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- ARTICLES -

THE TIMES THEY ARE A-CHANGIN': TIME TO REVISIT QUILL CORPORATION V. NORTH DAKOTA

By

A. David Austill[*] & Thomas Y. Proctor[**]

I. INTRODUCTION

States and municipalities always need additional revenues. They have limited ability to increase their revenues for governmental operations. Several states, such as the authors' state of Tennessee, do not collect broad-based individual income taxes. Those states without a broad-based individual income tax system depend principally upon sales taxes. Currently, 45 states and the District of Columbia impose sales or use tax.[1] A "sales tax" is defined, generally, as "[a] tax imposed on the sale of goods and services."[2] If the sale does not take place in a state, then the transaction is generally subject to a use tax, defined as "[a] tax imposed on the use of certain goods that are bought outside the taxing authority's jurisdiction."[3] The tax rates are usually the same. Furthermore,

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[1] Mary McLaughlin, *The Streamlined Sales Tax Project*, CPA J, Dec. 2003, *available at* http://www.nysscpa.org/cpajournal/2003/1203/dept/d125803.htm (last visited Mar. 11, 2010). The states that do not collect sales tax are Delaware, Montana, New Hampshire, Oregon, and Alaska.

[2] BLACK'S LAW DICTIONARY 1498-99 (8th ed. 2004).

[3] *Id*. at 1499.

local governments usually derive the bulk of their revenues from sales taxes and property taxes. State governments relied on sales taxes for approximately one-third of their total tax revenue in 2003.[4] Sales taxes seem to be preferred over other forms of state and local taxes, such as an income tax or property tax.[5] When taxable sales transactions decline, which usually occurs during recessionary periods, state and local governments suffer the consequences of reduced revenues.

During the 1980s, an old type of business transaction became a common commercial practice, namely, catalog (or mail-order) sales. Retailers knew goods shipped to a state in which the retailer had no physical presence or agents would be free from state sales tax, and they could not be forced to collect use taxes on the transactions. Thus, those remote sellers were provided an economic advantage over "brick and mortar" stores. They could sell cheaper because the net cost to the purchaser was less. When the net cost to the purchaser was the same, the remote seller obtained a higher profit margin than their brick and mortar competitors. States and local governments also lost tax revenues on those sales to remote sellers based on U.S. Supreme Court decision limiting the power of states to force remote sellers from collecting use taxes.

In 1992, when this nation was in an economic recession, the states were eager for the U.S. Supreme Court to decide *Quill v. North Dakota*[6] (discussed infra). The Court rejected the state's claim that

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[4] Christopher G. Reddick & Jerrell D. Coggburn, *E-commerce and the Future of the State Sales Tax System: Critical Issues and Policy Recommendations*, 30 INT'L J OF PUB. ADMIN. 1021, 1024 (2007). States receiving more than 50 percent of their revenues from sales taxes include Florida, Nevada, South Dakota, Tennessee, Texas, and Washington.

[5] Dennis Cauchion, *States look to sales tax for funds: Increases would bring in billions*, USA TODAY, Oct. 31, 2007, at A1.

[6] 504 U.S.298 (1992).

National Bellas Hess, Inc. v. Department of Revenue of Illinois[7] should be overruled on both its Due Process Clause and dormant Commerce Clause grounds. Continuing the old policy, with the Due Process Clause factor removed, states still could not force remote sellers to collect and remit use taxes paid by the purchasers of goods shipped into the state by the remote sellers. This was before the vast changes in commerce due to the Internet.

This paper argues that the U.S. Supreme Court should overrule *Quill*, or, in the alternative, Congress should pass legislation to override the judicial effect of *Quill* to allow states the right to force remote sellers to collect and remit use taxes. The paper will first discuss the growth of e-commerce and the poor economic environment of state and local governments today, which, to a substantial degree, has been caused by sales tax or use avoidance. An in-depth discussion of *Quill* and its rationale follows that provides a basis for much of the discussion thereafter. The Internet Tax Freedom Act is briefly explained to clarify misconceptions and to distinguish that problem from the sales tax problem. The remainder of the paper considers legislative and judicial responses to *Quill*. Here approaches states have been taking to circumvent *Quill*'s negative effects, including judicial arguments in state courts and new sales tax legislation and initiatives. Discussions of the state sales tax initiative, the Streamlined Sales Tax Project, and a new approach to value added taxation by the European Union that affects American companies selling via the Internet in the EU. Finally, arguments and strategy will be presented to convince Congress to legislatively nullify the *Quill* effect and to convince the Courts to overrule *Quill*. The rationale behind *Quill* and the case's effect has become anachronistic given the development of electronic commerce today. *Oh, the times they are a-changin'*.

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[7] 386 U.S. 753 (1967).

A. Growth of the Internet and the Effect on State Sales Tax Revenues

The growth of the Internet for commercial purposes represented a radical change in business strategy and marketing techniques. It was ideal for exploiting sales transactions free of sales and use tax consequences to buyers from remote sellers. It is this radical change in the business model for many companies, new and old, that exacerbates the sales and use tax collection problem for the states and creates inequity to purchasers based on economic wherewithal and a tax preference to remote sellers over brick-and-mortar stores.

Internet sales (or e-commerce) have been continuously growing since the early 1990s. For instance, e-commerce sales accounted for about 2.2 percent of total sales in the U.S. during the third quarter of 1995.[8] Forrester Research, Inc., a Cambridge, Massachusetts technology and market research company, in 2005 forecast the level of e-commerce for 2005 to 2010. Forrester estimated the following:

1. $172 billion in online retail sales in 2005;
2. Online retail sales were expected to grow to $329 billion in 2010;
3. In 2010, e-commerce would represent 13% of total U.S. retail sales;
4. Annual growth rate in e-commerce was expected to be about 14 percent; and
5. By 2010, 29% of small appliances sales would migrate online, 14% of jewelry sales would be online, health and

[8] U.S. Census Bureau, *Quarterly Retail E-Commerce Sales 3rd Quarter 2005*, U.S. CENSUS BUREAU NEWS (Nov. 28, 2005), *available at* http://www.census.gov/mrts/www/data/pdf/05Q3.pdf (last visited Mar. 11, 2010).

beauty products would grow at an annual rate of 22 percent.[9]

In early 2007, JupiterResearch estimated U.S. online retail sales to be $116 billion in 2007, a 16% growth over 2006. It estimated U.S. online retail sales would reach $171 billion in 2011.[10] Finally, CNNMoney.com reported that 2006 online sales in the U.S. were $146.4 billion, excluding travel, and represented 6 percent of overall retail sales in 2006. Online sales for 2006 rose by 29 percent over 2005. Online retail sales were expected to increase by 19.1% to $174.5 billion in 2007, excluding travel. Including travel, the National Retail Federation and Shop.org estimated total online sales in 2007 to be $259.1 billion.[11]

In a more recent study, the U.S. Bureau of the Census found that e-commerce sales grew from $995 billion in 1999 to $2,385 billion by 2006, a 13.3 percent compound annual growth rate with about 93 percent of that being business-to-business (B2B) sales transactions.[12] Bruce, Fox and Luna of the University of

[9] Irene Cherkassky, *Target Marketing Tipline*, September 21, 2005, *available at* http://ga1.org/tmgroup/notice-description.tcl?newsletter_id=1960075&r=#3 (last visited Mar. 25. 2008).

[10] *Internet Marketing NewsWatch*, IMNEWSWATCH.COM, Jan. 16, 2007, *available at* http://www.imnewswatch.com/archives/2007/01/us_online_retai_5.html?visitFrom=2 (last visited Mar. 26, 2008).

[11] CNNMoney.com, *Online sales spike 19 percent*, May 14, 2007, *available at* http://cnnmoney.printthis.clickability.com/pt/cpt?action=cpt&title=Total+online+sales+ex (last visited Mar. 26, 2008).

[12] Donald Bruce, William F. Fox & LeAnn Luna, *State and Local Government Sales Tax Revenue Losses from Electronic Commerce*, Apr. 13, 2009, at 1, *available at* http://www.streamlinedsalestax.org/uploads/downloads/EC%20Executive%20Committee%20Meeting%20Docs/SSTP%20e-commerce%202009%20REV041309.pdf (last visited Mar. 8, 2010).

Tennessee in 2009 forecast e-commerce sales to rise from $3.0 trillion in 2010 to $4.0 trillion in 2012.[13]

The effect of online retail sales to state and local governments has been substantial and is getting worse very quickly. Bruce, Fox and Luna have estimated federal, state and local sales tax loss on their forecasted e-commerce sales above at $8.6 billion (2010), $10.1 billion (2011), and $11.4 billion (2012). As large as these lost tax revenues are, they are substantially lower than forecasters had estimated in 2004.[14] Part of difference between the later and earlier forecasts may be explained that more Internet companies are collecting sales and use tax for reasons discussed in this paper. Losses in tax revenues due to the Quill effect also hit local governments hard. For example, the New York City Independent Budget Office estimated $50 million of sales taxes due New York and New York City went uncollected in fiscal year 2007 mainly due to e-commerce.[15]

The current recession has been devastating for state and local governments. *Quill* exacerbates the pain of budget deficits. Additional tax revenues are essential for state and local governments. Overruling *Quill* judicially or effectively by

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[13] *Id*. at 3.

[14] Steven Maguire, *State and Local Sales and Use Taxes and Internet Commerce*, CRS REPORT FOR CONGRESS 1 (Jan. 2005), *available at* http://www.ipmall.info/hosted_resources/crs/RL31252_050128.pdf (last visited Mar. 11, 2010). Researchers at the University of Tennessee found that in 2004 the estimated tax loss to state and local governments was $15.5 billion. It was expected to climb to about $21.5 billion in 2008.

[15] Ted Phillips, *New York Sales Taxes Uncollected, Northeast Bond-Watch*, BOND BUYER, www.bondbuyer.com, Aug. 25, 2008, at 9. Of $4.4 billion in e-commerce sales of products and services generated in fiscal year 2007, about $2.2 billion were taxable. Taxes on those taxable sales should have yielded $91 million, but collection fell short by $21 million for the state and $29 million for the city. For a discussion of estimates of losses to New York City and Chicago, *see* Bruce, Fox & Luna, *supra* note 12, at 8.

Congressional legislation, would help some. The Census Bureau reported a decline in the October to December quarter of 2008 total state tax revenue by 4.7 percent from the year earlier with sales taxes down by 6.1 percent, income tax down by 1.1 percent, and corporate income tax down 15.5 percent. With 35 states having a decline in tax revenues, and six states having a double-digit decline, it was the worst quarter in 50 years for total state tax collections.[16] Furthermore, the drop in state and local revenues as a result of economic recessionary effects on the fourth quarter of 2008 and first quarter of 2009 led to large federal grants to state and local governments during the first quarter of 2009. This made federal aid the top revenue for the first quarter of 2009, surpassing sales, property and income taxes as the largest source of revenue.[17]

II. QUILL CORPORATION V. NORTH DAKOTA

In 1987, Quill Corporation ("Quill") was a supplier of office supplies through its mail-order business. It had offices and warehouses in Illinois, California, and Georgia. It owned little, if any, tangible property and had no employees in North Dakota. Quill solicited business in North Dakota through catalogs and flyers, advertisements in national periodicals, and telephone calls. Its annual sales exceeded $200 million of which almost $1 million were made to about 3,000 customers in North Dakota. Delivery of goods to its North Dakota customers was by mail or common carrier from its out-of-state locations.[18]

North Dakota collected both sales and use taxes. North Dakota

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[16] Donald J. Boyd & Lucy Dadayan, *Sales Tax Decline in Late 2008 Was the Worst in 50 Years*, STATE REVENUE REPORT, THE NELSON A. ROCKEFELLER INSTITUTE OF GOVERNMENT, 75, at 1-6 (Apr. 2009), *available at* http://www.rockinst.org/pdf/government_finance/state_revenue_report/2009-04-14-(75)-state_revenue_report_sales_tax_decline.pdf (last visited Mar. 8, 2010).
[17] Cauchon, *supra* note 5.
[18] *Quill*, *supra* note 6, at 302.

"[i]mposed a use tax upon property purchased for storage, use, or consumption within the State . . . [and required] every retailer maintaining a place of business in the State to collect the tax from the consumer and remit it to the State."[19] North Dakota defined the term "retailer" to include "every person who engages in regular or systematic solicitation of a consumer market in the state."[20] Under North Dakotan regulations[21] "regular and systematic" was defined to mean three or more advertisements within a 12-month period.[22] Thus, the North Dakota Tax Commissioner took the position that under North Dakota tax law Quill was obligated to collect the use tax from North Dakotan purchasers and to remit it to the State. Quill argued that there were neither the requisite minimum contacts for due process nor substantial nexus for dormant Commerce Clause requirements in order for North Dakota to force it to collect and remit use taxes on Quill's sales to North Dakota customers.[23]

Holding the case was indistinguishable from *Bellas Hess*[24], the trial court found for Quill. The U.S. Supreme Court in *Bellas Hess* had held that a similar Illinois tax statute violated the Fourteenth Amendment's Due Process Clause and created an unconstitutional burden on interstate commerce. A seller whose only connection with the customers in the taxing state is by common carrier or the mail lacked the requisite minimum contacts with the state to meet due process requirements and lacked substantial nexus with the taxing state to meet Commerce Clause requirements.[25] The *Quill* trial court found the State had not shown that it had spent tax

[19] *Id*.
[20] *Id*.
[21] N.D. ADMIN. CODE § 81-04.1-01-03.1 (1988).
[22] *Quill*, *supra* note 6, at 303.
[23] *Id*. at 301-303.
[24] *Id*., *supra* note 7.
[25] *Id*. at 757-758.

revenues for the benefit of the mail-order business and that there was not a substantial nexus between Quill and the State.[26]

The North Dakota Supreme Court reversed the trial court's decision. It concluded "that 'wholesale changes' in both the economy and the law made it inappropriate to follow *Bellas Hess* today."[27] The Court noted (1) the "remarkable growth" of the mail-order business in the economy, (2) the advances in computer technology that greatly eased the burden of compliance, and (3) that *Complete Auto Transit, Inc. v. Brady*[28] had rejected the line of cases holding that the direct taxation of interstate commerce was impermissible and had adopted a consistent and rational method of inquiry focusing on the practical effect of the challenged tax.[29] Furthermore, the State had provided sufficient services and benefits to Quill by creating an economic climate that fostered demand for Quill's products and in maintaining "a legal infrastructure that protected [Quill's] market, and disposed of 24 tons of catalogs and flyers mailed by Quill into the State every year".[30] The Court concluded that "Quill's 'economic presence' in North Dakota depended on services and benefits provided by the State, and therefore generated 'a constitutionally sufficient nexus to justify imposition of the purely administrative duty of collecting and remitting the use tax'."[31] Finally, since the "very object" of the Commerce Clause is to protect interstate commerce against discriminatory practices, the Court noted it would be ironic to exempt an out-of-state vendor like Quill from the burden of collecting and remitting the use tax and allow it to enjoy a significant competitive advantage over local retailers.[32]

[26] *Quill*, *supra* note 6, at 303.
[27] *Id.*
[28] 430 U.S. 274 (1977).
[29] *Quill*, *supra* note 6, at 303.
[30] *Id*. at 304.
[31] *Id*.
[32] *Id*. at 304, note 2.

In a majority opinion written by Justice Stevens, the U.S. Supreme Court reversed. The Court considered the two applicable constitutional provisions, namely, the Due Process Clause and the Commerce Clause, that were the bases for *Bellas Hess*. The Court noted that although the two clauses are closely related in this tax issue, they pose distinct limits on the taxing powers of the States. Under the Due Process Clause, there is a requirement of some "definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[33] Following *International Shoe Co. v. Washington*[34], the relevant inquiry was whether a defendant had minimum contacts with the taxing jurisdiction such that maintenance of the suit did not offend traditional notions of fair play and justice. The Court in *Burger King, Inc. v. Rudzewicz*[35] stated that if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum state, it may subject itself to the state's in personam jurisdiction even if it has no physical presence in the state. As it pertains to the Due Process Clause, a corporation has fair warning that it is subject to the imposition of collection of use taxes and due process is met when a mail-order company is engaged in continuous and widespread solicitation of business within a state even if it does not have a physical presence in the state. The Court found that Quill had directed its activities at North Dakota residents and the nexus was sufficient to make Quill subject to use tax collection and remittance in North Dakota. The Court overruled *Bellas Hess* to the extent that *Bellas Hess* required physical presence in the taxing state to meet the due process requirement for taxation.[36]

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[33] *Id*. at 306 (citing *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954)).
[34] 326 U.S. 310 (1945).
[35] 471 U.S. 462 (1985).
[36] *Quill*, *supra* note 6, at 305.

Bellas Hess prohibits remote sellers from being subject to collecting and remitting use taxes unless the remote seller has a substantial nexus with the taxing state.[37] The purpose of the substantial nexus requirement is to limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce. A seller may have sufficient minimum contacts to meet the Due Process Clause but lack a substantial nexus with the taxing State required by the Commerce Clause.[38] Citing *Complete Auto*, the Court emphasized the importance of looking past the formal language of the tax statute to its practical effect. The *Complete Auto* Court established a four-part test to determine whether a remote seller was subject to state taxation under the Commerce Clause. Under the Complete Auto's four-part test, a court "will sustain a tax against a Commerce Clause challenge so long as the tax (1) is applied to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State."[39] The first of the tests was at issue in *Quill* as it was in *Bellas Hess*.

The *Bellas Hess* Court adopted a bright-line rule for substantial nexus. It set forth a conservative judicial policy of requiring a remote seller to maintain a physical presence in the taxing state before there is substantial nexus to meet the dormant Commerce Clause requirement.[40] The *Quill* Court reaffirmed the bright-line rule. In *Quill* the Court noted that such "a bright-line rule in the area of sales and use taxes also encourage settled expectations and, in doing so, fosters investment by businesses and individuals."[41] The Court, however, did not explicitly say what constituted "physical presence", as it had not in the earlier cases. It noted in

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[37] *Id*. at 309-318.
[38] *Id*. at 313-314.
[39] *Id*. at 313 (citing *Complete Auto*, *supra* note 28, at 279).
[40] *Bellas Hess*, *supra* note 7, at 759-760.
[41] *Id*. at 315.

dicta that the presence in the taxing state of "a small sales force, a plant, or office" may meet the physical presence requirement for substantial nexus under the Commerce Clause.[42]

The Court also based its reasoning for reaffirming its bright-line rule on the doctrine of *stare decisis*. It stated the bright-line rule had "engendered substantial reliance, [b]ecome part of the basic framework of a sizable industry", and was necessary for stability and orderly development of the law.[43] Finally, the Court noted that with the issue of due process settled, Congress had the ultimate power "to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.[44] The Court left the final resolution of the issue to Congress and reversed the decision of the North Dakota Supreme Court.

Justice White strongly dissented to the majority's opinion on the Commerce Clause issue.[45] In his dissenting opinion he stated that *Bellas Hess* should be overruled on Commerce Clause grounds as it requires physical presence for substantial nexus. His view was that the nexus requirement for due process providing jurisdiction to tax interstate commerce was sufficient to meet the Commerce Clause nexus requirement. He argued that the four-pronged test in *Complete Transit* was "traceable to concerns grounded in the Due Process Clause, and not the Commerce Clause…. For the Court

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[42] *Id*.
[43] *Id*. *See also* Justice Scalia's concurring opinion (*id*. at 334). In Justice Scalia's concurring opinion, joined by Justices Kennedy and Thomas, Justice Scalia argued that the merits of *Bellas Hess*' bright-line rule should not have been revisited. He noted that "we have long recognized the doctrine of *stare decisis* has 'special force' where Congress remains free to alter what we have done…. Moreover, the demands of the doctrine are at their acme … where reliance interests are involved…. [T]he 'physical presence' rule established in *Bellas Hess* is not 'unworkable'."
[44] *Id*. at 318.
[45] *Id*. at 321-333.

now to assert that our Commerce Clause jurisprudence supports a separate notion of nexus is without precedent or explanation."[46]

In rejecting the need for a bright-line rule, Justice White considered the post-*Bellas Hess* and *Complete Auto* case of *National Geographic Society v. California Board of Equalization*.[47] In *National Geographic* an out-of-state mail order vendor with its only physical presence in California being two small offices unrelated to its mail order sales was required by California to collect and remit use tax. The Court rejected the vendor's argument that under *Bellas Hess* there was not substantial nexus. The *National Geographic* Court rejected that argument and held the "requisite nexus for requiring an out-of-state seller [the Society] to collect and pay the use tax is not whether the duty to collect the use tax relates to the seller's activities carried on within the state, but simply whether the facts demonstrate 'some definite link, some minimum connection between (the State and) the person … it seeks to tax.'"[48] The Court went on to state that [b]y decoupling any notion of a transactional nexus from the inquiry, the *National Geographic* Court in fact repudiated the free trade rationale of the *Bellas Hess* majority." Justice White's characterization of the holding of *National Geographic* was not an adoption of the rationale of *Bellas Hess* but rather the *National Geographic* Court "politely brush[ed] it aside."[49]

In reasoning as relevant to e-commerce today as it was to mail order business two decades ago, Justice White stated:[50]

> Even were there to be such an independent requirement under the Commerce Clause, there is

[46] *Id*. at 327.
[47] 430 U.S. 551 (1977).
[48] *Quill*, *supra* note 6, at 324 (citing *National Geographic*, *id*. at 561).
[49] *Id*. at 324.
[50] *Id*. at 327-328.

no relationship between the physical-presence /nexus rule the Court retains and Commerce Clause considerations that allegedly justify it. Perhaps long ago a seller's "physical presence" was a sufficient part of a trade to condition imposition of a tax on such presence. But in today's economy, physical presence frequently has very little to do with a transaction a State might seek to tax. Wire transfers of money involving billions of dollars take place every day; purchasers place orders with sellers by fax, phone, and computer linkup; sellers ship goods by air, road, and sea through sundry delivery services without leaving their place of business. It is certainly true that the days of the door-to-door salesperson are not gone. Nevertheless, an out-of-state direct marketer derives numerous commercial benefits from the State in which it does business. These advantages include laws establishing sound local banking institutions to support credit transactions; courts to ensure collection of the purchase price from the seller's customers; means of waste disposal from garbage generated by mail-order solicitations; and creation and enforcement of consumer protection laws, which protect buyers and sellers alike, the former by ensuring that they will have a ready means of protecting against fraud, and the latter by creating a climate of consumer confidence that inures to the benefit of reputable dealers in mail-order transactions. To create, for the first time, a nexus requirement under the Commerce Clause independent of that established for due process purposes is one thing; to attempt to justify an anachronistic notion of physical presence in economic terms is quite another…. The majority clings to the physical-presence rule not because of

> any logical relation to fairness or any economic rationale related to principles underlying the Commerce Clause, but simply out of the supposed convenience of having a bright-line rule.[51]

His dissent also points out, and rightfully so, that the physical-presence requirement to establish substantial nexus for the dormant Commerce Clause creates an interstate commerce shelter for one form of business—mail-order sellers—but no countervailing advantage for its competitors.[52] It creates unfairness among retailers. One can argue that this sales/use tax advantage in large part has created a growth in mail-order and Internet retail sales to the disadvantage over brick and mortar retailers, which as a significant payer of property taxes should be favored to assist municipalities to fund governmental services. Finally, he rejected the majority's argument that *Bellas Hess*' bright-line test should be retained under the doctrine of *stare decisis* and that changing the law should be left to Congress. He argued that the physical presence test could no longer be rationally justified and that the Supreme Court should not wait on Congress to correct an unfair law.[53] He concluded that "[t]he Commerce Clause aspect of *Bellas Hess*, along with its due process holding, should be overruled."[54]

Quill remains a very strong precedent today. No federal appellate court has ruled against it on the physical presence bright-line rule. There is no law suit on appeal that is heading to the Supreme Court for the Court to reconsider its holding. The last major section of the paper will discuss arguments that may be made in an effort to overturn *Quill*, but Justice White's dissent is a sound place to start.

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[51] *Id*.
[52] *Id*. at 330.
[53] *Id*. at 331-333.
[54] *Id*. at 333.

III. INTERNET TAX FREEDOM ACT—PROTECTING THE INTERNET

In response to the development of the Internet and the state and local governments' desire for new taxes, Congress has chosen to limit state and local governments' ability to tax the Internet. However, this restriction is limited. Understanding of Congressional attitudes and political strategy may be more revealing about the Internet Tax Freedom Act of 1998 (ITFA).[55] The ITFA has been extended several times to prevent it from lapsing. The last extension was in 2007 which extended the Act to 2014.[56] Presently, there is a bill in committee in the 111th Congress that would make the Internet Tax Free Act Amendments Act of 2007 permanent.[57]

The ITFA is actually a moratorium on state and local taxes on Internet access fees.[58] Contrary to popular opinion, it does not prevent state and local sales or use taxes to be collected by states. These taxes were authorized before the ITFA was enacted. Furthermore, they are not "multiple or discriminatory taxes on electronic commerce."[59] The ITFA defines "multiple or discriminatory taxes on electronic commerce" as any state or local tax on electronic commerce that is not generally imposed and legally collectible by such state or local taxing authority on transactions involving "similar property, goods, services, or information accomplished through other means."[60]

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[55] Pub. L. No. 105-277, 112 Stat. 2681 (1998), 47 U.S.C. § 151.
[56] Internet Tax Freedom Act Amendments Act of 2007, Pub. L. 110-108, 121 Stat. 1024 (2007), 47 U.S.C. § 151.
[57] *See* Permanent Internet Tax Freedom Act of 2009, S. 43, H.R. 1560, 111th Congress, 1st sess. (2009).
[58] ITFA, *supra* note 55, at § 1101(a)(1).
[59] *Id*. at § 1101(a)(2).
[60] *Id*. at § 1104(2).

In passing the Act Congress included its wishes to protect the Internet. The Sense of Congress states that "the President should seek bilateral, regional, and multinational agreements to remove barriers to global electronic commerce through" various important trade organizations and trade agreements. Furthermore, the Sense of Congress states negotiating objectives of the United States which shall be "(1) to assure that electronic commerce is free from (A) tariff and nontariff barriers; (B) burdensome and discriminatory regulation and standards; and (C) discriminatory taxation."[61] This indicates an unwillingness to allow states to tax the Internet and to grant the states their full sovereignty under federalism. Why did Congress pursue this policy regarding taxation of the Internet? ITFA reflects a strong free-market philosophy and the political restraints associated with the political fear of being labeled "a tax and spender". [62] As states and localities have been limited in their ability to tax the Internet to find new revenues from a growth telecommunications industry, the ITFA and the Congress have contributed to state and local government financial hardships.

IV. RESPONSES TO *QUILL*

There have been several significant responses by state legislatures and state courts that have ameliorated, at least to some degree, the effect of *Quill* on state and local sales tax revenues. First, like a boxer whose strategy is counterpunching, a number of states have passed new sales/use tax legislation that redefines what commercial sales transactions are taxable and who may be defined as a vendor subject to collection and remittance of sales or use taxes. Second, state courts, notably in California and New York, relying on notions of agency and the legal proposition that one cannot do indirectly what one cannot do directly, have decided a

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[61] *Id*. at § 1203(a) and (b).

[62] *See* Eric Menhart, *Taxing the Internet: Analyzing the States' Plan to Derive Online Sales Revenue*, J. ST. TAX'N. Jul.-Aug. 2007, at 23, 29.

few state sales/use tax cases since *Quill* resulting in liability of out-of-state Internet vendors for the collection and remittance of use taxes. Finally, a collective effort of a substantial number of states is in progress through the Streamlined Sales Tax Project ("SSTP"), which is aimed at encouraging the Supreme Court to overrule *Quill* or having Congress pass legislation allowing SSTP states to collect sales or use taxes from out-of-state seller. The first two of these responses will be discussed together followed by discussions of the SSTP and value added taxation on international companies selling in the European Union.

A. Expanding the Physical Presence Notion through Legislative and Judicial Means

Given the physical presence bright-line rule of Bellas Hess, reaffirmed in Quill, states have few avenues to force out-of-state vendors, usually Internet vendors, to collect and remit state use taxes. If what is regarded as "physical presence" could be broadened but still meet the substantial nexus requirements, for example, without being substantial, then a state could force a remote seller to collect use tax and state revenues would increase significantly. The vague language found in the *Bellas Hess* line of dormant Commerce Clause cases and stated in *Quill* that physical presence, which would allow a state to compel a vendor to collect sales or use tax, "may turn on the presence in the taxing State of a small sales force, plant, or office"[63] became important in drafting state sales/use tax legislation. The following will consider three successful attempts by California and New York that at least temporarily resulted in victories for the states against remote Internet vendors. It should be noted, however, that Internet vendors tend to change their marketing strategies to combat the states' imposition of use tax collection once they have lost in court. These firms recognize that they have a price advantage over in-

[63] *Quill*, *supra* note 6, at 315.

state "brick-and-mortar stores and this is a salient product characteristic they do not want to lose.

B. Orvis Company— Level of Physical Presence Required

The New York Court of Appeals gave a broad interpretation to dormant Commerce Clause, and in particular, to the notions of "physical presence" in *Orvis Co., Inc. v. Tax Appeals Tribunal of the State of New York*.[64] The Court reversed the Appellate Division of the Supreme Court which had held that New York could not require an out-of-state seller to collect use tax unless the seller has a "substantial" physical presence in New York.[65]

In *Orvis*, a Vermont firm was ordered by the New York State Commissioner of Taxation and Finance to collect use taxes from its New York mail-order retail customers. In 1981, Orvis was a vendor of retail and wholesale outdoor clothing and sport products. Its retail sales were almost entirely through mail-order catalogs purchases shipped from Vermont to retail customers using common carriers or U.S. mail. In its wholesale operations Orvis employees visited New York retailers to make sales calls, with approval of all sales in Vermont. Its annual New York sales activity was about $1 million to $1.5 million of which wholesale orders represented about 15 percent to 9 to 16 New York customers. Orvis also extended credit to New York wholesale purchasers. Orvis claimed that its employees had only made 12 visits to New York over a three-year audit period.[66] Orvis argued

[64] 86 N.Y.2d 165 (1995).
[65] *Id*. at 169-170. The facts in this case, as discussed herein, omit those facts pertaining to a companion case but included in the *Orvis* opinion. It issue was the same as with Orvis Co., Inc. and involved a Vermont software company that sold computer software to New York customers. The Vermont software developer's employees made several visits to New York for customer support. The Court held that this also constituted physical presence in the state.
[66] *Id*. at 169 and 179.

that its activity within New York was of such a small amount unrelated to its retail operations that it failed to reach a "substantial" threshold for physical presence required for substantial nexus under the dormant Commerce Clause. The lower court concluded that Orvis' "sporadic activities in New York" failed to meet the substantial physical presence standard and invalidated the tax.[67]

The New York Court of Appeals in reversing the lower court held that *Quill* did not require a substantial physical presence of an out-of-state vendor in order to impose the duty on the vendor to collect use tax from its in-state (New York) customers.[68] The Court reasoned that U. S. Supreme Court cases decided after *Bellas Hess* considered the practical effect of the taxing statute even though the bright-line rule was reaffirmed.[69] The Court concluded that the Supreme Court in *Quill* had reluctantly reaffirmed the bright-line rule in *Bellas Hess* and required some physical presence to support taxation while at the same time endorsing more flexible approach of later Commerce Clause jurisprudence. In this later jurisprudence "the quid pro quo for State taxation could be found in the benefits and protections the State confers in providing for a stable and secure legal-economic environment for a mail-order vendor's substantial marketing efforts aimed at the taxing State."[70] Citing *National Geographic* the Court noted that the nexus with the taxing state did not necessarily have to be related to the activity being taxed but could simply demonstrate some definite link, some minimum connection between the taxing state and the person it seeks to tax.[71] The Court considered a history of U.S. Supreme Court cases that found substantial nexus without a substantial

[67] *Id*. at 169-170.
[68] *Id*. at 170.
[69] *Id*. at 173 (citing *Complete Auto*, *supra* note 28, at 279).
[70] *Id*. at 175.
[71] *Id*. at 174 (citing *National Geographic*, *supra* note 47, at 556).

physical presence in the taxing state.[72] Its reasoning was further based on a practice result that if *Quill* required a substantial physical presence to meet the substantial nexus prong of the *Complete Auto* test, then it would defeat the benefit derived from using the bright-line rule of physical presence. A factual determination would have to be made on a case-by-case basis of the burdens on the vendor and the weighing of all relevant factors to physical presence to see if they reached the demarcation of "substantial".[73] The Court concluded that to meet the substantial nexus prong of the *Complete Auto* four-pronged test under contemporary Commerce Clause analysis, the physical presence required need not be substantial, but it "must be demonstrably more than a 'slightest presence'… And it may be manifested by the presence in the taxing State of the vendor's property or the conduct of economic activities in the taxing State performed by the vendor's personnel or on its behalf."[74]

C. Borders Online—Becoming a Retailer by Using an Agent or Representative

The California Court of Appeals in *Borders Online, LLC. v. State Board of Equalization*[75] narrowly construed the dormant Commerce Clause requirement of substantial nexus and held a remote Internet bookseller had to collect and remit use taxes to the State of California. In 1998 and 1999, the tax years at issue here, Borders Online, LLC (Online) was a Delaware company with its headquarters in Michigan. Online sold books, book accessories, magazines, compact discs, videotapes and similar tangible goods on the Internet, which totaled about $1.5 million to California purchasers. Online did not own or lease any property or have any employees or bank accounts in California during 1998 and 1999.

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[72] *Id*. at 177.
[73] *Id*.
[74] *Id*. at 178.
[75] 129 Cal. App. 4th 1179 (2005).

Online and Borders stores, which were distinct separate companies, they were owned by a common parent, Borders, Inc. (Borders) A policy of Borders allowed customers to exchange items purchased from Online or receive a credit card refund at Borders stores. Merchandise purchased from Online that was returned to Borders stores was absorbed into Borders' own inventory or disposed of by Borders. Borders stores did not charge Online for accepting the returns. Borders and Online also engaged in incidental cross-marketing practices to benefit the Borders brand. Borders operated stores in California. Employees of Borders stores were encouraged to refer customers to Online.[76]

The State of California collects a use tax "on the storage, use, or other consumption in [the] state of tangible personal property purchased from any retailer . . . for storage, use, or other consumption in [the] state."[77] If a retailer is "engaged in business" in the State, it is required to collect and remit a use tax.[78] The tax statute defines a retailer engaged in business as "[a]ny retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property."[79]

In 1999, Online was ordered by the Board of Equalization by letter to collect and remit use taxes on all sales to California purchasers because of Online's affiliate Borders stores acted as Online's agent by accepting returned merchandise and this act constituted selling for purposes of the statute. The Board broadly construed "selling" to include "all activities that are an integral part of making sales."[80]

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[76] *Id*. at 1189.
[77] CAL. REV. & TAX § 6201.
[78] *Id*. § 6203(a).
[79] *Id*. § 6203(c)(2).
[80] *Borders Online*, *supra* note 75, at 1186.

Online filed suit in California seeking a refund and took the position that under *Quill* it was not subject to collect and remit California use taxes. The trial court issued summary judgment for the State in holding that (1) Online was subject to the tax based on Online's merchandise return policy which constituted having agents in the State to effectuate Online's return policy and (2) imposition of the tax on Online did not violate the Commerce Clause as Online had a sufficient physical presence in California to support a finding of "substantial nexus".[81]

On appeal, the California Court of Appeals affirmed the trial court's decision. Online argued that Borders stores were not agents of Online, that Online did not intend for them to act as agents, that the return policy was also Borders' policy, and that a four-factor test to determine the existence of an agency relationship should be applied, and that test included the ability of the agent to alter the legal relationships of the principal. The Court rejected the argument that it had to apply the four-factor test as a bright-line test. The Court noted that an agency relationship could be based on conduct and circumstances, as well as ratification by the principal of the agent's act.

The Court cited *Scholastic Book Clubs, Inc. v. State Board of Equalization*[82] in which the Court had found an agency relationship had existed between the appellant-out-of-state mail-order vendor of children's books and school teachers who received the vendor's book catalogs, distributed the offer sheets to the students, and forwarded orders to the vendor. The mail-order vendor had argued that no agency relationship existed with the teachers, but the Court found an agency relationship based on apparent authority from the facts that the vendor had accepted the orders and the payments, and had shipped the merchandise, all of

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[81] *Id*. at 1187.
[82] 207 Cal. App. 3d 734 (1989).

which was a ratification of the acts of the teachers and confirmation of their authority as the vendor's agents or representatives.[83] By accepting Online's merchandise for return pursuant to Online's return policy, Borders acted on behalf of Online as its agent or representative in California.[84]

The second reason the Court gave for concluding the tax statute applied to Online was that Online's return policy constituted "selling" in the State under the statute. As selling was defined broadly by the California legislature, and giving "selling" its common usage, the Court concluded that the authorization of remote sellers to allow in-state persons to receive merchandise returns on behalf of the remote seller constitutes an integral part of the remote seller's selling efforts.[85] The Court rejected Online's narrow definition of "selling" as "the act of making a sales transaction". Thus, under Online's definition of "selling", an agent would only count if it was actively involved in the solicitation or the transaction itself.[86] The Court also focused on the fact that the return policy was Online's policy intended to benefit Online and to induce sales in California. Logically, Online's return policy would give greater confidence to California consumers of Online's operations since the return, exchange, or refund could be affected locally at one of Borders' stores. In concluding that the return policy was an integral part of Online's selling in the State, the Court noted that the return made the sale more attractive, convenient, and gave trustworthiness to the seller, all of which is important in the context of e-commerce.[87] Finally, the Court reasoned that Online's policy of allowing California customers to receive a store credit at Borders for merchandise returns also was

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[83] *Id*.
[84] *Borders Online*, *supra* note 75, at 1191.
[85] *Id*. at 1193.
[86] *Id*.
[87] *Id*. at 1195.

contemplated in the statutory definition of "sale" for sales tax purposes.

In construing *Quill* and the bright-line test of physical presence for substantial nexus to satisfy the Commerce Clause, the Court broadly construed what constitutes substantial nexus between a taxing state and a remote seller. The Court cited an earlier case, *Tyler Pipe Industries v. Dept. of Revenue*[88], in which the U.S. Supreme Court stated that "the crucial factor governing nexus is whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for the sales."[89] In assessing whether the out-of-state seller had employees or agents within a state to meet the physical presence test, the California Court of Appeals took a more liberal position as to what constitutes an agent of the out-of-state seller. Consistent with Justice White's dissent in *Quill*, the Court stated:

> The pivotal question when testing a state's taxing authority against the dormant commerce clause is not whether the foreign company has agents soliciting sales in the state. The question, rather, as articulated in *Tyler Pipe*, is whether the activities of the retailer's in-state representatives are 'significantly associated with [its] ability to establish and maintain a market in [the] state for the sales.[90]

Finally, the Court reviewed recent cases that considered the substantial nexus requirement of the dormant Commerce Clause to

[88] 483 U.S. 232 (1987).
[89] *Id*. at 250.
[90] *Borders Online*, *supra* note 75, at 1197.

state taxation of out-of-state sellers.[91] The Court applied the reasoning of the New York Court of Appeals in *Orvis* as it articulated that a substantial physical presence was not required for substantial nexus. It agreed with the *Orvis* Court that such a construction of the dormant Commerce Clause requirement of physical presence in the taxing State was "more in keeping with the realities of 21st century marketing and technology, which increasingly affords opportunities for out-of-state vendors to establish a strong economic presence in California, utilizing California's 'legal-economic environment,' while maintaining only a minimal or vicarious presence here."[92]

D. Amazon.com--New York's Commission-Agreement Provision (/AKA/ Amazon Tax)

New York's tax law requires every vendor in the state to collect sales tax. It defines "vendor" as:

> A person who solicits business either:
> (1) By employees, independent contractors, agents, or other representatives …
> and by reason thereof makes sales to persons within the state of tangible personal property or services, the use of which is taxed by this article.[93]

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[91] *See*, *Town Crier, Inc. v. Department of Revenue*, 733 N.E.2d 780 (Ill. Ct. App. 2000); *Dept. of Revenue v. Care Computer Systems*, 4 P.3d 469 (Ariz. Ct. App. 2000); *In re Appeal of Intercard, Inc*., 14 P.3d 1111 (Kan. 2000); *Dept. of Revenue v. Share International*, 676 So.2d 1362 (Fla. 1996); and *Orvis*, *supra* note 64. For a general review of these cases in applying the physical presence test, *see generally*, Chris Atkins, *Establishing Physical Presence: Borders Online Case Reveals Court Disharmony in Applying Physical Presence Rules to State Sales Taxes,* ST. TAX NOTES, September 26, 2006, *available at* http://taxfoundation.org/research/show/1873.html (last visited Mar. 9, 2010).

[92] *Borders Online*, *supra* note 75, at 190.

[93] NY TAX LAW § 1101(b)(8)(i)(C).

On April 23, 2008, New York amended its sales tax law to add the Commission-Agreement Provision, commonly referred to as the "Amazon tax".[94] The new provision is aimed at requiring out-of-state Internet vendors to collect and remit sales tax when compensation, i.e., a commission or referral fee, is paid to other persons in the State of New York for providing services in soliciting customers, directly or indirectly, in the state, provided the vendor's gross receipts from the state is above a *de minimis* $10,000 amount.[95]

Amazon.com LLC and Amazon Services, LLC (collectively "Amazon") filed suit[96] against the State of New York to have the Commission-Agreement Provision declared unconstitutional, *inter alia*, on grounds that it imposes tax collection obligations on out-of-state entities who have no substantial nexus with New York as required under the dormant Commerce Clause. The State sought to have the lawsuit dismissed and Amazon cross-moved for summary

[94] *Id*., at § 1101(b)(8)(vi), which states:

> [A] person making sales of tangible personal property or services taxable under this article ("seller") shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods . . . This presumption may be rebutted by proof that the resident with whom the seller has an agreement did not engage in any solicitations in the state on behalf of the seller that would satisfy the nexus requirement of the United States constitution during the four quarterly periods in question.

[95] *Id*.

[96] *Amazon.com LLC v. New York State Department of Taxation and Finance*, 23 Misc.3d 418 (N.Y. Sup. Ct. 2009).

judgment.[97] The Supreme Court in New York County, New York dismissed Amazon's suit and cross-motion for summary judgment in holding that Amazon maintained a substantial nexus with the State.[98]

Amazon, as did other Internet vendors in New York, maintained a marketing strategy of having other websites solicit business for Amazon via a "click-through" process. Amazon maintained an associates program which allowed participants (or "associates") to maintain links to Amazon.com on their own websites and Amazon compensated them by paying a percentage of the sales proceeds. In another program Amazon paid a "$12 bounty" for each new enrollee for direct referrals of customers to its Amazon Prime program through website links.[99] Amazon admitted that it received more than the $10,000 in sales receipts by using associates in New York, which constituted less than 1.5 percent of its New York sales.

In finding that Amazon had substantial nexus with New York, the Court rejected Amazon's argument that compensation it paid to its associates was for advertising or that the Commission-Agreement Provision was unfair as it presumed compensation was paid for referrals and specifically targeted Amazon denying it due process and equal protection rights. The Court applied Orvis in concluding that a substantial nexus was not required. Since Amazon had used associates in New York to a degree greater than the $10,000 minimum threshold, there was more than the "slightest presence" in the state.[100] It cited *Scripto v. Carson*[101] for the proposition that an out-of-state's vendor's presence in the state could be by the use of independent contractors to solicit business in the taxing state.

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[97] *Id*. at 420.
[98] *Id*. at 429.
[99] *Id*. at 420-421.
[100] *Id*. at 423-424.
[101] 362 U.S. 207, 209 (1960).

The extent of the direction Amazon gave or did not give its New York associates or the limitations placed on those associates were irrelevant to the inquiry of using independent contractors as solicitors. What mattered was that Amazon chose "to benefit from New York Associates that are free to target New Yorkers and encourage Amazon sales, all the while earning money for Amazon in return for which Amazon pays them commission."[102] Finally, in holding to the notion of fairness of the statute as applied to Amazon, the Court stated:

> Amazon should not be permitted to escape tax collection directly, through use of an incentive New York sales force to generate revenue, when it would not be able to achieve tax avoidance directly through use of New York employees engaged in the very same activities.[103]

With the success in the New York of enacting the Commission-Agreement Provision and passing its first hurdles at the trial court level, several other states have followed New York in enacting a similar provision.[104] It was estimated that the provision would bring New York an estimated $70 million in additional revenues in

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[102] *Id*. at 426.
[103] *Id*. at 427.
[104] *See* N.C. GEN STAT. § 105-164-8(b)(3), which became effective August 29, 2009, and R.I. GEN. LAWS ANN. § 44-18-15, which became effective July 1, 2009. Hawaii's legislature passed its version of the "Amazon tax" bill (H. B. 1405), but the governor vetoed the bill on July 1, 2009. *See* Spinzone, *South Hawaii Tax Internet Sales?*, *available at* http://www.hawaiibusiness.com/Hawaii-Business/August-2009/Should-Hawaii-Tax-Internet-Sales/ (last visited Mar. 9, 2010). As of October 19, 2009, similar legislation has been considered by California, Connecticut, Minnesota, Tennessee, and Wisconsin. Andrew W. Swain, *Is New York's Amazon Tax Law the First of Many?* TAX LAW CENTER, October 19, 2009, *available at* http://law.lexisnexis.com/practiceareas/Insights--Analysis/Tax//Is-New-Yorks-Amazon-Tax-Law-the-First-of-Many/ (last visited Mar. 9, 2010).

fiscal year 2010 and $40 million for New York City in its 2010 fiscal year.[105] These estimates, however, seem excessive, but still impressive and substantial, considering the estimates of sales tax losses in fiscal year 2007 by the New York City Independent Budget Office. Furthermore, Amazon.com and Overstock.com, a firm that lost a similar suit against New York, were reported to have cancelled their associate programs in Hawaii, North Carolina, and Rhode Island following legislative action to adopt "Amazon nexus" sales tax amendments.[106] Another potential problem resulting from New York's victory is the effect that the new strategy using the "Amazon tax" by states may have on the SSTP. If this approach is successful, some states, in particular large states, may forego pursuing the SSTP. It may dampen the push for uniformity in sales tax laws and make Congress more reluctant to authorize collection of sales or use taxes from remote sellers.[107]

E. Streamlined Sales Tax Project

First, in a response to the Supreme Court's preference to have Congress give legislative authorization for states to require remote sellers to collect and remit use taxes, many states initiated the Streamlined Sales Tax Project ("SSTP"). The SSTP is an attempt by the states to standardize their sales and use tax laws and to create computer software for use by remote sellers to reduce the

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[105] Ted Phillips, *supra* note 15.

[106] Jeff Segal, *States fire shots in Internet sales tax war*, CNNNONEY.COM, July 2, 2009, *available at* http://money.cnn.com/2009/07/02/technology/internet_sales_tax.breakingviews.index.htm (last visited Dec. 21, 2009). *See also* H. Jacob Lager, *The "Amazon Tax" Upheld in New York, Enabling State Taxation of Web Sales*, LAWUPDATES.COM, April 8, 2009, *available at* http://www.lawupdates.com/commentary/the_amazon_tax_upheld_in_new_york_enabling_state_taxation_of_web_sales/ (last visited Mar. 9, 2010).

[107] *See* News Briefs, *Court Case May Undermine SSTP*, MANAGING ACCOUNTS PAYABLE, Mar. 2009, *available at* www.AcountsPayable.com (last visited Mar. 9, 2010).

sellers' administrative burden in collecting and remitting sales and use taxes. Although Justice Stevens in *Quill* noted the unreasonable burden of having the out-of-state seller subject to over 6,000 taxing jurisdictions, a number which seems overwhelming, Sean P. Nehill claims that there are now are more than 7,500 taxing jurisdictions.[108] Success of the SSTP will more likely make Congress less hostile to enacting legislation overriding *Quill*.

States have begun to work together to satisfy the Supreme Court's concerns about burdening interstate commerce with state and local sales and use taxes on Internet or mail-order sales. Since the late 1990s and still in progress, the States and the District of Columbia began the Streamlined Sales Tax Project ("SSTP"), the mission of which is to "develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes" for out-of-state sellers.[109] This is a multi-state agreement among a majority of the states (presently, 42 plus the District of Columbia). This process, much like the harmonization of tariffs and efforts to achieve greater transparency in international trade under the General Agreement of Tariff and Trade (GATT) and creates uniform definitions, reduces or limits the number of sales/use tax rates. For instance, states will be allowed one state tax rate for each uniformly defined good, and will be allowed a second tax rate for very narrowly defined goods such as food or pharmaceuticals.[110]

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[108] Walter J. Baudier, *Internet Sales Taxes from Borders to Amazon: How Long before All of Your Purchases Are Taxed?*, 5 DUKE LAW & TECH. REV. 8, note 59 (2006), copied from Sean P. Nehill, *The Tax Man Cometh? An Argument for the Taxation of Online Purchases*, 13 COMMLAW CONSPECTUS 193, 208 (2004).
[109] *See* STREAMLINED SALES TAX GOVERNING BOARD, INC., STRUCTURE AND OPERATING RULES STREAMLINED SALES TAX PROJECT (Adopted March 20, 2000), *available at* http://www.streamlinedsalestax.org/oprules.html (last visited Mar. 26, 2008). *See also*, Mary McLaughlin, *supra* note 1 ; Eric Menhart, *supra* note 62, at 30-32..
[110] Eric Menhart, *supra* note 62, at 30.

There are other significant provisions of the SSTP. First, a retailer would only have to file a tax return with each of the participating states. Each state would have the burden of accounting for and administering compliance and distribution of sales taxes to its municipalities. This will remove the stigma, which is unfairly used as an argument in favor of *Quill*'s holding, of having to potentially comply with such a large number of jurisdictions. Second, participating states have chosen to give amnesty for those retailers who have not in the past collected use taxes on their Internet, phone, or mail-order sales to consumers out of state.[111] Third, there are sourcing rules following a set hierarchy to determine what state is to receive the sales/use tax. Last, the agreement requires each state to participate in the registration of sellers.[112]

F. Costs of Compliance with the SSTP

The SSTP has not developed a computer software program of its own for retailers to use. Retailers have to select from three models to select from in order to remit taxes to the states. These include: (1) a third party agent to collect the tax; (2) a pre-approved software program; and, (3) use a software program of their own if it is approved.[113] The SSTP has four certified service providers that retailers may use. Each of the companies is under contract with the SST Governing Board. These four providers are Avalara,

[111] *Id*. at 31. This amnesty may have played a large role in small and medium-sized companies (1,163 as of September 2009) voluntarily complying with states participating in the SSTP. *See* Madeline Christiansen, *Remote sellers: The tax man cometh?* FEDGAZETTE, Sep. 2009, at 17.

[112] Mary McLaughlin, *supra* note 1.

[113] Jan J. Redpath, Eric M. Redpath & Kathleen Ryan, *Sales and Use Taxation in E-Commerce: Where We Are and What Needs to Be Done*, 24 INFO. SYS. MGMT. 239, 242 (2007) (hereinafter Redpath).

ADP Taxware, Exactor, and Speedtax.[114] The cost of each of these packages varies greatly depending on the needs of the retailer.

While software is available for retailers to use to comply with the SSTP, the costs of compliance are high with the shift from origin-sourcing to destination-sourcing. This is especially true for smaller retailers. A survey conducted by PricewaterhouseCoopers found that compliance costs for small retailers were 0.82 percent of total taxable sales compared to 0.13 percent for large retailers. It was further found that on a national basis the average sales tax compliance cost relative to taxable sales was six times greater for small retailers than for large retailers.[115] Another study conducted by Ernst and Young showed that small retailers' compliance costs would equal 7 percent of the sale tax collected compared to 1 percent for large retailers. They also found that if retailers were forced to collect for all 46 states that collect sales taxes, small retailers would incur compliance costs up to 87 percent compared to 14 percent for large retailers.[116]

As states have signed on to the Streamlined Sales and Use Tax Agreement (SSUTA), difficulties beyond the initial compliance costs have occurred. The SSUTA requires the use of uniform definitions by the states; however, states often have the ability to circumvent these by applying an excise tax on an item excluded

[114] Streamlined Sales Tax Governing Board, *Certified Service Providers*, available at http://www.streamlinedsalestax.org/certifiedserviceprovider.htm. (last visited Jan. 4, 2009).

[115] PricewaterhouseCoopers LLP, *Retail Sales Tax Compliance Costs: A National Estimate*, Volume One: Main Report, Apr. 7, 2006, *available at* www.streamlinedsalestax.org/DOCUMENTS/CostStudy/Cost_of_Collections.html (last visited Jan. 4, 2009).

[116] Robert J. Cline & Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System And Compliance Cost for Multistate Retailers*, Ernst and Young LLP (1999), *available at* http://govinfo.library.unt.edu/ecommerce/document/MastersOfComplexity.pdf (last visited Mar. 11, 2010).

from sales tax under the SSUTA definitions.[117] This would require additional compliance costs for such items. Further complications have occurred in six states—Kansas, Ohio, Tennessee, Texas, Utah, and Washington. These states have a history of using origin-sourcing taxation for local taxation within the state. The adoption of the SSUTA requires a shift to destination-sourcing for local taxation for practical reasons.[118] It would be difficult for retailers to distinguish between local customers and interstate customers using different tax systems. Of these six states, only Kansas and Washington are in full compliance with the SSUTA. The experiences of two states, Washington and Ohio, will be examined.

Washington State came into full compliance with the SSUTA on July 1, 2008 thus switching from origin-sourcing to destination-sourcing. The estimated costs to comply with the new taxing system in Washington were anticipated by many businesses to be high. An internet retailer, OneCall.com, anticipated costs in the tens of thousands in order to integrate all the necessary tax tables. OneCall currently was serving customers in 325 ZIP codes in Washington. The Washington ZIP codes represented only 2.5 percent of OneCall's ZIP codes. Mountain Gear, Inc., a Spokane outdoor equipment company anticipated costs of $100,000 to comply with new system.[119] Washington State is still a full-member of the SSTP and in full compliance with the SSUTA.

Ohio, after adopting the change from origin-sourcing to destination-sourcing, felt forced to abandon compliance with the

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[117] *See*, Joseph D. Henchman, *Testimony before Maryland Legislature on the Streamlined Sales Tax Project*, Feb. 18, 2009, at 3, available at http://www.taxfoundation.org/research/show/24346.html (last visited Mar. 10, 2010).

[118] John Healy & Bruce Nelson, *New Challenges Ahead if the Streamlined Sales Tax Project is to Succeed*, 24 J. ST. TAX'N. 11 (May-June 2006).

[119] Richard Ripley, *Tax-system Change to hit Mid-Size Businesses Hard*, 22 J. OF BUS., at A7 (Aug. 2007).

SSUTA in order to protect its small businesses. Ohio had established a process that would have all retailers in compliance with SSUTA by January 1, 2008. However, the compliance costs to small retailers were significant and pressure was placed on the Ohio legislature. Ohio approached the SSTP with a number of amendments to the SSUTA, in particular, one amendment that sellers with less than $500,000 in sales in a state be given an exemption from tax if the seller did not have a permanent location in that state. This amendment was rejected by the SSTP Governing Board. Following this, Ohio withdrew from the SSUTA and returned to origin-source taxation.[120]

The costs of compliance on the part of retailers, especially small retailers, are a significant obstacle for further compliance to the SSTP. This is evidenced by only 19 states being in full compliance with the SSTP and only an additional three states anticipated being in full compliance by July 1, 2009. The SSTP will find it necessary to consider amendments to the SSUTA to increase the flexibility of the agreement and increase participation by more states.

V. THE EUROPEAN UNION APPROACH TO VALUE ADDED TAX

The U.S. could adopt the European approach to taxing Internet sales of digitally transmitted goods and services consumed in the EU.[121] The EU's approach is instructive and has elements similar to the SSTP and SSUTA. A value added tax ("VAT") is a tax

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[120] Nicholas Hahn, *Sourcing and the Streamlined Sales Tax Project*, 26 J. ST. TAX'N 27 (2008).

[121] *See generally*, IBLS Editorial Staff, *Internet Law—EU Special VAT Registration Scheme for Non-EU Businesses*, IBLS INTERNET LAW—NEWS PORTAL, May 2, 2007, *available at* http://www.ibls.com/internet_law_news_portal_view.aspx?id=1746&s=latestnews (last visited Feb. 22, 2010).

imposed on the supplier of goods and services and is regarded as a consumption tax. It is a tax on "value added" each time inputs are sold (i.e., material supplies, manufactured product, wholesale, and retail). The VAT is usually charged to the buyer. Whereas VAT has been applicable on goods sold in the EU by EU merchants or imported into the EU, it was not until 2003 that the EU enacted Council Directive 2002/38/EC that taxed digital transmissions of goods and services. Before the directive became effective on July 1, 2003, those goods and services transmitted digitally were escaping VAT in a manner like sales and use taxes escape taxation in the U.S.[122] Exact obligations under the directive depend on whether the seller has a place of business in the EU and whether the sale is business-to-business (B2B) versus business-to-consumer (B2C) or EU seller versus non-EU seller of these digital services. Business-to business sales are to be accounted for on VAT returns of the purchaser under a reverse charge (self-assessment) mechanism, with no obligation to the seller. Business-to-consumer sales by EU suppliers are responsible for collecting the proper amount of VAT for the supplier's home state and remitting the VAT to supplier's home state VAT authority. The EU state in which the EU supplier is registered will send the applicable amounts to the states where the EU purchasers reside. VAT rates vary with each EU member state and range from 15 percent to 25 percent.[123]

The directive requires non-EU suppliers of digital services to register with a single VAT authority in one of the EU member

[122] *See* WilmerHale, *Value Added Tax (VAT) on Online Sales in the European Union*, May 28, 2003, *available at* http://www/wilmerhale.com/publications/whPubsDetail.aspx?publication=1945 (last visited Feb. 22, 2010).
[123] *Id*. *See also* E-Commerce – Taxation and Customs Union -- European Commission, *Frequently asked questions*, *available at* http://ec.europa.eu/taxation_customs/taxation/vat/traders/e-commerce/article_1610_en.htm (last visited Feb. 22, 2010).

states of the supplier's choice. There is a threshold for mandatory registration. Annual sales by non-EU suppliers to EU non-business customers must not exceed €100,000 to avoid registration.[124] The non-EU suppliers in B2B sales do not need to collect any VAT from the purchaser due to self-assessment of VAT by EU businesses. When non-EU suppliers with no EU affiliate make B2C sales, the supplier must collect the appropriate amount of VAT from the EU purchaser. The VAT for the purchase will be the proper amount for the purchaser's state of residence. If a non-EU supplier establishes an EU subsidiary, however, and usually one in a low VAT rate country, the non-EU supplier in B2C sales will charge the VAT rate in the state where the EU subsidiary is located. It has become a vehicle for some competitive advantage.[125] The VAT authority in the EU state of registration will be the single administration for the non-EU supplier to file the VAT return and remit the VAT. The registrant's state will handle allocating the VAT to the EU states of the supplier's purchasers. The directive provides a benefit of a single point of contact for the entire European Union with a set of simplified, harmonized tax obligations, a streamlined set of obligations. The new directive has elements of SSTP but is more harmonized and simplistic than the SSUTA.

States should argue that U.S. remote sellers should be treated the same as U.S. Internet retailers that sell digital goods and services to the European Union.[126] Domestic and foreign sellers in the E.U.

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[124] European Union, *Proposed amendments to the VAT treatment of electronically delivered services frequently asked questions*, July 6, 2000, at 2, *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/00/31 (last visited Feb. 22, 2010).

[125] *See* WilmerHale, *supra* note 122, at 2-3.

[126] *See generally* Veronique de Rugy, *U.S. Companies Become EU Tax Collectors*, BUDGET&TAX NEWS, Dec. 1, 2003, *available at* http://www.heartland.org/policybot/results/13768/US_Companies_Become_EU_Tax_Collectors.html (last visited Mar. 9, 2010).

must register with the European taxing authorizes to be able to charge, collect, and remit VAT for their sales. EU tax authorities consider such a tax policy imposing the tax burden on non-EU sellers fair because it places foreign goods under the same tax standards assigned to EU products. Under Council Directive 2002/38/EC physical presence is not a requirement for obligating the collection of VAT on goods sold to or used by EU residents.[127]

VI. OPTIONS AND ARGUMENTS FOR THE STATES

It is obvious that the status quo is unacceptable. Unless the negative effects of *Quill* are reversed, substantial pressure will be placed on state and local legislatures such that they will be forced to have to restructure their sales tax regimes or increase tax rates to substantially increase property and/or income taxes. While it could be argued that this would result in greater equity given sales taxes are generally more regressive than either property or income taxes, it would not alleviate the inequity as it pertains to taxing sales transactions by brick-and-mortar stores but not out-of-state Internet vendors' transactions in the state. The following are options for the states and arguments that may be made to achieve a desired end to the *Quill* effect. Again, the most obvious desired result is having the Supreme Court overrule *Quill*, with having Congress enact legislation that would allow states to tax Internet sales as a desirable alternative. To that end, the following represent arguable positions for state and federal legislative action and legal arguments for judicial action.

[127] Martha L. Arias, *Internet Law – Do Non-European Merchants Have to Collect Value Added Taxes?*, IBLS INTERNET LAW – NEWS PORTAL, *available at* http://www.idls.com/internet_law_news_portal_view_prn.aspz?s=latestnews&id=1999 (last visited Mar. 25, 2008).

A. Proceed with the SSTP

States should proceed quickly in implementing all facets of the Streamlined Sales Tax Project. To the degree possible, member states need to make the SSTP more cost efficient, transparent, and harmonized to maximize its appeal to Congress and the Supreme Court, should the Court take up the physical presence test for substantial nexus again. A workable *de minimis* threshold must be adopted to reduce the burden on small Internet and mail order vendors. Affordable, reliable, and effective software for processing transactions by Internet and mail order sellers must be found from enough software developers to allow for price competition. This is imperative even if the states have to underwrite a substantial part of the costs and provide the software and its maintenance to small vendors. States should show a willingness to provide less administrative burden in terms of administrative labor computing costs on remote sellers by having an exception or exclusion from filing by small sellers (i.e., a small number of low-dollar transactions) and underwriting some or all of the cost of the computer software for small retailers.[128] The eBay.com vendor should be considered when establishing the threshold. There are so many of them, and eBay.com as an Internet marketing vehicle is constantly growing.

One study of Pennsylvania small business owners and experts in market research and small business management revealed that respondents were concerned about sales taxation of Internet sales. They wanted (1) the tax rules to be standardized across the country, (2) tax collection to be simplified and (3) mail and telephone orders also to be taxed.[129] Their concerns also reflect the concerns of the Supreme Court and Congress in terms of fairness

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[128] *Id*. at 32.

[129] Prashanth Nagendra Bharadivaj & Ramesh G. Soni, *E-Commerce Usage and Perception of E-Come Issues among Small Firms: Results and Implications from an Empirical Study*, 45 J. SMALL BUS. MGMT. 4:501-521, at 511 (2007).

and cost-burden. The key cannot be over stressed: the burden in operational costs in time and money must not be substantial on the vendors.

The time frame for getting the SSTP operational is important because, the longer it takes to get it fully operational with the significant problems resolved, the longer it will take Congress to give proper consideration to passing legislation allowing member states in the SSTP to apply sales and use tax laws to out-of-state Internet companies. If the SSTP is successful, much of the argument by the majority in *Quill* will be defeated. Reducing the large number of taxing jurisdictions with different tax rates has been a laudable goal, but it appears that it is one not fully achievable due to lack of political will.[130] Presently, there remain simply too many taxing jurisdictions under the SSTP to make voluntary compliance by remote vendors appealing. States must be careful not to circumvent the SSUTA by adding new forms of consumption taxes, such as "excise" taxes on the sale of a certain product or service, and complicating tax compliance with an additional new tax return.[131]

Even with the problem of maintaining a large number of taxing jurisdictions with different tax rates under the SSTP, there has already been some progress in voluntary compliance by remote sellers. The number of out-of-state vendors collecting sales or use taxes is increasing, and the collections are trickling in slowly. This is in large part due to the tax amnesty provision offered by member states. As of September 2009, Minnesota received the most revenue from the SSTP initiative of the member states in the Ninth Federal Reserve District, collecting $11 million in 2008 and up from $1.5 million in 2006.[132]

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[130] *See generally* Henchman, *supra* note 117.
[131] *See* Redpath, *supra* note 113, at 243. *See also*, Henchman, *id*. at 3, which discusses Minnesota's separate "fur tax" on fur sales.
[132] Christensen, *supra* note 111.

B. Seek Assistance from Congress for Legislation

States should aggressively lobby Congress to change the political objection to allow them to impose sales or use tax collection and remittance obligations on out-of-state vendors selling goods and services in the state. Since persons in the Congress are reluctant to vote for almost any tax increases, it may be difficult to persuade Congress to act in the states' best interest in this regard. Congress should consider Joseph Sneed's criteria for sound tax policy[133] in considering whether or not to enact legislation and the scope of legislation. Some of these criteria, which are as relevant to state sales taxation as they are to income taxation, are (1) administrability of the tax regime, (2) equity in terms of supporting progressivity rather than regressivity, (3) equity in terms of groups to which the law applies or exemptions are given, (4) promotion of free market principles and competition, (5) adequacy of tax revenues, and (6) political feasibility.[134]

Congress must accept that States are limited in their ability to raise revenues and that state sales tax revenue has been reduced by increased usage of e-commerce by businesses and consumers. As has been discussed, the economic data reveals that e-commerce is a valid concern and a growing problem to states. The current severe economic recession and the state budget deficits reflect this. The huge federal grants that Congress has made to state and local governments reflect, at least temporarily, Congress' understanding of the need for greater sales tax revenue. It may be argued that the

[133] *See* Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REVIEW 567 (1965).

[134] *See* S. P. Horn, *Taxation of E-Commerce*, 2 J. AM. ACAD. BUS. 329 (2003). Horn provides the following characteristics of a good sales and use tax system: (1) neutrality, (2) efficiency, (3) certainty and simplicity, (4) effectiveness and fairness, and (5) flexibility. These are similar in effect and application to Sneed's criteria; thus, the authors use variations of both versions in their analysis hereinafter.

federal government as a matter of policy should not encourage consumption via Internet purchases, where sales or use taxation is avoided, while at the same time subsidizing states for revenue lost directly to those Internet purchases.

Remote vendors, Internet and mail order, should pay their fair share for the benefits they derive from doing business in a state. The notion of paying one's fair share to avoid free-loading has been adopted by all three branches of federal government. For example, a non-union worker is required to contribute a proportional cost for services provided by a union in negotiating collective bargaining agreements with the employer. The non-union employee will benefit from the union's activity. Similarly, Congressional legislation and administrative regulations have followed a general policy that those seeking administrative or technical services from the federal government should pay a user fee when there is wherewithal to pay--effectively, a consumption tax. This is the case, for example, when tax determination letters are requested. Internet vendors purposefully avail themselves of the benefits and privileges of the state where they market their goods and services. These public goods make the vendors' marketing possible, including legal protection, collection means, infrastructure for making the transaction and fulfilling warranty obligations, etc. These Internet vendors are consumers of public goods and services, and they should suffer the administrative burden of sales/use tax collection and remittance to the states. Justice demands it.

Congress should enact a sales tax authorization law that is just and equitable. Goolsbee and Zitrain[135] found the inequity in giving a price advantage to Internet vendors (through preferential tax policies) also benefits persons more well-off than those of lesser

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[135] Alan Goolsbee & Jonathan Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, 52 NAT'L TAX J. 413 (1999).

means. The average Internet user has almost two more years of education and $22,000 more family income than the average nonuser.[136] If online purchases are not taxed, anyone with enough money to buy a computer can avoid sales tax, while less well-off individuals cannot. This creates greater regressivity of sales tax than even for local shopping where all citizens are taxed. Inequity can also be found in the marketing process. Persons, who are not financially well-off, such as economically disadvantaged persons, generally do not have use of a credit card or usable bank debit card. A credit card or debit card is usually a necessity for online purchasing. Since some persons have access to the Internet but no access to a credit or debit card, those persons cannot benefit from sales tax avoidance by shopping on the Internet. This also is inequitable. Obviously, within both sets of these groups there may be subgroups, for example well-off senior citizens, who may not have skills to use the Internet, and they could also not benefit from tax avoidance. Access to the Internet has been growing year-to-year; thus, inequity resulting from lack of Internet access is becoming less significant.[137]

Whereas Judge Learned Hand in *Helvering v. Gregory*[138] stated his famous tax proposition on tax avoidance,[139] Congress does not have to place its imprimatur on sales tax avoidance by disregarding state request for legislation to stop it. Internet shoppers have been shown to strategically use the Internet to avoid sales taxes and

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[136] *Id*. at 420.
[137] *Id*.
[138] 69 F.2d 809 (2d Cir. 1934).
[139] *Id*. at 810-811. The following is often cited for the freedom of taxpayers to use any legal means available under the law to avoid taxation:

> We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one chooses, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

those shoppers tend to be better educated and more affluent. Using data from the Current Population Survey for the years 1997 to 2001, Ballard and Lee found results to be consistent with the interpretation that Internet shopping, cross-border shopping, and home-county shopping are substitutes.[140] Consumers use Internet shopping to avoid sales taxes. Consumers who live in counties adjacent to counties with lower sales taxes are less likely to shop via the Internet. They found these determinations to be evidence of cross-border shopping.[141] Other studies of shopping on the Interest reveal consistent findings, more or less. Goolsbee found that Internet purchases are highly sensitive to sales taxes, with tax-price elasticity in the range of two to four.[142] The probability of buying something online grows as the local sales tax rate rises (a positive co-efficient). Alm and Melnik found similar results but with a substantially lower tax-price elasticity of 0.5.[143]

The present state of law in which out-of-state vendors are not subject to sales or use tax collection creates a discriminatory effect in favor of Internet and mail order companies against brick-and-mortar stores. This discriminatory effect, when combined with the fact that tax-price elasticity exists and consumers do shop on the Internet to avoid sales tax, goes contrary to the notion of interstate commerce protection. Sales tax policy should be transparent and be evenly applied in the market. Policy should encourage free competition and remain neutral, unless, of course, utilitarian principles can explain the need for tax preferences. That is not the case now. From a purely economic analysis, Congress should try

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[140] Charles L. Ballard & Jaimin Lee, *Internet Purchases, Cross-Border Shopping, and Sales Taxes*. 60 NAT'L TAX J. 711 (2007).
[141] *Id.* at 712.
[142] *Id*. at 712-713. *See also* Austan Goolsbee, *In a World without Borders: The Impact of Taxes on Internet Commerce*, 115 Q. J. ECON. 561, 566 (2000).
[143] Ballard & Lee, *supra* note 140, at 713.

to optimize any tax preferences it gives. Zodrow[144] considered whether preferential sales tax treatment is preferable for electronic commerce. Using a modified version of the standard single-period optimal commodity taxation model with fixed producer prices, Zodrow concluded it is generally more optimal to tax electronic commerce using tax rates for traditional goods and using a uniform sales tax system like the SSTP or a more radical system proposed by economist Charles E. McLure, Jr..[145]

Congress should not take a cowardly position and be reluctant to authorize states to tax their citizens. Timidity towards being labeled a "tax and spender" should not impede Congress from enacting a law that effectively restores, at least to some degree, state sovereignty over taxation. The sales or use tax is not a tax on the seller; it is a tax on the consumption of goods and services. Congress should encourage brick-and-mortar stores rather than online sellers. It is the ***state*** legislature that is taxing its citizens—not the Congress. Congress would simply be authorizing the state of the purchaser to impose administrative duties, with some adherent legal risks, on the remote sellers. An argument by some in Congress or persons in the e-commerce sector that the Internet should be encouraged to grow ignores the progress that has already been made in e-commerce brought about, to a significant degree, by its tax preference for remote sellers both here and in the EU. Federal legislation would result in free market competition where transactional costs allow consumers to weigh cost factors against

[144] George R. Zodrow, *Optimal Commodity Taxation of Traditional and Electronic Commerce*, 59 NAT'L TAX J. 7 (2006).
[145] *Id*. at 28-29. Charles E. McLure, Jr. maintained a theory that, although the SSTP was a good start, it was not optimal and was still excessively complicated. His proposal, simply stated, is to tax Internet sales like sales from local merchants at the same tax rates and exempt all sales to business from sales taxation. *See* Charles E. McLure, Jr., *Thinking Straight about the Taxation of Electronic Commerce: Tax Principles, Compliance Problems, and Nexus*, in 16 TAX POLICY AND THE ECONOMY 115 (James M. Poterba, ed. 2002).

personal preferences in shopping, both Internet vendors and brick-and-mortar stores having both advantages and disadvantages.

There are substantial social and economic benefits to supporting local businesses and this should be encouraged through greater equity in sales tax law. Brick-and-mortar stores pay property and sales taxes to the local community which provides public goods. To the extent these traditional stores are owned by local business persons, these business owners and managers make substantial charitable contributions from their profits or income which contributions more often are spent locally. Local firms hire local citizens and a greater economic multiplier exits for the community. When citizens make purchases from remote Internet vendors, it is the equivalent of an immigrant repatriating a large portion of his or her income for relatives in his or her home country. The local economy is not benefited. When citizens purchase goods and services locally, the locality is theoretically benefited from compliance with the social compact in which citizens to look out for one another and the collective all. Finally, if the federal government in this recession is trying to stimulate the economy of a state, it is not rational to encourage purchasing from remote Internet vendors by giving a price advantage due to avoidance of sales taxes. This would be analogous to Congress enacting comprehensive environmental legislation with a promise of an expansive, new green economy without taking away the incentive of the business community to import new environmental-friendly technology and materials. The business community in such a case undeterred would purchase those goods and services for the green revolution from low-cost foreign sources, like China.[146]

[146] Another analogy may be drawn from Congress' 2009 Cash for Clunkers Program which tended to benefit foreign automobile manufacturers more than the Big Three, Ford, General Motors and Chrysler. The Department of Transportation reported that the top three car types were foreign vehicles, with the biggest seller being the Toyota Corolla and only two American-made car types made it onto the top-ten list. *See* Kevin Gassman, *Cash for Clunkers*

Could Congress provide an incentive to shop locally and stimulate the local economy by quickly enacting the desired sales tax authorization? Probably, yes. Goolsbee found that by applying existing sales tax rates to the Internet, this would reduce the number of buyers online from 20 to 25 percent and reduce total online sales from 25 to 30 percent.[147] This works, in part because of the tax-price elasticity discussed earlier.

States should be allowed to tax international suppliers consistent with the E.U. VAT policy. The federal government could not establish a federal consumption tax (VAT or sales tax) applied to foreign imported goods and services only. To do so would violate the non-discrimination and national treatment principles of The General Agreement on Tariffs and Trade (GATT) and the General Agreement of Trade in Services (GATS). However, Congress could even handedly allow the states to tax sales of goods and services from foreign sources as long as the foreign sellers were treated no worse than in-state sellers. Probably, these foreign suppliers could not be made to pay local sales tax or to file local sales tax returns. The lack of transparency and economic burden would simply be too great for foreign suppliers in the U.S. Congress could pass legislation that is similar in effect to the EU Council Directive 2002/38/EU using a comparable threshold amount, say $150,000--$200,000 in annual sales of a foreign supplier to U.S. customers before compliance with state sales tax law would be required.

There have been bills introduced in Congress since *Quill* that would allow States to collect sales and use taxes on remote sellers, but they all have died. For example, Senator Ernest Hollings (D. SC) introduced a bill in the 106th Congress that would have

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Sputters to a Halt: The Aftermath, AMERICANS FOR TAX REFORM, Aug. 31, 2009, *available at* http://www.atr.org/cash-clunkers-sputters-halt-aftermath-a3789 (last visited Mar. 11, 2010).

[147] Reddick & Coggburn, *supra* note 4, at 1035.

imposed a five percent national retail sales tax on Internet sales, but it was rejected by the Senate Finance Committee.[148] Thus far, no broad-based bill has been brought out of committee including the last substantive bill, the Sales Tax Fairness and Simplification Act.[149] The legislation would have granted consent of Congress to the Streamlined Sales and Use Tax Agreement to require remote sellers without a physical presence in the taxing state to collect and remit sales and use taxes to the states and their local taxing jurisdictions. Only those states fully participating in the SSTP would have been able to collect sales and use taxes from out-of-state vendors of goods and services.[150] No similar federal legislation has been proposed in the current Congress. There is, however, a bill presently in committee in the House of Representatives that would be very restrictive on state and local taxing jurisdictions. The bill narrowly defines "physical presence" and legislatively would require physical presence before sales, income, and other forms of taxes could be imposed on vendors.[151] The bill would undo New York's "Amazon tax".

The National Conference of State Legislatures has lobbied Congress without success for legislation to allow state and local governments to collect sales taxes from remote vendors.[152] It would seem that with almost half the states participating in the SSTP, Congress already providing large grants to states during this recession, and with PAYGO, at least in theory, limiting Congress' power to spend, Congress could pass legislation similar to the bill proposed in the 110th Congress.

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148 *Id*.
149 S.34 and H.R.3396, 110th Cong., 1st Sess. (2007).
150 *Id*.
151 H.R. 1083, 111th Cong., 2d Sess. (2009).
152 *Stimulus for Tax Collectors*, WSJ.COM, Jan. 15, 2009, *available at* http://online.wsj/article/SB123198417470484095.html (last visited Dec. 21, 2009).

Assuming Congress would enact some form of relief for states, what approach should Congress take? One approach might be that considered in the 110th Congress, the Sales Tax Fairness and Simplification Act. In that proposed piece of legislation, state and local governments determined what goods and services would be subject to a sale or use tax and the tax rates. Of some significance was the inclusion of a fairly high small business exception threshold amount of $5 million in sales by a vendor and its affiliates, before the vendor would be liable to collect and remit sales taxes on remote sales covered by the SSUTA.[153] The high threshold would alleviate much of the concern that it would place a heavy burden on small sellers. A $5 million threshold would logically facilitate most small eBay vendors.

Another approach might be for Congress simply to establish a single tax rate for those goods and services that would be subject to sales tax. In this case, administration and compliance would be simplified. This would, however, come at a cost of weakening federalism. Since there would be standardization, a model similar to the European VAT on digital services by non-EU sellers to non-business EU customers could be adopted. In the EU, sellers of digital services collect the VAT and file VAT tax returns with the government in which the seller is located or registered. The seller's home country in the EU then remits those collected taxes to the appropriate state where the consumer resides. This holds down administrative burden and compliance costs. The home state also has compliance enforcement obligations. In the U.S. this approach could only work if states alone were involved. Local jurisdictions could have no authority to levy sales tax on remote sellers. It would be incumbent upon the states to fairly allocate these sales tax receipts with local governments.

[153] Sales Tax Fairness and Simplification Act, *supra* note 149, § 4(d).

C. Amend State Sales Tax Law

State legislatures should consider amending their sales tax statutes to make them broad enough to cover physical presence by agency or marketing activities, like New York's "Amazon tax". State tax collectors should then move aggressively against Internet vendors. Another possible approach that may be plausible is to amend sales tax statutes to effectively "collapse" organizational structure and spin-offs of Internet operations through formation of dot.com incorporated or limited liability companies while still maintaining brick-and-mortar stores in the state. For instance, Borders Group, Inc. is a holding company for its subsidiaries which include Borders, Inc., a bricks-and-mortar stores company, and Borders Online, LLC. Since the trade-name "Borders" is a common trade-name creating goodwill and profits for any affiliate of the holding company, one may make a good argument that there is a joint marketing effort. What is good for Borders, Inc. is good for Borders Online. When a company with a registered trade- or service-mark allows an affiliate company to use that mark, then any use by the affiliate company should, by attribution, be treated as a common company for applying the substantial nexus test of *Complete Auto*.[154] In some areas of federal law[155] attribution rules apply to prevent the carving up of a company's operations to do

[154] Arkansas enacted sales tax legislation (ARK. ACTS 922 (2001)), effective January 1, 2002, imposing a duty on any out-of-state seller to collect sales tax if "(a) The vendor holds a substantial ownership interest, directly or through a subsidiary, in a retailer maintaining sales locations in Arkansas, or is owned in whole or in substantial part by such a retailer, or by a parent or subsidiary thereof; and (b) The vendor sells the same or substantially similar business name, or the facilities or employees of the Arkansas retailer are used to advertise or promote sales by the vendor to Arkansas purchasers."

[155] *E.g.*, I.R.C. § 1 et seq. (2006); Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001, et seq., and the Civil Rights Act of 1964, Title VII, 42 U.S.C. §2000e, et seq.

indirectly what is unlawful directly.[156] This would be a rational means of achieving a legitimate governmental interest and meet requirements for Commerce Clause and Equal Protection Clause purposes. Furthermore, since corporations and limited liability companies are creatures of the states, state legislatures would have the constitutional authority to place restrictions on those entities and tax them in any reasonable way.

D. Attack Quill with Legal Reasoning

The *Bellas Hess* bright-line rule for substantial nexus has undoubtedly reached what some U.S. senators referred to in the Judicial Subcommittee hearings on Justices Roberts' and Alito's Supreme Court nominations as a "super precedent".[157] That bright-line rule having survived for over 40 years, when there has been such a revolution in global commerce and an out-with-the-old and in-with-the-new line of thinking marketing strategy, is amazing in itself. Regardless of the most judicially conservative faction of justices on the Supreme Court, who rely heavily on the historical school of legal thought in legal reasoning,[158] probably the best way to become rid of the negative effects of *Quill* is to seek to have it overturned judicially through sound legal reasoning. This certainly will be difficult given that all nine justices in *Quill* agreed on the issue of a bright-line rule. This notwithstanding, the judicially liberal and moderate justices are usually more readily amenable to accept changes in culture, society, needs of local government, and practical realities in overturning precedent. This

[156] *See*, *e.g.*, I.R.C. § 267, which has been used by Arkansas for vendor definition by attribution in its sales tax law, ARK. ACTS 922 (2004), at § 4.

[157] The author will not go so far as to characterize it as a "super duper precedent", as was used by at least one senator to characterize *Roe v. Wade*, 410 U.S. 113 (1973), on the right to privacy issue.

[158] *See*, *e.g.*, Justice Scalia's concurrence in *Quill*, *supra* note 6, at 334, and discussed *supra* note 43. *See also*, Justice Rehnquist's dissent in *Planned Parenthood of South-Eastern Pennsylvania v. Casey,* 505 U.S. 833, 944 (1992).

attack should probably begin in New York courts, or possibly in California, where there has already been some success in broadening the definition of physical presence. States should proceed as quickly as possible through the judicial system where the Supreme Court could no longer ignore the issue.

The judicial reasoning must follow Justice Oliver Wendell Holmes' realism school or the slightly newer version, the pragmatist school, espoused by Judge Richard A. Posner of the Eighth Circuit Court of Appeals. Posner believes that pragmatism as the judicial ethos is the best guide to improve judicial performance. Furthermore, he argues that it is the "best normative as well as positive theory of the judicial role."[159] He regards an everyday pragmatist in law and an everyday pragmatist judge as persons "who wants to know what is at stake in a practical sense in deciding a case one way or another."[160] He accepts "everyday pragmatism" but rejects "philosophical pragmatism". He is an admirer of Darwin's evolutionary theories and bases his theory of judicial everyday pragmatism on Darwinian thought. Posner states:

> [H]uman intelligence is better at coping with practical problems…. [O]ur intelligence is primarily instrumental rather than contemplative. Theoretical reasoning is continuous with practical reasoning rather than a separate human faculty….Not only is our knowledge local; it is also perspectival, being shaped by the historical and other conditions in which it is produced. [161]

It is within this framework of legal reasoning that *Quill* can, and the authors believe, should be, overruled. Much of the rationale

[159] RICHARD A. POSNER, LAW, PRAGMATISM, AND DEMOCRACY 1 (2003).
[160] *Id.* at 12.
[161] *Id*. at 3-5.

for overruling Quill has been addressed above in the discussion of legislating change, Justice White strong dissent in *Quill*, and the rationale in *Borders Online*, *Orvis*, and *Amazon.com*.

The following is simply a summary of those points relating to litigating *Quill*'s demise. First, American remote sellers are at a disadvantage to foreign sellers on the Internet. When an American Internet supplier of goods and services sells to customers in the E.U., the VAT is applied. If the American supplier sells to non-business customers (B2C), the American supplier must collect the VAT and remit it to the VAT authority in the supplier's country for VAT registration. Foreign vendors in Internet sales to Americans do not have responsibility to register for sales tax purposes with any U.S. state in which it has customers or to collect and remit sales or use tax. This is an asymmetry in which *Quill* effectively causes discrimination against American e-commerce.

Second, the physical presence bright-line rule for substantial nexus is antiquated for this global Internet society and economy. The Court should not impede or prefer one form of commerce over another. The characteristic of sound tax policy is the encouragement of free competition and neutrality, but Quill's holding to the bright-line rule does not accomplish this goal. Internet marketing operations are completely unlike mail order operations 20 years ago. Computer systems and software make Internet marketing operations feasible. Today, it is possible for sales transactions, from order-taking to shipment and collection, to never have human contact with the transaction. Furthermore, given tax software today, sales tax returns may be completely automated, requiring only human audit and approval of the return for submission to the state. From this perspective, the burden on interstate commerce has been drastically reduced.

Third, the burden on interstate commerce to comply with state sales tax laws has also been reduced through advanced computerized tax software. Whereas sales tax compliance may still be burdensome, it probably cannot now be characterized as unreasonably burdensome. For example, many Internet sellers, such as Wal-Mart, Barnes and Nobel, Sears, and Home Depot, also have physical presence in all, or practically all, states. These firms do business both online and through brick-and-mortar stores, yet all file required sales tax returns as well as other types of tax returns. While firms with physical presence in states are required under Quill to collect sales tax, their burden to comply should be considered of no less consequence to the Court. These firms use sales tax software to reduce the administrative burden. If the administrative burden was too great on such firms, they would simply quit their operations with the state. The same argument can be made for Internet vendors. If sales tax compliance in a state was excessively burdensome, then the Internet firm could simply refuse to do business with that state's customers. This could easily be accomplished by flagging the purchaser's billing zip code. If Internet companies cannot compete with brick-and-mortar firms, they should not be judicially subsidized. The price savings due to sales tax avoidance reflect potential contribution margin for the Internet vendor.

Fourth, the burden on interstate commerce is being reduced by state participation in the SSTP. Whereas the efficiency of the SSTP has not been maximized to the extent of the VAT under Council Directive 2002/38/EC, it is substantially less burdensome for remote e-commerce vendors than was the case 20 or 40 years ago during the mail order era of *Bellas Hess* and *Quill*. Though it would be preferable to completely overrule *Quill*, a middle ground might be for the Court to distinguish the cases where the taxing state is a participant in the SSTP and in full compliance with the SSUTA. The SSTP reduces the administrative burden some by harmonizing commodity classifications, much like the Harmonized Tariff System does under the General Agreement on Tariffs and Trade (GATT). Unfortunately, it does not reduce the burden of the large number of local taxing jurisdictions with varying tax rates, which complicated the determination of the sales tax.[162] Home rule states have been reluctant under the SSUTA to force local jurisdictions to give up local sales tax rates for another tax allocation method administered by the state.

The burden on sales tax compliance has been reduced, however, with harmonization and the requirement of filing only one tax return per period for a state, which is made for all local jurisdictions within the state.[163] Certainly, a potential 50 or 51 sales tax returns is less burdensome than the trepidation an Internet vendor may suffer if one considered the extreme case of doing business in every taxing jurisdiction in the country and without *Quill*'s protection. The dormant Commerce Clause does not require the state's burden on interstate commerce to be slight—only not unreasonable given the facts and circumstances of the activity.

Thus, the Court could continue to apply the physical presence test for substantial nexus on a case-by-case basis while finding that a state's compliance with the SSUTA would no longer make compliance with the taxing state's law an unreasonable burden. A position taken by the Court that a state's compliance with the SSUTA was prima facie evidence that collection and remittance of sales tax was not an unreasonable burden on interstate commerce would give additional impetus to those states not participating in the SSTP to comply.

[162] Henchman, *supra* note 117.

[163] Streamlined Sales Tax Governing Board, *Streamlined Sales and Use Tax Agreement, adopted November 12, 2002, and amended through September 30, 2009,* § 318, at 42, *available at* http://www.streamlinedsalestax.org/uploads/downloads/Archive/SSUTA/SSUTA%20As%20Amended%2009-30-09.pdf (last visited Mar. 10, 2010).

Fifth, states should argue the points as Justice White argued in his dissenting opinion in *Quill* that there should be no difference in the minimum contacts requirement for due process and the substantial nexus requirement of the Commerce Clause. Substantial nexus does not require a physical presence. His argument seems particularly pertinent given the global nature of e-commerce.

Sixth, if the requirement of physical presence is to be a requirement for substantial nexus, an argument should be made, consistent with the opinions in Orvis, Borders Online, and Amazon.com, that “physical presence” may exist through surrogacy, agency or marketing activities of the remote seller without having a physical situs (employees, physical facilities, or property) in the taxing state. They should argue that present law is a combination of outdated thinking, practical infeasibility, and misguided policy.[164] The Court should accept a pragmatist’s argument, certainly as has been made by economists and discuss *supra*, that e-commerce should not be treated preferentially over brick-and-mortar firms.

Finally, the Quill Court’s dicta that Congress can on its own initiative legislatively authorize states to impose sales and use taxes on out-of-state vendors as its right under the Commerce Clause. While this is true, and Congress has considered doing this to some degree, the Supreme Court once again dodges a hard question and simply ignores the harmful effects of maintaining the physical presence bright-line rule. The Court’s reasoning in passing the buck off to Congress is as antiquated as its reasoning in the *Federal Baseball Club v. National League*[165] that professional baseball was not interstate commerce and was not subject to federal antitrust law. Fifty years later in *Flood v. Kuhn*[166], based on years of precedent and absent Congressional action on the issue,

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[164] Eric Menhart, *supra* note 62, at 31.
[165] 259 U.S. 200 (1922).
[166] 407 U.S. 258 (1972).

the Court reaffirmed baseball's antitrust exemption while recognizing that Major League Baseball, as with all other professional sports leagues, was interstate commerce. Holding onto a precedent in light of the vast evidence against it, does not comport to sound legal reasoning.

Given the development of e-commerce over the past 20 years and its radical effect on American society and business, a strong case can be made that the physical presence bright-line rule in *Bellas Hess* and *Quill* is no longer sound. The bright-line rule did have a benefit to interstate commerce and almost certainly aided the progress of the Internet, but now it does more harm than good. The Supreme Court should follow the admonition of Chief Justice Rehnquist in his dissent in *Planned Parenthood*: Our constitutional watch does not cease merely because we have spoken before on an issue; when it becomes clear that a prior constitutional interpretation is unsound we are obliged to reexamine the question.[167] As precedent, *Quill* should be overruled as unreasonable.

VII. CONCLUSION

Since 1992 with the U.S. Supreme Court's decision in *Quill* and Congress' inability to face its obligation of federalism, States have been locked into a frozen policy prohibiting them from mandating remote sellers to collect and remit sales and use taxes when they sell goods to consumers of those States. State legislatures have been more aggressively pursuing amendments to their sales tax laws to circumvent the negative effects of *Quill*. Courts in California and New York have given broader definition to "physical presence". Almost half the states are participating in the SSTP to harmonize their sales tax laws and reporting requirements to reduce the burden on interstate commerce. *Quill*'s policy is

[167] *Planned Parenthood*, *supra* note 158, at 955

outdated given the present state of electronic commerce using the Internet. Unfortunately, Congress has failed to provide legislative assistance to the states, even those participating in the SSTP. The authors have presented arguments that may be used to persuade Congress to legislate and the courts to overrule *Quill*.

TRADE SECRET THEFT AND PROTECTION

By

Michael B. Bixby* & Christopher Baughn**

I. INTRODUCTION

In recent years the venerable legal topic "Trade Secrets" has increasingly moved from the background into the forefront of business legal issues. Long considered in legal literature as the "Fourth Prong" of intellectual property (following copyrights, patents and trademarks) trade secret protection is now frequently discussed in the headlines in popular and business press, as well as academic literature.[168]

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[168] *See, e.g.* Annemarie Bridy, *Trade Secret Prices and High-Tech Devices: How Medical Device Manufacturers are Seeking to Sustain Profits by Propertizing Prices*, 17 TEXAS INT'L PROP. L.J. 187 (2009): Michael Risch, *Why Do We Have Trade Secrets?* 11 MARQ. INT'L PROP. L. REV. 1 (Winter 2007); Alan J. Tracey, *The Contract in the Trade Secret Ballroom—A Forgotten Dance Partner?* 16 TEXAS INT'L PROP. L. J. 48 (2007); Patricia Norman, *Are Your Secrets Safe? Knowledge Protection in Strategic Alliances*, 44 BUSINESS HORIZONS 51 (Nov/Dec 2001); Jeanne Andrea DiGrazio*, Professional Responsibility Considerations of Advising the Corporate Client on the Patent/Trade Secret Interface*, 13 INTELL. PROP. & TECH L. JOURNAL 5 (May 2001); *See generally*, ROGER M. MILGRIM, MILGRIM ON TRADE SECRETS (2008). The protection of trade secrets in international business is now becoming an important issue. *See e.g.*, Marisa Anne Pagnattaro, *Protecting Trade Secrets in China: Update on Employee Disclosures and the Limitations of*

In the past few years, many news reports have examined conflicts between business firms over the alleged theft, use and disclosure of trade secrets. In 2009 Starwood Hotels & Resorts sued Hilton Hotels Worldwide and two former Starwood executives who had gone to work for Hilton, alleging that they stole more than 100,000 documents and electronic files from Starwood which contained "competitively sensitive information."[169] The complaint claimed that the executives and Hilton intended to use the information to create a new luxury hotel brand called Denizen, as a rival to Starwood's successful "W" hotel chain.[170] In January 2010 Starwood filed an 86-page amended complaint that trade secrets theft reached the highest levels of Hilton management, including the CEO Christopher Nassetta, its head of development, and at least 5 of the 10 members of Hilton's executive committee.[171]

There are numerous instances of allegations and lawsuits between high tech companies regarding misappropriation and theft of trade secrets. In one recent case in California a jury ruled in favor of Taiwan Semiconductor Manufacturing Company (TSMC) after a lengthy legal battle with rival Chinese chip maker Semiconductor Manufacturing Corp. (SMIC). The amount of damages had not been determined at the time of the story, but TSMC's expert

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Law, 45 AM. BUS. LAW J. 399 (2008); and Larry R. Wood Jr., Emmett M. Hogan, Charmayne Bhadha & Jennifer Dadrewala, *Trade Secret Law and Protection in India*, 20 INTELL. PROP. & TECH. LAW J. 25 (Oct. 2008).

[169] *In Trade Secrets Flap, Might Criminal Charges Be Heading Hilton's Way?* WALL ST. J., Apr. 21, 2009.

[170] Peter Lattman, *Starwood Lobs New Allegations Against Hilton*, WALL ST. J., Jan. 15, 2010.

[171] *Id.* Hilton had returned a batch of confidential documents to Starwood in February 2009, but Starwood alleges that CEO Nassetta had knowledge of the documents for about three months before returning them, and that the documents had been placed on Hilton's computer server and were being used by Hilton. In addition, the U.S. attorney for Manhattan is investigating whether Hilton Worldwide and its former executives should face criminal charges for stealing trade secrets. *Id.*

witness put the amount in the range of $1 billion.[172] The attorney for TSMC said the case involved 65 instances of trade secrets theft, which was "the biggest case of wholesale corporate espionage" he had encountered.

Clearly, the protection of trade secrets—as well as the creation and maintenance of such information—has become a critical business issue.[173] This article will explore both management and legal issues, and will attempt to examine how business firms create, identify, maintain, safeguard, and protect trade secrets—especially in today's technologically-advanced world where information can be instantly shared around the world by the click of a mouse. We will describe what trade secrets are in general, discuss the role of trade secrets in the total intellectual property rights protection effort of the firm, examine some recent trends, look at various issues concerning disclosure and theft of trade secrets and certain steps taken by corporations to protect their trade secrets—while examining both legal and management issues.

II. WHAT IS A TRADE SECRET?

Unlike patent law, which traces its origins to a 1474 statute and is provided for in the U.S. Constitution, trade secret law developed at the common law.[174] Thus over the years a wide variety of cases resulted in significant differences in trade secret principles among

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[172] Don Clark, *TSMC Wins Trade Secret Verdict Over SMIC*, WALL ST. J., November 4, 2009.

[173] As one recent article in the Wall Street Journal noted, in a story about a lawsuit between two high tech companies, "We're hard pressed these days to come up with many practice areas that are "hot." One that might qualify—trade secrets. Dockets will almost assuredly keep filling up with these types of cases so long as moving data off a hard drive is as easy as a click and drag onto a thumb drive." *Trading With the Enemy? Jury in SV Says "No."* WALL ST. J., Nov. 23, 2009. (accessed online)

[174] Ramon A. Klitzke, *The Uniform Trade Secrets Act*, 64 MARQ. L. REV. 277 (1980).

the states. In 1939, the Restatement (First) of Torts attempted to collect and clarify the most prevalent common law theories, from what it described as a "confusing body of precedent."[175] In general there are three requirements for a common law cause of action: (1) proof of a trade secret; (2) improper disclosure or use of the trade secret; and (3) as a result of the improper disclosure or use, the owner of the trade secret suffered or will suffer a loss.[176]

The Restatement of Torts defined trade secrets as "any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it."[177] Although the Restatement definition has become the most widely accepted statement of common law trade secret principles and has been cited in many state court decisions, its principles have often been interpreted in different ways. Commentators have noted the variations in the law from state to state and the lack of law in many states. "Courts are not bound to adopt the Restatement view and . . . even when they do, interpretations vary."[178]

The Restatement of Torts emphasized that in order for information to constitute a trade secret, it must be substantially secret and continuously used in the operation of one's business.[179] In addition the Restatement provided, in a comment, six factors to consider in determining whether information constituted a trade secret. These factors are:

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[175] Robert G. Bone, *A New Look at Trade Secret Law: Doctrine in Search of Justification*, 86 CALIF. L. REV. 241, 247 (1998).

[176] Comment, *Common-Law and Statutory Sanctions for Industrial Espionage—A Need for Reform*, 52 IOWA L. REV. 63, 66-68 (1966).

[177] RESTATEMENT (FIRST) OF TORTS, §757 comt. b (1939).

[178] Linda B. Samuels & Bryan K. Johnson, *The Uniform Trade Secrets Act: The States' Response*, 24 CREIGHTON L. REV. 49, 53 (1990).

[179] Note*, Saforo & Associates, Inc. v. Porocel Corp: The Failure of the Uniform Trade Secrets Act to Clarify the Doubtful and Confused Status of Common Law Trade Secret Principles,* 53 ARK. L. REV. 687, 695 (2000).

(1) the extent to which the information is known outside the business;
(2) the extent to which it is known by employees and other involved in the business;
(3) the extent of measures taken by the Plaintiff [who is arguing that it is a trade secret] to guard the secrecy of the information;
(4) the value of the information to Plaintiff and to its competitors;
(5) the amount of effort or money expended by Plaintiff in developing the information; and
(6) the ease or difficulty with which the information could be properly acquired or duplicated by others.[180]

The standards described in the Restatement formed the basis for common law development of trade secret law for the next 40 years, although, as mentioned the principles varied considerably. When the Restatement of Torts was being revised in the 1970s, the American Law Institute could not agree on how to update or clarify trade secret law and consequently the Restatement (Second) of Torts issued in 1979 specifically eliminated all provisions regarding trade secrets.[181]

However, in 1995 the Restatement (Third) of Unfair Competition defined trade secrets as "any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic

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[180] RESTATEMENT (FIRST) OF TORTS,§757 cmt. b (1939).

[181] Klitzke notes "It was the opinion of the American Law Institute that trade regulation law, of which trade secrets law was a part, had developed into an independent body of law no longer based primarily upon tort principles. It was therefore not appropriate to include these principles in the second Restatement of Torts." Klitzke, *supra* note 7, at 283.

advantage over others." [182] This newer Restatement differed from the earlier (Torts) Restatement in several ways. The Torts Restatement focused on requiring the secret to be used continuously by the individual in order to receive trade secret protection, while the later Restatement (Unfair Competition) afforded protection to any information that *can be used* in a company.[183] In other words, the new approach recognized that once the potential value and the secrecy of the information have been determined, the individual can decide not to exploit the secret at that particular time and still receive protection under the law.[184]

Still, decisions in different states on the scope of trade secret law and protection varied considerably. In an effort to harmonize trade secret law across the United States, the National Conference of Commissioners on Uniform State Laws (NCCUSL) drafted the Uniform Trade Secrets Act (UTSA) in the 1970s. Many states—at least 43—have adopted the UTSA in some form since that time.[185] The purpose of the model law was "to produce systematic and predictable treatment of trade secrets in the various states." [186] The UTSA defines a trade secret as:

> Information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain

[182] RESTATEMENT (THIRD) OF UNFAIR COMPETITION 39 (1995).

[183] Compare RESTATEMENT (FIRST) OF TORTS, § 757 (1939) with RESTATEMENT (THIRD) OF UNFAIR COMPETITION, Section 39 (1995).

[184] See, Jessica L. Cole, *Can You Keep a Secret? An Analysis of Methods Competitors Should Use to Protect Trade Secrets Before Liability for Misappropriation Attaches*, 38 BRANDEIS L. J. 437, 439 (Winter 2000).

[185] See Brian M. Malsberger, TRADE SECRETS: A STATE-BY-STATE SURVEY (2006).

[186] 1 MELVIN F. JAGER, TRADE SECRET LAW, §3.05 at 3-70 (1999).

> economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[187]

The UTSA definition differs in two important ways from the Restatement of Torts definition. First, while the Restatement protection is limited to any "formula, pattern, device, compilation of information, or process," the UTSA definition is broader and covers such information as programs, methods, and techniques. Second, while the Restatement requires information to be in "continuous use in the operation of the business," to qualify as a trade secret, the UTSA contains no such requirement. Therefore, under this definition, the information itself would not qualify as a trade secret unless it has economic value, is not generally known and if it was *not readily ascertainable by proper means* by others. Under the UTSA therefore, one would also need to analyze the means employed by a competitor to acquire another's information if such information was being *protected reasonably.*

A more recent addition to trade secret law is the enactment of a federal criminal statute, the Economic Espionage Act of 1996 (EEA).[188] After considerable effort by the business community, Congress recognized that existing federal law, such as statutes against mail and wire fraud, had gaps and inadequacies in protecting valuable company information. Congress further found that state civil remedies were often insufficient to redress trade secret theft because companies lacked the time and resources to investigate and litigate or because the defendants had few or no assets.[189] The EEA attempts to provide a "comprehensive and

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[187] UNIF. TRADE SECRETS ACT, Sect. 1(4)(I-ii), 14 U.L.A. 438 (1985).

[188] 18 U.S.C. §1831-1839 (Supp. IV 1998).

[189] Susan V. Metcalfe*, Protecting Trade Secrets: Is the Remedy Worse Than the Wrong?* 104 DICKINSON L.REV. 503, 507 (2000). At the signing of the EEA, Pres. Clinton stated that "Until today, federal law has not accorded

systematic" solution that will "put some teeth into the punishment" for trade secret theft and other forms of industrial espionage.[190]

The Economic Espionage Act has two sections that criminalize the misappropriation of or use of misappropriated trade secrets. Section 1831 is directed against entities and individuals sponsored by foreign governments, and Section 1832 is directed against all individuals and entities regardless on whose behalf they were acting. Both sections prohibit the same types of misconduct regarding trade secrets, sanctioning anyone who:

> (1) steals, or without authorization appropriates, takes carries away or conceals, or by fraud, artifice, or deception obtains such information; (2) without authorization copies, duplicates, sketches, draws, photographs, downloads, uploads, alters, destroys, photocopies, replicates, transmits, delivers, sends, mails, communicates, or conveys such information; or (3) receives, buys, or possesses such information, knowing the same to have been stolen or appropriated, obtained or converted without authorization.[191]

The definition of "trade secret" in the EEA is more broad and comprehensive than that in the Uniform Trade Secrets Act. However, the EEA does repeat and incorporate the sections of the

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appropriate or adequate protection to trade secrets, making it difficult to prosecute thefts involving this type of information. Law enforcement officials relied instead on antiquated laws that have not kept pace with the technological advances of modern society." H.R. Rep. No. 104-788, at 14 (1996).

[190] Metcalfe, *supra* note 22 at 508; *see also*, Stan Crock & Jonathan Moore, *Corporate Spies Feel a Sting: The Feds Get Serious, But is a New Law Tough Enough?* BUS. WK., July 14, 1997 at 76; Chris Carr, Jack Morton & Jerry Furniss, *The Economic Espionage Act: Bear Trap or MouseTrap?* 8 TEXAS INTELL. PROP. L.J. 159 (2000).

[191] 18 U.S.C. §§1831-32

UTSA which require the owner to take reasonable measures to protect the secret information, and that the information must derive independent economic value from not being generally known to and not being readily ascertainable through proper means by the public.[192] What constitutes "reasonable measures" is fact-driven and case-specific, depending on the nature and importance of the information, as well as the size, ability, and sophistication of the owner.[193]

III. THE ROLE OF TRADE SECRETS IN PROTECTING THE FIRM'S INTELLECTUAL PROPERTY

As noted above, the potential domain of information covered by trade secret protection is quite broad, as long as that information serves as a source of competitive advantage and is treated in a way that could be reasonably be expected to prevent the public or competitors from learning about it.[194] While courts have tended to focus on scientific and technical information, virtually any type of information can be covered—it is basically the treatment of the information, rather than subject matter boundaries, which determines trade secret status.[195] Trade secrets may include such information as customer lists and other sensitive marketing information, accounting systems, databases, business plans, and

192 *Id*. at §1839 (3).

193 Steve Sozio & Dave Drab, *Economic Espionage in the New Millennium*, THE FEDERAL LAWYER, May 2001, p. 24, 26.

194 Stephen Elias, PATENT, COPYRIGHT & TRADEMARK. Berkeley: Ca: Nolo.com (1999) at 57.

195 Glenn S. Bacal, LAW OF TRADE SECRETS, NONCOMPETES, AND ANTIPIRACY AGREEMENTS—A PRACTICAL GUIDE FOR BUSINESS AND IN-HOUSE LAWYERS. Internet edition: 1996, accessed at http://www.azlink.com/lawyers/articles/secrets/htm on March 19, 2001.

pricing methods, as well as mathematical algorithms, cosmetic and chemical formulas.[196]

The organization's management of trade secrets will often involve coordination with other legal means of intellectual property protection. In some instances, for example, it may be wise to coordinate trade secret protection with protection provided by copyright. Copyrights protect the "expression" of an idea in a specific work (including books, movies, musical compositions, software, web page design, architectural drawings and advertising copy), though copyright protection does not extend to the ideas or facts underlying the work's expression.[197] One can, for example, maintain the firm's work of expression as a trade secret up until the time that it is distributed to the public on an unrestricted basis.[198] Since there is no absolute requirement of disclosure under copyright law, a firm may also wish to place copyright notices on confidential documents. This may yield at least some recourse to unauthorized duplication if trade secret protection is somehow lost[199].

Trade secret protection can also be used as a substitute for, or in conjunction with, patent protection in many instances. A U.S. patent conveys the right to exclude others from making, using or selling the patented invention for a limited time in the U.S.[200] Trade secrets may be used to protect an innovation in the conception and development stages until patent protection is invoked. In order to obtain a patent, the inventor must fully describe the invention in the patent application. In the U.S., that

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[196] Elias, *supra* note at 27, at 11-12. Also see Maxine Lans Retsky, *Trade Secrets are Vital to Biz, Tough to Keep,* 36 MARKETING NEWS, Issue 5, at 10. (2002).

[197] Elias, *supra* note 27 at 11-13 and 70.

[198] *Id.* at 5.

[199] Bacal, *supra* note 28 at 19.

[200] Shane Harris, *Precious Secrets*. 34 GOVERNMENT EXECUTIVE (2002) at 57.

description is kept confidential by the U.S. Patent and Trademark Office until the application is approved, at which time it is published. Therefore, until the time of publication by the U.S. Patent and Trademark office, it is possible to maintain the innovation as a trade secret.[201]

Patents, like copyrights, are a crucial component of the intellectual property armamentarium for many firms. Absent such statutory protection, competitors are free to duplicate the firm's invention if the competitor acquires information about that innovation though such means as reverse engineering, independent invention, or accidental disclosure.[202]

Nevertheless, patents do have their limitations, which have led many firms to forgo patent protection in many instances.[203] Patents have a limited life span, and (once the patent application is allowed), the invention is published by the U.S. Government on the Internet.[204] The life span of a trade secret, on the other hand, is determined only by the ability of the firm to keep it a secret and the ability of the information itself to continue to provide competitive advantage. Coca-Cola, for example, has kept its formula as a trade secret for nearly 100 years.[205] Protection provided by patents may not be seen to be justified by their cost (and the cost of patent litigation) in industries whose technology is undergoing rapid change. Because the patent application process may take several years—the vast majority of all patent applications are initially

[201] Elias, *supra* note 27 at 47.
[202] Metcalfe, supra note 22 at 2.
[203] *Many Companies will Forgo Patents in an Effort to Safeguard their Trade Secrets,* N. Y. TIMES, Feb 5, 2001, p. C.5.
[204] Geroge Salmas, *IT Professional as Gatekeepers to Trade Secrets*. 6(2) INFORMATION EXECUTIVE 16 (2002). p 16.
[205] Metcalfe, *supra*, note 22 at 2. Coca-Cola's formula is stored in a bank vault in Atlanta. The secret recipe of 11 herbs and spices used by Kentucky Fried Chicken is reportedly stored in a time capsule and constantly guarded in an undisclosed location. *Id.*

rejected—the innovation may be obsolete by the time the patent is approved.[206] Further, the narrowing scope of protection available for copyrights, patents, and trademarks also reduces the benefits of pursuing such statutory systems.[207]

IV. THE INCREASING PREVALENCE OF TRADE SECRET PROTECTION AND LITIGATION

As noted previously, the importance of trade secret protection and trade secret litigation have been steadily increasing in the business and legal environment. In 2008, the Womble Carlyle Trade Secret Blog reported the results of their search of the Westlaw federal database (federal district, appeals and Supreme Court cases) for the term "trade secrets," which returned 905 cases for 2007. That was a 20% increase over the number of published cases in 2006 (754 cases), and a 231% increase since 1997 (273 cases).[208] A study released by the American Society of Industrial Security several years ago reported a 323% increase in trade secret theft between 1992 and 1996.[209] There seem to be several reasons for this trend, including the growing importance of information and technological innovation in our economy, much greater employee mobility, the increasing use if inter-organizational alliances, and globalization.

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206 *Id.* at 2

207 Bacal, *supra* note 28 at 3.

208 *Trade Secret Lawsuits on the Rise*, Maryland Intellectual Property Law Blog, accessed March 8, 2010, linking to the Womble Carlyle Trade Secret Blog. The blog points out that not every one of these cases is a full-blown case about trade secrets. In some, the term may only be mentioned in passing. In addition, the Westlaw database may pick up lots more cases in 2007 than it did in 1997. But the blog concludes, "Nevertheless, it would be hard to deny that something's going on."

209 Chris Carr & Larry Gorman, *The Revictimization of Companies by the Stock Market who Report Trade Secret Theft Under the Economic Espionage Act*, 51 BUSINESS LAWYER 25 (2001) at 27.

V. TRADE SECRETS IN THE INFORMATION AGE

While it is true that the value of keeping competitive (both commercial and military) information secret has been recognized throughout history, organizations have become increasingly knowledge-dependent in recent years.[210] Fundamental sources of wealth and competitive advantage have moved from such factors as natural resources and physical labor to knowledge and communication.[211] Businesses are finding that the importance of their knowledge assets--including patents, processes, employee skills, technologies, and information about customers and suppliers--overshadow the more tangible attributes of their firms and their products.[212]. Trade secret theft is therefore increasingly profitable.[213] The proliferation of computers has greatly facilitated the creation of valuable information. Computers have also made the transfer, and therefore the theft, of proprietary information much easier. As noted by R. Mark Halligan, former chairman of the American Bar Association's Trade Secrets Committee, "today, you can carry the whole company out on a floppy disk in your shirt pocket".[214]

VI. EMPLOYEE MOBILITY

The increasing importance and ease of transferring intellectual capital is coupled with increased employee mobility. The employer-employee relationship has radically changed in an

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210 Bacal, *supra* note 28 at 3.
211 Michael Porter, THE COMPETITIVE ADVANTAGE OF NATIONS. NEW YORK: The Free Press (2000), at 77-78
212 Thomas A. Stewart, INTELLECTUAL CAPITAL, (1997) New York: Doubleday. Commenting on the knowledge content of everyday goods, Stewart notes "Thanks to research into high hybrid grains, farmers produce about five times more corn per acre than they could in the 1920s; put another way, today's ear of corn is 80 percent knowledge. Stewart at p. 15.
213 Carr & Gorman *supra* note 42 at 32.
214 Mr. Halligan was quoted in CRAIN'S CHICAGO BUSINESS, February 19, 2001.

environment where a career with a single company has become the exception rather than the norm. Job switching by employees is amplified by downsizing and cutbacks. Such downsizing may also follow corporate mergers. Experienced employees are thereby released to find work with competitors, begin consulting in their field, or start up a new company of their own.[215]

Obviously any employee is most likely to find new employment or start a business in the field where he/she is experienced and competent. Upon starting their own company, ex-employees may attract others from the previous employer to join the new start-up.[216] Further, attempts by firms to quickly develop competencies in a critical area may lead to large-scale hiring efforts (raiding), targeting a particular rival.[217] The increasing reliance on temporary employees also facilitates a flow of information across organizational boundaries. Former sales people, for example, may easily take customer lists with them.[218]

VII. INTER-ORGANIZATIONAL RELATIONSHIPS

Certainly a key feature of today's business environment is the development of inter-organizational relationships, including joint ventures, strategic business partnering, and preferred supplier arrangements.[219] While such collaboration may require the flow of knowledge between firms to create value, there is also the possibility that the alliance may lead to the unintended

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[215] Kathleen Murray, *HR takes steps to protect trade secrets*. 73(6) PERSONNEL JOURNAL 98 (1994) at 104-108.
[216] Catherine Siskos, *Whose idea is it, anyway?* 55(12) KIPLINGER'S PERSONAL FINANCE, 78 (2001) at 80.
[217] Gillian Flynn, *Raid the Competition for Workers, Not Their Secrets*, 77(12) WORKFORCE 121 (1998), at 121.
[218] Murray, *supra* note 48 at 100.
[219] Richard Daft, MANAGEMENT (5th Edition). Fort Worth, TX: Dryden Press (2000), p 253.

dissemination of proprietary information.[220] One's alliance partners may use this knowledge in a competitive challenge.[221]

VIII. GLOBALIZATION

Economic globalization certainly increases the number of potential competitors and their interactions (both as rivals and as alliance partners) among each other. Further, conducting business internationally places the firm in environments with very different standards regarding trade secret protection. Though trade secrets receive international protection under the General Agreement on Tariffs and Trade (GATT) and are addressed in the Agreement on Trade-Related Aspects of Intellectual Property Protection (TRIPS) accord, now enforced by the Word Trade Organization, trade secret theft and industrial espionage is tolerated as a normal part of doing business in some countries.[222] The end of the cold war led to an increased emphasis on economic, rather than simply military, espionage, as government spies moved to the private sector. The Federal Bureau of Investigation (FBI) has reported that at least 23 countries actively engage in illicit industrial espionage activities against U.S. companies.[223]

[220] C. Christopher Baughn, C., Johannes Denekamp, John Stevens, Richard Osborn, *Protecting Intellectual Capital in International Alliances,* 33 JOURNAL OF WORLD BUSINESS 103 (Sept. 1997), at 115.
[221] Patricia Norman, *Are Your Secrets Safe? 44*(6) *Knowledge Protection in Strategic Alliance 51*, 60 BUSINESS HORIZONS, (2001)
[222] AGREEMENT ON TRADE RELATED ASPECTS OF INTELLECTUAL PROPERTY PROTECTION, Part II, Section 7, Article 39. *See also* Elias, *supra* note 27 at 36. Noting that some countries do not recognize trade secret protection at all, Zolkas (see note 90 at p. 20) suggests that firms may wish to "quarantine" their trade secrets from those nations.
[223] Carr & Gorman, *supra* note 42 at 31

IX. ECONOMIC LOSSES FROM TRADE SECRET THEFT

Putting a price tag on trade secret theft in this country is remarkably difficult. Managers may not report the loss of proprietary information to their supervisors, and organizations may be reluctant to publicly reveal the loss to the press because of the possible negative impact on stock prices and customer confidence.[224] Estimates have ranged, however, from $24 billion to $100 billion a year.[225]

X. TRENDS IN TRADE SECRET CASES

A. Trade Secrets and the Internet

The incredible growth of the internet in recent years has presented difficult new problems in trade secret protection. Most of us (and tens of millions of others) use the internet and World Wide Web daily to access information and to communicate with others around the world. The advent of bloggers and those who post anonymously to chat rooms has created significant new dangers for trade secrets.[226] As has been discussed earlier, the creation and maintenance of a trade secret has generally required proof of several elements including: (1) that the information is secret and valuable; (2) that the owner took reasonable steps to keep the information secret; and (3) that the information is not "readily ascertainable by proper means."[227]

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[224] *Id*. at 30.
[225] Carr & Gorman *supra* note 42 at 27, 30.
[226] This interesting topic is beyond the scope of this article. For further exploration, *see, e.g.,* Margo Reder, *CEO Postings—Leveraging the Internet's Communications Potential While Managing the Message to Maintain Corporate Governance Interests in Information Security, Reputation and Compliance,* 7 DEPAUL BUS.& COMM. LAW J. 179 (2009); Tori Praul, *Apple Computer v. Does: An Unsatisfying Resolution to the Conflict Between Trade Secret Law, Journalist's Privilege, & Blogging*, 21 BERKELEY TECH. LAW J. 471 (2006).
[227] See U.T.S.A. Sect. 1(4), RESTATEMENT OF TORTS, § 757, cmt. b.

In previous years, misappropriation of a trade secret through breach of confidence or disloyalty could generally spread the information to a relatively small number of others before being discovered by the owner. Prompt issuance of an injunction could prevent further disclosure of the secret. Using the internet however, a trade secret can now be posted to a newsgroup and be published to the world instantly with the click of a button.[228]

One very troublesome development is that once information considered as a trade secret is posted on the internet, without the permission or knowledge of the owner--even if such action violates the UTSA or other applicable law--it arguably no longer qualifies for trade secret protection. A trilogy of cases involving the Religious Technology Center, an entity of the Church of Scientology explored this issue.[229]

In *Religious Technology Center v. Lerma,* the Washington Post published an article containing information from a former Church member, Arnaldo Lerma, concerning documents written by Church founder L. Ron Hubbard that the Church claimed to be trade secrets.[230] In *Netcom*, another former member of the Church

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[228] David G. Majdali*, Trade Secrets Versus the Internet: Can Trade Secret Protections Survive in the Internet Age?* 22 WHITTIER L. REV. 125 (Fall 2000) at 142.

[229] See *Religious Tech. Ctr. v. Netcom On-Line Commun. Servs., Inc.,* 923 F. Supp. 1231 (N.D. Cal. 1995); *Religious Tech. Ctr. v. F.A.C.T. Net, Inc.,* 901 F. Supp. 1519 (C. Colo. 1995); *Religious Tech. Ctr. v. Lerma*, 908 F. Supp. 1362 (E.D. Va. 1995).

[230] The Church closely guards access to these documents, which are known as "Advanced Technology." The adherent must proceed through a procedure known as "auditing," which uses the "technology" or "advanced technology" of the Church--a series of closely structured questions and answers to reach a "higher level of spiritual existence," in order to prevent a spiritually harmful effect caused by an unsupervised, premature exposure to these materials. *Religious Tech. Center v. Wollersheim*, 796 F. 2d 1076, 1077 (9th Cir. 1986), *cited in* Matthew R. Millikin, *www.misappropriation.com: Protecting Trade*

posted information highly critical of the Church of Scientology on an Internet newsgroup including proprietary writings by Mr. Hubbard which the Church alleged constituted trade secrets. In *F.A.C.T.Net,* a nonprofit corporation posted the Church's alleged trade secret information over the Internet. In all three cases, the federal courts denied the Church's request for injunctive relief, due partly to finding that the material was in the public domain.

The courts in *Netcom*[231] and *Lerma*[232] held that once information is posted on the Internet, the information loses its trade secret status. The *Lerma* court explained further:

> Once a trade secret is posted on the Internet, it is effectively part of the public domain, impossible to retrieve. Although the person who originally posted a trade secret on the Internet may be liable for trade secret misappropriation, the party who merely downloads Internet information cannot be liable for misappropriation because there is no misconduct involved in interacting with the Internet.[233]

Thus the Church lost its trade secret protection even though it implemented measures to protect its information that might well have been sufficient but for the Internet. The Church had used locked cabinets, safes, restricted logging and identification of

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Secrets After Mass Dissemination on the Internet, 78 WASH. U. LAW Q. 931 (Fall 2000) at 942.

[231] See *Netcom,* 923 F. Supp. At 1256 (concluding that the Church did not identify the trade secret with sufficient definiteness to support injunctive relief on trade secret grounds, and the information was already generally available to the public before the defendant's publication on the Internet).

[232] See *Lerma,* 908 F. Supp. at 1368 (noting that the information was in the public domain both because it was contained in unsealed court records and also available on the Internet).

[233] *Id.*

materials to a handful of sites worldwide and had placed electronic sensors on documents.[234]

Another well-publicized case, *Ford Motor Company v. Lane*,[235] concerned a dispute between the automaker and the creator of an internet site. Mr. Lane built a web site devoted to analyzing and commenting on Ford cars and trucks. Initially Ford gave support to Mr. Lane, allowing him access to key employees and some documents. But when Mr. Lane began to criticize Ford's products the relationship soured. Lane sent a letter to Ford indicating that he had obtained several "sensitive" Ford documents from a source within the company, and threatened to publish materials on the Web site that the company would find "disturbing."[236] In the next few weeks Lane posted on the Web site a story about problems with the Ford Mustang Cobra engine, and other articles containing information he had received from confidential sources within the company.

Ford filed suit alleging violation of its trade secrets, and obtained a temporary restraining order (TRO) from the federal district court the same day, blocking him from disclosing any more of the company's internal documents.[237] Lane accepted most of the TRO but argued that the restriction against "using, copying or disclosing" any Ford documents violated his 1st Amendment free speech rights. The court agreed with Mr. Lane on this point and refused to enter a preliminary injunction. Citing Reno v. American Civil Liberties Union for the proposition that the First Amendment applies with full force to the internet, the court found that the requested restriction would constitute an invalid prior restraint on

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[234] Majdali, *supra* note 61, at 143.
[235] 67 F. Supp. 2d 745 (E.D. Mich. 1999).
[236] *Id*. at 747.
[237] The court included a detailed list of confidential documents that Lane had posted on his Web site, including various internal memos and engineering blueprints. *Id.* at 748.

protected speech.[238] The court held that even though Lane had possibly violated the Michigan Uniform Trade Secrets Act, the use of an injunction would violate the First Amendment. Ford's remedy, stated the court, might be through criminal prosecution, not a civil injunction.[239]

B. Inevitable Disclosure

Under the Uniform Trade Secrets Act one of the required elements of a trade secret protection lawsuit is that the secret must have been actually misappropriated or "threatened" to be misappropriated. In recent years some courts have embraced a new theory which offers wide protection against even the possible future disclosure of trade secrets. In cases where a key employee of one firm accepts a very similar job with a competing business, courts have occasionally adopted the doctrine called "inevitable disclosure."[240]

The inevitable disclosure theory was first recognized as far back as 1960 in the case *Fountain v. Hudson Cush-N-Foam Corp*.[241] where the Florida Court affirmed the issuance of a temporary restraining order prohibiting a former employee of one company from performing similar duties with a competitor. The court noted that:

> Since defendant's employment with the appellee was the occasion for his acquiring knowledge of the appellee's trade secrets and manufacturing processes, it would seem logical that his

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[238] The court pointed out that based on previous cases, the plaintiff has a very high threshold to meet in order to overcome the free speech defense. *Id*. at 751.
[239] *Id*. at 753. See the discussion of the case in *Millikin, supra* note 63 at 946-48.
[240] Benjamin A. Emmert, *Keeping Confidence With Former Employees: California Courts Apply the Inevitable Disclosure Doctrine to California Trade Secrets Law*, 40 SANTA CLARA L. REV. 1171 (2000)
[241] 122 So. 2d 232 (Fla. Ct. App. 1960).

> employment by a competitor would eventually result in a disclosure of this information. In short, we think that his knowledge of the trade secrets would be so entwined with his employment as to render ineffective an injunction directed only toward prevention of disclosure.[242]

The leading case adopting the Inevitable Disclosure doctrine is *PepsiCo. v. Redmond,* decided by the Seventh Circuit in 1995.[243] Mr. William Redmond had been one of Pepsi's high-level managers for ten years. Just prior to the lawsuit he was general manager of the California business unit (responsible for 20% of Pepsi's national earnings) and had been a key figure in developing much important and sensitive internal information for Pepsi, including its overall strategic plans for marketing, manufacturing, production, packaging and distribution.[244]

At that time Pepsi's All Sport drink was engaged in fierce competition with Gatorade sports drink, produced by Quaker Oats Co. Without telling anyone at Pepsi, Mr. Redmond had been considering taking a job with Quaker for some time. When he announced he had accepted a position with Quaker as vice-president of Field Operations for the Gatorade division in Chicago, Pepsi immediately filed suit in federal court in Illinois. Pepsi asked for temporary and permanent injunctive relief prohibiting him from assuming his job at Quaker arguing that he would "inevitably" use Pepsi trade secrets in this position.[245]

The court, after hearing evidence, issued findings emphasizing Mr. Redmond's great familiarity with Pepsi's trade secrets, the similarity between his duties for PepsiCo and his planned

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[242] *Id*. at 234.
[243] 54 F. 3d 1262 (7th Cir. 1995).
[244] *Id*. at 1265.
[245] *Id.* at 1266.

responsibilities with Quaker, as well as his lack of candor about his job.[246] The district court then issued an injunction preventing Mr. Redmond from assuming his new position at Quaker for at least six months.

Quaker appealed the decision to the Seventh Circuit. In a unanimous decision the Court concluded that "a plaintiff may prove a claim of trade secret misappropriation by demonstrating that a defendant's new employment will inevitably lead him to rely on plaintiff's trade secrets."[247] Realizing that the inevitable disclosure rule certainly had a negative effect on a worker's right to pursue a livelihood, the Court gave much consideration to the question of when disclosure of trade secrets is "inevitable" so as to justify the imposition of an injunction prohibiting competitive employment.

The Court ultimately concluded that prohibiting a party from undertaking a new endeavor for a reasonable period of time is proper (even in the absence of a non-competition agreement) where: (1) the employee has knowledge of the employer's trade secrets; (2) the new employment involves the same, or substantially similar, duties or technology as the former employment; and (3) the employee cannot be trusted to avoid using these trade secrets in his or her new job.[248]

Many courts have considered the inevitable disclosure doctrine since its "rebirth" in the PepsiCo case. Some cases have resulted

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[246] *Id*. at 1267.

[247] *Id*. at 1269.

[248] *Id.* at 1272. Like the lower court, the appellate court made particular note of Mr. Redmond's lack of candor and truthfulness toward his associates at PepsiCo. He had denied any interest in another job while he was negotiating with Quaker, had delayed his resignation a few days after accepting the new job, and he and Quaker had submitted affidavits early in the case concerning his new position and duties that were later undermined and contradicted by testimony at the preliminary injunction hearing. Id. at

in the issuance of injunctions where the employee stockpiled confidential information immediately prior to leaving a job, [249]or where the party's new undertaking could not be accomplished without using another's confidential information. On the other hand, injunctions have been denied where subsequent activities did not appear to involve the subject matter of the confidential information,[250] where the information had lost its value as a secret, [251] and where the grant of an injunction would have effectively precluded the person from employment. [252]

The inevitable disclosure doctrine involves two important and conflicting principles of law and public policy—freedom of employment on one hand and protection of corporate trade secrets on the other. Opponents of the doctrine point out that expansion of the rule would have broad negative implications for employee freedom of mobility. Many courts have noted in the past that while an employee should not be able to take "confidential, particularized plans, or process developed by his employer," he/she should be free to take "general skills and knowledge acquired during his employment tenure."[253] However, business firms have strenuously urged courts to protect the investment of time, money and resources by which the company has developed trade secrets in order to attain a competitive a advantage. Some forty-one states have considered the inevitable disclosure doctrine, and approximately twenty states have adopted it in certain situations.[254]

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[249] See cases cited by Emmert, *supra* note 73 at 1198.
[250] *Bridgestone/Firestone Inc. v. Lockhart*, 5 F. Supp. 2d 667 (S.D. Ind. 1998).
[251] *Campbell Soup Co. v. Giles*, 47 F. 3d 467 (1st Cir. 1995).
[252] *See, e.g. FMC Corp. v. Cyprus Minerals Foote Co*., 899 F. Supp. 1477 (W.D. N.C. 1995).
[253] See *AMP Inc. v. Fleishhacker*, 823 F. 2d 1199, 1202 (7th Cir. 1987). This case was cited, discussed and distinguished by the 7th Circuit in the *PepsiCo*. case. *See also* Susan Street Whaley, *The Inevitable Disaster of Inevitable Disclosure,* 67 CINCINNATI L. REV. 816 (1999).
[254] See Kate Marquess, *Are They Walking and Talking?* ABA JOURNAL, June 2000, p. 86; Stephen L. Sheinfeld & Jennifer M. Chow, *Protecting Employer*

The doctrine has been vigorously opposed in California, where a state statute prohibits the enforcement of non-compete agreements. Commentators have asserted that adoption of the theory would effectively allow employers to "get around" the state policy against non-compete agreements, and would greatly limit employees' ability to change jobs in the fast-moving high technology industry.[255] It will be interesting to follow the development and cases testing this theory in California and elsewhere.

XI. METHODS OF PROTECTION

As noted previously, the courts will not treat information as a trade secret if it has not been maintained as such. The effective management of trade secrets involves developing a clear understanding of what information needs to be protected, taking proactive steps to prevent unauthorized disclosure, and insuring that these steps are actually being followed.

A. Trade Secret/Intellectual Property Audit

One critical problem in developing a sound trade secret protection program is that many firms do not have a good understanding of how much critical confidential information they have that could qualify as a trade secret. "It's hard to protect something if nobody knows it needs protecting."[256] Firms can begin by taking stock of their intellectual property, and determining what information would be most damaging if lost to a rival.[257] This assessment, or "trade secret audit," will help to prompt appropriate measures.

Secrets and the "Doctrine of Inevitable Disclosure" 600 PRAC. LAW INST. 367, 392 (1999).

[255] John H. Matheson, *Employee Beware: The Irreparable Damage of the Inevitable Disclosure Doctrine*, 10 LOYOLA CONSUMER L. REV. 145 (1998).

[256] Murray, *supra* note 48 at 99.

[257] Rodd Zolkos, *Risks Rise From One's Own, and Others' Trade Secrets*, 35 BUSINESS INSURANCE 20 (2001)

Conducted with a firm's inside or outside counsel, this audit could also be used to determine the most appropriate legal form of protection (trade secret protection, trade dress protection, copyright, patent, or trademark) to be extended to the information.[258] Courts will examine how much money a firm has spent on trade secret protection in determining the precautions taken to keep the information secret. The expenses and precautionary efforts, however, need not exceed the benefit in security that is obtained.[259] A periodic trade secret audit will help to ensure that the attention and resources of the firm are directed toward the protection of their most critical informational assets.

B. Employee Training and Awareness

Employees should also be made aware of the importance of maintaining the secrecy of the company's trade secrets. Many employees may inadvertently take or disclose proprietary information because they do not understand that the information is protected.[260] Accidental disclosure generally leads to the loss of trade secret protection.[261] Periodic forums to remind employees of their trade secret obligations, particularly when coupled with confidentiality agreements (to be discussed later) may prove helpful in litigation in countering the argument that the misappropriated information was not considered to be a trade secret.[262] The company's policies regarding limited dissemination

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[258] Bacal, *supra* note 28 at 6. Bacal notes that preventative steps are critical in defining the battlefield for any future disputes. "Doing nothing almost always allows a wrongdoer to dictate the initial conditions of commercial warfare."
[259] David Majdali, *supra* note 61, at 147.
[260] Murray, *supra* note 48 at 102.
[261] Elias, *supra* note 27 at 21.
[262] William G. Porter & Michael C. Griffaton*, Identifying and Protecting Employers' Interests in Trade Secrets and Proprietary Information*, 68 DEFENSE COUNSEL JOURNAL 439, 445 (2001). Training and awareness programs for newly-hired employees should also emphasize that the confidential and

of confidential information may also be included in the employees' handbook or a company policies manual. Such programs and policies may also promote the development of employees' perceived responsibility to report activities that they fear would lead to the loss of the company's competitive information.[263]

C. Barriers to Disclosure

Limiting access to confidential information helps to establish that the firm has taken reasonable measures to insure its secrecy.[264] More importantly, such barriers serve to reduce the likelihood that the information will be misappropriated in the first place. Trade secret litigation is very expensive, and may offer little recourse once the information becomes public. It is far wiser to be proactive.[265] Barriers to disclosure may be physical, technological, or contractual.

D. Physical Barriers to Disclosure

Physical barriers, such as restricted areas, authorized access, and keeping information under lock and key divide those who should have access to information from those who should not. This certainly includes restriction of visitor access as well.[266] Tangible physical barriers are often easier for the courts to understand than contractual barriers. To the extent that little has been done to physically segregate the confidential information, judges may feel that protective measures have been inadequate.[267] Additional disclosure barriers should be put into place. Confidential

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proprietary information of one's prior employer should not be utilized in the current job. Majdali, *supr*a note 62 at 11.

[263] Bacal, *supra* note 28 at 6.

[264] Majdali, *supra* note 61 at 148.

[265] Carr & Gorman, *supra* note 42 at 25.

[266] Majdali, *supra* note 61 at 149.

[267] Bacal, *supra* note 28 at 9.

information itself should clearly be labeled as such. Written information should be marked “Confidential” or “Proprietary.” Limited dissemination of such documents may be on a ”need to know” basis. The documents should be bound, to impede photocopying or easy removal.[268] Similarly, all trade secrets on floppy disks should be so labeled, as well as computer files containing secret information .[269]

E. Technological Measures

Computer technology can facilitate the rapid dissemination of once-proprietary information, as trade secrets may be readily disclosed by employees or accessed by outside hackers. Fortunately, technological solutions may also be called upon to protect against such risks. Technological barriers may include password access to the company’s computer system, firewalls to prevent unauthorized access, and encryption.[270] Computer security should also be included on the employee’s laptops. Security for notebook computers can allow only authorized users to log on.[271]

F. Contractual Barriers

When trade secrets have been provided to employees or such third parties as suppliers, consultants, licensees, or outside product testers, contractual barriers are used to prevent further disclosure. In providing information to third parties, this is necessary to

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268 Maxine L. Retsky, 36(5) *Trade Secrets are Vital to Biz, Tough to Keep,* MARKETING NEWS 10 (2002) at 12.
269 Majdali, *supra* note 61 at 153.
270 *Id*. at 154.
271 Lazzara, *Safeguarding the Company’s Jewels*. 73(5) MACHINE DESIGN. 128 (2001) p 130.

maintain the information's status as a trade secret.[272] Contractual barriers include nondisclosure and noncompetition agreements.[273]

The nondisclosure (or confidentiality) agreement is a contract wherein a person or business promises to treat specific information as a trade secret. The contract prohibits them from disclosing the secret to others without proper authorization.[274] The term "nondisclosure agreement" is often used interchangeably with "confidentiality agreement." Some argue, however, that the term "nondisclosure agreements" is to be applied in dealing with third parties, while "confidentiality" agreements apply to employees.[275]

Confidentially agreements may be readily implemented into employment contracts—the signing of such a contract may be a condition of employment.[276] In addition to committing the employee to the protection of the firm's trade secrets, the contract should also stipulate that the employee's obligation to maintain the secret does not end when he or she is no longer employed by the company.[277] It is also frequently recommended that regular review of the employee's obligation not to disclose the employer's trade secrets be provided.[278]

Such reminders may be particularly important at the time the employee is terminating employment with the firm. At this time, a formal exit interview may be conducted to remind the employee to return all of the company's proprietary documents and to again stress the importance of the agreements that the employee has signed, and that his or her unauthorized disclosure of trade secrets

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272 Majdali, *supra* note 61 at 150.
273 Bacal, *supra* note 28 at 10.
274 Elias, *supra* note 27 at 42.
275 *Id*. at 26.
276 Majdali, *supra* note 61 at 151.
277 Retsky, *supra* note 101 at 12.
278 Zolkos, *supra* note 90 at 20.

may result in personal liability.[279] This may be reinforced by a letter sent to the employee upon departure.[280] Some firms will also send notice to the new employer, informing them of this obligation, and that any disclosure of this information may not be used by the new employer. In the event that the new employer does make use of the information, the former employer may obtain greater judicial relief.[281]

Noncompetition agreements (or covenants not to compete) may serve to protect an organization from former employees' use of the confidential information gained during employment. These agreements entail a written promise by an employee not to compete with his or her employer for a specified time after the employer-employee relationship ends.[282] There may also be geographical limitations to the noncompetition agreement.[283] Traditionally firms applied separation agreements (including noncompete clauses) only for top executives. However,

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[279] Elias, *supra* note 27 at 32.
[280] Murray, *supra* note 48 at 104.
[281] Elias, *supra* note 27 at 42. Concerns about trade secret litigation certainly extend to the hiring firm as well. Firms are advised to conduct background checks on prospective employees (Lazurra, *supra* note 74 at 130), including criminal background checks on all clerical, custodial, or other personnel who may have access to classified information or secured areas (Robert Ramsey, *Keeping Trade Secrets Safe*, 62(7) SUPERVISION 11, at 13). Employers are to ask whether the applicant has signed confidentiality agreements and/or non-compete agreements with a former employer, and examine those documents. Extensive review of the applicant's former duties and responsibilities should also be conducted relative to risk of "inevitable disclosure". Explore the possibility of "sanitizing" the new position by ensuring that job demands do not exploit the new employees' proprietary knowledge gained from the former employer (Porter & Griffaton, *supra* note 95, at 442-445). New employees should be urged to leave the competitor's documents behind, and the new employee's offer letters and employment agreements should note that the employee is not to use trade secrets from their former employers (see Flynn, *supra* note 50 at 123).
[282] Elias, *supra* note 27 at 28.
[283] Bacal, *supra* note 28 at 10.

noncompetition agreements are now increasingly being used for technical and professional employees, as well as for those with less sophisticated skills.[284]

Despite their popularity, covenants not to compete have often proved difficult to enforce in court. Courts are often reluctant to favor contracts that restrict the worker's right to work. Some states have banned or greatly restricted the use of these covenants. However, most states will enforce noncompetition agreements if they are indeed seen as essential for the protection of trade secrets and do not overly restrict the employee's freedom to earn a living.[285] For this reason, it is important for a firm to tailor noncompetition agreements, ensuring that there is a legitimate business purpose justifying the restrictions called for in the covenant.[286]

XII. CONCLUSION

There is a need for balance in trade secret protection programs. Companies that have been victimized by trade secret theft may be tempted to adopt severely stringent practices in both physical and contractual restrictions. However, more is not always better. As just noted, the courts are loathe to enforce noncompetes that are felt to be overly broad. "Greed" in noncompetes may work against the interests of the firm, as judges weigh the firm's need to guard its intellectual assets against the rights of the individual to make a living.[287]

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[284] Clifford M. Koen, James D. Morgan & Susan Leidner, *Separation agreements: Legal and tax issues for consideration*. 17(5) JOURNAL OF COMPENSATION AND BENEFITS, 21 (2001) 21.

[285] Elias, *supra* note 27 at 28. California, North Dakota, and Montana generally do not recognize noncompete agreements (Siskos, *supra* note 48 at 83).

[286] Bacal, *supra* note 28 at 11.

[287] *Id.* at 24. A firm whose trade secrets have been improperly acquired by another party can seek relief from the courts. The courts may prohibit a defendant from using (or disclosing to others) a trade secret belonging to the

Similarly, stamping too many documents as confidential has the practical effect of reducing the impact of the notice. If everything is "confidential", there is no clear signal to the employee that any particular document is to be given special consideration.[288]

Another concern relates to the impact of trade secret practices on the ongoing operations of the firm. Overly strict physical barriers to disclosure may not only lead to a prison-like setting, but may impair the organization's ability to function. A not-uncommon recommendation, for example, is for companies to compartmentalize information. That is, information should be split among several employees, ensuring that no single individual has "all the pieces of the puzzle."[289] Such an environment is antithetical to innovation and creativity. Efforts to structure so-called "learning organizations" involve facilitating the free flow of information. "Boundaries don't just keep information in, they keep it out, too."[290]

These considerations suggest that firms must adjust their security precautions to the level of threat posed by the loss of a particular

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plaintiff. While such injunctions may sometimes be permanent, more often the court will limit the duration of the injunction to a period of time equivalent to that which it would have taken the defendant to have independently developed the information. The court may also award the trade secret owner money damages to compensate for the plaintiff's monetary losses . In very clear-cut cases, the trade secret thief may be subjected to punitive damages and criminal prosecution under federal and state criminal antitheft laws. However, firms may be reluctant to pursue litigation. This reluctance may stem from concerns about the cost of litigation, the risks of further disclosure of proprietary information during litigation, and the impact that public disclosure of the loss might have on public perception and stock prices. *See generally*, Elias, *supra note* 27, p. 30,38,59; Bacal, *supra* note 28 at 6; Carr & Gorrman, *supra* note 42 at 25.

[288] Carr & Gorman, supra note 42 at 23.

[289] Shira Levine, *Stealing secrets: the theft of corporate secrets is frustrating companies that attempt to stay competitive in high-tech's cutthroat environment*. 104 AMERICA'S NETWORK MAGAZINE 22 (Sept. 15, 2000) 22-24.

[290] Stewart, *supra* note 45 at 102.

trade secret. In some circumstances, fortress-like barriers may be indeed called for. Absent real business purpose, protection polices can dilute the actual protection provided, and interfere with the ability of the firm to continue to generate valuable intellectual capital.

MULTI-LEVEL MARKETING AND ITS BRETHREN: THE LEGAL AND REGULATORY ENVIRONMENT IN THE DOWN ECONOMY

By

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This article explores the current legal environment surrounding the multi-level marketing business model also known as "network marketing" or simply MLM.[291] MLM companies and the MLM model have generated legitimate direct selling business opportunities for non-salaried, independent business owners in the United States and around the world.[292] Michigan-based Amway Global is often recognized as one of the most popular and

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[291] *See* Grimes & Reese, P.L.L.C., *Legal Principles of Multilevel Marketing*, MLMLAW.COM, 2008, http://www.mlmlaw.com/library/guides/Primer.htm (Idaho-based law firm specializing in the direct selling industry and in-house counsel to direct selling company Melaleuca). Throughout this article, the acronym MLM may be used for "multi-level marketing organization or plan" for short. MLM is also referred to as direct selling and its members are often referred to as "distributors."

[292] *See generally,* Direct Selling Association, http://www.dsa.org/ (last visited Nov. 31, 2009). *See also,* Sergio Pareja, *Sales Gone Wild: Will the FTC's Business Opportunity Rule Put an End to Pyramid Marketing Schemes*?, 39 MCGEORGE L. REV. 83, 87-88 (2008) (thorough discussion of a variety of deceptive business opportunity schemes including pyramid schemes, Ponzi schemes, and MLMs, an analysis of a proposed modification to federal law with regard to the federal Franchise and Business Opportunity Rule at the time Pareja's writing, and noting the steady increase in of "direct selling" participants in recent years).

successful MLMs and celebrated its 50th anniversary in 2009.[293] Opportunities to work with an MLM such as Amway include the opportunity to start one's own business and even work out of one's own home.[294] Published legal research in the area of MLM appears to be somewhat lacking, however.[295]

Legitimate MLMs, though sometimes erroneously characterized as or confused with illegal pyramid or Ponzi schemes, have come under intense scrutiny due to the efforts of "rotten apples" which operated illegally and have been forced to pay hefty fines or terminate the operation altogether.[296] A discussion of Ponzi schemes continues to be relevant today especially after the exposure of numerous Ponzi schemers in recent years beginning, of course, with a discussion and analysis of the downfall of financier Bernard Madoff's scam, the largest Ponzi scheme in

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[293] *See* Amway 50th Anniversary-Tribute to Rich DeVos, YOUTUBE.COM, http://www.youtube.com/watch?v=vw6_Tk4Nv3s (on file with the author) (last visited Nov. 3, 2009); *See also*, Amway Media Blog, http://mediablog.amway.com/ (last visited Nov. 31, 2009); *But See* Robert T. Carroll, *Amway (Quixtar) (Team of Destiny) (TEAM) (Network 21)*, http://www.skepdic.com/amway.html (critical review of Amway and MLMs) (last visited Nov. 31, 2009); *See also*, Amway Global-Our Company, QUIXTAR.COM, http://www.quixtar.com/about/company/ (Quixtar became Amway Global in 2008) (last visited Nov. 31, 2009).

[294] Pareja, *supra* note 2, at 93-94. *See also*, Federal Trade Commission, *Consumer Sentinel Network*, http://www.ftc.gov/sentinel/. (last visited Nov. 31, 2009). *See also,* Dateline (with Stone Phillips), *Behind the Dream*, YOUTUBE.COM, 2004, http://www.youtube.com/watch?v=ot31XhgE_XE (on file with the author) (last visited Nov. 31, 2009).

[295] The author entered "multi-level marketing" into the Lexis.com database and there were only 32 articles under US Law Reviews and Journals, Combined, which mentioned the phrase (last visited Nov. 3, 2009).

[296] *See* Jeffrey A. Babener, *Investigating a Network Marketing Opportunity*, Feb. 1996, http://www.mlmone.org/investigating.html (last visited Nov. 2, 2009); *See also*, Robert FitzPatrick, *Why the FTC Let's MLM Run Wild in America*, PYRAMID SCHEME ALERT, Dec. 2007, http://www.pyramidschemealert.org/psamain/news/MLMInfluenceBuying.html (last visited Nov. 1, 2009).

history, which the Securities and Exchange Commission (SEC) failed to uncover for many years until the overall economy tanked.[297]

In response to illegitimate operations, the federal government and more than half of the states have enacted laws which address MLMs and their fraudulent counterparts.[298] MLM advocates and critics have infiltrated the internet by voicing their opinions and providing a volume of resources for anyone who might be interested in exploring a particular MLM or the multi-level marketing world generally.[299]

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297 *See, e.g.*, Kathie Kroll, *Ponzi Schemes Seem to Proliferate in Tough Economic Times*, May 2, 2009, CLEVELAND.COM, http://www.cleveland.com/business/index.ssf/2009/05/ponzi_schemes_seem_to_prolifer.html (last visited Dec. 3 2009)(offering that Ponzis crumble during tough financial times because worried investors start pulling money out creating a liquidity crisis for the schemer); *See also,* Associated Press, *Madoff: I Had 'Too Much Credibility' with SEC*, Oct. 31, 2009, CNBC.COM, http://www.cnbc.com/id/33560855 (last visited Nov. 3, 2009); John Waggoner, *Madoff's Gone but Ponzi Schemes Go On*, USATODAY.COM, Oct. 6, 2009, http://www.usatoday.com/money/markets/2009-10-02-other-ponzi-schemes-after-madoff_N.htm; Anne Applebaum, *Tumble from a Pyramid*, Dec. 16, 2008, WASHINGTONPOST.COM, http://www.washingtonpost.com/wp-dyn/content/article/2008/12/15/AR2008121502393.html (last visited Nov. 1, 2009) (using the term "pyramid" rather than Ponzi in reference to Madoff's scheme).

298 *See* Federal Trade Commission, *State Offices Administering Business Opportunity Disclosure Laws*, http://www.ftc.gov/bcp/franchise/netbusop.shtm. (Alaska, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, Washington, Wisconsin) (last visited Nov. 1, 2009); *See also,* Andrew B. Wright, *Idaho at a Crossroads: Choices for Regulating Viatical Settlements*, 39 IDAHO L. REV. 179, 182-93 (2002) (federal and state regulatory schemes).

299 *See generally,* Jeffrey A. Babener, MLM LEGAL, http://www.mlmlegal.com/ (Oregon-based attorney, editor, and member of Babener & Associates law firm) (last visited Nov. 1, 2009); *See also,* FitzPatrick, *supra* note 5, PYRAMID SCHEME ALERT, http://www.pyramidschemealert.org/ (Charlotte-based

Part I compares the MLM to pyramid schemes, Ponzi schemes and business opportunities. Part II explores the legislative authority and role that the administrative agencies have played in regulating MLMs with emphasis on the Federal Trade Commission (FTC) and the Securities and Exchange Commission (SEC).[300] An exploration of a few state anti-pyramid and consumer protection statutes is presented demonstrating that MLMs are subject to governmental regulation and public critique from many angles.[301] The author suggests that while MLMs will likely flourish in a down economy that it might be simple and appropriate to incorporate a three business day right-to rescind (i.e., "cooling-off") period for MLM enrollees within the various state consumer protection statutes mirroring the FTC's current door-to-door sales rule.[302]

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organization whose purpose is to expose, study and prevent illegal pyramid schemes); Dr. Jon M. Taylor, *Truth on MLM or Network Marketing*, MLM-THE TRUTH, : http://mlm-thetruth.com/ ("The most extensive research ever done on MLM compensation plans and profitability, on distinguishing characteristics separating legitimate direct selling from pyramid or chain selling, and on the deceptions used to sell product-based pyramid schemes."); Brian Garvin and Jeff West, MLM REVIEW KINGS, http://www.mlmreviewkings.com/ ("Your Network Marketing Authority Hub").

[300] *See, e.g.,* Federal Trade Commission, *FutureNet Defendant Settles FTC Charges*, Nov. 24, 1998, http://www.ftc.gov/opa/1998/11/huff.shtm (last visited Nov. 1, 2009); *But see* Pareja, *supra* note 2, at 87-88 (direct selling industry virtually unregulated leading to a "silent scandal").

[301] *See generally,* Babener, *supra* note 7; *See also,* FitzPatrick, and Taylor, *supra* note 7; ; *See also,* James P. Nehf, *Borderless Trade and the Consumer Interest: Protecting the Consumer in the Age of E-Commerce,* 38 COLUM. J. TRANSNAT'L L. 457 (1999) (Review of book by John Dickie, INTERNET AND ELECTRONIC COMMERCE LAW IN THE EUROPEAN UNION, and noting that some of the most common online consumer complaints involve, *inter alia*, multi-level marketing (pyramid schemes, chain letters), bogus business opportunities, and ineffective health and diet products).

[302] *See* Pareja, *supra* note 2 at 129 (refers to a three day "waiting" period); *See also*, FTC Rule Concerning Cooling-Off Period for Sales Made at Homes or Certain Other Locations, 16 C.F.R. § 429.0 et seq. (2009). (Door-to-Door Sale defined as "A sale, lease, or rental of consumer goods or services with a

Regardless of the statutory and regulatory landscape, information is readily available on the internet for consumers, prospective MLM members or anyone for that matter. Homepages of start-up and established MLM organizations, video postings on YouTube.com, MLM-related blogs and message boards provide ample access to MLMs.[303] While MLM has had its share of legal challenges, the current regulatory environment in the internet era provides loads of information for prospects willing to assume personal responsibility for joining the MLM and to assist in differentiating the legitimate schemes from the scams.[304]

I: THE MLM: LEGITIMATE BUSINESS OPPORTUNITY OR ILLEGAL PYRAMID SCHEME?

MLM is certainly big business in the United States, Canada and around the world involving millions of individual direct selling MLM members.[305] MLMs offer opportunities to sell from a broad

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purchase price of $25 or more, whether under single or multiple contracts, in which the seller or his representative personally solicits the sale, including those in response to or following an invitation by the buyer, and the buyer's agreement or offer to purchase is made at a place other than the place of business of the seller (e.g., sales at the buyer's residence or at facilities rented on a temporary or short-term basis, such as hotel or motel rooms, convention centers, fairgrounds and restaurants, or sales at the buyer's workplace or in dormitory lounges)...").

303 *See generally,* Robert L. FitzPatrick, FALSE PROFITS BLOG, http://www.falseprofits.com/FalseProfitsBlog.html (last visited Nov. 1, 2009); *See also,* Michal Hamblin, EVANGELICAL RESOURCES ON MULTI-LEVEL MARKETING, http://www.evangelicalresources.org/mlm.shtml; *Cf.* SCAM.COM, *MLM/Pyramid Scams* (message board) http://scam.com/forumdisplay.php?s=464449b16feb2823f88430a4837b015b&f=11 (last visited Nov. 1, 2009).

304 *See generally,* Babener, *supra* note 7.

305 *See* Direct Selling Association, DSA.ORG, http://www.dsa.org/pubs/numbers/ (industry statistics on numbers on MLM participants) (last visited Nov. 1, 2009); *See also,* John Sotos and Arthur J. Trebilcock, *Canadian Franchise Disclosure Statutes: Exemptions and Exclusions Analysis and Recommendations*, 8 ASPER REV. INT'L BUS. & TRADE L. 395, 409 (2008) (recommendation, *inter alia*, that MLM be exempt from

spectrum of goods ranging from cosmetics to cleaning supplies to weight-loss pills to nutritional supplements to insurance.[306] In addition to Amway, some of the more popular MLMs that have established themselves nationally and internationally include: Mary Kay,[307]Avon,[308] Tupperware,[309] and MonaVie.[310] Indeed, many of the MLMs have made their founders quite wealthy.[311]
While MLMs often relied on word-of-mouth campaigns and grass roots door-to-door sales, companies such as Amway have reappeared in mainstream media outlets with intense marketing including sponsorships of several American sports teams and arenas.[312] High-profile individuals, including celebrities and sports

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Canadian franchise disclosure laws since Canada already utilizes Section 55 of the Competition Act to regulate multi-level marketing).

306 *See* Jeffrey A. Babener, *MLM Company Profiles*, MLMLEGAL.COM, http://www.mlmlegal.com/profiles/index.html (list of over one hundred links to MLM companies, divided alphabetically and by category) (last visited Nov. 1, 2009).

307 *See* MARY KAY, http://www.marykay.com/ (last visited Nov. 1, 2009).

308 *See* AVON, http://www.avon.com/ (last visited Nov. 1, 2009).

309 *See* TUPPERWARE, http://order.tupperware.com/coe/app/home (last visited Nov. 1, 2009).

310 *See* MONAVIE, http://www.monavie.com/Web/US/en/index.dhtml (last visited Nov. 1, 2009); *But See* Tony Dokoupil, *A Drink's Purple Reign*, NEWSWEEK, Nov. 11, 2008, http://www.newsweek.com/id/150499 (last visited Nov. 1, 2009).

311 *See* Dokoupil*, supra* note 18. *See also,* Luisa Kroll, Matthew Miller, and Tatiana Serafin, *The World's Bilionaires, #698, Kenny Troutt*, FORBES.COM, http://www.forbes.com/lists/2006/10/HFN0.html (last visited Nov. 1, 2009). *But See* Seth Lubove, *But Where are the Distributor's Yachts*, FORBES.COM, Oct. 20, 1997, http://www.forbes.com/forbes/1997/1020/6009043a.html (last visited Nov. 1, 2009).

312 *See* News Release, *Amway Global Becomes Los Angeles Sol Presenting Sponsor*, AMWAY GLOBAL NEWS Mar. 5, 2009, http://www.amwayglobalnews.com/pr/awg/LA_Sol.aspx (last visited Nov. 1, 2009); Beth Kassab, *Orlando Naming Rights are All in the Family*, ORLANDOSENTINEL.COM, Nov. 5, 2009, http://www.orlandosentinel.com/business/orl-magic-amway-naming-rights-kassab-080509,0,6480231.column (last visited Nov. 1, 2009); Tripp Mickle, *Amway Global Signs Jersey Sponsorship With MLS Earthquakes*, SPORTS

stars, promote MLM products via endorsements as well.[313] Today, virtually all MLMs have a solid, web-based presence to provide for increased access to their message and remain competitive in the internet era.[314]

MLMs, including their founding members, have drawn scrutiny for decades from federal and state regulators who have alleged violations of federal criminal statutes and questioned their legitimacy altogether more akin to a pyramid scheme.[315] MLM recruitment techniques can be extremely intense and sometimes misleading.[316] Concerns over fanatic, cult-like pressures preying upon potential recruits in order to persuade them to join (or remain) within the MLM membership ranks are quite common. [317]

BUSINESS DAILY, Jan. 27, 2009, http://www.sportsbusinessdaily.com/article/127262 (last visited Nov. 1, 2009).

[313] Dokoupil, *supra* note 18 (Boston Red Sox outfielder J.D. Drew and NASCAR driver Geoff Bodine promoting their belief in MonaVie). *But see*, Associated Press, *Oprah Sues 3 Utah Companies*, KSL.COM, Nov. 22, 2009, http://www.ksl.com/?nid=148&sid=7637595 (last visited Nov. 1, 2009).

[314] *See, e.g.,* Pareja, *supra* note 2, at 119-129 (critical discussion and analysis of ACN, an MLM company).

[315] *See* Debra A. Valentine, *"Pyramid Schemes,"* Federal Trade Commission, May 13, 1998, http://www.ftc.gov/speeches/other/dvimf16.shtm (federal mail fraud statute, 18 U.S.C. §1341, securities fraud 15 U.S.C. §§78 j (b), 78 ff, 18 U.S.C. § 2, and 17 C.F.R. § 240.10b-5, money laundering 18 U.S.C. §§ 2, 1957).

[316] Pareja, *supra* note 2, at 84-87, 96-97 (discussion of Charles Ponzi's deceptive business scheme beginning in 1919, and noting a study demonstrated that 99.9 percent of investors in "business opportunities" lose money in the United States alone); *Cf.* Cabot Christianson, *You Can't Cheat an Honest Man: Everything You Want to Know About Ponzi Schemes*, 23 ALASKA B. RAG, Jan./Feb. 1999, (Review of book by James Walsh, noting that "Ponzi schemes have a strong-almost addictive-grasp on the people…").

[317] SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 479-80 (9th Cir. 1973) ("These meetings are like an old time revival meeting..."); *See also,* Robert T. Carroll, *Multi-Level Marketing (MLM) Harassment*, THE SKEPTIC'S DICTIONARY, http://www.skepdic.com/mlmhar.html (managers might unduly influence employee-subordinates to participate in an MLM) (last visited Nov. 1, 2009); Adam Hojnacki & Peter Scheck, *Get Rich Quick?*, GENERATION,

It appears that some former members must seek post-separation assistance.[318] Sometimes, a religious component might be used as part of the pep-rallies and sales pitches to new recruits or customers.[319] As one MLM commentator notes, MLM sales and recruiting pitches make such outrageous claims as, "Make money like a gangster."[320] MLMs have required new members to buy into the scheme by paying a non-refundable initiation fee; this has drawn considerable and skeptical attention.[321]

A. "Business Opportunity"

MLMs claim that they offer business opportunities for those who believe in their goods or services and wish to participate in selling them. However, the phrase "business opportunity" is actually a legal definition which has been legislated and interpreted at the federal and state levels as a matter of consumer protection.[322]

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http://www.subboard.com/generation/articles/116164656490688.asp ("Ponzi schemes have a strong - almost addictive - grasp on the people who perpetrate them and the people who invest in them").

318 *See generally,* MLMSURVIVOR.COM, http://www.mlmsurvivor.com/links.htm (replete with examples of first-hand and alleged cult-like experiences, and a chance to engage in discussion with assistance and support groups over the post-separation experience) (last visited Nov. 1, 2009); *See also,* Dr. Jon M. Taylor, *12 Steps Deprogram and Rehabilitate MLM Victims*, CONSUMER AWARENESS INSTITUTE, http://mlm-thetruth.com/DeprogrammingMLMvictims.htm.

319 *See* Pareja, *supra* note 2, at 119-20 (Reference to ACN video quoting "This is a blessed company. We're blessed people.").

320 *See* Gary Langan Goodenow, Sr., *The SEC and Multilevel Marketing*, MLM WATCH, http://www.mlmwatch.org/11Legal/sec.html (last visited Nov. 1, 2009). *See also,* Pareja, *supra* note 2, at 95-96.

321 *See* Donna Fenn, *Fast-Sinking Star*, INC., Oct. 15, 2000, http://www.inc.com/magazine/20001015/20767.html (Equinox members were also expected to buy the products).

322 *See* Federal Trade Commission, *Legal Resources-Statutes Related to Consumer Protection Mission*, http://www.ftc.gov/ogc/stat3.shtm. (last modified Mar., 2009) (last visited Nov. 1, 2009); *See also,* Mark H. Miller, *Unintentional Franchising*, 36 ST. MARY'S L. J. 301, 304 (2005).

According to the FTC website, twenty-six states currently have statutes which specifically address business opportunities and are almost always enforced though state attorney general offices.[323]

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[323] *See* Federal Trade Commission, *State Offices Administering Business Opportunity Disclosure Laws*, http://www.ftc.gov/bcp/franchise/netbusop.shtm (Short list of states and referencing that in many jurisdictions business opportunities must be registered often through the state office of the Attorney General. However, the website lists Wisconsin: this author not only could not find a specific "business opportunity" statute for Wisconsin, and the FTC website has a note underneath Wisconsin, at the bottom, "Never heard of a biz op filing requirement in Wisconsin.") (last visited Nov. 1, 2009). The following represents the list of states and citations to business opportunity statutes: Alaska, ALASKA STAT. §§ 45.66.010-.900 (2009); California, CAL. CIV. CODE §§ 1812.200-.221 (2009); Connecticut Business Opportunity Investment Act, CONN. GEN. STAT. ANN. §§ 36b-60 to -80 (2009); Florida Sale of Business Opportunities Act, FLA. STAT. ANN. §§ 559.80-.815 (2009); Georgia, GA. CODE ANN. §§ 10-1-410 to -417 (2009); Illinois Business Opportunity Sales Law of 1995, 815 ILL. COMP. STAT. ANN. §§ 602/5-1 to -95 (2009); Indiana, IND. CODE ANN. §§ 24-5-8-1 to -21 (2009); Iowa, IOWA CODE ANN. §§ 551A.1-.10 (2009); Kentucky, KY. REV. STAT ANN. §§ 367.801-.819 (2009); Louisiana, LA. REV. STAT. ANN. §§ 51:1821-1824 (2009); Maine, ME. REV. STAT. ANN. tit. 32, §§ 4691-4700 (2009); Maryland Business Opportunity Sales Act, MD. CODE ANN., BUS. REG. §§ 14-101 to -129 (2009); Michigan Consumer Protection Act, MICH. COMP. LAWS ANN. §§ 445.902-.921 (2009); Minnesota, MINN. STAT. ANN. §§ 80C.01-.17 (2009); Nebraska Seller-Assisted Marketing Plan Act, NEB. REV. STAT. ANN. §§ 59-1701 to -1762 (2009); New Hampshire Distributorship Disclosure Act, N.H. REV. STAT. ANN. §§ 358-E:1-6 (2009); North Carolina, N.C. GEN. STAT. ANN. §§ 66-94-66-100 (2009); Ohio, OHIO REV. CODE ANN. §§ 1334.01-.99 (2009); Oklahoma Business Opportunity Sales Act, OKLA STAT. ANN. tit. 71, §§ 801-829 (2009); South Carolina Business Opportunity Sales Act, S.C. CODE ANN. §§ 39-57-10 to -80 (2009); South Dakota Business Opportunities Act, S.D. CODIFIED LAWS §§ 37-25A-1 to -55 (2009); Texas Business Opportunity Act, TEX. [BUS. & COM.] CODE ANN. §§ 41.001-.009 (2009); Utah Business Opportunity Disclosure Act, UTAH CODE ANN. §§ 13-15-1 to -7 (2009); Virginia Business Opportunity Sales Act, VA. CODE ANN. §§ 59.1-262 to -269 (2009); Washington Business Opportunity Fraud Act, WASH. REV. CODE ANN. §§ 19.110.010-.930 (2009); *See* Rupert M. Barkoff, *Franchise Sales Regulation Reform: Taking the Noose Off the Golden Goose*, 3 ENTREPREN. BUS. L. J. 233, 239 (2009) (footnote 28).

One of the first and most important legal issues involving an MLM is whether it has been established to sell anything or, instead, it is set up primarily to solicit others to join the group, the latter being considered an illegal pyramid scheme.[324] Still, not all MLMs fall under the jurisdiction of state or federal "business opportunity" laws since the definition may contain specific exemptions or other ambiguities.[325] Indeed, MLMs might even intentionally find and exploit loopholes in the statutes to avoid falling within the definition of a "business opportunity" from the get-go.[326]

B. FTC's Franchise and Business Opportunity Rule

In the name of consumer protection and in response to the prevalence of fraudulent pyramid schemes disguised as legitimate businesses, the FTC established its Franchise and Business Opportunity Rule ("Rule") which appears to be undergoing consideration for modification.[327] One of the hallmarks of the Rule

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[324] *See* Pareja, *supra* note 2, at 117; *See also,* Joel Michael Schwarz, *Looking a Gift Horse in the Mouth: An Analysis of Free Internet Stock Offerings*, 6 MICH. TELECOMM. TECH. L. REV. 89, 132-33 (1999) (noting that the main focus in a pyramid scheme is to recruit others for "headhunting fees" though both MLMs and pyramid schemes do use referrals as part of developing the program).

[325] *See, e.g.,* Jeffrey Babener, *FTC Business Opportunity Rule Exemption Falls Short…Intent Clear…Draft Language Too Ambiguous: MLMLegal.com and DSA Offer Suggested Clarifying Language*, MLM LEGAL, 2008, http://www.mlmlegal.com/FTC%20Business%20Opportunity%20Rule/FTCFallsShort.html (noting that South Dakota Business Opportunity Act has a $250 minimum threshold in order for the act to apply) (last visited Nov. 3, 2009).

[326] *See* Pareja, *supra* note 2, at 121 (noting that companies such as ACN hire high-powered law firms and legal teams which are actually comprise of former state attorneys general).

[327] For clarification, there is not, apparently, just one rule which governs both franchises and business opportunities at the federal level at the time of this writing. The original FTC Rule had addressed both franchises and business opportunities, initially, and went into effect in 1979, "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," 43 Fed. Reg. 59,614 (Dec. 21, 1978) codified at 16 C.F.R. § 436.1. It was then amended in 2007, 72 Fed. Reg. 15,444 (Mar. 30, 2007) (and codified as 16

is the requirement that if the minimum initial investment to participate in a business opportunity (such as an MLM) is $500.00 or more then it falls under the FTC's federal jurisdictional umbrella and certain disclosure rules apply for potential buyers (participants).[328] Indeed, many states have modeled their business opportunity statutes in the same way.[329] Shady MLMs or fraudulent pyramid marketing schemes appear to have exploited the Rule with particular emphasis on avoiding the federal $500 minimum threshold.[330]

In April, 2006, the FTC considered a proposal to adopt an amended version of its Rule which would have included all MLMs under its umbrella and to better stamp out unfair and deceptive practices such as illegal pyramiding.[331] The FTC recognized that there was considerable input on the proposed Rule including

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C.F.R. §§436, 437 with separate sections governing disclosure requirements for franchises or business opportunities during the FTC comment period as part of its rulemaking process. 16 C.F.R. § 436 et seq. is for "Disclosure Requirements and Prohibitions Concerning Franchising" while 16 C.F.R. §437 reads "Disclosure Requirements and Prohibitions Concerning Business Opportunities," [Notice name change]; *See* Barkoff, *supra* note 32, at 239 (footnote 28).

[328] *See* Federal Trade Commission, *FTC's Facts for Consumers: 'Net Based Business Opportunities: Are Some Flop-portunities?*, June 2002, http://www2.ftc.gov/bcp/edu/pubs/consumer/tech/tec05.shtm (last visited Nov. 1, 2009).

[329] *See, e.g*., MD. CODE ANN., BUS. REG. §§ 14-104(2) (2009).

[330] Pareja, *supra* note 2, at 92 (suggesting ACN charged $499 to avoid the $500 minimum threshold).

[331] *See* Pareja, *supra* note 2, at 86 (referencing Business Opportunity Rule, Notice of Proposed Rulemaking, 71 Fed. Reg. 19,054 (proposed Apr. 12, 2006)); *Id.* at 106-119 (noting, *inter alia*, that the $500 minimum would have been eliminated altogether if adopted); *See also,* Charles Duhigg, *Why Short Sellers Want to Crash the Tupperware Party*, N.Y.TIMES.COM, Nov. 13, 2006, http://query.nytimes.com/gst/fullpage.html?res=9903E4DA163EF930A25752C1A9609C8B63 (last visited Nov. 11, 2009) (recognizing that several MLM stocks are actually publicly traded including Avon, Nu Skin, Pre-Paid Legal, and Tupperware).

opinions from a variety of sources generating over 17,000 comments.[332] On March 18, 2008, the FTC announced that it sought comments on a revised proposed Rule.[333] As of the time of this writing, the FTC has decided to keep the *status quo* and to address MLMs under its current scheme which allows for jurisdiction involving unfair or deceptive practices and acts generally under Section 5 (a) of the FTC Act though it continued to advance a revised proposal generally.[334] Though the current federal law related to business opportunities appears to be in flux, MLMs continue to press on.

C. The MLM's Upline-Downline Structure

Key to any legitimately successful MLM is to understand the upline-downline structure in which the MLM member has someone "above" them and someone "below" them in the organizational hierarchy.[335] MLMs compensate "upline" (i.e.,

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332 *See* Robert L. FitzPatrick, PYRAMID SCHEME ALERT, *Letter to Steven Toporoff, Federal Trade Commission/Office of the Secretary, Re: FTC Business Opportunity Rule R511993*, http://www.ftc.gov/os/comments/businessopprule/522418-70036.pdf (last visited Nov. 2, 2009); *See also*, Federal Trade Commission, *Jeffrey A. Babener, Letter to Federal Trade Commission/Office of the Secretary Position Statement of Babener and Associates on FTC Revised Proposed Business Opportunity Rule*, R511993), http://ftc.gov/os/comments/bizoprevised/comments/535221-00071.pdf (last visited Nov. 2, 2009); *See also,* Pareja, *supra* note 2, at 118-120 (MLM industry viewed the proposed Rule a "serious threat").

333 *See* Federal Trade Commission, *FTC Approves Federal Register Notice Seeking Comments on Revised Proposed Business Opportunity Rule*, http://ftc.gov/opa/2008/03/busrule.shtm (last visited Nov. 2, 2009).

334 15 U.S.C. § 45(a)(1) (2009); *See also,* FEDERAL REGISTER, *Public Workshop: Business Opportunity Rule An FTC Workshop Analyzing Business Opportunity Disclosure Form and Other Proposed Changes to the Business Opportunity Rule*, Vol. 74, no. 78, Apr. 24, 2009, http://www.ftc.gov/os/fedreg/2009/Apr./090424bizopprule.pdf (last visited Nov. 2, 2009); *See also*, Babener, *supra* note 34.

335 *See, e.g.,* Michele A. Wong, *China's Direct Marketing Ban: A Case Study of China's Response to Capital-Based Social Networks*, 11 PAC. RIM L. & POL'Y

vertical) members based upon actual sales of goods or services to customers from the "downline" members, theoretically *ad infinitum* in a pyramid-like structure.[336] However, a structure that compensates its downline participants primarily based upon the recruitment of new downline participants rather than the actual sale of goods or services represents an illegal pyramid scheme.[337] The distinguishing element between any MLM from its illegal adversary (i.e., the pyramid scheme) is that the legitimate MLM offers a third party (i.e., a third-party, retail consumer or any non-participant in the upline-downline structure) the chance to purchase an actual good or service. The illegal pyramid scheme only offers a promise of a positive return on an initial financial investment and only if additional members are recruited into the scheme.

To the ambitious MLM member, building a solid downline membership is vital and can be extremely exciting since residual income is earned from the continuous efforts and sales of the downline distribution network. An individual MLM member has a vested interest in the sustenance and success of the upline-downline structure, and this co-dependent upline-downline relationship can create an extreme synergistic-buzz of excitement for many MLM members who wish to benefit off the efforts of others.[338] This creates a pyramid-like structure with more members below (less members above) as the MLM's upline-downline organization grows. In that way, the downline generates multiple levels of possible commissions to the upline member as long as the

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257, 258-260 (2002) (discussion of MLM structure and the outright ban on direct selling in China); *Compare* A. Brooke Overby, *Consumer Protection in China After Accession to the WTO*, 33 SYRACUSE J. INT'L L. & COM. 347 (2006) (noting Chinese market is Amway's largest with revenue of $ 1.2 billion).

336 MLMs control the method and percentages of the commission structure, not individual members.

337 *See* Clinton D. Howie, *Is it a Pyramid Scheme?: Multilevel Marketing and Louisiana's "New"Anti-Pyramid Statute*, 49 LA. B. J. 288, 289 (2002).

338 *See* Fenn, *supra* note 30 (some Equinox meetings described as "high voltage" and cost up to $2,500).

downline distribution continues to sell. However, in order for the downline structure to expand, there must be the recruitment of new members as well which can be difficult to maintain.[339] This pyramid shape alone, however, does not mean it is a pyramid scheme.

D. Pyramid Schemes

Pyramid schemes (and Ponzi schemes) are doomed to fail and MLM legal problems often begin when regulators pursue the organization as an illegal pyramid scheme disguised as an MLM.[340] The FTC shed some light into how courts and governmental regulators might view the difference in a case in 1979 involving Amway.[341] This significant decision, which held that Amway did, in fact, operate legally, seems to set the standard for all cases when addressing the difference between MLM and pyramid scheme.

For example, the *Amway* decision was given great deference twenty years later in *U.S. v. Gold Unlimited, Inc.*, with the majority upholding a criminal conviction for a corporate "Get Rich Quick" scheme which focused more on pyramiding and less on retailing.[342]

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[339] *See* Financial & Tax Fraud Education Associates, Inc., *Multi-Level Marketing*, http://www.quatloos.com/mlm/mlm.htm (98% drop out immediately) (last visited Nov. 2, 2009).

[340] *See* Valentine, *supra* note 24; *See also,* Catherine Rampell, *A Scheme with No Off Button*, THE NEW YORK TIMES, Dec. 20, 2008, http://www.nytimes.com/2008/12/21/weekinreview/21rampell.html (last visited Nov. 2, 2009).

[341] *In re Amway Corp*., 93 F.T.C. 618, 715 (1979) ("a pyramid scheme is characterized by: The payment by participants of money to the company in return for which they receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users.").

[342] *U.S. v. Gold Unlimited, Inc.,* 177 F.3d 472, 475 (6th Cir. 1999).

Similarly, in *Webster v. Omnitrition, Int'l Inc,*[343] the Ninth Circuit Court of Appeals, citing *Amway* as well, noted that pyramid schemes "are said to be inherently fraudulent."[344]

Since the *Amway* decision in 1979 and its progeny, factors used to determine whether a business is a legitimate MLM or an illegitimate pyramid scheme, include:[345]

1. Products have "no real world marketplace" and that the marketing program is a cover for a scam;
2. Products are sold at inflated prices;
3. That there is a substantial "buy-in" qualification also known as "inventory loading" or "front-loading" for the membership; [346]
4. That there is an initial cash investment over $500;
5. That members must purchase ancillary products or services to remain in the program;

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343 *Webster v. Omnitrition Int'l, Inc*., 79 F.3d 776 (9th Cir 1996); *See also,* Pareja, *supra* note 2, at 101-02 (noting that the Omnitrition case was the "seminal" Ninth Circuit case on pyramid schemes).

344 *Webster at 781* (quoting *In re Koscot Interplanetary, Inc*., 86 F.T.C. 1106, 1181 (1975), *aff'd mem. sub nom*., *Turner.v. FTC,* 580 F.2d 701 (D.C. Cir. 1978)); *Compare Ger-Ro-Mar, Inc. v. FTC*, 518 F.2d. 33 (2d Cir. 1975) (FTC's claim that MLM business engaged in manufacture of brassieres, girdles, swimwear and lingerie constituted unfair practices failed though court found that some promotional materials were deceptive though not a pyramid scheme).

345 *See* Babener, *supra* note 5.

346 *See, e.g*., Jeffrey A. Babener, *FTC v. Equinox – Déjà vu*, 1999, http://www.mlmattorney.com/equinox.html (last visited Nov. 2, 2009).

6. Whether the MLM has an inventory repurchase policy in the event that the member leaves the MLM;

7. That the emphasis is, or has become, more focused on rewards for recruiting than selling goods or services; and

8. Whether there are misrepresentations related to membership earnings claims or outright misrepresentations related to potential income by the member.[347]

E. Ponzi Schemes

A Ponzi scheme is named after Charles Ponzi, an Italian immigrant and already convicted who perpetrated a fraud on investors who were duped into thinking they could gain investment returns of 50 percent in less than two months.[348] Unlike the legitimate MLM or the fraudulent pyramid scheme, a Ponzi scheme is an offer of a financial investment opportunity usually guaranteeing higher than

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[347] *Id.*; *See, e.g.,* Fenn, *supra* note 30 (more than 80% of Equinox distributors made less than $1,000 a year and less than 2% earned more than $20,000); *See also,* Stephen Barrett, CASEWATCH, *Quixtar Facing Class Action Lawsuit*, http://www.casewatch.org/civil/amway/class_action_complaint.shtml (noting that Pyramid Scheme Alert's Robert FitzPatrick submitted a declaration asserting that in 2001, 99.4% of all Quixtar distributors earned an average of $13.41 per week before product purchases, business expenses, and taxes, with the result that 99% of them made no profit) (last visited Nov. 2, 2009); *See also,* Kevin D. Grimes, *Income and Earnings Representations*, MLMSTARTUP.COM, 1996, http://www.mlmstartup.com/articles/incmreps.htm (last visited Nov. 2, 2009); *But See* MonaVie, *Income Disclosure Statement Global 2008*, http://media.monavie.com/pdf/corporate/income_disclosure_statement.pdf (last visited Nov. 2, 2009).

[348] *See* Ralph Blumenthal, *Lost Manuscript Unmasks Details of Original Ponzi*, THE NEW YORK TIMES, May 4, 2009, http://www.nytimes.com/2009/05/05/nyregion/05ponzi.html (last visited Nov. 2, 2009).

average returns but without any further effort by the investor.[349] While the terms "pyramid scheme" and "Ponzi scheme" are often used interchangeably, both are slightly different and they are illegal.[350] In recent years, the number of Ponzi schemes that have been exposed has simply exploded.[351] Anyone is susceptible to becoming a victim of a Ponzi scheme as demonstrated by the recent economic melt-down causing investors to withdraw their money from investment firms and banks.[352]

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349 *See, e.g.,* Barbara Rudolph and Sally B. Donnelly, *Poof Go the Profits*, TIME.COM, Nov. 8, 1994, http://www.time.com/time/magazine/article/0,9171,981229,00.html (last visited Nov. 2, 2009); *Compare* Ponzi Schemes, THE NEW YORK TIMES, http://topics.nytimes.com/topics/reference/timestopics/subjects/f/frauds_and_swindling/ponzi_schemes/index.html (Ponzi scheme almost bankrupted the country of Albania) (last visited Nov. 2, 2009). *See also,* Pareja, *supra* note 2, at 84-88.

350 *See* Mark C. Knutson, *The "Ponzi Scheme,"* http://www.mark-knutson.com/Ponzi/theScheme.html (last visited Nov. 2, 2009).

351 *See, e.g.,* Benjamin Weiser, *Lawyer Gets 20 Years in $700 Million Fraud*, July 13, 2009, THE NEW YORK TIMES, http://www.nytimes.com/2009/07/14/nyregion/14dreier.html (last visited Nov. 2, 2009); Josh Funk, *Former Athletes' Adviser Charged in Ponzi Scheme*, Nov. 24, 2009, http://www.wrcbtv.com/Global/story.asp?S=10983057; Gary T. Pakulski, *Firms Sued by SEC Leave Many in Limbo*, TOLEDOBLADE.COM, Nov. 23, 2009, http://www.toledoblade.com/apps/pbcs.dll/article?AID=/20090823/BUSINESS03/908230311; Ken Whitehouse, *Suspected Ponzi Scheme Conspirator Declares Bankruptcy*, NASHVILLEPOST.COM, Nov. 17, 2009, http://www.nashvillepost.com/news/2009/8/17/suspected_ponzi_scheme_conspirator_declares_bankruptcy (referencing several Nashville-area Ponzi schemes).

352 *See, e.g.,* Leslie Wayne, *Bank of America Accused in Ponzi Lawsuit*, THE NEW YORK TIMES, Mar. 27, 2009, http://www.nytimes.com/2009/03/28/business/28ponzi.html?fta=y (last visited Nov. 2, 2009). *See also,* Gregg Krupa, *Bank Sues Rich Rodriguez Over Va. Tech Condos*, DETNEWS.COM, Nov. 2, 2009, http://www.detroitnews.com/article/20090902/SPORTS0201/909020325/1004/U-M-hires-outside-firm-to-assist-in-investigation/Bank+sues+Rich+Rodriguez+over+Va.+Tech+condos (last visited Nov. 2, 2009).

Unlike the pyramid scheme or legitimate MLM, the Ponzi scheme does not provide any upline-downline commission incentive arrangement in which participants share a vested interest in the scheme and does not reward for selling products or recruiting new members. Returns on investments are often marketed to the investor to be higher than the average and involve paying the early investors large dividends which entices others to join the con.[353] From the outset of the initial investment, the promoter continually misrepresents how the investor's money is gaining financial returns. Ponzi promoters will send false financial statements to the investors stating bogus rates of returns comforting the investor who has no idea of the scam until it is too late.[354] Then, to appear legitimate and to keep the scheme from collapsing altogether, the Ponzi promoter still must continue attract new investors especially if earlier investors scramble to cash out. [355] However, the Ponzi scheme promoter has stolen the money, used it for themselves, lying to the investors all along. In some cases, the schemer files for bankruptcy itself to avoid paying creditors whose money has been stolen.[356]

Since the Ponzi scheme involves an investment rather than the purchase or sale of goods, the SEC becomes involved when

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353 *See* Christianson, *supra* note 25.

354 *See, e.g*., News Release, Securities and Exchange Commission, *SEC Halts Multi-Million Dollar Ponzi Scheme Operated by Long Island Investment Adviser*, Apr. 1, 2009, http://www.sec.gov/news/press/2009/2009-73.htm (last visited Nov. 2, 2009).

355 *See* Cunningham v. Brown, 265 U.S. 1 (1924); *See also,* U.S. v. Gold Unlimited, Inc., *supra* note 51, at 475.

356 *See generally,* C.R. "Chip" Bowles Jr. and Ivana B. Shallcross, *Dirty Rotten Scoundrels: Ponzi Schemes in Bankruptcy Cases,* 28-2 AM. BANKR. INST. J. 28, Mar. 1, 2009 (referencing numerous Ponzi schemes that have recently filed for bankruptcy protection); *See also,* Kevin McCoy, *Trustees Seeks Hearing on Compensation for Madoff Victims*, USATODAY.COM, Nov. 28, 2009, http://www.usatoday.com/money/markets/2009-08-28-picard-madoff-hearing_N.htm (last visited Nov. 2, 2009).

pursuing unfair and deceptive practices by the promoter.[357] In 2009, Bernard Madoff pled guilty to the largest Ponzi scheme in history and countless others were charged with operating illegal Ponzi schemes as well.[358] In the end, the Ponzi scheme bears no functional resemblance to an MLM or pyramid scheme other than that investors might, but are not required to, communicate and encourage others to join and even though no multi-level structure is involved.[359]

F. Internet

Those who consider joining the MLM ranks now have virtually unlimited resources to explore more information about a particular MLM than ever before.[360] Conducting diligent research via the internet from the home computer or public library can assist anyone in this decision-making process. Numerous websites provide a wealth of opportunity for the responsible decision-maker including the FTC website.[361] YouTube.com serves as a seemingly endless conduit of postings by individuals for the serious prospect

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[357] *See* Pareja, *supra* note 2, at 102-04.

[358] *See, e.g.,* Press Release, Securities and Exchange Commission, *SEC Charges R. Allen Stanford, Stanford International Bank for Multi-Billion Dollar Investment Scheme*, Feb. 17, 2009 http://www.sec.gov/news/press/2009/2009-26.htm (falsely claimed no direct or indirect exposure to the Madoff Ponzi scheme) (last visited Nov. 2, 2009).

[359] There are significant differences between an MLM and a business franchise for which this article does not address. *See, e.g.,* Keith J. Kanouse, *An Overview of Federal and State Business Opportunity Laws*, 23 FRANCHISE L.J. 102 (2003); *See also, See* Melissa Ann Gauthier, *The SJC and Dunkin' Donuts: Squeezing the Filling Out of the Small Franchisee*, 41 NEW ENG. L. REV. 757, 760-768 (2007); Debra Burke and E. Malcolm Abel II, *Franchising Fraud: The Continuing Need for Reform*, 40 AM. BUS. L.J. 355, 361-364 (2003); Pareja, *supra* note 2, at 91-93.

[360] *See* Fitzpatrick, Hamblin, *supra* note 11.

[361] Federal Trade Commission, *Multilevel Marketing Plans*, Nov. 1996, http://www.ftc.gov/bcp/edu/pubs/consumer/invest/inv12.shtm (last visited Nov. 2, 2009).

or investigator on a particular MLM or MLMs generally. However, the internet has also opened up the opportunity for scams claiming to be legitimate MLMs.[362] Social networking sites such as Facebook have recently changed their own policies to address concerns over schemes involving online incentivizing.[363] Regardless of the model, name, structure or business opportunity, participation in an MLM involves various degrees of risk and personal responsibility, but the internet has leveled the playing field to preemptively gather information for the diligent prospect.

II: ANTI-PYRAMID REGULATION

Concerns over MLMs and pyramid schemes have caused the FTC and SEC to step up governmental regulation of business investments and opportunities. As mentioned, various states have enacted MLM statutes, also known as "anti-pyramid" statutes, to specifically address consumer protection concerns while other states rely on a broader consumer protection statute. Part II explores how the FTC, the SEC and state legislation have specifically addressed MLMs exposing how they have come under fire since the *Amway* decision.

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[362] *See, e.g.,* News Release, Federal Trade Commission, *FTC Charges Internet Mall as a Pyramid Scam*, July 7, 2003, : http://www.ftc.gov/opa/2003/07/nexgen.shtm (last visited Nov. 2, 2009); *See also*, Miriam R. Albert, *E-Buyer Beware: Why Online Auction Fraud Should be Regulated*, 39 AM. BUS. L.J. 575, 579 (2002); John Rothchild, *Protecting the Digital Consumer: The Limits of Cyberspace Utopianism*, 74 IND. L.J. 893 (1999) (noting that pyramid schemes were most prevalent form of online fraud in 1996); *See also,* David E. Sorkin, *Technical and Legal Approaches to Unsolicited Electronic Mail+*, 35 U.S.F. L. REV. 325 (2001) (spam has opened up opportunities to promote questionable MLM or illegal pyramid schemes).

[363] *See* Karl Bunyan, *Incentivized Invites No Longer Allowed on the Facebook Platform*, INSIDE FACEBOOK, http://www.insidefacebook.com/2008/08/13/incentivized-invites-no-longer-allowed-by-facebook/ (last visited Nov. 2, 2009); *See also,* James Grimmelmann, *Saving Facebook*, 94 IOWA L. REV. 1137, 1203 (2009).

A. Federal Trade Commission

The Federal Trade Commission (FTC) is considered an independent federal agency which works for the consumer to protect and prevent fraudulent, deceptive and unfair business practices in the interstate marketplace.[364] Since 1914, it has had the legal authority to investigate a variety of consumer complaints under the Federal Trade Commission Act (the FTC Act).[365] The FTC's Bureau of Consumer Protection has seven divisions which work to protect consumers against unfair, deceptive, or fraudulent practices in the marketplace including the internet.[366]The FTC is the leading federal administrative agency force behind protecting consumers from fraudulent MLMs, pyramid schemes and the like.
The FTC has been involved in significant litigation or administrative settlements related to MLMs which have conducted illegal activities including, but not limited to actions involving Amway,[367] JewelWay International, Inc.,[368] Equinox

[364] *See generally,*, Federal Trade Commission, http://www.ftc.gov (last visited Nov. 3, 2009); *See also,* Pareja, *supra* note 2, at 89.
[365] *See* Peter C. Ward, *Restitution for Consumers Under the Federal Trade Commission Act: Good Intentions or Congressional Intentions?*, 41 AM. U. L. REV. 1139, 1140-1158 (1992); *See also,* Patricia P. Bailey and Michael Pertschuck, *The Law of Deception: The Past as Prologue*, 33 AM. U. L. REV. 849 (1984).
[366] *See* Roscoe B. Starek, III , Lynda M. Rozell, *A Cyberspace Perspective: The Federal Trade Commission's Commitment to On-line Consumer Protection*, 15 J. MARSHALL J. COMPUTER & INFO. L. 679, 691 (1997); *Compare* Securities and Exchange Commission, *Internet Fraud: How to Avoid Internet Investment Scams*, http://www.sec.gov/investor/pubs/cyberfraud.htm (last visited Nov. 2, 2009).
[367] *In re Amway Corp*. 93 F.T.C. 618 (1979).
[368] *See* News Release, Federal Trade Commission, *FTC Settlement with JewelWay International Defendants Nets $5 Million in Consumer Redress*, Nov. 17, 1997, http://www.ftc.gov/opa/1997/11/jewel-2.shtm (last visited Nov. 2, 2009).

International,[369] SkyBiz,[370] Fortuna Alliance,[371] and many others. Following an investigation, the FTC might initiate an enforcement action if it has "reason to believe" that the law is being or has been violated.[372] Section 5(a) of the FTC Act is broad and powerful and provides that unfair or deceptive acts or practices in or affecting commerce are unlawful.[373] The FTC may pursue federal district court proceedings to enjoin violations of the FTC Act and to secure equitable relief in each case including restitution and disgorgement.[374]

In the 1979 *Amway decision*, the FTC ruled that Amway was not a pyramid scheme because it adopted and enforced certain rules that were intended to avoid the characteristics of a pyramid scheme.[375] In sum, this decision held that a direct marketing business like Amway would not be considered a pyramid scheme if the sponsor of the business did not violate various rules including the *Amway*

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369 *See* News Release, Federal Trade Commission, *Equinox International Settles Case with FTC, Eight States, Nearly $40 Million in Restitution for Alleged Pyramid Victims*, Apr. 25, 2000, http://www.ftc.gov/opa/2000/04/equinox.shtm (last visited Nov. 2, 2009); *See also*, Fenn, *supra* note 30; Babener, *supra* note 56; *See also*, David Strow, *FTC, States Succeed in Quest to Close Equinox International*, LAS VEGAS SUN, Apr. 21, 2000, http://www.npros.com/news/equinox042100.htm (last visited Nov. 2, 2009).

370 *See* News Release, Federal Trade Commission, *Qualified Consumers to Share $20 Million in Redress*, May 14, 2004, http://www.ftc.gov/opa/2004/05/skybiz.shtm (last visited Nov. 2, 2009).

371 *See* News Release, Federal Trade Commission, *$5.5 Million in Refunds to Victims of Fortuna Alliance Pyramid*, July 22, 1998, http://www.ftc.gov/opa/1998/07/fortunar.shtm (last visited Nov. 2, 2009).

372 *See* Federal Trade Commission Act § 5, 15 U.S.C. §45 (b) (2009); *See also,* Corey A. Ciocchetti, *E-Commerce and Information Privacy: Privacy Policies as Personal Information Protectors*, 44 AM. BUS. L. J. 55, 93-94 (2007).

373 Federal Trade Commission Act § 5, 15 U.S.C. §45 (1) (2009).

374 15 U.S.C. 53 § (b) (2009).

375 *In re Amway Corp.*, 93 F.T.C. 618, 717 (1979). The 70 percent rule requires distributors to have sold 70 percent of previously purchased product before reordering (preventing "inventory loading").

"initial investment" rule, the "70%" rule, the "buy-back" rule, and the "ten customer" rule.[376] Many MLMs have considered the rules in an attempt to remain in good standing with the FTC. Though many have stayed in-bounds, others have been viewed with considerable skepticism by the courts and the FTC in light of *Amway*.[377] Even if the *Amway* safeguard provisions adopted by an MLM could overcome scrutiny under the FTC Act, the operation could nevertheless be found to be illegitimate by a more general Section 5 action.[378]

B. Securities and Exchange Commission

Like the FTC, the SEC is an independent governmental agency which has the authority to protect those who have been harmed by the fraudulent efforts of others. Created by section 4 of the Securities Exchange Act of 1934, the SEC is primarily responsible for enforcing the federal securities laws and regulating the securities industry.[379] It was created by section 4 of the Securities Exchange Act of 1934.[380] It enforces the Securities Act of 1933 among other acts and statutes.[381]

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[376] Known as the "Amway safeguards." *See* Jeffrey A. Babener, *Network Marketing and the Law*, 57 OR. ST. B. BULL. 23, 35 (1997); *See also,* Pareja, *supra* note 2, at 95.

[377] *See U.S. v. Gold Unlimited, Inc.*, 177 F.3d 472, 482 (6th Cir. 1999) ("the critical determination of the legality of [defendant's] operations will not be based on the written plan but on the actual practices of the company," *quoting SEC v. Int'l Heritage, Inc.*, 4 F.Supp.2d 1378, 1384 (N.D. Ga. 1998); *But see Webster v. Omnitrition Int'l, Inc.*, 79 F.3d 776, 783 (Amway safeguards are essentially meaningless if commissions are paid based on a distributor's wholesale sales, and not those sold at retail); *See also*, Valentine, *supra* note 24 (noting that at time the FTC had brought eight cases against pyramid schemes in two years alone).

[378] Federal Trade Commission Act § 5, 15 U.S.C. § 45 (1) (2009).

[379] Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (2009). *See also*, Pareja, *supra* note 2, at 90.

[380] 15 U.S.C. § 78d (2009).

[381] Securities Act of 1933, 15 U.S.C. §§77a to 77aa (2009).

With respect to MLMs, the SEC first asks whether there is a security involved and, if so, are there materially false or misleading statements.[382] The SEC has asserted jurisdiction over allegations of Ponzi and pyramid schemes on the grounds that they constitute "investment contracts" subject to enforcement under federal securities laws.[383] The SEC has also utilized temporary restraining orders, injunctions and "freeze orders" when Ponzi schemers have attempted to avoid returning investors' money by filing for bankruptcy protection.[384]

Some MLMs may pretend to be product-based to avoid appearing as an investment, thereby avoiding SEC scrutiny.[385] However, the SEC notes that the hallmark of pyramid schemes is "the promise of sky-high returns in a short period of time for doing nothing other than handing over your money and getting others to do the same."[386] The SEC also points out that "fraudsters simply use money coming in from new recruits to pay off early state investors. But eventually the pyramid will collapse. At some point the schemes get too big, the promoter cannot raise enough money from

[382] "Security" according to the 1993 Securities act is broadly defined as an "investment contract" which has required courts, in many cases, to determine whether the MLM is actually purchasing one. *See* SEC v. Int'l Loan Network, Inc., 770 F. Supp. 678 (D.D.C. 1991), *aff'd* 968 F.2d 1304 (D.C. Cir. 1992) (SEC obtained injunction against financial "distribution networks" which were in fact selling unregistered securities); *See also,* Pareja, *supra* note 2, at 97-98.

[383] *See, e.g., SEC v. Glenn W. Turner Enters., Inc.,* 474 F.2d 476 (9th Cir. 1973); *See also, SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946).

[384] Bowles and Shallcross, *supra* note 66, at 28. (referencing *Eberhard v. Marcu*, 530 F.3d 122 (2d Cir. 2008) and *SEC v. Homa*, 514 F.3d 661, 672-673 (7th Cir. 2008).

[385] Spencer M. Reese, *Securities Law and MLM – What's the Deal?*, 1999, http://www.mlmlaw.com/library/guides/securities4.html (last visited Nov. 2, 2009).

[386] *See* U.S. Securities and Exchange Commission, *Pyramid Schemes*, http://www.sec.gov/answers/pyramid.htm (last visited Nov. 2, 2009).

new investors to pay earlier investors, and many people lose their money."[387]

As mentioned, securities regulators examine MLMs, pyramid schemes, and Ponzi schemes for an investment contract, and therefore, securities, as defined by Section 2(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934.[388] The SEC established that an MLM could be transformed into a security when the scheme looked more like a pyramid scheme in which the activity of a distributor was "passive" rather than "active," triggering its jurisdiction umbrella to open.[389] Unfortunately for this agency, the SEC also was thrust into the spotlight during the discovery of Madoff's $50 billion Ponzi scheme, albeit in a negative light, as having failed miserably in its regulation and the failure to investigate Madoff's "curiously steady" annual returns, and ignoring the cries from whistleblowers exclaiming his operation was full of fraud.[390]

C. The Howey Test

In 1946, the United States Supreme Court in *SEC v. W.J. Howey Co.* handed down a landmark decision related to securities

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387 *Id.*

388 *SEC v. Int'l Loan Network, Inc., supra* note 92, at 688 ("The statutory definitions of a security in § 2(1) of the 1933 Act and § 3(a)(10) of the 1934 Act are very broad, covering stocks, notes, and bonds as well as investment contracts and profit-sharing agreements.").

389 *See* Pareja, *supra* note 2, at 90; *See also,* Gregory J. Pease, *Bluer Skies in Tennessee-The Recent Broadening of the Definition of Investment Contract as a Security and an Argument for a Unified Federal-State Definition of Investment Contract*, 35 U. MEM. L. REV. 109, 117 (2004).

390 *See* Marcy Gordon, *SEC Mishandled Madoff Probes, Agency Watchdog Says*, USATODAY.COM, Nov. 2, 2009, http://www.usatoday.com/money/companies/regulation/2009-09-02-sec-madoff_N.htm (last visited Nov. 2, 2009).; *See also,* Stephen Labaton, *S.E.C. Chief Pursues Tougher Enforcement*, Feb. 22, 2009, http://www.nytimes.com/2009/02/23/business/23schapiro.html?_r=1.

regulation.[391] According to the Court, key for purposes of SEC regulation are the existence and elements of an "investment contract" which include, (1) an investment (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived solely from the entrepreneurial or managerial efforts of others.[392] The *Howey* court stressed that the definition of "securities" is a flexible principle that is "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[393] It emphasized that the *Howey* test would serve the statutory policy of "affording broad protection to investors."[394]

The *Howey* test has had a broad interpretation in subsequent cases. In *Tcherepnin v. Knight*, decided over twenty years later, the court furthered a broader reading of the term "securities" by stating that "even a casual reading of . . . the 1934 Act reveals that Congress did not intend to adopt a narrow or restrictive concept of security in defining that term."[395] Wright also notes that in *SEC v. Glenn W. Turner Enterprises* the Ninth Circuit held that the word "solely," as applied in the *Howey* test, should not be read as a strict limitation in defining what a security is.[396] Wright notes that the "efforts" of the promoters in *Turner* satisfied the *Howey* test because they were the "undeniably significant ones, those essential

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[391] *SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946).

[392] *Id*. at 294-301. *But see State v. Irons*, 574 N.W.2d 144, 150 (Neb. 1998) (state MLM criminal case addressing whether investment profits must be derived "solely" from the efforts of others, citing *Reves v. Ernst & Young*, 494 U.S. 56 (1990)).

[393] *Id*. at 299.

[394] *Id*. at 301.

[395] Wright, *supra* note 6, at 183, quoting Tcherepnin v. Knight, 389 U.S. 332, 338 (1967).

[396] Wright, referencing SEC v. Glenn W. Turner Enters., Inc., *supra* note 93, at 481-482 ("the sticking point in the Howey definition is "solely,"…).

managerial efforts which affect the failure or success of the enterprise."[397]

In *SEC v. Koscot Interplanetary, Inc.,* Wright notes that the scheme was deemed to involve securities because the "investor's realization of profits is inextricably tied to the success of the promotional scheme."[398] However, the appellate court in *Koscot* warned that the "*Howey* test is not possessed of the talismanic quality ascribed to it by the court below."[399] Thus, though the *Koscot* court used the *Howey* test, it stressed the importance for the test to be resilient enough to encompass egregious promotional schemes.[400]

In sum, both the FTC and SEC have broad powers to regulate business opportunities such as MLMs and investment securities. With regard to actually what a "security" is, the *Howey* test appears to remain interpreted in the broadest light.[401] As discussed, both the FTC and SEC have been involved in MLM litigation, but they are not the only government agencies who have the ability to pursue illegitimate schemers. Various states have specifically enacted statutes which address the actions of the schemers as well.[402]

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[397] *SEC v. Glenn W. Turner Enters., Inc., supra* note 93, at 482.

[398] *SEC v. Koscot Interplanetary, Inc.,* 497 F.2d 473, 485 (5th Cir. 1974).

[399] *Id*. at 481.

[400] *Id*. at 486.

[401] *See generally,* Kyle M. Globerman, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271 (1999).

[402] Attempts have been made to establish a federal anti-pyramiding bill which actually passed the United States Senate twice in the 1970s. *See* Valentine, *supra*, note 25; *See also,* Pareja, *supra* note 2, at 105 (noting that state laws are inadequate an unmanageable by state enforcement agencies especially when they cross state lines, all the more reason in support for a comprehensive federal rule with regard to pyramid schemes).

D. State Regulation

There is no federal anti-pyramid statute in the United States, but states have enacted laws directed specifically at MLM plans often referred to as "anti-pyramid" scheme legislation.[403] Many of these state laws prohibit sales of business opportunities unless the seller gives potential purchasers a pre-sale disclosure document that has first been filed with a designated state agency.[404] However, disclosures required by state business opportunity laws differ and might provide more abbreviated information than the FTC's Rule requires.[405]

Louisiana adopted its anti-pyramid statute in 1997 and defines a prohibited "pyramid promotional scheme" as: "Any plan or operation by which a participant gives consideration for the opportunity to receive compensation which is derived primarily from the person's introduction of other persons into a plan or operation rather than from the sale of goods, services, or intangible property by the participant or other persons introduced into the plan or operation."[406] California defines pyramid schemes as "endless chains" and prohibits: "Any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the

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403 *See* Grimes & Reese, P.L.L.C., *supra* note 1 (noting that only a few states actual define MLM plans including Georgia, Louisiana, Maryland, Massachusetts, Puerto Rico, and Wyoming though many states use the term "pyramid," "chain distributor" or "endless-chain" instead, including, for example North Carolina, New York, Texas, and others); *See also,* Grimes & Reese, P.L.L.C., *Multilevel Marketing Cases*, MLMLAW.COM, http://www.mlmlaw.com/mlmstates.html (last visited Nov. 2, 2009).

404 *See* Grimes & Reese, P.L.L.C., *supra* note 1.

405 *See* Pareja, *supra* note 2, at 104-5.

406 LA. R.S. §§51:361 et seq. (2009); *See also,* Howie, *supra* note 46, at 289.

scheme."[407] Other states, including Texas, contain similar definitions of "endless chain" as well.[408]

State consumer protection statutes might be relevant in addition to (or in the absence of) any specific "anti-pyramid" statute. Michigan, like many states, has several statutes dealing with anti-pyramid laws, and consumer protection generally.[409] The Michigan statutes include, for example, *inter alia*:

> 445.1528 Pyramid or chain promotion or distribution.
>
> Sec. 28.
>
> (1) A person may not offer or sell any form of participation in a pyramid or chain promotion. A pyramid or chain promotion is any plan or scheme or device by which (a) a participant gives a valuable consideration for the opportunity to receive compensation or things of value in return for inducing other persons to become participants in the program or (b) a participant is to receive compensation when a person introduced by the

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407 CAL. PENAL CODE § 327 (2009).

408 "Endless chain" means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. V.T.C.A., PENAL CODE 32.48 (2009); Compare Illinois' which classifies pyramid schemes as criminal acts of deception directed against property. 720 ILL. COMP. STAT. ANN. §5/17-7 (2009).

409 *See* Mike Cox, Attorney General, *The $100,000 Pyramid Scheme*, Feb. 2009, http://michigan.gov/ag/0,1607,7-164-34739-208400--,00.html (discussion of Michigan's Pyramid Promotion
Act, and Michigan's Consumer Protection Act) (last visited Nov. 2, 2009).

> participant introduces one or more additional persons into participation in the plan, each of whom receives the same or similar right, privilege, license, chance, or opportunity.
>
> (2) A pyramid or chain promotion is declared to be illegal and against the public policy of the state. Any contract made in violation of this section is voidable at the sole option of the purchaser.
>
> (3) The department shall not accept for filing a franchise which involves a pyramid or chain distribution contrary to the laws of this state.[410]

It would be certainly wise to review all of these state laws for anyone involved with an MLM or those wishing to start one in a particular state. Unfortunately, state consumer protection statutes regarding pyramid schemes appear to have devolved into impotent provisions lacking an effective enforcement mechanism.[411] According to a 2009 report, almost all states' unfair deceptive acts and practices statutes have been undermined by significant gaps or court decisions.[412]

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[410] MICH. COMP. LAWS ANN. § 445.1528 (2009) (Franchise Investment Law).

[411] *See* Carolyn L. Carter, *Consumer Protection in the States, A 50-State Report on Unfair and Deceptive Acts and Practices Statues*, National Consumer Law Center, Inc., http://www.consumerlaw.org/issues/udap/content/UDAP_Report_Feb09.pdf (on file with the author) (last visited Nov. 2, 2009); *See also,* Gary M. Victor, *Consumer Law: Recent Attorney Fee Cases and Their Potential Effect on the Calculation of Attorney Fees in Consumer Protection Cases*, 78 MICH. B. J. 278 (1999).

[412] Carter, *supra* note 121.

E. Future Consideration

As discussed, the regulatory environment for the MLM includes a combination of state and federal laws under a jurisdictional umbrella which includes federal administrative watchdog agencies such as the FTC and SEC. Still, many individuals might seek opportunities to generate income (such as by joining the MLM) even if it means relying more on the attraction of an initial revival-like excitement portrayed by its membership instead of a thorough analysis of the organization, its often non-refundable sign-up fees, the realistic (or average) earning potential of the enrollees, and the quality of its products or services.[413] With little hope for new jobs in this down economy, some might join the MLM ranks as a commission-based independent contractor in an act of desperation.[414]

So, while some measure of personal responsibility must be expected when determining whether to join an MLM, is it realistic to assume that most MLM participants will take the initiative to research MLMs prior to agreeing to participate in them? Joining an MLM is a matter of personal choice, but it is possible that many enrollees could regret joining and suffer from buyer's remorse after they hype has subsided. Others may become disenchanted with the lack of income generated from the investment in the MLM after diligent efforts to produce.

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[413] *See, e.g.,* Pareja, *supra* note 2, at 129 ("Prospective purchasers must also be given sufficient time to absorb the information. At a minimum, this means that an individual opportunity seller must provide the prospective recruit with a written disclosure of average and median net, not gross, income of all company representatives over a one year period.").

[414] *See* Hibah Yousuf, *Severe Unemployment Worsens in Cities*, CNNMONEY.COM, Jan. 5, 2010, http://money.cnn.com/2010/01/05/news/economy/metro_unemployment/index.html (noting that in October, 2009, 17 of the 372 metropolitan areas had unemployment rates higher than 15% with particular concern over cities in Michigan and California) (last visited Apr. 7, 2010).

This author supports a suggestion that the various states could include in their consumer protection statutes a three business day right-to-rescind (i.e., "cooling off") period specifically to address MLM enrollees.[415] State legislatures could modify state laws to mirror the FTC's door-to-door sales rule and could allow for this three-day "cooling off" period after joining an MLM which would make the contract voidable during that time-frame for any reason even if the "sale" was not made in the home.[416] In this way, those who decide to join the MLM could feel some measure of comfort in knowing at least they could remove themselves from the organization within three business days from the hype of signing up. Requiring a conspicuous disclosure of this three-day right to rescind period would also be consistent with other state consumer protection statutes as well.[417]

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[415] *See* Pareja, *supra* note 2, at 104-05, 129 (Pareja's discussion actually suggests that a contract to join could not even be offered until three days after the first meeting and calls for a federal rule focusing more on disclosure requirements at the federal level than at the state levels. Pareja recognizes the difficulties in attempting to administratively enforce state disclosure rules involving "pyramid marketing schemes" especially since MLMs are involved in interstate activity involving inconsistent state laws. However, this author suggests that a more localized approach to MLM regulation might be more appropriate (even with the lack of consistency among states), and that incorporating a three-day cooling-off period in a state consumer protection statute might be a less bureaucratic first step in the right direction mirroring and already accepted FTC rule).

[416] *See* FTC Rule Concerning Cooling-Off Period for Sales Made at Homes or Certain Other Locations, 16 C.F.R. § 429.0 et seq. (2009), *supra* note 12; *See also,* Mike Cox, Attorney General, *I Changed My Mind…Can I Cancel this Contract*, Jan. 2009, http://www.michigan.gov/ag/0,1607,7-164-34739_20942-44718--,00.html (discussion of various Michigan provisions which address a right to cancellation) (last visited Apr. 12, 2010).
Act, and Michigan's Consumer Protection Act) (last visited Nov. 2, 2009); *See also generally,* Caroline O. Shoenberger, *Consumer Myths v. Legal Realities: How Can Businesses Cope?*, 16 LOY. CONSUMER L. REV. 189, 213 (2004).

[417] *See* Jean Braucher, *Deception, Economic Loss and Mass-Market Customers: Consumer Protection Statutes as Persuasive Authority in the Common Law of Fraud*, 48 ARIZ. L. REV. 829 (2006) (citing Sellinger v.

III. CONCLUSION

While legitimate MLMs, such as Amway, emphasize the selling goods or services (i.e., retailing) rather than signing-up recruits to join the organization's ranks (i.e., pyramiding), this article has demonstrated that the legal environment in the MLM world is quite complex and involves a myriad of regulatory schemes emanating from FTC, SEC, and the various state anti-pyramid or consumer protection statutes. The revelation of swarms of numerous financial swindlers in recent years such as Bernard Madoff have certainly not helped those who support the MLM model even if Ponzi schemes or pyramids have little in common with legitimate MLMs.

The internet allows an MLM to share its vision and spread its message to anyone in the world via the computer. Potential MLM members are able to conduct thorough investigations of an MLM on their own time, in their own home, even before agreeing to attend "opportunity meetings" in order to make an informed, educated decision.[418] Thus, MLM prospects must share some measure of personal responsibility for participating in any MLM venture today.[419] One consideration to balance the concern

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Freeway Mobile Home Sales, 521 P.2d 1119 (Ariz. 1974)); *See also, e.g.*, Paul L. Reynolds, *Chernick v. Fasig-Tipton: A Caveat to the Horse Trader*, 74 KY. L.J. 889 (1985); *Compare* Anthony M. Balloon, *From Wax Seals to Hypertext: Electronic Signatures, Contract Formation, and a New Model for Consumer Protection in Internet Transactions*, 50 EMORY L.J. 905 (2001); *See also generally,* Pareja, *supra* note 2, (discussion of importance of disclosure requirements at the federal and state levels including the disclosure requirements under the revised proposed Rule).

[418] *See* Pareja, *supra* note 2, at 119-20 (support of revised proposed Rule which would have mandated a waiting period after the occurrence of an "opportunity meeting" to allow for a cooling-off for potential MLM members to avoid the "pressure of the moment" before even being able to sign up).

[419] The author notes that throughout this article he is not making any disparaging remark about or judgment related to the quality of any product

between personal responsibility and consumer protection generally could be specifically to include MLMs under state consumer protection statutes providing a three day right-to-rescind period akin to the protections offered under FTC's door-to-door sales rules even if the opportunity to join was not presented in one's home.

It will be interesting to see in the coming years how many more MLMs, pyramid schemes, Ponzi schemes and other business opportunities will be exposed as illegitimate frauds in this world or the virtual one. There appears to be a paucity of legal research in the area of MLMs. Nonetheless, numerous websites, including the homepages of MLMs, have loads of information for prospective participants to help themselves in weeding out the good from the bad, the reality of participation in an MLM from the fantasy.[420]

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offered by an MLM, and recognizes that many specific MLM products certainly may be of high quality.

[420] *See* Ger-Ro-Mar, Inc. v. FTC, *supra* note 54 at 37 ("We find no flaw in the mathematics…that the prospect of a quarter of a billion brassiere and girdle hawkers is not only impossible but frightening to contemplate, particularly since it is in excess of the present population of the Nation, only about half of whom hopefully are prospective lingerie consumers. However, we live in a real world and not fantasyland.").

GENDER STEREOTYPING: THE EVOLUTION OF LEGAL PROTECTIONS FOR GENDER NONCONFORMANCE

By

Bonnie L. Roach*

I. INTRODUCTION

Consider the following situations: A woman who was told she couldn't make partner because she didn't dress or act "femininely enough"; a woman who was terminated because she was considered "too masculine"; a man who was told he held his serving tray "like a woman"; a male firefighter who experienced adverse actions when he had to dress as a female for his sexual reassignment surgery; a male police officer who decided to go through with gender reassignment surgery and when he dressed as a woman was told he did not possess a "command presence"; and a male machine operator who was told he was "too flamboyant". All of these individuals filed discrimination charges based TVII sex discrimination based on nonconformance to gender stereotype.

Since its inception, TVII has considered gender discrimination, whether intentional or not, is a federal offense for employers with 15 or more employees. It has long been held that Title VII protects men and women against intentional discrimination, known as disparate treatment, and also protects individuals against disparate

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impact where any employment policy or practice results in discrimination of men and women. The history of Title VII is one where gender discrimination equates exclusively with one's biological gender. In other words, in order to invoke Title VII protection, an employee would first have to demonstrate that he or she is a member of a protected class based on their biological status. Recently, there have been a number of decisions which suggest that, in addition to biological gender, legal protection must be extended to individuals who fail to conform to society's notions of stereotypical gender-appropriate appearance and conduct. Employees who have been perceived as straying from society's ideal of gender-appropriate behavior have been the subject of adverse employment decisions, sexual harassment and differential treatment in the workplace. So, while the employer may not establish any clear pattern of biologically-based sex discrimination per se, the employer and his agents may be guilty of discrimination due to gender-stereotyping. This paper examines the legal developments in the area of gender-stereotyping and what these legal decisions mean for the business community.

II. WHAT IS GENDER STEREOTYPING?

Gender stereotyping is the perception that an individual fails to conform to preconceived notions of how someone of a particular gender should look and act.[421] A male who is considered effeminate may be labeled as such because he appears or acts in nonconformance to society's view of a male stereotype, and he may face adverse consequences in employment because of that nonconformity. Similarly, a female employee may face adverse consequences due to her male colleagues viewing her behavior as gender-inappropriate. Borgida, Hunt and Kim cite examined

[421] Hunt, Jennifer S., Borigida, E., & Burgess, D. *Gender Stereotyping*: *Scientific Status, in* MODERN SCIENTIFIC EVIDENCE: THE LAW AND SCIENCE OF EXPERT TESTIMONY, 2[ND] ED. D.L. Faigman, et. al., eds., (St. Paul, MN: West Publishing Co.) 2002.

gender-stereotyping research and noted that there are specific traits that are associated with males and females and that these traits are used to judge whether an individual's behavior is in conformity with these traits.[422] Members of our society expect that individuals will behave in consistent ways and will judge those that don't in a harsh fashion. Each gender represents a constellation of traits. For example, males are typically seen as being aggressive and achievement-oriented while females are more passive and nurturing.[423] To complicate things further, the social context of a situation may favor or encourage the expression of certain gender specific traits and this is especially true in business. Borgida points out the irony in the fact that society also has determined that primarily male traits are needed to be successful in business, but if females demonstrate these necessary traits that they are frequently penalized for doing so.[424] It would seem that there are definite stereotypes for the "successful" business person and when the gender stereotype does not meet up with the business stereotype, discrimination occurs. Borgida and his associates found that when subjects were asked to rate stereotypes of females versus males in a gender-neutral situation, women were only rated slightly less successful than males. However, when women and men were judged against stereotypical male-oriented situation, women were rated significantly less successful than men causing the authors to conclude that women are judged more harshly for acting in a gender-inconsistent way. [425] It is logical to assume that the results

[422] Borgida, E., Hunt, C., and Kim, A. *On the Use of Gender Stereotyping Research in Sex Discrimination Litigation*, 13 JOURNAL OF LAW AND POLICY 613 (2005).

[423] *Id.* citing Jennifer S. Hunt et al., *Gender Stereotyping: Scientific Status, in 2 Modern Scientific Evidence: The Law and Science of Expert Testimony* 374 in David L. Faigman et al., LEGAL ISSUES, IN 2 MODERN SCIENTIFIC EVIDENCE: THE LAW AND SCIENCE OF EXPERT TESTIMONY 374 (David L. Faigman et al. eds., 2002).

[424] *Id.* at 616.

[425] *Id.* citing Janet Swim et al., *McKay vs. McKay: Is There a Case for Gender Biased Evaluations*?, 105 PSYCHOL. BULL. 409 (1989).

of this study and others will translate into negative employment consequences for women and men employees who are perceived to be acting against “type”.

Early cases of gender stereotyping were not successful since it was commonly held that Title VII discrimination involved men and women being treated differently than members of the opposite sex. One of the first cases to test the illegality of discrimination based on gender-stereotyping was *Price Waterhouse v. Hopkins*, where a female candidate for partnership was considered too “macho” and the result was that her application for a partnership was placed on hold. The case was the first time gender stereotyping was considered to be actionable under Title VII. The case involved mixed-motive decisions -- where an adverse action may be taken partly because of gender stereotyping and partly for legitimate, work-related reasons – which may figure prominently in gender-stereotype discrimination claims.

A. Price Waterhouse v. Hopkins[426] *and Gender Stereotyping*

Ann Hopkins was a senior manager who was under consideration to become a partner in the accounting firm of Price Waterhouse. She had worked for the firm for five years before she was nominated as a partner. The firm did not have a good record regarding female partners – there were only seven female partners out of all of the 662 partners.[427] Hopkins had made significant contributions to the firm such as securing a 25 million dollar contract with the State Department. It seemed clear from the evidence that was presented that Hopkins was a hard-working individual who had good relations with her clients and she was instrumental at securing major contracts. On the flip side, there

426 *Price Waterhouse v. Hopkins*, 490 U.S. 228 (1989).
427 *Id*. at 233.

was also evidence that she sustained poor relationships with her staff stemming from her "abrasive" behavior.[428]

The most controversial assessments of Hopkins' performance stemmed from some of the partners who viewed her behavior as being not only aggressive, but inappropriately aggressive for a female. The comments ranged from describing her as "macho", "overcompensated for being a woman", to objections regarding her use of profanity, "because it's a lady using foul language". [429] The coup de grace involved the partner who informed Hopkins that she might have a better chance of achieving the partnership if she would, "walk more femininely, talk more femininely, dress more femininely, wear make-up, have her hair styled, and wear jewelry."[430] The evidence was sufficient for the district court to find Price Waterhouse liable for Title VII sex discrimination and the decision was affirmed by the Appellate Court for the District of Columbia.[431]

It was the district court's opinion that the comments made by the partners were the result of the partners' gender stereotypes, which the court equated with impermissible discrimination under Title VII. In other words, the partners felt that Hopkins' behavior was unacceptable simply because a woman was exhibiting the offending behaviors. Had she been a man exhibiting these same behaviors the partners may have come to a different conclusion. The court noted that some of the partners had expressed particular views as to how females should behave and the denial of partnership was based on those comments. The judge made note that Price Waterhouse could have avoided equitable relief if they were able to demonstrate with clear and convincing evidence that it

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428 *Id.* at 229 and 224.
429 *Id*. at 235.
430 *Hopkins v. Price Waterhouse*, 618 F. Supp. 1109, 1117 (D.C. Cir 1985).
431 *Price Waterhouse v. Hopkins*, 825 F.2d 458 (D.C. Cir 1987).

would have put Hopkins' candidacy on hold absent the discriminatory information, but such was not the case.[432]

The appellate court affirmed the decision but it was held that if the defendant could prove beyond a preponderance of the evidence that the same employment decision would have been made in the absence of the discriminatory information, -- that Hopkins would have been denied the partnership even if the impermissible stereotyping never was part of the discussion -- then the defendant would escape ALL liability including any finding of TVII discrimination. This is very different than the district court's approach which said only equitable relief could be waived.[433]

The Supreme Court was left to resolve the District Court's split regarding the question of the kind of burden of proof that the plaintiff and the defendant must present in a mixed motive case. Price Waterhouse asserted that it was the plaintiff's burden to demonstrate that the gender stereotyping was the decisive factor in the adverse employment decision and the plaintiff should have the burden to demonstrate that a different outcome would have been reached had it not been for the gender discrimination. [434] Hopkins' contented that a plaintiff would fulfill her burden of proof should she demonstrate that any <u>one</u> factor in the selection process was impermissibly based on gender. The burden of proof would shift to the employer to demonstrate that that they would have reached the same decision even in the absence of the discriminatory factor.[435]

The Court came to the conclusion that although Title VII would allow employers to consider gender when gender is a BFOQ, it is not permissible for gender to be a motivating factor in other

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432 *Hopkins* 618 F Supp at 1117.
433 *Price Waterhouse,* 825 F.2d at 470-71.
434 *Price Waterhouse,* 490 U.S. at 244-5.
435 *Id.* at 237-238.

employment decisions.[436] It was held that if a plaintiff fulfilled their burden of proof by showing that gender was a motivating factor in the employment decision, then the defendant would have to demonstrate that they would have made the same decision absent the discriminatory factor through a preponderance of the evidence (rather than clear and convincing evidence).[437] The Court reasoned that if gender was shown to be a motivating factor in the employer's decision process, then the burden must fall on the employer to "justify decisions related to that practice".[438] If the employer has acted on a belief that "a woman cannot be aggressive" or that a woman shouldn't be aggressive, that employer acted on the basis of gender stereotyping.[439]

On remand, the district court decided that Price Waterhouse failed to show that the same decision would have been made through a preponderance of evidence that demonstrated that Hopkins would have been held back for partner, therefore it was decided that Hopkins was a victim of sex discrimination under Title VII. Accordingly, the court ordered that Hopkins be made a partner in the firm; be given the appropriate "partnership shares", and that she be given $371,000 backpay with interest, and reasonable attorney's fees.[440]

The *Price Waterhouse* case was one of the first cases to establish the possibility of bringing a Title VII claim for gender stereotyping and provided a roadmap as to how to present proof in a mixed-motive case. Since that time, cases of gender stereotyping have been litigated and won under Title VII. The cases generally involve stereotyping based on appearance, nonconforming

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[436] *Id.* at 244.
[437] *Id.* at 246-247 and 252-253.
[438] *Id.* at 248.
[439] *Id.* at 249.
[440] *Hopkins*, 618 F. Supp. at 1209-1217.

behaviors and sexual harassment based on gender-nonconformance.

III. GENDER STEREOTYPING BASED ON APPEARANCE AND DRESS CODES

The infamous comments in *Hopkins* regarding Hopkins' lack of feminine appearance illustrates a common example of where employers may be vulnerable to claims of sex stereotyping. Although the courts have traditionally upheld the practice of unequal applications of dress codes, such as requiring women to wear skirts and men to wear pants, it is not clear that this trend will be allowed to continue. For example, the appearance of an individual may give rise to the kind of mixed-motive case that was at the heart of *Hopkins.*

A. Doe v. The Boeing Company

Some of the early cases regarding gender stereotyping based on adherence to dress code standards involved transsexuals who are required to dress as the opposite gender for a period of one year prior to their sex-reassignment surgery. In *Jane Doe v. the Boeing Company*[441], a biological male was reprimanded for wearing "excessively" feminine attire, i.e., pink pearls. Doe had applied to the company and was originally hired as a male in 1978. In 1984, Doe concluded that she was a transsexual and her assessment was confirmed by her treating physicians. Doe notified her employers in March of 1985 of her intent to undergo reassignment surgery and the requirement that she would have to live as a full-time female for at least 12 months prior to the surgery.[442]

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441 *Doe v. the Boeing Company,* 846 P.2d 531 (Wash.) 1993.
442 *Id.* at 533.

The airline said as long as Doe was a biological male, Doe could not wear feminine attire or use the women's restroom, but she would be allowed to do so upon completion of her reassignment surgery. Boeing did permit Doe to wear a unisex uniform, but Doe was absolutely forbidden to wear female attire on the job. It should be noted that the unisex attire included nylons, earrings, lipstick, foundation and clear nail polish, but Doe could not wear "excessively" frilly clothing like dresses. Doe's physician and psychiatrist testified that the unisex attire was "sufficiently feminine" for Doe to qualify for sex reassignment surgery. [443]

Boeing started receiving a number of anonymous complaints about Doe's attire and use of the women's restrooms and Doe was issued a written warning saying that if Doe violated the rules about the unisex attire and using the women's restroom, she would be terminated. Doe added a set of pink pearls to her uniform which she refused to remove. It was decided that the addition of the pearls rendered the unisex uniform as being "excessively feminine". Doe was terminated.[444]

Doe brought suit saying that her termination was in violation of Washington's Law Against Discrimination,[445] which requires an

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[443] *Id.* at 534.

[444] *Id*.

[445] WASHINGTON'S LAW AGAINST DISCRIMINATION, WASH. REV. CODE §49.60.180 (2010) (The regulation provides that:
(a) A condition is a "sensory, mental, or physical handicap" if it is an abnormality and is a reason why the person having the condition did not get or keep the job in question ... In other words, for enforcement purposes a person will be considered to be *handicapped* by a sensory, mental, or physical condition if he or she is *discriminated against because of the condition* and the condition is abnormal.
(b) "The presence of a sensory, mental, or physical handicap" includes, but is not limited to,

employer to accommodate an individual who is considered to be handicapped (i.e., gender dysphoria) under the statute.[446] The trial court ruled against her saying that she was only temporarily handicapped under the statute, and thus the law would not provide her with any protection. The Appellate court reversed, saying that Boeing failed to accommodate Doe. Washington's Supreme Court reversed the Appellate court. The court concluded that while gender dysphoria was an abnormal condition,[447] Boeing did not discharge Doe because of her condition. The court also reiterated that the employer is not required to provide an accommodation that

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circumstances where a sensory, mental, or physical condition:

(i) Is medically cognizable or diagnosable;
(ii) Exists as a record or history; or
(iii) Is perceived to exist, whether or not it exists in fact. The regulation provides that:
(a) A condition is a "sensory, mental, or physical handicap" if it is an abnormality and is a reason why the person having the condition did not get or keep the job in question ... In other words, for enforcement purposes a person will be considered to be *handicapped* by a sensory, mental, or physical condition if he or she is *discriminated against because of the condition* and the condition is abnormal.
(b) "The presence of a sensory, mental, or physical handicap" includes, but is not limited to, circumstances where a sensory, mental, or physical condition:

(i) Is medically cognizable or diagnosable;
(ii) Exists as a record or history; or
(iii) Is perceived to exist, whether or not it exists in fact.

[446] *Doe,* 846 P.2d at 534.
[447] *Id*.

is preferred by the employee, but merely offer a reasonable accommodation.[448]

Boeing's accommodation of the unisex uniform was considered a reasonable accommodation and there was no medical need for Doe to dress as a woman at work as a prerequisite for her surgery. The medical experts stated that the unisex uniform met the requirements for living in the social role as a woman. Since Doe's dress did not directly impact her performance, there was no accommodation that Boeing could have provided that would have enhanced Doe's performance and thus there was no duty on the employer to provide any accommodation. [449]

B. Dawson v. Bumble & Bumble

While some cases focus on whether an employee dresses too femininely, others have disciplined employees for failing to project a more "feminine" appearance. For example, in *Dawson v. Bumble & Bumble*,[450] Dawn Dawson worked as a stylist's assistant at Bumble & Bumble, which was a very prestigious and progressive hair styling salon in New York City. Ms. Dawson, a self-described "lesbian female, who does not conform to gender norms in that she does not meet stereotyped expectations of femininity and may be perceived as more masculine than a stereotypical woman," filed a state and federal discrimination charges against the salon based on sex, sexual stereotyping, and sexual orientation.[451] Dawson was undergoing stylist training while performing her duties as a stylist's assistant. The training was described as "rigorous" and required several years to complete the program.[452] Employees of the salon reported that Dawson's work was erratic and her

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448 *Id*. at 536-7.
449 *Id*. at 537-8.
450 *Dawson v. Bumble & Bumble*, 398 F.3d 211 (2nd Cir. 2005).
451 *Id*. at 213.
452 *Id*. at 213-214.

performance declined in the training program to such a degree that she could not progress to the more advanced classes. Dawson was reportedly rude and hostile to customers and failed in her assistant duties, and several stylists registered their complaints with the manager of the salon.[453] Eventually, Dawson was terminated from her position.[454]

Dawson alleged that the decision to deny her advancement in the training program was due to discriminatory animus. She claims that her manager told her that it was rare for females to achieve the status of a stylist and she claimed that she was constantly harassed by coworkers about her appearance – that she looked "too much like a man" and that she should "act less like a man and more like a woman".[455] The district court granted summary judgment to Bumble & Bumble on all counts because Dawson failed to make a clear claim of discrimination. On appeal, the court agreed with the district court's assertion that Dawson pleadings were not clear in putting forward her discrimination cases and it wasn't clear whether her claims were based on gender, sexual stereotyping, sexual orientation, or some combination.[456] Since TVII did not cover sexual orientation claims, the appellate court felt that she was bringing her sexual stereotyping claim under the *Price Waterhouse* finding that those who deviate from stereotypical notions of gender are a protected class under Title VII.[457] It was noted that when the plaintiff is homosexual, then the issue becomes whether the discrimination was due to nonconformity to gender stereotypes or discrimination due to preconceived notions

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[453] *Id*. at 214-215.
[454] *Id*.
[455] *Id.* at 215. Dawson pointed to several instances where stylists referred to her as "Donald" and that "she was wearing her sexuality like a costume" which she claims underscores her sexual stereotyping claim. Even when she was terminated, she claims that her manager terminated her because she seemed "unhappy" by the way she dressed and wore her hair.
[456] *Id*, at 217.
[457] *Id*., at 217-218.

of homosexuals and thus runs the danger of impermissible "bootstrapping".[458] Dawson had not alleged gender stereotyping since she was never told that she had to act more femininely nor were her duties restricted to "appropriate" feminine duties.[459] The court could find no relationship between her appearance and any adverse consequence on the job. Bumble & Bumble did not have a formal dress code and the salon employed a very diverse group of individuals.[460]

Dawson's sexual harassment claim failed since the comments directed at her, while vulgar, were directed at her sexual orientation, rather than her nonconformance to a gender stereotype. One of her coworkers proclaimed loudly and in vulgar terms, that she needed "to have sex with a man" and while both the district court and appellate court found the statement to be offensive, it was determined that there were no triable issues of fact as to whether the incidents rose to the level of being "pervasively severe and offensive". In addition, Bumble & Bumble disciplined the coworker thus undercutting Dawson's cause of action. [461] Similarly, her claim that she was not promoted due to her being lesbian and not conforming to gender norms. Her claim rested on the alleged reasons that her manager gave her as to why she was not promoted i.e., that only men would succeed as stylists which seemed to contradict her statement in her complain that only heterosexual males and females who conformed to gender norms would be promoted.[462] Bumble & Bumble provided evidence that

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458 *Id.,* citing *Simonton v. Runyon,* 232 F.3d 35, 38 (2nd Cir. 2000).

459 *Id.* at 221.

460 *Id.* at 222. The court noted that there was a haircut policy where stylist assistants must have their hair cut by the stylists, but Dawson never asserted that this policy was discriminatory. In fact, there were several individuals, including Dawson who wore hairstyles that might not be considered "feminine" without any repercussions.

461 *Id*. at 227 citing Dawson v. Bumble & Bumble, 246 F.Supp.2d 301, 326-327 (S.D.N.Y.2003).

462 *Id*.

out of fifteen assistants who were selected to proceed on to the advanced hair styling training, nine were female. Statistics demonstrated that of the four assistants that were promoted to stylists, all of them women.[463] Since Dawson never refuted the statistics, the appellate court affirmed that there was no evidence that Dawson was not promoted due to discriminatory intent.

Dawson was unable to succeed in her claim of gender stereotyping due to the lack of clarity of her pleadings and the concern of the court that her claim of gender stereotyping was bootstrapping the claims of sexual harassment due to sexual orientation. The court seemed to suggest that any expectations of how employees should appear must be reasonable and not fall into the trap of gender-stereotyping. Where dress codes do exist, a careful examination as to whether both sexes are treated similarly how the dress code is applied.

C. Jesperson v. Harrah's Operating Co., Inc.

Employers have been allowed in the past to have differential grooming standards such as requiring men to have short hair and women to wear skirts. But what about requiring women to wear makeup even though some women might prefer not to wear any? In a recent Ninth Circuit decision, *Jesperson v. Harrah's Operating Co.,Inc.,*[464] the principle issue was whether Harrah's had committed Title VII gender discrimination for dismissing Jesperson for her refusal to wear makeup which was required in Harrah's appearance and grooming policy. Darlene Jesperson had worked for 20 years as a Harrah's bartender and maintained an "exemplary record" as a bartender.[465] Harrah's had a policy requiring their female beverage servers to wear makeup, but the

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[463] *Id*. citing *Dawson,* 246 F. Supp. at 323.

[464] *Jesperson v. Harrah's Operating, Co., Inc.,* 444 F.3d 1104 (9th Cir., Nev. 2006).

[465] *Id.* at 1107.

policy was never enforced until 2000. In 2000, Harrah's adopted a new "Personal Best" grooming standards in an attempt to improve the image of the Beverage department. The new grooming standards were adopted by twenty of the casinos. The dress code required men and women to wear the same type of uniform (black slacks, white shirts, black vest and black tie) but the standards were later amended to require women in the department wear makeup. The makeup standard for females read as follows: "Make up (face powder, blush and mascara) must be worn and applied neatly in complimentary colors. Lip color must be worn at all times."[466]

Jesperson regarded the makeup requirement as contrary to her self-image and offensive.[467] She refused to comply with the standard and since there was no other position at Harrah's which could pay her at her current rate, Jespersen left Harrah's. She filed a gender discrimination suit which alleged that the makeup requirement impacted on female employees by: "(1) subjecting them to terms and conditions of employment to which men are not similarly subjected, and (2) requiring that women conform to sex-based stereotypes as a term and condition of employment."[468] It was her assertion that the policy affected her self dignity and that Harrah's "'sells' and exploits its female employees".[469] Jespersen sought declarative and injunctive relief as well as a retaliation claim for which she sought damages. Harrah's sought summary judgment, saying that there were job-related reasons for the policy and that the policy was consistently applied with only minor variations (such as hair length and makeup). It was Jesperson's claim that the standard presented an unequal burden upon men and women. She also asserted that her personal dignity was so offended by the requirement that it affected her job performance. However, the

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466 *Id.* at 1107.
467 *Id.* at 1108.
468 *Id.*
469 *Id.*

district court granted Harrah's motion for summary judgment on all counts noting that the only evidence that Jesperson presented was her subjective opinion of the makeup standard in her deposition and provided no other testimony or evidence that the standard presented an unequal burden to female and male employees. She presented customer opinions of her good performance as a bartender, but the court did not find this persuasive.

In her appeal, the Ninth Circuit felt that Jesperson had not met her prima facie burden since she merely contended that the mere existence of the makeup policy was enough to establish a *prima facie* case for discriminatory intent and that Harrah's would have to demonstrate that the policy was a Bona Fide Occupational Qualification (BFOQ). The court saw a parallel between this case and various cases where differential weight standards were applied to males and females.[470] [471] The makeup standard at Harrah's was perceived by the court as being an attempt to maintain a professional appearance in both male and female employees in such a way not to unduly burden either sex. The court pointed out that the policy was only different in the grooming standards that it imposed and just because the grooming standards "appropriately

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470 *Gerdom v. Continental Airlines Inc.,* 692 F.2d 602 (9th Cir. 1982). (The court noted that there were strict weight requirements placed on the female flight attendants yet no such restrictions were placed on male employees who performed substantially equal work to that of the female flight attendants. Continental touted the policy as one which would foster a public image of providing passengers with flight attendants that were thin and attractive. The executives referred to the female flight attendants as "Continental's Girls". Continental justified its policy by saying it needed to be competitive with the other airlines. The court found that to be discriminatory on its face and a violation of Title VII)

471 *Frank v. United Airlines, Inc.,* 216 F.3d 845 (9th Cir. 2000). (The weight standard was more strictly applied to females who were required to maintain a weight appropriate for a medium frame whereas males were held to a more generous "large framed" individual. The court concluded that this was facially discriminatory and posed an unequal burden on men and women).

differentiated" between the sexes was not enough to construe it as being facially discriminatory.[472] The court went on to say that it was not the place of the court to take judicial notice of whether the grooming standards caused female employees to have to take more time and money to comply with the standard. It was up to the plaintiff to present the salient facts and the court felt Jesperson had not done so.[473] The court held that the district court properly granted summary judgment on the issue of unequal burden.

The court next turned its attention to the gender stereotyping issue and compared the issues and situation in *Price Waterhouse* with that of *Harrah's*. In *Price Waterhouse*, Hopkins was held to a feminine stereotype, while the Harrah's policy applied to men and women. In the eyes of the court, the policy was primarily unisex in nature and did not require men or women to conform to a stereotypical ideal,[474] nor was the dress code designed to present women in a sexually provocative way.[475] Since Jesperson did not provide any evidence of Harrah's intent to hold women to a gender stereotype and since the policy was not enforced in a discriminatory way, the court found for Harrah's. The dissent expressed concern that the majority's analysis would suppress any discriminatory aspect of grooming standards provided that the overall standard was non-discriminatory.

Many times when employees deviate in their appearance or behavior from the stereotypical norm, they may be subjected to harassment on the job. Various cases have determined that sexual

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472 *Jesperson*, 444 F.3d at 1109.
473 *Id.* at 1110-1111.
474 *Id.* at 1111-1112.
475 *Id.* The court referred to *EEOC v. Sage Realty Corp.,* 507 F. Supp. 599 (S.D.N.Y. 1981) where female lobby attendants were required to wear a poncho with nothing underneath causing exposure of various parts of the body. This was quite different than the unisex uniform required at Harrah's.

harassment due to gender nonconformance is a violation of Title VII.

IV. SEXUAL HARASSMENT AND GENDER-STEREOTYPING

Much of what makes up any stereotype is labeling or classifying individuals according to their perceived set of traits, behaviors and appearance. Employees who may deviate from that stereotype may experience a great amount of hostility from co-workers precisely because they do not conform to the "typical" stereotypical male or female. The hostility may rise to such a level that it is considered sexual harassment. Although Title VII does not specifically prohibit sexual harassment, case law and the EEOC have determined that sexual harassment is a violation of Title VII. The majority of the cases involve one gender harassing another, but in *Oncale v. Sundowner Offshore Service, Inc.,*[476] the Supreme Court opened the possibility that a sexual harassment case involving same-sex harassment could be actionable under Title VII and suggested, albeit broadly, that sexual harassment of an employee who deviated from a stereotype (perceived as being homosexual) could be actionable under Title VII.

Oncale worked on an oil rig with an all-male crew. He was perceived to be somewhat effeminate. His co-workers harassed him mercilessly which escalated to physical assault (coworker Lyons putting a bar of soap in Oncale's anus while he was held down by other coworkers) and threats of rape by his male coworkers.[477] Oncale complained to his superiors about the abuse but not only were his complaints ignored, his superiors joined in on the harassment. He eventually quit and filed suit for sex discrimination under Title VII. The Supreme Court, held for the

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[476] *Oncale v. Sundowner Offshore Services, Inc.,* 523 U.S. 75 (1998).
[477] *Id.* at 77.

first time that Title VII does not bar a claim simply because the plaintiff and the defendant are of the same sex and that claims of harassment can be brought forward if 1) the prohibited behavior arose out of sexual desire; 2) there was general hostility towards men at the workplace or 3) men were treated differently then women by the harasser.[478] Recent cases have relied on *Oncale* to bring forward claims of same-sex sexual harassment due to gender-stereotyping.

A. Nichols v. Azteca Restaurant

Sexual stereotyping was behind the sexual harassment in *Nichols v. Azteca Restaurant Enterprises, Inc.*[479] Antonio Sanchez worked at Azteca first as a host and then as a food server for four years. During that time, he was constantly taunted by his coworkers who constantly referred to him as "she", a "f****ing whore", and told him that he "carried his tray like a woman".[480] The abuse occurred several times a day. Azteca had a harassment policy which required anyone who felt they were harassed to report the incident to the EEO officer. Even though Sanchez knew the policy and had attended sexual harassment he never reported the harassment to the EEO officer or the area manager. He did report the abuse to the assistant manager, the general manager and the human resource director for Azteca during a meeting to discuss a fight that had erupted between Sanchez and a co-worker. It was resolved that Sanchez would report any future abuse to the general manager, who promised to take action on the complaints, or call the human resource director. Sanchez did not make any further complaints to the human resource director who believed everything was improving, but Sanchez ended up walking off the job during a

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478 *Id.* at 79-80.
479 *Nichols v. Azteca Restaurant Enterprises, Inc.,* 256 F.3d 864 (9th Cir. 2001).
480 *Id.* at 870.

heated argument with the assistant manager who subsequently fired Sanchez for leaving work in the middle of his shift.[481]

Sanchez brought a Title VII sexual harassment and retaliation claim but the district court found for Azteca stating that Sanchez had failed to demonstrate that the workplace was objectively or subjectively offensive or that he the behavior directed at him was because of sex.[482] The district court found that the taunts and comments occurred frequently enough to establish an objectively hostile work environment. In the examination as to whether Sanchez himself found the conduct unwelcome, it was clear that Sanchez had complained to his superiors and his conduct was seen by the Ninth Circuit as clear evidence that the conduct was subjectively unwelcomed.[483]

The court next tackled the issue as to whether Sanchez was harassed due to his sex. Sanchez contended that he was harassed because he failed to conform to a male stereotype. The court found that since Sanchez was consistently referred to as “she” and there were other incidents which made it clear that Sanchez’s co-workers behavior was prompted because he did not conform to their sexual stereotypes, the court concluded that the abuse was in fact the result of Sanchez’s gender nonconformance.[484] In considering whether Azteca was liable for the harassment by its supervisors, the court considered whether Azteca’s anti-harassment policy helped to prevent the harassment and whether its handling of Sanchez’s complaints were prompt and designed to correct the

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[481] *Id.* at 870-871.
[482] *Id.* at 871.
[483] *Id.* at 872-874.
[484] *Id.* at 874-875. The court used *Price Waterhouse,* 490 U.S. 228 (1989) *supra* note 6, as the basis for their finding that gender-stereotyping is impermissible under Title VII thus negating their previous decision in *DeSantis v. Pacific Telephone & Telegraph, Co., Inc,*. 608 F.2d 327 (9th Cir. 1979), where the court specifically stated that it was not within the purview of Title VII to find discrimination when a man does not conform to a virile stereotype.

harassment.[485] The court felt that Azteca had failed to act with "reasonable care" on the complaints of Sanchez.[486] However, the court did not find that Sanchez's firing was in retaliation for his complaints.

It seems clear that sexual harassment litigation is including harassment due to sexual stereotyping and that the standards for determining whether harassment has occurred will be the same for harassment due to deviations of gender stereotyping as harassment stemming from the gender of the individual. Individuals who are most susceptible from deviations of gender stereotypes are those who are seeking sex reassignment surgery who are required to dress and live as the opposite gender in preparation for their sex-reassignment surgery making them particularly vulnerable to adverse employment decisions and harassment. Recent decisions in the Sixth Circuit have illustrated how the court has determined that gender-stereotyping will prove to be an actionable offense for transsexuals.

V. GENDER STEREOTYPING AND THE SIXTH CIRCUIT

One particular group of individuals who are at greater particularly susceptible to gender-stereotyping are transsexuals since their appearance and behavior is in nonconformity to their biology. Transsexuals are at higher risk at being stereotyped since they are biologically one gender, but must present themselves as the opposite gender to society as part of any transgender reassignment surgery. If employers and co-workers equate the appearance and behavior of the transgender employee with their biological gender rather than the gender they present to society, it is a virtual certainty that gender stereotyping takes place. Two cases have been brought before the Sixth Circuit which involves

[485] *Id.* at 877.
[486] *Id.*

discrimination against transsexuals because of their failure to conform to a particular gender stereotype. The decisions in these cases may pave the way for transsexuals and pre-op transgendered employees to successfully litigate claims for Title VII discrimination. However, the Sixth Circuit still refuses to extend Title VII for individuals who claim discrimination based on gender-stereotyping based on sexual orientation.

A. Smith v. City of Salem

In *Smith v. City of Salem, Ohio*,[487] a firefighter, who was born genetically male and who was subsequently diagnosed as gender identity disorder, filed a discrimination suit against the city and city officials for TVII sex discrimination. Smith was a lieutenant firefighter for seven years and had no blemish on his employment record. He was subsequently diagnosed with Gender Identity Disorder (GID) which the American Psychiatric Association characterizes as a disjunction between an individual's sexual organs and sexual identity.[488] Once he was diagnosed, Smith adopted a more feminine style of dress which was in keeping with the medical protocols for treating GID. Co-workers began to question him about his appearance stating that he was not "masculine enough". As a result, Smith went to his supervisor, and told him about the coworkers' behavior and provided notice to his supervisor of Smith's impending sex-reassignment surgery.

Smith specifically asked his supervisor not to divulge the nature of the conversation to the fire chief. Unfortunately, the supervisor did not keep his promise and divulged everything. The Fire Chief then met with the Law Director for the City of Salem, with the intention

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487 *Smith v. City of Salem*, 378 F.3d 566 (6th Cir 2004), *Rehearing en banc denied; Smith v. City of Salem,* 2004 U.S. App. LEXIS 22668 (6th Cir October 18, 2004) (Case No. 03-3399).

488 *Id.* at 568. *See* American Psychiatric Association, DIAGNOSTIC AND STATISTICAL MANUAL OF MENTAL DISORDERS, 576-582 (4th ed.2000).

of using Smith's transsexualism as a basis for terminating his employment. On April 18, 2001, they both arranged a meeting of the City's executive body to discuss Smith and devise a plan for terminating his employment. This particular meeting, while permissible, did not follow the prescribed procedures which were mandated by law.[489]

It was decided at the meeting to require Smith to undergo three psychological examinations. The committee believed that Smith would refuse this request and if he did, he could be immediately terminated for insubordination. One member of the committee, who remained silent throughout the meeting, immediately phoned Smith to inform him of the Committee's plan upon which he immediately sought out legal counsel. Smith's attorney informed the Committee of the legal ramifications of their plan. Two days later, Smith received his "right to sue" letter from the EEOC. Four days after that, Smith was suspended for a 20-hour shift assignment for allegedly violating a City and Fire Department policy.

A hearing was held in front of the Salem Civil Service Commission where Smith maintained that his suspension was due to selective enforcement of the City's policy because of his transsexualism. Smith wished to introduce evidence regarding the meeting where the Committee hatched its plan, but the Commission's chairman would not allow it, despite the fact that Ohio law would allow Smith to introduce such evidence.[490] The suspension was upheld but later reversed by the Columbiana Court of Common Pleas. Smith filed a federal TVII sex discrimination and retaliation, a 42 U.S.C. §1983 claim, and state law claims of invasion of privacy and civil conspiracy. The district court dismissed the state and federal claim and granted the City's motion

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[489] OHIO REV. CODE ANN. §121.22(G) (1998)
[490] OHIO ADMIN. CODE §124-9-11 (1994)

to dismiss. Smith claimed on appeal that the district court was wrong to dismiss the case on the principle that a Title VII claim was unavailable to transsexuals. He also challenged the trial court's finding that he did not suffer any adverse employment action. The appellate court found that Smith had made out a prima facie case of Title VII discrimination.

To establish a *prima facie* case of retaliation pursuant to Title VII, a plaintiff must show that: (1) he engaged in an activity protected by Title VII; (2) the defendant knew he engaged in this protected activity; (3) thereafter, the defendant took an employment action adverse to him; and (4) there was a causal connection between the protected activity and the adverse employment action.[491] Smith's complaint satisfied the first two requirements by explaining how he sought legal counsel after learning of the Salem executive body's meeting concerning his employment; how his attorney contacted the defendant to advise of Smith's representation; and how Smith filed a complaint with the EEOC concerning Defendants' meeting and intended actions. With respect to the fourth requirement, a causal connection between the protected activity and the adverse employment action, "[a]lthough no one factor is dispositive in establishing a causal connection, evidence … that the adverse action was taken shortly after the plaintiff's exercise of protected rights is relevant to causation." [492] Smith was suspended just days after he engaged in protected activity by receiving his "right to sue" letter from the EEOC, which occurred four days before the suspension, and by his attorney contacting the

[491] *DiCarlo v. Potter,* 358 F.3d 408, 420 (6th Cir.2004).

[492] *Nguyen v. City of Cleveland*, 229 F.3d 559, 563 (6th Cir.2000); *See also, Oliver v. Digital Equip. Corp.,* 846 F.2d 103, 110 (1st Cir.1988) (employee's discharge "soon after" engaging in protected activity "is indirect proof of a causal connection between the firing and the activity because it is strongly suggestive of retaliation."); *Miller v. Fairchild Indus., Inc.,* 797 F.2d 727, 731 (9th Cir.1986) ("Causation sufficient to establish a prima facie case of unlawful retaliation may be inferred from the proximity in time between the protected action and the allegedly retaliatory discharge.").

Mayor, which occurred six days before the suspension. The temporal proximity between the events was significant enough to constitute direct evidence of a causal connection for the purpose of satisfying Smith's burden of demonstrating a *prima facie* case.

One of the most interesting aspects of the case was that Smith based his claim of TVII discrimination on sex stereotyping, which was at issue in *Price Waterhouse v. Hopkins*.[493] Hopkins had been considered for partnership, but was denied because she was considered "too macho".[494] The Supreme Court made clear that in the context of Title VII, discrimination because of "sex" includes gender discrimination: "In the context of sex stereotyping, an employer who acts on the basis of a belief that a woman cannot be aggressive, or that she must not be, has acted on the basis of gender."[495] The Court emphasized that "we are beyond the day when an employer could evaluate employees by assuming or insisting that they matched the stereotype associated with their group."[496]

Smith stated that the same type of gender stereotyping was present in his case since his coworkers began commenting on his lack of a masculine appearance and the resulting plan to force him to resign was done because he did not conform to a masculine stereotype. The Sixth Circuit agreed that the City acted in a discriminatory manner based on sex stereotyping and that the district court was in error for dismissing the case because TVII does not protect transsexuals. The appellate court adopted the same reasoning as that found in *Price Waterhouse* – when an employer acts in a discriminatory way against an employee for failing to conform to gender stereotypes, the employer is in violation of Title VII. "Sex stereotyping based on a person's gender non-conforming behavior

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493 *Price Waterhouse* 490 U.S. at 248.
494 *Id.,* at 235.
495 *Id.,* at 250.
496 *Id.* at 251.

is impermissible discrimination, irrespective of the cause of that behavior; a label, such as 'transsexual', is not fatal to a sex discrimination claim where the victim has suffered discrimination because of his or her gender non-conformity" and so, the court held that Smith has stated a claim for relief pursuant to Title VII's prohibition of sex discrimination.[497]

Relying on the findings of *White v. Burlington Northern & Santa Fe Ry. Co.,*[498] the district court held that Smith's suspension was not an adverse employment action because the Court of Common Pleas, which rendered the "ultimate employment decision," reversed the suspension. Accordingly, Smith's Title VII claim could not stand. However, the Sixth Circuit subsequently overruled and vacated *White*, and because of this, the appellate court held for Smith. Although the Fire Department suspended Smith for only twenty-four hours the suspension was a significant employment decision since Smith worked in twenty-four hour shifts and a twenty-four hour suspension was the equivalent of three eight-hour days for the average worker, or, approximately 60% of a forty-hour work week. The Sixth Circuit found that Smith had sufficiently met his burden of proof regarding his §1983 claim for gender discrimination on the basis of violations of the Equal Protection Clause of the Constitution thus reversing the district court's dismissal of the claim.

The *Smith* case was a very significant case for transgender employees. For the first time, an appellate court recognized the gender stereotyping of transsexuals as actionable under Title VII and if any employer treated any individual because of their failure to conform to a gender stereotype, that employer would be guilty of gender discrimination. It wasn't long before the Sixth Circuit

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497 *Smith,* 378 F.3d 575.

498 *White v. Burlington Northern & Santa Fe Railway. Co.,* 310 F.3d 443 (6th Cir.2002)

was presented with another claim involving gender stereotyping and a transsexual employee.

B. Barnes v. City of Cincinnati

In *Barnes v. City of Cincinnati*,[499] the issue was whether the City impermissibly discriminated against Barnes because of her transsexualism. The case was slightly different than that of Smith, since Barnes was forced to submit to an intensive probationary period which put her under scrutiny that no other employee had to endure. The City was alleging that there were "legitimate" reasons for her failure of her probationary period. Barnes joined the Cincinnati police in 1981 and passed the sergeant's promotional test seventeen years later. Barnes scored 18th out of the 105 officers who sat for the exam. At the time of the exam, Barnes was in the process of going through a male to female sex change transition, but Barnes dressed as a male while on duty and dressed as a female while off duty. However, Barnes did come to work with makeup, a French manicure and arched eyebrows. The other officers generally held the impression that Barnes was gay or feminine in appearance.[500]

Once Barnes was promoted, he was required to undergo a probationary period during which time his superior officers evaluated his capabilities as sergeant. Eighteen traits were used in the evaluation with the factor of "judgment" being the most important. The city stated that it was extremely important to evaluate a candidate's supervisory capabilities since the position of sergeant is extremely critical and not all officers can make the transition from police officer to sergeant.[501] Barnes admitted that

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[499] *Barnes v. City of Cincinnati,* 401 F.3d 729 (6th Cir. 2005) *cert. denied*, *City of Cincinnati v. Barnes,* 546 U.S. 1003 (November 7, 2005).
[500] *Id.* at 733-4.
[501] *Id.,* at 733.

he had difficulty in the probationary period.[502] Barnes failed his probationary period since it was determined that he lacked "command presence" which his superiors translated into projecting "a certain image of confidence".[503] The City claimed that any sergeant lacking command presence would have trouble eliciting any respect from his or her subordinates. However, Barnes' expert witness claimed that the City was using vague and subjective standards for the sole purpose to discriminate. In fact, several evaluators were questioned as to what "command presence" meant and nearly every one of the evaluators had a different definition lending credence to the assertion that the standards were subjective.[504]

Barnes was first assigned to Lieutenant Wilger when he began his probationary period. Wilger claimed that Barnes was having trouble meeting his responsibilities and that others did not take him seriously and later reported to Captain Demasi that Barnes was having trouble in meeting his obligations such as preparing documents, exercising proper judgment and completing assignments on time. Barnes was subsequently assigned to a new training program. The new program required that he be evaluated on a daily basis for three months by seven different sergeants using the standard eighteen performance categories each category contained a scale ranging from zero to twenty-five. At all times, Barnes was not allowed to go into the field alone and was also required to be fitted with a microphone. During the last week of the training, Barnes was videotaped in the patrol car. No other sergeant was evaluated in this way and the whole process left Barnes feeling incompetent and ignorant. While Barnes hesitated to say that the process was the result of discrimination, Sergeant Ford testified that the purpose of the evaluation was to document

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[502] *Id*. at 734.
[503] *Id*.
[504] *Id*.

every single mistake so that Barnes would be sure to fail the evaluation.[505]

All in all there were twenty-two evaluations and Captain Demasi recommended to the Chief of Police, Chief Streicher, that Barnes should fail his evaluations due to violations of procedure and rules. Streicher refused to fail Barnes and gave him the opportunity to pick a mentor for further training. The mentor, Sgt. Hoffbauer, rated Barnes as being mediocre in the beginning but later gave Barnes zeroes in some of the categories.[506]

Lieutenant Colonel Twitty instructed Captain Demasi to submit a second report on Barnes recommending that Barnes fail his probationary period citing Barnes' lack of improvement, several acts of dishonesty, Barnes' departed from departmental grooming standards, and Barnes' failure to achieve a commanding presence. Streicher communicated to Barnes that he failed his probation in 1999. Colonel Twitty told Barnes that he needed to lose the makeup and to act more masculine.[507] Barnes' expert witness, Industrial Psychologist Dr. Cranny, maintained that Barnes passed the minimum standards and that there was no reason that Barnes should have failed probation.[508] Barnes filed a Title VII sex discrimination case and an Equal Protection violation. The City filed a motion to dismiss along with a motion for summary judgment saying that the reason for Barnes' dismissal was due to poor performance, not gender discrimination.[509] The district court denied both motions and jury returned with a verdict in favor of Barnes along with substantial damages.[510] The City filed their

[505] *Id.*
[506] *Id.*
[507] *Id.*
[508] *Id.*
[509] *Id.* at 735.
[510] *Id.*

appeal with the Sixth Circuit which found that Barnes had adequately presented a case of sex discrimination.[511]

The key question for the court was whether Barnes had made out a case for sex discrimination by a preponderance of the evidence rather than whether he had made a prima facie case of discrimination.[512] The court used the *McDonnell Douglas*[513] standard where in order to prove a case of gender discrimination a plaintiff must demonstrate that 1) he is a member of a protected class; 2) applied and was qualified for a promotion; 3) he was considered for and denied the promotion; 4) other employees with similar qualifications but not of the same protected class received promotions.[514] The City disputed the first element by saying that Barnes had failed to demonstrate he was a member of a protected class and he had failed to show the fourth element because he had not shown the court any other similarly qualified individuals who were not in the protected class who received promotions.[515]

Barnes claimed the City discriminated against him due to his failure to conform to a gender stereotype. The Court relied on its decision in *Smith* which said that any gender stereotyping must be considered impermissible TVII discrimination irrespective of whether the individual is transsexual.[516] The Court pointed out that Barnes did not have to find someone who is a perfect

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511 *Id*.

512 *Id. See Noble v. Brinker Intern., Inc*., 391 F.3d 715, 724-26 (6th Cir. 2004)(noting that when the case proceeds to a full trial on the merits, the district court is "in a position to decide the ultimate factual issue in the case, that is, whether the defendant intentionally discriminated against the plaintiff)." Thus, "the proper inquiry following the presentation of all evidence in a Title VII case is whether plaintiff has proven its case by a preponderance [of the evidence.]" *EEOC v. Avery Dennison Corp.,* 104 F.3d 858, 862 (6th Cir. 1997).

513 *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973)

514 *Barnes,* 401 F.3d at 735.

515 *Id.*

516 *Id*. citing *Smith,* 378 F.3d at 575.

counterpart who did get promoted; rather, Barnes had to find someone who was equal in all relevant respects.[517] It was enough that Barnes found another individual who had lower probationary scores who was not a member of Barnes protected class who was promoted to sergeant.[518]

The Court then turned its full attention to the critical issue which was whether Barnes had proven that he had been the victim of intentional discrimination due to his failure to conform to sexual stereotypes. It was held that a reasonable jury could have found for Barnes since he had produced evidence demonstrating the CPD's constant references to his nonconformance to gender stereotypes in making comments regarding his wearing of makeup and it was well known that he was living as a woman during his off-hours. There were many comments regarding his lack of "command presence". No other sergeant had ever failed the probationary period and Barnes had shown that another officer receiving lower probationary marks had passed the probationary period. No other officer had ever undergone the intensive scrutiny that Barnes had faced and that scrutiny had caused Barnes to become nervous and make mistakes that were duly noted by the evaluators, causing one of the evaluators to remark that Barnes would never pass his probation since he was not masculine enough.[519] The Court felt that Barnes produced sufficient evidence for a jury to believe that the reason for his failure was due to discrimination and not due to the City's excuse that he was not qualified. Therefore, the Court concluded that Barnes had proven

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517 *Id*. citing *Ercegovich v. Goodyear Tire & Rubber Co.,* 154 F.3d 344, 353 (6th Cir. 1998) (noting that inflexible criteria for establishing the similarly-situated requirement would mean that "a plaintiff whose job responsibilities are unique to his or her position will never successfully establish a prima facie case (absent direct evidence of discrimination)").

518 *Id*.

519 *Id*. at 738.

both his prima facie case as well as provided substantial proof of discrimination based on sexual stereotype found in *Smith*.[520]

The City made the claim that Barnes did not have standing to bring his Equal Protection claim nor his Title VII claim since Title VII did not cover transsexuals.[521] To bring an Equal Protection claim, the Court stated that Barnes would have to demonstrate that he suffered discrimination because he was a member of a "vulnerable minority class of protected individuals".[522] The City claimed that Barnes was not a member of a protected class due to his transgender status, but the court disagreed stating that he had standing in both his TVII claim and in the Equal Protection claim. The Court pointed out that Barnes would have standing in the Equal Protection claim whether he was a man or woman.[523]

The City challenged the district court's jury instructions claiming that the mixed-motive instructions were improperly given since they failed to require that Barnes demonstrate that the legitimate reasons for his dismissal were pretextual.[524] The District Court gave the following instructions:

> Your verdict will be for plaintiff if you find that plaintiff demonstrated by a preponderance of the evidence that plaintiff's failure to conform to sex stereotypes was a motivating factor in defendant's decision to demote plaintiff, even if other factors . .

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[520] *Id*.
[521] *Id.* at 739. *See Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560-61 (1992). For purposes of an Article III standing analysis, an injury in fact means "an invasion of a legally protected interest[.]" *Northeastern Florida Chapter, Associated General Contractors of America v. City of Jacksonville*, 508 U.S. 656, 663 (1993).
[522] *Id.* citing *Arlington Heights v. Metropolitan Housing Dev. Corp.*, 429 U.S. 252, 256 (1977).
[523] *Id.* at 739.
[524] *Id*.

> . also motivated defendant's decision.. . . Plaintiff is entitled to damages unless defendant proves by a preponderance of the evidence that defendant would have demoted plaintiff even if plaintiff's failure to conform to sex stereotypes had played no role in the decision.[525]

The court relied on *Desert Palace* to determine whether the instruction was proper under 42 U.S.C. § 2000e-2(m), and whether the plaintiff presented sufficient evidence for a reasonable jury to conclude, by a preponderance of the evidence, that "race, color, religion, sex, or national origin was a motivating factor for any employment practice."[526] The City claimed that the jury instructions were not proper since they did not follow the "legal niceties" of *McDonnell Douglas*[527] The Court ruled that a mixed-motive instruction was proper provided that the plaintiff had presented sufficient evidence for a jury to conclude that the City's employment decision was motivated by sex.[528] Since Barnes provided the necessary evidentiary criteria, the court ruled that the instructions were proper.[529]

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525 *Id.* at 740.

526 Desert Palace, Inc. v. Costa*,* 539 U.S. 90, 96-97, 101-02, (2003) (citing 42 U.S.C. § 2000e-2(m)). In *Desert Palace*, the Court upheld a district court's decision to instruct the jury in a Title VII sex discrimination case, where the instructions were the same as that used in *Barnes*.

527 *Barnes,* 401 F.3d at 740 citing *McDonnell Douglas,* 411 U.S. at 792 and Texas Dept. of Community Affairs v. Burdine, 450 U.S. 248 (1981). *See* Brown v. Packaging Corp. of Am*.,* 338 F.3d 586, 591 (6th Cir. 2003); *See also* Wexler v. White's Fine Furniture, Inc., 317 F.3d 564, 571 (6th Cir. 2003) (stating that criticism of an employee's performance, even if true, which is linked to stereotypes associated with a plaintiff's membership in a protected class is therefore squarely within the rubric of a mixed-motive analysis).

528 *Id*.

529 *Id.* The Court refused to consider the City's allegation that the court had erred in its instructions for the Equal Protection claim. The court had instructed the jury that the Equal Protection Clause "prohibits discrimination against public employees on the basis of an employee's perceived sexual orientation, gender

The City relied on *Price Waterhouse v. Hopkins*,[530] by saying that the court had erred in telling the jurors that discrimination "based on sex" included gender stereotyping. The Court responded by relying on *Smith*,[531] saying that no error occurred since Title VII claims can be brought where discrimination has occurred due to sexual stereotypes.[532] The City also argued that certain testimony should never have been admitted, but the court ruled that no error occurred nor had any prejudicial testimony and evidence been admitted.[533] Another point of contention was the City's appeal of the award of "excessive" attorney fees,[534] but the court felt they were entirely appropriate.[535] The finding may encourage transsexual plaintiff's to go forward with expensive and lengthy litigation, not to mention encouraging attorney's to take on such cases given the fact there is a greater possibility of recovering fees.

It seems clear that ever since the Supreme Court found that gender stereotyping is akin to Title VII discrimination and that if the transsexual employee will be able to prevail if it can be shown that the impermissible stereotyping was a motivating factor in the adverse employment decision and if the employer fails to demonstrate that the same adverse decision would have been made absent the gender stereotyping. The door has been opened for

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identity, transsexuality, or failure to conform to sex stereotypes." The court concluded that since Barnes met the burden of proof in the Title VII claim, there was no need to address the City's allegation of error in the Equal Protection claim.

530 *Price Waterhouse,* 490 U.S. 228 (1989).

531 *Smith*, 378 F.3d at 566.

532 *Barnes,* 401 F.3d at 740.

533 *Id*. at 740- 745. Specifically, the City argued that the district court erred in denying the City's motion in limine to exclude post-probation statements made by Sergeant Ford regarding lesbians and "fags" as well as the introduction of Article XII of the city charter.

534 *Id*. at 745.

535 *Id.* at 746-7.

Federal protection of transsexuals who face the adverse effects of gender-stereotyping in the workplace.

C. Vickers v. Fairfield Medical Center

On July 19, 2006, the Sixth Circuit affirmed the district court's decision that Christopher Vickers sex discrimination, sexual harassment, and retaliation claims under Title VII were properly dismissed.[536] The Fairfield Medical Center had employed Vickers as a private police officer. Vickers had befriended a doctor who was homosexual and had assisted the doctor in an investigation regarding sexual misconduct that was being alleged against the physician. As soon as his coworkers found out about the friendship, the harassment began. Two coworkers, questioned his masculinity and called him "gay" or "homosexual".[537] Vickers' superior did nothing about the harassment and would actually join in the harassment. The harassment progressed beyond comments to the point where a co-worker simulated having sex with Vickers during a handcuff training and another co-worker took photographs and Dixon's wife faxed the photo to Fairfield Medical Registration where several people saw the photo.[538] Eventually, the picture was hung up at the registration desk in full view of the staff and visitors. There were other instances of abuse where Vickers' co-workers "repeatedly touched his crotch with a tape measure, grabbed Vickers' chest while making derogatory comments, tried to shove a sanitary napkin in Vickers' face, and simulated sex with a stuffed animal and then tried to push the stuffed animal into Vickers' crotch".[539] Vickers voiced his complaints on several occasions, but nothing was ever done. Finally, Vickers' attorney

[536] *Vickers v. Fairfield Medical Center,* 453 F.3d 757 (6th Cir. Ohio) 2006. *Cert Denied* by *Vickers v. Fairfield Medical Center*, 551 U.S. 1104 (2007).
[537] *Id.*, at 759.
[538] *Id.*
[539] *Id.*

met with FMC representatives who promised to take prompt action.

Vickers' met with the human resource department who disclosed that the co-workers had been suspended at different times after Vickers' complaints had been investigated and the representative promised that Vickers' schedule would be made in such a way as to minimize Vickers' contact with the harassers. Just as the meeting was concluding, the human resource representative stated they had uncovered misconduct by Vickers, but elected not to discipline Vickers. When Vickers requested details of the alleged misconduct, the representative declined.[540] Vickers was never assigned to another shift as promised by human resources and was told to meet with the human resource department, but a coworker informed Vickers that the purpose of the meeting was to initiate a personnel action against Vickers to discredit him in case Vickers decided to file a lawsuit. Vickers decided to resign after consultation with his attorney and shortly filed an action with the Equal Employment Opportunity Commission and then filed suit in the federal district court for the Southern District of Ohio.

Fairfield Medical requested summary judgment against all of Vickers claims.[541] The district court granted the defendants their motion on all counts saying that Title VII does not protect against discrimination on the basis of sexual orientation. On appeal, Vickers argued that while his coworkers might have perceived him to be homosexual, he was being harassed because of his nonconformity to his gender and thus should be afforded the same protection as in *Price Waterhouse.* He furthered argued that the

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[540] *Id.* at 760.

[541] *Id.* Vickers filed a complaint alleging sex discrimination, sexual harassment, and retaliation in violation of Title VII, 42 U.S.C. § 2000e *et seq.,* conspiracy to violate Vickers' equal protection rights in violation of 42 U.S.C. § 1985(3), failure to prevent the conspiracy in violation of 42 U.S.C. § 1986, and twenty-one state law claims.

Sixth Circuit had opened the door for same-sex discrimination claims after the holding in *Smith.* The district court had stated that Vickers did not present evidence which would fit in the *Price Waterhouse* framework since "Vickers had not alleged that the harassers were motivated by sexual desire for Vickers or by general hostility for men in the workplace, nor was any information presented regarding how females were treated in comparison at FMC. Although the district court expressed sympathy for Vickers' situation, the district court found that Vickers pled no harassment or discrimination claim under Title VII."[542]

The Sixth Circuit felt that cases such as *Oncale*, paved the way for Title VII claims of discrimination based on sexual orientation under certain circumstances. Having said that, the court felt that *Price Waterhouse* was not broad enough to encompass the theory of Vickers' position, namely, that his perceived homosexual practices did not conform to a stereotypical male role.[543] The court claimed that case law that gender stereotyping occurred either when 1) the appearance or 2) the behavior of the person deviated from accepted norms.[544] The court felt that the gender nonconforming behavior, i.e., his perceived homosexuality, did not exhibit itself at work nor affected his behavior at work. In addition, the court expressed its belief that perceived homosexuality is different than gender nonconformance.[545] The court was trying to avoid any bootstrapping a possible sexual orientation claims such as in *Dawson v. Bumble & Bumble*.[546]

542 *Id.* at 761.
543 *Id.* at 761-2.
544 *Id.* at 763 quoting *Smith*, 378 F.3d at 573. *See also Jespersen,* 444 F.3d at 1110-12*; Weinstock v. Columbia Univ.,* 224 F.3d 33, 57 (2d Cir.2000).
545 *Id*.
546 *Id.,* at 763-4 quoting *Dawson*, 398 F.3d, at 218 ("When utilized by an avowedly homosexual plaintiff, . . .gender stereotyping claims can easily present problems for an adjudicator. This is for the simple reason that stereotypical notions about how men and women should behave will often necessarily blur

Since Vickers never alleged that he did not conform to a gender stereotype in any observable way at work, then his claim would have the effect of broadening Title VII's definition of gender discrimination to include sexual orientation. So, while the court found the harassment experienced by Vickers to be reprehensible, the claim itself did not fall under any actionable legal theory.

Vickers claimed that the defendants presented a hostile workplace such as that in *Oncale,* where a plaintiff could bring a same-sex harassment suit if 1) the prohibited behavior arose out of sexual desire; 2) there was general hostility towards men at the workplace or 3) men were treated differently then women by the harasser.[547] Other similar claims had been rejected by the Sixth Circuit,[548] as well as other circuits.[549] Consequently, the Sixth Circuit affirmed

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into ideas about heterosexuality and homosexuality. Like other courts, we have therefore recognized that a gender stereotyping claim should not be used to bootstrap protection for sexual orientation into Title VII.")

[547] *Id.,* at 765; *See Oncale,* 523 U.S. at 79.

[548] *Id.,* at 765-6 *See EEOC v. Harbert-Yeargin, Inc.,* 266 F.3d 498, 519-23 (6th Cir.2001) (hostile work environment claim rejected where plaintiff experienced frequent inappropriate touching because though harassment was sexual in nature, it could not be said to be "because of . . . sex" as required by Title VII); *King,* 68 Fed Appx. at 664 (rejecting hostile work environment claim where plaintiff was subject to verbal and physical abuse insinuating that plaintiff was a homosexual because his claim did not fit into the three examples given in *Oncale* of same sex harassment); *Dillon v. Frank,* 952 F.2d 403, (6th Cir. 1992), (No. 90-2290, 1992 WL 5436), at *7 (6th Cir. Jan 15, 1992) (rejecting plaintiff's claim where plaintiff suffered severe verbal harassment and physical assault based on co-workers' belief that plaintiff was a homosexual, because the plaintiff failed to allege that "harassment was directed at [him] for a statutorily impermissible reason").

[549] *Id. See e.g*., *Bibby v. Philadelphia Coca-Cola Bottling Company*, 260 F.3d 257, 264 (3rd Cir. 2001) (hostile work environment claim fails where plaintiff was subjected to vulgar statements regarding his sexual orientation and practices accompanied by physical assault and graffiti because the plaintiff "[h]is claim was, pure and simple, that he was discriminated against because of his sexual orientation."); *Spearman v. Ford Motor Co*., 231 F.3d 1080, 1085 (7th Cir.2000) (male employee who endured threatening and hostile statements, taunting, and

the district court's decision for the defendants based on Rule 12(c).[550] Judge Lawson, writing for the dissent, felt that Vickers made a cognizable claim and that the reading of his complaint by the court was too narrow and exacting.[551] Vickers claim presented very specific details of the abuse that he experienced and that these details provided enough evidence that Vickers might be the subject of gender stereotyping. Since the facts of the pleading suggest that there might be actionable claims of gender stereotyping and since it is difficult to make the distinction between gender stereotyping and the discrimination on the basis of sexual orientation, and since Vickers did allege he was discriminated against because he was not considered masculine enough, the claim should not have been dismissed.[552] There were many examples of behaviors and actions taken by the defendants that would suggest that Vickers was being discriminated on nonconformance to stereotype.[553] There was no

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graffiti did not establish hostile work environment claim because his co-workers "maligned him because of his apparent homosexuality, and not because of his sex"); *See Id*. at 1086 ("Title VII is not a 'general civility code' for the workplace; it does not prohibit harassment in general or of one's homosexuality in particular.") (quoting *Oncale*, 523 U.S. at 81); *Higgins v. New Balance Athletic Shoe, Inc.,* 194 F.3d 252, 258 (1st Cir.1999) (rejecting hostile work environment claim where plaintiff was verbally harassed and mocked due to his homosexuality because he failed to show that harassment occurred because of his sex). *But see Rene v. MGM Grand Hotel*, 305 F.3d at1066 (finding that male employer who was subject to severe, pervasive, and unwelcome physical conduct was harassed because of his sex because he was subjected to attacks "which targeted body parts clearly linked to his sexuality").

[550] *Id.,* at 766.

[551] *Id.,* at 766-7. (Lawson, D. dissenting).

[552] *Id.* at 767-8.

[553] *Id.* at 768-9. One example used by the dissent was when Dixon stated that Vickers was in a bad mood. Mueller responded by saying that " Maybe he is having a heavy (menstrual) flow day, huh? " Mueller then said to Vickers, " Why don't you pluck that tampon out and put a new pad in and lose some of that pressure? " Meuller stepped out of the office and returned with a sanitary napkin which he proceeded to rub in Vickers face making sexual grunting and panting noises. He eventually affixed the sanitary napkin to Vickers. When

doubt in the dissent's mind that some of the allegations involve the defendants' perception of Vickers homosexuality, but, as in *Smith*, Title VII claims of discrimination based on the perceived homosexuality of an individual should not automatically disqualify a claim of discrimination.[554] Since the facts alleged in the pleadings could not wholly exclude the possibility that the harassment arose from Vickers' perceived homosexuality alone, the dissent felt that the claim had been improperly dismissed. The Sixth Circuit made it very clear that while discrimination based on gender-stereotyping is actionable under Title VII, it is impermissible to use it as a way of bootstrapping a claim of discrimination based on sexual orientation and refuses to equate homosexuality with gender-nonconformance. In order to be successful in a claim of gender-stereotyping, the plaintiff will have to present very clear evidence that adverse employment decisions were made specifically because the plaintiff did not conform in behavior and/or appearance to gender expectations.

VI. CURRENT DEVELOPMENTS

It seems clear that the courts accept gender nonconformance as a Title VII claim for gender discrimination based on appearance and behavioral differences. Current cases are dealing with a dilemma. Plaintiffs are bringing claims for both gender stereotyping and for sexual orientation discrimination. Title VII does not cover instances of discrimination based on sexual orientation but does for

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Vickers returned to work the next day, Mueller had asked him if his mood had improved.

[554] *Id.,* at 769-770, quoting *Smith v. City of Salem*, 378 F.3d at 575 (6th Cir.2004) which said "Sex stereotyping based on a person's gender non-conforming behavior is impermissible discrimination, irrespective of the cause of that behavior; a label, such as 'transsexual,' is not fatal to a sex discrimination claim where the victim has suffered discrimination because of his or her gender non-conformity." *See also Barnes,* 401 F.3d at 737,"[s]ex stereotyping based on a person's gender non-conforming behavior is impermissible discrimination, irrespective of the cause of that behavior."

gender stereotyping. Even though the courts have recognized that gender stereotyping is in violation of TVII, gender stereotyping claims will be disallowed if the plaintiff fails to demonstrate that adverse employment actions resulted in deviations from stereotype and not derived from an individual's sexual orientation. Any evidence of bootstrapping will lead to a dismissal or denial of the claim.

A. Prowel v. Wise

In *Prowel v. Wise,*[555] Prowel asserted that he was the victim of harassment due to the gender stereotyping of his co-workers. He had worked at Wise for 13 years as a nale encoder prior to the time the company laid him off. Prowel had stated that he was an "effeminate" man and that his mannerisms caused him to be the target of harassment by his coworkers. In contrast to his blue-collar, rough-around-the-edges coworkers, Prowel testified that he:

> [h]ad a high voice and did not curse; was very well-groomed; wore what others would consider dressy clothes; was neat; filed his nails instead of ripping them off with a utility knife; crossed his legs and had a tendency to shake his foot "the way a woman would sit"; walked and carried himself in an effeminate manner; drove a clean car; had a rainbow decal on the trunk of his car; talked about things like art, music, interior design, and decor; and pushed the buttons on the nale encoder with "pizzazz.[556]

The harassing behavior seemed to occur after Prowel was "outted" at work. The harassment ranged from calling him nicknames such

[555] *Prowel v. Wise Business Forms, Inc,.* 579 F.3d 285 (3rd Cir. 2009).
[556] *Id.* at 287

as "Princess" and "Rosebud" to coworkers leaving him a pink light-up tiara with lubricant jelly on his encoder machine. One co-worker even went so far as to as to say "I hate him. They should shoot all the fags."[557] Finally, messages began to appear on the bathroom wall stating that Prowel had had sexual relations with his make co-workers and that he had AIDS.[558] The incidents were reported to Prowel's superiors, the restroom was painted and the offending tiara was removed, however, it was never clear that any of the individuals who made the offensive remarks were disciplined. The harassment became so severe that Prowel's work environment caused him to vomit before reporting to work. He was routinely given extra assignments, yet not given the appropriate compensation for doing the extra work. He resolved to take the case to court and informed four of the non-managerial personnel of his intentions to file a claim based on his "not fitting in" with his male colleagues. The four promptly turned around and complained to Prowel's supervisors citing that he was "bothering" them. Soon after, the supervisors met to allegedly discuss the issue that Prowel had raised about being assigned extra duties with no pay, and told him soon afterwards that they were terminating him due to "lack of work".

Prowel sued for wrongful termination based on sex and religion under TVII of the Civil Rights Act of 1964, 42 U.S.C. §2000e et. Seq., and the Pennsylvania Human Relations Act[559]. The court granted Wise's request for summary judgment stating that Prowel's claims for gender stereotyping and religious discrimination was, in reality, a sexual orientation case which the court claimed was not permissible under Title VII. The Appellate Court for the Third Circuit and the parties relied very heavily on

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557 *Id.*

558 *Id.*

559 PENNSYLVANIA HUMAN RELATIONS ACT, 43 PA. CONS. STAT. § 951*, et seq*. (PHRA) (2009).

Bibby v. Philadelphia Coca Cola Bottling Company.[560] In *Bibby*, the Third Circuit had decided that TVII does not prohibit a claim of sexual orientation provided that the homosexual individual brings a *gender* discrimination claim. In other words, the aggrieved individual must claim that the adverse actions were due to his gender, not his sexual orientation. It was decided that a gender discrimination case could be made upon the gender stereotyping claim first brought in *Price Waterhouse.* Unfortunately, Bibby did not present any such evidence and his case was dismissed upon summary motion. Nonetheless, the court recognized and accepted the gender stereotyping claim of action.

The court also referred back to *Price Waterhouse* as the authority in the gender-stereotyping case, however, the court did not feel that the case was adequate to cover the situation here. Since Prowel is a homosexual, the essential question of the court was whether the harassment was due to failure to conform to a gender stereotype, or was the harassment due to his sexual orientation, or a combination of both. The District Court felt that Prowel was simply proffering an "artfully pleaded" claim of sexual orientation discrimination and granted Wise summary judgment. The appellate court disagreed saying that there was evidence for both types of claims and that it would have to be up to a jury to decide the matter.

Wise claimed that they dismissed Prowel due to the need to downsize and because of insubordination for his remarks on his production reports, his complaints about having to operate other machines and because he was one of the highest paid employees. Prowel claimed this was just pretext and the real reason for his dismissal was because he complained about his harassment and that he tipped off his coworkers that he was going to file a lawsuit. Prowel certainly seemed to have the facts on his side – his performance and attendance was better than that of his coworkers

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560 *Bibby,* 260 F.3d at 257.

and he was made to operate other machines 54 times compared to once for a coworker. Prowel claimed that his dismissal was due to his failure to conform to gender stereotypes. His previous testimony provided credible reasons for the Appellate court to vacate the District Court's order for summary judgment on the gender stereotyping issue.

It is clear that in order to be successful in claiming discrimination under gender stereotyping, the plaintiff must carefully craft the complaint to demonstrate that the adverse actions were due to non-conformity to one's gender and not because of one's sexual orientation. In *Anderson v. Napolitano,*[561] Richard Anderson was employed as a Federal Air Marshal and was eventually promoted to Supervisory Air Marshal and was transferred to the Miami Office. Shortly after the transfer, he began to experience discrimination based on his sexual orientation. He claimed that coworkers shunned him and warned others not to associate with him due to his sexuality.[562] For example, Anderson's supervisor told him that "It's my perception, and I could be wrong-that because you're gay you're super sensitive to issues of discrimination."[563] When Anderson denied this characterization, Bauer allegedly told Anderson, "You're too gay. You're too flamboyant. You're too 'in your face' around others [Federal Air Marshals]."[564]When Anderson asked his supervisor to clarify the remark, he stated that Anderson was behaving inappropriately with some of his coworkers by making a comment regarding the attractiveness of a coworker. Anderson didn't think anything was wrong about that since the coworkers had made a comment on the attractiveness of a female coworker. In response, his supervisor

561 *Anderson v. Napolitano,* No. 09-60744-CIV, 2010 WL 431898. Slip op. (S.D. Fla. Feb. 8, 2010).

562 *Id.* at 1.

563 *Id.* Anderson had informed his supervisor of a claim for racial discrimination that had been brought by Anderson's subordinate.

564 *Id.*

said, Bauer allegedly responded, “No. That's ‘in your face behavior’ and too flamboyant. You are not entitled to equal time.”[565]

These incidents led Anderson to file a claim of TVII discrimination and harassment with the EEOC on the basis of sexual orientation harassment. His EEO complaint was amended several times with the final claims consisting of not only discrimination but retaliation for supposedly going AWOL for leaving work early. Richardson was demoted by his supervisor and received a reduction in pay as a result of leaving work early. Specifically the supervisor claimed that Richardson was “lack of candor, failure to follow instructions, and absence without leave (AWOL).” [566] The Administrative Law Judge (the ALJ) dismissed the sexual orientation claim and eventually denied the retaliation claim as well. Richardson was advised that he could file his claims with the District court within 90 days and that is exactly what he did.

The Department of Homeland Security filed a Motion for Summary Judgment. Although Anderson had amended his complaint to reflect that he suffered discrimination and harassment because of his failure to conform to male stereotypes due to his homosexuality, the court decided that Anderson had not framed the issue as one of discrimination based on gender stereotyping and sexual orientation. Relying on *Prowel*, the court pointed out that Prowel had presented several instances of coworkers picking on his effeminate behaviors but Anderson had only cited two examples which, the court stated, were not related to traits of a woman, but of a homosexual man such as lisping.[567] In fact the court took issue with Anderson’s apparent “confusion” of the concepts of discrimination based on gender stereotyping as opposed to discrimination based on sexual orientation. Anderson

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565 *Id.*
566 *Id.* at 2.
567 *Id.* at 6.

seemed to contend that by virtue of being a gay man, he automatically would fail to conform to the typical male stereotype. Since it is not true that all gay men fail to conform to male stereotypes, there is a danger that such an assumption could subvert the original intent of Congress not to include sexual orientation discrimination in Title VII. If the assumption were allowed to hold, then discrimination based on sexual orientation would automatically include gender stereotyping and be automatically actionable under TVII. This is exactly the kind of bootstrapping that other courts feared and because of these reasons, the District court decided to grant the Defendant's motion for summary judgment on the sex discrimination claims.[568]

It seems clear that while the courts recognize gender stereotyping as a legitimate TVII claim, such a claim will quickly fail should the plaintiff fail to carefully point to actual instances of adverse employment actions based on specific examples of nonconformity to a gender stereotype. Any presumption that gender nonconformity is inherent in one's sexual orientation will quickly result in a denial of the claim.

B. Glenn v. Brumby

Such was the case in *Glenn v. Brumby,*[569] where Glenn was hired by the Georgia General Assembly's Office of Legislative Counsel for the position of Legislative Editor. Glenn's job duties included editing proposed legislation and resolutions for grammar, spelling, and format. At the time of hire, Glenn was perceived to be male, but he was later diagnosed with Gender Identity Disorder (GID) and took steps to make the transition from male to female. Part of that transition was the requirement that Glenn dress and act as a female for a year prior to his sex-change operation. He informed

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568 *Id.* at 6-7.

569 *Glenn v. Brumby,* 632 F.Supp.2d 1308 (N.D. GA) 2009.

the Senior Editor of his decision and she did not foresee any problems, but when Glenn came to work in female attire, defendant Brumby sent him home for being "inappropriately dressed".[570]

When Glenn informed his Senior Editor about his decision to go forward with the gender reassignment surgery, he provided her with literature regarding gender transitioning in the workplace. The Senior Editor sent the materials to Brumby. Brumby informed Glenn he was going to go to the leaders of the General Assembly about Glenn's situation. Brumby later met with Glenn to confirm that he was going to receive gender reassignment surgery. It was at that meeting that Brumby fired Glenn because gender reassignment surgery and dressing as a woman could be seen as being "immoral" and would make the other employees uncomfortable.[571] Glenn promptly filed a Section 1983 Equal Protection claim based on gender stereotype and discrimination based on medical condition known as GID.[572]

Glenn asserted that it has been established that adverse employment actions based on nonconformance to gender stereotype has been held as impermissible discrimination.[573] The

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570 *Id.* at 1311.
571 *Id.* at 1311-12.
572 *Id.* at 1312.
573 *Id.* at 1314. *See, e.g.*, *Smith*, 378 F.3d at 577, (holding that transsexual firefighter was impermissibly terminated for failing to conform to employer's sex stereotypes, and had alleged facts that "easily constitute a claim of sex discrimination grounded in the Equal Protection Clause of the Constitution, pursuant to § 1983"); *Back v. Hastings on the Hudson Union Free Sch. Dist.,* 365 F.3d 107, 117-21 (2d Cir.2004) (holding that claims premised on sex stereotyping theory sufficiently constitute claim of sex discrimination pursuant to §1983, and observing that "the Equal Protection Clause forbids sex discrimination no matter how it is labeled"); *Nichols*, 256 F.3d at 874-75 (holding that plaintiff can prove sex discrimination by presenting evidence that he was harassed based on perception that he had "feminine mannerisms" and a

Defendants countered with the fact that the District court has held that transsexuals are not a suspect class based on sex.[574] However, the Court relied on *Price Waterhouse*, which recognized that gender stereotyping is must be included in sex discrimination,[575] and thus an Equal Protection claim could be brought if employees were adversely treated due to their gender nonconformity. Glenn had sufficiently demonstrated that he was treated differently due to his nonconformity and that his nonconformity to a male stereotype was the precise reason why he was terminated.[576] Glenn had met his burden of proof for bringing an Equal Protection claim based on sex discrimination and the motion for summary judgment was denied.

VII. CONCLUSION

It would seem that the concept of Title VII gender discrimination has undergone a metamorphosis. The courts seem to now acknowledge that gender discrimination is far more than complex than just a matter of discrimination due to biological gender. Gender is identified by society by the way someone dresses, acts or speaks. Even though some experts have stated that gender is a

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belief that he "did not act as a man should act"); *Schroer v. Billington*, 577 F.Supp.2d 293 (D.D.C.2008) (concluding that denying job to individual who disclosed his intent to transition to female constituted sex stereotyping and discrimination because of sex); *Lopez v. River Oaks Imaging & Diagnostic Group, Inc.,* 542 F.Supp.2d 653 (S.D.Tex.2008) (holding that plaintiff could proceed to trial on impermissible sex stereotyping theory against employer who withdrew job offer and accused her of misrepresentation after learning of her transsexual status).

[574] *Id. See, e.g. Rush v. Johnson,* 565 F.Supp. 856 (N.D.Ga.1983).

[575] *Id.* at 1315 quoting *Price Waterhouse,* "we are beyond the day when an employer could evaluate employees by assuming or insisting that they matched the stereotype associated with their group." *Price* 490 U.S. at 251.

[576] *Id.* at 1316. *See Thigpen v. Bibb County, Ga., Sheriff's Dept.,* 223 F.3d 1231, 1237 (11th Cir.2000) (stating that "[T]o properly plead an equal protection claim, a plaintiff need only allege that through state action, similarly situated persons have been treated disparately.")

mental state of being which may be in conflict with the biological gender of the individual, society generally expects that those of a certain biological gender must appear and act in accordance to their biology. Individuals who exhibit such dissonance are met with hostility and ill-treatment in the workplace. Recent cases would suggest that gender stereotyping and adverse actions resulting from gender stereotyping will not be tolerated by the courts, provided that there are not other, job-related reasons for the adverse treatment. At the same time, recent cases such as *Vickers, Prowel,* and *Glenn* illustrate that the courts will be ever vigilant for cases which try to bootstrap a claim of sexual orientation discrimination via a gender stereotype claim.

ANTECEDENTS OF ETHICAL DECISION MAKING: AN INVESTIGATION INTO MORAL INTENSITY AND JURISPRUDENCE

By

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I. INTRODUCTION

Ethical decision making is a well researched topic in the literature and has been receiving increasing attention in business environments.[577] Previous research has investigated the impact of

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[577] *See, e.g.,* Tim Barnett, Dimensions of Moral Intensity and Ethical Decision Making: An Empirical Study, 31 J. APPLIED SOC. PSYCHOL., (2001); G. Alder, et al., *The Impact of Individual Ethics on Reactions to Potentially Invasive HR*

ethical decision making throughout various fields. For example, scholars have researched ethical decision making in marketing,[578] accounting,[579] information technology,[580] consulting,[581] and the healthcare industries.[582]

While previous research has investigated specific antecedents associated with ethical decision making,[583] as well as the legal aspects of ethical decision making,[584] very little research exists studying the impact of one's personal jurisprudence on the ethical decision making process. For purposes of this paper jurisprudence is defined as, "the study of the general or fundamental elements of a particular legal system, as opposed to its practical and concrete details." Additionally, there is an area of jurisprudence entitled ethical jurisprudence which is defined as, "the branch of legal philosophy concerned with the law from the viewpoint of its ethical significance and adequacy."[585] Since individuals are influenced by the law on a daily basis, investigating one's personal

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Practices, J. BUS. ETHICS, (2007); David M. Mayer, et al., *How Low Does Ethical Leadership Flow? Test of a Trickle-Down Model*, ORG. BEHAV. & HUM. DECISION PROCESSES (2009).

578 *See, e.g.,* David J. Fritzsche & Helmut Becker, *Ethical Behavior of Marketing Managers*, 2 J. BUS. ETHICS, (1983).

579 *See, e.g.,* William H. Belski, et al., *Ethical Judgments in Accounting: An Examination on the Ethics of Managed Earnings*, 2 J. GLOBAL BUS. ISSUES (2008).

580 *See, e.g.,* Roger Lindsay, Information Technology Ethics, 39 BRIT. J. EDUC. TECH. (2008).

581 *See, e.g.,* D. B. Rubin, The Ethics of Consulting for the Tobacco Industry, 11 STAT. METHODS IN MED. RES. (2002).

582 *See, e.g.,* John Xavier Rolley, Safety and Ethics in Healthcare: A Guide to Getting it Right, 60 J. ADVANCED NURSING (2007).

583 *See, e.g.,* Anusorn Singhapakdi, et al., *Antecedents and Consequences of Perceived Importance of Ethics in Marketing Situations: A Study of Thai Businesspeople*, J. BUS. ETHICS, (2008).

584 *See, e.g.,* Barbara Libby & Vincent Agnello, *Ethical Decision Making and the Law*, 26 J. BUS. ETHICS, (2000).

585 BLACK'S LAW DICTIONARY 871 (8th ed. 2009).

jurisprudence and, more specifically, one's ethical jurisprudence can be beneficial to the literature.

This paper aims to combine a traditional ethical framework with several traditionally legal philosophies. Using Jones's[586] framework of moral intensity, we take a look into four main areas of jurisprudence. These include natural law, moral relativism, common law, and statutory law. These areas of jurisprudence have previously been investigated in the literature.[587] However, we combine Jones's[588] framework of moral intensity with these areas of jurisprudence. We analyze each of the primary components of his model and identify which of the four areas of jurisprudence each component is most likely related to. It is important to take a jurisprudence perspective when analyzing moral intent because the law impacts each individual in the work place as well as in daily life. Ethical decisions are rarely made in a vacuum. The prevalent social norms and the relevant legal framework all effect the way ethical and unethical decisions are shaped in today's business environment. Rarely has business research investigated the interactive effect of both the moral intensity and the legal repercussions of a decision made by an individual. By analyzing the framework of moral intensity alongside these areas of jurisprudence, we can develop a better understanding of what individuals emphasize when faced with an ethical decision as well as show the importance of legal studies and an understanding of a legal framework outside of traditionally legal environments.

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[586] Thomas M. Jones, *Ethical Decision Making by Individuals in Organizations: An Issue-Contingent Model*, 16 ACAD. MGMT. REV., (1991).
[587] *See, e.g.,* Oliver Wendell Holmes, THE COMMON LAW (Howe Ed. 1964); Matthew Levering, *God and Natural Law: Reflectionson Genesis 22*, 24 MOD. THEOLOGY, (2008); Gordon Tullock, *Does Punishment Deter Crime*, CENT. CURRENTS SOC. THEORY: CONTEMP. SOC. THEORY 1920-2000 (2000).
[588] Jones, *supra* note 10.

The remainder of this paper is structured as follows. First we review the literature related to moral intensity. Second, we discuss four main concepts of jurisprudence and develop our arguments. Third, we discuss potential implications. Finally, we conclude with limitations as well as opportunities for future research.

II. MORAL INTENSITY

Moral intensity is "a construct that captures the extent of issue-related moral imperative in a situation."[589] It is argued that every ethical decision can be analyzed in terms of moral intensity, i.e. the consequences of the act under consideration.[590] Furthermore, moral intensity is comprised of six components. These components are magnitude of consequences, social consensus, probability of effect, temporal immediacy, proximity, and concentration of effect.[591] We now elaborate on each of these six components and discuss which one of our four antecedents each of these components most closely relates to. Table 1 summarizes these six components of moral intensity.

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589 *Id*. at 372.
590 Dawn S. Carlson, et al., *The Impact of Moral Intensity Dimensions on Ethical Decision Making: Assessing the Relevance of Orientation*, 14 J. MANAGERIAL ISSUES, (2002).
591 Jones, *supra* note 10, at 374.

Table 1: Components of Moral Intensity

Component of Jones's Framework	**Definition**[592]
Magnitude of consequences of a moral issue	*the sum of the harms (or benefits) done to victims (or beneficiaries) of the moral act in question*
Social consensus of a moral issue	*the degree of social agreement that a proposed act is evil*
Probability of effect of the moral act in question	*a joint function of the probability that the act in question will actually take place, and that the act in question will actually cause the harm (benefit) predicted*
Temporal immediacy of a moral issue	*the length of time between the present and the onset of consequences of the moral act in question (shorter length of time implies greater immediacy)*
Proximity of a moral issue	*the feeling of nearness (social, cultural, psychological, or physical) that the moral agent has for victims (or beneficiaries) of the evil (or beneficial) act in question*
Concentration of effect of the moral act	*is an inverse function of the number of people affected by an act of given magnitude*

592 *Id.* at 374-377.

The first component of moral intensity, magnitude of consequences of a moral issue, is defined as "the sum of the harms (or benefits) done to victims (or beneficiaries) of the moral act in question."[593] Previous research testing moral intensity has investigated the impact of perceived consequences on ethical decision making. For example, research has suggested that when evaluating situations, such as sexual harassment, subjects considered the severity of the consequences when forming an ethical opinion.[594] Furthermore, additional research noted a link between subjects considering the consequences of particular actions when making ethical decisions.[595] Due to the nature of focusing on the consequences of a particular action, we group the magnitude of consequences component with statutory law. We base this decision on the fact that with statutory law, individuals know what the consequences are of not following such a law.[596]

Social consensus of a moral issue, the second component of moral intensity, is defined as "the degree of social agreement that a proposed act is evil (or good)."[597] Jones further argues that a high social consensus reduces ambiguity in a social situation.[598] In addition, empirical evidence has demonstrated that when individuals are confronted with an ethical decision, they are more likely to reject illegal decisions than they are to reject unethical decisions which are not necessarily against a state or federal statute.[599] Thus, the legality of a society may be chosen over the

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593 *Id.* at 374.
594 *See* Kenneth M. York, *Defining Sexual Harassment in Workplaces: A Policy-Capturing Approach*, 32 ACAD. MGMT. J. (1989).
595 *See* James Weber, *Managers' Moral Reasoning: Assessing Their Responses to Three Moral Dilemmas*, 43 HUM. REL. (1990).
596 *See* L.H. Rosenthal, FEDERAL CRIMINAL CODE AND RULES (2009).
597 Jones, *supra* note 10, at 375.
598 *Id*.
599 *See* Gener R. Laczniak & Edward J. Inderrieden, *The Influence of Stated Organizational Concern Upon Ethical Decision Making*, 6 J. BUS. ETHICS, (1987).

question of morality or ethics. Based on these findings, we group social consensus with statutory law and with moral relativism. Moral relativists, especially individual moral relativists, may strictly adhere to a given moral code or ethic if they believe it to hold true in their society. The relativist's belief that the dictate of an act being ethical or unethical is decided by the transient society might, in our opinion, align them to base their ethical decisions on the social consensus of the moral issue.

The third component, probability of effect of the moral act in question, is "a joint function of the probability that the act in question will actually take place, and that the act in question will actually cause the harm (benefit) predicted."[600] In this instance, Jones gives the example that selling a firearm to a known armed robber has a greater probability of causing harm to another individual than does selling a firearm to a law-abiding citizen.[601] Based on this probabilistic thinking, we group the probability of effect with common law as the Courts often use this manner of thinking (probability of effect) when deciding cases.[602]

The fourth component, temporal immediacy of a moral issue, is "the length of time between the present and the onset of consequences of the moral act in question (shorter length of time implies greater immediacy)."[603] Jones gives two reasons why temporal immediacy is an important part of moral intensity.[604] First, people tend to think less about the impact of events occurring in the distant future. Second, as the time period between a given act and the period of the consequences expands, the likelihood of

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[600] Jones, *supra* note 10, at 375.
[601] *Id.*
[602] *See, e.g., Atkins v. Virginia*, 536 U.S. 304 (2002) and *Lawrence and Garner v. Texas*, 539 U.S. 558 (2003).
[603] Jones, *supra* note 10, at 376.
[604] *Id.*

predicted harm actually occurring decreases.[605] For purposes of our classification of this component into our antecedents, we focus on the second reason. Due to the fact that the length of time is considered, we group the temporal immediacy of a moral issue with common law. This decision is based primarily on the fact that as time passes, Courts often overrule previous legal decisions.[606]

The fifth component of moral intensity, proximity of a moral issue, is "the feeling of nearness (social, cultural, psychological, or physical) that the moral agent has for victims (or beneficiaries) of the evil (or beneficial) act in question."[607] Furthermore, people care more about others who are closer to them rather than those who are distant. For example, people who are close culturally experience a greater sense of belonging than those who are not and this sense of belonging can lead to unselfish behaviors.[608] Thus, expanding on this sense of belonging and tendency for unselfish behaviors, we group the proximity of a moral issue with natural law and moral relativism. Individuals who adhere to the natural law look at the proximity in terms of a broader human race, while those who look at it from a moral relativistic perspective, see it from the cultural perspective. Moral relativists may in fact hold higher standards for the same immoral act in their own culture, but they may condone it in another culture, due to the proximity of the moral issue in their own setting.

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605 *Id.*

606 *See, e.g., Brown v. Board of Education of Topeka*, 347 U.S. 483 (1954) and *Roe v. Wade*, 410 U.S. 113 (1973).

607 Jones, *supra* note 10, at 376.

608 *See e.g.,* B. Malinowski, ARGONAUTS OF THE WESTERN PACIFIC (1922); B. MALINOWSKI & H. ELLIS, THE SEXUAL LIFE OF SAVAGES IN NORTHWESTERN MELANESIA: AN ETHNOGRAPHIC ACCOUNT OF COURTSHIP, MARRIAGE AND FAMILY LIFE AMONG THE NATIVES OF THE TROBRIAND ISLANDS IN BRITISH NEW GUINEA (1929) AND MARGARET MEAD, COMING OF AGE IN SAMOA: A PSYCHOLOGICAL STUDY OF PRIMITIVE YOUTH FOR WESTERN CIVILIZATION (1953).

Finally, the concentration of effect of the moral act "is an inverse function of the number of people, affected by an act, of given magnitude."[609] Jones gives the example that cheating an individual or a small group of individuals has a more concentrated effect than cheating a corporation out of the same sum of money.[610] This is partly due to the fact that individuals personalize more with individuals rather than corporations. Thus, this leads to individuals finding greater displeasure in moral acts with concentrated effects.[611] Based on this connection to concentrated effects, we group the concentration of a moral act with natural law. Table 2 presents the four areas of jurisprudence under our investigation along with their definitions whereas Table 3 presents the components of Jones's framework and which area of jurisprudence we link them to.

Table 2: Primary Areas of Jurisprudence

Area	**Definition**
Natural Law	*A philosophical system of legal and moral principles purportedly deriving from a universalized conception of human nature or divine justice rather than from legislative or judicial action; moral law embodied in principles of right and wrong*[612]

[609] Jones, *supra* note 10, at 377.
[610] *Id.*
[611] *Id.*
[612] BLACK'S, *supra* note 9, at 1055.

Moral Relativism	*The view that there are no absolute or constant standards of right and wrong*[613]
Common Law	*The body of law derived from judicial decisions, rather than from statutes or constitutions* *The body of law based on the English legal system as distinct from a civil-law system; the general Anglo-American system of legal concepts, together with the techniques of applying them, that form the basis of the law in jurisdictions where the system applies*[614]
Statutory Law	*The body of law derived from statutes rather than from constitutions or judicial decisions*[615]

613 *Id.* at 1030.
614 *Id.* at 293
615 *Id.* at 1452.

Table 3: Moral Intensity and Jurisprudence

Component of Jones's Framework	**Legal Grouping**
Magnitude of consequences of a moral issue	*Statutory law*
Social consensus of a moral issue	*Statutory law and moral relativism*
Probability of effect of the moral act in question	*Common law*
Temporal immediacy of a moral issue	*Common law*
Proximity of a moral issue	*Natural law and moral relativism*
Concentration of effect of the moral act	*Natural law*

III. ANTECEDENTS OF ETHICAL DECISION MAKING

A. Natural Law

Natural law is "a philosophical system of legal and moral principles purportedly deriving from a universalized conception of human nature or divine justice rather than from legislative or judicial action; moral law embodied in principles of right and wrong."[616] Many ethical teachings derive from natural law.[617]

When discussing natural law, it is important to consider the Catholic natural law tradition. Many ethics scholars have expanded on this and have discussed it in the context of

[616] *Id.* at 1055.
[617] *Id.*

religiosity.[618] Natural law-based manuals were administered in four forms which served as the basis for teaching natural law: Celtic penitentials, the medieval decretals, the natural law ethic of St. Thomas Aquinas, and the casuist tradition of the eighteenth century.

St. Thomas Aquinas is most often credited for the natural law we refer to today. St. Thomas Aquinas argues that natural law should govern all practical reasoning. Furthermore, according to St. Thomas Aquinas, natural law is a guiding principle which calls for good to be pursued and evil avoided. While many confuse natural law with an absolute set of right and wrong which can never be deviated from, St. Thomas Aquinas does argue there are instances where the overall idea of what is good can be deviated from. For example, St. Thomas Aquinas does say that murder in defense of oneself is morally acceptable. Natural law simply calls upon individuals to pursue prudence, justice, courage, and moderation.[619]

St. Thomas Aquinas also addressed how natural law applies to business transactions. He argues that there are four primary ways natural law can be violated in business transactions. First, it is in violation of natural law to charge a price to a customer for a good which is in excess of its fair price. Second, natural law is violated by failing to inform a buyer of a known product defect or another characteristic of a product which may reduce the product's true value. Third, it is in violation of natural law to conduct business transactions for the sole purpose of pursuing profit rather than conducting business transactions in order to pursue profit to

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618 *See, e.g.,* Tim Barnett, et al., *Religiosity, Ethical Ideology, and Intentions to Report a Peer's Wrongdoing*, 15 J. BUS. ETHICS, (1996) and Daniel B. Gallagher, *Natural Law, Religion, and Rights*, 69 THEOLOGICAL STUDIES, (2008).

619 *See* Manuel Velasquez & F. Neil Brady, *Natural Law and Business Ethics*, 7 BUS. ETHICS Q. (1997).

support oneself and family. Finally, it is in violation of natural law to charge interest on money lent as St. Thomas Aquinas argues this is usury.

Thus, due to the fact that natural law addresses unselfish obligations to society and is similar to the proximity and concentration of effect of moral acts as it relates to moral intent, we argue that the more emphasis an individual places on natural law, the less likely that individual is to engage in an unethical act.

B. Moral Relativism

Contrary to natural law is moral relativism. Moral relativism is "the view that there are no absolute or constant standards of right and wrong."[620] Moral relativism is also referred to as "ethical relativism" or "subjective ethics." Moral relativism encompasses a whole set of widely divergent views. More specifically, moral relativism argues morality is relative to one or more frameworks. These frameworks include a set of moral standards or beliefs held by a particular individual, group, society, culture, religion, or tradition.[621]

Societies have different cultures, customs, beliefs, and values.[622] Expanding on this notion of differences, moral relativism takes a polar opposite view to natural law as it relates to the rigidity in applying an absolute "right or wrong" approach in evaluating an ethical decision. Moral relativists argue that since societies, as well as individuals have disagreements over moral judgments,

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[620] BLACK'S, *supra* note 9, at 1030.
[621] *See* James A. Ryan, *Moral Relativism and the Argument From Disagreement*, 34 J. SOC. PHIL. (2003).
[622] *See, e.g.,* Geert Hofstede, *Cultural Dimensions in Management and Planning*, 1 ASIA PAC. J. MGMT., (1984) and Geert Hofstede & Robert R. McCrae, *Personality and Culture Revisited: Linking Traits and Dimensions of Culture*, 38 CROSS-CULTURAL RESEARCH (2004).

universalism (i.e. the idea that there is a unified set of moral judgments which holds true across societies and individuals) is false, while relativism is true.[623]

Investigating all aspects of moral relativism is beyond the scope of this paper. Thus, we select two key concepts of moral relativism and apply them to the business community. The first concept of moral relativism is utilitarianism. Utilitarianism is "the philosophical and economic doctrine that the best social policy is that which does the most good for the greatest number of people; esp., an ethical theory that judges the rightness or wrongness of actions according to the pleasure they create or the pain they inflict and recommending whatever action creates the greatest good for the greatest number."[624] Legal scholars have extended this theory into jurisprudence and often refer to hedonistic utilitarianism which is defined as, "the theory that the validity of a law should be measured by determining the extent to which it would promote the greatest happiness to the greatest number of citizens."[625]

Thus, what is "right" refers to what is "right in my society" or what is "right in a particular context." For example, at WorldCom, Chief of Internal Audit, Cynthia Cooper struggled with her decision to "blow the whistle" on accounting fraud occurring within the company. She describes the difficulty of knowing what would happen to employees' and shareholders' retirement funds if she blew the whistle. However, she further describes she believed the fraud eventually would have been uncovered and the damage would have only been worse and adversely affected more people. Thus, this utilitarian "greatest good for the greatest number" led Cynthia Cooper to make the decision to disclose the fraudulent activity. Cynthia Cooper also describes the numerous amounts of

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[623] *See, e.g.,* James A. Ryan, *Moral Relativism and the Argument From Disagreement*, 34 J. SOC. PHIL. (2003).
[624] BLACK'S, *supra* note 9, at 1581.
[625] *Id*.

people who knew about the fraud and the justifications people made defending it. These people were able to point to areas of accounting standards or other areas to satisfy their own moral compass.[626]

Our second concept of moral relativism we feel is germane to ethical decision making is individualistic relativism. Individualistic relativism allows each individual in a society to decide which moral standards are appropriate for a given society. Thus, such individuals often do not possess a "strictly univocal set of moral terms."[627] This concept of individualistic relativism often leads to moral disputes in societies. Applying this to WorldCom, we can see that the moral compasses of the individuals involved in the scandal varied widely.[628]

Keeping in mind the differences between utilitarian moral relativism and individualistic moral relativism, we develop two separate arguments based on these theories. Since utilitarian moral relativism focuses on the greatest good, we argue that the greater emphasis an individual places on utilitarian moral relativism as it relates to utilitarianism, the less likely an individual is to engage in an unethical act. Furthermore, since moral relativism allows the individual to determine the set of moral principles which are appropriate and the fact that moral relativism lacks a universal set of moral standards, we argue that the more emphasis an individual places on individual moral relativism, the more likely that individual is to engage in an unethical act.

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[626] Cynthia Cooper, EXTRAORDINARY CIRCUMSTANCES: THE JOURNEY OF A CORPORATE WHISTLEBLOWER (2008).
[627] Ryan, *supra* note 45.
[628] Cooper, *supra* note 50.

C. Common Law

Our next antecedent of ethical decision making is common law. Common law has several accepted definitions in the legal community and literature. In the interests of parsimony, we focus on two of these definitions. First, common law is "the body of law derived from judicial decisions, rather than from statutes or constitutions."[629] Second, common law is "the body of law based on the English legal system as distinct from a civil-law system; the general Anglo-American system of legal concepts, together with the techniques of applying them that form the basis of the law in jurisdictions where the system applies."[630] Common law gained its popularity during the Howard Taft Court through Oliver Wendell Holmes.[631]

Common law has also been addressed in the realm of ethical reasoning.[632] A guiding force behind common law is that precedent and tradition establish an innate form of wisdom. The key issue surrounding common law is the overall worth of tradition and adherence to such tradition leads to guiding ethical and moral principles. Proponents of the importance of common law see common law as a guideline for an important kind of ethical tradition which unfolds over time. This common law draws on larger social and political traditions as well.[633]

Two common concepts which have long been in the judicial decision making process are foreseeable future and mens rea. Foreseeability is, "the quality of being reasonably anticipatable."[634]

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629 BLACK'S, *supra* note 9, at 293.
630 *Id.*
631 *See* Oliver Wendell Holmes, THE COMMON LAW (Howe Ed. 1964).
632 *See, e.g.,* Adrian Vermeule, Common Law Constitutionalism and the Limits of Reason, 107 COLUM. L. REV. (2007).
633 *Id.*
634 BLACK'S, *supra* note 9, at 293.

In addition, in tort cases, courts often consider foreseeable damages. Foreseeable damages are, "damages that a breaching party knew or should have known would result from a breach when the contract was made."[635] Mens rea (Latin for guilty mind) is, "the state of mind that the prosecution, to secure a conviction, must prove that a defendant had when committing a crime."[636]

Foreseeability and mens rea were both evident in the case of U.S. v. Madoff. At his allocution hearing, former chairman of the NASDAQ Stock Market, Bernard Madoff, stated, "I operated a Ponzi scheme…I thought it would end quickly, but it proved impossible. I am ashamed for these criminal acts. I always knew this day would come."[637] Thus, in evaluating whether to enter into this ponzi scheme, Bernard Madoff weighed the possibility of getting caught (foreseeability) against the potential benefits from the scheme. Additionally, Madoff admitted to having mens rea during allocution. This has led to victims of this crime to seek recourse in the courts. At his hearing, several of the victims of the ponzi scheme were present. All were turning to the court to take proper recourse.

There is an idea that judges serve as moral arbiters of the law and individuals turn to judges for ethical guidance. It has been proposed that an increasingly number of the writs of certiorari appearing before the United States Supreme Court deal with moral issues. As Associate Justice Antonin Scalia points out, "Around the world, there seems to be a notion that that's what judges do. When you put on a black robe you somehow become an expert on morality…even though I never learned much of either one at Harvard Law School."[638] In addition Justice Scalia has also mentioned that people want and perhaps even expect "judges to be

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[635] *Id.* at 417.
[636] *Id*. at 1006.
[637] *United States v. Madoff*, 09 Cr. 213 (DC).
[638] *The State of Civil Liberties, (*CSPAN television broadcast October 15, 2006).

moral arbiters of the world."[639] This, in turn, has created an outlet for people to reference when evaluating ethical decisions. We argue that individuals often use the Courts and their opinions to determine if an ethical decision is moral or not. Several Court opinions have become so engrained in American jurisprudence and culture that many Americans place high moral applicability to these opinions.[640]

Thus, due to the emphasis on a tradition of ethical guidance over time, as well as the similarity to the probability of effect, and the temporal immediacy of a moral issue as they relate to moral intent, we argue that the greater emphasis an individual places on common law, the less likely that individual is to engage in an unethical act.

D. Statutory Law

Statutory law is "the body of law derived from statutes rather than from constitutions or judicial decisions."[641] Statutory law includes federal, state, and local statues.[642] Previous research has investigated the influence of the law on ethical decision making and the prevention of crime.[643] Such research has suggested that punishment does not necessarily deter crime.

Businesses are required to comply with the American Law Institute's *Principles of Corporate Governance.* This act summarized the Institute's expectations regarding a company's

[639] *Id*.
[640] *Id*.
[641] BLACK'S, *supra* note 9, at 1452.
[642] L.H. Rosenthal, *supra* note 20.
[643] *See, e.g.,* Gordon Tullock, *Does Punishment Deter Crime*, CENT. CURRENTS IN SOC. THEORY: CONTEMP. SOC. THEORY 1920-2000, (2000).

corporate compliance with the law.[644] Furthermore, the American Law Institute further emphasizes that there is a duty of corporations to not simply apply a strict and literal compliance to the law but the corporation has a social responsibility to take into consideration the purposes behind the laws in question.[645] Thus, a decision maker should not read a law narrowly as an attempt to reject the spirit of the legal requirement. For example, if there is uncertainty in evaluating an ethical decision, the American Law Institute dictates that the corporation is to engage in conduct consistent with the law's original purpose.[646] While, this sounds good in theory, the concept of utilizing statutory law as a guiding framework for ethical decision making has not found support in the literature.

Specifically, previous research has utilized ethical vignettes to study the impact of the law on how individuals approach an ethical decision.[647] In this study, students were approached with multiple scenarios. In these scenarios, students were asked to evaluate situations ranging from stealing intellectual property, sharing trade secrets, bribery, and hiring the handicapped. These students were also confronted with situations which are unethical but were not necessarily illegal. This study did not indicate the legality of an act had any influence over the evaluations students placed on such scenarios.

Thus, based on the results of previous research indicating that legality does not influence ethical decisions, as well as the similarity of the magnitude of consequences and social consensus

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[644] *See* Melvin Aron Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 BUS. LAW. (1993).
[645] *See* V. Di Lorenzo, *Business Ethics: Law as a Determinant of Business Conduct*, 71 J. BUS. ETHICS, (2007).
[646] *Id.*
[647] *See, e.g.,* Barbara Libby & Vincent Agnello, *Ethical Decision Making and the Law*, 26 J. BUS. ETHICS, (2000).

on the effects of moral acts as they relate to moral intent, we argue that the greater emphasis an individual places on statutory law, the more likely the individual is to engage in an unethical act.

IV. DISCUSSION

Decision making is a complex cognitive phenomenon,[648] and when making a choice for ethical or unethical decisions, we utilize not just our cognitive schemas, but also our social and moral frameworks that we learn both as children[649] and later as adults during our interaction with the social and legal environment. In a business setting, people are guided both by the social norms and expectations and the legal standards mandated by the organization and the society at the meso level. In many instances, the decisions that individuals take, make them open to legal scrutiny. It thus seems prudent to understand how the moral and ethical standards of decision making for each individual are affected by their jurisprudence. This paper is an initial endeavor to do just that. The utility of such an approach can be seen by the fact that philosophical inclinations can be the guiding framework for helping decision makers make more informed and ethical decisions while keeping, and being able to explain those decisions to others who may not share their framework.

We began by discussing Jones's[650] framework of moral intensity. Jones argues that each ethical decision can be analyzed in terms of moral intensity. We attempted to extend this theory by applying four specific aspects of American jurisprudence to the ethical decision process. First, we discussed natural law. We argued that an individual emphasizing natural law has a preconceived idea of

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[648] *See, e.g.,* N.H. Leonard, et al., *Information Processing Style and Decision Making*, 20 J. ORG. BEHAVIOR, (1999).
[649] *See, e.g.,* Lawrence Kohlberg, THE PHILOSOPHY OF MORAL DEVELOPMENT: MORAL STAGES AND THE IDEA OF JUSTICE (1981).
[650] Jones, *supra* note 10.

right and wrong and applies this preconception to the ethical decision making process. Second, we discussed a concept which is often considered by legal scholars as contradictory to natural law:[651] moral relativism. Due to its complexity and for purposes of parsimony, we focus on two key aspects of moral relativism: utilitarianism and individualistic relativism. Due to its emphasis on the greatest good for the greatest number, we argue an individual emphasizing utilitarianism, considers the impact of the outcome of an individual decision on several individuals before coming to a decision. On the contrary, a moral relativist emphasizing individual relativism is more likely to engage in an unethical act because individualistic relativism allows an individual to make the decision of what is and what is not moral behavior.

Finally, we investigated common law and statutory law. As previously discussed, common law creates a tradition of morality through jurisprudence in which individuals emphasize when determining the morality of a specific issue.[652] Furthermore, there is a growing conception that individuals look to judges to determine individual disconnects relating to moral dilemmas.[653] Statutory law demonstrates a weak emphasis on morality, as individuals emphasizing statutory law often emphasize a strict interpretation of the words of the codification rather than the spirit of the law.[654] Thus, this strict textualist interpretation can serve as a reason to engage in an unethical act due to viewing the law as the determinant of the ethical decision instead of any other component.

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[651] CIVIL LIBERTIES, *supra* note 62.

[652] *See Id.* where the following cases are discussed: *Brown*, 347 U.S. 483 (1954); *Roe*, 410 U.S. 113 (1973); *Atkins*, 536 U.S. 304 (2002); and *Lawrence and Garner*, 539 U.S. 558 (2003).

[653] *Id.*

[654] *See, e.g.,* Melvin Aron Eisenberg, An Overview of the Principles of Corporate Governance, 48 BUS. LAW. (1993).

Therefore, utilizing jurisprudence as antecedents of ethical decision making offers hope for ethical decision making research. First, jurisprudence has been part of American culture since the ratification of the United States Constitution in 1791, and arguably dates back to English common law. Second, all businesses are exposed to the law through legislation such as the Uniform Commercial Code (UCC), Internal Revenue Service (IRS) guidelines, and regulations by the Securities and Exchange Commission (SEC). Third, we all interact with the law on a daily basis. Thus, it is important to understand how individuals view such laws and how their personal jurisprudence plays a role in their ethical decision making. We thus believe that it is unwise to ignore the personal jurisprudence that individuals use when making ethical decisions, and investigating how this affects their decision making can shed light on the important aspects of ethical decision making in the business environment.

V. IMPLICATIONS FOR PRACTICE

This paper offers several implications for pedagogy and for practitioners. Teaching ethics and ethical decision making is an important part of the curriculum of most business schools today.[655] Unlike medicine and psychology which have a definitive code of ethics that the students in the field are trained in and have to follow, business is still in its nascent stages, grappling with the understanding of how to instill moral and ethical standards into the population of students, the majority of whom seek to run, or work for, business ventures aimed at profit making. We hope that this paper provides insights to educators and practitioners on how to increase philosophical, moral and jurisprudential awareness in their students and clients so as to elicit more ethical decision making.

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[655] *See, e.g.,* Gael M. McDonald & Gabriel D. Donleavy, *Objections to the Teaching of Business Ethics*, 14 J. BUS. ETHICS, (1995).

VI. LIMITATIONS AND FUTURE RESEARCH

We also need to discuss limitations. This paper utilizes a jurisprudence perspective in evaluating ethical decisions. We chose four components of jurisprudence and argue these four components influence the ethical decision making process. Due to the complexity of law, one can argue there are far more than four components of jurisprudence influencing the ethical decision making process. Thus, our decision to include only four components of jurisprudence may be a potential limitation. Furthermore, there are several interpretations regarding the four components of jurisprudence chosen for this study. Thus, we adopted the most general interpretation of these components vis-à-vis Bryan Garner's Black's Law Dictionary. However, one can easily argue additional interpretations.

It is also important to discuss avenues for future research. The current wave of unethical decisions made by Enron, WorldCom and Countrywide in the more recent past are stark examples that the legal perspective of the ethical decision making process needs to be studied in its entirety. In addition to testing these propositions, future research would benefit from comparing these antecedents of ethical decision making in the context of different industries. More specifically, it would be ideal to obtain a sample of employees across industries such as consulting and sales and collect data related to the constructs discussed in this study. Thus, through a comparison, we can make better inferences regarding different emphases employees place upon these antecedents in the ethical decision making process.

Finally, future research should also consider the increasing influence which is being placed on international law.[656] Future

[656] *See, e.g.,* Stephen Allen, *International Law by Vaughan Lowe*, 72 MOD. L. REV. (2009).

research should also address the impact natural law has on ethical decision making. Expanding upon this, future research should also consider cultural differences in interpretations of the laws of both one's home country and the international environment.

VII. CONCLUSION

Utilizing the moral intensity literature as our guiding framework, the impact of one's emphasis on natural law, moral relativism, common law, and statutory law on ethical decision making were investigated. Due to the increasing attention the law is receiving, we propose these areas are subconscious approaches individuals utilize when evaluating an ethical dilemma. Specifically, we argue individuals emphasizing natural law are less likely to engage in an unethical act while individuals emphasizing common law and statutory law are more likely to engage in an unethical act. Moral relativism is discussed in two ways. First individuals emphasizing utilitarianism are less likely to engage in unethical behavior while individuals emphasizing individualistic relativism are more likely to engage in unethical behavior. Finally implications for practice and avenues for future research are discussed. The propositions in this paper are conceptual guiding frameworks to stimulate research in this field. As interest in this area increases, we are hopeful that more theoretical and empirical research will be able to contribute to our understanding of the influence jurisprudence has on the ethical decision making process.

AN APPEALING EXERCISE: GROUP REVIEW OF MULTIPLE-CHOICE EXAMS

By

Dexter R. Woods, Jr.*

I. INTRODUCTION

Many instructors are skeptical of multiple-choice questions (MCQs), perhaps even to the point of feeling somewhat guilty for using MCQ exams rather than the more "PC" (pedagogically correct) essay exams. Many instructors, however, continue to use MCQs to facilitate course learning and assessment. This article discusses why MCQs are bad, why MCQs are good, and how instructors can make MCQs better. The article then sets forth one technique for making MCQs better - a group review process whereby students file written appeals to MCQs in order to earn extra exam points. The article discusses how the technique operates, how it improves MCQ testing, and how it has evolved over twenty years to adapt to various classroom settings and technologies.

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II. WHY MCQS ARE BAD

Some authors disdain MCQs to the point of equating them with all that is wrong about America and American education:

> Multiple-choice testing has become the standard measurement of academic achievement not simply because the tests are easy to administer but more because they normalize the deep anti-intellectualism of American culture. Multiple-choice testing reduces the highly complex and sophisticated conceptual working out of problems to mechanical, easy-to-follow operations. The result is a student body that is not only increasingly incapable but also intolerant of being asked to think in complex ways. Americans find something scary about the intellectual, and multiple-choice testing is the educational articulation of this fear.[657]

MCQ testing differs from constructed response (CR) testing in that students select offered choices, rather than constructing answers themselves.[658] Though many different types of MCQs exist, this article contemplates the standard MCQ that has a stem with four choices. One of the choices is the best[659] choice, and the other three choices are distracters.

Though instructors may disagree as to the best type of testing, they generally agree that some type of testing is good for both

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[657] Stephen C. Tumino, Letter to the Editor, *Predicting the Life Expectancy of the Multiple-Choice Exam,* CHRON. HIGHER EDUC., Apr. 14, 2006, at B16.
[658] David E. Tanner, *Multiple-Choice Items: Pariah, Panacea, or Neither of the Above?* AM. SECONDARY EDUC., Spring, 2003, at 27, 34.
[659] This author learned early on to ask for the "best" answer, rather than the "correct" answer. In many MCQs, more than one answer may be correct or partially correct, but the goal is to have only one "best" answer.

assessment and for learning.[660] Instructors know that tests motivate students to learn and review material in a more rigorous manner than they otherwise would.[661] Accordingly, though, students will often limit their learning and reviewing to what gets tested. Similarly, instructors will sometimes "teach to the test." In other words, "what gets tested gets taught"[662] and what gets tested gets learned. Studies have shown that students preparing for MCQ testing spend less time studying and take notes on different material than students preparing for CR testing.[663] The fact that MCQ testing appears inherently less demanding than CR testing,[664] leads to the belief that MCQ testing leads to lower-level learning.[665]

Bloom's taxonomy of educational achievement sets forth six levels of cognition and learning, going from lowest order to highest order. First is knowledge, which is the ability simply to remember previously learned materials (rote memory). Second is comprehension, which is the ability to understand as indicated by translation, interpretation, and extrapolation. Third is application, which is applying knowledge to new situations. Fourth is analysis, which is parsing and organizing information to make inferences and generalizations. Fifth is synthesis, which is compiling information in a different way to produce new materials. Sixth is

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[660] Jooyong Park, *Learning in a New Computerized Testing System*, 97 J. EDUC. PSYCHOL. 436, 436 (2005).
[661] *Id.*
[662] Gabriel A. Reich, *Testing Historical Knowledge: Standards, Multiple-Choice Questions and Student Reasoning,* 37 THEORY AND RES. SOC. EDUC. 325, 349 (2009).
[663] Henry L. Roediger III, *The Positive and Negative Consequences of Multiple-Choice Testing*, 31 J. EXPERIMENTAL PSYCHOL.: LEARNING MEMORY COGNITION 1155, 1155 (2005).
[664] Park, *supra* note 4, at 437.
[665] *See* Tumino, *supra* note 1.

evaluation, which is presenting and defending judgments in terms of internal evidence and/or external criteria.[666]

Though some may believe that MCQs can test only the first two levels of learning, knowledge and comprehension (with the resultant detriment to deeper learning), others would argue that MCQs can also test higher levels.[667] For example, one economics instructor noted:

> We contend that multiple-choice questions can be used to test student achievement up through Bloom's level four—analysis. We do not know how to test synthesis and evaluation using multiple-choice questions and suspect that it cannot be done or, at a minimum, requires efforts beyond the abilities of most academic question writers.[668]

Somewhat similarly, the Academy of Legal Studies in Business (ALSB) Assessment Taskforce authored MCQs that required students to not only know and comprehend legal concepts, but also to apply and evaluate them.[669] The Taskforce did not categorize any of its MCQs as assessing analysis or synthesis.[670]

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[666] Stephen Buckles & John J. Siegfried, *Using Multiple-Choice Questions to Evaluate In-Depth Learning of Economics,* 37 J. ECON. EDUC. 48, 49-50 (2006). Bloom's research, though authoritative for the existence of the levels of learning, *id.* at 49, still faces debate about the ordering of the levels. For example, some see the three highest levels as parallel, rather than sequential. *See, e.g.,* RICHARD W. PAUL, A. J. BINKER & JANE WILLIAMS, CRITICAL THINKING: WHAT EVERY PERSON NEEDS TO SURVIVE IN A RAPIDLY CHANGING WORLD (3rd ed. 1993).

[667] Buckles & Siegfried, *supra* note 10, at 50.

[668] *Id.*

[669] Nancy Oppenheim, *Empirical Analysis of an Examination Based on the Academy of Legal Studies in Business Test Bank*, 20 J. LEGAL STUD. EDUC. 129, 137 (2002).

[670] *Id.* Even though one can write MCQs for higher-level *assessment*, higher-level *learning* from those questions may be problematic. To the extent that

Whether MCQs are limited to assessing three, four, or five of Bloom's levels of learning, they are indeed limited. Because selecting is much different from constructing, MCQs tend to measure "*knowing about* rather than *knowing how*."[671] To the extent that students focus their learning on what they need to know to score well on MCQ tests, they will not engage in the highest levels of learning.

Exclusive MCQ assessment would adversely affect students' ability to acquire the highest levels of learning and, in a related manner, would also adversely affect their ability to acquire particular skills needed for their education. MCQs pertain more to a "lecture/take notes/take tests" model for lower-level general education courses rather than to a "performance-based" model for higher-level courses.[672] For management education, MCQ testing and learning not only do not facilitate higher-order learning, they also do not facilitate improvement of students' written and oral communication skills.[673] Similar arguments exist for other disciplines, such as history (need for discipline-based thinking skills)[674] and nursing (need for critical thinking skills).[675]

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learning from MCQs depends on the learners' prior exposure to the MCQs, learning may be basic knowledge (rote) learning, rather than higher-level learning. Tanner, *supra* note 2, at 32.

671 Patti Shank, *Better Multiple-Choice Tests (Assessments, Part 3)*, ONLINE CLASSROOM, Mar. 2006, at 4, 4.

672 Michael F. Shaughnessy, *Delivery of the Knowledge Curriculum vs. Skill and Competency Curriculum*, EDUC. RESOURCES INFO. CENTER, No. ED454805 (2001), *available at* http://www.eric.ed.gov/ (search ERIC number).

673 Linda B. Samuels & Richard L. Coffinberger, *Balancing the Needs to Assess Depth and Breadth of Knowledge: Does Essay Choice Provide a Solution?* 22 J. LEGAL STUD. EDUC. 103, 108 (2005).

674 *See* Reich, *supra* note 6, at 349.

675 *See* Sandra L. Clifton & Cheryl L. Schriner, *Assessing the Quality of Multiple-Choice Test Items*, 35 NURSE EDUCATOR 12, 12 (2010).

Aside from the relative inability of MCQ testing (as compared to CR testing) to facilitate higher-level learning and skills learning, an additional criticism of MCQ testing as it pertains to learning is the problem of acquiring false knowledge. Standard MCQs often expose students to one right answer and three distracters. This constant exposure to misinformation increases the possibility that students will come to view information in the distracters as correct.[676] The problem becomes even greater if students cannot adequately review which answers were correct when instructors try to protect the MCQ test banks for future use by not making them readily available.[677]

Although detractors of MCQ assessment primarily argue that such assessment is bad for higher-level and skills learning, they also argue that MCQ assessment is simply not a good form of assessment of even lower-level learning. They claim that scoring does not necessarily reflect knowledge but instead could reflect guessing, test-wiseness, and/or reading ability. Moreover, they maintain that MCQs could unfairly discriminate among certain categories of students.

MCQs, which students would refer to as MGQs (multiple guess questions), often do encourage guessing because points are given for right answers and not taken away for wrong answers. Thus, someone with no knowledge of the material could score 25% on an exam consisting of standard four-answer MCQs. The potential impact of guessing is greater for MCQ exams with fewer questions.[678]

Test-wiseness, which is sometimes little more than educated guessing, is the ability of students to correctly answer questions without knowing the content by using traditional concepts that

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[676] Roediger, *supra* note 7, at 1158.
[677] *Id.* at 1155.
[678] Tanner, *supra* note 2, at 34.

sometimes work such as selecting the longest answer or selecting answer C.[679] Students can also become test-wise from experience and from taking courses on how to take tests.[680]

Though guessing and test-wiseness may impact MCQ scores, reading ability likely has a much greater impact.[681] One reason that good readers score better than poor readers on MCQs is because the MCQs often contain words not important to the content of the course that students conclude mean the opposite of what they actually mean.[682] Moreover, relative reading ability may adversely impact certain categories of students based on ethnicity or gender.[683]

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679 *Id.* at 32-33; Shank, *supra* note 15, at 8.

680 Tanner, *supra* note 2, at 32. For example, based on past courses and experiences, I have conveyed to students in Law School Admissions Test (LSAT) workshops several test-taking tips, including those mentioned below. The tips range from the obvious to the miniscule, but they potentially could make a difference in score that would not be based completely on knowledge of the material. (1) Never leave a question blank; there is no penalty for guessing. (2) POE - use the process of elimination. (3) Transfer your answers to the answer sheet in groups at logical rest points. Doing so is more efficient and gives you a small period of relaxation. (4) Write all over your test booklet. (5) Read some the morning before the test in order to wake up your mind. (6) A watch for keeping time is an absolute necessity. (7) Pencils should be not too blunt, nor too sharp for better filling in the circles. (8) Be ready for test conditions: don't let your eyes wander, dress in layers, bring earplugs. (9) Don't drink too many liquids before the test. (10) Anyone who finishes early is either a genius or an idiot. Speed kills! There are no bonus points for early completion. (11) Letters A, B, C, D, and E are used as correct answers approximately the same number of times.

681 *See* Reich, *supra* note 6, at 347; Jeremy B. Williams, *Assertion-Reason Multiple-Choice Testing as a Tool for Deep Learning: A Qualitative Analysis*, 31 ASSESSMENT & EVALUATION HIGHER EDUC. 287, 298 (2006).

682 Ella L. Ingram & Craig E. Nelson, *Using Discussions of Multiple Choice Questions*, 68 AM. BIOLOGY TCHR. 275, 275 (May 2006). Example words in one study included “abundant” and “negligible.” *Id.*

683 *See* William B. Walstad & Denise Robson, *Differential Item Functioning and Male-Female Differences on Multiple-Choice Tests in Economics*. 28 J. ECON. EDUC. 155, 168 (1997). *But see*, Winfred Arthur, Jr., Bryan D. Edwards &

MCQs may also adversely impact students categorized as impulsive, rather than reflective. One study showed that students classified as impulsive who worked at their own pace were likely to answer questions more quickly and less accurately than the students classified as reflective.[684] The study also showed that impulsive students who were forced to delay answering for at least twenty-five seconds scored just as accurately as the reflective students.[685]

III. WHY MCQS ARE GOOD

Assessors continue to use MCQs despite the difficulties with learning and assessment described above. They do so for reasons other than merely because students like them by a wide margin over CRQs[686] and instructors find them useful to manage time demands of teaching, research, and service.[687] Testing services continue to validate and use MCQs. For example, graded sections of the American College Testing Program (ACT), the Scholastic Aptitude Test (SAT), the Law School Admission Test (LSAT), the Graduate Record Exam (GRE), the core business exam of the

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Gerald V. Barrett, *Multiple-Choice and Constructed Response Tests of Ability: Race-Based Subgroup Performance Differences on Alternative Paper-And-Pencil Test Formats,* 55 PERSONNEL PSYCHOL. 985, 1001 (2002).

[684] Douglas A Waring & Cheryl Beck Farthing, *Impulsive Response Style Affects Computer-Administered Multiple-Choice Test Performance,* 26 J. INSTRUCTIONAL PSYCHOL. 121, 126 (1999).

[685] *Id.*

[686] *See* Peter Kennedy & William B. Walstad, *Combining Multiple-Choice and Constructed-Response Test Scores: An Economist's View*, 10 APPLIED MEASUREMENT EDUC. 359, 362 (1997) (70% of students prefer MCQs); Pete Bridge, Rob Appleyard & Rob Wilson, *Automated Multiple-Choice Testing for Summative Assessment: What Do Students Think?* EDUC. RESOURCES INFO. CENTER, No. ED500077 (2007), *available at* http://www.eric.ed.gov (search ERIC number) (74% of students prefer MCQs).

[687] Michael J. Garrison, James D. Hansen & Terry W. Knoepfle, *An Analysis of Multiple-Choice Questions from Business Law Testbanks and from the CPA Examination*, 15 J. LEGAL STUD. EDUC. 91, 92 (1997).

Educational Testing Service (ETS), and the Graduate Management Admission Test (GMAT) all contain MCQs.[688]

With respect to assessment, MCQs have significant advantages over CRQs. First, scoring is easily, objectively, and accurately done by computers or human graders without expertise in the subject matter of the exam.[689] By comparison, the scoring of CRQs is more difficult, more subjective, and must be done by a person who has expertise in the subject matter.[690] Second, but related, MCQ scoring generates significant data that allow complicated item analysis to determine the validity of individual questions.[691]

Third, MCQs provide greater breadth of coverage of the materials in comparison with CRQs, especially essay exams.[692] The larger number of MCQs on an exam allows examiners to test a broader range of subjects in a shorter amount of time than for most CRQ testing.[693]

Fourth, although there is some debate over the issue,[694] many studies have shown that MCQs can measure essentially the same thing as CRQs and adequately measure students' mastery of materials.[695] Considering the aforementioned benefits of MCQs

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[688] MCQs first appeared on the SAT in the mid-1920s. Daniel J. Cohen & Roy Rosenzweig, *No Computer Left Behind*, CHRON. HIGHER EDUC., Feb. 14, 2006, at B6.
[689] Roediger, *supra* note 7, at 1155.
[690] Tanner, *supra* note 2, at 34-35.
[691] Cohen & Rosenzweig, *supra* note 32, at B6; Shank, *supra* note 15, at 4.
[692] Tanner, *supra* note 2, at 34.
[693] Cohen & Rosenzweig, *supra* note 32, at B6; Garrison et al., *supra* note 31, at 92-93.
[694] Lynn Bible, Mark G. Simkin & William L. Kuechler, *Using Multiple-Choice Tests to Evaluate Students' Understanding of Accounting,* 17 ACCT. EDUC. (SUPP. 1) 55, 57 (2008).
[695] *Id.* at 59.

and the inability of CRQs to add additional information about student achievement, cost-benefit analysis favors continued usage of MCQs as a form of assessment.[696] For example, one study of student performances on Advanced Placement economics exams showed that using MCQs rather than CRQs would classify only 165 out of 10,000 students higher than they actually should be based on their subject matter learning.[697] The study noted that to use CRQs and improve upon the 98.35% accuracy rate would cost $909 per misclassification (approximately $150,000).[698]

Thus, as a form of assessment, MCQs provide in a cost beneficial manner many advantages that CRQs cannot. However, as previously discussed, the primary disadvantages of MCQs have been in the context of learning.

Learning, at least at lower levels, does occur in connection with MCQ testing as students do retain knowledge tested by MCQs."[699] Even knowledge retained as rote memory is useful as "[b]efore a student can think critically, he needs something to think critically about!"[700] Moreover, even if MCQs cannot directly test advanced-level learning and communication and professional skills, "decades of research into reasoning and thinking have unequivocally shown that knowledge of a domain is the single best determinant of expertise."[701] MCQs can capably test such knowledge. Moreover, many would argue that MCQs can also test more than simple recall knowledge, including comprehension, application, analysis, and evaluation.[702]

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[696] Kennedy & Walstad, *supra* note 30, at 359.
[697] *Id.* at 374.
[698] *Id.*
[699] Roediger, *supra* note 7, at 1157.
[700] Oppenheim, *supra* note 13, at 138.
[701] Paul McCoubrie, *Improving the Fairness of Multiple-Choice Questions: A Literature Review*, 26 MED. TCHR. 709, 709 (2004).
[702] *See* Shank, *supra* note 15, at 4.

IV. HOW TO MAKE MCQS BETTER

Instructors can act in various ways to improve their MCQs so that they do adequately assess content and facilitate important learning.[703] Instructors should make sure that their MCQs are written well, contain an appropriate number of choices, and adequately provide against the benefits of guessing.

Much published advice exists as to how to better draft MCQs.[704] Generally, drafters should focus on using clear, precise language and writing good distracters.[705] Specific advice directed to legal studies professors, which bears repeating, includes the following:

1. Present a single problem in the stem.
2. State the stem in simple, clear language.
3. Put as much wording as possible into the stem.
4. State the stem in positive form.
5. Emphasize any negative wording.
6. Make the intended answer clearly the best answer.
7. Make distracters grammatically consistent with the stem and parallel.
8. Avoid similarity of wording in the stem and distracters.
9. Avoid intended answers that are more detailed than distracters.
10. Avoid absolute terms such as “all” or “never” in the distracters.
11. Avoid pairs of responses that are all inclusive.

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[703] Tanner, *supra* note 2, at 35.
[704] *See, e.g.,* NORMAN E. GRONLUND, HOW TO MAKE ACHIEVEMENT TESTS AND ASSESSMENTS (1993); Shank, *supra* note 15; Garrison et al., *supra* note 31.
[705] Shank, *supra* note 15, at 5-8.

12. Avoid responses that have the same meaning.
13. Make all distracters plausible to those who do not know the answer.
14. Avoid using "all of the above."
15. Avoid using "none of the above" (except for computational problems).
16. Follow normal rules of grammar and punctuation.
17. Place correct answers in random order.
18. Avoid information from one question answering another question.[706]

Drafters of MCQs might want to pay particular attention to an unorthodox, but apparently sound and helpful, question-writing practice pertaining to the number of choices offered. Most test banks offer, and most instructors draft, four (and sometimes five) choices per question. Such practice, however, seems based on

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[706] Garrison et al., *supra* note 31, at 95-96. The authors also include the rationale for each suggestion. *Id.* In reviewing test banks and the certified public accounting exam, the authors found that fifty percent of the violations to the MCQ writing guidelines pertained to items 4, 5, 14, and 15. *Id.* at 99. MCQs that are written well and that measure in-depth understanding are difficult and time-consuming to draft, which is why many introductory text test banks contain so many questions from Bloom's first two levels – knowledge and comprehension. Buckles & Siegfried, *supra* note 10, at 56. The scarcity of useable, high quality MCQs is exacerbated by the existence of websites such as Course Hero, which contains amazingly complete and current "study" materials, including test bank questions and instructors' solution manuals, for all types of courses. *See* http://www.coursehero.com/. Course Hero is particularly prolific in gathering such information because it affords free membership to students who download significant amounts of information to the site. Consequently, Course Hero contains many past exams with answers and exam review questions that students have simply copied from course management systems such as WebCT and Blackboard. *See* Steve Kolowich, *Course Hero or Course Villain*, INSIDE HIGHER ED, Oct. 6, 2009, http://www.insidehighered.com/news/2009/10/06/coursehero (last visited June. 3, 2010).

tradition rather than research. Research over an eighty-year period indicates that MCQs with three choices are just as effective in assessing learning as MCQs with more than three choices.[707] Using three choices also reduces the amount of reading per question, which could permit additional questions and concomitantly additional content coverage.[708] Moreover, reducing the number of choices and the amount of reading per question seems to mitigate the assessment issue pertaining to MCQs being a measure of reading skills rather than a measure of content-related learning.[709] Research has also shown that reducing the number of choices reduces the false learning issue because students are subjected to fewer distracters.[710]

In a related issue, instructors can make MCQ testing better by attempting to minimize the impact of guessing. Some authors strongly recommend that instructors should discourage students from guessing by negative scoring, i.e., taking off points for incorrect answers rather than just awarding points for correct answers.[711] Other authors suggest, instead, that instructors mitigate the effects of guessing by either increasing the number of distracters for each item (which would conflict with notion of three-choice MCQs) or by increasing the number of questions (which would dovetail with the notion of three-choice MCQs).[712]

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[707] Michael C. Rodriguez, *Three Options are Optimal for Multiple-Choice Items: A Meta-Analysis of 80 Years of Research*, EDUC. MEASUREMENT: ISSUES AND PRAC., Summer, 2005, at 3, 3-12.
[708] *Id.* at 11.
[709] Arthur et al., *supra* note 27, at 1002.
[710] Roediger, *supra* note 7, at 1157.
[711] Richard F. Burton & David J. Miller, *Statistical Modeling of Multiple-Choice and True/False Tests: Ways of Considering, And of Reducing, The Uncertainties Attributable to Guessing*, 24 ASSESSMENT & EVALUATION HIGHER EDUC. 399, 408-09 (1999).
[712] Tanner, *supra* note 2, at 34. Interestingly, one author notes that instructors may have "a moral responsibility to encourage students to guess" because

Even if an instructor were able to write excellent MCQs with an optimal number of choices and in a manner that minimized the impact of guessing upon assessment, the MCQ exams would still be inadequate to facilitate the most effective teaching and learning. Studies continue to show that enhancement of learning is greater for CRQs than for MCQs.[713] Simply put, a "recall test is more instructive than a recognition test."[714] Accordingly, many authors suggest that one way to make MCQs better is simply to supplement them with CRQs because any form of assessment (including CRQs) has its limitations.[715] Supplementing MCQs with CRQs allows an instructor to understand the extent of student learning more completely than using either item exclusively.[716]

Another way to improve MCQs is to find an effective way to review them.[717] To facilitate greater retention of learning, such review should be delayed and not occur immediately after the taking of the exam.[718] Review of MCQs also permits students to understand the MCQs better. Many times even upper level students do not understand that MCQs can and should do more than simply ask students to recall information. As a result, students' performance on MCQs that test application and analysis does not necessarily reflect what they actually understand. Review of the questions helps students to "demystify" these types of MCQs and the higher orders of learning upon which they are

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research has shown that students do better on exams when they guess even when the exams are subject to negative scoring for incorrect answers. *Id.*

713 Park, *supra* note 4, at 436.

714 *Id.* at 437.

715 Tanner, *supra* note 2, at 35.

716 *Id;* Samuels & Coffinberger, *supra* note 17, at 110; Susan Martin, *Flexible Exams in the Introductory Legal Environment Course*, 13 J. LEGAL STUD. EDUC. 185, 185 (1995).

717 Park, *supra* note 4, at 437.

718 Andrew C. Butler, Jeffrey D. Karpicke & Henry L. Roediger III, *The Effect of Type and Timing of Feedback on Learning From Multiple-Choice Tests,* 13 J. EXPERIMENTAL PSYCHOL.: APPLIED 273, 279-80 (2007).

based.[719] After review, instructors may also view some MCQs in a different light because students can often point out weaknesses in particular MCQs.[720]

One way to effectively and efficiently review MCQs is by a group process that can enhance the review process and provide collateral benefits that derive from group work. One instructor formed student groups that reviewed certain MCQs choice by choice, attempted to write better choices, and then discussed their efforts in class.[721] Benefits from that group review process included a reiteration of the material, a new thoughtfulness about the language and complexity of the MCQs, and use of past learning to complement additional learning.[722] Another instructor required students to take MCQ exams as individuals and then in groups in which they also had the opportunity to appeal questions.[723] Benefits from that exercise included higher student achievement and a greater use of higher-level learning and critical thinking skills.[724]

V. GROUP APPEALS OF MCQS

The remainder of this article discusses how this author's technique for group appeals of MCQs operates and how it improves MCQ exams via supplementation, review, and group learning. The

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719 Mellisa Holtzman, *Demystifying Application-Based Multiple-Choice Questions*, 56 C. TEACHING 114, 116 (2008). *See also* Ingram & Nelson, *supra* note 26, at 275-79.
720 Buckles & Siegfried, *supra* note 10, at 53.
721 Ingram & Nelson, *supra* note 26, at 275.
722 *Id.* at 276.
723 Susan W. Dana, *Implementing Team-Based Learning in an Introduction to Law Course*, 24 J. LEGAL STUD. EDUC. 59, 59 (2007).
724 *Id.* at 59-60.

article also describes how the technique can be adapted to different classroom settings and technologies.

I have used group appeals of MCQs ever since attending a seminar in 1990 where Professor Larry Michaelson demonstrated various group techniques.[725] He encouraged group work that stimulated high levels of group interaction and that rewarded group success.[726] Experience shows that permitting students to appeal their MCQs for additional points meets those criteria.[727]

The group appeals process starts with students turning in computer-gradable answers from which a computer program can generate results for the students and an item analysis for the instructor.[728] The student results generally tell each student the questions answered correctly or incorrectly, the correct answers for all questions (including any alternative answers), the student's overall test score, and the class's overall mean and median score. The item analysis sets forth the difficulty and fairness of each question.

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[725] The seminar was entitled "Getting the Most Out of Groups" and was coordinated by Dr. William F. Bentz, then chair of accounting and management information systems at Ohio State University.

[726] *See* Larry K. Michaelsen, Robert H. Black & L. Dee Fink, *Problems with Learning Groups: An Ounce of Prevention…*, 17 J. LEGAL STUD. EDUC. 91, 95-96 (1999). The authors encourage group appeals of exams, *id.* at 105, and strongly discourage group term papers, *Id.* at 106-08.

[727] Instructors can use the group appeal technique for any type of class, but considering the role of legal appeals in case law, the technique seems particularly suitable for legal studies classes.

[728] Over twenty years, the technology of the process in my classes has evolved from punch cards, to Scantron answer sheets, to online submissions of answers with WebCT. The ability to grade MCQs by computer is very important to the group appeals process because computerized grading allows rapid regrading for successful appeals.

The class devotes the entire next class day after the exam to review the exam in groups.[729] Four or five students per group work well in my classes as the use of two or three students per group does not promote adequate interchange of ideas and the use of more than five is cumbersome and does not permit all students sufficient input.[730] I ask students to count off to create random groups of four.[731] I do not permit students to form their own groups for several reasons. To better practice group skills, each student should learn how to work with any other student in the class. In addition, interestingly, research shows that when students form their own groups, they are less likely to enjoy the group experience.[732] Moreover, random selection will cause a more even distribution of students who performed well with those who did not. Occasionally, based on the grade distribution, I have formed the groups for the students to make certain that both high and low performers are in each group.

After students form their groups, I give each group several appeal sheets (on half-sheets of paper),[733] which explain the process and leave room for students' written appeals, as follows:

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[729] Prior to using the group review technique, I used to lead the review of the MCQs with the students in a "one-headed" review process. Use of the technique with groups of four students yields a much more productive and efficient "four-headed" review process. *See* Dexter R. Woods, Jr., *Four Heads Are Better Than One: Group Review of Multiple Choice Tests*, OHIO N.U. MONOGRAPH SER., NO. 39 (Fall 1992) (discussed an earlier version of the appeals process and also a justification process for MCQ exams).

[730] *See* Susan B. Feichtner & Elaine A. Davis, *Why Some Groups Fail: A Survey of Students' Experiences With Learning Groups*, 9 ORG. BEHAV. TEACHING REV. 58, 60 (1985) (students like working with four to seven students per group).

[731] If the number of students present is not exactly divisible by four, some groups will have five students. I have not found one more or less student in the group to be either advantageous or disadvantageous and students have never complained about the number difference.

[732] Feichtner & Davis, *supra* note 74, at 60.

[733] The MCQs in legal studies classes are susceptible to appeals because of the uncertainty and flexibility within the law. MCQs in other classes, such as tax

Appeal Sheet

Members of group #____:

1.
2.
3.
4.

You need to explain why your answer is just as good as the professor's answer. For example, you could explain why an ambiguity in the question or why inadequate coverage of the tested material precludes you from selecting the correct answer, or you could explain why two answers are equally correct. Your explanation should cite specific support in your text or notes (include a

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class, might be more computational in nature and less subject to appeal. Those classes, however, still review their MCQs in groups. Instead of using an appeal process, they use a justification process. A group justifies what I claim is the correct answer by explaining why that answer is correct and why each of the other answers is incorrect. I also ask students to cite specific support in their text or notes for the correct answer. After group discussion, one student in the group writes the justification, and the others review it for accuracy. Each student in the group must write essentially the same number of justifications. I award each student in the group one point (half credit) for each successful justification by the group. I usually have groups justify questions missed by at least fifty percent of the class. Incidentally, with information from the item analysis, I explain to students how such difficult questions can still be fair questions by showing the class how higher-scoring students on the exam should and did perform substantially better on those questions than lower-scoring students. Those questions would be too difficult for some students to justify on an individual basis, but groups can usually figure them out. Either someone in the group answered the question correctly or someone will understand my hints during the group review. I usually grade the justifications leniently because they take the place of a curve, which by its very nature awards points to students.

page number). Each affected person in the class will receive credit for each successful appeal by any group.

[Space for Appeals]

Students can appeal as many questions as they can fit into the class time. Each student in the class receives two points for each successful appeal by <u>any</u> group in <u>any</u> section of the class, <u>if</u> that student originally missed that question and would be covered by the appeal. For example, if a question was successfully appealed because answer B was just as correct as my choice of answer A, all students who put B would earn two points. Those students who put C or D would not earn credit. If answer B was even better than my choice of answer A, I still give credit to all those students who put A or B. I do not take away points from students. Some appeals successfully argue that a question has no right answer. Rather than simply not counting that question, I give credit to all students who missed it. I believe such questions are my fault and students who had to labor over them deserve credit for them.

During the group discussion, I wander the room to supply information and answer questions about appeal possibilities. I also try to make certain that all students are participating and that the groups are functioning as they should. One of my major concerns about the group appeals process is that "freeloaders" and absent students could get extra points without earning them. I deal with that concern in two ways. First, I give no credit to those who do not attend. Second, I require each person in the group to write approximately the same number of appeals as everyone else. Fortunately, the process itself seems to stimulate those most likely to "freeload" and least likely to attend because those students usually have the lowest grades and the most incentive to earn extra points.

Another concern is that groups simply divide questions and do them individually, minimizing the group effect. One way to counter that is to limit the number of appeals so that students are not encouraged to draft as many as they possibly can. Another way is to demonstrate how the group effect is successful in other class exercises. For example, on the first day of class I have pretested individuals and groups to show how much better the group average is than the individual average. A group almost always performs better than the sum of its parts.[734]

When each group is done or when class time has run out, I collect the appeals and grade them outside of class. I either grant or deny them, always explaining in writing the reasons why an appeal is denied. The success or failure of an appeal is based solely on its own merits. For example, more than one group may appeal a particular question, but I may deny one group's appeal while granting the other. If no group successfully appeals a question that an individual student wants to appeal, I permit that student to visit with me and write out an individual appeal. In that way students do not feel disadvantaged by working in groups.

The written group appeals technique is a valuable supplement and review to MCQ exams. The process benefits both students and instructors with respect to assessment, learning, and practicing valuable skills in a variety of ways.

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[734] For those rare situations where the group does not perform better than the sum of its parts, I rely upon past results to demonstrate the usual occurrence. Through the years, the overall individual average has been about 11 points less than the overall group average and each group average usually improves the averages of each individual within the group from 2.5 to 17.5 points. Aside from demonstrating the value of group work, such pretesting also shows students that even if they do not earn an A or B in the course, they have learned something by the end of the course. Individual students' final class averages are almost always higher than their pretest averages.

The review process, per se, is good for comprehension and reinforcement of class materials. Students learn better study skills because they must examine their text and notes in order to write their appeals. Thus, they see how their notes and interpretation of the text differ from that of other students. Students who miss many questions often find that their notes are deficient compared to the notes of students who miss few questions.

Group review also helps students develop analytical skills. Students who perform poorly learn how students who perform well think about and resolve questions. Students who perform well learn to listen to and understand the positions of others.

The process also requires students to exercise oral and interpersonal communication skills when they explain their positions on what and how to appeal. They must compromise by sometimes appealing questions they missed and sometimes appealing questions others missed. Students with correct answers learn to convince and lead others. Students with wrong answers learn to listen. All students learn to respect the positions of others even if those positions are incorrect. They also learn to tell others that their positions are not valid, and to accept the fact that their own positions may not be valid.

Students' written communication skills also improve. Each student must draft appeals, which the group reviews. Many times students find that what they intend to say is not what they write.

As students' comprehension, analysis, and communication skills improve, so do their advocacy skills. The more frequently students undergo the group appeals process, the more they improve their ability to argue their position. The appeals success rate increases significantly as students proceed through my courses.

The process also reinforces some moral lessons. Students have to earn their extra points, rather than having them given to them as a gratuitous curve. They learn to help others even if they, themselves, did very well on the exam. They receive the opportunity to be treated fairly by being able to remedy unfair MCQs.

Instructors who use this process can also benefit in numerous ways. The group interaction permits instructors to leverage the teaching and learning process because students can learn from and teach each other. Each student becomes a teacher, which improves the teacher to student ratio tremendously.

The process helps overcome MCQ negativism. Students often say they can narrow MCQ answers down to two, but then choose the wrong one of the two. They also complain about not being able to write all they know. During the group review process, students frequently admit particular questions were much fairer than what they originally thought.

On the other hand, some MCQs do turn out to be unfair, and students can continually help instructors to improve their MCQs. For example, the appeals process led me to believe that the following question could be unfair to some students.

> Question: Which of the following is most likely to be considered a fixture?
> A. A free-standing microwave oven.
> B. A refrigerator.
> C. A clothesline in the back yard.
> D. A rocking chair.

Knowing that a fixture is personal property that has become permanently attached to real property, I agreed with the test bank author's selection of answer C as the correct answer. Answers A, B, and D are not fixtures because they can all be easily removed from real property. Answer C, a clothesline, however, is set in concrete and can be considered permanently affixed.

The group appeal argued, however, that B could also be correct.

> Appeal: We feel B could also be correct. A refrigerator can be a fixture because often large appliances such as this are sold along with the house. Many times refrigerators are custom made to fit a certain kitchen (example: a door to open a certain direction). The clothesline (C) does not say what type. It could be tied to two trees in the back yard. That can easily be removed. Page 234 defines fixture and we feel either answer can come under the definition given.

I granted the well-written appeal, gave credit to everyone in the class who had C or B, and changed answer B in subsequent tests to "welcome mat."

Instructors can also use the group appeal process to evaluate what students are getting out of class lecture and class materials. For example, one MCQ pertained to liability for bribery. Based on a group appeal, I found that neither the book nor my notes indicated whether the person doing the bribing, the person being bribed, or both would be liable for the crime.

The process has adapted well throughout the years regardless of class size and available technology. The appeals do take time to grade, but instructors can put a limitation on the number of appeals and/or the time to submit appeals. Because students stand only to gain points from appeals, some can be frivolous. Instructors could discourage such appeals by awarding points to those groups with the highest appeal percentage.

In recent years, I have used the group appeals process for MCQ exams that are open-materials (including the Internet) and take-home. Benefits of such exams include their real-world focus on analysis and research rather than on memorization. Such exams also take up no class time, fit within student schedules, and give students an opportunity to act ethically by resisting the temptation to collaborate. The impact of such exams on the functioning of the group appeals process has been negligible. Two additional benefits of permitting open-materials exams are that "lack of coverage" is no longer a good appeal option and students soon learn that not everything on the Internet is correct.

Even more recently, I have used the group appeals process via our course management software, WebCT. The discussion board takes the place of the appeals sheets and students appeal not as groups of four, synchronously, and in class, but as an entire class, asynchronously, and outside of class. Within WebCT's discussion board, I set up a numbered blank message to correspond to each of the numbered MCQs and students communicate within each threaded message, pursuant to the following directions:

> Directions
>
> Please draft any appeals that you might have for any of the questions, which are listed as separate subjects. Appeals must be submitted by [particular time and date].
>
> For each appeal, you need to explain why your answer is just as good as (or better than) the professor's answer. Include detailed reference and/or citation to any authority you use in order to help the professor consider such authority.
>
> Please read other appeals in this public space to

> make sure your appeal is not redundant. Each student who effectively participates in this process will get credit for successful appeals that impact that student's exam. The "safe harbor" for effective participation is writing at least one non-frivolous appeal, substantially strengthening at least one existing appeal, and explaining why at least one existing appeal should be denied.
>
> "Reply" to messages, rather than "reply privately" so that everyone can see each other's writing.

Putting the group appeals process on WebCT led to a four to five-fold increase in the number of appeals (from about 50 from a class of thirty students to about 200-250). Part of the increase was due to the additional time permitted and part was due to the increased communication (written instead of face to face and oral) between students. Following is an example question and corresponding student appeal communications:

> Question: Under the UCC Secured Transactions Article, which of the following conditions must be satisfied for a security interest to attach?
>
> A. The debtor must have title to the collateral.
> B. The debtor must agree to the creation of the security interest.
> C. The creditor must be in possession of part of the collateral.
> D. The creditor must properly file a financing statement.
>
> Message #72 posted by Doug: I believe that Answer C could also be correct because, as stated

in UCC 9-102(a)(7)(69), a security interest is automatically attached if the collateral is in the possession of the secured party. If the collateral is not in possession of the third party then there must be a security agreement signed or authenticated by the debtor.

<u>Message #86 posted by Robert:</u> I believe that answer A is also correct with answer B. According to Section 9-203, "Attachment and Enforceability of Security Interest (1) … a security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless:

(a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral…;

(b) value has been given; and

(c) the debtor has rights in the collateral."

As discussed in class, having the title gives you rights in the collateral.

<u>Message # 97 posted by Adam:</u> I agree with Doug with the correct answer being C, because according to, http://search.abanet.org/..., it says, "for most security agreements, attachment requires that the debtor authenticate a security agreement containing a description of the collateral. However, these requirements need not be met if, pursuant to the debtor's security agreement, the secured party has obtained possession of collateral in which a security interest can be perfected by possession."

<u>Message #112 posted by Chris:</u> I agree answer C should be correct. The debtor must have title to the collateral, rights in the collateral, as per our class notes. Regardless of the debtor's desire to create security interest, he/she must have something on the table to create agreement.

<u>Message #118 posted by the Instructor:</u> Denied. A and C are both possible when attachment exists, but they are not necessary. The question asks what <u>must</u> be. The only one of the answers that <u>must</u> be is that there must be a security agreement. The notes, which are in agreement with code sections that appealers have cited, read as follows:

"a) Attachment of security interest – relationship between secured party creditor and debtor.

i) The two parties made a security agreement and either:

(1) It is in writing, describes the collateral, and is signed by the debtor, or

(2) The secured party has possession of the collateral.

ii) The secured party gave value in order to get the security agreement.

iii) The debtor has rights in the collateral."

Section a)i) is the key to this question. There needs to be a security agreement. Section a)iii) says that the debtor has to have rights in the collateral, but such rights do not have to be title. Moreover, although as envisioned by a)i)2), the creditor could have possession, he does not have to have possession (and most of the time will not, as indicated in our class example with the car

> inventory where the debtor maintained possession in order to sell the cars).

One can see from the above communications that even an unsuccessful appeal of a relatively straightforward question can generate good research,[735] review, and analysis of MCQs. A significant advantage to using an electronic discussion board for the group appeals process is that students have access to the thinking of all the students in the class, not just group members. Review of the postings and analysis of the WebCT student time logs indicate that students spend a great amount of time reading and commenting upon the postings. I think the extra learning that goes on with this process on WebCT is well worth the additional reading the process requires of the instructor.[736]

Whether an instructor uses course management software or not for the group appeals process, students overwhelmingly approve of the process. They can earn extra points and do something different at the same time. Formal student evaluations reflect student satisfaction with the group review process. Moreover, informal student feedback is positive even to the extent that students were disappointed in a class where I instituted a generous gratuitous curve and they did not have a chance to earn their curve via the appeals process.

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[735] When taking open materials exams, students frequently research answers from sources beyond their book. In this case, even though we did not do so in class, students utilized the Uniform Commercial Code. Instructors who allow open material exams, however, should not use MCQs from any prior test banks because the MCQs and their answers are likely available somewhere on the Internet. *See, e.g.,* http://books.google.com/(search "satisfied for a security interest" in Google Advanced Search) (sets forth the question, answer, and rationale for the question above) (last visited June. 3, 2010).

[736] The instructor does save some time in looking up students' support materials, which often are hyperlinked and accessible via a single mouse click.

I enjoy the process because the students enjoy it and because I think we accomplish so much. Students consistently indicate on their evaluations that my exams are too hard, but this process helps. Students love to find the professor wrong. As I go around the room during the appeals process, they will sometimes smile knowingly and say confidently "We have you on this one." Sometimes their confidence is misplaced, but sometimes not. I enjoy reading the appeals and find the grading process fun. Some appeals are very difficult to answer, and I get to sharpen my own advocacy and teaching skills in trying to do so.

My peers have also reviewed the process favorably throughout the years. For example, one peer review committee wrote: "In several early class visitations two of the reviewers were exposed to a class period when Professor Woods was reviewing an examination that had been given in the prior class...The students were then given a group opportunity to challenge the answer to the three questions most frequently missed. The students took to this opportunity quite well. Student-faculty feedback was quite animated and well managed by the professor...In the examination review sessions each student appeared to have a solid idea of how and why test scores were arrived at and there were no cases of even the appearance of student dissent regarding the results."

VI. CONCLUSION

One can find much satisfaction in using this engaging and pedagogically sound technique of groups engaging in written group appeals of MCQs in order to earn extra exam points. The technique reduces disadvantages and enhances advantages inherent to MCQ testing with respect to both assessment and learning. Over the past twenty years, the technique has adapted well to a variety of classes and technologies and likely will continue to evolve to benefit students and instructors.

- END ARTICLES -

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