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COMMENTS

SHUTE: THE MATH IS OFF

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INTRODUCTION

This year marks the twentieth anniversary of the Supreme Court's decision in *Carnival Cruise Lines, Inc. v. Shute*.[1] Reversing the common law rule that forum-selection clauses in "form contracts"[2] are presumptively unenforceable, the Court reasoned that such clauses should be enforced because consumers "benefit in the form of reduced [prices] reflecting the savings that the [firm] enjoys by limiting the fora in which it may be sued."[3] The Court's calculation was off, however, because it failed to account for the latent costs of such clauses. The time has come to get the math (and perhaps the law) right.

To begin, it is useful to understand the relationship between insurance and contracts. Consumer insurance agreements are, of course, one type of contract. And contracts strangely enough are also a form of insurance. Judge Richard Posner, for example, notes that contracts allocate risk and "also shift risks, and thus provide a form of insurance."[4] Of course, mere risk shifting is not insurance—insurance also requires risk spreading. Many people pay the insurer relatively small amounts of money so that the insurer has a pool of money large enough to cover the costs for those few who suffer loss.[5] A relatively low probability risk for the individual is converted into a certain cost for the group. And because most individuals are risk averse, social welfare is increased.

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1 499 U.S. 585 (1991).

2 This Essay uses the term "form contract" instead of "adhesion contract" because of the pejorative connotation sometimes given to adhesion contracts, although for present purposes the two are synonymous. *See* BLACK'S LAW DICTIONARY 366 (9th ed. 2009) (defining "adhesion contract" in part as a "standard-form contract prepared by one party, to be signed by another party in a weaker position, usu. a consumer, who has little choice about the terms.").

3 *Shute*, 499 U.S. at 594 ("[I]t stands to reason that passengers who purchase tickets containing a forum clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued.").

4 RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 105 (6th ed. 2003).

5 TOM BAKER, INSURANCE LAW AND POLICY 2 (2d ed. 2008).

The typical consumer contract—the form contract—often contains standard clauses that function not as insurance, but as *reverse* insurance. Instead of spreading costs across the group, the clauses concentrate them on the few who suffer loss. To illustrate, the risk to an individual consumer that a particular product will give rise to a cause of action approaches zero. But for the firm, the risk that at least one defective product will give rise to a cause of action approaches 100%. Litigation, of course, also involves risks and costs. Forum-selection clauses shift some of this risk and cost from the firm to the consumer. Choice-of-law clauses shift some of the risk and cost as well. By transferring risks and costs, a product's price may be reduced. Indeed, this price mechanism was the analytical foundation of *Shute* and is, so far as it goes, accurate.[6]

Yet this simple model overlooks two significant costs. First, as noted above, although all consumers may enjoy a reduced purchase price, it is at the expense of the few who face concentrated risks and costs after the purchase has been completed and after the improbable loss has occurred. Second, the reduced purchase price carries a hidden cost for all. If a firm is aware that its tort exposure has been reduced, absent other considerations (such as reputational costs), the firm is less likely to take safety precautions at the margin. Thus, risks and costs are not only concentrated, but magnified.[7]

While a number of different types of contract clauses may create this type of "reverse insurance,"[8] forum-selection clauses and choice-of-law clauses (collectively "procedural clauses")[9] do so pervasively.

The Supreme Court's two leading decisions on the enforceability of procedural clauses, *Shute* and *M/S Bremen v. Zapata Off-Shore Co.*,[10] illustrate the risk and cost concentration in practice. A relatively recent development in the law, *Shute* was the first and only Court case to hold such clauses enforceable in form contracts.[11] The case began when Mr. and Mrs. Shute went to their local Washington state travel agent and booked a one-week cruise aboard a Carnival Cruise ship sailing from Los Angeles to

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6 *See Shute*, 499 U.S. at 594.

7 This insight was first pointed out by Professor Michelle Boardman in various discussions.

8 For example, arbitration clauses, the subject of a forthcoming article by this author. This Essay addresses only two facets of form contracts: forum-selection clauses and choice-of-law clauses.

9 *Cf.* David Marcus, *The Perils of Contract Procedure: A Revised History of Forum Selection Clauses in the Federal Courts*, 82 TUL. L. REV. 973, 976 (2008) (coining the term "contract procedure" for those clauses which attempt "to reorder procedural rules by contract"). For a recent thought-provoking, comprehensive analysis of the limits of procedural private ordering, see Jaime Dodge, *The Limits of Procedural Private Ordering*, 97 VA. L. REV. 723 (2011).

10 407 U.S. 1 (1972).

11 For a thorough historical analysis of forum-selection clauses, *see* Marcus, *supra* note 9, at 988-1015.

Puerto Vallarta, Mexico.[12] While the ship was in international waters, Mrs. Shute slipped on a deck mat while on a tour of the ship's galley and was injured.[13] The Shutes brought suit in Washington, alleging that Carnival was negligent.[14] Carnival moved to transfer the case to Florida based on a forum-selection clause printed on the "passage contract ticket" mailed to the Shutes after they had purchased the cruise,[15] which stated:

> It is agreed by and between the passenger and the Carrier that all disputes and matters whatsoever arising under, in connection with or incident to this Contract shall be litigated, if at all, in and before a Court located in the State of Florida, U.S.A., to the exclusion of the courts of any other state or country.[16]

The Ninth Circuit refused to enforce the forum-selection clause, explaining that "[b]ecause this provision was not freely bargained for, we hold that it does not represent the expressed intent of the parties, and should not receive the deference generally accorded to such provisions."[17] The Supreme Court reversed, enforcing what it acknowledged to be "a nonnegotiated forum-selection clause in a form ticket contract"[18] in part because of the "benefit" which such clauses conferred on customers—"reduced fares."[19] As a result, the Shutes bore the costs and risks of litigating in Carnival's home-state court, about thirty-five hundred miles away.[20]

To understand just how significant the choice of forum can be, one need only look to *The Bremen*, which involved a contract containing a forum-selection clause selecting "the London Court of Justice."[21] The contract also contained an exculpatory clause waiving liability for damages "in any case."[22] The exculpatory clause was unenforceable in courts in the United States, but "prima facie valid and enforceable"[23] in London. Thus, enforcing the forum-selection clause would decide the substantive law to be applied[24] and, quite simply, the case. Hired to tow Zapata Off-Shore's drilling rig from Louisiana to Italy, the *Bremen* hit a storm in the Gulf of Mexi-

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12 Shute v. Carnival Cruise Lines, 897 F.2d 377, 379 (9th Cir. 1990), *rev'd sub nom.* Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991).

13 *Id.*

14 *Id.*

15 *Id.*

16 *Id.*

17 *Id.* at 389.

18 Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 593 (1991).

19 *Id.* at 594.

20 Indeed, the evidence showed "that the Shutes [we]re physically and financially incapable of pursuing this litigation in Florida." *Shute*, 897 F.2d at 389.

21 M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 2 (1972).

22 *Id.* at 2 n.2.

23 *Id.* at 8 n.8.

24 Choice-of-law provisions are an even more effective method of selecting the substantive law to be applied.

co and the rig was damaged.[25] After the *Bremen* towed the rig to "Tampa, Florida, the nearest port of refuge,"[26] Zapata brought suit in rem against the *Bremen* and in personam against its owner for "negligent towage and breach of contract"[27] in Tampa's federal district court. The *Bremen*'s owner invoked the forum-selection clause, but the Fifth Circuit refused to enforce it, noting "that remanding Zapata to a foreign forum, with no practical contact with the controversy, could raise a bar to recovery by a United States citizen which its own convenient courts would not countenance."[28] The Supreme Court reversed, explaining: "The choice of that forum was made in an arm's-length negotiation by experienced and sophisticated businessmen, and absent some compelling and countervailing reason it should be honored by the parties and enforced by the courts."[29]

While *The Bremen* involved two sophisticated international corporations negotiating contract terms clause-by-clause with "strong evidence that the forum clause was a vital part of the agreement,"[30] the Court in *Shute* thought this a distinction without a difference.[31] Taken together, *Shute* and *The Bremen* mean the costs of litigating claims in a far-away forum and the risk of outcome-determinative substantive law may be concentrated through procedural clauses in form contracts.

This is not to say that all clauses in form contracts have this concentrating effect. Professor David Gilo and Dean Ariel Porat, for example, have identified a number of "beneficial boilerplate provisions."[32] Some, like standard warranties and exchange provisions, function as insurance. Because form contracts can act as both insurance and reverse insurance, a more nuanced analysis is needed.

This Essay provides that analysis, focusing on one category of form contract provisions, procedural clauses. The thesis is that these procedural clauses create a negative externality sufficient to counsel a change in the law back to the pre-*Shute* rule under which procedural clauses in form contracts were presumptively unenforceable. It proposes requiring the parties to internalize the cost of the externality by eliminating the enforceability of

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25 *Bremen*, 407 U.S. at 2-3.

26 *Id.* at 3.

27 *Id.* at 4.

28 *In re* Unterweser Reederei, 428 F.2d 888, 895 (5th Cir. 1970), *rev'd* M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972).

29 *Bremen*, 407 U.S. at 12.

30 *Bremen*, 407 U.S. at 14.

31 Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 593 (1991) ("[T]he Court of Appeals' analysis seems to us to have distorted somewhat this Court's holding in *The Bremen*. . . . [W]e do not adopt the Court of Appeals' determination that a nonnegotiated forum-selection clause in a form ticket contract is never enforceable simply because it is not the subject of bargaining.").

32 David Gilo & Ariel Porat, *The Hidden Roles of Boilerplate and Standard-Form Contracts: Strategic Imposition of Transaction Costs, Segmentation of Consumers, and Anticompetitive Effects*, 104 MICH. L. REV. 983, 988 (2006).

procedural clauses in form contracts. In sum, it contributes two insights: (1) procedural clauses in form contracts are not merely a fundamental fairness concern, they are an externality; and (2) changing the baseline of enforceability fixes this externality.

Starting from the standard law and economics position that assumes efficiency is the purpose of contract law, this Essay begins with the same assumption—the function of contracts is the efficient allocation of resources. Likewise, this Essay begins with the standard law and economics position that, generally, freedom of contract is the most efficient method of allocating resources. Form contracts, however, complicate these assumptions.[33]

Part I challenges the standard law and economics position as applied to procedural clauses in form contracts, identifying the bounded rationality, rational ignorance, and predictable irrationality[34] of consumers which contribute to the externality. Building upon the work of Professor Todd Rakoff,[35] this part further considers the firms' incentives, both healthy and perverse, regarding procedural clauses in form contracts. To be clear, the problem is not that the contract is being offered on a take-it-or-leave-it basis. Professor Rakoff has persuasively explained how standardized terms promote transactional efficiency from the firm's perspective.[36] Nor is the problem a mere failure to read. As explained below, notice is not sufficient to repair the externality. Part II considers some repairs that would be sufficient, and concludes that the most efficient solution is a legislative fix implementing a market-oriented solution. This Essay proposes forcing the contracting parties to internalize the externality's costs by changing the baseline of post-*Shute* enforceability of procedural clauses back to their traditional unenforceability. This Essay concludes with some brief thoughts about who will pay under the proposal and whether it matters. The ultimate conclusion is not that the proposal redistributes wealth, but rather that it is net efficient, internalizing the social costs into the contract price.

I. THE PROBLEM

An externality, according to Professor Ronald Coase, may be "defined as the effect of one person's decision on someone who is not a party to that decision."[37] Judge Posner elaborates that an externality is a cost which a

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33 *See infra* Part I.C.

34 *See generally* DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS (HarperCollins 2008).

35 Todd Rakoff, *Contracts of Adhesion: A Reconstruction*, 96 HARV. L. REV. 1174, 1220-25 (1983).

36 *See id.*

37 RONALD H. COASE, THE FIRM, THE MARKET, AND THE LAW 24 (2d ed. 1990).

party "will not take into account in making its decision; the cost is external to its decision-making."[38]

Procedural clauses in form contracts create an externality for several reasons. First, as discussed above, they not only shift the risks and costs of litigation, they magnify them. As a preliminary matter:

> [T]he seller can expect a given number of problems to arise and may subsidize the costs of travel in those cases through marginally higher prices on all goods. The effect is the same as for the investor who has enough investments to diversify his or her portfolio. Risk is reduced. By contrast, consumers may engage in only one such transaction and therefore face a significant "undiversified" risk.[39]

Of course, the "undiversified risk" includes more than travel costs. It involves the risk and cost of litigating in the firm's chosen forum, as in *Shute*, where the firm enjoys the advantages of being a repeat player.[40] It involves the risk and cost of an outcome-determinative set of substantive laws, as in *The Bremen*. And it involves inefficient incentives—such as the firm's incentives to rent-seek.[41] By increasing overall risks and costs, and incentivizing inefficient rules of law, procedural clauses decrease overall social welfare.[42]

Second, the clauses concentrate costs away from the lower-cost avoider. As a general matter, the firm is usually better able to prevent the type of harms that give rise to litigation (e.g., the widget blowing up). But the firm will only take safety measures at the margin when the expected cost of taking safety measure is less than the expected cost of *not* taking the safety measure.[43] Because procedural clauses reduce the firm's expected costs (both the cost of litigation and the cost of adverse judgments), it reduces the firm's incentives to produce safer products. This is not to suggest, of course, that all safety measures are efficient.[44] Rather, it merely suggests

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38 POSNER, *supra* note 4, at 71.

39 Lee Goldman, *My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts*, 86 NW. U. L. REV. 700, 722-23 (1992).

40 *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 98 (1989).

41 One example may be statutory caps on recoverable damages in for certain types of torts. *See, e.g.*, VA. CODE ANN. § 8.01-581.15 (limiting awards in medical malpractice cases).

42 Cass Sunstein notes that people are particularly "risk-averse with respect to low-probability risks of catastrophe." Cass Sunstein, *Lives, Life-Years, and Willingness to Pay*, 104 COLUM. L. REV. 205, 234 & n.114 (2004) (citing Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, *in* CHOICES, VALUES, AND FRAMES 17, 20 (Daniel Kahneman & Amos Tversky eds., 2000)).

43 *Compare* Learned Hand's celebrated B < P x L formula in United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947) (where B is the burden or cost of avoiding accidental loss, P is the probability of loss absent B, and L is the expected magnitude or cost of such loss), *with* POSNER, *supra* note 4, at 167-70.

44 *See* POSNER, *supra* note 4, at 167-70.

that procedural clauses shift the "expected cost" equilibrium point, marginally reducing the firm's incentive to take a safety measure. But, as will be demonstrated below, because consumers do not "price" the latent cost of procedural clauses, this equilibrium point is inefficient.[45] That is, it encourages overconsumption of "inferior" products (those with fewer safety measures at the margin) to the detriment of both the purchasers and the firms producing "superior" products.

It bears noting at this juncture that although this Essay focuses on the manner in which procedural clauses affect a firm's incentives regarding marginal safety precautions, the thesis holds whether the damages ultimately sound in contract or tort. That is, firms may limit their liability in both tort and contract through procedural clauses. Procedural clauses may not only reduce a consumer's incentive to sue for negligence, but also for breach of contract (e.g., the widget does not blow up, but simply stops functioning as promised). Because procedural clauses may reduce the likelihood that a firm will be sued for purely economic losses, they reduce the expected cost of breach. Consequently, the clauses change the firm's contract calculus—shifting the point at where breach becomes "efficient" for the firm.

Third, the clauses concentrate costs away from the cheaper information-gatherer. Professor Anthony Kronman notes that a "court concerned with economic efficiency should impose the risk on the better information-gatherer. Thus, an efficiency-minded court reduces the transaction costs of the contracting process itself."[46] Professors Ian Ayres and Robert Gertner observe: "If one side is repeatedly in the relevant contractual setting while the other side rarely is, it is a sensible presumption that the former is better informed than the latter."[47] As the repeat player, the firm can gather information more cheaply in at least two respects: the expected cost of injury from the product as well as the expected costs of litigation.

Fourth, the clauses concentrate costs away from the superior risk-bearer. The firm is better able to bear the costs—not because it is the deeper pocket (although it generally is)—but because it is the repeat player who can spread the cost over multiple transactions. In effect, it is able to act as an insurer by converting a low probability risk into a certain cost.[48] And, of course, the firm need not self-insure; as the repeat player, it is also in a better position to purchase market insurance.

Finally, the clauses concentrate costs away from the party who actually takes them into account in its decision-making process. As discussed

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45 *See infra* Part I.C.

46 Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 4 (1978), *reprinted in* RANDY E. BARNETT, PERSPECTIVES ON CONTRACT LAW 397 (3d ed. 2005).

47 Ayres & Gertner, *supra* note 40, at 98.

48 Goldman, *supra* note 39, at 722-23.

above, firms utilizing such clauses may recognize that by transferring the risks and costs of litigation, a product's price may be reduced.[49] In contrast, because of consumers' bounded rationality, rational ignorance, and predictable irrationality, consumers do not factor in the cost of procedural clauses in pricing products.[50] Consequently, consumers demand an inefficiently inflated quantity. When coupled with the firm's reduced incentives to produce safer products, the result is overconsumption of inferior products.

Recognizing the controversy that behavioral economics has provoked in some quarters,[51] it is important to note that this Essay does not pursue what Judge Posner refers to as that "most common of criticisms of the economic analysis of law," namely, "that it rests on the unrealistic assumption that people are rational maximizers of their self-interest."[52] Rather, it uses the available empirical research to pursue what Posner refers to as "[o]ne of the main purposes of law, from an economic standpoint, . . . the control of externalities."[53] To internalize the externality created by procedural clauses, however, a look inside the mind of the consumer is first necessary.

A. *A First Look: Some Symptoms*

Empirical research has consistently shown that we are not perfectly rational. Put more precisely, we are rational, but within certain boundaries.[54] For example, in one study recently reviewed in the *University of Chicago Law Review*, subjects were asked to choose from among two or more alternative products based "on four, eight, or twelve attributes. Faced with only two alternatives of four attributes each, the subjects consulted all of the

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[49] *See, e.g.*, Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 594 (1991) ("[I]t stands to reason that passengers who purchase tickets containing a forum clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued.").

[50] *See, e.g.*, Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203 (2003); Melvin Eisenberg, *Why There Is No Law of Relational Contracts*, 94 NW. U. L. REV. 805 (2000); Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583 (1990).

[51] *See, e.g.*, Andrew Ferguson, *Nudge Nudge Wink Wink*, WKLY. STANDARD, Apr. 19, 2010, *available at* http://www.weeklystandard.com/articles/nudge-nudge-wink-wink. For those interested in further discussion of the issue, in April 2010 the Cato Institute hosted an online forum where diverse scholars debate the topic. Jason Kuznicki, *Slippery Slopes and the New Paternalism*, CATO, http://www.cato-at-liberty.org/slippery-slopes-and-the-new-paternalism/ (last visited June 16, 2011).

[52] Richard Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 302 (1979).

[53] *Id.* at 305.

[54] *See, e.g.*, Korobkin, *supra* note 50; Eisenberg, *supra* note 50.

available information before making a choice."[55] But surprisingly, as the number of alternatives increased, the information consulted prior to choosing decreased. "With more alternatives, subjects consulted even less information."[56] In other words, our decision-making process is limited by more than external factors such as search and information costs; it is limited by our innate limitations, our bounded rationality. There is only so much we will consider before deciding. Summing up "[a] great body of theoretical and empirical work in cognitive psychology,"[57] Professor Melvin Eisenberg observes, "the substantive action that would maximize an actor's utility may not even be considered by the actor, because actors set process limits on their search for and their deliberation on alternatives."[58]

And when juxtaposed against attributes like physical appearance, product reputation, and, of course, price, procedural clauses are substantially less likely to be factored into purchasing decisions. Professor Rakoff labels this divide as the difference between "visible" and "invisible" attributes.[59] For Professor Korobkin, they are "salient" versus "non-salient" attributes.[60] Whatever the label, common experience confirms that although we regularly take into account some things in making purchasing decisions, some things we do not.[61]

A skeptical reader may wonder whether product reputation might implicitly account for the cost of oppressive procedural clauses. The short answer is that it can, but it generally does not, because firms would prefer to screen out litigious consumers: "because a change in a term's status from non-salient to salient for a particular buyer could be viewed by sellers as a signal that the buyer is particularly difficult to please or quarrelsome, the seller might consider the loss of that buyer's patronage in future transactions a benefit rather than a cost."[62]

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55 Korobkin, *supra* note 50, at 1228 & n.91 (citing John W. Payne, *Task Complexity and Contingent Processing in Decision Making: An Information Search and Protocol Analysis*, 16 ORG. BEHAV. & HUM. PERFORMANCE 366 (1976)).

56 *Id.* at 1228 (citing Payne, *supra* note 55).

57 Eisenberg, *supra* note 50, at 811.

58 *See id.*

59 Rakoff, *supra* note 35, at 1250-52.

60 Korobkin, *supra* note 50, at 1206.

61 Consider your own experience. About how many form contracts have you entered into over the past two decades (the time since *Shute* was decided)? How many times did you first investigate whether the contract contained procedural clauses? And how many times did you factor the clauses into your evaluation of the product's price? And would you, dear reader, consider yourself more or less likely than the average consumer to be aware of the existence of form contract provisions and their legal effect?

62 Korobkin, *supra* note 50, at 1241.

A related, albeit slightly more sophisticated, challenge to this Essay's thesis that procedural clauses are inefficient is posed by the theory of "hypothetical market assent,"[63] taken up next.

B. *What Peter Parker Can Teach Us About Procedural Clauses in Form Contracts*

According to the hypothetical market assent theory, although the majority of consumers have not read or shopped for boilerplate terms, "a quite small proportion of smart consumers who actually read and shopped for good standard-form contract clauses could put enough competitive pressure on firms so that they would adopt efficient standard-form terms."[64] In theory, these super shoppers save us from otherwise inefficient behavior. Sadly, however, as applied to procedural clauses in form contracts, these superheroes transform—like Peter Parker infected by an extraterrestrial symbiote in Spider-Man 3[65]—into something darker and far more dangerous to firms: a litigiously-minded consumer.

In more formal law and economics terms, the hypothetical market assent theory does not function in the procedural clause context because of an adverse selection problem. The theory is predicated on a group of consumers considering the clauses salient, thus creating enough market pressure to create efficient procedural terms. But the type of consumer who is looking for a "high-quality" (i.e., more protective, less restrictive) procedural clause is the type of consumer the firm would prefer to screen—the litigious type. Professor Korobkin elaborates:

> Although circumstances will occur that cause a form term to become relevant regardless of the identity of the buyer, terms will become relevant more often for buyers inclined to search for product defects and problems, buyers with a low tolerance for such problems, buyers inclined toward invoking legal rights (including litigation) in case of conflict, and buyers inclined not to perform their obligations in the customary manner desired by the seller. If these buyers are both more likely than average to find form terms salient and less profitable on average to sellers—both reasonable assumptions—sellers will face an adverse selection problem.[66]

That is, the firm's inclination to avoid lawsuits creates an incentive to screen out those customers predisposed to sue. Procedural clauses facilitate

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63 *See generally* Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983), *cited in* Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation Between Businesses and Consumers*, 104 MICH. L. REV. 857, 863 & n.19 (2006).

64 Johnston, *supra* note 63, at 862-63.

65 SPIDER-MAN 3 (Columbia Pictures 2007).

66 Korobkin, *supra* note 50, at 1238-39.

this screening in a net-inefficient, mildly perverse way: filtering out are the super shoppers capable of creating the efficient hypothetical market assent. Who remains? The ordinary consumer, of course; but who is the ordinary consumer?

C. *A Second Look: Bounded Rationality, Rational Ignorance, and Predictable Irrationality*

Consumers are rational and self-interested naturally, but in some very interesting ways. As noted above, we are rational within certain boundaries.[67] When making purchasing decisions, we use heuristics—mental shortcuts—and sometimes these shortcuts lead us astray.

The "availability heuristic," for example, leads us astray when it comes to estimating risk, particularly low-probability risk. Discussing the availability heuristic, Professors Richard Thaler and Cass Sunstein explain that people "assess the likelihood of risks by asking how readily examples come to mind."[68] "[V]ivid and easily imagined causes of death (for example, tornadoes) often receive inflated estimates of probability, and less-vivid causes (for example, asthma attacks) receive low estimates, even if they occur with a far greater frequency."[69] Procedural clauses in form contracts, of course, allocate risks with relatively low probabilities. And when "these possible but unlikely outcomes are not readily 'available' to buyers, they are likely to respond to the risk of these harms by treating them as if they do not exist at all."[70] Indeed, empirical research on the point is overwhelming: "One of the most robust findings of social science research on judgment and decision making is that individuals are quite bad at taking into account probability estimates when making decisions."[71]

In this context, of course, the availability heuristic describes a similar phenomenon as Professor Rakoff's discussion of "invisible" attributes and Professor Korobkin's discussion of "non-salient" attributes. Because of our bounded rationality, we discount (or fail to account for) the costs of procedural clauses in making purchasing decisions.

This is not to say that such behavior is irrational. Indeed, from a certain perspective, consumers' ignoring procedural clauses in making purchasing decisions is quite rational. Professor Randy Barnett observes that "the low probability of the term ever being invoked in some future lawsuit, combined with the relatively low stakes of many such contracts, makes it

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67 *See supra* Part I.A.

68 RICHARD THALER & CASS SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 25 (Yale Univ. Press 2008).

69 *Id.*

70 Korobkin, *supra* note 50, at 1233.

71 *Id.* at 1232.

irrational for form-receiving parties to spend time reading, much less understanding, the terms in the forms they sign."[72] Professor Barnett notes an opposite presumption applies to the firms, who are "repeat players" that "can amortize the cost of obtaining knowledge of the background rules over a great many transactions."[73]

Put differently, transaction costs make consumers' ignorance rational. Broadly defined, transaction costs include "search and information costs, bargaining and decision costs, [and] policing and enforcement costs."[74] It is well understood that procedural clauses in form contracts reduce a firm's transaction costs.[75] Yet this accounts for only one side of the ledger; it fails to account for consumers' transaction costs. For consumers, it may be relatively inexpensive to obtain the basic information regarding the contract's procedural clauses (i.e., the forum-selection and choice-of-law clauses are often available on the firm's website), but evaluating this information is not cheap. Professor Michael Meyerson, for example, points out that on an elemental level, "[w]ithout legal advice, consumers cannot understand how typical [procedural clause] contract terms shift risks away from the seller and onto the consumer."[76] Compounding consumers' transaction costs, in the unlikely event they seek legal advice regarding the terms' consequences, it is not obvious that an attorney would be able to quantitatively evaluate the procedural clauses.

In the even more unlikely event that consumers accurately priced a particular contract's procedural clauses, shopping for a different contract with preferable procedural terms would also entail significant transaction costs. Advertising cannot be expected to reduce the costs of shopping because procedural clauses "deal with risks that a competitor would be foolish to emphasize. For example, it would be ludicrous for a seller to base an advertising campaign on the claim that 'if you injure yourself on our cruise, you can sue us anywhere.'"[77] Moreover, as a practical matter, "sellers will not want to divert their limited advertising budgets to publicizing factors that will play at most a minimal role in purchasing decisions."[78]

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72 Randy Barnett, *Consenting to Form Contracts*, 71 FORDHAM L. REV. 627, 631 (2002).

73 Randy Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 887-88 (1992).

74 COASE, *supra* note 37, at 6 (quoting Carl Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 148 (1979)).

75 *See, e.g.*, Korobkin, *supra* note 50, at 1246 ("[F]orm contracts exist, of course, because of the substantial transaction cost savings that they produce. A requirement that all contracts be individually negotiated would increase transaction costs so substantially that many common and productive transactions would be rendered economically unfeasible, potentially causing commerce to grind to a halt." (footnotes omitted)).

76 *See* Meyerson, *supra* note 50, at 599.

77 Goldman, *supra* note 39, at 719 (quoting Meyerson, *supra* note 50, at 602).

78 Meyerson, *supra* note 50, at 602.

In sum, consumers are rationally ignorant of procedural clauses[79] and firms have incentives to keep consumers that way. Not only do procedural clauses keep the firm's transaction costs down but they limit litigation exposure as well. This information asymmetry leads to inefficiencies—rationally ignorant consumers will not demand efficient terms.[80] Perversely, this presents a hidden cost for all: when a firm is aware that its litigation exposure has been reduced, it is less likely to take safety precautions at the margin. Because of rational ignorance, we are all left less safe (defective products, after all, may injure someone other than the purchaser) as an externality is created.

Moreover, consumers are more than rationally limited and rationally ignorant—they are predictably irrational, too. Professor Dan Ariely, a behavioral economist at the Massachusetts Institute of Technology, explains that we are "predictably irrational . . . our irrationality happens the same way, again and again."[81] For example, we are predictably irrational when it comes to "emotion laden" tradeoffs: "comparing dissimilar attributes [that] require the decision maker to put an implicit price on attributes that [he or] she intuitively feels should not be commodified."[82] Among these attributes are the legal rights implicated by procedural clauses. Professor Korobkin explains:

> If buyers believe that personal safety or the right to seek redress of legal wrongs in a court of law are entitlements that should be inalienable and not subject to commodification, explicitly trading off these types of entitlements against a product's price and physical features might create elevated stress levels. . . . Buyers are likely to respond to the stress caused by sellers' attempts to force them to commodify personal safety or legal rights by employing non-compensatory decision-making strategies that allow them to avoid making such tradeoffs—by effectively ignoring these terms during the selection process and thus rendering them non-salient.[83]

That is, when faced with putting a price on something which the consumer feels should not be commodified, the predictably irrational consumer often ignores the term.

Consequently, actual notice is not a viable solution to the externality. To illustrate: assume that before purchasing a ticket, each cruise line customer had to watch a video that explained the clauses in plain English, in-

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79 In all, procedural clauses in form contracts do a remarkably bad job of performing Fuller functions, particularly the cautionary function. *See generally* Lon Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941).

80 Professor Korobkin, for example, observes: "[A]lthough market forces should ensure that sellers will offer efficient salient contract terms, non-salient attributes are subject to inefficiencies driven by the strategic behavior of sellers." Korobkin, *supra* note 50, at 1234.

81 ARIELY, *supra* note 34, at xx.

82 Korobkin, *supra* note 50, at 1230 (citing Mark Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669, 692 (1979)).

83 *Id.* at 1231-32.

cluding calculations on the risk of injuries on a given cruise, the expected cost of litigating in the particular forum, the relevant laws, and likelihood of recovery in the forum. Would this be sufficient to eliminate the externality? Putting to one side the improbability of such an arrangement, recall the research discussed above. Paradoxically, the research shows more information does not lead to more informed decisions. As the number of attributes involved in a decision increases, the information consulted prior to choosing decreases at a certain point.[84] Moreover, the information contained in procedural clauses is precisely the type toward which consumers act predictably irrational—ignoring it, even with actual notice—because it involves something the consumer feels should not be commodified.

This brings us back to the problem of procedural clauses' inefficiencies. Of course, standard economic analysis assumes that as a general matter freedom of contract combined with market pressures will lead to efficient contract terms. As applied to form contracts, however, this assumption begins to break down. Consumers do not factor in the cost of procedural clauses in purchasing decisions. This leads to overconsumption, as "uninformed consumers will actually prefer an inefficient contract, with a lower stated price but higher actual cost."[85] This, in turn, creates social costs:

> First, consumers may purchase inappropriately large quantities of consumer goods because they have not accurately internalized the product's true costs (the "quantity effect"). . . . Second, sellers are encouraged to include subordinate clauses unfavorable to the consumer even when the seller would be in a better position to bear the risk addressed by the clause (the "quality effect").[86]

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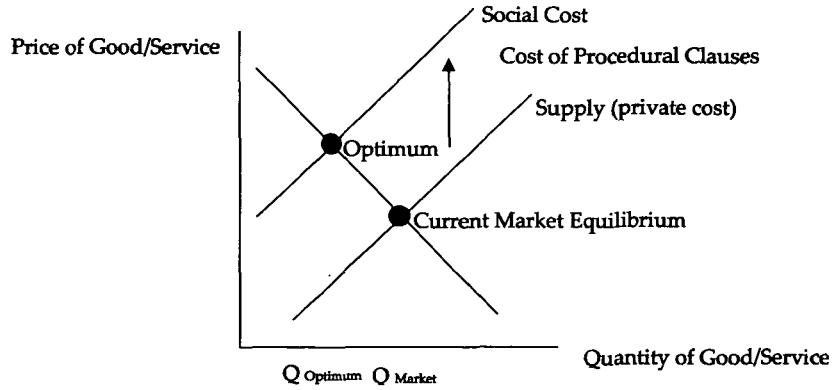
84 *Id.* at 1228 (citing Payne, *supra* note 55, at 374).

85 Meyerson, *supra* note 50, at 605.

86 Goldman, *supra* note 39, at 718.

The resulting social cost is illustrated in the following figure:[87]



Although the precise cost of these inefficiencies is unclear, one of the contributions this Essay makes is that a precise calculation is unnecessary: the market will decide. It is to this proposed solution this Essay now turns.

II. SOLUTIONS

This Part considers various methods of addressing the externality resulting from procedural clauses and concludes that the most efficient solution is a legislative fix implementing a market-oriented solution. First, however, four alternatives are considered: (1) unconscionability; (2) reasonable expectations; (3) Pigouvian tax; and (4) inaction.

A. *The Orthodoxy: Classic Command & Control*

One possible method of addressing the externality is through the unconscionability doctrine. Professor Korobkin advocates for this approach, proposing a "modified unconscionability doctrine," with procedural unconscionability determined according to "salience" and substantive unconscionability determined according to "efficiency."[88] Candidly, he acknowledges that his expansive application of the unconscionability doctrine entails a social cost of its own, as it "clearly invites an intensely factual inquiry, thus making it difficult for courts to resolve disputes on motions for summary judgment."[89] Professor Korobkin is prepared, however, to trade higher decision costs in exchange for lower error costs.

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87 Adapted from N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 206 fig.2 (4th ed. 2007).

88 Korobkin, *supra* note 50, at 1208.

89 *Id.* at 1281.

Yet on careful examination it is not obvious that Professor Korobkin's proposal would actually result in lower error costs. As Professor Richard Epstein points out, one of the unconscionability doctrine's principal problems is the degree of discretion it transfers to "courts to act as roving commissions to set aside those agreements whose substantive terms they find objectionable."[90] The large measure of discretionary authority Professor Korobkin's proposal would vest in courts to redraft contracts would inevitably lead to unpredictability in application. Rather than the judicial ex post redrafting of contracts, a more certain, evenhanded method of internalizing the externality is needed.

A second method, the doctrine of reasonable expectations, holds more promise, though it too entails high decision costs, judicial discretion, and consequent unpredictability. The doctrine, first developed by Professor Robert Keeton in the insurance law context, provides that "objectively reasonable expectations" of consumers "regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."[91] Critics contend that courts applying the doctrine of reasonable expectations do not base their decision on consumers' ex ante expectations, but rather on the courts' ex post equitable judgments. Yet, assuming, arguendo, that this criticism has some merit as applied to insurance contracts, it is nevertheless possible that the criticism does not apply with equal force to other types of form contracts. Insurance contracts are usually form contracts—rich in boilerplate and offered on a take-it-or-leave-it basis. These contracts, however, are a class unto themselves, involving technical provisions that are often far more complex than other types of form contracts. While consumers may not have objectively reasonable expectations about insurance contracts, they may have such expectations about other types of consumer contracts. Thus, Professor Meyerson, proposes placing "the focus on the reasonable expectations of the consumer" when evaluating the enforceability of form contract terms.[92]

Professor Meyerson's proposal should also be rejected, however, given that the evidence collected above shows that, at the time of contracting, consumers actually do not have any expectations regarding procedural clauses—objectively reasonable or otherwise. Of course, courts might ask what consumers would have expected had they thought about it, but this too seems to invite little more than ex post redrafting. The deficiencies in both Professors Meyerson and Korobkin's ex post remedy proposals illustrate why a better ex ante solution internalizing the costs of the externality is needed.

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90 Richard Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 294 (1975).

91 Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970).

92 Meyerson, *supra* note 50, at 611.

Professor Arthur Pigou offers a third alternative—imposing a tax equal to the marginal social cost.[93] Given the difficulty of calculating the third-party costs, however, it is unlikely that the government could accurately assess an appropriate level of taxation. Even if such calculations were possible (an assumption famously challenged in *The Problem of Social Cost*),[94] it is far from clear that such a solution would be desirable. Professors Maxwell Stearns and Todd Zywicki explain: "The government, even if theoretically capable of operating as a Pigouvian central planner, is unlikely to actually do so in practice."[95] Put simply, the choice is not between an imperfect market and perfect government regulation (or between a perfect market and a corrupt, incompetent legislature). Public choice theory's insight is that neither one is perfect.[96]

In sum, the market as currently organized is not internalizing the cost of procedural clauses in form contracts. None of the above proposals appear well suited to address this task. The judiciary's ex post application of unconscionably and reasonable expectations present daunting potential decision and error costs. The legislature's application of a tax seems ill-equipped to calculate the cost ex ante. The fourth option is to do nothing about the externality, which would make sense if the expected costs of the intervention exceed the benefits. Professor Coase observes:

> Whether there is a presumption, when we observe an "externality," that governmental intervention is desirable, depends on the cost conditions in the economy concerned. We can imagine cost conditions in which this presumption would be correct and also those in which it is not.[97]

Ultimately, this is an empirical question. A closer look at the expected costs and benefits of this Essay's proposed solution is taken up in the following sections.

B. *An Unorthodox Proposal: A Market-Oriented Solution*

State legislatures should consider adopting a per se rule. This Essay proposes changing the baseline from enforceability to unenforceability of procedural clauses in form contracts. Although this proposal is admittedly a command and control solution in that it is government-imposed, it is actually predominantly market-oriented in that it seeks neither taxation nor direct regulation of the productive activity. Instead, the proposal enables the market participants to recognize the actual cost of their transactions and

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93 MAXWELL STEARNS & TODD ZYWICKI, PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW 44-45 (2009). *See generally* ARTHUR C. PIGOU, THE ECONOMICS OF WELFARE (4th ed. 1932).

94 Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

95 STEARNS & ZYWICKI, *supra* note 93, at 45.

96 *Id.*

97 COASE, *supra* note 37, at 26.

begin to bargain over who should pay. While unorthodox, the substantive law it proposes is not unprecedented. Indeed, refusing to enforce procedural clauses in form contracts was the dominant approach as recently as twenty years ago—when *Shute* was decided.

As a threshold matter, and as a matter of law, neither *Shute* nor *The Bremen* bar a proposal supporting a per se rule against the enforceability of procedural clauses in form contracts.[98] Both cases were decided under the federal common law of admiralty,[99] not under a federal general common law.[100] Thus, states are free to craft their own approaches to the enforceability of procedural clauses in form contracts. Indeed, both Louisiana[101] and Wisconsin[102] have adopted consumer protection statutes making some types of procedural clauses unenforceable. The Louisiana statute, for example, states:

> The following terms of a writing executed by a consumer are invalid with respect to consumer transactions or modifications thereof: (1) that the law of another state will apply; (2) that the consumer consents to the jurisdiction of another state; or (3) any term that fixes venue.[103]

The key to this Essay's proposal is that by making a procedural term salient—by including cost within price—market pressures will force the parties to internalize the cost of the externality. Of course, intervention in the marketplace will also entail costs.

1. Three Counterarguments

Admittedly, this proposal will come at the cost of potential efficiencies. By selecting certain fora, for example, forum-selection clauses could encourage certain courts to develop subject matter expertise on particular issues. One response to this argument, derived from public choice theory, is that while these courts may develop a more coherent body of law, they are also more likely to be captured by special interests. Specifically, in this

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98 Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 590 (1991); M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 10 (1972).

99 *Shute*, 499 U.S. at 590 ("We begin by noting the boundaries of our inquiry. First, this is a case in admiralty, and federal law governs the enforceability of the forum-selection clause we scrutinize."); *The Bremen*, 407 U.S. at 10 (noting the case came before the Court sitting in admiralty).

100 The federal general common law was rejected in Erie v. Tompkins, 304 U.S. 64, 78 (1938) ("Except in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state. And whether the law of the state shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern. There is no federal general common law.").

101 LA. REV. STAT. ANN. § 51:1418 (2003), *cited in* Goldman, *supra* note 39, at 740 n.192.

102 WIS. STAT. § 421.201 (2005), *cited in* Goldman, *supra* note 39, at 740 n.192.

103 LA. REV. STAT. ANN. § 51:1418(C).

scenario, a firm is more likely to successfully engage in rent seeking if it can concentrate its attentions on a single state's policymakers, rather than diffusing its lobbying efforts nationwide. A second response is that the judicial system already has tools for making interstate or multiparty dispute resolution more efficient, including *forum non conveniens* and transfer pursuant to 28 U.S.C. § 1404(a). Other firm-centered efficiencies (e.g., the ability to use the same counsel with jurisdictional expertise) are subject to similar replies.

Another potential criticism is that this proposal is inconsistent with the freedom of contract. One response to this criticism is that up until about twenty years ago, procedural clauses in form contracts were unenforceable.[104] This response is itself subject to criticism, however, because the historical practice may also be seen as inconsistent with the freedom of contract. Yet, the previous application of this practice nevertheless undercuts the notion that the present proposal is a wholesale departure from traditional contract principles. Rather, the harder question regarding the freedom of contract critique centers on consent. Professor Barnett, for example, argues that "[r]efusing to enforce all of these [procedural] terms would violate the [parties'] freedom to contract."[105] And although he admits that consumers "are not realistically manifesting their assent to radically unexpected terms[, e]nforcing such an unread term would [still] violate the parties' freedom from contract."[106] While the ubiquity of procedural clauses makes it unlikely that they are "radically unexpected" as Professor Barnett uses the term,[107] the key question remain unanswered, namely, what do consumers actually think they are assenting to when they breeze past the boilerplate? The answer to this question is not obvious, and therefore the answer to the freedom of contract issue is not, either. Thus, it does not seem plausible to contend, as Professor Rakoff does, that the freedom of contract argument is "incongruous"[108] and "unsupportable"[109] as applied to form contracts. Candidly, rather, the proposal advocated for here is in tension with an ideal conception of the freedom of contract. As are form contracts themselves.

A third potential criticism is that, as a bright-line rule, the proposal will be over- and under-inclusive. Regarding its over-inclusiveness, some may say that the higher price will, in some cases, discourage customers who

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104 *See* Marcus, *supra* note 9, at 988-1015.

105 Barnett, *supra* note 72, at 639.

106 *Id.*

107 Professor Barnett illustrates what he means by radically unexpected with a hypothetical "your-favorite-pet" term. *Id.* at 637. He explains: "If a term . . . specifies that in consequence of breach one must transfer custody of one's beloved dog or cat, it could surely be contended by the promisor that 'while I did agree to be bound by terms I did not read, I did not agree to that.'" *Id.* (internal citation omitted).

108 Rakoff, *supra* note 35, at 1236.

109 *Id.* at 1237.

share a common domicile with the firm's selected forum. This critique may have merit regarding concentrated post-purchase litigation costs for the individual, but it overlooks the hidden costs procedural clauses impose on society generally, i.e., the firm's reduced incentive to take safety precautions at the margin. The proposal may also be criticized as under-inclusive because other clauses in form contracts may create externalities overlooked by the proposal. Although this critique is accurate, it misses the public choice insight. Perfect solutions do not exist. The real question is whether the benefits exceed the costs. This section examined the anticipated costs of the proposal. The next examines the anticipated benefits.

2. Coase, Baselines, and Distributional Consequences

A legal baseline already exists; procedural provisions in form contracts are generally enforced. Yet, this baseline does not account for the externality. Eliminating the enforceability of procedural clauses in form contracts moves the baseline to account for the externality. This happens because as parties contract around the revised baseline by modifying price, the parties will also be forced to internalize the costs. Specifically, because firms' costs will increase, they will spread these costs over all contracts by incrementally raising their prices. Because firms will face increased risk of tort liability, they will also increase safety measures at the margin. And because firms will face increased contract liability, they will recalibrate their calculation of when it is efficient to breach.

Even though consumers generally do not want to pay higher prices, they would prefer higher prices and higher quality products to the inferior products carrying latent risks and costs hidden within procedural clauses. This premise holds even while acknowledging that standard law and economics analysis assumes that the most reliable guide of what consumers actually prefer is what they choose, because this assumption is less reliable when consumers are unaware of what they are choosing. That said, one oft-quoted statement of standard law and economics certainly does apply—"there is no such thing as a free lunch." Discounts consumers get from procedural clauses are not free, and as a matter of policy, we should make consumers aware of their costs.

The proposal attempts to fulfill this obligation by addressing information asymmetry in a manner similar to the penalty default rules proposed by Professors Ayres and Gertner.[110] Like penalty defaults, the proposal is designed to create an incentive for the parties to exchange information—the cost of the clauses. Furthermore, the proposal lets the market determine what the cost is. The superficial distinction between the proposal and a penalty default is that a penalty default can be contracted around, but the

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[110] *Cf.* Ayres & Gertner, *supra* note 40.

proposal cannot. This distinction is accurate, but largely academic. As things currently stand, procedural clauses could, in theory, be contracted around. But, as a practical matter, they are not because of transaction costs. One of the strengths of the proposal, however, is that it reallocates the risks to the party that economic theory predicts would bear the cost, absent transaction costs.

Additionally, the proposal eliminates the cost concentration and restores the risk to the lower cost-avoider. The result is net efficient, internalizing into the price of the form contract the types of social costs identified above: (1) the magnified risks and costs the reverse insurance function creates; (2) the firms' decreased incentives to take safety precautions at the margin; and (3) the consumers' bounded rationality, rational ignorance, and predictable irrationality, which lead to overconsumption. The proposed solution moves the supply of consumer goods to the socially optimal level, and the societal gains exist no matter which market participants, consumers or firms, pay the eventual cost. This Essay concludes by considering what party will likely pay and whether it matters.

CONCLUSION

If there were no transaction costs associated with procedural clauses, then the elimination of their enforceability would just change the distribution—it would simply be a wealth transfer.[111] The proposed solution also entails transaction costs, but it will force parties to internalize the externality created by form contracts. That is, the proposal does more than effect distributional change; by eliminating procedural provisions in form contracts it changes participant behavior and also eliminates the externality.

Nevertheless, disallowing procedural clauses in contracts will have distributional implications, depending on the relative elasticity of the market. Who will pay the price is an empirical question outside the scope of this Essay, ultimately relying "on the shape of the supply and demand curves."[112] Normatively, however, paying a slightly higher premium for mandatory market insurance is not all bad, even if most of the costs are passed on to consumers. Furthermore, although increased costs would reduce consumer surplus, the increases would also move the market toward a socially optimal outcome by essentially forcing market participants to recognize the actual cost of their transactions. Overall, refusing to enforce procedural clauses will reduce the current overconsumption of inferior, less safe products and move the market towards a socially optimal level.

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111 *See generally* Coase, *supra* note 94.

112 Richard Craswell, *Passing On the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361, 361 (1991).

AVOIDING OVERSIGHT: LEGISLATOR PREFERENCES AND CONGRESSIONAL MONITORING OF THE ADMINISTRATIVE STATE

Brian D. Feinstein[*]

INTRODUCTION

In recent decades, the longstanding conflict between Capitol Hill and the White House over control of the administrative state has intensified, with both institutions devising new mechanisms that test the limits of their respective roles.[1] In response, administrative law scholars have focused their attention on congressional and presidential involvement in administration that approaches—or oversteps—constitutional boundaries.[2] As a result, the legal academic literature tends to overlook Congress's ordinary involvement in administrative decision making.[3] In particular, legal scholarship mostly neglects one of the most fundamental means of involvement in executive affairs available to the Legislative Branch: the oversight hearing. Surprisingly little is known about the motivations of members of Congress to perform this most basic means of monitoring the

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[1] These new mechanisms have had varying degrees of success passing constitutional muster. *See, e.g.*, Clinton v. New York, 524 U.S. 417, 447-49 (1998) (holding the presidential line-item veto unconstitutional); Morrison v. Olson, 487 U.S. 654, 696-97 (1988) (upholding congressionally mandated good cause protections for the office of the independent counsel); Bowsher v. Synar, 478 U.S. 714, 726-27 (1986) (disallowing an executive officer removable by Congress from exercising budgetary authority); INS v. Chadha, 462 U.S. 919, 958-59 (1983) (prohibiting congressional committees' use of the legislative veto); Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (1993), *reprinted as amended in* 5 U.S.C. § 601 (2000) (clarifying the functions of the Office of Information and Regulatory Affairs (OIRA), a presidentially controlled regulatory planning office within the Office of Management and Budget).

[2] This focus on boundary testing is understandable. Considering that legal challenges to congressional and presidential control mechanisms often arise when those mechanisms test the limits of separation of powers norms, it is unsurprising that legal scholars devote considerable attention to those mechanisms that appear to be near the boundaries of what is constitutionally permissible.

[3] Jack M. Beermann, *Congressional Administration*, 43 SAN DIEGO L. REV 61, 64-65 (2006) (noting the fact that "Congress is deeply involved in the day to day administration of the law" as "insufficiently noted in legal scholarship"). *But see* Mark Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules*, 51 DUKE L.J. 1059 (2001); Jonathan R. Macey, *Organizational Design and Political Control of Administrative Agencies*, 8 J.L. ECON. & ORG. 93 (1992).

administrative state.[4] Questions concerning the extent to which members of Congress are incentivized to pursue oversight or, more basically, whether they are interested in doing so largely have been ignored.[5] A firmer understanding of the extent to which members of Congress are motivated to pursue oversight will offer insights into how seriously Congress views its oversight charge.

Taking a page from a group of political scientists that place legislators' motivations front and center in their explanations of various congressional actions, this analysis looks to House members' incentives and preferences as the driving force behind oversight activity.[6] By examining the value that members place on oversight subcommittee service, it is possible to gain a sense of whether Congress pursues oversight enthusiastically or reluctantly, and, by extension, how Congress perceives its role in the administrative state.[7]

This article proceeds as follows: Part I places oversight hearings in the context of a larger struggle between the President and Congress for control over the administrative state. Part II presents an overview of two competing political science perspectives on ex post congressional control of administrative agencies, and argues that a better understanding of the extent to which members are motivated to pursue oversight would shed light on this debate. To that end, Part III examines members' subcommittee seat transfers to determine members' revealed preferences for oversight-focused subcommittees versus other subcommittees. The article concludes with the finding that legislators generally view subcommittees with oversight functions as undesirable.

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[4] *But see* Beermann, *supra* note 3, at 122-27.

[5] Douglas Kriner, *Can Enhanced Oversight Repair "The Broken Branch"?*, 89 B.U. L. REV. 765, 783 (2009) (arguing that this debate "overlook[s] the initial problem with oversight—whether those who control the gavel have the personal and institutional incentives to use it.").

[6] *Cf.* ERIC SCHICKLER, DISJOINTED PLURALISM: INSTITUTIONAL INNOVATION AND THE DEVELOPMENT OF THE U.S. CONGRESS (2001) (discussing how members' multiple motivations explain various changes in congressional rules and procedures); R. DOUGLAS ARNOLD, THE LOGIC OF CONGRESSIONAL ACTION (1990) (presenting the conditions under which legislators are incentivized for the production of general versus particularistic legislation); RICHARD F. FENNO, JR., CONGRESSMEN IN COMMITTEES (1973) (noting members' preferences for various committee assignments).

[7] In addition, findings concerning members' motivations to pursue oversight could offer insights into the ongoing debate among political scientists regarding whether "congressional abdication" or "congressional dominance" better describes the contemporary Congress's performance of its oversight function.

I. CONGRESSIONAL MONITORING OF ADMINISTRATION

With the increasing size and complexity of the administrative state,[8] and recent presidential innovations aimed at strengthening the White House's control over administrative agencies,[9] Congress continues to grapple with the interrelated issues of how best to exert control over administrative agencies and counter the President's strengthened hand.[10] In the process, Congress has devised—and the Judiciary has approved—new mechanisms to expand congressional involvement in administration: testing traditional separation of powers concepts by creating executive offices outside of the conventional executive command structure and placing executive functions in the hands of officers beholden to Congress.[11] At times, however, the courts have disallowed Congress from employing novel means of involvement in administration. Most prominently, the Supreme Court declared in *INS v. Chadha*[12] that the single-chamber legislative veto of proposed agency rulemaking violated the Constitution's mandate that legislation pass both houses of Congress and garner either presidential approval or

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[8] *See* JOEL D. ABERBACH, KEEPING A WATCHFUL EYE: THE POLITICS OF CONGRESSIONAL OVERSIGHT 43-45 (1990) (noting a marked increase in the number of pages in the *Federal Register* in the 1970s); Keith W. Smith, Styles of Oversight: Congressional Committee Oversight of the Executive Branch 42 (2005) (unpublished Ph.D. dissertation, University of California, Berkeley) (on file with Moffitt Library, Berkeley) (finding that the number of terminal administrative agencies listed in the *United States Government Manual* increased by 125% between 1947 and 2000).

[9] *See, e.g.*, Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (1993), *reprinted as amended in* 5 U.S.C. § 601 (2000) (establishing a centralized regulatory planning mechanism within the White House-controlled OIRA and mandating presidential resolution of disagreements between OIRA and administrative agencies). *See generally* Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245 (2001) (arguing that recent presidents have played a greater role in the functioning of administrative agencies).

[10] *See, e.g.*, BARBARA SINCLAIR, UNORTHODOX LAWMAKING: NEW LEGISLATIVE PROCESSES IN THE U.S. CONGRESS 127-28 (3d ed. 2007) (explaining that inter-branch hostility has encouraged Congress to legislate via omnibus bills, in which legislators include relatively minor measures that the President opposes, knowing that the President would not veto the entire bill); WILLIAM WEST, CONTROLLING THE BUREAUCRACY: INSTITUTIONAL CONSTRAINTS IN THEORY AND PRACTICE 131, 141-43 (1995) (noting the growth of the Government Accountability Office and other legislative support agencies, which Congress uses to monitor and investigate the administrative state).

[11] *See* Morrison v. Olson, 487 U.S. 654, 676, 696-97 (1988) (approving congressional establishment of an office of independent counsel, with the individual holding this office appointed by a federal court and removable by the Attorney General solely for good cause); Ameron, Inc. v. U.S. Army Corps of Eng'rs, 809 F.2d 979, 989-93 (3d Cir. 1986) (upholding as constitutional a statute placing nonbinding review authority concerning government contracting bid protests with the Comptroller General, an executive officer subject to removal by unilateral congressional action). In addition, the courts have approved the use of a mechanism allowing a congressional subunit to block proposed executive branch action. *See* City of Alexandria v. United States, 737 F.2d 1022, 1025-27 (D.C. Cir. 1984) (upholding a procedure with the practical effect of allowing a congressional committee to unilaterally block an executive plan for distributing surplus government property).

[12] INS v. Chadha, 462 U.S. 919 (1983).

sufficient congressional support to override a presidential veto.[13] In addition, the Judiciary has struck down numerous congressional attempts at greater involvement in executive affairs through an enhanced role in the appointment and removal of executive officers.[14]

Some scholars argue that in the midst of this boundary testing Congress has not made sufficient use of one of the most basic mechanisms available to it for influencing administrative action: the oversight hearing.[15] While oversight activity can involve many functions,[16] formal committee and subcommittee oversight hearings are the most firmly rooted form of oversight.[17] Indeed, Congress began holding oversight hearings as early as

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[13] *Id.* at 959. *See also* U.S. Senate v. FTC, 673 F.2d 425, 434, 466 n.167 (D.C. Cir.1982) (declaring a one-chamber veto of agency rules to be unconstitutional and holding that a two-chamber veto of agency rules is unconstitutional) *aff'd sub nom.* Process Gas Consumers Grp. v. Consumer Energy Council of Am., 463 U.S. 1216 (1983). *But see* Congressional Review of Agency Rulemaking Act, 5 U.S.C. §§ 801-808 (Supp. III 1994) (a constitutionally permitted, albeit rarely used and arguably redundant, means of congressional review of administrative rules). *See generally* Louis Fisher, *The Legislative Veto: Invalidated, It Survives*, 56 LAW & CONTEMP. PROBS. 273, 275, 288 (1993) (noting that hundreds of formal legislative veto provisions have been enacted post-*Chadha*, and additional, informal understandings between the Legislative and Executive Branches are also, in effect, de facto legislative vetoes).

[14] *See* Metro. Wash. Airports Auth. v. Citizens for Abatement of Aircraft Noise, Inc., 501 U.S. 252, 279 (1991) (holding that members of Congress may not serve concurrently as officers in administrative agencies); Bowsher v. Synar, 478 U.S. 714, 732-733 (1986) (holding that the Comptroller General, an executive officer subject to removal by unilateral congressional action, cannot exercise independent authority concerning budget matters); Buckley v. Valeo, 424 U.S. 1, 126-127 (1976) (disallowing the Speaker of the House and President pro tempore of the Senate from appointing members of the Federal Election Commission); Myers v. United States, 272 U.S. 52, 107-108, 177 (1926) (striking down a law that required Senate approval for the firing of certain executive officers); Fed. Election Comm'n v. NRA Political Victory Fund, 6 F.3d 821, 822 (D.C. Cir. 1993) (barring the Clerk of the House and Secretary of the Senate from serving as nonvoting members of the Federal Election Commission). *See generally* LOUIS FISHER, CONSTITUTIONAL CONFLICTS BETWEEN CONGRESS AND THE PRESIDENT 21-83 (5th ed. 2007) (discussing inter-branch tensions regarding the appointments and removal powers).

[15] *See* MORRIS S. OGUL, CONGRESS OVERSEES THE BUREAUCRACY: STUDIES IN LEGISLATIVE SUPERVISION 182 (1976) (finding that members of Congress spend little time preparing for or engaged in oversight hearings).

[16] *See* ABERBACH, *supra* note 8, at 132 (viewing informal communication between congressional staffers and agencies' legislative liaisons as a form of oversight); WILLIAM T. GORMLEY: TAMING THE BUREAUCRACY 199 (1989) (arguing that some constituent casework can be considered a form of oversight); *see also* Carl J. Friedrich, *Public Policy and the Nature of Administrative Responsibility*, 1 PUB. POL. 6 (Carl J. Friedrich & Edward Mason eds., 1940) (asserting that policymaking "is a continuous process, the formulation of which is inseparable from its execution").

[17] *See* CONG. RESEARCH SERV., CONGRESSIONAL INVESTIGATIONS, CRS ANNOTATED CONSTITUTION 90, *available at* http://www.law.cornell.edu/anncon/html/art1frag9_user.html ("The Court has long since accorded its agreement with Congress that the investigatory power is so essential to the legislative function as to be implied from the general vesting of legislative power in Congress."); *see also* Beermann, *supra* note 3, at 122 (explaining how the Legislative Reorganization Act of 1946 rearranged committee jurisdictions and formed professional oversight staffs for certain committees, thereby

1791.[18] According to Arthur Schlesinger, Jr., the Constitution does not explicitly refer to Congress's oversight authority for the simple reason that such authority was considered implicit in the body's general legislative powers. In other words, oversight was considered a given.[19]

The Supreme Court recognizes the importance and constitutional validity of vigorous congressional oversight hearings. Perhaps most notably, the Court stated in *McGrain v. Daugherty*[20] that Congress has the authority "to compel a private individual to appear before it or one of its committees and give testimony needed to enable it efficiently to exercise a legislative function belonging to it under the Constitution."[21] Although a series of cases regarding the McCarthy and House Committee of Un-American Activities hearings established that Congress's investigatory powers are not unrestricted, the relatively weak requirement that the Judiciary placed on the exercise of these powers—that investigations must be connected at least to the possibility of future legislative action—affirms the strength and importance of Congress's oversight authority.[22] In a sense, the "red scare cases" are the exception that proves the rule.

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establishing long-lasting oversight institutions); M. Nelson McGeary, *Congressional Investigations: Historical Development*, 18 U. CHI. L. REV. 425, 425-28 (1951) (describing the gradual development of congressional oversight institutions).

[18] McGeary, *supra* note 17, at 425 (noting that the House convened a special committee in 1791 to investigate the U.S. Army's defeat by Native American forces in the Battle of the Wabash).

[19] ARTHUR M. SCHLESINGER, JR., CONGRESS INVESTIGATES: A DOCUMENTED HISTORY, 1792-1974, VOL. 1, xix (Arthur M. Schlesinger, Jr. & Roger Bruns eds., 1975) ("[I]t was not considered necessary to make an explicit grant of such authority. The power to make laws implied the power to see whether they were faithfully executed.").

[20] 273 U.S. 135, 154 (1927).

[21] *Id. See also* Nixon v. Adm'r of Gen. Servs., 433 U.S. 425, 453 (1977) (stating Congress may act to preserve White House documents related to President Nixon's resignation, executive privilege notwithstanding, since the possibility that such documents could be relevant to future legislation places their preservation within the scope of Congress's investigative power); Eastland v. U.S. Servicemen's Fund, 421 U.S. 491, 503-07 (1975) (members of Congress cannot be sued for alleged constitutional violations stemming from issuing subpoenas to individuals to appear before a congressional committee because the Constitution's Speech and Debate Clause encompasses legislators' subpoena powers).

[22] Barenblatt v. United States, 360 U.S. 109, 111 (1959) ("The scope of the [congressional] power of inquiry . . . is as penetrating and far-reaching as the potential power to enact and appropriate, [subject to the limitation that] Congress may only investigate into those areas in which it may potentially legislate or appropriate."); Barsky v. United States, 167 F.2d 241, 250 (D.C. Cir. 1948) ("The courts have no authority to speak or act upon the conduct by the legislative branch of its own business, so long as the bounds of power and pertinency are not exceeded."); United States v. Bryan, 72 F. Supp. 58, 61 (D.C. Cir. 1947) ("If the subject under scrutiny may have any possible relevancy and materiality, no matter how remote, to some possible legislation, it is within the power of the Congress to investigate the matter. Moreover, the relevancy and the materiality of the subject matter must be presumed."). *But see* Watkins v. United States, 354 U.S. 178, 187 (1957) (curtailing House Un-American Activities Committee inquiries into witnesses' personal beliefs, although dictum affirmed that Congress's "[broad] power . . . to conduct investigations is inherent in the legislative process.").

Observed connections between oversight and legislative action serve to further buttress the theoretical significance of Congress's oversight function. For instance, David Epstein and Sharyn O'Halloran report a positive correlation between the frequency of oversight hearings within a given committee jurisdiction and the passage of bills within that jurisdiction that grant broad discretion to executive agencies.[23] This finding suggests that Congress may consider the crafting of narrowly tailored statutory delegations (an ex ante control) and vigorous oversight (a post-enactment check on bureaucratic action) as substitute means of preventing bureaucratic drift.[24] Moreover, oversight hearings can alter agency behavior significantly. Bureaucratic infractions that are the subject of hearings are approximately 22% less likely to reoccur than similar infractions for which congressional committees and subcommittees choose not to hold hearings.[25] Taken together, the deep historical roots of oversight hearings, the judicial recognition of their importance, and social scientists' findings that hearings are consequential in terms of policy design and bureaucratic responsiveness suggest that oversight hearings ought to be an important tool for Congress to monitor the administrative state in a system of separated institutions sharing power.

II. CONGRESSIONAL ABDICATION OR DOMINANCE?

Despite the theoretical and observed importance of oversight hearings, some scholars have charged that Congress has not lived up to its oversight responsibilities. Thomas Mann and Norman Ornstein decry the "disappearance" of oversight hearings,[26] which they consider a symptom in their diagnosis of Congress as "the broken branch."[27] Douglas Kriner sounds a more specific, and arguably more troubling, alarm; despite the 9/11 Commission's emphasis on enhancing congressional oversight of counterterrorism policy, Kriner warns that "Congress has done little to

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23 David Epstein & Sharyn O'Halloran, *The Nondelegation Doctrine and the Separation of Powers: A Political Science Approach*, 20 CARDOZO L. REV. 947, 982 (1999).

24 *Id.* at 958. *See also* Kathleen Bawn, *Choosing Strategies to Control the Bureaucracy: Statutory Constraints, Oversight and the Committee System*, 13 J.L. ECON. & ORG. 101, 112 (1997) (formal theoretic model's positing that ex ante statutory controls and ex post oversight are substitute mechanisms for controlling agency action).

25 Brian D. Feinstein, Oversight, Despite the Odds: Assessing Congressional Committee Hearings as a Means of Control over the Federal Bureaucracy 177 (2009) (unpublished Ph.D. dissertation, Harvard University) (on file with Pusey Library, Harvard University).

26 THOMAS E. MANN & NORMAN J. ORNSTEIN, THE BROKEN BRANCH: HOW CONGRESS IS FAILING AMERICA AND HOW TO GET IT BACK ON TRACK 170 (2006).

27 *Id.* at 215.

improve its oversight capacity . . . in the realm of miliary policy and terrorism."[28]

In offering their comments on contemporary Congresses, these observers are tapping into a decades-long debate between political scientists that see the congressional-administrative agency relationship as characterized by congressional abdication and those that view it in terms of congressional dominance. Grounded in capture theory, the abdication perspective holds that because subcommittees, agencies, and interest groups tend to have close, "mutually rewarding" ties, the prospects for vigorous oversight are slim.[29] Scholars who subscribe to the abdication perspective claim that oversight is extremely limited and point to what they perceive as the underproduction of subcommittee oversight hearings during the 1960s.[30] More recent scholars have offered a rational choice corollary to this perspective, arguing that reelection-focused members of Congress have little motivation to forcefully check the Executive Branch.[31] According to the congressional abdication perspective, oversight can be seen as a classic collective action problem, with reelection-focused representatives being poorly incentivized for their production.

Just as the low oversight levels of the 1960s motivated pluralist scholars to argue that oversight is incompatible with members' incentives, higher oversight levels in the 1970s and 1980s encouraged a second group of scholars to speak of congressional dominance.[32] According to the congressional dominance perspective, because committees are privileged

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28 Kriner, *supra* note 5, at 774.

29 Seymour Scher, *Conditions for Legislative Control*, 25 J. POL. 526, 533-34 (1963). *See also* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. 3 (1971) (discussing capture theory, a perspective on the policymaking process stating that mobilized, resource-laden interest groups play an outsized role in affecting outcomes in the policy areas in which they operate). *See generally* LAWRENCE DODD & RICHARD SCHOTT, CONGRESS AND THE ADMINISTRATIVE STATE (1979); THEODORE J. LOWI, THE END OF LIBERALISM: THE SECOND REPUBLIC OF THE UNITED STATES (1979) (seminal works on congressional action that are grounded in the subcommittee government, or "iron triangles" view of the policy process).

30 OGUL, *supra* note 15.

31 *See* WILLIAM G. HOWELL, POWER WITHOUT PERSUASION: THE POLITICS OF DIRECT PRESIDENTIAL ACTION (2003); Terry M. Moe, *The Presidency and the Bureaucracy: The Presidential Advantage*, *in* THE PRESIDENCY AND THE POLITICAL SYSTEM 425 (Michael Nelson ed., 2003).

32 Mathew McCubbins, Roger Noll, & Barry Weingast, *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431 (1989) [hereinafter McNollgast, *Structure and Process*]; Mathew McCubbins, Roger Noll, & Barry Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J.L. ECON. & ORG. 243 (1987) [hereinafter McNollgast, *Administrative Procedures as Instruments*]; Mathew McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms*, 28 AM. J. POL. SCI. 165 (1984).

actors during the legislative process,[33] they are empowered to take on recalcitrant agencies. Committee prerogatives during the budgeting and reauthorization processes enable these subunits to effectively oversee the administrative agencies under their jurisdictions.[34] The ability of congressional committees and subcommittees to oversee and direct the bureaucracy does not imply, however, that these entities engage in frequent and consistent monitoring. Rather, scholars writing from the congressional dominance perspective contend that rational legislators can design bureaucratic institutions to be responsive to their preferences through the enactment of information-forcing provisions and via an active role in the appointment process, thus effectively substituting ex ante measures in place of ex post oversight.[35] Only when outside actors notify the subcommittee of bureaucratic drift, shirking, or other misbehavior will the subcommittee exercise its formidable oversight capabilities.[36]

This version of the congressional dominance perspective introduces a "fire alarm" analogy to congressional oversight. Rather than actively patrolling, fire departments mostly respond to calls received. Similarly, congressional subcommittees are mobilized to act only when an outside group sounds an alarm that an executive agency is engaged in action that the group disfavors.[37] Under the "fire alarm" view, infrequent oversight is therefore entirely consistent with the congressional dominance perspective.[38]

The fact that certain observed behaviors could be considered supportive of both theories has stymied empirical tests of the opposing abdication and dominance theories. Most notably, an assertion that subcommittees do not devote significant time and resources to oversight hearings would be consistent with both theories. The same is true of a hypothetical finding that oversight hearings—when they actually occur—rarely lead to consequential changes in agency behavior. While both of

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33 *See, e.g.*, KEITH KREHBIEL, INFORMATION AND LEGISLATION ORGANIZATION 97 (1991) (arguing that the granting of restrictive rules for floor consideration of committee bills incentivizes committee members to gain policy expertise in their committees' jurisdictions).

34 Barry R. Weingast & Mark J. Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765 (1983).

35 Randall L. Calvert, Mathew D. McCubbins, & Barry R. Weingast, *A Theory of Political Control and Agency Discretion*, 33 AM. J. POL. SCI. 588, 598, 604 (1989).

36 McCubbins & Schwartz, *supra* note 32, at 165-66. The fire alarm analogy of infrequent, yet effective, oversight following an outside group alerting Congress to problematic agency action stands in contrast to a "police patrol" analogy of oversight, in which oversight subcommittees vigorously monitor the bureaucracy, much like police officers patroling a neighborhood, and respond with oversight hearings if they uncover problematic behavior. *Id.*

37 *Id.*

38 Morris P. Fiorina, *Congressional Control of the Bureaucracy: A Mismatch of Incentives and Capabilities*, *in* CONGRESS RECONSIDERED 333, 333 (Lawrence C. Dodd & Bruce I. Oppenheimer eds., 2d ed. 1981) ("[T]he Congress controls the bureaucracy, and the Congress gives us the kind of bureaucracy it wants.").

these hypothetical observations would provide a priori support for the congressional abdication perspective, they also are consistent with congressional dominance. The latter theory could explain infrequent oversight as a consequence of well-crafted procedural requirements that allow subcommittee-favored groups to influence agency decision making directly, reducing the need for oversight hearings as an ex post means of control.[39] Whereas congressional abdication scholars might view infrequent oversight as the consequence of an insurmountable expertise gap between principal and agent, or perhaps a debilitating collective action problem within Congress, congressional dominance scholars would argue instead that this relative lack of subcommittee-based oversight is evidence not of abdication, but of acquiescence. According to the congressional dominance perspective, congressional subcommittees would spring into action if a fire alarm were pulled by the right interest group or voting bloc.

Studies of subcommittee oversight levels or the bureaucratic consequences of oversight activity, therefore, cannot provide a complete picture of Congress's interest in and capacity for oversight. This article presents an alternative, complementary means of evaluation: using insights into the extent to which members are motivated to conduct oversight as a window into the value that the Legislative Branch places on monitoring the Executive. With a sense of whether members tend to value oversight activity (and, relatedly, *which* members tend to be most active in oversight), it is possible to make inferences concerning the extent to which Congress as an institution prioritizes oversight.

With this objective in mind, an ordering of members' preferences for all House subcommittees during the 105th through 109th Congresses is estimated, using an original dataset of member transfers among these subcommittees. If this subcommittee transfers analysis indicates that members place a high value on oversight-focused subcommittees, that result would suggest that members believe that oversight is a worthwhile endeavor. Conversely, if oversight subcommittees are clustered toward the bottom of these rankings, such a finding would suggest a lack of interest in oversight of the administrative state.

III. SEAT TRANSFERS AS REVEALED PREFERENCES

To determine the value that members of Congress attach to service on each of the 119 House subcommittees in existence for at least one session

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[39] McNollgast, *Structure and Process*, *supra* note 32, at 443; McNollgast, *Administrative Procedures as Instruments*, *supra* note 32, at 244. Moreover, congressional dominance theory would argue that ineffective oversight is evidence that congressional committees simply do not *want* to conduct vigorous oversight (perhaps due to lack of pressure from allied outside groups), not per se that committees are *unable* to conduct effective oversight. *See* Fiorina, *supra* note 38, at 333.

between 1997 and 2006, I examined transfers among subcommittees during the 105th through 109th Congresses, considering an individual's transfer from Subcommittee A to Subcommittee B as an expression of preference of B over A.

This view of subcommittee transfers as an expression of preference is grounded in a well-established literature that states the same at the committee level.[40] Freshman representatives, the theory goes, are initially placed on a set of committees and subcommittees that may not represent their most preferred portfolio. As they ascend the seniority and power ladders, members often elect to transfer to more preferred bodies.[41]

The experience of Congresswoman Shirley Chisholm (D-NY-12) provides a good illustration of this concept. Upon entering Congress in 1969, Chisholm was initially assigned to the Agriculture Committee.[42] As she was elected to represent a district in Brooklyn, New York, Chisholm was understandably unhappy with this assignment. She successfully transferred to the Veterans' Affairs Committee shortly thereafter.[43] Her later statement that "there are a lot more veterans in my district than there

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[40] *See* Charles Stewart III & Tim Groseclose, *The Value of Committee Seats in the United States Senate, 1947-91*, 43 AM. J. POL. SCI. 963 (1999); Tim Groseclose & Charles Stewart III, *The Value of Committee Seats in the House, 1947-91*, 42 AM. J. POL. SCI. 453 (1998); Michael C. Munger, *Allocation of Desirable Committee Assignments: Extended Queues versus Committee Expansion*, 32 AM. J. POL. SCI. 317 (1988); Charles S. Bullock, III, *Committee Transfers in the United States House of Representatives*, 35 J. POL. 85 (1973). *But see* GARY W. COX & MATHEW D. MCCUBBINS, LEGISLATIVE LEVIATHAN: PARTY GOVERNMENT IN THE HOUSE 34 (1993) (finding that approximately three-quarters of all transfer requests during the 86th through 97th Congresses were approved). Cox and McCubbins point to an alternative hypothesis: that transfers are carried out by House leaders to reward (or punish) members for their behavior. *Id.* at 182. While, by one interpretation, this high proportion of approved transfer requests may seem indicative of a strong connection between member preferences and committee transfers, Cox and McCubbins caution that members would not formally request a transfer unless there is a reasonable likelihood of success. *Id.* at 32. As with any study that seeks to divine subjects' opinions from their observed actions, any examination of committee and subcommittee transfers as revealed preferences runs the risk of neglecting "second face of power" issues. For example, KENNETH A. SHEPSLE, THE GIANT JIGSAW PUZZLE: DEMOCRATIC COMMITTEE ASSIGNMENTS IN THE MODERN HOUSE 65 (1978) shows that newly elected Democratic members recognize that they are less likely to gain assignment to the more popular committees, and take this into account when making their initial assignment requests. Despite this limitation, the fact that the committee rankings reported in the above-cited publications match up with FENNO, *supra* note 6, at 150 (a qualitative account of which committees members of Congress most highly value) provides prima facie evidence of these measures' content validity.

[41] *See* Bullock, *supra* note 40, at 89 (stating, "transfers can be thought of as occurring at the juncture of motivation and opportunity curves," with members seeking new assignments for "the power and prestige it offers, to serve . . . constituents' interests better, or to exert influence over matters which interest [them].").

[42] James Barron, *Shirley Chisholm, 80, Dies; 'Unbossed' Pioneer in Congress and Presidential Candidate*, N.Y. TIMES, Jan. 4, 2005, at B9.

[43] SHIRLEY CHISHOLM, UNBOUGHT AND UNBOSSED 84-86 (1970).

are trees" indicates that she viewed this transfer as an improvement.[44] As a reward for her support of Congressman Hale Boggs for House Majority Leader a few years later, she gained a seat on the Education and Labor Committee,[45] with a jurisdiction that arguably most closely aligned with her programmatic liberal policy interests. One may assume, therefore, that this second transfer represents another expression of preferences.

A. *Research Design*

To assess the desirability of oversight subcommittee assignments, I collected original data on members' transfers among subcommittees during the 105th through 109th Congresses (1997–2006)—a total of 1,648 transfers.[46] I then used this data to estimate members' relative preferences for each subcommittee during this period[47] by applying a probit-based statistical method that considers not only Subcommittee A's relative proportion of transfers on to transfers off, but also from which other committees Subcommittee A is gaining (and to which others it is losing) members. This statistical method was developed by Timothy Groseclose and Charles Stewart in companion articles.[48]

Leveraging information concerning from which (to which) other subcommittees a given subcommittee is gaining (losing) members is important. A datum that Subommittee A lost twelve members would be

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[44] *Id.*

[45] Barron, *supra* note 42.

[46] To obtain a reliable record of subcommittee transfers, a variety of congressional documents that regularly publish subcommittee membership lists were examined. These sources include the "List of Standing Committees and Select Committees and their Subcommittees" published biennially by the Clerk of the House and various committee prints, usually entitled "Journal and History of Legislation" or "Committee Legislative Calendar." Although the primary purpose of these publications is to provide a record of committees' actions, they typically also include subcommittee membership rosters. Between these two sources, it was possible to obtain subcommittee membership lists updated at least once per year during the period under study.

[47] Even though the subcommittee system was relatively stable during this period of Republican rule, occasionally new subcommittees were born, old ones died, and marriages and divorces (in which multiple committees merged their jurisdictions into one new committee, and vice-versa) occurred. An accurate compilation of subcommittee transfers requires distinguishing inconsequential changes in subcommittee names from these more significant events. In making these determinations, the Policy Agendas Project's Subcommittee Codebook is used as a guide. POLICY AGENDAS PROJECT, "Congressional Hearings," *available at* http://www.policyagendas.org/page/datasets-codebooks#committee_codebook; POLICY AGENDAS PROJECT, "Congressional Quarterly Almanac," *available at* http://www.policyagendas.org/page/datasets-codebooks#committee_codebook; POLICY AGENDAS PROJECT, "Public Laws," *available at* http://www.policyagendas.org/page/datasets-codebooks#committee_codebook; POLICY AGENDAS PROJECT, "Most Important Laws," *available at* http://www.policyagendas.org/page/datasets-codebooks#committee_codebook.

[48] Stewart & Groseclose, *supra* note 40; Groseclose & Stewart, *supra* note 40. See the Appendix for more details concerning how to implement the method.

interpreted very differently if the members were lost to a desirable subcommittee such as the Select Revenue Measures Subcommittee of the Ways and Means Committee than if they instead left to join the Committee on Standards of Official Conduct, which many observers consider a "burden committee."

The analysis is limited to the 1997–2006 interval—a period during which the Republicans held a majority of House seats—for two reasons. First, drastic shifts in the partisan composition of subcommittees accompany changes in partisan control of the chamber, as party ratios on committees and subcommittees are altered to favor the new majority. Clearly, these mass movements of members to and from subcommittees—particularly during the 104th Congress (1995–1996) immediately following the Republicans' ascent—do not represent expressions of preference, as outlined above. Second, reforms initiated by Speaker Newt Gingrich (R-GA-6) and Congressman David Dreier (R-CA-26) altered the committee system, making comparisons between the pre- and post-"Republican Revolution" periods more difficult.[49] This analysis is therefore restricted to one era, the 105th through 109th Congresses.

B. *Results: Members' Aversion to Oversight Service*

Figures 1 and 2 show subcommittee preference rankings for Democratic and Republican representatives, respectively, during the 105th through 109th Congresses. Each dot signifies a $\hat{v}$ point estimate for a subcommittee's cardinal preference ranking, with the corresponding bars denoting the 95% confidence interval. Subcommittees with an oversight-focused jurisdiction are shown in black.[50]

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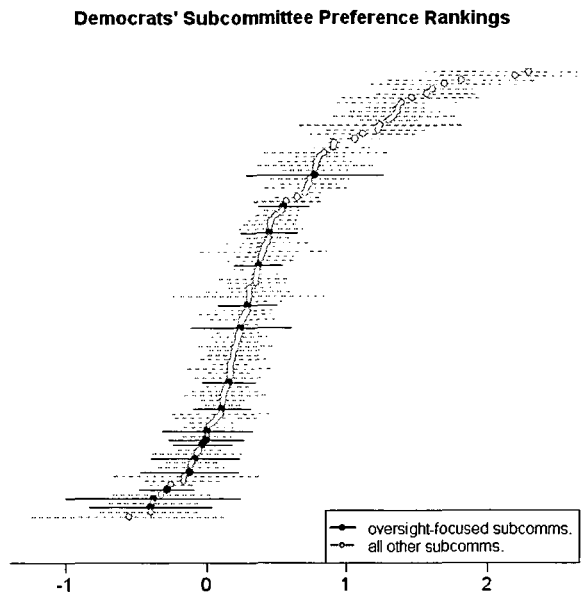
[49] *See* JUDY SCHNEIDER, CHRISTOPHER DAVIS, & BETSY PALMER, CONG. RESEARCH SERV., RL31835, REORGANIZATION OF THE HOUSE OF REPRESENTATIVES: MODERN REFORM EFFORTS 54-60 (2003).

[50] "Oversight-focused" subcommittees encompass the various authorization committees' oversight and investigations subcommittees—which typically include language in their parent committees' rule manuals limiting these subcommittees' jurisdictions "to existing law"—as well as the subcommittees of the Government Reform and Oversight Committee. For the curious (and those willing to ignore confidence intervals), the Defense Appropriations Subcommittee of the Appropriations Committee is the most preferred subcommittee assignment for Democrats, and the Environment, Technology and Standards Subcommittee of the Science Committee is the least preferred. Among Republicans, the Transportation Appropriations Subcommittee of the Appropriations Committee is the most favored appointment, while the Oversight and Investigations Subcommittee of the Education and Labor Committee is the least favored.

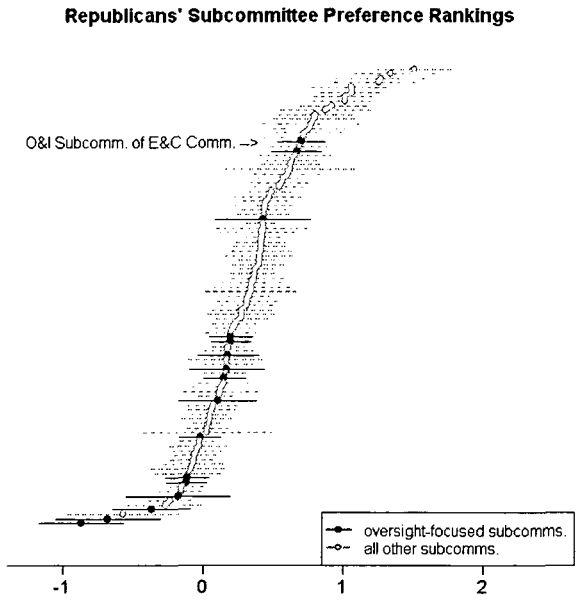
Note that the confidence intervals surrounding many of these preference value estimates overlap. Perhaps these large intervals are due to the relatively high ratio of covariates-to-observations. After all, precise estimates may be difficult to achieve with any model that includes 119 subcommittee-covariates and only 795 observations (transfers) for the Democratic analysis and 853 for the Republican analysis. Or perhaps members, in the aggregate, genuinely are indifferent between seats on many

FIGURE 1



different subcommittees. In either case, the size of the resulting standard errors means that one cannot make declarative statements concerning the exact placement of specific subcommittees.

FIGURE 2



These figures provide a general sense of many subcommittees' relative positions in the pecking order. Take, for example, the Oversight and Investigations Subcommittee of the Energy and Commerce Committee. This subcommittee's estimate for the Republicans appears as the right-most black dot in Figure 2, as is labeled in the figure. The associated 95% confidence interval for this subcommittee lies entirely to the right of fifty-two other subcommittees' confidence intervals; lies entirely to the left of three other subcommittees' confidence intervals; and overlaps with the confidence intervals of sixty-four other subcommittees. Thus, one can say with 95% confidence that House Republicans strictly prefer the Energy and Commerce Committee's Oversight and Investigations Subcommittee to fifty-two other specific subcommittees; three other subcommittees are strictly preferred to this subcommittee, and one cannot reject the null hypothesis of preference indifference between this and sixty-four other subcommittees. Statements of this sort, despite lacking the precision of "$a \succ b \succ c$"-type declarations, are nonetheless useful in determining members' relative preferences for oversight-specific subcommittees.

From a cursory look at Figures 1 and 2, it appears that the oversight-specific subcommittees are clustered towards the bottom of the distribution, indicating that these bodies are among the least-preferred subcommittees for both Democratic and Republican members of Congress. Two difference of means tests confirm this initial observation. For the Democrats, 0.411

points separate the mean cardinal value of a seat on an oversight-focused subcommittee and the mean cardinal value of a seat on a non-oversight-focused subcommittee. For the Republicans, a 0.355 point gap exists.[51] On a scale in which less than 2.5 points separate the most and least preferred subcommittees, these differences are nontrivial.[52]

The same result holds when one focuses exclusively on intra-committee transfers (i.e., transfers between subcommittees within the same parent committee). Because the rules governing intra-committee transfers differ from those concerning transfers between committees, there is value in examining intra-committee transfers separately.[53] Table 1 shows the results of this intra-committee transfer analysis for the eight House authorization committees that contained an oversight subcommittee for at least two consecutive Congresses between the 105th and 109th.[54]

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[51] Results obtained via paired-samples t-tests. For the Democratic data: t=3.90, df=35.6, p=0.000; for the Republican data: t=3.12, df=20.0, p=0.005. In other words, both differences of means are statistically significant.

[52] Converting these cardinal values to an ordinal scale (assigning a value of 1 to the most-preferred subcommittee and 119 to the least-preferred) yields similar results. Democrats and Republicans both assign oversight-focused subcommittees a mean rank of approximately sixty-seven, while other subcommittees have a mean rank of approximately fifty-one—a difference of sixteen positions. Results obtained via paired-samples t-tests are as follows: for the Democrats: t=1.96, df=23.1, p=0.062; for the Republicans: t=1.86, df=22.1, p=0.076.

[53] Unfortunately, the relatively low number of intra-committee transfers compared to the number of subcommittees disallows a more comprehensive analysis (because the Stewart and Groseclose method treats each transfer as an observation and each subcommittee as a covariate, resulting in a low ratio of observations to covariates). *See* Stewart & Groseclose, *supra* note 40, and Groseclose & Stewart, *supra* note 40.

[54] The requirement that a subcommittee must be in existence for at least two consecutive Congresses means that the short-lived Oversight, Investigations and Emergency Management Subcommittee of the Transportation Committee, which met only during the 106th Congress, is excluded. The general paucity of intra-committee transfers involving subcommittees that were only in existence for one Congress makes it infeasible to include these subcommittees in this analysis.

TABLE 1: PREFERENCES FOR OVERSIGHT SUBCOMMITTEE SEATS, EXCLUDING INTER-COMMITTEE TRANSFERS[55]

Parent Committee	Preference Estimate *oversight subcomm.*	Preference Estimate *Other subcomms. in parent comm.*	Difference in Preference Estimates
Agriculture	0.237	0.410	-0.173
Banking, Financial Services	0.714	0.467	0.247
Education and the Workforce	0.233	0.478	-0.245
Commerce	-0.226	0.012	-0.238
International Relations	0.076	0.319	-0.243
Small Business	0.928	0.531	0.397
Veterans' Affairs	0.428	0.628	-0.199
Ways and Means	0.105	0.177	-0.072

Table 1 displays both the cardinal value estimates for the listed oversight subcommittees and the average cardinal value estimate for all other subcommittees within the same parent committee.[56] The difference between these two preference estimates is also reported. Positive values of this difference suggest that a given committee's members generally prefer oversight subcommittee assignment over a seat on the average other

[55] Analysis conducted for those House authorization committees that contained an oversight-focused subcommittee during at least two consecutive Congresses between the 105th and 109th Congress (1997–2006). For those committees that underwent a name change, the official name at the beginning of the period is used. The Agriculture Committee's oversight subcommittee also had authorization jurisdiction over departmental operations, dairy, nutrition, and forestry for part of this period.

[56] For each row, the average cardinal value estimate for all other subcommittees within the same parent committee is estimated only for those years in which the relevant oversight subcommittee was in existence. Note the absence of standard error estimates associated with these preference estimates. Because of the generally low volume of intra-committee transfers, for each committee the $\hat{v}_j$ coefficient estimates for only one or two subcommittees achieve conventionally accepted levels of statistical significance, and in some cases the standard error estimates dwarf the coefficient estimates, meaning that the uncertainty surrounding these estimates prevents the analyst from making strong claims regarding members' relative preferences among subcommittees. This shortcoming notwithstanding, the coefficient estimates are reported here as "best guesses," which offer some value in terms of divining members' true preferences among subcommittees within the same parent committee.

subcommittee within that parent committee. Negative values suggest the opposite—that committee members assign a lower value to oversight seats relative to membership on the committee's other subunits. It is also important to note that because most of the (unreported) standard errors are larger than their corresponding coefficient estimates—perhaps due to the low number of intra-committee transfers—one must temper any conclusions drawn from the coefficient estimates.

Nevertheless, this negative difference in six of the eight cases reported in Table 1 provides additional support for the earlier finding that members tend not to value oversight subcommittee seats. For six out of these eight committees, the estimated preference value for the oversight subcommittee is lower than that of the average of other subcommittees within the committee.

Although the relative lack of data concerning intra-committee transfers and, relatedly, the omission of standard error estimates suggests that caution is needed in interpreting Table 1, the basic finding from this analysis confirms the findings from the earlier, more comprehensive analyses: members tend to favor other subcommittee assignments over seats on oversight-focused subunits. Taken together, these findings strongly suggest that members of Congress, on average, prefer assignments on subcommittees that do not focus on oversight and investigative work to those that do.

A. *Oversight as a Partisan Activity*

In addition, seats on oversight-focused subcommittees may be more attractive for a representative when the President and that individual are members of opposing political parties. In these instances, party leaders look favorably upon the representative's efforts to embarrass the President, which could, in relative terms, improve the public's perception of the representative's own party. Conversely, when the member of Congress and the President share a party attachment, the member faces a strong disincentive to investigate the Executive Branch. In these instances, calling attention to perceived Executive Branch failings could damage the party's collective electoral fortunes.

Difference of means tests for the cardinal values, reported in Table 2, indicate that the cardinal value that Republicans placed on oversight subcommittee seats during the Clinton Administration was 0.74 points higher than during the Bush Administration. One must proceed with some caution in interpreting this figure, however, as the associated p-value of 0.12 is slightly higher than conventionally-accepted levels of statistical significance. Still, this 0.74 difference is substantial, considering that the total range of cardinal values is approximately 2.5. These results confirm many political observers' intuitions: Republican members of Congress

appear to have been more interested in investigating the Executive Branch during the Clinton Administration than during the Bush Administration.

For the Democrats, one observes a null finding. Considering that congressional Democrats were in the minority during this period, it is unsurprising that they did not seem any more interested in serving on oversight-focused subcommittees during Republican versus Democratic administrations. With Republican chairs controlling their subcommittees' agendas, perhaps Democrats' opportunities for active involvement in oversight were slim regardless of the president in office.

TABLE 2: OVERSIGHT PREFERENCES AND MEMBERS' PARTISAN ALIGNMENT WITH THE PRESIDENT[57]

	With Same-Party President	With Opposition President	Difference in Means	p-value
Democrats	0.57	0.18	-0.39	0.43
Republicans	0.15	0.89	0.74	0.12

Note that Table 2 does not purport to show differences in preferences for oversight work during a period of divided versus unified government. Instead, it examines both Democratic and Republican members' oversight preferences during periods when the White House is controlled by either a same- or opposition-party President. Nonetheless, the finding that, at least among Republican members of Congress, the presence of a Democratic President makes assignment to an oversight subcommittee more desirable may have implications for the ongoing scholarly debate over whether the existence of divided versus unified government impacts congressional engagement in oversight.

CONCLUSION

This article sought to determine the value that members of Congress assign to oversight subcommittee service, arguing that such knowledge could facilitate evaluations of the extent to which Congress as an institution prioritizes oversight. Treating members' movement from one subcommittee to another as revealing a preference for the latter over the

[57] Differences of means obtained by computing the difference between the mean coefficient for oversight-specific subcommittees when the representative and the President are members of opposing parties and the mean coefficient for oversight-specific subcommittees when the representative and the President share a partisan affiliation. Results obtained via paired-samples t-tests.

former assignment, I used an original dataset of subcommittee transfers to create an index of members' cardinal preferences for all House subcommittees—with oversight subcommittees clustered in the lower portion of the distribution. From this analysis, the finding emerges that seats on oversight subcommittees generally are not as highly valued as seats on other subcommittees. This statement holds true for Republicans, who were in the majority during this period, and for out-of-power Democrats.[58]

This result strongly suggests that oversight subcommittees are generally undesirable appointments. When he first entered the House as a newly elected representative, future Speaker Dennis Hastert (R-IL-14) was placed on the Government Reform and Oversight Committee, which, he later recalled, "is where a lot of freshmen wind up."[59] The empirical results in this article support the notion—implicit in Speaker Hastert's observation that this committee was a dumping ground for freshmen—that members of Congress do not value oversight activity. Instead, oversight is pursued reluctantly. The generally low preference estimates for oversight seats hint at the possibility that members assigned to oversight duties would rather pursue other goals. Even the "fire alarm" strand of congressional dominance, which holds that Congress can effectively oversee executive agencies with minimal observed congressional action, presumes that Congress must be willing to hold hearings if bureaucratic drift or shirking is detected. Indeed, under this theory the threat of congressional action following a sounded alarm regarding agency "misbehavior" is what keeps agencies from straying too far,[60] which presupposes that Congress is willing to conduct oversight if needed. Legislators' lack of interest in serving on oversight subcommittees suggests that this assumption may not be accurate.

This finding also casts doubt of the ability of these subcommittees to effectively monitor administrative agencies, as one wonders how responsive executive branch officials will be to oversight hearings conducted by members of Congress who would rather be elsewhere. With members of Congress relatively uninterested in oversight subcommittee service, signs point to the conclusion that Congress is not enthusiastic about performing its oversight function. The outsized presence of uninterested members on oversight subcommittees suggests, if not congressional abdication, at least congressional reluctance.

This reluctance may have significant implications for the functioning of the administrative state. As presidential involvement in administrative processes has increased,[61] and as the Supreme Court has placed limits on

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58 Although Republicans tended to value these assignments more during Clinton's tenure than during Bush's, these results generally hold across party affiliation and presidential regime.

59 DENNIS HASTERT, SPEAKER: LESSONS FROM FORTY YEARS IN COACHING AND POLITICS 86 (2004).

60 McCubbins & Schwartz, *supra* note 32, at 176.

61 *See generally* Kagan, *supra* note 9, at 2246-48.

the Judiciary's role in the workings of administrative agencies,[62] Congress must vigorously use the tools at its disposal in order to maintain some semblance of the Framers' intended system of separated institutions sharing power.[63] Legislators' reluctance to serve on oversight subcommittees suggests that Congress is not fully meeting this charge.

METHODOLOGICAL APPENDIX

The statistical model utilized in this article was first implemented and developed by Timothy Groseclose and Charles Stewart.[64] This appendix provides an explanation of their methodology. First they define the average value that members attach to service on unit j as v_j. The value that individual House member i places on subcommittee j, denoted as v_j^i, is equal to $v_j + \varepsilon_j^i$, where ε_j^i is the difference between i's value placed on subcommittee j and the average value.[65] Therefore, if i prefers a seat on subcommittee j over seats on both subcommittee k and subcommittee l, for instance, this would be expressed as:

$$v_j^i > v_k^i + v_l^i \quad (1)$$

or alternatively,

$$v_j + \varepsilon_j^i > (v_k + \varepsilon_k^i) + (v_l + \varepsilon_l^i) \quad (2)$$

$$v_j - v_k - v_l > \varepsilon_k^i + \varepsilon_l^i - \varepsilon_j^i \quad (3)$$

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62 Most notably, the *Chevron* Court restricted courts' role in interpreting agencies' organic statutes, and the *Vermont Yankee* Court barred the Judiciary from creating new procedural requirements for agency rulemaking. Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc. 467 U.S. 837 (1984); Vt. Yankee Nuclear Power Corp. v. Natural Res. Def. Council, Inc. 435 U.S. 519 (1978).

63 *See* Beermann, *supra* note 3, at 140 (arguing that as the President's policymaking powers have increased, "[c]ongressional administration [including oversight institutions] may be important to maintaining any hope for balance."); Abner S. Greene, *Checks and Balances in an Era of Presidential Lawmaking*, 61 U. CHI. L. REV. 123, 131 (1994) (arguing that "in an era of presidential lawmaking, preserving the framers' core principle of dividing legislative from executive power requires . . . structural adjustments."). In addition, robust post-enactment oversight of agency actions could serve as a corrective for the separation of powers concerns related to a lenient nondelegation doctrine. *See* Beermann, *supra* note 3, at 123 ("From the perspective of someone concerned that Congress delegates too much power to the executive branch, informal oversight is an important ameliorative, picking up some of the slack in legislative guidance that is lacking in broad delegations."). *See also* DAVID SCHOENBROD, POWER WITHOUT RESPONSIBILITY: HOW CONGRESS ABUSES THE PEOPLE THROUGH DELEGATION (1993), for a general critique of congressional delegation.

64 Stewart & Groseclose, *supra* note 40; Groseclose & Stewart, *supra* note 40.

65 Each member's ε_j^i value is assumed to be independent and identically distributed, $N(0,\sigma^2)$.

Thus, the probability that i prefers subcommittee j over subcommittees k and l is:

$$\Phi\left(\frac{v_j - v_k - v_l}{\sigma\sqrt{3}}\right) \quad (4)$$

To extend this logic to all transfers, the total number of transfers is defined as T, J is the total number of subcommittees, and x_j^t is the role that subcommittee j played in transfer t. For example, if the member in transfer #49 moved onto subcommittee j, $x_j^{49} = 1$; if she left subcommittee j, $x_j^{49} = -1$; and if subcommittee j did not come into play at all in her move (as is the case for the vast majority of subcommittees in most transfers), then $x_j^{49} = 0$. The probability that a transfer occurred in a given way, therefore, is:

$$\Phi \frac{\sum_{j=1}^{J} v_i x_j^t}{\sigma\sqrt{\sum_{j=1}^{J} |x_j^t|}} \quad (5)$$

and it is possible to estimate the v_j values by maximizing the following likelihood:

$$\prod_{t=1}^{T} \Phi \frac{\sum_{j=1}^{J} v_i x_j^t}{\sigma\sqrt{\sum_{j=1}^{J} |x_j^t|}} \quad (6)$$

The value of σ is then set to one, resulting in a maximum likelihood function that is similar to a probit function.[66]

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[66] Setting $\sigma = 1$ means that the v_j values are considered to be subcommittee values in terms of σ.

IN WHOSE SHOES?: THIRD-PARTY STANDING AND "BINDING" ARBITRATION CLAUSES IN SECURITIES FRAUD RECEIVERSHIPS

Jared A. Wilkerson[*]

This article exposes a question that is uncertain in the circuit courts: in whose shoes do federal equity receivers stand when disentangling a Ponzi scheme or other securities fraud? This question has enormous implications for investors, employees, and service providers of failed schemes who have arbitration agreements with the entities in receivership and are added as defendants by a receiver. If the supervising court allows the receiver to stand in place of creditors, with whom the defendants have no arbitration agreement, then the defendants will not be able to arbitrate their claims and will instead be subject to summary proceedings as a group—an outcome that ignores arbitration in favor of efficiency. Notwithstanding efficiency, however, federal courts have generally answered the receiver standing question by holding that receivers stand exclusively in receivership entities' shoes. One recent diversion from this rule is the Fifth Circuit's decision in Janvey v. Alguire, *in which the court allowed a receiver to stand in third-party creditors' shoes to avoid 331 binding arbitration clauses. This article argues, contrary to efficiency and in favor of the predictable rule of law, that courts should follow both the Federal Arbitration Act (FAA) and the Supreme Court's prohibition against third-party standing by holding that receivers stand only in the place of receivership entities and so must arbitrate according to binding agreements made by those entities. In cases with a large number of arbitration agreement-wielding defendants, such as* Alguire, *this solution is terribly inefficient, but it is, at least until Congress or the Court says otherwise, the only solution that respects both Article III and the FAA.*

INTRODUCTION

When Sir Allen Stanford's Ponzi scheme fell apart and landed him in prison in 2009, he had some 30,000 investors scattered throughout the world, all of whom had placed their money and trust in his certificates of

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deposit (CDs).[1] His scheme had primarily consisted of the Stanford International Bank, based in Antigua, offering "super-safe" CDs at unusually high and consistent interest rates—even in the midst of a financial crisis.[2] He sold the CDs through hundreds of licensed financial advisors who worked for the Stanford Group Company, a respected Houston-based broker–dealer that was registered with the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA).[3] His lavish multinational offices, homes, yachts, jets, and even his charitable donations were written off as products of financial savvy and low overhead.[4] For more than fifteen years he ran his scheme, skimming investment proceeds, paying old investors with new investments, and falsifying numbers with the help of a very small and very close circle of co-conspirators.[5]

When the FBI stormed the Stanford Group Company headquarters in 2009, the SEC filed its civil suit and Judge Godbey of the United States District Court for the Northern District of Texas appointed Ralph Janvey as receiver for the Stanford entities.[6] Sir Allen owed investors over $7 billion in principal and promised interest on the CDs.[7] As the entities claimed to have $50 billion in assets,[8] many initially hoped that investors would be paid the amount of their principal and possibly some interest, but Janvey and others soon saw that such hope was futile.[9] By mid-2010, after more than a year of work, the receiver had gathered only $126 million, $41 million of which had already gone to himself and his team of professionals.[10] His only hope for a significant payout to investors lay in litigation claims and overseas accounts. But even if he were to recover everything he sought

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[1] Clifford Krauss, Phillip L. Zweig, & Julie Creswell, *Texas Firm Accused of $8 Billion Fraud*, N.Y. TIMES, Feb. 18, 2009, at A1, *available at* http://www.nytimes.com/2009/02/18/business/18stanford.html.

[2] *See* First Amended Complaint at 1-3, SEC v. Stanford Int'l Bank, Ltd., 776 F. Supp. 2d 323 (N.D. Tex. 2011) (No. 3:09-cv-00298-N), ECF No. 48.

[3] *See id.* at 6.

[4] *See* Matthew Goldstein, *Is Stanford Financial's Offer Too Good to Be True?*, BUS. WK., Feb. 11, 2009, *available at* http://www.businessweek.com/magazine/content/09_08/b4120022131798.htm.; Robert Chew, *How to Spot a Ponzi Con Artist? Follow the Yachts*, TIME.COM (Mar. 6, 2009), http://www.time.com/time/business/article/0,8599,1883205,00.html; Lawrence Delevingne, *Stanford Financial: How to buy a reputation*, CNNMONEY, (Mar. 4, 2009), http://money.cnn.com/2009/03/04/news/newsmakers/stanford_influence.fortune/.

[5] *See* First Amended Complaint, *supra* note 2, at 5-7.

[6] *See id.*

[7] Janvey v. Alguire, 628 F.3d 164, 169 (5th Cir. 2010).

[8] Erik Larson, *Stanford Receiver May Need a Decade to Pay Victims*, BLOOMBERG.COM, (Feb. 20, 2009), http://www.bloomberg.com/apps/news?pid =newsarchive&sid=adE7U5dJ7I_I.

[9] *See, e.g.*, *Stanford Receiver Hopes to Recoup $1.5 Billion*, NEW YORK TIMES DEALBOOK, (Oct. 30, 2009), http://dealbook.nytimes.com/2009/10/30/stanford-receiver-hopes-to-recoup-15-billion.

[10] *See* Jared Wilkerson, Comment, *Investors and Employees as Relief Defendants in Investment Fraud Receiverships: Promoting Efficiency by Following the Plain Meaning of "Legitimate Claim or Ownership Interest,"* 3 FIN. FRAUD L. REP. 300, 328 (2011).

from these sources—an impossible proposition—his total recovery would be just under $1 billion before subtracting fees for him and his team and also addressing the more than $300 million in IRS, vendor, landlord, and employee claims against the estate.[11] In other words, even in the most hopeful scenario, investors would receive very few pennies on the dollar.

Against this depressing backdrop, Janvey's $217 million claim against 331 ex-financial advisors for their CD-related compensation was incredibly sympathetic: how could those who sold the fraudulent securities, innocent or not, be allowed to walk away with their paychecks while those who innocently purchased the securities would receive next to nothing?[12] Sympathy aside, the advisors had some compelling ammunition to stall the receiver—they had arbitration agreements with Stanford Group Company, which the receiver represented.[13] They wanted to force the receiver to arbitrate his claims against each individual advisor.[14] Janvey, on the other hand, wanted to bring the claims en masse before the supervising federal court in Dallas to save time and money for investors' benefit.[15] The expense of paying Janvey and his team out of the receivership estate to bring individual claims would have dug further into the pockets of the defrauded investors, who were waiting for whatever morsel might be left.[16] Thus, the receiver asked the Fifth Circuit to find a way for him to avoid the arbitration agreements—a proposition that raised the specter of the Federal Arbitration Act (FAA) and Article III of the Constitution.[17]

This article argues against efficiency and—until Congress or the Supreme Court says otherwise—instead puts forth the argument that constitutional and contractual principles require courts to allow federal equity receivers to stand only in the shoes of receivership entities and not in the shoes of un-consenting third-party creditors. Consequently, defendants of receivers' claims, with whom the receivership entities have binding arbitration agreements encompassing particular disputes, must be allowed to enforce those agreements against the receiver, regardless of the potential economic inefficiency this rule causes. Various courts have refined receiver standing in light of equitable principles, but only one maverick circuit—the

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[11] Receiver's Interim Report Regarding Status of Receivership, Asset Collection and Ongoing Activities at 11-14, SEC v. Stanford Int'l Bank, Ltd., 776 F. Supp. 2d 323 (N.D. Tex. 2011) (No. 3:09-CV-0298-N), ECF No. 1117; Appendix in Support of Receiver's Interim Report Regarding Status of Receivership, Asset Collection and Ongoing Activities at 4, *Stanford Int'l Bank*, 776 F. Supp. 2d 323 (No. 3:09-CV-0298-N).

[12] *See* Brief of Appellee Ralph S. Janvey, Janvey v. Alguire, 628 F.3d 164 (5th Cir. 2010) (No. 10-10617), 2010 WL 5078580 at *26-28.

[13] *See* Brief of Appellants (76 FA Defendants), *Janvey*, 628 F.3d 164 (5th Cir. 2010) (No. 10-10617), 2010 WL 5078572 at *9.

[14] *Id.*

[15] Brief of Appellee Ralph S. Janvey, *supra* note 12, at 26-28.

[16] *Id.*

[17] *Id.*

Fifth—has handed third-party standing to receivers and ignored the FAA's strong policy of upholding arbitration agreements to prevent economic inefficiency and funnel a few more pennies toward defrauded investors.[18]

Part I introduces the three building blocks of the *Janvey v. Alguire* problems: federal equity receiverships, Article III standing requirements on receivers, and the strong presumption of arbitration clause enforceability. First, federal courts often appoint equity receivers in SEC and Commodity Futures Trading Commission (CFTC) enforcement actions to replace controllers of fraudulent investment schemes, with the ultimate goal of distributing those assets to investors and other creditors according to a court-approved, equitable distribution plan.[19] Receivers, who are officers of the court, act "for the benefit of" creditors while acting "on behalf of" (i.e., in the shoes of and subject to the contractual defenses against) the receivership entities.[20]

Second, while gathering assets, the receiver litigates claims against those with funds traceable to the receivership estate and against whom the estate has claims.[21] In whose place a receiver may stand to bring these claims has been clear in most recent federal appellate cases, with nearly all circuits following the traditional rule that receivers can only stand in the shoes of, and therefore bring claims for harms to, receivership entities.[22] Some of these circuits have stretched equity, yet stayed within constitutional bounds, to allow receivers standing to redress actual harms to receivership entities if the entities are distinct from and harmed by the fraudster.[23] Only the Fifth Circuit has given a receiver the ability to stand in creditors' shoes to avoid arbitration clauses.[24]

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18 Janvey v. Alguire, 628 F.3d 164 (5th Cir. 2010). *Alguire* was withdrawn and replaced, after a clamor for rehearing, in "*Alguire II.*" Janvey v. Alguire, 647 F.3d 585 (5th Cir. 2011). The withdrawal, based on a lack of jurisdiction, sidesteps the standing and arbitration issues raised by this Article. However, the Fifth Circuit did not criticize its earlier reasoning, and the inter-circuit confusion causing the first decision remains unresolved.

19 *See generally, e.g.*, SEC v. Hardy, 803 F.2d 1034 (9th Cir. 1986).

20 *See, e.g.*, Javitch v. First Union Sec., Inc., 315 F.3d 619, 627 (6th Cir. 2003) ("[A]lthough the stated objective of a receivership may be to preserve the estate for the benefit of the creditors, that does not equate to a grant of authority to pursue claims belonging to the creditors.").

21 *See Alguire*, 628 F.3d at 167, *withdrawn and superseded by Alguire II*, 647 F.3d 585 (noting withdrawal was based on lack of jurisdiction; however prior substantive decision affirmed).

22 *See, e.g.*, Marion v. TDI Inc., 591 F.3d 137 (3d Cir. 2010); Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787 (6th Cir. 2009); Eberhard v. Marcu, 530 F.3d 122, 126-27 (2d Cir. 2008); Donell v. Kowell, 533 F.3d 762, 777 (9th Cir. 2008); Knauer v. Jonathon Roberts Fin. Grp., Inc. 348 F.3d 230 (7th Cir. 2003); Miller v. Harding, 248 F.3d 1127, 1128 (1st Cir. 2000).

23 *See, e.g.*, *Eberhard*, 530 F.3d at 126-27; *Knauer*, 348 F.3d at 235-38. An additional problem, as discussed in notes 112 and 130, *infra*, is that even if the entities are distinct from the fraudster, they might have participated in the fraud—a situation that could lead to the receiver, standing in the shoes of those entities, being subject to *in pari delicto*, or unclean hands defenses.

24 *Alguire*, 628 F.3d at 164, *withdrawn and superseded by Alguire II*, 647 F.3d 585 (noting withdrawal was based on lack of jurisdiction; however prior substantive decision affirmed).

The final building block of the problem in *Alguire* is the strong policy favoring enforceability of arbitration agreements between contracting parties, a presumption that has generally grown stronger over the last several decades and was ignored in *Alguire*.[25]

In Part II, the potential circuit split on receiver standing and its implications on arbitration agreements is explored. Two lines of cases display the general rule and its expansive, but not unlimited, boundaries. The general rule—that receivers stand only in entities' shoes—is illustrated first, using Sixth Circuit cases that involve binding arbitration clauses. Next, the breadth of receiver standing, stretched by equity, is discussed using cases from the Seventh Circuit.

After the general rule, two problematic approaches to receiver standing are examined: first, the little-known and little-used approach by which district courts give themselves carte blanche to define receiver standing (and ignore Article III) in receiver appointment orders; and second, the naked grant of third-party standing to the receiver in *Alguire*. Among the breadth of equity tested in Part II, the approach in *Alguire* is both the most problematic and, paradoxically, the most equitable.

This article concludes by recommending that federal courts calm the confusion raised in *Alguire* by following principles of standing and the enforceability of arbitration agreements in two ways. First, the courts should strictly adhere to the notion that receivers have been thrust only into the place of the receivership entities' controllers and therefore stand only in the entities' shoes. Second, the courts should hold that receivers, acting only on behalf of receivership entities, are subject to arbitration agreements to the same extent as those entities, even where such a finding is economically inefficient. Congress, which has power to make exceptions both to the FAA and the prudential standing requirements, or the Supreme Court, which can also make changes to prudential standing, might give receivers power to avoid inequity in the future. Until then, however, courts should follow established constitutional and statutory doctrine.

I. GENERAL PRINCIPLES OF RECEIVERS, STANDING, AND ARBITRATION CLAUSES

A. *Federal Equity Receiverships*

The federal equity receivership is an old remedial tool that has become relatively common in regulatory enforcements of securities and commodi-

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[25] *See, e.g.*, Margaret L. Moses, *Statutory Misconstruction: How the Supreme Court Created a Federal Arbitration Law Never Enacted by Congress*, 34 FLA. ST. U. L. REV. 99, 106 (2006).

ties trading laws while becoming rare in most other insolvency actions.[26] Notwithstanding their usefulness in securities and commodities frauds, however, receiverships were originally used broadly in insolvency proceedings, and their general purpose was to manage and control people or business associations that were either insolvent or at risk of insolvency for the benefit of their creditors.[27] Today, equity receiverships compete with much more defined proceedings in bankruptcy and statutory receiverships, and thus have become less common as a general tool.[28] Still, some argue that they are the best vehicles for liquidating fraudulent schemes.[29]

Notwithstanding their decline, there are various brands of receiverships today. This article focuses on the brand most often requested by the SEC or CFTC in securities fraud enforcement actions and liquidation proceedings—the federal equity receivership.[30] Unlike many other receivership types, the normal goal of federal equity receiverships is the winding up and liquidation of a fraudulent scheme so that deserving creditors, most of whom are investors, will receive the greatest recovery possible.[31] These receiverships, as opposed to, for example, state insurance company receiverships[32] or Federal Deposit Insurance Corporation receiverships instituted in bank insolvencies,[33] are governed almost entirely by the common law of equity rather than by statute. They are procedural shells into which federal

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26 SEC v. Am. Bd. of Trade, Inc., 830 F.2d 431, 436 (2d Cir. 1987) ("Although neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 explicitly vests district courts with the power to appoint trustees or receivers, courts have consistently held that such power exists.").

27 12 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 2981 (2d ed. 2010).

28 *Id.* ("The scope of federal equity receivership in this country has diminished sharply as the scope of bankruptcy practice and other statutory receiverships have enlarged.").

29 *See, e.g.*, Receiver's Response and Objections to Petition for Recognition of Foreign Main Proceeding Pursuant to Chapter 15 of the Bankruptcy Code, at 32, SEC v. Stanford Int'l Bank, Ltd., No. 3:09-CV-0721-N (N.D. Tex, June 9, 2009), ECF No. 20 ("There is more than 115 years of U.S. legal precedent for appointing equity receivers upon a showing that a corporation has been used to perpetrate a fraud upon investors. *See e.g.*, Tyler v. Savage, 12 S. Ct. 340, 143 U.S. 79 (1892). The Bankruptcy Code . . . on the other hand was designed as a framework for the orderly reorganization or liquidation of legitimate businesses (both solvent and insolvent); not as a means for investigating and disassembling massive fraud. Granting recognition to the Antiguan proceedings would run counter to the decades-long practice approved in decisions of virtually all federal circuits, of using an equity receivership to accomplish the winding up of entities that were the subject of Ponzi schemes and other frauds.").

30 WRIGHT, *supra* note 27, § 2983.

31 *Cf.* SEC v. TLC Invs. & Trade Co., 147 F. Supp. 2d 1031, 1036 (C.D. Cal. 2001) (stating, before ultimately finding that the estate was to be liquidated, that "[i]t is only in rare cases that it is appropriate for a receiver, rather than the bankruptcy court and particularly before judgment has been entered, to liquidate, rather than manage, the assets of a receivership.").

32 *See, e.g.*, ALA. CODE §§ 27-32-37 to 27-32-41 (2011); CAL. INS. CODE § 1064.2 (2011); TEX. INS. CODE ANN. art. 443.001-.017 (West 2011); VA. CODE ANN. § 38.2-1505 (2011).

33 *See generally* 12 U.S.C. §§ 1821-1822 (2006) (mandatory FDIC receivership for FDIC-insured banks); *see also* 12 U.S.C. §§ 5381-5394 (2006) (optional FDIC receivership for financial institutions under the 2010 Dodd-Frank Wall St. Reform and Consumer Protection Act); 4 A FEDERAL PROCEDURE, LAWYERS EDITION § 8:827 (2011).

and state claims and defenses fit; they do not confer any substantive rights on receivers that were not exercisable by the entities in whose shoes the receiver stands.

The three main statutes that govern equity receiverships are simple and broad, leaving enormous discretion to common law precedent in equity.[34] Aside from these three rules, receivers are generally governed only by the Constitution, precedent, the equitable discretion of the appointing court, and state law.[35] State contract law, for example, generally dictates that when successors-in-interest, such as receivers, take control of property, they are subject to all of the same defenses, claims, and equities against the property or entity prior to the receiver's appointment.[36]

Receivers are officers of the court appointing them, and so are not agents of any side of the dispute.[37] Thus, a receiver's appointment order and any amendments to it made by the court define, subject to conflicting laws, the receiver's power.[38] Further, following traditional equitable prac-

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[34] FED. R. CIV. P. 66 (stating that the appointment and actions by and against federal equity receivers are governed by the Rules, but that the practice of administering the receivership is left to historical equity practice or local federal district court rule, if available, and that a receiver can only be dismissed by court order); 28 U.S.C. § 754 (2006) (stating that upon a receiver's appointment she is given jurisdiction and control over all receivership assets regardless of the federal district in which they are found, as long as she files her appointment order and the complaint associated with it in those district courts within ten days of her appointment); Liberte Capital Grp., LLC v. Capwill, 462 F.3d 543, 551 (6th Cir. 2006) (stating that a receiver appointed by one district court can sue and be sued in any district containing receivership property, although any execution of judgment against the receiver or receivership entities in another district is generally at the discretion of the appointing court); 28 U.S.C. § 959 (2006) (establishing that receivers can be sued for their actions and transactions as receivers and that receivers are directed to "manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof."); SEC v. Wealth Mgmt. LLC, 628 F.3d 323, 334 (7th Cir. 2010) ("Just as an owner or possessor of property is required to comply with state law, so too must a receiver comply with state law in the 'management and operation' of the receivership property in his possession.").

[35] 28 U.S.C. § 959.

[36] *See, e.g.*, Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 799 (6th Cir. 2009) ("As Liberte's successor-in-interest, the Receiver is precluded by Liberte's unclean hands from bringing the rescission claims.") (applying Ohio law); SEC v. Ryan, 747 F. Supp. 2d 355, 362 (N.D.N.Y. 2010) ("Levine, as Receiver and successor to the management of Prime," had ability to waive attorney–client privilege) (applying New York law); Modart, Inc. v. Penrose Indus. Corp., 293 F. Supp. 1116, 1119 (D. Pa. 1967) (applying Pennsylvania law). Of course, where a contract is executory, the receiver can elect to repudiate or accept that contract. *See* Citibank, N.A. v. Nyland (CF8) Ltd., 839 F.2d 93, 98 (2d Cir. 1988); *cf.* Rosner v. Peregrine Fin. Ltd., No. 95-CIV-10904(KTD), 1998 WL 249197, at *9 (S.D.N.Y. May 18, 1998) (holding that receiver could not be bound to contract because he was not signatory to the contract).

[37] 2 PAUL H. DAWES, WILLIAM J. MEESKE, & MARC W. RAPPEL, BUSINESS & COMMERCIAL LITIGATION IN FEDERAL COURTS § 14:63 (Robert L. Haig, ed., 2d ed. 2010).

[38] *See, e.g.*, Javitch v. First Union Sec., Inc., 315 F.3d 619, 626-27 (6th Cir. 2003) (noting that receiver could not bring certain claims in shoes of creditors to avoid arbitration clauses because appointment order did not allow it).

tice as allowed by Rule 66 of the Federal Rules of Civil Procedure (FRCP),[39] the appointing court normally issues a blanket stay enjoining all proceedings against the receivership until leave is given by the court to bring such suits.[40] A party must be heard if she can show a colorable claim against the receiver or receivership entities, but the court has discretion to establish the time and manner of such actions.[41]

In short, the receiver, in attempting to control and likely liquidate the estate, is governed by broad equitable principles but few statutes. Consequently, in the liquidation process, she can create a distribution plan that flexibly subordinates less deserving (or somewhat culpable) classes to more deserving (usually investor) classes, which—due to the inadequate size of the insolvent receivership estate—usually are paid on a pro rata basis.[42] Under federal equity receiverships, receivers have the ability to ignore required subordination of securities-based claims under the Bankruptcy Code[43] and bring the SEC enforcement action and the liquidation in the same court. This flexibility is cited as one of the main benefits of using receivership rather than bankruptcy proceedings in securities fraud clean-ups.[44]

B. *Receiver Standing Generally*

Article III of the Constitution requires that, for a court to take jurisdiction over a dispute, the dispute must be a justiciable "case or controversy."[45] Over the last century,[46] the Supreme Court has created six rules of standing

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39 FED. R. CIV. P. 66.

40 Liberte Capital Grp., LLC v. Capwill, 462 F.3d 543, 551 (6th Cir. 2006) (citing Barton v. Barbour, 104 U.S. 126, 128 (1881)).

41 *Id.* at 552 (citing Liberte Capital Grp., LLC v. Capwill, 421 F.3d 377, 382 (6th Cir. 2005); SEC v. Basic Energy & Affiliated Res., Inc., 273 F.3d 657, 668 (6th Cir. 2001)); SEC v. Am. Capital Invs., Inc., 98 F.3d 1133, 1146-47 (9th Cir. 1996), *abrogated by* Steel Co. v. Citizens for a Better Env't, 523 U.S. 83 (1998).

42 *See* SEC v. Wealth Mgmt. LLC, 628 F.3d 323, 334 (7th Cir. 2010); SEC v. Enter. Trust Co., 559 F.3d 649 (7th Cir. 2009); United States v. Vanguard Inv. Co., 6 F.3d 222, 226-27 (4th Cir. 1993); SEC v. Elliott, 953 F.2d 1560, 1569-70 (11th Cir. 1992).

43 11 U.S.C. § 510(b) (2006).

44 Receiver's Response Opposing Bukrinsky Motion for Relief from Injunction Against Involuntary Bankruptcy Filing at 2-4, SEC v. Stanford Int'l Bank, 776 F. Supp. 2d 323 (N.D. Tex. 2011) (No. 3-09-CV-0298-N) ("Unlike a trustee in bankruptcy, the Receiver can take into account relative fault within a class of creditors, and fashion an equitable plan of distribution that does not treat all creditors within a class identically if they are not deserving of equal treatment.").

45 *See generally* Lujan v. Defenders of Wildlife, 504 U.S. 555 (1992).

46 Although its roots may be traced back farther, the standing doctrine did not begin to take its modern jurisdiction-determinative form until the 1930s. *See* Charles D. Kelso & R. Randall Kelso, *Standing to Sue: Transformations in Supreme Court Methodology, Doctrine and Results*, 28 U. TOL. L. REV. 93, 111-14 (1996).

tied to this language, three of which are "constitutional" requirements based in Article III, and are therefore unassailable even by Congress. These constitutional requirements demand that claimants in federal court have a cognizable injury that is traceable to the responding party, and redressible under the cause of action asserted and remedy sought.[47] The other three rules, created to ensure that suits are brought by parties particularly fit for the task, are "prudential," Supreme Court-created rules that Congress can explicitly waive and the Court can alter.[48] Generally, these rules disallow third-party claims, generalized grievances, and claims outside the zone of interest of a challenged statute.[49] All of these standing requirements apply to receivers when they file suit in federal court.

The prohibition against third-party standing is problematic for receivers who attempt to bring claims in creditors' shoes.[50] In a case—like one related to a securities fraud—in which third parties are capable of bringing their own claims, a receiver and third-party creditors might have different ideas about what is best: "[A] suit by [the receiver] on behalf of [creditors] may be inconsistent with any independent actions that they might bring themselves. . . . [It is] extremely doubtful that the [receiver] and all [creditors] would agree on the amount of damages to seek, or even on the theory on which to sue."[51]

There are four main exceptions to the prohibition against third-party standing:[52] Where the third party is unlikely to protect her own rights;[53] where there is a close, interchangeable economic relationship between the plaintiff and the third party;[54] where a person claims that a statute violates

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47 *See* United States v. Hays, 115 S. Ct. 2431, 2435-36 (1995).

48 *See generally* Jonathan Remy Nash, *Standing and the Precautionary Principle*, 108 COLUM. L. REV. 494 (2008); Henry P. Monaghan, *Third Party Standing*, 84 COLUM. L. REV. 277 (1984).

49 *See, e.g.*, Friends of the Earth, Inc. v. Laidlaw Envtl. Servs., 528 U.S. 167, 180-81 (2000); Bennett v. Spear, 520 U.S. 154, 162-63 (1997) (describing zone of interest test); *Lujan*, 504 U.S. at 570 n.4; Warth v. Seldin, 422 U.S. 490, 499-500 (1975) (stating prohibition on third-party claims); Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 793 (6th Cir. 2009).

50 *See* United Food and Commercial Workers v. Brown Grp., 517 U.S. 544, 557 (1996); *Warth*, 422 U.S. at 499.

51 Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 431-32 (1972).

52 *See generally* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 82-90 (3d ed. 2006).

53 *See* Sec'y of State v. J.H. Munson Co., 467 U.S. 947, 956 (1984).

54 *See* Singleton v. Wulff, 428 U.S. 106, 117-18 (1976) (finding that doctors had standing to sue to allow non-therapeutic abortions because they were harmed financially by the decrease in business the ban imposed); Craig v. Boren, 429 U.S. 190 (1976) (finding that bartender had standing, due to his harmed economic interest, to challenge law prohibiting men from purchasing certain types of beer until the age of 21 but allowing women to purchase at age 18). *But see* Gilmore v. Utah, 429 U.S. 1012 (1976) (denying standing to mother of death row inmate); Whitmore v. Arkansas, 495 U.S. 149 (1990) (denying inmate standing on behalf of fellow, death row, inmate); Elk Grove Unified School Dist. v. Newdow, 542 U.S. 1 (2004) (denying standing to father to sue on daughter's behalf in First Amendment establishment case).

the First Amendment rights of others;[55] and where an association sues based on injuries to itself or association-related injuries to its members.[56] Receivers wishing to avoid arbitration agreements fit into none of these exceptions: creditors are willing and able to bring their own claims; there is no consensual,[57] interchangeable economic interest between receivers and creditors (as there is between a bartender and patrons, or a doctor and patients);[58] the First Amendment is not involved; and there is normally no association involved. Even if receivers do act "for the benefit of" the receivership's creditors,[59] the creditors are still third parties willing and able to bring their own claims, and have not certified as a class with the receiver as their representative.

Thus, notwithstanding the holdings of the Fifth Circuit and a few district courts,[60] federal equity receivers should be barred from bringing claims in creditors' shoes until Congress or the Supreme Court modifies the applicability of the prudential requirements in federal securities fraud receiverships. Although receivers are officers of the court, the general—and, some courts would say, exclusive—rule is that receivers stand only in the shoes of receivership entities because they have replaced the controllers of those entities. If standing in for individuals, then they have replaced those people and represent them and their assets.[61] They have not replaced creditors.

Indeed, receivership is an extraordinary remedy meant to oust the wrongdoing or incompetent controllers of a securities scheme.[62] Investors and other creditors of that scheme, however, are not displaced, as they are neither wrongdoers nor incapable of representing their own interests. They still own and can assert their claims against, for example, fraudulent transferees of the scheme. Receivers should not take creditors' claims from them or assume their injuries without their consent.

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55 *See generally* Richard Fallon, *Making Sense of Overbreadth*, 100 YALE L. J. 853 (1991).

56 United Food & Commercial Workers v. Brown Grp., Inc., 517 U.S. 544, 556 (1996).

57 *See* Wilkerson, *supra* note 10, at 327-28 (showing that receivers are virtually guaranteed payment from receivership funds regardless of regulators'—let alone investors'—objections).

58 *See Singleton*, 428 U.S. at 117-18; *Craig*, 429 U.S. at 194-96.

59 *See* Brief of Appellants (76 FA Defendants), *supra* note 13, at *6-7 (citing Javitch v. First Union Sec., 315 F.3d 619, 627 (6th Cir. 2003)) (explaining difference between bringing claims "for the benefit of" creditors, meaning bringing claims that may secure funds ultimately distributed to creditors, and "on behalf of" creditors, meaning bringing claims in creditors' shoes).

60 *See infra* Part II.B.

61 *See* Scholes v. Lehmann, 56 F.3d 750, 753 (7th Cir. 1995) ("[A]n equity receiver may sue only to redress injuries to the entity in receivership."); *see also* Eberhard v. Marcu, 530 F.3d 122, 132-34 (2d Cir. 2008) (holding that receiver lacked standing to assert fraudulent conveyance claim because he did not represent any creditor); Troelstrup v. Index Futures Grp., Inc., 130 F.3d 1274, 1277 (7th Cir. 1997) (holding that receiver lacked standing to assert claims because he was appointed only in place of the fraudster, not in place of the account on behalf of which he claimed to sue).

62 *See* Citibank, N.A. v. Nyland, Ltd., 839 F.2d 93, 97 (2d Cir. 1988) (articulating that a receivership is an "extraordinary remedy" and is only used as a last resort).

However, receivers often argue, and most courts agree,[63] that if receivership entities have been harmed and become creditors with claims, receivers can bring those claims—like fraudulent transfer actions[64]—even though

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63 *See infra* Part II.A.2.

64 It is true that fraudulent transfers harm all creditors alike, but these claims still belong to creditors alone under the Uniform Fraudulent Transfer Act. Unif. Fraudulent Transfer Act § 4 (1984). "Creditor" is defined as "a person who has a claim." *Id.* at § 1(4) (1984). Unless the receivership has been harmed by a transfer and therefore has a claim against the transferor, most courts hold, and all should, that the receiver is barred from bringing such a claim. *See infra* Part II.A.2.

A related topic for another article is that, in the context of the Uniform Fraudulent Transfer Act, which tracks the language in § 548 of the Bankruptcy Code, 11 U.S.C. § 548 (2006), arguments may arise that the same authority Congress grants a trustee or debtor in possession under § 544(b)—i.e., power to avoid a fraudulent transfer if a creditor could have brought an avoidance action under state law—should be given to receivers by courts' equitable authority. *See In re* Burton Wiand Receivership Cases, No. 8:05-CV-1856T27MSS, 2008 WL 818509, at *10-11 (M.D. Fla., Jan. 28, 2008) *report and recommendation adopted in part, rejected in part sub nom. In re* Burton Wiand Receivership Cases, No. 8:05-CV-1856T27MSS, 2008 WL 818504 (M.D. Fla., Mar. 26, 2008). Trustees and debtors in possession have causes of action created for them that specifically grant them standing defined by the standing of creditors (hypothetical creditors under the strong-arm power of § 544(a) and actual unsecured creditors under § 544(b)) for the limited purpose of avoiding transfers. Such causes of action cannot be questioned because the cause of action defines who has standing under it. Importantly, trustees are bound precisely to the cause of action created for them and thus cannot sue under § 544 for anything but the avoidance of transfers. *See, e.g., In re* Ozark Rest. Equip. Co., 816 F.2d 1222, 1226-27 (8th Cir. 1987) (quoting Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 424, 431 (1972) (preventing trustee from acquiring "all rights and powers" of creditors and limiting trustee to voidable transfer claims under § 544(b)—even though he sought to bring other claims—because, among other reasons, "[i]t would be 'extremely doubtful that the trustee and all debenture holders would agree on the amount of damages to seek, or even on the theory on which to sue.'"). This rule is a clear indication that even trustees and debtors in possession do not actually stand in the shoes of creditors—they merely exercise a cause of action defined by those creditors' ability under state law to avoid a transfer, even if arbitration is evaded in the process. Allegaert v. Perot, 548 F.2d 432, 436 (2d Cir. 1977); Hagerstown Fiber Ltd. P'ship v. Carl C. Landegger, 277 B.R. 181 (Bankr. S.D.N.Y. 2002) (granting motion to compel arbitration of fraud claims but not fraudulent transfer claims brought pursuant to § 544(b) because § 544 defines the trustee's claim by reference to creditors; if a creditor could have avoided the transfer under state law without arbitrating, then so can the trustee). The purpose of granting bankruptcy trustees such power is to ensure that all of the assets traceable to the estate, which are to be ultimately given to creditors, are gathered into one place and then distributed according to the fairness of the Code rather than having individual creditors racing to the courthouse to avoid transfers on their own behalf while leaving other creditors without recovery. Such fairness among creditors is at the very heart of equity, so it is arguable that receivers should have the same avoidance powers as bankruptcy trustees.

The obvious problem with this argument is that Congress, which has the ability to draft around prudential (but not constitutional) standing requirements has not created a federal cause of action for receivers akin to that created in § 544(b) of the Bankruptcy Code. *See* Lujan v. Defenders of Wildlife, 504 U.S. 555, 576 (1992) (holding that constitutional standing principles cannot be waived by Congress); *see, e.g.*, Bennett v. Spear, 520 U.S. 154, 162 (1997) (noting that prudential standing requirements can be modified or abolished by Congress); *see generally* Joshua L. Sohn, *The Case for Prudential Standing*, 37 U. MEM. L. REV. 727, 731-32 (2003). That is, the reason trustees and debtors in possession have standing to bring fraudulent transfer claims where a creditor could have under state law is not that trustees and debtors in possession are granted standing in creditors' shoes, but rather that trus-

they could not adopt and pursue, for example, a tort claim belonging to an individual creditor.[65]

C. *Arbitration Agreements and the Strong Presumption of Arbitrability*

American courts used to eschew arbitration clauses, despising the division of judicial power from the power of private agreement.[66] It has been noted that "Judicial hostility toward enforcing arbitration agreements was rooted in the perception that the agreements allowed parties to circumvent the court's jurisdiction. In other words, parties agreeing to arbitration were indicating their intention of bypassing or ousting the courts, an act which the courts did not wish to encourage."[67] From the colonial era to the mid-twentieth century, arbitration agreements were flimsy in most jurisdictions, with arbitrators serving at the will of the parties, parties withdrawing from arbitration agreements with relative ease, and a general unenforceability of contracts to resolve future disputes.[68]

Although Congress passed the FAA in 1925,[69] encompassing most arbitration agreements, the states were slow to follow. The tide eventually

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tees and debtors in possession are explicitly granted standing under the § 544(b) cause of action, which happens to be defined by reference to state fraudulent transfer law. The bankruptcy provisions creating a cause of action to recover for fraudulent transfers are distinct from the UFTA, and trustees and debtors in possession sue not under the UFTA or other state fraudulent transfer law, but under the cause of action in the Bankruptcy Code that is defined by state law. "[T]hese are statutory causes of action belonging to the trustee, not to the bankrupt. . . ." Allegaert v. Perot, 548 F.2d 432, 436 (2d Cir. 1977). Receivers bringing fraudulent transfer claims, on the other hand, have no federal statute granting them a cause of action; they must sue under state fraudulent transfer law itself, which, in every state, grants standing only to creditors. "Congress did not grant similar authority in the statute relied upon by the SEC for the appointment of the Receiver. Thus, no such common law or statutory 'creditor' status is conferred upon SEC equity receivers. Rather, their status under FUFTA is defined by their relationship to the transferor." *In re* Wiand, No. 8:05-CV-1856-T27MSS, 2007 WL 963162 (M.D. Fla. Jan. 12, 2007) *report and recommendation adopted as modified*, No. 8:05-CV-1856-T27MSS, 2007 WL 963165 (M.D. Fla. Mar. 27, 2007).

65 For example, consider the absurd situation in which a receiver, on behalf of all creditors and in the name of treating all creditors equitably and providing pro rata relief, appropriates and pursues a battery claim belonging to a single creditor who had been punched in the nose by the fraudster.

66 Peter H. Berge, *The Uniform Arbitration Act: A Retrospective on Its Thirty-Fifth Anniversary*, 14 HAMLINE L. REV. 301, 303-04 (1991).

67 MARTIN DOMKE, ET AL., 1 DOMKE ON COMMERCIAL ARBITRATION § 6:1 (2010).

68 *Id.*

69 9 U.S.C. §§ 1-16 (2006). Section 2 is the most relevant provision for present purposes: "A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, *shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract*." 9 U.S.C. § 2 (emphasis added).

turned, and arbitration currently enjoys broad statutory support: forty-nine states have now adopted either the 1955 Uniform Arbitration Act (UAA) or the 2000 Revised Uniform Arbitration Act (RUAA), and all fifty have embraced arbitration through legislation.[70]

At its core, the policy behind arbitration is the same policy underlying private contracts in general: to allow those closest to a transaction to determine the terms of that transaction, thereby promoting efficiency and predictability. In fact, the purpose of the FAA was to "give arbitration agreements the same stature as any other contractual agreement"[71]—a policy that some courts only reluctantly follow.[72] However, the mandate requiring district courts to enforce arbitration agreements is as strict as possible: "By its terms, the [Arbitration] Act leaves no place for the exercise of discretion by a district court, but instead mandates that district courts *shall* direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed."[73] This policy extends to the very limits of the Commerce Clause.[74] Consequently, receivers are bound by such agreements, as under any other contract, unless they can (1) sue in the shoes of some party that has not signed the agreement, but was also harmed (as in *Janvey v. Alguire*);[75] (2) show that the dispute is not within the arbitration agreement of the parties;[76] (3) prove that some principle of law or equity demands rescission of the agreements within the contracts;[77] or (4) demon-

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70 BETTE J. ROTH, ET AL., 1 ALTERNATIVE DISPUTE RESOLUTION PRACTICE GUIDE § 2:11 (2010). In addition to statutory arbitration, common law arbitration is available in many states for parties who do not fulfill statutory requirements. *See also* THOMAS H. OEMKE, 1 COMMERCIAL ARBITRATION § 4:2 (2010).

71 Costle v. Fremont Indem. Co., 839 F. Supp. 265, 271-72 (D. Vt. 1993) (citing Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 225-26 (1987)).

72 *See, e.g.*, Goldman Sachs Execution & Clearing, L.P. v. Official Unsecured Creditors' Comm. of Bayou Grp., LLC, No. 10-CIV-5622-JSR, 2010 WL 4877847, at *1 (S.D.N.Y. Nov. 30, 2010) ("Although arbitration is touted as a quick and cheap alternative to litigation, experience suggests that it can be slow and expensive. But it does have these "advantages": unlike courts, arbitrators do not have to give reasons for their decisions, and their decisions are essentially unappealable. Here, petitioner Goldman Sachs Execution & Clearing, L.P.[,] having voluntarily chosen to avail itself of *this wondrous alternative to the rule of reason*, must suffer the consequences.") (emphasis added).

73 Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 218 (1985).

74 *See* Allied-Bruce Terminix Cos., Inc. v. Dobson, 513 U.S. 265, 277 (1995) (upholding notion that Congress intended to exercise its "commerce power to the full" when enacting FAA). Thus, although the FAA does not reach wholly intrastate arbitration agreements, MARTIN DOMKE, ET AL., 1 DOMKE ON COMMERCIAL ARBITRATION § 7:4 (2011), its reach is extremely broad.

75 Janvey v. Alguire, 628 F.3d 164, 179 (5th Cir. 2010).

76 Scope is interpreted very broadly so as to encompass as much of the dispute as possible. *See generally* Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 BROOK. L. REV. 1335, 1336 (1996) (citing McMahan Co., L.P. v. Forum Capital Mkts., L.P., 35 F.3d 82, 86 (2d Cir. 1994) (holding that even claims of misappropriation of assets fell under the arbitration agreement)).

77 Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 404 (1967) ("[I]f the claim is fraud in the inducement of the arbitration clause itself—an issue which goes to the 'making' of the

strate that some other federal statute excepts receivers from arbitration.[78] There is no exception for a court's equitable discretion, even to promote economic efficiency.

Arbitration generally reduces judicial caseloads, permits privately-selected experts to determine disputes, avoids public airing of disputes, and allows parties to avoid some of the formalities, expenses, and delays of litigation.[79] In its ideal form,

> [A]rbitration is a contractual proceeding, whereby the parties to any controversy or dispute, in order to obtain an inexpensive and speedy final disposition of the matter involved, select judges of their own choice and by consent submit their controversy to such judges for determination, in the place of the tribunals provided by the ordinary processes of law.[80]

This policy is well served when the parties are in privity with one another, and when the arbitration of their dispute will not determine others' rights. However, in securities fraud cleanups, the rights of the insolvent entity, the receiver, investors, and other creditors are intertwined. Indeed, any decrease in efficiency does not harm the debtor (who is insolvent either way) or the receiver (who will be paid either way), but innocent creditors. In these situations, as in *Alguire*, ex-employees of the entity often have binding arbitration agreements with their former employer that mandate arbitration of any dispute arising from the employment relationship.

Although arbitration is meant to increase efficiency, binding receivers to arbitration agreements may decrease efficiency. Each agreement will almost certainly require the dispute to be individually arbitrated,[81] making

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agreement to arbitrate—the federal court may proceed to adjudicate it."); *cf.* Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 447 (2006) (holding that claim that purportedly usurious contract containing an arbitration provision was void for illegality was to be determined by arbitrator, not court, because attack was on contract as a whole, not arbitration clause in particular).

78 Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 227 (1987) (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)) ("The burden is on the party opposing arbitration, however, to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue."); Moran v. Svete, 366 F. App'x. 624, 630-31 (6th Cir. 2010) (citing Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 445 (2006); *Prima Paint Corp.*, 388 U.S. at 403-04 (1967)) (explaining that a court can only ignore an arbitration clause, *even if a receiver wants the court to ignore it as fraudulent*, if the parties did not in fact agree to arbitrate; whether the arbitration agreement was induced by fraud or is otherwise invalid is often a question for the arbitrator).

79 *See generally* Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549 (2003) (examining costs and benefits of arbitration agreements in franchise contracts empirically); Gabriel Herrmann, *Discovering Policy under the Federal Arbitration Act*, 88 CORNELL L. REV. 779 (2003); MARTIN DOMKE, ET AL., 1 DOMKE ON COMMERCIAL ARBITRATION § 1:4 (2010).

80 Gates v. Ariz. Brewing Co., 95 P.2d 49, 50 (Ariz. 1939).

81 Although group arbitration certainly is possible in some circumstances, it is generally a plaintiffs'—not a defendants'—tool to reduce costs. Indeed, defendants in insolvency situations such as receiverships have an incentive to extend the process as long as possible by forcing individuated arbitra-

the receiver return to arbitration time and again, depending on the number of defendants. Dispute resolution costs would rise dramatically, probably putting the cost beyond the benefit of pursuing defendants with smaller potential liabilities. In the supervising court, however, the receiver would be able to sue multiple defendants at once and receive a single order from the court disgorging the ex-employees, investors, or other defendants, of funds.[82] This efficiency concern, legitimate but not controlling, provides the only explanation for the Fifth Circuit's decision in *Alguire*,[83] in which the court decided that the receiver was standing in creditors' shoes so he could avoid the cost (paid for by the receivership estate, thereby decreasing any ultimate payment to investors) of arbitrating hundreds of individual claims.[84] Whether equity should be able to set aside the incredibly strong presumption in favor of arbitration is dubious from the perspective of FAA case law, which is quite clear.

II. EMERGING CIRCUIT CONFUSION ON RECEIVER STANDING

A court can avoid holding receivers to receivership entities' arbitration agreements by determining that the receiver stands in the place of third-party creditors, who do not have arbitration agreements with the defendants. As shown in this Part, all but one circuit court follow the traditional rule that receivers stand in the shoes of receivership entities alone. This traditional rule would preclude the third-party standing sanctioned in *Alguire*.

The first subsection describes the majority rule, which is flexible but bound by third-party standing principles. The rule is first generally de-

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tions to give the receiver (who is draining receivership funds by pursuing the defendants) a disincentive to pursuing them at all. Certainly, those for whom individual pursuit would cost the estate more than it would benefit from a potential recovery could escape disgorgement altogether. For a discussion of group employee arbitration (with the employees as plaintiffs) outside the Fair Labor Standards Act, see Matthew W. Finkin, *Employee Representation Outside the Labor Act: Thoughts on Arbitral Representation, Group Arbitration, and Workplace Committees*, 5 U. PA. J. LAB. & EMP. L. 75, 82 (2002); *see generally* Michael Z. Green, *Opposing Excessive Use of Employer Bargaining Power in Mandatory Arbitration Agreements through Collective Employee Actions*, 10 TEX. WESLEYAN L. REV. 77 (2003). Class action arbitration, much like group arbitration, also may be possible, assuming potential plaintiffs do not waive class-action rights as did the plaintiffs in *AT&T Mobility, LLC v. Concepcion*, 131 S. Ct. 1740 (2011), wherein the Court held that California's ban on class-action waivers was barred under the FAA.

82 *See* Armstrong v. Collins, No. 01-CIV.2437(PAC), 2010 WL 1141158 (S.D.N.Y. Mar. 24, 2010), *reconsideration denied*, No. 01-CIV.2437(PAC), 2011 WL 308260 (S.D.N.Y. Jan. 31, 2011) (allowing receiver to sue and recover from multiple defendants simultaneously). *See generally* Wilkerson, *supra* note 10 (describing cases in which receivers *sued* multiple, even hundreds, of "relief defendants" simultaneously).

83 Brief of Appellee Ralph S. Janvey, *supra* note 12, at 26-28 (making various policy arguments, including economic efficiency, as to why arbitration should be disallowed).

84 Janvey v. Alguire, 628 F.3d 164, 182-85 (2010).

scribed in a short line of recent Sixth Circuit cases. The ability of equity to stretch standing requirements to benefit creditors is then displayed by the various courts that have allowed entities, separated from the wrongdoer and cleansed of his influence, to find the wrongdoer's actions injurious to the entities themselves—thereby establishing the receiver's standing for certain causes of action. This discussion of the ability of courts to stretch equity by finding injury to entities that were actually vehicles of the wrongdoer's fraud—and still stay within the boundaries of Article III—demonstrates how radical a decision must be to breach those boundaries.

With this background, the second subsection describes the two problematic approaches. First, some district courts have unwittingly followed the dangerous idea that receivers can stand in creditors' shoes if their appointment order allows them. Second, the Fifth Circuit's recent *Alguire* decision, which held that the receiver *could* stand in the shoes of investors, is the most problematic (yet efficient) case on receiver standing, as it violated both standing and arbitration principles. Had this case not been withdrawn on jurisdictional grounds, it would have saved investors' time and money.

A. *The Current Majority Rule and Its Limits*

1. Article III Standing Requirements Applied to Receivers

Although it is one of many circuits adhering to the traditional rules of receiver standing and a strong presumption favoring arbitrability, the Sixth Circuit has had ample opportunity to become exemplarily conscientious in its approach to receiver standing, particularly receivers' ability to avoid or be bound by arbitration clauses. Cases from the circuit, illustrated by the three below, form a bright line. As will be shown, *Javitch* left some room for confusion, but *Liberte* and *Wuliger* clarified the rule that, under Article III, a federal equity receiver stands only in the shoes of the receivership entities and is bound to the agreements of those entities.

i. *Javitch v. First Union Securities*[85]

Javitch was the receiver of two companies: Viatical Escrow Services (VES) and Capital Fund Leasing (CFL). James Capwill had used these companies to defraud viatical funding companies and viatical investors by colluding with insurance companies to persuade elderly people to purchase life insurance and immediately assign the policies to Liberte Capital Group.

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[85] 315 F.3d 619 (6th Cir. 2003).

Liberte would then sell the policies to investors—transactions known as "wet ink" viatical sales.[86] Alleging, among other things, fraud, negligence, and securities law violations, Javitch sued brokerage firms and individual brokers who had followed Capwill's request to invest the money from VES. Javitch argued that the brokerages and brokers were at least partially responsible for the continuance of Capwill's fraud by "failing to know their customers, recommending or permitting unsuitable investments, allowing the improper designation of accounts, and permitting inappropriate fund transfers."[87] The defendants invoked binding arbitration clauses that Capwill had signed on behalf of VES and CFL, saying that Javitch should be bound by the clauses to the same extent as the entities.[88]

In ruling that the receiver could not evade the motions to compel arbitration, the circuit court, disagreeing with the district court, noted that:

> [F]raud on the *receivership entity* that operates to *its* damage is for the *receiver* to pursue (and to the extent that investors as the holders of equity interests in the entity may ultimately benefit from such pursuit, that does not alter the proposition that the receiver is the proper party to enforce the claim). . . .
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> . . . .
>
> We are convinced, based on our assessment of both the claims being asserted by Javitch *and the authority granted to him by the order appointing him as receiver*, that the district court properly found that Javitch has asserted claims belonging to the receivership entities. Thus, we find that Javitch, who is bringing claims on behalf of VES and CFL, is bound to the arbitration agreements to the same extent that the receivership entities would have been absent the appointment of the receiver.[89]

Although this statement seems clear, the court went on to address Javitch's argument that he stood in the creditors' shoes.

Answering this question, the court admitted that some state court receivers had been granted power in their appointment orders to act on behalf of creditors.[90] For example, in *McGinness v. United States,*[91] the state re-

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86 Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 790-91 (6th Cir. 2009) (describing the fraudulent scheme).

87 *Javitch*, 315 F.3d at 622.

88 *Id.* at 623.

89 *Id.* at 625, 627 (quoting Scholes v. Schroeder, 744 F. Supp. 1419, 1422-23 (N.D.Ill.1990)) (emphasis in original) (internal citations and quotation marks omitted).

90 *Id.* at 626–27 (citing Capitol Life Ins. Co. v. Gallagher, No. 94-1040, 1995 WL 66602 (10th Cir. 1995)). As recognized by the Sixth Circuit later in *Liberte Capital Grp., LLC v. Capwill*, 248 F. App'x. 650, 665 (6th Cir. 2007) and *Wuliger v. Mfrs. Life Ins. Co.*, 567 F.3d 787, 793 (6th Cir. 2009) (analogizing state regulatory receivers to federal equity receivers is dangerous because two different bodies of law, including common and statutory law, bind each type, and Article III only applies in federal court).

91 90 F.3d 143, 145 (6th Cir. 1996).

ceiver had been granted, according to Ohio statutory and common law, the ability to accede to the rights of both the debtor and the creditors. The *Javitch* court held that, because the appointment order in *McGinness* gave the receiver in that case the power to stand in creditors' shoes, he could do so: "As we see it, *McGinness* does not stand for the proposition that a receiver never stands in the shoes of the entity in receivership, but suggests that the question *depends on the authority granted by the appointing court* and actually exercised by the receiver."[92] This idea—that appointing courts could settle the standing confusion by simply granting receivers the ability to sue on creditor's behalf[93]—is an elegant and convenient notion but one the Sixth Circuit later limited under Article III in *Liberte* and *Wuliger*.

ii. *Liberte Capital Group, LLC v. Capwill*[94]

In the unpublished *Liberte* opinion, the Sixth Circuit again confronted (again in the context of Capwill's fraud) the question of receivers' standing and power to ignore arbitration agreements. After the district court appointed William Wuliger, Javitch's replacement receiver for VES and Capwill, investors intervened and received class certification.[95] Some of these investors then sued the receiver, saying that the arbitration claims he was bringing against broker–dealers and brokers belonged to those harmed—the *investors*, who had lost money because of the fraudulent insurance policies underlying their viatical investments—and not to the receiver.[96] Notwithstanding the fact that the receiver wanted to bring the arbitration claims himself or force the investors to bring such claims in his name to form a pro rata pool for all investors or that individual investors might obtain a comparative windfall by seeking arbitration awards in their own names, the court held that the claims did not belong to the receiver. Beginning its discussion, the court drew a bright line:

> The appointment of a receiver is inherently limited by the jurisdictional constraints of Article III and all other curbs on federal court jurisdiction. . . .
>
> To satisfy the "case" or "controversy requirement" of Article III, which is the "irreducible constitutional minimum" of standing, a plaintiff must, generally speaking, demonstrate that he has suffered "injury in fact," that the injury is "fairly traceable" to the actions of the defendant, and that the injury will likely be redressed by a favorable decision. [A] party must have a 'personal stake in the outcome of the controversy' to satisfy Article III.
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> . . . .

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92 *Javitch*, 315 F.3d at 626-627 (emphasis added).

93 *See infra* Part II.B.1 for district courts that have followed this reasoning.

94 248 F. App'x. 650 (6th Cir. 2007).

95 *Id.* at 652.

96 *Id.* at 653-54.

> . . . The mere fact that the [receiver] *would like* to pull the arbitration proceeds into the receivership pool does not establish a "personal stake" for the receivership entities.[97]

Continuing with its bright line, the court went on to clarify *Javitch*, stating that a broad appointment order cannot abrogate constitutional requirements.[98] Where a receiver cannot show that the entities in receivership could have brought a claim, he likewise cannot bring that claim, irrespective of the breadth of the appointment order or other permission from the supervising district court.[99] Article III simply cannot bend, even to equity, and courts act outside their authority when they grant power to receivers to bring creditors' claims.[100]

In a strenuous dissent, Judge Clay argued that the equitable power of district courts should extend to grants of authority to receivers to stand in creditors' shoes.[101] Particularly, "[t]he majority's conclusion contravenes established case law that recognizes a district court's broad equitable powers to define the scope of a receiver's authority."[102]

After arguing that Article III did not bar a receiver from appropriating creditors' causes of action in pursuit of equitable distribution, Judge Clay turned to the policy considerations that would later contribute to the Fifth Circuit's *Janvey v. Alguire* opinion.[103] He stated that, by preventing the

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97 *Id.* at 655-56 (internal citations and quotation marks omitted); *see also* 13 MOORE'S FEDERAL PRACTICE § 66.08(1)(b) (3d ed. 2005) (stating the bright-line rule that a receiver can only bring claims on behalf of receivership entities).

98 *Liberte*, 248 F. App'x. at 657-665.

99 *Id.* at 657-58.

100 *Id.* at 665 ("[W]e have uncovered no case in which a court held, or even suggested, that equitable considerations could trump a district court's exceeding its Article III powers by permitting a receiver to raise claims of investors. . . . The district court operated outside of Article III, granting excessive authority to Appellee in the name of equity.").

101 *Id.* at 666 (Clay, J., dissenting).

102 *Id.* Interestingly, Judge Clay went on to note that "[a] bankruptcy receiver's duties and functions are different from those of an equity receiver, particularly because the scope of a bankruptcy receiver's power is set forth in statutes," *id.* at 667, thereby implying that bankruptcy trustees have less power than equity receivers. This argument can, and has, cut both ways. For instance, while here Clay used it to argue that receivers should have *more* power in equity to bring claims on behalf of creditors than trustees have in bankruptcy, other courts have used the very same fact—that trustees are bound by statute while receivers are bound by equity—to argue that *trustees* have more power to stand in others' shoes because they are granted that power by Congress, whereas receivers cannot stand in others' shoes to bring fraudulent conveyance claims, regardless of what the district court permits, because they have no such statutory grant. *See supra* note 64.

103 *See infra* Part II.B.2. In *Alguire*, although the court did not focus on this issue in its opinion (the receiver did address this issue in his brief, however, one of the options could have been for the court to allow individual investors to sue the financial advisors, in which case those individuals would presumably receive a windfall to the detriment of other investors. Brief of Appellee Ralph S. Janvey, *supra* note 12, at 26-28. Those who did not sue first would almost certainly recover nothing, because the causes of action likely to be successful against the advisors would be restitutionary, meaning the advi-

receiver from bringing claims on behalf of investors, the court was giving wealthy investors a windfall at the expense of lower-income investors:

> The majority's . . . decision will result in substantial and significant harm to lower-income investors who lack the resources and capacity to pursue claims against brokerage firms on their own. . . . [T]he majority is precluding the Receiver from holding brokerage firms accountable for their wrongdoing on behalf of all other members [those aside from appellant investors, who have sued on their own behalf] of the class action. . . . The Receiver plays an important role in advocating on behalf of a large class of defrauded investors and should be allowed to represent lower-income investors because not all investors have Appellants' resources and capacity to arbitrate claims against brokerage firms. . . . The individual investors have already suffered a great financial harm, the majority's holding will exacerbate and compound this financial harm by precluding the Receiver from continuing to represent all other members of this large and complex class action.[104]

This argument, more persuasive than his standing analysis, is that preventing the receiver from bringing claims on behalf of any investor for the purpose of pro rata distribution to all investors prejudices those who cannot afford to be first in line to sue. In addition, it provides a windfall to those with the means to bring such suits. In other words, he argued that the majority's holding was antithetical to equity, which would treat all innocent investors alike even if a receiver has to appropriate their causes of action. Whether Judge Clay's view of equity—a view that is clearly fairer to investors as a group than the alternative—would comport with Article III was left open. This question appears to have been resolved by the Sixth Circuit's requirement that a receiver comply with all conditions of standing, constitutional and prudential, to bring suit.[105]

iii. *Wuliger v. Manufacturers Life Ins. Co.*[106]

Wuliger also involved the Liberte Capital VES investment fraud. There, the receiver, Wuliger, who stood in Liberte's shoes, sued Manufacturers Life Insurance Company (MLIC), seeking rescission of three life insurance policies (which had been solicited as wet ink viatical sales by Liberte) that he claimed were consequently void *ab initio* as fraudulently procured.[107] He claimed that the premium payments on the underlying fraudulent policies had unjustly enriched MLIC and sought restitution for

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sors would only have to disgorge once for all rather than being liable for disgorgement of their CD-related income many times over.

104 *Liberte*, 248 F. App'x at 674-75.

105 Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 793 (6th Cir. 2009). *See also* Gordon v. Dadante, 294 F. App'x 235, 239 (6th Cir. 2008) (holding that H&R Block could compel arbitration, notwithstanding both the brokerage firm's extensive participation in the litigation and the efficiency to be gained by denying arbitration).

106 567 F.3d 787.

107 *Id.* at 791-92.

those payments, even though MLIC may have known nothing of the fraud.[108]

Addressing standing, Judge Clay, now writing for the court, centered his analysis on the constitutional and prudential requirements of Article III, as the majority had done in *Liberte*.[109] Citing the decisions in *Javitch* and *Liberte* for the notion that receivers can only bring suits that an entity in receivership could have brought, Clay rejected MLIC's argument that Wuliger had no standing to bring the rescission and unjust enrichment claims.[110] MLIC argued that Wuliger was attempting to bring claims that belonged to creditors and should therefore not have standing to sue. Particularly, MLIC pointed to Wuliger's argument that he was bringing suit for the benefit of investors.[111] The court, however, rightly pointed out—as discussed in Part II.A.2, below—that the receiver had proven standing on behalf of Liberte: The corporation had been injured by paying premiums on fraudulent insurance policies; the injury was traceable to MLIC, which refused to pay back the premiums after the fraud had been exposed; and the injury could be redressed by a court order to repay the premiums.[112] Clay also found that the three prudential considerations were fulfilled.[113] Thus, Wuliger had standing to bring the claims because the entity in receivership had been injured.[114]

In its line of receiver standing cases, the Sixth Circuit has followed the two general rules of standing and binding arbitration: First, a receiver can

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108 *Id.* at 792.

109 *Id.* at 793.

110 *Id.* at 793-96. Notably, these claims were based on harm to all creditors and, if brought by the receiver, would benefit all creditors. In this way the claims were very similar to fraudulent transfer claims.

111 *Id.* at 794-95.

112 *Id.* at 795.

113 *Wuliger*, 567 F.3d at 795. MLIC also argued that the receiver had no standing because the injury was self-inflicted by Liberte, not by MLIC's issuance of the policies. *Id.* at 796. The court, however, quoting Simon v. E. Ky. Welfare Rights Org., 426 U.S. 26, 41-42 (1976), stated that a plaintiff "need only allege an 'injury that fairly can be traced to the challenged action of the defendant, and not injury that results from the independent action of some third party not before the court.'" Thus, the court properly found standing, even though MLIC's nearly identical argument of unclean hands won the matter on the merits.

114 *Id.* Despite its finding of standing, the court went on to hold that the equitable doctrine of unclean hands barred the receiver from recovering anything because he had admitted in his pleading that Liberte had committed fraud in procuring the policies, and as Liberte's successor in interest and standing in that entity's shoes, the receiver was subject to the defenses against Liberte. *Id.* at 797-99. For a discussion and equitable sidestepping of the *in pari delicto* (equal fault) defense, see note 110, *supra*, and note 128, *infra*, and the surrounding text of both. Obviously, if the Sixth Circuit had allowed the receiver to bring claims on creditors' behalf, he would not have encountered any unclean hands concerns. Thus, even though the claims would have benefited all creditors had the receiver been granted creditor standing, the court found that constitutional concerns prevented it. Creditors were quite capable of pursuing their own unjust enrichment claims.

stand only in the shoes of, and bring suit on behalf of, receivership entities; second, arbitration agreements of the receivership entities bind the receiver to the same extent they bound the entities and can only be avoided "upon such grounds as exist at law or in equity for the revocation of any contract."[115] Although the principles of standing may seem rigid, courts, such as the Sixth Circuit in *Wuliger* and the Seventh Circuit in the cases that follow, stretch them to permit the receiver to show, and sue to redress, harm to the entities themselves. Such flexibility is in stark contrast with the cases discussed in Part II.B, which ignore Article III and, in *Alguire*, FAA requirements while seeking to promote efficiency.

2. Stretching Equity: Standing When Receivership Entities Are Harmed

As demonstrated in *Wuliger*, the strongest blend of constitutionality and equity appears when courts grant receivers standing to redress injuries to receivership entities—injuries that arise thanks to the entities' subjection to and separation from the wrongdoer. Many courts have properly followed this trend, particularly with respect to fraudulent transfer, unjust enrichment, and other claims arguably traceable to harm to the entities, which are cleansed by an overbearing fraudster's removal and replacement with the receiver.[116] This proposition should not be carried too far, however. Three

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115 Moran v. Svete, 366 F. App'x 624, 629 (6th Cir. 2010) (quoting 9 U.S.C. § 2 (2006)).

116 *See, e.g.*, Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 793-97 (6th Cir. 2009) (finding that, because entities in receivership had been harmed, receiver had standing to bring claims, but also holding that receiver could not recover on those claims because, among other reasons, he was barred by doctrine of unclean hands, which stained receiver when he stepped into entities' shoes); Donell v. Kowell, 533 F.3d 762, 776-77 (9th Cir. 2008) ("We agree with the Seventh Circuit's colorful analysis [in *Scholes*]. The Receiver has standing to bring this suit because, although the losing investors will ultimately benefit from the asset recovery, the Receiver is in fact suing to redress injuries that Wallenbrock suffered when its managers caused Wallenbrock to commit waste and fraud."). *See also* Cobalt MultiFamily Investors I, LLC v. Lisa Arden, No. 06-CIV.6172(KMW)(MHD), 2010 WL 3791040 (S.D.N.Y. Sept. 9, 2010), *report and recommendation adopted sub nom.* Cobalt Multifamily Investors I, LLC v. Arden, No. 06-CIV.6172-KMW-MHD, 2010 WL 3790915 (S.D.N.Y. Sept. 28, 2010); Wing v. Wharton, No. 2:08-CV-00887-DB, 2009 WL 1392679 (D. Utah May 15, 2009); Hays v. Adam, 512 F. Supp. 2d 1330, 1341 (N.D. Ga. 2007); *In re* Wiand, No. 8:05-CV-1856-T-27MSS, 2007 WL 963165 (M.D. Fla. Mar. 27, 2007); Quilling v. Cristell, No. Civ.A.304-CV-252, 2006 WL 316981 (W.D.N.C. Feb. 9, 2006); Warfield v. Alaniz, 453 F. Supp. 2d 1118 (D. Ariz. 2006), *aff'd*, 569 F.3d 1015 (9th Cir. 2009); Quilling v. Grand St. Trust, No. 3:04-CV-251, 2005 WL 1983879 (W.D.N.C. Aug. 12, 2005); Obermaier v. Arnett, No. 2:02-CV-111-FTM-29-DNF, 2002 WL 31654535 (M.D. Fla. Nov. 20, 2002); Missal v. Washington, No. 97-982 (TFH), 1998 U.S. Dist. LEXIS 6016 (D. D.C. Apr. 17, 1998); *cf.* Eberhard v. Marcu, 530 F.3d 122, 132-34 (2d Cir. 2008) (finding that receiver did not have standing to assert fraudulent conveyance claim because he represented no creditors); Wiand v. Mitchell, No. 8:06-CV-1085-T-27MSS, 2007 U.S. Dist. LEXIS 24069 (M.D. Fla. Mar. 27, 2007) (holding that if receiver could plead facts showing that business he represented was separate legal entity from fraudster and was injured by unauthorized disbursements, receiver could include entity as a plaintiff for UFTA fraudulent

Seventh Circuit cases, *Scholes v. Lehmann*,[117] *Troelstrup v. Index Futures Group, Inc.*,[118] and *Knauer v. Jonathon Roberts Financial Group, Inc.*,[119] illustrate the proposition and its limits. These limits keep the analysis within Article III but allow for the opening of a new universe of standing possibilities for receivers of harmed entities.

i. *Scholes v. Lehmann*[120]

In this oft-cited case, the receiver of various corporations and limited partnerships created by the fraudster, Michael S. Douglas, brought fraudulent transfer claims against the following: Douglas's ex-wife, for gifts she received; an investor in Douglas's scheme, for the return on his investment; and five religious charities, for donations they received.[121] The district court granted summary judgment to the receiver.[122] On appeal, the first question was whether the receiver had standing to bring fraudulent conveyance claims against the defendants.[123] These claims must be brought by creditors who have been harmed by the fraudster's deviation of funds, not by the entities in receivership who were tools of the fraudulent scheme.[124]

Judge Posner, in an equitably flexible move, concluded that the receiver could bring the fraudulent transfer claims because Douglas, who had personally and exclusively controlled the entities, had harmed the corporations by deviating funds from them.[125] Thus, when he was removed and replaced by the receiver, the corporations and partnerships were no longer his "evil zombies" and, therefore, creditors were able to seek disgorgement of the fraudulent conveyances that had harmed them and enriched the defendants.[126] Instead of allowing the receiver to stand in the shoes of current

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transfer claims; however, receiver had not alleged that entities were creditors with claim against controller fraudster).

117 56 F.3d 750 (7th Cir. 1995).

118 130 F.3d 1274 (7th Cir. 1997).

119 348 F.3d 230 (7th Cir. 2003).

120 56 F.3d 750.

121 *Id.* at 752-53.

122 *Id.* at 750.

123 *Id.* at 753.

124 *Id.* at 753-54.

125 *Id.* at 754.

126 *Scholes*, 56 F.3d at 754. The Seventh Circuit went on to find that *in pari delicto* (a defense very similar to unclean hands but with a slightly higher requirement of culpability) was not a valid defense to the receiver's claims because Douglas, the one who conducted the fraud and benefited from the wrongdoing, was no longer controlling the entities: "Freed from [Douglas's] spell [the entities] became entitled to return of the moneys—for the benefit not of Douglas but of innocent investors—that Douglas had made the corporations divert to unauthorized purposes . . . ." *Id.* Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated." *Id.* For a description of the

creditors, the court found that the receivership entities were creditors, thereby permitting the receiver to sue for injuries but keeping the door open to such inconveniences as an *in pari delicto* defense or arbitration clauses.[127]

When stretching equity, courts must be careful that allowing the receiver to sue by finding a cognizable transfer-related injury to the receivership entities does not violate third-party standing principles or create "the anomalous situation of allowing recovery only where the corporation becomes insolvent and enters receivership, while denying recovery by a going concern which suffered the same sort of injury."[128] The Seventh Circuit recognized this need for discretion in *Troelstrup*, where the court emphasized that receivers are bound to bring claims belonging only to entities in receivership for which the receivership entities can trace a clear injury.[129]

ii. *Troelstrup v. Index Futures Group, Inc.*[130]

Taken to its logical extreme, *Scholes* might have created a blanket allowance for receivers to construe the entities in receivership as harmed parties in any case that depleted their coffers. This would grant the receiver standing to bring claims that only creditors of the entities would have. This problem, rather than allowing the receiver to avoid arbitration agreements of the receivership entities, would allow receivers to appropriate third parties' causes of action, thereby eroding the prohibition against third-party

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in pari delicto defense and its elements, see Nisselson v. Lernout, 469 F.3d 143, 152 (1st Cir. 2006); *see also* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 311 (1985).

The differences in courts' application of the unclean hands and *in pari delicto* defenses between *Wuliger* and *Scholes* deserve attention but are largely beyond the scope of this article. The obvious distinction between the cases is that in *Wuliger*, the receiver admitted that the corporation itself had been a participant in the fraud; the corporation was not removed from the scene when the receiver was installed. In *Scholes*, the wrongdoer was a single person, Douglas, who used and coerced his corporations as puppets. *See* Eberhard v. Marcu, 530 F.3d 122, 132 (2d Cir. 2008). When Douglas was removed, those corporations were cleansed and no longer zombies of a single mastermind. It should be noted that the purpose of both of these defenses—to prevent a wrongdoer from benefiting—stands on its head when a receiver or trustee is involved with liquidating an insolvent scheme. That is, if a receiver or trustee is barred by one of these defenses because of the receivership entities' or debtor's actions, a wrongdoer (the defendant) will keep the funds at the expense of innocent investors, not at the expense of another wrongdoer. Liberte did not actually stand to gain if Wuliger could have recovered. *See generally* Pamela Rogers Chepiga & Lanier Saperstein, *Receivers and the In Pari Delicto Doctrine*, 238 N.Y. L. J. No. 5 (2007) (arguing that the difference between trustees and receivers should be abrogated for *in pari delicto* purposes). For an analysis of this problem and how it is changing in bankruptcy and receiverships (including a discussion of *Scholes*), see Robert Bruner, *The Collapse of the in Pari Delicto Defense to Bankruptcy Trustee Claims: How the Fifth Circuit Has Opened a New Door for Trustee Litigation*, 17 TEX. WESLEYAN L. REV. 91 (2011).

127 *See* JAMES WM. MOORE ET AL., 13 MOORE'S FEDERAL PRACTICE – CIVIL § 66.08 (3d ed. 2011).

128 Lank v. New York Stock Exch., 548 F.2d 61, 67 (2d Cir. 1977).

129 Troelstrup v. Index Futures Grp., Inc., 130 F.3d 1274, 1277 (7th Cir. 1997).

130 *Id.* at 1274.

standing. In *Troelstrup*, however, Judge Posner clarified his reasoning and the court limited *Scholes* to situations where the receiver represents entities that are legally distinct from the wrongdoer.

Posner noted that the receiver in *Scholes* was appointed for both Douglas and his corporations, so when Douglas was removed, the corporations could be seen as creditors that had been divested of their rightful funds by Douglas's fraudulent transfers: "We held that [Douglas's] receiver, *who had also been appointed the corporations' receiver,* had standing to sue on behalf of the corporations, because they were entitled to the return of the money that the defrauder had improperly diverted from them."[131]

Troelstrup, however, presented a different situation. There, John Troelstrup was appointed receiver only for Tobin (the defrauding commodities trader) and his assets, and not for any corporations Tobin had created, even though Tobin had used Index, a CFTC-registered merchant, to make his trades.[132] When Troelstrup was appointed in place of Tobin to gather assets and compensate creditors, he sued Index for negligent supervision (a claim that, like fraudulent transfer, belonged to and could benefit all creditors) in a suit ancillary to the CFTC's enforcement action.[133] Because standing in Tobin's shoes certainly would not have provided standing, Troelstrup sued on behalf of Phoenix Pharynol, which was one of the accounts Tobin had established with Index and one of the assets of the receivership estate.[134] The court held that Tobin, in whose shoes Troelstrup stood, was not harmed by Index's negligence, and Phoenix Pharynol was not a receivership entity at all, but a mere account that Tobin had controlled. Thus,

> If Tobin had a claim against Index, the analogy [to *Scholes*] would be complete. But Tobin has no claim against Index. The receiver is not trying to build up Tobin's assets. He is suing a third party on behalf of Tobin's creditors to enforce a personal right of theirs, not a right of Tobin's in which they have an interest by virtue of being his creditors. . . .
>
> . . . Not only was Troelstrup not appointed the receiver of anyone except Tobin; he could not have been appointed the receiver of Phoenix Pharynol because it is not a corporation or other legally recognized entity on whose behalf a receiver or anyone else could sue. In *Scholes* there were entities that might be bearers of legal rights, besides the defrauder, and so the receiver wasn't limited to being a receiver for the defrauder. All there is here, besides Tobin himself, is an account in a brokerage house.[135]

Judge Posner therefore clarified his stance: a receiver can bring a cause of action only if it clearly belongs to a harmed, legally separate entity

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131 *Id.* at 1277.

132 *Id.* at 1275-76.

133 *Id.*

134 *Id.* at 1277.

135 *Troelstrup*, 130 F.3d at 1277.

in receivership.[136] With this structure in place, the court again addressed the question of injury to receivership entities in *Knauer*, this time usefully refining the concept even further by dividing securities frauds—Ponzi schemes in particular—into two phases and solidifying the standing analysis when receivership entities are arguably harmed.[137]

iii. *Knauer v. Jonathon Roberts Financial Group, Inc.*[138]

Knauer was the receiver for Heartland Financial Services (HFS) and JMS Investment Group (JMS), operated exclusively by Kenneth Payne, Daniel Danker, and two others, who together had operated a Ponzi scheme by soliciting investments in securities issued by HFS and JMS.[139] Payne and Danker were registered securities representatives of Jonathan Roberts Financial Group and the other broker–dealer defendants.[140] Knauer, alleging negligent supervision, sued in a suit ancillary to the SEC's enforcement action. Knauer claimed that the broker–dealers had failed to supervise and control Payne and Danker, and that the Ponzi scheme was only possible because Payne and Danker could hold themselves out as licensed representatives of registered broker–dealers.[141] The defendants claimed that Knauer could not succeed because he had no standing to bring the claims.[142]

The Seventh Circuit divided the fraudulent scheme into two time periods: the solicitation phase and the embezzlement phase.[143] No harm could come to the receivership entities from selling unregistered securities in the solicitation phase because the sales "fatten[ed] the companies' coffers."[144] The court then addressed whether Knauer had standing to bring the negligent supervision claim, which was based on Payne's and Danker's actions during the embezzlement phase—the phase that harmed the entities by *draining* its coffers.[145]

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136 *See id.* Eberhard v. Marcu, 530 F.3d 122 (2d Cir. 2008), is nearly identical to *Troelstrup* in the issue presented, the reasoning, and the holding. There, the receiver stood in the shoes of the fraudster Eberhard and his assets. The receiver sought to avoid a fraudulent conveyance—a cause of action reserved to creditors under New York law. *Id.* at 129-30. The court, explicitly agreeing with *Scholes* and *Troelstrup*, held that since the receiver represented Eberhard but none of his creditors, the receiver lacked standing to set aside the conveyance as fraudulent. *Id.* at 134.

137 Knauer v. Jonathon Roberts Fin. Grp., Inc., 348 F.3d 230 (7th Cir. 2003).

138 *Id.*

139 *Id.* at 231-32.

140 *Id.*

141 *Id.*

142 *Id.* at 233.

143 *Knauer*, 348 F.3d at 233-34.

144 *Id.*

145 *Id.* at 234.

The standing question led the court to clarify *Scholes* again. Judge Cudahy noted that, in *Scholes*,

> [T]here was standing because Scholes was proceeding not only on behalf of Douglas, but on behalf of corporate entities. The corporations, as *legally distinct persons*, were harmed by Douglas's fraudulent conveyances. . . . As long as an entity is legally distinct from the person who diverted funds from the entity, a receiver for the entity has standing to recover the removed funds. . . . The diversion of assets is a legally cognizable injury even if '[a]s sole shareholder, [the Ponzi perpetrator] could lawfully have ratified the diversion of corporate assets to noncorporate purposes.'[146]

In other words, a court supervising a receivership can get as much mileage as possible from the corporate fiction as long as the entities were not alter egos of the wrongdoer. Thus, Knauer, standing in the shoes of the legally distinct entities, had standing to bring claims against the broker–dealers for, among other things, negligently supervising Payne and Danker as they looted HFS and JMS during the embezzlement phase.[147]

As many courts have asserted, fraudulent transfer and other claims that have harmed and will benefit all creditors alike are special because any creditor, even the harmed receivership entities, can usually bring these claims. Creditors include entities in receivership if a controller has improperly diverted funds from those entities and if the entities are legally distinct from the controller. The emerging consensus is that the receiver can sue for the benefit of the receivership as long as: (1) a receiver stands only in the shoes of a receivership entity that is legally distinct from the wrongdoer;

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146 *Id.* at 235 (quoting Scholes v. Lehman, 56 F.3d 750, 754 (7th Cir. 1995)) (emphasis added).

147 It must be noted that the Seventh Circuit struggled, after finding standing, with the *in pari delicto* defense. For some reason (presumably because there were alleged violations of both state and federal law and the claims brought by the receiver were state claims), the parties agreed to use Indiana law to determine the receiver's standing, thereby opening the door for Article III violations, as the proceedings occurred in federal court. The court stayed within the traditional rule, however, and found that the receiver stood only in the shoes of the entities which had participated in the fraud. Therefore, the *in pari delicto* defense barred recovery. This holding distinguished the case from *Scholes*, in which the court held that the removal wrongdoing controller cleansed the corporations for the receiver's presence, against whom no *in pari delicto* defense could be upheld. Contrastingly, in *Knauer*, the court held that:

> The receiver's core argument is that Heartland and JMS should be allowed to pursue claims against the broker dealers because, as a receiver, he is somehow separated from the past crimes of Payne, Danker, Heartland, and JMS. While that may be true, the extent of the separation, for purposes of applying standing and *in pari delicto* principles, is an equitable determination. Given the facts here, we do not see how the fact that Heartland and JMS are represented by a receiver should alone force us to ignore the fact that their nexus to Payne and Danker was far more immediate than that of the broker dealers, and deprive the broker dealers of the defense of *in pari delicto*. The doctrine of applies to defeat the receiver's claims.

348 F.3d at 238. This holding came in spite of the fact that Heartland and JMS would not benefit by any recovery of the receiver. Innocent investors, not Heartland and JMS, were denied recovery by this ruling. Thus, as mentioned in note 126, *supra*, the doctrine of *in pari delicto*, as well as that of unclean hands, needs greater attention in insolvency cases.

and (2) the wrongdoer is completely removed from the scene and will not benefit by the receivership's enrichment. As a very special type of creditor, the receiver will then distribute the funds to other creditors—almost as if the receivership entities are the de facto, equitable representatives of all classes of creditors. This flexible approach, however, still demands that receivers respect the binding arbitration agreements entered into by the receivership entities because the receiver still stands in those entities' shoes. A few courts have bucked this principle, allowing receivers to appropriate the claims of third-party creditors in two ways: by giving unbridled authority to district courts to define standing in the receiver's appointment order, or, as in *Alguire*, by simple fiat.

B. *Off the Beaten Path: Allowing Receivers to Stand in Creditors' Shoes*

1. Allowing Third-Party Standing Based on an Appointment Order Alone

As explained in Part II.A.1, the Sixth Circuit initially left open the possibility to allow receivers to represent any party—receivership entity, creditor, or otherwise—for whom they were given standing in their appointment order.[148] In *Liberte* and *Wuliger*, however, the court made clear that a receiver is subject to the strictures of Article III, regardless of what an appointment order says.[149]

A few lower courts, however, have suggested that the boundaries of receiver standing are defined by the appointment order.[150] For example, in *Wing ex rel. 4NExchange v. Yager*, the receiver for 4NExchange brought an ancillary suit of unjust enrichment, disgorgement, and fraudulent conveyance claims against Yager, a 4NExchange investor for his profits.[151] Yager challenged the receiver's authority to bring such an action, arguing that 4NExchange could not have been harmed by paying a return on investment because such payments were made not to defraud creditors but to perpetuate the scheme and were therefore beneficial to 4NExchange.[152] Consequently, Yager argued that the receiver, standing in the shoes of the entity,

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148 McGinniss v. United States 90 F.3d 143, 146 (6th Cir. 1996).

149 Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 793 (6th Cir. 2009); Liberte Capital Grp., LLC v. Capwill, 248 F. App'x 650, 655–656 (6th Cir. 2007).

150 *See, e.g.*, Lewis v. Jackson, No. 09CV4237, 2010 WL 2008079, at *3 (D. Colo. Feb. 1, 2010); Hodgson v. Kottke Assocs., LLC, No. CIV.A-06-5040, 2007 WL 2234525, at *3-4 (E.D. Pa. Aug. 1, 2007); Wing ex rel. 4NExchange, LLC v. Yager, No. 103CV54DAK, 2003 WL 23354487, at *3 (D. Utah Nov. 7, 2003).

151 *Yager*, No. 103CV54DAK, 2003 WL 23354487, at *1.

152 *Id.*

could point to no injury on which to base his statutory (fraudulent transfer) or equitable (unjust enrichment) claims.

The court disagreed, finding that

> [T]he Receiver in this case has been appointed by the court to marshal and preserve assets for the benefit of 4NExchange's creditors and investors. The court does not believe that its appointment of a Receiver for the benefit of investors defrauded by the company is at odds with Utah law on receivership. Because the Receiver was appointed for the benefit of any creditors or defrauded investors, he is in a position to assert equitable claims.[153]

The court avoided the obvious contention that a receiver appointed for the benefit of—as opposed to one appointed on behalf of—creditors cannot appropriate those creditors' causes of action.[154] But it also completely ignored constitutional standing requirements pointed out so forcefully in *Liberte* and *Wuliger*. Utah law, even if it had applied, had nothing to do with Yager's Article III assertions in federal court, and the court improperly held otherwise.

A rule such as that in *Yager*, which overlooks standing requirements to avoid the prudential dictates of Article III, is almost never used even if it is efficient. A receiver's power is certainly bounded by her appointment order, but a district court cannot trump the Constitution. The far better, and almost universally accepted, rule is that "the authority of a receiver is defined by the entity or entities in the receivership. '[T]he plaintiff in his capacity of receiver has no greater rights or powers than the corporation itself would have.'"[155] For some time, the question of receiver standing was settled at the federal appellate level under this universal rule. Unfortunately, however, the Fifth Circuit has created a circuit split on the question.

2. *Stretching Standing Too Far, for Efficiency's Sake:* Janvey v. Alguire

Among the circuits' approaches to receiver standing, one is notable for its equity, its economic efficiency and, alas, its unconstitutionality. This approach, which explicitly allows receivers to stand in the shoes of creditors who are not receivership entities, has been used in a few district courts,[156] but it is best displayed in *Alguire*.

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153 *Id.* at *3.

154 For the difference between for the benefit of and on behalf of, see note 59, *supra*.

155 Eberhard v. Marcu, 530 F.3d 122, 132 (2d Cir. 2008) (citing Fleming v. Lind-Waldock & Co., 922 F.2d 20, 25 (1st Cir. 1990)).

156 Wing v. Kendrick, No. 2:08-CV-01002-DB, 2009 WL 1362383 (D. Utah May 14, 2009) *reconsideration denied*, No. 2:08-CV-1002, 2009 WL 2477639 (D. Utah Aug. 10, 2009); Wing v. Hammons, No. 2:08-CV-00620, 2009 WL 1362389 (D. Utah May 14, 2009) *motion to certify appeal denied*, No. 2:08-CV-00620, 2009 WL 2477635 (D. Utah Aug. 10, 2009); Hodgson v. Kottke Assocs., LLC, No.

Although not the only example of judicial deviation from general standing and arbitration principles,[157] *Alguire* exemplifies the tension that can arise between equity, the Constitution, and the FAA. This case arose out of the *SEC v. Stanford International Bank* family of cases tied to a Ponzi scheme started in the 1980s.[158] Janvey was the receiver of the Stanford estate, comprising Stanford Group Company (SGC, a registered broker–dealer and FINRA member) and various related entities.[159] Allen Stanford, the sole shareholder of SGC and the Antigua-based Stanford International Bank (SIBL), orchestrated a multi-billion dollar scheme by which financial advisors employed by SGC sold SIBL certificates of deposit (CDs). The income derived therefrom was used to fund, in addition to nominal investments, Stanford's lavish lifestyle.

When the SEC finally stepped in to seek the appointment of a receiver in early 2009, total Stanford assets were worth less than $1 billion, even though investors were owed over $7 billion.[160] The hundreds of dismissed financial advisors,[161] 117 of whose brokerage accounts were frozen upon Janvey's appointment,[162] were innocent puppets in Stanford's scheme. These financial advisors had been paid for their services to SGC. The receiver claimed that the transfers to them, many of which were held by Janvey in the frozen brokerage accounts, had been fraudulent under the Texas Uniform Fraudulent Transfer Act (TUFTA) or had unjustly enriched the advisors.[163]

The advisors argued that any dispute with the receiver regarding their employment with SGC had to be submitted to FINRA arbitration under their employment contracts.[164] Without reaching the merits of the motion to compel arbitration, Judge Godbey of the United States District Court for the

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CIV.A 06-5040, 2007 WL 2234525 (E.D. Pa. Aug. 1, 2007); Wing *ex rel.* 4NExchange, L.L.C. v. Yager, No. 103-CV-54DAK, 2003 WL 23354487 (D. Utah Nov. 7, 2003); SEC v. Cook, No. CA 3:00-CV-272-R, 2001 WL 256172 (N.D. Tex. Mar. 8, 2001).

157 *See, e.g.*, Rosner v. Peregrine Fin. Ltd., No. 95-CIV.10904(KTD), 1998 WL 249197, at *7 (S.D.N.Y. May 18, 1998) (holding that receiver could not be bound by arbitration agreement because receiver never signed agreement and none of the theories binding nonsignatories applied).

158 Janvey v. Alguire, 628 F.3d 164, 177 (5th Cir. 2010) (noting that district court had sufficient evidence to hold that Stanford had been operating Ponzi scheme since late 1980s).

159 *Id.* at 168.

160 *Id.* at 169.

161 In his First Amended Complaint against Former Stanford Employees at 17-23, Janvey v. Alguire, 628 F.3d 164 (N.D. Tex. Nov. 13, 2009) (No. 3:09-cv-00724-N), Janvey pursued 331 advisors. In the *Alguire* opinion, however, the court recognized "approximately 330" advisors. *Alguire*, 628 F.3d at 185, n.3.

162 In his Application for Temporary Restraining Order, Preliminary Injunction, and in the Alternative, Writ of Attachment, Concerning Accounts of Former Stanford Employees at 5, Janvey v. Alguire, 628 F.3d 164 (N.D. Tex. Apr. 19, 2010) (No. 3:09-cv-00724-N), Janvey named the 117 advisors whose accounts he held frozen.

163 *Alguire*, 628 F.3d at 170.

164 *Id.*

Northern District of Texas granted the receiver's motion for preliminary injunction under TUFTA. This preliminary injunction extended the freeze on the advisors' accounts.[165] The advisors appealed, again arguing that their disputes with the receiver were governed by binding arbitration agreements with SGC—agreements that, according to the FAA, had to be respected like any other contract,[166] countered with policy concerns that weighed heavily in his favor:

> If this Court were to decide that the Receiver is limited to 'standing in the shoes' of SGC and that arbitration of the Receiver's claims must therefore be compelled, the result will be piecemeal litigation and a substantial risk of inconsistent rulings on important questions of law . . . .
>
> . . . Numerous arbitration actions would further deplete the assets of the Receivership Estate to the direct harm of the Estate's creditors and the thousands of defrauded investors . . .[167]

The Fifth Circuit panel faced two possible solutions on the merits. First, the judges could follow the clear, established rule that a receiver stands only in the shoes of receivership entities. In this case, the judges would have to find that the receiver could bring the fraudulent transfer claims on behalf of the harmed entities but would be subject to the entities' agreements to arbitrate. Enforcement of those agreements would keep receivership money flowing toward the receiver and his team as they arbitrated individual claims—likely for years.[168] Even by stretching equity as far as *Scholes* had done,[169] the receiver would have stood exclusively in the shoes of receivership entities. If the receiver was barred from bringing the claims (presumably by an *in pari delicto* or unclean hands defense) or decided not to bring them (presumably for efficiency's sake), the district court could allow investors to certify as a class to bring the fraudulent transfer claims or allow individuals or small groups to litigate the claims at will. These outcomes would have extended litigation and possibly given com-

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165 *Id.* at 169.

166 *Id.* at 171-72.

167 Brief of Appellee Ralph S. Janvey, *supra* note 12, at 27-28. Ironically, the secrecy argument is one of the main reasons parties enter arbitration agreements in the first place. Many parties prefer arbitration, and contract for it, precisely because it offers a chance (but not certainty) to resolve disputes without a public record. *See, e.g.*, Richard C. Reuben, *Confidentiality in Arbitration: Beyond the Myth*, 54 U. KAN. L. REV. 1255, 1257 (2006); JAY E. GRENIG, 1 ALT. DISP. RESOL. § 6:2 (3d ed. 2010).

168 *See* Johnson v. Ga. Highway Express, Inc., 488 F.2d 714, 717-17 (5th Cir. 1974). *See generally* Wilkerson, *supra* note 10, at 326-27 (discussing factors used when determining receivers' compensation).

169 *See supra* Part II.A.2.

paratively large recoveries to a few swiftly-suing or well-connected investors while leaving thousands of other investors without recovery.[170]

Second, the judges could disregard principles of receiver standing and federal arbitration presumptions and, in the name of equity, allow the receiver to litigate claims in the supervising federal court on behalf of creditors. In this way, the court could ensure a relatively quick (and much less expensive) pro rata distribution of any recovery—an efficient, equitable outcome.

The *Alguire* court chose the second solution, giving the receiver power to appropriate a statutory cause of action, fraudulent transfer, which is reserved for creditors.[171] In reaching the court's decision, Judge Prado first outlined the general analytical steps to deciding an arbitrability question:

> [W]e perform a two-step inquiry to determine whether to compel a party to arbitrate. In the first step, we determine whether the parties agreed to arbitrate the dispute. This step is further sub-divided into an inquiry into whether (1) there is a valid agreement to arbitrate the claims and (2) the dispute in question falls within the scope of that arbitration agreement. If we find affirmatively as to the first step, then we must determine whether any federal statute or policy renders the claims nonarbitrable.[172]

The court began and ended at the first step, asking "in what capacity is the Receiver suing the Employee Defendants?"[173] The advisors argued that the receiver was bound to the arbitration agreements to the same extent that SGC would have been bound.[174] The receiver argued that he was suing either as a creditor or as a representative of the creditors, pointing to district court decisions that allowed such receiver standing in fraudulent transfer cases.[175] The court recognized that "[i]t is a general rule that the receiver cannot recover, except where recovery could have been had by the corporation."[176] Yet the court reasoned, without actually saying that it wanted to avoid the 331 arbitration agreements for efficiency's sake, that exceptions to the rule applied: since receivers' actions ultimately benefit creditors of

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170 *See supra* notes 90-92 and accompanying text (citing Liberte Capital Grp., LLC v. Capwill, 248 F. App'x. 650, 665-67 (6th Cir. 2007) (Clay, J., dissenting)).

171 Janvey v. Alguire, 628 F.3d 164, 184-85 (5th Cir. 2010); TEX. BUS. & COM. CODE ANN. § 24.005 (West 2010) ("A transfer made or obligation incurred by a debtor is fraudulent *as to a creditor* . . . .") (emphasis added). As mentioned in note 8, *supra*, the Fifth Circuit later withdrew its opinion on jurisdictional grounds. Thus, the court's desired outcomes did not fully materialize, but its reasoning was not criticized in the withdrawal, and the confusion raised by the first opinion remains.

172 *Alguire*, 628 F.3d at 182 (citations and quotations omitted).

173 *Id.*

174 Brief of Appellants (76 FA Defendants), *supra* note 13, at *26-27.

175 Brief of Appellee Ralph S. Janvey, *supra* note 12, at 18-19. As the advisors noted, the receiver's position that he could stand in creditors' shoes was a new one; he had to that point consistently recognized that he stood only in the entities' shoes. Reply Brief of Appellants (76 Fa Defendants), *supra* note 13, at 4-6.

176 *Alguire*, 628 F.3d at 183 (citations and quotations omitted).

the failed scheme, receivers are "legal hybrids, imbued with rights and obligations analogous to the various actors required to effectively manage an estate in the absence of the 'true' owner."[177]

This reasoning is incorrect on its face because Stanford's creditors still stood in their own shoes. That is, the "true" owners of the claims were not absent at all—they were among the "various actors" but had clearly not lost the ability to manage their rights to the estate. Disregarding this fact, the panel cited *McGinness v. United States*, an outdated (its implications were put down in *Wuliger*)[178] and inapplicable (it did not involve a federal equity receiver) case.[179] The court incorrectly stated that "[i]t is well settled that, at different points during the pendency of the receivership, a receiver may represent different interests."[180]

With this outdated and inapplicable foundation, the Fifth Circuit then sidestepped the weight of current persuasion. In a footnote "easily" distinguishing *Alguire* from *Javitch*, the court merely noted that,

> Because the *Javitch* receiver sued on behalf of the insolvent corporation, and that corporation had enforceable arbitration agreements with the defendants, the Sixth Circuit held that the receiver was bound to arbitrate.. Here, as explained above, the Receiver's fraudulent transfer claims are brought on behalf of defrauded creditors under TUFTA . . . ."[181]

The court did nothing to justify avoiding standing principles or to distinguish its holding from *Javitch*; the receiver's bald assertion of creditor's causes of action resulted in cleanly opposing outcomes in the two cases. The district court in neither case had even granted the receiver the ability to stand in the shoes of creditors. More importantly, in crafting a solution to the receiver standing problem, the Fifth Circuit ignored Article III concerns and how those concerns had been resolved in such clear cases as *Javitch* and *Liberte*.[182]

In its continued attempt to avoid relevant authority, and stating that "receivers have long held the power to assert creditor claims," the court turned to two cases, *Meyers v. Moody*[183] and *Cotten v. Republic National Bank of Dallas*[184] to support its conclusion.[185] Both of these cases involved a particular statutory receivership—that of state insurance regulators stepping into the shoes of insolvent insurance companies—that is governed by

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177 *Id.*

178 Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 793 (6th Cir. 2009).

179 90 F.3d 143, 146 (6th Cir. 1996).

180 *Alguire*, 628 F.3d at 184 (quoting *McGinness*, 90 F.3d at 146).

181 *Id.* at 184-85 n.12.

182 *Id.* at 185 n.12 (emphasis in original).

183 693 F.2d 1196, 1206 (5th Cir.1982).

184 395 S.W.2d 930, 941 (Tex. Civ. App. 1965).

185 *Alguire*, 628 F.3d at 184.

state insurance codes.[186] The question of in whose place federal equity receivers (who are officers of federal courts) stand, however, is one of the appointment order and relevant federal law, including Article III of the Constitution.[187] Notably, the court ignored both federal law and a cascade of relevant circuit cases that involved federal equity receivers in securities frauds but, unlike *Alguire*, followed standing doctrine.[188] The panel's reliance on insurance receivership cases was simply misplaced.

State insurance receivership law, however, was perhaps the only source to which the court could turn to support its conclusion. The other federal circuits addressing receiver standing had unanimously decided that receivers stand only in the shoes of receivership entities. Had the court followed the other circuits, Janvey would have been hoisted with his own petard: if he had argued that the receivership entities had been harmed by the transfers, then he would have had to individually arbitrate hundreds of cases—a tedious and costly task. If the court had held that he could bring fraudulent transfer claims against the advisors while standing in the shoes of SGC—the precise holding of the Seventh Circuit in *Scholes v. Lehman*,[189] which the court failed to mention at all—then he would have been forced to arbitrate, as in *Javitch*.[190] Consequently, to find that the receiver stood in the shoes of creditors and could therefore avoid arbitration agreements the court had to ignore the weight of authority and rely on inapplicable case law.

Notwithstanding its flawed Article III and FAA analysis, the Fifth Circuit's decision would have been more efficient, in terms of aggregate payout to investors, than the general rule embraced by other circuits—even

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186 *See, e.g.*, TEX. INS. CODE ANN. art. 443 (West 2011). *See also* Karl L. Rubinstein, *The Legal Standing of an Insurance Insolvency Receiver: When the Shoe Doesn't Fit*, 10 CONN. INS. L.J. 309, 309 (2004) (arguing that state insurance receivers, as "embodiment of the state's police power and as the representative of innocent policyholders and creditors," should not be subject to *in pari delicto* or estoppel defenses but should be able to gather assets regardless of the insurer's pre-receivership actions).

187 *See supra* Part II.A.-B.

188 *See* Marion v. TDI Inc., 591 F.3d 137 (3d Cir. 2010); Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787 (6th Cir. 2009); Eberhard v. Marcu, 530 F.3d 122, 126-27 (2d Cir. 2008); Donell v. Kowell, 533 F.3d 762, 777 (9th Cir. 2008); Liberte Capital Grp., LLC v. Capwill, 421 F.3d 377, 382 (6th Cir. 2005); Javitch v. First Union Sec., Inc., 315 F.3d 619, 627 (6th Cir. 2003); Knauer v. Jonathon Roberts Fin. Grp., Inc. 348 F.3d 230 (7th Cir. 2003); Miller v. Harding, 248 F.3d 1127, 1128 (1st Cir. 2000) (unpublished table decision); Scholes v. Lehmann, 56 F.3d 750, 753 (7th Cir. 1995).

189 56 F.3d at 753, 755.

190 315 F.3d at 627. As mentioned in notes 117 and 136, *supra*, a court finding that the receiver stands only in entities' shoes could mean that the receiver is barred from recovery by some equitable doctrine, such as unclean hands or *in pari delicto*. *See* Brief of Appellee Ralph S. Janvey, *supra* note 12, at 21-22. Unpredictability abounds in this area, and *in pari delicto* and unclean hands may be seen in a distinct light in receiverships given that "[a] receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the debtor; it is thrust into those shoes." Wuliger v. Liberty Bank, N.A., No. 3:02 CV 1378, 2004 WL 3377416, at *6 (N.D. Ohio 2004) (quoting FDIC v. O'Melveny & Meyers, 969 F.2d 744, 751-52 (9th Cir. 1992)).

when the rule is stretched to allow a finding of injury to receivership entities (and therefore standing for the receiver).[191] Thus, although wrong and later withdrawn, the decision's efficiency might be a catalyst for changing how prudential standing requirements and the FAA apply to federal equity receivers, at least in large, cumbersome cases like *Alguire*.

CONCLUSION: FOR NOW, ARTICLE III AND THE FAA SHOULD PREVENT SUCH EFFICIENT DECISIONS AS *ALGUIRE*

Alguire is the first circuit court opinion to hold that federal equity receivers can stand in creditors' shoes. Taken to its logical boundary, *Alguire* supports the freewheeling proposition that a receiver is a "legal hybrid" that "may represent different interests" and appropriate creditors' causes of action. It also ignores standing requirements and federal arbitration presumptions that bind parties to the same extent as any other contract regardless of efficiency concerns. Notwithstanding the Fifth Circuit's efficient outcome allowing the receiver to bring claims en masse, both standing requirements and federal arbitration policy demand that receivers only bring claims that belong to receivership entities—until Congress or the Supreme Court modifies the rules.

As the Sixth Circuit has recognized, a court in equity cannot ignore Article III standing requirements, especially the prohibition against third-party standing which the *Alguire* decision defied.[192] Under the reasoning of many other courts,[193] the receivership entities could have been seen as harmed by transfers made to the financial advisors. Thus, as long as the wrongdoers were wholly removed from the scene and would not benefit from the receiver's action, the Fifth Circuit could have found that the receiver had standing to bring the claims in the entities' shoes. Such a move would not have avoided the arbitration clauses, however, so the court explicitly found that the receiver stood in the shoes of third-party creditors, who, conveniently, did not have binding arbitration agreements with the financial advisors. Those creditors had not been dislocated when the receiver was "[t]hrust into [the entities'] shoes,"[194] and their causes of action were improperly given to the receiver. They still occupied their own place, could assert their own causes of action, and had not been certified as a class with the receiver at their head. Perhaps most importantly, there simply is no exception to third-party standing under which receivers fall.[195] Thus, the

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191 Note that if receivers are granted creditor standing, defenses such as *in pari delicto* and unclean hands will almost certainly not apply.

192 *See* Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 793 (6th Cir. 2009).

193 *See supra* Part II.A.2.

194 *Liberty Bank*, 2004 WL 3377416 at *6.

195 *See supra* Part II.B.

Fifth Circuit violated the prohibition against third party standing by holding that Janvey could stand in the third party creditors' shoes.

In addition to Article III requirements, the FAA also weighs against a receiver's ability to stand in the shoes of third parties for the sole purpose of avoiding arbitration clauses. Of course, it could be argued that, just as some core bankruptcy proceedings are freed from burdensome arbitration arrangements,[196] so should asset-gathering proceedings in receiverships be freed from arbitration agreements when those agreements become unduly burdensome. Receivership, however, is not bankruptcy, and for purposes of the FAA, equity cannot avoid arbitration clauses because there is no exception in equity to the presumption of arbitrability. Arbitration can be avoided in certain core bankruptcy proceedings only because Congress has passed the Bankruptcy Code, which sometimes directly conflicts with the FAA.[197] When there is no express finding of statutory conflict, however, the trustee is bound to the same extent to which the debtor would have been bound.[198] And trustees and debtors in possession are bound by pre-petition arbitration agreements even more strictly.[199] Thus, for now, receivers are bound by the pre-receivership arbitration agreements entered into by receivership entities.

The Fifth Circuit's decision in *Alguire* directly contravened this policy and favored efficiency instead.[200] No statute affected the federal equity

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196 *See* Marianne B. Culhane, *ADR Meets Bankruptcy: Cross-Purposes or Cross-Pollination?: Limiting Litigation over Arbitration in Bankruptcy*, 17 AM. BANKR. INST. L. REV. 493, 493-98 (2009); Paul F. Kirgis, *Arbitration, Bankruptcy, and Public Policy: A Contractarian Analysis*, 17 AM. BANKR. INST. L. REV. 503, 503-05, 514-16 (2009) (stating that judges "typically refuse to enforce arbitration agreements when they find that bankruptcy policy would favor resolution in the bankruptcy proceeding instead of in some other adjudicative forum."); Alan N. Resnick, *The Enforceability of Arbitration Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 183, 200-10 (2007).

197 Shearson/Am. Express v. McMahon, 482 U.S. 220, 226 (1987) ("Like any statutory directive, the Arbitration Act's mandate may be overridden by a contrary congressional command.").

198 *See* Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149, 1154 (3d Cir. 1989).

199 *See* Fallick v. Kehr, 369 F.2d 899, 904 (2d Cir. 1966) (binding a bankruptcy debtor under the Bankruptcy Act to a pre-petition arbitration agreement); Bender Shipbuilding & Repair Co., Inc. v. Morgan (*In re* Morgan), 28 B.R. 3, 5 (B.A.P. 9th Cir. 1983) ("A reorganization debtor-in-possession is bound by the mandatory arbitration provisions contained in a contract where he makes a claim arising out of that contract against a non-creditor."); Guy C. Long, Inc. v. Park Plaza Dev. Corp. (*In re* Guy C. Long, Inc.), 90 B.R. 99, 104 (E.D. Pa. 1988) (concluding that an arbitration clause was enforceable against a Chapter 11 debtor); Barber Greene Co. v. Zeco Co., 17 B.R. 248, 250 (Bankr. D. Minn. 1982) (enforcing arbitration clause against a Chapter 11 debtor); Cres Rivera Concrete Co. v. Bill Stuckman Constr. Co., Inc. (*In re* Cres Rivera Concrete Co.), 21 B.R. 155, 156, 158 (Bankr. D. N.M. 1982) (ordering arbitration against a Chapter 7 debtor).

200 Although the Fifth Circuit did not address this point, it could be argued that size matters: because the receiver was attempting to avoid the incredibly inefficient possibility of over 300 arbitrations, his equitable argument was stronger than that of any other similar case to date. Congress or the Supreme Court might carve out a rule based on size alone, as all insolvency proceedings are rough justice and should not be made rougher by stringent prudential standing doctrines.

receiver's standing or gave him a cause of action that could avoid the arbitration clauses. Knowing this, the court had to make an end run around the FAA's requirement to treat arbitration agreements like any other contract. Thus, it initially allowed the receiver to stand in third parties' shoes—parties who were not signatories of those contracts. This move, though later withdrawn and deferred to the district court, clearly violates the spirit of the FAA, just as it violated standing principles.

It is certainly possible that Congress could pass a law excepting receivers, at least in large cases in which arbitration of numerous claims would be especially costly, from application of the FAA or to third-party standing principles. It is also possible that the Court could carve out another exception to the third-party standing prohibition to allow receivers to stand in third-party creditors' shoes to avoid arbitration. Until one of these contingencies occurs, however, *Alguire* is on the wrong side of the law, even if it is on the right side of equity.

WHISTLE-BLOWING IN THE INTELLIGENCE COMMUNITY: WHY A NEW BOARD WILL BE A STEP IN THE RIGHT DIRECTION

*Andrew Galle**

INTRODUCTION

On February 14, 2006, Lt. Col. Anthony Shaffer made a statement to the House of Representatives that encapsulates the current problem that whistle-blowers in the Intelligence Community (IC) face.[1] Shaffer explained that part of his duties as an intelligence operative with the Defense Intelligence Agency (DIA) required him to work on a project named "Able Danger," which was designed to disrupt Al Qaeda operations shortly before the 9/11 terrorist attacks.[2] From his unique position inside the operation, Shaffer observed mismanagement of intelligence resources so severe that he believed it allowed the 9/11 tragedy to occur.[3] In 2003, he disclosed these allegations to Congress in an effort to prevent mismanagement by the DIA from leading to similar attacks in the future.[4] Even though then-current law protected his ability to make such disclosures,[5] the DIA revoked Shaffer's security clearance within forty-eight hours of his disclosure, effectively ending his career.[6] The DIA told Shaffer that his security clearance was revoked because of several administrative irregularities, such as the occasional work-related twenty-five cent charge on his government phone and his high school marijuana use, which curiously became a career-ending issue even though it had not been in the fifteen-plus years since he admitted to the behavior.[7] Shaffer had nowhere to turn to seek meaningful review of the retaliatory revocation of his security clearance, which was

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1 *National Security Whistleblowers in the Post-September 11th Era: Lost in a Labyrinth and Facing Subtle Retaliation: Hearing Before the Subcomm. on Nat'l Sec., Emerging Threats, and Int'l Relations of the Comm. on Gov't Reform*, 109th Cong. 125 (2006) (statement of Lt. Col. Anthony Shaffer) [hereinafter *Lost in a Labyrinth*].

2 *Id.* at 126.

3 *Id.* at 127.

4 *Id.* at 125.

5 *See infra* Part I.B.2 for a discussion on the Intelligence Community Whistleblower Protection Act, which provides this pathway to Congress for concerned whistle-blowers.

6 *Lost in a Labyrinth*, *supra* note 1, at 128.

7 *Id.* at 128-29.

obviously based on pretextual justifications and intended to silence him.[8] The result of incontestable terminations such as this was to generate an atmosphere of "abhorrent . . . values" within the DIA, where employees focused on "self preservation and obfuscation of responsibility," rather than their mission of safeguarding the nation.[9]

Shaffer faced two main problems that continue to plague the IC. First, intelligence workers have no meaningful forum for review of potentially retaliatory revocations of their security clearances. Second, intelligence workers having knowledge of mismanagement have no incentive to come forward, do the right thing, and make disclosures that could save lives. These employees may even take matters into their own hands and leak the information to anyone who will listen.[10] Without eliminating these problems, people like Lt. Col. Anthony Shaffer will remain victims of retaliation, those who fear for their job security will not make critical disclosures, and national defense will ultimately suffer as mismanagement will continue to place the nation at risk for tragedies like 9/11.

However, a proposed piece of legislation may provide the solution to these problems. In 2009, Senate bill S. 372, also known as the Whistleblower Protection Enhancement Act of 2009 (WPEA), was released from committee and scheduled for consideration.[11] An ambitious piece of legislation, S. 372[12] proposes the creation of the Intelligence Community Whistleblower Protection Board (ICWPB), a forum that would extend traditional whistle-blower protections to IC whistle-blowers and finally provide a meaningful place for security clearance retaliation complaints to be heard.[13] While S. 372 does not currently provide significant incentives for IC whistle-blowers to come forward with critical disclosures, it does create a useful framework for such a scheme in the future.[14]

This Comment has two purposes: (1) to survey the current state of whistle-blower protections in the IC; and (2) to analyze if the creation of

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[8] *See infra* Part II for a discussion of security clearance retaliation and why it is not subject to meaningful review.

[9] *Lost in a Labyrinth*, *supra* note 1, at 125.

[10] *See infra* Part III.A.2 for a discussion on the dangers of such vigilante whistle-blowing and the recent Wikileaks incident.

[11] Whistleblower Protection Enhancement Act of 2009 (WPEA), S. 372, 111th Cong. (2009); *Bill Summary & Status: 111th Congress (2009-2010) S. 372*, LIBRARY OF CONGRESS THOMAS, http://hdl.loc.gov/loc.uscongress/legislation.111s372: (last visited Nov. 6 2011).

[12] S. 372, officially titled the "Whistleblower Protection Enhancement Act of 2009," contains many provisions besides the creation of the Intelligence Community Whistleblower Protection Board that are well-covered by existing scholarship. *See, e.g.*, Jocelyn Patricia Bond, *Efficiency Considerations and the Use of Taxpayer Resources: An Analysis of Proposed Whistleblower Protection Act Revisions*, 19 FED. CIR. B.J. 107 (2009). However, existing scholarship has not examined the portions of the bill that would create the Board. This paper limits its consideration to these unvisited provisions.

[13] *See infra* Part I.B.3 for the powers of the ICWPB.

[14] *See infra* Part IV for suggestions as to how the ICWPB can be upgraded to properly incentivize whistle-blowers.

the ICWPB can achieve the socially optimum level of whistle blowing. It will first describe the historical tug-of-war among the branches of government over the authority to make reforms in this field, the current pathways available to IC whistle-blowers, and the enhancements proposed by S. 372. Next, it will assess the effectiveness of the current system and the legal challenges that face any proposals to improve the system. It will then explore efficiency concerns and argue that the benefits of increasing whistle-blower protections to intelligence workers outweigh the costs of not doing so. It will also recommend the creation of the ICWPB and include suggestions on how the proposal can be improved. Finally, this Comment will conclude that although the ICWPB, as currently planned, is insufficient to encourage IC whistle-blowers to come forward, it should be created because it provides an ideal framework to which essential upgrades can be added later.

I. BACKGROUND

A. *The Competition Over Information Related to National Security and Why it Frustrates Meaningful Reform*

Workers in the IC agencies[15] are fundamentally different from other federal employees primarily because of the nature of their work. Their business requires them to collect, analyze, and disseminate information related to national security.[16] As the handling of information related to national security is inherently dangerous, disclosure of such sensitive information must be properly restricted.[17] However, the workers who deal in this information may discover evidence of theft, waste, and abuse[18] intertwined

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[15] The current intelligence agencies include, among others, the Defense Intelligence Agency (DIA), the Central Intelligence Agency (CIA), the National Security Agency (NSA), and the intelligence elements within the Department of Defense, the Department of State, the Army, Navy, Air Force and Marine Corps, the Department of the Treasury and the Federal Bureau of Investigation. Exec. Order No. 12,333, 46 Fed. Reg. 59,941, 59,953 (Dec. 8, 1981). The list of intelligence agencies grows either by Congressional inclusion into statutes or by Presidential designation. Czarkowski v. MSPB, 390 F.3d 1347, 1350 (Fed. Cir. 2004).

[16] *See* OFFICE OF THE DIR. OF NAT'L INTELLIGENCE, OVERVIEW OF THE INTELLIGENCE COMMUNITY FOR THE 111TH CONGRESS (2010), *available at* http://www.dni.gov/overview.pdf.

[17] Executive Order 12,968 recognizes that information classified in the interest of national security "can cause irreparable damage to the national security and loss of human life." Exec. Order No. 12,968, 60 Fed. Reg. 40,245, 40,245 (Aug. 2, 1995).

[18] For the sake of preventing confusion, this paper uses the terms "theft, waste, and abuse" to include all manner of protected disclosures. Individual legislation controls the ultimate scope of protected disclosures, and their language as to what constitutes theft, waste, and abuse differs slightly, but not meaningfully. For example, the Inspector General Act of 1978 labels disclosures that trigger whistle-blower protections as "activity constituting a violation of law, rules, or regulations, or mismanagement, gross waste of

with restricted information.[19] Even if an intelligence worker wanted to blow the whistle after discovering theft, waste, or abuse, the restrictions on the disclosure of such sensitive information may prevent him from doing so.[20] Therefore, to discuss whistle-blower reform in the IC, it must first be determined who is entrusted with placing restrictions on information related to national security.

1. The Executive Interpretation

Article II, Section 1 of the United States Constitution vests the President with the executive power of the nation and compels him to execute his office faithfully.[21] Further, Article II, Section 2 makes the President Commander-in-Chief of the nation's military forces.[22] Taken together, these two provisions show that the Executive Branch has a constitutionally vested interest in providing for the nation's security and enforcing related laws. For the President to be successful in meeting his constitutional mandate, he requires the ability to keep information related to national security secret.[23] For example, a covert operation will yield little information if the enemy it is directed against knows who is involved and what methods are used to gather information.[24] Worse yet, an IC operative whose identity is improperly disclosed may lead to his "incarceration, interrogation, torture and death."[25] Finally, exposed operations within a foreign nation could frustrate diplomatic relations with that nation, especially if American citizens are expelled, peace talks break down, or trade embargos are imposed.[26] In short, without secrecy, the Executive's intelligence operations would be

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funds, abuse of authority or a substantial and specific danger to the public health and safety," where the Whistleblower Protection Act instead refers to disclosures of "(i) a violation of any law, rule, or regulation, or (ii) gross mismanagement, a gross waste of funds, an abuse of authority, or a substantial and specific danger to public health or safety." Whistleblower Protection Act of 1989, 5 U.S.C. § 2302(b)(8)(i)-(ii) (2010); Inspector General Act of 1978, 5 U.S.C. app. § 7(a) (2007). For our purposes, the definition of protected disclosures will be simplified to those relating to "theft, waste, and abuse."

19 Lt. Col. Anthony Shaffer's discovery of DIA mismanagement, discussed *supra* text accompanying note 3, at 1, would be an example of such a discovery.

20 Executive Order 12,968 requires that access to information related to national security can only be given to those with a demonstrated need to know of it, and that only an agency head can make such a determination, not an employee-whistle-blower. Exec. Order No. 12,968, 60 Fed. Reg. 40,245, 40,246 (1995).

21 U.S. CONST. art. II, § 1.

22 U.S. CONST. art. II, § 2, cl. 1.

23 Nathan Alexander Sales, *Secrecy and National Security Investigations*, 58 ALA. L. REV. 811, 821 (2007).

24 *Id.* at 818-19.

25 *Id.* at 819.

26 *Id.* at 820.

ineffective, much more dangerous to conduct, and may sour relations with other countries.

The Executive Branch has long argued that because these intelligence operations are so vital to national security, it alone must be the exclusive authority over how information related to national security is classified, restricted, and disclosed. For example, in signing the Intelligence Community Whistleblower Protection Act of 1998 (ICWPA) into law,[27] President Clinton made clear that he was doing so because he did not think that it conflicted with the President's exclusive power to control the disclosure of information related to national security.[28] He explained that the Constitution is the source of this executive power and that Congress cannot interfere with or constrain his ability to exercise this authority through legislation.[29] In a recent statement by Deputy Assistant Attorney General Rajesh De, the Department of Justice made clear that the Obama Administration continues to endorse the idea that Congress cannot interfere with the Executive's exclusive control of national security information.[30] Furthermore, he cautioned Congress that any legislation that would allow it to evaluate determinations on the matter will be viewed as unconstitutional and will not be endorsed by the President.[31] This means that when an executive agency (as an extension of the President) determines that information may only be disclosed to those with a certain security clearance level, no other branch can evaluate the reasonableness of the restriction.[32] Similarly, if an executive agency determines that a person is unfit to receive or maintain his security clearance, then the decision on the matter is incontestable outside of the Executive Branch.

2. The Judicial Interpretation

The Supreme Court of the United States has long recognized that the Executive Branch requires secrecy to accomplish its constitutional mandate to provide national security and enforce related laws. For example, the Court in *CIA v. Sims*[33] recognized that intelligence operations require se-

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[27] *See infra* Part II.B.2 for a discussion of this legislation and how it relates to the executive/legislative contest over information related to national security.

[28] Statement on Signing the Intelligence Authorization Act for Fiscal Year 1999, 2 PUB. PAPERS 1825, 1825 (Oct. 20, 1998).

[29] *Id.*

[30] *S. 372 – The Whistleblower Protection Enhancement Act of 2009, Before the Subcomm. on Oversight of Gov't Managment, the Fed. Workforce, and D.C.*, U.S. Senate 11 (2009) (statement of Rajesh De, Deputy Assistant Att'y Gen.), *available at* http://www.justice.gov/olp/pdf/rajeshde-whistleblower-senate.pdf.

[31] *Id.* at 10.

[32] *See* Exec. Order No. 12,968, 60 Fed. Reg. 40,245, 40,246, 40,252, 40,254 (Aug. 7, 1995).

[33] CIA v. Sims, 471 U.S. 159 (1985).

crecy to be effective, and the failure to maintain secrecy in one instance would reduce effectiveness in the future, as potential sources would "close up like a clam."[34] Commentators have observed that the courts have consistently and pervasively recognized the Executive's need for secrecy when carrying out national security operations.[35]

Courts recognize that secrecy is important to the Executive Branch and acknowledge that control over the disclosure of national security information exclusively resides with the Executive Branch. The Supreme Court made this "exclusive control" doctrine clear in its decision *Department of the Navy v. Egan*.[36] In *Egan*, the Navy employed a laborer to perform work on a nuclear submarine.[37] The work he was hired to perform required a security clearance, which he was unable to obtain due to his criminal history.[38] The Navy terminated his employment because his inability to obtain a clearance prevented him from performing the work he was hired to do.[39] The Court found that the Navy could terminate employees for failure to obtain a security clearance when that failure precluded them from performing the work for which they were hired.[40] The Court also found that the Judicial Branch could not review the reasonableness of an adverse security clearance determination that led to the termination.[41] In justifying this holding, the Court observed that executive authority over security clearance determinations "flows primarily from this constitutional investment of power in the President and exists quite apart from any explicit congressional grant."[42] Therefore, because the grant is constitutionally reserved to the Executive Branch, the Legislative Branch cannot pass laws providing for a review of such determinations, and the Judicial Branch cannot perform one. In this way, the Judicial Branch's interpretation of where the Constitution places authority over national security information complements the Executive Branch's interpretation, especially as it relates to the Executive's exclusive authority to issue security clearances.

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34 *Id.* at 172, 175.

35 While an extensive study of the evolution of this need for secrecy is beyond the scope of this paper, it is sufficient to conclude that the need for secrecy in national security matters is well accepted by American courts. For an excellent piece tracing the developments through judicial decisions, see Sales, *supra* note 23, at 818-65.

36 Dep't of the Navy v. Egan, 484 U.S. 518, 518-34 (1988).

37 *Id.* at 521.

38 *Id.* at 521-22.

39 *Id.*

40 *Id.* at 527-28.

41 *Id.* at 529-30.

42 *Egan*, 484 U.S. at 527.

3. The Legislative Interpretation

Congress, however, rejects the idea that the President has exclusive authority over information related to national security.[43] Even outside the realm of national security, Congress has long insisted that to preserve its constitutionally-created role as a separate and coequal branch of government, a federal worker's ability to bring disclosures of theft, waste, and abuse before Congress must be preserved.[44] One of the earliest examples of this stance can be found in the 1902 debates leading up to the passage of the Lloyd–LaFollette Act of 1912.[45] In 1902, President Roosevelt issued an executive order prohibiting any federal employee from communicating directly with members of Congress.[46] Instead, federal employees with a concern that would require congressional oversight would need to bring the matter to their agency head; if the matter was worth looking into, the agency head would have access to channels that would lead to Congress.[47] Congress was outraged by this arrangement, feeling that congressional oversight was impossible if the rank-and-file worker was unable to come to Congress with whistle-blowing information.[48] In one congressman's words, the end result would be to reduce the federal government to one "aristocratic Government, dominated completely by the official family of the President."[49] Congress temporarily remedied this problem with the passage of the Lloyd–LaFollette Act of 1912, which prohibited the President from issuing such "gag orders" that would prevent a federal employee from speaking with Congress directly.[50]

As discussed earlier, however, information related to national security is inherently dangerous and treated differently from regular disclosures made by employees. For a federal employee to disclose any classified information to another, a determination must first be made that the recipient, even a senator or representative, "need[s]-to-know" of the information.[51] While it may be the case that Congress has a need to know of information that lies intertwined with national security information, that determination must be made by the agency head, not a rank-and-file intelligence em-

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43 Intelligence Community Whistleblower Protection Act of 1998, Pub. L. No. 105-272, § 701(b), 112 Stat. 2396, 2413-14 (1998) (codified at 5 U.S.C. app. § 8H (2007)).

44 *See, e.g.*, LOUIS FISHER, CONG. RESEARCH SERV., RL 33215, NATIONAL SECURITY WHISTLEBLOWERS 2-5 (2005), *available at* http://www.lexisnexis.com.mutex.gmu.edu/congcomp/getdoc?CRDC-ID=CRS-2005-GVF-0663 (last accessed August 31, 2010).

45 *Id.* at 3-4.

46 *Id.* at 2-3.

47 *Id.*

48 *Id.* at 3-4.

49 *Id.*

50 Lloyd-LaFollette Act of 1912, Pub. L. No. 62-336, § 6, 37 Stat. 539, 555 (1912).

51 Exec. Order No. 12,968, 60 Fed. Reg. 40,245, 40,246 (Aug. 2, 1995).

ployee.[52] Thus, even after the Lloyd–LaFollette Act, IC employees effectively remained barred from bringing whistle-blower disclosures before Congress, as any information they came across would likely be intertwined with classified information.

Despite the unique qualities of information related to national security, Congress has firmly maintained that rank-and-file federal workers must be empowered to directly disclose whistle-blowing allegations to Congress so that it may act as an effective check on executive agency wrongdoing.[53] In the ICWPA, discussed in-depth in the next section, Congress made its position clear by enumerating six key points:

> (1) national security is a shared responsibility, requiring joint efforts and mutual respect by Congress and the President;
>
> (2) the principles of comity between the branches of Government apply to the handling of national security information;
>
> (3) Congress, as a coequal branch of Government, is empowered by the Constitution to serve as a check on the Executive Branch; in that capacity, it has a "need to know" of allegations of wrongdoing within the Executive Branch, including allegations of wrongdoing in the Intelligence Community;
>
> (4) no basis in law exists for requiring prior authorization of disclosures to the intelligence committees of Congress by employees of the Executive Branch of classified information about wrongdoing within the Intelligence Community;
>
> (5) the risk of reprisal perceived by employees and contractors of the Intelligence Community for reporting serious or flagrant problems to Congress may have impaired the flow of information needed by the intelligence committees to carry out oversight responsibilities; and
>
> (6) to encourage such reporting, an additional procedure should be established that provides a means for such employees and contractors to report to Congress while safeguarding the classified information involved in such reporting.[54]

Interestingly, at the time of the ICWPA's passage, President Clinton found that the legislation did not conflict with the Executive's interpretation of where the Constitution assigns responsibility for controlling information related to national security.[55] However, because the ICWPA allows an IC employee to disclose classified information to Congress, even against the

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52 *Id.*

53 *See* Intelligence Community Whistleblower Protection Act of 1998, Pub. L. No. 105-272, § 701(b) 112 Stat. 2396, 2413-14 (1998) (codified at 5 U.S.C. app. § 8H (2007)).

54 *Id.*

55 Statement on Signing the Intelligence Authorization Act for Fiscal Year 1999, 2 PUB. PAPERS 1825 (Oct. 20, 1998).

wishes of his agency head or the President, the legislation erodes the Executive's ability to prevent such disclosures from being made.[56]

B. *Pathways to Whistle-blowing*

As information related to national security is dangerous, its disclosure must be sufficiently restricted to preserve national security. At the same time, such information must not be so restricted that IC agencies will go without oversight, which could result in agency excesses. Therefore, it is reasonable to treat IC whistle-blowers differently than other federal whistle-blowers due to the special restrictions on information related to national security. This explains, in part, why the Whistleblower Protection Act (WPA), the legislation that provides protection for most federal workers, specifically excludes IC workers.[57] Similarly, an IC whistle-blower is generally not permitted to pursue an action under the False Claims Act (FCA), which incentivizes whistle-blowing by awarding him 15%–30% of the waste he prevents or uncovers, because the FCA does not authorize the disclosure of information related to national security.[58]

However, even though the most common and most lucrative pathways to whistle-blowing are closed to intelligence workers, Congress did not intend for these employees to be entirely foreclosed from whistle-blowing. It instituted two main routes to enable whistle-blowing by such workers—the Inspector General system and the ICWPA.[59]

1. The "Ask the Boss" Method: Inspectors General

The Inspector General Act of 1978 (IGA)[60] was one of the first attempts to give whistle-blowers an opportunity to come forward without fear of losing their jobs. An Inspector General (IG) is a presidential appointee, confirmed with the advice and consent of the Senate,[61] whose purpose is to prevent, detect, and report to Congress and agency heads incidents of fraud and abuse within their assigned executive agencies.[62] One way IGs accomplish this charge is by guaranteeing that employees, who come to them

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56 *See id.* § 702, 112 Stat. at 2413-16.

57 Whistleblower Protection Act of 1989, 5 U.S.C. § 2302(a)(2)(C)(ii) (2006).

58 False Claims Act, 31 U.S.C. § 3730(d) (2006). *See also infra* Part IV for a discussion of why the FCA is not available to IC workers.

59 Intelligence Community Whistleblower Protection Act of 1998, Pub. L. No. 105-272, § 702, 112 Stat. 2396 (1998) (codified at 5 U.S.C. app. § 8H (2007)); Inspector General Act of 1978, Pub. L. No. 95-452, 92 Stat. 1101 (codified as amended at 5 U.S.C. app. §§ 1-12 (2007)).

60 5 U.S.C. app. §§ 1-12 (2007).

61 *Id.* § 3(a).

62 *Id.* § 2(2)-(3).

seeking to disclose an incident of theft, waste, or abuse[63] will not be subject to reprisal unless the disclosure was made "with the knowledge that it was false or with willful disregard for its truth or falsity."[64] It is interesting to note that the President may remove an IG at any time; although Congress must be informed before the dismissal, the IGA does not provide a mechanism for Congress to prevent the removal.[65] Even though Congress could take other actions, such as exercising its spending power or exerting political pressure, they are less convenient to use than a built-in mechanism would be. Currently, each IC agency, like all other federal agencies, has access to an IG.[66]

It is important for the IC whistle-blower to understand that when he chooses this path, it goes no further for him than the IG's door.[67] The whistle-blower is not asking permission to contact Congress with his urgent concerns (doing so is forbidden if the information is classified),[68] but rather he is asking the IG to do so for him while informing the agency head.[69] Should the IG decide the complaint is not credible and not worth mentioning in any of his reports, the whistle-blower's allegations end there and no appeal of the decision is possible.[70] While in those instances the IG must inform Congress and the agency head that he has conducted an investigation, the report need not amount to little more than statistical data.[71]

2. The Direct Approach: The Intelligence Community Whistleblower Protection Act

Congress passed the ICWPA[72] in 1998 to prevent IGs and agency heads from escaping congressional oversight by downplaying the merit of

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63 Specifically, the statute allows the IG to hear and investigate complaints of the "possible existence of an activity constituting a violation of law, rules, or regulations, or mismanagement, gross waste of funds, abuse of authority or a substantial and specific danger to the public health and safety." *Id.* § 7(a).

64 *Id.* § 7(c).

65 Inspector General Act of 1978, Pub. L. No. 95-452, 92 Stat. 1101 (codified as amended at 5 U.S.C. app. § 3(b) (2007)).

66 *Id.* §§ 3(a), § 8H(a)(1).

67 This was true before the ICWPA. The next section will detail how this scenario has changed.

68 Inspector General Act of 1978, 5 U.S.C. app. § 5(e) (2007).

69 The IG would make the disclosure to the agency head and Congress by including it in his annual or periodic reports to Congress. *Id.* § 5.

70 The Inspector General Act does not require reporting on the number of complaints made but found not to be credible. *Id.* § 5.

71 *See Id.* § 5(b)-(d) (requiring the Inspectors General to make periodical, statistics-based reports to the agency heads for transmittal to Congress, and compelling them to immediately make a detailed report if they believe the information concerns to be "particularly serious or flagrant problems . . . .").

72 Intelligence Community Whistleblower Protection Act of 1998, Pub. L. No. 105-272, § 702, 112 Stat. 2396 (1998) (codified at 5 U.S.C. app. § 8H (2007)).

credible IC whistle-blower reports. The ICWPA provides an IC whistle-blower with an alternative path to reach Congress when his agency head or IG did not believe the information to be credible.[73] The employee must still first make a report to his agency's IG, who has fourteen days to determine if the complaint is credible.[74] If the IG finds the report to be credible, the report must be forwarded to the agency head, who has seven more days to provide comments before the report then heads to Congress's intelligence committees.[75] However, if the IG finds that the information is not credible, the whistle-blower may still contact the intelligence committees as long as he informs the IG and the agency head of his intention to do so and complies with all security precautions and instructions in contacting the committees.[76]

The net effect of the ICWPA is to create a path to Congress for the IC whistle-blower who remains concerned about improper agency behavior even after his agency head and IG insist that the information should not reach Congress. In theory, this legislation should have ended the Executive's hegemony over the IC and restored legislative oversight.

3. The WPEA Proposals

In February 2006, the House Committee on Government Reform held hearings entitled "National Security Whistleblowers in the Post-September 11th Era: Lost in a Labyrinth and Facing Subtle Retaliation,"[77] to determine whether existing whistle-blower protections were adequate for intelligence workers.[78] In these hearings, Lt. Col. Shaffer, whose unfortunate story is recounted in this Comment's introduction, finally had his opportunity to address Congress about the unjust and retaliatory revocation of his security clearance.[79] Other victims of agency retaliation, including Former FBI Special Agent Michael German, joined Shaffer in the hearings.[80] German was an FBI whistle-blower who made allegations against his agency to the Department of Justice's IG, accusing the Bureau of conducting illegal wiretaps and falsifying official documents.[81] His reward for blowing the whistle on his agency was an investigation into his own expense accounts, with an eye

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73 *Id.* § 8H.

74 *Id.* § 8H(a)-(b).

75 *Id.* § 8H(c).

76 *Id.* § 8H(d).

77 *Lost in a Labyrinth*, *supra* note 1, at 1-4.

78 *Id.* at 5-6 (statement of Rep. Henry Waxman).

79 *Id.* at 122-32 (statement of Lt. Col. Anthony Shaffer).

80 *Id.* at 132-42 (statement of Michael German, former Special Agent, Fed. Bureau of Investigation).

81 *Id.* at 135-36.

toward revoking his security clearance.[82] After struggling for years with the IG to properly investigate his complaints, German quit the Bureau, disgusted over the IG's disinterest in the FBI's integrity.[83]

The allegations of retaliation reported by German, Shaffer, and others convinced Congress to reform whistle-blower protections for IC workers. Each chamber came up with its own proposal, entitled the Whistleblower Protection Enhancement Act of 2009 (WPEA).[84]

The House version, H.R. 1507, would provide that IC employees "may not be discharged, demoted, or otherwise discriminated against (including by denying, suspending, or revoking a security clearance)" as a reprisal for making protected disclosures of theft, waste, or abuse.[85] Furthermore, should such a reprisal occur, the United States Court of Appeals for the Federal Circuit, or another appropriate federal appellate court, would have jurisdiction to review the alleged prohibited activity.[86] If the reprisal involved a security clearance determination, judicial review would also be available before the Merit Systems Protection Board (MSPB)[87] following an appeal within the whistle-blower's agency. If the MSPB (or the reviewing appellate court) finds that the security clearance determination was made in retaliation of a protected disclosure, the agency would be required to re-review the determination, "giving great weight to the Board or court judgment."[88]

The Senate's version, S. 372, offers similar protections to its House counterpart, but includes different protections against improper review board decisions. Where H.R. 1507 relies on the existing federal appellate courts to hear complaints, S. 372 proposes the creation of a new forum, the ICWPB.[89] As part of the Office of the Director of National Intelligence (ODNI), the ICWPB would be entirely within the Executive Branch.[90] The ICWPB would be composed of one chairperson and four members, two of whom must be IGs.[91] Two alternate IGs would be available in case the issue before the ICWPB affects any of the member IGs' agencies.[92] The

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82 *Id.* at 136-39.

83 *Lost in a Labyrinth, supra* note 1, at 136-37 (statement of Michael German, Former Special Agent, Fed. Bureau of Investigation).

84 H.R. 1507, 111th Cong. (2009); S. 372, 111th Cong. (2009).

85 *Id.* § 10 (amending 5 U.S.C. § 2302, adding § 2303A(a)(1)-(2)).

86 *Id.* (amending 5 U.S.C. § 2302, adding § 2303A(c)(4)).

87 The MSPB describes itself as a "quasi-judicial agency in the Executive branch that serves as the guardian of Federal merit systems." It accomplishes this role by adjudicating appeals by individual federal employees, as well as studying the merits system. MERIT SYS. PROT. BD., *About MSPB*, http://www.mspb.gov/About/about.htm (last visited Jan. 15, 2011).

88 H.R. 1507, 111th Cong. § 14 (2009) (amending 5 U.S.C. § 77, adding § 7702A).

89 S. 372, 111th Cong. § 201 (2009) (amending 50 U.S.C. § 402, adding § 120).

90 *Id.* § 201 (adding § 120(a)-(b)).

91 *Id.* § 201 (amending 50 U.S.C. § 402, adding § 120(b)).

92 *Id.*

President would appoint each ICWPB member with the advice and consent of the Senate.[93]

An IC employee would be authorized to appeal an adverse personnel action (except a security clearance determination) when he believes he is being retaliated against for making a protected disclosure of theft, waste, or abuse.[94] He would first appeal within his agency according to ICWPB-established procedures, which closely resemble procedures under the WPA.[95] Should the intra-agency appeal result in a finding against the employee, the employee may then appeal to the ICWPB.[96] If the ICWPB finds against the employee, review is then available in the United States Court of Appeals for the Federal Circuit.[97] In any event, if the reviewer finds against the agency at any level, the employee is to be returned to the position he would have occupied had the prohibited personnel action not injured him.[98] This may be accomplished by ordering the agency to pay reasonable attorney fees, back pay, benefits and compensatory damages not to exceed $300,000,[99] but neither the ICWPB nor the court is authorized to order the agency to reinstate the employee.[100]

If the retaliation is alleged to have involved an adverse security clearance determination, the process is slightly different. The first step is to appeal within the agency and then before the ICWPB, as with other types of prohibited personnel actions.[101] If the ICWPB finds against the whistleblower, then no further appeals are possible.[102] However, should the Board find that the security clearance action was retaliatory, then it shall reinstate the clearance as long as doing so is "clearly consistent" with the interests of national security.[103] Furthermore, though the ICWPB can provide the same remedies to a victim of security clearance retaliation as it could for other offenses, the President can void the ICWPB's remedy if it "would endanger national security."[104]

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93 *Id.*

94 *Id.*

95 S. 372, 111th Cong. § 201 (2009) (adding § 121(c)).

96 *Id.* (adding § 121(c)(4)).

97 *Id.* (adding § 121(c)(5)(A)(i)-(ii)).

98 *Id.* (adding §§ 121(c)(2), 121(c)(4)(E)).

99 *Id.*

100 *Id.* (amending 50 U.S.C. § 402, adding § 121(c)(4)(E)).

101 Whistleblower Protection Enhancement Act of 2009, S. 372, 111th Cong. § 202 (as reported by S. Comm. on Homeland Sec. and Governmental Affairs, Dec. 3, 2009) (amending 50 U.S.C. § 435B(b), adding § 3001(j)(3)-(4)).

102 *Id.* (amending 50 U.S.C. § 435B(b), adding § 3001(j)(5)).

103 *Id.* (amending 50 U.S.C. § 435B(b), adding § 3001(j)(4)(F)).

104 *Id.* (amending 50 U.S.C. § 435B(b), adding § 3001(j)(4)(G)).

II. LEGAL ANALYSIS

The trail of legislation leading up to the WPEA tracks decades of attempts by Congress to convince IC whistle-blowers that it is safe for them to speak out. The Executive Branch similarly claims that whistle-blowers are a vital part of effective government, even if they are blowing the whistle on executive agency abuses.[105] Executive Order 12674 commands all federal employees to report all occurrences of "waste, fraud, abuse and corruption" that they encounter "to appropriate authorities."[106] Despite legislative protections and presidential encouragement, few intelligence workers will raise allegations of theft, waste, or abuse if they are not confident that their careers will be safe.

A. *Problems with the Inspector General System*

The IG is not always perceived as a safe route to disclosing information.[107] One explanation for this perception can be found in the legislation that created the office. In the IGA, the position of Inspector General is subservient to, not independent of, executive authority.[108] The IG is appointed by the President with the advice and consent of the Senate, but is only removable by the President.[109] Although the President must submit his reasoning for the removal to Congress, the IGA provides Congress with no mechanism to modify his decision.[110] This means that by design, the IG is more dependent on the Executive than Congress for his continued employment, and therefore is more susceptible to the Executive's influence.

Admittedly, some examples tend to show that in practice, IGs behave more independently than the IGA seems to envision.[111] For example, Inspector General Glenn Fine of the Justice Department produced reports damning the Bush Administration's conduct.[112] One commentator de-

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105 Exec. Order No. 12674, 54 Fed. Reg. 15159, 15159 (1989).

106 *Id.*

107 *See, e.g.*, *Lost in a Labyrinth*, *supra* note 1, at 130-31 (statement of Lt. Col. Anthony Shaffer) (who felt there was no place, including the office of the IG, to seek meaningful review of his retaliatory security clearance determination); *see also id.* at 135-37 (statement of Michael German, Former Special Agent, Fed. Bureau of Investigation) (who tried to coax his agency's IG into protecting him from a malicious investigation made in retaliation for his protected disclosures).

108 Inspector General Act of 1978, 5 U.S.C. app. § 3(a) (2007).

109 *Id.* § 3(a)-(b).

110 *Id.* § 3.

111 Pamela S. Karlan, *Lessons Learned: Voting Rights and the Bush Administration*, 4 DUKE J. CONST. L. & PUB. POL'Y 17, 28 (2009).

112 *See, e.g.*, U.S. DEP'T OF JUSTICE OFFICE OF THE INSPECTOR GEN. & OFFICE OF PROF'L RESPONSIBILITY, AN INVESTIGATION INTO THE REMOVAL OF NINE U.S. ATTORNEYS IN 2006 56-59 (2008), *available at* http://www.usdoj.gov/oig/special/s0809a/final.pdf (finding that the conduct of key,

scribed Fine's reports as "gripping, if sickening, reading," which "show[ed] a Department . . . that squandered literally hundreds of years of experience and expertise that were acquired and deployed during previous Administrations."[113] If the President truly had absolute control over IGs and Congress was powerless to stop their removal, then the President would presumably fire IGs like Fine. The continued employment of such IGs, even after severely criticizing the Administration, suggests a "soft power" check on the President's removal power. Perhaps presidents fear that adopting draconian personnel policies would sour public opinion. Alternatively, they may be aware that Congress will not cooperate with such an Administration and will pass legislation to change the system if it is abused. Whatever the reason, past practice cannot guarantee future performance. Soft power checks can never be as reliable as actual legislative barriers to executive excesses, and the fact remains that IGs are ultimately accountable to the President.

In fact, there is reason to believe that the Executive's domination of the IG system has caused IGs to resist conducting proper investigations against the Administrations they work under. Recall Former FBI Special Agent Michael German's testimony about the difficulty of convincing the Department of Justice's IG to look into serious and flagrant crimes in the FBI.[114] He complained that it took years of struggling to convince the IG to even start an investigation that later substantiated his claims. Despite his ultimate vindication, German left the Bureau in disgust.[115] Does this IG sound like an individual that is zealously seeking to ferret out corruption, theft, waste, or abuse wherever it can be found? Or does he sound more like an agent of the Executive who is reluctant to reveal his employer's corruption, dragging his feet until the problem employee goes away?

Even some of the IGs' own statements at the 2006 "Lost in a Labyrinth" hearings smack strongly of a disinterested and ineffective office.[116] The primary purpose of the hearings was to investigate the alarming rise in security clearance revocations made in retaliation against whistle-blowers after they made protected disclosures.[117] Yet the IGs who could be reached for comment had never heard that such a problem existed.[118] The CIA's IG, for example, did not even attend the hearings, and declined his invitation

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high level presidential appointees severely damaged public confidence in the Justice Department due to their unfair, arbitrary and "fundamentally flawed" removal decisions); *see also* Karlan, *supra* note 110, at 28.

113 Karlan, *supra* note 111.

114 *Lost in a Labyrinth*, *supra* note 1, at 135-37 (statement of Michael German, Former Special Agent, Fed. Bureau of Investigation).

115 *Id.*

116 *Id.* at 374-422.

117 *Id.* at 4 (statement of Rep. Christopher Shays).

118 *Id.* at 374-422.

with a letter indicating that he had nothing to add because his office had never heard such a complaint.[119]

Similarly, the Department of Energy's IG reported no substantiated allegations of whistle-blowers being retaliated against by having their security clearances removed.[120] Inspector General Gregory Friedman reported that his office had received three complaints alleging security clearance retaliation in the past ten years, every one of which was resolved in favor of the Department.[121] Furthermore, Mr. Friedman said his office received approximately 10,000 whistle-blower complaints unrelated to security clearance retaliation during the same period, many of which were sustained.[122] How is it that the same agency can be so likely to commit so many abuses, yet never commit security clearance retaliation? One answer may be that security clearance retaliation actually does occur, but goes largely unreported because it is not subject to meaningful review. This would explain both the incredibly low frequency of complaints alleging security clearance retaliation as well as the unlikely result that the IG will hold the agency responsible. A whistle-blower has little reason to bring a complaint when he has no chance of success.

Most shockingly, Inspector General Glenn Fine reported that the Department of Justice has never received a security clearance retaliation complaint.[123] Mr. Fine's statement was particularly surprising because earlier in the same hearing, Former FBI Special Agent Michael German stated that he had made precisely those allegations. German stated that not only was he the target of a malicious investigation to find a pretext to revoke his security clearance, but he had been struggling with the IG to do something about it for years.[124] Not surprisingly, Mr. Fine's office also did not receive any requests to contact Congress under the ICWPA.[125]

This is not to suggest that the IGs are colluding to ignore whistle-blower complaints and protect their executive agency masters in an effort to silence opposition. Neither does it suggest that the IGs conduct poor investigations. Instead, the point is simply that significant evidence exists that would support a perception in the IC community that the IG system is not a safe or effective vehicle for protecting IC whistle-blowers who depend on their security clearances.

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119 *Id.* at 41.

120 *Lost in a Labyrinth*, *supra* note 1, at 412-13 (statement of Inspector Gen. Gregory Friedman, U.S. Dep't of Energy).

121 *Id.*

122 *Id.* at 410.

123 *Id.* at 406 (statement of Inspector Gen. Glenn Fine, U.S. Dep't of Justice).

124 *Id.* at 132-42 (statement of Michael German, Former FBI Special Agent).

125 *Id.* at 405 (statement of Inspector Gen. Glenn Fine, U.S. Dep't of Justice).

B. *Problems with the Intelligence Community Whistleblower Protection Act*

Because the ICWPA allows IC whistle-blowers to sidestep the IGs and go directly to Congress with their allegations of theft, waste, and abuse, the ICWPA is an important step toward securing congressional oversight of intelligence agency conduct. However, whistle-blowers will only use the provisions if they can be assured that a safe and effective system will protect their post-disclosure careers. As the 2006 "Lost in a Labyrinth" hearings dramatically illustrated, whistle-blowers have ample reason to fear that blowing the whistle under the ICWPA will be the last career move they make.

Lt. Col. Anthony Shaffer testified in those 2006 hearings that he made a disclosure to the 9/11 Commission, alleging that the DIA's mismanagement had allowed the 9/11 tragedy to occur.[126] Because the DIA knew that *Egan* made security clearances unreviewable outside of the Executive Branch, it was confident that it could pick any pretext it wanted to revoke Shaffer's security clearance.[127] In his case, it was Shaffer's improper call-forwarding, which periodically cost the DIA twenty-five cents, that led the Agency to determine that he was unfit to handle information related to national security—a preposterous conclusion belying the DIA's true motive.[128] However, without meaningful review to shed light on pretextual determinations, the Agency could have chosen virtually any reason at all, no matter how ludicrous.

The Executive Branch rejects such analysis, arguing that meaningful review that prevents retaliatory security clearance revocations is already available.[129] Deputy Assistant Attorney General Rajesh De explained, in a statement regarding S. 372, that under Executive Order 12968 IC whistle-blowers are already guaranteed a "panoply of due process protections."[130] Executive Order 12968 provides that an employee is entitled to an appeal of a security clearance revocation in front of a panel chosen by the agency head.[131] The employee is allowed: (1) to access any documents that led to the revocation to aid in the preparation of the appeal; (2) to be aided by an attorney; and (3) to have any rulings made in writing.[132] However, the protections offered in Executive Order 12968 are unreliable. Any due process protection, or even the right to the appeal itself, is subject to the discretion

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126 *Lost in a Labyrinth*, *supra* note 1, at 127 (statement of Lt. Col. Anthony Shaffer).

127 Dep't of the Navy v. Egan, 484 U.S. 518, 527 (1988).

128 *Lost in a Labyrinth*, *supra* note 1, at 128-29 (statement of Lt. Col. Anthony Shaffer).

129 *See, e.g.*, DEP'T OF JUSTICE, STATEMENT OF RAJESH DE, *supra* note 30, at 8.

130 *Id.* at 7-8.

131 Exec. Order 12968, 60 Fed. Reg. 40,245, 40,252 (1995).

132 *Id.* at 40,252-53.

of the agency head, whose decisions are final.[133] Even Mr. De conceded that such protections were inadequate and that the President supports a system where review would be conducted outside of the agency that initially denied the security clearance.[134]

The protections currently in place within agencies are admittedly insufficient; even the Executive Branch is concerned about the impartiality of an agency head. Put simply, an IC whistle-blower is ill-advised to make disclosures, as his agency is likely to respond with career-ending retaliation.

C. *The Intelligence Community Whistle-blower Enhancement Act (WEA) Proposals*

H.R. 1507 is perhaps one of the best ways to guarantee IC whistle-blowers access to meaningful review, as it would enable them to appeal to federal courts.[135] The availability of such appeals would mean that personnel decisions, including security clearance revocations, could not be done in clear and obvious retaliation against intelligence employees for making disclosures against their employers. This is because the agency would have to answer to an independent fact finder outside of the Executive Branch, with eventual recourse to life-tenured Article III judges and possibly even the Supreme Court.[136] However, the H.R. 1507 scheme is likely to fail because allowing federal courts to hear appeals of adverse security clearance determinations ignores the Executive Branch's exclusive domain over such decisions.[137] Even though the intelligence agency is not obliged to accept the court's determination and restore a security clearance, it still must "give great weight" to the court's opinion, which improperly invites judicial influence to an area that *Egan* has made off-limits to the courts.[138] Although Mr. De may have indicated that the Obama Administration was not averse to review outside of the agency making a security clearance revocation, he was adamant that the Constitution mandates that such review must be entirely within the Executive Branch.[139]

S. 372, on the other hand, does not extend itself beyond the Executive Branch.[140] It organizes the ICWPB under ODNI and the President appoints

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133 *Id.*

134 DEP'T OF JUSTICE, STATEMENT OF RAJESH DE, *supra* note 30, at 7.

135 H.R. 1507 § 10(c)(3), 111th Cong. (2009) (amending 5 U.S.C. § 2302, adding § 2302A(c)(4)).

136 *See* U.S. CONST. art. III §§ 1-2 (providing life tenure for judges and assigning the Supreme Court appellate jurisdiction over the inferior federal courts).

137 H.R. 1507 § 10, 111th Cong. (2009) (amending 5 U.S.C. § 2302, adding § 2302A(c)(4)).

138 Dep't of the Navy v. Egan, 484 U.S. 518, 527 (1988); H.R. 1507 § 14(b)(1), 111th Cong. (2009) (amending 5 U.S.C. § 77, adding § 7702A).

139 *Lost in a Labyrinth*, *supra* note 1, at 6 (statement of Rajesh De, Deputy Assistant Att'y Gen., Office of Legal Policy, Dep't of Justice).

140 S. 372 § 201, 111th Cong. (2009).

the Board's membership.[141] Furthermore, when approximately half of the ICWPB's members must be IGs, who the President can remove without congressional approval, there can be no question that the Board is primarily a creature of the Executive.[142] Therefore, *Egan* would not preclude the Board's existence. Moreover, because the IGs cannot be from the same agency that is the subject of the IC whistle-blower's complaint, the ICWPB appears to be more impartial than the internal agency review provided under Executive Order 12,968.[143] With a greater perception of impartiality, it would follow that whistle-blowing would be more likely to occur because an IC employee would feel that his agency would have less of an opportunity to retaliate against him.

However, it is important to note that the stigma of agency bias would not completely disappear under S. 372. As long as the entire review process is contained within one branch of government, no check is placed upon executive power, and thus agencies' wrongdoing is not truly curbed under this new scheme. Therefore, while the ICWPB is a step in the right direction, it does not go far enough.

D. *The Missing Piece: Incentives*

The IGA, ICWPA, and WEA are all styled to provide protections from retaliation for making disclosures, but do nothing to encourage a whistle-blower to come forward in the first place. Put another way, aside from keeping his job, the IC whistle-blower does not benefit from whistle-blowing, even though such behavior is socially valuable. As commentators have pointed out, enabling an individual to profit from exposing theft, waste, and abuse is the single most effective tool in ending that wrongdoing.[144] The optimum level of incentives is an economic question, to which we turn to next.

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141 S. 372 § 201, 111th Cong. (2009) (amending 50 U.S.C. § 402, adding § 120).

142 Inspector General Act of 1978, 5 U.S.C. app. § 3 (2007).

143 Exec. Order No. 12968, 60 Fed. Reg. 40245, 40252-54 (Aug. 7, 1995); S. 372 § 201, 111th Cong. (2009) (amending 50 U.S.C. § 402, adding § 120(b)).

144 *False Claims Act Correction Act (S. 2041): Strengthening the Government's Most Effective Tool Against Fraud for the 21st Century, Hearing Before the S. Comm. on the Judiciary*, 110th Cong. 1 (2008) (statement of Sen. Leahy, Chairman, S. Comm. on the Judiciary), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_senate_hearings&docid=f:42809.wais.pdf (last accessed September 15, 2010). *See also* Barry M. Landry, Note, *Deterring Fraud to Increase Public Confidence: Why Congress Should Allow Government Employees to File Qui Tam Lawsuits*, 94 MINN. L. REV. 1239, 1241 (2010) (explaining that the FCA is the most effective tool because it gives the *qui tam* relator a monetary reason to come forward).

III. ECONOMIC ANALYSIS

Whistle-blowers provide a socially valuable function but also impose costs on society. First, the complaints whistle-blowers generate must be litigated and resolved by an appropriate authority, which requires funding. Second, especially in the IC, an increase in the level of whistle-blowing activity also increases the risk of exposing information related to national security. Therefore, to determine if the ICWPB can achieve the socially optimum level of whistle-blowing (where the benefits derived from the activity at least equal the costs), we must first identify the costs and benefits.

A. *Benefits of Whistle-blowing*

1. The IC Can No Longer Control Itself, and IC Whistle-Blowers Provide Self-Policing

The post-9/11 IC is fast becoming synonymous with wastefulness. In the July 2010 "Top Secret America" series of articles in the *Washington Post*, authors Dana Priest and William M. Arkin revealed the results of their two-year investigation into the shocking expansion of the IC and its troubling lack of transparency.[145] Their findings show that spending in the IC has reached astronomical proportions, reaching its height in 2009 at $75 billion annually.[146] In the past nine years, for example, the equivalent footprint of three Pentagons has been erected in the Washington, D.C. area.[147] Additionally, during that span, at least 263 new organizations were created to support the IC, bringing the community to an estimated 853,000 workers.[148] The Department of Homeland Security alone commands a workforce of 230,000.[149]

From this mushrooming community comes a work product that is so vast that it is unmanageable to the few individuals in a position to review and absorb it. As one high-level interviewee put it, "I'm not going to live long enough to be briefed on everything."[150] Another official assigned to review and audit portions of the IC concluded that "it inevitably results in

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145 Dana Priest & William M. Arkin, *Top Secret America: A Hidden World, Growing Beyond Control*, WASH. POST, July 19, 2010, at A1.

146 *Id.*

147 *Id.*

148 *Id.*

149 *Id.*

150 *Id.*

message dissonance, reduced effectiveness and waste, and [I] consequently can't effectively assess whether it is making us [safer]."[151]

Much of the excess volume of information is the result of redundancy within the IC. For example, fifty-one federal organizations all track the monetary transactions between terrorist networks, often duplicating the same work.[152] The reports of one organization are generally ignored by other organizations even if they are shared because agencies prefer to rely on their own in-house information.[153]

Combining unbridled spending with the inability of management to control expenditures results in an opportunity for the unscrupulous to fleece the government. The chances of being noticed, let alone caught, appear to be well in the favor of the defrauder.[154] Further, a thief's odds of succeeding are increased in the IC, as intelligence workers are unwilling to risk their careers by raising allegations in a culture that has been described as unfriendly toward whistle-blowers.[155]

Increasing whistle-blower protections therefore increases the ability of agency management to combat theft, waste, and abuse. Management will no longer need to be as vigilant and proactive in rooting out such wrongdoing if each employee has an incentive to bring wrongdoing to light. Thus, self-policing becomes a very real benefit of allowing whistle-blowing.

2. Discouraging Dangerous Vigilante Whistle-Blowing

Another benefit from providing effective, strong, and reliable whistle-blower protections is that such protections discourage well-meaning employees from taking matters into their own hands to expose instances of theft, waste, and abuse. This is because an employee who feels safe blowing the whistle through proper channels (let alone meriting a reward for his good deed)[156] will be less likely to attempt to hide his identity and disclose information related to national security directly to the public, as was the case in the 2010 Wikileaks incident.[157]

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151 Priest & Arkin, *supra* note 145.

152 *Id.*

153 *Id.*

154 *Lost in a Labyrinth*, *supra* note 1 (statement of Lt. Col. Anthony Shaffer).

155 *See, e.g., id.* (statement of Lt. Col. Anthony Shaffer) (describing his agency's culture of abhorrent values, self-preservation and fear of retaliation).

156 For example, an IG is authorized to give up to $10,000 to a whistle-blower in exchange for his money-saving disclosure. 5 U.S.C. § 4512(a) (2010).

157 Elizabeth Newell, *Backing Up Whistleblowers*, GOVERNMENTEXECUTIVE.COM (Feb. 2, 2011), http://www.govexec.com/dailyfed/0211/020211mm.htm.

In April 2010, Wikileaks.org, a fringe website dedicated to publishing secret documents,[158] displayed a video of an American helicopter firing at civilians in Afghanistan.[159] This video was just the start; over the next few weeks Wikileaks published approximately 92,000 classified documents leaked to the website by an anonymous source within the IC,[160] later identified to be Army intelligence analyst Pfc. Bradley Manning. The Pentagon has frequently objected to Wikileaks' policy of exposing national security secrets, saying "such information could be used by foreign intelligence services, terrorist groups and others to identify vulnerabilities, plan attacks and build new devices."[161] This level of unauthorized disclosure was unprecedented; Manning claimed to have trafficked 260,000 classified documents to Wikileaks.[162]

While arresting Manning was simple enough once he was identified, restoring national security by reclaiming the disclosed information was impossible.[163] Wikileaks refuses to return the ill-gotten documents and plans to continue publishing them.[164] This places the Pentagon in an undesirable position, as judicial injunctions are notoriously ineffective in curbing such behavior; shutting down one website leaves dozens of mirror sites free to operate abroad, beyond the reach of American courts.[165] The only safeguard that stops any interested party in obtaining information that could compromise the effectiveness of ongoing intelligence operations—not to mention the lives of those agents who depend on secrecy in the field—is the mere promise that Wikileaks will only release information it feels would not jeopardize national security operations.[166] From statements made by the *New York Times* and Wikileaks, it appears the leaked documents contain information that jeopardizes the safety of field operatives and could harm national security.[167] Instead of such information being in the hands of the intelligence committees who are knowledgeable and specialized in handling this sort of disclosure, it is in the hands of five untrained civilian volunteers

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158 Stephanie Strom, *Pentagon Sees a Threat From Online Muckrakers*, N.Y. TIMES, Mar. 18, 2010, at A18.

159 Noam Cohen & Brian Stelter, *Airstrike Video Brings Attention to Whistle-Blower Site*, N.Y. TIMES, Apr. 7, 2010, at A8.

160 Eric Schmitt & Helene Cooper, *Document Leak Adds to Pressure on White House*, N.Y. TIMES, July 27, 2010, at A1.

161 Strom, *supra* note 158.

162 Elisabeth Bumiller, *Army Leak Suspect Is Turned In, by Ex-Hacker*, N.Y. TIMES, June 8, 2010, at A1.

163 *See* Eric Schmitt, *In Disclosing Secret Documents, WikiLeaks Seeks 'Transparency,'* N.Y. TIMES, July 26, 2010, at A11.

164 Thom Shanker, *WikiLeaks and Pentagon Disagree About Talks*, N.Y. TIMES, Aug. 19, 2010, at A10.

165 Cohen & Stelter, *supra* note 159.

166 *See* Schmitt & Cooper, *supra* note 160.

167 *See id.*

who have stated that the goal is to use the information because they "enjoy crushing [the] bastards."[168]

The result of this leak underscores the importance of providing whistle-blowers with effective protection. Had Manning made his disclosures pursuant to the ICWPA procedures, the information he transferred would have been kept secure and gone directly into the hands of congressional intelligence committees, the legislative policymakers best suited to make meaningful changes in the IC when the Executive refuses to take action.[169] Had he done so, his agency would have been prohibited from retaliating against him because he would have done nothing wrong.[170] Even going to the IG would have been a safer alternative, as his disclosure would have been protected by statutory guarantees against agency retaliation.[171] Admittedly, he could have lost his security clearance in retaliation, but at least he could appeal that revocation within his agency.[172] By taking matters into his own hands and leaking information directly to the news media, Manning forfeited all protections available to him and now faces criminal charges.[173] Furthermore, the information he disclosed is now in unsafe hands, potentially accessible to every person in the world with an Internet connection. The only safeguards left are the promises of inexperienced civilians that they will redact what they deem to be sensitive information.[174] However, it is unlikely that these civilians will choose to redact much, as an increased volume of revealed information is more likely to provoke an investigation, which is their desired outcome.[175] Those who depend on secrecy to survive never agreed to have such individuals decide what is safe for disclosure and what is not.

B. *Disadvantages of Increasing Whistle-Blower Protections*

Though increased whistle-blower protection has unmistakable benefits, it must be conceded that protecting whistle-blowers has costs that must be considered as well.

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168 *Id.*; Cohen & Stelter, *supra* note 159.

169 5 U.S.C. app. § 8H(d) (2007).

170 *See* H.R. 1507 § 10, 111th Cong. (2009) (amending 5 U.S.C. § 2302, adding § 2303A(a)(1)-(2)).

171 *See* 5 U.S.C. app. § 7(c) (2007).

172 Exec. Order No. 12,968, 60 Fed. Reg. 40,245, 40,252 (Aug. 2, 1995).

173 *See* 5 U.S.C. app. §§ 8H(a), (d) (2011).

174 Schmitt & Cooper, *supra* note 160.

175 *Id.*

1. Calculable Costs

The first and most obvious cost is that whistle-blower protections require enforcement, and any enforcement effort requires funding. The proposal in S. 372, for example, will require additional salaries for ICWPB members[176] and facilities in which to conduct business.[177] Presumably, a support staff will be required to support the work of the new board, and agency workload in prosecuting these cases will increase as they need to prepare cases for a whole new level of review. As far as expenses can be calculated, the Congressional Budget Office (CBO) estimated the cost of the implementing the ICWPB will cost $3 million annually.[178]

To evaluate if this cost is worth accepting, we must estimate the amount of money that whistle-blowing can save the IC. Quantifying the amount of theft, waste, or abuse in any government agency is difficult, especially when the agency is notoriously opaque, as the IC agencies are known to be. However, at least one scholar has estimated that approximately 10% of the general federal budget is lost to theft, waste, and abuse every year.[179] That scholar investigated portions of the federal government where the FCA was available to whistle-blowers to help control abuse of government resources and described the FCA as the most effective means for combating waste and abuse within agencies.[180] It would seem to follow that because the FCA is not available to IC whistle-blowers, the loss from waste, fraud, and abuse in the IC will likely exceed the 10% estimate.[181] For argument's sake, we will use the conservative 10% estimate of the $75 billion annual IC budget and conclude that the IC loses $7.5 billion each year from theft, waste, or abuse.

To put this in perspective, an additional level of protection against agency wrongdoing could be implemented for a mere fraction of a percent of the estimated $7.5 billion annual loss from unscrupulous behavior.[182] Put another way, the cost of implementing the ICWPB is 2,500 times less than the cost of theft, waste, and abuse in the IC.[183]

However, it is important not to be misled here. The creation of the ICWPB will not eliminate all occurrences of theft, waste, or abuse in the IC. It will only make it more likely that an IC whistle-blower will feel

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176 S. 372, 111th Cong. § 201 (2009) (amending 50 U.S.C. § 402, adding § 120(b)(4)).

177 *Id.* (amending 50 U.S.C. § 402, adding § 120(c)).

178 CONG. BUDGET OFFICE, COST ESTIMATE, S. 372: WHISTLEBLOWER PROTECTION ENHANCEMENT ACT OF 2009 (2009), *available at* http://www.govtrack.us./data/us/111/bills.cbo/s372.pdf.

179 Landry, *supra* note 144, at 1239-40 n.3.

180 *Id.* at 1241-42.

181 See *infra* Part IV for a discussion of why the FCA is not available to IC workers.

182 This is calculated by dividing the cost of the ICWPB by the loss estimated at 10% of the IC budget of $75 billion, or (3,000,000 / 7,500,000,000) = .0004.

183 This is calculated by inverting the earlier value of .0004.

comfortable in exposing such occurrences because he will be able to seek meaningful review of retaliatory action taken against him. Although the amount saved under the ICWPB will not cancel out the entire annual loss to the IC from theft, waste, or abuse, the savings under the ICWPB will almost certainly exceed the amount saved under the current whistle-blowing scheme.

More important than the dollar amount of actual theft, waste, and abuse detected and saved is the dollar amount that will not occur in the first place once IC employees are empowered to become successful whistle-blowers. The IC would no longer have a reputation of being well-funded, yet unmanageable because any rank-and-file employee could potentially report on unscrupulousness. Therefore, theft, waste, and abuse in the IC would drop from its current level to a conceivably much lower level, as such dishonest actors move to easier targets to defraud.

2. Costs Due to Improperly Disclosed National Security Information

Thus far it has been estimated that the total cost of the ICWPB would be $3 million annually. However, in preparing this estimate, the CBO did not include the risk of increased accidental disclosures of information related to national security. Such risks can be of incalculable cost because, as the Pentagon noted, information related to national security can be used "by foreign intelligence services, terrorist groups and others to identify vulnerabilities, plan attacks and build new devices."[184] The risk of improper disclosure increases whenever information is entrusted to more individuals, which would occur as the complaint advances through additional layers of review. The risk increases because any individual may make disclosures to America's enemies either accidently, or, as in the case of spies or vigilante whistle-blowers, on purpose. Hence, controlling the information's security becomes increasingly difficult. As discussed in Part I.A.1, the cost of exposure is steep and can include embarrassment, ineffective intelligence operations, and even the deaths of agents in the field. Therefore, there is a strong argument for keeping information in as few hands as possible.

However, this argument does not foreclose the prudence of reform, and in fact may strengthen it. There will always be whistle-blowers who feel that they must do what is right and make disclosures to save lives or combat corruption, even when they have no legal means to do so. The Wikileaks incident showed how much damage a single whistle-blower of that ilk can cause and how quickly intelligence information can spread into so many hands. However, by increasing protections, it makes it less likely that such individuals will choose that route if an effective legal alternative exists. Therefore, by increasing whistle-blower protections, for instance, by

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184 Strom, *supra* note 158.

providing an additional layer of review through creating the more approachable and neutral ICWPB, the government reduces the number of hands into which information related to national security is placed.

V. SUGGESTIONS FOR IMPROVEMENT

As good a start as the ICWPB is, it is only a start. Two major problems still remain: (1) the ICWPB's location within the Executive Branch; and (2) the lack of proper incentives for IC whistle-blowers to report instances of theft, waste, and abuse.

The first problem can be corrected simply by making ICWPB decisions reviewable by the Federal Circuit. While this suggestion runs afoul of the Supreme Court's decision in *Egan*, its adoption is critical because review outside of the Executive Branch is necessary to prevent agency wrongdoing.[185] This suggestion is gaining greater acceptance, as evidenced by a recent MSPB decision that indicated a willingness to at least limit the reach of *Egan*. In *Conyer v. DOD*,[186] the MSPB held that *Egan's* prohibition against MSPB review of adverse personnel actions related to security clearances was inapplicable to positions designated as "sensitive" because such a designation merely indicated a relation to national security and trustworthiness, but did not grant access to classified information.[187] The MSPB reasoned that "any matter in which the government [merely] asserts a national security interest" cannot be free from judicial review unless a security clearance is at stake because it would "without any Congressional mandate or imprimatur, preclude Board and judicial review of alleged unlawful discrimination, whistle-blower retaliation, and a whole host of other constitutional and statutory violations for multitudes of federal employees subjected to otherwise appealable removals and other adverse actions."[188] While this single decision does not disturb *Egan* as it relates to security clearance revocations, *Conyer* may be evidence that in the future it will become less likely that the Executive can assert Commander-in-Chief privilege to evade judicial review. The next steps, like opening the ICWPB to Federal Circuit review, may not be far behind.

Furthermore, the ICWPB should be empowered to hear *qui tam* complaints from IC whistle-blowers and offer them a percentage of the waste saved, much like the FCA provides for relators.[189] The IGs are already au-

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185 Dep't of the Navy v. Egan, 484 U.S. 518 (1988).

186 Conyer v. U.S. Dep't of Defense, 2010 M.S.P.B. 247 (2010).

187 *Id.* at ¶¶ 13, 16.

188 *Id.* at ¶¶ 16-24.

189 The FCA permits plaintiffs to come forward who are not actually themselves injured by the fraud, but to proceed *qui tam* (that is, on behalf of the government) and share a percentage of the recovery. *See* False Claims Act, 31 U.S.C. § 3730(c)-(d) (2009). Here, the ICWPB would hear cases by

thorized to give awards to IC relators under federal statute, so the suggestion should not be foreign to the Executive Branch.[190] Pursuant to 5 U.S.C. § 4512, an agency's IG may give the lesser of $10,000 or 1% of agency savings to any employee who disclosed instances of fraud, waste, or abuse.[191] However, instead of capping the amount at $10,000, the award should be set to the maximum award possible from the ICWPB, currently fixed at $300,000.[192] Currently, the ICWPB can only award an amount sufficient "to return the employee . . . as nearly as practicable and reasonable, to the position such employee . . . would have held had the violation not occurred."[193] Therefore, the whistle-blower is not incentivized to bring cases, but rather merely reimbursed if he was improperly punished for doing so.

The reason for adding the *qui tam* capability is simple and straightforward. First, it would authorize the ICWPB to hear complaints from those not yet injured by retaliatory action. The ICWPB is the logical organization to hear such complaints because it is already staffed by individuals (presidential appointees, agency heads and IGs) who are: (1) authorized to hear classified information; (2) knowledgeable about the business of the IC; and (3) charged with rooting out instances of theft, waste, and abuse. Furthermore, the ICWPB would be perceived as a more impartial fact finding body than the intra-agency reviews currently available because of the ICWPB's recusal requirement. Additionally, the ability to recover in excess of the injury suffered by the relator whistle-blower would be the key requirement in transforming rank-and-file employees into a policing mechanism for the IC. Without giving a whistle-blower the ability to profit from his actions, the upgraded ICWPB will only attract those IC workers who would likely have done the right thing anyway. In an environment where agency management cannot effectively prevent waste on its own or where such instances will be subtle or difficult to detect, mere job protection is insufficient to motivate the average federal employee to take the time to root out wrongdoing, as he is required to do under Executive Order 12674. Even if Congress could guarantee that no whistle-blower will ever be retaliated against, there would still be a less than optimum level of whistle-blowing because whistle-blowers may not care to get bogged down in the courts when there is no incentive for them to blow the whistle in the first place. Furthermore, this new opportunity to obtain compensation for successful whistle-blowing would entice those workers who currently do not care enough to take action or prefer to look the other way. Therefore, empower-

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individuals having knowledge of instances of theft, waste, and abuse but who are not themselves victims of it.

190 5 U.S.C. § 4512(a).

191 *Id.*

192 S. 372, 111th Cong. § 202 (2009) (amending 50 U.S.C. § 435B(b), adding § 3001(j)(4)(B)).

193 *Id.*

ing the ICWPB to offer monetary incentives is one of the only ways that IC whistle-blowers will take up the extra work to hold their agencies responsible for wrongdoing. Moreover, the monetary incentive should be allowed to exceed $10,000 because waste in the IC can reach at least $7.5 billion per year. The amount awarded for successful whistle-blowing should more accurately reflect the social benefit derived from such activity in order to encourage a socially optimum level of whistle-blowing.[194]

An added benefit of authorizing the IC to use the ICWPB to bring *qui tam* actions is that it eliminates the need to resolve the current circuit split as to whether Congress intended the current version of the FCA to allow government relators.[195] If new legislation explicitly empowers the ICWPB to have jurisdiction over such cases, then there would be no such confusion frustrating the work of IC whistle-blowers, who by their nature must be government relators.

Some scholars have argued that extending this incentive to government workers creates a conflict of interest.[196] As one such scholar explained, it creates an incentive for a government relator who discovers an instance of theft, waste, or abuse to ignore it and even encourage it to grow until it becomes profitable for him to initiate a private lawsuit for personal gain.[197] Thus, theft, waste, and abuse are actually amplified by providing incentives. Though this is a troubling risk, the alternative is to stay the course and let all theft, waste, and abuse continue largely unchecked in the expansive IC bureaucracy, which can barely manage its work product, much less audit itself on every suspicion of waste.[198]

Incentivizing intelligence workers is perhaps the only way to effectively ferret out theft, waste, and abuse. Under the FCA, even if government workers could not be relators, at least a private citizen could.[199] In the IC, where information related to theft, waste, and abuse is likely to be intertwined with classified information, only government workers with security clearances would ever be able to learn of the wrongful conduct. Therefore, by denying IC workers an incentive to blow the whistle, the IC will become

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194 *See supra* Part III.B.1, for how this figure was calculated.

195 *Compare* United States *ex rel.* Leblanc v. Raytheon, 913 F.2d 17, 20 (1st Cir. 1990) (holding that government relators who are required to disclose fraud as a part of their job cannot bring FCA actions as original sources of the disclosure), *and* Exec. Order No. 12,674, 54 Fed. Reg. 15,159, 15,159 (Apr. 12, 1989) (requiring all federal employees to uncover and report instances of fraud), *with* United States *ex rel.* Williams v. NEC Corp., 931 F.2d 1493, 1501 (11th Cir. 1991) (holding that government employee relators are not barred from being original sources merely because they are required to uncover fraud as a condition of their employment). *See also* Joan R. Bullock, *The Pebble in the Shoe: Making the Case for the Government Employee*, 60 TENN. L. REV. 365 (1993) (discussing generally this circuit split and the rationales behind it).

196 Bullock, *supra* note 195, at 382-83, 387.

197 *Id.* at 382-83.

198 Priest & Arkin, *supra* note 145.

199 False Claims Act, 31 U.S.C. § 3730(b)(1) (2010).

uniquely immune to examination by motivated, self-interested whistle-blowers, and therefore will attract unscrupulous individuals.

CONCLUSION

The Executive oversees the IC more so than any other federal agencies. Its employees work under a virtual gag order and Congress is kept at arm's length from its day-to-day operations. As the IC expands, opportunities for theft, waste, and abuse multiply while the IC's ability to self-police deteriorates. Congress should act now to create a new forum where IC whistle-blowers can seek meaningful review outside of retaliatory security clearance revocations and other prohibited personnel practices—a place where they will have the opportunity to be heard outside of their own agency. The ICWPB can provide a framework, which can later be upgraded to enable review outside of the Executive Branch, that would finally end the Executive's hegemony over the critical issue of information related to national security. Also utilizing this forum, eventual additional legislation can give intelligence workers an opportunity to speak and a place to pursue *qui tam* actions, which would provide a financial incentive for IC whistle-blowers to do the right thing and potentially save the government billions of dollars.

The ICWPB is an important step in the right direction that makes possible real protection for IC whistle-blowers and lays the groundwork for them to overcome the social stigma of whistle-blowing. The IC is vulnerable to fraud, largely free from congressional oversight, and in need of strong, empowered, motivated whistle-blowers. The ICWPB can help the IC rise above the corruption that drains its resources and effectiveness and allow it to focus on its mission of protecting America.

GRANHOLM'S ENDS DO NOT JUSTIFY THE MEANS: THE TWENTY-FIRST AMENDMENT'S TEMPERANCE GOALS TRUMP FREE-MARKET IDEALISM

*Daniel Glynn**

INTRODUCTION

The Supreme Court's 2005 decision in *Granholm v. Heald*[1] has called into question the role of the states in regulating the commerce of alcohol. Many articles, published since the decision, have praised the ruling for preferring interstate commerce interests over states' rights in regulating the trade of alcohol.[2] This shift is contrary to what the drafters of the Twenty-First Amendment (the Amendment) intended—to use the law to increase the costs of alcohol, to decrease demand and to permit localities to retain the right to implement price and non-price restrictions on the sale of alcohol.[3] Many recent proposals to deregulate alcohol to improve free trade are antithetical to the letter and spirit of the Amendment.[4]

The proper way to assess the constitutionality of a state liquor law is to analyze it through public safety concerns, specifically the preservation of community morality. This Comment recommends that outdated state liquor laws should be reconsidered to properly address the local policy needs for regulating alcohol in a way that preserves the morals of the community. Recognizing that drawing a bright-line rule defining morality is difficult, this Comment frequently uses, as proxies, the three primary goals that the

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[1] Granholm v. Heald, 544 U.S. 460, 492-93 (2005) (holding two Michigan and New York statutes that restricted the shipment of wine from out-of-state wineries unconstitutional).

[2] James Alexander Tanford, *E-Commerce in Wine*, 3 J.L. ECON. & POL'Y 275, 315 (2006); Rachel M. Perkins, *Wine Wars: How We Have Painted Ourselves Into a Regulatory Corner*, 12 VAND. J. ENT. & TECH. L. 397, 434 (2010); Aaron Nielson, *Good History, Good Law (and by Coincidence Good Policy too):* Granholm v. Heald *125 S. Ct. 1885 (2005)*, 29 HARV. J.L. & PUB. POL'Y 743, 750 (2006).

[3] Marcia Yablon, *The Prohibition Hangover: Why We Are Still Feeling the Effects of Prohibition*, 13 VA. J. SOC. POL'Y & L. 552, 587 (2006); Brannon P. Denning, *Smokey and the Bandit in Cyberspace: The Dormant Commerce Clause, the Twenty-First Amendment, and State Regulation of Internet Alcohol Sales*, 19 CONST. COMMENT. 297, 310, 341-42 (2002).

[4] Yablon, *supra* note 3, at 587; *Scope of State Authority-Discriminatory Limitations on Direct Wine Shipment*, 119 HARV. L. REV. 307, 308 (2005) ("The Court's decision in [*Granholm*] reined in too far the expansive wording of Section 2; instead, the Court should have exempted from [D]ormant [C]ommerce [C]lause scrutiny all state laws regulating the importation of liquor.").

defendant States argued in *Granholm*: (1) safe, legal distribution; (2) orderly, transparent markets; and (3) the states' ability to tax alcohol.[5] These policy goals fit within the states' core concerns for the protection of public safety and morality.[6] This Comment considers fresh policies that may better serve the consumer while also serving the three major state goals in regulating alcohol, and addresses the likelihood of these respective policies coming to fruition.

Part I discusses historical trends in America's progressively adversarial relationship with alcohol from the early Republic, to the temperance movement, followed by the circumstances surrounding the passage of the Twenty-First Amendment, and finally a brief discussion of contemporary concerns. Part II provides a more in-depth comparison of the economic considerations and the moral and religious undertones of the temperance movement and the Twenty-First Amendment. Part III considers some of the current issues at the federal and state levels, illustrating the complexity of alcohol regulation and the effect instability of the law has on state lawmakers and consumers. Part IV discusses possible solutions to the issue of state control over alcohol distribution.

I. AMERICAN DRINKING CULTURE

To truly understand the issues currently surrounding alcohol regulation, it is necessary to examine historical developments during certain critical junctures in American history. The four areas that are most revealing to the discussion of alcohol regulation are 1) the colonial and early republican eras; 2) the temperance movement; 3) the passage of the Eighteenth and Twenty-First Amendments; and 4) contemporary arguments on the meaning of the Twenty-First Amendment. Each area serves as an example of the continuous battle between the "wets"[7] and "drys"[8] over alcohol consumption, and highlights the unusual position alcohol holds in American society.[9]

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[5] *Granholm*, 544 U.S. at 490-91.

[6] North Dakota v. United States, 495 U.S. 423, 432 (1990) (finding that only certain "regulations fall within the core of the State's power under the Twenty-First Amendment. In the interest of promoting temperance, ensuring orderly market conditions, and raising revenue, the State has established a comprehensive system for the distribution of liquor within its borders. That system is unquestionably legitimate.").

[7] A "wet" is defined as "an advocate of a policy of permitting the sale of intoxicating liquors." MERRIAM-WEBSTER'S ONLINE DICTIONARY, http://www.merriam-webster.com/dictionary/wet (last visited Oct. 14, 2011).

[8] A "dry" favors the "prohibit[ion of] the manufacture or distribution of alcoholic beverages." MERRIAM-WEBSTER'S ONLINE DICTIONARY, http://www.merriam-webster.com/dictionary/dry (last visited Oct. 30, 2011).

[9] *Compare* MARK EDWARD LENDER & JAMES KIRBY MARTIN, DRINKING IN AMERICA: A HISTORY 39 (Free Press 1982) (noting that James Madison denounced liquor as "inconsistent with the

A. *Early America*

In the early years of the Republic, the sale and consumption of alcohol was free from government scrutiny.[10] Indeed, much of the famed political discourse that pervaded early America occurred in village taverns.[11] Office-seekers used alcohol to reward loyal campaign supporters and encourage rural voters to trek to polling places on Election Day.[12] Alcohol was exceedingly popular in the seventeenth and eighteenth centuries[13] and was a part of daily life for most colonists.[14]

While drinking was popular, early America was not a freewheeling bacchanalian society.[15] Many citizens disapproved of the volume of alcohol consumed by their follow colonists. Indeed, some Founding Fathers disparagingly referred to the United States as the "alcohol republic."[16] Other colonial leaders feared that "luxury and vice," including alcohol abuse, threatened American "virtue."[17] They hoped that following the revolution, the new republic would be freed from the alcohol abuse of the "decadent" British Empire.[18]

Despite high alcohol consumption in the eighteenth and early nineteenth centuries,[19] the largely deferential and regimented society of early America checked alcohol abuse through public intervention in citizens'

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purity of moral and republican principles."), *with id.* at 9 ("[A]lcohol was more common at the family table in the colonial era than in our own; even children shared the dinner beer.").

[10] *Id.* at 9 ("[T]wo of the key characteristics of early drinking patterns were frequency and quantity. Simply stated, most settlers drank often and abundantly."); Lisa Lucas, *A New Approach to the Wine Wars: Reconciling the Twenty-First Amendment with the Commerce Clause*, 52 UCLA L. REV. 899, 914-15 (2005).

[11] John M. Faust, Note, *Of Saloons and Social Control: Assessing the Impact of State Liquor Control on Individual Expression*, 80 VA. L. REV. 745, 761 (1994).

[12] LENDER & MARTIN, *supra* note 9, at 10, 54-55 (noting that this trend continued well into the nineteenth century where candidates "demonstrate[d] their ties to the people—by drinking with them").

[13] *Id.* at 4 ("[O]ver the years between the founding at Plymouth and the close of the eighteenth century, the colonists integrated alcohol into their evolving American culture . . . ."); *id.* at 205 (according to one study, the average American drank over seven gallons of alcohol in 1810, but drank only 2.58 in 1985).

[14] *Id.* at 4, 9. Notably, in 1662, John Winthrop, Jr., the Governor of Connecticut, brewed beer using corn, Vermonters experimented in making honey mead, Southern colonies started making peach brandy, and Mid-Atlantic colonies produced applejack, a hard cider. George Washington is rumored to have been the first to produce rye whiskey. *Id.* at 5, 8-9, 33.

[15] *See* Faust, *supra* note 11, at 761-62 (demonstrating that controls on alcohol abuse were self-imposed or imposed within a small community in colonial times).

[16] Lucas, *supra* note 10, at 915 n.73 (citing Michael Pollan, *The (Agri)Cultural Contradictions of Obesity*, N.Y. TIMES MAG., Oct. 12, 2003, at 41, 42).

[17] LENDER & MARTIN, *supra* note 9, at 35-36.

[18] *Id.* at 35.

[19] *Id.* at 46-47.

private lives.[20] Even though localities generally accepted heavy alcohol consumption in colonial America, overconsumption was reproachable.[21] Church officials and civil authorities openly intervened in the lives of wayward individuals to enforce community mores.[22] The nature of eighteenth century society kept alcoholism in check—or at least to a minimum—when compared with later historical periods.[23] But where local efforts by church leaders and local government officials to curb overconsumption existed in the early Republic,[24] alcohol abuse in America's burgeoning nineteenth century cities threatened orderly society and altered the public's once relatively permissive attitude towards alcohol consumption.[25]

B. *The Temperance Movement and Prohibition*

Although there had been persistent concerns about alcohol abuse within some circles throughout American history, support for the temperance movement accelerated following the Civil War as the nation experienced dramatic social changes resulting from demographic shifts and industrialization.[26] As the nation industrialized, poor, working class men made alcohol a daily escape from the harsh reality of overcrowded cities.[27] In reaction to a growing fear of alcoholism and related debauchery, temperance

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20 *Id.* at 15-17.

21 *Id.* at 1 ("Drink is in itself a good creature from God, and to be received with thankfulness, but the abuse of drink is from Satan, the wine is from God, but the Drunkard is from the Devil." (quoting INCREASE MATHER, WO TO DRUNKARDS (1673))).

22 *Id.* at 15-16; Faust, *supra* note 11, at 761 (citing National Research Council, Report of the Panel, in ALCOHOL AND PUBLIC POLICY: BEYOND THE SHADOW OF PROHIBITION 8-9 (Mark H. Moore & Dean R. Gerstein eds., 1981) ("But even at this time, excessive resort to drink was considered a challenge to a prevailing colonial orthodoxy that valued moral responsibility and the doing of 'God's work on earth.'")).

23 *Compare* LENDER & MARTIN, *supra* note 9, at 15, *with id.* at 54.

24 *Id.* at 15-17.

25 Yablon, *supra* note 3, at 560; Faust, *supra* note 11, at 762 (citing Michael L. Prendergast, *A History of Alcohol Problem Prevention Efforts in the United States*, in CONTROL ISSUES IN ALCOHOL ABUSE PREVENTION: STRATEGIES FOR STATES AND COMMUNITIES 25, 28 (Harold D. Holder & Nancy K. Mello eds., 1987) ("From the ashes of the aristocracy rose an industrial, urban, middle-class orthodoxy preoccupied with economic and moral progress. Progress was thought to require a social discipline incompatible with the unmoderated drinking that tracked the decline of the agrarian colonial order.").

26 *See* Sidney J. Spaeth, *The Twenty-First Amendment and State Control Over Intoxicating Liquor: Accommodating the Federal Interest*, 79 CAL. L. REV. 161, 169 (1991) (noting that "Abraham Lincoln reportedly said . . . that, after Reconstruction, the country's next question would be the suppression of legalized liquor" (citing NORMAN H. CLARK, DELIVER US FROM EVIL: AN INTERPRETATION OF AMERICAN PROHIBITION 50 (Norton 1976))); *see also* LENDER & MARTIN, *supra* note 9, at 92.

27 Spaeth, *supra* note 26, at 165-66.

societies sprung up across the country to promote state prohibition laws.[28] Proponents of temperance, most often religious leaders, encouraged parishioners to abstain from alcohol so as to maintain good standing in the church and to represent middle-class respectability.[29]

During the nineteenth century, as thousands of Irish and German immigrants—particularly strong drinking cultures—brought their folkways to America, it also became patriotic to abstain from alcohol.[30] These immigrants did not mirror the stereotypical vision of the American family where the home was the center of family life.[31] Men in these immigrant families appeared to frequently fall prey to alcohol-based distractions, particularly saloons that drew husbands out of the home.[32] Temperance advocates felt that such debauchery was an attack on family values.[33] Many Americans were concerned with the atypical mores of this wave of immigrants and feared that the immigrants' behavior was deviant and immoral.[34] Notably, for many temperance advocates the consumption of alcohol was not the root of the problem. Rather, the root was the male-oriented nineteenth century saloon that promoted a club-like atmosphere that harmed the well-being of the family by excluding wives and children.[35]

The temperance movement may have been a reaction by rural Protestants to the dramatic economic and demographic changes of the late nineteenth century as an indirect way to assert their way of life over urban and non-Anglo-Saxon interests.[36] Whatever their motivation, temperance advocates genuinely sought to address the root of social problems through government intervention.[37]

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28 *Id.* at 168 (noting that ministers critical of Americans' "weakness for liquor" spread temperance societies throughout the country).

29 W. J. Rorabaugh, *Reexamining the Prohibition Amendment*, 8 YALE J.L. & HUMAN. 285, 288 (1996) (reviewing RICHARD F. HAMM, SHAPING THE EIGHTEENTH AMENDMENT: TEMPERANCE REFORM, LEGAL CULTURE, & THE POLITY 1880-1920 (1995)).

30 *Id.*

31 *See* Yablon, *supra* note 3, at 560-561 (stating the employment of women and children, typical in Irish families, was viewed as a contradiction of the "ideology of domesticity.").

32 *Id.* at 561.

33 *Id.*

34 *Id.*

35 *Id.* at 563-564 (stating saloons drew men because they served copious amounts of alcohol and provided a respite from the drudgery of daily life, but they were also often home to prostitution and other sources of debauchery).

36 Dennis Chong, *Values Versus Interests in the Explanation of Social Conflict*, 144 U. PA. L. REV. 2079, 2128 (1996) ("Prohibitionists pointed to alcohol consumption as a reliable indicator of individual and social decline, but this attack also reflected the larger skirmish over whether rural or urban interests would control the political and economic future of America.").

37 *Id.* at 2129 ("The actions [that nativist Protestants] took, however, were not merely designed to preserve their higher status in society; rather they reflected a direct attempt to address the causes of real social problems.").

The temperance movement gained momentum throughout the late nineteenth century[38] as many states passed laws limiting or prohibiting the sale of alcohol.[39] By the dawn of the twentieth century, prohibition had become a key political issue.[40] While the arguments for state and national prohibition were rooted in morality,[41] political considerations (notably the alliance of the temperance movement with the women's suffrage movement)[42] and financial considerations (the creation of the federal income tax gave the federal government an alternative source of revenue that could replace liquor tax revenue)[43] played an important role in pushing prohibition forward.

Temperance proponents successfully aligned their goal of limiting access to alcohol with the populist reform ideals of the late nineteenth century.[44] Prohibition advocates saw their movement as an opportunity to impose a moral authority over the nation for everyone's benefit,[45] a hallmark of cultural struggle.[46] This dichotomy between order and individualism,

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38 Spaeth, *supra* note 26, at 169.

39 *Id.* at 168, 171 (noting that in 1851 Maine was the first state to prohibit alcohol, and "[a]fter the Civil War, the states increased control over alcohol.").

40 Roger I. Abrams, *Alcohol, Drugs and the National Pastime*, 8 U. PA. J. LAB. & EMP. L. 861, 868 (2006) ("Temperance and the religious revival spurred public action. . . . [In 1899] Reverend J.Q.A. Henry told his Chicago congregants: 'The twentieth century will see the triumph either of the Christian church or of the saloon.'"). *See also* Jonathan M. Barnett, *The Rational Underenforcement of Vice Laws*, 54 RUTGERS L. REV. 423, 486 (2002) (finding that during the height of the campaign for prohibition, popular magazine articles in favor of prohibition outnumbered those opposed by a ratio of twenty to one (citing Jeffrey A. Miron & Jeffrey Zwiebel, *Alcohol Consumption During Prohibition*, 81 AM. ECON. REV., 242, 243 (1991))).

41 Michael Munger & Thomas Schaller, *The Prohibition-Repeal Amendments: A Natural Experiment in Interest Group Influence*, 90 PUB. CHOICE 139, 149 (1997) ("[T]he framing of the issue as moralistic, rather than economic, had key consequences for the outcome of the debate.").

42 Richard H. Chused, *Courts and Temperance "Ladies,"* 21 YALE J.L. & FEMINISM 339, 369-70 (2010).

43 *See* Donald J. Boudreaux & Adam C. Pritchard, *The Price of Prohibition*, 36 ARIZ. L. REV. 1, 2 (1994) ("[T]he federal income tax played a central role, albeit behind the scenes, in the proposal and ratification of both the Eighteenth and the Twenty-[F]irst Amendments. The income tax proved a viable alternative to liquor taxation . . . ."); *see also* LENDER & MARTIN, *supra* note 9, at 72 (noting that nineteenth century prohibitionist politicians seized upon the idea of using saloon licenses, which had previously only been a source of local tax revenue rather than a means of regulation, in order to prevent new saloons from opening and to close existing ones by not renewing their licenses).

44 Charles H. Whitebread, *Freeing Ourselves from the Prohibition Idea in the Twenty-First Century*, 33 SUFFOLK U. L. REV. 235, 237-38 (2000).

45 Granholm v. Heald, 544 U.S. 460, 494-95 (2005) (Stevens, J., dissenting); Chused, *supra* note 42, at 370.

46 Jack M. Balkin, *The Constitution of Status*, 106 YALE L.J. 2313, 2332 (1997) ("Debates about morality and moral approval are the medium through which status competition is carried out, but the moral debates are no less authentic for that reason."); Richard C.E. Beck, *Cancellation of Debt and Other Incidental Items of Income: Puritan Tax Rules in the U.S.*, 49 N.Y.L. SCH. L. REV. 695, 696 (2005) ("Attempts to legislate morality form a significant part of our legal tradition, and laws that are purely aspirational in nature still reflect a continuing legacy of our Puritan past.").

including the individual's right to engage in behavior that may be self-destructive, appears to be a fundamental conflict in American society.[47] In the early twentieth century, the prohibitionists won out because their concerns regarding "excessive consumption, political corruption, and unlicensed saloons" resonated with a large portion of the populace that was willing to outlaw the production of liquor in order to ensure order.[48] "Drys" framed the issue as a moral choice to save the working class from ruin through alcoholism.[49]

In 1919, the states ratified the Eighteenth Amendment, ushering in Prohibition.[50] The national ban on alcohol upset many Americans because it was the first time the federal government imposed a police power on the people, leading to invasive federal action into citizens' private lives.[51] A mere fourteen years later, the states ratified the Twenty-First Amendment, repealing Prohibition.[52]

C. *Repeal and the Twenty-First Amendment*

After repealing the Eighteenth Amendment, Congress and the states passed the Twenty-First Amendment, which gave states the power to regulate the importation of alcohol.[53] Section Two of the Twenty-First Amendment has created a deep constitutional divide concerning the relationship between the federal and the state governments over which predominates in regulating alcohol.[54]

While the Twenty-First Amendment remains the primary law on the regulation of alcohol, its interpretation has evolved since its enactment over seven decades ago.[55] There are two schools of thought on states' power to regulate alcohol within their respective jurisdictions. On one side are "fed-

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47 *See* LENDER & MARTIN, *supra* note 9, at 56 (arguing that the rise of the rugged individualism ideology and the breakdown of communal values and institutions of the colonial period led to more drinking). In turn, this appears to have led to a backlash from groups concerned about the increasing lack of order and traditional community to promote temperance.

48 Charles H. Whitebread, *"Us" and "Them" and the Nature of Moral Regulation*, 74 S. CAL. L. REV. 361, 363-64 (2000).

49 Munger & Schaller, *supra* note 41, at 151.

50 U.S. CONST. amend. XVIII.

51 Tanford, *supra* note 2, at 290-91.

52 U.S. CONST. amend. XXI. *See* Spaeth, *supra* note 26, at 180-81.

53 U.S. CONST. amend. XXI, § 2 ("The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited."). *See* Yablon, *supra* note 3, at 584 (noting that § 2 of the Amendment "was passed to ensure that the states had the legal tools necessary to continue to fully effectuate their temperance goals.").

54 Spaeth, *supra* note 26, at 180-81.

55 For a good overview of the major Supreme Court cases on this issue before the *Granholm* case, see Denning, *supra* note 3, at 310-33.

eralists," who believe that only dry states, those that forbid alcohol, can ban the importation or manufacture of liquor within their borders under the Twenty-First Amendment.[56] Under this view, states are subject to the Commerce Clause because they cannot discriminate against out-of-state interests when regulating alcohol.[57]

Alternatively, "absolutists" believe that states have "complete control" over the regulation of alcohol.[58] For absolutists, the Amendment removes state alcohol regulations from Commerce Clause scrutiny.[59] The plain language of Section Two appears to support an absolutist interpretation.[60] Early case law supported the idea that Section Two gave states free reign, without federal oversight, over the regulation of alcohol.[61] This position contributed to state power-grabbing under the guise of alcohol control.[62] Over the years, the Supreme Court narrowed state power to regulate alcohol to include only those regulations that corresponded with the actual transportation and consumption of alcohol.[63] This Comment does not recommend unlimited state control that may incentivize states to use liquor laws to infringe on individual rights, but instead suggests a deferential approach that is consistent with the Amendment's preference for local control over alcohol.[64]

The tension between federalists and absolutists persists to this day.[65] The crux of the debate still revolves around the meaning of Section Two of

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56 Spaeth, *supra* note 26, at 181.

57 *Id.* ("Federalists argued that the section simply constitutionalized the Webb-Kenyon Act's protections for dry states from the influx of liquor from wet states and in no way detracted from Congress's power to regulate interstate commerce.").

58 Denning, *supra* note 3, at 309; Spaeth, *supra* note 26, at 181.

59 Granholm v. Heald, 544 U.S. 460, 497 (2005) (Thomas, J., dissenting) ("A century ago, this Court repeatedly invalidated, as inconsistent with the [N]egative Commerce Clause, state liquor legislation that prevented out-of-state businesses from shipping liquor directly to a State's residents. The Webb-Kenyon Act and the Twenty-[F]irst Amendment cut off this intrusive review, as their text and history make clear . . . .").

60 Spaeth, *supra* note 26, at 182.

61 *See* State Bd. of Equalization of Cal. v. Young's Mkt. Co., 299 U.S. 59 (1936).

62 Spaeth, *supra* note 26, at 203.

63 For an overview of the evolution in the Court's interpretation of § 2, including varying interpretations of the meaning and relationship of pre-Prohibition laws to § 2, *compare* Spaeth, *supra* note 26, at 180-93 (arguing that states should not be allowed to overstep the individual rights of its citizens, but that the [D]ormant Commerce Clause is not necessarily applicable), *and* Yablon, *supra* note 3, at 581-87 (emphasizing that the troubled history of Prohibition and the history surrounding the ratification of the Twenty-First Amendment demonstrate the drafters' intention to give the states broad regulatory powers under § 2), *with* Tanford, *supra* note 2, at 295-301 (finding that the [D]ormant Commerce Clause prohibits states from discriminating against out-of-state interests).

64 Spaeth, *supra* note 26, at 203.

65 *Compare* Granholm v. Heald, 544 U.S. 460, 493 (2005) (holding that states may not discriminate against out-of-state liquor producers under the Dormant Commerce Clause), *and* Granholm v. Heald, 544 U.S. 460, 494 (2005) (Stevens, J., dissenting) (arguing that the Twenty-First Amendment has placed alcoholic beverages in a "special category" under state control), *with* Bridenbaugh v. Freeman-

the Amendment.[66] There are arguments on both sides that there is either a complete lack of coherent understanding about Section Two,[67] or that its interpretation is as clear as glass.[68]

D. Granholm *and the Modern Debate*

Granholm v. Heald paired the well-worn issues of how best to regulate interstate liquor shipments with the new concern over how to handle consumer demand in the emerging direct-to-consumer wine market.[69] The case addressed statutes in Michigan and New York that prohibited out-of-state wineries from selling directly to in-state consumers, but permitted in-state wineries to do the same.[70] The Supreme Court asked whether the Dormant Commerce Clause—which would give out-of-state producers the same market access as in-state producers—trumped Section Two of the Twenty-First Amendment, which may permit states to regulate alcohol as they see fit, regardless of discrimination.[71] The Court found that the Dormant Commerce Clause did trump Section Two and that the Michigan and New York laws discriminated against interstate commerce.[72] The Court determined that the states did not demonstrate that their discriminatory laws were necessary for public safety and the preservation of morals under their police power.[73]

The two dissenting opinions in *Granholm*, however, should give pause to those celebrating the majority's holding in favor of free markets.[74] The first dissent by Justice Stevens argued that the original intent of temperance advocated during the nineteenth and early twentieth centuries was to carve

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Wilson, 227 F.3d 848, 849 (7th Cir. 2000) (holding that the Twenty-First Amendment, "which appears in the Constitution" supersedes the Dormant Commerce Clause, "which does not.").

66 U.S. CONST. amend. XXI, § 2 ("The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.").

67 Denning, *supra* note 3, at 312 n.64.

68 *Id.* at 303 n.27, 320 n.95.

69 *See Granholm*, 544 U.S. at 476-89 (majority opinion) (discussing the evolution of state liquor laws from the late nineteenth century forward). *But see* Yablon, *supra* note 3, at 592 (finding that the majority's holding is inconsistent with the spirit and early interpretation of § 2 and is merely supporting "middle-class" mores to the detriment of the modern working class, which remains supportive of strict, local liquor controls).

70 *Granholm*, 544 U.S. at 465-66.

71 *Id.* at 471 ("Does a State's regulatory scheme that permits in-state wineries directly to ship alcohol to consumers but restricts the ability of out-of-state wineries to do so violate the [D]ormant Commerce Clause in light of § 2 of the Twenty-[F]irst Amendment?").

72 *Id.* at 476.

73 *Id.* at 492.

74 *See* Nielson, *supra* note 2, at 750 (finding that although *Granholm* "disregard[s] . . . the Constitution's text," it makes good economic policy).

out "demon rum" as a unique commercial item due to the social strife associated with alcohol during that time.[75] He found the (1) the plain text of the Twenty-First Amendment;[76] (2) the views of Justices who were present at the time of the Amendment's passage (such as Justices Black[77] and Frankfurter)[78]; and (3) early Supreme Court cases on the Amendment (such as *State Board of Equalization of California v. Young's Market Co.*), to weigh dispositively in favor of strong state regulatory power over the industry.[79]

The second dissent, written by Justice Thomas,[80] emphasized the text of the Twenty-First Amendment and preceding statutes to argue that the Amendment reserved the power to regulate liquor to the states.[81] He noted that the Amendment attempted to take away judicial oversight over state liquor markets.[82] The crux of his argument was that the Twenty-First Amendment's language follows that of the Webb–Kenyon Act,[83] which he believed permitted state control of alcohol regulation without federal oversight.[84] Justice Thomas also argued that the early Supreme Court case law supported his view that states were, and should continue to be, afforded great leeway in the regulation of alcohol.[85] Additionally, he distinguished more recent case law from the direct shipment issue, finding the majority's

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75 Granholm v. Heald, 544 U.S. 460, 494-96 (2005) (Stevens, J., dissenting) (arguing that the framers of the Eighteenth and Twenty-First Amendments placed alcohol in a "special category" due to a widely held fear of the social disorder alcohol abuse caused at the time).

76 *Id.* at 497.

77 *Id.* at 495 n.2 (citing Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324, 338 (1964) (Black, J., dissenting) ("§ 2 was intended to return 'absolute control' of liquor traffic to the States.")).

78 *Id.* at 496 (citing Carter v. Virginia, 321 U.S. 131, 141 (Frankfurter, J., concurring) (finding that § 2 should be "broadly and colloquially interpreted")).

79 *Id.* at 495 (citing State Bd. of Equalization of Cal. v. Young's Mkt. Co., 299 U.S. 59, 62-63 (1936)).

80 Joining Justice Thomas were Chief Justice Rehnquist and Justices O'Connor and Stevens. *Id.* at 497.

81 *Granholm*, 544 U.S. at 497-500, 509, 527 (Thomas, J., dissenting). For a good summary of, and counter to, this dissent *see* Nielson, *supra* note 2, at 748-50.

82 *Id.* at 497 (Thomas, J., dissenting) ("A century ago, this Court repeatedly invalidated, as inconsistent with the [N]egative Commerce Clause, state liquor legislation that prevented out-of-state businesses from shipping liquor directly to a State's residents. The Webb-Kenyon Act and the Twenty-[F]irst Amendment cut off this intrusive review, as their text and history make clear." (alteration in original)).

83 27 U.S.C. § 122 (2006). Justice Thomas contended that the original, and correct, interpretation of the Webb-Kenyon Act was that it immunized "all state laws regulating liquor imports from [N]egative Commerce Clause restraints." *Granholm*, 544 U.S. at 502 (alteration in original). The very language of the Webb-Kenyon Act, which predated the Twenty-First Amendment, contains very similar language to that of the Twenty-First Amendment. *Id.* at 514 ("[T]he Twenty-[F]irst Amendment mirrors the basic terminology of the Webb-Kenyon Act . . . .") (alteration in original).

84 *Granholm*, 544 U.S. at 514.

85 *Id.* at 515 ("*Young's Market* [299 U.S. 59 (1936)] held that this explicit discrimination against out-of-state beer products came within the terms of the Twenty-[F]irst Amendment, and therefore did not run afoul of the [N]egative Commerce Clause." (alteration in original)).

strongest case, *Bacchus Imports, Ltd. v. Dias*,[86] to be an outlier that is contrary to Supreme Court precedent and to the meaning of the Amendment.[87]

The plain text of the Amendment appears to support the dissent.[88] However, commentators dispute the true meaning of the Amendment's text and whether morality or economic policy should guide its interpretation.

II. JUSTIFICATIONS FOR THE TWENTY-FIRST AMENDMENT

A. *Moral and Religious*

Legislating morality was the norm during the Progressive Era.[89] Progressives believed social issues such as alcohol abuse, women's suffrage, and election law were all in need of reform.[90] Among these progressives, many considered alcohol a social evil that required unique rules.[91] As community-level efforts failed to solve alcohol-related social problems, temperance proponents sought to address the alcohol and its related social issues through legislation.[92]

Many supporters of strong alcohol regulation were highly religious and felt that alcohol abuse was a national cancer that they had a duty to destroy.[93] The turmoil of industrialization and heavy immigration in the nineteenth century, coupled with increasing alcohol use, raised concerns about the stability of the family and the moral rectitude of American society.[94] Many Americans were also concerned that the Eighteenth Amendment gave the federal government too much power over individuals and

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86 Bacchus Imps., Ltd. v. Dias, 468 U.S. 263 (1984).

87 *Granholm*, 544 U.S. at 524-26 (Thomas, J., dissenting).

88 *See* Nielson, *supra* note 2, at 750 ("The first objection to *Granholm* is its apparant [sic] disregard for the Constitution's text.").

89 Arnold's Wines, Inc. v. Boyle, 571 F.3d 185, 198 (2d Cir. 2009) (Calabresi, J., concurring) ("Laws frequently regulated 'morals,' and alcohol was often viewed as immoral. And even setting 'morals' aside, the prevailing view of alcohol was that it was a unique product that posed unusual dangers . . . .").

90 Munger & Schaller, *supra* note 40, at 148.

91 *See* Carter v. Virginia, 321 U.S. 131, 139 (1944) (Frankfurter, J., concurring) (stating that, under the Twenty-First Amendment, alcohol was not a typical article of commerce like "cabbages and candlesticks . . . ."); *see also* Yablon, *supra* note 3, at 559 ("During this period, alcohol was seen as a serious threat to the family precisely because it was so often consumed away from the family. Saloons were places that men went by themselves, separate from their wives and children.").

92 Chong, *supra* note 36, at 2129.

93 Lucas, *supra* note 10, at 915.

94 *See* Yablon, *supra* note 3, at 559-60, 563.

interfered with the traditional police power of the states while failing to stop alcohol abuse and alcohol-related crime.[95]

Key prohibition supporters had hoped for national unity and "moral orthodoxy" by eliminating alcohol, but once the Eighteenth Amendment failed, they abandoned this unrealistic goal.[96] In spite of the failure of national prohibition, many Americans still supported the goals of temperance and morality.[97] Thus, liquor regulation continued, however Congress and state conventions opted to return control over alcohol to the states.[98]

While morality and religiosity may have played a key factor in the minds of the Eighteenth Amendment's proponents, many contemporary scholars believe that the law should be interpreted in economic terms.[99] Indeed, economic arguments have strong policy benefits, but do not have clear historical evidence supporting such theories.[100]

B. *Economic*

A popular modern view, which emerged in the 1980s,[101] adopts a free-market approach to alcohol importation into the various states.[102] However,

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95 Tanford, *supra* note 2, at 292-93 ("[The Eighteenth Amendment] violated the natural constitutional order in which states had exclusive police power."). *See* Spaeth, *supra* note 26, at 165 (finding that the temperance movement was initially local).

96 *See* LENDER & MARTIN, *supra* note 9, at 164-66 (noting that powerful prohibition supporters, such as William Randolph Hearst, John D. Rockefeller, Jr., and the Du Pont family, changed their stance to support the repeal of the Eighteenth Amendment once they saw that it could not achieve a single national standard).

97 Denning, *supra* note 3, at 343 n.62 (citing Ralph L. Wiser & Richard L. Arledge, *Does the Repeal Amendment Empower a State to Erect Tariff Barriers and Disregard the Equal Protection Clause in Legislation on Intoxicating Liquors in Interstate Commerce?*, 7 GEO. WASH. L. REV. 402, 413 (1939) (arguing that the Twenty-First Amendment "deals with public health and morals, not with economics and commerce.")).

98 76 CONG. REC. 4141 (1933) (Statement of Sen. Blaine) ("[The Twenty-First Amendment] is restoring to the States, in effect, the right to regulate commerce respecting . . . intoxicating liquor. In other words, the State is not surrendering any power that it possesses, but rather . . . acquires powers that it has not at this time.").

99 *See* Matthew Dickson, *All or Nothing: State Reaction in the Wake of* Granholm v. Heald, 28 WHITTIER L. REV. 491, 502-03 (2006); *see also* Nielson, *supra* note 2, at 758 ("Believing in the importance of rule of law and taking pleasure in *Granholm*'s potential opening of freer markets, are, thankfully, not in conflict.").

100 *See* Spaeth, *supra* note 26, at 182 (arguing that the plain text of § 2 supports absolute state control over liquor outside of Federal Commerce Clause regulation).

101 *See* Tanford, *supra* note 2, at 299-300 (noting that in the 1980s, three U.S. Supreme Court decisions overturned state provisions that permitted in-state interests to have special protections that violated Dormant Commerce Clause considerations). *But see* Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 110 (1980) ("The Twenty-First Amendment grants the States virtually complete control over whether to permit importation or sale of liquor and how to structure the liquor distribution system.").

economic freedom was perhaps the least of the concerns for drafters of the Twenty-First Amendment.[103] The Twenty-First Amendment permitted the sale of liquor, but the means of sale were heavily regulated to prevent the return of the infamous nineteenth century saloon.[104]

In promulgating post-Prohibition liquor laws, many states believe that eliminating the profit motive was a key factor in controlling the alcohol industry and ensuring safe distribution.[105] Alternatively, the free-market viewpoint concerning state regulation of alcohol has taken hold amongst legal academics.[106]

During the Great Depression, cash-starved governments were desperate for tax revenue streams.[107] The significant revenue source that the alcohol market had previously provided was far too great for the federal and state governments to pass up.[108] Additionally, the federal and state governments hoped to recoup some of the many jobs that the alcohol industry had supported in the past.[109] But even with the pressing need for increased revenue to sustain the government, the "core concern of the state delegates was temperance."[110]

The major economic criticism of Section Two is that it permits the states to implement barriers to entry for out-of-state manufacturers.[111] One such barrier is the "three-tier system," which is the primary means of state liquor control.[112] The three-tier system requires that separate parties own liquor manufacturers, distributors, and retailers.[113] The system has been

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102 Perkins, *supra* note 2, at 400.

103 Granholm v. Heald, 544 U.S. 460, 494-95 (2005) (Stevens, J., dissenting).

104 Yablon, *supra* note 3, at 565-66.

105 Manuel v. State, 982 So.2d 316, 323 (La. App. 2008) (citing RAYMOND B. FOSDICK & ALBERT L. SCOTT, TOWARD LIQUOR CONTROL 57 (Harper & Bros. 1933)).

106 Perkins, *supra* note 2, at 434; Nielson *supra* note 2, at 750; Tanford, *supra* note 2, at 315; Aaron Nielson, *No More Cherry-Picking: The Real History of the 21st Amendment's § 2*, 28 HARV. J.L. & PUB. POL'Y 281, 281-82, 294 (2004).

107 Munger & Schaller, *supra* note 41, at 141 ("with the Depression growing worse and an increasing need for revenue . . . all political will to maintain Prohibition had disappeared.").

108 Lucas, *supra* note 10, at 918 n.94 (citing RATIFICATION OF THE TWENTY-FIRST AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES 7 (Everett Somerville Brown ed., 1938) ("speakers in several states addressed the failure of [P]rohibition, focusing their criticisms on the loss of tax revenue . . . ."). *See* Yablon, *supra* note 3, at 595 (noting that supporters of the repeal of the Eighteenth Amendment thought that new jobs in the liquor industry and a liquor tax could help end the Depression).

109 Chong, *supra* note 36, at 2129, n.187 (citing KERMIT L. HALL, THE MAGIC MIRROR 251 (1989) ("Ultimately, the [Eighteenth] Amendment was repealed in response to straightforward economic arguments that the liquor industry would generate needed jobs during the Depression.")).

110 Tanford, *supra* note 2, at 292.

111 *See* Vijay Shanker, *Alcohol Direct Shipment Laws, the Commerce Clause, and the Twenty-First Amendment*, 85 VA. L. REV. 353, 361-62 (1999) (discussing how distributors and retailers of alcohol have influenced state legislation to create monopolies).

112 Granholm v. Heald, 544 U.S. 460, 466 (2005).

113 *Id.*

criticized for its inefficiency and for its tendency to enrich distributors and retailers at the expense of manufacturers and consumers.[114] Many states require distributors and retailers to act as middlemen between beverage manufacturers and consumers.[115] The system generally requires all liquor manufacturers to sell only to distributors, who then sell only to retailers.[116] As such, distributors—who often have exclusive distribution rights within a given area of the state—and retailers can extract monopoly rents from manufacturers and consumers.[117] Most states implemented this system to discourage overconsumption, deter monopolies, and prevent organized crime from controlling the industry as it did before and during Prohibition.[118] Given the decline of organized crime in the liquor industry and the level of market concentration at the distributor level, this system has come under increasing attack from free-market supporters as an outdated and inefficient method of regulating liquor distribution.[119]

Small wineries, such as the Finger Lakes in New York, the Willamette Valley in Oregon, and the Columbia River Valley in Washington, have become a significant economic revitalization tool for rural areas.[120] Direct sales have been a key component in sustaining such small wineries, as distributors have neither the means nor the will to stock small volumes of lesser-known brands that may not sell as quickly as famous brands.[121] In addition to the on-site sales upon which many small wineries rely, the growing Internet market has become an important revenue source for many wineries.[122] While the rising popularity of wine in recent years has led to greater choice for consumers, the potentially unlimited Internet market has been considerably restricted by state laws banning direct shipments.[123]

Distributors have been the primary proponents of direct shipment laws that ban manufacturers, generally wineries, from selling alcoholic bever-

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114 Shanker, *supra* note 111, at 361-62.

115 *Id.*

116 *Granholm*, 544 U.S. at 466, 469. Of course, the issue in *Granholm* was that some in-state producers were exempted from this requirement, and could sell directly to retailers. *Id.* at 466. For an explanation of direct-to-consumer wine shipping, which was the core issue in that case see *supra* PART I.D.

117 Shanker, *supra* note 111, at 362.

118 *Id.* at 356 (citing Kim Marcus, *When Winemakers Become Criminals*, WINE SPECTATOR, May 15, 1997, http://www.winespectator.com/magazine/show/id/7210).

119 Tania K.M. Lex, *Of Wine and War: The Fall of State Twenty-First Amendment Power at the Hands of the Dormant Commerce Clause* – Granholm v. Heald, 32 WM. MITCHELL L. REV. 1145, 1173 (2006); Tanford, *supra* note 2, at 329; Lucas, *supra* note 10 at 906-09.

120 Tanford, *supra* note 2, at 304 (noting that small wineries in those regions have invigorated the regional economies and increased state tax revenue).

121 *Id.* at 303 (noting that while there are 4,000 wineries in the United States, fifty wineries make up 90% of the wine distributed through the three-tier system).

122 *Id.* at 304.

123 *Id.* at 304-5.

ages directly to the public outside of the three-tier system.[124] While these laws may be constitutional under the Twenty-First Amendment, *Granholm* held that such laws must prohibit all direct shipments, not merely shipments from outside the state.[125] Some commentators believe the Supreme Court is merely waiting for the right case to overturn the three-tier system for being inherently discriminatory against interstate commerce.[126] But entrenched interests, particularly distributors, are unlikely to let that happen without a fight.

III. CURRENT ISSUES

A. *Legislation*

At the federal level, former Congressman William Delahunt (MA-10) sponsored the CARE Act, a bill proposing that Congress scale back *Granholm* and restore much of the regulatory power over alcohol to the states.[127] Alternatively, Virginia is considering eliminating its seventy-year state-run monopoly on the sale of liquor.[128]

The CARE Act would give states preeminent power over the regulation of alcohol, including actions that courts may otherwise overturn under *Granholm*.[129] Manufacturers, particularly wineries, have reacted harshly to this bill, while distributors and religious organizations have been its primary supporters.[130] This clash between manufacturers and distributors demonstrates that if distributors and their unlikely allies, the attorneys gen-

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124 Shanker, *supra* note 111, at 361-62.

125 Granholm v. Heald, 544 U.S. 460, 467, 493 (2005) ("The differential treatment between in-state and out-of-state wineries constitutes explicit discrimination against interstate commerce.").

126 Lex, *supra* note 119, at 1173.

127 Comprehensive Alcohol Regulatory Effectiveness (CARE) Act of 2010, H.R. 5034, 111th Cong. (referred to the Subcommittee on Courts and Competition Policy, Apr. 15, 2010).

128 *See* Rosalind S. Helderman, *Virginia's Inner Struggle to get off the Scotch Tax*, WASH. POST, Aug. 5, 2010 at A1; *see also* Anita Kumar & Rosalind S. Helderman, *McDonnell Unveils Plan to Privatize Va. Liquor Sales, but Skeptics Question Taxes*, WASH. POST, Sept. 9, 2010 at B1.

129 H.R. 5034. *See* Robert Taylor, *An End to Direct Wine Shipping?*, WINE SPECTATOR, Apr. 16, 2010, http://www.winespectator.com/webfeature/show/id/42526 ("[t]he proposed bill calls for maintaining the states' control over alcohol shipped in, but no longer requires the state to treat it the same as alcohol produced within the state.").

130 Taylor, *supra* note 129.

eral of thirty-eight states,[131] gain the upper hand, *Granholm* may not have the desirable effect free-market advocates had hoped for.[132]

As it stands, the House bill supports the idea of state supremacy in alcohol regulation[133] by requiring courts to give deference to state regulatory schemes that satisfy the three core concerns stated in *Granholm*: (1) safe, legal distribution; (2) orderly, transparent markets; and (3) the ability of individual states to tax alcohol.[134] For the Supreme Court, the three-part test explicitly refers to a state government's right to discriminate against out-of-state interests,[135] but one should also consider those factors holistically to encompass the entire gambit of state regulation of alcohol.

The bill protects the status quo for state regulators and market participants by providing greater deference to state alcohol regulations in future legal challenges in federal court.[136] The bill also reasserts the authority of states to set alcohol policies, which appears to agree with the purpose of Section Two.[137] Under the legislation, states would maintain the ability to institute market control policies that may have anti-competitive effects through higher prices that result in decreased consumption.[138] States would also have firm control over reasonable taxation, ensuring continued state revenue from alcohol sales.[139] On the surface, this type of bill seems to serve the interests of the state,[140] but under such a scheme, states must wisely administer alcohol regulations to serve the health and morals of the peo-

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131 Taylor, *supra* note 129 ("On March 29, the National Association of Attorneys General (NAAG) sent a letter . . . in support of the bill. The letter . . . stated, 'We are writing to seek your help with the growing threat facing our states from unprecedented legal challenges that seek to eliminate our ability to regulate alcohol.'").

132 *See* Eric Asimov, *Proposed Law Could Limit Interstate Wine Shipping*, N.Y. TIMES, Oct. 18, 2010, *available at* http://www.nytimes.com/2010/10/20/dining/20pour.html?hpw ("Wholesalers argue that they are not acting to protect their own financial position but the rights of states.").

133 H.R. 5034.

134 Granholm v. Heald, 544 U.S. 460, 490-91 (2005).

135 *Id.*

136 H.R. 5034 (Under the bill, a state liquor law would be upheld unless it is proven by clear and convincing evidence that the "law has no effect on the promotion of temperance, the establishment or maintenance of orderly alcoholic beverage markets, the collection of alcoholic beverage taxes, the structure of the state alcoholic beverage distribution system, or the restriction of access to alcoholic beverages by those under the legal drinking age.").

137 Yablon, *supra* note 3, at 587; Denning, *supra* note 3, at 310, 341-42.

138 *See* James C. Cooper & Joshua D. Wright, *State Regulation of Alcohol Distribution: The Effects of Post & Hold Laws on Output and Social Harms* (Fed. Trade Comm'n, Working Paper No. 304, 2010), http://www.ftc.gov/be/workpapers/wp304.pdf (discussing anti-competitive effects of "post and hold" laws, state laws that require distributors to publish and maintain prices for a period of time, which discourages price competition between distributors).

139 H.R. 5034 (stating that "the collection of alcoholic beverage taxes" would be a protected state activity under the proposed law).

140 *Legal Issues Concerning State Alcohol Regulation Before the House Judiciary Committee, Subcommittee on Courts and Competition Policy*, 111th Cong. 1-2 (2010) (Statement of Rep. Bobby L. Rush), http://judiciary.house.gov/hearings/pdf/Rush100318.pdf (last visited Oct. 21, 2010).

ple.[141] If, instead, the states engage in protectionism for in-state manufacturers or distributors, then the law is inappropriate because it is not serving the public.

Some have argued that this bill is not really promoting state-regulated temperance.[142] These critics contend that the bill is a mere kickback to distributors and that states are insulating vested wholesaler interests from competition instead of actively protecting consumers.[143] While states should retain power to regulate alcohol, state regulators must be vigilant in regulating harmful behavior and social harm without blithely permitting an industry, or subset of an industry (e.g., alcohol distributors), to dictate the market.[144] Pure economic efficiency does not trump the goals of the Twenty-First Amendment,[145] but protectionism is not the same as protecting the public from social harm.[146] As discussed above, encouraging local control accords with historical precedent.[147] The core concerns of promoting temperance and orderly markets may afford states broad discretion.[148] However, this does not give the states the power to trample on individual rights.[149]

The governor of Virginia is taking a different track in proposing the elimination of state-administered liquor stores and allowing private liquor sales for the first time since before Prohibition.[150] In Virginia, the conflict between social protection through tight control of liquor sales and free-

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141 *See* Spaeth, *supra* note 26, at 203-04 ("[S]pecial deference should be accorded state statutes promulgated under the amendment's core power . . . [o]n the other hand, state power must be reasonably adapted toward actually controlling the flow of liquor.").

142 Joshua D. Wright, *Who CAREs About Beer and Wine Consumers?*, TRUTH ON THE MARKET (Aug. 3, 2010), http://truthonthemarket.com/2010/08/03/who-cares-about-beer-and-wine-consumers/ (arguing that distributors are driving the legislation in order to secure an antitrust exemption for themselves).

143 *Id.*

144 *See* Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 110 (1980) ("Although [s]tates retain substantial discretion to establish other liquor regulations, those controls may be subject to the [F]ederal [C]ommerce [Clause] power in appropriate situations."); *see also* Cooper & Wright, *supra* note 138, at 10 (finding that *Midcal* requires states to substantiate a connection between its regulatory scheme and the Twenty-First Amendment in order to survive the Commerce Clause).

145 Manuel v. State, 982 So.2d 316, 323 (La. App. 2008) (citing RAYMOND B. FOSDICK & ALBERT L. SCOTT, TOWARD LIQUOR CONTROL 57 (1933)) (discussing how many proponents of the Twenty-First Amendment wanted to eliminate the profit motive from the alcohol industry in order to limit production and consumption)).

146 *See* Cal. Retail Liquor Dealers Ass'n, 445 U.S. at 110.

147 *See Hearing on H.R. 5034, the Comprehensive Alcohol Regulatory Effectiveness (CARE) Act of 2010 Before the House Judiciary Committee*, 111th Cong. (2010) (Statement of Rep. Gary Miller), available at http://judiciary.house.gov/hearings/printers/111th/111-152_58477.pdf (last visited Oct. 12, 2011); *See also* Yablon, *supra* note 3, at 593-94.

148 Carter v. Virginia, 321 U.S. 131, 141 (1944) (Frankfurter, J., concurring) (arguing that § 2 should be "broadly and colloquially interpreted.").

149 *See* Spaeth, *supra* note 26, at 203.

150 Kumar & Helderman, *supra* note 128.

market ideals is at an interesting crossroad, which may come to a head in the near future.[151]

In considering the three core state concerns as outlined in *Granholm*,[152] the Virginia plan appears to be a mixed bag at best. Recently, the province of Alberta privatized its alcohol distribution system. In comparing this proposal to the privatization policy implemented by Alberta, Canada in 1993–1994, there appear to be some disconcerting figures regarding the moral and public safety concerns as seen through the three prongs of state regulation.[153]

In regards to the first prong, safe and legal distribution, it appears that consumption increased in Alberta post-privatization, at least relative to other provinces, as private retailers have expanded the number of retail locations.[154] Furthermore, this increased consumption may have some connection to greater crime and drunk driving offenses.[155] In Virginia, the proposed privatization plan may increase consumer convenience by tripling the number of retail outlets for liquor.[156]

With regard to the second prong, under Virginia's proposed plan, new private liquor retailers would have to participate in the state's three-tier system.[157] The fact that the private retailers will be part of the three-tier system should give pause to those that are hopeful of consumer benefits in light of Alberta's similar transition from a public system to a private three-tier system, which prevented any anticipated free-market benefits from occurring.[158] Consumer prices may rise in a privatized retail system, as a sin-

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151 Anita Kumar, *McDonnell Wants to show Virginia the way out of the Liquor Business*, WASH. POST, July 18, 2010 at A1.

152 Granholm v. Heald, 544 U.S. 460, 490-91 (2005).

153 Greg Flanagan, *Sobering Result: The Alberta Liquor Retailing Industry Ten Years after Privatization*, CAN. CTR. FOR POLICY ALT. & PARKLAND INST., iii-v (July 2003), http://www.policyalternatives.ca/sites/default/files/uploads/publications/National_Office_Pubs/sobering_result.pdf.

154 *Id.* at 16 (noting that in 1998 Alberta's drunk driving rate was 59% higher than the Canadian national average). *But see* Donald J. Boudreaux & Julia Williams, *Impaired Judgment: The Failure of Control States to Reduce Alcohol-Related Problems*, VA. INST. FOR PUB. POL'Y, 2 (Report No. 14, July 2010), http://www.virginiainstitute.org/pdf/ABC-revised-version-final.pdf. (finding that states that directly control alcohol distribution had the same level of alcohol-related problems as privatized states).

155 Flanagan, *supra* note 153, at 16.

156 Rosalind S. Helderman, *To Woo More Support, McDonnell Alters Liquor Privatization Plan*, WASH. POST, Sept. 30, 2010 at B1 ("McDonnell (R) wants to close 332 state-owned Alcoholic Beverage Control stores and auction new licenses to sell liquor to 1,000 private retailers, including grocery and convenience stores.").

157 *Summary and Modifications to Proposed ABC Privatization Model*, OFFICE OF THE GOVERNOR OF VA., 2 (Sept. 30, 2010), http://www.reform.virginia.gov/docs/scheds/Proposed_ABC_Privatiz_Model-9-30.ppt.

158 Flanagan, *supra* note 153, at 45 ("[E]fficiencies have been limited by the control on the wholesale distribution and transportation costs—limited in order to have a 'level playing field.'"). The purpose of this level playing field appears to have been to prevent large aggressive distributors from driving

gle government supplier that could extract deep discounts is replaced with a myriad of independent retail outlets with only modest buying power.[159] Private retailers were unable to reap the same volume discounts as the single state retailer had previously enjoyed because the provincial government prohibited volume discounting to prevent monopolization by larger retailers.[160] Also, the creation of a stand-alone wholesaler level, as opposed to a single state buyer acting as both wholesaler and retailer, is likely to increase costs because the wholesaler must pass on its own costs to retailers and take a profit for itself.[161]

Finally, it is uncertain whether Virginia would reap comparable tax revenue under a three-tier structure,[162] especially when compared to its highly profitable current system.[163] Given the experiences of Alberta, it is unclear how effective the privatization plan will be at serving the interests of Virginia and consumers.[164]

The benefits and drawbacks of plans such as the CARE Act, which presumably would encourage state regulation, and Virginia's plan, which decreases state regulation, demonstrate the difficulty in striking a balance between the preservation of morals and safety and consumer desires. While advocates for tighter and looser state liquor regulations continue to battle in the legislatures, there are also battles in the courts, showing that this issue is in as much turmoil as ever.

B. *Litigation*

Granholm has perhaps only intensified the struggle between federalists and absolutists.[165] In March 2010, Anheuser-Busch, Inc., raised the stakes

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out competition, such as mom-and-pop distributors and retailers, but this has simultaneously prevented expected innovation and efficiencies to come to bear in the market.

159 Darren Rippey, *Off the Wagon: Why ABC Privatization is a Bad Idea*, VA. INTERFAITH CTR. FOR PUB. POL'Y, (Aug. 2010), http://ufcw1776.uwsclient.com/sites/ufcw1776.uwsclient.com/files/Virginia%20Interfaith%20Center.pdf.

160 *Id.*

161 Shanker, *supra* note 111, at 361-62.

162 *See* Flanagan, *supra* note 153, at 46 (arguing that Alberta's liquor tax revenue was much lower than neighboring British Columbia and finding that "the privatization effort has been supported and subsidized by the government through a reduction in the tax share of the final retail price."); *see also* Rippey, *supra* note 159.

163 Kumar, *supra* note 151 (stating that Virginia earns about $220 million annually in profits and taxes from the commonwealth's liquor stores).

164 *See* Rippey, *supra* note 159 (citing Nuri T. Jazairi, *The Impact of Privatizing the Liquor Control Board of Ontario* (York University-Toronto, Sept. 1994) *available at* http://www.yorku.ca/nuri/lcbo.htm (finding that in 1981 Alabama reverted back to a state-run system for the sale of table wine after selection decreased and the prices in the state rose 11% following the 1978 privatization plan)).

165 *See* Yablon, *supra* note 3, at 580-81.

by filing a federal lawsuit against the State of Illinois for blocking its attempt to purchase a distributor.[166] Anheuser-Busch attempted to use *Granholm*[167] to help strengthen its competitive position.[168] Anheuser-Busch wanted to same rights to self-distribute as those enjoyed by small in-state breweries under Illinois law.[169] The District Court for Northern Illinois agreed with Anheuser-Busch that the law was improper for favoring in-state brewers over out-of-state ones.[170] Unfortunately for both Anheuser-Busch and in-state breweries, the court prohibited all manufacturers from self-distributing rather than allowing all manufacturers to self-distribute.[171]

This decision has created the opposite result that many *Granholm* supporters had hoped for. They believed *Granholm* would eventually erode state-level restrictions on the sale of alcoholic beverages, moving the nation towards a national open market for alcohol.[172] As Anheuser-Busch's case demonstrates, this "leveling down" may actually limit interstate alcohol shipments and lead to even more Draconian state liquor laws.[173] State laws that "level down" create very strict controls over the sale of alcohol but apply them to both intrastate and interstate producers, a move that does not further consumer interests.[174]

As it stands, the law surrounding state control over alcohol is unstable and confusing for the states.[175] While *Granholm* may make sense from a policy perspective by permitting more commercial freedom,[176] it runs counter to the letter and spirit of the Twenty-First Amendment,[177] whose very text proclaims that the states have broad powers to regulate alcohol.[178] It is

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166 Anheuser-Busch, Inc. v. Schnorf, 738 F. Supp. 2d 793, 796 (N. D. Ill. 2010).

167 *See* Granholm v. Heald, 544 U.S. 460, 467 (2005).

168 *Schnorf*, 738 F. Supp. 2d at 807.

169 *Id.* at 796-97.

170 *Id.* at 817.

171 *Id.*

172 *See* Tanford, *supra* note 2, at 329-30 (finding that burdens to interstate commerce, such as the inefficiencies of the three-tier system, outweigh local benefits, and should therefore be eliminated).

173 *Id.* at 328 ("[H]arder issues will involve the validity of state laws that severely level down and treat in-state and out-of-state wineries equally badly.").

174 *See id.*

175 *See* Eric Asimov, *Proposed Law Would Limit Interstate Wine Shipping*, N.Y. TIMES, Oct. 20, 2010, at D5, *available at* http://www.nytimes.com/2010/10/20/dining/20pour.html?hpw (noting that some have found the current state of the law to be "confusing and inconsistent . . . ."); *see also* Arnold's Wines, Inc. v. Boyle, 571 F.3d 185, 200 (2d Cir. 2009) (Calabresi, J., concurring) ("[W]hen the High Court carves out one exception after another, it becomes difficult to know how any individual case should come out.").

176 Nielson, *supra* note 2, at 750.

177 Granholm v. Heald, 544 U.S. 460, 496 (2005) (Stevens, J., dissenting) ("Today's decision may represent sound economic policy . . . it is not, however, consistent with the policy choices made by those who amended our Constitution in 1919 and 1933.").

178 Carter v. Virginia, 321 U.S. 131, 140-41 (1944) (Frankfurter, J., concurring) (arguing that § 2 should be "broadly and colloquially interpreted . . . .").

ill-advised to argue that we should ignore the text of a constitutional amendment because it is an inconvenience.[179]

Alcohol's unique history in America demonstrates that it is not a normal article of commerce.[180] The continued presence of alcohol in American culture has necessitated careful governmental review to ensure safe use.[181] Throughout American history, particularly since the late nineteenth century, many people have held apprehensions about alcohol, especially alcohol abuse and its resulting harm to families.[182] In fact, temperance goals still remain a key function of current liquor laws.[183]

Given the Twenty-First Amendment's purpose to encourage temperance at the state level,[184] laws that promote that purpose ought to be upheld.[185] The problem is figuring out a way to encourage the three core state values in a way that acknowledges the unusual position of alcohol in American culture as a unique commercial item.[186]

IV. IS THERE A BETTER WAY?

A. *Federal Mandates*

One possibility for making a more uniform and comprehensible alcohol distribution system is to standardize it as much as possible through federal legislation.[187] However, given that the establishment of the minimum

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179 *See* Yablon, *supra* note 3, at 587; *see also* Nielson, *supra* note 2, at 750, 758 (finding that even although the *Granholm* decision has "disregard for the Constitution's text" and may be troubling for those that want "to get the law right," that the decision is acceptable because the majority showed sufficient evidence to support freer markets).

180 *Granholm*, 544 U.S. at 496 (Stevens, J., dissenting) (arguing that it "would have seemed strange indeed to the millions of Americans who condemned the use of 'demon rum'" to consider alcohol a normal article of commerce).

181 *See* Mike Figge, Note, *Constitutional Law—Challenging Anti-Commerce State Regulatory Schemes in Light of the Supreme Court's Admonition of Protectionist Alcohol Regulations*; Granholm v. Heald, 544 U.S. 460 (2005), 8 WYO. L. REV. 231, 235-39 (2008) (outlining the history of alcohol regulation in the United States).

182 *See* Yablon, *supra* note 3, at 559 (arguing that the social harm caused by alcohol justified laws strictly regulating alcohol use). *But see* Faust, *supra* note 11, at 745-46 (arguing that alcohol should not be treated as a "unique" item in which law enforcement can trample individual rights in the name of social order).

183 Shanker, *supra* note 111, at 377.

184 Yablon, *supra* note 3, at 587.

185 *See* Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 110 (1980) (stating that the "Twenty-First Amendment grants the States virtually complete control over whether to permit importation or sale of liquor and how to structure the liquor distribution system.").

186 *See* Spaeth, *supra* note 26, at 163 ("[T]reating liquor as just another article of commerce . . . ignore[s] lessons learned over a century of internal discord in this country.").

187 Perkins, *supra* note 2, at 437.

drinking age at twenty-one led to a major revolt by ten states, it is unlikely that such a law could realistically come about.[188] Furthermore, even if a uniform law did pass, the courts might strike it down. The dissenting opinions in *Dole*, which upheld the twenty-one year old drinking age minimum, considered the legislation at issue as an intrusion on state power.[189] Even in *Granholm*, which decided a relatively narrow issue of interstate wine sales, the Supreme Court split by a slim five-to-four margin.[190]

The current backlash against federal power by many politically active citizens would likely make any such federal legislation impossible.[191] Further, federal legislation prohibiting state regulations that may explicitly or implicitly favor in-state interests could eviscerate § 2 of the Twenty-First Amendment, leaving the states with virtually no power over the commerce of alcohol.[192] Additionally, as the failure of national prohibition demonstrated, local decision-making on alcohol policy is more effective than federal oversight.[193]

B. *Direct State Sales*

A major goal of some liquor experts in the 1930s was to eliminate the profit motive of alcohol manufacturers and retailers so as to decrease their interest in selling as much liquor as possible.[194] While the idea at that time was to decrease the incentives to sell alcohol, the idea today is that a state monopoly may be more beneficial to state residents by reaping in more tax revenue for the state.[195] Allowing third parties to distribute and sell alcohol

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188 National Minimum Drinking Age Amendment, 23 U.S.C. § 158 (2006). South Dakota was joined by nine other states in opposing the twenty-one year minimum drinking age. *See* South Dakota v. Dole, 483 U.S. 203 (1987); brief for *amici curae* for the States of Colorado, Hawaii, Louisiana, Montana, Ohio, South Carolina, Vermont and Wyoming, South Dakota v. Dole, 483 U.S. 203 (1987); brief for *amici curae* of Mountain States Legal Foundation and the State of New Mexico, South Dakota v. Dole, 483 U.S. 203 (1987).

189 *See Dole*, 483 U.S. at 212-18 (O'Connor, Brennan, JJ., dissenting).

190 Granholm v. Heald, 544 U.S. 460, 463 (2005) (Rehnquist, C.J.; Stevens, Thomas, O'Connor, JJJ. dissenting).

191 Kate Zernike, *For G.O.P., Tea Party Wields a Double-Edged Sword*, N.Y. TIMES, Sept. 6, 2010, at A1, *available at* http://www.nytimes.com/2010/09/06/us/politics/06teaparty.html?pagewanted=all ("[S]tandard Tea Party positions [include] . . . getting rid of the Departments of Energy, Commerce and Education; phasing out Social Security and Medicare; and instituting a 23[%] national sales tax to replace the income tax."). Such policy positions are unlikely to comport with an increase in federal power in a sphere that falls within the states' police powers.

192 *Scope of State Authority—Discriminatory Limitations on Direct Wine Shipment*, *supra* note 4, at 317.

193 *See* Yablon, *supra* note 3, at 594.

194 Manuel v. State, 982 So. 2d 316, 323 (La. Ct. App. 2008) (citing RAYMOND B. FOSDICK & ALBERT L. SCOTT, TOWARD LIQUOR CONTROL 57 (1933)).

195 Helderman, *supra* note 128.

under strict state guidelines may minimize variety for consumers and yield less revenue to the state.[196] Some states are responding to *Granholm* by eliminating all direct shipping, which may actually contract the market for boutique alcoholic beverages, such as unusual beers and wine.[197]

Alternatively, states that are truly concerned with temperance, orderly markets, and revenue could establish non-profit boards to act as distributors, as opposed to merely regulating for-profit distributors. This type of board would actually have an interest in regulating and restricting the sale of alcohol and would not have the profit motive to increase sales that for-profit distributors do.[198] The significant profits often earned by private distributors now could go into state treasuries.[199] Several jurisdictions have experienced satisfactory selection and greater state revenues under a public system, including Alabama, which returned to state-run stores after an unsatisfactory experience with the private sale of table wine.[200]

C. *Creative State Taxes*

Other alternatives include establishing various state taxes that would tax according to some sort of novel metric. This could be by volume[201] or perhaps by considering which types of alcoholic beverages are most likely to lead to safety issues that violate the moral values of a community. The locality could raise the taxes on these beverages in order to decrease the demand from underage or at-risk individuals, such as prior drunk drivers or college students, and leave tax rates for beverages that are not as closely linked to dangerous behavior at lower rates.[202]

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196 *See* FLANAGAN, *supra* note 155, at 46.

197 Tanford, *supra* note 2, at 324-25.

198 *Cf.* Manuel v. State, 982 So. 2d 316, 323 (La. Ct. App. 2008) (citing RAYMOND B. FOSDICK & ALBERT L. SCOTT, TOWARD LIQUOR CONTROL 57 (1933)) (noting that the preferred method of alcohol distribution post-[P]rohibition was through state-run retailers and distributors that would have less incentive to sell large amounts of alcohol than for-profit retailers and distributors).

199 Helderman, *supra* note 127 (discussing how Virginia earns substantial profits in the sale of hard liquor since the state acts as a monopolist wholesaler and retailer that buys in large volumes at low prices from manufacturers and sells at competitive, if not supracompetitive prices, compared to neighboring jurisdictions).

200 Rippey, *supra* note 159.

201 *See* August A. Busch & Co. v. Tex. Alcoholic Beverage Comm'n, 649 S.W.2d 652, 654-55 (Tex. App. 1982) (holding that the state alcohol control commission could discriminate against an Anheuser-Busch, Inc., subsidiary in denying its petition to self-distribute because of its sheer size, while a small, local manufacturer could self-distribute. The court reasoned that if Anheuser-Busch self-distributed its absence would destroy the three-tier system, while a small producer would have little impact on the system's efficacy.).

202 FED. TRADE COMM'N, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: WINE 12 (2003), http://www.ftc.gov/os/2003/07/winereport2.pdf (noting that minors generally favor beer, hard liquor, or wine coolers as opposed to wine). Consider also the problems associated with certain alcohol

Alternatively, state governments could use statistical data gleaned from Census or other reports to create special safety zones where alcohol abuse is unusually high.[203] Such zones exist in cities such as New York and prohibit the sale of single units of certain products, a practice known as "single sales."[204] While these sorts of proposals may be facially valid, as they do not explicitly disfavor out-of-state interests, such taxes may be struck down if they are perceived to advantage in-state interests over out-of-state interests.[205]

Due to significant constitutional issues, such as potential violations of the Due Process and Equal Protection Clauses,[206] regulations that target certain groups or behavior would be strictly scrutinized to ensure that they protect the safety and morality of the community, but do not infringe on individual rights.[207] Nevertheless, there is some indication that zoning or similar land use restrictions at the local or state level may have public health benefits with relation to alcohol abuse.[208]

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beverages, such as Four Loko, which states attempted on their own to ban as dangerous to their college student population when they perceived that the federal government had been too slow to take any action to discourage or ban consumption of such drinks. Abby Goodnough & Dan Frosch, *F.D.A. Expected to Act on Alcoholic Energy Drinks*, N.Y. TIMES, Nov. 16, 2010, at A14, *available at* http://www.nytimes.com/2010/11/16/us/16drinks.html. Creating stricter regulations, or banning, Four Loko may make sense, but would banning all coffee-infused beer from high-end brewers make sense given their high cost and popularity with responsible beer connoisseurs?

203 *See* DEPT. OF HEALTH & HUMAN SERVS., *Driving Under the Influence of Alcohol or Illegal Drugs*, http://oas.samhsa.gov/DWI.htm (last visited Sept. 18, 2010) (data such as this is widely collected and could give policy-makers the necessary information to implement such rules); *see also* Nat'l Inst. for Alcohol Abuse & Alcoholism (NIAAA), *Database Resources*, http://www.niaaa.nih.gov/Resources/DatabaseResources/Pages/default.aspx (last visited Oct. 19, 2010) (the NIAAA already disseminates a tremendous amount of data on alcohol use).

204 *Hearing on: H.R. 5034, the Comprehensive Alcohol Regulatory Effectiveness (CARE) Act of 2010 Before the House Judiciary Committee*, 111th Cong. (2010) (Statement of Rep. Edolphus Towns), available at http://judiciary.house.gov/hearings/pdf/Towns100929.pdf (last visited Nov. 3, 2010).

205 Figge, *supra* note 179, at 241; Tanford, *supra* note 2, at 329-30.

206 *See* Thomas B. Griffen, *Zoning Away the Evils of Alcohol*, 61 S. CAL. L. REV. 1373, 1377-82, 1405 (1988) (finding that zoning is generally an improper tool for social control and that municipalities must contend with federal and state level scrutiny of zoning regulations that restrict alcohol sales in certain locations). *But see* Shelley Ross Saxer, *"Down with Demon Drink!": Strategies for Resolving Liquor Outlet Overconcentration in Urban Areas*, 35 SANTA CLARA L. REV. 123, 125-26 (1994) (arguing that local zoning controls are a proper exercise of state police power directed at activities contributing to social blight in inner cities).

207 Griffen, *supra* note 204, at 1404-05.

208 *Id.* at 1401 (citing Friedner D. Wittman & Michael E. Hilton, *Uses of Planning and Zoning Ordinances to Regulate Alcohol Outlets in California Cities*, in CONTROL ISSUES IN ALCOHOL ABUSE PREVENTION: STRATEGIES FOR STATES AND COMMUNITIES 360-61 (Harold D. Holder ed., 1987) ("[L]ocal citizenries have the opportunity to insert preventive influences in the patterns of their own drinking by using local ordinances to shape the distribution and character of consumption.")).

D. *The Three-Tier System*

The Supreme Court has held the three-tier system constitutional.[209] However, state carve-outs from this system, purportedly designed to serve temperance goals or potentially protect in-state companies, have been held unconstitutional.[210] The question is whether states should continue to hold fast to a system that was implemented over seventy years ago.[211] In considering this question, one must recognize the unique commercial position of alcohol and the special power of the states to regulate the alcohol market.[212]

Free-market supporters contend that the three-tier system, despite its historically legitimate purpose, has devolved into mere economic protectionism for distributors.[213] While this may be true,[214] proponents of deregulation should focus their arguments on the idea that the system does not advance state control over the morality and health of its citizens, not that it inhibits commerce.[215] To merely argue that deregulation of the alcohol markets would lead to consumer gain is inconsistent with the purpose and scope of the Twenty-First Amendment.[216]

Such an argument also defeats the Amendment's latent rationale, which was to permit states to make the alcohol market unwieldy for market participants as a means to regulate and limit the market.[217]

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209 North Dakota v. United States, 495 U.S. 423, 432 (1990).

210 *See* Granholm v. Heald, 544 U.S. 460, 465-66 (2005) (barring carve-out permitting in-state wineries from directly selling to consumers); *see also* Anheuser-Busch, Inc. v. Schnorf, 738 F.Supp.2d 793, 817 (N.D. Ill. 2010) (prohibiting in-state micro-breweries and Anheuser-Busch, Inc., which had planned to vertically integrate by acquiring an in-state distributor to sell its products directly to Illinois retailers, from directly selling to retailers).

211 Granholm v. Heald, 544 U.S. 460, 466 (2005).

212 *See* Spaeth, *supra* note 26, at 204 ("Only by guarding the central purpose of the [T]wenty-[F]irst [A]mendment, however, will the Court protect the states' hard-won power to control intoxicating liquor within their borders.").

213 Tanford, *supra* note 2, at 318.

214 *See id.* (arguing distributors have maintained the three-tier system to protect their economic interests and that a free market of wine would lead to better value); *see also* Shanker, *supra* note 110, at 362 (noting that distributors and retailers have a monopoly over consumers through the three-tier system and have much to lose in direct alcohol shipping).

215 Yablon, *supra* note 3, at 592 ("the temperance movement was a battle over whose morals would define the country.").

216 *Id.* at 594.

217 *See* North Dakota v. United States, 495 U.S. 423, 431-32 (1990) (declaring that promoting temperance, ensuring orderly market conditions, and raising revenue are all core concerns of the Twenty-First Amendment); State Bd. of Equalization of Cal. v. Young's Mkt. Co., 299 U.S. 59, 63 (1936) ("Can it be doubted that a [s]tate might establish a state monopoly . . . and either prohibit all competing importations, or discourage importation by laying a heavy impost[?]"); *see also* Manuel v. State, 982 So.2d 316, 323 (La. App. 2008) (citing RAYMOND B. FOSDICK & ALBERT L. SCOTT, TOWARD LIQUOR CONTROL 57 (1933)).

The only proper way to attack the three-tier system is to focus on its shortcomings in addressing state moral and public safety concerns. One method to do so is to illustrate how alternative market controls may be more effective at curbing social harm than the current three-tier system and related regulations.[218] One alternative may be to modernize the state regulatory framework to more directly attack the social problems that state alcohol distribution laws were intended to address under the Twenty-First Amendment.[219]

Consider the "post-and-hold" scheme in which each wholesaler must publish its prices and maintain those prices for a set period of time, thereby eliminating all price competition among distributors.[220] In publishing and maintaining set prices, distributors lose the freedom to lower prices to increase market share.[221] This price-setting essentially creates a cartel within a given market where distributors are much more likely to charge above-market prices and continually increase those prices, leading to higher retail prices and decreased consumption by the consumer.[222] On their face, the laws serve the overarching goal of the Amendment: to decrease consumption if a state wishes to do so.[223] However, a more sophisticated approach would consider whether such laws alleviate the social costs of alcohol abuse.[224] One study found that post-and-hold laws have only a minimal effect on alcohol abuse because problematic consumers, such as alcoholics or recidivist drunk drivers, are not discouraged from purchasing alcohol at slightly higher prices, while the average consumer would be discouraged.[225] Alternatives could be higher taxes, which would benefit the state rather than a private wholesaler, or more restrictive blood alcohol content limits for drunk drivers.[226]

States should embrace policies that target the social ills of alcohol abuse. States can, of course, embrace freer markets, but "balkanization" is an unfortunate standard that the Twenty-First Amendment has imposed on the alcohol market.[227]

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218 Wright, *supra* note 141.

219 Cooper & Wright, *supra* note 137, at 25.

220 *Id.* at 2 (finding that "post and hold" laws can lead to higher prices at the wholesale level).

221 *Id.* at 5.

222 *Id.*

223 Yablon, *supra* note 3, at 594.

224 Cooper & Wright, *supra* note 137, at 2.

225 *Id.* at 25.

226 *Id.*

227 Granholm v. Heald, 544 U.S. 460, 496 (2005) (Stevens, J., dissenting).

E. *The Need to Respect State Powers*

In considering new policies, it is necessary to realize that the states, not the federal courts,[228] should recognize where there are flaws in their liquor laws. To this end, the states should act diligently to ensure that their laws conform to their abilities to ensure the safe and legal distribution of alcohol through orderly and transparent markets and tax alcohol.[229] Unfortunate as it may be for individuals who wish to consume a broader or lower-priced selection of alcoholic beverages, the consequences of sweeping regulatory changes can be unpredictable and may not necessarily lead to the desired outcomes.[230] The unavoidable history of this nation's tumultuous relationship with alcohol resulted in an unusual community and state-based regulatory approach.[231] As cumbersome as it is for today's consumers to follow seemingly arcane laws, negating such laws may have harmful consequences for safely controlling the flow of alcohol.[232]

Courts should be wary of updating constitutional provisions for the sake of modern convenience.[233] Creating carve-outs to amendments, as in the case of the Twenty-First Amendment, can lead to confusion in the actual state of the law.[234] Also, well-meaning courts may inadvertently "substitute

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228 Duckworth v. Arkansas, 314 U.S. 390, 398-399 (1941) (Jackson, J., concurring) ("The people . . . did not leave it to the courts to devise special distortions of the general rules as to interstate commerce to curb [the alcohol market]. It was their unsatisfactory experience with that method that resulted in giving liquor an exclusive place in constitutional law . . . ."); *Granholm*, 544 U.S. at 527 (Thomas, J., dissenting) (arguing that the Court must have thought that the *Granholm* decision would benefit the nation, but the Twenty-First Amendment "took those policy choices away from judges and returned them to the States. Whatever the wisdom of that choice, the Court does this Nation no service by ignoring the textual commands of the Constitution and Acts of Congress.").

229 *Granholm*, 544 U.S. at 490-91.

230 Tanford, *supra* note 2, at 316-17 (arguing that deregulation of the current three-tier system and Internet wine purchasing statutes would likely create economic benefits, but conceding that "[n]o one can predict the consequences" of deregulation).

231 *See Granholm*, 544 U.S. at 496 (Stevens, J., dissenting) ("The notion that discriminatory state laws violated the unwritten prohibition against balkanizing the American economy . . . would have seemed strange indeed to the millions of Americans who condemned 'demon rum' in the 1920s and 1930s."); *see also* Spaeth, *supra* note 26, at 162 ("The drunken revelry of the nineteenth century . . . [and the failure of national prohibition to regulate alcohol resulted in] the [T]wenty-[F]irst [A]mendment [which] places control of liquor regulation where it belongs—in the communities that feel the impact of these laws.").

232 *See* Yablon, *supra* note 3, at 591-92 (noting that states may attempt to block interstate direct shipments of alcohol to protect dry counties that would be helpless to stop such shipments otherwise).

233 *See id.* at 593-94 (arguing that while middle-class values have evolved to be more accepting of alcohol, their values should not automatically trump those of modern temperance advocates, who are generally in the lower-class).

234 *See* Arnold's Wines, Inc. v. Boyle, 571 F.3d 185, 200 (2d Cir. 2009) (Calabresi, J., concurring) (arguing that it is unclear if some constitutional provisions can, and if so, how they may be updated, finding that this confusion exists with regard to the Twenty-First Amendment: "It can leave state legislatures and lower federal courts with no firm understanding of what the law actually is . . . when the High

their own notions of modern needs" for those of the people.[235] Moreover, this can short-circuit the democratic process by substituting the judgment of the courts for that of the legislatures.[236]

States should modernize their liquor laws to combat problem drinking by utilizing the wealth of sophisticated knowledge about alcoholism and alcohol treatment that exists today rather than antiquated systems from over seventy years ago.[237] But because the Twenty-First Amendment leaves the control of alcohol within communities, these modernization efforts should occur within the states.[238] The diverse and varied public health concerns of each state necessitate community-based standards that local officials find necessary to protect the safety of their citizens.[239]

CONCLUSION

States are not only in the best position to decide what is in the best moral and safety interests of their citizens—states retain this right under their police powers. Recognizing this, § 2 of the Twenty-First Amendment authorizes the states to implement controls on the importation and sale of alcoholic beverages in a manner that best serves public safety. The moral undertones of the period leading up to the ratification of the Twenty-First Amendment, as well as the strong presumption in favor of the states in earlier Supreme Court decisions, negate the relevance of arguments supporting economic freedom for alcohol consumers in a more open national market. A freer market may very well provide economic benefits to consumers, but that is not the Amendment's primary purpose. Open markets are a hallmark

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Court carves out one exception after another, it becomes difficult to know how any individual case should come out.").

235 *Id.* (citing LEWIS B. NAMIER, CONFLICTS: STUDIES IN CONTEMPORARY HISTORY 69-70 (1942) (arguing that this psychological substitution occurs when "[people] imagine [history] in terms of their own experience, and when trying to gauge the future they cite supposed analogies from the past: [until], by double process of repetition, they imagine the past and remember the future.")).

236 *See* Granholm v. Heald, 544 U.S. 460, 527 (2005) (Thomas, J., dissenting) (arguing that the Court felt that *Granholm* would benefit the nation, but the Twenty-First Amendment "took those policy choices away from judges and returned them to the States. Whatever the wisdom of that choice, the Court does this Nation no service by ignoring the textual commands of the Constitution and Acts of Congress."); *see also Arnold's Wines*, 571 F.3d at 200 (Calabresi, J., concurring).

237 Tanford, *supra* note 2, at 318.

238 Spaeth, *supra* note 26, at 203 ("For no other item is state and local control so necessary, and for no other item does the United States Constitution expressly provide for state control.").

239 LENDER & MARTIN, *supra* note 9, at 195 ("The alcohol question . . . [is one] of keeping drinking within limits society can tolerate . . . [this attitude may] reflect a more flexible return to the orderly communal ideas of the past."); Philly's, Inc. v. Byrne, 732 F.2d 87, 92 (7th Cir. 1984) ("[N]o national or even regional consensus has emerged with respect to the morality and consequence of alcoholic beverages. It has seemed best, in default of consensus, to leave the matter to local preference as expressed in the voting booth.").

of economic growth and well-being, but they do not trump constitutional law. As such, it is unreasonable to weaken an express provision of the Constitution only because it fails to comport with contemporary popular attitudes.

States are free to (and should) update their liquor laws, but the decision whether to do so should remain with the states. America's tumultuous history with alcohol has led to an unusually balkanized marketplace. As inefficient as the current system may be, it must be the people of the various states that take the step of turning from morals-based laws to modern free markets.

INTERPRETING *CAPERTON*: A HYBRID SOLUTION TO THE PUBLIC CHOICE PROBLEM OF JUDICIAL ELECTIONS

*Christina Newton**

INTRODUCTION

Recent Supreme Court cases have once again drawn attention to the influence of money in the judicial selection process.[1] *Caperton v. A.T. Massey Coal Co.*[2] illustrated the Supreme Court's interest in maintaining the impartiality of judges when a party before a court is a large donor to the sitting judge's campaign.[3] *Citizens United v. Federal Election Commission*[4] and *Republican Party of Minnesota v. White* (*White I*)[5] show the Supreme Court's reluctance to uphold restraints on political speech during elections, including speech through campaign donations.[6] Despite the possibility that campaign contributions allow special interests to seep into state court systems and influence decision making,[7] states continue to elect their judges instead of establishing an appointment process.[8] As Justice O'Connor stated in *White I*, "If the State has a problem with judicial impartiality, it is largely one that the State brought upon itself by continuing the practice of popularly electing judges."[9] Further, Justice O'Connor noted the failure of judicial elections to create judicial impartiality: "[T]he cost of campaigning requires judicial candidates to engage in fundraising. Yet relying on campaign donations may leave judges feeling indebted to certain parties or interest groups."[10] So what can states do to maintain the independence of

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1 *See, e.g.*, Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876 (2010); Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2263-64 (2009).

2 Caperton, 129 S. Ct. 2252.

3 *Id.* at 2256-57.

4 *Citizens United*, 130 S. Ct. at 891, 913

5 Republican Party of Minn. v. White, 536 U.S. 765, 776 (2002).

6 *Citizens United*, 130 S. Ct. at 891, 913; *White I*, 536 U.S. at 776.

7 Bert Brandenburg, *Big Money and Impartial Justice: Can They Live Together?*, 52 ARIZ. L. REV. 207, 209-10 (2010).

8 Adam Skaggs, *Disclosure in the State Courts*, BRENNAN CTR. FOR JUSTICE (May 12, 2010), http://www.brennancenter.org/blog/archives/disclosure_in_the_courts/.

9 *White I*, 536 U.S. at 792 (O'Connor, J., concurring).

10 *Id.* at 789-90 (O'Connor, J., concurring).

their courts while continuing to hold judicial elections? Is this a zero-sum game, or can states have their judicial election cake and eat it too?

One suggestion, which may allow states to protect judicial impartiality while retaining judicial elections, is for states to incorporate stricter recusal standards.[11] A specific, mandatory recusal standard tailored to address campaign contributions, coupled with a ban on judicial candidates from personally accepting campaign contributions, may comfort court and state fears that special interest money is taking over the judicial branch.[12] Mandating recusal of a party who donated or refused to donate to the judge's campaign reduces the problem of judges deciding cases based on favoritism.[13]

The American Bar Association (ABA) has also considered recusal as a possible means of protecting judicial propriety.[14] The ABA has suggested language that mandates recusal when there is actual bias or the appearance of bias because a party before the court has made a significant donation.[15] However, this standard is both over- and under-inclusive.[16] On the one hand, the standard forces recusal even if the judge lacks knowledge of the donor's identity.[17] This over-inclusiveness chills potential donors from expressing their support for fear of forcing recusal. On the other hand, the standard is under-inclusive because it does not address the problem a small campaign contribution may present if the judge is aware of the donor's identity.[18] Even small contributions create a human connection between donor and judge, resulting in a subconscious bias. The shortfalls of the ABA's standard highlight the need for a strict and specific standard that addresses the main problem in judicial elections—the attributability of donation to donor.[19]

Understanding state fears of judicial impartiality is important in constructing an effective recusal standard. These state fears can be analyzed through public choice theory,[20] which suggests that judges, like other elected officials, will make self-interested decisions in office.[21] Once elected, the goal of reelection will likely shape a judge's decision making.[22] As

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11 *See id. See also infra* Part III.B.

12 *See infra* Part III.B.

13 *See infra* Part III.C.

14 *See* MODEL CODE OF JUDICIAL CONDUCT Canon 1 (2007), http://www.abanet.org/judicialethics/ABA_MCJC_approved.pdf.

15 *Id.*

16 *See id. See also infra* Part III.B.

17 *See* MODEL CODE OF JUDICIAL CONDUCT, *supra* note 11, Canon 1; *see also infra* Part III.B.

18 *See infra* Part III.B.

19 Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2264-65 (2009). *See also infra* Part IV.B.

20 *See* Richard L. Hasen, *"High Court Wrongly Elected": A Public Choice Model of Judging and Its Implications for the Voting Rights Act*, 75 N.C. L. REV. 1305, 1313-14 (1997).

21 *Id. See also infra* Part III.C.

22 *See* Hasen, *supra* note 20, at 1313-14. *See also infra* Part III.C.

special interests take a more prominent role in campaign fundraising, their influence on the judicial system post-election increases.[23] Because judges want to continue receiving special interests' campaign contributions in the next election, judges will make decisions favoring their special interest contributors.[24] By making it difficult for judges to link donations or independent expenditures to the donor, and by implementing a stricter prophylactic recusal standard to eliminate attributability, states can protect the independence of their courts and avoid the problems presented by public choice theory.[25]

In Part I, this Comment provides an overview of judicial elections, the rising costs of judicial campaigns, and the increasing influence of special interests on state courts. Part II of this Comment discusses the Supreme Court's propensity to strike down restraints on political speech and unjustified state limits on campaign contributions. Part III argues that the Supreme Court and the states are principally concerned with the bias created by the attributability of campaign contributions—a concern that may be resolved by a specifically tailored recusal standard. Finally, Part IV discusses how contribution-specific recusal standards can be used to solve the problem of a non-impartial judiciary created by judicial elections and addressed by public choice theory.

I. JUDICIAL ELECTIONS, THE RISE OF CAMPAIGN SPENDING, AND SPECIAL INTEREST INFLUENCE

Thirty-nine states use an election system to select their appellate and trial judges.[26] Recently, money has taken an increasingly prominent role in many of these states' judicial elections.[27] Between 1990 and 1999, candidates for state high court seats raised an aggregate of $83 million.[28] This aggregate fundraising figure more than doubled during the following decade, topping $207 million for the 2000 to 2009 period.[29] The 2000s also ushered in a trend of record-breaking campaign spending in which candidates in nineteen out of the twenty states with high court judicial elections spent more funds than the prior year.[30] Even more recently, two of the three

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23 *See infra* Part III.C.

24 *Id.*

25 *Id.*

26 Skaggs, *Disclosure in the State Courts*, *supra* note 8.

27 *Id.*

28 Editorial, *Judges for Sale: The Corrosive Effect of Judicial Elections*, WASH. POST, Aug. 23, 2010, *available at* 2010 WLNR 16784435.

29 *Id.*

30 Adam Skaggs, *Buying Justice: The Impact of Citizens United on Judicial Elections*, BRENNAN CTR. FOR JUSTICE (May 5, 2010), http://www.brennancenter.org/content/resource/buying_justice_the_impact_of_citizens_united_on_judicial_elections/.

states that held high court elections in 2009 saw record-breaking individual fund-raising levels.[31]

Candidate fund-raising is not the only factor in the massive increase of campaign spending.[32] Millions of dollars are spent by organizations outside of the judicial candidate's own campaign organization.[33] Non-candidate organizations such as political parties and interest groups compete through massive campaign expenditures favoring the candidate they are seeking to elect.[34] Special interest organizations are less interested in judicial qualifications such as independence, impartiality, or experience.[35] Instead, these organizations usually seek to elect candidates for judicial office who hold similar views and whom they think will reshape laws in their favor.[36] Special interest organizations utilize independent expenditures, specifically television advertising, as a way to influence voters, and ultimately judges, without making direct contributions to the judicial candidate.[37]

The last decade witnessed a surge in judicial campaign advertising by political parties and special interest groups.[38] State high court candidates, special interest groups, and political parties spent an estimated $93.6 million on television advertisements.[39] Non-candidate groups spent nearly $39 million, or 42% of the total, while special interest groups spent $27.5 million on television advertising alone.[40]

The state of Washington's 2006 high court judicial campaign is an example of the drastic influx of non-candidate group spending.[41] In 2006, Washington witnessed the most expensive judicial race the state had ever seen.[42] Even more alarming, special interest groups paid for every television advertisement during Washington's 2006 judicial election season.[43] An Ohio AFL-CIO official described the motivation behind special interest's campaign involvement: "We figured out a long time ago that it's easier to elect seven judges than to elect one hundred and [sic] thirty-two legis-

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31 JAMES SAMPLE, ADAM SKAGGS, JONATHAN BLITZER & LINDA CASEY, NEW POLITICS OF JUDICIAL ELECTIONS 2000-2009 22 (Charles Hall ed. 2010), *available at* http://brennan.3cdn.net/d091dc911bd67ff73b_09m6yvpgv.pdf.

32 Brandenburg, *supra* note 7, at 209.

33 *Id.*

34 *Id.*

35 *See* Bert Brandenburg & Roy A. Schotland, *Justice in Peril: The Endangered Balance Between Impartial Courts and Judicial Election Campaigns*, 21 GEO. J. LEGAL ETHICS 1229, 1232, 1241-42 (2008).

36 *Id.*

37 Brandenburg, *supra* note 7, at 209.

38 SAMPLE ET AL., *supra* note 31, at 25.

39 *Id.* at 2.

40 *Id. See also* Brandenburg, *supra* note 7, at 209.

41 Adam Skaggs, *Judging for Dollars*, THE NEW REPUBLIC (Apr. 3, 2010, 12:00 AM), http://www.tnr.com/print/article/politics/judging-dollars.

42 *Id.*

43 *Id.*

lators."[44] This sentiment vividly illustrates the threat special interest campaigning poses to judicial impartiality.

The public has taken notice of this trend in special interest influence.[45] Recent polls illustrate voter concern about the influence money and special interest groups have on judicial elections and, ultimately, on the decision making of elected judges.[46] Seventy-six percent of voters believed that campaign contributions have "some" influence on judicial decision making.[47] Interestingly, the belief that independent groups bias courts with elected judges is equally bipartisan: 69% of Democrats and 64% of Republicans believed that "individuals or groups who give money to judicial candidates often get favorable treatment."[48] With the increase in campaign spending, specifically from interest groups, many doubt whether elected judges can remain impartial.[49] To be exact, 89% of voters surveyed by a 2009 USA Today–Gallup poll believed that campaign contributions have an impact on a judge's ruling.[50]

Voters are not alone. A 2002 national survey reported that 26% of elected state judges believed campaign contributions had "at least some influence" on judges' rulings.[51] Even more troubling, 9% of elected state judges believed campaign contributions had a "great deal of influence."[52] Further, 80% of state judges were concerned with the inequality in the judicial system.[53] However, these same state judges who feared that campaign contributions were influencing judicial decision making faced a difficult decision: whether to add to the troubling spending trend by accepting contributions that may taint their decision making and result in unfair judicial decisions, or risk losing the election.[54]

Along these same lines, prior to leaving the Court, Justice O'Connor highlighted the problems of judicial elections in her concurring opinion in *Republican Party of Minnesota v. White* (*White I*).[55] Justice O'Connor emphasized the pressures campaign fund-raising puts on judicial candidates

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44 *Id.*

45 Memorandum from Stan Greenberg, Chairman & Chief Exec. Officer, Greenberg Quinlan Rosner Research, & Linda A. DiVall, President, American Viewpoint, to Geri Palast, Exec. Dir., Justice at Stake Campaign, Justice at Stake: National Surveys of American Voters and State Judges (Feb. 14, 2002), *available at* http://www.justiceatstake.org/media/cms/PollingsummaryFINAL_9EDA3EB3BEA78.pdf.

46 *Id.*

47 *Id.* at 1.

48 *Id.*

49 *Judges for Sale*, *supra* note 28.

50 *Id.*

51 Brief for American Bar Ass'n as Amici Curiae Supporting Petitioners, Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252 (No. 08-22), 2009 WL 45978 at *8.

52 *Id.*

53 Memorandum from Stan Greenberg, *supra* note 45, at 2.

54 *See id.*

55 *Id.*

and the desperation created by increasing fund-raising amounts.[56] In addition, O'Connor brought attention to the presence of special interest groups and their ability to take advantage of vulnerable judicial candidates as a means of influencing judicial decision making.[57] In essence, O'Connor illuminated the reality that rising campaign costs and increased pressure from interest groups are severe symptoms of judicial elections.[58]

Recent state court actions and corresponding Supreme Court decisions highlight the ever-increasing battle to combat these symptoms while maintaining the impartiality, independence, and legitimacy of the judiciary.[59] These decisions address the importance of preserving core Constitutional rights while identifying appropriate rules to increase the perception and reality that the courts are above politics and focused on the fair application of the law.[60]

II. THE SUPREME COURT GRAPPLES WITH RESTRICTIONS ON CAMPAIGN CONTRIBUTIONS AND POLITICAL SPEECH

To combat the politicization of judges and protect the independence of the judiciary, some states began enacting expansive judicial reform. Trying to limit political influences within the judiciary, these states established restrictions restraining judicial candidates from acting politically while campaigning and limiting the ability of judges to garner financial support from outside parties. With good intentions, these states believed that preserving the independence of the judiciary justified such restraints. However, some judicial candidates and third parties rebuffed the states' efforts to strictly dictate the campaign practices candidates could and could not employ.

Recently, the Supreme Court has heard several campaign finance cases, including cases specific to judicial elections. These cases have highlighted the Court's apprehension towards campaign speech restraints on both candidates and third-party donors. The Court's tendency to strike down campaign speech restraints creates a difficult situation for states hoping to ensure the impartiality of their elected judges through strict campaign regulations. The following sections chronicle Supreme Court decisions that affect a state's ability to impose judicial campaign regulations.

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56 *Id.* at 789-90.

57 *Id.*

58 *See id.*; Hasen, *supra* note 20.

59 Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2266-67 (2009). *See also White I*, 536 U.S. at 779-80 (O'Connor, J. concurring).

60 Michael R. Dimino, *Pay No Attention to That Man Behind the Robe: Judicial Elections, the First Amendment, and Judges as Politicians*, 21 YALE L. & POL'Y REV. 301, 373 (2003).

A. *The White Cases*

Hoping to curtail partisan power in Minnesota's judicial elections, the Supreme Court of Minnesota incorporated Canon 5 of the Minnesota Code of Judicial Conduct.[61] The court designed Canon 5 to govern political activity deemed inappropriate for judicial office holders.[62] Canon 5 contained several prohibitory clauses including an "announce clause"[63] that prohibited candidates for judicial office from announcing views on disputed legal and political issues.[64] As interpreted, Minnesota's clause "prohibit[ed] a judicial candidate from stating his views on any specific non-fanciful legal question within the province of the court for which he is running."[65] Although the clause allowed candidates to criticize past judicial decisions, this ability was severely limited because candidates were banned from stating that, if elected, they would attempt to overturn any of these prior decisions.[66]

Gregory Wersal, a candidate for associate justice of the Minnesota Supreme Court, initiated a lawsuit claiming Minnesota's Code of Judicial Conduct—specifically the announce clause—violated the First Amendment.[67] Wersal alleged that during his 1998 campaign he was unable to adequately address questions from the public and the media out of fear that he would violate the announce clause.[68] Essentially, Wersal and his fellow plaintiffs claimed that the announce clause resulted in uninformed electoral selections because voters are prevented from learning a candidate's views.[69] However, the Eighth Circuit disagreed and affirmed summary judgment, holding that the clause did not violate the First Amendment.[70] Wersal appealed to the Supreme Court.[71]

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61 Republican Party of Minn. v. Kelly, 247 F.3d 854, 857 (8th Cir. 2001).

62 *Id.*

63 Republican Party of Minn. v. White, 536 U.S. 765, 768 (2002).

64 *Id.*

65 *Id.* at 773.

66 The defendants-respondents "acknowledged at oral argument that statements critical of past judicial decisions are *not* permissible if the candidate also states that he is against stare decisis." *Id.* at 772. The ban on repudiating stare decisis makes any dissents the candidate has with judicial decisions superfluous. For example, allowing a candidate to announce, "this ruling is wrong," but then forcing the candidate to clarify that "although it is wrong, I cannot do anything about it," makes the first statement meaningless. *Id.*

67 *Id.* at 769-70.

68 The consequences for violating Minnesota's announce clause are not minor. "Those who violate [the announce clause] are subject to, *inter alia*, disbarment, suspension, and probation." *Id.* at 768.

69 *See White I*, 536 U.S. at 770.

70 *Id.*

71 *Id.*

Hoping to salvage the clause, Minnesota justified the speech restrictions with two rationales: "preserving the impartiality of the state judiciary and preserving the appearance of the impartiality of the state judiciary."[72] The state insisted the restrictions were justified by state interests in judicial impartiality, "protect[ing] the due process rights of litigants" and the appearance of impartiality, as well as "preserv[ing] public confidence in the judiciary."[73] However, the Court disagreed and found that Minnesota's announce clause violated the First Amendment.[74]

Applying strict scrutiny analysis, the Court found that the announce clause violated the First Amendment because it suppressed too much speech.[75] The Court noted that the announce clause prevented judicial candidates from "communicating relevant information to voters" on "matters of current public importance."[76] Further, the Court found that Minnesota did not narrowly tailor the clause to advance the state's interest of a nonpartisan impartial judiciary.[77] Accordingly, the Court reversed the summary judgment, remanding the case to the Eighth Circuit to reconsider Minnesota's Code of Judicial Conduct in light of the Court's opinion.[78]

On remand, the Eighth Circuit reviewed the case (*White II*) en banc and considered the remaining contested clauses within Canon 5.[79] Specifically, the court considered the constitutionality of the "solicitation clause," which prohibited the personal solicitation of campaign contributions by judicial candidates.[80] Addressing the personal solicitation clause, the court noted, "In effect, candidates are completely chilled from speaking to potential contributors and endorsers about their potential contributions and endorsements."[81] Campaigns are used to promote a political message, speech that the court recognized as highly protected by the First Amendment.[82] In order to successfully transmit that message, campaigns must be adequately funded.[83] Because the solicitation clause prohibited donation requests to fund a candidate's campaign, it severely burdened campaign fundraising and therefore severely burdened a candidate's ability to transmit protected

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72 *Id.* at 775.

73 *Id.*

74 *White I*, 536 U.S. at 779-80, 788.

75 *Id.* at 774-75, 781-82, 788.

76 *Id.* at 781-82.

77 *Id.* at 776.

78 *Id.* at 788.

79 Republican Party of Minn. v. White, 416 F.3d 738, 744-45 (8th Cir. 2005).

80 *Id.* at 745.

81 *Id.* at 763 (quoting Weaver v. Bonner, 309 F.3d 1312, 1322 (11th Cir. 2002)).

82 *Id.* at 748, 764.

83 *Id.* at 764.

political speech.[84] Thus, the court held that the Minnesota's personal solicitation clause violated the First Amendment.[85]

B. Caperton v. A.T. Massey Coal Co., Inc. *Brings Recusal to the Forefront*

More recently, the Supreme Court confronted the reality that large campaign contributions and independent expenditures may force judges to feel a "debt of gratitude" to the donor and create impartiality issues before the bench.[86] Confronted with a state high court judge who benefited from a $3 million campaign television advertising expenditure from a party to a suit before him, the Court held that the judge's failure to recuse himself violated the Due Process Clause.[87]

Caperton rocked West Virginia and even attracted the attention of author John Grisham, who has since written a *New York Times* Best Seller novel based on the case.[88] The case began when Don Blakenship, CEO of Massey Coal Co., lost a $50 million jury verdict in a fraud lawsuit brought by Hugh Caperton, the owner of a small West Virginia mining company.[89] Knowing the Supreme Court of Appeals of West Virginia would consider an appeal of the verdict, Blakenship funded a $3 million statewide attack ad campaign to defeat Supreme Court of Appeals Justice Warren McGraw and help elect McGraw's challenger, Brent Benjamin.[90] Blakenship's $3 million expenditure was "more than the total amount spent by all other Benjamin supporters and three times the amount spent by Benjamin's own committee."[91] With the help of Blakenship, Benjamin won the election.[92]

Following the massive expenditure in favor of Benjamin, Blakenship filed an appeal in the Supreme Court of Appeals of West Virginia, the bench of now-Justice Benjamin, contesting the $50 million verdict.[93] Caperton moved to disqualify Justice Benjamin because of Blakenship's cam-

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84 *See White II*, 416 F.3d at 764.

85 *Id.* at 766.

86 Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2262 (2009).

87 *Id.* at 2257, 2264, 2267.

88 The Grisham novel, *The Appeal*, was published in 2008. Joan Biskupic, *Supreme Court Case with the Feel of a Best Seller*, USA TODAY (Feb. 16, 2009, 10:12 PM), http://www.usatoday.com/news/washington/2009-02-16-grisham-court_N.htm.

89 *Caperton*, 129 S. Ct. at 2257.

90 *Id.*; John Gibeaut, *Caperton's Coal*, ABA JOURNAL (Feb. 1, 2009, 11:20 PM), http://www.abajournal.com/magazine/article/capertons_coal/.

91 *Caperton*, 129 S. Ct. at 2257.

92 The election results were close. Benjamin received 382,036 votes (53.3%) and McGraw received 334,301 (46.7%). *Id.*

93 *Id.* at 2258.

paign involvement, but Justice Benjamin refused to recuse himself.[94] Ultimately, in a split 3–2 decision, Justice Benjamin and the court reversed the $50 million verdict against Massey.[95] Caperton sought a re-hearing and again moved to disqualify Justice Benjamin, which was denied.[96] After rehearing the case, the court, divided in another 3–2 decision, again reversed the jury's verdict.[97]

However, Caperton was not without recourse. Upon reaching the Supreme Court, the Court held that as a matter of due process, Justice Benjamin, having been substantially influenced by Blakenship's campaign expenditure, should have recused himself.[98] The Court found that Blankenship's campaign contributions significantly influenced the election of Justice Benjamin, thereby virtually securing his participation in the appellate review of the case.[99] According to the Court, due process requires an objective inquiry into whether the campaign contributions "would offer a possible temptation to the average . . . judge to . . . lead him not to hold the balance nice, clear, and true . . . ."[100] The Court reasoned that the case presented a "serious risk of actual bias—based on objective and reasonable perceptions—when a person with a personal stake in a particular case had a significant and disproportionate influence in placing the judge on the case by raising funds . . . when the case was pending or imminent."[101] The Court found that Blakenship's contributions significantly contributed to Benjamin's election because of the disproportionately large size of Blankenship's contributions compared to the total amount donated to Benjamin's campaign.[102] The Court also noted that Blakenship could have reasonably foreseen that his pending case would be presented before Benjamin, if elected, when Blakenship made the contributions.[103] The Court held that under the Due Process Clause, a high *probability* of actual bias, not just proof of actual bias, justifies the forced recusal of a judge.[104] Therefore, the Court mandated the recusal of Justice Benjamin.[105]

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94 *Id.* at 2257-58.

95 *Id.* at 2258; Caperton v. A.T. Massey Coal Co., 679 S.E.2d 223, 264 (W. Va. 2008).

96 *Caperton*, 129 S. Ct. at 2258.

97 *Id.* at 2258; *Caperton*, 679 S.E.2d at 223.

98 Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2264-65 (2009).

99 *Id.* at 2264.

100 *Id.* (quoting Tumey v. Ohio, 273 U.S. 510, 532 (1927)).

101 *Id.* at 2263-64.

102 Blakenship's $3 million expenditure exceeded the total amount spent by every other one of Benjamin's supporters. *Id.* at 2264. Blakenship donated 300% more than Benjamin's actual campaign committee spent on the entire election. *Id.* In fact, Blakenship's $3 million donation even exceeded, by $1 million, the total amount spent by both Benjamin and McGraw's campaign committees. *Id.*

103 *Caperton*, 129 S. Ct. at 2264-65.

104 *Id.* at 2265.

105 *Id.*

Additionally, *Caperton* emphasized that judicial integrity is an important state interest that can be protected by state judicial canons.[106] The Court noted that "[t]he Due Process Clause demarks only the outer boundaries of judicial disqualifications. Congress and the states, of course, remain free to impose more rigorous standards for judicial disqualification than those we find mandated here today."[107] Finally, the Court called upon states to pursue recusal reform individually and to adopt judicial canons that will protect the integrity of their judicial branch.[108]

C. Citizens United v. Federal Election Commission: *The Threat of Special Interests Increases*

In 2009, the Court was presented with another campaign-related case.[109] *Citizens United v. Federal Election Commission* challenged federal election laws prohibiting direct corporate and union treasury spending in campaigns.[110] In a 5–4 decision, a split Court invalidated such restrictions because the laws violated the First Amendment.[111]

Citizens United, a nonprofit organization, produced *Hillary: The Movie,* which critically depicted then-Senator Hillary Clinton, a candidate for the Democratic presidential nomination at the time.[112] Citizens United planned to air the movie thirty days prior to the 2008 primary election and run television advertisements promoting the film.[113] However, federal election laws prohibited corporations from using their general treasury funds to make independent "expenditures" for "electioneering communications" within thirty days of a primary election or sixty days of a general election for federal office.[114] In effect, the laws prohibited Citizens United from using corporate treasury funds to finance the organization's desired movie advertisements.[115] Fearing that the film and advertisements would violate these federal election laws, Citizens United brought an action in the United

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106 *Id.* at 2266-67.

107 *Id.* at 2267 (quoting Aetna Life Ins. Co. v. Lavoie, 475 U.S. 813, 828 (1986)).

108 *Id.* at 2266-67.

109 Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876, 960-62 (2010).

110 The original federal corporate ban on campaign donations was established in 1907. *Id.* The Supreme Court has also upheld similar bans in 1990 and 2003. *Id.*

111 *Id.* at 917.

112 *Id.* at 887.

113 *Id.* at 887-88.

114 "Electioneering communication" is defined as any broadcast, cable, or satellite communication that refers to a candidate for federal office and is made within 30 day of a primary election and 60 days of a general election. "Expenditure" is a distribution of money or anything of value made "for the purpose of influencing any election for Federal office." Federal Election Campaign Act of 1971, 2 U.S.C.A. §§ 431(9)(A), 434(f)(3)(A)(i), 441b(b)(2); 11 C.F.R. § 100.29(a)(2), (b)(3)(ii) (2008).

115 *Citizens United*, 130 S. Ct. at 887.

States District Court for the District of Columbia seeking declaratory and injunctive relief against the Federal Election Commission.[116] However, the district court denied Citizens United's motion for a preliminary injunction and granted the FEC summary judgment.[117] Subsequently, Citizens United appealed to the Supreme Court.[118]

Although *Citizens United* centered on the 2008 presidential election, the case's outcome implicated judicial elections at large.[119] Justice at Stake, a nonpartisan organization dedicated to keeping American courts "fair and impartial," filed an amicus brief reminding the Court of their recent decision in *Caperton*.[120] The brief stressed *Caperton*'s holding, stating that:

> Special interest spending on judicial elections—by corporations, labor unions, and other groups—poses an unprecedented threat to public trust in the courts and to the rights of litigants. . . . This Court itself held last term in *Caperton* . . . that some independent expenditures in judicial campaigns are so excessive that they in fact deny litigants due process under the law. If corporate treasury spending were unregulated in judicial elections, these concerns would only get worse.[121]

Justice at Stake was fearful that a ruling allowing unlimited corporate funds to flow into elections would facilitate special interest groups in their pursuit to influence the judiciary through judicial campaigns.[122] Corporations could access their deep treasuries to fund campaign speech intended to bias elected judges and influence judicial outcomes.[123] Further, the brief warned that groups would begin competing for influence and corporate treasury spending "would only snowball," exacerbating the rising cost of judicial campaigns.[124]

Ultimately, the Court ignored Justice at Stake's warnings and held that the First Amendment does not tolerate the suppression of political speech based on the speaker's corporate identity.[125] Moreover, the Court held that federal election laws prohibiting independent corporate expenditures for "electioneering communications" also violated the First Amendment.[126] In his separate opinion, concurring in part and dissenting in part, Justice Stevens argued that the Court's ruling "threatens to undermine the integrity of

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116 *Id.* at 886-87.

117 *Id.* at 888.

118 *Id.* at 887.

119 *See* Brief for Justice at Stake et al. as Amici Curiae Supporting Respondent at 1-3, Citizens United v. Fed. Election Comm'n, 130 S.Ct. 876 (2010) (No. 08-205), 2009 WL 2365225.

120 *Id.*

121 *Id.*

122 *Id.*

123 *Id.*

124 *Id.* at 19.

125 Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876, 913 (2009).

126 *Id.* at 887.

elected institutions . . . ."[127] Stevens echoed the concerns of groups like Justice at Stake: "At a time when concerns about the conduct of judicial elections have reached a fever pitch, the Court today unleashes the floodgates of corporate and union general treasury spending in these races."[128]

After *Citizens United*, corporations and outside organizations can potentially spend unlimited amounts of money to advocate for candidates in judicial elections.[129] *Citizens United* held many states' corporate spending prohibition laws unconstitutional.[130] To combat the Court's decision, many states are now pursuing stricter disclosure and disclaimer requirements to try and salvage the independence of their courts.[131] These states are concerned that corporations' and other special interest groups' unlimited ability to pour money into judicial campaigns will ultimately create *quid pro quo* situations post elections.[132]

III. RECUSAL MAY PROTECT THE IMPARTIALITY OF THE JUDICIARY

A. Wersal v. Sexton*: Minnesota Court Makes a Suggestion—Recusal is the Less Restrictive Alternative to Judicial Campaign Restrictions*

Prior to *Caperton*, several states initiated policies to curtail the influence of special interest money on state court systems.[133] Minnesota's Code of Judicial Conduct serves as an exemplar to its neighbors.[134] While Michigan and Wisconsin have witnessed a surge in special interest group funding, the judicial elections in Minnesota have remained relatively clean.[135] However, Minnesota felt pressure from the mounting monetary influence tainting the credibility of its neighboring courts.[136] Reacting to this trend, the Minnesota Supreme Court ordered sweeping judicial reform in 2008.[137]

The cost of judicial elections was not the only factor forcing the court to consider judicial reform.[138] Recent court decisions, *White I* and *White II*,

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127 *Id.* at 931 (Stevens, J., dissenting).

128 *Id.* at 968.

129 *Id.*

130 *Id.*

131 *Citizens United*, 130 S. Ct. at 968.

132 Wersal v. Sexton, 613 F.3d 821, 839 (8th Cir. 2010).

133 Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2266 (2009).

134 JUSTICE AT STAKE, NEW POLITICS OF JUDICIAL ELECTIONS IN THE GREAT LAKES STATES 2000-2008 20 (Jesse Rutledge ed. 2008), *available at* http://www.justiceatstake.org/media/cms/NPJEGreatLakes20002008_DE945C4A0839D.pdf.

135 *Id.*

136 *Id.*

137 Order Promulgating Revised Minnesota Code of Judicial Conduct, ADM08-8004 (2008), *available at* http://www.bjs.state.mn.us/Code%20of%20Judicial%20Conduct%202009.pdf.

138 *See, e.g.*, Wersal v. Sexton, 613 F.3d 821, 826 (8th Cir. 2010).

invalidated several clauses within Canon 5 of Minnesota's Code of Judicial Conduct on First Amendment grounds.[139] In amending the invalid clauses, the court looked to the American Bar Association's model code for guidance.[140]

Gregory Wersal, a plaintiff in both *White I* and *White II*, brought suit soon thereafter challenging Minnesota's newly drafted clauses.[141] Wersal, who was running for Chief Justice of the Minnesota Supreme Court in the state's 2008 judicial elections, challenged the freshly altered "solicitation clause," claiming that it continued to violate his First Amendment rights.[142] Minnesota's solicitation clause prohibited judicial candidates from "personally solicit[ing] or accept[ing] campaign contributions."[143] Wersal argued that because the clause prohibited him from executing his campaign strategy of personally soliciting campaign contributions from non-attorneys by going door-to-door, it constrained his ability to amass enough contributions to run an effective campaign.[144] He dropped out of the race after it became obvious that Wersal would not receive adequate relief prior to the 2008 election.[145] He then decided to run for the Minnesota Supreme Court in 2010, hoping to implement a door-to-door initiative identical to his 2008 campaign strategy.[146] Again, Wersal felt constrained by the Minnesota Code of Judicial Conduct, especially its solicitation clause.[147]

Considering Minnesota's attempt to adjust the solicitation clause, the Eighth Circuit noted that "a regulation which burdens political speech will only withstand constitutional scrutiny if it is 'as *precisely* tailored as possible' to meet a very important end."[148] In other words, to survive constitutional review, Minnesota must show that the law both promotes a compelling state interest and is narrowly tailored to serve that interest.[149] To support the regulation of a judicial candidate's speech, Minnesota argued that judicial impartiality is a sufficiently compelling interest to withstand constitutional scrutiny.[150] The court found that impartiality, defined as a "lack of bias for or against either party to a proceeding," qualifies as a compelling state interest.[151]

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139 *Id.*

140 *See, e.g.*, JUSTICE AT STAKE, *supra* note 134.

141 *Wersal*, 613 F.3d at 826.

142 *Id.*

143 MINN. CODE OF JUDICIAL CONDUCT R. 4.1(A)(6) (2009).

144 *Wersal*, 613 F.3d at 826-27.

145 *Id.*

146 *Id.*

147 *Id.*

148 *Id.* at 832-33 (quoting Republican Party of Minn. v. White, 416 F.3d 738, 749 (8th Cir. 2005)).

149 *Wersal*, 613 F.3d at 831-32 (quoting *White II*, 416 F.3d at 749).

150 *Id.* at 832.

151 *Id.* at 832-33 (quoting Republican Party of Minn. v. White, 536 U.S. 765, 775 (2002)).

Specifically addressing the issue of biased judges, the court recognized that as long as Minnesota maintains a privately financed judicial election system, fears of judicial impropriety are inevitable.[152] These fears are created by the risk that candidates, after being elected, will ultimately favor campaign contributors over non-contributors.[153] However, the court pointed out that the risk of impropriety does not originate in "the mere solicitation—the 'ask'—but rather in the resulting contribution."[154] The real problem is not the funding of the campaign, but rather the ability of the candidate to trace the funding back to the individual contributor.[155] Therefore, the provision is under-inclusive because it constrains a candidate's ability to personally solicit funds but allows the candidate's committee to solicit funds.[156] Ultimately, the court held that "[s]ince the identity of the solicitor is irrelevant to the candidate's ultimate bias toward a party, Minnesota's rules on personal solicitation are not narrowly tailored to serve this interest."[157]

Additionally, the court reasoned that two portions of the personal solicitation provision already prevent candidates from tracing funds back to individual donors.[158] Canon 4 prohibits a candidate from "personally . . . accept[ing] campaign contributions" and the candidate's campaign committee from revealing the identity of donors.[159] The court emphasized that these limited restrictions act as a "less restrictive alternative" than a total ban on one-on-one solicitations.[160] The candidate can pursue an effective means of collecting campaign contributions through personal solicitation without learning the funds' sources.[161]

Suggestively, the court noted that Minnesota's recusal provision could bolster protection from judicial impropriety.[162] The recusal provision mandated recusal if the judge becomes aware of a litigant's contribution or the litigant's refusal to contribute.[163] Reasoning that "recusal serves both to protect a litigant's due process rights and a candidate's right of speech through receipt of campaign contributions," the court concluded that the Constitution favors a system with fewer speech restrictions and stricter

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152 *Id.* at 839.

153 *Id.*

154 *Id.* at 840.

155 *Wersal*, 613 F.3d (citing *White II*, 416 F.3d at 765).

156 *Id.* at 840.

157 *Id.*

158 *Id.*

159 MINN. CODE OF JUDICIAL CONDUCT, *supra* note 143, R. 4.1(A)(6).

160 *Wersal*, 613 F.3d at 840.

161 *Id.*

162 *Id.* at 841; MINN. CODE OF JUDICIAL CONDUCT, *supra* note 143, R. 2.11.

163 MINN. CODE OF JUDICIAL CONDUCT, *supra* note 143, R. 2.11 (enumerating instances in which recusal is required because "the judge's impartiality might reasonably be questioned," including when the judge has a personal bias or prejudice or an economic interest in one of the parties).

recusal standards.[164] Once again, the Eighth Circuit found Minnesota's solicitation clause invalid because it infringed on judicial candidates' First Amendment rights.[165]

B. *ABA's Suggested Recusal Standard*

Caperton illustrates the weak recusal standard problem.[166] In *Caperton*, the Supreme Court called upon states to consider recusal standards that encourage judges to disqualify themselves in light of potential bias.[167] The ABA proposed a possible standard that forty-seven states have since adopted.[168]

The ABA described their proposed model language in an amicus curiae brief filed in *Caperton*.[169] In its brief, the ABA pushed for the Court to consider implications beyond the case and the positive precedent that would be set if the Court decided to require recusal under the constitutional grounds of due process.[170] The ABA assured the Court that recusal is necessary when there is either "actual bias" or the "appearance of bias" because of the importance of maintaining judicial legitimacy.[171] The judiciary relies on the public's confidence for authority.[172] If the public believes that the judicial branch is tainted by power and financial influence, public confidence will diminish along with judicial authority.[173]

Canon 1 of the ABA's code states, "A judge shall uphold and promote the independence, integrity, and impartiality of the judiciary, and *shall avoid impropriety and the appearance of impropriety*."[174] The ABA focuses on an objective "reasonable man" recusal standard.[175] The test for the appearance of impropriety is "whether the conduct would create in *reasonable minds* a perception that the judge violated this Code or engaged in

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164 *Wersal*, 613 F.3d at 841-42.

165 *Id.* A federal district court in Kentucky responded similarly, invalidating Kentucky's ban on personal solicitation in judicial elections. The court reasoned that having judicial committees solicit contributions on behalf of the candidate "does not appreciably lessen the damage caused by such solicitations to the state's interest in an impartial and open-minded judiciary or the appearance of the same." Carey v. Wolnitzek, No. 3:06-36-KKC, 2008 WL 4602786, at *16 (E.D. Ky. Oct. 15, 2008).

166 *See* Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2267 (2009).

167 *Id.*

168 Jonathan Blitzer, *Recusal Reform in Michigan*, BRENNAN CTR. FOR JUSTICE (July 31, 2009), http://www.brennancenter.org/blog/archives/recusal_reform_in_michigan.

169 *See* Brief for American Bar Ass'n, *supra* note 51, at 2.

170 *Id.*

171 *Id.*

172 *Id.*

173 *Id.*

174 MODEL CODE OF JUDICIAL CONDUCT, *supra* note 14, Canon 1 (emphasis added).

175 *Id.* at R. 1.2[5].

other conduct that reflects adversely on the judge's honesty, impartiality, temperament, or fitness to serve as a judge."[176]

The ABA's suggested recusal regime also includes a requirement of disqualification when a judge knows that a party to the suit, or the party's lawyer, has contributed beyond a certain threshold towards the judge's campaign.[177] The ABA suggests states insert contribution levels that they deem appropriate.[178] For states that decline to use a specific dollar amount, the ABA recommends the language "reasonable and appropriate for an individual or an entity."[179]

C. *States Adopt the ABA Language*

Since *Caperton*, many states have initiated stricter and more detailed recusal requirements, and forty-seven states have adopted the ABA's general recusal standard.[180] Among the states that have followed the ABA's model, several have opted to pursue recusal standards that incorporate specific monetary amounts.[181] These state proposals have varied drastically.[182] In Nevada, the Commission on the Amendment to the Nevada Code of Judicial Conduct has recommended disqualification when a judge receives campaign contributions of $50,000 or more from a party before the court.[183] On the other hand, Montana has proposed a much lower benchmark, requiring a judge to recuse himself if a party before the court has donated in excess of $250 to the sitting judge's campaign.[184] Other states, such as California and Texas, have followed with standards around $1,000.[185]

IV. THE PATH FORWARD: A RECUSAL OPTION THAT ADDRESSES PUBLIC CHOICE PROBLEMS

As seen in *White I*, *White II*, and *Wersal*, attempts to regulate judicial candidates' and campaign contributors' free speech will likely not pass con-

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176 *Id.* (emphasis added).

177 *Id.* at Canon 2 R. 2.11[4].

178 *Id.*

179 MODEL CODE OF JUDICIAL CONDUCT, *supra* note 14, R. 2.11[4].

180 Blitzer, *supra* note 170; *2009-2010 State Judicial Reform Efforts*, BRENNAN CTR. FOR JUSTICE (July 20, 2010), http://www.brennancenter.org/content/resource/state_judicial_reform_efforts_2009/.

181 *2009-10 Judicial Disqualification Initiatives in the States*, *supra* note 180.

182 *Id.*

183 *Id.*

184 *Id.*

185 California has proposed a $1,500 limit and Texas has proposed a $1,000 limit. *2009-10 Judicial Disqualification Initiatives in the States*, *supra* note 180.

stitutional muster.[186] Further, the Supreme Court re-affirmed in *Citizens United* that these First Amendment rights even extend to corporations.[187] Accordingly, states' future attempts at restricting a judicial candidate's speech or a supporter's ability to contribute to a judicial campaign will likely face stiff constitutional challenges.[188]

As demonstrated in Part III, recusal remains a viable option for judicial canon reform. Instead of regulating campaigns, states can adopt recusal standards that specifically address the influence campaign contributions and independent expenditures have on judicial decision making.[189] Essentially, states can use ex post recusal standards instead of ex ante speech restrictions during the campaign process.[190]

One suggestion is for states to include some form of the following language in their judicial canons:

> A judge must disqualify himself or herself if the judge has knowledge a party, or their lawyer has made, or refused to make, a contribution to the judge's campaign. Further, a judge must disqualify himself or herself if the judge has knowledge that a party, or their lawyer, has made independent expenditures in express advocacy for the judge or the defeat of the judge's opponent during a campaign.

The above model language imposes effective safeguards to judicial impartiality while complying with Supreme Court campaign finance jurisprudence. States should either adopt the above recusal standard or develop methods that erase the link between donor and donation. If a party before the court has donated or refused to donate to the sitting judge and the judge knows of this donation or refusal, then the judge must disqualify himself. Similarly, the standard should apply to parties who have made independent expenditures in favor of a judicial candidate. To be effective, a contribution-specific recusal standard must be accompanied by a prohibition on the candidate's ability to personally accept contributions. This would decrease the amount of necessary recusals because the judge would be insulated from knowing the identity of the donor or the supporter. However, a ban on personal solicitations, which has been attempted in Minnesota and Kentucky, would be unnecessary.[191] As the judge would be prohibited from accepting the funds and must recuse himself if he learns the identity of a supporter, further restrictions during campaigns are unnecessary.

A contribution-specific recusal standard, such as the one previously detailed, would satisfy the state concern evident in *Caperton*: the ability to

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186 Wersal v. Sexton, 613 F.3d 821, 840 (8th Cir. 2010).

187 Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876, 913 (2010).

188 *See Wersal*, 613 F.3d at 826; Carey v. Wolnitzek, No. 3:06-36-KKC, 2008 WL 4602786, at *1 (E.D. Ky. Oct. 15, 2008).

189 *See Wersal*, 613 F.3d at 840; *Wolnitzek*, 2008 WL 4602786, at *18.

190 *See Wersal*, 613 F.3d at 840; *Wolnitzek*, 2008 WL 4602786, at *18.

191 *See Wersal*, 613 F.3d at 827; *Wolnitzek*, 2008 WL 4602786, at *16.

trace the donation to the donor.[192] By erasing the identifying features of donations and independent expenditures, judges are able to impartially preside over the cases before them. A court system protected by a contribution-specific recusal standard shields judges from consciously or subconsciously deciding cases based on favoritism. A recusal standard which forces recusal when a judge knows the party before him has supported his campaign quells the problem public choice theory suggests—that special interests will influence the judicial system through campaign contributions and expenditures.

A. *Both the Supreme Court in Caperton and the States are Concerned with the "Attributability" of Donations—Recusal is a Possible Solution*

As illustrated in the Minnesota and Kentucky cases, states are concerned with the influence of money on judicial decisions.[193] When trying to resolve this perceived problem, states look to ex ante restrictions on campaign donations.[194] However, the courts have been reluctant to uphold these restrictions because they either blatantly violate First Amendment rights or appear to chill the speech of both the candidate and donor.[195] Nevertheless, states have been unsuccessful in obtaining their objectives.[196]

A possible solution arises from *Caperton*.[197] Strict recusal standards allow for fewer restrictions on donations and, ultimately, campaign speech. The *Caperton* Court was concerned with the attribution aspects of the campaign donations.[198] Justice Benjamin could easily link the $3 million donation back to Blankenship.[199] A viable solution is to remove the possibility of a judge linking donation money to a party, and when that is impractical, recusal is the recourse.

B. *States Should Adopt Contribution and Independent Expenditure-Specific Recusal Standards to Combat Special Interest Influence*

States should adopt strict recusal standards. States can then allow more lenient campaign restrictions. This means eliminating the ban on personal solicitation and filling the gap with a specific recusal clause. Judicial

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192 *See* Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2263-64 (2009).

193 *See Wersal*, 613 F.3d at 839-41; *Wolnitzek*, 2008 WL 4602786.

194 *See Wersal*, 613 F.3d at 840; *Wolnitzek*, 2008 WL 4602786, at *16.

195 *See Wersal*, 613 F.3d at 840-42; *Wolnitzek*, 2008 WL 4602786, at *16.

196 *See Wersal*, 613 F.3d at 840-42; *Wolnitzek*, 2008 WL 4602786, at *21.

197 *Caperton*, 129 S. Ct. 2252, 2263-64 (2009).

198 *See id.*

199 *See id.*

candidates should be allowed to personally solicit donations but be prohibited from personally receiving them. Instead, the judicial candidate's campaign committee should receive these donations. Realistically, some donor identities will be exposed to the judicial candidate. If this occurs and the identified donor is a party in a suit before the judge, the judge must disqualify himself from that case. A recusal regime that incorporates contribution considerations also addresses states' concerns of an independent judiciary.[200] Erasing the link between supporter and donation or independent expenditure restricts the opportunity for special interests to influence the outcome of decisions through judicial campaigns.

This proposal disposes of the link between donor and donation that taints the judicial decision-making process. Recusal standards that mandate recusal when campaign contributions appear to bias judges, whether or not the judge even knows of the donation, are over-inclusive and create an unnecessary disincentive for donors. Potential donors may refrain from exercising their political speech rights through campaign donations out of fear that a donation would alienate them from the judge they feel is the most qualified.

On the other hand, the "appearance of bias" recusal standard is under-inclusive because it ignores small donations of even $25. In *Capterton*, the Supreme Court held that due process mandates recusal when there is a substantial donation made to a judge's campaign and that donor is before the court.[201] This "substantial donation" criterion is reflected in the appearance of bias standard.[202] Recusal standards drafted solely pursuant to the appearance of bias standard will most likely view a $25 donation as too insignificant to create bias or even an appearance of bias. Further proof exists because many states that have adopted the ABA's standard have also included bright-line contribution thresholds ranging from $250 to $50,000.[203] The threshold amounts show that states believe it is improbable that contributions have an effect on the judges' impartiality unless these contributions are substantial.[204] This standard is under-inclusive because it ignores the human inclination to feel a connection with supporters. Even a $25 contribution, if known by the judge, may create a subconscious bias in favor of the donor. The failures of the appearance of bias standard show that a stricter and more specific recusal standard may be more effective in dispelling judicial impropriety and freeing the courts from harmful special interest influence.

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200 *Id.* at 2266-67.

201 *Id.* at 2267.

202 MODEL CODE OF JUDICIAL CONDUCT, *supra* note 14, Canon 1.

203 *2009-10 State Recusal Reform Efforts*, *supra* note 180.

204 *See id.*

C. *Recusal Solves the Problems Raised by Public Choice Theory*

Public choice theory applied to judicial elections purports that judges, like other elected officials, act in their self-interest when making decisions in office.[205] As reelection is the goal of self-interested elected judges, they will conform their behavior and decisions according to what they believe will be advantageous in their next election.[206] Considering this, judicial elections can influence judges' decision making in two major ways.[207] Elections can force judges to make decisions based on the majority's views (the "majoritarian difficulty") or based on their relationship with individual parties ("favoritism").[208] State legislatures and officials who create state judicial canons are concerned with the public choice problem of favoritism.[209] Through this lens, "public choice theory suggests that well-organized interest groups may have a greater effect on elected officials than diffuse majorities, and thus elected judges might be more attentive to this small subset of the population than to the majority as a whole . . . ."[210]

As seen in *White I*, *White II*, *Caperton*, and *Citizens United*, states have a strong interest in maintaining the propriety of their court systems.[211] *Caperton* illustrates the fear that special interests have easy access to the courts and can influence decision making through campaign contributions.[212] States are concerned with the link between campaign contributions and the donor.[213] They worry about the effect of this link because elected judges may feel a debt of gratitude toward their donors and reward them through their decision-making position.[214] When special interests and wealthy donors are making massive contributions to judicial campaigns, they have the ability to hijack the system and use it to their advantage.

Recusal is a solution to the problems addressed in public choice theory. States can enact stricter and more specific recusal standards that strip judges' decision-making power over parties they may favor. The most effective recusal standard, in terms of diminishing the influence of special interests and large donations on court decisions, would cover campaign

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205 Hasen, *supra* note 20, at 1313-14.

206 *See id.*

207 David E. Pozen, Article, *The Irony of Judicial Elections*, 108 COLUM. L. REV. 265, 278 (2008).

208 *Id.*

209 *See* Wersal v. Sexton, 613 F.3d 821, 840 (8th Cir. 2010); Carey v. Wolnitzek, No. 3:06-36-KKC, 2008 WL 4602786, *16 (E.D. Ky. Oct. 15, 2008).

210 Amanda Frost & Stefanie A. Lindquist, *Countering the Majoritarian Difficulty*, 96 VA. L. REV. 719, n.32 (2010).

211 Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876, 968 (2010) (Stevens, J., dissenting); Caperton v. A.T. Massey Coal Co., 129 S. Ct. 2252, 2263-64 (2009); Republican Party of Minn. v. White, 536 U.S. 765, 776 (2002); Republican Party of Minn. v. White, 416 F.3d 738, 766 (2005).

212 *See Caperton*, 129 S. Ct. at 2263-64.

213 *See id.*; *Wersal*, 613 F.3d at 840.

214 *See Caperton*, 129 S. Ct. at 2263-64; *Wersal*, 613 F.3d at 840.

contributions and independent expenditures. While the court in *White II* and *Wersal* found that prohibitions on personal solicitation could not withstand constitutional scrutiny, *Wersal* suggested that recusal is appropriate when a party before the judge is a donor.[215]

Recusal standards must include mandatory disqualification when the judge knows that a party before him has donated or refused to donate to his campaign. States should incorporate a clause in their judicial canons that allows judicial candidates to personally solicit contributions, but prohibits candidates from personally accepting the contribution. Similarly, states should incorporate independent expenditures in their recusal standards. If the judge knows that a party has made an independent expenditure in favor of the judge, recusal is required. A recusal standard that incorporates both contributions and independent expenditures erases the possibility that the judge will connect the donor to the donation and ultimately reward the donor in a court decision.

In addition to protecting impartiality through personal bias in favor of contributors, the proposed standard also indirectly removes the incentive for ill-intentioned contributions. The knowledge that recusal will be mandated if the judge learns of the donor's identity will deter special interests, like Mr. Blankenship in *Caperton*, hoping to manipulate judicial decision making through campaign contributions. Therefore, the proposed recusal standard not only reduces impartiality directly, but it also reduces the probability that contributions will be made with then intent of swaying the judge when a party, or its interests, are specifically before the court.

CONCLUSION

While the cost of judicial elections is skyrocketing, states worry about the effect these donations will have on the independence of their courts. This fear has been illustrated in state initiatives to impose campaign restrictions on candidates for judicial office.[216] This is exemplified in *White I* and *White II*, which addressed Minnesota's attempt to maintain the independence of its judiciary through restrictions on speech and contributions.[217]

State fears of an impartial judiciary can be understood through public choice theory.[218] As special interests takes a more prominent role in campaign fund-raising, their influence on the judicial system post-election in-

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215 *Wersal*, 613 F.3d at 841; *White II*, 416 F.3d at 766.

216 *See Wersal*, 613 F.3d at 840; *White II*, 416 F.3d at 766; Carey v. Wolnitzek, No. 3:06-36-KKC, 2008 WL 4602786, *16 (E.D. Ky. Oct. 15, 2008).

217 *White I*, 536 U.S. at 776; Republican Party of Minn. v. White, 416 F.3d 738, 766 (2005).

218 *See* Hasen, *supra* note 20, at 1313-14.

creases.[219] Public choice theory suggests that judges will have an incentive to decide according to the interests of these special interest donors.[220]

The fear of a judicial branch hijacked by special interests may be solved by contribution-specific recusal standards that emphasize donor anonymity. States can allow for more speech ex ante, by imposing stricter and more specific ex post recusal standards. States should incorporate provisions that allow personal solicitation of campaign contributions but prohibit judicial candidates from personally accepting these contributions. This standard dissolves the link between the donor and the donation without restricting the speech of either the candidate or the donor. In addition, recusal standards should mandate disqualification if a judge knows a party before him has donated or refused to donate to his campaign. The judge must also recuse himself if he has knowledge that a party before him has made independent expenditures in the judge's favor.

By breaking the link between donor and donation, or mandating disqualification if the link exists, special interests will be unable to infiltrate the decision making of the courts through monetary influence. If adopted by states, the proposed recusal standard may prove to be a cure to vulnerable judicial candidates trying to compete with the increasing cost of campaigning.

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219 *See id.*

220 *See id.*