curve for several reasons. First, law school degrees, especially top-tier law school degrees, are conspicuously consumed luxury goods⁸¹ and buttressed by the bimodal salary distribution for law school graduates. Second, the annual law school rankings spur spending by law schools to implement projects that would increase their rankings. Third, law school consumption also exhibits properties of a Giffen good due to artificial restrictions on free market forces in both education and the practice of law.⁸² Finally, globalization and the trend over the past fifty years of admitting women, minorities, and international students has put upward pressures on the demand for law schools that is out pacing the supply of available enrollment spots.⁸³ These forces alone would be enough to produce a steady rise in tuition that would outpace inflation, just as land restrictions did with the housing market.

Education will always be a conspicuously consumed good. A Princeton Law degree is not just another degree—it is a ticket to jobs, connec-

years the freshman class had grown 56%. Jonathan D. Glater & Alan Finder, *In Tuition Game, Popularity Rises With Price*, N.Y. TIMES (Dec. 12, 2006), <http://www.nytimes.com/2006/12/12/education/12tuition.html>.

⁷⁸ See Penelope Wang, *Is College still worth the price?*, CNNMONEY.COM (Apr. 13, 2009, 12:26 PM), http://money.cnn.com/2008/08/20/pf/college/college_price.moneymag/.

⁷⁹ *Id.*

⁸⁰ *Id.* In this case, many law school consumers have wrongly believed that mere admission to and graduation from a law school will result in increased earning power in the short and long term, as well as a dividend that more than pays the sunk costs and lost opportunity costs. As employment realities and sagging wages become more well known, the demand may become much more elastic – at least with regard to certain tiers of the law school market.

⁸¹ See generally THORSTEIN VEBLÉN, *THE THEORY OF THE LEISURE CLASS* 68-101 (1912).

⁸² Education may actually be both a Veblen good and a Giffen good. Giffen goods are inelastic because there are no available cost alternatives and the good may be a necessity. Education, particularly the professional schools where tuition rates move in lock step, exhibit both of these features—students deem them necessary and there are no available cheaper cost alternatives. Veblen goods are goods that exhibit the traits of conspicuous consumption.

⁸³ Normative claims are not made here. While equal access is a good development, when the applicant pool doubles without increasing supply at the top law schools, prices will rise. Furthermore, just a decade ago there were 174 ABA accredited law schools—now, there are over 200. However, as this article explains *infra*, enrollment at the top universities is shrinking.

tions, and even exclusive social clubs.⁸⁴ The legal community takes pride in the fact that a surname no longer opens and closes doors in the practice of law. Today, it does not matter whether your name is Adams, Gonzales or Finklestien—everyone is accepted in the legal community. However, it appears that surnames have been replaced by degrees from institutions such as Harvard, Yale and Columbia as the etymological basis for favoring law school graduates in the employment market. Law is the one profession, with the possible exception of academia, in which merit remains subordinate to pedigree even years after graduation. In fact, it has become conventional wisdom that pedigree is the basis of merit.⁸⁵ In order to maintain the conspicuousness of a law degree's status, admissions must be limited, even if there is very little academic difference among applicants.⁸⁶ The ever-expanding pool of qualified law school applicants without a corresponding expansion of available positions at the top law schools has led to increased competition for admission, to the point where accepted applicants are hardly distinguishable from those who are rejected.⁸⁷ Among those qualified, it is almost a crapshoot as to who will be canonized in the legal community.

Admittedly, there is good reason to be proud of a distinguished law degree. This article does not advocate mediocrity; there should be stratification in the legal profession, both in salaries and reputations. However, lawyers in particular, place too much weight on pedigree over merit, long into a lawyer's career and this obsession only fuels an already hyper-competitive race to Princeton Law School. This phenomenon means stu-

⁸⁴ Michael Walsh, *Is Harvard Law a Racket, a Cartel, Or the Hogwarts School Of Witchcraft?*, BIG JOURNALISM (May 13, 2010, 8:43 AM), <http://bigjournalism.com/mwalsh/2010/05/13/is-harvard-law-a-racket-a-cartel-or-the-hogwarts-school-of-witchcraft/>. “Starting with Obama himself, whose transition team alone included 20 Crimson classmates, there are more than 70 graduates of Harvard Law in the administration.” *Id.*

⁸⁵ Clark Hoyt, *Love and Marriage*, *New York Times Style*, N.Y. TIMES (July 12, 2009), <http://www.nytimes.com/2009/07/12/opinion/12pubed.html>. This appears to be a general cultural phenomenon in some parts of the county. See also DAVID BROOKS, *BOBOS IN PARADISE: THE NEW UPPER CLASS & HOW THEY GOT THERE* 13-18 (2000) (noting that the *New York Times* wedding announcements had shifted over the years from an emphasis on bloodlines to education and brains).

⁸⁶ Richard H. Sander & Jane Yakowitz, *The Secret of My Success: How Status, Prestige & School Performance Shape Legal Careers*, (Brook. Law Sch. Legal Stud., Working Paper No. 207), available at <http://ssrn.com/abstract=1640058>; Jack Ladinsky, *The Impact of Social Backgrounds of Lawyers on Law Practice & the Law*, 16 J. LEGAL EDUC. 127, 128 (1963). A central idea in sociological theories of the professions is that a profession distinguishes itself from a mere “occupation” by limiting entry. See ERWIN SMIGEL, *WALL STREET LAWYER: PROFESSIONAL ORGANIZATION MAN?* (1964), for an anecdotal portrait of these social mechanisms.

⁸⁷ There are actually fewer seats at the very top schools for applicants than previously, not just more applicants. That is, there is a strong political drive to place students in the top schools in which they do not qualify based on GPA and LSAT scores. So if Harvard takes a handful of students with a 159 LSAT to fill a political initiative, and only has 1,500 seats, not only has Harvard not expanded the number of seats for top students, but it has actually reduced that number by accepting students for reasons other than pure academic purposes.

dents are willing to pay anything asked for the degree and will value the degree more if the degree precludes others from entrance.

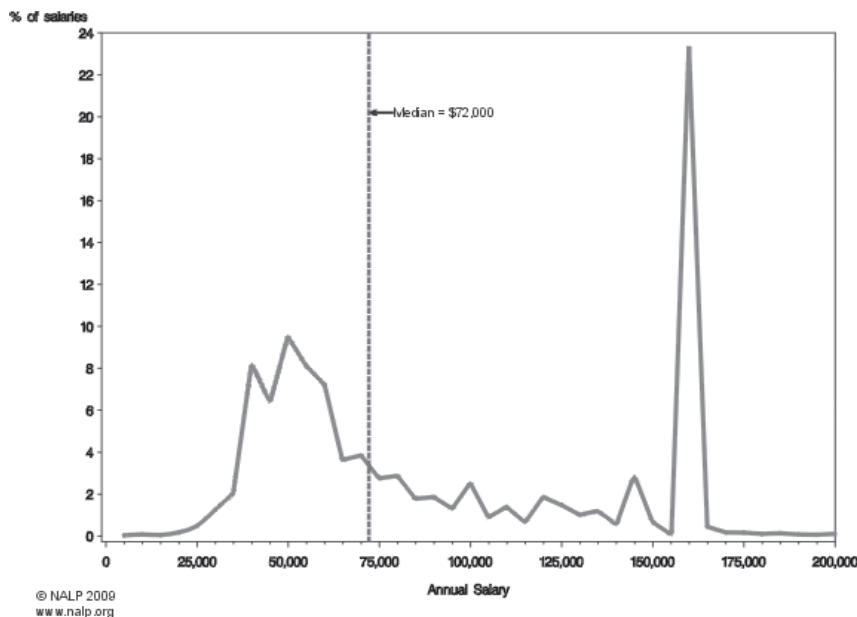
But putting pedigree on a pedestal does not exist in a vacuum. The main reason students race to Princeton Law School is that attending a highly ranked law school is the ticket to the highest starting salaries, even though other factors tend to be a better indicator of legal success and salary in the long run.⁸⁸ One reason for this is that the top students become concentrated at the top universities, resulting in large corporations and law firms concentrating their recruiting at these institutions. This selective recruitment provides increased impetus for the next generation of top students to attend these schools.⁸⁹ The obvious corollary is that not every lawyer desires to work at the big law firms. However, with increasing amounts of necessary student debt, many prospective law students are finding that they do not have alternative options, if they are lucky enough to be accepted to top schools in the first place. Furthermore, the economic reality of the legal industry increases the pressure to get into a top law firm. Law school graduates' starting salaries are distributed along a bimodal distribution curve, not a normal bell shaped curve. As a result, the consequences of not landing a top job are dramatic. A bimodal curve⁹⁰ means that if a graduate takes a job at a top law firm, her starting salary will be approximately \$160,000 a year; however, after the top firm jobs are filled, there is no gradual decline in possible salaries. Instead, they drop off precipitously.⁹¹

⁸⁸ *C.f. Starting Salary Distribution for Class of 2008 More Dramatic than Previous Years*, NAT'L ASSOC. FOR LEGAL CAREER PROF'LS (June 2009), <http://www.nalp.org/404.cfm?404>; <http://nalp.org:80/08saldistribution?s=salaries%20distribution>.

⁸⁹ EHRENBERG, *supra* note 17 at 13.

⁹⁰ A bimodal distribution is markedly different from a regular bell curve distribution. For instance, if the starting salaries of 1,100 law school graduates were distributed in a typical bell curve, there *should be approximately* twenty jobs starting at \$160,000 a year, fifty jobs at \$140,000 a year, 100 jobs at \$120,000 a year, 200 jobs at \$100,000 a year, 400 jobs at \$80,000 a year, 200 jobs at \$60,000 a year, 100 jobs at \$40,000 a year, and fifty jobs at \$20,000 a year. On the other hand, a bell curve distribution for starting law salaries does not reflect the real world. In the real world, it would be more accurate to say that there are 700 jobs starting between \$40,000 a year and \$70,000 a year, exhibiting a miniature bell curve distribution, and 200 jobs starting at \$160,000 a year, exhibiting a second, much sharper peak, with the remaining 200 jobs between \$70,000 a year to \$170,000 a year.

⁹¹ *Starting Salary Distribution for Class of 2008 More Dramatic than Previous Years*, NAT'L ASSOC. FOR LEGAL CAREER PROF'LS (June 2009), <http://www.nalp.org/404.cfm?404>; <http://nalp.org:80/08saldistribution?s=salaries%20distribution>.

GRAPH 1: DISTRIBUTION OF FULL-TIME SALARIES—CLASS OF 2008⁹²

The result of the bimodal distribution of legal salaries for law school graduates means the pressure to get a job at a top law firm is immense because the drop off in salary is significant for other less lucrative jobs. For example, consider two students at a second tier school; one finishes their first year in the top 10% of the class and the other finishes in the top 20%. Despite the 10% difference between the students, chances are that the first student will have a starting salary at a top firm that is at least twice as much as the second student. Put differently, the difference between finishing sixteenth in the class and thirty-second in the class may only be the difference between graduating with a 3.5 and 3.6 grade point average. But the salary difference between the two students would likely be the difference between making \$160,000 a year and \$60,000 a year. This salary gap, unreflective of the true differences in students' abilities, helps explain the intense competition to gain admission at top law schools. This competition for relatively few spots might not be a problem if students did not take out so many loans to fund their education. However, as the amount of student debt continues to increase, the pressure to get one of those top-paying jobs just to service one's debt will increase, thus fueling the race to Princeton Law School. As long as this type of distribution exists in legal salaries,

⁹² Graph copyrighted by NALP and reprinted with permission. Note: The graph is based on 22,305 salaries; a few salaries of about \$200,000 are excluded for clarity. Collectively, salaries of between \$40,000 and \$65,000 accounted for 42% of reported salaries. *Id.*

there will be strong financial pressures on students to get a top job, and the race to Princeton Law School and its guaranteed ticket to a top job will continue to intensify.

Empirical studies have confirmed the existence of these pressures. For instance, the Law School Admissions Council's (LSAC) landmark Longitudinal Bar Passage Study asked students entering law school in 1991 to assess how important sixteen different factors were in choosing their law school. The most important factor, by a considerable margin, was the school's academic reputation.⁹³ The study produced this result even though other factors tend to be more dispositive of a student's future legal and monetary success, such as grades and location.⁹⁴ Nonetheless, a major driving force in the race to Princeton Law School is that businesses and law firms put a high demand on the Princeton Law degree, irrespective of the underlying value of the student holding the degree. However, this phenomenon is simply irrational. Any study of human nature, capacity, talent, ambition, work ethic, or intelligence would show that law students, like any other segment of society, are dispersed along a bell curve. There is no bimodal distribution of these attributes. The bimodal distribution in starting salaries is an arguably cartel-like creation of anti-competitive market forces among large law firms.⁹⁵

⁹³ Sander & Yakowitz, *supra* note 86, at 4.

⁹⁴ *Id.* (noting that matriculation reports from the Law School Admissions Council show that when students are deciding between schools of even modestly different levels of eliteness, ranking tends to drive decisions). See also Wang, *supra* note 78 (noting that the effect of a prestigious degree is not the best indicator of long term success at the undergraduate level either). One well-known study compared the salaries of graduates who earned degrees from top-tier colleges with those of graduates who were accepted by these schools but chose to attend less selective institutions. Stacy Berg Dale & Alan B. Krueger, *Estimating the Payoff to Attending a More Selective College: An Application of Selection on Observables and Unobservables* (Nat'l Bureau of Econ. Research, Working Paper No. 7322, 1999), available at <http://www.nber.org/papers/w7322>. The research found that the two groups of students ended up with similar incomes. *Id.* at 30. It appears that bright students excel no matter where they get their degree. "According to a 2004 University of Pennsylvania study, prestigious degrees are not as valuable at major corporations as they were a generation ago. The study looked at the top executives at Fortune 100 companies in 1980 and 2001. During that time, the percentage of top guns with Ivy League undergraduate degrees dropped by nearly a third, from 14% to 10%, while the percentage who attended other highly ranked schools, such as Williams or Notre Dame, fell from 54% to 42%. Meanwhile, public university graduates soared to nearly 50% from 32%. Meritocracy in corporate America is a good thing, but it doesn't support the notion that whatever you pay for an elite education is worth it." Penelope Wang, *The Real Return on Your College Investment*, CNNMONEY (Apr. 13, 2009, 12:36 PM), http://money.cnn.com/2008/08/20/pf/college/college_price.moneymag/index3.htm.

⁹⁵ The real reasons for the existence of the bimodal dispersion of salaries is another paper in and of itself, but the legal industry could arguably thwart the pressure on the race to Princeton Law School. However, given the current law firm business model, this method of hiring the best academic students from the highest ranking schools is still the best way to conduct business efficiently. The firm is assured of hard working intelligent associates that will get the job done and be profitable for five years, and the transactional cost of selecting for such a student is very low.

In sum, the bimodal salary distribution fuels the demand for enrollment at the top schools regardless of cost, which means that demand will increase even if the costs of a legal education continues to increase. The artificial value placed on the pedigree of law schools in the legal community, combined with the artificial bimodal salary distribution, excessively fuel the race to Princeton Law School and, thus, inflate the value of legal degrees from top law schools.

III. POLITICAL RESPONSE

The aforementioned are the market forces that would lead to an increasing cost of education without the government flooding the system with leverage. However, just as the government responded to an inflating housing market by stepping in to make housing affordable, its response to the increasing cost of education has been to step in and make college affordable for all. To further this end, politicians seem to have a monolithic response to the rising cost of education—making low-cost student loans available in excess—which only serves to flood the market with liquidity and dramatically inflate the price of education. Special interests and the law schools themselves have much to gain financially from putting more leverage in the system, and thus they join the call for more student loans. For example, “the ABA urges Congress and the administration to lift the cap on federal loans to finance law and other professional schools so that all students with talent and desire can attend law school—not only those of economic means.”⁹⁶ Higher tuition requires more loans, which leads to higher tuition and even larger loans. This cycle is the result of transforming a student loan program from a means to help the indigent afford college into a program that gives money to all students regardless of true financial need.

The student loan industry began as a means-tested program whose purpose was to make college affordable for the indigent. The Higher Education Act of 1965⁹⁷ “established Educational Opportunity Grants based on institutions aggressively pursuing students with ‘exceptional financial need.’”⁹⁸ However, the “Guaranteed Student Loan Program (to become the Stafford Loan) was designed to appeal more to middle-income students by providing loan subsidies.”⁹⁹ By 1972, the Higher Education Act was amended to include “postsecondary education” in order to expand aid to students entering junior colleges as well as trade schools and career colleg-

⁹⁶ Weiss, *supra* note 9.

⁹⁷ Higher Education Act of 1965, Pub. L. No. 89-329, 79 Stat. 1219 (1965).

⁹⁸ *Not Just for the Elite: A History of College Student Loans in America*, RANDOM HISTORY (Mar. 15, 2008), <http://www.randomhistory.com/1-50/032loan.html?>

⁹⁹ *Id.*

es.¹⁰⁰ Furthermore, the Middle Income Student Assistance Act¹⁰¹ widened Pell Grant eligibility to the middle class.¹⁰² By 1993, federal programs increased borrowing limits and brought about unsubsidized loans for middle-income students. In 2007, the College Cost Reduction and Access Act¹⁰³ increased the maximum Pell grant award and reduced interest rates on subsidized student loans, capping the loan repayment at 15% of an individual's discretionary income.¹⁰⁴ In addition, there are many tax incentives, like the Hope Credit, Lifetime Learning Credit, and student loan interest deductions, as well as tax-advantaged savings plans like Coverdell Education Savings Accounts and 529 college savings plans that have made it easier to borrow and spend to get an education.¹⁰⁵

Just as the federal government created government-sponsored enterprises like Fannie Mae and Freddie Mac to make housing affordable, it also created the Student Loan Marketing Association (commonly known as Sallie Mae) in 1972 to make education affordable by making more loans available to more people.¹⁰⁶ Although Sallie Mae has been privatized in the past decade, it remains the country's largest originator of federally insured student loans.¹⁰⁷ Sallie Mae makes money by servicing loans and borrowing money at a low interest rate and then lending to students at a higher rate.¹⁰⁸ Furthermore, just as Fannie Mae and Freddie Mac were used as a backstop against risky home loans, Congress used Sallie Mae to guarantee lenders a 9.5% return on loans in the 1980s, a time when the economy was sour and the cost of making student loans was soaring.¹⁰⁹ This government-backed guarantee increased leverage in the system when the normal market forces signaled to lenders that it was not profitable to make such risky loans without higher interest rates. Had market forces gone unrestrained, lending would have decreased, which would have reduced the total amount students could borrow.

The perennial creation and expansion of student loan programs merely flooded the education system with leverage and led to even more inflation.

¹⁰⁰ *Id.*

¹⁰¹ Middle Income Student Assistance Act, Pub. L. No. 95-566, 92 Stat. 2402 (1978).

¹⁰² *Not Just for the Elite*, *supra* note 98.

¹⁰³ College Cost Reduction and Access Act, Pub. L. No. 110-84, 121 Stat. 784 (2007).

¹⁰⁴ AM. ASS'N OF UNIV. WOMEN, *Improve Access to Higher Education* (Jan. 2008), available at www.aauw.org/act/issue_advocacy/upload/AAUWHEArecs.pdf.

¹⁰⁵ Liz Pulliam Weston, *The Real Reasons College Costs So Much*, MSNMONEY (Sept. 10, 2010) (on file with author).

¹⁰⁶ *About Us*, SALLIE MAE, www.salliemae.com/about/ (last visited Mar. 24, 2011).

¹⁰⁷ *SLM Holding Corp.*, FUNDING UNIVERSE, <http://www.fundinguniverse.com/company-histories/SLM-Holding-Corp-Company-History.html> (last visited Mar. 24, 2011).

¹⁰⁸ *Id.*

¹⁰⁹ Kelly Field, *Sallie Mae Received \$22-Million in Excess Subsidies, Audit Finds*, THE CHRONICLE OF HIGHER EDUCATION (Aug. 3, 2009), www.chronicle.com/article/Sallie-Mae-Received-Millions/47923/.

Two-thirds of American students now borrow money to pay for their college education.¹¹⁰ In the 2008–2009 academic year, the amount of money borrowed by students grew about 25% over the previous year to reach \$75.1 billion.¹¹¹ According to estimates by the Office of Management and Budget, the balance of all outstanding U.S. student loans is \$730 billion as of 2010.¹¹²

The increased amount of loan money has only exacerbated the rising cost of education because student loan programs: (1) reduce the real “pocket book” cost of education; (2) eliminate credit risks of the borrowers; and (3) create both moral hazards and negative externalities. All of these factors increase the amount of money students are able and willing to borrow, which fuels the increasing cost of education.

A. *The “Real” Cost of Education*

If people are not feeling the real cost of their purchases, they have less incentive to change their behavior.

If you are paying the full tab for school out of pocket and [Princeton Law School] increases its rates 10%, you might opt for the [University of Illinois].¹¹³ If enough others followed your lead, [Princeton Law School] might rethink its price hikes.¹¹⁴ However, with the help of student loans, [Princeton Law School] only needs to boost your financial aid package by 8% or so, and you will complain but stay put.¹¹⁵

This is because the “real” or “present” or “out-of-wallet” price at Princeton Law School is not increasing. When students can borrow money to pay for something, they are more willing to pay a higher price simply because they can without additional, immediately-realized consequences. In this case, the politically-created excessive leverage in the system does not affect the out-of-pocket expense that a student pays for college. It is more likely that out-of-pocket expenses for education have decreased in the past thirty years, just as they did in the housing market bubble when no-down-payment loans were made available.

¹¹⁰ Lewin, *supra* note 6. See also Scott Cohn, *Student Loans Leave Crushing Debt Burden*, CNBC TV ON MSNBC (Dec. 21, 2010, 7:39 PM), http://www.msnbc.msn.com/id/40772705/ns/business-cnbc_tv/ (“Two-thirds of American college students will graduate with a sizeable debt; for the class of 2009, the average debt was \$24,000.”).

¹¹¹ Chaker, *supra* note 7.

¹¹² Mark Kantrowitz, *Total College Debt Now Exceeds Total Credit Card Debt*, FASTWEB (Aug. 11, 2010), <http://www.fastweb.com/financial-aid/articles/2589-total-college-debt-now-exceeds-total-credit-card-debt>.

¹¹³ Weston, *supra* note 105.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

As explained above, when a homeowner has \$10,000 to spend on a house and the bank requires a 20% down payment, the homeowner can only buy a \$50,000 house. But when the bank only requires 3% down the homeowner can buy a \$330,000 house with the same out-of-pocket expense. The same principle applies to student loans. If a student can borrow the entire cost of her tuition and living expenses from the government, usually at a low, fixed interest rate, the present day out-of-pocket cost of education is in effect non-existent and there is no natural market force to keep costs down. Students will borrow as much as they believe they need.

B. *Moral Hazards Caused by Eliminating the Credit Risks*

Excessively cheap credit is made available by the government to almost all applicants without concern for their potential ability to repay the debt. This is the same phenomenon witnessed in the housing market which eliminated the lenders' natural desire to screen potential borrowers based on the credit risk the borrower may pose. This phenomenon occurs because politicians declare that the government must "make sure that loans will be available regardless of the credit markets" or the creditworthiness of the borrowers.¹¹⁶ There is also no distinction made between the ability to repay the loan based on a student's major, earning potential, or declared career goals.

Eliminating this credit risk creates a moral hazard, which is most prevalent in the for-profit colleges but is by no means limited to them.¹¹⁷ Mortgage loans in the housing market and student loans in the for-profit college case were made to people who were at high risk of defaulting, and in both cases rating agencies (credit-rating agencies in the case of the housing market, college accreditation agencies in the case of colleges), were afflicted with a conflict of interest because they were paid by the institutions whose securities (in the case of the banks) or educational programs (in the case of the colleges) they were rating.¹¹⁸

As long as student loans are made without any analysis of ability to repay, more and more money will flood the system and inflate the prices. Furthermore, because Stafford Student Loans are guaranteed by the full faith and credit of the U.S. Government, they can be offered at a lower interest rate than the borrower would otherwise be able to obtain through a

¹¹⁶ Lewin, *supra* note 6.

¹¹⁷ One author has documented the uncanny resemblance between the financial situation of for-profit colleges and that of banks before the collapse. See Steve Eisman, *Subprime Goes to College*, N.Y. POST (June 6, 2010, 4:54 AM), http://www.nypost.com/p/news/opinion/opedcolumnists/subprime_goes_to_college_FeiheNJfGYtoSwm tl5etJP.

¹¹⁸ See *id.*

private loan. Any time the government guarantees a loan, the lender no longer needs to concern themselves with the full risk of default and is willing to make loans regardless of the borrower's ability to repay.

A final factor that affects the credit risk associated with a student loan is the threat that the loan will be discharged if the borrower has to declare bankruptcy. However, after the passage of bankruptcy reform in 2005,¹¹⁹ student loans, public and private, are not discharged during bankruptcy, which decreases the risk for the lender.¹²⁰ In lobbying for the Bankruptcy Reform Bill, Scott Talbott of the Financial Services Roundtable declared "[i]f private student debt can be discharged in bankruptcy, that creates risk, and the result will increase the cost of tuition."¹²¹ This is not true, as removing the risk of default is what increases the cost of tuition. Eliminating the threat of discharge via bankruptcy decreases the rate of interest lenders are willing to receive and increases the amount lenders are willing to loan, which increases the size of loans students receive, thereby adding more money to the system and increasing the price of tuition.¹²²

C. *Negative Externalities, Prisoner's Dilemmas and Corruption*

The elimination of risks to lenders has flooded the student loan market with money and caused the great inflation in law school tuition. But one more factor that increases the cost of tuition for all students is a classic prisoner's dilemma where students individually acting in their best interest results in the worst scenario for all. That is, students are merely being rational actors within the system they are operating in based upon the information they are given. Although law schools trumpet average or median starting salaries at about \$80,000 a year, most lawyers make between about \$40,000 a year and \$60,000 a year, and this statistic has held constant for many years.¹²³ Students are simply making rational investment decisions based on misrepresented employment statistics and the relatively low out-of-pocket cost of attending law school. However, when every student makes this independent rational decision, the system is flooded with money and tuition naturally inflates due to students' increasing ability to borrow money to cover tuition costs.

¹¹⁹ Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8, 119 Stat. 23 (2005).

¹²⁰ Christine Dugas, *College Graduates Struggle to Repay Student Loans*, USA TODAY (May 12, 2009), www.usatoday.com/money/perfi/college/2009-05-12-student-loan-debt-bankruptcy_N.htm.

¹²¹ *Id.*

¹²² *Id.* "Sen. Dick Durbin, D-Ill., says he plans to re-introduce a bill that stayed in the Judiciary Committee last year. It would turn back the 2005 change in bankruptcy law and allow private student loans to be discharged."

¹²³ Sam Glover, *The Law School Bubble is about to Burst*, MINN. POST (Dec. 16, 2009), http://www.minnpost.com/samglover/2009/12/16/14327/the_law_school_bubble_is_about_to_burst.

A final effect of so much money now flowing through the education system that deserves mention is the inevitability that universities will become complicit in corruption, just as mortgage brokers were in the housing bubble. In fact, in 2007, the Attorney General of New York State, Andrew Cuomo, led investigations that found that universities steered student borrowers to preferred lenders, which resulted in those borrowers incurring higher interest rates.¹²⁴ Some of these preferred lenders allegedly rewarded university financial aid staff with kickbacks.¹²⁵ Cuomo's investigations led to changes in lending policy at many major American universities and the return of millions of dollars in fees to affected borrowers.¹²⁶

IV. SOLUTIONS

This article merely seeks to shine the light on the federal government's excessive lending practices and proffer some ideas that may help curb the problem.

A. *Means Testing*

As of 2010, nearly all students are eligible for unsubsidized loans regardless of demonstrated need.¹²⁷ Under the Stafford Loan Program, undergraduates who are dependents of their parents still have access to \$31,000 in subsidized and unsubsidized loans over the course of four years.¹²⁸ Undergraduates who are not dependents have access to a total of \$57,500 in loans over the course of a four-year program.¹²⁹ Graduate and professional students have access to \$138,500 in loans from the federal government.¹³⁰ Students engaged in specialized training requiring "exceptionally high costs of education," namely medical students, have access to \$224,000 in cumulative Stafford loans.¹³¹ The federal government may now also issue PLUS

¹²⁴ Jonathan D. Glater, *Marketing Code for Student Lenders*, N.Y. TIMES (Sept. 9, 2008), <http://www.nytimes.com/2008/09/10/business/10loan.html>.

¹²⁵ *Id.*

¹²⁶ Kareem Fahim, *Cuomo Names Developers of a Student Loan Center*, N.Y. TIMES (Dec. 31, 2010), <http://www.nytimes.com/2011/01/01/nyregion/01student.html>.

¹²⁷ Unsubsidized loans are loans in which the interest rates accrue on the principal while the student is still attending school. Subsidized loans are loans in which the government pays the interest and thus the interest charges do not accrue on the principal while the student is in school.

¹²⁸ *Federal Stafford Loan Program*, C. ZONE, http://www.collegezone.com/studentzone/416_933.htm (last visited Mar. 24, 2011). This statement is true as of 2010.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ Mark Kantrowitz, *Student Loans*, FIN. AID, <http://www.finaid.org/loans/studentloan.phtml>.

loans to the parents of an undergraduate student or to a graduate student usually in an amount to cover any gap in the cost of education and apparently without any cumulative loan limits.¹³² Furthermore, in addition to Stafford loans and PLUS loans, Perkins loans are awarded to undergraduate and graduate students with exceptional financial need with cumulative limits of \$27,500 for undergraduate loans and \$60,000 for undergraduate and graduate loans combined.¹³³

Given the amount of student loans currently outstanding, one solution is to conduct a means test prior to granting a loans. As of 2010, 25% of subsidized Stafford loans were awarded to students whose families' adjusted gross income was greater than \$50,000, and about 10% of subsidized loans were given to students whose combined family income was over \$100,000.¹³⁴ Even if a student does not qualify for subsidized loans because of the adjusted gross income of their parents, they are still eligible for unsubsidized government loans and private loans. Given these numbers, which may actually undercount the percentage of loans to higher income families, a better program would be grants limited to those with family income under \$50,000 in combination with tuition caps and progressive tuition rates based on a family's income.

B. *Tuition Caps*

Another solution to the problem is to simply cap tuition. Most states could do so, as a majority of universities and some law schools are public universities. For instance, Maryland State Senator Jim Rosapepe has introduced legislation that would tie undergraduate tuition increases to median family income in the state.¹³⁵ In addition, California's Senate Education Committee is considering a bill, SB 969, also known as the California College and University Stabilization Act of 2010, in which the budget would forbid four-year state colleges from raising tuition by more than 4%.¹³⁶ Yet university officials are protesting these caps stating that "[i]f we continue to enroll the same number of students as we have in the past, we risk affecting

¹³² See Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8005(c), creating the Graduate and Professional Student PLUS Loan.

¹³³ Kantrowitz, *supra* note 131.

¹³⁴ *Subsidized and Unsubsidized Stafford Student Loans*, COLL. SCHOLARSHIP ESSENTIALS (Feb. 21, 2011), <http://www.collegescholarshipessentials.com/college-grants-and-loans/subsidized-and-unsubsidized-stafford-student-loans>.

¹³⁵ Daniel de Vise, *Lawmaker Proposes Maryland Tuition Cap*, WASH. POST, (March 23, 2010, 4:20 PM), http://www.voices.washingtonpost.com/college-inc/2010/03/lawmaker_proposes_maryland_tui.html.

¹³⁶ S.B. 969, 2009-2010 Sess. (Cal. 2010), available at http://info.sen.ca.gov/pub/09-10/bill/sen/sb_0951-1000/sb_969_bill_20100205_introduced.pdf.

the quality of education for our current students.”¹³⁷ Although tuition caps could not be the sole solution to the student loan bubble, it is one facet worth exploring at this point.

C. *Progressive Tuition Rates*

Another possible solution to the rising cost of education is progressive tuition policies. A university or law school could charge tuition based upon 10% of the student’s family income. In this regime, the student from a family that made \$50,000 a year would pay \$5,000 a year in tuition, whereas the student from the family with an income of \$1 million would pay \$100,000 a year. In England, one influential think tank has suggested that the interest rates on student loans be linked to the family’s income.¹³⁸ Alternatively, a university could charge tuition based upon the student’s future income. Under that program, a student would pay the university 2% of their salary for twenty years. American policy makers flirt with the idea of progressive tuition rates but the implemented policies have not put significant downward pressures on the price of education. That is, instead of setting a progressive tuition scale like a progressive tax scale, in which those with lesser means pay a smaller percentage of their salary for tuition, the American education system subsidizes those that cannot afford education with grants and loans that simply funnel more money into the education system.

D. *Expansion and Mergers*

It is clear that part of the structural problem that leads to the inflation of law school tuition and elite undergraduate tuition is the name associated with the degree. The prestigious law schools and universities in America have made no effort to expand their class size as the number of qualified students has increased over the years. Sixty years ago, something slightly better than a gentleman’s C would suffice to enroll at a top tier law school. Today, applicants to top law schools have become dramatically more competitive, and typically have spectacular undergraduate records and LSAT scores in the ninety-ninth percentile. However, expansion of elite universities and law schools does not seem to be an option for the very reason that they are conspicuously consumed goods. For instance, Ronald Ehrenberg documents that Cornell’s trustees set 3,000 as the target number of fresh-

¹³⁷ *Id.* (quoting Nina Robinson, University of California Director of Student Policy).

¹³⁸ Graeme Paton, *Student loans 'should be linked to income'*, THE TELEGRAM (Aug. 26, 2009, 7:01 AM), www.telegraph.co.uk/education/6089141/Student-loans-should-be-linked-to-income.html.

man for many years,¹³⁹ and they will not expand the number of entering freshman because it would reduce selectivity.¹⁴⁰ As Ehrenberg points out regarding expansion through distance learning, “[i]t would be suicide for selective universities to do anything in the distance learning arena that depreciates the value of their core residential education programs.”¹⁴¹ Nonetheless, top law firms recruit almost exclusively at top law schools creating a bimodal salary curve for law graduates. Since this salary curve fuels the race to the top schools, which in turn pushes tuition prices up, it seems like one logical way to temper the cycle is to expand the enrollment at the top universities. Such a change would increase the supply of spots at top universities and should therefore reduce the cost of tuition.

E. *Other Remedies*

There have been many other proposals to limit the rising cost of tuition. Some suggest reducing administrative costs through eliminating the Free Application for Federal Student Aid (FAFSA) and using IRS data already on record.¹⁴² Other suggestions include a state income tax credit for students attending colleges that limit tuition increase rates to the rate of increase for the U.S. Urban Consumer Price Index (CPI), or issuing Pell Plus Grants to schools that keep their annual net tuition increases at a rate equal to, or below the Higher Education Price Index (HEPI), and giving students and their families access to accurate information about the school.¹⁴³ One politician has suggested the expansion of volunteer programs that help students pay for college if they commit themselves to national service.¹⁴⁴ However, other proposals do nothing to reduce the amount of leverage in the system; instead they merely replace the source of the leverage. Suggestions that employers should fund 529 tax savings plans and that states should establish community foundations for scholarships¹⁴⁵ would do nothing to reduce the amount of money in the system and, thus, would not reduce the cost of education.

¹³⁹ EHRENBURG, *supra* note 17, at 171.

¹⁴⁰ *Id.* at 177.

¹⁴¹ *Id.* at 206.

¹⁴² Robert C. Dickerson, *Collision Course: Rising College Costs Threatens America's Future and Requires Shared Solutions*, LUMINA FOUND. FOR EDUC. (2004), available at <http://www.luminafoundation.org/publications/CollisionCourse.pdf>.

¹⁴³ *Id.*

¹⁴⁴ Ian Jannetta, *Biden Courts D.C. Jews*, GEO. WASH. HATCHET (Sept. 25, 2008), <http://media.www.gwhatchet.com/media/storage/paper332/news/2008/09/25/News/Biden.Courts.D.c.Jews-3452278.shtml>.

¹⁴⁵ *Id.*

CONCLUSION

The balance of all outstanding student loan debt continues to grow at a fast pace.¹⁴⁶ There does not seem to be any end to the continuing inflation of the cost of college. The college inflation paradigm follows the same paradigm of the housing bubble: there are specific identifiable market forces that cause the higher education market to inflate faster than the normal rate of inflation. Further, politicians respond to the inflation by creating programs that loan money to students so that they can afford higher education at the inflated prices. This involvement injects excessive leverage into the markets and exacerbates the problem by disrupting the market's homeostasis regulation mechanism.

The main reason education costs have outpaced inflation, with or without the addition of leverage, is because the education market in America exhibits inelastic demand due to our society's reverence of a university's rankings. A prime example of this phenomenon is law school, a conspicuously consumed luxury good where graduates' salaries are distributed along a bimodal salary distribution. Law schools continuously initiate various projects that would facilitate a competitive and improving national ranking. The costs of these projects result in a steady rise in tuition that would outpace inflation; however, the forces driving up the cost of tuition are accelerated when politicians attempt to make education affordable by making student loans widely available. The political response to the increasing cost of education has been to create program after program that pours more leverage into an already over-leveraged system. The result of these programs is no different from the government's involvement in housing bubble, and the consequences from the student loan bubble could be just as disastrous.

¹⁴⁶ Kamenetz, *supra* note 15.

WITH THE PASSAGE OF THE FAMILY SMOKING PREVENTION AND
TOBACCO CONTROL ACT, WILL COMMERCIAL SPEECH RIGHTS
BE UP IN SMOKE?

*Laura M. Farley**

INTRODUCTION

Advertising makes up an overwhelming portion of the tobacco industry.¹ Society has always considered cigarettes and other tobacco products a luxury good—something that man does not need.² Because tobacco products are not vital to survival, or even something most people would consider essential, tobacco companies must create demand where none existed before.³ To generate demand, tobacco companies spend nearly 15% of the price of each pack of cigarettes sold in the United States, on advertising.⁴ This percentage is high even compared to companies in traditional advertising intensive industries such as the Proctor & Gamble Company (about 10% of sales), Nike, Incorporated (about 9% of sales) and General Motors Company (about 2% of sales).⁵

Through the Family Smoking Prevention and Tobacco Control Act (FSPTCA), Congress gave the Food and Drug Administration (FDA) the right and ability to regulate tobacco products—what is in the package; what is on the package; and what is said about the products in advertisements.⁶ Until the passage of the FSPTCA, federal laws governing cigarettes and other tobacco products dispersed regulatory authority across several administrative agencies, excluding the FDA. The primary purposes of the federal regulatory laws prior to FSPTCA were to regulate advertising and prohibit false or misleading statements. None of these laws went nearly as far as the FSPTCA does in restricting the commercial speech rights of companies. Today, the FDA not only has the authority to regulate many aspects of ciga-

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¹ See TARA PARKER-POPE, CIGARETTES: ANATOMY OF AN INDUSTRY FROM SEED TO SMOKE 74 (2001).

² *Id.* at 73.

³ *Id.* (citing GERARD S. PETRONE, TOBACCO ADVERTISING: THE GREAT SEDUCTION 34 (1996)).

⁴ *Id.* at 74.

⁵ *Id.*

⁶ Family Smoking Prevention and Tobacco Control Act, Pub. L. No. 111-31, § 2, 123 Stat. 1776, 1776-81 (2009).

rettes and tobacco product ingredients,⁷ but now FDA may also regulate advertisements for these products—a subject that traditionally fell under the Federal Trade Commission’s (FTC) authority.⁸ When the United States House Committee on Energy and Commerce considered the FSPTCA, several members of Congress expressed fears that it would end commercial speech rights for tobacco companies.⁹

First, this comment provides a history of local, state, and federal government attempts to regulate tobacco advertising; including the FDA’s 1996 Regulations, the cases that sprung from the 1996 Regulations, and similar state and local regulations. Second, this comment provides a background on the commercial speech doctrine. Third, this comment gives a brief overview of certain FSPTCA provisions and regulatory history, along with legal and industry reactions to the Act. Finally, this comment analyzes the Act’s First Amendment implications, predicts the likely outcome of pending litigation, and suggests how the FDA and Congress may achieve similar goals without violating tobacco companies’ commercial speech rights.

I. HISTORY OF FDA AND TOBACCO REGULATION

A. *U.S. History of Federal, State and Local Governmental Tobacco Regulation*

The Centers for Disease Control and Prevention (CDC) estimates that 19.8% of U.S. adults (approximately 43 million people) are cigarette smokers.¹⁰ Additionally, the CDC estimates that 19.8% of U.S. high school students are cigarette smokers.¹¹ Cigarette smoking is the leading preventable cause of death in the United States, accounting for about one out of every five deaths annually.¹² According to the Institute of Medicine (IOM),¹³ smoking-related deaths account for more deaths than AIDS, alcohol, co-

⁷ C. STEPHEN REDHEAD & VANESSA K. BURROWS, *FDA REGULATION OF TOBACCO PRODUCTS: A HISTORICAL, POLICY, AND LEGAL ANALYSIS*, *FDA REGULATION OF TOBACCO PRODUCTS* 3 (Victoria C. Lockwood ed., 2009).

⁸ *Id.*

⁹ See H.R. REP. NO. 111-58 pt. 1, at 103-04 (2009), *reprinted in* 2009 U.S.C.C.A.N. 468, 502 [hereinafter *FSPTCA House Committee Report*]; *see also* discussion of commercial speech doctrine *infra* Part II.

¹⁰ *Id.* at 2, *reprinted in* 2009 U.S.C.C.A.N. at 469.

¹¹ *Id.*

¹² *Id.*; *see also* FRED H. DEGNAN, *FDA’S CREATIVE APPLICATION OF THE LAW: NOT MERELY A COLLECTION OF WORDS* 149 (2d ed. 2006).

¹³ IOM is a non-profit component of the National Academy of Science with a stated mission of serving as an adviser to improve the health of the nation. About, INST. OF MED., <http://www.iom.edu/About-IOM.aspx> (last updated Apr. 7, 2011).

caine, heroin, homicide, suicide, motor vehicle crashes, and fires combined.¹⁴

1. Federal Cigarette Labeling and Advertising Act¹⁵

In the spring of 1964, the FTC conducted rulemaking proceedings which determined that many cigarette advertisements were deceptive or untrue, and that tobacco companies should be required to attach warnings to all advertisements and on every pack, box, carton or other container of cigarettes.¹⁶ FTC's new regulations would require all tobacco products sold after January 1965, and all advertisements starting in June 1965, to include the warning "Smoking is Dangerous to Health. It May Cause Death from Cancer and Other Diseases."¹⁷

The tobacco industry was displeased and lobbied Congress to intervene.¹⁸ The result of Congress's intervention was the Federal Cigarette Labeling and Advertising Act (FCLAA).¹⁹ Under the FCLAA, Congress reserved jurisdiction over the regulation of cigarettes.²⁰ One FCLAA provision allowed the Federal Communications Commission (FCC) to regulate cigarette advertising.²¹ In 1967, when the FCC began regulating cigarette advertising, it applied the "Fairness Doctrine."²² Under the Fairness Doctrine,²³ broadcasters had "to air one anti-smoking commercial for every three to four tobacco advertisements."²⁴

¹⁴ FSPTCA House Committee Report, *supra* note 9, at 2.

¹⁵ Federal Cigarette Labeling and Advertising Act, Pub. L. No. 89-92, 79 Stat. 282 (1965) (codified as amended at 15 U.S.C. §§ 1331-1340 (1970)).

¹⁶ David A. Rienzo, *About-Face: How FDA Changed Its Mind, Took on the Tobacco Companies in Their Own Back Yard, and Won*, 53 FOOD & DRUG L.J. 243, 246 (1998); Christine P. Bump, *Close But No Cigar: The WHO Framework Convention on Tobacco Control's Futile Ban on Tobacco Advertising*, 17 EMORY INT'L L. REV. 1251, 1275 (2003).

¹⁷ Rienzo, *supra* note 16, at 246.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ Richard Waters, *The FDA: It's Not Just About Tobacco*, 52 J. MO. B. 231, 231 (1996) (citing Claudia MacLachlan, *FDA Draws First in Tobacco Wars*, NAT'L L.J., Aug. 28, 1995, at A1); *see also* FRED C. PAMPEL, TOBACCO INDUSTRY AND SMOKING 75-76 (1st ed. 2004).

²¹ Bump, *supra* note 16, at 1276.

²² Jennifer Costello, Note & Comment, *The FDA's Struggle to Regulate Tobacco*, 49 ADMIN. L. REV. 671, 677 (1997) (citing Fairness Doctrine & Public Interest Standards, 39 Fed. Reg. 26,372, 26,374 (July 18, 1974)).

²³ The Fairness Doctrine was originally enunciated in 1929 by the Federal Radio Commission and evolved over the next forty years. The doctrine required that "those given the privilege of access hold their licenses and use their facilities as trustees for the public at large," which came with the obligation to provide an equal opportunity to opposing sides to air their views. *In re Public Issues Under the Fairness Doctrine and the Public Interest Standards of the Communications Act*, 30 F.C.C. 2d 26, 27 (1971). In 1968, the D.C. Circuit Court held that advertisements must count as expressions covered by

While the FCLAA required a health warning to appear on cigarette packages, it “barred such a warning on and in advertisements for cigarettes. Under Section 4 of the FCLAA, it became unlawful to sell or distribute any cigarettes in the United States that did not bear a conspicuous label stating, ‘CAUTION: CIGARETTE SMOKING MAY BE HAZARDOUS TO YOUR HEALTH.’”²⁵ Over the next two decades, Congress made changes to the FCLAA allowing for stronger warnings and granting enforcement authority to the FTC.²⁶

2. Enforcement Through Litigation: The Master Settlement Agreement

While Congress was regulating tobacco advertising through the FCLAA, consumers sought their own form of regulation through nearly fifty years of litigation.²⁷ These lawsuits began with claims brought by smokers and their families seeking to recover the costs of tobacco-related illnesses and deaths, usually based on tort claims.²⁸ For a number of reasons, including limited medical knowledge in the earlier cases and the hostility juries felt toward plaintiffs who blamed others for the consequences of their own decision to smoke, most of these claims failed.²⁹

In 1993, Mississippi was the first state to file a lawsuit against the tobacco companies, trying a different form of attack.³⁰ Mississippi avoided the stumbling blocks which stopped consumers from successfully litigating against tobacco manufacturers by using a novel legal theory: states should be able to recover the costs of treating diseases and illnesses caused by cigarette smoking, based on Medicaid expenses attributed to tobacco use.³¹

By 1998, more than forty states filed lawsuits against the four major American tobacco companies, seeking monetary damages and equitable and injunctive relief for violating consumer protection laws, and interfering

the Fairness Doctrine because of their profound effect on consumer consciousness. *Banzhaf v. FCC*, 405 F.2d 1082, 1098-99 (D.C. Cir. 1968).

²⁴ Costello, *supra* note 22, at 677.

²⁵ Bump, *supra* note 16, at 1275 (citing Lawrence A. Schemmel, *Cigarette Litigation and Products Liability: Did Someone Win the War or Have the Battle Lines Just Been Drawn?*, 14 MISS. C. L. REV. 657, 667 (1994); *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 514 (1992)).

²⁶ Rienzo, *supra* note 16, at 247.

²⁷ Bump, *supra* note 16, at 1279.

²⁸ *Id.* at 1279-82.

²⁹ *Id.* at 1280.

³⁰ *Id.* at 1282.

³¹ *Id.*

with the states' ability to further public health goals.³² Due to these lawsuits, all fifty states and the major American tobacco companies (Brown and Williamson Tobacco Corporation, Lorillard Tobacco Company, Philip Morris Incorporated, and R.J. Reynolds Tobacco Company), together with their subsidiaries, signed the Master Settlement Agreement (MSA).³³

The MSA did not shield these companies from suits brought by individuals, but it addressed what duties these companies owed to the states.³⁴ Under the MSA, states received \$260 billion over twenty-five years to compensate their costs of treating tobacco-related illnesses.³⁵ The signing tobacco companies also agreed to finance nationwide anti-smoking programs aimed at informing American youths of the dangers of smoking.³⁶ Money paid under the MSA established a national foundation to combat youth tobacco use.³⁷ The foundation's two primary purposes were (1) to conduct research on and create programs to reduce youth tobacco product usage, and (2) to prevent diseases associated with tobacco product use.³⁸

1. City of Baltimore, Maryland Regulations

In 1994, the City of Baltimore, Maryland, enacted comprehensive regulations prohibiting billboard advertisements for alcoholic beverages and cigarettes in most "publicly visible locations."³⁹ The regulations banned billboard advertisements for cigarettes and alcoholic beverages in the city except along certain interstate highways in heavily industrialized areas, and near major sports arenas.⁴⁰ At the time, and for many years after, Baltimore's regulations were seen as "an impenetrable model that other state and local governments should adopt" because they were upheld by both the United States District Court for the District of Maryland and the United States Court of Appeals for the Fourth Circuit.⁴¹

³² *Id.* at 1283; *see also* Master Settlement Agreement [hereinafter MSA] at 1-2, *available at* http://www.naag.org/backpages/naag/tobacco/msa/msa-pdf/MSA%20with%20Sig%20Pages%20and%20Exhibits.pdf/file_view (last modified Mar. 4, 2010).

³³ Bump, *supra* note 16, at 1283.

³⁴ *Id.* at 1283-84.

³⁵ *Id.* at 1283.

³⁶ *Id.*

³⁷ MSA, *supra* note 32, at 41.

³⁸ *Id.*

³⁹ Michael Clisham, Commercial Speech, Federal Preemption, and Tobacco Signage: Obstacles to Eliminating Outdoor Tobacco Advertising, 36 URB. LAW. 713, 734 (2004) (citing BALT., MD. ORDINANCE NO. 301 (1994)).

⁴⁰ Donald Garner & Richard Whitney, Protecting Children From Joe Camel and His Friends: A New First Amendment and Federal Preemption Analysis of Tobacco Billboard Regulation, 46 EMORY L.J. 479, 482 (1997).

⁴¹ Clisham, *supra* note 39, at 734; *see* discussion of cases *infra* Part I.C.

One significant difference between Baltimore's regulations and other regulations, such as the FSPTCA, is the scope of the restrictions. The Baltimore ordinance prevents outdoor advertisements in locations that "most directly affect minors where they live, attend school, attend church and engage in recreational activities," but still provides an important exception protecting legitimate business activities.⁴² The ordinance exempts "certain designated business and industrial zones . . . with reasonable and appropriate setback from adjoining zones."⁴³ Additionally, the ordinances do not apply to signs containing a generic product description, on-site advertisements by premises authorized to sell the products, and signs adjacent to an interstate highway.⁴⁴

2. Massachusetts Regulations

In early 1999, the Attorney General for the Commonwealth of Massachusetts promulgated regulations governing the advertisement and sale of cigarettes.⁴⁵ The purpose of the regulations were "to eliminate deception and unfairness in the way cigarettes and smokeless tobacco products are marketed, sold and distributed in Massachusetts in order to address the incidence of cigarette smoking and smokeless tobacco use by children under legal age . . . [and] . . . to prevent access to such products by underage consumers."⁴⁶

The Massachusetts regulations made it an "unfair or deceptive practice" to place advertisements outdoors, in enclosed stadiums, or inside an establishment in such a way that the advertisement is visible from outside, within a 1,000-foot radius of a public playground, playground in a public park, elementary or middle school.⁴⁷ Additionally, any point-of-sale⁴⁸ advertisement placed within five feet of the floor of an establishment located within a 1,000-foot radius of a public playground, playground in a public park, elementary school or middle school is an "unfair or deceptive practice."⁴⁹ The only exception to these regulations was that retailers may place a single sign, no larger than 576 square inches, (approximately two feet,

⁴² Garner & Whitney, *supra* note 40, at 585 n.10.

⁴³ *Id.* (citing BALT., MD. ORDINANCE NO. 301).

⁴⁴ Clisham, *supra* note 39, at 735-36.

⁴⁵ Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 532 (2001).

⁴⁶ 940 MASS. CODE REGS. 21.01 (LexisNexis 2000).

⁴⁷ 940 MASS. CODE REGS. 21.04(5)(a) (LexisNexis 2000).

⁴⁸ "Point-of-sale" is generally defined as "any location at which a consumer can purchase or otherwise obtain cigarettes or smokeless tobacco for personal consumption." 940 MASS. CODE REGS. 21.03 (LexisNexis 2010).

⁴⁹ 940 MASS. CODE REGS. 21.04(5)(b) (LexisNexis 2000).

squared) stating in black text on a white background “Tobacco Products Sold Here” on the outside of their store.⁵⁰

B. *History of FDA’s Attempts to Regulate Tobacco*

1. Early History—FDA Denies the Ability to Regulate Tobacco

Despite no mention of tobacco, the United States Department of Agriculture’s Bureau of Chemistry (BOC), the FDA’s predecessor, interpreted the Pure Food and Drugs Act of 1906 (1906 Act)⁵¹ to give the BOC the authority to regulate tobacco products as long as the product’s labeling indicated a use for “the cure, mitigation or prevention of a disease.”⁵² In 1914, the BOC proclaimed that tobacco was beyond its reach and it could not regulate it as a drug because tobacco companies did not label their products as therapeutic agents.⁵³ That same year, Congress failed in an attempt to give the BOC explicit authority to regulate tobacco.⁵⁴

In the 1906 Act, drugs were defined as “all medicines or preparations recognized in the United States Pharmacopoeia or National Formulary.”⁵⁵ The 1890 edition of the United States Pharmacopoeia (USP)⁵⁶ listed tobacco as a drug, but it dropped tobacco in later editions, prior to the passage of the 1906 Act.⁵⁷ Some people speculated that the USP dropped tobacco as a drug to ensure support for the passage of the 1906 Act from the tobacco-growing states.⁵⁸ However, nicotine remains listed in the USP, possibly providing a justification for the FDA to claim authority to regulate cigarettes as drug delivery devices even before Congress granted it the explicit right to do so.⁵⁹

⁵⁰ 940 MASS. CODE REGS. 21.04(6) (LexisNexis 2000).

⁵¹ Pure Food and Drug Act, ch. 3915, Pub. L. No. 59-384, 34 Stat. 768 (1906).

⁵² DEGNAN, *supra* note 12, at 150 (citing U.S. DEPT. OF AGRIC., BUREAU OF CHEM., 13 SERVICE AND REGULATORY ANNOUNCEMENTS 24 (1914)).

⁵³ Rienzo, *supra* note 16, at 244.

⁵⁴ *Id.*

⁵⁵ *Id.* (citing Pub. L. No. 59-384 § 7, 34 Stat. at 769).

⁵⁶ The United States Pharmacopoeia is a non-governmental, not-for-profit public health organization that publishes the United States Pharmacopoeia-National Formulary (USP-NF) as a guide of standards for prescription medicines, over-the-counter medicines and other healthcare products manufactured or sold in the United States. The standards set include quality, purity, strength and consistency of products. About USP, U.S. PHARMACOPEIA, <http://www.usp.org/aboutUSP/> (last visited Mar. 13, 2011).

⁵⁷ Rienzo, *supra* note 16, at 244.

⁵⁸ *Id.*

⁵⁹ Joseph A. Page, Federal Regulation of Tobacco Products and Products that Treat Tobacco Dependence: Are the Playing Fields Level?, 53 FOOD & DRUG L.J. 11, 31 (1998).

In 1938, Congress replaced the 1906 Act when it passed the Federal Food, Drug, and Cosmetic Act (FDCA),⁶⁰ creating the FDA and expanding the definition of a drug to include, *inter alia*, articles other than food “intended to affect the structure and function of the body.”⁶¹ While neither the language of the FDCA, nor its legislative history mentions tobacco or tobacco products, the FDA continued to assert that it had the authority to regulate any tobacco product when there was sufficient evidence on record to establish that the manufacturer intended its products to treat or prevent disease.⁶² During this time, the FDA did not attempt to regulate any tobacco product that did not claim to treat or prevent any disease.⁶³ In a letter regarding regulation of tobacco products, the FDA said that “without accompanying therapeutic claims, [tobacco products do] not meet the definitions in the [FDCA] for food, drug, device or cosmetic.”⁶⁴

In fact, when the private group Action on Smoking and Health (ASH) filed a citizen petition⁶⁵ requesting that the FDA assert jurisdiction over cigarettes and begin regulating them, the agency refused.⁶⁶ In its response to ASH’s citizen petition, FDA Commissioner Kennedy stated that the FDA consistently interpreted the Act to exclude cigarettes from the definition of a drug unless vendors made health claims.⁶⁷ ASH then filed a lawsuit in federal court challenging the Commissioner’s action.⁶⁸ The district court deferred to the FDA’s interpretation of its governance laws, stating that Congress knew the FDA’s position and could draft legislation providing the FDA with the authority to regulate tobacco products if it wanted to do so.⁶⁹

Over the past eighty years, Congress refrained from giving the FDA jurisdiction over the regulation of advertising or labeling of tobacco or tobacco products.⁷⁰ In fact, until 1995, the FDA itself repeatedly denied it had any jurisdiction over tobacco.⁷¹ Part of this denial of jurisdiction may

⁶⁰ Federal Food, Drug, and Cosmetic Act, Pub. L. No. 75-717, 52 Stat. 1040 (1938) (codified as amended in scattered sections of 21 U.S.C. (2010)).

⁶¹ DEGNAN, *supra* note 12, at 150 (citing 21 U.S.C. § 321(ff)(1); FDCA § 201(g)(1)(C)); Waters, *supra* note 20, at 232.

⁶² DEGNAN, *supra* note 12, at 150.

⁶³ *Id.*

⁶⁴ *Id.* (citing Letter to Dir. of Bureaus & Div., & Dir of Dist. From FDA Bureau of Enforcement (May 24, 1963), reprinted in Public Health Cigarette Amendments of 1971: Hearing on S. 1454 Before the Consumer Subcomm. of the S. Comm. on Commerce, 92d Cong. 240 (1972)).

⁶⁵ Action on Smoking and Health, Citizen Petition, FDA Docket No. 77P-0185-CP1 (May 26, 1977).

⁶⁶ Claudia MacLachlan, *FDA Draws First in Tobacco Wars*, NAT’L L.J., Aug. 28, 1995, at A1.

⁶⁷ *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 152 (2000) (citing Letter from Donald Kennedy, Comm’r, Food & Drug Admin., to John Banzhaf, Exec. Dir., Action on Smoking & Health (Dec. 5, 1977)).

⁶⁸ *Action on Smoking & Health v. Harris*, 655 F.2d 236, 237 (D.C. Cir. 1980).

⁶⁹ *Id.* at 243.

⁷⁰ DEGNAN, *supra* note 12, at 149.

⁷¹ *Id.*

have come from how firmly cigarettes were entrenched in American culture, and from the tobacco industry's powerful influence, making the thought of regulating tobacco products unappealing.⁷² Leading up to the FDA's changed view of tobacco regulation was the nation's changed view of tobacco products.⁷³ In 1985, two Colorado cities, Aspen and Vail, banned smoking in restaurants.⁷⁴ In 1993, the Environmental Protection Agency declared second-hand smoke a carcinogen.⁷⁵ By the end of 1993, 436 cities had smoking restrictions.⁷⁶

In 1990, President Bush appointed David Kessler Commissioner of the FDA.⁷⁷ With a principal goal of "invigorating the agency's enforcement with expanded power and staff," Kessler began asserting the FDA's authority and winning battles against other federal agencies.⁷⁸ In trying to find a way to regulate cigarettes, Kessler made a strategic move in 1994 by sending a letter to Scott Ballin, Chairman of the Coalition on Smoking OR Health,⁷⁹ who persistently sent the FDA citizen petitions requesting that the FDA regulate tobacco products.⁸⁰ The timing of the letter was key—just before ABC News was about to air an exposé on the tobacco industry.⁸¹ Additionally, President Clinton's plan for universal health insurance was faltering, suggesting Kessler would get support from the President.⁸² When the FDA reversed its prior position in 1995, it relied heavily on the broad FDCA interpretation, which it applied to other products, such as drugs and medical devices.⁸³

3. 1995 Proposed Rule & Jurisdictional Analysis

In 1995, the FDA published a proposed rule along with a jurisdictional analysis stating that the FDA believed it had the authority to regulate tobac-

⁷² Laurie McGinley & Timothy Noah, *Lighting a Fire: Long FDA Campaign and Bit of Serendipity Led to Tobacco Move*, WALL ST. J., Aug. 22, 1995, at A1.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ MARTHA A. DERTHICK, *UP IN SMOKE: FROM LEGISLATION TO LITIGATION IN TOBACCO POLITICS* 52 (2d ed. 2005).

⁷⁸ *Id.* at 52-53.

⁷⁹ The Coalition on Smoking OR Health was a public policy project with the National Interagency Council on Smoking and Health, a voluntary association of health, education, and youth leadership organizations concerned with the effect of tobacco use on human health.

⁸⁰ DERTHICK, *supra* note 77, at 54-55.

⁸¹ *Id.*

⁸² *Id.*

⁸³ DEGNAN, *supra* note 12, at 150.

co products under the FDCA.⁸⁴ The FDA's primary purpose for proposing the regulation of tobacco product advertising was not to outright ban tobacco products, but to prevent future generations from nicotine addiction.⁸⁵ To prevent Americans from future tobacco product addiction, the FDA took a three-pronged approach in its regulation: (1) limiting sales and distribution of tobacco products to minors; (2) regulating labeling and advertising of tobacco products to prevent them from being attractive to minors; and (3) requiring tobacco companies to establish and maintain educational programs directed at minors.⁸⁶

Once the FDA decided that it would regulate tobacco, it next needed to decide which regulatory path to use—whether it should classify tobacco as a drug or a medical device.⁸⁷ The FDA shortly realized that it would face great hurdles in trying to regulate tobacco as a drug.⁸⁸ By classifying nicotine as a drug, the FDA managed to classify tobacco products as medical devices that delivered a drug to the bloodstream.⁸⁹

Rather than using its drug control authority which would require the FDA to outright ban cigarettes, the FDA relied on the Medical Device Amendments of 1976⁹⁰ (MDA).⁹¹ By classifying cigarettes as medical devices and then relying on the MDA, the FDA would be able to regulate advertising and sales without requiring tobacco products be shown as safe and effective—the standard for evaluating drugs.⁹²

In recognition of the unique jurisdictional issue of whether the FDA had the right and ability to regulate tobacco products, the FDA released a jurisdictional analysis with the proposed rule.⁹³ In its jurisdictional analysis, the FDA found that: (1) cigarettes and smokeless tobacco products affect the structure and function of the body because they have pharmacolog-

⁸⁴ Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect Children and Adolescents, 60 Fed. Reg. 41,314 (proposed Aug. 11, 1995) (to be codified at 21 C.F.R. pts. 801, 803, 804, and 897); Nicotine in Cigarettes and Smokeless Tobacco Products is a Drug and These Products are Nicotine Delivery Devices Under the Federal Food, Drug, and Cosmetic Act, 60 Fed. Reg. 41,453 (Aug. 11, 1995).

⁸⁵ Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect Children and Adolescents, 60 Fed. Reg. at 41,314.

⁸⁶ *Id.* at 41,315.

⁸⁷ A “drug” is defined, in part, as an “article[] (other than food) intended to affect the structure or any function of the body of man” 21 U.S.C. § 321(g)(1)(c) (2010). A “device” is also an article (other than food) “intended to affect the structure or any function of the body of man . . . and which does not achieve its primary intended purposes through chemical action within or on the body of man” 21 U.S.C. § 321(h) (2010).

⁸⁸ McGinley & Noah, *supra* note 72, at A1.

⁸⁹ *Id.*

⁹⁰ Medical Device Amendments of 1976, Pub. L. No. 94-295, 90 Stat. 539 (1976).

⁹¹ MacLachlan, *supra* note 66.

⁹² *Id.*

⁹³ Notice: Analysis Regarding The Food and Drug Administration's Jurisdiction Over Nicotine-Containing Cigarettes and Smokeless Tobacco Products, 60 Fed. Reg. at 41,453 (Aug. 11, 1995).

ical effects and lead to addiction; (2) tobacco manufacturers intend for their products to have addictive and significant pharmacological effects; and (3) nicotine-containing cigarettes and smokeless tobacco products are drug delivery systems that are appropriately regulated as medical devices.⁹⁴

4. 1996 Final Rule & Jurisdictional Determination

Approximately one year after publishing the proposed rule, the FDA finalized the rule and published a jurisdictional determination explaining, once again, why the FDA believed it had the power to regulate tobacco products.⁹⁵ Citing to the 1996 jurisdictional determination that the agency performed, the FDA declared it “determined that cigarettes and smokeless tobacco are combination products consisting of a drug (nicotine) and device components intended to deliver nicotine to the body.”⁹⁶

One issue arising from the FDA’s final rule was that it was only trying to partially regulate a device—by restricting its advertising while not imposing all FDA restrictions on medical devices.⁹⁷ If the FDA imposed all the medical device restrictions on cigarettes, it would have to outright ban the products because they are known to be harmful without any clinical benefits.⁹⁸ Additionally, by classifying nicotine as a drug and claiming that tobacco products served as the delivery mechanisms, some individuals began to question how cigarettes differed from nicotine patches or nicotine chewing gum; both of which the FDA regulated as drug products, not medical devices.⁹⁹

⁹⁴ *Id.* at 41,460-61.

⁹⁵ Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect Children and Adolescents, 61 Fed. Reg. 44,396 (Aug. 28, 1996).

⁹⁶ *Id.* at 44,400.

⁹⁷ Waters, *supra* note 20, at 231.

⁹⁸ MacLachlan, *supra* note 66.

⁹⁹ *Id.*

C. *Responses to the States' and FDA Attempts to Regulate Tobacco Products*

1. *Penn Advertising of Baltimore v. Mayor of Baltimore*¹⁰⁰ and *Anheuser-Busch v. Mayor of Baltimore*¹⁰¹

Penn Advertising of Baltimore, an advertising company located in Baltimore, Maryland, challenged the Baltimore ordinance banning tobacco advertisements except in limited locations, arguing that it violated the First Amendment and that the FCLAA preempted the ordinances.¹⁰² Anheuser-Busch, Incorporated brought a similar First Amendment challenge to the Baltimore ordinance in the same court.¹⁰³ In both cases, Baltimore won its summary judgment motion at the district court level and on appeal to the United States Court of Appeals for the Fourth Circuit.¹⁰⁴ After summary judgment hearings, the district court upheld the constitutionality of the ordinances, concluding that the FCLAA did not preempt Ordinance 301.¹⁰⁵ Both plaintiffs appealed to the Fourth Circuit.¹⁰⁶

On appeal, the principal debate focused on the third and fourth prongs of the *Central Hudson* test.¹⁰⁷ The Fourth Circuit held that the restrictions were reasonable because the regulations were directed at “a unique and distinct medium which subjects the public to involuntary . . . solicitation.”¹⁰⁸

In both *Penn Advertising* and *Anheuser-Busch*, appellants petitioned the Supreme Court for a writ of certiorari.¹⁰⁹ The Court granted the petitions, but in light of its recent decision in *44 Liquormart, Inc. v. Rhode Island*, it vacated the judgment of the court of appeals and remanded the case for further consideration.¹¹⁰ On remand, the court of appeals was able to differentiate Baltimore's ordinances from the blanket ban on price advertising, which was invalidated in *44 Liquormart*.¹¹¹

¹⁰⁰ *Penn. Adver., Inc. v. Mayor of Balt.*, 862 F. Supp. 1402 (D. Md. 1994), *aff'd*, 63 F.3d 1318 (4th Cir. 1995), *vacated sub nom.* *Penn. Adver., Inc. v. Schmoke*, 518 U.S. 1030 (1996).

¹⁰¹ *Anheuser-Busch, Inc. v. Mayor of Balt.*, 855 F. Supp. 811 (D. Md. 1994), *aff'd sub nom.* *Anheuser-Busch, Inc. v. Schmoke*, 63 F.3d 1305 (4th Cir. 1995), *vacated*, 517 U.S. 1206 (1996).

¹⁰² Garner & Whitney, *supra* note 40, at 483 (citing *Penn Adver., Inc.*, 862 F. Supp. at 1402); Clisham, *supra* note 39, at 736.

¹⁰³ Garner & Whitney, *supra* note 40, at 483 (citing *Anheuser-Busch, Inc.*, 855 F. Supp. at 811).

¹⁰⁴ *Id.* (citing *Penn Adver., Inc.*, 63 F.3d at 1305; *Anheuser-Busch, Inc.*, 63 F.3d at 1305).

¹⁰⁵ Clisham, *supra* note 39, at 736 (citing *Penn Adver., Inc.*, 63 F.3d at 1322).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 737. For a discussion of the *Central Hudson* test, see *infra* Part II.

¹⁰⁸ *Id.* at 736 (citing *Anheuser-Busch, Inc.*, 63 F.3d at 1314).

¹⁰⁹ *Id.* at 738.

¹¹⁰ *Id.*

¹¹¹ Clisham, *supra* note 39, at 738 (citing *Penn. Adver., Inc.*, 518 U.S. at 1030).

In 1956, the Rhode Island legislature enacted two prohibitions against advertising the retail prices of alcoholic beverages in any way except in establishments licensed to sell alcoholic beverages, so long as the prices were not visible from the street.¹¹² The provisions applied to vendors, as well as out-of-state manufacturers, wholesalers, shippers, and the Rhode Island news media.¹¹³ Challenging the statute on First Amendment grounds, licensed liquor retailers filed suit in the United States District Court for the District of Rhode Island after receiving fines for violating the statute.¹¹⁴ The district court held that the price advertising ban was unconstitutional because it did not “directly advance” the state’s interest in reducing alcohol consumption and was more extensive than necessary, thus failing the third and fourth prongs of the *Central Hudson* test.¹¹⁵

The United States Court of Appeals for the First Circuit reversed, holding that there was “inherent merit” in Rhode Island’s argument that competitive price advertising would lower prices, which would in turn produce more sales.¹¹⁶ It concluded that the Supreme Court’s decision in *Queensgate Investment Co. v. Liquor Control Commission*,¹¹⁷ where a prohibition on off-site price advertising was upheld for alcoholic beverages that were sold individually, compelled reversal.¹¹⁸ Because courts have both followed and distinguished *Queensgate Investment Co.* in several subsequent cases, the Supreme Court felt the need to address the First Amendment issues raised in such cases with a more thorough analysis.¹¹⁹

The Court distinguished between complete bans on truthful, nonmisleading commercial messages and simple restrictions which left open other means for disseminating the same information, such as by restricting the time, location or method of advertising.¹²⁰ A complete ban on commercial advertising requires “the rigorous review that the First Amendment generally demands” at least in part, because complete bans against truthful, nonmisleading commercial speech “usually rest solely on the offensive assumption that the public will respond ‘irrationally’ to the truth.”¹²¹

¹¹² 44 *Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 489 (1996).

¹¹³ *Id.*

¹¹⁴ *Id.* at 492.

¹¹⁵ *Id.* at 494.

¹¹⁶ *Id.*

¹¹⁷ *Queensgate Inv. Co. v. Liquor Control Comm’n*, 459 U.S. 807 (1982).

¹¹⁸ 44 *Liquormart, Inc.*, 517 U.S. at 494.

¹¹⁹ *Id.* at 494-95.

¹²⁰ *Id.* at 501-02.

¹²¹ *Id.* at 501, 503.

2. *Lorillard Tobacco Co. v. Reilly*¹²²

Before the 1999 Massachusetts regulations took effect, members of the tobacco industry sued the commonwealth attorney general, claiming the regulations violated their First Amendment rights, and that the Commerce Clause preempted the laws.¹²³ Applying the *Central Hudson* test,¹²⁴ the United States District Court for the District of Massachusetts held that with one exception, relating to point-of-sale advertisements, the First Amendment prohibits regulations banning tobacco product advertisements visible from areas likely to be frequented by minors.¹²⁵ The court held that the government advanced a substantial interest in a direct and material way by the regulations and they tailored the regulations narrowly enough to not suppress any more speech than necessary.¹²⁶ When invalidating the point-of-sale advertising regulations, which prohibited retailers from placing advertisements below five feet from the floor in any retail establishment located within a 1,000-foot radius of public playgrounds, playgrounds within public parks, elementary or secondary schools, the court did not believe the attorney general provided sufficient justification for the restrictions.¹²⁷ Both parties appealed the decision.¹²⁸

On appeal, the United States Court of Appeals for the First Circuit agreed that the *Central Hudson* test for commercial speech restrictions was appropriate, and that regulations limiting tobacco advertising did not violate the First Amendment.¹²⁹ The court of appeals upheld the district court's ruling that the restriction on outdoor advertising did not violate the First Amendment because the regulations met the *Central Hudson* test.¹³⁰ However, the court of appeals reversed the district court's holding on the point-of-sale regulations because it believed that the regulations directly advanced the state's interest and were narrowly tailored enough so as to not overly restrict commercial speech.¹³¹ The tobacco companies petitioned the Supreme Court for a writ of certiorari, challenging the First Circuit's holding in part on First Amendment grounds.¹³²

¹²² *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 525 (2001).

¹²³ *See Lorillard Tobacco Co. v. Reilly*, 84 F. Supp. 2d 180 (D. Mass. 2000), *aff'd in part, rev'd in part sub nom. Consol. Cigar Corp. v. Reilly*, 218 F.3d 30 (1st Cir. 2000).

¹²⁴ *See discussion infra* Part II.

¹²⁵ *Lorillard Tobacco Co.*, 84 F. Supp. 2d at 193.

¹²⁶ Clisham, *supra* note 39, at 727 (citing *Lorillard Tobacco Co.*, 84 F. Supp. 2d at 185-93).

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Consol. Cigar Corp.*, 218 F.3d at 31.

¹³⁰ Clisham, *supra* note 39, at 727 (citing *Consol. Cigar Corp.*, 218 F.3d at 44, 49-50).

¹³¹ *Id.* at 727-28 (citing *Consol. Cigar Corp.*, 218 F.3d at 51).

¹³² *Id.* at 728 (citing *Lorillard Tobacco Co.*, 533 U.S. at 540).

The Supreme Court granted the petition, in part, to decide the First Amendment issues.¹³³ Affirming in part and reversing in part, the Supreme Court held that the FCLAA preempted three types of regulations.¹³⁴ The first were regulations governing outdoor and point-of-sale cigarette advertising.¹³⁵ The second were regulations governing outdoor advertising of smokeless tobacco or cigars within 1,000 feet of schools or playgrounds, which violated the First Amendment.¹³⁶ Third, the FCLAA preempted regulations prohibiting indoor, point-of-sale advertising of smokeless tobacco and cigars lower than five feet from the floors of retail establishments located within 1,000 feet of schools or playgrounds.¹³⁷

Further, the Supreme Court held that requiring retailers to place tobacco products behind counters and requiring customers to have contact with a salesperson before they were able to handle such products did not violate the First Amendment.¹³⁸ Because the FCLAA did not address smokeless tobacco and cigar advertising restrictions, but only cigarette advertising restrictions, the Supreme Court reviewed these restrictions under the First Amendment.¹³⁹ The Court focused its analysis on the last two *Central Hudson* test factors—the direct advancement of the government’s interest and whether the restriction suppressed more speech than necessary, because the first two factors were not in controversy.¹⁴⁰

The Court held that the outdoor advertising restrictions failed the fourth element of the test because of their substantial breadth.¹⁴¹ Additionally, the Court “expressed great concern over a complete ban of truthful information enacted to protect children when applied to a product that is legal for adults.”¹⁴² In his concurring opinion, Justice Kennedy explained that he believed the outdoor advertising restrictions were broad enough to invalidate the regulations under the fourth *Central Hudson* test prong and therefore, considering the third prong was unnecessary.¹⁴³

3. *FDA v. Brown & Williamson Tobacco Corp.*

After the FDA promulgated the 1996 final rule, a group of tobacco manufacturers, retailers, and advertisers challenged the rule by filing suit in

¹³³ *Id.*

¹³⁴ *Lorillard Tobacco Co.*, 533 U.S. at 550-53.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Clisham*, *supra* note 39, at 729.

¹⁴⁰ *Id.* (citing *Lorillard Tobacco Co.*, 533 U.S. at 553-55).

¹⁴¹ *Id.* at 730.

¹⁴² *Id.* (citing *Lorillard Tobacco Co.*, 533 U.S. at 564).

¹⁴³ *Id.* at 731 (citing *Lorillard Tobacco Co.*, 533 U.S. at 571).

the United States District Court for the Middle District of North Carolina.¹⁴⁴ Ruling on the group's summary judgment motion that the FDA lacked jurisdiction to regulate tobacco products, the court held that the FDCA authorized the FDA to regulate tobacco products as customarily marketed, that the FDA's access and labeling regulations were permissible, but that the Agency's advertising and promotion restrictions exceeded its authority.¹⁴⁵ The Court of Appeals for the Fourth Circuit reversed, finding that Congress did not grant the FDA jurisdiction to regulate tobacco products.¹⁴⁶

The Supreme Court affirmed the appellate court, finding that upon reading the FDCA together with other tobacco-specific legislation, Congress never intended for the FDA to regulate tobacco products.¹⁴⁷ Relying on its decision in *ETSI Pipeline Project v. Missouri*, the Court reiterated that "[r]egardless of how serious the problem an administrative agency seeks to address . . . it may not exercise its authority 'in a manner that is inconsistent with the administrative structure that Congress enacted into law.'"¹⁴⁸ The Supreme Court found that the authority to regulate tobacco products was clearly inconsistent with congressional intent expressed not only in the FDCA's overall regulatory scheme, but also in subsequent tobacco-specific legislation.¹⁴⁹

Using the *Chevron* test to analyze an administrative agency's construction of a statute, the court must first determine if Congress has directly spoken to the precise question at issue.¹⁵⁰ If Congress has done so, the court must defer to Congress and its unambiguously expressed intent.¹⁵¹ If Congress has not expressly addressed the issue, the reviewing court must respect the agency's construction of the statute as long as it is permissible.¹⁵² When determining if Congress has spoken to an issue, the court should look to three things: (1) the entire regulatory scheme, (2) related statutes, and (3) common sense as to the manner in which Congress is likely to delegate such a decision.¹⁵³

When the *Brown & Williamson Tobacco* Court applied the *Chevron* test, it determined that Congress had indeed spoken directly to the issue and precluded the FDA's jurisdiction to regulate tobacco products.¹⁵⁴ Viewing the FDCA as a whole, if the FDA regulated tobacco products it would have to ban all of them because there is no possible therapeutic purpose for

¹⁴⁴ *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 129 (2000).

¹⁴⁵ *Id.* at 129-30.

¹⁴⁶ *Id.* at 130.

¹⁴⁷ *Id.* at 160-62.

¹⁴⁸ *Id.* at 125 (citing *ETSI Pipeline Project v. Missouri*, 484 U.S. 495, 517 (1988)).

¹⁴⁹ *Id.* at 126.

¹⁵⁰ *Brown & Williamson Tobacco Corp.*, 529 U.S. at 132 (citing *Chevron*, 467 U.S. at 842).

¹⁵¹ *Chevron*, 467 U.S. at 842-43.

¹⁵² *Brown & Williamson Tobacco Corp.*, 529 U.S. at 132.

¹⁵³ *Id.* at 132-33.

¹⁵⁴ *Id.* at 133.

which the products are safe.¹⁵⁵ Since 1965, Congress has directly addressed the problem of tobacco and health through legislation at least six times, and despite the known harmful side effects of these products, “Congress stopped well short of ordering a ban.”¹⁵⁶ The Court held that because Congress has directly addressed tobacco products, while not banning them, the FDA would have to either go against Congress by banning tobacco products or violate the FDCA by allowing unsafe products in the market.¹⁵⁷

II. SUMMARY OF COMMERCIAL SPEECH DOCTRINE

Commercial speech has never had a clear working definition.¹⁵⁸ Something is not automatically “commercial speech” when it is created in hopes of making money.¹⁵⁹ Otherwise, books, movies and television would all qualify as commercial speech.¹⁶⁰ While there is no solid definition of commercial speech, advertisements are assumed protected when they meet the four-part *Central-Hudson* test.¹⁶¹

“The commercial speech doctrine is a subset of First Amendment jurisprudence that creates a category of intermediate scrutiny for speech falling within its boundaries.”¹⁶² While the standard is an intermediate scrutiny test, more recently, regulations had to meet a test that looks much more like strict scrutiny.¹⁶³

To receive First Amendment protection, speech does not need to closely resemble a traditional advertisement.¹⁶⁴ Courts rely on six factors to determine if speech qualifies as commercial¹⁶⁵:

- (1) Does the speech in question propose a commercial transaction?¹⁶⁶
- (2) Is an advertisement involved?
- (3) Does the speech make reference to a specific product?
- (4) Is there an economic motivation behind the speech?
- (5) Is the activity being advertised itself protected by the First Amendment?
- (6) Does the speech discuss important public issues?¹⁶⁷

¹⁵⁵ *Id.* at 142.

¹⁵⁶ *Id.* at 137-38.

¹⁵⁷ *Id.* at 142-43.

¹⁵⁸ Tamara R. Piety, *Against Freedom of Commercial Expression*, 29 *CARDOZO L. REV.* 2583, 2592 (2008).

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Clisham*, *supra* note 39, at 719.

¹⁶² Piety, *supra* note 158, at 2599 (citing *Bd. of Trs. v. Fox*, 492 U.S. 469, 480 (1989)).

¹⁶³ *Id.*

¹⁶⁴ 1-6 *MATTHEW BENDER & CO.*, *The Law of Advertising* § 6.03[3][a] (2009).

¹⁶⁵ *Id.*

¹⁶⁶ This is a prime requisite.

In 1976, the Supreme Court established “the modern view that the First Amendment protects commercial speech” in *Virginia Board of Pharmacy v. Virginia Citizens Consumer Council*.¹⁶⁸ In holding that the First Amendment protects commercial speech, the Court found that “First Amendment interests in the free flow of price information could be found to outweigh the countervailing interests of the State.”¹⁶⁹ Justice Blackmun cited four principles to justify protecting purely commercial speech: (1) a profit motivation does not remove a speaker’s First Amendment protection; (2) the public need for commercial information is important to consumers; (3) “free dissemination and availability of commercial information is required to sustain a free economy and democracy;” and (4) the First Amendment prohibits the federal government from restricting the “free flow of commercial information for the purpose of affecting public decisions.”¹⁷⁰

The Court placed limits on what would be covered by the First Amendment, stating that speech regulations would likely be justifiable if the speech was false or misleading; if the advertisement was for an illegal product or transaction; or if the regulation related to the time, place, and manner of the speech.¹⁷¹ The Court also said that commercial speech had a “limited measure of protection, commensurate with its subordinate position in the scale of First Amendment values.”¹⁷²

Four years after *Virginia Board of Pharmacy*, the Supreme Court addressed regulations of commercial speech again in *Central Hudson Gas and Electric Corp. v. Public Service Commission of New York*.¹⁷³ In *Central Hudson*, the Court laid out a four-part balancing test in explaining when states can regulate commercial speech: (1) whether the expression is protected by the First Amendment; (2) whether the asserted governmental interest is substantial; (3) whether the regulation directly advances the governmental interest asserted; and (4) whether it is not more extensive than is necessary to advance that interest.¹⁷⁴

¹⁶⁷ MATTHEW BENDER & CO., *supra* note 164.

¹⁶⁸ C. Edwin Baker, *The First Amendment and Commercial Speech*, 84 IND. L.J. 981, 982 (2009) (citing *Va. Bd. of Pharm. v. Va. Citizens Consumer Council*, 425 U.S. 748 (1976)).

¹⁶⁹ *Va. Bd. of Pharm.*, 425 U.S. at 755.

¹⁷⁰ Nicole Endejann, *Is the FDA’s Nose Growing?: The FDA Does Not “Exaggerate Its Overall Place in the Universe” When Regulating Speech Incident to “Off-Label” Prescription Drug Labeling and Advertising*, 35 AKRON L. REV. 491, 494 (2002).

¹⁷¹ Baker, *supra* note 168, at 982.

¹⁷² Endejann, *supra* note 170, at 495 (quoting *Ohralik v. Ohio State Bar Ass’n*, 463 U.S. 447, 456 (1978)).

¹⁷³ *See Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm’n*, 447 U.S. 557 (1980).

¹⁷⁴ *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 554 (2001) (quoting *Central Hudson Gas & Elec. Corp.*, 447 U.S. at 566); *see also* MATTHEW BENDER & CO., *supra* note 164.

III. SUMMARY OF FAMILY SMOKING PREVENTION AND TOBACCO CONTROL ACT

A. *FSPTCA Background*

1. House Committee Report

The United States House Committee on Energy and Commerce (House Committee) determined that past efforts to restrict advertising and marketing of tobacco products to children and teens have failed, stating that “[t]he current lack of government regulation has allowed the tobacco industry to design new products or modify existing ones in ways that increase their appeal to children.”¹⁷⁵ Additionally, the House Committee found that children and adolescents “are more influenced by tobacco marketing than adults and are exposed to substantial and unavoidable advertising that leads to favorable attitudes about tobacco use.”¹⁷⁶ In an attempt to “level the playing field” and to protect public health, the House Committee voted to report H.R. 1256 favorably to the full House of Representatives.¹⁷⁷

2. Majority View of How FSPTCA Will Impact Commercial Speech Rights

In an attempt to nip any potential First Amendment suits in the bud, Congress included several findings in Section 2 of the Act.¹⁷⁸ Finding 31 states that the FSPTCA (incorporating the 1996 regulations) will “directly and materially advance the federal government’s substantial interest in reducing the number of children and adolescents who use cigarettes and smokeless tobacco.”¹⁷⁹ Congress then cited to several studies conducted prior to the 1996 regulations, which the FDA cited as the reason for it to regulate tobacco; more recently, the 2006 study published in the *Archives of Pediatrics and Adolescent Medicine*, found that tobacco marketing doubled the odds that children under the age of eighteen would become tobacco users.¹⁸⁰ The report goes on to state that “less restrictive and less comprehensive approaches have not been and will not be effective in reducing the problems addressed by the regulations.”¹⁸¹ The report finally claims that the

¹⁷⁵ FSPTCA House Committee Report, *supra* note 9, at 3.

¹⁷⁶ *Id.* at 2.

¹⁷⁷ *Id.* at 3.

¹⁷⁸ *Id.* at 12.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ FSPTCA House Committee Report, *supra* note 9, at 12.

regulations are no more restrictive than necessary to prevent advertising to children, while still allowing companies to inform adults of “what they are selling, for what reason, and for what price.”¹⁸²

3. Minority Fears of How FSPTCA Will Impact Commercial Speech Rights

In dissenting views of the House Committee Report,¹⁸³ several representatives expressed fears that in instructing the FDA to publish a rule “identical in its provisions” to the 1996 rule, commercial speech rights will be violated and resulting lawsuits will be similar to those filed after the publication of the 1996 final rule.¹⁸⁴ Citing the *Central Hudson* test,¹⁸⁵ the dissenting view believed the majority incorrectly addressed potential future First Amendment challenges by simply listing what it believed would answer the two-prong test in Findings 30 and 31.¹⁸⁶ The minority felt that short of the findings, the bill does not include any provisions designed to protect minors from tobacco use.¹⁸⁷

B. Overview of FSPTCA Elements¹⁸⁸

Title I of the FSPTCA amends the FDCA to add the definition of tobacco products and other specifications, such as what an “adulterated product” is.¹⁸⁹ Title II specifies that there will be nine new warning statements, which are to be distributed evenly throughout the country and rotated on a quarterly basis.¹⁹⁰ Additionally, the warning statements must cover the top 50% of the front and rear panels of each package and at least the top of 20% of any advertisement for tobacco products, prominently displayed.¹⁹¹ The text of the warning statements must be either black font on a white background or white font on a black background.¹⁹² Within twenty-four months

¹⁸² *Id.* at 13.

¹⁸³ *Id.* at 81.

¹⁸⁴ *Id.* at 83.

¹⁸⁵ *Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n*, 447 U.S. 557, 566 (1980).

¹⁸⁶ FSPTCA House Committee Report, *supra* note 9, at 83.

¹⁸⁷ *Id.*

¹⁸⁸ See Ricardo Carvajal et al., *The Family Smoking Prevention and Tobacco Control Act: An Overview*, 64 FOOD & DRUG L.J. 717 (2009), for a more complete overview of FSPTCA provisions.

¹⁸⁹ Family Smoking Prevention and Tobacco Control Act, Pub. L. No. 111-31, §§ 101-06, 123 Stat. 1776, 1783-1842 (2009).

¹⁹⁰ Family Smoking Prevention and Tobacco Control Act, Pub. L. No. 111-31, § 201, 123 Stat. 1776, 1842-45 (2009).

¹⁹¹ *Id.*

¹⁹² *Id.*

of the FSPTCA passing, the FDA must issue regulations requiring color graphics depicting the negative health consequences of smoking to accompany the warning statements.¹⁹³ Sections 204 and 205 reflect similar changes to the laws governing smokeless tobacco products.¹⁹⁴

IV. DOES THE ACT VIOLATE COMMERCIAL SPEECH RIGHTS?

Even if Congress now allows the FDA to regulate tobacco products, and even directs it to include provisions regarding advertising and packaging, does the FDA really have the authority? Under the *Central Hudson* test, the FSPTCA would apply to protected First Amendment speech, promote a substantial governmental interest, directly advance that interest and not be more extensive than necessary. Preventing children from smoking is a substantial government interest, and, assuming that tobacco advertisements constitute protected First Amendment commercial speech, the FSPTCA still fails the last two *Central Hudson* elements. There has been no evidence that the federal government's interest in preventing children from smoking is advanced at all, let alone directly, by the type and level of restrictions that are being placed on advertisements of tobacco products. Additionally, there are several other regulatory options available that would be less restrictive than the FSPTCA provisions.

Despite significant evidence that most American youth are routinely and heavily exposed to tobacco advertisements, the impact of this exposure on smoking behavior is not well understood.¹⁹⁵ While there have been no studies directly looking at the relationship between tobacco advertising and promotion and smoking rates in teens, research into the impact of advertisements and promotion on adults shows either no significant relationship or only a small relationship.¹⁹⁶ In fact, studies of both complete advertising bans and only partial advertising bans have not consistently found an impact on smoking rates.¹⁹⁷ Because there are no studies showing a link between tobacco advertising and smoking rates in teens, and studies on the impact of advertising and adult use shows little to no relationship, a ban or even restriction on tobacco advertisements cannot be said to directly advance the government's interest in lowering addiction and use rates.

While the federal government is not required to use the most lenient form of restrictions when trying to meet a regulatory objective, the means

¹⁹³ *Id.*

¹⁹⁴ Family Smoking Prevention and Tobacco Control Act, Pub. L. No. 111-31, §§ 204-05, 123 Stat. 1776, 1846-49 (2009).

¹⁹⁵ PETER D. JACOBSON ET AL., COMBATING TEEN SMOKING: RESEARCH AND POLICY STRATEGIES 157 (2001).

¹⁹⁶ *Id.* at 158.

¹⁹⁷ *Id.*

chosen must be narrowly tailored.¹⁹⁸ In order to be narrowly tailored, restrictions on commercial speech “must be aimed at eliminating false or misleading communication ‘without at the same time banning or significantly restricting a substantial quantity of speech that does not create the same evils.’”¹⁹⁹ In fact, as the Supreme Court points out in *44 Liquormart*, “[t]he First Amendment directs us to be especially skeptical of regulations that seek to keep people in the dark for what the government perceives to be their own good.”²⁰⁰

The broad, sweeping regulations of the FSPTCA’s advertising provisions are not narrowly tailored so as to only eliminate false or misleading communications, while not simultaneously “banning or significantly restricting a substantial quantity of speech that does not create the same evils.” The government has now seized the top half of the front and rear panels of cigarette packaging to contain a warning statement written in “conspicuous” seventeen-point font, dictating what language, font, color and style shall be seen on every package.

The same has been done when it comes to press and poster advertisements for cigarette products where 20% of the advertising space located in a “conspicuous and prominent” space at the top of each advertisement must now include a statement dictated by the government in the font, color and format specified in the FSPTCA.²⁰¹ Furthermore, within twenty-four months after the enactment of FSPTCA, the FDA must issue regulations requiring a color graphic depicting the negative health consequences of smoking.²⁰² There is no exception for advertisements run in adult-only publications, or publications that have a majority of subscribers that are above the age of eighteen. If the only, or even primary, purpose of the FSPTCA is to prevent American youths from becoming addicted to tobacco products, there is no reason to regulate advertisements run in publications that are only available to adults. By creating a blanket regulation on the content of tobacco advertisements, Congress has gone beyond its stated purpose of protecting American youths and has created an overly broad regulation that inhibits tobacco companies from providing adult customers with truthful, nonmisleading information.

FSPTCA advertising regulations have nothing to do with the regulation of tobacco products.²⁰³ In *44 Liquormart*, the Supreme Court unani-

¹⁹⁸ *Bd. of Trs. v. Fox*, 492 U.S. 469, 477-78 (1989).

¹⁹⁹ Washington Legal Fund, Comments to FDA Concerning Request for Comments Regarding Implementation of the FSPTCA in Response to the Public Notice Published at 74 Fed. Reg. 31,457, No. 2009-N-0294-0501.1 (July 1, 2009) (citing *Ward v. Rock Against Racism*, 491 U.S. 781, 800 n.7 (1989)) [hereinafter WLF Comment].

²⁰⁰ *44 Liquormart, Inc. v. Rhode Island*, 517 U.S. 484, 503 (1996).

²⁰¹ Family Smoking Prevention and Tobacco Control Act, Pub. L. No. 111-31, § 201, 123 Stat. 1776, 1843 (2009).

²⁰² Pub. L. No. 111-31, § 201, 123 Stat. at 1845.

²⁰³ Costello, *supra* note 22, at 683.

mously struck down a statute aimed at restricting commercial speech.²⁰⁴ Writing for the majority, Justice Stevens noted that bans targeting “truthful, nonmisleading commercial messages rarely protect consumers from...harm[.]. Instead, such bans often serve only to obscure an ‘underlying governmental policy’ that could be implemented without regulating speech.”²⁰⁵ The Court unanimously agreed that the advertising prohibitions violated the First Amendment.²⁰⁶

When applying *Central Hudson* to the FSPTCA, only two of the four requirements are met—protected First Amendment speech and a substantial government interest. Because the FSPTCA does not directly advance the government’s interests when applied to either children or adults, and it is more extensive than necessary, it is likely that the courts will strike down the Act.

A. Responses to FSPTCA

1. *Commonwealth Brands v. United States*

On August 31, 2009, Commonwealth Brands, along with five other tobacco companies, filed a lawsuit in the United States District Court for the Western District of Kentucky, challenging the FSPTCA’s constitutionality.²⁰⁷ The *Commonwealth Brands* plaintiffs allege that their commercial speech rights were violated because the restrictions placed upon their advertising and packaging are numerous, without exception, do not directly advance the governmental interest asserted and are more extensive than necessary to advance the interest asserted.²⁰⁸

On January 5, 2010, the district court granted in part and denied in part both parties’ cross-motions for summary judgment.²⁰⁹ Applying the *Central Hudson* test, the court found that the total ban on using color and images in tobacco labels and advertising was overly broad and not carefully tailored to address the government’s interest.²¹⁰ Key to this finding was the Supreme Court’s explanation in *Central Hudson* that “[t]he regulatory technique may extend only as far as the interest it serves. The State cannot regulate speech that poses no danger to the asserted state interest . . . nor can it

²⁰⁴ *44 Liquormart, Inc.*, 517 U.S. at 503.

²⁰⁵ *Id.* (citing *Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm’n*, 447 U.S. 557, 566 (1980)).

²⁰⁶ *Id.* at 489.

²⁰⁷ See *Commonwealth Brands v. United States*, 678 F. Supp. 2d 512 (W.D. Ky. 2010).

²⁰⁸ *Id.* at 521.

²⁰⁹ *Id.* at 519.

²¹⁰ *Id.* at 525-26.

completely suppress information when narrower restrictions on expression would serve its interest as well.²¹¹

The court also struck down the provision which prohibits any express or implied statements that tobacco products are safer or less harmful because of their regulation or inspection by the FDA.²¹² Because the FSPTCA bans statements not only by tobacco companies, but by anyone, it applies to more than just commercial speech and therefore must overcome strict scrutiny.²¹³ Because the government did not attempt to justify the ban under the strict scrutiny standard, and the court believed it clear that the restriction could not be justified under the higher standard, it found the provision facially unconstitutional.²¹⁴

The tobacco companies also challenged the ban on outdoor advertising which would prohibit any outdoor advertising within 1,000 feet of a school or playground, claiming that the FSPTCA provisions are indistinguishable from the Massachusetts ban struck down by the Supreme Court in *Lorillard Tobacco*.²¹⁵ The district court agreed that the provisions were almost identical, but pointed out that Congress instructed the FDA to “include such modifications . . . , if any, that [the FDA] determines are appropriate in light of governing First Amendment case law.”²¹⁶ Furthermore, the FDA does not have to issue a final regulation until March 22, 2010, which would be effective on June 22, 2010.²¹⁷ Because there were still two months until a final rule and three months before the rule would become effective at the time of the decision, the court ruled that the challenge was not yet ripe.²¹⁸

While the Government is permanently enjoined from enforcing the two provisions found unconstitutional, all other provisions of the FSPTCA that were challenged in the lawsuit were held to be constitutional.²¹⁹ Both sides have said that they are pleased with the outcome of the case.²²⁰ A spokesman for R.J. Reynolds said, “the company continues to believe that the other challenged provisions of the law are unconstitutional and is considering its options.”²²¹ In slightly more ambiguous language, an FDA spokeswoman said, “[t]he agency will thoroughly review the opinion ren-

211 *Id.* at 525 (citing *Central Hudson Gas & Elec. Corp.*, 447 U.S. at 565).

212 *Id.* at 535.

213 *Commonwealth Brands*, 678 F. Supp. 2d at 535.

214 *Id.*

215 *Id.*

216 *Id.*

217 *Id.*

218 *Id.*

219 *Commonwealth Brands*, 678 F. Supp. 2d at 541.

220 Bob Van Voris, *Ban on Color and Graphics in Tobacco Ads Thrown Out*, BUSINESSWEEK, Jan. 5, 2010, <http://www.businessweek.com/news/2010-01-05/ban-on-color-and-graphics-in-tobacco-ads-thrown-out-update2-.html>.

221 *Id.*

dered by the judge.”²²² Based on these statements, it is unclear whether either side will file an appeal.

2. Issues Introduced in Response to FDA’s Request For Comments

As part of the Administrative Procedure Act, the FDA is required to request comments and feedback on new regulations before finalizing them. Before finalizing the FSPTCA regulations, the FDA issued a request for comments and feedback from the public on how to implement the new law.²²³ While there have been numerous comments to the docket, the Washington Legal Foundation (WLF) submitted a comment expressing concerns about the commercial speech rights of companies.²²⁴ While the WLF primarily addresses the concerns of companies that manufacture “modified risk tobacco products,”²²⁵ the concerns it raises apply to all tobacco manufacturing companies.²²⁶

3. Other Responses

In addition to filing lawsuits to protect their commercial speech rights, tobacco companies have started looking to other ways to continue marketing their products while dealing with the new regulations.²²⁷ One such example comes from R.J. Reynolds Tobacco Company, maker of Pall Mall and Salem brand cigarettes.²²⁸ With the looming ban on the words “mild,” “light,” and “ultralight,” R.J. Reynolds now uses colors to inform customers of differences between their cigarettes.²²⁹ Pall Mall Lights are now Pall Mall Blue, packaged in a royal blue color and Salem Lights are now Salem Gold Box, packaged in pastels.²³⁰ While Congress sought to dispel consumer misconceptions that products labeled “mild” or “light” are any less harmful than other cigarettes, studies seem to show that the words are not the only thing adding to the consumer belief that some products are safer.²³¹

²²² *Id.*

²²³ Request for Comments, 74 Fed. Reg. 31,457 (Food & Drug Admin. July 1, 2009).

²²⁴ WLF Comment, *supra* note 199.

²²⁵ “Modified Risk Tobacco Products” are products designed to reduce harm or the risk of tobacco related diseases. Family Smoking Prevention and Tobacco Control Act, Pub. L. No. 111-31, § 101, 123 Stat. 1776, 1812 (2009) (to be codified at 21 U.S.C. § 387k).

²²⁶ WLF Comment, *supra* note 199.

²²⁷ Stephen Smith, *New rules, new smoke signals: Color change called trick to subvert word ban*, BOSTON GLOBE, Oct. 8, 2009, at 1.

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.*

Studies in the United Kingdom and Canada have shown that “smokers believe that products with labels such as ‘silver,’ ‘gold,’ or ‘smooth’ are safer and easier to stop using than high-octane cigarettes.”²³²

R.J. Reynolds is also test marketing new products which, while not cigarettes, are still tobacco-based and deliver a dose of nicotine at least that of traditional cigarettes.²³³ The new products that are being test-marketed in Columbus, Ohio; Indianapolis, Indiana; and Portland, Oregon, are flavored Camel Orbs, Camel Strips and Camel Sticks—melt-in-your-mouth items that resemble breath mints, breath strips and toothpicks, respectively.²³⁴

B. *Suggestions For Congress and the FDA if the FSPTCA is Struck Down*

If the courts side with the *Commonwealth Brands* plaintiffs, the FDA and Congress may be back at square one in trying to prevent American youths from smoking and helping future generations avoid addiction to tobacco products. There are two general categories of prevention available to Congress and the FDA: primary prevention, which strives to prevent non-smokers from ever starting; and secondary prevention, which targets smoking youths and have the goal of quitting assistance.²³⁵ The primary preventions break down further into supply-focused and demand-focused strategies.²³⁶ Supply-focused strategies are those which restrict access to minors by enforcing sales regulations in a stricter fashion.²³⁷ Demand-focused strategies, on the other hand, can be both educational campaigns and fines for youths with tobacco products.²³⁸

One option is to use “counter-speech” to prevent or discourage tobacco use.²³⁹ Counter-speech is the belief that instead of using regulations to prevent speech, speaking out is a better method. As Stanford University law professor Kathleen Sullivan writes, “the best answer to speech is not regulation but more speech.”²⁴⁰ To support her theory that the best answer to speech is more speech, Sullivan points to the anti-smoking campaigns run by the American Cancer Society and other groups in the 1960s, stating the “ads [were] so effective they induced the tobacco companies themselves to take cigarette ads off the air.”²⁴¹ After the FCC implemented the Fairness

232 *Id.*

233 Editorial, *Smoke 'em out*, COLUMBUS DISPATCH (OHIO), Oct. 8, 2009, at 14A.

234 *Id.*

235 See JACOBSON ET AL., *supra* note 195, at 116.

236 *Id.* at 204.

237 *Id.*

238 *Id.*

239 Costello, *supra* note 22, at 687.

240 Kathleen M. Sullivan, *Muzzle Joe Camel? It May Be Illegal*, NEWSDAY, May 30, 1996, at A51.

241 *Id.*

Doctrine in 1967, the industry worked with congressional allies, supporting a ban on tobacco advertising in broadcast media.²⁴²

Additionally, there are school-based programs. Most school-based programs for tobacco use prevention target elementary school and middle school students.²⁴³ These programs tend to fall into three categories of approaches.²⁴⁴ First, the information-deficit model provides information about the health risks and negative consequences of tobacco use, and is based on the premise that youths are generally misinformed about the risks of smoking.²⁴⁵ Second, the affective-education model attempts to “influence beliefs, attitudes, intentions, and norms related to tobacco use, with a focus on enhancing self-esteem” and will often try to use fear in preventing kids from smoking.²⁴⁶ Third, the social-influence-resistance model, recognizes and emphasizes the social environment in decision-making and helps build the skills necessary to resist peer pressure.²⁴⁷ Of the three approaches, studies have shown the third model is the most effective in long-term prevention of youth smoking.²⁴⁸

As the tobacco companies in *Commonwealth Brands* point out, there are numerous other options available to the federal government, including increasing the enforcement of state laws prohibiting the sale of tobacco products to minors, criminalizing possession of tobacco products for minors, increasing anti-smoking educational campaigns, and imposing federal restrictions on possessing or selling cigarettes.²⁴⁹ Any of these options would achieve the goal of the FSPTCA while not infringing on tobacco companies’ First Amendment rights.

Such suggestions are not just tobacco companies attempting to sidestep regulations; an Illinois town implemented tobacco regulations modeled on liquor control laws and saw a decrease of 65% in illegal merchant sales, and a decrease in smoking by children by one-half.²⁵⁰ In a study conducted in the early 1990s, approximately 70% of tobacco vendors in Woodridge, Illinois, sold cigarettes to minors.²⁵¹ To combat this high rate of sales to minors, the community developed legislation that involved both licensing

²⁴² Robert L. Rabin, *Tobacco Control Strategies: Past Efficacy and Future Promise*, 41 LOY. L.A. L. REV. 1721, 1724-25 (2008).

²⁴³ JACOBSON ET AL., *supra* note 195, at 117.

²⁴⁴ *Id.*

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ *Id.* at 117-18.

²⁴⁸ *Id.* at 118.

²⁴⁹ *Commonwealth Brands, Inc. v. United States*, 678 F. Supp. 2d 512, 536-38 (W.D. Ky. 2010).

²⁵⁰ Costello, *supra* note 22, at 687-88.

²⁵¹ Leonard A. Jason et al., *Introduction: Preventing Youth Access to Tobacco*, in PREVENTING YOUTH ACCESS TO TOBACCO 4 (Leonard A. Jason & Steven B. Pokorney eds., 2002) (citing Leonard A. Jason et al., *Active Enforcement of Cigarette Control Laws in the Prevention of Cigarette Sales to Minors*, 266 JAMA 3159-61 (1991)).

and enforcement measures.²⁵² Police issued citations to merchants who sold cigarettes to minors, and then reported the vendors to the mayor, who is the local liquor and tobacco commissioner.²⁵³ The mayor would impose fines and suspend the licenses of merchants if they had violated the regulations, as found in an administrative hearing.²⁵⁴ In addition to punishing vendors who sold cigarettes to minors, the youths were fined for tobacco possession.²⁵⁵ After implementing the regulations, sales to minors dropped to below 5%.²⁵⁶ Furthermore, a survey of middle school students conducted two years after the implementation of the regulations found that regular smoking rates decreased from 16% to 5%.²⁵⁷

When comparing the Woodridge study to other studies comparing the effectiveness of enforcement regulations, no other town showed such positive results.²⁵⁸ One possible explanation for the difference is that the Woodridge fined minors for possessing tobacco products.²⁵⁹ Therefore, while enforcing laws which restrict merchant sales to minors is important, it may be just as important to fine minors for possessing tobacco products. Rather than taking the extreme measure of infringing on tobacco companies' commercial speech rights by conscripting a large portion of advertisements and product packaging under the guise of making the products less enticing to minors, Congress should consider going straight to the source they are trying to protect by fining minors who possess tobacco products. Congress has not started punishing automobile companies when individuals fail to wear seatbelts; individuals who are engaged in what has been deemed dangerous behavior are the ones receiving fines.

In order to test the hypothesis that combining enforcement actions with fining minors possessing tobacco products would be more effective in reducing youth smoking than simple enforcement alone, Leonard Jason conducted an eight-town randomized test between 1999 and 2001.²⁶⁰ After initial contact with sixty-eight towns, the study narrowed to eight as a result of various factors, including active enforcement and willingness to participate.²⁶¹ Jason then randomly assigned the eight towns eligible and willing to participate in the study to one of two conditions: possession (enforcement of both tobacco possession and sales laws) or no possession (enforcement of only the tobacco sales laws).²⁶² For the eight towns included

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ Jason et al., *supra* note 251, at 4.

²⁵⁸ *Id.* at 4-6.

²⁵⁹ *Id.* at 6.

²⁶⁰ *Id.* at 8.

²⁶¹ *Id.*

²⁶² *Id.*

in the study, the population and median family incomes were not significantly different between the two groups, and there was geographic diversity amongst the groups.²⁶³

The towns treated all violations of possession and sales laws as civil crimes, not criminal.²⁶⁴ Participating police departments checked retailer compliance with local sales laws two to three times per year, and issued court citations and fines to any retailers found in violation of the sales laws.²⁶⁵ The fines for selling cigarettes to a minor ranged between \$50 and \$100 for the first offense, with a progressively longer suspension of the license to sell cigarettes and a higher fine for subsequent violations.²⁶⁶ In the communities that fined minors for possession of tobacco products, they issued citations to a minimum of .15% of the population of the town in order to ensure that youths knew of the fines and their active enforcement.²⁶⁷ At the end of the study, towns with possession fines had significantly smaller increases in occasional (4.1% compared to 15.6%) or daily use (2% compared to 6.8%) by white participants²⁶⁸ between sixth and eighth grades.²⁶⁹

Additionally, in 1988, California successfully combined legislation and counter-speech to reduce the overall number of smokers in the state.²⁷⁰ California raised the taxes on cigarettes to twenty-five cents per pack and used most of the additional revenue from the program on providing health care for the poor.²⁷¹ The rest of the revenue generated from the additional tax funded programs and public service advertisements aimed at helping California residents quit smoking.²⁷² As a result of the program, California saw a decrease in smoking at nearly twice the national average.²⁷³

State tobacco control programs are often more effective than federal programs.²⁷⁴ Both California and Massachusetts mounted their own anti-tobacco programs and saw a much greater decrease in tobacco use, over 50% and 15% respectively, than other states which participated in the American Stop Smoking Intervention Study funded by the National Cancer Institute, which only showed an aggregate 7% decrease.²⁷⁵

²⁶³ Jason et al., *supra* note 251, at 8.

²⁶⁴ *Id.*

²⁶⁵ *Id.* at 8-9.

²⁶⁶ *Id.* at 9.

²⁶⁷ *Id.*

²⁶⁸ In both categories, rates were similar for non-white participants regardless of whether they were in a town with or without possession fines. *Id.*

²⁶⁹ Jason et al., *supra* note 251, at 9.

²⁷⁰ Costello, *supra* note 22, at 688.

²⁷¹ *Id.*

²⁷² *Id.*

²⁷³ *Id.*

²⁷⁴ See HAYLEY MITCHELL HAUGEN, TEEN SMOKING 45 (2004).

²⁷⁵ *Id.* at 45-46.

CONCLUSION

Despite the best efforts of Congress to prevent challenges to the FSPTCA by including findings in Section 2 explicitly addressing each element of the *Central Hudson* Test, dissenting representatives' views predicted the almost certain challenges which arose in *Commonwealth Brands*. If Congress and the FDA find that the FSPTCA's advertising provisions are struck down as unconstitutional for infringing on tobacco companies' commercial speech rights, there are other ways to prevent underage smoking. By using both supply-focused and demand-focused strategies, Congress and the FDA will be able to achieve results without infringing on the commercial speech rights of tobacco companies. Based on the results achieved in Woodridge, Illinois, implementing a program that fines minors for tobacco possession would achieve the desired results without the First Amendment issues created by the FSPTCA's current provisions.

A DOUBLE-EDGED SWORD: HOW THE DEFENSE OF MARRIAGE
ACT INDIRECTLY PROTECTS SAME-SEX COUPLES FROM INSIDER
TRADING LIABILITY

*Michael Misiewicz**

INTRODUCTION

The Defense of Marriage Act (DOMA)¹ prevents the recognition of same-sex marriage under federal law.² This Act bars granting federal privileges, such as tax benefits,³ social security payments,⁴ joint petitions for bankruptcy,⁵ and many others⁶ to same-sex married couples. The language of the Act, however, coupled with the Securities and Exchange Commission's (SEC) Rule 10b5-2(b)(3)⁷ and judicial application of the "misappropriation theory"⁸ of insider trading, creates an unintended result. Collectively, DOMA, SEC Rule 10b5-2(b)(3), and case law, provide protection and immunity from insider trading liability to any person who trades on material nonpublic information received from his same-sex spouse without permission of the spouse.⁹ The combination of these three areas of law bars a finding that a same-sex marriage is a relationship of trust and confidence.¹⁰ Without this relationship of trust and confidence, the party in-

* J.D., George Mason University School of Law, 2010; B.A., Westminster College, 2003. I wish to thank Morgan Mason, JLEP Notes Editor 2009-2010, and Randall Quinn, Adjunct Professor, American University Washington College of Law, for their valuable feedback on earlier drafts of this Comment. I also wish to thank Larry for his support during the time-consuming research and writing process.

¹ 1 U.S.C. § 7 (2011); 28 U.S.C. § 1738C (2010) (applying DOMA to the states).

² See, e.g., *In re Levenson*, 560 F.3d 1145, 1148 (9th Cir. 2009); *Matthews v. Gonzales*, 171 F. App'x 120, 122 (9th Cir. 2006); *Mueller v. Comm'r*, 39 F. App'x 437, 438 (7th Cir. 2002); *Aleman v. Glickman*, 217 F.3d 1191, 1196 (9th Cir. 2000); *United States v. Costigan*, No. Crim. 00-9-B-H, 2000 U.S. Dist. LEXIS 8625, at *7-8, 2000 WL 898455 at *3 (D. Me. June 16, 2000); *In re Roll*, 400 B.R. 694, 679 n.1 (Bankr. W.D. Wis. 2008); *In re Goodale*, 298 B.R. 886, 893-94 (Bankr. W.D. Wash 2003); *Hara v. Office of Personnel Mgmt.*, No. PH-0831-08-0099-1-2, 2008 MSPB LEXIS 6601, at *51 (Merit Sys. Prot. Bd. Dec. 17, 2008); I.R.S. Priv. Ltr. Rul. 200108010 (Nov. 17, 2000).

³ See, e.g., *Mueller*, 39 F. App'x at 438; I.R.S. Priv. Ltr. Rul. 200108010.

⁴ See, e.g., *Hara*, 2008 MSPB LEXIS 6601, at *51.

⁵ See, e.g., *In re Roll*, 400 B.R. at 679 n.1; *In re Goodale*, 298 B.R. at 893-94.

⁶ See, e.g., *In re Levenson*, 560 F.3d at 1148 (federal employee benefits); *Matthews*, 171 F. App'x at 122 (immigration protections); *Aleman*, 217 F.3d at 1196 (welfare benefits).

⁷ 17 C.F.R. § 240.10b5-2(b)(3) (2009); see discussion *infra* Part II.A.3.

⁸ *United States v. O'Hagan*, 521 U.S. 642, 652 (1997); see discussion *infra* Part II.B.2.

⁹ See discussion *infra* Part III.B.

¹⁰ *Id.*

volved in trading may reveal confidential, material, nonpublic information received by virtue of the relationship without violating an imposed duty.¹¹

Part I of this comment begins by examining DOMA and outlines its consequences on federal law. Next, Part I discusses DOMA's legislative history and Congress's intentions in passing the Act. Finally, Part I discusses DOMA's application in the area of federal bankruptcy law.

Part II begins by detailing the insider trading prohibitions in § 10(b) of the Securities Exchange Act of 1934 (Exchange Act).¹² Next, it discusses SEC Rule 10b5-2 by explaining its plain language and the SEC's reasons for creating it.¹³ Part II also details the public concerns raised during the Rule's notice-and-comment period to show the SEC's awareness of the implications of this Rule for "domestic partners." Then, this Part discusses the seminal Supreme Court case *United States v. O'Hagan*, which set out the "misappropriation theory" of insider trading and established the basis for spousal trading liability.¹⁴ Finally, Part II considers how the federal courts have viewed spousal and familial relationships when deciding insider trading cases and how these cases leave unanswered questions regarding the application of case law and Rule 10b5-2 to same-sex married couples.

Part III analogizes bankruptcy law to securities law in order to predict how a federal court may apply DOMA to both Rule 10b5-2 and securities law generally if such a case arises. Part III then offers solutions to avoid the unintended consequences caused by the DOMA's interplay with Rule 10b5-2. Part IV concludes this comment by summarizing some unintended consequences DOMA creates in securities law and solutions for policymakers.

I. AN OVERVIEW OF THE DEFENSE OF MARRIAGE ACT

A. *The Statute and Its History*

President Bill Clinton signed DOMA into law on September 21, 1996, just over four months after the U.S. House of Representatives initially introduced the Act.¹⁵ The Act, which passed both houses of Congress with over 80% support,¹⁶ codified two provisions.¹⁷ The first provision of the

¹¹ See discussion *infra* Part III.B.

¹² Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (current version at 15 U.S.C. §§ 78a-78oo (2010)).

¹³ 17 C.F.R. § 240.10b5-2 (2009).

¹⁴ See *O'Hagan*, 521 U.S. 642.

¹⁵ Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 2419 (1996); H.R. Res. 3396, 104th Cong. (1996) (enacted).

¹⁶ H.R. Res. 3396, 142 CONG. REC. S10129 (daily ed. Sept. 10, 1996); 142 CONG. REC. H7505 (daily ed. July 12, 1996) (vote count) (enacted).

Act defines, for purposes of federal law, the words “marriage” and “spouse.”¹⁸ DOMA defines the word “marriage” as meaning “only a legal union between one man and one woman as husband and wife” and the word “spouse” as meaning “a person of the opposite sex who is a husband or a wife.”¹⁹ This provision means that an opposite-sex marriage will be the only type of marriage recognized under federal law.²⁰ The second provision of the Act provides that any “state, territory, or possession of the United States” may choose to opt out of recognizing the laws and judicial proceedings of any other U.S. jurisdictions related to “relationship[s] between persons of the same sex that [are] treated as a marriage under the laws [of that jurisdiction]. . . .”²¹ The latter provision means that any state can refuse to recognize a same-sex marriage performed in another state or refuse to recognize another state’s court decisions or statutory law related to same-sex marriage.²²

At the time Congress debated and passed DOMA, no U.S. state had legalized same-sex marriage.²³ The federal government had not previously considered how legalized same-sex marriage would affect federal rights and privileges. However, the Supreme Court of Hawaii ruled that the state’s requirements for a valid marriage contract were presumptively unconstitutional because these requirements denied access for same-sex couples.²⁴ As a result of that ruling, some members of Congress believed Hawaii would imminently legalize same-sex marriage.²⁵ During the debates in the House of Representatives, several representatives in favor of the passing DOMA argued that the Act would prevent an expansion of federal benefits, such as social security, federal employee health benefits, pension access, and tax benefits to same-sex married couples.²⁶ The same representatives believed that withholding these rights from same-sex married couples was important for the financial and structural stability of those federal benefits.²⁷ Representatives opposed to the Act similarly argued that DOMA would prevent

¹⁷ 1 U.S.C. § 7 (2011); 28 U.S.C. § 1738C (2010).

¹⁸ 1 U.S.C. § 7.

¹⁹ *Id.*

²⁰ *See, e.g.*, H.R. Res. 3396, 142 CONG. REC. H7270 (daily ed. July 11, 1996) (statement of Rep. McInnis).

²¹ 28 U.S.C. § 1738C. This part of DOMA is beyond the scope of this comment, which focuses on the effects of DOMA on federal securities law.

²² *See, e.g.*, H.R. Res. 3396, 142 CONG. REC. H7270 (daily ed. July 11, 1996) (statement of Rep. McInnis).

²³ *Marriage Equality & Other Relationship Recognition Laws*, HUM. RTS. CAMPAIGN (2009), http://www.hrc.org/documents/Relationship_Recognition_Laws_Map.pdf.

²⁴ *Baehr v. Lewin*, 852 P.2d 44, 67 (Haw. 1993).

²⁵ *See, e.g.*, H.R. Res. 3396, 142 CONG. REC. H7270 (daily ed. July 11, 1996) (statement of Rep. McInnis).

²⁶ *See, e.g.*, H.R. Res. 3396, 142 CONG. REC. H7493 (daily ed. July 12, 1996) (statement of Rep. Weldon).

²⁷ *Id.*

the granting of these benefits to same-sex married couples.²⁸ In fact, representatives on both sides of the debate focused on the rights and privileges that would be denied.²⁹ Remarkably, the debate was silent as to whether DOMA would or could *grant*, directly or indirectly, any rights or benefits to same-sex married couples.³⁰ Indeed, the final legislation states that the purpose of the Act is to “define and protect the institution of marriage”³¹ but remains silent on whether the Act grants any rights or benefits.³²

B. *DOMA's Impact on Federal Law*

Since DOMA was passed into law, courts have applied the statute to several areas of federal law which use “spouse” or “marriage” as criteria for granting or denying federal benefits and privileges.³³ The majority of cases stemming from federal law applying DOMA have adversely affected the party in the same-sex relationship.³⁴ However, a number of bankruptcy cases interpreting DOMA ended with beneficial results for same-sex married debtors.³⁵ These beneficial end results are analogous to those which

²⁸ See, e.g., H.R. Res. 3396, 142 CONG. REC. H7482-84, H7491 (daily ed. July 12, 1996) (statement of Rep. Frank; Rep. Studds).

²⁹ See, e.g., H.R. Res. 3396, 142 CONG. REC. H7482-84, H7491, H7493 (daily ed. July 12, 1996) (statement of Rep. Frank, Rep. Studds, Rep. Weldon).

³⁰ See generally H.R. Res. 3396, 104th Cong., 142 CONG. REC. S10100 (daily ed. Sept. 10, 1996) (enacted); H.R. Res. 3396, 142 CONG. REC. H7270 (daily ed. July 11, 1996); H.R. Res. 3396, 142 CONG. REC. H7480 (daily ed. July 12, 1996) (congressional debates do not discuss whether DOMA grants any rights or benefits).

³¹ Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 2419 (1996) (codified at 1 U.S.C. § 7 (2011) and 28 U.S.C. § 1738C (2010)).

³² See generally *id.* (DOMA does not affirmatively grant any rights or benefits).

³³ See, e.g., *In re Levenson*, 560 F.3d 1145, 1148 (9th Cir. 2009) (federal employee benefits); *Matthews v. Gonzales*, 171 F. App'x 120, 122 (9th Cir. 2006) (immigration); *Mueller*, 39 F. App'x at 438 (federal income tax); *Aleman v. Glickman*, 217 F.3d 1191, 1196 (9th Cir. 2000) (welfare benefits); *United States v. Costigan*, No. Crim. 00-9-B-H, 2000 U.S. Dist. LEXIS 8625, at *7-8, 2000 WL 898455 at *3 (D. Me. June 16, 2000) (federal criminal law); *In re Roll*, 400 B.R. 674, 679 n.1 (Bankr. W.D. Wis. 2008) (bankruptcy); *In re Goodale*, 298 B.R. 886, 893-94 (Bankr. W.D. Wash. 2003) (bankruptcy); *Hara v. Office of Pers. Mgmt.*, No. PH-0831-08-0099-I-2, 2008 MSPB LEXIS 6601, at *51 (Merit Sys. Prot. Bd. Dec. 17, 2008) (survivor pension benefits); I.R.S. Priv. Ltr. Rul. 200108010 (Nov. 17, 2000) (tax on employee domestic partner health benefits).

³⁴ See, e.g., *In re Levenson*, 560 F.3d at 1148 (federal employee could only receive health benefits for his same-sex spouse because this court declared DOMA unconstitutional in a very narrow way); *Matthews*, 171 F. App'x at 122 (alien same-sex spouse of a U.S. citizen could not get permanent resident status); *Mueller*, 39 F. App'x at 438 (same-sex couple could not file joint federal income tax return); *Aleman*, 217 F.3d at 1196 (party could not use same-sex spouses work credit to obtain food stamps); *Hara*, 2008 MSPB LEXIS 6601, at *51 (survivor same-sex spouse could not receive deceased spouse's federal pension payments); I.R.S. Priv. Ltr. Rul. 200108010 (tax on employee domestic partner health benefits).

³⁵ See, e.g., *In re Roll*, 400 B.R. at 679 n.1; *In re Goodale*, 298 B.R. at 893-94.

may come from an action seeking to enforce SEC Rule 10b5-2(b)(3)³⁶ or other insider trading laws against a party in a same-sex marriage. The analogy is apt because, in both bankruptcy proceedings and insider trading cases, the same-sex married party benefits when a court finds his marriage invalid under federal law.

1. Bankruptcy Law: The *Roll* Case³⁷

In April 2008, Shari Roll and Renee Currie, a same-sex couple in Wisconsin, filed individual petitions for Chapter 7 bankruptcy relief.³⁸ Each party's individual income fell below the Wisconsin median family income, barring the U.S. Trustee from using the "means test"³⁹ to convert the bankruptcy petitions into Chapter 13 bankruptcy petitions,⁴⁰ or altogether dismiss the petitions on grounds of abuse.⁴¹ Instead, the Bankruptcy Code placed the burden of proving abuse on the U.S. Trustee under a "totality of the circumstances" standard.⁴² The court would have found a presumption of abuse under the Bankruptcy Code if the parties were in a federally-recognized marriage,⁴³ as the parties' combined income exceeded the Wisconsin median family income.⁴⁴

In July 2008, the U.S. Trustee moved to dismiss the case for abuse of certain provisions of the Bankruptcy Code.⁴⁵ The Trustee argued that Roll and Currie engaged in "manipulating the means test" by filing separate petitions and not counting the other debtor's income as their own for purposes of the means test."⁴⁶

The court denied the motion, explaining that the U.S. Trustee's argument lacked merit because "only married persons may file joint returns," and DOMA precluded the court's recognition of same-sex marriages for joint bankruptcy petition purposes.⁴⁷ Since DOMA required the U.S. Trus-

³⁶ 17 C.F.R. § 240.10b5-2(b)(3) (2009).

³⁷ See *In re Roll*, 400 B.R. 674 (Bankr. W.D. Wis. 2008).

³⁸ *Id.* at 675.

³⁹ 11 U.S.C. § 707(b)(2) (2006). Under bankruptcy law, if a debtor's income falls above his state's median family income, the U.S. Trustee assigned to the case may determine whether the debtor can repay, within five years, any of the obligations that the debtor seeks to discharge in bankruptcy. If the Trustee finds that the debtor is able to repay some of the obligations within five years, these obligations will not be discharged in bankruptcy.

⁴⁰ If this occurred, each party would pay back more of her debt than under her original Chapter 7 filing.

⁴¹ *In re Roll*, 400 B.R. at 677-78.

⁴² *Id.* at 679.

⁴³ *Id.* at 679 n.6.

⁴⁴ *Id.* at 679.

⁴⁵ *Id.* at 675.

⁴⁶ *Id.* at 679.

⁴⁷ *In re Roll*, 400 B.R. at 679.

tee to satisfy a more stringent burden of proof when claiming that the debtors were abusing the Bankruptcy Code, these two debtors benefitted from DOMA's application to their case.

2. Bankruptcy Law: The *Goodale* Case⁴⁸

In January 2001, Mitchell Foshay brought suit against Russell Goodale in a Washington court for an equitable distribution of assets accumulated over the course of their eighteen-year same-sex relationship, which had ended approximately six months earlier.⁴⁹ The state action ended in a judgment in favor of Mr. Foshay awarding him over \$91,000.00, including a one-half interest in their Seattle-area home.⁵⁰ Mr. Goodale subsequently filed a petition for Chapter 7 bankruptcy relief, claimed a homestead exemption in his one-half interest in the home,⁵¹ and sought to avoid attachment of a lien on the home to secure Mr. Foshay's judgment.⁵²

Under the Bankruptcy Code in effect at that time,⁵³ a debtor could not avoid a lien if it was a judicial lien held by a "spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child."⁵⁴ Mr. Goodale, the debtor, argued that Mr. Foshay did not qualify for this exception because he was not a spouse under federal law.⁵⁵ The court agreed.⁵⁶ In applying DOMA's definition of spouse, the court held that Mr. Foshay was not a spouse for purposes of the Bankruptcy Code.⁵⁷ Therefore, Mr. Foshay could not utilize any Bankruptcy Code exceptions⁵⁸ to attach his lien to Mr. Goodale's interest in the real property.⁵⁹ Mr. Goodale benefitted by the application of DOMA's definition of spouse to his case because his former partner could not easily reach his assets in bankruptcy.

In the bankruptcy cases discussed above, the parties attempted to *avoid* recognition of their same-sex relationships under federal law because they would discharge greater amounts of debt in bankruptcy as unmarried per-

⁴⁸ See *In re Goodale*, 298 B.R. 886 (Bankr. W.D. Wash. 2003).

⁴⁹ *Id.* at 888.

⁵⁰ *Id.* at 888-89.

⁵¹ WASH. REV. CODE § 6.13.030 (1999).

⁵² *In re Goodale*, 298 B.R. at 889.

⁵³ Bankruptcy, Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended in title 11 of the U.S.C.); *but see* Pub. L. No. 109-8, 119 Stat. 188 (2005) (the Bankruptcy Code underwent significant modification in 2005 and this provision was reworded with the term "spouse" excluded).

⁵⁴ *In re Goodale*, 298 B.R. at 889 (citing 11 U.S.C. § 522(f)(1)(A)(i)).

⁵⁵ *Id.* at 893.

⁵⁶ *Id.*

⁵⁷ *Id.* at 893-94 (citing 11 U.S.C. § 7).

⁵⁸ 11 U.S.C. § 522(f)(1)(A)(i).

⁵⁹ *In re Goodale*, 298 B.R. at 893-94.

sons.⁶⁰ In these situations, DOMA provided a benefit to the parties because the statutory law supported the parties' positions that their relationships fell outside the scope of federally-recognizable marriages.

II. AN OVERVIEW OF SECURITIES LAWS AND INSIDER TRADING RULES

Congressional lawmaking and subsequent rulemaking by the SEC has been primarily reactive to social events or to judicial opinions; it has not developed proactively.⁶¹ This reactive development resulted in patchy securities regulation that is open to exploitation.⁶²

A. *10(b) of the Securities Exchange Act of 1934 and Subsequent Agency Rulemaking*

1. 10(b) of the Securities Exchange Act⁶³

Following the stock market crash of 1929, Congress passed the Securities Act of 1933 (Securities Act)⁶⁴ and the Securities Exchange Act of 1934 (Exchange Act).⁶⁵ The Securities Act primarily governs the initial offering of securities, while the Exchange Act primarily governs secondary transactions involving securities.⁶⁶ Section 10(b) of the Exchange Act makes it unlawful for any person to use or employ "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe [in connection with the purchase or sale of securities]. . . ."⁶⁷ The very broad language of § 10(b) grants the SEC wide latitude in making rules governing deceptive trading practices.⁶⁸

⁶⁰ *In re Roll*, 400 B.R. 674, 677 (2008); *In re Goodale*, 298 B.R. at 889.

⁶¹ Joel Seligman, *Should Investment Companies Be Subject to A New Statutory Self-Regulatory Organization?*, 83 WASH. U. L.Q. 1115, 1123 (2005).

⁶² Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading after United States v. O'Hagan*, 84 VA. L. REV. 153, 196 (1998).

⁶³ 15 U.S.C. § 78j(b) (2010).

⁶⁴ Securities Act of 1933, ch. 38, 48 Stat. 74 (current version at 15 U.S.C. §§ 77a-77aa (2010)).

⁶⁵ Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (current version at 15 U.S.C. §§ 78a-78oo (2010)).

⁶⁶ STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 36-37 (Robert C. Clark et al. eds., 2d ed. 2008).

⁶⁷ 15 U.S.C. § 78j(b) (2010).

⁶⁸ Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing With the Meritorious As Well As the Frivolous*, 40 WM. & MARY L. REV. 1055, 1128 (1999).

2. SEC Rule 10b-5⁶⁹

Heeding to the Congressional decree for agency rulemaking, the SEC promulgated Rule 10b-5 to provide more concrete definitions to the terms set out in § 10(b) of the Exchange Act.⁷⁰ Among other prohibitions, Rule 10b-5 prohibits any person from “engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”⁷¹ Therefore, a seller of securities dealing directly with a buyer (or vice versa) must not act deceitfully in the transaction.⁷²

3. SEC Rule 10b5-2⁷³

More recently in 2000, following the judicially created “misappropriation theory” of insider trading,⁷⁴ the SEC promulgated Rule 10b5-2 in order to “defin[e] circumstances in which a person has a duty of trust or confidence for purposes of the ‘misappropriation theory’ of insider trading. . . .”⁷⁵ Subsection (b)(3) of the Rule provides that a duty of trust or confidence exists in the following circumstances, amongst others:

Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties’ history, patter, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.⁷⁶

At the time the SEC promulgated this rule, the majority of case law articulating the misappropriation theory of insider trading focused on deception within business relationships.⁷⁷ Case law was inconsistent as to when family or other non-business relationships gave rise to liability under the

⁶⁹ 17 C.F.R. § 240.10b-5 (2009).

⁷⁰ 17 C.F.R. § 240.10b-5; CHOI & PRITCHARD, *supra* note 66, at 240 (quoting Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967)).

⁷¹ 17 C.F.R. § 240.10b-5.

⁷² *Strong v. Repide*, 213 U.S. 419, 430-31 (1909).

⁷³ 17 C.F.R. § 240.10b5-2 (2009).

⁷⁴ *See supra* Part II.B.2.

⁷⁵ 17 C.F.R. § 240.10b5-2.

⁷⁶ 17 C.F.R. § 240.10b5-2(b)(3) (2009) (emphasis added).

⁷⁷ *See, e.g.*, *United States v. O’Hagan*, 521 U.S. 642 (1997); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); *O’Connor & Assoc. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179 (S.D.N.Y. 1981).

misappropriation theory.⁷⁸ Rule 10b5-2 created a “presumption of a relationship of trust and confidentiality in the case of close family members.”⁷⁹

In the notice-and-comment period preceding Rule 10b5-2’s finalization, some commentators noted that Subsection (b)(3) of the Rule did not include domestic partnerships, the precursor to same-sex marriages, and therefore could not reach these types of relationships.⁸⁰ The SEC took note of the commentators’ concerns, but stated that the scope of the other subsections of Rule 10b5-2 could reach domestic partnerships.⁸¹

B. *Insider Trading in Federal Case Law*

1. Classical Theory of Insider Trading

Historically, prohibitions on trading while using material, nonpublic information applied only to “core insiders,” which were persons holding a position within any organization and receiving material, nonpublic information by virtue of that inside position.⁸² However, in 1968, the Second Circuit issued a sweeping new restriction on the use of inside information in *SEC v. Texas Gulf Sulphur*.⁸³ The court stated that “anyone in possession of material inside information must either disclose it to the investing public, or . . . abstain from trading in . . . the securities concerned while such inside information remains undisclosed.”⁸⁴ In a later case, *Chiarella v. United States*, the Supreme Court rejected the Second Circuit’s broad approach.⁸⁵ The Court held that the duty to disclose material, nonpublic information in the course of a trade, arose only if the person possessing the information had a duty to the *other party in the transaction* because of an existing fiduciary relationship.⁸⁶ This narrowed standard continued to include core insiders, who, by virtue of their inside position, owed a fiduciary duty to all shareholders to protect the value of a company’s shares.⁸⁷ The standard did not include outside parties of a corporation, such as family members, who

⁷⁸ Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 65 Fed. Reg. 51,716 (Aug. 24, 2000) [hereinafter Selective Disclosure]; see also *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985), *rev’d on other grounds*, 773 F.2d 477 (2d Cir. 1985).

⁷⁹ *SEC v. Yun*, 327 F.3d 1263, 1273 n.23 (11th Cir. 2003).

⁸⁰ 17 C.F.R. § 240.10b5-2(b)(3); Selective Disclosure, *supra* note 78.

⁸¹ Selective Disclosure, *supra* note 78.

⁸² See *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 SEC Docket 907 (Nov. 8, 1961).

⁸³ See *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

⁸⁴ *Id.* at 848.

⁸⁵ *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

⁸⁶ See *id.*

⁸⁷ *Id.* at 228-29.

owed no fiduciary duty to protect the shares' value.⁸⁸ In his dissent in *Chiarella*, Chief Justice Burger proposed an alternative basis for insider trading liability, which ultimately became the misappropriation theory that the Supreme Court embraced more than ten years later in *United States v. O'Hagan*.⁸⁹

In *Dirks v. SEC*, the Supreme Court expanded insider trading liability under the classical theory to include "tippees"—those who received nonpublic information from core insiders.⁹⁰ However, the Court limited tippee liability; a court could only find tippees liable *if* the tippees knew that the core insider wrongfully disclosed the information *and* the insider benefitted by disclosing the information.⁹¹ Courts could broadly construe the benefit received by the insider by finding that giving a gift of confidential information to the tippee was a "benefit" to the insider.⁹² Thus, only core insiders of a corporation and a select group of tippees were liable for trading on material, nonpublic information under the classical theory of insider trading.⁹³

2. The Misappropriation Theory of Insider Trading

Since a court could only find tippees liable if the divulging insider received a benefit, outsiders who received material, nonpublic information from the insider by means of deception were still exempt from liability.⁹⁴ However, in *SEC v. Materia*, the Second Circuit responded to this loophole by constructing the misappropriation theory of insider trading.⁹⁵ The Supreme Court solidified the misappropriation theory in *United States v. O'Hagan*,⁹⁶ holding that a court may find liable any party who deceptively obtains, in breach of his duty of trust or confidence, material, nonpublic information, and subsequently trades on this information.⁹⁷ In *O'Hagan*, the Court made deception an essential element of liability; if the party fully disclosed his intent to use the information for trading purposes, the party did not use a "deceptive device" under § 10(b).⁹⁸ Similarly, the breach of duty of trust or confidence to the source of information did not occur until

⁸⁸ *Id.*

⁸⁹ *Id.* at 240 (Burger, C.J., dissenting).

⁹⁰ *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

⁹¹ *Id.* at 661-63.

⁹² *Id.* at 664.

⁹³ *Id.* at 661-63.

⁹⁴ *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984).

⁹⁵ *See id.*; *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981).

⁹⁶ *See United States v. O'Hagan*, 521 U.S. 642 (1997).

⁹⁷ *Id.* at 652.

⁹⁸ *Id.* at 655.

the party traded on the information, thus satisfying the “in connection with the purchase or sale of any security” language in § 10(b).⁹⁹

3. Relationships of Trust and Confidence

For many years before the Supreme Court’s holding in *O’Hagan*, lower courts had been applying the misappropriation theory.¹⁰⁰ In doing so, the courts interpreted what constituted a relationship of trust and confidence that created a duty not to disclose material, nonpublic information.¹⁰¹ In this line of decisions, the courts primarily analyzed employer–employee or similar business relationships.¹⁰² The courts had little trouble finding non-disclosure duties within these professional relationships.¹⁰³

In *United States v. Reed*, the Southern District of New York faced an issue of first impression: was a father–son relationship, as a matter of law, a relationship of trust and confidence creating a duty not to disclose material, nonpublic information that was revealed in the relationship?¹⁰⁴ In an extremely in-depth analysis of the history of insider trading, with a particular focus on cases discussing relationships of trust and confidence, the court declined to adopt a bright-line test.¹⁰⁵ Instead, it concluded that “the assessment of the existence or absence of such a relationship invariably requires a series of factual findings and generally rests with . . . the jury, at trial.”¹⁰⁶ In denying the defendant trader’s motion to dismiss, the court explained that it would be very rare to determine the status of a relationship at that stage in the proceeding.¹⁰⁷ Such a finding would only be appropriate if there was reason for the judge to make the decision that the relationship was or was not a relationship of trust and confidence *as a matter of law*.¹⁰⁸ The court did, however, emphasize that the existence of a blood or marriage relationship did not, in itself, establish a relationship of trust and confidence.¹⁰⁹

⁹⁹ *Id.* at 656.

¹⁰⁰ *See, e.g., Materia*, 745 F.2d 197; *Newman*, 664 F.2d 12; *O’Connor & Assoc. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179 (S.D.N.Y. 1981).

¹⁰¹ *United States v. Reed*, 601 F. Supp. 685, 703-08 (S.D.N.Y. 1985), *rev’d on other grounds*, 773 F.2d 447 (2d Cir. 1985).

¹⁰² *SEC v. Yun*, 327 F.3d 1263, 1271 (11th Cir. 2003) (citing *O’Hagan*, 521 U.S. at 647-49; *United States v. Carpenter*, 791 F.2d 1024, 1028 (2d Cir. 1986)).

¹⁰³ *Id.*

¹⁰⁴ *Reed*, 601 F. Supp. at 704.

¹⁰⁵ *Id.* at 705.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* at 706 (quoting George Gleason Bogert, *Confidential Relations and Unenforceable Express Trusts*, 13 CORNELL L.Q. 237, 300-11 (1928)).

In 1991, prior to the passage of SEC Rule 10b5-2, the Second Circuit in *United States v. Chestman* addressed whether a marriage was a relationship of trust or confidence.¹¹⁰ There, the court reiterated the Southern District of New York's holding in *Reed* that marriage alone does not create a fiduciary relationship.¹¹¹ In *Chestman*, the Second Circuit held that the husband did not owe a fiduciary duty to his wife because he did not expressly agree to maintain confidentiality.¹¹² Furthermore, although the husband and wife had "shared and maintained generic confidences," the court found no evidence that these were "fiduciary, rather than normal marital, obligations."¹¹³ Finally, in addition to the lack of express agreement of confidentiality, the court found no evidence of an implied agreement of confidentiality based on a "pre-existing fiduciary-like relationship between the parties."¹¹⁴ The court provided the following factors that would weigh in favor of a fiduciary relationship: (1) some purpose for the disclosure, business or otherwise; (2) an inducement for disclosure by the husband; (3) superiority on the part of the husband and reliance on the part of the wife; or (4) a pattern of sharing business confidences between the couple.¹¹⁵

The first case to address relationships of trust and confidence following the implementation of Rule 10b5-2 arose in the Northern District of California in *United States v. Kim*.¹¹⁶ In *Kim*, the alleged insider trading occurred prior to the finalization of the Rule, thus making the Rule inapplicable to the case.¹¹⁷ Nevertheless, the court provided insightful dicta into the meaning of the Rule.¹¹⁸ The court opined that the SEC passed the Rule because it felt that the Second Circuit in *Chestman* defined relationships of trust and confidence too narrowly.¹¹⁹ The court believed that going forward, relationships that were previously exempt, including familial relationships, would form the basis for the duty of trust and confidence in insider trading lawsuits.¹²⁰

In 2003, the Eleventh Circuit adopted a broader approach to spousal liability.¹²¹ It held where spouses historically had exchanged business con-

¹¹⁰ *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991).

¹¹¹ *Id.*

¹¹² *Id.* at 571.

¹¹³ *Id.* The court recognized that every marriage will contain confidences, but these marital confidences alone do not create a fiduciary duty to refrain from insider trading. For such a duty to arise, the confidences must be more closely related to a business, rather than the marital, relationship between the spouses.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *See United States v. Kim*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002).

¹¹⁷ *Id.* at 1014.

¹¹⁸ *Id.* at 1014-15.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ *SEC v. Yun*, 327 F.3d 1263, 1273 (11th Cir. 2003).

fidences, a spouse would breach his duty and would be liable if he used the information in trading.¹²² The court acknowledged that the holding narrowed liability more than the new SEC Rule 10b5-2, even though the holding was broader than previous court decisions.¹²³ The court believed that Rule 10b5-2 created the presumption of a relationship of trust and confidence based on the mere existence of a marriage relationship, regardless of whether there was a history of sharing business confidences.¹²⁴

III. THE DEFENSE OF MARRIAGE ACT'S APPLICATION TO SECURITIES LAW

A. *Strict Application of DOMA is Warranted*

Congress explicitly stated its intent that the courts strictly apply DOMA's exact language to all areas of federal law, including securities law.¹²⁵ Furthermore, the federal courts' history in utilizing DOMA indicates that the courts must apply DOMA across all types of federal law.¹²⁶ A court is to "hold Congress to its words," meaning that a court cannot look beyond the language of the statute, if the language of the statute is unambiguous.¹²⁷ The language of DOMA is clear: "spouse" means "a person of the opposite sex who is a husband or a wife," and "marriage" means "only a legal union between one man and one woman as a husband and wife."¹²⁸ The court must apply the plain meaning of the statute because DOMA's language leaves no room for judicial interpretation, even if the end result leads to a ruling against the government's position, as it did in the *Roll* case.¹²⁹

Even if a court finds some ambiguity in DOMA's plain language and therefore looks beyond the language of the statute to Congress's intent,¹³⁰ the court will discover that Congress has spoken directly on how courts are to apply DOMA. Fierce debates on DOMA make clear that representatives on both sides of the debate believed and predicted that courts would strictly apply DOMA's language and definitions to all areas of federal law, which

¹²² *Id.*

¹²³ *Id.* at 1273 n.23.

¹²⁴ *Id.*

¹²⁵ *See, e.g.*, 142 CONG. REC. H7279 (daily ed. July 11, 1996) (statement of Rep. McInnis).

¹²⁶ *See* cases cited *supra* note 2.

¹²⁷ *Brooker v. Desert Hosp. Corp.*, 947 F.2d 412, 414-15 (9th Cir. 1991).

¹²⁸ 1 U.S.C. § 7 (2011).

¹²⁹ *In re Roll*, 400 B.R. 674, 679 (Bankr. W.D. Wis. 2008).

¹³⁰ *See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984).

reference the words “spouse” or “marriage.”¹³¹ Indeed, proponents of DOMA lauded the Act’s language because it precludes any opportunity for judicial interpretation of “spouse” and “marriage” in federal law.¹³² DOMA’s language, Congress’s intent, and previous court decisions mandate that courts must strictly apply DOMA’s language to all areas of federal law, including securities laws.

B. *Application of DOMA to Rule 10b5-2 Nullifies the Rule’s Practical Application to Same-Sex Couples*

The SEC promulgated Rule 10b5-2 in 2000, four years after Congress signed DOMA into law.¹³³ By this time, courts had already broadly applied DOMA to cases in many other areas of federal law.¹³⁴ The SEC was aware of the limitation of the word “spouse” in federal law when it chose to use the word in Rule 10b5-2.¹³⁵ The SEC acknowledged that the term would exclude same-sex relationships, but it did not consider insider trading by same-sex couples as sufficiently frequent to specifically warrant its inclusion in the new Rule.¹³⁶ Rather, the SEC believed that other parts of the Rule would encompass such relationships.¹³⁷

In its Preliminary Note to Rule 10b5-2, the SEC explained that it provided a “non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the ‘misappropriation theory’ of insider trading.”¹³⁸ The SEC further explained that the new rule “does not modify the scope of insider trading law in any other respect” beyond providing a definition for the relationships which create a duty of trust and confidence.¹³⁹ The SEC made clear that the pre-rule case law related to the misappropriation theory of insider trading would remain valid.¹⁴⁰

The SEC created Rule 10b5-2 in large part due to the holding in *Chestman*, which discussed spousal and familial relationships in detail.¹⁴¹ Subsection (b)(3) is the only “new law” the SEC created in Rule 10b5-2.¹⁴²

¹³¹ See, e.g., 142 CONG. REC. H7482 (daily ed. July 12, 1996) (statement of Rep. Frank) (arguing against DOMA because courts would apply it to every area of federal law, thereby precluding the granting of a vast array of federal benefits to same-sex couples).

¹³² See, e.g., 142 CONG. REC. H7480, 7489 (daily ed. July 12, 1996) (statement of Rep. Canady).

¹³³ 1 U.S.C. § 7; 17 C.F.R. § 240.10b5-2 (2009).

¹³⁴ See cases cited *supra* note 2.

¹³⁵ Selective Disclosure, *supra* note 78.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ 17 C.F.R. § 240.10b5-2.

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *United States v. Kim*, 184 F. Supp. 2d 1006, 1014 (N.D. Cal. 2002).

¹⁴² *Id.*

This subsection creates the presumption of a relationship of trust and confidence in spousal or familial relationships.¹⁴³ Therefore, the government need not prove this element in a case of a violation of insider trading under the misappropriation theory line of cases.¹⁴⁴ Subsections (b)(1) and (b)(2) of Rule 10b5-2(b) merely codify the holdings in *O'Hagan* and its progeny's discussion of relationships of trust and confidence.¹⁴⁵ The subsections do not change the law on relationships of trust and confidence for insider trading.¹⁴⁶

Where the parties were previously liable for insider trading for violating the duty of trust and confidence, they remain liable.¹⁴⁷ Where the parties did not violate such a duty, and where the relationship is not enumerated in Subsection (b)(3) of Rule 10b5-2, they are not liable.¹⁴⁸ Aside from Subsection (b)(3), the only purpose of Rule 10b5-2 is to serve as one more piece of binding law on courts deciding insider trading cases under the misappropriation theory.¹⁴⁹ Because *O'Hagan*, which continues to bind all federal courts, provides a definition of the duty of trust and confidence, Subsections (b)(1) and (b)(2) are, as a practical matter, superfluous. The same pre-rule, judicially-created standards for relationships of trust and confidence apply to parties not encompassed in Subsection (b)(3).¹⁵⁰

Subsection (b)(3) of SEC Rule 10b5-2 provides that a relationship of trust and confidence is found “[w]henver a person receives or obtains material nonpublic information from his or her *spouse*, parent, child, or sibling. . . .”¹⁵¹ The SEC enumerated relationships of trust and confidence in this Subsection, which includes spousal relationships.¹⁵² When a court applies DOMA to the language of this Subsection, the combination acts to make Subsection (b)(3) wholly inapplicable to same-sex married couples. A court may not use Subsection (b)(3) to find liability for insider trading because DOMA prevents the court from finding that a same-sex partner is a spouse under federal law.¹⁵³ As discussed above, while Subsections (b)(1) and (b)(2) of the Rule technically cover same-sex couples, the applicable law for them has not changed.¹⁵⁴ Pre-rule standards for relationships of trust and confidence related to insider trading continue to govern same-sex

¹⁴³ 17 C.F.R. § 240.10b5-2(b)(3) (2009).

¹⁴⁴ Selective Disclosure, *supra* note 78.

¹⁴⁵ *Kim*, 184 F. Supp. 2d at 1014.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ 17 C.F.R. § 240.10b5-2(b)(3) (2009) (emphasis added).

¹⁵² *Id.*

¹⁵³ 1 U.S.C. § 7 (2011).

¹⁵⁴ *Kim*, 184 F. Supp. 2d at 1014.

couples.¹⁵⁵ The government carries the full burden of proving that a relationship of trust and confidence exists in order to prove liability for insider trading.

C. *DOMA Requires Courts to Find, as a Matter of Law, that Same-Sex Marriages are Not Relationships of Trust and Confidence*

DOMA binds judicial discretion in determining whether a same-sex marriage forms a relationship of trust and confidence sufficient to create a duty against insider trading. While SEC Rule 10b5-2 provides concrete guidelines on the types of relationships that create a duty of trust and confidence, as an Act of Congress, DOMA overrides those guidelines.¹⁵⁶ Furthermore, with its clear mandate that federal law shall not recognize same-sex spouses or marriages, the plain language of DOMA invalidates all contrary decisions that attempt to recognize the validity of same-sex relationships as it pertains to securities laws.¹⁵⁷

Additionally, the legislative history of DOMA illustrates that Congress intended the Act to prevent recognition of same-sex marriages in all areas of federal law.¹⁵⁸ Congress did not craft provisions for flexibility or judicial discretion in the statute's language. The legislative history illustrates that DOMA's opponents in Congress argued against it specifically because the Act is so rigid in its application.¹⁵⁹

Under most circumstances, a court will interpret a statute's language so as to avoid absurd results.¹⁶⁰ However, the interpretative power of the judiciary is not absolute.¹⁶¹ When Congress uses a statute to declare specific limits, the courts cannot exercise judicial discretion to apply doctrines and laws inconsistent with Congress's intent.¹⁶² Instead, courts must adhere to Congress's intent in interpreting a statute.¹⁶³ In *Reed*, the Southern District Court of New York explained that only in very limited circumstances will it be proper and possible for the "assessment of the existence or *absence* of . . . a relationship [of trust and confidence]" to be determined as a

¹⁵⁵ *Id.*

¹⁵⁶ *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).

¹⁵⁷ 1 U.S.C. § 7 (2011).

¹⁵⁸ 1 U.S.C. § 7; *see, e.g.*, 142 CONG. REC. H7482 (daily ed. July 12, 1996) (statement of Rep. Frank).

¹⁵⁹ *See, e.g.*, 142 CONG. REC. H7482, H7491 (daily ed. July 12, 1996) (statement of Rep. Frank; Rep. Studds).

¹⁶⁰ *Rowland v. Cal. Men's Colony, Unit II Men's Advisory Council*, 506 U.S. 194, 200 (1993).

¹⁶¹ *United States v. Nat'l City Lines, Inc.*, 334 U.S. 573, 588 (1948).

¹⁶² *Id.*

¹⁶³ *Id.*

matter of law.¹⁶⁴ Given the limitations DOMA places on judicial interpretations of same-sex relationships, the analysis of a same-sex marriage through the lens of insider trading is the type of limited circumstance where a court should find the absence of a relationship of trust and confidence as a matter of law.

Given Congress's express intent throughout the Congressional Record that no exceptions to the provisions of DOMA exist in federal law,¹⁶⁵ courts cannot grant recognition of a same-sex marriage as a relationship of trust and confidence under federal securities law. The government's proof of a relationship of trust and confidence will be irrelevant. As a result, courts must treat the parties as unmarried in securities law, as they have done in other areas of federal law.¹⁶⁶ As the bankruptcy cases discussed above illustrate, federal courts must rule this way even when the results are contrary to the government's position in the case.¹⁶⁷

D. *Tipper–Tippee Liability is Still Applicable*

Although DOMA strips courts of the ability to find a party liable for insider trading under the misappropriation theory, a party who receives a tip from his same-sex spouse and trades on the material, nonpublic information may still be liable under the theory of tipper–tippee liability created in *Dirks v. SEC*.¹⁶⁸ Liability attaches when a core insider, the tipper, provides information and intends that the tippee use the information for insider trading.¹⁶⁹ The tippee cannot deceive the tipper in order to gain the information.¹⁷⁰ If the tipper has the requisite intent and has not been deceived, it is unnecessary for the court to find a relationship of trust and confidence or attempt to use SEC Rule 10b5-2.¹⁷¹ So long as the tipper receives a benefit¹⁷² by providing the information and intends to allow the tippee to use the information, both the insider tipper and his same-sex spouse tippee can be liable for insider trading.

¹⁶⁴ *United States v. Reed*, 601 F. Supp. 685, 705 (S.D.N.Y. 1985), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985) (emphasis added).

¹⁶⁵ *See, e.g.*, 142 CONG. REC. H7482 (daily ed. July 12, 1996) (statement of Rep. Frank).

¹⁶⁶ *See* cases cited *supra* note 2.

¹⁶⁷ *See In re Roll*, 400 B.R. 674 (Bankr. W.D. Wis. 2008).

¹⁶⁸ *Dirks v. SEC*, 463 U.S. 646, 661-63 (1983).

¹⁶⁹ *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984).

¹⁷⁰ *Id.*

¹⁷¹ *Dirks*, 463 U.S. at 661-63.

¹⁷² *See id.* at 660 (indicating that a benefit can be broadly construed to include the enjoyment of giving a "gift" of insider information to the tippee).

E. *A DOMA Exception to Insider Trading: Larry and Dave*¹⁷³

Larry and Dave legally married in Massachusetts in 2006. Since that time, Larry and Dave have resided in the same Boston home and lived life like any other couple married under the laws of the Commonwealth. Like many married couples, Larry and Dave regularly discuss their professional lives at home.

Dave is a board member of the publicly traded Equality Corporation,¹⁷⁴ and frequently privy to material, nonpublic information about the company. One evening over dinner at home, Dave tells Larry that Equality Corporation will announce its sale to mega-conglomerate, Inequality, Incorporated in two weeks and that the price of Equality's stock should rise steeply. Larry acknowledges this interesting development but discusses it in no further detail with Dave. Larry gives Dave no indication that he plans to use this information in any way.

The next morning, Larry accesses his retirement investment account online and purchases 1,000 shares of Equality Corporation at the prevailing market rate of \$25. Larry holds these shares in his retirement account until the sale is announced. Larry then sells the shares at the new market rate of \$50. Larry is elated that he has made a \$25,000 profit in two weeks. His elation ends when he learns that he is being prosecuted for insider trading in federal district court.

At trial, the SEC argues that Larry misappropriated the information from Dave in violation of his duty of trust and confidence. If "Larry" was "Laura" and a spouse of Dave, their marriage would carry a presumption of the duty of trust and confidence by virtue of SEC Rule 10b5-2(b)(3).¹⁷⁵ This case would be an easy win for the SEC. But Larry is not Laura, nor is he a spouse under federal law, and the presumption from Rule 10b5-2(b)(3) is thus inapplicable.

The SEC also argues that Larry is guilty of insider trading under Rule 10b5-2(b)(2)¹⁷⁶ or, alternatively, under *United States v. O'Hagan*¹⁷⁷ and its progeny because Larry misappropriated material, nonpublic information from Dave in violation of his duty of trust and confidence to Dave. This argument would be plausible but for the existence of DOMA. DOMA precludes the court from recognizing the relationship between Larry and Dave under federal securities law unless it takes the bold step of invalidating the Act on constitutional or other grounds. The court must follow DOMA's plain language and legislative history, which instruct the court that there are no exceptions to DOMA's application to federal law. Since

¹⁷³ Based loosely on the facts in *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991).

¹⁷⁴ Not affiliated or associated with the eQuality Corporation of Arlington, Texas.

¹⁷⁵ 17 C.F.R. § 240.10b5-2(b)(3) (2009).

¹⁷⁶ 17 C.F.R. § 240.10b5-2(b)(2) (2009).

¹⁷⁷ See *United States v. O'Hagan*, 521 U.S. 642 (1997).

there is no flexibility in the language of the Act, the court cannot exercise judicial discretion, even to prevent the absurd result of dismissing the case against Larry.

As a matter of law, the court must hold that no relationship of trust and confidence exists between Larry and Dave under federal law. Thus, Larry owed Dave no duty related to the information he received over dinner. Furthermore, the court must hold that Larry is not liable under the tipper–tippee theory of insider trading. Larry is not a tippee because he effectively gained the information from Dave by deception as he did not disclose to Dave his intent to trade on the information. Because Dave had no knowledge that Larry would trade on the information, Dave received no benefit by providing the information to Larry. Larry did not violate § 10(b) or Rule 10b-5 in trading on the information. The case is dismissed and Larry leaves the courtroom a free man.

F. *Solutions to Unintended Consequences*

The interplay between DOMA and federal securities law allows a party to lawfully trade on material, nonpublic information received from his same-sex spouse. While beneficial for the inside trader, this result does not serve the needs and desires of the government or the market.¹⁷⁸ Four alternatives are arguable, but only one is viable: a full DOMA repeal.

1. Judicial Discretion to Prevent an Absurd Result

One possible solution to this unintended consequence is for a court to exercise judicial discretion in order to find a duty of trust and confidence between the same-sex spouses. In most circumstances, a court may exercise judicial discretion to interpret a statute in order to avoid an absurd result.¹⁷⁹ However, DOMA forecloses this judicial power. Its legislative history demonstrates that Congress intended no exceptions to DOMA’s application.¹⁸⁰

¹⁷⁸ See Note, *Insider Trading in Junk Bonds*, 105 HARV. L. REV. 1720, 1730 (1992); Roy A. Schotland, *Unsafe At Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1429 (1967).

¹⁷⁹ *Rowland v. Cal. Men’s Colony, Unit II Men’s Advisory Council*, 506 U.S. 194, 200 (1993).

¹⁸⁰ See, e.g., 142 CONG. REC. H7482 (daily ed. July 12, 1996) (statement of Rep. Frank).

2. Amended SEC Rule 10b5-2 Which Includes Same-Sex Relationships

Alternatively, the SEC may decide to amend SEC Rule 10b5-2 to include same-sex couples in Subsection (b)(3) of the rule, thereby creating a presumption of a duty of trust and confidence. DOMA precludes this solution because its legislative history makes clear that Congress intended for DOMA to apply to all federal definitions of spouse.¹⁸¹ If the SEC chooses to amend this rule, a court will ignore the rule or strike it down as contrary to DOMA, the superseding law.¹⁸²

3. Exception to DOMA's Scope

Congress may seek to amend DOMA to exclude its application to federal securities law. Partial repeals by implication are disfavored, and the Supreme Court does not recognize them.¹⁸³ Therefore, Congress would need to explicitly repeal or amend portions of DOMA in order for a court to give effect to the changes.¹⁸⁴ Congress may be hesitant to amend DOMA in a way that causes further injury to same-sex couples, as public support for laws detrimental to same-sex couples has waned in recent years.¹⁸⁵ Finally, DOMA is more open to attack when it is applied selectively rather than uniformly.¹⁸⁶ A selectively-applied statute may violate constitutional equal protection rights.¹⁸⁷

4. Full Repeal of DOMA

Congress may repeal DOMA in order to resolve the unintended result in securities law. A DOMA repeal would bring same-sex marriages within the scope of Rule 10b5-2(b)(3). Furthermore, a court could find that a same-sex marriage is a relationship that creates a duty of trust and confidence. Although public support for DOMA has waned in recent years, the

¹⁸¹ *Id.*

¹⁸² *See* *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984).

¹⁸³ *Rodriguez v. United States*, 480 U.S. 522, 524 (1987).

¹⁸⁴ *Id.*

¹⁸⁵ Nancy K. Kubasek et al., *Civil Union Statutes: A Shortcut to Legal Equity for Same-Sex Partners in a Landscape Littered with Defense of Marriage Acts*, 15 U. FLA. J.L. & PUB. POL'Y 229, 258-59 (2004).

¹⁸⁶ Jay Michaelson, *On Listening to the Kulturkampf, or, How America Overruled Bowers v. Hardwick, Even Though Romer v. Evans Didn't*, 49 DUKE L.J. 1559, 1566 (2000).

¹⁸⁷ *Furman v. Georgia*, 408 U.S. 238, 256-57 (1972) (Douglas, J., concurring); *id.* at 1566.

full political implications, both favorable and unfavorable, of a full DOMA repeal, are beyond the scope of this comment.¹⁸⁸

CONCLUSION

When a federal court applies DOMA within the context of the misappropriation theory of insider trading, an unintended result occurs. This wrinkle in law creates an immunity for a person trading on material, non-public information received from his same-sex spouse for several reasons. First, a same-sex spouse does not fall within the definition of spouse under SEC Rule 10b5-2(b)(3), which creates a presumption of duty of trust and confidence.¹⁸⁹ Second, DOMA precludes judicial recognition of the marriage under any federal law.¹⁹⁰ A court must treat the parties as strangers; it cannot exercise discretion in determining that the parties' relationship is one of trust and confidence under SEC Rule 10b5-2(b)(2) or case law. Thus, the court must find that no relationship of trust and confidence exists and there is no liability for use of the material, nonpublic information. Any SEC attempts to amend its rules to close this loophole will be unsuccessful as DOMA is the controlling law.¹⁹¹ The only viable solution to this unintended result is a full DOMA repeal.

¹⁸⁸ See Kubasek et al., *supra* note 185.

¹⁸⁹ 17 C.F.R. § 240.10b5-2(b)(3) (2009).

¹⁹⁰ 1 U.S.C. § 7 (2011).

¹⁹¹ See *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).

