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CONTENTS

HEDGE FUNDS: THE FINAL FRONTIER OF SECURITIES REGULATION AND A LAST HOPE FOR ECONOMIC REVIVAL

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INTRODUCTION

Hedge funds are the final frontier in securities regulation. To date, most hedge funds have managed to slip through the government's attempts to regulate the financial markets. The benefit to the economy has been enormous. From capital efficiency to market liquidity, hedge funds have enabled broad economic growth. Yet, with the financial collapse of 2008, hedge fund regulation is a storm brewing once again.[1]

In a post-2008 economy, hedge funds will play an unparalleled role in lending and providing institutional capital.[2] Hedge funds will be charged to fill in for investment banks to create wealth and promote corporate efficiency through industry incentives and market mechanisms. With capital markets in crisis, there could be no worse a time to regulate hedge funds. Hedge funds are in many respects the last hope for economic revival.

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[1] Andrew Clark, *Wall Street Braces for Change*, THE GUARDIAN, Jan. 18, 2009, *available at* http://www.guardian.co.uk/business/2009/jan/18/barackobama-globalrecession (suggesting that Senate Democrats are eager to close tax loopholes for hedge funds and mandate additional regulation including registration for hedge funds); Kara Scannel, *Schapiro Pledges Vigilance as SEC Chief*, WALL ST. J., Jan. 15, 2009, at C3 (suggesting that Schapiro will increase supervision of loosely regulated financial products such as credit default swaps and hedge funds through registration); *Geithner: Strengthen Derivatives, Hedge Fund Rules*, REUTERS, Jan. 23, 2009, http://uk.reuters.com/article/worldNews/idUKTRE50M4YG20090123 ("I support the goal of having a registration regime for hedge funds because we need greater information and better disclosure in the marketplace.") (quoting U.S. Treasury Secretary Timothy Geithner); *see also* Andrew Cohen, *Obama Bad News for Hedge Funds*, INVESTMENT NEWS, Nov. 13, 2008; Jenny Strasburg, *Hedge Funds on the Hot Seat*, WALL ST. J., Nov. 10, 2008, at C2.

[2] Carol Lewis, *Hedge fund industry could become the investment banks of the future*, THE TIMES ONLINE, Jan. 20, 2009, http://business.timesonline.co.uk/tol/business/management/article5548321.ece (arguing that hedge funds will consolidate into large institutions and inject large sums of capital in existing corporations); Jenny Strasburg, *Smaller Hedge Funds Struggle as Money Pipeline Dries Up*, WALL ST. J., Oct. 4, 2008, at B1; Ling Ling Wei and Anton Troianovski, *U.S. May Help Private Funds to Purchase Troubled Assets*, WALL ST. J., Oct. 8, 2008, at C1; *see also Hedge Funds Help Fund Obama Inauguration*, FINALTERNATIVES, Jan. 20, 2009, http://www.finalternatives.com/node/6656 (suggesting that hedge funds provided the maximum allowed amounts of capital to help fund Obama's presidential inauguration).

The Securities Exchange Commission (SEC) has tried to regulate hedge funds in the past, citing broad concerns for the industry.[3] Regulators have expressed concern that because hedge funds shield themselves behind a veil of privacy, those managing the funds can commit extensive securities fraud by deceiving investors[4] or over-leveraging their assets, setting themselves and their investors up for a tremendous fall.[5] Since hedge funds will continue to play a more important role in capitalizing risk to publicly traded institutions, hedge fund investment also affects the bulk of the market.[6] In the wake of the financial collapse of 2008, the government seeks to regulate the hedge fund industry by claiming the need to secure markets and prevent a second wave of financial crisis.[7]

This comment explores the future of hedge fund regulation in the context of the financial collapse of 2008 in five parts. Part I briefly explains the structure and definition of a hedge fund, how it creates capital, and why the hedge fund industry is critical to the economy. Part II discusses how hedge funds currently escape SEC regulation. Part III explores the SEC's motivation for hedge fund regulation in the context of previous attempts to regulate. Part IV explores whether additional regulation is necessary given existing regulation and industry incentives. Part IV argues that even after the *Goldstein* decision invalidated the Hedge Fund Rule in 2006,[8] the SEC's original concerns about the industry do not warrant additional regulation. Rather, existing regulation and industry incentives adequately address the SEC's original concerns. Finally, Part V suggests that regulation may be inevitable given the SEC's past actions and the market's current state. Part V also proposes suggestions to help regulators achieve their goals and minimize damage to the hedge fund industry. Specifically, regulators should focus on curbing indirect risk exposure of institutional investors by placing the burden of minimal leverage and risk disclosure on institutional investors through a default disclosure rule.

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[3] IMPLICATIONS FOR THE GROWTH OF HEDGE FUNDS, SEC, (Sept. 2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (finding that the hedge fund industry as a whole lacks fraud protection and disclosure requirements, and that the hedge fund industry allows for overleveraging and the retailization of hedge funds to investors) [hereinafter SEC, *Implications*].

[4] *Id.* at 81-82.

[5] *Id.* at 82-83.

[6] *See id.* at 82.

[7] Indeed, the SEC has sought this result before. *See generally Securities and Exchange Act of 1933*, 15 U.S.C. § 77a (2008); *Securities and Exchange Act of 1934*, 15 U.S.C. § 78a (2008); *Investment Advisors Act of 1940*, 15 U.S.C. § 80a-1 (2008); *Investment Advisors Act of 1940*, 15 U.S.C. § 80b-1.

[8] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

I. BACKGROUND

A. *Definition and Fund Structure*

The phrase "hedge fund" is a non-legal term that generally refers to a broad group of investment firms or pools that are typically exempt from traditional regulation by the SEC.[9] Defining what funds fall into the category of hedge funds often proves to be an elusive task.[10] A report released following the 2003 SEC Roundtable on hedge funds revealed fourteen different definitions of a "hedge fund" from industry and government sources.[11] The SEC has since defined a hedge fund as "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering, and which is not registered as an investment company under the Investment Company Act."[12] One thing is clear: unregistered hedge funds are a powerful and dominating force in capital markets.[13] Estimates indicate that there are nearly ten thousand hedge funds currently operating and managing roughly $1.5 trillion in assets.[14]

Hedge fund managers structure their funds to create internal incentives that maximize return.[15] Fund managers typically receive performance fees of about 20% and management fees of 2% of all fund assets.[16] Thus, the more the fund returns, the greater the payout to the manager.[17] Historically, this structure has worked well, as demonstrated by hedge funds' consistency in outperforming traditional market indexes.[18]

Every hedge fund's trading strategy is unique.[19] Hedge funds are generally high-risk investments, as many funds sacrifice risk diversification in exchange for higher yield investments and derivatives.[20] The term "hedge"

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9 *What is a Hedge Fund?*, The Hennessee Group, http://www.hennesseegroup.com/hedgefund/index.html (last visited Jul. 31, 2009).

10 *Id.*; *See also Goldstein*, 451 F.3d at 875.

11 *Selected Definitions of Hedge Fund*, SEC (May 13, 2003), http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm (comments of David A. Vaughan).

12 SEC, *Implications*, *supra* note 3, at viii.

13 *See, e.g., Hedge Fund Industry Information*, The Hennessee Group, http://hennesseegroup.com/information/index.html (last visited Jul. 31, 2009).

14 *Id.* (The estimates account for massive withdrawals in 2008, which have since put hedge fund assets back to 2006 levels. At the start of 2008, the Hennessee Group estimates that hedge fund assets had surged to $2 trillion.).

15 HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 30 (1999), http://ustreas.gov/press/releases/reports/hedgfund.pdf [hereinafter *PWG Report*].

16 Victor Fliescher, *Two and Twenty: Taxing Partnership Profits in Private Equity Firms*, 83 N.Y.U. L. Rev. 1, 8 (2008).

17 *See id.*

18 *What is a Hedge Fund?*, *supra* note 9, ¶ 3.

19 Joseph Lanzkron, *The Hedge Fund Holdup*, 73 BROOK. L. REV. 1509, 1513 (2008).

20 *Id.*

was first coined by the agricultural industry, when farmers hedged against price fluctuations by purchasing contract rights to shipments in advance, thus locking in reasonable prices and ensuring a profit.[21] The first hedge fund firms used a similar strategy by selling both long and short equity positions, often shielding against market fluctuations.[22] Today, hedge funds employ a broad range of creative strategies and financial models to maximize return.[23] Because hedge funds do not have to register with the SEC, they are not subject to extensive disclosure requirements and often keep specific strategies secret.[24]

Popular hedge fund strategies previously revolved around distressed debt transactions, leveraging assets, swaps, currency trades, short selling, and equity trading.[25] While hedge funds on average fell nearly 18% overall in 2008, some strategies outperformed others.[26] Short-bias indices[27] gained nearly 29%; systematic diversified indexes[28] rose almost 18% for the year; and macro indexes increased 5%.[29]

Hedge funds differ extensively from mutual funds, which are regulated by the SEC.[30] While mutual funds may also employ creative strategies to raise capital, they are generally more limited because mutual funds are more transparent than hedge funds.[31] Consequently, fewer resources are dedicated to developing new investment strategies since other funds can easily adopt these strategies at zero development cost and reap the benefits.[32] Moreover, specific SEC regulations prohibit certain types of investment strategies in registered firms.[33] Additionally, mutual fund fees are

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21 *What is a Hedge Fund?*, *supra* note 9, ¶ 4.

22 *Id.*

23 *Id.*

24 *Id.*

25 *Id.*; *See also* Jonathon H. Gatsik, *Hedge Funds: The Ultimate Game of Liar's Poker*, 35 SUFFOLK U. L. REV. 591, 594 (2001).

26 *Hedge Fund Industry Information*, *supra* note 13.

27 Short-bias indices track short-bias funds, whose managers take short positions mostly in equities and derivatives. The short bias of a manager's portfolio must be constantly greater than zero to be classified in this category. *See* Hedge Fund Consistency Index (2009), http://www.hedgefund-index.com/SectorDefinitions.asp#EquityShortBias (last visited Jul. 22, 2009).

28 Systematic diversified indices track global macro funds, whose managers trade primarily in diversified capital markets. *See generally* Hedge Fund Research, Inc. (2009), https://www.hedgefund research.com (last visited Jul. 29, 2009).

29 *Id.*

30 Laurin B. Kleiman & Carla G. Teodoro, *Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations*, *in* THE ABCS OF MUTUAL FUNDS 49-56 (PLI Corp. Law & Practice, Course Handbook Series No. 8455, 2006).

31 *Id.*

32 *Id.*

33 Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006).

dramatically lower than those of hedge funds,[34] resulting in historically lower profit margins.[35]

Hedge funds also differ significantly from private equity funds. While both are unregulated investment pools, private equity investors typically commit to invest a specified amount over the fund's lifetime.[36] Usually, the private equity fund's management initiates additional contributions through "collateral calls."[37] By contrast, liquid hedge funds maintain capital to pay off investors who wish to pull out or invest more based on performance.[38]

Venture capital funds are similar to hedge funds because they also are unregulated investment pools.[39] However, like private equity funds, venture capital funds may require mandatory capital contributions, and investments typically span the fund's lifetime.[40] Additionally, unlike hedge funds, venture capital fund managers tend to be more interested in the day-to-day management of the companies in which they invest over a longer period of time.[41]

Finally, formation of domestic and foreign hedge funds differs.[42] Domestic funds typically associate as limited partnerships or as limited liability companies, reaping tax benefits for their investors and advisors.[43] The industry as a whole has achieved this purpose and has consistently returned better averages than equity markets for the past two decades.[44] The lack of regulation allows hedge funds to adapt better to dynamic markets by encouraging research and development of new and creative financial models.

B. *Hedge Funds Play An Important Role In Our Economy*

Hedge funds affect investors as well as the overall economy. Over the past decade, the hedge fund industry has drastically outperformed the market average.[45] Investors use hedge funds as a diversification method, as the

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34 Kleiman, *supra* note 30, at 39-41.

35 *Id.*

36 SEC, *Implications*, *supra* note 3, at 7.

37 *Id.*

38 *Id.* For instance, hedge funds experienced massive withdrawals over the fourth quarter of 2008 due to poor performance across the board. *See* Strasburg, *supra* note 2.

39 SEC, *Implications*, *supra* note 3, at 8.

40 *Id.*

41 *Id.*

42 SEC, *Implications*, *supra* note 3, at 9.

43 *Id.*

44 Even though hedge funds on average were down about 20% for 2008, the S&P was down approximately 37% for 2008. *See Hennessee Hedge Fund Indices—2008*, The Hennessee Group, http://hennesseegroup.com/indices/returns/year/2008.html (last visited Jul. 31, 2009).

45 *See, e.g.*, *Hennessee Hedge Fund Indices—Historical Annual Performance*, The Hennessee Group, http://hennesseegroup.com/indices/returns/hhfiannual.html (last visited Jul. 31, 2009).

industry rarely tracks traditional market indexes.[46] Hedge fund assets have soared from $210 billion in 1998 to $1.5 trillion by the beginning of 2008.[47] Today investors can choose from roughly ten thousand hedge funds, compared to about three thousand a decade ago and a few hundred a decade before that.[48]

Because funds specialize in a unique financial model, which may be shielded in privacy,[49] investors are able to achieve diversification by spreading their wealth across multiple funds.[50] Alternatively, investors may use hedge funds to complement traditional equity trading, also resulting in diversification.[51] Though traditionally considered a more risky investment, some analysts are pushing for increased hedge fund investing, citing unpredictable market conditions and volatility of traditional equity trading post-2008.[52]

While some funds returned upwards of 50% before management fees, others failed altogether. Some extremely volatile funds returned 40% after fees for consecutive years and then lost everything a year later.[53] As an industry, however, hedge funds returned an average of 10% per year, higher than the market average.[54] Thus, hedge funds provided a unique opportunity for investors to diversify their holdings.

Hedge funds also help market liquidity, capitalization, and price discovery.[55] Funds provide a means for a large amount of cash to enter non-traditional investments and help force assets to their true valuations.[56] For instance, a common hedge fund position involves derivatives, where the fund essentially bets on the asset's true value.[57] As the price moves up or down towards true valuation, the fund earns profit depending on the bet.[58]

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46 SEC, *Implications*, *supra* note 3, at 5.

47 *Hedge Fund Assets vs. Number of Hedge Funds*, The Hennessee Group, http://hennesseegroup.com/information/info/Hedge%20Fund%20Assets%20vs.%20Number%20of%20Hedge%20Funds%20graph.pdf (last visited Jul. 31, 2009).

48 *Id.*

49 The lack of registration with the SEC is the primary reason for this phenomenon and it is unique to the hedge fund industry. Compare mutual funds, the hedge funds' regulated counterpart, and the various regulations that prevent such privacy and creative strategies. *See* Kleiman, *supra* note 30; Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006).

50 SEC, *Implications*, *supra* note 3, at 5.

51 *Id.*

52 Mark Fuchs, *Hedge Funds: The Least Risky Investment*, CNBC, Jan. 23, 2009, http://www.cnbc.com/id/28808405 (suggesting that the best way to fight the financial crisis is to use diversified hedge fund investing).

53 Such was the case with Long Term Capital Management. *See infra* Part III.A.2.

54 *See Hedge Fund Indices—Historical Annual Performance*, *supra* note 44.

55 SEC, *Implications*, *supra* note 3, at 4.

56 *Id.*

57 *Id.*

58 *Id.*

Thus, the market is more efficient as assets move closer to true valuation.[59] Additionally, with more capital in the market, investors can more easily trade through the increased liquidity.[60]

Moreover, hedge funds create incentives for corporations to maximize efficiency. Corporations often face high agency costs where shareholders lack adequate control over the day-to-day decisions of management.[61] Where large public corporations often attract passive investors or relatively small voting share blocks, agency costs are even higher.[62] Such shareholders lack the ability to adequately monitor the corporation's operations and therefore face a collective action problem, allowing managers to shirk corporate responsibilities.[63]

Hedge funds invest not only in derivative trading and credit swaps, but also in traditional equity markets, often times acquiring large shares of publicly traded corporations.[64] Hedge funds, unlike passive investors, have more incentive to be activists in the corporation, squeezing out inefficiencies.[65] With a larger voting block, the hedge fund can avoid collective action problems that most shareholders face by making decisions about board of director elections and even pressuring managers to increase productivity.[66] This results in an efficient corporation which maximizes return to shareholders and to the market as a whole.[67]

The lack of regulation has been paramount to the hedge fund's success.[68] Hedge funds employ a variety of strategies and spend a significant amount of time on researching and developing financial models.[69] When regulation forces the hedge fund to publicly reveal strategies and investment positions, in the long run, the fund can no longer use those strategies and positions.[70] The Investment Company Act also "forecloses registered

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59 *Id.*

60 *Id.*

61 J.W. Verret, *Economics Makes Strange Bedfellows: Pensions, Trusts, and Hedge Funds in an Era of Financial Re-intermediation*, 10 U. PA. J. BUS. & EMP. L. 63, 64 (2007) (explaining the traditional theory of capital market evolution).

62 *Id.*; *see also* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453 (1991) (suggesting causes of the collective action problem among shareholders of publicly traded corporations).

63 Verret, *supra* note 61, at 64-65.

64 *See* Robert Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap For Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 228-29 (2007).

65 *Id.*

66 *Id.* at 303.

67 *Id.* at 231-32.

68 SEC, *Implications*, *supra* note 3, at 92-96.

69 *Id.*

70 The idea is that if everyone is doing it, it will no longer be as profitable. Financial models that utilize spreads and asset valuations create wealth during price discovery. Speeding up that process or eliminating it altogether produces little gain to hedge funds spending resources developing the trading strategies. *See* Gatsik, *supra* note 25.

companies from trading on margin or engaging in short sales."[71] Moreover, such companies "must secure shareholder approval to take on significant debt or invest in certain types of assets."[72]

The SEC maintains that hedge fund *advisor* registration, as opposed to hedge fund *company* registration, would solve this problem. Advisor registration would allow the SEC to track who is managing hedge funds and watch for fraudulent practices while still allowing the non-disclosure of trading practices.[73] However, registration of managers poses a unique set of problems. First, it may signal the SEC's "implied seal of approval" to investors, suggesting that the hedge fund is a safe investment.[74] Second, the registration costs would be high,[75] likely preventing smaller hedge funds from adequately absorbing these costs.[76]

Hedge funds' success over the past two decades is largely attributable to their general lack of regulation. The benefits of their success extend far beyond investor diversification. Price discovery, asset valuation, and market liquidity create value for both hedge fund investors and non-hedge fund investors. Moreover, because hedge funds can uniquely reduce agency costs for large corporations, the economy as a whole benefits from hedge fund independence.

II. THE FINAL FRONTIER OF SECURITIES REGULATION

A. *General Exemptions In Legislation*

Three pieces of legislation define the bulk of securities law in the United States; however, hedge funds manage to elude all three. This section explains the current regulatory framework for hedge funds by showing how funds escape SEC registration under traditional securities law and the SEC's recent response to the industry.

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71 Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006) (citing 15 U.S.C. §§ 80a-12(a)(1), 13(a)(2)).

72 *Id.*

73 SEC, *Implications*, *supra* note 3, at 92-96.

74 J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799, 830 (2007).

75 *See* SEC, *Implications*, *supra* note 3, at 96.

76 Verret, *supra* note 74 at 807 ("Registration as an adviser would also mean that the advisers and their staff will be subject to compliance examinations by the SEC. In addition, advisers would be required to answer a revised Form ADV, which asks if the investment manager is involved in any other investment funds, and if so, the details of this other fund(s). The new requirement would also have caused some funds to hire a compliance officer, an attorney whose salary may range from $125,000 to $500,000 annually depending on the size of the fund.").

1. The Securities and Exchange Act of 1933

In 1929, the United States suffered one of the most devastating market collapses in history. Investor confidence in capital markets fell to historic lows. To bolster confidence and increase market liquidity, Congress passed the Securities Act of 1933 (1933 Act)[77] and later created the SEC with the Securities Exchange Act of 1934.[78]

The 1933 Act provides general regulation for all companies issuing securities by requiring disclosure and registration with the SEC.[79] These disclosure requirements are strict and require company identification information, which includes the names of managers, principals, investors, and those with ownership interests in the firm.[80] Moreover, the 1933 Act requires the issuing company to make detailed balance sheet disclosures of the value of securities issued, including outstanding firm debts, profits and losses.[81] Section 5 of the 1933 Act requires that the offer and sale of an issuer's securities comply with certain registration requirements unless an exemption from registration is available for that transaction or class of securities.[82]

Hedge funds can generally avoid the 1933 Act under a few statutory exemptions.[83] Section 4(2) of the 1933 Act exempts any "transaction by an issuer not involving a public offering" from the otherwise stringent registration requirements.[84] Before 1982, the SEC generally required a firm seeking reliance on Section 4(2) to "make a subjective determination that (1) each offeree had sufficient knowledge and experience in financial and business matters to enable that offeree to evaluate the merits of the prospective investment, or (2) such offeree was able to bear the economic risk of the investment."[85] In response to the vagueness of the "subjective determination" required in Section 4(2), the SEC adopted Regulation D under the Securities Act in 1982 to establish a non-exclusive "safe harbor" criterion for the Section 4(2) private offering exemption.[86]

Regulation D of the revised 1933 Act provides that firms that offer securities only through a private, as opposed to a public offering, are exempt

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77 *See* Securities and Exchange Act of 1933, 15 U.S.C. § 77(a)-(c) (creating liability for non-disclosure of certain information involved in securities offerings).

78 *See* 15 U.S.C. § 78d(a).

79 15 U.S.C. § 77e(c); 15 U.S.C. § 77j.

80 15 U.S.C. § 77j; 15 U.S.C. § 77aa.

81 *Id.*

82 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles: Accredited Investors in Certain Private Investment Vehicles, Exchange Act Release No. 33-8766 at 14 (2006), *available at* http://www.sec.gov/rules/proposed/2006/33-8766.pdf [hereinafter *SEC Release 33-8766*].

83 General Rules and Regulations, Securities Act of 1933, 17 C.F.R. § 230.506 (2009).

84 *SEC Release 33-8766*, *supra* note 82, at 15.

85 *Id.*

86 *Id.*

from the registration requirements.[87] Rule 506 of Regulation D specifies the criteria for a private offering.[88] First, the firm must limit all security sales to "accredited investors."[89] Accredited individual investors are those whose net worth exceeds $1 million, or whose total income is more than $200 thousand.[90] For institutional investors, such as other companies or universities, net worth must be more than $5 million.[91] Second, the firm must not advertise or otherwise solicit investors to purchase securities.[92]

Hedge funds typically meet the requirements of Regulation D by limiting fund investors to individuals with high net worth or institutional investors that meet the minimum thresholds.[93] In 2003, the SEC reported that hedge funds typically maintained additional limitations on qualified investors and suggested that the investment minimum for hedge funds typically ranges between $50 thousand and $10 million.[94] Additionally, hedge funds generally refrain from advertising to the public, relying instead on word of mouth or specialists who directly contract pre-qualifying investors.[95] Thus, by maintaining an investment pool limited to qualified investors and refraining from general solicitation, the hedge fund escapes the strict disclosure requirements of the 1933 Act.

2. The Investment Company Act of 1940

To further protect investors from abusive manager and director misconduct, Congress passed The Investment Company Act of 1940 (1940 ICA).[96] The 1940 ICA provides that all investment companies that receive commission fees for investing on shareholders' behalf are required to register with the SEC and disclose investment activities and records.[97] Qualifying investment companies are further required to maintain a board of directors elected by shareholders under the 1940 ICA.[98]

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87 17 C.F.R. §§ 230.501-230.508.

88 17 C.F.R. § 230.506(b).

89 *Id.*; The Regulation D minimums have since been updated by SEC regulations. 17 C.F.R. § 230.506; *see infra* Part II.B.

90 The threshold is raised to $300,000 if filing jointly. The net worth requirement is the same for individual and joint filings. *See* 17 C.F.R. § 230.501.

91 *Id.*

92 17 C.F.R. § 230.502(c).

93 SEC, *Implications*, *supra* note 3, at 80 (suggesting also that these minimums are decreasing).

94 *Id.*

95 *Id.* at 45-46.

96 15 U.S.C. § 80a-1.

97 15 U.S.C. § 80a-8(b).

98 15 U.S.C. § 80a-16(a).

To qualify for an exemption to the 1940 ICA, firms must meet one of two possible conditions.[99] The first condition is a cap on the number of firm investors.[100] Any firm with less than one hundred investors does not have to register with the SEC under the 1940 ICA. The second condition involves "qualified purchasers."[101] Similar to the exemption criteria under Regulation D of the 1933 Act, this exemption specifies that a "qualified purchaser" is anyone with at least $5 million in investments.[102] Thus, the hedge fund may have more than one hundred clients so long as each client is a qualified purchaser with at least $5 million in investments.

Hedge funds typically meet this exemption largely by investor minimums and limited solicitation of new investors. For the purposes of institutional investors, corporations count as one investor.[103] Because hedge funds typically do not make "public offerings" or solicit sales to the public, most hedge funds also meet this condition.

3. The Investment Advisors Act of 1940

The Investment Advisors Act of 1940 (1940 IAA) is complementary to the 1940 ICA. The 1940 IAA seeks to streamline investigations regarding individual advisors based on shareholder complaints of fraud.[104] For the purposes of the 1940 IAA, an "investment advisor" is any person who engages in the business of advising others in exchange for compensation.[105] The SEC has even stated that advisors to pooled investment vehicles who invest in securities, including unregistered pools and hedge funds, are "investment advisors" under the 1940 IAA.[106]

The 1940 IAA requires all investment advisors to register with the SEC and provide the SEC with identification information including the identity of all business partners, educational background, and previous business experience.[107] The 1940 IAA also requires qualifying investors to provide the SEC information regarding the manner in which the advisor is compensated, the individual advisor's balance sheet, and the manner in which the advisor provides advice to clients.[108]

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99 SEC, *Implications*, *supra* note 3, at 11.

100 15 U.S.C. § 80a-3(c)(7)(B).

101 15 U.S.C. § 80a-3(c)(7)(A).

102 15 U.S.C. § 80a-2(a)(51).

103 SEC, *Implications*, *supra* note 3, at 11.

104 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 401 (Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230, 275).

105 *Id.*

106 *Id.* at 400-01.

107 15 U.S.C. § 80b-3(a), (c).

108 15 U.S.C. § 80b-3(c).

Moreover, the 1940 IAA requires investment advisors to maintain books and records subject to periodic audits by the SEC.[109] Investment advisors must also comply with other requirements, including safeguarding client assets that are in the advisor's custody and requiring that advisors disclose any adverse financial positions to clients.[110]

There is a *de minimis* exception to the 1940 IAA.[111] Advisors with fewer than fifteen clients and who are otherwise exempt from registration under the 1940 ICA are exempt from registration and reporting requirements under the 1940 IAA.[112] Traditionally, hedge fund advisors avoided registration under the 1940 IAA by arguing that fund managers maintain only one client, the hedge fund itself.[113] Advisors argue that since they only provide guidance for a collective pool of assets, rather than for individual investors, only one client really exists.[114] Thus, hedge fund advisors are able to manage up to fourteen different hedge funds before having to register with the SEC as an investment advisor.

B. Goldstein *and Subsequent Regulations*

In 2004, the SEC released the Hedge Fund Rule (the Rule) to bring hedge funds under SEC regulation.[115] Through a series of reports, the SEC argued that hedge fund regulation was necessary to protect securities markets as a whole.[116] The SEC concluded that registering hedge fund managers would have minimal effect on the hedge fund industry since registration would not require strategy disclosure or investing limitations.[117]

The Rule brought two important changes. First, it changed the 1940 IAA's definition of "client" in order to disallow firms from arguing that the hedge fund itself is the sole client.[118] Under the new definition, any hedge fund with more than fifteen individual investors, as defined in the 1940 ICA, would have to register with the SEC.[119] Second, the Rule increased firm disclosure requirements for registered firms by allowing the SEC to

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109 Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. § 275.204-2 (2009).

110 17 C.F.R. § 275.206(4)-6.

111 17 C.F.R. § 275.203(b)(3)-2(a).

112 15 U.S.C. § 80b-3(b)(3).

113 Goldstein v. SEC, 451 F.3d 873, 874 (D.C. Cir. 2006) (affirming the general use of "client" as relating to the hedge fund itself, rather than to individual investors in the hedge fund).

114 *Id.*

115 Registration Under the Advisers Act of Certain Hedge Fund Advisers, Advisers Act Release No. IA-2333, 84 SEC Docket 1032 (Dec. 2, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.htm [hereinafter *Hedge Fund Rule*].

116 SEC, *Implications*, *supra* note 3; *PWG Report*, *supra* note 15.

117 *See* Verret, *supra* note 61, for a discussion of the effects of registration on disclosure.

118 *Hedge Fund Rule*, *supra* note 115, at 5.

119 *Id.*

inspect the books of not only the investment advisors and managers, but also the books of the firm as a whole.[120]

Hedge fund manager Philip Goldstein challenged the Rule soon after enactment.[121] In *Goldstein v. SEC*, Goldstein argued that the new definition of "client" under the Rule was inconsistent with the usage of "client" elsewhere in SEC regulations.[122] The Court of Appeals for the D.C. Circuit looked to congressional intent to determine what level of ambiguity previous securities regulations assigned to the term "client."[123] The court noted that legislative history suggested that Congress intentionally did not define "client" to make it ambiguous.[124] Specifically, the court found that a 1970 amendment to Section 203 appeared to reflect Congress's understanding at the time that investment company entities, not their shareholders, were the advisors' clients.[125] In the amendment, Congress eliminated a separate exemption from registration for advisors who counseled only investment companies and explicitly made the "fewer-than-fifteen-clients exemption" unavailable to such advisors.[126] The court concluded that this prohibition would have been unnecessary if the shareholders themselves could be counted as "clients."[127]

Moreover, the court held that the 1940 Act also suggested that Congress did not intend "client" to be used as the SEC proposed in the Rule.[128] The court held that, "[a]lthough the statute does not define 'client,' it does define 'investment advisor.'"[129] The court noted, "An investor in a private fund may benefit from the advisor's advice (or he may suffer from it) but he does not receive the advice *directly*. He invests a portion of his assets in the fund."[130] Thus, the court ruled in favor of Goldstein, arguing that the SEC improperly altered the definition of "client."[131]

The SEC did not appeal the decision.[132] Instead, the agency released two new regulations within six months of *Goldstein*.[133] The first was the

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120 Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. § 275.204-2 (2008).

121 *See* Goldstein v. SEC, 451 F.3d 873, 873 (D.C. Cir. 2006).

122 451 F.3d 873.

123 *Id.*

124 *Id.* at 879 ("[W]ith respect to persons or firms which *do not* advise business development companies, the . . . amendment . . . is not intended to suggest that each shareholder, partner, or beneficial owner of a company advised by such person or firm *should or should not be* regarded as a client . . . " (citing H.R. REP. No. 96-1341, at 62 (1980))).

125 *Id.* (citing Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 24, 84 Stat. 1413, 1430 (1970)).

126 *Id.* at 879.

127 *Id.*

128 *Goldstein*, 451 F.3d at 879.

129 *Id.* (citing 15 U.S.C. § 80b-2(a)(11)).

130 *Id.*

131 *Id.*

132 Lanzkron, *supra* note 19, at 1522.

133 *Id.*

Anti-Fraud Regulation (AFR), which sought to increase investor protection from fraudulent advisors.[134] The AFR went into effect September 10, 2007, and created strict liability for fraud.[135]

The AFR generally prohibits advisors from making untrue or fraudulent statements or omissions to investors or prospective investors of a fund, regardless of intent, and prohibits advisors from engaging in any practice or course of business that is fraudulent, deceptive, or manipulative with respect to the hedge fund.[136]

The second regulation, the Accredited Investors Proposal (AIP), focuses on protecting investors by limiting access to hedge fund investing by changing the definition of an "accredited investor."[137] Previously governed by Regulation D, an accredited investor is an investor with a net income above $200 thousand or $300 thousand if filing jointly, and whose net worth is more than $1 million.[138] The AIP provides that in addition to the income and net wealth regulation, an accredited investor is one whose investments are valued at $2.5 million.[139] The AIP further provides that the term "investment" does not include the investor's residence, place of business, or any real estate held in accordance with a business trade.[140] Moreover, the AIP provides that the minimum amounts be adjusted for inflation every five years beginning in 2012.[141]

The SEC's recent attempts to regulate hedge funds have enjoyed limited success. The Rule, invalidated by the *Goldstein* decision, was certainly the closest hedge funds have come to registration.[142] The AFR and the AIP, by contrast, do not purport to generally regulate hedge funds as much as they reinforce SEC norms and existing law. Both regulations add little to hedge fund regulation aside from reinforcing that fraud in the industry is illegal, and that hedge fund risk should not be available to all investors.

III. THE MOTIVATION FOR REGULATION

Before passing the Rule in 2004, the SEC released a report on the growth of the hedge fund industry, which outlined general concerns for

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134 72 Fed. Reg. 400, *supra* note 104, at 401-03.

135 Rules and Regulations, Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-8.

136 *Id.*

137 72 Fed. Reg. 400, *supra* note 104, at 400.

138 *See* General Rules and Regulations, Securities Act of 1933, 17 C.F.R. § 230.506.

139 72 Fed. Reg. 400, *supra* note 104, at 405.

140 *Id.* at 406.

141 *Id.*

142 In fact, no other regulation has come anywhere close to mandating complete registration of hedge fund advisors.

future regulation.[143] The SEC cited four primary reasons for regulating the hedge fund industry: fraudulent practices, over-leveraged firms, inadequate disclosure, and the retailization of hedge funds.[144] In the following sections, Subpart A explores the SEC's broad concerns for the hedge fund industry and Subpart B addresses how the SEC has responded to these concerns through regulation.

A. *SEC Concerns*

1. Fraud

The SEC is concerned about fraudulent management practices in the hedge fund industry due to a lack of regulatory oversight.[145] Concern about fraud and regulatory oversight is not limited to the hedge fund industry. For instance, Congress passed the 1940 IAA specifically to help prevent fraud by all investment advisors in the marketplace.[146]

The SEC has consistently argued that fraud decreases market efficiency and perpetuates market failure.[147] While the SEC is able to prosecute fraud in the hedge fund industry,[148] it argues that such prosecution is ineffective because without registration, there is no way to *preempt* fraud.[149] The SEC argues that when investment advisors are subject to periodic evaluation by the SEC, early discovery of fraud has empirically been successful in other regulated industries.[150] Thus, the SEC argues, increased oversight will facilitate fraud detection in the hedge fund industry.[151]

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143 SEC, *Implications*, *supra* note 3, at 76-86.

144 *Id.*

145 *Id.* at 76.

146 72 Fed. Reg. 400, *supra* note 104, at 400.

147 *See* H.R. Rep. No. 104-50 (1995) (stating that for investors to have confidence in the securities markets, they must have confidence in their right to seek fair recovery from those that may defraud them) (quoting Arthur Levitt, SEC Chairman); *and see* H.R. Rep. 103-255 (1993) ("(Transparency) can help to improve the liquidity and efficiency of the market by assuring that comprehensive price and trading information is disseminated to as many market participants as possible."); *see, e.g.*, 72 Fed. Reg. at 400.

148 The SEC has prosecuted over 40 cases of hedge fund fraud from 1999-2004. One of the latest enforcement actions comes out of the 2008 financial collapse as the SEC initiates charges against Arthur Nadel, a hedge fund manager associated with Scoop Capital LLC and Scoop Management. *See* Darrell Hughes, *Fund Chief Is Charged With Fraud*, WALL ST. J., Jan. 22, 2009, *available at* http://online.wsj.com/article/SB123256845289403387.html.

149 SEC, *Implications*, *supra* note 3, at 76-77.

150 *Id.*

151 *Id.* at 77.

2. Leverage

Leveraging assets is a typical hedge fund strategy.[152] Leveraging allows funds to expand investment positions without expending additional resources.[153] Traditionally, firms increased leverage by purchasing securities on margin or with a loan.[154] Today, funds achieve the same results using a variety of methods including futures contracts, derivatives, and option contracts.[155] Leveraging increases risk. Should the fund take a loss on the trade, the firm must find money from other investments to pay back the borrowed funds.[156]

Such was the case with hedge fund Long-Term Capital Management (LTCM) in the late 1990s.[157] John W. Meriwether, previously a successful bond trader at Salomon Brothers, founded LTCM in early 1994.[158] In the first three years, LTCM returned high yields for investors, making it one of the most successful hedge funds of the mid-nineties. In 1995 and 1996, Meriwether returned nearly 40% after management fees to investors. In 1997, LTCM returned about 20% after management fees to investors, still better than most hedge funds.[159] In addition to the 20% return, Meriwether also returned approximately $2.7 billion in cash to investors thereby reducing LTCM's capital base by about 36%.[160]

Instead of decreasing investments accordingly, Meriwether continued to invest at 1996 levels, increasing the fund's leverage ratios.[161] Despite retaining a capital base of around $4.7 billion, LTCM still obtained leverage ratios of over 25:1.[162]

In 1998, a series of events caused LTCM to suffer substantial losses, which were then magnified by the extensive leverage ratios.[163] First, Russia devalued their currency, which set off a chain reaction prompting a "flight to quality" where many investors avoided risk in favor of liquidity.[164] As a

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152 *Id.* at 107.

153 *Id.* at 37.

154 *Id.*

155 SEC, *Implications*, *supra* note 3, at 37.

156 *See id.*

157 *PWG Report*, *supra* note 15, at 5.

158 *Id.* at 10. LTCM also boasted two Nobel Prize winning economists and numerous Ph.Ds. *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (Random House 2000).

159 *PWG Report*, *supra* note 15, at 11.

160 *Id.*

161 *Id.*

162 *Id.* at 12 ("The extent of this leverage implies a great deal of risk. Although exact comparisons are difficult, it is likely that the LTCM Fund's exposure to certain market risks was several times greater than that of the trading portfolios typically held by major dealer firms.").

163 *Id.*

164 *Id.* at 15.

result, "LTCM suffered losses in individual markets that greatly exceeded what conventional risk models . . . suggested were probable."[165] The simultaneous shocks to many markets confounded expectations of relatively low correlations between market prices and revealed the non-diversification of global trading portfolios such as LTCM.[166] Moreover, the push toward liquidity dramatically decreased demand for LTCM's investments, making it nearly impossible to sell them.[167]

By late 1998, the government was forced to step in and rescue the ailing fund or risk collapse of major financial institutions and commercial banks due to their overexposure in LTCM.[168] Consequently, the President's Working Group on Financial Markets issued a report and the SEC conducted an independent investigation and report of the hedge fund industry.[169] The Rule itself was a direct byproduct of these meetings.[170]

3. Disclosure

The SEC has expressed a need for increased disclosure about funds' current investment strategies and leverage ratios to both investors and potential investors.[171] Regulators worry that investors cannot adequately predict a fund's valuation given the opaque nature of hedge fund management.[172] Thus, without disclosure, investors will not be able to adequately gauge their investment risk.[173]

Additionally, the SEC has expressed concern over conflicts of interests both within the hedge fund and with managers who simultaneously run separate funds.[174] The SEC argues that a manager who runs a hedge fund and a mutual fund simultaneously faces perverse incentives to misuse capital.[175] The danger arises when firms allocate trading opportunities to the hedge fund instead of the mutual fund to take advantage of a higher performance fee.[176] The SEC argues that the only way to actively monitor these incentives is to regularly inspect the hedge fund's books.[177]

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165 *PWG Report*, *supra* note 15, at 12.

166 *Id.*

167 *Id.*

168 *Id.* at 13.

169 *Id.* at viii; SEC, *Implications*, *supra* note 3, at vii.

170 *Hedge Fund Rule*, *supra* note 115.

171 *See* SEC, *Implications*, *supra* note 3, at 83.

172 *Id.*

173 *Id.*

174 *Id.*

175 *Id.* at 83-84.

176 Verret, *supra* note 74, at 829.

177 *See id.*

4. Access and Retailization of Funds

The SEC has also expressed concern about the direct and indirect retailization of hedge funds because hedge funds are risky investments. Over the past decade, many funds have collapsed, while others have exploded in growth. Making hedge funds available to unsophisticated investors could result in investors inadvertently subjecting themselves to unforeseen risk. Thus, the SEC reasons, hedge funds should only be available to sophisticated investors who have a high net wealth thereby minimizing the risk of severe loss to average investors.[178]

The SEC has expressed concern about funds controlled by the hedge fund industry.[179] Funds of hedge funds are similar to mutual funds, except that they track or purchase securities of multiple hedge funds.[180] This permits average investors to subject themselves to the hedge fund industry.[181] The SEC has indicated that purchasing funds of hedge funds results in risk passed on to average, unsophisticated investors.[182] Simply put, the general lack of transparency in the industry means that funds of hedge funds may find it difficult to value the underlying hedge funds and the SEC has no independent means to verify these figures.[183]

Finally, the SEC has expressed concern of inadvertent, indirect exposure of average investors to hedge funds through publicly traded companies that invest capital in hedge funds.[184] Institutional investors include pension funds, universities, and corporations.[185] By investing in the public company, an investor has limited knowledge of the company's overall exposure to hedge funds.[186] Moreover, the investor has limited ability to adequately gauge the hedge fund's risk without disclosure.[187] Thus, by investing in the public company, the otherwise unaccredited investor has inadvertently subjected himself to hedge fund risk.[188] Furthermore, when investors are employees of a company whose pension fund is invested in hedge funds, the results could be disastrous for their retirement savings.[189]

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178 *See* SEC, *Implications*, *supra* note 3, at 83.

179 *Id.*

180 Lanzkron, *supra* note 19, at 1533.

181 SEC, *Implications*, *supra* note 3, at 83.

182 *See id.* at 82-83.

183 *Id.*

184 *Id.* at 82.

185 *Id.*

186 *Id.* at 83.

187 SEC, *Implications*, *supra* note 3, at 83.

188 *Id.* at 82-83.

189 *Id.* at 82.

B. *The Hedge Fund Rule and Subsequent Proposals: Remaining Concerns*

The Hedge Fund Rule attempted to address each of the SEC's stated concerns by changing the definition of "client" in the 1940 IAA, thereby requiring hedge fund advisors to register with the SEC.[190] The Rule was tailored to meet the SEC's stated concerns about the hedge fund industry.[191] First, the Rule addressed fraud through increased disclosure requirements by allowing the SEC to periodically inspect advisors' balance sheets and books thus facilitating early discovery of fraudulent management practices.[192] Second, the Rule encouraged funds to use leverage at more reasonable ratios since advisors' books would be subject to periodic review by the SEC and possibly third parties.[193] Third, the Rule addressed the SEC's disclosure concerns by requiring funds to communicate conflict of interest positions not only to investors or potential investors, but also to the SEC.[194] Fourth, by limiting exposure to the funds; requiring more information to be passed on to investors of funds of hedge funds; and providing indirect disclosure to investors of publicly traded institutions that invest pension funds and other capital in hedge funds, the Rule addressed the SEC's retailization concerns.[195] Thus, the Rule would have successfully addressed all of the SEC's major concerns about the hedge fund industry.

When the court vacated the Rule in *Goldstein* and the SEC chose not to appeal, the agency failed to readdress many of these concerns in subsequent regulation. Specifically, the AFR and the AIP confront only concerns about fraud and direct retailization of hedge funds.[196] The AFR adequately addresses concerns about fraud by effectively making fraud by hedge fund advisors a strict liability offense.[197]

The AIP attempts to address some concerns by providing an increased criterion for becoming an "accredited investor," thus further restricting di-

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190 72 Fed. Reg. 400, *supra* note 104.

191 Whether the SEC would have actually addressed each original concern is dubious at best. This portion merely purports that the Rule was at least tailored to address each of the SEC's stated concerns about the hedge fund industry. SEC Commissioner Paul Atkins even publicly criticized the ability of the Hedge Fund Rule to effectively curb the amount of fraud in the hedge fund industry. He eventually voted against the Rule. *See* Paul S. Atkins, Comm'r, SEC, Statement by SEC Comm'r at Open Meeting on Proposed Regulation under the Advisors Act of Certain Hedge Fund Advisors, (Jul. 14, 2004), http://sec.gov/news/speech/spch071404psa.htm.

192 *Hedge Fund Rule*, *supra* note 115.

193 *Id.*

194 *Id.*

195 *Id.*

196 72 Fed. Reg. 400, *supra* note 104.

197 *Id.* The AFR does not add anything new to securities law since fraud was illegal and a strict liability offense before the AFR. The AFR merely added new language to "remind" hedge fund managers that they too are subject to some securities regulation.

rect access to hedge funds.[198] While the SEC sought to address retailization concerns with regulation, the AIP stops short of fully addressing the concern in two ways.[199] First, the regulation does not address the SEC's concern about hedge fund investors who indirectly subject themselves to hedge fund risk. While many of these funds self-impose investor minimums, individual investors who otherwise would not qualify for AIP and Regulation D treatment may still access hedge funds through funds of hedge funds since those are not subject to the Regulation D investor minimums.[200]

Second, the regulation fails to protect investors of publicly traded companies who invest in hedge funds. Institutional investors may still subject third parties to excessive risk and high leverage ratios without disclosure since average investors can still invest in companies that are heavily invested in over-leveraged funds.[201] Thus, investors may inadvertently subject themselves to excessive risk without any disclosure from a company regarding its current investment positions.[202]

Following the LTCM collapse, the SEC stated four broad concerns for the hedge fund industry. As a result, it passed the Rule, which addressed nearly all of these concerns. Once the *Goldstein* decision invalidated the Rule, the SEC passed more regulation through the AFR and AIP. This subsequent regulation did not address all of the original concerns about hedge funds. In fact, the new regulation completely fails to address excessive leverage ratios, disclosure requirements, and indirect retailization of hedge funds via funds of hedge funds and institutional investors. Thus, should the SEC attempt to address the deficits in the coming months, resulting regulations will likely focus on concerns not addressed by current regulations.

IV. ADDITIONAL REGULATION IS NOT NECESSARY

The current regulatory framework does not address the SEC's stated concerns about the hedge fund industry. Hedge funds are still opaque, and lack serious disclosure requirements. The hedge fund industry as a whole lacks regulation to seriously combat excessive leverage ratios. Similarly, investors may still inadvertently subject themselves to excessive hedge fund risk. Congress and the SEC have already begun to address concerns with the industry.[203]

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198 Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. 45116 (proposed Aug. 10, 2007) (to be codified at 17 C.F.R. pts. 200, 230, 239).

199 *Id.*

200 72 Fed. Reg. 400, *supra* note 104, at 402.

201 SEC, *Implications*, *supra* note 3, at 97.

202 *PWG Report*, *supra* note 15, at viii.

203 *See* Jonathan D. Salant, *U.S. House Plans Separate Regulations for Hedge Funds, Banks*, BLOOMBERG, Aug. 7, 2009, http://www.bloomberg.com/apps/news?pid=20601087

An overwhelming majority of hedge fund managers believe that the new administration's policies will result in their firms becoming more costly to operate due to associated compliance expenses.[204] On November 10, 2008, Congress heard testimony from top hedge fund managers to attempt to understand who is ultimately to blame for the financial crisis, while not ruling out possibilities for further hedge fund oversight.[205] More recently, some hedge fund managers unexpectedly began pushing for advisor registration, arguing that advisor registration would be a less draconian alternative to mandatory firm registration by the SEC.[206]

While the SEC is correct in its ambitions to strive for transparency through disclosure and curbing fraudulent practices to protect investors, internal industry incentives and existing regulations effectively go above and beyond what is necessary to address nearly all of the SEC's original concerns with hedge funds.[207] First, the SEC should not be concerned about hedge fund fraud.[208] The AFR regulations create strict liability for fraudulent behavior that goes above and beyond what is actually necessary to create a deterrent to securities fraud. Instead of creating incentives to deter fraud, strict liability creates the possibility of a chilling effect on disclosure, unless other factors are at play. For instance, hedge fund advisors who are strictly liable for their comments will be less likely to communicate often and openly with investors, fearing that they may misrepresent a material fact about the fund's outlook. Given current market conditions, however, and noting that hedge funds will likely need to increase disclosure in order to attract investors, strict liability for fraud may be unnecessary.[209]

Second, the SEC should not be concerned with excessive leveraging in the post-2008 financial environment. Lenders will be more reluctant to

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&sid=aFrh783HGCUs (noting that the House now has their own plan to regulate hedge funds which is distinct from the Senate's plan, the SEC's position, and President Obama's plan); Sarah Lynch, *SEC Weighs Hedge Fund Registration*, WALL ST. J., Jun. 18, 2009, *available at* http://online.wsj.com/article/SB124533361307927645.html (quoting SEC Chairman Mary Shapiro as stating that direct hedge fund registration is still being analyzed despite President Obama's preference for indirect registration through advisor registration).

204 Howard Altman & Rothstein Kass, *A New Regime: The Regulatory Climate for Hedge Funds*, THE HEDGEFUND J., Dec. 2008/Jan. 2009, *available at* http://www.thehedgefundjournal.com/magazine/200812/research/a-new-regime-the-regulatory-climate-for-hedge-funds.php.

205 *See* Strasburg, *supra* note 1.

206 Rachelle Younglai & Svea Herst-Bayliss, *Momentum Grows for Hedge Fund Registration*, REUTERS, May 7, 2009, http://www.reuters.com/article/euRegulatoryNews/idUSN0737611120090507.

207 Lanzkron, *supra* note 19, at 1533.

208 *Id.* at 1531.

209 *See e.g.*, Michael Sesit, *Madoff Shows Banks Must Become Whistleblowers*, BLOOMBERG, Jan. 22, 2009, http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_sesit&sid=aKBGTQV2iRig (suggesting that banks will serve as a watchdog for hedge fund fraud after the Madoff scandal, eliminating the need for additional hedge fund oversight).

provide substantial lending to hedge funds in the future.[210] Given the number of hedge fund and investment company failures in 2008, managers will be more careful to diversify their positions when trading derivatives.[211] This environment will make it nearly impossible for hedge funds to reach the excessive leverage ratios of the past.

There is little debate that 2008 marked the worst year for hedge funds in over a decade.[212] Hedge fund investors across the board pulled money from their funds, forcing managers to cut and restructure their performance fees to encourage investors to stay the course.[213] Earlier this year, analysts predicted up to $450 billion more in hedge fund withdrawals are likely in 2009, sending the industry back to 2002 levels.[214] And while recovery hopes are certainly higher after substantial gains to the industry in the second quarter of 2009, there is little debate that the industry has changed and investors now understand the reality of losing substantial proportions of their investments.

When investors are concerned about the fund's performance, they typically demand more reassurance from the fund.[215] Where investors are reluctant to invest in a fund, and where funds indirectly compete for clients, funds will have to reach out to investors and disclose more information than usual about the fund's positions and prospects. To illustrate, the SEC has noted that hedge funds disclose a wealth of information to their investors in the form of a private offering memorandum or private placement memorandum.[216] Hedge funds also currently disclose additional outlook information to investors via conference calls, individual conversations, financial statements, and even access to the fund's prime broker.[217] While the SEC does

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210 Rich Miller & Jesse Westbrook, *Scrutiny on Loans to Hedge Funds*, INT'L HERALD TRIB., Jan. 10, 2007, *available at* 2007 WLNR 521751.

211 *See* Strasburg, *supra* note 1.

212 *Id. See also* Hedge Fund Research's HFRI Index, Sept. 2008, https://www.hedgefundresearch.com/monthly/index.php?fuse=showFund&fid=2899& (last visited Aug. 18, 2009).

213 Cassell Bryan-Low, *Hedge-Fund Managers Doing Deals to Keep Investors*, WALL ST. J., Oct. 1, 2008, at C2, *available at* http://online.wsj.com/article/SB122279726855591009.html (suggesting that hedge funds lower their fees and other special deals in an effort to keep investors' money in the fund).

214 Saijel Kishan, *Hedge Fund Assets May Fall by $450 Billion This Year*, BLOOMBERG, Jan. 23, 2009, http://www.bloomberg.com/apps/news?pid=20601085&sid=a9K0oMRQvf5o&refer=europe (last visited Jan. 24, 2009).

215 *See* SEC, *Implications*, *supra* note 3, at 46.

216 *Id.* at 46, 83; Public disclosure also may not provide any relevant information to investors. In Congressional testimony, hedge fund manager George Soros made clear that with such a volatile market, hedge funds turn over their positions every few weeks. Where there is generally a 6-week delay in the reporting requirements currently promulgated by the SEC, disclosure may not benefit investors. Moreover, Soros and other hedge fund managers noted that amateur investors tend to read too much into these reports. *See* Richard Beales, *Hedge fund hearings: More disclosure does not always mean more clarity*, TELEGRAPH, Nov. 14, 2008, http://www.telegraph.co.uk/finance/breakingviewscom/3457302/Hedge-fund-hearings-More-disclosure-doesnt-always-mean-more-clarity.html.

217 SEC, *Implications*, *supra* note 3, at 46.

not require hedge funds to disclose the information, it is industry practice, and sophisticated investors expect it.[218] Thus, disclosure to investors should not be a legitimate SEC concern warranting additional regulation.[219]

Finally, the SEC should not be concerned with the direct retailization of hedge funds due to existing regulation limiting access to hedge funds.[220] The Regulation D requirements provide a strict standard of investor sophistication.[221] Current regulations allow only a very small percentage of the population to invest directly in hedge funds.[222] The chance that these high net worth investors would inadvertently subject themselves to hedge fund risk is thus minimal.[223]

Furthermore, funds of hedge funds should not raise concerns of indirect investor exposure to hedge fund risk. Commentators warn that funds of hedge funds are faring worse than hedge funds, decreasing more than 18.7% this year.[224] Moreover, because these funds do not have similar mandated investor minimums required for direct hedge fund investing, commentators suggest that investors could accidentally buy into excessive risk.[225] However, funds of hedge funds are typically well diversified in multiple types of hedge fund strategies.[226] And while the overuse of leverage was a problem for funds of hedge funds in the past, managers are likely to be reluctant to make the same mistakes twice.[227] Accordingly, they operate similar to mutual funds, investing in a number of different hedge funds.[228] By exposing themselves to multiple hedge fund strategies, funds of hedge funds carry far less risk than single hedge funds.

While there are no government mandated investment minimums similar to the Regulation D requirement, many funds of hedge funds have self-imposed investment minimums.[229] The minimums range depending on the

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218 *Id.* at 46 n.161.

219 The SEC would actually be doubly regulating hedge funds here since the Commission already requires that all hedge fund investors be sophisticated. Interestingly, the SEC's rationale for limiting access to sophisticated investors is partly because sophisticated investors have the capability and knowledge basis to demand such disclosure. *See* 72 Fed. Reg. 400, *supra* note 104.

220 Lanzkron, *supra* note 19, at 1533, 1544.

221 17 C.F.R. § 230.506.

222 *Frequently Asked Questions*, The Hennessee Group, http://www.hennesseegroup.com/faq.html (last visited Jul. 31, 2009).

223 Assuming the SEC has correctly singled out sophisticated investors, accidental investments should not be a legitimate concern.

224 David Henry & Matthew Goldstein, *Fall of the Funds of Funds*, BUS. WK., Nov. 13, 2008, *available at* http://www.businessweek.com/magazine/content/08_47/b4109034618218.htm?chan=magazine+channel_news.

225 *Id.*

226 *Id.*

227 *See id.*

228 *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, SEC, Mar. 26, 2008, http://www.sec.gov/answers/hedge.htm.

229 *Id.*

fund, but typically start around $25,000.[230] Such self-imposed minimum investment requirements help limit investors to only those with sizable amounts of capital. As a result, investors in funds of hedge funds are not average traders trading small amounts of money. While larger amounts of money do increase risk of loss, most investors trading more than $25,000 will be more careful in deciding where to invest their money.[231]

Finally, registration or regulation of hedge funds may not actually reduce fraud or even benefit funds of hedge funds. For instance, funds of hedge funds which invested with Bernie Madoff may have done so as a result of a lack of due diligence.[232] As a result, funds will likely be much more careful in the future about which hedge funds they invest in.[233] Moreover, investors in funds will expect such diligence and similar disclosure of hedge funds.[234]

There is, however, one SEC concern that is not entirely addressed by internal incentives and regulation—indirect risk exposure through institutional investors. Hedge fund investors are not only individuals, but more commonly are banks, pension funds, and other publicly traded corporations.[235] The Hennessee Group reports that of all hedge fund sources of capital in January of 2005, 14% is directly from corporations, 7% is from pension funds, and another 7% is from charitable foundations and endowments.[236] Investors of the banks or beneficiaries of pension funds thus often indirectly, and often inadvertently, expose themselves to hedge fund risk. During the recent Congressional hearings on hedge funds, Representative Tom Davis of Virginia explained, "This isn't just about sophisticated, high-stakes investors anymore. Institutional funds and public pensions now have a huge stake in hedge funds' promises of steady, above-market returns. That means public employees and middle-income senior citizens . . . lose money when hedge funds decline or collapse."[237]

Pension funds should only be a secondary concern of indirect hedge fund risk. The Employee Retirement Income Security Act (ERISA) provides some protections for pension beneficiaries where the pension fund is more than 25% of a hedge fund's source of capital.[238] When investment in

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230 *Id.*

231 For similar reasons sophisticated investors demand more disclosure from hedge funds.

232 Martin de Sa'Pinto & James Molony, *Madoff Bad Omen for Fund of Hedge Fund Industry*, REUTERS, Dec. 17, 2008, http://www.reuters.com/article/euIpoNews/idUSLG48311320081217.

233 *See id.*

234 *See id.*

235 *Hedge Fund Sources of Capital*, The Hennessee Group, http://hennesseegroup.com/information/info/Sources%20of%20Capital%202005.pdf (last visited Jul. 31, 2009).

236 *Id.*

237 *The Role of Hedge Funds in the Current Financial Crisis: Hearing Before the House Comm. on Oversight and Gov't Reform*, 110th Cong. (Nov. 14, 2008).

238 SEC, *Implications*, *supra* note 3, at 28.

the hedge fund exceeds 25%, the hedge fund manager becomes an ERISA fiduciary.[239] Such a fiduciary holds discretionary management over plan assets and is thus subject to ERISA fiduciary duties of trust and loyalty to the beneficiaries of the pension plan.[240] Moreover, pension fund managers, who are already subject to ERISA requirements, may invest in hedge funds, but must "utilize proper methods to investigate, evaluate, and structure the investment; act in a manner as would others familiar with such matters; and exercise independent judgment when making investment decisions."[241] Therefore, the indirect exposure of hedge fund risk to pension plan beneficiaries is limited in two respects. First, hedge funds will avoid large amounts of pension fund investment in a single fund to avoid ERISA duties.[242] This forces pension plans to diversify their holdings among multiple hedge funds. The result is lower risk. Second, because of a heightened duty of care, pension plan managers have more incentive to research the hedge fund and demand disclosure of leverage ratios before.[243]

Other institutional investors, such as commercial banks, are not subject to similar limitations or heightened duties. This means the publicly traded company has a lower duty of care to research the hedge fund before investing. Moreover, because there are no disclosure requirements, investors often invest in corporations that are heavily invested in hedge funds. Because hedge fund risk is high and the risk of loss is great, investors in these institutions lack the ability to foresee hedge fund collapses, such as LTCM. Had the government not intervened in 1998 and bailed out LTCM, institutional banks, which were among some of the largest investors in LTCM, would have lost millions in shareholder equity. Shareholders would not have known what type of investments the institution was holding or the risk levels of the investments.

While most of the SEC's original concerns with the hedge fund industry are properly curbed by either existing regulation or market incentives, indirect exposure to excessive risk is not. If the SEC is convinced that regulation is key to restoring confidence in the economy, then it must walk a fine line to prevent full registration of hedge funds. While there certainly is risk involved with indirect exposure, overregulation could stifle economic sustainability.

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239 *Id.*

240 *Id.*

241 Verret, *supra* note 61, at 78.

242 SEC, *Implications*, *supra* note 3, at 28.

243 *See id.*

V. POLICY PROPOSAL

Existing regulation and industry incentives properly curb most of the SEC's original concerns about the hedge fund industry. In the wake of the financial collapse of 2008, however, the SEC may nonetheless push regulation to help increase investor confidence in financial markets.[244] If the SEC is intent upon regulating the hedge fund industry, the SEC should focus its energy on indirect retailization of hedge funds through institutional investors. This area is the one least addressed by industry incentives and has the most potential to hinder investor confidence.[245]

A. *The Problem*

Institutional investors are among some of the largest investors in hedge funds.[246] Institutional investors include corporations, universities, pension funds, charitable funds, among others.[247] Indirect exposure to hedge funds occurs when these institutions invest in hedge funds and the institution's shareholders or beneficiaries are subjected to hedge fund risk without disclosure.[248]

Of the institutional investors, pension funds are the best protected by existing regulations.[249] ERISA creates additional duties for pension plan managers to consider before investing in hedge funds.[250] ERISA also creates incentives for hedge funds to severely limit the amount that one pension plan may invest in an effort to stave off ERISA obligations on the hedge fund.[251] This, in turn, encourages pension plans to diversify in multiple hedge funds, since it cannot invest everything in a single fund. Other institutions that do not receive protection of ERISA subject their own inves-

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244 The SEC has responded in a like manner in the past. *See generally* the 1933 Act, the 1934 Act, and the 1940 Act, *supra* note 7; *see also* Scannel, *supra* note 1 (suggesting that some sort of hedge fund regulation will likely be soon created).

245 There are certainly incentives in place to curb institutional indirect risk. For instance, for the same reasons that sophisticated investors demand disclosure from hedge funds, so do institutional investors. However, SEC action that is minimally intrusive to the hedge fund industry, but nonetheless creates a light check against indirect retailization may come as a confidence boost to individual non-hedge fund investors.

246 *PWG Report*, *supra* note 15, at 1.

247 *Id.*

248 SEC, *Implications*, *supra* note 3, at 82.

249 *See id.* at 28 (discussing the implications of ERISA on hedge fund advisors); *see also id.* at n.97.

250 *Id.* at 28.

251 *Id.*

tors to excessive risk, which is rarely disclosed until the hedge fund investment fails.[252]

In 2008, the financial markets collapsed, sending capital markets reeling.[253] The SEC has stated that more regulation is needed to protect investors and restore confidence in the markets.[254] Some regulators already have hedge funds in their sights.[255] If the SEC and Congress are intent upon passing new regulation, then they should strive to curb inadvertent, indirect risk to investors of institutions that invest in hedge funds. Such an approach could improve investor protections without stifling the hedge fund industry.

B. *The Solution*

Regulators should set a default rule for all publicly traded institutional hedge fund investors to provide their own shareholders a basic report which assesses the risk of all of the hedge funds invested in, including leverage ratios above a minimum threshold.[256] The rule should apply only to those institutional investors that are already required to register with the SEC under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisors Act of 1940, the Investment Company Act of 1940, or similar relevant regulation.[257]

The rule would have multiple net benefits. First, it would curb the problem of inadvertent, indirect exposure. Investors would have, at a minimum, fair warning of the hedge fund risk. Note that the SEC's anti-fraud regulation would still apply.[258] Thus, any misrepresentation by the hedge fund to the institutional investor or from the institutional investor to the institution's investors would be punishable by the SEC. While the rule may in effect not actually curb indirect exposure, it would put investors on notice to the prospect of excess risk, thus reducing *inadvertent*, indirect exposure.

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252 *See id.* at 84.

253 *See* Testimony Concerning SEC Oversight: Hearing Before the Subcomm. on Capital Markets of the H. Comm. on Financial Services, 111th Cong. (Jul. 15, 2009) (testimony of SEC chairman Mary L. Schapiro), *available at* http://www.sec.gov/news/testimony/2009/ts071409mls.htm.

254 *Id.*

255 *Id.*

256 A leverage ratio of 2:1 tends to be about the average for hedge funds. *See* SEC, *Implications*, *supra* note 3, at 37. Perhaps the minimum threshold should be anything above the average leverage ratio.

257 Adapted from SEC, *Implications*, *supra* note 3; using default rules to generally regulate hedge funds adapted from Troy Paredes, *On the Decision to Regulate Hedge Funds*, 2006 U. ILL. L. REV. 975 (2006).

258 *See* 17 C.F.R. § 275.206(4)-4.

Second, the rule allows hedge funds to remain unregistered. This places the burden on institutions that are already subject to registration while decreasing the SEC's burden to close existing exemptions to regulations, as the SEC attempted via the Hedge Fund Rule.[259] The advantages to leaving hedge funds largely unregistered are numerous.[260] Hedge funds increase capital in markets as well as liquidity.[261] They provide institutional capital and fund venture operations, while promoting market efficiencies.[262] Investment in institutions by hedge funds will likewise play an unprecedented role in our recovering economy.[263] Without major investment banks to inject capital, hedge funds will have the ability to invest large amounts of capital with more diverse strategies.[264] Regulating funds will only decrease a fund's ability to adapt to market demands, and will consequently lower liquidity in essential parts of the market.[265] Simply put, unregulated hedge funds are a final hope to economic sustainability.

Third, the rule is a default rule, which allows flexibility to both institutional investors and hedge funds. A default rule is convenient because it allows parties to accept the rule or contract around it.[266] Should the organization choose the latter, it would still need to provide a rationale to the shareholders and beneficiaries for the decision not to disclose the hedge fund risk.[267] Hedge funds could thus opt out and not disclose the requested information if strategy concerns were truly at stake. Likewise, institutional investors could decide not to provide its shareholders with the information for similar reasons. More likely, however, the rule will create incentives for both hedge funds and institutional investors to cooperate and pass along the information at the risk of creating the appearance that either the institutional investor or the hedge fund is hiding potentially negative risk assessments. Regardless of whether the hedge fund complies with the institutional investor's information request or whether the institutional investor actually passes along the information to their investors, average investors will at minimum be put on notice that the institution has invested in a hedge fund to which significant risk is attached.

Fourth, the rule would bolster investor confidence by allowing investors and beneficiaries reasonably fair notice of the risk involved with their investments. Since investor confidence is key to economic recovery, bolstering risk assessment will be critical to encouraging investment over the

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259 *Hedge Fund Rule*, *supra* note 115.

260 *See supra*, Part I.B.

261 *See* SEC, *Implications*, *supra* note 3, at 4.

262 *Id.*

263 *See e.g.*, Lewis, *supra* note 2.

264 *Id.*

265 *See supra*, Part I.B.

266 Paredes, *supra* note 257, at 1026.

267 *Id.* at 1027-28.

next few years. Moreover, it is mutually beneficial if regulators are intent upon passing new protections for the market.

CONCLUSION

The SEC does not need additional regulation to effectively manage concerns about the hedge fund industry. While the SEC has legitimate concerns about fraud, overuse of leverage, lack of disclosure, and retailization of hedge funds, these concerns are managed by existing regulation or internal incentives within the hedge fund industry. Registration of hedge funds would be detrimental not only to the hedge fund industry, but would cripple the market economy by restricting vast amounts of capital, liquidity, and efficiencies. In an era lacking in mid-size investment banks, hedge funds will play an even more important role in capitalizing the market.

Though the SEC should not pass additional regulation, it may nonetheless feel pressured to act to bolster investor confidence. The one SEC concern that is least managed by existing regulation and internal incentives is indirect and inadvertent exposure to hedge fund risk by investors or beneficiaries of institutional hedge fund investors. Accordingly, the SEC should promulgate a default rule that places the burden on hedge fund's institutional investors to prepare and disclose a risk assessment memorandum to their shareholders and beneficiaries. A default rule would effectively manage inadvertent risk by putting investors on notice of the risk exposure. Moreover, the rule would allow hedge funds to remain unregistered, allowing them to sustain short- and long-term economic growth. Where hedge funds may be the final hope for economic sustainability, Congress simply cannot afford to over-regulate through hedge fund registration.

UNITED STATES V. ARNOLD: LEGALLY CORRECT BUT LOGISTICALLY IMPRACTICAL

*Nicole Kolinski**

I. INTRODUCTION

Convicted hacker Kevin Mitnick illegally accessed many computers, but he never dreamed that one of his own computers would have a hole drilled through its hard drive by Colombian customs officials.[1] While Colombian officials violated the hard drive that Mitnick had mailed to the United States in a fruitless search for contraband, United States Customs and Border Protection (CBP) agents seized Mitnick and his other electronic equipment.[2] CBP officials detained Mitnick for four hours even though he had already served time for the only crimes he had committed.[3] CBP agents then asked Mitnick to turn on one of his laptop computers to prove that he was flying into the United States to speak at a security conference.[4] When logging into his e-mail, he answered a default Firefox security question prompt that began automatically deleting his Internet history.[5] Afraid he was deleting evidence, customs officials snatched his computer away.[6] In response, Mitnick hit the power button to turn it off, fearful that he had given the agents access to the entire hard drive by typing in his password.[7] Once investigators confirmed his reason for entering the United States, they released him without any criminal charges or an explanation for his detainment.[8] The agents did, however, apologize.[9]

Mitnick's detention highlights the important issue of laptop searches at the U.S. border. When should CBP agents be allowed to look at laptops and other electronic media? What should the requirements for searching

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1 Elinor Mills, *Mitnick Cleared After Customs Scare*, ZD NET AUSTRALIA, Oct. 3, 2008, http://www.zdnet.com.au/news/security/soa/Mitnick-cleared-after-customs-scare/0,130061744,339292432,00.htm.

2 *Id.*

3 *Id.*

4 *Id.*

5 *Id.*

6 *Id.*

7 Mills, *supra* note 1.

8 *Id.*

9 *Id.*

the data be? How long may they hold a person's laptop? And what type of suspicion is required before they do? In *United States v. Arnold*,[10] the Ninth Circuit Court of Appeals held that no suspicion is required to search laptops at the U.S. border.[11] This decision overturned the Central District of California's decision, which held that reasonable suspicion was required.[12] The differences between the district court and the circuit court decisions in *Arnold* demonstrate the delicate issue of balancing personal privacy with the government's interest in searching travelers' luggage at the border.

Most of the cases on this issue favor the Ninth Circuit decision. But most of the scholarly articles on this issue favor the district court decision. This note gives careful consideration to the policy concerns on both sides. The government's concerns surrounding the search of digital data at the border are persuasive because the government has a broad interest in preventing contraband from entering the country.[13] The government is also concerned with treating electronically stored data and physical data equally, whether it is carried across the border in a suitcase or on a laptop.[14] However, there are also major privacy concerns involved, as technology evolves faster than the law. Scholars point out that laptops differ from other forms of luggage because the amount of data stored in a laptop makes a search more time-consuming and intrusive.[15] The significant concerns on both sides should be considered before formulating a laptop border search policy. While the government's interests in searching laptops at the border are important, the practical effects of a suspicionless search indicate the need for the law to catch up with technology. Courts have correctly interpreted the law as it stands. Congress should change the law to account for the practical effects of suspicionless searches and enact adequate safeguards to mitigate privacy concerns.

First, in Part II, this note explores the history of the border search exception to the Fourth Amendment and other cases dealing with laptop searches at the border. Part III discusses the differences between the two *Arnold* opinions, and lays the foundation for the tension between government and privacy interests. Part IV addresses the government's policy considerations and the individual's rights with respect to laptop searches at the border. Finally, Part V analyzes actions taken since the *Arnold* decision, including subsequent cases, public release of CBP policies, and Congressional legislation that could vastly improve the existing laptop border search policy. By fully considering the important concerns on each side of

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10 533 F.3d 1003 (9th Cir. 2008).

11 *Id.* at 1008.

12 United States v. Arnold, 454 F. Supp. 2d 999, 1003 (C.D. Cal. 2006).

13 United States v. Thirty-Seven (37) Photographs, 402 U.S. 363, 376 (1971).

14 United States v. Ramsey, 431 U.S. 606, 620 (1977).

15 *See* Orin S. Kerr, *Searches and Seizures in a Digital World*, 119 HARV. L. REV. 531, 555 (2005).

the debate as reflected in the two *Arnold* decisions, the government can make informed decisions regarding future laptop border search policies.

II. BACKGROUND—BORDER SEARCHES AND THE FOURTH AMENDMENT

A. *Foundations of the Border Search Exception*

The Fourth Amendment protects individuals from unreasonable searches and seizures of their "persons, houses, papers, and effects."[16] Courts have interpreted this to mean that law enforcement officers must secure a search warrant before conducting a search.[17] However, a warrant is not always required for a search: the courts instead require some sort of particularized suspicion, i.e. probable cause or reasonable suspicion. Courts have allowed searches of containers and vehicles in public places without a warrant, as long as law enforcement has "'probable cause' to believe that evidence of a crime will be found prior to conducting a search."[18] Reasonable suspicion is a lower standard than probable cause, and allows a law enforcement officer to pat-down a person's outer clothing where the officer believes the person poses a danger to the officer.[19]

Courts employ a balancing test between the government's interest and the individual's privacy interest to determine whether a search is reasonable under the Fourth Amendment.[20] The Founding Fathers who drafted the Fourth Amendment also passed the first customs statute, which carved out another exception to the warrant requirement.[21] The statute allowed customs officials to search any ship or vessel for concealed goods to ensure everyone paid the tax on goods entering the country.[22] In 1886, the Supreme Court upheld the seizure of goods under the first customs act in *Boyd v. United States*.[23] This case was the first in a series of cases where the court mentioned in dicta that a border search exception existed.[24]

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16 U.S. CONST. amend. IV.

17 California v. Carney, 471 U.S. 386, 390 (1985).

18 Jennifer M. Chacón, *Border Searches of Electronic Data*, LexisNexis Expert Commentary, 1-2 (June 2008).

19 *Id.* at 2.

20 United States v. Montoya de Hernandez, 473 U.S. 531, 537 (1985).

21 United States v. Ramsey, 431 U.S. 606, 616-17 (1977).

22 *Id.* at 616.

23 Boyd v. United States, 116 U.S. 616, 623 (1886) (explaining that the first Congress did not intend customs searches to be "unreasonable" under the Fourth Amendment because it authorized the searches by statute).

24 Larry Cunningham, *The Border Search Exception As Applied to Exit and Export Searches: A Global Conceptualization*, 26 QUINNIPIAC L. REV. 1, 2-4 (2007).

In 1925, in *Carroll v. United States*,[25] the Court considered the constitutionality of a car search away from the border.[26] The Court rejected the idea that law enforcement could stop every car on the road within the United States and legally conduct a search, yet specifically excluded cars entering the country.[27] The Court next considered the border search exception in two cases involving the forfeiture of obscene materials: *United States v. Thirty-Seven (37) Photographs*[28] and *United States v. 12 200-Ft. Super 8mm Reels of Film*.[29] In *Thirty-Seven Photographs*, the Court held that obscene materials could be seized from a traveler entering the country.[30] The Court explained that a port of entry was different from a traveler's home and that customs officials could routinely inspect a traveler's luggage to prevent illegal articles from entering the country.[31] In *12 200-Ft. Reels of Film*, the Court explained that Congress historically had the power to regulate commerce with foreign nations, and from this broad power, Congress may prevent prohibited materials from entering the country.[32] Finally, in *Almeida-Sanchez v. United States*,[33] the Supreme Court hinted that a border search exception existed without explicitly recognizing it.[34] There, the Court refused to extend the federal government's power to conduct routine border searches where CBP agents conducted a roving patrol search twenty-six miles from the Mexican border.[35]

The Supreme Court officially recognized the border search exception in 1977 in *United States v. Ramsey*,[36] where customs officials opened international mail without a warrant when they suspected it to contain drugs.[37] The Court considered whether the search was constitutional even though the search was authorized by an amended version of the first customs statute.[38] The Court examined the history of the border search doctrine throughout the Court's history, citing the cases mentioned previously.[39] From those cases, the Court concluded that border searches were reasonable "by the single fact that the person or item in question had entered into our

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25 267 U.S. 132 (1925).

26 *Id.*

27 *Id.* at 153-54 ("Travelers may be so stopped in crossing an international boundary because of national self protection reasonably requiring one entering the country to identify himself as entitled to come in, and his belongings as effects which may be lawfully brought in.").

28 402 U.S. 363, 364 (1971).

29 413 U.S. 123, 125 (1973).

30 United States v. Thirty-Seven (37) Photographs, 402 U.S. 363, 376 (1971).

31 *Id.*

32 United States v. 12 200 Ft. Reels of Super 8mm. Film, 413 U.S. 123, 125 (1973).

33 413 U.S. 266 (1973).

34 *Id.*

35 *Id.* at 272-73.

36 431 U.S. 606, 620 (1977).

37 *Id.* at 607.

38 *Id.* at 611-15.

39 *Id.* at 616-19.

country from outside."[40] The Court applied this conclusion and found that a customs agent could constitutionally open mail entering the country.[41] The United States has a right to control who and what comes into the country; the mode of transportation of people and articles entering the country does not affect the right to control that entry.[42]

B. *The Routine v. Non-routine Distinction*

After the Court officially recognized the border search exception, it distinguished routine searches from non-routine searches. Generally, no particularized suspicion is required for routine border searches of an entrant's person or effects because the government's interest in preventing illegal items from entering the country is greater than the traveler's expectation of privacy.[43] Routine searches include a person's outer clothing, vehicle, luggage, wallet, purse, pockets, and shoes.[44]

However, in *United States v. Montoya de Hernandez*,[45] the Supreme Court considered a situation where customs agents detained a suspect for sixteen hours to determine whether she was smuggling drugs in her alimentary canal.[46] While the Court focused on a seizure and not a search, the case offers insight into what types of situations are "non-routine."[47] The Court balanced the government's interest against the individual's privacy interest, and found the privacy interest to be greater.[48] The Court held that reasonable suspicion is required for a non-routine border search because the government's interest in preventing contraband from entering the country is great, especially compared to travelers' low expectation of privacy at the border.[49] The Court considered the alimentary canal search non-routine because of the highly intrusive nature and the dignity and privacy concerns it implicated.[50]

The Supreme Court recently considered the bounds of the routine/non-routine distinction. The issue in *United States v. Flores-Montano*[51] was whether disassembly of the suspect vehicle's gas tank was a non-routine

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40 *Id.* at 619.

41 *See id.* at 620.

42 *Ramsey*, 431 U.S. at 620.

43 United States v. Montoya de Hernandez, 473 U.S. 531, 538 (1985).

44 United States v. Irving, 452 F.3d 110, 123 (2d Cir. 2006).

45 473 U.S. 531 (1985).

46 *Id.* at 532-36.

47 Nathan A. Sales, *Run for the Border: Laptop Searches and the Fourth Amendment*, 43 U. RICH. L. REV. 1091, 1105 (2009).

48 *Montoya de Hernandez*, 473 U.S. at 539-40.

49 *Id.* at 539-41.

50 *See id.* at 541-42.

51 541 U.S. 149 (2004).

search.[52] The Court held that any vehicle search was routine because it did not raise the same "dignity and privacy interest" of "highly intrusive searches of the person."[53] The Court explicitly rejected a balancing test adopted by the Ninth Circuit that considered the degree of intrusiveness to determine whether a search was routine or non-routine.[54] The Court reaffirmed the importance of border searches by noting, "The Government's interest in preventing the entry of unwanted persons and effects is at its zenith at the international border."[55] The Court held that the defendant's claimed privacy interests were insufficient because smugglers regularly used gas tanks to hide contraband and travelers have only a minimal expectation of privacy at the border.[56]

In the *Flores-Montano* decision, the Court did not explicitly state a general rule for what constitutes a non-routine border search. The Court rejected the defendant's contention that the disassembly and reassembly of the gas tank was so damaging that it made the search unreasonable.[57] Because the procedure only took one or two hours and could be "reversed without damaging the safety or operation of the vehicle," the procedure was not sufficiently damaging to be unreasonable.[58] In addition, the Court declined to explain when a search would be unreasonable due to the manner in which it was conducted.[59] Through these cases, the Supreme Court laid the foundation for the routine/non-routine distinction that may be applied to laptop border searches, but did not explicitly rule on the issue.

C. *Pre-*Arnold *Laptop Border Search Decisions*

When other federal courts considered whether laptop border searches are routine or non-routine, two main types of decisions resulted. The courts either decided the cases on other grounds or found that reasonable suspicion validated the searches so the courts did not need to consider whether the searches violated the Fourth Amendment. Prior to *Arnold*, only four circuit court decisions and two district court decisions addressed this issue. Cases on laptop border searches decided after the Ninth Circuit decision in *Arnold* will be discussed later in this note.

The first court to consider a laptop border search was the Fifth Circuit in 2001 in *United States v. Roberts*.[60] The court avoided the laptop issue

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52 *Id.* at 150-52.

53 *Id.* at 152.

54 *Id.* at 151-52.

55 *Id.* at 152.

56 *Id.* at 153-54.

57 *Flores-Montano*, 541 U.S. at 154-55.

58 *Id.* at 155.

59 *Id.* at 154, n.2.

60 274 F.3d 1007, 1007 (5th Cir. 2001).

and found that the arresting officers obtained reasonable suspicion through a tip that the suspect was going to leave the country in possession of child pornography.[61] The Second Circuit followed suit in 2006 when it decided *United States v. Irving*.[62] There, the court held that the search was based on reasonable suspicion because the suspect was a convicted pedophile, photographed young boys in Mexico, and carried children's books in his luggage.[63] Since reasonable suspicion existed, the court did not decide whether the search of his computer disks was routine or non-routine.[64] In 2006, the Ninth Circuit declined to consider the issue in *United States v. Romm* because the defendant waived the issue by not raising it in his opening brief.[65]

In *United States v. Ickes*,[66] the Fourth Circuit considered the border search of a van entering the U.S. that uncovered a video that focused excessively on a young ball boy and photographs of nude young boys.[67] Though the court could have decided the case based on reasonable suspicion since finding the video led to a more thorough search and the photographs, the court instead decided the issue on both Fourth and First Amendment grounds. Ickes argued that the search of his computer and disks was unconstitutional, but the court stressed that warrantless searches at the border are reasonable and that the government's interest in preventing contraband from entering the country was greater than the individual's interest due to the lessened expectation of privacy at the border.[68] Ickes then argued that the computer search was invalid because it involved expressive material protected by the First Amendment.[69] The court rejected this argument as well, because it would have created a broad exception that would undermine the purpose of the border search exception and force customs officials to draw difficult lines.[70] The *Ickes* court rejected a First Amendment exception, and held that the search was permissible under the Fourth Amendment because "extensive searches at the border are permitted, even if the same search elsewhere would not be."[71]

Two district court decisions also considered the issue of laptop border searches before *Arnold*. The District of Minnesota adopted a magistrate's report which found that the court did not need to consider whether a laptop search was routine because there was reasonable suspicion from a tip that

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61 *Id.* at 1016-17.

62 United States v. Irving, 452 F.3d 110, 124 (2d Cir. 2006).

63 *Id.* at 124.

64 *Id.*

65 455 F.3d 990, 997 (9th Cir. 2006).

66 393 F.3d 501, 502 (4th Cir. 2005).

67 *Id.* at 502-03.

68 *Id.* at 505-06.

69 *Id.* at 506.

70 *Id.*

71 *Id.* at 502.

the defendant accessed a child pornography website.[72] The District of Maine considered the issue in *United States v. Hampe*.[73] During an inspection of Hampe's car on a return trip from Canada, border patrol officers found children's sleeping bags, superhero themed underwear, stickers, condoms, personal lubricant, a camera, and a computer.[74] The court held that the computer search, which involved clicking icons on the desktop, was a routine search.[75] In addition, the court found that even if reasonable suspicion was required, the disturbing combination of items in Hampe's car gave the officer reasonable suspicion that the computer contained child pornography.[76]

In the few cases determining whether a laptop border search was routine or non-routine, most courts avoided the issue by finding reasonable suspicion. While the Fourth Circuit in *Ickes* briefly addressed the Fourth Amendment issue, its decision ultimately turned on the First Amendment issue. These cases demonstrate the novelty of *Arnold*.

III. *UNITED STATES V. ARNOLD*—THE DISTRICT COURT AND THE CIRCUIT COURT COMPARED

A. *Facts of the Case*

On July 17, 2005, forty-three year old Michael Arnold arrived at Los Angeles International Airport after a trip to the Philippines.[77] Like other travelers, he was dressed in casual clothes, had short hair and a goatee.[78] After receiving his luggage, he went through customs like all other travelers returning to the country.[79] CBP Officer Laura Peng selected Arnold for secondary questioning and asked about his travels.[80] Arnold explained that he was on vacation for three weeks visiting friends in the Philippines.[81] Arnold's luggage contained a laptop, an external hard drive, a USB drive and six CDs.[82] Peng told Arnold to turn on the computer to prove it worked and then turned it over to CBP Officer Roberts.[83] Both Peng and Roberts reviewed the laptop and clicked on two desktop folders called "Kodak Pic-

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72 United States v. Furukawa, 2006 WL 3330726, at *5 (D. Minn. Nov. 16, 2006).

73 2007 WL 1192365, at *4 (D. Maine Apr. 18, 2007).

74 *Id.*

75 *Id.*

76 *Id.*

77 United States v. Arnold, 454 F. Supp. 2d 999, 1001 (C.D. Cal. 2006).

78 *Id.*

79 *Id.*

80 *Id.*

81 *Id.*

82 *Id.*

83 *Arnold*, 454 F. Supp. 2d at 1001.

tures" and "Kodak Memories."[84] The officers found a photo of two nude women in one folder, but there was no indication that the women were underage.[85] The photo caused Roberts to call in supervisors, who then called special agents from the Department of Homeland Security, Immigration and Customs Enforcement (ICE).[86]

ICE agents detained Arnold and questioned him about his computer's contents.[87] The ICE agents further searched his computer and found images of child pornography.[88] The agents released Arnold, but seized his computer and storage devices.[89] Two weeks later, the agents obtained a search warrant for the detained equipment, searched again and found more images of child pornography.[90] Arnold moved to suppress the evidence found in the airport as well as the evidence found using the search warrant.[91] Arnold argued that the warrantless search violated his Fourth Amendment rights.[92] The fact that Arnold's search was truly suspicionless sets *Arnold* apart from the cases considered by the other federal courts. Peng did not select Arnold from knowledge that he was a convicted pedophile, a tip from a law enforcement investigation, or an initial search that uncovered actual images of child pornography. Instead, Arnold was randomly selected while waiting to go through customs, and though the initial laptop search found pornography, it was not illegal pornography.

B. *The District Court Decision*

To analyze the search in *Arnold*, the district court first considered the role of the border search exception in Fourth Amendment jurisprudence. The court balanced the government's interest in conducting a laptop search against the individual's privacy interests and decided in favor of the individual.[93] Although the court noted that the lack of a suspicion requirement for non-routine searches was legitimized by important government interests in border searches, it held that more intrusive border searches required a showing of reasonable suspicion.[94] To apply the routine/non-routine distinction laid out in *Montoya de Hernandez*,[95] the court relied on the Ninth

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84 *Id.*
85 *Id.*
86 *Id.*
87 *Id.*
88 *Id.*
89 *Arnold*, 454 F. Supp. 2d at 1001.
90 *Id.*
91 *Id.* at 1000.
92 *Id.*
93 *Id.* at 1002.
94 *Id.*
95 United States v. Montoya de Hernandez, 473 U.S. 531, 540-41 (1985).

Circuit decision in *United States v. Vance*, which held that "as the intrusiveness of a search increases, so does the need for suspicion."[96] Applying this standard, the district court concluded that a laptop search at the border was indeed non-routine.[97] The district court analogized the dignity and privacy concerns for non-routine searches in *Flores-Montano* to a search of a laptop noting that "viewing confidential computer files implicates dignity and privacy interests."[98] Since computers can contain both a large amount and many different types of information, an individual's dignity and privacy interests are heightened.[99] To the court, information such as private diaries, confidential and privileged information, and trade secrets raise privacy concerns that outweigh government interests of a laptop border search.[100] Although Arnold kept child pornography on his laptop, which is a federal offense, the court explained that the law often protects our liberties while unfortunately benefiting some despicable people.[101]

After concluding the laptop search in *Arnold* was a non-routine search that needed to be supported by reasonable suspicion, the court then considered whether Officer Peng had reasonable suspicion to search Arnold's computer.[102] The court determined that Peng did not have reasonable suspicion because the government provided an incomplete record of the search and Officer Peng's testimony was inconsistent.[103] Therefore, the court excluded the illegally obtained evidence.[104] To clarify this area of law going forward, the court formulated a new rule for customs officials searching laptops at the border: customs agents may turn on a laptop to make sure that it is functioning rather than concealing a bomb or carrying drugs, but may not search the laptop's contents without reasonable suspicion.[105]

The district court decision was truly novel, as it was the first decision to hold that the search of a tangible item was non-routine. Previously, non-routine searches were limited to invasive physical searches of the person, such as the alimentary canal search in *Montoya de Hernandez*.[106] However, the Ninth Circuit overturned the ruling two years later.

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96 *Arnold*, 454 F. Supp. 2d at 1003 (citing United States v. Vance, 62 F.3d 1152, 1156 (9th Cir. 1995)).

97 *Id.* at 1003.

98 *Id.*

99 *Id.* at 1003-04.

100 *Id.* at 1004.

101 *Id.*

102 *Arnold*, 454 F. Supp. 2d at 1004.

103 *Id.* at 1005-07.

104 *Id.* at 1007.

105 *Id.*

106 United States v. Montoya de Hernandez, 473 U.S. 531, 540 (1985).

C. *The Ninth Circuit Opinion*

The Ninth Circuit decision pointed out the novelty of the district court ruling, but flatly rejected the district court's reasoning. The Ninth Circuit noted that agents have routinely searched closed containers at the border without suspicion and rejected the district court's use of a balancing test to determine whether a search is routine or non-routine.[107] As the Supreme Court stated in *Flores-Montano*, "complex balancing tests" should not be used for border searches of vehicles.[108] The Ninth Circuit further rejected the district court's distinction of a laptop from a vehicle, as the analysis in *Flores-Montano* was not based on the unique characteristics of a vehicle, but instead showed that a vehicle is property that does not implicate the same dignity and privacy concerns as highly intrusive searches of the person.[109] The court concluded that a laptop is simply another form of property, and thus does not require reasonable suspicion.[110]

The Ninth Circuit also found two grounds in Supreme Court decisions for requiring reasonable suspicion for border searches of property.[111] First, the Supreme Court indicated in *Flores-Montano* that extensive damage to the property during the search may invoke a higher level of suspicion.[112] This reasoning did not apply because Arnold never claimed that the government damaged his laptop during the search.[113] Second, the Supreme Court indicated there may be an exception if the search was carried out in a "particularly offensive manner."[114] But the Ninth Circuit determined that the search of Arnold's laptop was no different than the search of any other item, and an otherwise ordinary search does not become "particularly offensive" because of the storage capacity of the object.[115]

The Ninth Circuit also rejected Arnold's argument that a laptop is analogous to a home and therefore requires more particularized suspicion.[116] The court relied on the Supreme Court's decision in *California v. Carney*,[117] which upheld the warrantless search of a mobile home. There, the Court noted that although the mobile home was capable of functioning as a home, it was readily movable and had a lessened expectation of privacy when

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107 United States v. Arnold, 533 F.3d 1003, 1007 (9th Cir. 2008).

108 *Id.* at 1008 (citing United States v. Flores-Montano, 541 U.S. 149, 152 (2004)).

109 *Id.*

110 *Id.* at 1008.

111 *Id.* at 1008-09.

112 *Id.*

113 *Arnold*, 533 F.3d at 1008-09.

114 *Id.*

115 *Id.* at 1009-10.

116 *Id.* at 1009.

117 471 U.S. 386, 393-94 (1985).

crossing the border.[118] The Ninth Circuit analogized that laptops are also readily movable and carry a lessened expectation of privacy when carried across the border.[119]

Finally, the Ninth Circuit declined to create a circuit split with the Fourth Circuit in *Ickes*.[120] Generally, the court agreed with *Ickes*, which held that the search of the defendant's van was permissible and refused to carve out a First Amendment exception to the border search doctrine.[121] The Ninth Circuit, however, failed to recognize that *Ickes* was distinct because it only dealt with the First Amendment issue, not the Fourth Amendment issue presented in *Arnold*.[122] Since the Ninth Circuit did not recognize that reasonable suspicion was required for laptop border searches and rejected the other grounds articulated by the Supreme Court for requiring reasonable suspicion in Arnold's case, the court reversed the motion to suppress the evidence recovered during the search of Arnold's laptop.[123]

Under case law, it is clear that the Ninth Circuit reached the right conclusion. The Supreme Court explicitly rejected balancing tests for the routine/non-routine distinction in *Flores-Montano* and never indicated that it would extend the distinction to property outside the destructiveness or offensive manner contexts.[124] But the Ninth Circuit ignored some distinguishing features of laptop searches, which indicates that the law has not yet expanded to incorporate important technological developments. The question of whether courts or the other branches of the federal government should consider these distinguishing features remains.

IV. POLICY CONSIDERATIONS—INDIVIDUAL PRIVACY CONCERNS WEIGHED AGAINST GOVERNMENT INTERESTS

The district court in *Arnold* argued that an individual's privacy concerns in a laptop were sufficiently high to require reasonable suspicion. While many commentators agree with the district court's decision, the case law is on the Ninth Circuit's side. This split helps set the stage for a plethora of policy concerns that arise when considering this issue. First, this paper will lay out the government's broad, overarching concerns with border searches. Then it will consider the arguments in favor of the privacy interests and the government's counter-arguments to those. Analyzing both

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118 *Arnold*, 533 F.3d at 1009-10.

119 *Id.*

120 *Id.* at 1010.

121 *Id.* (citing United States v. Ickes, 393 F.3d 501, 502 (4th Cir. 2005)).

122 Brief of Appellee at 29, United States v. Arnold, 533 F.3d 1003 (9th Cir. 2008) (No. 06-50581).

123 *Arnold*, 533 F.3d at 1008, 1010.

124 *See* United States v. Flores-Montano, 541 U.S. 149, 154 (2004).

sides of the issue will help future courts, Congress, and the CBP make an informed decision about what the law should be for laptop border searches.

A. *Government Concerns at the Border*

It is clear from case law that border searches are a longstanding exception to the Fourth Amendment.[125] In his testimony before the Senate Judiciary Committee, Larry Cunningham laid out four reasons why routine border searches are justified under the Constitution.[126] First, there is a long history of customs officials having broad authority to conduct suspicionless and warrantless searches.[127] Second, "the sovereign has an inherent right to control who and what crosses its borders."[128] Third, searches prevent contraband from entering the country.[129] Finally, there is a diminished expectation of privacy at the border.[130] Over the years, the Supreme Court has repeatedly reaffirmed these justifications.

Cunningham's historical argument is supported by the Supreme Court's treatment of the history of the border search doctrine in *United States v. Ramsey*.[131] In that case, the Court officially recognized the border search exception by going through the lengthy history of border search cases listed above.[132] Cunningham's second argument is also supported by Supreme Court precedent. In *Torres v. Puerto Rico*,[133] the Supreme Court explained that "[the United States has] inherent sovereign authority to protect its territorial integrity. By reason of that authority, it is entitled to require that whoever seeks entry must establish the right to enter and to bring into the country whatever he may carry."[134] The Supreme Court explained in *United States v. 12 200-Ft. Reels of Film* that Congress has broad powers to regulate commerce with foreign nations, and these powers have been used to prevent smuggling and prohibited items from entering the United States, which supports Cunningham's third argument.[135] Lastly, the Supreme Court has explained that an individual has a lessened expectation of

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125 United States v. Ramsey, 431 U.S. 606, 616-19 (1977).

126 *Laptop Search and Privacy Violations Faced By Returning Travelers: Hearing Before the Subcomm. on the Constitution, Civil Rights and Property Rights of the S. Comm. on the Judiciary*, 110th Cong. 4 (2008) (statement of Larry Cunningham, Assistant Dist. Att'y, App. Bureau Bronx County Dist. Att'y's Office in New York City).

127 *Id.*

128 *Id.*

129 *Id.*

130 *Id.*

131 United States v. Ramsey, 431 U.S. 606, 616-19 (1977).

132 *Id.*

133 442 U.S. 465, 473 (1979).

134 *Id.* at 473.

135 United States v. 12 200 Ft. Reels of Super 8mm. Film, 413 U.S. 123, 125 (1973).

privacy at the border because, "a port of entry is not a travelers' home."[136] Border agents routinely and characteristically inspect luggage to prevent contraband from entering the country.[137] Travelers are accustomed to going through numerous security checkpoints not only at the border, but for flights inside the United States as well. For these reasons, the individual's expectations of privacy are diminished, and the government has the power to conduct routine searches of persons and their luggage entering this country without any suspicion at all.[138]

This is not to say that the individual has no privacy rights at the border. For highly intrusive, non-routine searches, the Supreme Court has held that reasonable suspicion is required.[139] However, the Court has limited this to searches of the person. Professor Nathan Sales suggests that the Court was drawing a bright-line rule between intrusive searches of the person, which require reasonable suspicion, and searches of property, which do not.[140] The Supreme Court flatly rejected the non-routine distinction for vehicles, another form of property, in *Flores-Montano*.[141] In that decision, the Court implied that the dignity and privacy concerns of the person could be raised only when custom agents were physically searching a person and not his property.[142]

The government also wishes to protect other interests in border searches not mentioned by Cunningham. One interest is not treating the same data differently because it is in electronic rather than physical form.[143] Laptops are another type of container that can hold highly personal innocent materials or evidence of criminal conduct.[144] Similarly, laptops can be used as a mode of transportation for contraband like child pornography. If the government were prohibited from searching laptops, it would create perverse incentives for criminals to transport contraband in a laptop.[145]

The government's concerns represent important policy considerations that should be taken into account. But as the non-routine search context indicates, the government's interests are not always supreme. Some circumstances require deference to the individual's privacy interests, and most commentators believe that a laptop search is one of these circumstances.

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136 United States v. Thirty-Seven (37) Photographs, 402 U.S. 363, 376 (1971); *accord* United States v. Montoya de Hernandez, 473 U.S. 531, 539 (1985).

137 *Thirty-Seven (37) Photographs*, 402 U.S. at 376.

138 *Montoya de Hernandez*, 473 U.S. at 540, 538.

139 *Id.* at 541.

140 Sales, *supra* note 47, at 1109-10.

141 United States v. Flores-Montano, 541 U.S. 149, 152 (2004).

142 *Id.*

143 Opening Brief of Gov't at 31, United States v. Arnold, 533 F.3d 1003 (9th Cir. 2008) (No. 06-50581).

144 *Id.*

145 Reply Brief of Gov't at 24, United States v. Arnold, 533 F.3d 1003 (9th Cir. 2008) (No. 06-50581).

Some of these concerns are valid, while others can be refuted by overriding privacy concerns. Ultimately, while the law and history are on the government's side, the practical effects of new technology in daily life require new legislation.

B. *Privacy Concerns—Why the District Court Found That Laptop Searches Are Not Routine and Why the Ninth Circuit Disagreed*

1. Laptops Contain Data That Raises Dignity and Privacy Concerns

The district court in *Arnold* noted that laptops contain vast amounts of personal data, which raises privacy concerns. Professor Orin Kerr comments that computers record more of our daily lives than ever, as they are "postal services, playgrounds, jukeboxes, dating services, movie theatres, daily planners, shopping malls, personal secretaries, virtual diaries and more."[146] Student writings compare searching a computer to peering into someone's mind. John Nelson explains that laptops contain highly personal snapshots from an individual's mind.[147] Rasha Alzahabi argues that a laptop is not a traditional closed container, but is an item that resembles the owner's memory.[148] Christine Colletta analogizes a laptop search to reading someone's diary or mail.[149] These commentators echo the district court's concern in *Arnold* that "some may value the sanctity of private thoughts memorialized on a data storage device above physical privacy."[150]

While this privacy argument is important, the government has a countervailing interest in treating data the same, regardless of its form. Laptops may contain highly private information about a person including personal contacts, medical information, and banking information; but so could items carried through a border in physical form, such as an address book, prescriptions, or a checkbook. A diary can be carried through a border checkpoint on a computer or in a notebook. The government would argue as it did successfully in *Arnold* that something should not be treated differently because it is in electronic rather than physical form.

The Supreme Court has indicated that the method of information, type of storage, or mode of transportation across the border does not matter. For

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146 Kerr, *supra* note 15, at 569.

147 John W. Nelson, Note, *Border Confidential: Why Searches of Laptop Computers at the Border Should Require Reasonable Suspicion*, 31 AM. J. TRIAL ADVOC. 137, 141 (2007).

148 Rasha Alzahabi, Note, *Should You Leave Your Laptop at Home When Traveling Abroad?: The Fourth Amendment and Border Searches of Laptop Computers*, 41 IND. L. REV. 161, 181 (2008).

149 Christine A. Colletta, Note, *Laptop Searches at the United States Borders and the Border Search Exception to the Fourth Amendment*, 48 B.C. L. REV. 971, 1000 (2007).

150 United States v. Arnold, 454 F. Supp. 2d 999, 1003 (C.D. Cal. 2006).

example, in *United States v. Ross*,[151] the Court declined to distinguish between different types of containers, as a traveler carrying his items in a knotted scarf had the same right to conceal his possessions as a traveler with a locked briefcase.[152] The government has argued that a laptop is just another container and thus should not be regarded with any higher concern.[153] It follows that a diary carried across the border in a backpack is subject to search in the same way as a diary on a laptop. The Supreme Court also indicated in *Ramsey* that the mode of transportation across the border did not matter.[154] The Court found that CBP had adequate safeguards to prevent privacy violations, because the Congressional mail statute required reasonable cause before opening mail and postal regulations prohibited reading the mail.[155] Congress or CBP could implement similar safeguards to help alleviate privacy concerns while recognizing the government's interest in treating all types of data equally. While the privacy of data contained on a laptop is an important concern, it alone does not prove that laptops are entitled to more protection.

2. Laptops Carry Confidential and Privileged Information That Needs To Be Protected

Besides protecting personal thoughts, individuals are also concerned about safeguarding confidential or privileged information. As Lindsay Harrell points out in her student note on the district court's decision in *Arnold*, computers raise numerous confidentiality concerns.[156] The first is whether privileged information, found in the context of a border search, is considered an inadvertent disclosure which could result in waiver of privilege during litigation.[157] The law expects attorneys to protect privileged information from disclosure, a duty which is complicated when information is transported over national borders.[158]

Harrell further points out that business travelers may carry sensitive data, such as customer information or trade secrets.[159] Since business trav-

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151 456 U.S. 798 (1982).

152 *Id.* at 822.

153 *Id.* at 822-23; United States v. Ramsey, 431 U.S. 606, 620 (1977). *See generally*, Opening Brief of Gov't, *supra* note 143, at 30-46 (advocating that computer storage devices are not any different from other closed storage containers that are subject to suspicionless border searches).

154 *Ramsey*, 431 U.S. at 620.

155 *Id.* at 623.

156 Lindsay E. Harrell, Note, *Down to the Last .JPEG: Addressing the Constitutionality of Suspicionless Border Searches of Computers and One Court's Pioneering Approach in* United States v. Arnold, 37 SW. U. L. REV. 205, 228-34 (2008).

157 *Id.* at 228.

158 *Id.* at 231.

159 *Id.* at 232-33.

elers are more likely to be traveling abroad with their laptops, their concerns are especially relevant to the laptop border search debate. In a Senate Judiciary Committee Hearing, Susan K. Gurley of the Association of Corporate Travel Executives explained that "the unjustified retention and/or copying of proprietary and sensitive business information . . . imposes both a personal and economic hardship on business travelers."[160] First, she explained that a business traveler's actual office extends beyond the physical office, thanks to mobile devices such as laptops.[161] If CBP can search and seize these devices without suspicion, business travelers may be quite literally "locked out" of their offices.[162] Gurley also stressed that since the government is not known for its data protection, businesses could be forced to implement new and expensive procedures to protect their data while traveling abroad.[163]

The role of computers in professions such as business, law, and medicine raises significant concerns about the types and amount of information stored on these devices. All of the above mentioned professions have confidentiality concerns, whether it is attorney-client privilege, doctor-patient confidentiality, or confidential business information such as trade secrets. Adequate safeguards could help alleviate these privacy concerns. For example, the respective professional organizations, such as the American Bar Association or American Medical Association, could fashion guidelines on the professional responsibility to protect confidential information on laptops, particularly when traveling abroad. Congress could also formulate procedures to protect confidential and privileged material.

CBP has vague guidelines in place to help protect confidential and privileged information. Following the *Arnold* decision, CBP released its *Policy Regarding Border Search of Information*, which contains specific safeguards for dealing with special types of information, such as business information and attorney-client privileged material.[164] For business information, the policy states that the information would be protected from unauthorized disclosure, and to prevent disclosure of trade secrets, CBP agents must comply with the Trade Secrets Act.[165] Concerning attorney-client privileged information, a CBP officer must "seek advice" from government attorneys before searching a court document or correspondence he suspects

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160 *Laptop Search and Privacy Violations Faced By Returning Travelers: Hearing Before the Subcomm. on the Constitution, Civil Rights and Property Rights of the S. Comm. on the Judiciary*, 110th Cong. 2 (2008) (statement of Susan K. Gurley, Executive Director, Association of Corporate Travel Executives).

161 *Id.*

162 *Id.*

163 *Id.*

164 U.S. CUSTOMS AND BORDER PROTECTION, POLICY REGARDING BORDER SEARCH OF INFORMATION 4 (2008), http://www.cbp.gov/linkhandler/cgov/travel/admissibility/search_authority.ctt/search_authority.pdf.

165 *Id.*

to be protected by attorney-client privilege.[166] As discussed below, the Obama Administration released new guidelines for both CBP and ICE on August 27th, 2009.[167] However, the new guidelines for each agency essentially state the same principles as the Bush Administration guidelines: that confidential and privileged information will be handled in accordance with applicable laws.[168] While safeguards are important, the current guidelines are vague and leave CBP agents with excessive discretion in dealing with sensitive confidential and privileged information. More specific guidelines for sensitive information would help alleviate professional travelers' concerns.

3. Laptops Retain Data Even After an Attempt to Delete the Data

Laptops retain data even after an individual attempts to delete the information. Professor Kerr explains the nuances of digital data in his article *Searches and Seizures in a Digital World.*[169] Computers store information that the user does not know about or control.[170] Once a user deletes a file, the file remains on the hard drive until the space it occupied is selected for use, often randomly, by another file.[171] Even though the user cannot see the data, analysts can forensically access it.[172] Harrell also notes that deletion of a document on a computer does not destroy the document and that a computer may store multiple copies of the same document.[173] This technological feature may result in a traveler's liability for something on his computer of which he was unaware.[174]

There are three main counter-arguments to this concern. First, the government pointed out in its *Arnold* reply brief that travelers may be liable for items in their luggage whether or not they were aware of the items.[175] Lack of knowledge that materials were in luggage or on a computer is a viable defense, but it does not prevent a search from taking place.[176] Second, a user usually deletes information through human action, indicating

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166 *Id.*

167 Press Release, Department of Homeland Security, Secretary Napolitano Announces New Directives on Border Searches of Electronic Media (Aug. 27, 2009) (on file with author).

168 *See* U.S. CUSTOMS AND BORDER PROTECTION, BORDER SEARCH OF ELECTRONIC DEVICES CONTAINING INFORMATION 3-4 (2009), http://www.dhs.gov/xlibrary/assets/cbp_directive_3340-049.pdf [hereinafter CBP POLICY]; U.S. IMMIGRATION AND CUSTOMS ENFORCEMENT, BORDER SEARCHES OF ELECTRONIC DEVICES 9 (2009), http://www.dhs.gov/xlibrary/assets/ice_border_search_electronic_devices.pdf [hereinafter ICE POLICY].

169 Kerr, *supra* note 15, at 542.

170 *Id.*

171 *Id.*

172 *Id.*

173 Harrell, *supra* note 156, at 231.

174 *See id.*

175 Reply Brief of Gov't, *supra* note 145, at 6.

176 *Id.*

that the user probably had knowledge of the information at some point. Thus, even if illegal materials remain on the user's computer after deletion, the original possession of the illegal materials was just that, illegal. Third, the government also argued in *Arnold* that it is common knowledge that information is not really gone when a user deletes it from a computer.[177] The last argument is not as strong as the other arguments as it is difficult to determine what each traveler may or may not know about computers. Educating the traveler about computer searches could help alleviate this concern.

4. Laptops Have a Vast Storage Capacity That Separates Them from Other Closed Containers

Commentators argue that laptops should be treated differently because they generally store a larger amount of information than anyone could carry across the border. Professor Kerr notes that the physical size of a laptop, unlike a home or a suitcase, does not limit the amount of information it can hold.[178] For example, a laptop with a storage capacity of eighty gigabytes is equal to forty million pages of text.[179] This capacity makes a laptop a "vast warehouse of information."[180] Individuals clearly have a privacy concern in such a large amount of information.

In its reply brief in *Arnold*, the government laid out its countervailing interest that laptops' larger storage capacity means that there is more space for illegal materials.[181] If criminals knew border security personnel would not search laptops, it would give them an incentive to transport illegal files over the border.[182] In light of cases such *Irving*, where the defendant crossed the border to photograph young boys,[183] the government has a substantial interest in detecting this type of material. In addition, Professor Sales also argues that having a changing legal standard based on the size of a container would be arbitrary—privacy protection would be founded on "mere happenstance—the size of the surrounding container."[184]

The Supreme Court has also declined to distinguish among the sizes of vehicles to determine whether a search is permissible. In *California v. Carney*, the Court found that a mobile home could be searched despite its larger size and ability to function as a home.[185] The Court refused to "apply

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177 *Id.* at 5.

178 Kerr, *supra* note 15, at 541.

179 *Id.* at 542.

180 *Id.*

181 Reply Brief of Gov't, *supra* note 145, at 5.

182 *Id.*

183 United States v. Irving, 452 F.3d 110, 110-11 (2d Cir. 2006).

184 Sales, *supra* note 47, at 1112.

185 California v. Carney, 471 U.S. 386, 393 (1985).

the exception depending upon the size of the vehicle and the quality of its appointments."[186] This logic could be applied to laptop search cases, and the United States government might argue that CBP agents should not have to apply different standards based on storage capacity.

5. Laptop Searches Take Longer Than the Average Physical Search

Storage capacity prolongs laptop searches. Professor Kerr explains that "computer searches require fewer people but more time."[187] The massive amount of data on a computer gives a forensic analyst great flexibility; the analyst could spend as much or as little time as a case permits to go through the data, which could be hours, days, weeks, or months.[188] Kerr notes that this differs from a traditional physical search, which is limited in search area and usually does not take more than a few hours.[189] By contrast, "invasive computer searches are much less expensive and less time pressured than traditional physical searches."[190] Further, it is easier and more cost-effective to perform a sweeping search on a computer than to conduct a narrow search, which will likely make the more invasive search the norm.[191]

In her note, Christine Colletta proposes that laptop searches be distinguished by the length of time taken to conduct them.[192] Citing *Flores-Montano*, where the Supreme Court found a gasoline tank disassembly and reassembly relatively quick and routine, Colletta suggests that longer searches may be considered non-routine.[193] Since CBP methods could range from opening and turning on a laptop to an advanced search of a hard drive, the search could take minutes, or it could take weeks, preventing the owner from accessing his computer.[194] Indeed, this is exactly what happened in *Arnold*, as the ICE agents released Arnold but detained his laptop for further searches.[195]

Search time emphasizes two major concerns: deprivation of property and deprivation of time. First, a laptop border search may deprive a person of his computer equipment. This is troubling due to the critical role computers play in our daily lives. Many people's morning routine includes turning on the computer and checking e-mail, weather, or news. Extensive

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186 *Id.*

187 Kerr, *supra* note 15, at 544.

188 *Id.*

189 *Id.* at 543-44.

190 *Id.* at 569.

191 *Id.* at 569-70.

192 Colletta, *supra* note 149, at 1002.

193 *Id.*

194 *Id.*

195 United States v. Arnold, 454 F. Supp. 2d 999, 1001 (C.D. Cal. 2006).

laptop searches could deprive business travelers of their virtual offices. The increasing role of technology is a definite practical concern when CBP deprives travelers of their equipment. One solution is copying the traveler's hard drive. However, this too takes time, and raises numerous privacy concerns about how the authorities use, store, and destroy the copied information.

Second, it is important to consider the length of a search prior to finding probable cause. The length of the search depends on a number of factors—the size of the hard drive, the search tool, the quantity of search items, and the language of the information.[196] A completely suspicionless search of an average-size hard drive would take several hours, if not longer, depending on the factors above.[197] That type of inconvenience is simply unnecessary and invasive without any suspicion.

6. Laptop Searches by Untrained Parties Could Result In Destruction of the Laptop

Another practical concern is the proper and safe use of technological equipment, such as laptops. The Supreme Court in *Flores-Montano* hinted at this when it stated that a property search could be non-routine if the search was destructive.[198] The Ninth Circuit also mentioned that Arnold's search may have required suspicion if it was destructive, though it determined that Arnold waived the issue because he never claimed that the government damaged his computer during its search.[199] Harrell suggests in her note that customs agents do not have the proper training to conduct laptop searches, which could be destructive because one of the biggest threats to a computer is an "unskilled user."[200] While Harrell does not cite any statistical data concerning how many laptops are actually damaged through national border searches, the possibility remains.

The Ninth Circuit considered the destruction of a vehicle during a search in *United States v. Chaudry*.[201] The court found that drilling a 5/16 inch hole in a truck bed was not sufficiently destructive because it did not hinder the operation or functionality of the vehicle.[202] In contrast, if CBP officials drilled a hole in a hard drive it would disrupt the functionality and operation of a laptop. The risk of damage to a laptop could partially be avoided through proper training for CBP agents conducting laptop searches.

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196 Interview with Jesse Lindmar, Assistant Director of Computer Forensics, Sensei Enterprises, Inc., in Fairfax, Va. (Nov. 14, 2008).

197 *Id.*

198 United States v. Flores-Montano, 541 U.S. 149, 154-55 (2004).

199 United States v. Arnold, 533 F.3d 1003, 1009 (9th Cir. 2008).

200 Harrell, *supra* note 156, at 227.

201 424 F.3d 1051, 1052-53 (9th Cir. 2005).

202 *Id.* at 1053.

However, the whole situation may be avoided if an agent must have particularized suspicion to search a laptop at the national border. Both options should be considered to avoid situations like Mitnick's inside the United States.

7. Laptop Searches Are Unnecessary Because Child Pornography Can Enter the Country through Other Means

The government is concerned about contraband entering the United States. But what happens if the contraband can enter the country through other means? Most laptop border searches deal with child pornography, a particularly despicable form of contraband. To undermine the prevention argument, Alzahabi discusses in his note that child pornography can traverse the border by other means, as the "presence of pornography on the laptop was incidental to the border crossing."[203] The nature of the Internet and electronic communications allows this type of material to travel across national borders easily.[204] According to Alzahabi, law enforcement could apprehend an offender inside the United States even if it did not find child pornography at the border.[205] Therefore, a suspicionless search of laptops at the border is unnecessary.

Countervailing this argument is the strong government interest in preventing contraband from entering the county through multiple means. In *12 200-Ft. Reels of Film*, the Supreme Court considered this issue—the defendant argued that the microfilm could have entered the United States by mail or other means.[206] The Court rejected the argument, explaining that "Congress is not precluded from barring some avenues of illegal importation because avenues exist that are more difficult to regulate."[207] Similarly, Professor Sales points out that although "terrorists and others might use a number of techniques to commit their crimes does not diminish the magnitude of the government's interest in inhibiting this particular technique."[208] Just because contraband can enter the United States via other means does not preclude the government preventing its entrance through laptops crossing the border. It should be difficult for criminals to bring contraband into the United States, but not impossible for law-abiding citizens to traverse borders. Though the issue may be difficult to regulate, it is possible to come up with a solution that takes both interests into account.

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203 Alzahabi, *supra* note 148, at 175.

204 *Id.* at 177.

205 *Id.*

206 United States v. 12 200 Ft. Reels of Super 8mm. Film, 413 U.S. 123, 129 (1973).

207 *Id.* (citing American Power & Light Co. v. SEC, 392 U.S. 90, 99-100 (1946)).

208 Sales, *supra* note 47, at 1097-98.

8. The Law Is Behind the Technology

A final argument in favor of privacy interests is that law is lagging behind technology. Alzahabi gives two examples of the Supreme Court taking new technology into account: (1) electronic listening devices attached to a phone booth in *Katz v. United States*, and (2) thermal imaging of a home in *Kyllo v. United States*.[209] In both cases, according to Alzahabi, the Court recognized the new technology in producing a rule to protect individuals' privacy.[210] Professor Richard Seamon explains that in *Katz*, the Court held that government conduct constituted a search if it interfered with a reasonable expectation of privacy.[211] The *Kyllo* decision criticized the *Katz* test as "circular," because "[a]s our reasonable expectations of privacy decrease, the types of government intrusions that will be found to fall outside of the Fourth Amendment, as not constituting searches, increases."[212] Our reasonable expectation of privacy decreases with the advent of new technology, and therefore "the less privacy we have . . . the less we can expect."[213] Seamon points out that in *Kyllo*, the Court's rule accounted for more sophisticated future technology.[214] Alzahabi also notes Justice Scalia's definition of the issue in *Kyllo*: "The question we confront today is what limits there are upon this power of technology to shrink the realm of guaranteed privacy."[215] These decisions demonstrate that courts have previously taken evolving technologies into account.

However, other cases indicate that the Supreme Court is not always deferential to technology, as Thomas C. Clancy explains.[216] In *Smith v. Maryland*, the Court found that an individual had no reasonable expectation of privacy in telephone numbers recorded by a pen register.[217] While Clancy admits that the Court's general reaction to technological innovations is not favorable, he also notes that the Court warned against the intrusion of new technology even when upholding its application in certain cases.[218] Further, Clancy states that *Kyllo* is in "stark contrast to those trends,"[219] indicating that perhaps as the privacy intrusions of new technology become greater, the Court would be more willing to accommodate the technology.

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209 Alzahabi, *supra* note 148, at 183-84.

210 *Id.*

211 Seamon, Richard, *New Technology Brings Up Old Question: the Fourth Amendment and the Issue of Search* Kyllo v. United States, 13 S. CAROLINA LAWYER 22, 25 (Nov./Dec. 2001).

212 *Id.*

213 *Id.*

214 *Id.*

215 Alzahabi, *supra* note 148, at 184 (citing Kyllo v. United States, 533 U.S. 27, 34 (2001)).

216 Thomas K. Clancy, *What is a "Search" Within the Meaning of the Fourth Amendment?*, 70 ALB. L. REV. 1, 32-33 (2006).

217 *Id.* (citing Smith v. Maryland, 442 U.S. 735 (1979)).

218 *Id.* at 33.

219 *Id.*

While *Kyllo* alleviated the privacy concern in the home, the national border is different because of the reduced expectation of privacy. Alzahabi argues that new technologies necessitate new rules, since the courts generally base their holdings on prior precedents that did not involve technology.[220] The question of laptop searches at the national border would be an issue of first impression for the Supreme Court. Analogies to border search case law require the courts to compare laptops to vehicles and the person, which do not have the same distinguishing features as laptops. These analogies do not hold in the context of a laptop search, especially considering the unique features of the technology. Lee Tien, Attorney for the Electronic Frontier Foundation, testified in front of the Senate Judiciary Committee that "perhaps neither quantity nor quality alone would be enough, but the combination clearly distinguishes laptops and similar devices from non-informational property like vehicles."[221] Separately, no one issue concerning laptop searches is determinative, but collectively they could be.

V. LIFE AFTER *ARNOLD*: THE IMPACT OF THE NINTH CIRCUIT DECISION

A. *Subsequent Court Decisions*

Not surprisingly, other courts have followed or agreed with the Ninth Circuit decision in *Arnold*. The U.S. District Court for the Western District of Texas agreed with *Arnold* and found that a laptop border search was routine in *United States v. McCauley*.[222] The court found that many items crossing the border contain sensitive information and that "a computer is simply an inanimate object made up of microprocessors and wires which happens to efficiently condense and digitize the information."[223] The court also found that the search was not embarrassing because it took place in a secluded room so other travelers could not see the items on the computer.[224] Another case from the Eastern District of Pennsylvania, *United States v. Bunty*,[225] followed *Arnold*.[226] The court determined that no suspicion was required for laptop border searches; however, if suspicion was required, the court found that the standard was satisfied in this case.[227] The Eastern Dis-

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220 Alzahabi, *supra* note 148, at 181.

221 *Laptop Search and Privacy Violations Faced by Returning Travelers: Hearing Before the Subcomm. on the Constitution, Civil Rights and Property Rights of the S. Comm. on the Judiciary*, 110th Cong. 4 (2008) (statement of Lee Tien, Senior Staff Attorney, Electronic Frontier Foundation).

222 United States v. McAuley, 563 F. Supp. 2d 672, 679 (W.D. Tex. 2008).

223 *Id.* at 677-78.

224 *Id.* at 678-79.

225 United States v. Bunty, 2008 WL 2371211 (E.D. Pa. June 10, 2008).

226 *Id.* at *3.

227 *Id.*

trict of Louisiana also held essentially the same thing as *Bunty*, agreeing with *Arnold* for a third time.[228]

The Supreme Court could have resolved the issue, but denied certiorari in the *Arnold* case on February 23, 2009.[229] Professor Sales correctly predicted in his testimony before the Senate Judiciary Committee that Supreme Court review was unlikely, particularly considering the lower court consensus.[230] Aside from the district court in *Arnold*, courts have either found that the privacy interests were not compelling or that the courts' role did not include changing existing law. As a practical matter, the judiciary is not the best branch to deal with law and changing technology. During the years it takes a case to wind its way through the federal court system, the technology is continuously evolving. Perhaps the issue of laptop border searches is best left to the other branches of government.

B. *CBP and Department of Homeland Security Action*

CBP and the Department of Homeland Security (DHS) took a variety of actions following the *Arnold* decision to clarify the laptop border search issue. On June 10, 2008, DHS issued a report entitled *Foreign Travel Threat Assessment: Electronic Communications Vulnerabilities*, which advised persons traveling abroad to leave laptops and other electronic media at home.[231] However, as Gurley testified, leaving laptops and other electronic devices at home is often not an option because these devices have become a virtual extension of the office.[232] The DHS report also warned travelers that electronic items were being stolen, data was being monitored, and foreign networks were installing viruses.[233] The report dealt strictly with foreign threats, but it did not advise travelers about the potential for laptop searches at the United States border. This issue likely should have been addressed in the DHS report.

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228 United States v. Pickett, 2008 WL 4330247, at *3-4 (E.D. La. Sept. 16, 2008).

229 Arnold v. United States, 129 S.Ct. 1312, 1313 (2009) (denying petition for writ of certiorari).

230 *Laptop Search and Privacy Violations Faced by Returning Travelers: Hearing Before the Subcomm. on the Constitution, Civil Rights and Property Rights of the S. Comm. on the Judiciary*, 110th Cong. 3-4 (2008) (statement of Nathan A. Sales, Assistant Professor of Law, George Mason University School of Law).

231 Thomas Clayburn, *DHS Report Says Leave Laptops At Home*, INFORMATION WEEK, Sept. 15, 2008, http://www.informationweek.com/story/showArticle.jhtml?articleID=210601724 (last visited Jan. 17, 2009).

232 *Laptop Search and Privacy Violations Faced by Returning Travelers: Hearing Before the Subcomm. on the Constitution, Civil Rights and Property Rights of the S. Comm. on the Judiciary*, 110th Cong. 2 (2008) (statement of Susan K. Gurley, Executive Director, Association of Corporate Travel Executives).

233 Clayburn, *supra* note 231.

A few weeks later, on June 30, 2008, Deputy Commissioner of CBP, Jayson Ahern, wrote a blog post for DHS relaying the importance of the ability to search electronic devices at the border.[234] Ahern illustrated the important government interests served by border searches by using examples of laptop searches that helped catch terrorism suspects, child pornographers, and copyright infringers.[235] Stating that federal courts have upheld CBP searches, Ahern referred to the Ninth Circuit decision in *Arnold*.[236] Despite these governmental interests, Ahern also assured that travelers' civil rights would not be violated, because constitutional and statutory restraints were in place.[237] While his blog provided some reassurance, it is not an official policy.

Following the Ninth Circuit decision in *Arnold,* CBP released an official policy on July 10, 2008. The policy notes that no suspicion is required to search laptops and other electronic media at the border.[238] The policy states that CBP agents are authorized to search such media and take written notes.[239] If the agents find probable cause, they may detain the devices or make copies of them.[240] Without probable cause, any copied information must be destroyed.[241] Further, the policy mandates that confidential business documents be protected from unauthorized disclosure and legal advice be sought if attorney-client privileged information is discovered.[242]

With the transition from the Bush Administration to the Obama Administration, the executive branch was bound to make some changes to the laptop border search policy, which became reality on August 27, 2009.[243] The Obama Administration conducted a Privacy Impact Assessment for the Border Searches of Electronic Devices, which was the basis for the two new policies issued for CBP and ICE.[244] The three documents are a vast improvement in the arena of transparency for laptop border searches. Unlike the Bush Administration guidelines, the three documents lay out detailed procedures for detention, seizure, and retention of electronic devices at the border. Many of these improvements are mentioned in Congressional legislation introduced before the Privacy Assessment was released, indicating that the proposed legislation had an impact on the Obama Administra-

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234 Posting of Jayson Ahern to CBP Laptop Searches, http://www.dhs.gov/journal/leadership/2008/06/cbp-laptop-searches.html (June 30, 2008, 12:07 EST).

235 *Id.*

236 *Id.*

237 *Id.*

238 U.S. CUSTOMS AND BORDER PROTECTION, *supra* note 164, at 1.

239 *Id.*

240 *Id.* at 1-2.

241 *Id.* at 2.

242 *Id.* at 4.

243 *See* Press Release, *supra* note 167.

244 *Id.*

tion.[245] One important change requires the relevant agencies to increase signage around border search areas, notifying travelers of the possibility of their electronic devices being searched.[246] Further, when a traveler's electronic device is detained, the traveler is given a receipt and a "tear away sheet" that notifies the traveler of his or her rights.[247] Traveler awareness is an important step to implement an efficient and effective laptop border search policy.

The Privacy Impact Assessment further lays out a step-by-step process that each traveler goes through when passing through the border into the United States.[248] Every traveler must go through a "primary inspection" to determine his or her admissibility into the country.[249] If from the primary inspection, an ICE or CBP officer determines that the traveler warrants further review, then the traveler is referred to a "secondary inspection."[250] In either of these inspections, the traveler's electronic devices are subject to a search, which can be as simple as turning on the device to ensure that it is functioning properly and is not drugs or a bomb, but may also include examination of the contents of the device.[251] Occasionally, the traveler's device will be copied without his or her knowledge when ICE or CBP determines that it is imprudent to inform the traveler of the copying for law enforcement reasons.[252] However, supervisory approval is required before copying, and the guidelines lay out detailed procedures for how the information is stored and destroyed.[253]

The guidelines also deal with the procedures for detention of electronic devices, which occurs when CBP or ICE holds onto the device after the traveler leaves the point of entry.[254] Detention normally does not exceed five days, customs provides the traveler with a receipt and the aforementioned "tear sheet," and the device is kept in a secured facility with restricted access.[255] If there is no evidence of criminal activity on the device, it is returned to the traveler.[256] If there is probable cause of criminal activity, then the detention transforms into a seizure.[257] The Privacy Impact Assessment also discusses procedures for sharing information with other

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245 *See infra* Part V.C.

246 U.S. DEPARTMENT OF HOMELAND SECURITY, PRIVACY IMPACT ASSESSMENT FOR THE BORDER SEARCHES OF ELECTRONIC DEVICES 6 (2009) [hereinafter PRIVACY IMPACT ASSESSMENT].

247 *Id.* at 7.

248 *Id.* at 6-11.

249 *Id.* at 6.

250 *Id.*

251 *Id.* at 6-7.

252 PRIVACY IMPACT ASSESSMENT, *supra* note 246, at 8.

253 *Id.* at 8, 10.

254 *Id.* at 7.

255 *Id.*

256 *Id.*

257 *Id.*

agencies and destruction of copies of electronic devices.[258] The procedure implements strict time limits for destruction of copies of devices, which may not occur later than seven days after it is determined that the copy is unnecessary for law enforcement purposes.[259] If the destruction requires more than seven days, an extension must be approved by a supervisor, and cannot be later than twenty-one days after the initial determination in any case.[260] All of these procedures help ensure the security of information after a laptop border search, and increase transparency.

While the increase in transparency is commendable, the policies perpetuate some major flaws pointed out by the District Court in *Arnold* and the various commentators on the issue. First, the procedures for dealing with confidential or privileged information are basically the same as the Bush Administration guidelines. Where the rest of the procedures are helpful in their detail, there is not similar detail covering more sensitive information. Second, and most importantly, the policies and Privacy Impact Assessment make clear that suspicion is not required for any border search of electronic devices.[261] The policies themselves state that the purpose of these searches is law enforcement.[262] As mentioned previously, without suspicion, law enforcement resources are inefficiently wasted by inconveniencing law abiding travelers. These policies provide some protection, but ultimately are lacking when it comes to stopping a traveler without legitimate reason.

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258 PRIVACY IMPACT ASSESSMENT, *supra* note 246, at 9-13.

259 *Id.* at 10-11.

260 *Id.* at 11.

261 *Id.* at 3-4 (explaining that travelers' electronic equipment may be searched at the border without a warrant or suspicion due to longstanding legal precedents); *see also* CBP POLICY, *supra* note 168, at 3 ("In the course of a border search, with or without individualized suspicion, an Officer may examine electronic devices. . ."); ICE POLICY, *supra* note 168, at 2 ("ICE Agents acting under border search authority may search, detain, seize, retain, and share electronic devices, or information contained therein, with or without individualized suspicion. . .").

262 PRIVACY IMPACT ASSESSMENT, *supra* note 246, at 2 ("CBP Officers and ICE Special Agents conduct border searches of electronic devices to determine whether a violation of U.S. law has occurred."); CBP POLICY, *supra* note 168, at 1 ("Searches of electronic devices help detect evidence relating to terrorism and other national security matters, human and bulk cash smuggling, contraband, and child pornography. They can also reveal information about financial and commercial crimes, such as those relating to copyright, trademark, and export control violations."); ICE POLICY, *supra* note 168, at 2 ("Searches of electronic devices are a crucial tool for detecting information concerning terrorism, narcotics smuggling, and other national security matters; alien admissibility; contraband including child pornography; laundering monetary instruments; violations of copyright or trademark laws; and evidence of embargo violations or other import or export control laws.").

C. *Congressional Legislation*

While the courts may not have found the individual's privacy interests compelling, some members of Congress have disagreed and introduced legislation on the issue. In the House, Representative Loretta Sanchez, Chairwoman of the Subcommittee on Border, Maritime and Global Counterterrorism, introduced H.R. 6869, the Border Search Accountability Act of 2008.[263] The bill outlines procedures for CBP to handle electronic data at the border, requires DHS to post information on individuals' rights near border checkpoints, establishes a clear process for reporting abuses, and creates rules for confidential and privileged information.[264] The legislation deals with many of the privacy concerns: confidential information, procedures for handling electronic data, and methods of informing travelers of their rights. While it passed the House Subcommittee on Border, Maritime, and Global Counterterrorism on July 22, 2009,[265] it is likely to be overshadowed by a bill that was introduced in the Senate two weeks later.

Senator Russ Feingold led the charge in the Senate against suspicionless laptop border searches with the Travelers' Privacy Protection Act; the bill's counterpart was introduced in the House the same day.[266] This bill could provide the solution to the laptop border search dilemma. The main provision of the bill permits CBP agents to search electronic equipment only if they have reasonable suspicion that the traveler is carrying contraband or is otherwise not entitled to enter the United States.[267] The bill also limits the seizure of electronic equipment to situations when law enforcement agencies obtain a warrant based on probable cause.[268]

The bill also implements a search procedure for CBP agents, including: obtaining supervisor approval to conduct the search, allowing the owner of the electronic equipment to be present when the search is conducted, limiting the search to the grounds for reasonable suspicion, making a detailed recording of what was searched, limiting the time of the search without a warrant to twenty-four hours, and destroying any copies of the electronic equipment within three days.[269] To seize the electronic equipment, the CBP agent must have probable cause, obtain a warrant and may not

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263 Press Release, Representative Loretta Sanchez, Rep. Sanchez Introduces Legislation to Protect Travelers' Civil Liberties at U.S. Points of Entry (Sept. 11, 2008) (on file with author).

264 *Id.*

265 Press Release, Subcommittee on Border, Maritime, and Global Counterterrorism, Rep. Sanchez Reports Out Three Border Bills (July 22, 2009) (on file with author).

266 Press Release, Senator Russ Feingold, et. al., Feingold, Cantwell, Smith Offer Bills Protecting Travelers from Suspicionless Laptop Searches (Sept. 29, 2008) (on file with author).

267 Travelers' Privacy Protection Act of 2008, S. 3612, 110th Cong. § 4(a) (2008).

268 *Id.* § 4(b).

269 *Id.*

keep the electronic equipment for longer than twenty-one days.[270] Finally, the bill provides a remedy for the traveler. If the electronic equipment is detained for longer than twenty-four hours, CBP must provide the owner with a receipt, a statement of the rights and remedies available, and the name and phone number of an official who can provide information about the status of the electronic equipment.[271] The traveler also may file a claim if any damage to the equipment occurred during the search.[272] Many of these changes were implemented by the new Obama Administration procedures, including the probable cause requirement, the twenty-one day time limit for a seizure, and providing a receipt to the traveler. However, the time limits for the initial search and destruction of copies are more stringent, and limit the search to the grounds for reasonable suspicion, which is obviously not required by the DHS policies.

This legislation is more effective than the House's first bill because it goes beyond simply forcing DHS to come up with its own rules, and it is clear from the current policies that more direction is necessary. The Feingold bill provides a feasible framework for border searches of electronic equipment because it would not greatly inconvenience any traveler without reason. One of the bill's findings is that "searching the electronic equipment of persons for whom no individualized suspicion exists is an inefficient and ineffective use of law enforcement resources."[273] This exemplifies the practical concerns that make laptop border searches without suspicion practically absurd.

CBP's mission is to locate evidence of child pornography (as indicated through every laptop border search case), terrorists, drug smugglers, and copyright infringement when conducting border searches.[274] Search of the average traveler without suspicion would require CBP agents to search for *all* of these things. As previously mentioned, the more items searched for on a traveler's computer, the longer it takes.[275] While travelers may expect to be stopped at the border, the Supreme Court has recognized that the time of a border search must be reasonable.[276] If a traveler poorly planned his flight time, being detained at the border may cause a person to miss his flight. Jesse Lindmar, Assistant Director of Computer Forensics at Sensei Enterprises, Inc., was detained on his way back from London and missed a connecting flight from Chicago.[277] Luckily for him, British Airways courteously arranged for him to stay in a hotel and catch another flight.[278] But

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270 *Id.* § 6(a).

271 *Id.* § 6(f).

272 *Id.* § 11.

273 Travelers' Privacy Protection Act § 2(6).

274 *See supra*, V.B. n.261.

275 Interview with Jesse Lindmar, *supra* note 196.

276 *See* United States v. Flores-Montano, 541 U.S. 149, 155 n.3 (2004).

277 Interview with Jesse Lindmar, *supra* note 196.

278 *Id.*

not all travelers will be so lucky, and the government certainly is not going to pay for extra plane tickets necessitated by its own inconveniences.

The average person coming across the border is not a terrorist, copyright infringer, pedophile, or drug smuggler. When one of these types of criminals attempts to cross the United States border, reasonable suspicion may be obtained from prior convictions, terrorist watch lists, suspicious behavior, or even a watch list of copyright infringers promulgated by the MPAA or RIAA. The important government concerns may be taken into account with a reasonable suspicion standard, and the practical reality of computer searches at the border does not allow for a lesser standard. The Travelers' Privacy Protection Act takes these concerns into account, particularly with the more stringent time limits, and provides a workable solution. The legislation needs clarification to take into account the district court's point in *Arnold*, which held that agents may turn on a laptop to ensure it is functioning but may not search it without suspicion.[279] The legislation does not specifically mention this point. It should, because turning a computer on to ensure it is functioning and is not a bomb or does not contain drugs is a legitimate and quick search that would not greatly inconvenience the average traveler. While DHS has implemented some of the legislation's requirements, with the increased transparency and procedures, the policies leave much to be desired. The legislation may not be perfect, but it is the best solution available.

VI. CONCLUSION

The Ninth Circuit in *Arnold* made the correct decision under current case law, but the law is flawed in light of the increased role of technology in our lives. It is not disputed that the government has important objectives in protecting the border, but technology brings into play vital considerations for laptop border searches—laptops have a large storage capacity, take a significant amount of time to search, and contain vast amounts of confidential data. These considerations override the government's concerns, and require further safeguards to protect travelers' privacy.

Further, the objectives that the government is trying to serve by searching laptops at the border do not affect the average traveler. The Travelers' Privacy Protection Act achieves the government's objectives of preventing contraband from entering the country in laptops by allowing CBP agents to search laptops and other electronic devices, but only with reasonable suspicion. The bill may need to be softened to properly acknowledge the government's concerns and to make clear that turning on a laptop to ensure that it is functioning is not an unreasonable search. How-

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279 *See also* PRIVACY IMPACT ASSESSMENT, *supra* note 246, at 6 (mentioning that a device may be turned on to ensure that it is working and not contraband or a bomb).

ever, the bill is the best solution currently available to alleviate both the government's concerns and the individual traveler's concerns when carrying a laptop across the border. With these safeguards in place, the government will be able to conduct laptop border searches more efficiently, and future travelers and their laptops will be protected from situations like Mitnick's.

USING COPYRIGHT REMEDIES TO PROMOTE EFFICIENCY IN THE OPEN SOURCE REGIME IN WAKE OF *JACOBSEN V. KATZER*

*Kristina N. Spencer**

INTRODUCTION

In August 2008, the United States Court of Appeals for the Federal Circuit decided a landmark case for software licensing. In *Jacobsen v. Katzer*, the Court held that violating terms of the Artistic License constitutes copyright infringement.[1] While *Jacobsen* only addressed the Artistic License, the outcome of this case will likely affect other open source licenses because they all share a common goal: to foster efficiency and innovation through freely accessible source code while providing limited protection to copyright holders. *Jacobsen* is imperative because the question of how to provide adequate and efficient relief to copyright holders in open source infringement actions remains unsettled.

This casenote promulgates two propositions that build on the *Jacobsen* decision. First, a copyright regime provides copyright holders in open source infringement actions with more sufficient and efficient remedies than a contract regime, despite practical concerns (e.g., difficulties measuring actual lost profits). Under a copyright regime, copyright holders can obtain both injunctive and monetary relief while avoiding the difficulties of contract formation (e.g., mutual consent and consideration). Second, electing statutory damages under the Copyright Act of 1976 ("Copyright Act") or employing remedies afforded by the Digital Millennium Copyright Act (DMCA) provide copyright holders with the most efficient forms of relief, depending on the copyright holder's goal. Statutory damages allow copyright holders to collect monetary relief without the complications of calculating actual damages or lost profits. The DMCA allows copyright holders to experience quasi-injunctive relief in a faster and less expensive manner than filing a lawsuit.

PART I provides a brief introduction to open source software licensing and a *Jacobsen* synopsis. PART II discusses the benefits of *Jacobsen* to copyright holders and offers suggestions regarding methods of relief in open source software infringement cases.

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[1] *See* Jacobsen v. Katzer, 535 F.3d 1373, 1382-83 (Fed. Cir. 2008).

I. THE OPEN SOURCE REGIME AND *JACOBSEN V. KATZER*

SUBPART A provides a primer on the open source movement and its relevant counterparts. The section defines the purpose of the open source movement, distinguishes open source software from commercial and free software, and discusses open source software restrictions, namely open source licensing. SUBPART B provides *Jacobsen*'s case history, including the decision of the United States District Court for the Northern District of California and the United States Court of Appeals for the Federal Circuit.

A. *Defining the Open Source Movement and Placing Restrictions on Open Source Software*

1. An Introduction to the Open Source Movement

A proper analysis of the issues concerning damages and remedies of open source software infringement requires a general understanding of the principles behind open source software and its counterparts. In 1998, computer programmer Eric Raymond and several others introduced the term "open source" to the public.[2] This term describes a disclosed method of creating software using widespread peer review to ensure "better quality, higher reliability, more flexibility, lower cost, and an end to predatory vendor lock-in."[3] Thus, the primary goal of the open source movement is to create a code superior to those written by commercial developers while enabling copyright holders to retain limited control over the developmental and distribution process through various imposed licenses. By developing the code in the public domain, users of all expertise levels may participate in its development and do so faster and cheaper than a single copyright holder working independently.[4] Allowing copyright holders to retain limited control in the process aims to keep source code accessible for downstream users.[5] This encourages innovation, efficiency, reliability, and longevity.[6]

Numerous similar definitions of open source software exist. The Open Source Initiative (OSI), a public benefit organization dedicated to promot-

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[2] *See* Michael Tiemann, Open Source Initiative, History of the OSI (Sept. 19, 2006), http://www.opensource.org/history.

[3] Open Source Initiative, Home (Mar. 13, 2007), http://www.opensource.org.

[4] *See Jacobsen*, 535 F.3d at 1378-79; Douglas D. McGhee, *Free and Open Source Software Licenses: Benefits, Risks, and Steps Toward Ensuring Compliance*, 19 NO. 11 INTELL. PROP. & TECH. L.J. 5, 5-6 (2005).

[5] *See Jacobsen*, 535 F.3d at 1379, 1381.

[6] Andrew M. St. Laurent, Understanding Open Source and Free Software Licensing 6-7 (2004). *See also Jacobsen*, 535 F.3d at 1378-79.

ing open source software, provides an apt definition of open source software. OSI's website provides that "open source does [not] just mean access to the source code."[7] To qualify as open source, software must meet the following distribution requirements: (1) software must be freely redistributed; (2) source code must be freely accessible; (3) derivative works must be permissible; (4) discrimination against any persons, groups, or fields of endeavor is prohibited; and (5) licenses must be technology-neutral and must not be product specific or restrict other software.[8] In sum, open source software allows end-users to access, read, modify, and distribute the underlying programming code.[9]

The distinction between open source and commercial software is important. A simple distinction is that commercial software is "closed source," whereas open source has benefits that include publicly available source code and the authorization to modify and distribute derivative versions of both the software and source code.[10] On the other hand, modifying or distributing commercial software requires owner authorization, and the software itself is usually only distributed in binary, executable form.[11] Some prefer the term "proprietary software" to describe commercial software;[12] that is, software that is commercially developed and distributed.[13] Others dislike the term "proprietary software" as they claim it does not adequately distinguish open source from commercial software. One criticism suggests that the vast majority of open source software is in fact proprietary; this is the reason copyright holders can use licenses in the first place.[14] It is important to note that in most cases the real issue is the type of licensing model involved.[15]

There is also a distinction between open source software and free software. While the majority of open source software is non-fee based, "open source software" and "free software" should not be used interchangeably as the two terms represent fundamentally different principles.[16]

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[7] Ken Coar, Open Source Initiative, The Open Source Definition (July 7, 2006), http://www.opensource.org/docs/osd.

[8] *Id.* Source code distribution may be limited to protect the integrity of the author's source code. *Id.*

[9] *See* Stephen J. Davidson & Nathan Kumagai, *Developments in the Open Source Community and the Impact of the Release of GPLv3*, 911 PLI/PAT 349, 354-55 (2007) (citing Cross Web, Glossary of Internet Terms, http://www.cross-web.com/information/glossary.htm#O (last visited June 11, 2009)).

[10] *See id.* at 355.

[11] *See id.*

[12] *See* Budi Rahardjo, Open Source v. Commercial Software: An Academic View, Presentation at the Business Software Alliance Seminar (Nov. 14, 2003), *available at* http://www.cert.or.id/~budi/presentations/open-source-vs-commercial.ppt.

[13] *Id.*

[14] *See* Davidson & Kumagai, *supra* note 9, at 355 n.5.

[15] *See id.*

[16] *See* Richard Stallman, Why "Open Source" Misses the Point of Free Software, http://www.gnu.org/philosophy/open-source-misses-the-point.html (last visited July 19, 2009).

Open source is a development process used to improve software, while free software focuses on user freedom.[17] The "free" in "free software" should not be construed to mean *gratis*, but rather *libre*. "'Free software' is a matter of liberty, not price. To understand the concept, you should think of 'free' as in 'free speech.'"[18]

The Free Software Foundation (FSF), a charity dedicated to promoting computer user freedom,[19] defines free software as "a matter of the users' freedom to run, copy, distribute, study, change and improve the software."[20] The FSF sets out four "central freedoms" users have in free software:

- Freedom 0: The freedom to run the program, for any purpose.
- Freedom 1: The freedom to study how the program works, and adapt it to your needs. (Access to the source code is a precondition for this.)
- Freedom 2: The freedom to redistribute copies so you can help your neighbor.
- Freedom 3: The freedom to improve the program, and release your improvements to the public, so that the whole community benefits. (Access to the source code is a precondition for this.)[21]

A program is not considered free software unless it encompasses all of the irrevocable freedoms listed above.[22] Therefore, a user of free software can redistribute the software to any person, either modified or unmodified, with or without charge, for commercial or non-commercial purposes.[23] More importantly, users do not have to seek permission or pay to redistribute said copies.[24] Other benefits of free software include the freedom to publish modified copies without notifying the original developer.[25] Requiring that the binary or executable forms of the software (i.e., source code) be accessible also helps further development.[26] Limited restrictions on free software are tolerable, as long as they remain consistent with the central

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17 *See id.*

18 Davidson & Kumagai, *supra* note 9, at 358-59 (citing Free Software Foundation, GNU Operating System: The Free Software Definition, http://www.gnu.org/philosophy/free-sw.html (last visited July 19, 2009)).

19 *See* Free Software Foundation, About Free Software and the GNU Operating System, http://www.fsf.org/about (last visited July 19, 2009).

20 Free Software Foundation, GNU Operating System: The Free Software Definition, http://www.gnu.org/philosophy/free-sw.html (last visited July 19, 2009).

21 *Id.*

22 *See id.*

23 *See id.*

24 *See id.*

25 *See id.*

26 *See* Free Software Foundation, *supra* note 20.

freedoms above (e.g., copyleft and packaging restrictions).[27] Copyleft is a requirement prohibiting user addition of restrictions that deny other users the central freedoms when redistributing free software.[28]

2. Basic Restrictions on Open Source Software: Open Source Licensing and Federal Copyright Law

Currently,[29] there are two legal frameworks governing open source software: open source licensing and federal copyright law. Open source licensing places restrictions on users, while federal copyright law provides copyright holders with remedies for license violations. The ultimate goal of the open source regime is to prevent persons from acquiring an exclusive right to exploit programs.[30] Open source licensing essentially requires creators to surrender most, if not all, of their rights granted by the Copyright Act to promote innovation and efficiency,[31] yet simultaneously allows creators to retain limited control over the development and distribution of the software.[32] Many different types of open source licenses exist and can be distinguished by their distribution terms.[33] To date, the OSI has approved sixty-six licenses,[34] with no requests awaiting approval.[35]

One scheme of open source licensing is the restrictive license. The GNU[36] General Public License (GPL) is the most well known and widely used copyleft license.[37] The GPL is one particular copyleft license that forbids modifications.[38] The GPL requires, *inter alia*, all source code be re-

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27 *See id.*

28 *See* Free Software Foundation, GNU Operating System: Licenses, http://www.gnu.org/licenses/licenses.html (last visited Dec. 30, 2008).

29 Currently, meaning *after* the Federal Circuit's holding in Jacobsen v. Katzer, 535 F.3d 1373 (Fed. Cir. 2008).

30 St. Laurent, *supra* note 6, at 4.

31 *See* Stephen Fishman, Open Source Licenses Are Not All the Same (Nov. 18, 2004), http://www.onlamp.com/pub/a/onlamp/2004/11/18/licenses.html.

32 *See Jacobsen*, 535 F.3d at 1381. The restrictive nature of open source licenses can be seen when viewing the terms and conditions of the GPL and the Artistic License below.

33 Davidson & Kumagai, *supra* note 9, at 354-55.

34 Open Source Initiative, Licenses by Name (Sept. 18, 2006), http://www.opensource.org/licenses/alphabetical.

35 Open Source Initiative, Open License Approval Requests, https://ideas.opensource.org/report/9 (last visited July 19, 2009).

36 GNU is a recursive acronym for "GNU's Not Unix." Richard Stallman, The GNU Project, http://www.gnu.org/gnu/thegnuproject.html (last visited July 19, 2009).

37 Currently, the GPL is used in nearly sixty percent of open source software licensing. *See* Erich M. Fabricius, Note, Jacobsen v. Katzer: *Failure of the Artistic License and Repercussions for Open Source*, 9 N.C. J.L. & TECH. JOLT ONLINE ED. 65, 69 (2008) (citing Black Duck Software, Open Source License Resource Center, http://www.blackducksoftware.com/oss (last visited Dec. 30, 2008)).

38 *See* The Linux Information Project, BSD License Definition (Apr. 19, 2004), http://www.linfo.org/bsdlicense.html.

leased when redistributing open source software, including the code of derivative works.[39] Originally released in 1989,[40] the GPL has undergone several modifications. GPLv3, the third version of the license, was released in 2007.[41] Authors of the GPLv3 claim it was necessary to reflect the advancements of the open source regime, namely "tivoization"[42] and software patents.[43] The most significant changes include:

> (1) a patent grant by the software distributor to curb the effects of software patents on open source distribution;
> (2) clauses extending patent authorizations beyond those originally listed in the license;
> (3) anti-tivoization measures;
> (4) defining "modified version" as a derivative work under copyright law; and
> (5) broadly defining "corresponding source" to include all source code required to generate, install, and run the object code and to modify the program.[44]

Because of the restrictive nature of the GPL, the FSF released the GNU Lesser General Public License (LGPL) to help reconcile the restrictive GPL and other more permissive licenses.[45] The LGPL has also undergone modifications to compliment the updated versions of the GPL.[46]

Another type of open source license is the permissive license, which includes the Berkeley Software Distribution (BSD) License. The BSD license is a liberal open source license first released in 1980.[47] Unlike other open source licenses, there are few restrictions on the BSD license. If users redistribute open source software, they must provide, "(1) the original copyright notice, (2) a list of two simple restrictions and (3) a disclaimer of liability."[48] Under the BSD license, users can neither claim authorship for

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39 *See* Free Software Foundation, GNU General Public License (June 29, 2007), http://www.gnu.org/licenses/gpl.html.

40 Free Software Foundation, GNU General Public License, Version 1 (Feb. 1989), http://www.gnu.org/licenses/old-licenses/gpl-1.0.html.

41 Free Software Foundation, *supra* note 39.

42 "Tivoization" was coined by Richard Stallman and refers to hardware that prevents users from running modified versions of software. *See* Richard Stallman & Eben Moglen, Address at the Massachusetts Institute of Technology (Jan. 16, 2006) (video *available at* http://gplv3.fsf.org/av/gplv3-draft1-release.ogg.torrent).

43 *See* Davidson & Kumagai, *supra* note 9, at 368.

44 *See id.* at 368-69; Free Software Foundation, *supra* note 39.

45 *See* Free Software Foundation, Why You Shouldn't Use the Lesser GPL for Your Next Library, http://www.gnu.org/licenses/why-not-lgpl.html (last visited Jan. 1, 2009).

46 *See* Free Software Foundation, *supra* note 28.

47 *See* The Linux Information Project, *supra* note 38.

48 *Id.*

works they did not create, nor can users sue developers for software malfunctions.[49] The BSD license can easily be distinguished from the GPL. Unlike the GPL, the BSD license is not a copyleft license, meaning that modified versions of code can be distributed under different terms than the original.[50] The BSD license does not require free access to modified source code.[51] By not requiring derivative software to be open source, developers can use the original source code to create commercial software while maintaining secrecy on any derivative code modifications.[52] Furthermore, while the BSD license permits developers to modify its terms, the GPL does not.[53]

Jacobsen concerned yet another open source license, the Artistic License. This license is a model of software licensing used for free and open source software packages that was developed and promulgated by computer programmer Larry Wall.[54] Currently, there are two versions of the Artistic License: Version 1.0,[55] released in 2006 and Version 2.0,[56] released in 2007. The Artistic License provides conditions under which open source and free software are to be copied, modified, and distributed.[57] The purpose of the Artistic License is to allow copyright holders to keep their software within the open source regime while retaining a modicum of control.[58] The most current version of the Artistic License permits users to, *inter alia*, (1) redistribute unmodified versions of the software, (2) create and use modified versions of the software, and (3) distribute modified versions of the software (provided that it contains clear documentation of differentiations).[59] Version 2.0 was a response to the widespread criticism of Version 1.0's unclear and ambiguous terms. Some argue that the Artistic License is distinguishable from other open source software licenses (such as the GPL)

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49 *See id.*

50 *See id.*

51 *See id.*

52 *See id.*

53 *See* The Linux Information Project, *supra* note 38.

54 For the distinction between the terms "Artistic License" and "artistic license," see The Linux Information Project, Artistic License Definition (June 25, 2004), http://www.linfo.org/artistic.html ("There is no relationship to the much more commonly used term *artistic license* (i.e., the same spelling but both words begin with lower case letters rather than capital letters), which refers to the distortions of reality that are sometimes incorporated into creative works for aesthetic or other purposes.").

55 *See generally* Open Source Initiative, The Artistic License (Oct. 31, 2006), http://www.opensource.org/licenses/artistic-license-1.0.php ("The intent of this document is to state the conditions under which a Package may be copied, such that the Copyright Holder maintains some semblance of artistic control over the development of the package, while giving the users of the package the right to use and distribute the Package in a more-or-less customary fashion, plus the right to make reasonable modifications.").

56 *See generally* Open Source Initiative, Artistic License 2.0 (Aug. 28, 2007), http://www.opensource.org/licenses/artistic-license-2.0.php.

57 *See id.*

58 *See id.*

59 *See id.*

because of its ambiguous nature.[60] The FSF even recommends against using Version 1.0, claiming that it is not a free software license because of its vagueness, cleverness, and ambiguity.[61]

B. Jacobsen v. Katzer: *Case Summary and the Court's Reasoning*

The innovative method of creating and modifying software though the open source regime has legal implications. In *Jacobsen v. Katzer*, the United States Court of Appeals for the Federal Circuit contemplated whether violating terms of the Artistic License used in an open source software project constituted copyright infringement. The Plaintiff-Appellant, Robert Jacobsen, is a leading member of the online, open source software Java Model Railroad Interface (JMRI) Project.[62] JMRI programmers created a model train control program that hobbyists could install on their computers to control various model train layouts.[63] This program contained a computer programming code called "DecoderPro" that was comprised of a series of decoder definition files.[64] While Jacobsen held a copyright to this programming code, he posted the definition files online free of charge pursuant to the Artistic License.[65] The files contained copyright notices and clearly stated the terms of the Artistic License.[66]

The Defendant-Appellee, Matthew Katzer, is the Chief Executive Officer and chair of the board of directors of Kamind Associates, Inc. ("Kamind"), a software company that develops and sells model train software, including the "Decoder Commander."[67] Katzer and his company downloaded files from JMRI's DecoderPro and used them in the development of

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60 *See* Free Software Foundation, Various Licenses and Comments about Them, http://www.gnu.org/philosophy/license-list.html (last visited June 11, 2009). *See also* Fabricius, *supra* note 37, at 83, 87 (suggesting that the *Jacobsen* District Court reached its conclusion due to the ambiguity of the Artistic License); Mark Radcliff, *New Open Source Legal Definition:* Jacobsen *and* Katzer *and How Model Train Software Will Have an Important Effect on Open Source Licensing* (Aug. 22, 2007, 09:14 EST), http://lawandlifesiliconvalley.blogspot.com/2007/08/new-open-source-legal-decision-jacobsen.html (stating that *Jacobsen* only pertains to Artistic Licenses, and issues involving other open source licenses (such as the GPL) may be distinguished).

61 *See* Fabricius, *supra* note 37, at 70; Free Software Foundation, *supra* note 60 ("We cannot say that this is a free software license because it is too vague; some passages are too clever for their own good, and their meaning is not clear. We urge you to avoid using it . . . .").

62 Jacobsen v. Katzer, No. C 06-01905 JSW, 2007 U.S. Dist. LEXIS 63568, at *2 (N.D. Cal. Aug. 17, 2007).

63 Brief for Creative Commons Corp., et al. as Amici Curiae in Support of Plaintiff-Appellant and Urging Reversal at 7, Jacobsen v. Katzer, No. 2008-1001 (N.D. Cal. filed Dec. 28, 2007) [hereinafter Amici Curiae].

64 *Id.*

65 Jacobsen v. Katzer, 535 F.3d 1373, 1375-76 (Fed. Cir. 2008).

66 *Id.* at 1376.

67 *Jacobsen*, 2007 U.S. Dist. LEXIS 63568 at *2-3; Amici Curiae, *supra* note 63, at 9.

Decoder Commander in a manner that allegedly violated the terms of the Artistic License.[68] Jacobsen filed suit and moved for a preliminary injunction.[69] He claimed, *inter alia*, that by copying decoder files from the JMRI Project and using them to develop commercial software,[70] Katzer committed copyright infringement in violation of the Artistic License.[71] In District Court, Katzer claimed that Kamind's use of the files developed and copyrighted by Jacobsen did not constitute copyright infringement, because Jacobsen had granted a broad license for use to the general public (i.e., open source software distribution).[72] Thus, Katzer argued that Jacobsen's cause of action for any alleged breach of the Artistic License lay in breach of contract, not copyright infringement.[73]

The United States District Court for the Northern District of California denied Jacobsen's request for a preliminary injunction,[74] holding that Jacobsen's claims sounded in contract law, not copyright.[75] Citing the Ninth Circuit's opinion in *S.O.S., Inc. v. Payday, Inc.*, the District Court stated that copyright infringement occurs when a licensee "exceeds the scope of the license."[76] In *S.O.S.*, the plaintiff permitted the defendant to use his software while explicitly reserving all other rights pursuant to a license.[77] The defendant's use beyond the scope of the license thus constituted infringement. In contrast, the JMRI Project's license permitted verbatim copying, modification, and commercial distribution.[78] The District Court concluded that the scope of the JMRI Project's license was "intentionally broad," and while Katzer may have breached the Artistic License, no liability for copyright infringement existed.[79]

On appeal, the Federal Circuit framed the issue as "the ability of a copyright holder to dedicate certain work to free public use and yet enforce an 'open source' copyright license to control the future distribution and

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68 *Jacobsen*, 535 F.3d at 1376 ("The Decoder Commander software did not include (1) the author's names, (2) JMRI copyright notices, (3) references to the COPYING file, (4) an identification of SourceForge or JMRI as the original source of the definition files, and (5) a description of how the files or computer code had been changed from the original source code.").

69 *Jacobsen*, 2007 U.S. Dist. LEXIS 63568 at *3.

70 Brief of Appellees at 4 n.1, Jacobsen v. Katzer, No. 2008-1001 (N.D. Cal. filed Jan. 29, 2008) ("Katzer has sold approximately 65 copies of [this misappropriated software], with total gross sales of approximately $1200.").

71 *Jacobsen*, 2007 U.S. Dist. LEXIS 63568 at *2-3.

72 *Id.* at *17-18.

73 *Id.* at *16-18. In open source licensing cases, defendants like Katzer prefer to be evaluated under a contract regime instead of a copyright regime. Copyright law often provides plaintiffs with injunctive relief, as well as greater damages.

74 *Id.* at *21.

75 *Id.* at *19.

76 *Id.* at *19 (citing S.O.S., Inc. v. Payday, Inc., 886 F.2d 1081, 1088 (9th Cir. 1989)).

77 *Jacobsen*, 2007 U.S. Dist. LEXIS 63568 at *19.

78 *Id.*

79 *Id.* at *20.

modification of that work."[80] Discussing the role of open source licensing and its benefits, the Court emphasized that the open source regime encourages innovation and efficiency as an infinite number of developers worldwide can create software faster and cheaper than a single copyright holder working alone.[81] However, the Court noted that in exchange for the collaborative effort, copyright holders grant developers (i.e., users) permission to copy, modify, and distribute the modified software code through licenses.[82] Although these licenses vary, each contains mandatory terms and conditions that aim to protect future users and to maintain an open source code.[83]

The Federal Circuit also addressed the economic concerns of open source licensing. It noted that the absence of monetary exchange does not imply an absence of economic consideration.[84] The Court provided several examples of economic considerations in open source licensing. First, by offering a limited number of non-fee based programs, developers may build market share for their fee-based software.[85] Users who access developers' websites to download open source software are exposed to fee-based software, which they can subsequently purchase. The theory is that these users would not have been aware or have purchased the fee-based software if the open source software had not been available. Second, open source projects can increase the developer's reputation, thereby increasing business.[86] This example is closely related to the first example. Developers anticipate that users who enjoy a particular developer's open source software will purchase the developer's fee-based software. Third, copyright holders benefit from open source since other users may use their expertise and improve a program for free.[87] The more people who collaborate, the better the product will be. The Court cited the Eleventh Circuit in *Planetary Motion, Inc. v. Techsplosion, Inc.* to support this proposition.[88] In *Planetary Motion*, the Eleventh Circuit held that open source licensing allowed a developer to increase the recognition and use of his software through continuous suggestions offered by an ever-increasing pool of users.[89]

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80 Jacobsen v. Katzer, 535 F.3d 1373, 1375 (Fed. Cir. 2008).

81 *Id.* at 1378-79.

82 *Id.* at 1379.

83 *Id.* (stating that by requiring users to restate the original license and attribution information, recipients of the modified code can readily identify the owner and scope of the license granted by the original owner; tracking changes allows future users to distinguish between the original and modified code).

84 *Id.*

85 *Id.*

86 *Jacobsen*, 535 F.3d at 1379.

87 *Id.*

88 *Id.* (citing Planetary Motion, Inc. v. Techsplosion, Inc., 261 F.3d 1188, 1200 (11th Cir. 2001)).

89 *Id.*

The Court then considered the validity of Jacobsen's copyright. The Court determined that Jacobsen had made out a prima facie case of copyright infringement since (1) Jacobsen held a copyright for the materials on his website that Katzer had downloaded and used, and (2) Katzer acknowledged that his company used and distributed modified segments of JMRI's DecoderPro code in its program.[90] However, Katzer continued to claim no infringement had occurred since he had permission to use the code pursuant to the Artistic License.[91] Therefore, the Court next addressed whether Katzer's use of the code exceeded the License's scope.[92]

To properly evaluate Katzer's claim, the Court had to determine whether the License's terms were (1) conditions or (2) covenants.[93] This distinction is important since contract law governs covenants that merely indicate terms of use, while copyright law governs conditions that regulate a license's overall scope.[94] Licensees who exceed the scope of a license subject themselves to copyright infringement.[95] Katzer contended that contract law governed the License since its terms did not regulate its scope, but rather acted only as mere contractual covenants.[96] Thus, he argued that Jacobsen was not entitled to damages or injunctive relief.[97]

The Federal Circuit proceeded to analyze the language of the Artistic License by looking for evidence of whether or not it created conditions.[98] The Court concluded that the License created conditions for two reasons.[99] First, the term "condition" actually appeared in the text.[100] Second, the License also contained the phrase "provided that,"[101] which is traditionally used to indicate a condition.[102] The Court emphasized the importance of the conditions in the Artistic License, stating that they allow copyright holders

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90 *Id.*

91 *Id.*

92 *Jacobsen*, 535 F.3d at 1379.

93 *Id.* at 1380.

94 *Id.* (citing Sun Microsystems, Inc. v. Microsoft Corp., 188 F.3d 1115, 1121 (9th Cir. 1999); Graham v. James, 144 F.3d 229, 236-37 (2d Cir. 1998)).

95 *Id.* (citing S.O.S., Inc. v. Payday, Inc., 886 F.2d 1081, 1087 (9th Cir. 1989); 3-10 NIMMER ON COPYRIGHT, § 10.15[A] (1999)).

96 *Id.*

97 *Id.* at 1380-81. Katzer argues that offering freely accessible code stripped Jacobsen of his economic rights in the code. *Jacobsen*, 535 F.3d at 1380. Katzer also contends that non-economic right claims are not actionable under copyright law. *Id.* at 1381 (citing Gilliam v. ABC, Inc., 538 F.2d 14, 20-21 (2d Cir. 1976)).

98 *Id.* at 1381.

99 *Id.*

100 *Id.* ("The intent of [the Artistic License] is to state the *conditions* under which a Package may be copied.").

101 *Id.* at 1381 ("The Artistic License also uses the traditional language of conditions by noting that the rights to copy, modify, and distribute are granted '*provided that*' the conditions are met.").

102 *Jacobsen*, 535 F.3d at 1381 (citing Diepenbrock v. Luiz, 159 Cal. 716, 720 (1911) (holding that the phrase "provided that" generally signifies a condition under California contract law)).

to reap the benefits of users' improvements.[103] Requiring users to track modifications and provide copyright notice on redistributed versions of Jacobsen's program notifies subsequent users of Jacobsen's work and business.[104] More importantly, this requirement informs users that the software is open source.[105] This generates even more efficiency and innovation as more users may collaborate on the open source project.[106]

Upon finding that the Artistic License did contain conditions rather than mere covenants, the Federal Circuit concluded that Katzer may have committed copyright infringement by not adhering to the terms of the Artistic License and remanded the case to the District Court for further proceedings.[107]

II. COPYRIGHT REMEDIES AS RELIEF IN OPEN SOURCE INFRINGEMENT ACTIONS

The *Jacobsen* holding allows developers who license their software under the open source scheme to recover damages under a copyright regime. In essence, the Federal Circuit expanded recovery options for open source licensors, but it did not explore the benefits of using a copyright regime over a contract regime for providing relief in open source infringement actions. SUBPART A discusses these benefits, which are sufficiency and efficiency. SUBPART B discusses the remedies available under the Copyright Act and more efficient methods of relief: statutory damages and DMCA remedies.

A. *Benefits of a Copyright Regime: Sufficiency and Efficiency*

1. A Copyright Regime Provides More Sufficient Remedies than a Contract Regime

While the Federal Circuit in *Jacobsen* held that violating terms of the Artistic License constitutes copyright infringement, the Court never discussed why a copyright regime is more remedially sufficient than a contract

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103 *Id.*

104 *Id.* at 1381-82.

105 *Id.* at 1381.

106 *Id.*

107 *Id.* at 1382-83. On remand, the District Court denied Jacobsen's motion for a preliminary injunction due to Jacobsen's failure to meet the new heightened burden of demonstrating irreparable harm. Jacobsen v. Matthew Katzer & Kamind Assocs., No. C 06-01905 JSW, 2009 U.S. Dist. LEXIS 1615, at *26-28 (N.D. Cal. Jan. 5, 2009). For details on the new heightened burden, see Winter v. Natural Res. Def. Council, Inc., 129 S. Ct. 365, 374-76 (2008) (holding plaintiffs seeking a preliminarily injunction must demonstrate a likelihood of irreparable harm, not a possibility of irreparable harm).

regime. In infringement actions pertaining to open source software licensing, calculating the amount of actual damages is problematic since it can be nearly unquantifiable.[108] Thus, equitable relief is often sought to prevent further infringement.

Generally, under contract law, courts award nominal damages[109] only when the breach causes no monetary loss.[110] Occasionally, courts grant equitable relief (e.g., an injunction or specific performance).[111] Because plaintiffs carry a heavy burden to show that an injunction is warranted[112] and the preferred remedy in contract law is monetary damages, plaintiffs are often unable to stop the harm from recurring.

Under copyright law, courts frequently issue injunctions to stop the continuing license violation.[113] Plaintiffs who make out a prima facie case of infringement and demonstrate, *inter alia*, a likelihood of success on the merits and a likelihood of irreparable harm in the absence of injunctive relief are granted an injunction.[114] Statutory damages are also available under copyright law.[115] Because calculating the amount of actual damages is often

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[108] *See infra* PART II, SUBPART B (discussing the problematic nature of calculating lost profits in an open source infringement action).

[109] Nominal damages are defined as "a trifling sum awarded when a legal injury is suffered but when there is no substantial loss or injury to be compensated" or "a small amount fixed as damages for breach of contract without regard to the amount of harm." BLACK'S LAW DICTIONARY 418 (8th ed. 2004).

[110] RESTATEMENT (SECOND) OF CONTRACTS § 346(2) (1981) ("If the breach caused no loss or if the amount of the loss is not proved under the rules stated in this Chapter, a small sum fixed without regard to the amount of loss will be awarded as nominal damages.").

[111] *See* E. ALLAN FARNSWORTH ET AL., CONTRACTS: CASES AND MATERIALS 451-53 (6th ed. 2001). Courts can grant an injunction if the breaching party had a duty of forbearance or a duty to act. RESTATEMENT (SECOND) OF CONTRACTS § 357(2). However, equitable relief will not be refused simply because other remedies are available for breach of contract. *Id.* § 359(3).

[112] Courts use a balancing test when determining whether a preliminary injunction is appropriate, weighing "[1] whether the plaintiff will be irreparably harmed if the injunction does not issue; [2] whether the defendant will be harmed if the injunction does issue; [3] whether the public interest will be served by the injunction; and [4] whether the plaintiff is likely to prevail on the merits." Univ. of Tex. v. Camenisch, 451 U.S. 390, 392 (1981).

[113] Injunctions are permitted by § 502(a) of the Copyright Act of 1976. Copyright Act of 1976, 17 U.S.C. § 502(a) (1976); RALPH S. BROWN & ROBERT C. DENICOLA, COPYRIGHT, UNFAIR COMPETITION, AND RELATED TOPICS BEARING ON THE PROTECTION OF WORKS OF AUTHORSHIP 619-20 (9th ed. 2005); David V. Radack, *Remedies for Copyright Infringement*, 50(5) JOM 51 (1998), *available at* http://www.tms.org/pubs/journals/JOM/matters/matters-9805.html.

[114] *See* Winter v. Natural Res. Def. Council, Inc., 129 S. Ct. 365, 374-76 (2008) (holding plaintiffs seeking a preliminarily injunction must demonstrate a likelihood of irreparable harm, not a possibility of irreparable harm). To establish a prima facie case of copyright infringement, the plaintiff needs only to show (1) he owns a valid copyright, and (2) the defendant copied original elements of the copyrighted work. Feist Publ'ns, Inc. v. Rural Tel. Serv. Co., 499 U.S. 340, 361 (1991). *See also* Apple Computer, Inc. v. Franklin Computer Corp., 714 F.2d 1240, 1254 (3d Cir. 1983); Atari, Inc. v. N. Am. Philips Consumer Elecs. Corp., 672 F.2d 607, 620 (7th Cir. 1982); Wainwright Sec., Inc. v. Wall St. Transcript Corp., 558 F.2d 91, 94 (2d Cir. 1977); 4-14 NIMMER, *supra* note 95, § 14.06.

[115] 17 U.S.C. § 504(c).

problematic in open source licensing actions,[116] statutory damages provide an easier and more efficient method of relief.[117] Additionally, the DMCA provides remedies to plaintiffs at a cheaper and faster rate than filing suit.[118] This less costly remedy might encourage copyright holders to prosecute infringers at a higher rate since it reduces the high cost of pursuing a full-blown lawsuit.

2. A Copyright Regime is More Efficient than a Contract Regime

The Federal Circuit in *Jacobsen* also did not discuss why a copyright regime is more efficient than a contract regime. There are three main reasons why a copyright scheme is more efficient. First, many open source licenses (including the GPL) are not designed to function as contracts.[119] Conceptually, attempts to manipulate them under contract law are difficult and inefficient. Second, there is more congruence of copyright law than contract law internationally.[120] Simply stated, this uniformity increases efficiency because of standardized ideas and processes. Third, and primary to this discussion, the difficulties arising from using contract law to enforce open source licenses are avoided.[121]

One difficulty with using contract law in the open source regime is that the users (i.e., licensees) may be anonymous.[122] If contract law governed open source licensing, every distributor would be required to execute a formal agreement before distributing his software (e.g., a user's signature would be required before receiving a program).[123] Acquiring formal assent from each open source user would be extremely tedious, if not impossible. Another difficulty is that many open source licenses do not require users' affirmative assent before receiving access to the program.[124] This absence of assent directly conflicts with the principles of contract law that require mutual consent and consideration.[125] Mutual consent is general-

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116 *See infra* PART II, SUBPART B (discussing the problematic nature of calculating lost profits in an open source infringement action).

117 *See infra* PART II, SUBPART B (discussing the advantages of applying statutory damages).

118 *See infra* PART II, SUBPART B (discussing these remedies in greater detail).

119 *See* Eben Moglen, Address at the Third Int'l GPLv3 Conference (June 22, 2006) (transcript *available at* http://fsfeurope.org/projects/gplv3/barcelona-moglen-transcript.en.html#q7-a-contract).

120 *See* Richard M. Stallman, Don't Let 'Intellectual Property' Twist Your Ethos (June 9, 2006), http://www.gnu.org/philosophy/no-ip-ethos.html.

121 *Id. See* St. Laurent, *supra* note 6, at 147.

122 St. Laurent, *supra* note 6, at 147.

123 Stallman, *supra* note 120.

124 St. Laurent, *supra* note 6, at 147 (noting that some open source licenses, such as the BSD license, require a user's affirmative assent before receiving access to a program, while more commonly used licenses, such as the GPL, do not).

125 *Id.* at 147-48.

ly not contested in the classic contract formation since both parties negotiate to reach a final agreement and sign a formal document.[126] However, mutual consent can be easily contested in open source licensing because of the informal nature of the open source regime.[127]

The vast majority of open source licensing is similar to shrink-wrap, browse-wrap, and click-wrap licenses.[128] A shrink-wrap license, or end-user license, is a license in which the terms and conditions can only be read after the purchaser tears open the cellophane wrapping; these licenses become effective immediately upon tearing.[129] The enforcement of shrink-wrap licenses has had mixed success in the courts.[130] Open source licenses differ from shrink-wrap licenses because everything exists and occurs in virtual space (i.e., the license, the product, offer, and acceptance).[131] On the other hand, browse-wrap licenses inform users that the software they are about to download is subject to a license.[132] Users have the option to click on a hyperlink that directs them to the license's terms, and then must click on another hyperlink to access the website to download the licensed software.[133] Because of this quasi-affirmative step, browse-wrap licenses sometimes create enforceable contracts.[134]

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126 *See id.* at 148. To have a contract voided (i.e., render it to have no legal effect), a party must prove his lack of consent at the time of contract formation, either by fraud in the inducement or by incompetence. *Id.* at 148-49. Inducement by fraud occurs when one party's misrepresentation of a material fact causes another party to enter into a contract; the latter party is injured because of the false impression of the risks or obligations created by the misrepresentation. BLACK'S LAW DICTIONARY, *supra* note 109, at 686. Incompetence refers to the lack of a legal ability to give consent (e.g., under the age of consent). *Id.* at 780.

127 *See* St. Laurent, *supra* note 6, at 149.

128 *Id.* at 149-50.

129 *See* ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1449 (7th Cir. 1996).

130 *See id.* at 1450-51 (holding that a license enclosed in a software package forms a binding contract between the seller and buyer if the package provides notice that the purchase is subject to a license and the buyer can receive a refund if the buyer does not agree to the license's terms). *But see* Klocek v. Gateway, Inc., 104 F. Supp. 2d 1332, 1341 (D. Kan. 2000) (holding that terms and conditions supplied along with and inside the packaging of a computer do not create a binding contract between the buyer and seller).

131 *See* St. Laurent, *supra* note 6, at 149 ("A potentially critical distinction . . . is the extent to which the purchaser was aware (or could have made himself aware) that the software was provided subject to a license and could have learned the terms of the license that would govern the use of the software.").

132 *Id.* at 149-50.

133 *Id.* at 150.

134 *Id.* Browse-wrap licenses may create enforceable contracts since the user is aware of the software license. *Id.* However, the fact that users are not required to affirmatively assent to the license's terms (e.g., click an "I accept" button, or even read the license's terms), has made courts reluctant to find an enforceable contract. *Id. See, e.g.*, Specht v. Netscape Commc'ns Corp., 306 F.3d 17 (2d Cir. 2002), *aff'g* 150 F. Supp. 2d 585 (S.D.N.Y. 2001) (holding that downloading software does not indicate assent to be bound by the terms of a license when the terms are found by clicking a link located below the portion of the user's screen after downloading the software); Ticketmaster Corp. v. Tickets.com,

Click-wrap licenses take this a step farther and generally create enforceable contracts.[135] In this construct, users have to both view the license's terms and take an affirmative action (i.e., click on a button to indicate assent) to download the program.[136] Variants of browse-wrap and click-wrap licenses also exist, and the enforceability of these licenses varies from case to case.[137] These variant licenses allow users to view the licenses' terms but do not require users to affirmatively assent to them.[138] However, some argue that simply downloading the software implies a user's assent.[139] Using copyright law helps to avoid these problems since the formalities and requirements of contract formation are not required. Thus, a copyright regime promulgates the efficiency goal the open source movement seeks to advance.

B. *Relief Available Under a Copyright Regime*

In light of the Federal Circuit's recent decision in *Jacobsen*, damages for breach of the Artistic License are now calculated under federal copyright law and not state contract law. Calculating damages under a copyright regime is difficult in open source licensing infringement actions since the public can generally access open source software free of charge. This section discusses the different forms of relief available under current federal copyright law for open source software infringement actions,[140] the difficulties that may arise under this regime, and the more advantageous methods of relief: statutory damages and remedies afforded by the DMCA.

Under the Copyright Act, injunctive and quasi-injunctive relief are available to copyright holders.[141] In addition, there are two avenues for

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Inc., No. 99-7654, 2000 U.S. Dist. LEXIS 4553 (C.D. Cal. Mar. 27, 2000) (holding that a link containing a license's terms indicating use of the website constitutes assent does not create an enforceable contract).

135 St. Laurent, *supra* note 6, at 150. *See, e.g.*, A.V. v. iParadigms, 544 F. Supp. 2d 473 (E.D. Va. 2008) (holding that the users entered into a valid click-wrap license agreement by clicking an "I agree" button that appeared directly below the online usage agreement and thereby indicated their assent to be bound by the license's terms); Mortgage Plus, Inc. v. DocMagic, Inc., No. 03-2582, 2004 U.S. Dist. LEXIS 20145 (D. Kan. Aug. 23, 2004) (holding that the user entered into a valid agreement by clicking a button indicating his assent to be bound by the license's terms).

136 St. Laurent, *supra* note 6, at 150.

137 *See id.* (noting that courts have been troubled in finding enforceability in these "variant licenses" since although licensees are aware of the license and have the opportunity to read it before accessing the software, no affirmative assent is made).

138 *Id.*

139 *Id.*

140 Open source software infringement actions refer to instances where the defendant violated the terms of an open source license.

141 Copyright Act of 1976, 17 U.S.C. § 502(a) (1976); Digital Millennium Copyright Act, 17 U.S.C. § 512 (1998).

recovering damages for copyright infringement: actual damages and profits,[142] and statutory damages.[143]

1. Injunctions: Section 502(a)

Both preliminary and permanent injunctions are permitted under § 502(a) of the Copyright Act.[144] Injunctions provide copyright holders a method of preventing further infringement from occurring. For a court to grant a preliminary injunction, the plaintiff must demonstrate (1) a likelihood of success on the merits, (2) a likelihood of irreparable harm in the absence of injunctive relief, (3) the balance of equities weighs in his favor, and (4) the injunction serves the public interest.[145] Upon success at trial, a preliminary injunction often becomes a permanent injunction. Since injunctive relief only allows copyright holders to stop current infringement and to prevent future infringement, the Copyright Act also permits copyright holders to seek monetary relief.

2. Actual Damages and Profits: Section 504(b)

Section 504(b) of the Copyright Act authorizes a copyright holder to recover both the actual damages suffered as a result of the defendant's infringement and the defendant's profits to the extent those profits were not already taken into account in calculating actual damages.[146] Typically, damages in infringement actions are calculated based on the plaintiff's lost profits from lost sales.[147] It is important to distinguish between "lost profits" and "lost sales."[148] A major distinction is that lost sales do not take production costs into account, while lost profits do.[149] In *Stevens Linen Assocs., Inc. v. Mastercraft Corp.*, the Second Circuit emphasized that the "object of the damages inquiry is to determine what sales probably would have been made without the infringement."[150] Courts acknowledge that

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142 17 U.S.C. § 504(b).

143 17 U.S.C. § 504(c).

144 17 U.S.C. § 502(a).

145 Winter v. Natural Res. Def. Council, Inc., 129 S. Ct. 365, 374 (2008).

146 17 U.S.C. § 504(b).

147 *See* BROWN & DENICOLA, *supra* note 113, at 611.

148 *See id.* at 611-12.

149 *See id.* at 612 ("If you sell less, you will ordinarily save some production costs, and these should be taken into account in computing damages." (citing Taylor v. Meirick, 712 F.2d 1112 (7th Cir. 1983))).

150 Stevens Linen Assocs., Inc. v. Mastercraft Corp., 656 F.2d 11, 15 (2d Cir. 1981).

some degree of speculation is required when determining lost sales.[151] However, courts prohibit speculation regarding actual damages—damages that must have a "necessary, immediate and direct causal connection" to the defendant's infringement.[152] Damages may also be calculated by using the decrease in a work's market value, or by the fair market value of an applicable copyright license.[153] These methods have proven useful because they show what a product is worth in a given market.

Courts may also calculate damages based on the defendant's profits. While this is an equitable method,[154] it is also difficult to measure. The defendant's profits are essentially the amount the plaintiff could have earned (instead of the defendant) but for the defendant's infringement. Using the defendant's profits as a gauge is beneficial because it provides a measure of a product's market value. However, the defendant's direct profits sometimes include profits generated by other factors not attributable to his infringement (e.g., marketing techniques and non-infringing features). To prevent copyright holders from collecting a defendant's profits that are not attributable to infringement, courts can make an apportionment when determining profits.[155] Additionally, since § 504(b) only entitles plaintiffs to the defendant's profits and not gross revenue, other disputes regarding the deduction of expenses arise. These include deductions related to labor and materials used to produce the infringing work, overhead, and income tax credit.[156]

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151 *See id.* at 14; Gross v. Van Dyk Gravure Co., 230 F. 412 (2d Cir. 1916); Fruit of the Loom, Inc. v. Andris Fabrics, Inc., 227 F. Supp. 977 (S.D.N.Y. 1963).

152 Sunset Lamp Corp. v. Alsy Corp., 749 F. Supp. 520, 522 (S.D.N.Y. 1990) (citing Abeshouse v. Ultragraphics, Inc., 754 F.2d 467, 470 (2d Cir. 1985); Big Seven Music Corp. v. Lennon, 554 F.2d 504, 509 (2d Cir. 1977)).

153 *See* BROWN & DENICOLA, *supra* note 113, at 612 ("Damages may instead be measured by the decrease in the market value of the copyrighted work." (citing Universal Pictures Co. v. Harold Lloyd Corp., 162 F.2d 354 (9th Cir. 1947))). *See also id.* ("It may be appropriate to measure the plaintiff's damages by the fair market value of a license that would cover the defendant's infringing use." (citing Davis v. The Gap, Inc., 246 F.3d 152 (2d Cir. 2001))).

154 *See id.* (citing H.R. REP. NO. 94-1476, at 161 (1976) (explaining that damages are awarded to compensate the copyright holder, while profits are awarded to prevent unjust enrichment)).

155 *See id.* at 613 (citing H.R. REP. NO. 94-1476, at 161 ("Where some of the defendant's profits result from the infringement and other profits are caused by different factors, it will be necessary for the court to make an apportionment.")). *See, e.g.*, Sheldon v. Metro-Goldwyn Pictures Corp., 309 U.S. 390, 402 (1940) (holding that apportionment was proper since the profits had been derived from a movie exhibition which had its own "distinctive profit-making features apart from the use of any infringing material."). *See generally* Copyright Act of 1976, 17 U.S.C. § 504(b) (1976) ("In establishing the infringer's profits, the copyright owner is required to present proof only of the infringer's gross revenue, and the infringer is required to prove his or her deductible expenses and the elements of profit attributable to factors other than the copyrighted work.").

156 *See* BROWN & DENICOLA, *supra* note 113, at 616.

3. Statutory Damages: Section 504(c)

Another remedy available for copyright infringement is statutory damages. Copyright holders may elect this recovery method instead of actual damages or the defendant's profits.[157] Statutory damages can range from $750 to $30,000 and are awarded per work infringed.[158] They are recoverable provided that the copyright holder registered (or preregistered) the work before the infringement started or within three months of first publication of the work.[159] In cases of willful infringement, courts can award up to $150,000.[160] In cases of innocent infringement, courts may award no less than $200 in statutory damages.[161]

4. The Digital Millennium Copyright Act: Section 512

Filing a lawsuit or collecting traditional monetary damages under the Copyright Act is not always efficient or practical for a copyright holder. Lawsuits are time consuming, expensive, and individuals and small businesses may not want to allocate their limited resources to them. Fortunately, the DMCA provides an alternative solution. Title II of the DMCA, the Online Copyright Infringement Liability Limitation Act (OCILLA), provides a faster and inexpensive alternative to stop infringement. Under the OCILLA, copyright holders may have infringing material (e.g., modified source code that does not comply with an open source license's terms) removed from the Internet without filing a lawsuit.

The process is easy and straightforward: copyright holders must notify Internet Service Providers (ISPs) in writing upon becoming aware of infringement.[162] ISPs that comply with the DMCA's notice and take down provision by removing infringing material upon receiving written notification maintain limited liability for infringement.[163] While ISPs are not required to comply with the DMCA's notice and take down provision, as a practical matter, sending a DMCA take down notice will often result in an ISP removing access to infringing material, as the ISP ultimately fears being sued. In essence, Title II of the DMCA provides copyright holders with an efficient quasi-injunctive and non-judicial method of relief.

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157 17 U.S.C. § 504(c).

158 *Id.*

159 17 U.S.C. § 412.

160 17 U.S.C. § 504(c)(2).

161 *Id.*

162 17 U.S.C. § 512(c)(3)(A) (requiring copyright holders to provide ISPs with written notification of infringement).

163 17 U.S.C. § 512(c)(1)-(3) (requiring ISPs to respond expeditiously to remove or disable access to infringing material upon receiving notice of infringement).

5. Evaluating the More Efficient Remedies for Open Source Copyright Infringement

Open source software infringement can result in lost profits because copyright holders can use non-fee based software as a marketing tactic. The "marketing" software attracts users to the copyright holder's website, which contains other material that is available for a fee. Users who download, copy, and disseminate the copyright holder's non-fee based software elsewhere essentially destroy this marketing scheme. Future users no longer have to access the copyright holder's website to view or download the non-fee based software since they can instead view or download this material from the infringer's website. This means that potential purchasers of the copyright holder's fee-based material are essentially lost.

The Federal Circuit also articulated this idea in *Jacobsen* when the Court provided several examples of the economic considerations in open source licensing. The Court noted that not only may developers build market share for their fee-based software by offering non-fee based software, but also that open source projects may increase developers' reputations and thereby increase business.[164] However, since open source software is often available to the public without cost, and since actual damages are merely speculative, determining what profits are being lost and how they can be adequately measured is difficult.

While in theory lost profits can result from open source software infringement, the problematic nature of calculating such damages is less efficient than electing statutory damages (or DMCA remedies for quasi-injunctive relief). Electing relief under § 504(c) (statutory damages) helps alleviate the difficulties in calculating damages based on § 504(b) (actual damages and the defendant's profits). Statutory damages are more efficient since they help reduce, if not eliminate, lost profit calculation confusion pertaining to open source software, and recovering actual damages and profits might only be worthwhile in cases where the alleged damages exceed the recoverable amount in statutory damages.

Furthermore, recovering monetary damages is not efficient or entirely practical in all instances of open source license infringement. Copyright holders will experience faster results under the DMCA without incurring the large expenses that they normally would by filing a lawsuit. The DMCA allows copyright holders to stop the infringement from occurring essentially for free.

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164 Jacobsen v. Katzer, 535 F.3d 1373, 1379 (Fed. Cir. 2008).

6. The "Infringement Generates Profits" Theory is Not Applicable to Open Source Infringement

Academic studies and commercial industry practice might lead open source copyright holders to believe that it is in their best interest not to pursue copyright infringement actions. Empirical evidence appears to indicate that infringement might actually help generate more business and profits for copyright holders. This theory can be applied to software companies such as Microsoft Corporation ("Microsoft") and recording companies both domestic and foreign.

In the summer of 2002, Microsoft and China entered into a $750 million "memorandum of understanding"—that lacked a copyright enforcement clause—to resolve their differences in copyright and software pricing.[165] Given China's ninety-two percent software piracy rate, this agreement seemed baffling to many.[166] However, this willful blindness towards piracy might be a new strategy to actually increase business in foreign markets.[167] Harvard researcher Carlos A. Osorio suggests that "companies stand to make more money if they view each new illegal user as one more mouthpiece for the software and one less customer for the competition."[168] This game theory strategy has been used by Microsoft in the past and has shown to be successful (e.g., Internet Explorer).[169] The theory is simple: companies that are willing to give their products away for free in the present enjoy a share of profits in the future.[170] Future profits are a result of network effects—the more users, the more valuable the software becomes.[171] This increased value might eventually lead to increased purchases and greater profits for companies.

Similarly, a 2002 study conducted by Felix Oberholzer, a Professor of Business Administration at Harvard Business School, and Koleman Strumpf, a Professor of Economics at the University of Kansas School of Business, revealed that illegal file sharing has limited, if any, negative impact on album sales and that "file sharing has a differential impact across sales categories."[172] Their research suggests that "five thousand downloads are needed to displace a single album sale."[173] They also found that sales

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165 *See* Sam Williams, Profits from Piracy (Sept. 26, 2002), http://dir.salon.com/story/tech/feature/2002/09/26/piracy_unlimited.

166 *See id.*

167 *See id.*

168 *Id.*

169 *See id.*

170 *See id.*

171 *See* Williams, *supra* note 165.

172 *See* Felix Oberholzer & Koleman Strumpf, *The Effect of File Sharing on Record Sales: An Empirical Analysis*, 115 J. POL. ECON. 1, 3 (2004).

173 *Id.*

actually increased for popular albums (i.e., albums that sold more than 600,000 copies) when downloaded more heavily.[174] This is because persons who illegally download music were less likely to purchase the music in the first place.[175] Thus, Oberholzer and Strumpf suggest that any decline in album sales is not primarily due to file sharing, but rather other possible causes such as poor macroeconomic conditions, a decrease in album releases, and competition from other entertainment sources.[176] Likewise, a 2005 study conducted by The Leading Question[177] found that persons who illegally share and download music files over the Internet spend approximately four-and-a-half times more on legal music downloads than average music consumers.[178]

The "infringement helps generate more business and profits" theory does not apply to cases of open source software infringement. Unlike cases of illegal music or software downloading, where the original source is readily apparent and available (e.g., listeners who illegally download a Rolling Stones song know the artist is the Rolling Stones), open source software infringement involves cases where the original source has been removed (e.g., in *Jacobsen*). In cases where the original source is apparent or included on the free material, users can choose to search for additional material created and distributed by the original source. Alternatively, where the original source has been removed, users are unaware of the original source, and therefore cannot search for additional (potentially fee-based) software created and distributed by the original source. Thus, the original source (i.e., copyright holder) potentially loses sales and profits.

Although the lost profits method of relief may be plausible, it is highly impractical. It would be near impossible to quantify exactly how much profit was *potentially* lost. Essentially, it would require courts to estimate approximately how much software would have been sold but for the infringement. The only situation where this might be practical is where the copyright holder of the original source can show a decrease in profits since the start of the defendant's infringement. Since this is not applicable to most cases, statutory damages still provide the best monetary relief available under the Copyright Act, while DMCA remedies provide the most efficient quasi-injunctive relief.

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174 *Id. See also* Morgan O'Rourke, *Setbacks in the Music Piracy War*, RISK MGMT. MAG., June 1, 2004, *available at* http://www.rmmag.com (search "*Setbacks in the Music Piracy War*").

175 Oberholzer & Strumpf, *supra* note 172, at 3-4.

176 *See id.* at 24.

177 The Leading Question is a specialist digital music research firm.

178 The Leading Question, Essential Music Research (July 27, 2005), *available at* http://www.musically.com/theleadingquestion/files/theleadingquestion_piracy.doc.

CONCLUSION

The Federal Circuit held that a violation of the Artistic License's terms constitutes copyright infringement. Consequently, the remedies under the Copyright Act now govern relief for open source infringement. A copyright regime affords copyright holders more sufficient remedies than under a contract regime since copyright holders are able to more easily obtain injunctive relief and have the option to elect statutory damages. Furthermore, seeking relief in open source infringement is more efficient under a copyright regime than under a contract regime since it provides uniformity and avoids the difficulties involved in contract formation.

Although lost profits are generally the remedy in copyright infringement, copyright holders should elect to collect statutory damages in open source infringement actions when seeking monetary relief. This would save courts from the intricacies involved in determining unknown lost profits when calculating damages. Additionally, some copyright holders may find it more efficient and effective to resort to quasi-injunctive remedies under the DMCA rather than collecting actual monetary damages since DMCA remedies eliminate the costs of filing suit.

The *Jacobsen* opinion provides great benefits to copyright holders participating in the open source licensing regime by allowing them to recover damages through easier and cheaper methods than under a contract regime. Indeed, a copyright regime promulgates the efficiency that the open source movement seeks to advance.

SOO LINE R.R. CO. V. UNITED STATES: WHEN IS INTEREST DUE A TAXPAYER UNDER I.R.C. § 6411?

*Morgan Mason**

I. INTRODUCTION

Albert Einstein once said, "The hardest thing in the world to understand is the income tax."[1] Well, Einstein was right. The Internal Revenue Code (hereinafter "I.R.C." or "Code") comprises rules for taxpayers to follow in determining their income and tax liability. Code sections are often individually confusing, and determining one's tax liability can become daunting when sections intermingle. For example, when a taxpayer overpays his taxes and needs a refund, he can find himself intertwined in I.R.C. sections. To receive a refund, the taxpayer can file a claim for refund under § 6402, or in some instances, a taxpayer can file a tentative allowance under § 6411.[2] The procedures, tax consequences, and interest rules of each section are different. Interest rules pertaining to both claims for refunds and tentative allowances are mandated under § 6611.[3] When all three of these I.R.C. sections come into play, their otherwise clear, bright line rules can become hazy.

Soo Line Railroad Co. v. United States is a prime example of the problems that can arise when these sections intertwine.[4] In *Soo Line,* the taxpayer applied for a tentative allowance and received it within forty-five days.[5] Later, the Internal Revenue Service (IRS) made an adjustment to the allowance that made the final refund due to Soo Line less than the original tentative allowance.[6] Soo Line claimed interest on the overpayment created by this new amount, but the Court of Federal Claims found that no interest was due because the original tentative allowance was paid within forty-five days.[7] The court strictly adhered to the forty-five day rule under § 6611(e); while it led to the correct decision in *Soo Line*, strict adherence as a

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1 Albert Einstein, Physicist (1879-1955).

2 I.R.C. §§ 6402, 6411 (2009).

3 I.R.C. § 6611 (2009).

4 Soo Line R.R. Co. v. United States, 44 Fed. Cl. 760 (1999).

5 *Id.* at 761.

6 *Id.*

7 *Id.* at 762.

precedent set in *Soo Line* could lead to taxpayers being denied interest when logically they should receive it.

In Part II, this note examines the legal framework of §§ 6411 and 6611 of the I.R.C., explaining the meaning of each statute and how they work together. It also highlights important differences between §§ 6402 and 6411.[8] Part II also lays out the facts and ruling of *Soo Line*. Part III analyzes the court's decision in *Soo Line* under the traditional rule of interest, the meaning of § 6611, and the "use of money" doctrine. Part III further discusses the effects of *Soo Line* on taxpayers, and presents a case that highlights some unanswered questions raised by *Soo Line* and the relationship between I.R.C. §§ 6411 and 6611. Finally, Part IV concludes with a summary of the meaning and effects of *Soo Line* and offers suggestions on amendments Congress could make to the I.R.C. to better clarify the interaction between §§ 6411 and 6611(e).

II. LEGAL FRAMEWORK

To understand how I.R.C §§ 6411 and 6611 work together, it is first necessary to understand the original intent and purpose of each section and how both sections work independent of one another.

A. *I.R.C. § 6411: Tentative Carryback and Refund Adjustments*

Congress originally enacted § 6411 as § 3780 of the I.R.C. of 1939 in anticipation of the conclusion of World War II.[9] Section 3780 was enacted as part of the Tax Adjustment Act of 1945, which Congress created to facilitate businesses' reconversion and readjustment into peacetime production.[10] Congress had two primary motivations: it feared that reconversion would be troubled by a shortage of ready money, and it recognized the length of time it took corporate taxpayers to get a refund from a carryback[11]

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[8] Although this casenote highlights some differences between I.R.C. §§ 6402 and 6411, this casenote will not include a complete discussion on § 6402, as it is not this note's main focus.

[9] Pesch v. Comm'r, 78 T.C. 100, 116 (1982).

[10] *Id.* at 116. *See* H.R. REP. NO. 79-849 (1945), 1945 C.B. 566, 566-67, 569, 573-74, 580-83; S. REP. NO. 79-458 (1945), 1945 C.B. 592, 593-95.

[11] A carryback results when an income tax deduction cannot be taken in a given period, and thus may be carried back to prior periods to offset income in those periods. *See* BLACK'S LAW DICTIONARY (8th ed. 2004). By carrying back a deduction from a previous year, the taxpayer reduces his taxable income in the year the deduction is carried back to, and thus, reduces his tax liability for that year. Carrybacks can occur for a number of reasons, but the one this paper will focus on is a carryback from a net operating loss (NOL). *See* I.R.C. § 1212 (2009) for capital loss carrybacks and I.R.C. § 39 (2009) for unused credit carrybacks. NOL carryback provisions were enacted to alleviate undue consequences of taxing income strictly on an annual basis and to permit a taxpayer to offset its bad years against its

of a net operating loss (NOL)[12] under the standard claim for a refund.[13] Thus, by enacting § 3780, Congress moved funds back into the hands of the corporate taxpayer in an attempt to get the wartime economy back on track.[14]

Section 6411 of the I.R.C. explains when carrybacks can lead to a tentative or temporary allowance, or a refund.[15] Under limited circumstances, a taxpayer can request a tentative carryback allowance pursuant to I.R.C. § 6411 rather than the standard procedure[16] under I.R.C. § 6402.[17] Only taxpayers that report a NOL carryback, an investment tax credit carryback, or a capitol loss carryback can request a tentative allowance under § 6411.[18] Requesting such an allowance is advantageous because the IRS must allow or disallow the request within ninety days of the date the application is filed, as compared to the six-month time limit given to the IRS under § 6402.[19] The Secretary makes a decision on the tentative allowance application after only a limited, brief examination of the taxpayer's records.[20] The procedure under § 6411 is designed to expedite refunds to taxpayers in need of cash. A tentative allowance is only denied if, after a cursory inspection of the tax return, the Secretary finds obvious errors or material omissions in the computation that cannot be fixed within the ninety-day time period.[21] The IRS must permit the tentative allowance for any other

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good years. Libson Shops v. Koehler, 353 U.S. 382, 386 (1957). Section 172 of the I.R.C. covers NOL carrybacks. I.R.C. § 172 (2009). The general rule, amended in 1997, is that a taxpayer may carry a NOL back to each of the two taxable years preceding the taxable year of such loss, and may carry the NOL forward to each of the twenty taxable years following the taxable year of the loss. I.R.C. § 172(b). For all taxable years prior to 1997, a taxpayer can use its NOL as a carryback for each of the three taxable years preceding the taxable year of the loss and can use its NOL as a carryforward for the fifteen taxable years following the taxable year of the loss. I.R.C. § 172 (1994 & Supp. III 1997). Section 172 mentions several exceptions to this general rule, but these exceptions are not applicable to this casenote. I.R.C. § 172(b).

12 A NOL is defined by § 172 as the excess of the deductions allowed over the gross income of a taxpayer. I.R.C. § 172(c). Practically speaking, a NOL occurs when a business or individual incurs business expenses that exceed the amount of gross income earned.

13 *Pesch*, 78 T.C. at 116; *See* H.R. REP. NO. 79-849 (1945); S. REP. NO. 79-458 (1945).

14 *Id.*

15 I.R.C. § 6411 (2009).

16 I.R.C. § 6402 controls claims for refunds. *See* I.R.C. § 6402 (2009). The corporation must file form 1120X, Amended U.S. Corporation Income Tax Return, in order to file a claim for refund under § 6402. Claims under § 6402 are not temporary; and if disallowed, or if the district director or director of a service center does not act on the claim within six months from the date it is filed, the taxpayer can file suit challenging the disallowance. 26 CFR.F.R. § 301.6402-3 (2009); 26 CFR.F.R. § 1.6411-1(b) (2009).

17 Columbia Gas Sys. Inc. v. United States, 32 Fed. Cl. 318, 323 (1994), *aff'd*, 70 F.3d 1244 (Fed. Cir. 1995).

18 *Id.* at 323 n.5; I.R.C. § 6411(a), (d) (2009).

19 I.R.C. § 6411(b) (2009).

20 I.R.C. § 6411(b).

21 *See* I.R.C. § 6411(b); *Columbia Gas Sys. Inc.*, 32 Fed. Cl. at 323.

reason.[22] The Secretary essentially takes the tax return at face value and gives the taxpayer the money claimed in a much faster time.[23]

Although a request for a tentative allowance under § 6411 allows for a quicker refund, a request under § 6411 has its disadvantages as well. A decision to disallow the application under § 6411, unlike a similar decision under § 6402, is not reviewable.[24] If a taxpayer's request for a tentative allowance is denied, in whole or in part, the taxpayer's only option is to then file a claim for a refund under § 6402.[25] Except for calculating interest, a tentative allowance under § 6411 does not constitute a claim for a refund or credit, and no suit may be filed in any court to recover any tax based on such application.[26]

Another disadvantage of § 6411 is that refunds given under § 6411 are more vulnerable to recapture[27] because, unlike refunds made under § 6402, the IRS may take the tentative refunds back without giving the taxpayer notice or a right to contest.[28] The instructions for Form 1139[29] explain that "the payment of the requested refund does not mean the IRS has accepted the application as correct," and that the IRS can later determine, after conducting a full audit of the tax year in question, that the tentative refund was overstated or erroneously allowed and make any necessary corrections.[30] If the IRS later determines the tentative allowance was erroneously allowed, the IRS has three remedies to recover the erroneous portion of the allowance.[31] First, the IRS may assess a deficiency attributable to a tentative carryback allowance as if due to a mathematical or clerical error appearing on the taxpayer's tax return.[32] If the IRS decides to issue a deficiency as if due to a mathematical or clerical error, the taxpayer does not have a right to file a petition of review with the Tax Court based on such notice, and the taxpayer's only option for relief is to request an abatement of assessment in which the IRS will reassess the tax it claims is due.[33] The IRS's second remedy is to bring a civil suit to recover the erroneous refund.[34] Finally, the

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22 I.R.C. § 6411(b); *Columbia Gas Sys. Inc.*, 32 Fed. Cl. at 323.

23 *Columbia Gas Sys. Inc.*, 32 Fed. Cl. at 323.

24 *Id.*

25 I.R.S. Instructions for Form 1139 (Rev. Aug. 2006).

26 I.R.C. § 6411(a) (2009); *see also Columbia Gas Sys. Inc.*, 32 Fed. Cl. at 323.

27 A recapture occurs when the IRS recovers or takes back a tax benefit from a credit previously taken that is no longer applicable to a tax year. *See* BLACK'S LAW DICTIONARY (8th ed. 2004).

28 *Columbia Gas Sys. Inc.*, 32 Fed. Cl. at 323.

29 Form 1139 is the current form a corporation uses to file for a tentative allowance. I.R.S. Instructions for Form 1139 (Rev. Mar. 2009), http://www.irs.gov/pub/irs-pdf/i1139.pdf.

30 *Id.*

31 Pesch v. Comm'r, 78 T.C. 100, 117 (1982); Midland Mortgage Co. v. Comm'r, 73 T.C. 902, 905-06 (1980); Fine v. Comm'r, 70 T.C. 684, 687-88 (1978). *See also* I.R.C. § 6213(b)(2) (2009).

32 *Pesch*, 78 T.C. at 117. *See also* I.R.C. § 6213(b)(3); Proced. & Admin. Regs. § 301.6213(b)(2)(i) (2009).

33 *See* I.R.C. § 6213(b)(1)-(2) (2009).

34 *Pesch*, 78 T.C. at 117; I.R.C. § 7405 (2009). *See also* I.R.C. § 6532(b) (2009).

IRS may issue a Notice of Deficiency under § 6212.[35] Issuing a Notice of Deficiency subjects the refund to ordinary procedures, including review by the Tax Court.[36] The IRS may choose which remedy it wants to use to correct the erroneous tentative allowance.[37]

B. *I.R.C. Section 6611: Interest on Overpayments*

I.R.C. § 6611 mandates when the IRS must pay interest on overpayments.[38] Section 6611(a) states, "Interest shall be allowed and paid upon any overpayment in respect of any internal revenue tax . . ."[39] Section 6611(e)[40] creates an exception to the general rule stated in subsection (a).[41] Section 6611(e) states that the IRS is not liable for interest on any refund claim or application for a tentative allowance if the refund is paid within forty-five days from the application's filing date.[42]

C. Soo Line R.R. Co. v. United States, *44 Fed. Cl. 760 (1999)*

In *Soo Line*, the plaintiff, Soo Line, requested a reduction to its 1980 tax liability due to a NOL carryback from its 1983 tax year.[43] Soo Line filed an application for a tentative allowance for $2,860,785 on September 20, 1984; the IRS paid the requested allowance without interest on October 12, 1984.[44] Neither party disputed that the IRS did not owe interest on the tentative allowance because the IRS paid the allowance within forty-five days.[45] Thereafter, Soo Line filed a petition with the Tax Court seeking certain adjustments not involving the tentative allowance but pertaining to its 1980 tax liability.[46] As a result, the parties determined that Soo Line had underestimated its NOL carryback. A recalculation showed that the NOL carryback should have been $5,676,358 instead of the $2,860,785 Soo Line

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35 *Pesch*, 78 T.C. at 117-18. *See also* I.R.C. § 6212 (2009); I.R.C. § 6213(b)(4) (2009).

36 *Pesch*, 78 T.C. at 118. *See also* I.R.C. §§ 6211-15 (2009).

37 *Pesch*, 78 T.C. at 118; Midland Mortgage Co. v. Comm'r., 73 T.C. 902, 906 (1980); Fine v. Comm'r., 70 T.C. 684, 688 (1978).

38 I.R.C. § 6611 (2009).

39 I.R.C. § 6611(a).

40 I.R.C. § 6611(e) ("If any overpayment of tax . . . is refunded within 45 days after the last day prescribed for filing the return of such tax (determined without regard to any extension of time for filing the return) or, in case the return is filed after such last date, is refunded within 45 days after the date the return is filed, no interest shall be allowed under subsection (a) on such overpayment.").

41 *See* I.R.C. § 6611(e).

42 *Id.*

43 Soo Line R.R. Co. v. United States, 44 Fed. Cl. 760, 761 (1999).

44 *Id.*

45 *Id.*

46 *Id.*

reported on its application for the tentative allowance.[47] The parties also determined that Soo Line underestimated its tax liability for 1980 and owed $3,260,582.28.[48] The new NOL carryback ($5,676,358) offset the increase in Soo Line's tax liability ($3,260,582.28).[49] After this offset was made, Soo Line had an interim overpayment of $2,415,775.72, which had a starting date of March 15, 1984 (the filing date for the tax year in which the loss that produced the NOL carryback occurred), and ran until the IRS refunded the original tentative allowance on October 12, 1984.[50] Soo Line requested interest on the interim overpayment for the period between the effective date of the carryback[51] and the date the IRS paid the tentative allowance.[52]

Soo Line argued that the limitations on interest provided under § 6611(e) did not apply because Soo Line's application for a tentative allowance was not made based on the IRS-corrected amount of $5,676,358.[53] Soo Line claimed the tentative allowance was only made for the $2,860,785 and that it was entitled to interest on the $2,415,775.72 difference between the correct NOL carryback and the correct tax liability.[54] Soo Line claimed it was due interest on the difference because it believed, "[W]here the amount owed the taxpayer is adjusted by the IRS, the taxpayer is entitled to interest on the IRS-adjusted amount without regard to previous payments made by the IRS for that same tax year."[55] The government argued that the IRS payment of the original tentative allowance within forty-five days could not be ignored and that as long as the original tentative allowance payment met or exceeded the final payment amount, no interest was due the taxpayer.[56]

The Court of Federal Claims held that Soo Line was not entitled to overpayment interest on the IRS-adjusted overpayment amount.[57] The court stated "[I]t seems plain to this court that it cannot ignore the tentative allowance the IRS paid to plaintiff on October 12, 1984, in deciding whether plaintiff is entitled to interest on the IRS-adjusted amount. To suggest that the prior payment is not relevant defies common sense."[58] The court noted

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47 *Id.*

48 *Id.*

49 *Soo Line R.R. Co.*, 44 Fed. Cl. at 761.

50 *Id.* at 761-62.

51 *See* I.R.C. § 6611(f)(1) (2009) ("For purposes of subsection (a), if any overpayment of tax imposed by subtitle A results from a carryback of a net operating loss or net capital loss, such overpayment shall be deemed not to have been made prior to the filing date for the taxable year in which such net operating loss or net capital loss arises.").

52 *Soo Line R.R. Co.*, 44 Fed. Cl. at 762.

53 *Id.* at 762-63.

54 *Id.* at 763.

55 *Id.*

56 *Id.*

57 *Id.* at 763-64.

58 *Soo Line R.R. Co.*, 44 Fed. Cl. at 763.

that nothing in the Code, tax regulations, or case law supported Soo Line's position that interest should be paid on the IRS-adjusted amount.[59] Allowing interest on the overpayment would "render section 6611(e) a nullity in this case."[60] Had the overpayment due Soo Line been larger than the original tentative refund, the IRS would owe interest on the difference between the payments.[61] But this was not the case. The court determined that the IRS did not owe interest because the IRS paid the original tentative allowance within forty-five days, and the original allowance was more than the amount eventually due to Soo Line.[62]

III. ANALYSIS

Part III of this note analyzes the holding of *Soo Line* and examines three principles that help explain the court's rationale. After analyzing the court's holding, Part III then discusses the effects of the *Soo Line* decision, including the effects on taxpayers from strict adherence to the forty-five day rule. These effects are shown through cases such as *Hunt v. United States*.[63] Lastly, Part III highlights some of the unanswered questions from *Soo Line* and the problems these unanswered questions create. A recent case, *Coca-Cola v. United States*,[64] is used to exhibit the shortcomings of *Soo Line* and to predict how the court will decide future cases involving *Soo Line* principles.

A. *The Court of Federal Claims' Holding in* Soo Line

The court in *Soo Line* reached the correct decision by ruling not to give Soo Line interest on the refund. This paper's analysis of the court's holding in *Soo Line* focuses on three principles that clearly explain, individually and as a whole, why no interest is due on Soo Line's interim overpayment. The discussion below begins with the traditional rule of interest, namely, that no interest is due to a taxpayer without a specific statute mandating the interest in that circumstance. The second part of the analysis focuses on the "use of money" doctrine and its applicability in *Soo Line*. The final principle discussed is § 6611 of the I.R.C., including an explanation of the literal meaning of the statute and Congress's intentions in enacting it.

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59 *Id.*

60 *Id.*

61 *Id.* at 764.

62 *Id.*

63 94 F. Supp. 2d 665 (D. Md. 2000), *rev'd sub nom.* Estate of Hunt v. United States, 103 F. App'x 475 (4th Cir. 2004).

64 87 Fed. Cl. 253 (2009).

1. Traditional Rule of Interest

In any suit for interest, the discussion must begin with the traditional rule that interest on claims against the United States cannot be recovered without an express provision or statute clearly stating that interest is due to the taxpayer.[65] Even in cases where taxpayers argue that the use of money doctrine should apply, the Supreme Court has observed that, "So rigorously is the [traditional] rule applied, that, in the adjustment of mutual claims between an individual and the government, the latter has been held entitled to interest on its credit although relieved from the payment of interest on the charges against it."[66] Practically speaking, this means that there will be instances in which the government will collect what is rightfully the taxpayer's money and when the government refunds it to the taxpayer, the government will not pay the interest. Interest is strictly a creature of statute and is not given to the taxpayer, even if it produces an unfair result, unless there is a clear command to do so.[67]

The court in *Soo Line* recognized this traditional rule and correctly used it to support its decision to not grant Soo Line interest.[68] In considering whether Soo Line was correct in asserting it was due interest, the court stated, "[T]here is nothing in the Code, regulations, or case law that would support this result."[69] In fact, the court noticed that by granting Soo Line interest, it would not only defy the traditional no-interest rule, but it would also make § 6611(e) a nullity in this case.[70] Because no explicit statute or code section mandated the government pay interest to taxpayers in Soo Line's circumstances, and since a statute existed that forbade interest, the court was correct in deciding that Soo Line was not due interest.

2. The Use of Money Doctrine

The use of money doctrine stems from the theory that individuals have the right to do whatever they choose with what is rightfully theirs.[71] The doctrine is invoked in most instances where interest is involved. The basic idea is that when a taxpayer, or the government, has a rightful claim to

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65 Universal Pictures Co. v. United States, 237 F. Supp. 169, 175 (S.D.N.Y. 1964), *aff'd*, 345 F.2d 1002 (2d Cir. 1965); *See also* Rosenman v. United States, 323 U.S. 658, 663 (1945) ("Exaction of interest from the Government requires statutory authority . . .").

66 United States v. N. Am. Transp. & Trading Co., 253 U.S. 330, 336 (1920).

67 United States *ex rel.* Angarica v. Bayard, 127 U.S. 251, 260 (1888).

68 *See* Soo Line R.R. Co. v. United States, 44 Fed. Cl. 760, 763 (1999).

69 *Id.*

70 *Id.* at 763-64.

71 *See* Manning v. Seeley Tube & Box Co., 338 U.S. 561, 565-66 (1950); Universal Pictures Co. v. United States, 237 F. Supp. 169, 175 (1964), *aff'd*, 345 F.2d 1002 (2d Cir. 1965).

money, they should also have a rightful claim to earn interest on that money.[72] If the money is not in their possession during the time of rightful ownership, the taxpayer or government is stripped of their right to earn interest and should be compensated.[73] The doctrine boils down to the following premise: if the government or taxpayer is holding onto money that is not rightfully theirs, neither party should be able to benefit from the money by earning interest on it.[74] Although the court in *Soo Line* never mentions this doctrine specifically, it alludes to the doctrine in its rationale.[75]

At no time was Soo Line without the refund that was rightfully owed them. The IRS paid Soo Line's requested allowance of $2,860,785 without interest on October 12, 1984.[76] After several adjustments a few months later, Soo Line and the IRS agreed that Soo Line should have carried back a larger NOL and also have a larger liability than originally recorded.[77] Because Soo Line had a larger tax liability, the new NOL had to offset the liability.[78] Once calculated, Soo Line was only due a refund of $2,415,775.72, an amount less than the original tentative allowance.[79] But the IRS had already paid Soo Line $2,860,785 and did not take this refund away.[80] This means that Soo Line maintained possession of its full refund and could earn interest on it or use it however Soo Line chose. The IRS never had possession of any of the money due to Soo Line, and thus, owed Soo Line no interest because Soo Line had the power to earn interest on its refund.

The court acknowledged the use of money theory in *Soo Line* when it stated, "To be sure, if the IRS-adjusted overpayment had exceeded the earlier tentative allowance, interest would be owed on the difference."[81] In this instance, Soo Line would not have possessed the money it was due the entire time, and the government would have benefited from having Soo Line's money. Consistent with the use of money doctrine, the court stated that in those circumstances, the IRS would owe interest.[82]

The court in *Soo Line* reached the correct decision in ruling not to give Soo Line interest. Soo Line received a refund, without interest, in the amount it requested within forty-five days. No statutory provision or Code section explicitly granted Soo Line interest in this situation and § 6611(e) specifically forbids interest from being paid when a taxpayer receives its

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72 *See Manning*, 338 U.S. at 566; *Universal Pictures Co.*, 237 F. Supp. at 175.

73 *Id.*

74 *Id.*

75 *See Soo Line R.R. Co.*, 44 Fed. Cl. at 764.

76 *Id.* at 761.

77 *Id.*

78 *Id.*; *See generally* I.R.C. § 6411(b) (2009).

79 *Soo Line R.R. Co.*, 44 Fed. Cl. at 761.

80 *Id.* at 762.

81 *Id.* at 764.

82 *Id.*

tentative allowance within forty-five days. Further, Soo Line never lost possession of the money that it was rightfully due at any time during the period between the original tentative allowance and the date the IRS adjusted Soo Line's refund. Thus, the court in *Soo Line* correctly decided Soo Line was not due statutory interest on its interim overpayment.

3. I.R.C. Section 6611(e)

I.R.C. § 6611(e) was created as an exception to the general rule under § 6611(a), which provides that interest is due on any overpayment of federal income tax.[83] I.R.C. § 6611(e) states in part:

> If any overpayment of tax . . . is refunded within 45 days after the last day prescribed for filing the return of such tax (determined without regard to any extension of time for filing the return) or, in case the return is filed after such last date, is refunded within 45 days after the date the return is filed, no interest shall be allowed under subsection (a) on such overpayment.[84]

This section applies to tentative allowances under § 6411.[85] The central transaction in *Soo Line* is the application and granting of Soo Line's tentative allowance. It is not disputed that Soo Line's application for its tentative allowance was granted within forty-five days.[86] In fact, the IRS granted Soo Line's application within twenty-two days.[87] The court correctly concluded it could not ignore this central transaction and said that to do so would defy common sense.[88] No other claim was filed, no other form was filled out, and the adjustment to the tentative allowance came when the IRS, in accordance to procedures under § 6411, completed a full audit of the tax year in which the NOL occurred.[89] The IRS simply made an adjustment to the original tentative allowance, which was paid within forty-five days.[90]

To force the IRS to pay interest later when it found an error in the original amount would frustrate Congress's purpose for creating the forty-five day rule.[91] The drafters' main focus was to prevent the IRS from hav-

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83 I.R.C. § 6611(a), (e) (2009).

84 I.R.C. § 6611(e) (2009).

85 I.R.C. § 6611(f)(4)(B) (2009). *See Soo Line R.R. Co.*, 44 Fed. Cl. at 763; Phico Group, Inc. v. United States, 692 F. Supp. 437, 439-40 (M.D. Pa. 1988).

86 *Soo Line R.R. Co.*, 44 Fed. Cl. at 761.

87 *Id.*

88 *Id.* at 763.

89 *Id.* at 761.

90 *See id.* at 761-62.

91 *Id.* at 763-64.

ing to pay interest on the "quickie refunds" found under § 6411.[92] Tax scholars point out that "[t]he legislative history observed that the drafters confined the new rule to carrybacks of losses and business credits because of the availability of an expedited refund procedure for such amounts."[93] Thus, Congress wanted to limit the availability of interest because the taxpayer was already getting a faster refund than it would under the standard procedure of § 6402. If the IRS had to pay interest from the day the application was filed, it would drastically increase the difficulty of getting a tentative allowance and would frustrate the purpose of the tentative allowance, which is to give a quick refund to corporations to facilitate reconversion. If interest is due from the date of the application, the IRS has an incentive to disallow the application, even if it found an error that could be corrected in the ninety-day time period, because the IRS would not want to pay interest. Since the taxpayer cannot challenge the IRS's decision on a tentative allowance, the taxpayer would be forced to file a claim for refund under § 6402 and wait even longer for that to be approved. This would inevitably cost the taxpayer a lot of trouble and time, defeating the purpose of the tentative allowance. Thus, the court was correct in refusing to look past the fact that the IRS paid the original tentative allowance within forty-five days and that § 6611(e) specifically forbade payment of interest in such circumstances.

B. *Effect on Taxpayers*

The ruling in *Soo Line* will have no detrimental effect on taxpayers where the facts are identical. While neither Soo Line nor the future taxpayer will be able to collect interest in this circumstance when the IRS adjusts the tentative allowance, that is a factor the taxpayer must consider when deciding to apply for a tentative allowance under § 6411 or a refund under § 6402. If the taxpayer decides to apply for a tentative allowance and does not initially receive interest because he receives the allowance within forty-five days, the taxpayer is then no worse off if the IRS reduces the allowed refund later and refuses to pay interest. The taxpayer would not have received interest either way. There are cases, though, in which strict adherence to the forty-five day rule causes an unfair result for the taxpayer. Courts have chosen to enforce the rule as written under § 6611(e) even when it prejudices the taxpayer.

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92 James Salles & Stafford Smiley, *"45-Day Rule" Can Pose Problems For Foreign Tax Credit Carryback Claims*, 35 CORP. TAX'N 36, 36 (2008).

93 *Id.*

In *Hunt v. United States*, the IRS issued deficiencies in August of 1991 on the taxpayer's 1983 and 1985 tax years.[94] The taxpayer, Hunt, brought suit in the United States Tax Court in November of 1991.[95] The parties settled, and final settlement documents were filed in the Tax Court in December of 1993.[96] The settlement acknowledged that the IRS had erred in issuing a deficiency and that Hunt had properly reported an NOL for 1985 that he could carry back to 1982.[97] This entitled Hunt to a refund in the amount of $57,571.[98] The question then became whether Hunt was entitled to interest on the overpayment.[99] During the settlement negotiations, Hunt's understanding was that he was settling for the overpayment and interest.[100] After the final settlement papers were filed in the Tax Court, the IRS advised Hunt that in order to receive his refund, he would have to file a Form 1040X for his 1982 tax year.[101] Hunt filed the Form 1080X on March 12, 1994.[102]

On March 28, 1994, more than three years after the IRS erroneously issued a deficiency in Hunt's 1985 tax year, but just sixteen days after Hunt filed for a refund, the IRS credited the refund to Hunt's other tax years.[103] The IRS took the position that, because it made this payment within forty-five days of the application date, no interest was due under § 6611(e).[104] The United States District Court for the District of Maryland ruled in favor of Hunt, not because § 6611(e) did not apply, but under an equitable estoppel theory.[105] The Court of Appeals for the Fourth Circuit reversed, finding that equitable estoppel could not require the Government to make a payment when it violated a statute because to do so would violate the Appropriations Clause.[106] The Court of Appeals instead concluded that strict adherence to the forty-five day rule was necessary, and that Hunt was not entitled to interest since the IRS paid the refund within forty-five days of his application date.[107]

Hunt is a prime example of how the forty-five day rule can work against the taxpayer. Here, the IRS erroneously issued a deficiency that

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94 Hunt v. United States, 94 F. Supp. 2d 665, 666 (D. Md. 2000), *rev'd sub nom.* Estate of Hunt v. United States, 103 F. App'x 475, 476 (4th Cir. 2004).

95 *Estate of Hunt*, 103 F. App'x at 476.

96 *Hunt*, 94 F. Supp. 2d at 666.

97 *Estate of Hunt*, 103 F. App'x at 476.

98 *Hunt*, 94 F. Supp. 2d at 666.

99 *Id.*

100 *Id.* at 667.

101 *Id.* at 668.

102 *Id.*

103 *Id.*

104 *Hunt*, 94 F. Supp. 2d at 668.

105 *Estate of Hunt*, 103 F. App'x at 477.

106 *Id.*

107 *Id.* at 478-79.

was later settled, determining that the taxpayer was correct in ascertaining the amount of a NOL and carrying it back to a previous tax year. However, when the taxpayer requested interest on the overpayment, the only consideration was that the refund was paid within forty-five days of the application. Hunt was instructed to file a claim for refund, which he did on March 12, 1994, and the date of this claim was used to determine if interest should be paid. Neither the date of the settlement and overpayment refund in December 1993, nor the date of the overpayment starting April 15, 1986, mattered for the IRS's calculation. Having paid Hunt's 1994 refund claim within forty-five days, the IRS simply determined that the taxpayer was not due interest, even though the overpayments stemmed from the IRS's error. Thus, the taxpayer was without money rightfully due to him for several years.

Strict adherence to the forty-five day rule has detrimental effects on taxpayers such as Hunt. If the IRS makes a mistake in their calculation of a taxpayer's income tax, it could be years before the mistake is corrected and the taxpayer is refunded his money. Not only would the IRS not refund the taxpayer's money until the dispute is settled, but the IRS would also not give the taxpayer interest if the money were repaid within forty-five days of filing an application for refund, no matter how long the IRS erroneously held the taxpayer's money. Such strict adherence to this rule creates a perverse incentive for the IRS to automatically issue a deficiency if it thinks there is a remote chance the taxpayer could have underpaid his income taxes. If the IRS does not have to worry about paying interest regardless of how long it holds the taxpayer's money, it has no incentive to not issue a deficiency and makes the taxpayer overpay until the dispute is settled.

C. *Unanswered Questions from* Soo Line

The court in *Soo Line* left several questions unanswered. First, the court failed to specify which of the principles discussed above was the main reason the court did not grant Soo Line interest. Second, the court's discussion of the interaction between §§ 6411 and 6611(e) leaves two questions: (1) when the tentative allowance application expires, taking it out of the forty-five day rule; and (2) under what later events, if any, is a taxpayer allowed to collect interest.

Regarding the first question, the court seemed to focus mostly on the fact that the final amount owed Soo Line was less than the original tentative allowance. If this is the case, then *Soo Line* might be erroneously used as precedent to decide cases that are not as obvious and should lean towards granting the taxpayer interest. Considering the second question, the court gave no guidance on when the tentative allowance application expires and the taxpayer might be able to collect interest again. Using strict adherence to the forty-five day rule and the main focus of the *Soo Line* court, the re-

cent case *Coca-Cola Co. v. United States*[108] sheds light on some problems courts will face when deciding how to apply § 6611(e) to § 6411.

1. *Coca-Cola Co. v. United States*, 87 Fed. Cl. 253 (2009)

In *Coca-Cola Co.*, Coca-Cola filed a Form 1139 (Corporation's Application for a Tentative Refund) in 1985 requesting a refund for its 1981 tax year with respect to a net operating loss/credit carryback from its 1984 tax year.[109] The IRS issued this tentative allowance twelve days later without interest, consistent with I.R.C. § 6611(e) because the refund was paid within forty-five days.[110] In 1991, as the procedure under § 6411 prescribes, the IRS audited Coca-Cola's 1981 tax return and assessed additional tax and deficiency interest.[111] The additional tax liability arose from the IRS's recapture of a significant portion of the carryback from the 1984 net operating loss/credit.[112] Coca-Cola then paid the additional assessments and filed Form 1120X (Amended U.S. Corporation Income Tax Return) seeking a refund for the amount recaptured plus interest.[113] Coca-Cola brought suit in the United States Tax Court to determine if the IRS was correct in recapturing part of the carryback and thus disallowing part of Coca-Cola's tentative allowance.[114]

The United States Tax Court in 1997, twelve years after the IRS granted the original tentative allowance, entered a stipulated decision finding that the IRS owed Coca-Cola a refund for an overpayment for the 1981 tax year, the year for which the original tentative allowance was granted.[115] As a result of the Tax Court decision, the IRS refunded Coca-Cola an amount less than but almost equal to the original tentative allowance.[116] The IRS did not refund any allowable or statutory interest to Coca-Cola for the interim overpayment that existed between March 15, 1985 and September 27, 1985 after the IRS abated Coca-Cola's 1981 taxes.[117]

The issue in *Coca-Cola Co.* is whether the final judgment can relate back to the tentative allowance that was paid within forty-five days and is less than the original amount owed, creating another situation in which the taxpayer is not due interest. There are certainly arguments for the taxpayer and the IRS. Following precedent, it appears that strict adherence to the

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108 Coca-Cola Co. v. United States, 87 Fed. Cl. 253 (2009).

109 *Coca-Cola Co.*, 87 Fed. Cl. at 254.

110 *Id.*

111 *Id.* at 254-55.

112 *Id.* at 255.

113 *Id.*

114 *Id.*

115 *Coca-Cola Co.*, 87 Fed. Cl. at 255.

116 *Id.*

117 *Id.*

forty-five day rule under § 6611(e) applies, and Coca-Cola would not be due interest. Both in *Soo Line* and *Estate of Hunt*, the court did not look at the surrounding circumstances and simply focused on the expedience under which the refund was paid.[118] As in both *Soo Line* and *Hunt*, the original tentative refund in *Coca-Cola Co.* was also paid within forty-five days. The events following the original tentative refund do not change the circumstances. Although the IRS erroneously recaptured the allowance and assessed a deficiency, similar to *Hunt*, this did not change the fact that the initial payment was made within forty-five days.[119] Moreover, the final refund amount to Coca-Cola was less than the original tentative allowance—the criterion upon which the court in *Soo Line* seemed to have based its opinion.[120] Although the circumstances here are different, a strict reading and enforcement of *Soo Line* seems to indicate that Coca-Cola would not be due interest.

Conversely, several arguments can be made in favor of Coca-Cola receiving interest. First, although the tentative allowance was paid within forty-five days, the Tax Court's ruling was not related to the tentative allowance. No suit or claim can arise from a tentative allowance.[121] But Coca-Cola filed suit in the United States Tax Court. This happened only after it filed a formal claim for a refund with Form 1120X. Thus, the overpayment was no longer related to the tentative allowance, but was instead related to a claim of refund, under which interest is payable per § 6611(a).[122] If courts accepted this argument, it would answer the question of when the application for a tentative allowance expires, making the original refund in forty-five days irrelevant. The argument makes the forty-five day rule involving tentative allowances effective until a formal claim for a refund is made pertaining to the same funds. After a formal claim is filed, the tentative allowance application and the forty-five day payment rule should no longer be pertinent. Interest would start accruing forty-five days after the date the claim for a refund was filed.

Second, although the final overpayment was less than the original tentative allowance, *Coca-Cola Co.* is different from *Soo Line* because Coca-Cola did not have possession of the refund while its case was in dispute. The IRS in *Coca-Cola Co.* recaptured part of the tentative allowance, possessing it for more than six years until the Tax Court finally determined that Coca-Cola was legally entitled to the money. Practically and under the use of money doctrine, the IRS should owe Coca-Cola interest for holding its

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118 *See Soo Line R.R. Co.*, 44 Fed. Cl. 760, 762-64 (1999); *Estate of Hunt*, 103 F. App'x at 478.

119 *See Hunt*, 94 F. Supp. 2d 665, 666 (2000).

120 *See Soo Line R.R. Co.*, 44 Fed. Cl. at 762-64.

121 Columbia Gas Sys. Inc. v. United States, 32 Fed. Cl. 318, 323 (1994); *see* I.R.S. Instructions for Form 1139 (Rev. Mar. 2009), http://www.irs.gov/pub/irs-pdf/i1139.pdf.

122 I.R.C. § 6611(a) (2009) ("Interest shall be allowed and paid upon any overpayment in respect of any internal revenue tax . . .").

money and depriving Coca-Cola of its use. Why should the IRS get to earn interest on someone else's money? If this is allowed, the previously mentioned perverse incentives will become a reality, and the IRS will be encouraged to act improperly.

Although it seems logical and practical that the IRS should not earn interest on someone else's money, the I.R.C. is not always logical or practical. In fact in many circumstances where the IRS should owe the taxpayer a refund from the standpoint that the money does not rightfully belong to the IRS, the I.R.C. does not grant the taxpayer a refund. For instance, in *United States v. Lewis* the taxpayer, Lewis, received approximately $22,000 as a bonus from his employer that he recorded as income and paid taxes on for the 1944 tax year.[123] In 1946, the Court of Claims found that Lewis' bonus should have only been about $11,000, rather than the $22,000 he received.[124] Lewis was ordered to repay his employer the excess amount.[125] Lewis filed a claim for a tax refund in the Court of Claims asserting that he should be able to recalculate his 1944 tax year so that he would be refunded for the taxes he paid on the approximately $11,000 that he had to return to his employer.[126] The Court of Claims agreed with Lewis' position and awarded him approximately $7,000, the difference between the taxes he already paid and the taxes that he should have paid if his bonus was calculated correctly at the time.[127] The Supreme Court disagreed and found that under the claim of right doctrine[128] the taxpayer's taxes for 1944 should not be recomputed and the IRS did not have to refund any money to Lewis.[129] Instead, the Court found that Lewis could take a deduction in 1946 for the amount he gave back to his employer.[130] Refusing to allow a recalculation of a previous year's tax filing causes prejudice to the taxpayer because he is not refunded the taxes that he paid on money he no longer has. He will receive a deduction in a future year, but such a deduction only reduces income and does not necessarily equal the amount in taxes that the IRS unrightfully kept.[131] Essentially, the claim of right doctrine allows the IRS to

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123 United States v. Lewis, 340 U.S. 590, 590 (1951).

124 *Id.*

125 *Id.*

126 Lewis v. United States, 91 F. Supp. 1017, 1019 (Ct. Cl. 1950).

127 *Id.* at 1019, 1022.

128 Under the claim of right doctrine, a taxpayer has to report income he is entitled to or has a claim of right to in the year he received it, and if, in a subsequent year, it is decided that the taxpayer is no longer entitled to the income, his only option is to deduct the amount of that income in the year of repayment; he cannot recalculate his income for the year of receipt. The claim of right doctrine is enforced to ensure finality of the annual accounting period. *Lewis*, 340 U.S. at 592.

129 *Id.* at 591.

130 *Id.* at 592.

131 Because Congress found that in many circumstances that the deduction allowed in the later year did not compensate the taxpayer adequately for the tax paid in the earlier year, Congress enacted I.R.C. § 1341. *See* United States v. Skelly Oil Co., 394 U.S. 678, 680-81 (1969); 26 U.S.C. § 1341 (2009).

keep taxes that it should no longer have a right to because the payment was made on money that was not income to the taxpayer.

Third, from a policy perspective, if interest is denied in *Coca-Cola Co.*, the court would create even more perverse incentives for the IRS. If the IRS is not required to pay interest to the taxpayer after erroneously recapturing a refund, the IRS could issue a refund within forty-five days to every taxpayer who requests a tentative refund, recapture it, and hold on to the money until the taxpayer goes through the complete recovery process. This would allow the IRS to earn interest on the money due to the taxpayer until a final judgment is reached and the courts order the IRS to refund the original allowance. This would defeat Congress's original intention of § 6411, which was to quickly refund money to corporate taxpayers.

If the court applied *Soo Line* and the forty-five day rule strictly, then it should have ruled that Coca-Cola was not due interest. However, this is not how the United States Court of Federal Claims ruled. The court ruled that Coca-Cola was due interest on the interim overpayment.[132] The court analyzed the above arguments for and against issuing interest and found that the arguments for issuing interest were greater than the arguments against issuing interest. Specifically, the court noted that since a decision regarding a § 6411 allowance is final, Coca-Cola had no other option than to file a regular § 6402 claim for refund after the IRS partially recaptured the original tentative allowance.[133] This meant that the overpayment the Tax Court decided was due Coca-Cola had to relate to the claim for refund under § 6402 for which interest was not paid within forty-five days.

The court also noted that even though a "statutory interpretation begins with the statute's text, structure, and purpose, ultimately, 'it is the reasonableness of the interpretation that controls.'"[134] The court agreed that a strict reading of § 6611(e) would prohibit Coca-Cola from receiving interest but emphasized that this strict reading would require the court to ignore significant subsequent events and the IRS's erroneous recapture of the tentative allowance.[135] Alluding to the use of money doctrine, the court was not willing to ignore subsequent events because "the IRS did not restore plaintiff at all, recapturing and withholding money from January 23, 1991 to May 19, 1997 to which plaintiff was rightfully entitled."[136] The court

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See H.R. REP. NO. 83-1337, at 86, *reprinted in* 1954 U.S.C.C.A.N. at 4113. Section 1341 allows a taxpayer in some circumstances to go back and recalculate his taxes for the earlier year instead of taking a deduction in the later year. *See Skelly Oil Co.*, 394 U.S. at 682; I.R.C. 1341 (2009). The claim of right doctrine is still used occasionally today but it took Congressional action to allow the Court to come to the more logical result and give the taxpayer what he was due.

132 *Coca-Cola Co.*, 87 Fed. Cl. at 260.

133 *Id.* at 258.

134 *Id.* at 258-59 (quoting Prati v. United States, 81 Fed.Cl. 422, 430-31 (2008)).

135 *Id.* at 259.

136 *Id.*

thought this was illogical and would promote the perverse incentives mentioned in the policy argument above.[137]

The court correctly ruled in favor of Coca-Cola. Not only did the IRS erroneously recapture part of the NOL, but it also held onto the taxpayer's money for years. In addition, the taxpayer sued the Commissioner in the United States Tax Court, and an application for a tentative allowance could not lead to this result since a suit could not arise from the claim. To bring a suit in the Tax Court, the taxpayer had to file a formal claim for refund. The argument can thus be made that this refund claim extinguished the tentative allowance and the overpayment the taxpayer was due resulted from the former and not the latter. Since the overpayment resulted from the claim for refund, the tentative refund that was paid within forty-five days has no bearing on whether interest is due on the final overpayment.

2. Congressional Amendments to the I.R.C.

Although the Court of Federal Claims correctly ruled in favor of Coca-Cola, the questions left unanswered in *Soo Line* will perpetuate until Congress passes an amendment to § 6411 to clarify how it interacts with §§ 6402 and 6611. One of the main issues Congress should clarify is how long the effects of a tentative refund under § 6411 will linger. As seen in the *Coca-Cola Co.* case, it can be unclear when the effects of a tentative refund end and the effects of a claim for refund begin. Congress should amend § 6411 to state that once a standard claim for refund is filed under § 6402, the overpayment is no longer a result of the original tentative allowance application, but is instead subject to the rules under § 6402. This amendment would not alter any of Congress's intended consequences of either §§ 6411 or 6402. Further, it would allow the same correct conclusion of both *Soo Line* and *Coca-Cola Co.* and give a concrete explanation for the conclusion.

Additionally, Congress could amend § 6411 to deal specifically with recapture events and its effects on the original tentative allowance. For example, to prevent perverse incentives, Congress could create an amendment stating that if the IRS erroneously recaptures all or a portion of the original tentative allowance, then interest should be paid on the time the allowance was erroneously held by the IRS. Both amendments would clarify the question of when interest is or should be paid under § 6411 and would prevent some of the unfair results that can currently occur when §§ 6411 and 6611(e) overlap. This amendment again would not alter Congress's original intent for either section and would be effective when interest is due in exceptional circumstances. This amendment would allow the IRS to give a quickie refund and challenge that refund at a later time, but it

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137 *Id.*

would not give the IRS the opportunity to recapture a taxpayer's money and collect interest on it while the taxpayer takes legal action to recover the original amount.

Both these amendments are sufficiently in-depth to cover the problems currently found under § 6411 but are tailored enough to not interfere with Congress's original intent of § 6411 or any other section in the I.R.C. To prevent further problems and legislation, Congress should consider amending § 6411 of the Code.

IV. CONCLUSION

Sections 6411 and 6611(e) of the I.R.C. may be easy to understand on their own, but when aggregated, complications and confusion quickly arise. The *Soo Line* court, in reaching the correct decision to withhold interest from the taxpayer, attemped to make the application of the two sections less complicated. However, the court left several questions unanswered, creating a dangerous precedent. In relation to § 6411 and the tentative allowance application, § 6611(e) cannot be applied strictly in every circumstance, and the courts must consider other factors in deciding whether a taxpayer is due interest on an overpayment, as displayed in *Coca-Cola Co.* The court in *Coca-Cola Co.* took a great step away from the dangerous path of strict adherence to § 6611(e). However, if the courts stray from this ruling and revert back to applying § 6611(e) strictly, Congress will be left to enact legislation to protect the taxpayer and take away the perverse incentives for the IRS.

To solve these problems, Congress should modify the current I.R.C. sections. Congress could retain all the intended consequences of §§ 6411, 6402, and 6611 while making necessary amendments to § 6411. Congress could either amend § 6411 to clarify how long the effects of § 6411 last or amend § 6411 to clarify what interest is due when the tentative allowance is recaptured. Both amendments would help clarify the Code and reduce unnecessary litigation between taxpayers and the IRS.

UNLOCKING ACCESS TO INSURANCE COVERAGE FOR AUTISM TREATMENT

*Angela Barner**

INTRODUCTION

Autism is a neurological disorder "with no known cause and no cure"[1] that "inhibits a person's ability to communicate and develop social relationships, [and] is often accompanied by extreme behavioral episodes."[2] It causes complex developmental disabilities that interfere with "verbal and nonverbal communication and social interactions."[3] Leo Kanner of Johns Hopkins University first identified autism in 1943, while German scientist Hans Asperger identified a less severe version of the condition around the same time.[4] Autism became a specific clinical diagnosis in 1980, and has since evolved to include a spectrum of disabilities.[5]

The Health Resources and Services Administration estimates that 1 out of every 100 children are autistic,[6] which makes autism "more common than pediatric cancer, diabetes, and AIDS combined."[7] It is also "more common in children than hearing loss or vision impairment."[8] Boys are four times more likely than girls to be diagnosed with autism.[9] Autism spectrum disorder has been called "mind blindness" because it "affects the

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1 Barbara Kantrowitz & Julie Scelfo, *What Happens When They Grow Up*, NEWSWEEK, Nov. 27, 2006, at 46, *available at* http://www.newsweek.com/id/44634/page/1.

2 Tom Reinke, *States Increasingly Mandate Special Autism Services*, MANAGED CARE, Aug. 2008, http://www.managedcaremag.com/archives/0808/0808.autism.html.

3 Compl. at 4, Johns v. Blue Cross Blue Shield of Michigan, No. 2:08-cv-12272 (E.D. Mich. May 23, 2008).

4 Kantrowitz & Scelfo, *supra* note 1.

5 *Id.*

6 Carla K. Johnson, *More Kids Have Autism Than Thought*, ASSOCIATED PRESS, Oct. 5, 2009, *available at* http://hosted.ap.org/dynamic/stories/U/US_MED_AUTISM_HOW_MANY?SITE=WSAW&SECTION=HOME&TEMPLATE=DEFAULT.

7 Autism Speaks, *Arguments In Support of Private Insurance Coverage of Autism-Related Services* 5 Oct. 24, 2007, http://www.autismspeaks.org/docs/arguments_for_private_insurance_coverage.pdf.

8 Elizabeth Hervey Osborn, *What Happened to "Paul's Law"?: Insights on Advocating For Better Training and Better Outcomes in Encounters Between Law Enforcement and Persons With Autism Spectrum Disorders*, 79 U. COLO. L. REV. 333, 339 (2008).

9 Autism Speaks, *supra* note 7, at 5.

brain's ability to understand and process many kinds of sensory information vital to understanding language and social interaction, including sight, sound, and touch."[10] Autism disorders are characterized by "obsessive behaviors, excessive rigidities, limited social skills, and communication deficits."[11]

Without proper treatment, autistic children may "grow into adulthood without the ability to perform the most basic functions."[12] The Harvard School of Public Health notes that in the United States, lifetime care for an autistic person costs about $3.2 million.[13] Across the nation, families with autistic children are struggling to determine how to pay for early treatments that teach autistic children basic functions.[14] One effective treatment option is Applied Behavioral Analysis therapy (ABA).[15] However, according to Autism Speaks, there are few private insurance companies that cover ABA or other behavioral therapies.[16] "Behavioral therapy sits between the medical interventions most insurers feel compelled to help with, and the experimental treatments most of them see as more developmental than clinical."[17] ABA raises controversy about whether it is an educational or medical service that can address clinical issues.[18] For instance, Kaiser Permanente has stated that ABA therapy is "primarily used to change behavior to achieve educational objectives rather than address clinical problems."[19] Determining whether private health insurance or special education services funded by the government should pay for autism treatment is a question of public policy for the legislature.[20]

This article argues that mandated insurance coverage for ABA is necessary and is the most efficient option for society. Treatment is typically given in the educational system, but the education system is already financially strained.[21] In practice, this means that health insurance companies must assume the financial burden for autistic children—approximately

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10 Osborn, *supra* note 8, at 338 n.33 (citing SIMON BARON-COHEN, MINDBLINDNESS: AN ESSAY ON AUTISM AND THEORY OF MIND (1997)).

11 Barbara Firestone, C.A. Garland & Michael O'Hanlon, THE BROOKINGS INSTITUTION, *Autism and Hope,* Nov. 23, 2005, http://listsignup.brookings.edu/opinions/2005/1123healthcare_ohanlon.aspx.

12 Compl. at 4, Johns v. Blue Cross Blue Shield of Michigan, No. 2:08-cv-12272 (E.D. Mich. May 23, 2008).

13 Kantrowitz & Scelfo, *supra* note 1.

14 *See* Autism Speaks, *supra* note 7, at 7.

15 *See id.* at 10.

16 *See id.* at 8.

17 Mary Jo Feldstein, *Autistic and Uncovered*, ST. LOUIS POST-DISPATCH, Apr. 14, 2008, at A1.

18 Reinke, *supra* note 2.

19 *Id.*

20 *Id.*

21 The debate over what proportion of treatment options should be paid for by private insurers as opposed to state and federal governments is a topic with a proliferation of arguments on both sides; it is best left to another paper.

$50,000 per year per child—currently shouldered by families and school districts.[22]

Part I of this paper describes ABA therapy by specifically addressing its function and effectiveness, and provides an overview of state insurance laws for autism treatment. Next, Part I examines state statutes that mandate treatment for behavioral therapies, including ABA, in South Carolina, Texas, Indiana, Arizona, Louisiana, and Pennsylvania. It also presents a Minnesota case-settlement approach that effectively mandates insurance coverage for autism treatment, a New Jersey case where one family successfully challenged their insurer to cover autism treatment, and an ongoing case that challenges an insurer to cover ABA in Michigan. Finally, Part I provides examples of private companies, such as Microsoft, Eli Lilly, and Home Depot which provide coverage for ABA therapy through private insurers.

Part II analyzes the costs of mandating insurers to cover treatment of behavioral therapies by considering both the economic and social benefits in mandating such coverage.[23] Part II also considers the unintended incentives that result from such insurance mandates. As parents and society organize on behalf of autistic children, a number of state legislatures will soon face the challenge of drafting appropriate legislation.[24] Part III proposes model legislation lawmakers may use in mandating insurance coverage of ABA.

I. BACKGROUND

A. *Description of ABA Therapy*

1. How ABA Treatment Works

ABA is a treatment that consists of frequent, repetitive, one-on-one interactions between therapist and child to increase social learning and communication and decrease inappropriate behavior.[25] Thomas Higbee, director of ASSERT Autism Program at Utah State University, explains this interaction, also known as Discrete Trial Teaching (DTT), in his article *Autism*

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[22] Victoria Craig Bunce, THE COUNCIL FOR AFFORDABLE HEALTH INSURANCE, TRENDS IN STATE MANDATED BENEFITS, 2008 1 (May 2008), http://www.cahi.org/cahi_contents/resources/pdf/TrendsEndsMandatedBenefits2008.pdf.

[23] Behavioral therapy is the most researched form of treatment; however, there are many other treatment options such as nutrition and speech therapy, which the child's health care provider may consider to determine the best individual treatment option.

[24] *See* Autism Speaks, *Autism Speaks State Initiatives*, Oct. 24, 2007, http://www.autismvotes.org/site/c.frKNI3PCImE/b.3909861/k.B9DF/State_Initiatives.htm.

[25] NATIONAL INSTITUTE OF MENTAL HEALTH, *Autism: Treatment Options*, ENOTALONE (2009), http://www.enotalone.com/article/6867.html.

and Applied Behavior (ABA): Its More Than You Think!.[26] ABA therapists also use other techniques such as social scripting, video modeling (an approach that creates footage of "model" behaviors involving a variety of skills which are then played for the autistic individual who has an opportunity to imitate a similar behavior), photographic activity schedules (the use of "a sequence of pictures that serve as cues for children with disabilities to independently complete complex chains of behaviors" such that verbal prompts are removed from the situation teaching the autistic individual not to rely on an outside party but rather to act more independently), and "mand training" (a technique which uses the natural motivation of an autistic individual to request an item to prompt him to then make an appropriate communicative response in order to obtain that item).[27] Through these techniques, ABA teaches "social, motor, and verbal" behavioral and reasoning skills.[28]

Early intervention is especially useful before age ten because one-on-one intervention stimulates the brain's neurons as information is processed. Around age ten, inactivated neurons are lost as the brain shifts away from acquiring new synapses.[29] During early interactions between autistic children and ABA therapists, therapists will guide the child through repetitive actions to increase social interactions. For instance, a therapist might encourage the child to do basic tasks such as making eye contact, giving a high-five, or passing a building block. Or, the therapy session might "spend hours practicing how to answer a question with an appropriate answer."[30]

2. The Effectiveness of ABA Treatment

According to advocacy organization Autism Speaks' evaluation of a 1987 study by O. Ivar Lovaas[31] and a 1993 study by John J. McEachin, with

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[26] Thomas S. Higbee, *Autism and Applied Behavior Analysis (ABA): It's More Than You Think!*, UTAH SPECIAL EDUCATOR, Feb. 2008, at 16-19, *available at* http://www.cpdusu.org/newsflash/2008-05-01/aba.

[27] *Id.*

[28] Compl. at 7, Johns v. Blue Cross Blue Shield of Michigan, No. 2:08-cv-12272 (E.D. Mich. May 23, 2008).

[29] Leah M. Helvering, Address Before the Indiana Commission on Autism 4 (Sept. 26, 2008), *available at* http://www.ai.org/legislative/interim/committee/2000/committees/minutes/AUTI39Q.pdf.

[30] Larry Abramson, *Family Wins Suit for Autistic Son's Health Care*, NAT'L PUB. RADIO, Oct. 7, 2008, http://www.npr.org./templates/story/story.php?storyId=14577821.

[31] Autism Speaks, *supra* note 7, at 9 (citing O. Ivar Lovaas, *Behavioral Treatment and Normal Educational and Intellectual Functioning In Young Autistic Children*, 55 J. CONSULTING & CLINICAL PSYCHOL. 3-9 (1987)).

Lovaas and Smith,[32] ABA therapy resulted in both short-term and long-term gains in intellectual functioning and educational progression.[33] The 2001 U.S. Surgeon General's Report on Mental Health validated that ABA minimizes socially inappropriate behavior, while increasing socially appropriate behavior, communication, and learning.[34] The New York State Department of Health Bureau of Early Intervention considers ABA "an essential element of any intervention program for young autistic children."[35] "The Association for Science in Autism Treatment endorses ABA as the only treatment modality with scientific evidence supporting its effectiveness."[36] Furthermore, Louis Hapogian and Eric Boelter of the Kennedy Krieger Institute and Johns Hopkins University School of Medicine stated that, "Over the past 40 years a large body of literature has shown the successful use of ABA-based procedures to reduce problem behavior and increase appropriate skills," and "[b]ased on the empirical evidence, many scientific, government, and professional agencies and organizations have concluded that ABA-based procedures represent best practices for individuals with autism."[37] Further emphasizing that ABA is a best practice, Hapogian and Boelter noted that the American Association for Intellectual and Developmental Disabilities assigned ABA therapies its highest possible rating."[38] Finally, Hapogian and Boelter conducted a survey of scientific and governmental organizations which indicates that many have concluded ABA is highly effective.[39]

Yet many insurance companies that refuse to cover ABA therapy "view it as experimental and unproven."[40] Cigna and Aetna are two private insurers who sent press releases to National Public Radio (NPR) stating that they do not cover experimental therapies, including ABA.[41] According to an NPR story, "Pamela Greenberg of the Association for Behavioral Health

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[32] *Id.* at 13 (citing J.J. McEachin, T. Smith & O. Ivar Lovaas, *Long-Term Outcome for Children with Autism Who Received Early Intensive Behavioral Treatment*, 97 AM. J. ON MENTAL RETARDATION 359-72 (1993)).

[33] *Id.* at 10.

[34] *Id.* at 11 (citing U.S. DEP'T OF HEALTH AND HUMAN SERVS., MENTAL HEALTH: A REPORT OF THE SURGEON GENERAL, 163-64 (1999)).

[35] Compl. at 8, Johns v. Blue Cross Blue Shield of Michigan, No. 2:08-cv-12272 (E.D. Mich. May 23, 2008).

[36] *Id.*

[37] Louis Hapogian & Eric Boelter, *Applied Behavior Analysis and Neurodevelopmental Disorders: Overview and Summary of Scientific Support*, KENNEDY KRIEGER INSTITUTE (2005), http://www.kennedykrieger.org/kki_misc.jsp?pid=4761.

[38] *Id.*

[39] *Id.* (The named organizations are: National Institute of Mental Health; The National Academies Press; Association for Science in Autism Treatment; Autism Speaks; Organization for Autism Research; Surgeon General of the United States; New York State Department of Health; and Maine Administrators of Services for Children with Disabilities).

[40] Abramson, *supra* note 30.

[41] *Id.*

and Wellness says there is just not enough data on the effectiveness of ABA therapy."[42] She said that there are examples where ABA treatment has been "very effective," yet other examples where it has been "very harmful."[43] However, James Todd of the Behavior Analysis Association of Michigan (BAAM) posted a letter in response to Ms. Greenberg's comment, challenging her statement and asserting that there is no "evidence from reputable, peer-reviewed journals that any kind of harm results from intensive ABA treatments for autism as conducted by qualified and ethical professionals."[44]

The Lovaas and McEachin studies demonstrated the effectiveness of early intervention therapy, contradicting the notion that ABA treatment is experimental.[45] Early therapeutic intervention for autistic children could be the key difference between an autistic child developing into an adult needing full-time care and an adult capable of living a productive life.[46] According to Andrew Zimmerman, Pediatric Neurologist and Medical Autism Research Director at the Kennedy Krieger Institute in Baltimore, numerous studies provide evidentiary support that ABA improves the lives of autistic children, and enables them to function more normally.[47]

B. *ABA Insurance Coverage*

1. An Overview of Insurance Laws for Treating Autism

Time is precious given the necessity of making ABA therapy available to autistic children during a narrow window of opportunity.[48] Autism treatment is very expensive, and when insurers deny coverage or act slowly in deciding to cover ABA therapy, families must pay out-of-pocket or watch their child's window of opportunity close.[49] Families battling for the best possible treatment for their autistic child struggle with an immense financial burden. To afford treatment, parents of autistic children may work multiple jobs, take out second mortgages, or sacrifice saving for their

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42 *Id.*

43 *Id.*

44 Letter from James T. Todd, Ph. D., to Pamela Greenberg, Association for Behavioral Health and Wellness (July 7, 2009), http://www.baam.emich.edu/baampracticewatch/baamabhwletter.htm.

45 Autism Speaks, *supra* note 7, at 10.

46 Firestone et al., *supra* note 11.

47 Reinke, *supra* note 2; *see* Svein Eikeseth *Outcome of comprehensive psycho-educational interventions for young children with autism*, 30 RES. IN DEVELOPMENTAL DISABILITIES 158-78 (2009).

48 Milt Freudenheim, *Battling Insurers Over Autism Treatment*, N.Y. TIMES, Dec. 21, 2004, at C1, *available at* http://depts.washington.edu/uwautism/pdf/NYT-AutismInsuranceTreatment.pdf.

49 *See* Erica Noonan, *Push on for insurers to share autism costs*, THE BOSTON GLOBE, Sept. 16, 2008, at A1, *available at* http://www.communityresourcesforautism.org/matriarch/documents/Push%20on%20for%20insurers%20to%20share%20autism%20costs%20-%20The%20Boston%20Globe.pdf.

other children's college educations.[50] Still, families that are able to provide treatment for their autistic child are more fortunate than those who simply cannot earn the wages necessary to pay for care. As noted, a Harvard School of Public Health study indicated that in the United States "[c]aring for all persons with autism over their lifetimes costs an estimated $35 billion per year."[51] This burden has fueled a nationwide trend where autism advocates are requesting state mandates that require insurers to pay for medical treatment for autistic children, specifically ABA therapy.[52]

According to the Office of Legislative Research's Research Project Report:

> [E]ight [states] require coverage for behavioral treatment services for the treatment of autism (Arizona, Florida, Indiana, Kentucky, Louisiana, Pennsylvania, South Carolina, and Texas) and five require other coverage related to autism (Colorado, Georgia, Maryland, New York, and Tennessee) . . . Nine other states include autism in their laws mandating coverage for mental illness (California, Illinois, Iowa, Kansas, Maine, Montana, New Hampshire, New Jersey, and Virginia) . . .
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> The laws most recently enacted (Arizona, Florida, Louisiana, Pennsylvania, and South Carolina) generally require coverage for Applied Behavioral Analysis services, establish benefit maximums, and do not apply to individual health insurance policies or policies issued to small employers (50 or fewer employees).[53]

It is useful to consider and understand specific state mandates,[54] which require "a health insurance policy or health plan to cover (or offer to cover) specific providers, procedures, benefits or people."[55] In particular, this paper evaluates insurance mandates in South Carolina,[56] Texas,[57] Indiana,[58] Arizona,[59] Louisiana,[60] and Pennsylvania.[61] The following chart compares the statutes side by side.[62]

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50 *See* Freudenheim, *supra* note 48.

51 Press Release, Harvard School of Public Health, Autism Has High Costs to U.S. Society (Apr. 25, 2006) *available at* http://www.hsph.harvard.edu/news/press-releases/2006-releases/press04252006.html; *see also* Kantrowitz & Scelfo, *supra* note 1.

52 *See generally* Bunce, *supra* note 22.

53 Janet L. Kaminski Leduc, Private Insurance Coverage for Treatment of Autism, OLR Research Report, July 31, 2008, *available at* http://www.cga.ct.gov/2008/rpt/2008-R-0427.htm.

54 Autism Votes reported that on March 20, 2009 New Mexico passed legislation mandating insurance coverage up to $36,000 per year until the child turns nineteen or twenty-two so long as the child remains in high school.

55 Bunce, *supra* note 22, at 1.

56 S.C. CODE ANN. § 38-71-280 (2007).

57 TEX. INS. CODE ANN. § 1355.015 (Vernon 2007).

58 IND. CODE § 27-8-14.2 (2001).

59 ARIZ. REV. STAT. ANN. §§ 20-826.04, 20-1057.11, 20-1402.03, 20-1404.03 (2008).

60 LA. REV. STAT. ANN. § 22:1050 (2008).

61 40 PA. CONS. STAT. § 764h (2008).

62 *See generally* Autism Speaks, *supra* note 7.

State Law	Effective Date	Ages Covered	Caps	ABA Coverage	Other
S. Carolina "Ryan's Law" S.C. CODE ANN. § 38-71-280	July 1, 2008	If diagnosed before age 8, covered through age 15.	$50,000/yr	Does not specifically say ABA, but rather behavioral therapy.	The Legislature overrode the Governor's veto.
Texas TEX. INS. CODE ANN. § 1355.015	Sept. 1, 2007, updates effective Sept. 1, 2009	From diagnosis until age 10.	N/A but coverage is in same amount as for other physical illnesses.	Specifically for ABA therapy.	N/A
Indiana IND. CODE § 27-13-7-14.7	July 1, 2001	N/A	N/A but coverage is in the same amount as for other physical illnesses.	Not specifically in mandate. Indiana department of Insurance issued *Bulletin 136* to clarify application of mandate to ABA.	If for individuals, insurance must *offer* to cover autism treatment. If for group, insurers *must* cover treatment.
Arizona "Steven's Law" ARIZ. REV. STAT. ANN. §§ 20-826.04, 20-1057.11, 20-1402.03, 20-1404.03	June 30, 2009	Coverage until child turns 16.	$50,000/yr, until age 8; $25,000 per year through age 15.	Specifically lists ABA treatment.	N/A
Louisiana LA. REV. STAT. ANN. § 22:1050	Jan. 1, 2009	Until child turns 17.	$36,000/yr; $144,000 over lifetime if under 17 years.	Specifically defines ABA therapy.	N/A
Pennsylvania 40 PA. CONS. STAT. § 764h	July 1, 2009	Until child turns 21.	$36,000/ yr	Specifically defines ABA therapy.	N/A

2. Legislation Specially Mandating Insurance Coverage for Behavioral Therapy, Including ABA

In 2007, South Carolina legislators overrode Governor Mark Sanford's veto to pass "Ryan's Law" (named for the autistic son of the mother/attorney who authored the legislation), effective July 2008.[63] The statute reads:

> (B) A health insurance plan as defined in this section must provide coverage for the treatment of autism spectrum disorder. Coverage provided under this section is limited to treatment that is prescribed by the insured's treating medical doctor in accordance with a treatment plan . . . .

63 Autism Votes, South Carolina Autism Bill Passed, http://www.autismvotes.org/site/c.frKNI3PCImE/b.4051119/k.9DEE/South_Carolina.htm (last visited Oct. 7, 2009).

> (C) The coverage required pursuant to subsection (B) must not be subject to dollar limits, deductibles, or coinsurance provisions that are less favorable to an insured than the dollar limits, deductibles, or coinsurance provisions that apply to physical illness generally under the health insurance plan, ...
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> . . . .
>
> (E) To be eligible for benefits and coverage under this section, an individual must be diagnosed with autistic spectrum disorder at age eight or younger. The benefits and coverage provided pursuant to this section must be provided to any eligible person under sixteen years of age. Coverage for behavioral therapy is subject to a fifty thousand dollar maximum benefit per year. Beginning one year after the effective date of this act, this maximum benefit shall be adjusted annually on January 1 of each calendar year to reflect any change from the previous year in the current Consumer Price Index, All Urban Consumers, as published by the United States Department of Labor's Bureau of Labor Statistics.[64]

Thus, to receive coverage under this South Carolina mandate, a child must be diagnosed before age eight, and the coverage remains in effect until the child reaches age sixteen.[65] Behavioral therapy coverage is capped at $50,000 per year.[66] Although Ryan's Law does not specifically use the words "applied behavioral analysis," it refers to behavioral therapy which includes coverage of ABA. The cap is high enough to reasonably provide for ABA therapy each year, and is not limited over a lifetime as other states, such as Louisiana,[67] have mandated.

Texas enacted a similar statute, effective September 1, 2007, and updated it on June 19, 2009. The statute mandates that insurance companies cover autism treatments and specifically identifies coverage for ABA therapy, as well as other listed treatments for children from the date of diagnosis until the completion of nine years of age.[68] It states:

> (a) At a minimum, a health benefit plan must provide coverage as provided by this section to an enrollee who is diagnosed with autism spectrum disorder from the date of diagnosis until the enrollee completes nine years of age. If an enrollee who is being treated for autism spectrum disorder becomes 10 years of age or older and continues to need treatment, this subsection does not preclude coverage of treatment and services described by Subsection (b).
>
> (b) The health benefit plan must provide coverage under this section to the enrollee for all generally recognized services prescribed in relation to autism spectrum disorder by the enrollee's primary care physician in the treatment plan recommended by that physician . . . .
>
> (c) For purposes of Subsection (b), "generally recognized services" may include services such as: . . . .

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64 S.C. CODE ANN. § 38-71-280 (2007).

65 *Id.*

66 *Id.*

67 LA. REV. STAT. ANN. § 22:1050 (2008).

68 TEX. INS. CODE ANN. § 1355.015 (Vernon 2007).

(2) applied behavior analysis.[69]

Originally, Texas law only mandated coverage for a child between the age of three and five years old—usually during the time between when a child was diagnosed and entered the school system.[70] The original law avoided an overlap in benefits by requiring private insurance to cover a child's treatment until he entered the education system, ensuring some form of treatment during a crucial time period for effective intervention.[71] However, where school systems were unable to provide the behavioral treatments, parents were burdened with out-of-pocket expenses. Texas's original law provided an important beginning for autistic children to receive benefits; however, lawmakers updated the law to ensure coverage until a child turns ten years old.

Similarly, Indiana lawmakers enacted insurance coverage for pervasive developmental disorders in 2001. This law states:

> Sec. 3. As used in this chapter, "pervasive developmental disorder" means a neurological condition, including Asperger's syndrome and autism, as defined in the most recent edition of the Diagnostic and Statistical Manual of Mental Disorders of the American Psychiatric Association.
>
> Sec. 4. (a) An accident and sickness insurance policy that is issued on a group basis must provide coverage for the treatment of a pervasive developmental disorder of an insured. Coverage provided under this section is limited to treatment that is prescribed by the insured's treating physician in accordance with a treatment plan.
>
> (b) The coverage required under this section may not be subject to dollar limits, deductibles, or coinsurance provisions that are less favorable to an insured than the dollar limits, deductibles, or coinsurance provisions that apply to physical illness generally under the accident and sickness insurance policy.
>
> Sec. 5. (a) An insurer that issues an accident and sickness insurance policy on an individual basis must offer to provide coverage for the treatment of a pervasive developmental disorder of an insured. Coverage provided under this section is limited to treatment that is prescribed by the insured's treating physician in accordance with a treatment plan.
>
> (b) The coverage that must be offered under this section may not be subject to dollar limits, deductibles, or coinsurance provisions that are less favorable to an insured than the dollar limits, deductibles, or coinsurance provisions that apply to physical illness generally under the accident and sickness insurance policy.[72]

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69 *Id.*

70 Reinke, *supra* note 2.

71 *Id.*

72 IND. CODE §§ 27-8-14.2-3, 27-8-14.2-4, 27-8-14.2-5 (2001).

The statute mandates insurers that issue accident and sickness policies on an individual basis to provide the same coverage offered for physician-recommended treatments for physical illnesses. Similarly, the state requires group insurers to provide coverage for treatment of pervasive developmental disorders including autism.[73] Insurers maintain the right to review and challenge treatment prescribed by the treating physician. However, to challenge the treatment, they must list grievances in the same manner as any other insurance appeals process and the insured may challenge the ruling.[74] The Indiana Department of Insurance issued Bulletin 136 to guide insurers and consumers on the contract language in the Indiana Code, which specifically states, "It is the Department's position that behavioral therapies such as Applied Behavioral Analysis Services may not be subject to limitations that apply to therapies such as physical, occupational or speech therapy."[75]

Indiana's statute has no age limits, and the treatment follows the individual's physician's orders. Also, the benefits are not capped at a specific amount. Rather, Indiana treats autism like other physical illnesses in terms of insurance coverage. Group insurers must provide such coverage, while individual policies need only offer to provide it.[76] This is presumably reflected in a cost differential. However, many health benefits in private policies are provided at an additional cost, similar to maternity care, so this legislation is at least helpful to families able to pay additional costs for such coverage. Importantly, the insurer may not refuse coverage because an individual has been diagnosed with a pervasive developmental disorder like autism.[77]

Arizona passed "Steven's Law," effective June 30, 2009. It states that a hospital service corporation or medical service corporation, health care service organization, group disability insurer, or blanket disability insurer shall not:

> 1. Exclude or deny coverage for a treatment or impose dollar limits, deductibles and coinsurance provisions based solely on the diagnosis of autism spectrum disorder. For the purposes of this paragraph, "treatment" includes diagnosis, assessment and services.
>
> 2. Exclude or deny coverage for medically necessary behavioral therapy services. To be eligible for coverage, behavioral therapy services shall be provided or supervised by a licensed or certified provider.

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73 *Id.*; Autism Speaks, *supra* note 7, at 14; IND. DEPT. OF INS. BULLETIN 136, Insurance Coverage for Pervasive Developmental Disorders, at 3 (Mar. 30, 2006), *available at* http://www.in.gov/idoi/files/Bulletin136.pdf.

74 IND. DEPT. OF INS. BULLETIN 136, *supra* note 73, at 1.

75 *Id.* at 2.

76 IND. CODE §§ 27-8-14.2-4, 27-8-14.2-5 (2001).

77 § 27-13-7-14.7.

. . . .

D. Coverage for behavioral therapy is subject to:

1. A fifty thousand dollar maximum benefit per year for an eligible person up to the age of nine.

2. A twenty-five thousand dollar maximum benefit per year for an eligible person who is between the ages of nine and sixteen.

E. For the purposes of this section:

1. "Autism spectrum disorder" means one of the three following disorders as defined in the most recent edition of the diagnostic and statistical manual of mental disorders of the American psychiatric association:

(a) Autistic disorder.

(b) Asperger's syndrome.

(c) Pervasive developmental disorder—not otherwise specified.

2. "Behavioral therapy" means interactive therapies derived from evidence based research, including applied behavior analysis, which includes discrete trial training, pivotal response training, intensive intervention programs and early intensive behavioral intervention.[78]

Thus, Steven's Law provides that hospital service corporations, medical service corporations, health care service organizations, group disability insurers, blanket disability insurers, and contractors that offer coverage may not exclude or deny[79] medically necessary behavioral therapy up to a $50,000 per year benefit for a child through age eight and $25,000 for a child between the ages of nine and sixteen.[80] As with Texas's law, because the cap of $50,000 per year is halved to $25,000 once the child reaches age eight, it is probable that the legislature considered the availability of educational resources to help with treatment options. This reflects legislators' possible belief that ABA was most effective for younger children; legisla-

78 ARIZ. REV. STAT. ANN. §§ 20-826.04, 20-1057.11, 20-1402.03, 20-1404.03 (2008).

79 H.R.B. Summ., H.B. 2847, 48th Leg., Reg. Sess. (Ariz. 2008).

80 ARIZ. REV. STAT. ANN. §§ 20-826.04, 20-1057.11, 20-1402.03, 20-1404.03 (2008).

tors may have further wished to avoid overlap between educational training and medically appropriate ABA. This mandate does not apply to individual policies,[81] nor does it require insurers to offer coverage as is the case under Indiana law.

Louisiana passed a health insurance law requiring coverage of autism treatment up to $36,000 per year, with a lifetime cap of $144,000 for children under seventeen, effective January 1, 2009.[82] The bill even defines ABA as "the design, implementation, and evaluation of environmental modifications, using behavioral stimuli and consequences, to produce socially significant improvement in human behavior, including the use of direct observation, measurement, and functional analysis of the relations between environment and behavior."[83]

In pertinent parts, the bill reads:

> § 1050. Requirement for coverage of diagnosis and treatment of autism spectrum disorders in individuals less than seventeen years of age.
>
> A. (1) . . . any health coverage plan specified in Paragraph (G)(6) of this Section which is issued for delivery, delivered, renewed, or otherwise contracted for in this state on or after January 1, 2009, shall provide coverage for the diagnosis and treatment of autism spectrum disorders in individuals less than seventeen years of age.
>
> . . . .
>
> D. (1) Coverage under this Section shall be subject to a maximum benefit of thirty-six thousand dollars per year and a lifetime maximum benefit of one hundred forty-four thousand dollars.
>
> . . . .
>
> G. As used in this Section:
>
> . . . .
>
> (6) "Health coverage plan" means any hospital, health, or medical expense insurance policy, hospital or medical service contract, employee welfare benefit plan, contract or agreement with a health maintenance organization or a preferred provider organization, health and accident insurance policy, or any other insurance contract of this type, including a group insurance plan and the Office of Group Benefits programs.[84]

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81 Autism Votes, Summary of Arizona Legislation, http://www.autismvotes.org/site/c.frKNI3PCImE/b.3937863/k.C942/Arizona.htm (last visited Sept. 13, 2009).

82 LA. REV. STAT. ANN. § 22:1050 (2008).

83 § 22:1050(G)(1).

84 § 22:1050.

In specifically identifying ABA therapy, this bill is similar to legislation supported by organizations such as Autism Speaks. This bill requires coverage for children with autism, through a child's twentieth year. This appears logical given that some children are diagnosed later than others and doctors may recommend ABA treatment at any age. While at first this bill seems very comprehensive, it is nevertheless restrictive because it only requires up to $144,000 worth of coverage over the course of a lifetime, and given the expense of ABA therapy, an individual could easily reach this limit in less than three years.

Pennsylvania also passed a law requiring Autism Spectrum Disorders Coverage:

> (a) A health insurance policy or government program covered under this section shall provide to covered individuals or recipients under twenty-one (21) years of age coverage for the diagnostic assessment of autism spectrum disorders and for the treatment of autism spectrum disorders.
>
> (b) Coverage provided under this section by an insurer shall be subject to a maximum benefit of thirty-six thousand dollars ($36,000) per year but shall not be subject to any limits on the number of visits to an autism service provider for treatment of autism spectrum disorders.
>
> ....
>
> (f) As used in this section:
>
> (1) "Applied behavioral analysis" means the design, implementation and evaluation of environmental modifications, using behavioral stimuli and consequences, to produce socially significant improvement in human behavior or to prevent loss of attained skill or function, including the use of direct observation, measurement and functional analysis of the relations between environment and behavior.[85]

Autism Spectrum Disorders Coverage requires that either a health insurance policy or government program provide coverage for autistic individuals under age twenty-one.[86] The coverage is subject to a $36,000 annual cap and includes ABA under "rehabilitative care," which the Pennsylvania legislature considered necessary to "produce socially significant improvements in human behavior or to prevent loss of attained skill or function."[87]

Again, Pennsylvania legislators were clearly concerned with avoiding unnecessary overlap between private insurers and government programs. These concerns may have been the result of an impact analysis performed by ABT Associates for the Pennsylvania Health Care Cost Containment

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85 40 PA. CONS. STAT. § 764h (2008).

86 *Id.*

87 *Id.*

Council. This report suggests "that a mandate is not justified because coverage is already available through the state's Medicaid program, and that a mandate for private coverage would shift costs from the public sector to the private sector."[88] A $36,000 yearly cap[89] falls on the low end of the cost for intensive ABA therapy. However, the coverage is reasonable because it may continue through the individual's twentieth year without a lifetime cap.

In effect, the bill allows for longer-term treatment, spread out over the autistic individual's crux developmental years. By specifically addressing ABA therapy in the bill, the legislators aligned their interests with advocates (such as Autism Speaks) who lobbied on behalf of the bill.[90] Even insurers acknowledged the benefits: Richard Snyder, Senior Vice President for Health Services at Independence Blue Cross said, "[a]t first pass, we believe the legislation will provide increased opportunities for us to coordinate care and help families with autistic children by providing additional services not traditionally covered by their insurance."[91]

3. Lawsuits Affecting Insurance Coverage of Autism Treatment

Although state legislative mandates for insurance coverage of autism treatments remain the most popular method of bringing about coverage, Minnesota took a different approach. Attorney General Mike Hatch sued Blue Cross Blue Shield of Minnesota in 2000, resulting in a settlement agreement to provide "research, treatment and coverage for those in need of . . . autism treatment and services."[92] The policy implemented by Blue Cross Blue Shield as a result of the agreement, entitled *Pervasive Development Disorders: Identification, Evaluation, and Treatment*, defines pervasive developmental disorders (PDD) to include autism.[93] It also provides standardized screening for early identification of developmental delays at nine, eighteen, and thirty months of age, or at any time parents or others raise developmental concerns.[94] The policy sets forth accepted tools for diagnosing PDD and lists accepted treatments. Of particular interest, the treatments listed are not specific, but rather provide for a "multidisciplinary

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88 Reinke, *supra* note 2.

89 *Id.*

90 *See id.*

91 *Id.*

92 Settlement Agreement at 2, State v. Blue Cross & Blue Shield of Minn. (2001), *available at* http://www.autismvotes.org/atf/cf/%7B2A179B73-96E2-44C3-8816-1B1C0BE5334B%7D/MNCourtDecision.pdf.

93 BLUE CROSS AND BLUE SHIELD OF MINNESOTA, MEDICAL AND BEHAVIORAL HEALTH POLICY MANUAL (2008), *available at* http://notes.bluecrossmn.com/web/medpolman.nsf/50c2d5c81dd37e6a862569bd0054c1b2/B3FF5E9776107D8E86256C4800562AF9?OpenDocument.

94 *Id.*

treatment plan . . . specific to the child's identified and quantified disabling symptoms."[95]

The policy ensures that autistic children are not denied access to a treatment plan. It assists in early identification and treatment-based interventions provided by a licensed professional. In addition, it specifically avoids an overlap in benefits by providing for "coordination of specific therapies with school (education system) programs."[96] However, because it does not specifically identify ABA therapy, parents must investigate whether their child is eligible for coverage of ABA therapy.

Another lawsuit in New Jersey, *Micheletti v. State Health Benefits Commission*, involved individual coverage of autism therapy.[97] Joe Micheletti, a deputy in the New Jersey state attorney general's office, brought a claim against the state health plan which denied coverage for his autistic son Jake's ABA therapy.[98] In particular, the insurance company denied coverage for the verbal behavioral therapy, claiming it was not restorative "of a previously existing function."[99] The insurance company fought having to pay for the behavioral therapy to the Supreme Court of New Jersey.[100] The Michelettis explained that the standard of educational treatment from the school systems was simply "some progress" whereas the neurologist said Jake would benefit from "more intensive therapy"— his parents fought for his right to thrive, not just get by.[101] The parents' persistence in the legal battle paid off when the justices ordered the insurance company to pay for the full cost of their son's therapy.[102]

This case illustrates how the persistence of parents of an autistic child, coupled with their legal capability as attorneys, enabled them to fight an insurance company and obtain a just outcome for an autistic child. This case may also set a useful precedent for parents wishing to pursue treatments they believe should be covered by insurance. However, legal battles with insurance companies are often very costly and time-consuming, and many parents already coping with raising a child with special needs cannot devote additional resources to a legal battle. It is unclear how this case may change insurers' approach to denying or providing benefits, inspire other families to fight for their rights, or potentially influence the New Jersey legislature.

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95 *Id.*

96 *Id.*

97 Micheletti v. State Health Benefits Comm'n, 913 A.2d 842 (N.J. Super. Ct. App. Div.), *aff'd*, 934 A.2d 633 (N.J. 2007).

98 Abramson, *supra* note 30.

99 *Id.*

100 *Id.*

101 *Id.*

102 *Id.*

Chris Johns v. Blue Cross Blue Shield of Michigan is a current lawsuit claiming wrongful refusal to cover ABA.[103] The plaintiffs are relying *inter alia* on the State of Michigan's Insurance Commissioner's opinion that "ABA is a reasonable, safe, and necessary treatment for children with autism."[104] The complaint alleged that Blue Cross Blue Shield of Michigan (BCBS) "wrongfully denies coverage on the bad faith basis that it is experimental or investigative, despite the multitude of studies showing, among other things, the efficacy of ABA treatment."[105] BCBS, in support of its Motion to Dismiss, cites to several articles, one that notes "continued research is clearly needed to demonstrate the efficacy of developing treatment techniques and interventions in controlled trials, particularly refining the ability to select the most appropriate and cost-effective treatments for specific children and families."[106] Each side has advanced arguments that reflect the current debate about autism treatments and costs.

Although this paper does not address whether such judicial precedent is desirable when compared to carefully debated legislative acts that mandate insurance coverage, it is an open question deserving of future research. Ultimately, it is possible that the rights of autistic children and private insurers are better balanced by legislative debate, as illustrated by caps on coverage, than by judicial decrees which do not limit the amounts insurers are required to cover.

4. Companies Offering Private Insurance May Elect to Cover ABA Treatment

In addition to popular legislative mandates and unique legal cases, private companies may provide such benefits voluntarily. Microsoft, Eli Lilly, and Home Depot are a few companies that have agreed to pay for ABA therapies.[107]

When eight Microsoft employees with autistic children compared notes on the benefits of behavioral treatment and the difficulties they were having in affording such treatment, they e-mailed the President of Human

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103 Compl. at 13, Johns v. Blue Cross Blue Shield of Michigan, No. 2:08-cv-12272 (E.D. Mich. May 23, 2008).

104 *Id.* at 8.

105 *Id.* at 12.

106 Def.'s Mot. to Dismiss at 9, Johns v. Blue Cross Blue Shield of Michigan, No. 2:08-cv-12272 (E.D. Mich. June 19, 2008) (citing Vanessa K. Jensen & Leslie V. Sinclair, *Treatment of Autism in Young Children: Behavioral Intervention and Applied Behaviors Analyses,* 14 INFANTS AND YOUNG CHILDREN 42 (2002)).

107 Freudenheim, *supra* note 48.

Resources at Microsoft.[108] With the help of the University of Washington, Microsoft learned more about autism and available treatments, and decided to provide coverage.[109] "Microsoft covers about three years worth of ABA treatment for each autistic child. Because the software company is self-insured, Microsoft can make its own decisions about which medical conditions to cover, rather than having to choose from the benefits available through an insurance company."[110] In all, Microsoft provides up to $70,000 for each family with an autistic child, which includes 85% of the costs for up to 180 sessions with a program manager and 1,350 sessions with a program assistant.[111]

Microsoft also provides approximately three years of ABA therapy, which could be used to fill the gap between diagnosis and entrance into the educational system. This provides an incentive for Microsoft employees with an autistic child to remain loyal to Microsoft. For instance, Erin Brewer, a Microsoft employee with an autistic child, has noted, "I'm working for the benefits."[112]

Similar to Microsoft, Home Depot decided to provide coverage for a "full range of childhood autism" benefits after employees denied benefits for their autistic children were forced to drudge through their insurers' appeal process.[113] Dissatisfied employees brought the issue of autism coverage to Home Depot and were rewarded when the company decided to establish "a package of autism benefits that was essentially written by medical experts from the Marcus Institute and the Kennedy Krieger Institute, a treatment and research center in Baltimore."[114]

Eli Lilly took a slightly different approach and voluntarily created a self-funded plan that provides insurance benefits for autistic children.[115] Eli Lilly creates thimerosal, a type of mercury sometimes placed in vaccines such as that for Measles, Mumps, and Rubella.[116] In 2005, environmental attorney Robert F. Kennedy Jr. blamed thimerosal for causing autism

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108 Amanda Spake, *Families Changed Microsoft's View of Autism*, SMART MONEY, May 8, 2007, *available at* http://www.smartmoney.com/personal-finance/health-care/Families-Changed-Microsofts-View-of-Autism-21226.

109 *Id.*

110 Beth Taylor, *Microsoft, Employees Collaborate to Craft Autism Benefit*, PUGET SOUND BUS. J., May 10, 2002, *available at* http://www.bizjournals.com/seattle/stories/2002/05/13/focus6.html.

111 Freudenheim, *supra* note 48.

112 *Id.*

113 Spake, *supra* note 108.

114 *Id.*

115 Beverly Chase, *ABA via Insurance: How to Get ABA and Other Services Funded Via Insurance for Those on the Autism Spectrum*, DORENE J. PHILPOT LAW, Oct. 12, 2008, http://www.dphilpotlaw.com/html/aba_via_insurance.html.

116 Robert F. Kennedy Jr., *Deadly Immunity*, ROLLING STONE, June 20, 2005, http://www.rollingstone.com/politics/story/7395411/deadly_immunity.

through a form of mercury poisoning.[117] Kennedy challenged an earlier 2002 study, *A Population-Based Study of Measles, Mumps, Vaccination and Autism*, which concluded that there was no link between the MMR vaccine and autism.[118] Kennedy has been criticized for alleging a massive governmental conspiracy with pharmaceutical companies.[119]

Regardless of the accuracy of Kennedy's statements, they have fueled the popularity of the mercury-autism link hypothesis. This theory is based on the correlation between increased rates of autism and increased mercury doses from thimerosal and childhood vaccinations, including the MMR immunization in the 1980s and 1990s.[120] Although correlation does not prove causation, former head of the National Institutes of Health Dr. Bernadine Healy stated that "public health officials have been too quick to dismiss the hypothesis [vaccination-autism link] as 'irrational,' without sufficient studies of causation . . . without studying the population that got sick."[121] Autism Speaks also acknowledges that more research is required to determine the etiology of autism.[122] Specifically, it would be useful to determine whether "the use of combination vaccines or the practice of giving several vaccinations in one day confer[s] increase[d] risk for adverse events."[123]

In February 2009, the U.S. Court of Federal Claims determined it was "*extremely unlikely*" that thimerosal and the MMR vaccine were causally connected to autism.[124] The Special Master held that there was a lack of evidence to support this link, but he noted that "parents and relatives are sincere in their belief that the MMR vaccine played a role in causing . . . devastating disorders."[125] He also recognized that "the mere fact that . . . autistic symptoms first became evident to her family during the months after her MMR vaccination might make them wonder about a poss-

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117 *Id.*

118 Kreesten Meldgaard Madsen, M.D. et. al., *A Population-Based Study of Measles, Mumps, Vaccination and Autism*, 347 NEW ENG. J. MED. 1477 (2002), *available at* http://content.nejm.org/cgi/content/full/347/19/1477.

119 Michael Fumento, *There is No Thimerosal-Autism Conspiracy*, WALL ST. J., July 14, 2005, at A11.

120 David A. Geier & Mark R. Geier, *A Comparative Evaluation of the Effects of MMR Immunization and Mercury Doses from Thimerosal-Containing Childhood Vaccines on the Population Prevalence of Autism*, 10 MED. SCI. MONIT. 133 (2004), *available at* http://journals.indexcopernicus.com/fulltxt.php?ICID=11608.

121 Jay N. Gordon, *Foreword* to JENNY MCCARTHY, MOTHER WARRIORS: A NATION OF PARENTS HEALING AUTISM AGAINST ALL ODDS xiii, xvi (Penguin Group (USA) Inc. 2008).

122 Autism Speaks, Statement on Vaccine Research and Safety, http://www.autismspeaks.org/policy_statements.php (last visited Sept. 19, 2009).

123 *Id.*

124 Cedillo v. Sec'y of Health & Human Servs., No. 98-916V, 2009 WL 331968, at *134 (Fed. Cl. Feb. 12, 2009).

125 *Id.* at *135.

ible causal connection."[126] Although he rejected the claim, he recognized that the parents' belief was sincere.

Regardless of the merits behind these claims, the popularity of the mercury vaccine hypothesis may provide a reputational incentive for Eli Lilly to provide autism treatment benefits. In addition, even though Eli Lilly is headquartered in Indianapolis, where Indiana's law does not apply to self-insurers, it seems reasonable that Eli Lilly would try to avoid further finger-pointing[127] by instituting such treatment options.

Individuals can organize to request that their insurer's private policy cover autism treatments, which may be implemented most effectively with the help of a medical institution having expertise in autism research and treatment. Companies may be motivated to help parents altruistically, out of concern for their reputation, or some combination of the two, but autistic children benefit in any of these situations.

II. ECONOMIC EFFECTS OF STATE MANDATES

While this paper takes the position that it is in the public interest for states to mandate insurance coverage for ABA treatment of autism, there are a number of arguments on both sides regarding the overall costs and benefits of such mandates. The costs of mandating autism insurance coverage may shift the financial burden onto families and employers carrying insurance. However, there are societal costs when coverage is not mandated and families with autistic children are forced to shoulder the financial strain of providing adequate treatment for their child. There is also evidence that mandating insurance coverage for autism treatments would be cost-effective because successful therapy can rehabilitate an autistic child so that he or she can live independently and without life-long care. This paper takes the position that society should help shoulder the financial costs families with autistic children bear, and that it is preferable that insurers help pay for ABA therapy instead of requiring states and the federal government to carry the financial burden alone.

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126 *Id.*

127 Joel Roberts, *The Man Behind the Vaccine Mystery, Dick Armey Says He Put Drug Company Protection into Homeland Bill*, CBS NEWS, Dec. 12, 2002, http://www.cbsnews.com/stories/2002/12/12/eveningnews/main532886.shtml ("Just before President Bush signed the homeland security bill into law an unknown member of Congress inserted a provision into the legislation that blocks lawsuits against the maker of a controversial vaccine preservative called 'thimerosal,' used in vaccines that are given to children. Drug giant Eli Lilly and Company makes thimerosal. It's the mercury in the preservative that many parents say causes autism in thousands of children . . .").

A. *The Costs*

The Council for Affordable Health Insurance assessed less than a 1% increase in incremental costs across ten states mandating or offering coverage for autism.[128] An example of state-specific cost is found in South Carolina Governor Mark Sanford's veto of Ryan's Law, where he estimated that an autism treatment mandate would add forty-eight dollars annually to families' insurance coverage costs.[129] Governor Sanford noted that he was "overwhelmingly predisposed to veto any other mandated coverage" arguing that there were only three variables in financing health care: "cost, access, and quality" and that pushing on one variable affects the other two.[130] The Governor was concerned about increasing health insurance costs paid by individuals and employers, and the corresponding effect that increased insurance costs would have on lowering other families' access to health care.[131] As previously noted, the South Carolina legislature overrode the Governor's veto.[132]

Besides Governor Sanford, there are others who oppose such mandates. Dr. Wayne Meyer, Medical Director of Anthem Blue Cross Blue Shield of Missouri, has said, "The problem with mandates in general is they tend to be emotionally based rather than evidence based."[133] He added that mandates "require payment for treatments that haven't been shown to improve outcomes or show benefit, and in today's world that can really run up the cost of health care."[134] One comment on mandated health benefits notes that "whatever the cost is, it will not be borne by the insurance companies" but rather it "will be passed on to private insurance ratepayers."[135]

Yet, even assuming that costs would be passed on to the ratepayers, taxpayers are already shouldering the cost of educational programs. As Autism Speaks notes, "there isn't enough money in school budgets to provide the therapy needed by the swelling numbers of autistic children, and it will be years before enough ABA-trained therapists can be hired into most

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128 Victoria Craig Bunce, JP Wieske, & Vlasta Prikazsky, COUNCIL FOR AFFORDABLE HEALTH INSURANCE, HEALTH INSURANCE MANDATES IN THE STATES at 3 (2007), http://www.cahi.org/cahi_contents/resources/pdf/MandatesInTheStates2007.pdf; *see* Autism Speaks, *supra* note 7, at 15.

129 Letter from Mark Sanford, Governor of South Carolina, to André Bauer, President of the Senate of South Carolina, at 2 (June 6, 2007), *available at* http://governor.sc.gov/NR/rdonlyres/F6923F50-92A1-4CE2-9800-9387F11DA2D8/0/S20.pdf.

130 *Id.*

131 *Id.* at 1-2.

132 Autism Speaks, *supra* note 7, at 13.

133 Feldstein, *supra* note 17.

134 *Id.*

135 William O. Pitts, *Commentary: Mandated Health Insurance Coverage Needs Study*, J. REC., June 9, 2008, *available at* http://findarticles.com/p/articles/mi_qn4182/is_20080609/ai_n25503992/?tag=content;col1.

public school classrooms."[136] When insurance mandates are resisted and autistic children are not provided adequate health care, society faces lost productivity from families with autistic children who have less time to focus on work and less discretionary spending money.[137]

B. *The Benefits*

There are equally poignant arguments regarding the real financial and social benefits of mandating ABA. A study by John Jacobson examined the costs and benefits of early intensive behavioral therapy and estimated that each child treated resulted in $1.6 to $2.8 million in savings between the ages of three to fifty-five.[138] Clearly this is a substantial amount. In part, the savings can be explained by an assumed increase in the number of autistic children able to live and work independently as a result of successful therapy. As Kantrowitz and Scelfo note, "thousands of youngsters who in earlier generations would have been consigned to institutions are now going to college and looking forward to a normal life with a job."[139]

Independent living resulting from intensive behavioral therapies, like ABA, contrasts sharply with the fact that at one time, "90 percent of children identified as autistic were institutionalized as adults."[140] This may be because when a child receives behavioral therapy, there is an increase in the child's IQ and social interaction.[141] Thus, "while the economic impact of such legislation . . . is of vital importance, legislators should not overlook the possible social and long-term costs of failure to treat autistic children."[142]

In addition, a study published in the 1998 *Journal of Behavioral Interventions* concluded that providing autistic children three years of intensive early intervention ABA before entering the educational system would result in substantial cost savings.[143] This particular study concluded that an early investment of $50,000 for three years of ABA therapy could reap the benefit of $1 million per person by the time an affected child reached age fifty-five.[144] Amanda Spake of *SmartMoney* cited the above-mentioned study

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136 Noonan, *supra* note 49.

137 Michael L. Ganz, *The Lifetime Distribution of the Incremental Societal Costs of Autism*, 161 ARCHIVES PEDIATRIC & ADOLESCENT MED. 343, 344 (2007); *see* Autism Speaks, *supra* note 7, at 18.

138 John W. Jacobson, James A. Mulick & Gina Green, *Cost-Benefit Estimates for Early Intensive Behavioral Intervention for Young Children with Autism—General Model and Single State Case*, 13 BEHAV. INTERVENTIONS 201, 213-14 (1998); *see* Autism Speaks, *supra* note 7, at 16-17.

139 Kantrowitz & Scelfo, *supra* note 1.

140 Freudenheim, *supra* note 48.

141 McEachin, *supra* note 32, at 360, 364-65.

142 Pitts, *supra* note 135.

143 Spake, *supra* note 108.

144 *Id.*

and concluded that "early behavioral therapy looks like it could be a good investment."[145] If, as Autism Speaks contends, insurance premiums are only increased by an average of 1% nationwide by such mandates,[146] then the insurance mandates shift the costs from parents and society as a whole to parents and insurers. Overall, the cost shifting approach seems to be beneficial.

C. *The Overall Effect of Mandated ABA Coverage*

Varying state mandates create unintended incentives for parents to move between states to maximize insurance coverage for their autistic child. Considering the state mandates discussed in Part I, it would be possible to move from state to state in order to obtain the maximum benefits for the child's life. For example, it would be possible to live in Arizona where insurers have to pay up to $50,000 through a child's eighth year, or Louisiana where insurers would pay up to $36,000 until a $144,000 cap were reached, and then move to a state like South Carolina to be eligible for $50,000 until the child turns sixteen. South Carolina is a better choice than Pennsylvania for children under the age of sixteen, where the cap is $36,000 per year. However, since South Carolina benefits are no longer paid once the child turns sixteen, at that point it might be beneficial to move to Pennsylvania where the autistic teen can receive $36,000 until he or she turns twenty-one years old. From Pennsylvania, it might be useful to relocate to Indiana, where there is no age limit, and coverage is the same as would be given to a physical illness requiring such therapies.

Depending on the effectiveness of ABA therapy and the severity of the autistic disorder, there may or may not still be a need for therapy. The greater the need for continued treatment (ABA, speech, social and behavioral therapies) and the lower the family's income and ability to pay out-of-pocket expenses, the more likely the family will consider moving to obtain benefits. Of course, those families with very low incomes will still have to pay for the move, but in the long-run a move will save those families out-of-pocket expenses for treatment. It will also be more advantageous for the affected child, and, in return, the family. Naturally, moving a child from one program to another undermines consistency and treatment and may slow therapeutic results. However, having access to ABA is better than no access to treatment. It is likely that despite the transactional costs of moving, such as switching employers and insurers, and finding new treatments for the child, there remain unintended incentives for families to move. In an effort to capitalize on mandated insurance coverage for autism

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145 *Id.*

146 Noonan, *supra* note 49.

treatments, each family must determine whether a move will benefit them, and this hypothetical represents those families who conclude it will.

Some employers even transfer between jobs to obtain better coverage for their autistic child. For instance,

> Lisa Parles, whose [seventeen]-year-old son Andrew has been in ABA therapy—without insurance—since the age of [three], argues the skills he's learning will save society some of the cost of care he'll need as an adult. Parles gave up her law practice to move to a state that pays for treatment.[147]

Unable to afford to care for her autistic son, Parles recognized that moving to a state where insurers were required to pay for her child's treatment was in her family's best interest.

It is also conceivable that an individual working for an employer that provides insurance coverage for autism treatment would subsequently choose to move to another company that also offers benefits once coverage at her current company caps out. After all, as Richard Gardner noted, "[t]he majority of Americans with health insurance have plans through their employment."[148] While the child's benefits could result in mobility between employers, it would be against society's interests because an employee is unlikely to be equally productive when he or she is transferring—not because of a given skill set or job description—but rather, because of the insurance benefits that her child so desperately needs. Employees transferring jobs may also be willing to work where they are overqualified to obtain insurance benefits, which is counter-productive for society. At least in the examples outlined above, it is unlikely that a lateral transfer between companies such as Microsoft, Home Depot or Eli Lilly would occur.

Many state mandates require that any individual who provides ABA services be professionally licensed to do so, which is not unusual since "many state laws guarantee access to certain specialists."[149] This requirement creates an incentive for states to license more ABA trained professionals to meet insurance requirements. Further, licensing standardizes the level of care, which ultimately aids families with autistic children who are seeking competent professionals to provide the behavioral training necessary. As a result, mandates help establish standardized minimums for treatment. On the flip side, it may be a slow process to train and license professionals in ABA therapies, especially in small towns without hospitals or institutes prepared to train individuals in ABA treatment. But overall, a

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147 John Donvan, *Insurance vs. Autism: For Parents, Insurance Is a Personal Fight*, ABC NEWS, Mar. 24, 2008, http://i.abcnews.com/Health/story?id=4515825&page=1.

148 Richard E. Gardner, *Mind Over Matter?: The Historical Search for Meaningful Parity Between Mental and Physical Health Care Coverage*, 49 EMORY L.J. 675, 677 (2000).

149 Cheryl A.C. Brown, *Interpreting Exclusions or Limitations On Coverage for Mental Illness Under Health and Disability Policies*, 35 THE BRIEF 52, 54 (2005).

mandate will increase the standard of ABA therapy training, and raise awareness as to the most effective treatment methods.

III. RECOMMENDATIONS FOR STATE LEGISLATORS CONSIDERING MANDATING THE IDEAL INSURANCE COVERAGE FOR AUTISM TREATMENT

A. *Autism Speaks: A Voice from the Autism Community*

Autism Speaks, founded by Suzanne and Bob Wright, the grandparents of an autistic child,[150] is a powerful advocacy organization providing the autistic community with a voice.[151] In 2006, Autism Speaks merged with the National Alliance for Autism Research, and in 2007 Autism Speaks merged with Cure Autism Now, making it the nation's largest autism advocacy organization.[152] Autism Speaks seeks to unite the autism community and raise public awareness about autism spectrum disorders while tackling such goals as legislative change and biomedical research.[153] Autism Speaks is well-organized and has propelled the trend for legislative mandates requiring insurance coverage.[154]

Autism Speaks prepared a Model Autism Insurance Act (Model Act), which suggests diagnosis and treatment for autistic individuals under twenty-one years of age. It also recommends that if the benefits must be limited, the cap should be somewhere between $36,000 and $50,000 per year, adjusted annually for inflation.[155] This reflects the most accurate estimate of the cost of ABA therapy per year. The Model Act allows for co-pay and deductibles that are comparable to those for other covered medical services,[156] which reflects a principle of fairness. The mandates do not request any more coverage that other medical disorders receive.

The Model Act defines ABA as "the design, implementation, and evaluation of environmental modifications, using behavioral stimuli and

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150 Tom Brokaw, *Bob and Suzanne Wright—The 2008 TIME 100 Heroes and Pioneers*, TIME, Apr. 25, 2008, http://www.time.com/time/specials/2007/article/0,28804,1733748_1733756_1735237,00.html.

151 Press Release, Autism Speaks, Autism Speaks Launches Unprecedented Global health Initiative (Sept. 26, 2008), http://www.autismspeaks.org/press/global_autism_public_health_initiative.php.

152 *Id.*

153 Autism Speaks, Our Mission, http://www.autismspeaks.org/goals.php (last visited Oct. 10, 2009).

154 Autism Votes, http://www.autismvotes.org/site/c.frKNI3PCImE/b.3909853/ (last visited July 25, 2009).

155 Autism Votes, Model Autism Insurance Act, http://www.autismvotes.org/atf/cf/%7B2A179B73-96E2-44C3-8816-1B1C0BE5334B%7D/model_autism_insurance_act_final.doc (last visited Sept. 13, 2009).

156 *Id.*

consequences, to produce socially significant improvement in human behavior, including the use of direct observation, measurement, and functional analysis of the relations between environment and behavior."[157] The Model Act bases its definition of autism spectrum disorders on the "most recent edition of the *Diagnostic and Statistical Manual of Mental Disorders* (*DSM*), including Autistic Disorder, Asperger's Disorder, and Pervasive Developmental Disorder Not Otherwise Specified."[158]

The Model Act notes that insurance coverage for autism is geared towards group health policies, and explicitly provides:

> "Medically necessary" means any care, treatment, intervention, service or item that is prescribed, provided, or ordered by a licensed physician or a licensed psychologist in accordance with accepted standards of practice and that will, or is reasonably expected to do any of the following:
>
> a. prevent the onset of an illness, condition, injury or disability;
>
> b. reduce or ameliorate the physical, mental or developmental effects of an illness, condition, injury or disability; or
>
> c. assist to achieve or maintain maximum functional capacity of the individual and the functional capacities that are appropriate for individuals of the same age.[159]

The Model Act repeatedly emphasizes that autism should be treated similar to any other illness, condition, injury or disability, and suggests that if an insurer wants to review the necessity of the treatment, the insurer should bear the cost, and the insurer may only request review a limited number of times.[160]

B. *Options for State Legislatures*

States considering legislation to mandate insurance coverage for autism spectrum disorders face a wide array of drafting choices. However, not all statutes are created equally, and some better address the concerns of the autism community. A review of mental health mandates caused attorney Youndy C. Cook to conclude that "using more precise language would provide insurers with more predictability in mental health care costs, and the state mandates would ensure that those most in need of mental health care

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157 *Id.*
158 *Id.*
159 *Id.*
160 *Id.*

would receive it."[161] This conclusion is also applicable to determining which mandates best protect autistic children's treatment options. The more precise the mandate's language, the better insurers are able to predict costs, and the more autistic individuals are able to obtain necessary treatment.

For example, statutes that specifically include ABA in the drafting language are very effective, such as the statutes in Louisiana[162] or Pennsylvania.[163] Where the statute does not explicitly provide for insurance coverage of ABA therapy, questions arise as parents seeking the best possible treatment for their autistic child attempt to obtain coverage, and insurers attempt to keep costs low by denying coverage. These types of questions led to conflict over the correct interpretation of the mandate in Indiana, which caused Indiana's Department of Insurance to issue Bulletin 136 to clarify that the mandate covered ABA.[164]

A gap in coverage still exists for those who are insured individually rather than through a group plan. For example, in Louisiana, "[i]ndividual plans and large self-funded plans received exemptions, significantly reducing the number of people covered."[165] In that situation, many families struggling with insurance costs may decline to pay higher prices when coverage is offered at a higher premium, whereas an insurance mandate would cause the cost to be spread out among the insured. Although the higher premium would very likely more than pay for itself with the cost of autism treatments, it is possible that a family would simply be unable to afford such coverage, and the child's treatment options would be severely limited or nonexistent. Furthermore, it is the tax-funded educational system that strains to provide some form of treatment for the autistic child to improve his social and intellectual functioning.[166]

In addition, there also is the issue of insurance caps. Most states which have passed autism treatment mandates also implemented either yearly or lifetime caps. However, the Chair of the Board of Directors for Lubbock, Texas, Regional Mental Health & Mental Retardation Center Brian Shannon correctly notes, "The problem with annual and lifetime caps is self-evident. Once the patient reaches such a cap, the coverage for the year (or lifetime) is exhausted . . . the mere fact that benefits are at an end does not equate to any miraculous cure."[167] Indiana's statute does not explicitly place a yearly or lifetime cap; however, benefits are to be treated

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161 Youndy C. Cook, *Messing with our Minds: The Mental Illness Limitation in Health Insurance*, 50 U. MIAMI L. REV. 345, 350 (1996).

162 LA. REV. STAT. ANN. § 22:1050 (2008).

163 40 PA. CONS. STAT. § 764h (2008).

164 IND. DEPT. OF INS. BULLETIN 136, *supra* note 73, at 1.

165 Reinke, *supra* note 2.

166 *Id.*

167 Brian D. Shannon, *Paving the Path to Parity in Health Insurance Coverage for Mental Illness: New Law or Merely Good Intentions?*, 68 U. COLO. L. REV. 63, 67 (1997).

similarly to other illnesses, so it is plausible that caps within the policy would apply.[168] Although caps may disappoint families with autistic children, they are the result of legislators balancing the interests of insurers and families with autistic children. Caps exist partly to ensure that insurers are not overly burdened, just as benefits exist to ensure that parents are not overly burdened with the cost of treatments.

CONCLUSION

Mandating insurance coverage to pay for autism treatment, specifically ABA therapy, is a question many state legislatures across the nation have either already considered, or will soon consider. At the federal level, the government has stood on both sides of the debate. The military's Tricare program requires coverage of autism treatment for children whose parents serve on active duty, but "[t]he Federal Employees Health Benefits Program is resisting efforts by a group of families in northern Virginia to add autism therapy to the list of required benefits."[169] However, while sitting as President-elect, Barack Obama drafted a broad-based federal autism insurance mandate, the Autism Treatment Acceleration Act of 2008.[170] While consideration of federal coverage is outside the scope of this paper, it may be of interest in the future to discover what resources are available to pay for autistic children's treatment.

As parents of autistic children in the several states join together to fight for equal coverage, it is necessary for society to support their cause. In the long run society as a whole will benefit from the decrease in taxpayers' educational burden and the increase in productivity from the families of autistic children. Society has a responsibility to fight against enabling an "insurer's fears of increasing costs to burden a relatively small, but needy, group of people."[171] Lobbyist J. P. Wieske, who opposes insurance mandates, said autism legislation is "the hottest trend in mandates we've seen in a long time."[172] Some states have already forged the way, so it may be easier for state legislatures considering implementing such coverage to learn from the early mandates. "Availability of adequate coverage should lead to greater utilization of needed services."[173]

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168 IND. CODE §§ 27-13-7-14.7, 27-8-14.2-1, 27-8-14.2-5 (2001).

169 Freudenheim, *supra* note 48.

170 Autism Speaks, President-Elect Barack Obama's Federal Autism Insurance Mandate Bill, http://www.autismvotes.org/site/c.frKNI3PCImE/b.4784269/k.C0E5/ATAA.htm (last visited Sept. 21, 2009).

171 Cook, *supra* note 161, at 362.

172 Carla K. Johnson, *Parents Press States for Autism Insurance Laws*, ASSOCIATED PRESS, *available at* http://www.autismspeaks.org/inthenews/autism_insurance_ap.php.

173 Shannon, *supra* note 167, at 92.

Utilization of ABA services among other treatments for autism will help an autistic individual improve his or her functioning. Improvements are likely to be hard-earned, as ABA requires a level of financial and time commitment that becomes a way of life. Many hours are the hard reality of a difficult battle, but it can mean the difference between an autistic child turning completely inward and being unable to communicate or interact with others and a child developing into a functioning, productive member of society. Social withdrawal is a particularly painful problem for families who want to hug their autistic child, as such physical contact could potentially set off a temper tantrum because touch is processed in an atypical way. Or, an autistic child who does not receive therapy may be unable to communicate such basic and essential pieces of information that many children give easily, such as a simple "I love you." Heather Montross, a parent of an autistic child, writing on a discussion forum about what ABA has done for her son, said the following:

> I am the mother of three-and-a-half year-old Adam, a beautiful boy with autism. I can honestly say that ABA therapy changed his life. He is a different child than he was just a year ago. Adam spoke no words until he was three. I had never heard his sweet little voice. Now I hear him trying to repeat the words of his teachers and therapists and he will say "I love you" as he gets on the bus for school. It is truly heart-warming. Autism took my child away but ABA brings him back.[174]

Numerous other parents can also point to the effectiveness of ABA treatment in assisting their child's development. Of course, there are also parents who have found it necessary to implement combination therapies. From a moral standpoint, parents should have the option to obtain the best possible, most effective, medically-approved treatments for autism, and this includes ABA. Parents should not be stifled by costs or forced to mortgage their future in order to provide medically necessary treatment for their autistic child when they are part of an insurance plan and the insurer is simply discriminating among illnesses and choosing not to pay for ABA treatment because of the expense. As this nation deals with unprecedented rates of autism, all states should mandate insurance coverage to reflect current medical knowledge of the best possible treatment.

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[174] Autism Speaks, 'What Do You Think' About ABA Therapy?: Flood of Email Responses Spotlight Your Views, http://www.autismspeaks.org/community/ownwords/your_thoughts_aba.php (last visited Sept. 21, 2009).