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Editor's Corner

The Annual Conference meeting of the Academy of Legal Studies in Business was held March 19-20, 2000, at the Loews Annapolis Hotel in Annapolis, Maryland. The academic program was attended by approximately 30 members. The program included papers on teaching, employment, tort, intellectual property, and research and corporate law. From the paper presented, twelve were submitted for doubled-line review. Approximately fifty percent were accepted for publication in the *Atlantic Law Journal (ALJ).*

We give special thanks to Program Chair Brad Reid for planning the academic program. We give special thanks to Andrea Giampetro-Meyer of Loyola College for her assistant in the hotel selection.

The 2001 annual meeting will be in Norfolk, Virginia from March 22-23, 2001. Please meet us in Norfolk on the Virginia Waterfront. We encourage all ALSB members and other professors and professionals to participate. We will have paper presentations and a great luncheon. We look forward seeing you in the Waterfront in the Norfolk.

The *ALJ* is refereed journal. The *ALJ* is listed in CABELL'S DIRECTORY OF PUBLISHING OPPORTUNITIES IN MANAGEMENT AND MARKETING. We encourage all readers to prepare and submit manuscripts for publication in the *Atlantic Law Journal.*

James E. Holloway
Editor-in-chief

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We also thank to our reviewers who have been gracious enough to give their time to ensure the quality of the articles.

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ARTICLES

ANTITRUST, PATENT POOLS, AND THE MANAGEMENT OF UNCERTAINTY

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I. *INTRODUCTION*

Much has been written in recent years on the role of antitrust law in regulating the conduct of combinations of high-technology firms.[1] Some commentators have concluded that existing law is equal to the tasks of distinguishing the procompetitive benefits from the anticompetitive effects of such combinations and policing the anticompetitive restraints appropriately.[2] Others have suggested that some important policy concerns -- most notably the encouragement of technological innovation -- are not adequately addressed by established antitrust analysis, and that significant changes in antitrust doctrine and enforcement policy are needed.[3] Because antitrust is essentially a common-law field in which the basic statutes are written in the most general terms and new legislation tends be rare and incremental, any agenda for significantly changing antitrust analysis must contend with the case law.

This article critically evaluates the antitrust case law that has been applied to patent pooling arrangements -- a specific type of combination that is often employed by high-technology firms. Section I briefly reviews the major antitrust policy issues that arise in the analysis of patent pools. Section II analyzes four of the leading United States Supreme Court cases applying antitrust law to pooling arrangements. In Section III, two high-technology patent pooling arrangements recently reviewed by the Justice Department and the

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1. *See generally* FEDERAL TRADE COMMISSION STAFF, ANTICIPATING THE 21ST CENTURY: COMPETITION POLICY IN THE NEW HIGH-TECH, GLOBAL MARKETPLACE (1996); Joseph Kattan, *Antitrust Analysis of Technology Joint Ventures: Allocative Efficiency and the Rewards of Innovation*, 61 ANTITRUST L.J. 937 (1993); ANTITRUST, INNOVATION AND COMPETITIVENESS (Thomas M. Jorde &. David I. Teece eds., 1992) [hereinafter "Jorde & Teece"]; Janusz A. Ordover &. Robert D. Willig, *Antitrust for High-Technology Industries: Assessing Research Joint Ventures and Mergers*, 28 J. L. & ECON. 311 (1985).

2. *See, e.g.*, FTC STAFF, *supra* note 1; Kattan, *supra* note 1.

3. *See, e.g.*, Jorde & Teece, *supra* note 1.

Federal Trade Commission -- the *MPEG-2* and *Summit/VISX* patent pools[4] -- are analyzed under antitrust doctrine derived from Supreme Court cases and in light of current policy concerns. Consideration of the complex facts of these two recent cases highlights serious weaknesses in the established antitrust analysis of patent pools and suggests an agenda for future doctrinal development.

II. ANTITRUST CONCERNS IN THE ANALYSIS OF PATENT POOLS

Although they take many different forms, patent pooling arrangements are essentially reciprocal agreements to share patent rights. Because a patent is a right to exclude, the basic legal mechanism for sharing patent rights in a pool is a "mutual agreement among patent owners to waive their exclusive patent rights."[5]

The threshold concern in the antitrust analysis of patent pools is allocative efficiency; that is, in this context, avoiding the deadweight loss of monopoly attributable to the exercise of market power by firms that have combined to share intellectual property rights in a pooling arrangement.[6] Above and beyond the traditional concern with *static* allocative efficiency is that of fostering technical innovation or *dynamic* efficiency.[7] The concern with innovation or dynamic efficiency holds within it at least two conceptually distinct dimensions to be considered in the evaluation of pooling arrangements: First, the encouragement of initial inventive innovation, and second, follow-on or sequential innovation.[8] As will be illustrated by the cases discussed below,

4. MPEG-2, Business Review Letter, 1997 DOJBRL LEXIS 14 (Dep't of Justice Jun. 26, 1997); Summit Technology, Inc., FTC Dkt. No. 9286 (Aug. 21, 1998), available at http://www.ftc.gov/os/1998/d09286viagr.htm.

5. Roger B. Andewelt, *Analysis of Patent Pools Under the Antitrust Laws*, 53 ANTITRUST L. J. 611 (1984).

6. *See generally* Ward S. Bowman, Jr., PATENT AND ANTITRUST LAW: A LEGAL AND ECONOMIC APPRAISAL 1 (1973) (common goal of patent and antitrust law is wealth maximization).

7. One commentator expressed the relative importance of static and dynamic efficiency as follows:

> An antitrust policy that reduced prices by 5 percent today at the expense of reducing by 1 percent the annual rate at which innovation lowers the costs of production would be a calamity. In the long run a continuous rate of change, compounded, swamps static losses.

Frank H. Easterbrook, *Ignorance and Antitrust*, *in* Jorde & Teece, *supra* note 1, at 122-23.

8. On the economics of incremental or sequential innovation, *see, e.g.*, John H. Barton, *Patents and Antitrust: A Rethinking in Light of Patent Breadth and Sequential Innovation*, 65 ANTITRUST L. J. 449 (1997); Jerry R. Green & Suzanne Scotchmer, *On the Division of Profit in Sequential Innovation*, 26 RAND J. ECON. 20 (1995); Howard F. Chang, *Patent Scope, Antitrust Policy, and Cumulative Innovation*, 26 RAND J. ECON. 34 (1995); Robert P. Merges & Richard Nelson, *Market Structure and Technical Advance: The Role of Patent Scope Decisions*, *in* Jorde & Teece, *supra* note 1, at 82. A central and vigorously debated issue in this literature is the socially optimal division of returns among initial innovators and follow-on innovators. *See* Barton, *supra*, at 450-53 (summarizing sources).

pooling arrangements may enhance both static and dynamic efficiency by, for example "integrating complementary technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation."[9] On the other hand, depending on their structure and restraints, patent pools can also reduce static and dynamic efficiency.[10]

Whether a pooling arrangement is likely to be procompetitive or anticompetitive is substantially determined by the economic relationship of the pooled patents. The conventional taxonomy describes the economic relationships among pooled patents as competing, complementary, blocking, or unrelated.[11] Combinations of complements generally establish vertical relationships.[12] Thus the combination of complements in a patent pooling arrangement promises the economic benefits of vertical integration; particularly, the reduction of transaction costs and the elimination of successive monopolies or "double marginalization."[13] In the purest case, the relationship is *completely* vertical if two firms each possess patents that would block the other from using its respective technologies, and it is not possible for either firm to invent around the other's position or challenge its validity or scope.[14] In such a case, the firms would not "have been actual or likely potential competitors in a relevant market in the

9. U.S. Department of Justice & Federal Trade Commission, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY § 5.5 (Apr. 6, 1995)(Hereinafter *IP Guidelines*); *see also* Andewelt, *supra* note 5, at 615-17.

10. *See* Andewelt, *supra note 5*, at 617-619.

11. *See Id.* at 613-14; *see also* BOWMAN, *supra* note 6, at 200 ("Merging of patents, like merging of other assets, may be horizontal, vertical, or conglomerate.").

12. *See IP Guidelines* § 3.3

13. *See generally* W. Kip Viscusi, John M. Vernon & Joseph E. Harrington, Jr., ECONOMICS OF REGULATION AND ANTITRUST 221-24 (1992).

14. The *IP Guidelines* describe the problem of blocking patents as follows:

> Sometimes the use of one item of intellectual property requires access to another. An item of intellectual property "blocks" another when the second cannot be practiced without using the first. For example, an improvement on a patented machine can be blocked by the patent on the machine. Licensing may promote the coordinated development of technologies that are in a blocking relationship. *IP Guidelines* § 2.3.

absence of the license."[15] The connection between blocking relationships and innovation bears emphasis because what is paradigmatically "blocked" in a "blocking" relationship among patents is the practice of an innovative, patented *improvement* upon an existing patented invention.[16] "Blocking" is a well-recognized problem of patent scope that typically arises when an improvement upon an existing patented invention is sufficiently useful, novel, and nonobvious to be patented itself:

> Two patents are said to block each other when one patentee has a broad patent on an invention and another has a narrower patent on some improved feature of that invention. The broad patent is said to "dominate" the narrower one. In such a situation, the holder of the narrower ("subservient") patent cannot practice her invention without a license from the holder of the dominant patent. At the same time, the holder of the dominant patent cannot practice the particular improved feature claimed in the narrower patent without a license.[17]

Where such a blocking relationship exists, a licensing arrangement that permits the practice of the subservient improvement patent encourages sequential innovation and is therefore procompetitive. At the opposite pole, firms would be solely horizontal competitors if their intellectual property were pure substitutes. In that case, price, output, or territorial restraints in connection with a cross-licensing or pooling arrangement could harm competition in the same manner as such restraints among

[15]. *Id.*, § 3.3.

[16]. *See, e.g., Standard Oil Co. (Indiana) v. United States*, 283 U.S. 163, 171 n.5 (1931)(blocking often arises "where patents covering *improvements* of a basic process, owned by one manufacturer, are granted to another")(emphasis added); *Carpet Seaming Tape Licensing*, 616 F.2d 1133, 1142 (9th Cir. 1980)(noting "well-established law that patents on basic processes and products may block patents on improvements to those products and processes"), *cert. denied*, 464 U.S. 818 (1983); *International Nickel Company v. Ford Motor Company*, 166 F. Supp. 551, 565-66 (S.D.N.Y. 1958)(upholding non-exclusive grantback where practice of improvements upon licensed patents would be otherwise blocked); Mark A. Lemley, *The Economics of Improvement in Intellectual Property Law*, 75 TEX. L. REV. 989, 1009-10 (1997)("Blocking" arises where "[t]he original patent owner can prevent the improver from using his patented technology, but the improver can also prevent the original owner from using the improvement."); Andewelt, *supra* note 5, at 614 ("If the practicing of your discovery infringes the patent on the invention that you improved upon, you cannot practice your patent unless you receive a license under that basic patent. In such case, the original patent "blocks" the practicing of your patent.").

[17]. Robert P. Merges & Richard R. Nelson, *On the Complex Economics of Patent Scope*, 90 COLUM. L. REV. 839, 860-61 (1990).

competitors can do so outside the intellectual property context.[18] It follows, then, that the characterization of the economic relationship among pooled patents is crucial to the antitrust analysis of any patent pooling arrangement.

Unfortunately, intellectual property often defies orderly categorization. The relationships among patents may, for example, have both complementary and horizontal aspects.[19] Alternatively, the relationship among some patents may be best described as fundamentally uncertain or indeterminate. In part, this stems from the nature of the patent system. A patent is, after all, no more than a right to exclude based on a recitation of claims allowed by the Patent and Trademark Office; the right to bring an infringement lawsuit. Although it is only infringement litigation that offers a formal test of a patent's exclusionary power, untested perceptions of a patent's breadth or of a patent's "strength" or "weakness" may literally move markets. And as we shall see below, such perceptions can play a crucial part in the formation and conduct of patent pools.

III. SUPREME COURT POOLING CASES

A. *Bement v. National Harrow*: Horizontal Combination Allowed[20]

The first Supreme Court case to apply the Sherman Act to a patent pooling arrangement was *E. Bement & Sons v. National Harrow Co.*[21] In the *Bement* case, the Court favored the economic interests and legal rights of initial patent holders to the virtual exclusion of other important concerns, such as static efficiency and incentives for follow-on innovators. The result was a legal blessing for an industry-wide, price-fixing patent pool that accomplished no apparent integration of complementary technologies.

[18]. *IP Guidelines* § 5.5.

[19]. *Cf.* Bowman, *supra* note 6, at 202 ("[T]he relationship that patents bear to each other is not often an either/or matter. The relationship of patented processes or products can be competing, complementary, or blocking, or a little of each"); *see also* Gilbert Goller, *Competing, Complementary and Blocking Patents: Their Role in Determining Antitrust Violations in the Areas of Cross-Licensing, Patent Pooling and Package Licensing*, 50 J. PAT. OFF. SOC'Y 723 (1968).

[20]. Portions of this discussion have been adapted from Willard K. Tom & Joshua A. Newberg, *Antitrust and Intellectual Property: From Separate Spheres to Unified Field*, 66 ANTITRUST L. J. 167 (1997).

[21]. 186 U.S. 70 (1902).

The technology at issue in *Bement* -- a farming implement called a "float spring tooth harrow" -- was the subject of several patent infringement suits among various manufacturers in the late 1880s and the first months of 1890. In September of 1890, six of the firms that had been parties to the patent infringement litigation settled their lawsuits and agreed to assign their float spring tooth harrow patents -- eighty-five in all -- to the newly-formed National Harrow Company (National Harrow). In exchange for assigning their patents to National Harrow, the six firms received shares in the Company and a license to manufacture and sell float spring tooth harrows. The pool quickly grew from six to twenty-two firms accounting for over 90% of float spring tooth harrow production and sales in the United States. The pooling agreement contained numerous restrictions and obligations, three of which bear particular attention. Pool members were: (1) obliged to pay to National Harrow a one-dollar royalty for each harrow sold, (2) required to adhere to a price schedule set by National Harrow, and (3) obligated to manufacture and sell only the type of harrow they had been manufacturing at the time they entered into the license with National Harrow. When one of the pool members -- E. Bement & Sons -- refused to follow the price schedule, National Harrow sued for breach of contract. Bement raised the defense that the contract by which it had joined the pooling arrangement was invalid and unenforceable because it violated the Sherman Act. Holding for National Harrow, the Supreme Court explained:

> ... [T]he general rule is absolute freedom in the use or sale of rights under the patent laws of the United States. The very object of these laws is monopoly, and the rule is, with few exceptions, that any conditions which are not by their very nature illegal with regard to this kind of property, imposed by the patentee and agreed to by the licensee for the right to manufacture or use or sell the article, will be upheld by the courts. The fact that the conditions in the contracts keep up the monopoly or fix prices does not render them illegal.[22]

In its reasoning, the Court begins with the premise that a patent confers a "monopoly." The patent "monopoly" here is not the same as the economic "monopoly" in current antitrust analysis of market power.[23] It is rather the bundle of exclusionary rights granted by society to the

[22]. *Id.* at 91 (emphasis added).

[23]. *See, e.g., IP Guidelines* § 2.2 (defining "market power" as "the ability to maintain prices above, or output below, competitive levels for a significant period of time").

patentee in exchange for the benefits of inventive activity.[24] In the opinion of the *Bement* Court, that "bundle" included the rights to combine with other patentees in industry-wide pooling arrangements.[25] Intertwined with the arguments based on the rights of the patent holder, the Court articulated several additional justifications for the restraints in the patent pooling agreement: The pool provided the basis for settling "a large amount" of infringement litigation; in its view, "a legitimate and desirable result in itself."[26] Fixing the sale price of the manufactured harrows was also "appropriate and reasonable," given the "nature" and "value" of the implements, and the patent holder's right to set the price at which a licensee sells a product manufactured with the licensed patent.[27] Even the restriction that barred any pool member from using any technology other than that which he had contributed to the pool was lawful: first, because the restraint "had no *purpose* to stifle competition," nor to "prevent the licensee from attempting to make any improvement in harrows"; and second, because the prohibition prevented Bement from infringing the patents of other pool members.[28]

Although *Bement* has an internal philosophical coherence that follows from the Court's expansive understanding of the patentee's rights, the decision is fundamentally flawed. It is instructive, nevertheless, for the analytical issues it raises. One threshold problem with the opinion is its failure to inquire rigorously into the economic relationship among the pooled patents and relevant market or markets affected by the pooling arrangement. Although the Supreme Court's opinion is ambiguous as to the precise economic relationship of the pooled patents, factual accounts in lower court cases strongly suggest that most or all of the National Harrow pool members held patents covering *competing* methods or designs for manufacturing float spring tooth harrows.[29] It also seems likely that the pool included some complementary patents of use in manufacturing float spring tooth harrows. But since the pool prohibits members from integrating the complementary patents of other members, no economic benefit was realized from "combining" the complements in the National Harrow pool.

What are the relevant markets for purposes of analyzing the effects of the National Harrow patent pool? There appear to be two: A "technology" market for patents covering the manufacture of float

[24]. *Bement*, 186 U.S. at 88-89.

[25]. *Id.* at 91, 93.

[26]. *Id.* at 93.

[27]. *Id.*

[28]. *Id.* at 94 (emphasis added).

[29]. *See generally* National Harrow Co. v. E. Bement & Sons, 47 N.Y.S. 462 (1897); National Harrow v. Hench, 76 F. 667 (E.D. Pa. 1896).

spring tooth harrows, and a "goods" market for the harrows themselves. A technology market is appropriate in this case because there seem to have been market transactions for the patents (manufacturers buying, selling, and licensing harrow patents) that were separate and distinct from the sales of the manufactured harrows to wholesalers or directly to farmers.[30] Indeed, the pool itself may be understood as a transaction in the technology market. Of course float spring tooth harrow technology and float spring tooth harrows would constitute relevant markets only if there were no close substitutes for them. Although the record is less than complete on this issue, it suggests that float spring tooth harrows were the state of the art at the turn of the century. As Judge Follett of the New York Supreme Court's Appellate Division explained:

> A harrow is an implement as important and as generally used by farmers as a plow, and is quite as necessary for the proper cultivation of land as any other agricultural implement, and is in use on every properly cultivated farm. Float spring tooth harrows have come into general use and have largely superseded the old-fashioned square and three-cornered harrows or drags having peg teeth . . . .[31]

The National Harrow patent pool, then, appears to have been a cartel arrangement that combined substantially all of the patented technologies for the manufacture of a product for which there were no close substitutes. The pool fixed the downstream sale price of the manufactured harrows as well, and, as noted earlier, flatly prohibited follow-on innovation by barring pool members from using any technology other than that which they had brought with them when they joined the pool. The anticompetitive effects of the Harrow pool were probably not appreciably different from the anticompetitive effects of most other agreements among competitors exercising market power; *i.e.*, supracompetitive prices, reduced output, and/or reduced innovation. In the technology market, in the absence of the pool, the holders of different float spring tooth harrow patents might have competed for manufacturer licensees. Prospective licensees might have engaged in bidding for licenses to the patented technologies they judged to be most efficient. In the downstream goods market, in the absence of the pool restraints, harrow manufacturers -- whether they were technology licensees or patent holders themselves -- would have

[30]. *IP Guidelines* § 3.2.2 (Technology markets consist of the intellectual property that is licensed [the 'licensed technology'] and its close substitutes--that is, the technologies or goods that are close enough substitutes significantly to constrain the exercise of market power with respect to the intellectual property that is licensed).

[31]. *National Harrow*, 1897 N.Y. App. Div. LEXIS 2013 at **14.

been free to compete on price and, by means of licensing complementary technology, to improve their products. On the other side of the ledger, the pool allowed float spring tooth harrow patent holders -- initial innovators and their assignees -- to profit from the technologies they had patented. Allowing patent holders to profit from their inventions is, to borrow Justice Peckham's phrase, "a legitimate and desirable result in itself," in that it rewards initial innovation. But by pooling competing patents, National Harrow's shareholders placed themselves in a position to receive a return on the pooled patents that would have likely included a supracompetitive premium in excess of that which the individual patent holders would have been able to extract in a competitive technology market. Also, since National Harrow appears to have devoted substantial resources to the legal enforcement of the pooling agreement, it is unclear whether the pool resulted in a net reduction in litigation.

It seems, then, that the expansively interpreted "rights" of the National Harrow patent holders were favored at the cost of the deadweight loss of monopoly. From what can be surmised at a distance of a hundred years, the anticompetitive effects of the National Harrow patent pool almost certainly outweighed its likely procompetitive benefits.

B. *Standard Oil (Indiana) v. United States*: Problems of Characterization

In *Standard Oil Co. (Indiana) v. United States*,[32] (also known as the "*Cracking Patents*" case) the Supreme Court reviewed several cross-licensing arrangements among four firms that held patents relating to the refinement of petroleum into gasoline.[33] The case pointedly illustrates the problems of determining the relevant markets and the economic relationships of pooled patents, and the very confused state of the law. Although it is almost certainly the leading Supreme Court case on the subject, upon close analysis, it reads more like a cautionary tale of how easy it is to mishandle the basic analytical questions presented by patent pools.

"Cracking" is the controlled application of heat and pressure to crude oil in order to increase the yield of gasoline from the refining process.[34] First patented in 1913, the process achieved a very

[32]. 283 U.S. 163 (1931).

[33]. *Id.* at 166-67.

[34]. For discussion of the factual background of the *Cracking Patents* case, see generally Bowman, *supra* note 6, at 203; John S. McGee, *Patent Exploitation: Some*

substantial increase in the efficiency of gasoline refining, when compared with the then-existing methods. Within a few years, several other cracking methods were patented and successive rounds of infringement litigation followed in short order. By the early 1920s, four firms emerged as the leading cracking patent holders: Standard Oil of Indiana, Standard Oil of New Jersey, the Texas Company, and the Gasoline Products Company. In hopes of preventing future litigation amongst themselves, these firms entered into a series of cross-licensing[35] agreements with each other in several different combinations, which for simplicity we will treat as a single agreement. Under the terms of the agreement, the four licensed each other's cracking patent portfolios. Each could practice the other's patents without fear of infringement and each could license the patents of other pool members to third-party licensees outside the pool.[36] In consideration for licensing their patents to third parties, the pool members received royalties set as part of the pooling arrangement.

The Justice Department sued the pool members in 1924 charging a horizontal price-fixing conspiracy in violation of the Sherman Act. Applying rule of reason analysis to the pooling arrangement, the Supreme Court held in favor of the pool members.[37] The case is widely, and properly, cited for the proposition that patent pools are to be analyzed in most cases under the rule of reason. But it is also frequently cited for the far less certain proposition that patent pools do not offend the antitrust laws if they are entered into in order to resolve blocking relationships. The source of this latter interpretation is the Court's statement in a single footnote that cross-licensing agreements settling "legitimately conflicting claims" are not precluded by the Sherman Act and "are frequently necessary if technical advancement is not to be blocked by threatened litigation."[38] The footnote continues:

> This is often the case where patents covering improvements of a basic process, owned by one manufacturer, are granted to another. A patent may

Economic and Legal Problems, 9 J. L. & ECON. 135 (1966); John Lawrence Enos, PETROLEUM PROGRESS AND PROFITS: A HISTORY OF PROCESS INNOVATION (1962).

35. Because a cross-license is the basis of any patent pooling arrangement, this paper uses the terms "patent pool" and "cross-licensing arrangement" interchangeably.

36. The licensees were oil refiners who used the processes embodied in the pooled patents to refine oil into gasoline more efficiently.

37. The Court held that the cross-licenses, which had been entered into in order to settle infringement and interference litigation, were not unlawful because they did not create monopoly power for the members of the pool. *Standard Oil*, 283 U.S. at 167-68 & 176-79.

38. *Id.* at 171.

> be rendered quite useless, or "blocked," by another unexpired patent which covers a vitally related feature of the manufacturing process. Unless some agreement can be reached, the parties are hampered and exposed to litigation.[39]

Sound and sober though these words may be, they bear little relation to the Court's legal analysis of the case. This is because Justice Brandeis, writing for the Court, quite clearly identifies the pooled intellectual property not as complementary, much less *blocking* patents, but as "*competing* patented processes."[40] A third possibility -- that these patents may have been competing, but sufficiently overlapping to provide a non-trivial basis for litigation -- is broadly consistent with the facts of the case, but entirely unexamined by the Court.

As an analysis of a horizontal combination of competing patents, the opinion is a frustrating series of useful principles articulated and missed opportunities for their application. The first useful principle is the above-quoted language on blocking patents. But, as already noted, the Court does not analyze the patents at issue in the case as blocking. The second useful principle is the application of the rule of reason to patent pooling arrangements. The purpose of the rule of reason is to inquire into all relevant facts in order to determine whether the procompetitive benefits of a business arrangement outweigh its anticompetitive effects. In the case of patent pools, which will often be efficient combinations of complementary assets, such analysis of costs and benefits is likely to be an appropriate use of judicial resources. In this case, however, the Court, like the drunk who searches for his lost keys only under the light of the street lamp, looked in the wrong place for anticompetitive effects and found none.

The Court looked at the pooling agreement and the licenses to third-party licensees and found no evidence of price or output restraints. The pool did not fix the price of the gasoline refined and sold by its licensees, nor did it restrict the number of licensees or their output. Pool members were free to license their own patents to third parties if they chose and were under no obligation to license the pooled patents as a single package. The Court also looked at the pool members' combined share of the gasoline market and found no evidence of "dominance." From the spotty and outdated record before the Court, Justice Brandeis determined that the defendant firms accounted for approximately 55% of cracking capacity and that cracked gasoline accounted for only 26% of total gasoline production. Based primarily on this relatively small share of total gasoline production,

39. *Id.* at 171 n.5.

40. *Id.* at 176.

Brandeis appears to have misapplied the third useful principle articulated in the opinion; that is, that a patent pooling agreement among competitors that does not confer market power, can be, like some horizontal mergers, competitively benign or even procompetitive.

The Court's actual conclusion that the *Cracking Patent* pool members lacked market power may or may not have been correct. But it was almost certainly based on a competitive analysis of the wrong market. Although three of the four pool members were refiners as well as patent holders, the pool was not in the business of selling *gasoline*. The pool was in the business of selling the right to use cracking *technology*. It is appropriate, then, to look for market power and anticompetitive effects in the *technology* market.[41] Although the record is incomplete, it suggests that the pool members' share of the technology market -- measured in terms of gasoline refined under their patented processes -- may have been over 90%.[42] By pooling the leading cracking processes and leaving only straight-run methods and inefficient cracking processes -- that is, processes that were not close substitutes -- outside of the pool, the defendant firms may well have gained market power in the technology market.

By focusing on the downstream market, Justice Brandeis missed the possible anticompetitive effects of the pool, which may have included a supracompetitive premium on the royalties charged for the pooled patents. Also missed, and of potentially greater concern, were the possible effects of the pool on innovation incentives. As independent competitors, it would have been in the interests of the pool members to continue to innovate in order to gain advantage over one another in the competition for licensees. As members of the pool, the four firms could package and license each other's patents and thereby share in royalties that they may or may not have earned individually as independent firms. The incentive to engage in follow-on innovation to improve the pooled processes may have therefore been lessened.

As precedent, then, it is not clear what the *Standard Oil* case teaches beyond the general point that the rule of reason should be applied to the analysis of patent pools, which, as we will see below, did not constrain the Court in the *Line Materials* case seventeen years later. As a cautionary tale, however, it highlights the uncertainty that can often confront decision-makers seeking to evaluate actual patent pools.

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41. *See IP Guidelines* § 3.2.2 ("Technology markets consist of the intellectual property that is licensed . . . and its close substitutes."). For an extended discussion of the application of antitrust technology market analysis to the *Cracking Patents* case, see Joshua A. Newberg, *Antitrust for the Economy of Ideas: The Logic of Technology Markets*, 14 HARV. J. L. & TECH. __ (forthcoming 2001).

42. *See* George L. Priest, *Cartels and Patent License Arrangements*, 20 J. L. & ECON. 309, 329 (1977)(reviewing analyses of *Cracking Patents* market data).

The economic relationship of the pooled cracking patents had a substantial horizontal component. But the pool was, at least in some part, a response to years of infringement litigation and the threat of much more to come. That suggests, as noted above, that some of the patents may have been competing, but arguably overlapping. What then? It is a question worth considering when the two modern high-technology patent pools are discussed below.

C. *United States v. Line Materials*: The Problem of Blocking Patents

If *Standard Oil* is the competing patents case that is always cited for what it says about blocking patents, *United States v. Line Materials Co.*[43] is the blocking patents case that is rarely cited for what it says about blocking patents. The holding of *Line Materials* -- that a patent pool established to resolve a blocking relationship between a dominant patent and a far more efficient improvement patent is *per se* unlawful -- is defended by no one.[44] Indeed, the FTC and DOJ enforcement guidelines implicitly, but quite unmistakably, reject its holding.[45] Yet it remains the law of the land.

In *United States v. Line Materials Co.*,[46] the Supreme Court reviewed a cross-licensing arrangement between two manufacturers of electrical equipment: Line Materials Company and Southern States Equipment Corporation. Southern held a patent covering a dropout fuse with a complicated and expensive mechanism to break electric circuits when the current becomes excessive.[47] Although Line patented a simpler and less expensive version of the dropout fuse release mechanism, it could not be used without infringing Southern's patent.[48] To resolve the blocking position, Line and Southern entered into a cross-licensing arrangement and further agreed to sublicense their combined patents to several third-party licensees.[49] Line, Southern, and the parties to the sub-license arrangements agreed to minimum

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43. 333 U.S. 287 (1948).

44. George Priest has raised the possibility that the Court may have mischaracterized the patents and that the pooling arrangement may "disguise a cartel agreement." Priest, *supra* note 42, at 357 n.5. But the only evidence he offers is the low royalty rate charged to one of the pool's principal licensees. *Id.*

45. *IP Guidelines* §§ 3.4 & 5.5.

46. 333 U.S. 287 (1948).

47. *Id.* at 290 n.4.

48. After an interference proceeding, the Patent Office had awarded "dominant claims to Southern and subservient claims to Line." *Id.* at 291 n.5 ("Only when both patents could be lawfully used by a single maker could the public or the patentees obtain the full benefit of the efficiency and economy of the inventions.").

49. *Id.* at 292-93, 297.

price levels for the sale of circuit breakers made with the patents Line and Southern had cross-licensed.[50]

The Supreme Court held that the parties had engaged in price-fixing in violation of the Sherman Act. In the Court's view, the price fixing was obvious: "[b]y the patentees' agreement the dominant . . . and the subservient . . . patents were combined to fix prices."[51] The issue, therefore, was whether the patent laws provided defendants with immunity from the antitrust laws,[52] for "[i]n the absence of patent or other statutory authorization, a contract to fix or maintain prices in interstate commerce has long been recognized as illegal *per se* under the Sherman Act."[53] The Court concluded that there was no such immunity, explaining "that the possession of a valid patent or patents does not give the patentee any exemption from the provisions of the Sherman Act *beyond the limits of the patent monopoly*."[54]

The Court acknowledged both that, but for the cross-licensing arrangement, the blocking positions of the relevant patents made it impossible for "the public or the patentees [to] obtain the full benefit of the efficiency and economy of the inventions"[55] and that the patents cross-licensed by Line and Southern were "not commercially competitive."[56] Nevertheless, finding "no suggestion in the patent statutes of authority to combine with other patent owners to fix prices on articles covered by the respective patents,"[57] the Court reasoned that such an arrangement was "outside the patent monopoly" and unlawful.[58]

If the Line and Southern patents were valid and blocking, it is difficult to find merit in the Court's *per se* condemnation of the licensing arrangement. In *Line Materials,* the patent holder's loss is society's loss. If in the absence of the Line/Southern pooling arrangement, no others attempt to combine these patents, the value of Line's more efficient circuit breaker will be lost and future innovation is discouraged. If, as is more likely, others attempt to combine the two patents by concluding separate bargains with Line and Southern, the

[50]. *Id.* at 293-297.

[51]. *Id.* at 307.

[52]. *Id.* at 309 (citing *Bement*, 186 U.S. at 92)("The Sherman Act was enacted to prevent restraints of commerce but has been interpreted as recognizing that patents were an exception.").

[53]. *Id.* at 307 (footnotes omitted).

[54]. *Id.* at 308 (emphasis added).

[55]. *Id.* at 291 & 297. *See also* Priest, *supra* note 42, at 356-58 (discussing *Line Materials* and procompetitive aspects of cross-licensing complementary and blocking patents).

[56]. *Line Materials,* 333 U.S. at 311.

[57]. *Id.* at 312.

[58]. *Id.*

cost is likely to be higher and the output lower than would have been the case under the pooling arrangement because of the successive monopoly or "double marginalization" problem.[59]

In choosing to apply the *per se* rule, the Court focused only on the classification of the horizontal price restraint and refused to give any weight to efficiency arguments. Given that it was the fixing of the downstream prices of the circuit breakers manufactured by Line's licensees that moved the Court to condemn the entire arrangement as *per se* unlawful, it is worth exploring whether Line and Southern might have chosen any less restrictive licensing alternatives. One less restrictive alternative is a simple cross-license, with no agreements on price of any kind. The Court might have accepted such an alternative, but it would have left Line and Southern worse off than the arrangement condemned by the Court and perhaps not much better off than if they concluded no license at all. With such a cross-license, Line and Southern would become competitors in the combined technology and there would be no way -- short of the very collusion condemned by the Court -- to keep from competing away the monopoly rents of the combination.[60] Another alternative would be the same cross-license with an additional term by which Line and Southern would agree upon the royalty to be charged to third-party licensees of the combined patents, but would not set the downstream sale price of circuit breakers manufactured by the pool's licensees. Under this scenario, Line and Southern would not be competitors in the licensing of the technology, so they could share the rents from the combined patents. At the same time, the licensees of the Line/Southern pool would face a fixed input price for the combined patents, but would be free to compete on the sale price of the finished circuit breaker. Under a rule of reason analysis (especially one that gives due consideration to innovation incentives), a court should conclude that the procompetitive benefits of such an arrangement outweigh any anticompetitive effects.[61] But under *Line Materials*, the arrangement would be condemned as *per se*

[59]. *See Dennis W. Carlton & Jeffrey M. Perloff*, MODERN INDUSTRIAL ORGANIZATION 527 (1990)([B]oth consumers and firms are worse off with successive monopolists than when there is a single, integrated monopolist.); *F.M. Scherer & David Ross*, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 489 (3d ed. 1990) (same).

[60]. *See* Priest, *supra* note 42, at 357.

[61]. Indeed, under rule of reason analysis, a court should conclude that the original arrangement condemned by the *Line Materials* Court is lawful. Even if downstream prices are fixed -- a restraint for which there may be independent procompetitive justifications in the patent pooling context -- the *Line Materials* pool is output-enhancing when compared with no exploitation of the combined patents or double marginalization.

unlawful because of the agreement to "fix" the royalties charged to licensees, without any balancing of competitive effects.

If the Supreme Court's antitrust analysis of patent pools resolving blocking relationships is to facilitate wealth maximization and technical advance, *Line Materials* must be overruled.

D. The *BMI* Case: Procompetitive Horizontal Price-Fixing

Broadcast Music, Inc. v. Columbia Broadcasting System[62] (*BMI*) concerns a copyright pooling arrangement. In it, the Supreme Court applies a rule of reason inquiry to a facially anticompetitive horizontal price-fixing agreement to find the procompetitive substance behind the troubling facade. Although it is relevant to the present discussion, for reasons that are discussed below, the case has not resolved the problems in patent pooling analysis raised by *Standard Oil* and *Line Materials*.

In *BMI* the Court reviewed a private plaintiff's antitrust challenge to the "blanket" licensing of music copyrights. Broadcast Music, Inc. (BMI) and the American Society of Composers, Authors and Publishers (ASCAP), serve as the nonexclusive licensing agents for thousands of composers for whom BMI or ASCAP also monitor usage, prosecute infringement, and collect and distribute royalty income.[63] Under the type of blanket license challenged in the *BMI* case, licensees, such as the CBS television network, pay a fee for the rights to broadcast any of the works in the repertories of BMI or ASCAP, for a fixed period of time, regardless of how many compositions are actually used or how often the works are broadcast. Under the blanket broadcast licenses at issue in the *BMI* case, then, the fee paid by CBS as a blanket licensee was not based on charges for specific uses of specific compositions. Rather, in exchange for the right to broadcast any ASCAP and (under a separately negotiated license) any BMI composition at any time during the term of the blanket licenses, CBS agreed to pay ASCAP and BMI a fixed percentage of the network's broadcast advertising revenue.[64] Although CBS and the individual composers whose works were broadcast by the blanket licensee were free to enter into individual per-performance licensing agreements, CBS argued that the BMI and ASCAP blanket licensing arrangements

62. 441 U.S. 1 (1979).

63. CBS v. ASCAP., 400 F. Supp. 737, 742 (S.D.N.Y. 1975) ("As a practical matter virtually every domestic copyrighted composition is in the repertory of either ASCAP . . . or BMI"), *rev'd*, 562 F.2d 130 (2d Cir. 1977), *rev'd sub. nom.*, BMI v. CBS, 441 U.S. 1 (1979).

64. 400 F. Supp. at 743.

amounted nevertheless to *per se* unlawful price fixing in violation of the Sherman Act.[65] More specifically, CBS contended that BMI and ASCAP were "'using the leverage inherent in [their] copyright pool to insist that . . . [blanket licensees] pay royalties on a basis which . . . [did] not bear any relationship to the amount of music performed.'"[66]

The U.S. Court of Appeals for the Second Circuit, in its opinion finding that the *BMI* licensing arrangements violated Section 1 of the Sherman Act, analogized the blanket broadcast licenses to the patent pooling agreement that had been condemned as per se unlawful price-fixing in *United States v. Line Materials, Inc.*[67] Looking beyond the form of the arrangement and refusing to accept the "price-fixing" label as a basis for *per se* condemnation of blanket broadcast licensing, the Supreme Court reversed the Second Circuit, holding that the legality of the licensing arrangement was to be determined under the rule of reason. The Court observed that "ASCAP [and BMI] and *the blanket license developed together out of the practical situation in the marketplace*;"[68] a marketplace in which the transaction costs of separately negotiating rights with respect to each individual musical composition are, for even the largest customers, prohibitively high.[69] The Court's inquiry into actual market conditions and competitive effects revealed no indication that much, if any, competition that might have existed but for the blanket licenses, had been materially restrained. Nothing, moreover, prevented individual customers from licensing compositions directly from individual composers or through other agents on a non-exclusive basis.[70] The actual effect of blanket licensing through ASCAP and BMI was rather to create competition that would otherwise have been stymied because of prohibitively high transaction costs.[71]

The contrast between the *BMI* analysis and the condemnation of the patent pooling arrangement in the *Line Materials* case is

65. At trial, price fixing was just one of five claims CBS asserted in challenging the blanket licenses. The television network also argued that the blanket licensing arrangements constituted unlawful tying, a concerted refusal to deal, monopolization, and copyright misuse. *Id.* at 745.

66. *Id.* (quoting from the CBS complaint).

67. *CBS*, 562 F.2d at 136 ("There is . . . some analogy to the patent pooling cases which broadly hold that the pooling of competing, and perhaps even non-competing, patents is illegal.") (citing, *inter alia*, United States v. Line Materials, 333 U.S. 287 (1948)).

68. *BMI*, 441 U.S. at 20 (emphasis added).

69. *Id.* at 20-21.

70. *CBS*, 400 F. Supp. at 744-45 (ASCAP and BMI licensed their repertories on a non-exclusive basis allowing any composer to license performance rights to his works to any other non-exclusive licensee.).

71. *BMI*, 441 U.S. at 19.

instructive. Presented with evidence in the earlier case that a patent pooling arrangement may have resolved a blocking relationship and thereby provided for the diffusion of a superior product at a lower price, the *Line Materials* Court subjected the agreement to *per se* condemnation and eschewed any serious inquiry into whether the restraint might have been procompetitive on balance.[72] As the *BMI* Court noted, a literal approach to application of *per se* rules is "overly simplistic and often overbroad."[73] The *BMI* Court looked beyond the mere classification of the restraints: *Price-fixing* this certainly was. But a careful study of the exigencies of the music licensing industry suggested that the price-fixing of BMI's blanket license could be procompetitive. The blanket license was also a massive agreement among competitors -- *i.e.,* all of the participating composers -- under the direction of a single entity. But this was not the National Harrow Company. All of the composers remained free to license their works to anyone else in any manner they chose. In the absence of a BMI or an ASCAP, however, individual composers had not been able to maximize the licensing of their works because the transaction costs were simply too high for individual composers to bear. Thus, practically speaking, in the absence of the pool, most of the composers would not have been actual horizontal competitors. Competition therefore was not restrained. Nor was there any evidence that licensing prices were higher than they would have been in the absence of the pool. In the absence of a BMI, most of the music licensing transactions that now take place, would not have occurred at all. Moreover, BMI almost certainly realized substantial efficiencies in its provision of monitoring, enforcement and management services. Finally, innovation was rewarded as composers were more likely to receive royalties for the use of their works without incurring the costs of licensing individually and hence inefficiently.

Does *BMI* lift the doctrinal burdens of the earlier cases? Regrettably, it does not. *BMI* was not a patent case. Thus its application to the patent pooling context is uncertain at best. *BMI*, moreover, does not overrule *Standard Oil* or *Line Materials*, both of which remain the leading Supreme Court patent pooling cases. Perhaps most importantly, the courts and the antitrust enforcement agencies have been unwilling to embrace the full implications of *BMI*. Indeed, the case has been strangely marginalized by the widely-held view that the Supreme Court only applied rule of reason analysis (as opposed to *per se* condemnation) to the horizontal restraints in *BMI* because those restraints effectively resulted in the creation of a "new product;" *i.e.,*

[72]. *See generally Line Materials,* 333 U.S. at 287.
[73]. *BMI,* 441 U.S. at 8-9.

the blanket license for copyrighted music. If one interprets *BMI* broadly to apply the full import of its analysis, the rule of reason would apply even to patent pooling arrangements that include horizontal agreements on price. However, under the narrow interpretation of *BMI*, such pooling arrangements would only be accorded rule of reason treatment if it could be demonstrated that the restraints themselves create a new product. For these reasons, then, *BMI* remains persuasive -- albeit highly persuasive -- rather than mandatory authority for the antitrust analysis of patent pools.

IV. TWO HIGH-TECHNOLOGY PATENT POOLS

In this section, the discussion turns to two high-technology patent pools that were reviewed by the antitrust enforcement agencies within the past few years. The *MPEG-2* pool, which was the subject of a Justice Department Business Review Letter, was pronounced lawful and procompetitive, while the *Summit/VISX* pool was challenged by the Federal Trade Commission. While it may be tempting to portray the MPEG-2 pool as the model citizen and Summit/VISX as the outlaw, the reality is both more interesting and more troubling.

A. MPEG-2: "THE MODEL CITIZEN"

The MPEG-2 patent pool, having been structured and favorably reviewed under the DOJ and FTC *IP Guidelines*, is an example of how a patent pool may be organized and administered to meet the concerns of current antitrust enforcement policy regarding pooling arrangements.[74] The pool is an agreement among nine patent holders[75] to combine 27 patents that are needed to meet an international standard known as "MPEG-2 video compression technology."[76] Under the agreement, the patent holders all license their MPEG-2 patents to "MPEG LA," a licensing agent which administers the pool on their behalf. MPEG LA licenses the 27-patent portfolio to third parties who manufacture products to meet the MPEG-2 standard. The products that use the MPEG-2 patents as inputs are those that store or transmit video

[74]. MPEG-2, Business Review Letter, 1997 DOJBRL LEXIS 14 (Dep't of Justice Jun. 26, 1997).
[75]. The pool members are Fujitsu, Mitsubishi, Philips, Columbia University, General Instrument, Lucent, Scientific Atlanta, Matsushita, and Sony.
[76]. *Id.* at *1 ("The technology standard eliminates redundant information . . . reducing the amount of data, storage and transmission space required to reproduce video sequences").

information: televisions, digital video disk players, telecommunications equipment, as well as cable satellite and broadcast equipment.

In structure, the *portfolio license* is broadly analogous to the *blanket license* that was analyzed in the *BMI* case.[77] On the procompetitive side of the ledger, the pooling arrangement brings together complementary inputs (the 27 MPEG-2 patents), reduces transaction costs (by creating a mechanism for one-stop shopping for most of the patents required to meet the MPEG-2 standard), and promotes the dissemination of new technology. But what of its anticompetitive effects? Because no firm can make a product that meets the MPEG-2 standard without infringing one or more of the pooled patents, there are grounds for concern. Does the pool anticompetitively exclude or disadvantage rivals, facilitate collusion, or reduce innovation incentives?

Several provisions of the arrangement substantially reduce the likelihood that the pool will anticompetitively disadvantage rivals. First, the agreement commits the licensors to extend the portfolio license on nondiscriminatory terms to any party requesting a license.[78] Second, although MPEG LA only licenses the portfolio as a package, any of the pooled patents may be licensed from the pool members individually.[79] Thus, a firm that does not wish to license all 27 patents need only pay for the patents it requires. Third, the patent pool is structured to reduce the likelihood of anticompetitive overbreadth. According to the agreement, the pool is limited to "essential" MPEG-2 patents, i.e., those complementary patents "necessary for compliance with the MPEG-2 standard."[80] Neither substitutable patents nor non-essential complementary technologies meet the requirements for inclusion in the pool.[81]

The structure of the agreement also minimizes the dangers that it will facilitate collusion among the licensors. Confidentiality provisions prohibit the licensing agent "from transmitting competitively sensitive information among the Licensors or other licensees."[82] The Justice Department concluded, moreover, that "since the contemplated royalty rates are likely to constitute a tiny fraction of MPEG-2 products' prices, at least in the near term, it appears highly unlikely that

[77]. *See supra* Part III.D.

[78]. MPEG-2, 1997 DOJBRL LEXIS at *9.

[79]. *Id.* at 15.

[80]. *Id.* at 8 n.4.

[81]. The licensors agree to submit all disputes regarding the "essentiality" of any patent, within or without the pool, to an independent patent expert whose determinations regarding continuing inclusion and exclusion of patents are binding upon pool members. *Id.* at 12-13.

[82]. *Id.* at 24.

the royalty rate could be used during that period as a device to coordinate the prices of downstream products."[83]

Finally, nothing in the pooling arrangement appears to impose anticompetitive restraints on the development of improvements or new products and technologies. There are no provisions limiting any licensor or licensee to the use or development of the technology covered by the pooling arrangement, nor are any of the improvements developed by any licensors or licensees subject to grantback provisions.[84]

Before drawing any ultimate conclusions about MPEG-2, consider the unhappy story of the Summit/VISX patent pool.

B. The Summit/Visx Patent Pool[85]

1. Background

The technology at issue in the Summit/VISX matter is laser refractive surgery (also referred to as "Photorefractive Keratectomy" or "PRK"). PRK is a revolutionary surgical procedure in which the most common refractive errors -- nearsightedness, farsightedness, and astigmatism -- are corrected by the application of computer-controlled pulses of excimer laser light to the surface of the cornea. The excimer removes extremely precise amounts of corneal tissue by means of a process called "photochemical ablation" or "ablative

[83]. *Id.*

[84]. While licensees are not subject to any general grantback provisions, licensors are obligated to license to the pool any patent that is determined by the independent expert to be "essential." *Id.* at 26. However, improvement patents and technological alternatives to "essential" patents are not subject to the mandatory licensing requirement. *Id.* at 26 n.47.

[85]. The FTC enforcement action against Summit and VISX began with the filing of a 3-count complaint. 1998 FTC LEXIS 29 (filed Mar. 24, 1998)(administrative complaint). The complaint charged that: (1) the patent pooling arrangement between Summit and VISX – by which the firms agreed, *inter alia,* to cross-license several PRK-related patents – was an agreement in restraint of trade; (2) the agreement and related conduct constituted a conspiracy to monopolize markets for the sale of PRK equipment and the licensing of PRK technology; and (3) VISX had fraudulently procured a key PRK industry patent by withholding relevant information from the Patent and Trademark Office. *Id.* ¶¶ 25-30. Summit and VISX entered into consent agreements with the Commission settling Counts 1 and 2 of the administrative complaint, covering the issues involving the patent poling arrangement between Summit and VISX. *Summit Technology, Inc. and VISX, Inc.*, FTC Dkt. No. 9286 (filed Feb. 23, 1999)(decision and order). Administrative proceedings against VISX continued pursuant to Count 3 of the complaint and an Administrative Law Judge (ALJ) dismissed the remaining Count in May of 1999 after an administrative trial. *VISX, incorporated*, FTC Dkt. No. 9286 (filed May 27, 1999)(initial decision), available at, http://www.ftc.gov/os/1998/d09286viagr.htm.

photodecomposition." In this process, light from the far ultraviolet range of the spectrum interacts with corneal tissue to break the chemical bonds of the molecules non-thermally and without damage to surrounding tissue. The struggle to develop and commercialize this technology has been rife with conflict that has frequently spilled over into litigation.

In the mid-1980s, several firms began research and development of excimer lasers suitable for use in PRK. Because the lasers require approval by the Food & Drug Administration before they can be used for PRK, the long and expensive clinical trials required before FDA approval constitute a major obstacle for excimer laser firms. By the early 1990s, two firms -- Summit Technology and VISX Incorporated -- had taken the lead in the development of lasers for refractive surgery. Both had excimer lasers in FDA clinical trials and both had patents covering various aspects of the emerging PRK industry. These patents may be classified very broadly for the sake of simplicity as "method" patents covering the surgical methods used to perform PRK, and "apparatus" patents which covered the excimer laser hardware. With each of the firms vying for capital to finance the long lead time from prototype, through clinical trials, to FDA approval, Summit and VISX tried to make educated guesses about the relative scope of each other's patent portfolios based on very limited information. The stakes were potentially very high: If it was determined that the machine or process one firm was developing was within the scope of the other firm's patents, that other firm might have the power to exclude the infringing firm from the market altogether.

2. Pool Structure, Restraints, and Conduct

Against this background in June of 1992, Summit and VISX announced the formation of a patent pooling arrangement called the Pillar Point Partnership ("PPP"). Pursuant to the partnership agreement, Summit and VISX each assigned all of their PRK and PRK-related patents to PPP, and PPP licensed back the entire pooled portfolio to each of the two partners. The agreement included several other restraints: Each of the partners would be permitted to sub-license the patent portfolio to purchasers of their respective lasers. Thus, when Summit sold an excimer laser to an ophthalmologist, Summit would extend a non-exclusive sub-license to the physician so that the laser machine and PRK methods could be used without infringing the pooled patents. Both Summit and VISX further agreed that each time a procedure was performed on a Summit or VISX laser, Summit or VISX would pay a $250 per-procedure fee ("PPF") into the pool. Once paid

to the pool, the fee would be distributed back to the partners; 45% to Summit and 55% to VISX, reflecting the fact that VISX had contributed a broader patent portfolio to the pool than had Summit. Summit and VISX collected the PPF from ophthalmologists by designing their machines to work only upon the insertion of a key card. The key cards, which would activate the machine for one procedure each, were sold by Summit and VISX to purchasers of their machines for about $250 per card. By the terms of the partnership agreement, PPP was authorized to license any or all of the pooled patents to third-party licensees. The third parties likely to be interested in such licenses were other manufacturers of excimer lasers that were at different stages of development and which might infringe one or more of the PPP patents. No third-party licenses could be entered into unless both Summit and VISX agreed. Part and parcel of this "single-firm veto" provision was an absolute prohibition upon Summit or VISX licensing unilaterally to third parties any of the patents they had contributed to the pool. At no time during the five-year existence of the pool did PPP license any of its patents to a third-party laser manufacturer.

In October of 1995, Summit became the first of the two firms to receive FDA approval for the commercial use of its excimer laser for performing PRK. VISX received FDA approval in March of 1996.

3. FTC Assessment/*Rashomon* Views

In March of 1998, the Federal Trade Commission voted out a complaint against Summit and VISX charging the firms with, among other things, price-fixing and the exclusion of competition through the mechanism of the PPP pool in violation of the antitrust laws. According to the Commission, Summit and VISX had pooled *competing* apparatus patents as well as *complementary* patents. Having analyzed the broadest of the patents -- a VISX method patent covering all PRK procedures -- and concluded that the patent was invalid because of obviousness and inequitable conduct before the Patent and Trademark Office, the Commission found no blocking patents in the pool that might have justified the combination. Because Summit and VISX were the only two firms with FDA approval, they alone shared the U.S. market for laser refractive surgery devices. If, as the Commission had concluded, Summit and VISX could have competed independently absent the pooling arrangement, PPP was an agreement among competitors comprising 100% of the market to: (1) set the per-procedure fee, and (2) exclude third-party laser manufacturers seeking to license one or more of the pooled patents.

Although the Commission's analysis of the Summit/VISX pool is well-considered and supported by evidence, there may be other, perhaps equally, valid interpretations of the same patent relationships; interpretations which may yield very different legal results. If the Supreme Court pooling cases teach us anything, it is that in the realm of technology licensing, things are not always as they seem. In the case of PPP, one can look at the same patent pool and the same technologies and see, not combination of competitors, but a procompetitive agreement resolving *mutually blocking* patents.[86] Based on the uncertain claims of the pooled patents and the designs of the similar Summit and VISX machines, there may well have been a nontrivial basis for Summit to believe that it could have been blocked by one or more of VISX's patents and vice versa. A third interpretation also finds some support in the same set of facts. VISX is widely-acknowledged to have the broadest and strongest PRK-related patent portfolio in the world. Between its broad method patent -- which the Commission has challenged, but which VISX vigorously defends -- and a formidable array of apparatus patents covering most, if not all, of the ways that have been thought up for aiming an excimer laser, VISX may be justified in viewing itself as a *lawful patent monopolist*. From this perspective, PPP is transformed from an agreement among competitors into a *vertical* licensing arrangement in which VISX has extended a license to Summit without which Summit could not compete at all. It all depends on fairly small differences of opinion regarding the scope of 25 patents, most of which have never been tested in litigation.

C. Comparison of MPEG-2 and Summit/VISX

Even if we grant the possibility that the PPP pool resolved one or more blocking relationships, are the pool's price and licensing restraints justified? In other words: Could Summit and VISX have been more like the model citizens of the MPEG patent pool? Perhaps the starting point for an answer is the contrast between the two industries, their likely futures, and their historical burdens.

The MPEG-2 pool members are huge firms with enormous resources. The main business of most of the MPEG-2 pool members is not the licensing of these pooled patents, but rather, the manufacture and sale of telecommunications and consumer electronics hardware. Although the MPEG patents may have great strategic significance, they are not paying the pool members' rent. The pool members appear to

[86]. Summit and VISX claimed that two of the Summit patents ('093 and '058) and six of the VISX patents ('913, '418, '372, '148, '204, and '388) in the PPP pool are "blocking," and that the other patents in the pool are complementary.

have entered into the arrangement in order to establish a video compression standard, to profit from the network externalities of maximally diffusing the standard, and using the standard to sell more hardware in the market of the future. In order to establish MPEG as a standard, they avail themselves of mechanisms to reduce uncertainty. The independent expert review mechanism minimizes uncertainty regarding which patents are needed to manufacture in accordance with the standard and which patents are not. At the same time, this review mechanism serves the function of assuring that all of the pooled patents are in fact complementary and *essential*; that is, *blocking*. Licensing at a relatively low royalty to any and all those requesting a license is another mechanism for overcoming uncertainty. Since it is harder to establish a standard if some players doubt whether they will be granted access, the MPEG pool members want to maximize access. Open licensing eliminates that concern while at the same time calming Justice Department fears that the pool might be used as a tool of anticompetitive exclusion.

Summit and VISX, by contrast, are small start-up companies trying to create a completely new industry based on a technological innovation. They faced a capital-intensive technology, a long product development cycle, massive regulatory barriers, and potentially ruinous patent infringement litigation. For Summit and VISX, the laser refractive surgery business was the only business, and a single adverse patent ruling -- or even the perception of vulnerability to adverse patent rulings -- could dry up their capital and put them out of business. How did they respond to these concerns? First, instead of trying to recover their capital investment by charging high machine prices, they adjusted their pricing to lower the machine acquisition cost and used the per-procedure fee as a kind of metering device; at $250 the PPF was set at a relatively high rate -- 10-15% of the cost of the PRK procedure -- to make up for the lower revenues from machine sales. The more the machines were used, the more money Summit and VISX would make in procedure fees. Second, they use the pooling arrangement to reduce the risk of litigation, while continuing to compete on machine sales, and also as a way of hedging the risk that one firm would receive FDA approval later, or perhaps not at all. At the same time, they have been quite slow to license third-party manufacturers. This probably reflects a judgment that they can maximize revenue and recover their high development costs more quickly by using their technology exclusively, at least initially. As other firms gain FDA approval and bring out new differentiated machines, the strategy will likely shift toward licensing third parties and earning revenues from machine sales that would not otherwise have gone to Summit or VISX.

While the MPEG pool has been blessed under current agency enforcement policy, it is not clear how the arrangement would fare before the Supreme Court. If the Court looked at the MPEG arrangement and heard echoes of the *BMI* copyright pooling case, the agreement would be analyzed under the rule of reason and the procompetitive benefits would almost certainly be found to outweigh any anticompetitive effects. If, on the other hand, the Court chose to apply the *Line Materials* analysis, the MPEG pool would probably be condemned as a *per se* unlawful agreement among (some) competitors to set the price of licensing the pooled patents, notwithstanding the fact that the full value of the patents can be realized only through pooling.

The prospects for the Summit/VISX pool turn substantially upon uncertain judgments regarding the scope and validity of the pooled patents. If the Court looked at the Summit pool and saw the resolution of a blocking relationship, the arrangement could be analyzed under the rule of reason following *Standard Oil* or condemned under the *per se* rule following *Line Materials.* If the Court saw an agreement among competitors, comprising 100% of the market, it would be hard-pressed to find the single-firm veto and the per procedure fee, on balance procompetitive. Still, nothing in the case law or current enforcement policy adequately addresses Summit/VISX's *Rashomon* problem; the uncertain economic relationships among technology rights.[87]

V. *CONCLUSION*

The foregoing review of antitrust analysis of patent pooling arrangements offers some perspectives on how antitrust law can facilitate or impede the production of innovation. The misapplication of the *per se* rule to pooling agreements resolving blocking relationships is the paradigmatic example of the latter, while the rule of reason analysis in the *BMI* case exemplifies the former. The discussion also underscores the value of some generally underutilized analytical tools, such as technology market analysis, in assessing the competitive effects of patent pools. The limitations of other analytical tools, such as the conventional classification of the economic relationship of patents as competing, complementary or blocking have also been highlighted. The tendency to wish away uncertainty by imposing orderly classifications upon conduct and business relationships is understandable, but ultimately antithetical to the task of analysis. For it is only by confronting the full implications of uncertainty that we can hope to develop methodologies for its management.

87. At least one author has argued that because of the danger that pools will engage in cartel behavior, ambiguity regarding blocking relationships should be resolved in favor of vigorous antitrust enforcement. *See* Steven C. Carlson, Note, *Patent Pools and the Antitrust Dilemma*, 16 YALE L. J. 358, 399 (1999). This implicitly assumes, however, that the costs of underdeterrence exceed the costs of overdeterrence.

COSTS AFFECTING THE CHOICE BETWEEN THE DEATH PENALTY AND LIFE IMPRISONMENT WITHOUT PAROLE

*Howard C. Ellis**

I. *INTRODUCTION*

The death penalty opponents (opponents) continue to attack death penalty (death) on grounds of morality, constitutionality, and perhaps somewhat surprisingly, efficiency. The death penalty proponents (proponents) rise to do battle on all grounds. Of those grounds, it is efficiency that is the grounds of this paper. Efficiency, in the sense meant here, implies a balancing of costs and benefits. Much of the debate and study of the efficiency of the death penalty has focused on the strength of its deterrent effect. Opponents argue that if this effect is weak or even neutral then the penalty is inefficient. This argument remains hotly contested and each camp cites empirical studies but these studies are not persuasive.

There are compelling arguments on other issues. The morality of state sanctioned killing races the issue of whether death is a "cruel and unusual" punishment and therefore unconstitutional under the Eighth Amendment. Another issue is whether capital punishment is imposed in a racially discriminatory manner. Proponents have another issue they could offer in support of the death penalty. It is avoidance of the high cost of life imprisonment (life). Compared to the other costs and benefits of the death penalty, the savings generated by avoiding imprisonment are quantifiable, mostly uncontestable and significant. With prison costs approaching $75,000 per year per prisoner in maximum security,[1] the costs of keeping a convicted murderer alive approaches $3 million for forty years of confinement. When the death penalty avoids these costs, one has another powerful argument that capital punishment is a socially desirable response in capital cases.

In recent years, opponents have marshaled a compelling counter-argument. While acknowledging that savings would be gained by avoiding the high cost of lengthy prison terms, opponents cite the additional costs incurred when a murder case is tried as a capital case.

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1. Jill Smolowy, . . . *And Throw Away the Key*, TIME, February 7, 1994, at 52, 52-59.

Capital cases include additional costs for investigation, trial, appeals and other matters. Opponents claim that these costs are less than the imprisonment costs avoided by the death penalty. Studies have been done in an attempt to measure these costs. Their findings were examined in a law review and other scholarly journal and popular press. Ultimately these study findings become the wisdom or the *truth* about the costs of prosecuting a capital case. The finding can be astonishing. For example, one newspaper estimated that the death penalty in Florida costs $3.2 million per execution, compared to $600,000 for life in prison.[2] Another newspaper reported that an execution in Texas costs $2.3 million as compared to $750,000 to incarcerate someone for forty years.[3]

These respected findings accurate if add significant weight to the arguments of death penalty opponents. They argue that the death penalty immoral, irrevocable, and discriminatory manner, and fails the utilitarian goal of saving money. The conclusions these studies reach are shockingly counterintuitive. Advocates had previously felt that with all its shortcomings, at least death was cheaper than life imprisonment. Advocates have an incentive to question such studies, wondering had used appropriate methodology, using accounting concepts that would lead to an acceptable or reliable accurate comparison of costs.

This article examines the policy studies that death is more expensive than life. The article critiques the cost concepts. It discusses four conceptual issues: First, it distinguishes costs that would increase if the case is tried as a death case from those costs that would be affected. Second, it identifies costs that are incurred as a result of attempting to decrease the probability of an erroneous conviction. Third, it distinguishes additional death related costs that are constitutionally required from those that are incurred by the choice of local authorities. Forth, it distinguishes costs that result in an increase in expenditures from the public treasury from those costs that are otherwise absorbed by the judicial system. The article concludes that a proper calculation of the costs of death must make these distinctions. Isolating the costs that appropriately can be allocated as death costs leads to the conclusion that death may in fact be cheaper than life.[4]

2. Henry P. Curtis, *No Plea in Fatal Carjacking*, ORLANDO SEN. TRIB., Mar. 13, 1993, at 1.

3. John Gilardi, Houston Sets Record with Six Death Penalty Cases, REUTERS, LTD., Sept. 12, 1994, available in LEXIS, News Library, Curnws File.

4. I am not, however, urging that therefore death is a desirable punishment. I make no judgment here on issues of its morality or constitutionality.

II. COST OF PROCEDURES CONCERNING GUILT OR INNOCENCE

Death penalty opponents want to have both arguments. They argue that death cases should be subject to myriad appeals and habeas proceedings that take ten to twenty years to complete, ensuring few executions take place. They also argue that the death penalty has no deterrent effect. They argue strenuously that in death cases the state and government must have complicated procedures every step of the way - sometimes referred to as "super due process"[5] - that will increase the costs enormously, and then complain about that cost. The validity of their argument, therefore, depends on whether these extraordinary procedures are necessary or desirable in death cases, but not in life cases. When the death penalty was commonly believed to be less expensive than life imprisonment, death penalty opponents could be heard to remark that "cost arguments, focusing solely on expense, should never replace a moral discussion concerning the sanctity of life. . . ."[6] They also could be heard to say that "this argument is disturbing since it reduces the moral complexity of state imposed killing to a debate over dollars and cents."[7] Of course, cost arguments are implicit in making the choice between death or life punishments. If costs were not a consideration, the law could mandate the most elaborate procedures for determining guilt in all cases, regardless of the punishment. The fact that the law does not do this, even though an innocent defendant wrongfully convicted could spend the rest of his life in prison, shows that society does not think that it is worth the cost. In other spheres of life the government must often choose between the risk of loss of life and spending money, whether for research into the causes of diseases, providing food and shelter for the unfortunate, or requiring expensive safety features on products.

There may be no need for "super due process" be available for defendants in death cases. Concerning procedures that go to proving guilt or innocence, having super due process would make sense only if that high standard is more important to reduce the probability of erroneous conviction in death cases than in life cases. The possibility of a death sentence raises the stakes. But consider how one would feel

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[5]. Margaret Jane Radin, *Cruel Punishment and Respect for Persons: Super Due Process for Death*, 53 S. CAL. L. REV. 1143 (1980), *cited in*, Robert Spangenberg & Elizabeth Walsh, *Capital Punishment or Life Imprisonment? Some Cost Considerations*, 23 LOY. L.A. L. REV. 45, 47 (1989).

[6]. Margot Garey, Comment, *The Cost of Taking a Life: Dollars and Sense of the Death Penalty*, 18 U.C. DAVIS L. REV. 1221, 1245 (1985).

[7]. *Id.* at 1222.

if me were an innocent defendant facing a charge of murder that could lead to a sentence of life without parole. One would possibly devote all of his or her personal resources to decreasing the likelihood of an erroneous conviction. Once the level of expenditure has reached the point where additional expenditures would decrease the likelihood of error infinitesimally or not at all, it becomes inappropriate to expend any more.[8] Now, suppose a person was facing the death penalty, one still would not increase the level of expenditure to prove her innocence if the expenditure level has already reached its maximum.

If this analysis is correct, it is no more sensible the public should not spend additional resources to reduce the probability of erroneous convictions in death cases if the defendant would not do so. This point does not say that death is not a more severe punishment than life in prison. In my mind this conclusion is argumentative, if not erroneous. It is, or defendants would not try so hard to avoid it. Life without parole which severe punishment that the efficient level of expenditure of resources to reduce its wrongful imposition is the same as the level appropriate to reduce the wrongful imposition of the death penalty.

A. Pre-Trial Procedures During Plea Bargaining and Investigation

Some commentators[9] have suggested that the existence of the death penalty leads to fewer murder cases being resolved through plea-bargaining.[10] These conclusions are largely based on a North Carolina study[11] which indicated that of 42 capital cases, only 21% were decided by a guilty plea and 79% went to trial. This datum was compared to the average for non-capital cases, in which about 80% of cases are plea bargained and only 20% go to trial. This reported reduction in plea-bargaining would be a factor increasing the costs of prosecuting murder cases. Case would be a mistake, however, to conclude from such data that the existence of the death penalty that reduces the number of cases that are plea bargained.

The reasons that a murder case is a capital case are as follows: 1) the crime is horrific, 2) the prosecutor believes she can prove

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[8]. Even a defendant facing life has reasons to conserve his resources, perhaps for his family to have something left to live on.

[9]. Alex Kozinski & Sean Gallagher, *Death: The Ultimate Run-On Sentence*, 46 CASE W. RES. L. Rev. 1 (1995); Margot Garey, Comment, *The Cost of Taking a Life: Dollars and Sense of the Death Penalty*, 18 U.C. DAVIS L. Rev.1221, 1253 (1985).

[10]. Garey, *supra* note 6, at 1247.

[11]. Philip J. Cook & Donna B. Slawson, THE COSTS OF PROCESSING MURDER CASES IN NORTH CAROLINA 38 (1993).

aggravating circumstances, and 3) the prosecutor has determined that her chances of winning are high enough to warrant the expenditure of the additional resources. Such resources will be necessary to complete the prosecution. These reasons reduce the incentive of the prosecutor to plea bargain. Thus the option of death does not reduce the incidence of bargaining, but rather, the nature of the criminal conduct alleged.

The argument is made that in the case of a heinous crime the prosecutor may be disinclined to plea bargain if she feels that her responsibility to the public requires the state to seek death. If death were not available, the prosecutor might believe it acceptable to bargain for less than the maximum sentence.[12] This argument is unconvincing. The public may not accept a sentence of less than life for a serious murder if it would not accept less than death. A prosecutor who can legally invoke the death penalty might do so in two disparate sets of cases: 1) those cases in which the proponent believes that the chance of conviction is great and does not want to plea bargain; or 2) those cases where the prosecutor's chance of conviction is not so great and death penalty maximizes leverage in the plea bargaining process.[13] In this latter group of cases, the bargain may be a guilty plea in exchange for asking for no more than life without parole. If death were not an option the prosecutor would have to offer something less than life without parole, such as some finite number of years, or life with the possibility of parole. Otherwise, the defendant has incentive to forego trial.

The defendant's point of view is greatly influence by the penalty: the greater the threatened penalty, the greater the incentive to bargain. The authors of the North Carolina study themselves conclude as much.[14] There are a number of cases in which the threat of death may well have induced a defendant to accept a guilty plea to a lesser degree of murder who, if only facing life, might have taken his chance on a first-degree murder charge.[15] These cases show up in the data as plea-bargained life cases, rather than plea-bargained death cases. Data from Ohio indicates that of approximately 125 indictments per year for capital cases only 20% proceed to trial.[16] Focusing on the comparison

[12]. *Id.*

[13]. Garey states that "the prosecutor is dissuaded from plea bargaining since reducing the charge or promising a lighter sentence would render the case noncapital." Garey, *supra* note 6, at 1247. However, what prosecutor wants to spend the effort and money to take a capital case to trial that he doesn't think he can win? Wouldn't he want to plea bargain unless he believes 1) he can win, and 2) the defendant deserves nothing less than death for this crime?

[14]. Cook & Slawson, *supra* note 11, at 37.

[15]. *Id.* at 38.

[16]. Robert Spangenberg & Elizabeth Walsh, *Capital Punishment or Life Imprisonment? Some Cost Considerations*, 23 LOY.L.A. L. REV. 45, 49 (1989).

of capital indictments to capital trials seems a better gauge of the effect of death on plea bargaining than a comparison of guilty pleas in capital cases to trials in capital cases. Thus the single datum that death cases result in jury trials ten times more often than noncapital cases[17] does not imply that those same cases would be bargained if they were noncapital. These cases that were bargained are no longer counted in the category of capital cases. The cases that go to trial do so, not because they are capital cases, but because one or both of the parties has refused to compromise. A defendant might be more likely to refuse to bargain if he faces death rather than life. A prosecutor might be more likely to refuse to bargain in a death case knowing that the expenditure of resources for the trial will be much greater than if it were a life case. In any event, the authors of the North Carolina study conclude that:

> [S]ince we have no direct evidence on the effect of the death penalty option on the likelihood of trial, and since there are plausible arguments in both directions, we proceed on the assumption that there are neither more nor fewer trials as a result of the death penalty option.[18]

In the investigation phase during pre-trail, investigators know that the case is likely to be a death case may spend more time on the investigation.[19] In the early stages, prior to the indictment, it is possible that they would not know if it is a death case or not. In so far as the investigation only concerns *who did it* there is no reason to believe that investigators skimp on trying to find evidence just because the case is noncapital. It seems likely that other factors will have much more effect on the level of expenditure the authorities (and the defendant) devote to the investigation regarding guilt or innocence. These factors include the social status of the victim and the threat the culprit poses to the community if unless identified and apprehended.

B. Trial Phase and Determining Guilt

There is no question that it will generally take longer to try a capital case. One study estimates that it takes, on average, 3.5 times as

[17]. Barry Nakell, *The Cost of the Death Penalty*, 14 CRIM. L. BULL. 69, 71 (1978).

[18]. Cook & Slawson, *supra* note 11, at 38.

[19]. *See* Spangenberg & Walsh, *supra* note 16 at 47. Spangenberg & Walsh present the argument that in death cases the state has a heightened burden of proof, and the defendant is entitled to *super due process* and therefore investigators will invest greater resources toward identifying the perpetrator. *Id.* The authors offer no evidence that this proposition is the case.

long to try capital cases, an additional 30 days.[20] In the typical of death penalty cost studies, the authors multiply the number of expected extra days by the cost per day of operating a courtroom. In one study they found that $65,580 was the additional cost for courtroom time in a capital case.[21] Such studies do not ask whether these costs are ever actually paid by the public or whether they are otherwise absorbed by the judicial system. This distinction is crucial. Given the relatively small number of capital cases that a given governmental agency faces in a year, the most likely scenario is not that the state builds an additional courtroom or creates an additional judgeship. The additional burden on the system is absorbed by an increase in the plea bargaining of other cases (including noncapital murder cases) to reduce the caseload to a manageable level. The same could be said of the district attorney time and other inputs into the trial process. The actual cost of the capital trial is not the dollar figure computed by the average cost of running the building. The cost is the reduction in the quality of justice afforded by the additional plea-bargaining that takes place in other cases. This cost may be a significant, but it is impossible to measure in dollar terms. In fact it may be set off by the psychic benefit the society reaps from its belief that justice demands the imposition of the death penalty in those cases where it is deserved.

Justice Thurgood Marshall was no doubt correct regarding death cases when he said in *Furman v. Georgia,* [22] "defense counsel will reasonably exhaust every possible means to save his client from execution."[23] During the penalty phase and for the many years of post-trial proceedings attorneys might extend themselves to the limit. During the guilt phase of a trial, this attorney would not do more to prove her client's innocence if he were facing death than if he were merely facing life in prison. Life is a sufficiently onerous punishment to ensure that the reasonable attorney would leave no stone unturned in efforts to avoid an erroneous conviction. It is difficult to imagine what shortcut a defense attorney would take, and what compromises she would be willing to accept because her client merely faces life without possibility of parole.

Identifying procedure, required by statute in some jurisdictions for capital cases, may reduce the jury's bias by eliminating the possibility that a prospective juror might hear the other jurors' answers to voir dire questions, thus learning what answers are expected of them. Individual voir dire improves the selection process by

20. Garey, *supra* note 6, at 1258.
21. *Id.*
22. 408 U.S. 238, 358 (1972).
23. 408 U.S. at 358.

allowing jurors to be more candid in answering the questions put to them.[24] However, to the extent that this is true in death cases, it is also true in noncapital cases. This procedure will increase the time it takes for a jury trial. If it increases the probability of reaching a correct verdict, it should be required in all serious criminal cases. The determination to sequester the venire while questioning it would fit into the category of decisions not constitutionally required, but decisions made by local authorities in an attempt to reduce the probability of wrongful conviction. Thus it is arguably equally appropriate in life, as in death, cases.

Death penalty cost studies often include the cost of psychiatrists that are called as expert witnesses by both sides to establish 1) whether the defendant is competent to stand trial, and 2) whether the defense of insanity or diminished should be argued. Such costs can be extensive.[25] However, there is no justifiable reason to find that this cost should be more extensive in a capital case than in a noncapital murder case. If the defendant is not guilty by reason of insanity, he is technically not guilty regardless of the punishment at stake. The same applies to his capacity to stand trial.

C. Post-Trial

Appeals concerning the procedures followed during the guilt phase, including the charge to the jury are just as likely in life cases as they are in death cases. Much is made of the fact that the defense attorney in a death case will file every conceivable appeal, including those that have no chance of success. This tactic should not result in the waste of too much of the appellate court's time if the judges are able to dispose of specious grounds for appeal.

Another reason that the putative extra cost of death appeals might be inflated is related to "super due process" already allowed in the guilt phase of the trial. If super due process has the desired effect of reducing the probability of erroneous convictions, it should result in a higher number of acquittals than would otherwise be observed. Although each appeal in a death case might be more expensive, there should be fewer of them. Those appeals that remain are more likely to concern issues surrounding the penalty itself and not the guilt of the accused. If super due process does not reduce the probability of an erroneous conviction, then there is no point in paying for it.

24. Garry Goodpaster, *The Trial for Life: Effective Assistance of Counsel in Death Penalty Cases*, 58 N.Y.U. L. REV. 299, 327 (1983).
25. Spangenberg & Walsh, *supra* note 16, at 49.

III. COSTS OF PROCEDURES UNIQUE TO DEATH CASES

Most of the additional cost associated with investigating capital cases is for the purpose of uncovering information regarding mitigating circumstances, including a thorough investigation of the defendant's background and character. Because the defendant will offer mitigating circumstances in an attempt to avoid death, the prosecution must be ready to refute the defense arguments with background information of its own. Some commentators claim that this can be very expensive.[26] These costs are readily quantified and could vary widely depending on circumstances. In some cases these costs could be substantial.

A. Pretrial, Investigation and Motions

Motions in capital cases are filed in greater numbers, are more detailed in capital cases, and raise far more issues. Perhaps two to six times as many issues on average as motions in noncapital cases.[27] It would appear that most such motions could be (but in practice might not be) disposed of by the court without any great expenditure of judicial resources. One reason for believing that motions unique to death cases should be relatively easy to resolve is that they raise issues that have already been litigated in so many prior cases. Every trial court (or appellate court, for that matter) most seriously motions challenging "the penological justification of the death penalty, its arbitrary and capricious nature, and its cruelty."[28] Those motions challenging no more than the constitutionality of the penalty in theory (as opposed to in operation) should be decided out of hand unless they raise legitimate issues that have not previously been litigated, they raise spurious arguments offered merely for the purpose of delay and increase the costs of the trial. Many of the motions made in death cases would be made in noncapital cases as well. These motions include change of venue, requesting funds for investigators, expert witnesses, or psychiatrists.[29]

[26]. *Id.* (*citing*, Comment, *The Cost of Taking a Life: Dollars and Sense of the Death Penalty*, 18 U.C. DAVIS L. REV.1221, 1251 (1985)).
[27]. Spangenberg & Walsh, *supra* note 16, at 50.
[28]. Garey, *supra* note 6, at 1248.
[29]. *Id.* at 1250.

B. Guilt and Penalty Phases of Trial

The jury selection process in a death case may require an especially elaborate voir dire. Jury selection includes an increased likelihood of requiring individual questioning of prospective jurors, a time-consuming process. The court generally allows a greater number of peremptory challenges. For example, California allows 26 in capital cases but only 10 in noncapital cases. These challenge prolong voir dire. There is no constitutional requirement to allow so many peremptories. One wonders whether the central rationale behind peremptories, which are to reduce bias, such as racially animated bias, is any less significant in noncapital cases. A defendant facing life without parole should be entitled to as bias-free a jury as can be impaneled.

Death qualifying the jury requires asking each juror about his or her views on capital punishment, and disqualifying jurors whose opposition makes them unfit to serve as capital jurors.[30] This aspect of jury selection is constitutionally required and offer prolongs the jury selection process. Some studies indicate that a death-qualified jury may be more prone to convict.[31] However, such an argument does not necessarily mean that they are not fair and impartial. It could mean that jurors who oppose the penalty are less likely to find guilt even when the facts point to its appropriateness because they fear being responsible for imposing death. The right to a jury trial "does not include the right to be tried by jurors who are unable or unwilling to follow the law and the instructions of the trial judge in a capital case."[32]

In the penalty phase of trail, capital cases require bifurcated trials, including separating the guilt and penalty phases. The penalty phase can be extensive and will consist mostly of the prosecution's trying to establish aggravating factors surrounding the crime that warrant of death. The defense would try to establish mitigating factors that often involve the defendant's personal history in an attempt to garner sympathy in trying to persuade the jury to impose a lesser punishment. Noncapital cases avoid much of this extra procedure. In such cases there is no penalty phase. A simple imposition of the penalty after closely follows the verdict of guilt.

[30]. E. Krauss & B. Bonora, THE NATIONAL JURY PROJECT, INC., JURYWORK: SYSTEMATIC TECHNIQUES § 10.03 [8] 2d ed. (1988).
[31]. Claudia L. Cowan, William C. Thompson, & Phoebe C. Ellsworth, *The Effects of Death Qualification on Jurors' Predisposition to Convict on the Quality of Deliberation*, 8 L. & HUM. BEHAV. 53 (1984).
[32]. Keeten v. Garrison, 742 F.2d 129 (4th Cir. 1984).

One error that the death penalty cost studies make is to add in the additional cost of the penalty phase as a fixed part of the cost of every death penalty trial. In fact some such trials end in acquittals during the guilt phase, and the penalty phase is avoided altogether. To the extent that the super due process afforded the defendant during the guilt phase (the cost of which is already accounted for in the cost studies) reduces the probability of an erroneous conviction, there should be a corresponding reduction in the cost of the penalty phase.

C. Appeal

A state supreme court review of capital cases is mandatory in most states, but not required in noncapital cases.[33] Studies indicate that on average a capital appeal case take up to 1,000 hours of defense attorney time.[34] At an average cost of $150 per hour, that is a total of $150,000 per appeal. This cost seems substantial. The crucial question is not how much the appeals process costs, but how many of these hours are in exceed of the number taken by appeals in life cases? Any issues having to do with challenges to the procedures utilized during the guilt phase would be considered on appeal in either kind of case. Issues having to do with the judge's charge to the jury regarding the offense committed would be considered. A death case would give rise to certain singular issues regarding the judge's charge on the penalty itself and procedures followed during the trial that were required to provide super due process. There are countless possible challenges to the death penalty.[35] After twenty years and hundreds of appeals, most possible challenges have already been made and their constitutionality decided. Garey cites issues such as the excessiveness of the punishment related to the crime committed, the wrongfully exclusion of mitigating evidence, and the vagueness of the language of the death penalty statute. These issues have been litigated conclusively in hundreds of cases. Bringing up the same issues over and over again in cases that do not differ substantially on their facts may not be added anything. Proper management of judicial resources at the appellate level could reduce the cost of appeals in death cases substantially.

While only a tiny percentage of state and federal criminal cases are reversed on direct appeal, the rate of reversal in death cases approaches 50%.[36] This datum is offered to show that we spend more appeals time and wasted trial time on death cases. If there is some

33. Spangenberg & Walsh, *supra* note 16, at 52.
34. *Id.*
35. Garey, *supra* note 6, at 1226.
36. Kozinski & Gallagher, *supra* note 9, at 1.

doubt about the guilt of the accused the extra effort may be worthwhile in noncapital cases as well. If not, most of the effort is superfluous regardless of the penalty.

D. Death Row Costs

Some studies suggest that maintaining prisoners on death row is considerably more expensive than maintaining them in an "ordinary" maximum security prison. Little explanation is offered for this suggestion. One reason might be that death row prisoners are not allowed to work, whereas their life without parole counterparts can. The difference in treatment means we keep a man idle for ten or more years when he could be productive? No cogent explanation has been given as to why death row costs, at least when the execution is not imminent, should be so excessive.

IV. *METHODOLOGICAL PROBLEMS IN THE COST STUDIES*

Most of the literature concludes that the death penalty is more expensive than life and relies heavily on just a few studies of death related costs. The North Carolina Study[37] is very heavily relied on, and exemplifies the approach taken by the other studies. There are some reasons to doubt the conclusions reached in those studies. One problem is that a significant amount of the cost comes from line items that might be fixed costs, that is, costs incurred regardless of whether the death penalty is imposed or not. Consider the treatment the North Carolina study gives to the district attorney's office time. "For each position, costs are divided into annual (recurring) and one time (nonrecurring) expenditures for equipment, furniture, books and so forth. We amortized the latter on a straight line basis over five years."[38]

The authors used the total of the annual salary cost of an attorney in the district attorney's office, the annual cost of support staff, and the annual overhead of the office. They divided this total by the average number of work days per year (220), and divided this quotient by the number of work hours in a day (8).[39] The average costs identified were $83 and $56 per hour for the district attorney and the assistant attorney, respectively. Similar calculations are made for

37. Cook & Slawson, *supra* note 11, at 38.
38. *Id.* at 41.
39. *Id.* at 45.

judges and other court officials.[40] These costs were included the daily rental costs of courtroom space.[41] The daily rental cost is used as a surrogate for the actual (unknown) costs of using the courtroom for a day. Finally, similar computations are made for the cost of the time of state supreme court justices.

The weakness with this methodology is that overhead costs and other fixed costs would have been incurred whether the death penalty was involved or not. Only if additional attorneys would be hired, additional courtrooms built, and additional equipment purchased would these amounts be appropriately attributable to the imposition of the death penalty. Most likely, much of the burden placed on local authorities, facilities and personnel are "paid for" by efficiencies in other aspects of the judicial system's operations. Consider this analogy. A university whose classes average 35 students per section decides to offer senior seminars with 15 students per section. It might incur the extra cost of constructing an additional classroom building and hiring additional faculty, or it could absorb the cost by increasing the class size in its other sections to 37 each. There has been a cost of the seminars, but it is not easily measured in dollars. It is the cost of a slightly diminished professor presence in the non-seminar classes. In much the same way, the real cost of complex death penalty trials is reduced efficiency in the other cases the system must deal with. The dollar measurement of these costs does not equal to the hypothetical costs of buildings and hours.

A second problem in the North Carolina study is the use of the so-called "cohort perspective." The authors take the total additional costs of all trials brought as capital cases and reach their final conclusion by dividing this total by the number *of death sentences carried out*, and not by the number of death sentences imposed. According to their own calculations, the extra cost (in excess the noncapital case) of taking a death penalty case completely through the system including appeals is approximately $200,000 per death sentence imposed, but is $2.16 million per execution actually carried out. This latter number becomes the figure that they publish in their conclusion,[42] that is, the extra cost of the death penalty. This number is then compared to the cost of life imprisonment for twenty years, which, by their calculations, it greatly exceeds.

This methodology can be misleading. The executions being carried out today were imposed as much as ten or twenty years ago. As the death penalties imposed today become completed executions with

40. *Id.*
41. *Id.* at 46.
42. *Id.* at 98.

the passage of time, the cost "per execution" should drop precipitously. For example, suppose that since 1977 Pennsylvania has imposed 30 death penalties at a cost of $200,000 each or $6 million in total, and has executed two murderers in that same period. The "cohort" cost per execution is $3 million. However, suppose that after a few more years there are ten more executions from this same group of death row inmates. The cost per execution drops to $500,000 ($6 million divided by 12).

V. CONCLUSION

The arguments set out in this paper lead to the conclusion that the costs of the death penalty are not necessarily higher than the incarceration costs incurred by imposing life in prison without possibility of parole. The studies which purport to show that these costs are higher suffer from several methodological flaws. Some of the supposed costs would have been incurred even if the only sentence available were life without parole. These costs mainly are incurred in order to prove guilt or innocence. Some of the costs are the direct result of the death penalty's being sought, but are absorbed as part of the fixed costs in the judicial system. Some of the costs incurred are constitutionally mandated, local judicial authorities have decided to incur them and could easily be avoid.

A complete cost-benefit analysis should also consider additional benefits that death provides in addition to the avoidance of incarceration costs. A comprehensive discussion of these benefits is beyond the scope of this rticle, but brief mention is required. Some studies indicate that the death penalty has a deterrent effect on murder, while others show that it does not. This conflict is not surprising, when one considers the difficulties inherent in attempting to measure deterrence. Some death opponents point to the fact that even with a death penalty in place a fairly large number of murders are still committed. However, it is the number of murders that were *not* committed that defy counting. How to prove the negative? Common sense indicates that if death were not a deterrent, those defendants facing it would not try so hard to avoid it. Consider the argument that perpetrators are not deterred by the death penalty because they do not believe they will be caught. If this argument has any validity, it should apply with as much strength to other punishments, such as imprisonment, and thus, to the argument that punishment of whatever sort has no deterrent effect on crime. This is an obvious absurdity.

There may be something to the argument that a punishment seldom carried out has weak deterrent effect. There have been 620 executions in the United States since 1977,[43] but more than 400,000 murders since then. That means that the probability of any particular murderer's being executed has been something on the order of 0.00155, or not much more than one in a thousand. If death is to be a deterrent, the probability of its imposition would have to be increased. One significant benefit that the death penalty provides is a reduction in the number of murders and other crimes committed by persons after they are convicted of their first murder(s). A significant number of murders are committed by paroled, pardoned and escaped convicts. In addition, there are murders of other imprisoned inmates. Without the possibility of death, a convict who is serving life without parole knows he cannot lose his life by committing further violent crimes.

It is very difficult to speak with any confidence about the costs of the death penalty. If the government costs in death penalty cases lead to abandoning capital punishment in favor of life without parole, the decision to retain or abandon cannot - as a practical matter - should not be based totally on costs. All the studies are fraught with reservations regarding the accuracy of their data, and qualifications regarding their ability to identify how much judicial system inputs really cost per case. These limitations might not be so bad if the cost difference between capital and noncapital cases is large enough to justify confidence that we have measured that difference precisely or have determined that it is positive or negative. Unfortunately, this small confidence is not justified. Too many unknown costs exist, and too many methodological difficulties are found in the studies to accept their conclusion that death costs more than life.

43. As of March 15, 2000, Rick Halperin states that data was available at www.smu.edu/~deathpen.

RECENT DEVELOPMENTS IN VIRGINIA'S PUBLIC POLICY EXCEPTION TO EMPLOYMENT-AT-WILL DOCTRINE

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I. *INTRODUCTION*

This article examines the Supreme Court of Virginia's most recent decisions regarding Virginia *public policy exception* to the common-law doctrine of employment-at-will,[1] an exception it first enunciated in 1985 in *Bowman v. State Bank of Keysville.*[2] The Supreme Court's first two decisions of the 21st century addressing the *Bowman* exception reflect the continuing tension between the Supreme Court's effort to maintain its self-described "narrow exception" to the employment-at-will doctrine and the Court's obligation to comport its decisions with a portion of the Virginia Human Rights Act[3] which arguably limits the right of a discharged employee to assert such a common-law tort action. An overview of the evolution of the *Bowman* exception and how it was impacted by legislative enactments in the 20th century is provided as a backdrop to the examination of the two recent decisions. Finally, the article seeks to predict to what extent the *Bowman* exception will be expanded in future Virginia cases.

II. *EVOLUTION OF VIRGINIA PUBLIC POLICY EXCEPTION*

Since 1906, Virginia has adhered to the American[4] common-law rule that when a contract calls for the rendition of services, but the

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1. *See* City of Virginia Beach v. Harris, 259 Va. 220 (Record No. 990535, January 14, 2000), 523 S.E.2d 239, 2000 LEXIS 10; *Mitchem v. Counts*, 259 Va. 179 (Record No. 990399, January 14, 2000), 2000 LEXIS 25.

2. 229 Va. 534, 331 S.E.2d 797 (1985).

3. § 2.1-725 (D) of the Code of Virginia, 1950, as amended.

4. The Supreme Court of South Carolina credited Professor H.G. Wood as the first author to clearly articulate the so-called "American rule" of employment-at-will in his 1877 treatise, MASTER AND SERVANT, which rule is that "where an employment contract is indefinite as to its duration, the employer may discharge employees for good cause, no cause, or even cause morally wrong." *See* Ludwick v. This Minute of Carolina, Inc., 337 S.E.2d 213, 214 (S.C. 1985). The Supreme Court of South Carolina noted that

period of its intended duration cannot be determined by a fair inference from its provisions, either party is ordinarily at liberty to terminate the contract at will upon giving reasonable notice of intention to terminate.[5] In 1985, the *Bowman* Court made clear that Virginia has neither abrogated nor altered the traditional rule.[6] Rather, the *Bowman* Court simply acknowledged that the rule is not absolute and it applied one of the recognized exceptions.[7] It should also be noted that since 1932, the Supreme Court of Virginia has held that the employment-at-will doctrine, in Virginia, is not a substantive rule of law but rather merely raises a rebuttable presumption of the intent of the parties.[8] Where the presumption is overcome, the Virginia Court has always recognized an action for wrongful discharge predicated on breach of contract theory.[9] On the other hand, the same supreme court recognized that if the presumption is not overcome then both contract law and agency law support a finding of a terminable-at-will relationship.[10]

Due in large part to the fact that approximately sixty to sixty-five percent of American workers are subject to the employment-at-will doctrine[11] and accordingly need protection against unjust dismissal, the various state courts have recognized three types of modifications to the general employment-at-will rule: (1) the *public policy exception;* (2) the *tort theory exception* (sometimes referred to as the *implied duty of good faith and fair dealing exception);* and (3) the *implied contract exception.*[12] Professor Henry H. Perritt, in commenting upon the *Bowman* decision by the Supreme Court of Virginia, briefly discussed the differences in these exceptions to the general employment-at-will

this doctrine was a departure from the English common law rule that employment contracts for indefinite periods were presumed to extend for one year unless terminated for cause. *Id.* The first reported case utilizing the "American rule" was apparently a Tennessee decision in 1884. *See Payne v. Western & A.R.Co.*, 81 Tenn. 507 (1884).

5. *Stonega Coal and Coke Co. v. Louisville and Nashville R.R. Co.*, 106 Va. 223, 226, 55 S.E. 551, 552 (1906).

6. *See, e.g.*, Conrad v. Ellison-Harvey Co., 120 Va. 458, 466, 91 S.E. 763,766 (1917); Title Ins. Co. v. Howell, 158 Va. 713, 718, 164 S.E. 387, 389 (1932); Plaskitt v. Black Diamond Trailer Co., 209 Va. 460, 164 S.E.2d 645 (1968); Wards Co. v. Lewis & Dobrow, Inc., 210 Va. 751, 756, 173 S.E.2d 861, 865 (1970).

7. Bowman v. State Bank of Keysville, 229 Va. 534, 539, 331 S.E.2d 797 (1985).

8. Hoffman Specialty Co. v. Pelonze, 158 Va. 586, 594, 164 S.E. 397, 399 (1932).

9. *Hoffman Specialty Co.*, 158 Va. at 594, 164 S.E. at 399.

10. *Plaskitt*, 209 Va. at 465 (citing 17 Am. Jur.2d, Contracts, § 486, at 956, 957; 35 Am. Jur., Master and Servant, § 19, 457, 458; Title Ins. Co. v. Howell, 158 Va. 713, 718, 164 S.E. 387, 389 (1932)).

11. *See* Crosier v. United Parcel Service Inc., 150 Cal App 3rd 1132, 198 Cal Rptr. 361, (1983, 2d Dist).

12. *See* Thompson v. American Motor Inns, Inc., 623 F. Supp. 409, 413 n.12 (D.C.Va. 1985)(citing Note, 96 HARV. L. REV. 1931, 1935 (1976)).

rule and pointed out that, at that time, about forty states had recognized one or more of these three theories.[13] Several articles have extensively discussed the evolution of the various exceptions recognized prior to the 1985 *Bowman* decision.[14] The Supreme Court of Virginia, in 1982, reaffirmed its recognition of the *implied contract exception* in deciding *Sea-Land Service, Inc. v. O'Neal,*[15] noting that a finding of an implied-in-fact contract exception simply negates the normal presumption that an at-will relationship was intended and, accordingly, results in a finding that *fixed* duration was intended and that the employment was not, in fact, at-will. By contrast, a *public policy exception* accepts the predicate assumption that an employment-at-will relationship exists but yet imposes liability for the employer's conduct in terminating the employee where such employer conduct is perceived as harmful to attainment of some clearly recognized public policy. Thus a *public policy exception* is completely inapposite to a case where the *implied contract exception* is found to exist.[16]

13. H. Perritt, *Wrongful Dismissal in Virginia*, VA. BAR NEWS, December 1985, at 21, 21-28.

14. *See, e.g.*, Annot., *Modern Status of Rule That Employer May Discharge At-Will Employee For Any Reason*, 12 A.L.R. 4th 544 (1981); Special Repot (BNA), *The Employment-At-Will Issue* (1982); Lopatka, *The Emerging Law of Wrongful Discharge-A Quadrennial Assessment of the Labor Law Issues of the 80's*, 40 BUS. LAW 1 (1984); The Research Institute of America, Inc., *Employment-At-Will & Unjust Dismissal* (July 1984); Note, *Employee Handbooks and Employment-At-Will Contracts*, 1985 DUKE L. J. 196.

15. 224 Va. 343, 297 S.E.2d 647 (1982). While Professor Perritt commented that this was the case in which the "Virginia Supreme Court essentially recognized this theory," H. Perritt, *supra* note 13, at 22, this court had recognized the same almost thirty years earlier in Norfolk Southern Railway Co. v. Harris, 190 Va. 966, 59 S.E.2d 110 (1950) and as aptly noted by the Honorable Jackson L. Kizer, District Judge, in Barger v. General Electric Co., 599 F. Supp. 1154 (W.D.Va. 1984), the *Norfolk Southern* case had even earlier predicate decisions in Virginia. *See, e.g.* Kizer v. Amalgamated Clothing Workers, 169 Va. 574, 194 S.E. 727; 114 A.L.R. 1291 (1938). As Professor Perritt noted, commenting on the *Sea-Land* case, "when an employee can prove employer promises of employment security made in personnel policies or handbooks, combined with consideration, the employee can recover damages for breach of those promises" in Virginia based on this *implied contract exception*. Perritt, *supra* note 13, at 22. While Professor Perritt seems to have suggested that the employer promises of employment security must be *expressly* contained within the personnel policies or handbooks, the U.S. District Court, applying Virginia law, held that such promises may also be *implied* from an employee handbook. *See Thompson*, 623 F. Supp. at 417.

16. *See, e.g.*, *Thompson*, 623 F. Supp. at 417.

III. PUBLIC POLICY EXCEPTION ANTECEDENTS TO BOWMAN

To understand the Virginia *public policy exception* recognized by the *Bowman* decision, it is helpful to briefly consider the range of cases decided in other states prior to *Bowman* and which, one would assume, were probably examined by the Supreme Court of Virginia before deciding *Bowman*. The 1959 California case of *Petermann v. International Brotherhood of Teamsters*[17] is widely considered as seminal in the area of so-called "retaliatory discharge" prohibited by *public policy*. In *Petermann*, the employee's refusal to commit perjury on his employer's behalf resulted in his promptly being fired. The *Petermann* Court held that in order to effectuate *public policy* against perjury, a tort action for wrongful retaliatory discharge must be recognized.[18] A federal appellate court, applying Michigan's *public policy exception,* in 1983, upheld an award of damages to a bank manager who appeared before his county's grand jury and, as a result, was fired.[19] Next, the Wisconsin *public policy exception* articulated in 1983 provides that an employee may not be discharged for refusing to perform an act that violates a clear mandate of public policy.[20] The Wisconsin Court limited *public policy* to that enunciated in the state constitution and statutes only. Under this rule, once an employee shows that the discharge violates such a policy, then the employer must show just cause for the employee's discharge or be held accountable for damages.

The Supreme Court of Washington has adopted an even broader definition of *public policy* which includes those policies created by judicial decision[21], apparently adopting (with some procedural differences regarding burden of proof) a similar definition of *public policy* articulated by the Supreme Court of Hawaii in 1982.[22] In 1985, a North Carolina Court, in *Sides v. Duke Hospital,* followed the California *Petermann* approach that, generally, an employer can terminate an at-will employee for arbitrary, irrational or no reason at all, but *not* for an unlawful reason or purpose which violates *public*

[17]. 174 Cal.App.2d 184, 344 P.2d 25 (1959).

[18]. *Petermann,* 344 P.2d at 27.

[19]. *See* Wiskotoni v. Michigan National Bank-West, 716 F.2d 378 (6th Cir. 1983).

[20]. *See* Brockmeyer v. Dun & Bradstreet, 113 Wis.2d 561, 335 N.W.2d 834, 838 (1983).

[21]. Thompson v. St. Regis Paper Co., 102 Wash.2d 219, 685 P.2d 1081, 1089 (1984).

[22]. Parnar v. American Hotels, Inc., 65 Hawaii 370, 652 P.2d 625 (1982).

policy[23]. In *Sides*, a nurse was fired for testifying truthfully at a deposition rather than withholding information as instructed by her employer. Also in 1985, a Texas Court ruled that the *public policy exception* in that state is limited to the situation where an employee is fired for refusal to commit an *illegal* act, that is one which under federal or state law carries a *criminal* penalty.[24] The same year, the Arizona Court of Appeals recognized a *public policy exception* where an employee was fired after reporting to one of the employer's customers that the employer had stolen some of the customer's property.[25] In reversing the trial court's dismissal of the terminated employee's claim, the Court of Appeals made clear that this *public policy exception*, in Arizona, was limited to the facts involving a state policy against theft found in the state's *criminal* statutes. Next, the Oregon Court of Appeals, in 1985, rejected a *public policy exception* being urged by a fired at-will employee who had been discharged for refusal to stop dating a female co-worker, the Court noting that in Oregon the *public policy exception* only includes either (1) termination for fulfilling a societal goal, such as serving jury duty, or (2) termination for pursuing a statutory right related to the employee's role as an employee.[26]

The foregoing summary illustrates a fairly narrow or restrictive approach in defining the *public policy exception* to the employment-at-will doctrine. Of course, some of the state courts in 1985 declined to recognize a *public policy exception*. For instance, both the Missouri and Florida courts refused to recognize such an exception to the employment-at-will doctrine in their respective states. The Missouri Court stated that it would only recognize a *statutory* exception or *contractual violation*, and the Florida Court rejected a claim by a worker fired for refusal to violate federal environmental statutes.[27] Since the Supreme Court of Virginia is fairly regarded as a body which exercises judicial restraint and which historically has left major policy changes to the Virginia General Assembly, it was not very surprising that the 1985 *Bowman* Court employed the phrase *narrow exception* to describe its approach to its decision in *Bowman.*

[23]. 74 N.C. App. 331, 328 S.E.2d 818 (1985).

[24]. Sabine Pilot Service, Inc. v. Hanck, 687 S.W. 2d 733 (Tex. 1985).

[25]. Vermillion v. AAA Pro Moving and Storage, 146 Ariz. 215, 704 P.2d 1360 (Ariz. App. 1985).

[26]. Patton v. J.C. Penney Co. Inc., 75 Or App 638, 707 P.2d 1256 (Or App 1985).

[27]. *See* Dake v. Tuell, 687 S.W.2d 191 (Mo. en banc 1985), Hartley v. Ocean Reef Club, Inc., 476 So.2d 1327 (Fla. App. 3 Dist. 1985).

IV. THE BOWMAN PUBLIC POLICY DECISION

In *Bowman*, the Supreme Court of Virginia reinstated the plaintiffs' actions for wrongful discharge which had been dismissed by the trial court on the basis of the defendants' demurrers. The plaintiffs, who both owned a small amount of stock of the bank which employed them, were threatened with discharge if they failed to vote in favor of a proposed merger. Although they both initially yielded to the threat and voted as instructed, two days later each demanded that their votes be negated as invalid, illegally obtained, improper and null and void. Shortly thereafter, the merger was abandoned and within a week both plaintiffs had been fired. On appeal, the defendants urged the supreme court not to make any exceptions to the employment-at-will doctrine in Virginia, stating that any changes should be made, if at all, by the General Assembly. The plaintiffs responded that the real issue was not whether to alter the doctrine but rather whether an employer can, with absolute immunity, discharge employees in retaliation for the employees' proper exercise of legal rights.

The Supreme Court of Virginia in identifying recognized exceptions to the rule of terminability purportedly did not alter the "traditional rule."[28] The cases cited by the Court as *recognized exceptions* involved retaliatory discharges for: (1) employee insisting employer comply with state law relating to food labeling, (2) employee refusing employer's request that employee attempt to be excused from jury duty, (3) employee refusal to perform illegal acts, and (4) employee insistence that employer comply with state and federal consumer credit protection laws.[29]

The *Bowman* Court, after discussing the *public policy* of unfettered exercise by stockholders of their voting privileges, as provided in the *civil* provisions of the Virginia Stock Corporation Act, concluded that a *narrow exception to the employment-at-will doctrine* would be applied to reinstate the plaintiffs' tort claims for " improper discharge from employment."[30] An examination of the *Bowman* Court's rationale reveals few clues as to its willingness to expand the *public policy exception.* While using the phrase "narrow exception", the Court did not expressly limit application of the exception to only those public policies enunciated in the state constitution, statutes, administrative regulations or previously announced judicial recognition

[28]. *Bowman*, 229 Va. at 539.
[29]. *Id.* at 539-40.
[30]. *Id.* at 540.

of *public policies*. Nor did the *Bowman* Court adopt an expansive exception as had been done in some states.[31]

Professor Perritt, in his commentary on *Bowman*, reviewed the *prima facie tort* concept "enshrined in § 870 of the Restatement of Torts (2d).[32] He then suggested that the analysis using the interest balancing equation is "exactly the analysis used by the *Bowman* Court."[33] This assertion, though made without reference to any part of the text of the *Bowman* decision to support it, is not inconsistent with that decision. Such a balancing test would insure that legitimate cases not be mechanically foreclosed by an overly restrictive definition of *public policy* but yet this test would not completely open the floodgates to all disgruntled and fired employees whose private rights may have been infringed upon but whose claims do not represent situations which, if tolerated, would jeopardize the attainment of *public policy.* The *Bowman* Court recognized as *public policy* the statutory voting rights of individual shareholders, whose rights shall be exercised free of duress and intimidation by corporate management. The supreme court then declared that "[i]n order for the goal of the statute to be realized and the public policy fulfilled, the shareholder must be able to exercise this right without fear of reprisal from corporate management, which happens also to be the employer. Because the right conferred by statute is in furtherance of established public policy, the employer may not use the threat of discharge of an at-will employee as a device to control the otherwise unfettered discretion of a shareholder to vote freely his or her stock in the corporation."[34] In short, the language of the *Bowman* decision left open the Supreme Court of Virginia's options to further refine the *Bowman public policy exception.*

V. *20th CENTURY POST-BOWMAN DEVELOPMENTS*

During the last fourteen and one-half years of the twentieth century, both case decisions and statutory enactments have affected the *Bowman public policy exception.* The Supreme Court of Virginia has shown some willingness to expand the *Bowman* type exception, where appropriate, but has struggled with the impact of certain legislative enactments, which restrict certain causes of action.

[31]. *See, e.g.*, Monge v. Beebee Rubber Co., 114 N.H. 130, 316 A.2d 549 (1974); Fortune v. National Cash Register Co., 373 Mass. 96, 364 N.E.2d 1251 (1977).
[32]. Perritt, *supra* note 13, at 22-23.
[33]. *Id.* at 23.
[34]. *Bowman*, 229 Va. at 540.

Bowman was followed by *Miller v. SEVAMP, Inc.*[35] in which the Supreme Court of Virginia affirmed the trial court's dismissal of an at-will employee's wrongful discharge claim. The employee alleged that her termination was in retaliation for her appearance as a witness at a co-employee's grievance hearing, and the trial court sustained the employer's demurrer, concluding that the case did not constitute a *Bowman public policy exception.* The Supreme Court of Virginia affirmed the dismissal, noting that the exception recognized in *Bowman* only allows recovery of damages for "discharges which violate public policy, that is, the policy underlying existing laws designed to protect the property rights, personal freedoms, health, safety, or welfare of the people in general."[36] The supreme court held that the *Bowman public policy exception* was not applicable because the retaliatory discharge of Miller would impinge only upon private rights established by the employer's internal regulations and "would have no impact upon any public policy established by existing law for the protection of the public generally."[37] Without expressly stating, the Supreme Court of Virginia seemed to be indicating that a public policy, for *Bowman* purposes, would not only have to be found in "existing law" (presumably a constitutional, statutory, or administrative regulation-based claim but possibly including claims based upon public policy judicially recognized in prior reported decisions) but that the public policy must also be of the kind designed for the protection of the general population.

In 1987, the General Assembly adopted the initial version of the Virginia Human Rights Act[38], which declared, in part, that "it is the policy of the Commonwealth of Virginia to safeguard all individuals within the Commonwealth from unlawful discrimination because of race, color, religion, national origin, sex, age, marital status or disability in employment."[39] While the statute states a laudatory policy, it created no enforcement mechanism nor did it establish any statutory remedies for employment discrimination. Moreover, as originally enacted, it contained the following provision:

> Nothing in this chapter creates, nor shall it be construed to create, an independent or private cause of action to enforce its provisions. Nor shall the policies or provisions of this chapter be construed to allow tort actions to be instituted instead of or in addition to the current statutory actions for unlawful discrimination.[40]

This provision appears to be an attempt to exclude application of the *Bowman public policy exception* to the new statutorily announced policy against employment discrimination. But a literal reading of the provision does not necessarily result in that conclusion. The first sentence, it could be argued, is of no consequence since the phrase "its provisions" means nothing in terms of enforcement provisions or remedies because it did not provide any such remedies. In addition, the second sentence, one could argue, would apply only in cases where a federal statutory remedy exists and would not prohibit a tort action being instituted against small employers not covered by Title VII of the 1964 Civil Rights Act when fewer than fifteen employees are employed; this follows because such tort actions could not be "instead of or in addition to the current statutory actions" when such actions are not possible because of the size of the employer. In subsequent cases, this statutory provision certainly became an issue in cases where plaintiffs asserted the existence of a *Bowman public policy exception* to advance a wrongful discharge action when the discharge could be fairly characterized as motivated by the type of employment discrimination addressed in the Virginia Human Rights Act.

In 1994, the Supreme Court of Virginia announced what was perhaps its most controversial *Bowman public policy exception* case of the twentieth century, *Lockhart v. Commonwealth Educ. Sys. Corp.*[41] *Lockhart involved* claims of two female at-will employees who asserted wrongful discharge claims based on the *Bowman public policy exception*, one alleging discharge based upon her race and alleging discharge based upon her gender. The trial court in each case dismissed the respective plaintiff's suit on the basis that the plaintiff had failed to state a cause of action for wrongful discharge within the *Bowman public policy exception*. In reversing the trial courts' dismissal of the two suits, the Supreme Court of Virginia, in a 4-3 decision, after noting the Virginia Human Rights Act reflects the "Commonwealth's strong public policy against employment discrimination based upon race or gender"[42] stated as follows:

35. 234 Va. 462, 362 S.E.2d 915 (1987).
36. *Id.* at 468, 362 S.E.2d at 918.
37. *Id.* at 468, 362 S.E.2d at 919.
38. 1987 Va. Acts ch. 581 (Chapter 43 of Title 2.1 of the Code of Virginia, §§ 2.1-714 through -725).
39. At its 1997 session, the General Assembly amended Va. Code §2.1-715 by adding "pregnancy, childbirth or related medical conditions" to the list of unlawful bases for discrimination in employment.

40. Va. Code § 2.1-275.
41. 247 Va. 98, 439 S.E.2d 328 (1994). This was a consolidated appeal that included *Wright v. Donnelly & Co., Record No. 930205.*
42. *Lockhart v. Commonwealth Educ. Sys. Corp.*, 247 Va. 98, 105, 439 S.E.2d 328, 331 (1994).

> We recognize that the Virginia Human Rights Act does not create any new causes of action. Code §2.1-725. Here, we do not rely upon the Virginia Human Rights Act to create new causes of action. Rather, we rely solely on the narrow exception that we recognized in 1985 in Bowman, decided two years before the enactment of the Virginia Human Rights Act. Without question, it is the public policy of this Commonwealth that all individuals within this Commonwealth are entitled to pursue employment free of discrimination based on race or gender. Indeed, racial or gender discrimination practiced in the work place is not only an invidious violation of the rights of the individual, but such discrimination also affects the property rights, personal freedoms, and welfare of the people in general.[43]

Essentially, what the *Lockhart* majority was asserting, was that although it is the Virginia Human Rights Act which stated the *public policy* which would be fulfilled by recognizing a wrongful discharge tort for termination based upon race or gender, that it is the *Bowman public policy exception* created prior to enactment of that statute which provides the basis for the cause of action. The dissenting opinion in *Lockhart*, however, asserted that it was obvious that the majority had contravened the explicit language of the statute by allowing private causes of action to enforce the statute's provisions and by allowing generalized, common-law actions for wrongful discharge to be maintained in addition to the statutory actions then available for unlawful discrimination.[44]

At the 1995 session of the General Assembly, a bill was introduced (S. 1025) that would have had the effect of overruling the 1994 *Lockhart* decision. Two versions submitted as amendments in the nature of substitutes expressly stated that their purpose was the "nullification" of the *Lockhart* decision. However, the version which was enacted did not contain the "nullification" language but instead substantially modified the Virginia Human Rights Act by specifically prohibiting construction of the statute in a way which creates an independent or private cause of action to enforce its provisions, "except as specifically provided in subsections B and C of this section."[45] Subsection B prohibits an employer of more than five but less than fifteen persons from discharging an employee "on the basis of race,

[43]. *Id.* at 105, 439 S.E.2d at 331.
[44]. *Id.* at 107.
[45]. Va. Code §2.1-275 (A).

color, national origin or sex, or of age if the employee is forty years or older."[46] Subsection C created new, but very limited, statutory remedies for wrongful discharge in violation of Subsection B. Finally, Subsection D, also new, provides in pertinent part as follows:

> Causes of action based upon the public policies reflected in this chapter shall be exclusively limited to those actions, procedures and remedies, if any, afforded by applicable federal or state civil rights statutes or local ordinances.[47]

Clearly, this provision severely threatened expansion of the *Bowman public policy exception,* at least when the cause of action is based upon the prohibited bases for discharge articulated in Va. Code § 2.1-275(B). In 1996, in *Lawrence Chrysler Plymouth Corp. v. Brooks,*[48] the Supreme Court of Virginia reversed an award of damages in a wrongful discharge action asserted by an at-will employee who claimed he was discharged because he refused to perform certain repairs in a manner which the employee believed was unsafe. The employee asserted that "to repair a car in such a manner as was requested is an obvious violation of both statutory and common law duties" and referred very generally to the Consumer Protection laws, the Automobile Salvage Laws and the common-law duties concerning the exercise of due care; however, the employee did not specify what precise statute the employer purportedly contravened. In reversing and dismissing the employee's suit, the Supreme Court of Virginia noted that Brooks, unlike the plaintiffs in the *Bowman* and *Lockhart* cases, failed to identify specific Virginia statutes in which the General Assembly had established public policies that the employer had contravened.[49] More noteworthy, because it suggests the supreme court's unwillingness to recognize a *public policy* not established by statute or constitutional provision, was the supreme court's pronouncement that "[we] also reject *Brook's* attempt to expand the narrow exception we recognized in *Bowman* by relying upon so-called 'common law duties of the dealership.'"[50]

In 1997, the Supreme Court of Virginia recognized a valid *Bowman public policy exception* in two cases involving gender discrimination and disability, respectively. In *Bailey v. Scott-Gallaher, Inc.,*[51] the employee was discharged following the birth of a child, the

[46]. *See supra* note 39.
[47]. Va. Code §2.1-725(D).
[48]. 251 Va. 94, 465 S.E.2d 806 (1996)
[49]. 251 Va. at 98.
[50]. *Id.* at 99.
[51]. 253 Va. 121, 480 S.E.2d 502 (1997).

employer having explained the termination by telling the plaintiff that her place was at home with her child and that because babies get sick sometimes and she would have to miss work to care for her child that the employer needed someone more dependable. The trial court dismissed the plaintiff's *Bowman* claim for wrongful discharge and the Supreme Court of Virginia, by a 4-3 decision, reversed the trial court and reinstated the plaintiff's cause of action based on *Bowman* and *Lockhart,* specifically declining the employer's invitation to retreat from those decisions. The dissenting opinion complained that the Virginia Human Rights Act, although prohibiting employment discrimination based on gender, does not expressly prohibit discrimination based upon pregnancy and childbirth and that the majority should not have inferred a *public policy* not expressly articulated by the statute; it also commented that, in light of the 1995 legislative response to the *Lockhart* decision, the continued viability of *Lockhart* is doubtful.[52] In *Bradick v. Grumman Data Sys. Corp.*[53], the Supreme Court of Virginia, in answering a certified question from the United States Court of Appeals for the Fourth Circuit, held, by another 4-3 decision, that a *Bowman public policy exception* wrongful discharge claim exists where an at-will employee is discharged by an employer covered by the Rehabilitation Act of 1973, 29 U.S.C. § 701, et seq., on account of his disability or the employer's perception of his disability. The *Bradick* majority found the necessary expression of *public policy* in both the Virginia Human Rights Act and the Virginians With Disabilities Act (VDA).[54]The dissenting opinion complained that part of the VDA states that "[the] relief available for violations of this chapter shall be limited to the relief set forth in this section." The majority opinion found that the exclusivity of the remedy provision was not applicable since the state statute exempted employers covered by the federal Rehabilitation Act of 1973 and that, accordingly, actions by exempt employers are not "violations of this chapter."[55]

In late 1997, the Supreme Court of Virginia, in yet another case presenting a question certified to it by a federal court involving the legitimacy of a *Bowman public policy exception* wrongful discharge claim, was squarely faced with the issue of what effect did the post-*Lockhart* legislative enactments have upon the *Bowman* and *Lockhart* cases. In *Doss v. Jamco, Inc.*[56], an at-will employee had asserted both Title VII claims and a *Bowman public policy exception* claim in U.S.

[52]. 253 Va. at 127-28.
[53]. 254 Va. 156, 486 S.E.2d 545 (1997).
[54]. Va. Code §§ 51.1 to 51.5-52.
[55]. *Bradick,* 254 Va. at 160.
[56]. 254 Va. 362, 492 S.E.2d 441 (1997).

District Court, which certified the following question to the Supreme Court of Virginia: Does Va. Code § 2.1-725(D) prohibit a common law cause of action based upon the policies reflected in the Virginia Human Rights Act, Va. Code § 2.1-714 *et seq.*?

Unlike the *Bailey v. Scott-Gallaher, Inc.* case, which although decided in 1997 was controlled by the Virginia law which existed before the 1995 legislative response to the *Lockhart* case, the plaintiff here, Doss, did not file her gender discrimination case until 1996 based upon a 1996 termination by her employer. She was terminated because her maternity leave would cause her to be out during the employer's busy time which was unacceptable to the employer. Her state law claim was based upon the public policy of Virginia as embodied in the Virginia Human Rights Act. After reviewing the employment-at-will doctrine in Virginia and the *Bowman* and *Lockhart* decisions which recognized exceptions thereto, the Supreme Court addressed the effect of the 1995 legislative response to *Lockhart* upon the continued viability of a *Bowman* type wrongful discharge claim. The Supreme Court carefully noted that its decision was "limited by the terms of the certification order to 'the public policies reflected in the Virginia Human Rights Act.' Therefore, we express no opinion concerning the public policy of Virginia as it might be articulated in sources other than the Virginia Human Rights Act."[57] Finding that, in enacting the 1995 amendments to Va. Code § 2.1-275, the General Assembly plainly manifested intent to abrogate the common law with respect to causes of action for unlawful termination of employment based upon the public policies reflected in the Virginia Human Rights Act, the Supreme Court answered the certified question in the affirmative. The *Doss v. Jamco, Inc.* decision appeared to have clearly eliminated the *Bowman public policy exception* if the *public policy* upon which the plaintiff relies is those reflected in the Virginia Human Rights Act as amended in 1995.

In 1998, the Supreme Court of Virginia again answered questions of law certified to it by the United States Court of Appeals for the Fourth Circuit involving wrongful termination of employment claims brought by an at-will employee on the basis of the *Bowman public policy exception.* While the case presented a claim arising prior to the post-*Lockhart* amendments to the Virginia Human Rights Act, it is still instructive regarding proper jury instructions about the plaintiff's requirement to show that an improper motive was the proximate cause for termination and that punitive damages may be recovered in cases not based upon the public policies reflected in the Virginia Human Rights Act. The case is *Shaw v. Titan Corporation*[58] in which the

[57]. *Id.* at 366, 492 S.E.2d at 443.
[58]. 255 Va. 535, 498 S.E.2d 696 (1998).

plaintiff was a white, 62 years old male at the time of his discharge resulting from the employer's *reduction-in-force*. Shaw contended that he was selected for termination as a defensive measure by the employer which had concluded it was vulnerable for *letting go 10 to 1 women and minorities* and needed to have *an ace to throw on the pile*; he was also told that he had been selected as the "ace on the pile" because of his age. Shaw had initiated his wrongful discharge claim in state court based upon a violation of the public policy embodied in the original version of the Virginia Human Rights Act (prior to the 1995 amendments) but the case was removed to federal court based on diversity of citizenship. A federal jury awarded Shaw $65,000 in compensatory damages and $400,000 in punitive damages. The employer appealed to the Fourth Circuit Court of Appeals contending that the jury had been improperly instructed regarding the cause or motive for Shaw's termination and further contending that punitive damages are not available under a *Bowman* claim. The Supreme Court of Virginia found that the U.S. District Court had properly instructed the jury that Shaw was required to prove that he was discharged because of his race, gender or age, or any combination of those factors, rather than because of any non-discriminatory reasons; it further found that a mixed-motive instruction was not required since the employer had not argued that Shaw's discharge was based upon a mixed motive. Addressing the punitive damages issue, the Supreme Court of Virginia answered that punitive damages are properly awarded for a *Bowman* type of wrongful discharge since the claim is an intentional tort claim.

In an early 1999 case, *Conner v. National Pest Control Association, Inc.,*[59] the Supreme Court of Virginia considered the question whether Va. Code § 2.1-725(D) prohibits a common law cause of action for wrongful termination based on a violation of *public policies* enunciated in both the Virginia Human Rights Act and in other provisions of state, federal, or local statutes or ordinances. The plaintiff, Conner, alleged that her termination was discrimination based on her gender and that the employer's conduct was prohibited by portions of the Virginia Constitution, the Fairfax County Code, a variety of other state statutes and Title VII of the Civil Rights Act of 1964. The trial court dismissed her claim for failure to state a claim recognized in Virginia as an exception to the employment-at-will doctrine and because of the 1995 amendments to the Virginia Human Rights Act. At first glance, one is tempted to assume that this issue was disposed of in the *Doss v. Jamco, Inc.* case, *supra*, but the Court, in that case, had very carefully limited its ruling to answering the question

[59]. 257 Va. 286, 513 S.E.2d 398 (1999).

certified to it, which question dealt only with the effect of the 1995 amendments on a *Bowman* type claim based *solely* on the policies reflected in the Virginia Human Rights Act. In *Conner*, as stated above, the plaintiff's claim of gender discrimination was based upon public policy prohibiting such discrimination found in constitutional or statutory pronouncements *other than* the Virginia Human Rights Act. However, the Supreme Court of Virginia had little difficulty in extending the rationale of *Doss* (i.e. that the General Assembly had plainly spoken in the 1995 amendments to the Virginia Human Rights Act and had clearly limited claims based on the policies reflected in that act to the applicable statutory remedies) to the *Conner* situation where the same public policies are "reflected" in the Virginia Human Rights Acts *and* in other constitutional or statutory pronouncements.

In its last *Bowman* claim case of the twentieth century, *Dray v. New Market Poultry Products, Inc.,*[60] the Supreme Court of Virginia affirmed the trial court's dismissal, for failure to state a claim, of an at-will employee's claim of wrongful discharge alleging that the employer had discharged her for reporting alleged sanitary deficiencies in a poultry products plant to governmental inspectors after being warned by the employer to report such problems only to her superiors at the plant. Dray asserted that the *public policy* upon which she based her *Bowman public policy exception* claim was articulated by the Commonwealth in the "Virginia Meat and Poultry Products Inspection Act,"[61] but the trial court found that such statute did not evince a specific public policy intended to benefit the class of individuals to which the plaintiff belonged. A unanimous Supreme Court of Virginia agreed, describing the employee's action as "a generalized, common-law 'whistleblower' retaliatory discharge claim" and stating "[such] a claim has not been recognized as an exception to Virginia's employment-at-will doctrine, and we refuse to recognize it today."[62] The Court went on to point out that the statute in question merely establishes a regulatory mechanism directed only to government inspectors and industry management and does not secure any rights to the plaintiff.

[60]. 258 Va. 187, 518 S.E.2d 312 (1999)
[61]. Va. Code §§ 3.1-884.17 through -884.36.
[62]. *Dray*, 258 Va. at 191, 518 S.E.2d at 313.

VI. *BOWMAN PUBLIC POLICY EXCEPTION IN THE 21ST CENTURY*

On January 14, 2000, the Supreme Court of Virginia announced its first two *Bowman public policy exception* cases of the new century, addressing terminated at-will employees' claims based upon alleged *public policies* found in the Virginia criminal statutes.

The first case, *Harris v. City of Virginia Beach,*[63] involved the claim of a police officer who had been fired for allegedly disobeying an order and abuse of his position; the officer had secured criminal warrants against his superior officer for obstruction of justice and delay in executing lawful process following the superior officer's orders to Harris not to obtain warrants against a suspect due to conflicting information about how Harris had handled the matter involving the suspect. In regard to the Harris wrongful discharge claim based upon the policies in the criminal statutes allegedly violated by the plaintiff's supervisor, a unanimous Supreme Court of Virginia found that the two criminal statutes in question did not evince a public policy that would be frustrated by tolerating the termination of Harris. The Court noted that all criminal statutes have as an underlying policy the protection of the public's safety and welfare but that Harris' reliance on the statutes in question to shield himself from the consequences of his decision to charge his superior officer with obstruction of justice is not in accordance with that policy.[64] The Court also noted that neither criminal statute was designed to protect any public rights pertaining to property, personal freedoms, health, safety, or welfare and that the *Bowman* exception is not broad enough to make actionable the discharge of an at-will employee when a discharge violates only private rights or interests.[65]

In *Mitchem v. Counts,*[66] the Supreme Court of Virginia, reversed the trial court's dismissal of a terminated at-will employee's *Bowman public policy exception* claim that was based upon public policy found in certain criminal statutes. Mitchem alleged that she had been the victim of gender discrimination in the form of sexual harassment, and specifically that she had been discharged as an insurance marketing representative after she refused to engage in a sexual relationship with her former employer. Her pleadings asserted a number of statutes as the source of the public policies upon which her *Bowman exception* case was grounded, including the Virginia Human

[63]. *See supra* note 1.
[64]. *Id.*
[65]. *Id.*
[66]. *Id.*

Rights Act. During her argument before the Supreme Court of Virginia, Mitchem abandoned reliance on all statutes except two provisions of the criminal code, one prohibiting fornication and the other prohibiting lewd and lascivious cohabitation. She asserted that she had been fired for refusal to engage in these two crimes with, and at the insistence of, her employer. The Supreme Court said that it was faced with two issues:

> 1) whether Code § 2.1-275(D) of the Virginia Human Rights Act (VHRA). . . . . bars a common law action for wrongful termination of employment based on a violation of public policy not reflected in the VHRA, when the conduct alleged also violates a public policy reflected in the VHRA; and 2) whether a violation of the public policies embodied in two criminal statutes may support such a common law action.[67]

Despite the arguments of the defendant employer and a vigorously asserted dissenting opinion, the *Mitchem v. Counts* majority distinguished the supreme court's holdings in the *Doss* and *Conner* decisions. It stated that the public policy upon which the plaintiff's *Bowman* claim in *Doss* was based arose solely from the VHRA and that the exclusive remedy language in §2.1-275(D) thereof necessarily precluded Doss' common law *Bowman* claim. In regard to the *Conner* decision, the *Mitchem v. Counts* majority stated that although Conner's claims were based upon a public policy found both in the VHRA and in other sources that it was the *same* public policy and, accordingly, the preclusive language of §2.1-275(D) again prohibited a *Bowman* claim. The majority concluded that the public policy which prohibits conduct in violation of the two criminal statutes relied upon by Mitchem is different from the policy "reflected in the VHRA" even where the same conduct also violated the latter policy. The dissenting opinion lambasted the majority's rationale as exalting form over substance and making a distinction without a difference. Moreover, the dissent argued that the effect of the majority decision is to create "an avenue through which virtually all employees asserting allegations similar to Mitchem's can bypass the General Assembly's clear intent," as expressed in § 2.1-275(D) of the VHRA.[68] The dissent concluded that the majority, in ignoring this clear legislative intent, functioned as a "super-legislative body."[69]

[67]. *Id.*
[68]. *Id.*
[69]. *Id.*

VII. CONCLUSION

Whether Virginia at-will employees claiming to have been wrongfully terminated in violation of a *public policy* will continue to have valid *Bowman exception* claims in the 21st century appears to depend upon whether the employee can point to a public policy which is not reflected in the Virginia Human Rights Act and which would be frustrated by not recognizing a *Bowman exception* in such circumstances. As is evident by the *Mitchem v. Counts* decision, clever pleading characterizing conduct which violates the public policies reflected in the VHRA as also violating a *public policy* not reflected in that statute may allow the preservation of a *Bowman exception* that would otherwise have been eliminated by *Doss* and *Conner*. The lingering tension between the Supreme Court of Virginia's desire to recognize the *Bowman public policy exception*, and the General Assembly's intent to limit such exceptions in cases traditionally characterized as employment discrimination cases, could be alleviated by amendment of the VHRA to increase the statutory remedies or by reducing or eliminating the exclusivity preclusion under current § 2.1-275(D). Until such an amendment occurs, there does not appear to be many reasons for hope that application of the *Bowman public policy exception* by the Supreme Court of Virginia will be substantially expanded in the foreseeable future to improve the plight of at-will employees in Virginia.

COPYRIGHT INFRINGEMENT IN THE WAKE OF ROGERS V. KOONS

*LeGene Quesenberry**

I. INTRODUCTION

With Art Chicago as the second largest art exposition in the world, exhibiting a billion dollars worth of art and selling 50 million of it to 40,000 visitors, the United States is earning its place in the world art market. The laws protecting the economic aspect of art are becoming increasingly important. Popular and inexpensive technology like digital cameras, transformative software, CD burners, and VCR's have made copyright infringement even easier. It is more important than ever to protect intellectual property without retarding creative momentum.

Art is often thought of as more an intellectual exercise than as a property right. It is the expression of contemplation and exposé, of exuberance and sorrow, of exploration and detachment. But, artists create objects: paintings, drawings, sculpture in many different fabrications from dirt[1] to steel, manuscripts, textiles, and utilitarian things. It is this quality of rendering the spiritual in a tangible form that imbues art with legal protection as property. The law regulates its ownership and sale,[2] taxes its transfer,[3] protects its

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[1]. Clay artist Laura Jean McLaughlin refers to her finished product as "just dirt."

[2]. The Uniform Commercial Code (hereinafter UCC) applies to the transfer of artwork since they are movable chattel. U.C.C. § 2-105 (1993). For a court decision that applied both the U.C.C. and property law in the transfer of a painting, see O'Keefe v. Synder, 416 A.2d 862 (N.J. 1980).

[3]. Gruen v. Gruen, 496 N.E.2d 869 (N.Y. 1986), provides a good discussion regarding the tax implications of a testamentary disposition of a painting.

integrity[4] and even imposes, under strict scrutiny, limitations on content.[5]

II. GENERAL BACKGROUND

We all remember our property professors describing property as a "bundle of sticks" or a "bundle of rights." For the artist[6] the most important of these is copyright. More than the traditional rights of possession, use, and enjoyment, copyright allows creators to profit from their investment of time, energy, and skill. The most important source of income is that derived from the reproduction, adaptation, distribution, performance, and display of work of arts.

These basic considerations are rooted in the United States Constitution Article I§8 which provides that Congress has the power

[4]. The Visual Artists Rights Act (hereinafter VARA) provides protection for attribution and integrity. Subject to few exceptions the author of a work of visual art

(1) Shall have the right
 (A) to claim authorship
 (B) prevent the use of his/her name as author of a work he/she did not create
(2) Should have the right to prevent the use of his/her name as the author of a work of visual art in the event of a distortion mutilation or other modification of the work which would be prejudicial to his or her honor or reputation, and
(3) Subject to limitations . . . shall have the right
 (A) to prevent any intentional distortion, mutilation, or modification of that work which would be prejudicial to his or her honor or reputation, and any intentional distortion, mutilation, or modification of that work is a violation of that right, and
 (B) to prevent any destruction of a work of recognized stature, and any intentional or grossly negligent destruction of that work is a violation of that right.

17 U.S.C.A. § 106A (2000).

[5]. Miller v. California, 413 U.S. 15 (1973), articulated the test for obscenity. *Miller* was prosecuted for mailing brochures that advertised sexually explicit books. The test consists of three parts:

> (a) whether "the average person, applying contemporary community standards, would find that the work, taken as a whole, appeals to the prurient interest; (b) whether the work describes or depicts, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value.

Id. at 24. The First Amendment does not protect work that fails the *Miller* test and therefore may be censored as obscene.

[6]. The word artist encompasses all creators in a variety of mediums: print, music, performance, sculpture, and visual.

"to promote the progress of science and the useful arts by securing for limited times to authors, and inventors the exclusive rights to their writings and discoveries." Pursuant to this power Congress enacted The Copyright Law of 1790. Congress extended copyright protection to three-dimensional works of art in the Copyright Act of 1870.[7]
It hasbeen periodically revised culminating in the Copyright Revision Act of 1976.[8] The most recent legislation in this area is The Digital Millennium Copyright Act,[9] which provides Internet and online service providers (ISP's) with limited protection from liability and implements the World Intellectual Property Organization Treaties and the Copyright Damages Improvement Act of 1999.[10]

III. WHAT IS PROTECTED?

A. Categories

There are eight categories of works of authorship that are protected under copyright law. Federal copyright law states that:

> Copyright protection subsists . . . in original works of authorship fixed in any tangible medium of expression, now known or later developed, from

[7]. Copyrightable subject matter was defined as: "any book, map, chart, dramatic or musical composition, engraving, art, print, or photograph negative thereof, or of a painting, drawing, chromo, statue, statuary and of models as intended to be perfected as works of fine arts." Act of July 8, 1870, Ch. 230, § 86, 16 Stat. 198, 202 (repealed 1916). The Court precipitated the liberalization of copyright law in Bleistein v. Donaldson Lithography Co.,188 U.S. 239, 23 S.Ct. 298, 47 L.Ed. 460 (1903) in which it held that chromo-lithograph used in a circus poster were not barred from protection. In Bleistein, Holmes articulated the "anti-discrimination" principle:

> It would be a dangerous undertaking for persons trained only to the law to constitute themselves final judges of the worth of pictorial illustrations, outside of the narrowest and most obvious limits. At the one extreme some works of genius would be sure to miss appreciation. Their very novelty would make them repulsive until the public had learned the new language in which their author spoke. It may be more than doubted, for instance, whether the etchings of Goya or the paintings of Manet would have been sure of protection when seen for the first time. At the other end, copyright would be denied to pictures which appealed to a public less educated than the judge.

Id. at 251-52, 23 S.Ct. at 300-01.

[8]. 17 U.S.C.A. § 101 *et seq.*, effective January 1, 1978.

[9]. P. L. No. 105-304, 112 Stat. 2860 (1998).

[10]. **The Copyright Damages Improvement Act of 1999 increases statutory damages available for infringement to between $750-$30,000 per incident and the penalty for willful infringement to a maximum of $150,000.**

which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. Works of authorship includes the following:

1. literary works
2. musical works, including any accompanying words
3. dramatic works, including accompanying music
4. pantomimes and choreographic works
5. pictorial, graphic and sculptural works
6. motion pictures and other audiovisual works
7. sound recordings; and
8. architectural works." . . . . [11]

Most of the eight categories are undefined. The definitions provided do contain limitations as to the subject matter, which may be copyrighted. For the purposes of this paper the definition of pictorial graphic and sculptural works is important:

> Works of artistic craftsmanship insofar as their form but not their mechanical or utilitarian aspects are concerned; the design of a "useful article". . . shall be considered a pictorial, graphic or sculptural work only if, and only to the extent that, such design incorporates . . . features that can be identified separately from and are capable of existing independently of the utilitarian aspects of the article.[12]

This reluctance by Congress to protect applied art has created much confusion - and litigation - over objects which possess both an artistic and utilitarian component. In *Mazer v Stein,*[13] the Supreme Court answered the question of whether a lamp manufacturer could copyright the lamp base in the affirmative. The decision to extend copyright protection to applied art required the Copyright Office to develop distinctions between useful objects which would receive protection as "works of art" and those that would not. The delicacy of that line is demonstrated in *Esquire, Inc. v. Ringer.* [14]

Esquire, Inc. submitted three applications to the Copyright Office for stationary outdoor luminaries of contemporary design, with rounded or elliptically-shaped housings. The applications requested copyright protection as "works of art." The Register of Copyright

[11]. 17 U.S.C.A. § 102(a).
[12]. *Id.* at § 101.
[13]. 347 U.S. 201, 74 S.Ct. 460, 98 L.Ed. 630 (1954).
[14]. 591 F.2d 796 (D.C. Cir. 1978).

refused to accept those claims relying on the Copyright Office regulations which preclude registration of the design of a utilitarian article such as lighting fixtures "when all of the design elements...are directly related to the useful functions of the article.[15]" Because the fixtures did not contain "elements either alone or in combination which are capable of independent existence as a copyrightable pictorial, graphic or sculptural work apart from the utilitarian aspect,"[16] they are industrial designs which are not copyrightable. After two applications and two refusals, Esquire filed suit to require the Copyright Office to issue the registration. The district court relied on *Mazer* in finding that if copyright attaches to mass-produced statuettes used as lamp bases then it must also extend to the more abstract and contemporary design of the Esquire lamps. It determined, "the forms of the articles here in dispute are clearly art [and] are entitled to the same recognition afforded more traditional sculpture."[17]

The heart of this controversy is the semantic dispute over the regulation, 37 C.F.R. § 202.10(c). The provision at issue provides that:

> (c) If the sole intrinsic function of an article is its utility, the fact that the article is unique and attractively shaped will not qualify it as a work of art. However, if the shape of a utilitarian article incorporates features, such as artistic sculpture, carving, or pictorial representation which can be identified separately and are capable of existing independently as a work of art. Such features will be eligible for registration.[18]

The Register interpreted this section to bar copyright on the overall shape of a utilitarian object, no matter how aesthetically pleasing that shape may be. The Register noted that the regulation limits copyright to features that "can be identified separately and capable of existing independently as a work of art." This reading is necessary to achieve the Congressional policy against copyright of industrial designs.

Esquire, on the other hand, argued that copyright attaches as long as the shape or design satisfies the requirements appurtenant to works of art - originally and creativity.[19] *Esquire* claimed it designed its

[15]. 37 C.F.R § 202.10(c) (1976).
[16]. Joint Appendix (J.A.) at 28-29.
[17]. Esquire, Inc. v. Ringer, 414 F. Supp 939, 941 (D.D.C. 1976).
[18]. 37 C.F.R. § 202.10(c).
[19]. "[T]he courts have uniformly inferred the [originality] requirement from the fact that copyright protection may only be claimed by authors . . . . 1. M. Nimmer, COPYRIGHT §10 at 32 (1976). The requirement of creativity with respect to works of art is embodied in 37 C.F.R. § 202.10(b): "In order to be acceptable as a work of art, the

fixtures with the intent of creativity "works of modernistic form sculpture,"[20] and therefore that their sole function was not utility. The court found the Register's argument most compelling especially since Congress had deleted a proposed section from the Copyright Act of 1976 that would have created limited copyright protection for original designs which are part of a useful article. In rejecting the proposal, Congress weighed three economic considerations. First in the case of some objects, shape is mandated by form. Granting a copyright would exclude competing manufacturers. Second, consumer preference demands uniformity of shape. Again, to grant one manufacturer a copyright would be anticompetitive. Third, regarding geometric shapes, there are only a limited amount of basic shapes. These shapes are in the public domain. It would be unfair to grant a monopoly to the use of a particular shape, no matter how well it was integrated into a utilitarian article.[21] The court found that the regulation attempts to define boundaries between copyrightable works of art and noncopyrightable industrial designs. Since the Register's interpretation was not plainly erroneous or inconsistent with the regulation it was found to be controlling.[22]

Congress, never having enacted a comprehensive statute dealing with the protection of utilitarian objects, has left this question to the courts. The *Kieselstein-Cord* decision was considered on the edge of copyright law.[23] It was a case involving belt buckles, not usually copyrightable because they are utilitarian. But these buckles were sculptural designs cast in precious metals. The Copyright Office had granted applications for copyright and the defendant manufacturer of the knock-off item was found to have infringed on that copyright.

The problem is determining when a pictorial, graphic, or sculptural feature "can be identified separately from and [is] capable of existing independently of the utilitarian aspects of the article[24]." An example of conceptual art might be Christo's Running Fence: it did not contain sculptural features that were physically separable from the utilitarian aspects of the fence, but the whole point of the work was that the artistic aspects were conceptually separable. The problem is

work must embody some creative authorship in its delineation or form." 37 C.F.R. § 202.10(b).

20. *Esquire*, 414 F. Supp. at 939 (Brief for Appellant at 5).

21. *Esquire*, 414 F. Supp. at 939 (Brief for Appellant at 18-19). *See also* Note, *Protection for the Artistic Aspects of Articles of Utility*, 72 HARV. L. REV. 1520, 1532 (1959).

22. Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 414, 65 S.Ct. 1215 (1945).

23. Kieselstein-Cord v. Accessories by Pearl, Inc., 632 F.2d 989 (2d Cir. 1980).

24. 17 U.S.C.A. § 101.

difficult because, according to the legislative history such separability may occur "physically or conceptually."[25]

A test for conceptual separateness was offered by Judge C. J. Newman in *Carol Barnhart Inc. v Economy Cover Corp*[26] ". . .the article must stimulate in the mind of the beholder [the ordinary, reasonable observer] a concept that is separate from the concept worked by its utilitarian function." [27] In drawing this line, courts will inevitably be drawn into some minimal inquiry as to the nature of art. Of course, the court must not assess the quality of art, but determine whether a design engenders the concept of a work of art.

B. *The Idea/Expression Dichotomy*

In order for copyright to attach the work must be "fixed in a tangible medium of expression."[28]

> In no case does copyright protection for an original work of authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery regardless of the form in which it is described, explained, illustrated or embodied in such work.[29]

The primary rule of copyright is that the expression of an idea and not the idea itself is protected. For example, in *Musto v. Meyer,*[30] the federal district court held that the book, THE SEVEN PERCENT SOLUTION, did not infringe on an article published in a medical journal which portrayed Sherlock Holmes as a cocaine addict tricked into treatment from Sigmund Freud by Watson.

Similarly, in *Miller v Columbia Broadcasting System, Inc.*,[31] A television series portraying an ex-convict who obtained a law degree in prison did not infringe upon a biography with the same plot. Again, the court noted that if an author could prevent the use of ideas, concepts or notions, poetry, science, fiction would be hindered by copyright rather than promoted by it. Whether a character is subject to copyright protection depends on whether it has been sufficiently delineated. A

25. H.R. Rep. No. 1476, 94th Cong., 2d Sess. at 55 *reprinted* in [1976] U.S. Code Cong. & Admin. News pp 5659, 5668.

26. 773 F.2d 411 (2d. Cir. 1985).

27. *Id.* at 423.

28. *See* 17 U.S.C.A. § 101; *supra* note 8.

29. 17 U.S.C.A. § 102(b).

30. Musto v Meyer, 434 F. Supp. 32 (D.C.N.Y. 1977), *aff'd.*, 598 F.2d 609 (2d Cir. 1979).

31. Miller v. Columbia Broadcasting System, Inc., 209 U.S. P.Q. (BNA) 502 (C.D.Cal. 1980).

character that exists in a graphic medium such as comic books or cartoons clearly meets the standard required for copyright protection.[32]

C. *FAIR USE*

The fair use doctrine permits limited use of copyrighted work. Federal copyright law states that:

> Notwithstanding the provisions of sections 106 and 106A, the fair use of a copyrighted work, including such use . . . as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship or research, is not an infringement of copyright. In determining whether the use made of a work . . . is a fair use the factors to be considered shall include:
> (1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes;
> (2) the nature of the copyrighted work;
> (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
> (4) the effect of the use upon the potential market for or value of the copyrighted work.[33]

The Copyright Act does not rank these four criteria, nor does it exclude other factors in determining fair use. The Supreme Court has held, however, that the economic factor is the most important.[34]

IV. *PARODY*

Parody is an unauthorized use of copyrightable material that can be categorized as fair use. The Supreme Court defines parody as:

> For the purposes of copyright law, the nub of the definitions, and the heart of any parodist's claim to quote from existing material, is the use of some elements of a prior author's composition to create a new one that, at least in part, comments on that author's works...If, on the contrary, the commentary

[32]. Superman and Mickey Mouse have been successfully defended from being copied. *See* Detective Comics, Inc. v. Bruns Publications, 11 F.2d 432 (2d Cir. 1940); Walt Disney Productions v. Air Pirates 581 F.2d 751 (9th Cir. 1978).

[33]. 17 U.S.C. § 107.

[34]. Stewart v. Abend, 495 U.S. 207, 214 (1990).

> has no critical bearing on the substance or style of the original composition, which the alleged infringer merely uses to get attention or to avoid the drudgery in working up something fresh, the claim to fairness in borrowing from another's work diminishes accordingly (if it does not vanish), and other factors, like the extent of its commerciality, loom larger.[35]

So, in *Fisher v Dees*,[36] the defendant created a song, *When Sonny Sniffs Glue*, a comic rendition of *When Sonny Gets Blue* using the musical score of the plaintiff's song. The Ninth Circuit found no infringement based on four criteria: (1) The subject of the parody was the song itself; (2) There was no bad faith; (3) The use was commercial, but did not diminish the value of the original song; and (4) The parody was not a substitute for the original.[37]

The Second Circuit decided that a Jeff Koons' colorful sculpture infringed upon a black and white photograph by Rogers and states that:

> It is the rule in this Circuit that though the satire need not be only of the copied work and may . . . also be a parody of modern society, the copied work must be, at least in part, an object of the parody, otherwise there would be no need to conjure up the original work . . . .By requiring that the copied work be an object of the parody, we merely insist that the audience be aware that underlying the parody there is an original and separate expression, attributable to a different artist.[38]

A. Recent Cases

Defendants were enjoined from releasing their book, THE CAT NOT IN THE HAT" A PARODY BY DR. JUICE" The book is a rhyming summary of the O.J. Simpson trial done in the style of the Dr. Seuss books and was meant to mimic ONE FISH, TWO FISH, RED FISH, BLUE FISH.

> "A happy town Inside L.A. Where rich folks play the day away.
> But under the moon The 12th of June. Two victims flail Assault!

[35]. Campbell v. Acuff-Rose Music, Inc. 114 S.Ct. 1164 (1994).

[36]. Fisher v. Dees, 794 F.2d 432 (9th Cir. 1986).

[37]. *Id* at 432.

[38]. Rogers v. Koons, 960 F.2d 301, 310 (2d Cir. 1992).

Somebody will go to jail!
Who will it be? Oh my! Oh me!"
"One Knife?/Two Knife?/Red Knife/Dead Wife."
"A plea went out to Rob Shapiro Can you save the fallen hero?
And Marcia Clark, hooray, hooray Was called in with a justice play.
A man this famous Never hires Lawyers like Jacoby-Meyers.
When you're accused of a killing scheme You need to build a real Dream Team.

In granting the injunction the Court stated that:

> These stanzas and illustrations simply retell the Simpson tale. Although "The Cat NOT in the Hat!" does broadly mimic Dr. Seuss' characteristic style, it does not hold his style up to ridicule. The stanzas have no critical bearing on the substance or style of "The Cat in the Hat."[39]

How these cases can be distinguished from *Fisher v Dees* is not clear. The abstractions test articulated by Judge Learned Hand[40] advised that infringement had to be determined on an ad hoc basis. Hand asserted that the boundary between idea and expression could not be fixed and that the test for copyright infringement is of necessity vague. Unfortunately, the abstractions test did not provide guidelines to practicing artists and their representatives, which would prevent liability for infringement.

V. CONCLUSION

In order to create an environment which encourages the proliferation of art and artistic expression we need to develop a test which, if met, protects an artist from liability for copyright infringement. When the derivative work is identifiably different from the inspirational one, some areas of inquiry to determine infringement would include:

(1) Does the new work diminish the value of the inspirational work?
(2) Does the new work confuse the reputation of the artist in the public's mind?

[39]. Dr. Seuss Enterprises, L.P. v. Penguin Books, USA, Inc., 109 F.3d 1394, 1401 (9th Cir. 1997).

[40]. Nichols v. Universal Pictures Corp., 45 F.2d 119 (2d Cir. 1930), *cert. denied*, 282 U.S. 902 (1931).

(3) Is the new work confused with the original by the public?
(4) Does the new work diminish the reputation of the original artist?

Using The Internet As A Teaching Opportunity

Susanna Monseau[*]

I. INTRODUCTION

Most business students are very familiar with and comfortable with using computer technology – often to a far greater extent than the professor. In informal poles of juniors and seniors in a social and legal environment of business class the author finds that 90% or more students have their own computer and access to the Internet at home or in their dorm rooms. Others use computers belonging to the school. When asked the same students admit that they often use the Internet in addition to or even in place of traditional library research for assignments which require reading outside the textbook. A common use of the Internet by students is the key word search on a web search engine such as Yahoo or Lycos[1]. The student faced with a research problem types in what he views as the key words defining the topic. The search is run. On finding that a prodigious quantity of information is available on the subject the student does a quick review of the document headings and then picks a few web sites. He either quotes extensively from the information he finds at these web sites or incorporates the information from various web sites into his answer without attribution. Many students routinely fail to consider or even note the source (or possible bias) of the materials found via their web research. It is easier to ignore the source of information found by a computer search than the source of information found from a search through hard-copy documents such as books or newspapers. Most people note whether they are reading the *National Enquirer* or the *New York Times* but it is surprising how often they do not note where they get information from in a web search as one page can often lead almost seamlessly through a "click on" link directly on to another maintained by a completely different entity. Given the prodigious quantity of information available to anyone who "surfs the Web" which is inaccurate, out of date, of questionable worth or just plain wrong, ignoring source in this medium is dangerous.

Despite, or even because of these problems the Internet can be used very effectively as a teaching tool. There are three areas of

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1. <http://www.yahoo.com> and <http://www.lycos.com>.

teaching where the author has found the Internet to be a useful teaching tool. First, it is a wonderful repository of primary (and secondary) source materials to which access has never been so easy and which students can be encouraged to use to supplement classroom discussion and in their research. Second, the wealth of information available on the Internet allows students to access and compare information on a course topic from many different sources much more easily than in a library, particularly in practical courses such as business law and legal environment of business. Lastly, the various aspects of the Internet itself and its history furnish up-to-date and interesting illustrations of some important legal topics and concepts.

II. PRIMARY SOURCE MATERIALS

Most instructors probably have a list of favorite sites that contain useful commentary or primary source materials, relevant to their courses and discipline. There are many resources on the Internet that are useful to the business law instructor. It is becoming a particularly rich source of reports of legal decisions thanks mainly to university projects. United States Supreme Court Decisions can be found at the web site of the Oyez Project of Northwestern University.[2] It is even possible on this site to hear audio clips of the Justices reading from their opinions. All court decisions in certain key areas are another popular project of some institutions. A Stanford University project[3] has all recent court decisions in the area of securities regulation. There is a site at DePaul[4] which has important decisions and case materials in ethics and law and a site at Cornell[5] which provides basic information on many legal topics and links to lots of primary sources. The Global Business Responsibility Resource Center[6] has a large information resource devoted to issues of corporate social responsibility. All sorts of useful and interesting primary source documents from the Magna Carta[7] to the US government white paper on Internet governance[8] can

2. <http://www.oyez.nwu.edu>.
3. <http://securities.stanford.edu>.
4. <http://depaul.edu/ethics>.
5. <http://www.law.cornell.edu/topical.html>.
6. <http://www.bsr.org/resourcecenter/>.
7. A copy can be found at <http://www.nara.gov/exhall/charters/magnacarta/magmain.html> (site visited March 10, 2000).
8. NTIA "Management of Internet Names and Addresses," Docket No. 98021036-8146-02, June 5, 1998. A copy of this paper can be found at several internet sites including one maintained by the World Intellectual Property Association (WIPO) at

now been found in full on some web site or other. Government web sites are useful for first hand information on government initiatives and the texts of various laws, white papers, green papers and government regulations. The FDA's site[9] is fairly informative and well designed. Students can be directed to look at particular sites which are useful as a source of content information for course topics or concepts. Corporate web sites are also useful as a way of obtaining information about a company quickly and easily, as long as their commercial objectives are borne in mind when using them. Some contain no more than basic contact details but others are very sophisticated and informative and give a great deal of information about the company's mission, objectives and position on various issues of ethics and corporate social responsibility that can be useful in a legal environment course to illustrate course topics in practice. For current updates on legal stories of interest there are sites such as the legal news site, Law.com[10] and Court TV.[11]

III. CRITICAL THINKING and WEB-BASED RESEARCH ASSIGNMENTS

One of the main objectives of education is to develop critical thinking abilities. Many educators have written about the importance of encouraging critical thinking in business law and legal environment courses.[12] We want our students to be able to acquire "the ability to understand the structure of an argument and apply a set of evaluative criteria to assess its merits."[13] As a first step to acquiring the ability to understand an argument (and therefore be able to develop their own) students must be able to evaluate the facts which form the basis of the argument. And there are ever expanding stores of facts available. It is more and more important, given the wealth of information available on the Internet and elsewhere, to evaluate the source and validity of information before endorsing it.

<http://commerce.wipo.int/domains/process/eng/processhome.html> (site visited January 27, 2000).

9. <http://www.fda.gov>.

10. <http://www.law.com>.

11. <http://www.courttv.com>.

12. *See, e.g.* Susan M. Denbo, *Employee v. Employer: Integrating Employment Law Issues and Critical Thinking Skills Into the Undergraduate Business Law Curriculum*, 15 J. LEGAL STUD. EDUC. 107, 107 (1997).

13. Denbo, *supra* note 12, at 107 (quoting from Nancy M. Kubasek, Bartley A. Brennan & Neil Browne, *The Legal Environment of Business: A Critical Thinking Approach*, 14 J. LEGAL STUD. EDUC. 35 (1996)).

The benefits of using web-based research assignments are many. It is generally easy for students to find relevant materials and information that can also be more current than textbook examples and often comes direct from the corporate world. The author's experience has been that students enjoy their ability to do independent research with such ease and are prepared to spend surprising amounts of time in obtaining data from many web sources. This is partly also due no doubt to the addictive nature of *surfing the web*.

Before research commences the students must be alerted to the fact that part of the exercise involves focusing on the source of information in determining its relevance and validity. It is helpful to illustrate this by asking students to consider the difference between physical documentary sources such as newspapers, corporate press releases, and the information in government publications. They can be asked if they would view a story differently when printed in the *New York Times* and when printed in the *National Enquirer.*

IV. THE ASSIGNMENTS

There is a lot of information on the Internet on various legal and commercial topics. It is possible for the instructor, with a few prior Internet searches of her own, to find issues or topics which are covered from different angles on different sites.

The merits and drawbacks of Alternative Dispute Resolution (ADR) and the concept of corporate social responsibility in practice are both topics where the author uses web-based assignments to teach content and to develop critical thinking skills. The techniques used can be adapted to any topic in any course where there is sufficient information and discussion of the topic in the media, by government and by the corporate world. In social and legal environment of business courses, civil litigation, procedure and practice are important subjects. The high financial costs and time involved in litigation have led to a huge growth in various methods of resolving disputes outside of the traditional court system, often referred to as ADR. There are so many different methods of ADR available that it is hard to describe them all and evaluate the advantages and disadvantages of each by contrast with the courts in an effective and comprehensible manner in a short class period. To get students to consider and evaluate the various methods of ADR for themselves they are each asked to locate before class the web site of one entity that describes itself as providing ADR services and educate themselves about its services, clients and cases. There are many ADR providers who provide a wealth of information on their clients, the types of disputes they resolve and their methods on the Internet so this is not a time-consuming or difficult exercise. The resulting materials enable the instructor to compile a long and varied list of types of ADR providers, the types of cases they deal with and their methods in class from student sources. This then permits a discussion of the many types of ADR, such as conciliation, arbitration, and mini-trials and their merits, in different types of dispute, from the student-generated source materials. Students often become advocates for the ADR provider they have chosen and its methods which stimulate classroom discussion of the advantages and disadvantages of ADR in different situations.

In this exercise, which takes place near the beginning of the semester, students do no more than locate and retrieve information. However, as there is usually great variety in the material retrieved it becomes possible to use the materials to do some comparisons in class and analyze the different pieces of material in answering a question – in this case about the benefits and disadvantages of ADR.

The accessibility of corporate web sites provides the instructor with the possibility of getting students to do some independent research and consider an issue from a practical perspective. This works particularly well with topics such as business ethics or corporate social responsibility. Many companies include information on their web sites such as their mission statements and specific areas of corporate citizenship or corporate social responsibility,[14] whether it is their exemplary environmental practices or the working conditions in their overseas factories. These areas are just as often highlighted by the web sites of non-profit associations committed to exposing corporate wrongdoing such as environmental pollution and labor and human rights abuses.[15]

In class, we discuss areas of topical concern and students are asked to choose an issue of business ethics or corporate social responsibility that they find interesting and look at the performance of one or more companies in this area. Sometimes they are led to a particular topic by a news story and sometimes they start with the claims at the company's own web site. The task is to consider both sides of the issue and evaluate the validity of the company's statements and those of its critics. In order to do this evaluation, the students have

14. *See, e.g.* Johnson & Johnson, <http://jnj.com/who_is_jnj/1998enviro/environmental_affairs.html>; McDonalds, <http://mcdonalds.com/community/environ/info/index.html> (both visited March 10, 2000).

15. *See, e.g.*, Campaign For Labor Rights at <http://www.summersault.com> and National Labor Committee at <http://www.nlcnet.org>.

to seek out information not only from the company web site but also from other sources such as web-based news providers and the web sites of other organizations monitoring the issue. Students are forced to consider the source of each piece of information they find on the topic and the company and trace issues raised by different sources. Usually students are asked to write a report on their findings and do a brief presentation to the class.

Student enjoy researching topics that have received a lot of press and are relevant to their lives or concerns. For example Nike's labor practices, Texaco's problems with workplace diversity and McDonalds' environmental efforts have been reviewed in the author's class by students using the Internet to do the research. Nike devotes much space at its web site to details of its good labor practices at foreign factories because of constant allegations of human rights abuses.[16] There are many other web sites, mostly maintained by non-profit organizations, which catalog Nike's abuses and failures in this area.[17]

The highly publicized battles and debates over the litigation and government regulation of the tobacco industry provide another good area for Internet research assignments to illustrate major themes such as civil litigation, government regulation of business and the role of business in society. There is so much information about the various aspects of the tobacco saga on the Web[18] that students can be asked to consider it from many different standpoints. Current information on the regulation of tobacco advertising issue is easy to locate on a variety of web sites. A variety of tobacco information and links including a link to the recent United States Supreme Court decision that the FDA does not have the power to regulate tobacco can be found at the FDA web site[19]. For a different perspective there are the web sites of the various tobacco companies[20] and their critics.[21]

16. *See, e.g.*, <http://nikebiz.com/labor/manu_lead.html> (visited March 9, 2000).

17. Campaign For Labor Rights and National Labor Committee, *supra* note 15.

18. *See, e.g.*, the FDA page at <http://www.fda.gov/opacom/campaigns/tobacco/tobcourt.html> and the Court TV online special at <http://www.courttv.com/trials/tobacco/speical.html>.

19. *See* <http://fda.gov/opacom/campaigns/tobacco/default.html>.

20. *See, e.g.*, <http://philipmorris.com/tobacco_bus/tobacco_issues/marketing_practice.htm>.

21. *See, e.g.* <http://www.buttout.com>. This is a website of a private corporation that sells anti-tobacco merchandise and is dedicated to reducing tobacco consumption.

V. *CONCEPTS and CONTENT*

As stated, students today are familiar with computers and the Internet to a far greater extent than even a decade ago. They have grown up using computer technology. Thus using aspects of the technology as examples to explain course concepts is especially appropriate because students can relate to the examples easily and the concepts are more likely to be remembered. Several areas of content in the business law and social and legal environment of business courses can be taught using some aspect of the Internet as an illustration of the concepts discussed. Among these are personal jurisdiction of the courts, government regulation of business, and the First Amendment, issues such as free speech and the Internet.

The concept of the personal jurisdiction of the courts is often taught using as examples automobile actions involving an accident in one state where the driver of the vehicle is from outside the jurisdiction or the vehicle was purchased outside the jurisdiction.[22] These cases are not immediately interesting to the student. Jurisdiction, however, is an important concept in any study of how the legal system affects business. A court must have both subject matter jurisdiction over the issue and personal jurisdiction over the parties to adjudicate in a dispute brought before it. In an increasingly global business environment, jurisdiction is often at issue because the defendant does not have a physical presence in the state, or even country, where the plaintiff has suffered injury and wants to sue him.

The explosion of E-commerce provides many up-to-date examples of jurisdiction problems. The very nature of E-commerce means that it does not matter whether you are physically located near the person with whom you are transacting business. It is often the case that a contract between two companies can involve activities in many different states or countries. The question is, if something goes wrong, where may the dispute be litigated? In these cases the courts have to decide whether something done in one jurisdiction has an effect in another sufficient to bring about personal jurisdiction in the forum state over the defendant.

Many students have themselves bought items over the Internet and asking them to consider what they could do in the event of a problem with an item bought from a company with no physical presence in their state enables them to gain some immediate understanding of the concept of jurisdiction. If a company with a web

[22]. *See, e.g.*, World-Wide Volkswagen Corp. v. Woodson, 100 S.Ct. 559 (1980).

presence can always be called in to court in any jurisdiction where harm has occurred as a result of its web presence that means that it can be called into court literally anywhere in the world regardless of whether or not it intended to do business in that location. Students understand, perhaps better than some courts that have considered this issue, that if the test of jurisdiction is simply whether the company maintains a web site which is accessible from inside the jurisdiction this accessibility can place a potentially heavy burden on companies engaged in web-based commerce and lead to inequitable results.

United States and foreign courts have already decided numerous cases on jurisdiction issues in cyberspace. Many Internet cases concern the use of trademarks on web sites and whether consumers have been confused by misleading advertising involving other companies' trademarks.[23] As in many areas of new technology the courts have not yet developed a consistent approach or series of hard and fast principles to explain when a web presence will give rise to jurisdiction and when it will not. Such an inconsistent approach enables the instructor to discuss the way law constantly has to evolve to take into account new technologies and novel situations. There are a host of gray areas and undecided questions which can be discussed in connection with jurisdiction which helps students appreciate that the courts are constantly having to grapple with new problems as technology changes and that this issue is set to increase in importance in a world dominated by the Internet and global business operations.

There seems to be two very different lines of reasoning emerging in cases involving jurisdiction and the Internet[24]. In one line of cases starting with *Zippo Mfg. Co. v. Zippo Dot Com, Inc.*, [25] the courts have held that personal jurisdiction does not result simply because the non-resident defendant owns and operates a web site accessible from the forum jurisdiction. "The likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activities that an entity conducts over the Internet."[26] In cases following *Zippo*, the courts have consistently looked for something more active than simply maintaining an Internet presence to determine whether jurisdiction over the defendant should be found. The cyber-pirate cases such as those

[23]. *See, e.g.* Brookfield Communications Inc., v. West Coast Ent. Corp., 174 F. 3d 1036 (9th Cir. 1999).
[24]. Michael J. Dunne & Anna L. Musacchio, *Jurisdiction Over the Internet*, 54 BUS. LAW. 385, 391 (Nov. 1998).
[25]. Zippo Mfg. Co. v. Zippo Dot Com, Inc., 952 F. Supp. 1119 (W.D. Pa. 1997).
[26]. *Id.* at 1124.

involving Dennis Toeppen[27] illustrate the concept that the web site owner must do something active which has an effect in the forum state before he can be called into court there. Dennis Toeppen registered the names of well-known companies as web sites. He was sued by a number of these companies, including Panavision which was based in California.[28] He and the web site <panavision.com> were based in Illinois and he argued that the court in California did not have jurisdiction over him or the web site because he was not intending to do business there. However, the court found that the web site had been used as a vehicle to blackmail the true owners of the trademark PANAVISION. It was this activity which had an effect in California and enabled the Californian court to find jurisdiction over Toeppen and the web site <panavision.com>.[29]

The earlier of the two lines of cases began with a decision of the United States District Court in Connecticut called *Inset Systems, Inc. v. Instruction Set, Inc.*[30] In this case the rational for finding jurisdiction based on web presence is much broader. The court decided that merely having a web site is equivalent to having an advertisement in a nationally circulated magazine available 24 hours a day and leads to jurisdiction in any forum where the web site can be accessed.[31] Some courts have followed *Inset.*[32] More courts seem to be following *Zippo,* but even so the law remains unclear on the issue of jurisdiction in cases involving an Internet presence.

The issue of jurisdiction over domain names on the Internet was a subject of concern in the United States government's recent white paper[33] on future Internet governance because trademark owners particularly have complained about the difficulties of enforcing their nationally based trademark rights in this global medium.[34] One of the White Paper proposals for dealing with the so-called "trademark dilemma" was that the domain name registrars include as part of the registration contract that any dispute involving the domain name be heard in the jurisdiction where the registry is domiciled, the registry

[27]. Dennis Toeppen's activities have resulted in a number of reported cases. *See, e.g* , Intermatic Inc., v. Toeppen, 947 F. Supp. 1127; American Standard Inc., v. Toeppen, 96 CV02147 (C.D. Ill., filed May 31, 1996).

[28]. Panavision Int'l L. P. v. Toeppen, 141 F.3d 319 (9th Cir. 1999).

[29]. *Id.* at 333.

[30]. Inset Systems Inc., v. Instruction Set Inc., 937 F. Supp. 161 (D. Conn. 1996).

[31]. *Id.* at 165.

[32]. *See, e.g.,* IA, Inc. v. Thermacell Techs., Inc., 983 F. Supp. 697, 701 (E.D. Mich. 1997).

[33]. *Supra* note 8.

[34]. *See, e.g.,* Sally M. Abel & Connie L. Ellerbach, *Trademark Issues in Cyberspace: The Brave New Frontier.* The author has a copy of the paper which can also be accessed on the internet at http://www.fenwick.com/pub/cyber.html>.

database is maintained or the A root server is maintained.[35] This would simplify the issue of personal jurisdiction by giving jurisdiction over the web site, if not the owner of the site, to a particular court. This proposal upset many in the Internet community including the growing number of non-US Internet users because many of the registries and most of the A root servers are located in the US and so, they argued, US law would become the *de facto* law of the Internet. The new private corporation which has taken over the assigning of Internet addresses from the United States government, the Internet Corporation for Assigned Names and Numbers (ICANN), has implemented a policy to deal with the jurisdiction problem. Its policy requires registrars to ensure that as part of the registration agreement domain name holders submit without prejudice to the jurisdiction of either the court in the country where they live or the country where the registrar is located.[36]

Congress remains concerned with the jurisdiction issue on the Internet. Provisions in the recently passed Intellectual Property and Communications Omnibus Reform Act give power to courts to dispose of domain name rights as rights *in rem* in the absence of the domain name owners specifically to avoid the lack of personal jurisdiction often evident in cases involving cyberpiracy.[37]

The subject of government regulation can be illustrated with examples concerning the Internet. There is discussion in the press almost every day about whether business on the Internet should be subject to more government regulation or whether the job of regulating E-commerce should be left up to the business community itself.[38] For example the Clinton Administration had to consider the issue of whether on-line pharmacies that dispense drugs should be subject to regulation by the FDA.[39] Online pharmacies escape much of the regulation to which their bricks and mortar counterparts are subject by the states because of their lack of physical retail stores. Established pharmacies and pharmaceutical manufacturers are lobbying for stricter rules for online suppliers, as much to protect their own margins as the health and safety of consumers. Meanwhile Internet pharmacies

[35]. *Supra* note 8.

[36]. *See* Final Report of the WIPO Internet Domain Name Process, Official WIPO Publication No 92-805-0779-6 (April 30 1999), at paragraph 147. A copy of this document can be found at http://ecommerce.wipo.int/domains/process/eng/final-report.html (site visited Jan 10, 2000)

[37]. 15 U.S.C. § 1114(v).

[38]. *See* David S. Cloud & Joe Mathews, *US Legislation in Response to Attacks on Web Sites is Expected to be Minor*, WALL ST. J., B2 (March 7, 2000).

[39]. For a news story on the subject, *see* Chris Adams, *Plan to Curb Drugstores on Web is Hit*, WALL ST. J., A3 (December 29, 1999).

trumpet the cost savings for consumers of the largely unregulated Internet market.

A discussion of First Amendment free speech issues can also be updated in several ways using examples that involve computer technology and specifically the Internet. The balance between the government interest in restricting undesirable types of speech to protect children and the individual interest in free speech can be discussed in connection with the Communications Decency Act 1996 which barred the provision of indecent material to minors over the Internet but was struck down as unconstitutional.[40] Students may remember the press attention given to this Congressional attempt to curb children's access to pornography on the Internet and may find it interesting to debate whether there are different concerns in balancing free speech and government interest in this new medium in comparison to more traditional areas of free speech.

Students nowadays are more often to be found in their rooms "surfing the web" than in the library doing research. Instead of decrying this fact it is important for professors to seek to incorporate the new medium of the Internet into their teaching. Many web sites are useful as repositories of information on course topics, critical thinking exercises are easy to create because of the variety of information on the Internet and up-to-date Internet illustrations of legal concepts that are relevant to the student abound. Student interest in exercises and examples using the Internet is easy to generate. Educating students on how to evaluate information available on the Internet will stand them in good stead for the rest of their working lives.

[40]. Reno v. ACLU, 117 S.Ct. 2329 (1997).

The Current State Of Accountant Liability Regarding Third Party Plaintiffs

Michael A. Katz[*]

I. INTRODUCTION

Without a doubt, we live in a litigious society in which anyone suffering a loss, large or small, often turns to the courts for retribution, restitution or damages. The accounting profession has often been the target of litigation with no abatement expected. It therefore becomes incumbent on the accounting professional to understand the nature of potential sources of liability and act in a consistent manner that will lessen their exposure. Litigation will never end but culpability can be anticipated and controlled with proper conduct.

Regardless of whether the frequency or dollar amounts of litigation are considered, the accounting community must recognize that there is "a concern to the community at large"[1] and even "a point of danger, if not Crisis"[2], making accountant liability an issue that requires close scrutiny and exacting attention. In most cases the accountant is not only the deep-pocket but is in reality the *only* pocket. "The tendency to name the accountants as defendants is exacerbated because accountants are often the sole remaining solvent party among defendants - the "deep-pocket" concept."[3] While accountants make good faith efforts to police themselves by way of Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS), the courts often ignore or qualify these standards

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[1]. International Federation of Accountants, *IFAC Releases Study on Auditor Liability*, (Press Release quoting Bill Small, Chairman, IFAC Liability Task Force) June 16, 1998, <http://www.ifac.org/Lastest Developments/PressReleases/1998-06-16.htm>.

[2]. Barry S. Augenbraun, *Courts in Two States Reaffirm the Requirement of Privity for Accountants' Liability*, THE CPA J. ONLINE, July 1993, <http://www.luca.com/cpajournal/old/14467991.htm>.

[3]. Michael R. Lane, *Legislating Accountant's Third-party Liability*, THE CPA J. ONLINE, June 1989. <http://www.luca.com/cpajournal/old/07551220.htm>.

when faced with a party claiming injury due to the actions of the accountant.[4]

When the dispute is between the accountant and the immediate client, there is little question with regard to the clients standing to sue. The viability of law suits initiated by third parties leads to judicial interpretation and "Although injured third parties may sue the professional for fraudulent conduct, whether the third party may sue the professional for *negligence* is often in question."[5]

The problem is aggravated when one takes into account the fact that the accountant often is working with information provided to them by their own client. "In an audit engagement, an accountant reviews financial statements prepared by a client and issues an opinion stating whether such statements fairly represent the financial status of the audited entity." [6] An accountant's work product can take many forms and can include the preparation of financial statements, reports, opinions and audits. Third party litigants can include corporate shareholders, sureties, investors and creditors. The focus of this paper is to review and analyze those issues that arise when a third party brings a law suit due to a loss allegedly suffered after action taken based upon information contained in the accountant's work product prepared on behalf of the client where the third party is asserting negligence by the accountant. Discussions of liability for violations of the Securities Exchange Act of 1934, Sec. 10(b) have not been included within this work.

II. THEORIES OF LIABILITY TO THIRD PARTIES

Imagine that a bank executive is contemplating a loan request from the XYZ Corporation. XYZ furnishes the banker with a recent audit performed by a big six firm showing the company to be in conformity with GAAP reporting requirements and financially sound. In reality, the audit was performed negligently. The banker makes the

[4]. Edward Brodsky, *Liability of Accountants*, THE CPA JOURNAL ONLINE, June, 1993, <http://www.luca.com/cpajournal/old/14465879.htm/; Willis W. Hagen II., *Certified Public Accountant's Liability for Malpractice: Effect of compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65 (1987).

[5]. *Third Party Liability*, ACEC Programs, Liability Reform Issue Briefings, <http://www.acec.org/programs/issthird.htm>.

[6]. J. Siliciano, *Negligent Accounting and the Limits of Tort Reform*, 86 MICH. L. REV. 8 (1988).

loan and soon afterward, XYZ goes out of business and declares bankruptcy. Can this executive's bank sue the accounting firm successfully? What should or could this bank executive have done to insure liability on the part of the big six firm? From the accountant's point of view, should they be liable to the third party bank with whom they have never met or communicated with? If there was communication, does liability therefore automatically attach? Furthermore, what if they had no knowledge of the pending loan at all? Should they be liable to anyone that XYZ Corporation provides the information to? This is just one type of situation that courts have labored with over the years and a variety of theories of liability have emerged.

A. Privity of Contract

The principle of privity was first established in *Ultramares Corp. v. Touche Niven & Company*[7] in which Chief Justice Cardozo held that an accountant could only be held liable for negligence to his immediate client. Recognizing that the accountant is often dealing with information provided by his client, Justice Cardozo stated that:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

Embracing privity, Justice Cardozo further stated that:

If there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made.

The Court of Appeals of New York therefore qualified its opinion by stating that an accountant would indeed be responsible for willful ignorance of information that the accountant consciously disregarded. Hence the privity requirement in the opinion dealt only with ordinary negligence.

[7]. 255 N.Y. 17, 184 N.E. 441 (1931).

It is interesting to note that Justice Cardozo's opinion was somewhat of a surprise in contrast to two of his previous decisions involving privity of contract. In *MacPherson v. Buick Motor Co.*,[8] Justice Cardozo allowed a lawsuit against a manufacturer with whom the plaintiff had no privity. A spoke on a wheel snapped causing the wheel to break resulting in an accident. Privity regarding the wheel was between the manufacturer and Buick. His reasoning was that where a product is put into the stream of commerce, the manufacturer had to assume liability for negligence to all reasonably foreseeable users. Soon afterward, in *Glazer v. Shepard*,[9] Justice Cardozo allowed a law suit by a third party purchaser who was injured due to negligent service provided by a bean weigher providing inaccurate certificates of weight to the weigher's client. The purchaser suffered a loss due to overpayment resulting from the underweight measurements. Justice Cardozo rationalized that the purchaser was so tied into the transaction that it should enjoy the benefits of privity.

B. Near Privity

In 1985 the Court of Appeals of New York modified the privity rule allowing opportunity for suits by those approaching or near privity. In *Credit Alliance v. Arthur Anderson & Co.*[10] The court of appeals modified the strict privity requirement contained in *Ultramares* by allowing for linking of the non-privity parties finding that the auditors direct communications and personal meetings with the third party lender created a nexus between them sufficiently approaching privity, thereby allowing for liability.

The nexus however, had to be indisputable to allow liability. In *Credit Alliance,* there was a series of discussions and face-to-face meetings. Compare this to the decision in *Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.*[11] in which an investor was furnished with a "pencil draft" of a financial statement and then called the accountant to discuss the document. Company income and adequacy of reserves for accounts receivables were discussed, and the accountant assured the investor (a bank vice president) that they were comfortable with their work product and would be issuing their

[8]. 217 N.Y. 382 (1916).
[9]. 233 N.Y. 236 (1922).
[10]. 65 N.Y.2d 536, 949 N.Y.S.2d 435, 483 N.E.2d 110 (1985).
[11]. 79 N.Y.2d 695 (1992)

unqualified opinion, which they soon did. When the company failed, the investor sued the accounting firm. The Court of Appeals of New York determined that one phone call, regardless of the topics of conversation, was not enough to bring the plaintiff to a position sufficiently approaching privity. Unfortunately, the Court of Appeals of New York did not explain just what conduct would have been enough to do so.

III. RESTATEMENT AND FORSEEABILITY THEORIES

The narrowly construed strict privity rule stood for almost four decades until a rethinking and liberalization of the rule began due to the Restatement.[12] Application of the Restatement allowed for liability where information is provided and the issuer of that information knows that a third party will rely on that information for a particular purpose. In short, should an accountant provide an audit or some other statement to his client and the accountant knows that the information will be disseminated to some third party who will use that information in a business transaction, the accountant could be held liable for errors or omissions based on negligent misrepresentation. Many courts, attempting to broaden standards and move from the strict privity requirement, began to adopt the Restatement approach. While privity of contract was not erased, the courts rationalized that negligent misrepresentation was in fact a form of fraud rather that a category of

[12]. Section 552 of the Restatement (Second) of Torts states that negligent misrepresentation occurs when:

> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Restatement (Second) of Torts § 552 (1977). The Restatement restricts liability to:

> Loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Id.

negligence. The two major sticking points had to do with what representations could be relied upon and who was entitled to so rely.

A. Restatement Theory

The leading case expounding the restatement view is *Bily v. Arthur Young & Co.*[13] In terms of what could be relied upon, the California court applied long accepted California law rationalizing that:

[U]under certain circumstances, expressions of professional opinion are treated as representations of fact and that when a party possesses or holds itself out as possessing superior knowledge or special information or expertise regarding the subject matter and a plaintiff is so situated that it may reasonably rely on such supposed knowledge, information, or expertise, the defendant's representation may be treated as one of material fact.[14]

Using this line of reasoning, the court found that, there is no dispute that Arthur Young's statements in audit fall within these principals.[15]

The Restatement, clarifies and defines the appropriateness of potential plaintiffs as follows:

[I]t is not required that the person who is to become the plaintiff be identified or known to the defendant as an individual when the information is supplied. It is enough that the maker of the representation intends it to reach and influence either a particular person or persons, known to him, or a group or class of persons, distinct from the much larger class who might reasonably be expected sooner or later to have access to the information and foreseeably to take some action in reliance upon it. It is sufficient, in other words, insofar as the plaintiff's identity is concerned that the maker supplies the information for repetition to a certain group or class of persons and that the plaintiff proves to be one of them, even though the maker had never heard of him by name when the information was given. It is not enough that the maker merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon it, on the part of anyone to whom it may be repeated.[16]

Agreeing with *Bily*, the Supreme Judicial Court of Massachusetts, in a case of first impression for the state, recently adopted the Restatement

13. 3 Cal. 4th 370 (1992).
14. Gagne v. Bertran, 43 Cal 2d 481, 275 P.2d 15 (1954).
15. Bily v. Arthur Young & Co., 3 Cal. 4th 370 (1992).
16. Restatement (Second) of Torts § 552 cmt. h. (1977).

approach and embraced comment h.[17] After stating the position of the court, the judgment was rendered for the defendant based on the fact that the defendant was entirely unaware of the use to which their report would be used. It was further unaware of any contemplated transaction so it was impossible for them to have prepared the report to influence it. The *NYCAL* court agreed with the *Bily* court rational quoting *Bily* which stated, that "[u]nder the restatement rule, an auditor retained to conduct an annual audit and to furnish an opinion for no particular purpose generally undertakes no duty to third parties."

The *NYCAL* court further asserted that the accountant's knowledge is to be measured at the moment the audit report is published, not by the foreseeable path of harm envisioned by litigants years following an unfortunate business decision and that their interpretation of the restatement will not excuse an accountant's willful ignorance of information of which the accountant would have been aware had the accountant not consciously disregarded that information. The *NYCAL* holding has been praised in Supreme Judicial Court of Massachusetts. The Supreme Judicial Court stated that "[a] clear rule is now established that if the defendant accountant was reasonably unaware of the plaintiff's reliance at the time the work product is signed, then the plaintiff will not have standing to bring suit."[18]

B. Forseeability Theory

The most liberal theory of liability, granting the most opportunity for successful plaintiff litigation, is the doctrine of foreseeability. Under this doctrine, there is virtually unlimited liability that attaches to an accountant making them liable to any reasonably foreseeable plaintiffs. Under this approach, the accountant does not have to know that the client intends to distribute the work product to

17. NYCAL v. KPMG Peat Marwick LLP, 426 Mass. 491 (1998); *See also* Badische Corporation, et. al. V. Caylor 257 Ga. 131 (1987); Kohala Agriculture v. Deloitte & Touche (Hawaii, Inter. Ct. of App. November 10, 1997) (Civ. No. 91-0529).
18. Daniel L. Goldberg, Daniel S. Savrin & James E. O"Connell, *Supreme Judicial Court Issues Opinion Limiting Potential Liability of Accountants to Non-Clients*, MASSACHUSETTS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS ONLINE, Feb. 17, 1998, <http://www.mscpaonline.org/goldsaup.htm; *See also* Nutter, McClennen & Fish, LLP, *Massachusetts High Court Adopts Balanced Standard for Accountant's Liability to Non-Clients*, NEWSLETTER, November, 1997.

third parties or that the third party rely upon it. Therefore, a third party who is totally unknown to the accountant, can have a cause of action.[19]

Despite a plea by almost every plaintiff's attorney to adopt and follow this less stringent approach, the courts have not been swayed. The foreseeability approach has been rejected by a number of courts[20] and legislated out by six of states.[21] Wisconsin and Mississippi are the only two states following a foreseeability philosophy.[22] Of interest is the fact that *H. Rosenblum, Inc. v. Adler*[23], the recognized leading case in this area was preempted by the New Jersey Legislature in 1995 when a privity requirement became statutory. This represented a full swing from the most liberal of views to the most narrow of views.

IV. AGENCY AND FIDUCIARY RELATIONSHIPS

The four theories of liability discussed above account for the overwhelming majority of case decisions. Occasionally however, a new theory is offered that requires scrutiny. The Massachusetts courts recently dealt with a novel approach to liability when they decided *Spencer v. Ross.*[24] Business Finance Group (BFG) purchased accounts receivables at a discount, financing its operation by contracting with investors. The investors signed agency agreements with BFG. When BFG failed, the investors sued the accounting firm that BFG had engaged for an audit because it had failed to disclose that BFG was essentially a Ponzi scheme. Citing, among other theories, agency liability, the plantiffs lost because a business relationship could not be established. The agency theory however, was not rejected and *Spencer* suggests that under certain special and limited circumstances, auditors

[19]. Lane, *supra note 3, at p. 2.*

[20]. First National Bank v. Crawford, 182 W. Va. 107, 386 S.E.2d 310 (1989); Raritan River Steel Co. v. Cherry, Bekaert & Holland 322 N.C.200, 367 S.E.2d 609 (1988); First Florida Bank, N.A. v. Max Mitchell & Co., 558 So.2d 9 (Fla. 1990); Haberman v. Pub. Power Supply System, 109 Wash.2d 107, 744 P.2d 1032 (1987), *modified,* 750 P.2d 254 (1988).

[21]. Arkansas (Ark. Code Ann. Sec 16-114-302 (Michie 1995 Supp)); Illinois (Ill. Ann. Stat. Ch225 par 450/30.1 (Smith-Hurd 1993); Kansas (Kan. Stat. Ann. Sec 1-402(1991)); New Jersey (N.J. Stat. Ann. Sec. 2A:53A-25 (West 1995)); Utah (Utah Code Ann. Sec. 58-26-12 (1996)); Wyoming (Wyo. Stat. Sec.33-3-201 (Michie 1995 Supp).

[22]. Citizens State Bank v. Timm, Schmidt & Co., 113 Wis.2d 376, 335 N.W.2d 361 (1983); Touche Ross v. Commercial Union Ins. 514 So.2d 315 (Miss. 1987).

[23]. 461 A.2d 138 (N.J. 1983).

[24]. 7 Mass. L Rptr. No. 20, 466 (Dec. 1, 1997) 9090.

may be held liable to third parties who have an agency relationship with the party who hires them.[25]

V. CONCLUSION

Currently, fifteen (14) states apply the privity or near privity doctrine, seven (7) of them by statute. Moreover, twenty-one (21) states recognize the Restatement (Second) of Torts theory and two (2) states adhere to forseeability. The remaining thirteen (13) states, as well as the District of Columbia, have not yet addressed the issue either by statute or in a court of final jurisdiction.[26] The American Institute of CPAs (AICPA) predicts continued activity in terms of legislation in the immediate future.[27]

Accountants want to avoid or limit liability. Banks, and other third parties, want to impose liability for negligence of accountants. Banks, and other third parties, should therefore at minimum make it perfectly clear that they are one of the intended recipients of the accountant's work product. Such clarity is best done in writing.[28] The banks and other third parties should also make it clear that they intend to rely on the work product presented. If they can also direct the accountant to tailor the report so as to customize it they will have done as much as possible to assure liability on the part of the accountant.

The accountant should not volunteer any information other than what is required to satisfy the engagement. Without a doubt, the

[25]. Nutter, McClennen & Fish, LLP, *Massachusetts High Court Adopts Balanced Standard for Accountant's Liability to Non-Clients*, NEWSLETTER, November, 1997; *See also* Seolas v. Bilzerian (D. Utah Jan. 28, 1997) 1997 WL 34932.

[26]. *Tort Reform Issues in the Uniform Accountancy Act*, AICPA Online, (1999), http://www.aicpa.org/states/uaa/tort.htm. States that follow strict liability are as follows: Arkansas, Idaho, Illinois, Indiana, Kansas, Louisiana, Montana, Nebraska, New Jersey, New York, Pennsylvania, Utah, Virginia and Wyoming.

States that follow the Restatement are as follows: Alabama, Alaska, California, Florida, Georgia, Hawaii, Iowa, Kentucky, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, North Carolina, Ohio, Rhode Island, South Carolina, Tennessee, Texas, Washington and West Virginia.

States that follow forseeability are as follows: Mississippi and Wisconsin. Not fully addressed: Arizona, Colorado, Connecticut, Delaware, District of Columbia, Maine, Maryland, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, and Vermont.

[27]. *Tort Reform*, AICPA Online, (1998), <http://www.aicpa.org/states/dig98/tort.htm>.

[28]. **The Illinois Statute referred to previously requires a written notification.**

best defense that an accountant has is to issue a disclaimer. Recognizing that a disclaimer can be effective to preclude justifiable reliance by a third party on the accountant's work, it must be understood that it does not abrogate liability to the client. Aside from the disclaimer, reliance letters that expressly limit liability to third parties have been effective to limit liability to those identified parties. Just as with the disclaimer, reliance letters are not effective to limit the accountant's liability to his/her client.[29]

Considering the magnitude of the problem, no one state or jurisdiction can ever arrive at a perfect solution and magically concoct a context that will appease everyone.

Imposing unlimited liability on certified public accounting firms will consistently place huge, unfair, and economically inefficient burdens on relatively minor participants because accountants are not well positioned to serve as guarantors of the soundness of the business enterprises they audit.[30]

As a result of skyrocketing liability suits, some large firms are limiting exposure by cutting back on clients requiring audits.[31] Many firms, particularly the small and medium size firms, are simply going out of the audit business entirely.[32] Those firms that remain in the auditing business will eventually be forced to raise fees higher and higher just to protect themselves.[33]

Major corporations often do business both locally and nationally (and internationally) and the accounting firms they hire are equally entrenched. All fifty states are potential forums. They often wrestle with problems of analysis and application and sometimes lack a systematic means of interpretation. Perhaps, the answer is a true

[29]. Howard M. Garfield & Lyn D. Tadlock, *Privity Reviewed: Persons to whom Accountants Owe a Duty of Care*, LONG & LEVIT LLP LEGAL LEDGER, (Winter 1996), <http://www.longlevit.com>.

[30]. Jordan H. Liebman & Anne S. Kelly, *Accountant Liability To Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle*, 30 AM. BUS. L. J. 3 (1992).

[31]. Dan R. Dalton, *The Big Chill*, J. ACCT., Nov. 1994, at p. 53.

[32]. *More Accounting Firms Are Dumping Risky Clients*, WALL ST. J., April 25, 1997, at p. A2. *See also* Lee Berton, *Legal Liability Awards Are Frightening Smaller CPA Firms from Audits*, WALL ST. J., March 3, 1992, at p. B1 (A survey of California CPA firms revealed that 53% of those surveyed will not do audit work at all and that of the 47% that do, 32% of those are limiting exposure by turning down work in high risk industries.).

[33]. Thomas L. Gossman, *The Fallacy of Expanding Accountant Liability*, 1988 COLUM. BUS. L. REV. 213 (1988).

Uniform Accountancy Law. The AICPA has formulated a Uniform Accountancy Act and is lobbying for its acceptance as a standard for the industry. My suggestion is a conference of all states to develop a uniform body of laws that eventually could be enacted and implemented by the states. This uniform body of laws will clarify the roles and expectations of all parties. Courts will be able to readily apply standards that remain relatively constant. Just as the Uniform Commercial Code somewhat cleared the air, so too could a uniform law addressing the issue of liability in the profession of accountancy.

ACTUAL LOSS IN DETERMINING REASONABLENESS OF LIQUIDATED DAMAGES CLAUSES: VIRGINIA'S SHOW-ME LAW

*William H. Daughtrey, Jr.**

I. INTRODUCTION

The Supreme Court of Virginia is developing its law of liquidated damages,1 which are sometimes known as stipulated or stated damages.2 To facilitate a determination of appropriate compensation, the amount of a claim for breach of contract is determined in advance of breach by the parties' agreement. Such clauses eliminate the assessment of monetary loss by judge or jury. This contractual transfer of responsibility from the court to the parties, a transfer eliminating the requirement of evidence beyond the agreement's terms, is not, however, without limitations. If the nonbreaching party must show actual monetary loss at trial, then the value of the contractually designated liquidated damage clause is diminished.

The purpose of this article is to investigate the ways in which liquidated damage clauses can be attacked under Virginia

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1. *See, e.g.*, Gordonsville Energy, L. P. v. Virginia Electric and Power Co., 257 Va. 344, 512 S.E.2d 811 (1999) (Seller contractually waived its right to contest the liquidated damage clause.); O'Brian v. Langley School, 256 Va. 547, 507 S.E.2d 363 (1998) (Court allowed inquiry into school's actual monetary loss in determining propriety of liquidated damage clause.); 301 Dahlgren Limited Partnership v. Board of Supervisors of King George County, 240 Va. 200, 396 S.E.2d 651 (1990) (Forfeiture clause deemed an impermissible penalty when record was without evidence that board suffered any damages.); Taylor v. Sanders, 233 Va. 73, 353 S.E.2d 745 (1987)(An agreed upon forfeiture of a promissory note of $3,000 deposit on purchase of $63,000 residence represented enforceable liquidated damages.).

2. Welch v. McDonald, 85 Va. 500, 505, 8 S.E.2d 711, 713 (1888) (recognizing the contract parties' right to avoid all future question of damages by agreeing upon a sum to be paid the nonbreaching party).

law. When such clauses fail in enforcement, the anticipated efficiency and pre-determined certainty is lost. Favoring the law's allowance for liquidated damages are (1) time saved by judges, jurors, the nonbreaching disputant, and witnesses and (2) expense avoided by the claimant in preparing for litigation. Underlying the inquiry of enforceability is whether, as a matter of public policy, the propriety of the agreement should be tested in litigation against the parties' pre-estimate, against the actual loss at the time of the breach, or both.

Without regard to theory, one can applaud the fairness of the four main Virginia precedents.[3] The Supreme Court of Virginia upheld liquidated damage clauses against home buyers who breached a residential real estate contract for a sum apparently beyond their means[4] and against a supplier of electricity in a truly negotiated, arms-length bargain.[5] Escapes from predetermined, agreed-upon damages included parents who were thirteen days late in June in withdrawing from a contract with a private school for the next school-year's tuition for their child[6] and investors who sought return of $35,625 when a county ordinance, superimposed upon the application for services, provided forfeiture of fifty percent (50%) of a deposit when the application was withdrawn even during the application period.[7]

The aforementioned cases, however, create uncertainty as to whether the enforceability of liquidated damage clauses will be determined by (1) the parties' intent and perspective at the time their contract was made, (2) by comparison to the actual damages suffered by the nonbreaching party, or (3) both. Obviously, alternatives "(2)" and "(3)" will increase the expense of preparing a case for trial. Moreover, when the court's selection between the alternatives is uncertain under some circumstances, pretrial preparation must anticipate the need for proffers of evidence of actual damages, whether or not the court in the case at hand requires such evidence.

3. *See supra* note 1.

4. Taylor v. Sanders, 233 Va. 73, 353 S.E.2d 745 (1987).

5. Gordonsville Energy, L. P. v. Virginia Electric and Power Co., 257 Va. 344, 512 S.E.2d 811 (1999).

6. O'Brian v. Langley School, 256 Va. 547, 507 S.E.2d 363 (1998).

7. 301 Dahlgren Limited Partnership v. Board of Supervisors of King George County, 240 Va. 200, 396 S.E.2d 651 (1990).

II. *CLOUDY THEORY*

Virginia case law leaves some doubt as to whether a court will require proof of actual loss before selecting between the hoped-for label of *liquidated* or the condemnatory label of *penalty*. A seminal case, *Taylor v. Sanders*,[8] furnishes the criteria for the enforceability of subject clauses:

> [P]arties to a contract properly may agree in advance upon the amount to be paid for loss which may result from a breach of contract. When the actual damages *contemplated at the time of the agreement* are uncertain and difficult to determine with exactness and when the amount fixed is not out of all proportion to the *probable* loss, the amount is deemed to have been intended as enforceable liquidated damages.[9]

This statement is commendable for several reasons. First, it is consistent with the proposition that courts generally honor the parties' intent as found from the agreement. Second, the value of the parties' agreed-upon estimate of probable damages lies in avoidance of pretrial preparation necessary to prove actual loss. Third, the business risk is defined and contained by the liquidated damage clause. One must concede, however, that the *Taylor* test of enforceability includes the warning that the amount of the contractually fixed damages may not be "out of all proportion to the probableloss."[10] Logically, the issue of disparity cannot be addressed without knowledge of actual loss.

Three years after *Taylor* the Supreme Court decided *301 Dahlgren Limited Partnership v. Board of Supervisors of King George County.*[11] King George government returned only one-half of Dahlgren's deposit in reliance upon a forfeiture provision operating when an applicant for water and sewer connections made and later withdrew its application for these services.[12] With the trial court record

8. 233 Va. 73, 75, 353 S.E.2d 745, 746-47 (1987). *See infra* notes 12-23 and accompanying text (requiring proof of actual damages to determine whether certain denominated liquidated damage provisions are enforceable).

9. Taylor v. Sanders, 233 Va. 73, 75, 353 S.E.2d 745, 746-47 (1987) (emphasis added).

10. *Taylor*, 257 Va. at 355, 512 S.E.2d at 818.

11. 240 Va. 200, 396 S.E.2d 651 (1990).

12. 240 Va. at 202, 396 S.E.2d at 652.

"devoid of any evidence that the Board sustained damages"[13] resulting from the withdrawal, the Court declared the forfeiture provision an unlawful penalty.[14]

The adhesion contract issue was not raised in *301 Dahlgren* and, accordingly, not addressed on appeal. If the Court was impressed that the forfeiture provisions were imposed by a governmental entity, it did not even impliedly disclose the importance of such a factor.

Moving to 1996 when a trial court decided *Gordonsville Energy, L. P. v. Virginia Electric and Power Company,*[15] (six years after *301 Dahlgren*), the court opined "that what the parties contemplated and what the nonbreaching party actually lost are *both* relevant."[16] This 1996 circuit court case is dubbed in this article *Gordonsville One* since the same parties later dueled at the appellate court level over financial responsibility for another breach.[17] The agreement in *Gordonsville One* allowed Gordonsville a certain number of days on which it did not have to be capable of furnishing Virginia Power on-demand electric energy. Beyond such number, the parties agreed that Virginia Power could withhold from the amount otherwise due $600,000 for each of the "Forced Outage Days."[18] In its letter opinion, the trial judge ruled (in disposing of cross motions for summary judgment) that either or both parties may at trial present evidence of Virginia Power's actual damages.[19]

Another trail court reaches a conclusion opposite of *Gibsonville One*. In *O'Brian v. Langley School*,[20] the trial court entered summary judgment for the school without allowing the O'Brians to conduct discovery designed to investigate whether the school had any monetary loss and if so, its amount.[21] The O'Brians missed the withdrawal date by twelve days (June 13 rather than June 1), triggering the contract designated liquidated damage clause. Such

13. 240 Va. at 203, 396 S.E.2d at 653.

14. 240 Va. at 203, 396 S.E.2d at 653.

15. 39 Va. Cir. 292 (City of Richmond, 1996).

16. *Gordonsville Energy, L. P. v. Virginia Electric and Power Company*, 40 Va. Cir. 448, 450 (City of Richmond, 1996)(italics in original).

17. *See infra* notes 24-25 and accompanying text.

18. *Gordonsville Energy, L. P. v. Virginia Electric and Power Company*, 39 Va. Cir. 292, 294 (City of Richmond, 1996).

19. *Id.* at 300-01.

20. 256 Va. 547, 507 S.E.2d 363 (1998).

21. 256 Va. 550-52, 507 S.E.2d at 365-66.

damages included the next year's full tuition plus court costs and legal fees in the collection of such damages.[22]

The Supreme Court of Virginia reversed the trial court in *O'Brian* and reaffirmed its position expressed in *301 Dahlgren*. It held that if the O'Brians could show that the clause in question was a penalty clause, then Langley must prove its actual damages.[23] Indirectly at least, the Court continued to embrace the then-and-now standard of reasonableness in designating a damage clause as permissible or penal. Theory momentarily aside, summary judgment in favor of the school for the parents' twelve-day default well in advance of the start of the school year would appear to be a rather harsh and mechanical application of the contractually designated liquidated damage clause.

III. GORDONSVILLE TWO

The opponents in *Gordonsville Energy L. P. v. Virginia Electric and Power Company*,[24] *(Gordonsville Two)*, were the same as in *Gordonsville One*. The later pertinent issue was whether the court, as a matter of public policy, will enforce Gordonsville's contractual waiver not to contest validity of the liquidated damage clause?[25] The contract between Virginia Power and Gordonsville provided, in pertinent part, that the latter " 'waives any defense as to the validity of any liquidated damages stated in this Agreement as they may appear on the grounds that such liquidated damages are void as penalties or are not reasonably related to actual damages.' "[26] Despite the court's propensity to allow or require evidence of actual damages, the Court found that Gordonsville's contractual waiver was enforceable.[27] Although rather short on discussion as to society's advantages and disadvantages incident to enforcement of such a waiver, the Court cited *Flintkote Co. v. W. W. Wilkinson, Inc.*,[28] which allowed waiver of the right to a jury trial on amount of attorney's fees.[29] The *Gordonsville Two* court stated boldly that "[i]f the party being charged with

22. 256 Va. at 549-50, 507 S.E.2d at 364.
23. 256 Va. at 551-52, 507 S.E.2d at 365-66.
24. 257 Va. 344, 512 S.E.2d 811 (1999).
25. 257 Va. at 355-56, 512 S.E.2d at 817-18.
26. 257 Va. at 355, 512 S.E.2d at 817-18.
27. 257 Va. at 355-56, 512 S.E.2d at 818.
28. 220 Va. 564, 570, 260 S.E.2d 229, 239 (1979).
29. 220 Va. at 570, 260 S.E.2d at 239.

relinquishment of a right had knowledge of the right and intended to waive it, the waiver will be enforced."[30]

The *Gordonsville Two* court, however, did not sanction all waivers of the right to contest contractually denominated liquidated damage clauses. It noted that the Virginia Power-Gordonsville contract was the product of " 'arms-length' negotiations between two sophisticated corporate entities, both represented by counsel."[31] The court noted also the absence of duress, fraud, mistake, and "any other circumstances that might serve as a basis for declaring the waiver unenforceable."[32]

Obviously, when the liquidated damage clause is uncontestable by wavier, the issue of the appropriateness of requiring proof of actual damages is mooted. In other words, courts will allow evidence of actual damages unless a penalty has waived his or her right to complete the validity of the liquidated damages clause. The former rule of law leaves the courts with considerable discretion in distinguishing liquidated from penalty damages, while the latter rule virtually ensures enforcement of the parties' pre-estimates--at least in arms-length, seriously negotiated contracts.

IV. CONCLUSION

Under Virginia law, the tripartite test for separating enforceable from unenforceable liquidated damages clauses involves both foresight and hindsight. Reiterated in *Gordonsville Two*, a clause is unenforceable if the agreed-upon amount is " 'out of all proportion to the probable loss' "[33]--not a good faith, realistic forecast. Also reiterated is the hindsight test; the agreed amount must not be " 'grossly in excess of actual damages.' "[34] The third prong of the test most surely continues to exist, although not mentioned in *Gordonsville Two*; agreed-upon estimated damages are unenforceable if damages from the breach are "susceptible of definite measurement" at the time the

30. *Gordonsville Energy L. P. v. Virginia Electric and Power Company*, 257 Va. 344, 356, 512 S.E.2d 811, 818 (1999).
31. *Gordonsville*, 257 Va. at 356, 512 S.E.2d at 818.
32. *Id.*
33. *Id.*
34. *Id.*

contract is made.[35] Unless this difficulty exists, no legal justification exists to remove the damage assessment from the judge and jury.

Superimposed on the tripartite test for enforceability is Virginia's allowance for a party's waiver of the right to contest the validity of a denominated liquidated damages clause. This waiver feature, when incorporated into the contract, is an invaluable tool for avoiding litigation over the enforceability of liquidated damages clauses.

35. *Taylor*, 233 Va. at 75, 353 S.E.2d at 747.

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