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Founded by Adam B. Ross & Dennis W. Donley Jr. in MCMXCVI

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PREFACE

Since our last issue, Congress passed the historically-controversial "health care reform bill" over the protests of many Americans, effectively asserting control of yet another large parcel of our nation's economy and removing it from the exclusive realm of private industry. As the regulation expands and the bailouts continue, it may seem that we are proceeding inevitably toward a government-controlled economy where people trade economic freedom for perceived safety, and the nation's budget-makers allow the deficit to snowball. However, at the *Review*, we remain optimistic, confident that new leaders will rise up who are committed to protect conservative and libertarian ideals like a free economy and freedom of choice among private service-providers.

With this in mind, our first article, *The Controversial "Card Check" Bill, Stalled in the United States Congress, Presents Serious Legal and Policy Issues* confronts another controversial piece of legislation: the Employee Free Choice Act of 2009 (the "Card-Check Bill"). Mr. Raymond J. LaJeunesse, Jr. challenges the stalled bill, arguing that its purported revisions of the National Labor Relations Act will adversely affect both employers and employees by depriving employees of a right to information about unionization and abolishing fairness-protecting secret-ballot elections.

In *The TARP Bailout of GM: A Legal, Historical, and Literary Critique,* Professor Brent J. Horton analyzes the recent TARP bailout of General Motors (GM), looking at the policies of both the Bush and Obama administrations against the backdrop of Ayn Rand's literary work, *Atlas Shrugged.* Professor Horton argues that the Obama Administration's use of TARP to 'bail out' GM is similar to Franklin Delano Roosevelt's New Deal anti-competition policies. He concludes his discussion by using Rand's veiled criticism of the New Deal to argue that President Obama's policies, far from honest attempts to jump-start the economy, are aimed at social change.

Our next three articles all revolve around one issue: the Federal Trade Commission's proposed use of the Telemarketing Sales Rule (TSR) to regulate the debt-relief-services industry. In the first of these articles, *The Bear Hug That Is Crushing Debt-Burdened Americans: Why Overzealous Regulation of the Debt-Settlement Industry Ultimately Harms the Consumers It Means to Protect,* Professor Derek S. Witte argues for a genuine free-market approach to the regulation of for-profit debt-settlement companies. Professor Witte says regulators risk strangling the market if they regulate these companies out of business instead of allowing the American people to make that decision. In the current economy, he says, it is vital for average

Americans to have options for settling debt, and permitting the market to set prices is the best way to provide those options.

Joining the conversation, Mr. Michael Thurman and Mr. Michael L. Mallow argue that the Federal Trade Commission has over-expanded its administrative enforcement authority to the point of exceeding its original purpose in *"Hid[ing] Elephants in Mouseholes": the FTC's Unwarranted Attempt to Regulate the Debt-Relief-Services Industry Using Rulemaking Authority Purportedly Granted by the Telemarketing and Consumer Fraud and Abuse Prevention Act.* Mr. Mallow and Mr. Thurman use the historical background of the FTC to show that, while its early days may have been ineffective, the FTC has since expanded its authority beyond its originally delegated sphere, most recently in the proposal to use the TSR to add wide-ranging regulations to the debt-relief-services industry, even though debt-relief services were not originally contemplated in the Act.

In the last of this group of articles, *Tax-Exempt Credit Counseling Organizations and the Future of Debt-Settlement Services,* Mr. Ronald D. Kerridge and Mr. Robert E. Davis predict that if for-profit debt-settlement companies are put out of business by the proposed new regulations, non-profit organizations will be unable to step in to offer consumers competitive debt-settlement options because offering such services would endanger their tax-exempt status. This suggests the FTC's current direction may leave American consumers without any providers of true debt-settlement services.

Professor Allen Boyer provides an excellent review of Philip Hamburger's book, *Law and Judicial Duty,* discussing how it offers a fresh perspective on the Judicial Review debate, specifically suggesting that the appropriate historical realm for judges is to exercise "Judicial Duty" within the tradition of case law, rather than the normally accepted "Judicial Review" outside case law.

This issue concludes with a note by Ms. Kristina Campbell, *Will "Equal" Again Mean Equal?: Understanding* Ricci v. DeStefano. Ms. Campbell analyzes the *Ricci* case, arguing that the disparate-impact provisions of Title VII are unconstitutional because they conflict with the Equal Protection Clause, requiring inequality in some race-based decisions. Campbell argues that the Court should solve this by striking down the disparate-impact provision of Title VII.

The members of the *Review* continue to engage the pressing social, legal, and policy issues of our time. I would like to thank everyone who was involved with this issue, it has been a privilege and an honor to serve on the *Review.*

Amy Davis
Editor in Chief

Austin, Texas
June 2010

THE CONTROVERSIAL "CARD-CHECK" BILL, STALLED IN THE UNITED STATES CONGRESS, PRESENTS SERIOUS LEGAL AND POLICY ISSUES

RAYMOND J. LAJEUNESSE, JR.*

* Raymond J. LaJeunesse, Jr. is Vice President and Legal Director of the National Right to Work Legal Defense Foundation, Inc.

I. INTRODUCTION

On March 10, 2009, a controversial bill misleadingly entitled the "Employee Free Choice Act of 2009" (EFCA) was introduced in the 111th Congress.[1] Although a previous version of the bill failed in the 110th Congress, EFCA is strongly supported by organized labor and just as strongly opposed by the vast majority of Americans,[2] including business, conservative, and libertarian organizations, and some liberals, such as former Senator George McGovern.[3] Unlike President George W. Bush, who threatened a veto, [4] President Barack Obama has promised to sign EFCA if Congress sends it to him. [5] This controversial measure has drawn strenuous and widespread criticism on legal, constitutional, and policy grounds. As of this writing, proponents have been unable to obtain the votes needed in the Senate to invoke cloture on a threatened filibuster and thus obtain a vote on the bill itself. [6] Nor, apparently, have they been able to agree upon an alternative version on which cloture might possibly be invoked, because no alternative has yet been introduced in the Senate.[7]

EFCA is the most far-reaching revision to the National Labor Relations Act (NLRA)[8] to be given serious consideration in Congress since the 1970s.[9] It consists of three major provisions:

1. H.R. 1409, 111th Cong. (2009); S. 560, 111th Cong. (2009).

2. McLaughlin & Associates conducted a poll of 1,000 likely voters in the United States from January 7 to 11, 2009. The poll found that 74% of all voters oppose EFCA, and even in union households 74% oppose the bill while only 20% support it. Mclaughlinonline.com, New Poll: Union Members Oppose Big Labor's Card Check (Jan. 26, 2009), http://www.mclaughlinonline.com/6?article=8.

3. George S. McGovern, *The "Free Choice" Act Is Anything But*, WALL ST. J., May 7, 2009, at A15.

4. *Cheney Says Bush Would Veto Employee Free Choice Act If Passed*, Daily Lab. Rep., Feb. 15, 2007, at A-7.

5. Kris Maher, *President Tells Unions Organizing Act Will Pass*, Wall St. J., Mar. 4, 2009, at A4. Then-Senator Obama was an original co-sponsor of EFCA in the 110th Congress. S. 1041, 110th Cong. (2009). *Id.*

6. Derrick Cain, *Harkin Says He Does Not Have Enough Votes to Approve EFCA*, Daily Lab. Rep., May 14, 2010, at A-8.

7. *Id.*

8. National Labor Relations Act, 29 U.S.C. §§ 151–169 (2006).

9. *See generally* William B. Gould IV, *New Labor Law Reform Variations on an Old Theme: Is the Employee Free Choice Act the Answer?*, 70 LA. L. REV. 1 (2009) (providing a history of revisions to the NLRA).

"card check," compulsory interest arbitration, and increased employer penalties for unfair labor practices.

II. "CARD CHECK"

Under the NLRA, if a union presents evidence that a majority of its employees in an "appropriate bargaining unit" want the union to represent them, the employer has two options: it can either voluntarily recognize the union as the exclusive bargaining representative of all employees in that unit, including employees who oppose the union;[10] or it can ask the National Labor Relations Board (NLRB) to conduct a representation election in which the employees can vote by secret ballot as to whether they wish the union to be their exclusive bargaining agent.[11]

EFCA would effectively eliminate secret-ballot elections for choosing exclusive bargaining representatives.[12] Under EFCA, if union organizers presented authorization cards or a petition signed by 50% plus one of the employees in a bargaining unit, the NLRB would be required to certify the union and could not schedule a secret-ballot election.[13] Consequently, neither the employer nor individual employees who oppose unionization could request a secret-ballot election.

Opponents assert that the absence of a formal election process works an obvious unfairness, facilitates intimidation and deception of workers, and runs contrary to the American tradition of secret ballots and the freedom to vote in privacy.[14] The United States Supreme Court has already spoken to the issue, recognizing that "secret elections are generally the most satisfactory—indeed the preferred—method of ascertaining whether a union has majority support."[15]

10. 29 U.S.C. § 159(a).

11. 29 U.S.C. § 159(c)(1)(B).

12. Benjamin I. Sachs, *Enabling Employee Choice: A Structural Approach to the Rules of Union Organizing*, 123 HARV. L. REV. 655, 658 (2010).

13. H.R. 1409, 111th Cong. § 2 (2009); S. 560, 111th Cong. § 2 (2009).

14. H.R. REP. No. 110–23, at 51 (2007).

15. NLRB v. Gissel Packing Co., 395 U.S. 575, 602 (1969); *accord* Dana Corp., 351 N.L.R.B. 434, 438 (2007) ("[B]oth the Board and courts have long recognized that the freedom of choice guaranteed employees by Section 7 [of the NLRA, 29 U.S.C. § 157,] is better realized by a secret election than a card check") (citing cases) (3–2 decision). In *Dana Corp.*, the Board majority explained the four reasons why secret-ballot elections are more reliable than card checks: (1) "unlike votes cast in privacy by secret Board election ballots, card signings are public actions, susceptible to group pressure exerted at the moment of choice"; (2) "union card-solicitation campaigns have been accompanied by

There also is a serious question whether EFCA will unconstitutionally deny employers and employees their free speech rights. During an open election process under current law, employers and employees who are in favor of or opposed to unionization are free to debate their views on the merits of unionizing. Because there would be no open campaign leading up to a secret-ballot election, EFCA would eliminate open debate, thus curtailing the speech rights of employers and individual employees opposed to the union. The Supreme Court has also recently made this point. The Court explained that NLRA section 8(c),[16] expressly protecting the right of employers to engage in "noncoercive speech"[17] against unionization, "'merely implements the First Amendment.'"[18] Moreover, the Court held that the employees' "right to refrain from" union activities guaranteed by NLRA section 7,[19] "calls attention to the right of employees to refuse to join unions, *which implies an underlying right to receive information opposing unionization.*"[20]

III. COMPULSORY INTEREST ARBITRATION

Under the current NLRA, an employer is not required to enter into a labor contract with a union exclusive bargaining agent, only to bargain in good faith.[21] Moreover, once an agreement is reached between an employer and union, the union members in the bargaining unit usually have the opportunity to vote whether to ratify the contract or not.[22]

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misinformation or a lack of information about employees' representational options"; (3) "a Board election presents a clear picture of employee voter preference at a single moment," while "card signings take place over a protracted period of time" during which "employees can and do change their minds about union representation"; and, (4) "the Board will invalidate elections affected by improper electioneering tactics, and an employee's expression of choice is exercised by casting a ballot in private," but there "are no guarantees of comparable safeguards in the [card-check] process." 351 N.L.R.B. at 438–39.

16. 29 U.S.C. § 158(c) (2006).

17. Chamber of Commerce v. Brown, 128 S. Ct. 2408, 2413–14 (2008).

18. *Id.* at 2413 (quoting *Gissel*, 395 U.S. at 617); *see* Thomas v. Collins, 323 U.S. 516, 532 (1945) ("The right . . . to discuss, and inform people concerning, the advantages and disadvantages of unions and joining them is protected not only as part of free speech, but as part of free assembly.").

19. 29 U.S.C. § 157 (2006).

20. *Chamber of Commerce*, 128 S. Ct. at 2414 (emphasis added).

21. 29 U.S.C. § 158(d) (2006).

22. DEREK C. BOK & JOHN T. DUNLOP, LABOR AND THE AMERICAN COMMUNITY 78 (Simon and Schuster, 1970).

EFCA, however, would mandate government-imposed contracts by requiring that when a union is certified or recognized as an exclusive bargaining agent, and the parties fail to reach agreement on a first contract after 120 days of bargaining and mediation, the Federal Mediation and Conciliation Service (FMCS) would appoint an arbitration panel.[23] That panel, which would not necessarily take into consideration the necessities of the employer's business, would then decide on the contract to establish the terms and conditions of employment that would be binding on the employer and employees for two years.[24] Union members in the bargaining unit thus would have no opportunity to vote on ratification of the contract even if, in states not having a "right-to-work" law,[25] the contract requires all unit employees to become members or pay union "agency fees" as a condition of employment. Moreover, under an existing NLRB-created rule, unit employees could not obtain a decertification election until the end of that contract.[26]

One of the NLRA's "fundamental policies is freedom of contract."[27] The Supreme Court has held that "allowing the [NLRB] to compel agreement when the parties themselves are unable to agree would violate th[is] fundamental premise."[28] A fortiorari, EFCA's mandatory arbitration provision is inconsistent with that same underlying premise of the NLRA, because it takes away from all parties the freedom to cease dealing and simply walk away if they cannot reach a mutually acceptable agreement.

Mandatory governmentally-imposed binding interest arbitration also runs afoul of various provisions of the U.S. Constitution. In 1937, the Supreme Court held, by a margin of one vote, that the original NLRA was not an arbitrary or

23. H.R. 1409, 111th Cong. § 3 (2009); S. 560, 111th Cong. § 3 (2009).

24. *Id.*

25. NLRA § 14(b), 29 U.S.C. § 164(b), authorizes states to prohibit "agreements requiring membership in a labor organization as a condition of employment." The Supreme Court has construed this provision as also allowing states to prohibit agreements requiring payment of union "agency fees" as a condition of employment. Retail Clerks Intl. Assn., Local 1625 v. Schermerhorn, 373 U.S. 746 (1963). Such statutes are commonly called "right-to-work" laws. *Id.* at 750. These laws have been enacted by twenty-two states. 2 JOHN E. HIGGINS, JR. ET AL., THE DEVELOPING LABOR LAW: THE BOARD, THE COURTS, AND THE NATIONAL LABOR RELATIONS ACT 2150 (5th ed. 2006).

26. 1 HIGGINS ET AL., *supra* note 24, at 567.

27. H.K. Porter Co. v. NLRB, 397 U.S. 99, 108 (1970).

28. *Id.*

capricious restraint on an employer's right to conduct its business within the due process clause and other constitutional restrictions only because, the act "does not compel any agreement whatever"[29] and "does not prevent the employer 'from refusing to make a collective contract.'"[30] EFCA does precisely that. Moreover, in requiring governmentally-imposed arbitrators to dictate contract terms, EFCA would unconstitutionally take the property of employers and give that property to their employees (as wages, for example) for a non-public use, in violation of the takings clause, as Professor Richard Epstein has charged.[31]

Finally, a serious argument can also be made that in providing absolutely no standards, guidelines, criteria, or limitations for the FMCS in prescribing regulations for the arbitrators who would unilaterally impose wage, hour, benefit, and other contract provisions on employers and employees, the statute is impermissibly vague, violates due process, and is an unconstitutional delegation of legislative powers. In contrast, the NLRA was held not to violate "the constitutional requirements governing the creation and action of administrative bodies," because it "establishes standards to which the [NLRB] must conform."[32]

IV. INCREASED EMPLOYER PENALTIES

EFCA would also impose three new penalties for employer—but none for union—unfair labor practices committed during union organizing campaigns or in bargaining for a first contract. Those penalties are:

- liquidated damages equivalent to triple back pay for employees fired in violation of the NLRA;[33]

29. NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1, 45 (1937) (5–4 decision).

30. *Id.* (quoting Virginian Ry. Co. v. System Fed'n No. 40, Ry. Employees Dep't. of the Am. Fed'n of Labor, 300 U.S. 515, 549 n.6 (1937)).

31. Richard Epstein, *The Employee Free Choice Act Is Unconstitutional*, WALL ST. J., Dec. 19, 2008, at A15.

32. Jones & Laughlin Corp., 301 U.S. at 46–47.

33. H.R. 1409, 111th Cong. § 4(b)(1) (2009); S. 560, 111th Cong. § 4(b)(1) (2009).

- fines of up to $20,000 for each unfair labor practice committed by employers who "willfully or repeatedly" engage in unlawful conduct;[34] and

- mandatory expedited investigations and injunction proceedings when an employer is alleged to have committed unfair labor practices.[35]

These drastic new penalties for unfair labor practices that apply to employers but not to unions raise concerns under the Equal Protection Clause of the Fourteenth Amendment[36] and may violate the Seventh Amendment[37] right to a jury trial.[38]

These one-sided changes in the NLRA's remedial scheme would adversely affect employees as well as employers. With the Damoclean sword of punitive remedies looming, employers faced with union organizing campaigns will be more likely to gag themselves to avoid unfair labor practice charges by unions, thus depriving employees of the "information opposing unionization," which they have an implicit "right to receive" under NLRA section 7,[39] and which is necessary to make an informed and free choice about whether to support unionization or not.[40]

V. CONCLUSION

The many serious policy issues presented by each of the three parts of EFCA—"card check," mandatory interest arbitration, and increased employer penalties—are undoubtedly why this controversial bill has not been enacted in the last two Congresses. Moreover, should the bill nonetheless be enacted,

34. H.R. 1409 § 4(b)(2)(B); S. 560 § 4(b)(2)(B).

35. H.R. 1409 § 4(a); S. 560 § 4(a).

36. U.S. CONST. amend. XIV, § 1.

37. U.S. CONST. amend. VII.

38. *Cf. Jones & Laughlin*, 301 U.S. at 48–49 (upholding NLRA against a Seventh Amendment challenge because statutory remedies were limited to reinstatement and back pay).

39. *Chamber of Commerce*, 128 S. Ct. at 2414.

40. *See* Excelsior Underwear, 156 N.L.R.B. 1236, 1240 (1966):

> Among the factors that undoubtedly tend to impede [employee free choice] is a lack of information with respect to one of the choices available. In other words, an employee who has had an effective opportunity to hear the arguments concerning representation is in a better position to make a more fully informed and reasonable choice.

it is certain to face significant legal challenges that it may well not survive.

THE TARP BAILOUT OF GM: A LEGAL, HISTORICAL, AND LITERARY CRITIQUE

BRENT J. HORTON*

* Assistant Professor of Law & Ethics, Fordham University; Corporate LL.M., New York University College of Law; J.D., Syracuse University College of Law. Thanks are in order to my ever-patient fiancée, Kelley. Thank you to Jack Vrablik for research assistance. Thank you to my colleagues Benjamin Cole, Mark Conrad, Kenneth Davis, Kevin Jackson, and Elizabeth Pinho Cosenza for your comments on prior drafts.

ABSTRACT

This Article argues that President Obama's use of TARP to fund a Chapter 11 restructuring of GM is reminiscent of the anticompetitive economic policies favored by Franklin Delano Roosevelt during the New Deal. However, it is largely agreed that FDR's New Deal economic policies prolonged the Great Depression. As such, a question arises: why would President Obama repeat FDR's failed economic policies? This question assumes that President Obama's goal is economic in nature.

This Article argues that President Obama's true goal is not economic, but social—to transform the United States automotive industry into one that produces environmentally-friendly vehicles. If that is the case, that is fine—and perhaps laudable—but I am reminded of Arthur Leff's admonition that when politicians implement policy they "ought to have the political nerve to do so with some understanding (and some disclosure) of what [they] are doing."[1]

Finally, this Article concludes by discussing the fact that over fifty years ago, Ayn Rand described politicians using emergency economic legislation to implement social change. Her novel, *Atlas Shrugged*,[2] provides a unique prospective on this Article's discussion of both the New Deal and TARP.

INTRODUCTION

In 2008, General Motors Corporation (GM) was facing unsustainable legacy costs and increased competition from Asia and Europe.[3] The deepening economic recession in the United

1. *See infra* note 29.

2. AYN RAND, ATLAS SHRUGGED (1957).

3. Andrea Billups, *Out of Gas; On Verge of Extinction, American Auto Industry Must Make Big Changes*, WASH. TIMES, Jan. 18, 2009, at M04. One commentator explained:

> Population aging is also likely to create huge legacy costs for employers. This is particularly true in the United States, where health and pension benefits are largely provided by the private sector. General Motors (GM) now has 2.5 retirees on its pension rolls for every active worker and an unfunded pension debt of $19.2 billion. Honoring its legacy costs to retirees now adds $1,800 to the cost of every vehicle GM makes, according to a 2003 estimate by Morgan Stanley.

Phillip Longman, *The Global Baby Bust*, 83 FOREIGN AFF. May-June 2004, at 64, 73. As to competition from Asia, see Hailu Regassa & Ahmad Ahmadian, *Comparative Study of*

States was threatening to push GM into liquidation.[4] GM CEO Rick Wagoner testified before Congress that only federal government assistance could save GM.[5] President Bush, "[a]bandon[ing] free-market principles to save the free-market system,"[6] directed the Treasury to provide $14 billion to GM pursuant to the Emergency Economic Stabilization Act of 2008 (EESA)[7] and the Troubled Asset Relief Program (TARP).[8] However, following the inauguration of Barack Obama, the TARP bailout of GM expanded exponentially, and by June 3, 2009, GM had received an additional $36 billion.[9] But now the cash infusion was contingent upon GM restructuring under Chapter 11 of the Bankruptcy Code.[10] Why did the Obama Administration agree to fund GM's Chapter 11 restructuring?

The Obama Administration—at least in public—repeated the explanation offered by the Bush Administration, that bailing out GM was necessary to save the economy.[11] Consider the following public statement from the President:

> [No one doubts] the importance of a viable auto industry to the well-being of families and communities across our industrial Midwest and across the United States. In the midst of a deep recession and financial crisis, the collapse of these companies would have been *devastating* for countless

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American and Japanese Auto Industry: General Motors Versus Toyota Motors Corporations, 8 BUS. REV. 1 (2007).

4. Tom Krishner, *GM CEO Says Bankruptcy Would Cause Liquidation*, USA TODAY, Mar. 17, 2009.

5. *Examining the State of the Domestic Automobile Industry, Hearing before the S. Comm. on Banking, Housing, and Urban Aff.*, 110th Cong., 2–4 (2008) (statement of G. Richard Wagoner, Jr., Chairman and Chief Executive Officer of General Motors Corporation).

6. Dana Milbank, *The Confessor in Chief*, WASH. POST, Dec. 19, 2008, at A3.

7. Pub. L. No. 110-343, 122 Stat. 3765 (codified at 12 U.S.C. §§ 5201–61 (2008)).

8. *Id.* at § 101-136 (codified at 12 U.S.C. § 5211–38 (2008)) (creating TARP). As to the automobile industry, the relevant TARP sub-program is the Auto Industry Financing Program (AIFP). ACCOUNTABILITY FOR THE TROUBLED ASSET RELIEF PROGRAM, THE SECOND REPORT OF THE CONGRESSIONAL OVERSIGHT PANEL 7 (Jan. 9, 2009) (discussing AIFP); U.S. TREASURY DEPARTMENT OFFICE OF FINANCIAL STABILITY TROUBLED ASSET RELIEF PROGRAM TRANSACTIONS REPORT 10 (June 19, 2009) [hereinafter TARP TRANSACTION REPORT] (listing AIFP expenditures).

9. TARP TRANSACTION REPORT, *supra* note 8, at 10.

10. *See* 11 U.S.C. §§ 1101–45; Paul Kane, *Democrats' Push for Full-Scale Stimulus Stalled Until Jan. 20*, WASH. POST, Nov. 15, 2008, at A01 (describing additional requirements of the expanded bailout).

11. Kate Linebaugh & Sharon Terlep, *The Auto Industry Bailout: GM Dealers Await Word on Deeper Cuts*, WALL ST. J., Apr. 28, 2009, at A8; Sean Higgins, *Automakers Rally on Hopes for Bailout, but White House, GOP Have Concerns*, INV. BUS. DAILY, Dec. 9, 2008, at A01.

> Americans, and done *enormous damage to our economy*—beyond the auto industry.[12]

However, this Article argues that despite public statements to the contrary, the Obama Administration's expanded bailout of GM had very little to do with saving the economy. Instead, the Chapter 11 restructuring of GM was a first step in transforming the American automotive industry from one that produces large sports utility vehicles into one that produces environmentally-friendly cars and trucks.

First, this Article will expose the fallacy of the claim that government interference in private industry is necessary to avoid devastation to our economy.[13] The American people have been here before. Part I of this Article turns to the past, FDR's New Deal. FDR's New Deal was premised on a belief that the Great Depression was caused by the free market; that "cutthroat competition" and "foolish overproduction" drove down prices and rendered existing businesses insolvent.[14] FDR's New Deal

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12. President Barack Obama, Remarks by the President on General Motors Restructuring, Grand Foyer, White House (June 1, 2009) (emphasis added). The President's statement echoed prior statements from the House of Representatives. Speaker of the House Nancy Pelosi stated:

> In order to prevent the failure of one or more of the major American automobile manufacturers, which would have a *devastating impact on our economy*, particularly on the men and women who work in that industry, Congress and the Bush administration must take immediate action . . . I am confident Congress can consider emergency assistance legislation next week . . . .

David M. Herszenhorn & Carl Hulse, *Democrats Seek Emergency Help for Carmakers*, N.Y. TIMES, Nov. 12, 2008, at A1.

13. Obama, *supra* note 12.

14. FDR told the following fable about oversupply driving down prices:

> "[A] story that was told to me the other day." The story of what FDR called "a certain little sweater factory in a little town"— "I won't even give you the location of it." . . . The factory, which FDR said was the town's only industry, normally employed about 200 people who "had always been on exceedingly good terms" with the owners. However, "it was difficult to sell enough sweaters to keep them going because there were so many sweater factories" in the nation, all of which had had only about six weeks' worth of work in the past year. The town, FDR said, was "practically starving to death." So the people decided that they all could work if they reduced everyone's wages by 33 percent. That would cut the cost of their sweaters and enable them to undersell competitors. FDR said the factory's sales agent went to New York and "in 24 hours" sold "enough sweaters to keep that factory going for six months, 24 hours a day, three shifts."

George F. Will, *FDR's Sweater Fable*, NEWSWEEK, Mar 9, 2009, at 62. Roosevelt continued the fable by lamenting that the sweater factory likely "put two other sweater factories completely out of business." *Id.* He concluded that the best solution to this problem was less competition. *Id.*

attempted to reduce those competitive pressures on existing businesses—at least in part—with the Motor Carrier Act (MCA)[15] and the National Industrial Recovery Act (NIRA).[16] The MCA and NIRA limited competitive pressures on certain industries like trucking and steel by erecting barriers to entry that helped those industries at the expense of entrepreneurial firms.[17] When one considers the number of entrepreneurial firms stifled by the MCA and the NIRA and the fact that eighty percent of new jobs are created by small firms (defined as 100 or fewer employees),[18] common sense leads to the conclusion that these New Deal programs likely prolonged the Great Depression. As it turns out, both economists[19] and law and economics scholars agree with this common sense conclusion that government interference in business and anticompetitive policy harms, rather than helps, the economy.[20]

The other side of the New Deal was increasing demand. This portion of the New Deal was based on Keynesian economic theory. According to Keynes, in the event of economic recession, the government must take action to increase demand on goods and services. William H. Simon, *Rights and Redistribution in the Welfare System*, 38 STAN. L. REV. 1431, 1454 (1986). As such, FDR demanded that cartels increase worker wages to increase demand on goods. Jason E. Taylor, *The Output Effects of Government Sponsored Cartels During the New Deal*, 50 J. INDUS. ECON. 1, 3 n.5 (2002).

15. Motor Carrier Act of 1935, ch. 498, Pub. L. No. 74-225, 49 Stat. 543 (1935) (current version at 49 U.S.C. §§ 10101–02 (2000)); Legislation, *Federal Motor Carrier Act*, 36 COLUM. L. REV. 945, 952 (1936). The Motor Carrier Act was part of the third phase of the New Deal. Herbert E. Dougall, *Third Phase of the New Deal*, BARRONS, Jan. 20, 1936, at 15.

16. National Industrial Recovery Act, Pub. L. No. 73-67, 48 Stat. 195 (1933) (formerly codified at 15 U.S.C. 703–10), *invalidated by* Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935); David Kennedy, *What the New Deal Did*, 124 POL. SCI. Q. 251, 260 (2009) ("[T]he New Deal sought stability by directly curtailing price and cost competition, often by limiting new entrants.").

17. Kennedy, *supra* note 16, at 260.

18. David L. Birch, *Who Creates Jobs?*, PUB. INT., Fall 1981, at 3; David Neumark, *Do Small Businesses Create More Jobs?: New Evidence for the United States from the National Establishment Time Series* (Nat'l Bureau of Econ. Research, Working Paper No. 13818, 2008) (confirming Birch's research); *see also* Rafael Efrat, *The Tax Burden and the Propensity of Small Businesses to File for Bankruptcy*, 4 HASTINGS BUS. L.J. 175, 176 (2008) ("Small-business owners in the United States make a significant contribution to the economy. Small-business owners make up 6 percent of the adult population and approximately 11 percent of working Americans."); Note, Recent Legislation, 110 HARV. L. REV. 553 (1996) (If you define small business as companies with fewer than 500 employees, they "created almost four million net jobs from 1989 to 1993, whereas large businesses lost roughly 3.5 million net jobs during the same period.").

19. *See* Harold L. Cole & Lee E. Ohanian, *New Deal Policies and The Persistence Of The Great Depression: A General Equilibrium Analysis*, 112 J. POL. ECON. 779 (2004) (discussing economists' view of New Deal programs).

20. *See, e.g.*, Richard A. Posner, *Social Norms, Social Meaning, and the Economic Analysis of Law*, 27 J. LEGAL STUD. 553, 563 (1998) [hereinafter Posner, *Social Norms*] (stating that the New Deal was rule by expert); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1572 (1998) [hereinafter Posner, *Rational*

Part II argues that while it is true that FDR's use of economic legislation and President Obama's use of TARP are analogous—both rely on government control and reducing competition—it is a mistake to assume that President Obama's use of TARP is a reincarnation of FDR's New Deal economic policies. That would presume that President Obama refuses to learn from the failure of FDR's economic policies. I refuse to believe that a Harvard-trained lawyer and Visiting Law and Government Fellow at the University of Chicago[21]—an institution known for its law and economics approach to legislation[22]—would refuse to learn from history. "Contradictions do not exist. Whenever you think you are facing a contradiction, check your premises. You will find that one of them is wrong."[23]

As such, Part II.B continues with a more plausible explanation for the Obama Administration's use of TARP funds to restructure GM: the Obama Administration is not using TARP to repair the economy, but instead to "*transform* the economy,"[24] or at least the portion that produces automobiles. The Obama Administration does not "want a serious crisis to go to waste,"[25] and in President Obama's own words, the 2009 economic crisis provides a "chance to transform our economy . . . [and] put people to work building . . . fuel-efficient cars."[26] The Obama Administration used TARP support to purchase a *quid pro quo* from GM.[27] The Obama Administration was able to convince GM to cooperate in the promotion of a broader social interest,

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Choice] (same); Richard Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548, 621 (1969) [hereinafter Posner, *Natural Monopoly*] (discussing New Deal's "exaggerated faith in the independence and expertise of government administrators"). Likewise, there is a plethora of books discussing the topic. *See, e.g.*, BURTON W. FOLSOM JR., NEW DEAL OR RAW DEAL?: HOW FDR'S ECONOMIC LEGACY HAS DAMAGED AMERICA (Threshold 2008); JIM POWELL, FDR'S FOLLY: HOW ROOSEVELT AND HIS NEW DEAL PROLONGED THE GREAT DEPRESSION (Crown 2003); MICHAEL W. WEINSTEIN, RECOVERY AND REDISTRIBUTION UNDER THE NIRA (North–Holland Publishing Company 1980); E.W. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY (Princeton University Press 1966).

21. *See* BARACK OBAMA, DREAMS FROM MY FATHER, *passim* (1995) (discussing President Obama's legal career).

22. R.H. Coase, *Law and Economics at Chicago*, 36 J. L. & ECON. 239 (1993) (discussing the law and economics movement at the University of Chicago).

23. RAND, *supra* note 2, at 199.

24. President Barack Obama, Speech to the Business Council (Feb. 13, 2009) (emphasis added).

25. Timothy Carney, *Obamanomics: 'Crisis' is a Cover For Ruining Your Retirement*, WASH. TIMES, March 16, 2009, at A18 (quoting Rahm Emanuel, White House Chief of Staff).

26. Obama, *supra* note 24.

27. *See* discussion *infra* Part II.B.

transforming the American automobile industry into one that produces environmentally-friendly cars and trucks, in exchange for a TARP bailout.[28] If that is the case, that is fine—and perhaps a laudable goal—but I am reminded of Arthur Leff's admonition: when politicians implement policy they "ought to have the political nerve to do so with some understanding (*and some disclosure*) of what [they] are doing."[29] The Obama Administration should not try to convince us that TARP's application to GM is intended to improve the economy, when history shows it will have the opposite effect. The Obama Administration should tell us the truth, that they believe the current economic downturn presents an opportunity to implement broader social policy. They may find that the American people are receptive to the truth, and who knows, maybe even receptive to the policy.

Of course, using emergency economic legislation to force social change is not new. It repeats throughout history and has been the subject of legal scholars and novelists alike. Part III will thus conclude this Article by bringing a diverse perspective to the foregoing analysis of emergency economic legislation and its abuse in *Atlas Shrugged.*[30] Ayn Rand's magnum opus, *Atlas Shrugged,* is often derided by legal academics as a cold, exploitative picture of humanity,[31] a "utopian fantasy,"[32] and a "remarkably silly book."[33] They "protest[] too much, methinks."[34] *Atlas Shrugged* should be celebrated as bringing a diverse voice to the critique of emergency economic legislation.[35] In fact, *Atlas Shrugged*'s arguments are not so different from the more accepted arguments of law and economics scholars [36] who argue that the New Deal was a

28. *See* discussion *infra* Part II.C.

29. Arthur Leff, *Unconscionability and the Code—The Emperor's New Clause,* 115 U. PA. L. REV. 485, 558 (1967) (emphasis added).

30. RAND, *supra* note 2, *passim.*

31. Eleanor Fox, *Consumer Beware Chicago,* 84 MICH. L. REV. 1714, 1720 (1986) (briefly attacking *Atlas Shrugged* in a critique of Chicago's School of Economics).

32. Linda Hirshman, *The Rape of the Locke: Race, Gender, and the Loss of Liberal Virtue,* 44 STAN. L. REV. 1133, 1152 (1992).

33. Whittaker Chambers, *Big Sister Is Watching You,* 25 NAT'L REV. 594, 594 (1957).

34. WILLIAM SHAKESPEARE, HAMLET act 3, sc. 2, line 240 (George Baker ed., MacMillan 1913).

35. *See* discussion *infra* Part III.C.

36. Ayn Rand uses an approach akin to the law and economics balancing approach to attack the New Deal regulatory regime, but, amazingly, she did it two decades before Richard Posner. Let me be clear, I am not saying that Richard Posner was or is

progressive panacea[37] of "rule by expert,"[38] now discredited.[39] Nor is Rand's argument far removed from the thesis of this Article, that emergency economic legislation is often used by the ruling class to accomplish broader social ends.

While many law review articles explain the legal insight that can be gleaned from works of literature, from *To Kill a Mockingbird*,[40] to *The Great Gatsby*,[41] to *The Catcher in the Rye*,[42] there is an amazing lack of legal scholarship discussing *Atlas Shrugged*.[43] This failure is unforgivable when one considers that the book heavily influenced scholarship in economics[44] and

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channeling Ayn Rand's *Atlas Shrugged*, or was or is even influenced by the book or its author; in fact, in a 2009 article he stated that in the 1960s Ayn Rand did not appeal to him. *See* Posting of Richard Posner to the Becker-Posner Blog, http://www.becker-posner-blog.com/archives/2009/05/is_the_conserva.html (May 10, 2009, 14:32 EST). And in another article he was even less charitable, "I have long thought it troublesome that Alan Greenspan was a follower of Ayn Rand." Posting of Richard Posner to the Becker-Posner Blog, http://www.becker-posner-blog.com/archives/2008/04/reregulate_fina.htm (Apr. 28, 2008, 12:35 EST). What I *am* saying is that Rand and Posner have very similar evaluations of business regulation. Both Rand and Posner point out the high cost of regulation of monopolies and oligopolies—both in terms of higher prices to the consumer and barriers to entry.

37. Posner, *Rational Choice*, *supra* note 20, at 1572

38. Posner, *Social Norms*, *supra* note 20, at 563.

39. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 628 (4th ed. 1992).

40. Note, *Being Atticus Finch: The Professional Role of Empathy in* To Kill A Mockingbird, 117 HARV. L. REV. 1682 (2004); Rob Atkinson, *Liberating Lawyers: Divergent Parallels in* Intruder in the Dust *and* To Kill a Mockingbird, 49 DUKE L.J. 601 (1999).

41. Allen Boyer, The Great Gatsby, *the Black Sox, High Finance, and American Law*, 88 MICH. L. REV. 328 (1989); Brian Fintan Moore, *Assigning Moral Culpability in F. Scott Fitzgerald's* The Great Gatsby, 50 RUTGERS L. REV. 645 (1998).

42. Stewart G. Pollock, *Lawyers and Judges as Catchers in the Rye*, 34 TULSA L.J. 1 (1998).

43. Some notable exceptions are: Simone A. Rose, *Will Atlas Shrug? Dilution Protection For "Famous" Trademarks: Anti-Competitive "Monopoly" Or Earned "Property" Right?*, 47 FLA. L. REV. 653 (1995) (using *Atlas Shrugged* to discuss monopolization); John Kunich, *Fiddling Around While the Hotspots Burn Out*, 14 GEO. INT'L ENVTL. L. REV. 179 (2001) (applying *Atlas Shrugged* to environmental law); Michael Coblenz, *Not for Entertainment Only: Fair Use and Fiction as Social Commentary*, 16 UCLA ENT. L. REV. 265, 304 (2009). Many of the discussions simply mentioned *Atlas Shrugged* in passing, assuming that the reader would understand the reference due to the book's popularity. Ian Ayres and Joe Bankman, *Substitutes for Insider Trading*, 54 STAN. L. REV. 235, 281 n.141 (2001). Rand's prior book, *The Fountainhead*, did receive detailed treatment. Alan D. Hornstein, *Narrative Jurisprudence: The Trials of Howard Roark*, 23 LEGAL STUD. F. 431 (1999).

44. *See* David Friedman, *Many, Few, One: Social Harmony and the Shrunken Choice Set*, 70 AM. ECON. REV. 225, 226 n.4 (1980) (describing the quintessential capitalist as *Atlas Shrugged*'s Hank Reardon, who built his enterprise from the "sweat of his brow"); Lewis E. Hill & Robert L. Rouse, *The Sociology of Knowledge and the History of Economic Thought*, 36 AM. J. ECON. & SOC. 299, 305 (1977) (calling Ayn Rand's economic system utopian); Max E. Fletcher, *Harriet Martineux and Ayn Rand: Economics in the Guise of Fiction*, 33 AM. J. ECON.& SOC. 367 (1974); John B. Ridpath and James G. Lennox, *Ayn Rand's Novels: Art or Tracts? Two Additional Views*, 35 AM. J. ECON. & SOC. 213 (1976).

business ethics,[45] as well as influenced law students[46] and everyday Americans—in fact, according to the Library of Congress, *Atlas Shrugged* is second in influence only to the Bible.[47] As to the last group—the American people—Ayn Rand took on the herculean task of "convert[ing] her readers to the view that . . . a completely unregulated system is to be preferred to a mixture of freedom and regulation that now prevails in economic affairs."[48]

I. THE NEW DEAL

A. *The Transportation Act of 1920 and Enforcement in the 1930s*

President Theodore Roosevelt's cartel-busting crusade that dominated the first two decades of the twentieth century[49] was replaced by government-supported cartels during the presidency of FDR.[50] To be concise, the battle against cartels was already

45. *See* Christopher Michaelson, *Dealing with Swindlers and Devils: Literature and Business Ethics*, 58 J. BUS. ETHICS 359 (2005) (suggesting that Ayn Rand's philosophy encouraged scandals like Enron); Bernard Sarachek, *Images of Corporate Executives in Recent Fiction*, 14 J. BUS. ETHICS 195 (1995) ("For Rand, all forms of collectivism, including the corporation, government and community moral codes constitute barriers raised by mediocre people to inhibit and control the true doers and builders of society."); P. Eddy Wilson, *The Fiction of Corporate Scapegoating*, 12 J. BUS. ETHICS 779 (1993) (comparing scapegoating characters in *Atlas Shrugged* with actual corporate scapegoating).

46. A 2006 survey of entering law students ranks *Atlas Shrugged* fourth, behind, the *Catcher in the Rye* (3rd), The *DaVinci Code* (2nd) and *To Kill a Mockingbird* (1st). The students were asked for their favorite book. Ian Galacher, *"Who Are Those Guys?": The Results of a Survey Studying the Information Literacy of Incoming Law Students*, 44 CAL. W. L. REV. 151, app. A (2007).

47. Esther B. Fein, *Book Notes*, N.Y. TIMES, Nov. 20, 1991, at C26. Since it was published in 1957, *Atlas Shrugged* has sold over 6 million copies. Mark Sanford, *Atlas Hugged*, NEWSWEEK, Nov. 2, 2009.

48. Max E. Fletcher, *Harriet Martineux and Ayn Rand: Economics in the Guise of Fiction*, 33 AM. J. ECON. & SOC. 367, 369 (1974) (Ayn Rand "had great success in simplifying the esoteric ideas of [government involvement in] economics and bringing them to the public in the form of fiction").

49. Michael S. Lewis-Beck, *Maintaining Economic Competition: The Causes and Consequences of Antitrust*, 41 J. POL. 169, 179 (1979). Lewis-Beck argues:

> Although Theodore Roosevelt cultivated his reputation as a serious trustbuster, his immediate successors actually started more cases than he did. Democrat Woodrow Wilson, for example, initiated over twice as many suits as TR. In his 1912 campaign against Roosevelt, Wilson spoke out forcefully against politically-connected business combinations: "The masters of the government of the United States are the combined capitalists and manufacturers of the United States. . . . [the laws should] pull apart, and gently, but firmly and persistently dissect."

50. Relaxation of the antitrust laws corresponded with greater government cooperation with business. *See* Calvin Woodard, *Reality and Social Reform: The Transition*

coming to an end in the 1920s and early 1930s with legislation intended to promote closer cooperation between government and politically-connected business.[51] The Transportation Act of 1920,[52] which was the apparent model for Ayn Rand's fictional Anti-Dog-Eat-Dog Rule,[53] empowered the Interstate Commerce Commission (ICC) to regulate entry into the railroad industry by granting (or refusing to grant) certificates of public convenience and necessity.[54] The prospective entrant had to show that "the present or future public convenience and necessity require or will require the construction, or operation . . . of such additional or extended line of railroad."[55] Of course,

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from Laissez-Faire to the Welfare State, 72 YALE L.J. 286, 306, 323 (1962) (discussing the demise of laissez-faire and the rise of the welfare state). It would take the Supreme Court a decade and a half to accept the welfare state, not supporting government intervention in business until 1937. *See* Barry Cushman, *Rethinking the New Deal Court,* 80 VA. L. REV. 201, 206 (1994); Laura Kalman, *Law, Politics, and the New Deal(s),* 108 YALE L.J. 2165, 2184 n.145 (Jun. 1999).

51. The Transportation Act of 1920, Pub. L. No. 66-152, 41 Stat. 456 (1920), as amended by the Emergency Railroad Transportation Act of 1933, Pub. L. No. 73-68, 48 Stat. 211, 217 (1933):

> The carriers and any corporation affected by any order made under the foregoing provisions of this section shall be, and they are hereby, relieved from the operation of the antitrust laws as designated in section 1 of the Act entitled 'An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes,' approved October 15, 1914, and of all other restraints or prohibitions by or imposed under authority of law, State or Federal, insofar as may be necessary to enable them to do anything authorized or required by such order.

49 U.S.C. § 5–15 (1934); Texas v. United States, 292 U.S. 522 (1934); R. W. Harbeson, *The Emergency Railroad Transportation Act of 1933,* 42 J. POL ECON. 106, 112 (1934); Edwin C. Goddard, *The Emergency Railroad Transportation Act, 1933,* 31 MICH. L. REV. 1112, 1116 (1933); *but see* Edward Dumbauld, *Rate Fixing Conspiracies in Regulated Industries,* 95 PENN. L. REV. 643 (1947) (arguing that the railroads were still subject to antitrust laws).

52. Transportation Act of 1920, Pub. L. No. 66-152, 41 Stat. 456 (1920).

53. RAND, *supra* note 2, at 75; *see infra* Part III.A.

54. CHRISTOPHER JAMES CASTANEDA, REGULATED ENTERPRISE: NATURAL GAS PIPELINES AND MARKETS 1935–1954 8 (1993).

55. The applicable text of the statute provides:

> (18) After ninety days after this paragraph takes effect no carrier by railroad subject to this Act shall undertake the extension of its line of railroad, or the construction of a new line of railroad, or shall acquire or operate any line of railroad, or extension thereof, or shall engage in transportation under this Act over or by means of such additional or extended line of railroad, unless and until there shall first have been obtained from the Commission a certificate that the present or future public convenience and necessity require or will require the construction, or operation, or construction and operation, of such additional or extended line of railroad,
>
> . . . .
>
> (20) The Commission shall have power to issue such certificate as prayed for, or to refuse to issue it, or to issue it for a portion or portions of a line of railroad, or extension thereof, described in the application, or for the partial exercise only of such right or privilege, and may attach to the issuance of the

this is a fact-based question that leaves much room for chicanery on the part of railroad cartels that want to exclude new market entrants. Consider the case of *Piedmont & Northern Railway Co. v. United States.*[56] In 1925 the Piedmont region of South Carolina was beginning to diversify away from cotton to steel.[57] The Piedmont & Northern Railway Company (P&N) "realized the possibility of great industrial development" in the region of Piedmont, and sought to accelerate this process by extending its railroad line from Spartanburg, South Carolina to Gastonia, North Carolina,[58] a $15,000,000 project ($184,000,000 today).[59] The ICC became aware of these plans and intervened, sending a letter dated March 8, 1927, reprimanding P&N for not applying for governmental permission to expand.[60]

P&N responded to the letter from the ICC by begrudgingly filing an application for a certificate of public convenience and necessity, arguing that the ICC lacked jurisdiction over it because P&N was an inter-urban electric railroad, a species of railroad exempt from the Transportation Act.[61] Setting aside the issue of jurisdiction, the ICC turned to whether there was substantial demand for the lines of road proposed by P&N, and whether "service would be improved and the industrial development of the region would be stimulated and enlarged."[62] Even if we assume the propriety of the federal government in determining whether a new business is needed, it appeared that P&N had the better argument.[63] What P&N was proposing was novel, it would use its high speed electric cars (a new technology

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> certificate such terms and conditions as in its judgment the public convenience and necessity may require. From and after issuance of such certificate, and not before, the carrier by railroad may, without securing approval other than such certificate, comply with the terms and conditions contained in or attached to the issuance of such certificate and proceed with the construction, operation, or abandonment covered thereby.

41 Stat. 456, 477–78 (1920); *see also* Texas v. E. Tex. R.R. Co., 258 U.S. 204, 218 n.1 (1922).

56. 30 F.2d 421 (W.D.S.C. 1929), *rev'd*, 280 U.S. 469 (1930).

57. Frank Bohn, *New South Throbs with Industrial Life*, N.Y. TIMES, Oct. 25, 1925, at XX1; David Carleton, *The Piedmont and Waccamaw Regions: An Economic Comparison*, S.C. HIST. MAG., Apr. 1987, at 83.

58. *Piedmont*, 30 F.2d at 423; Note, *Judicial Review of Negative Orders by the Interstate Commerce Commission*, 34 COLUM. L. REV. 908, 914–16 (1934).

59. *P&N Answers I.C.C.*, WALL ST. J., May 5, 1930, at 7.

60. *Piedmont*, 30 F.2d at 422.

61. *Id.* at 423.

62. *Id.*

63. *Id. passim.*

before restricted to within cities)[64] to transport passengers and goods not only within cities, but between cities as well.[65] The electric cars could travel on intra-city tracks (via tracks imbedded in the streets) as well as along inter-city tracks previously dominated by steam locomotives.[66] "The switching service thus made available in the cities [would be] extremely convenient for industries of all sorts, including factories, wholesale houses, and even retail houses."[67] The new service would provide "means by which [inner-city] mills and factories could find connections with the steam railroads of the country for the delivery of freight."[68] Beyond the growth opportunities for local industry, consider the number of jobs that would have been created by a $184,000,000 construction project.

However, the existing railroad cartel lead by Southern Railway ("Southern") intervened in the action and, backed by the power of the ICC, sought to block the entry of P&N into their market, arguing that they alone adequately served the geographic area in question and that they would lose business to Northern.[69] The ICC denied the certificate to P&N, finding that the proposed line would duplicate service provided by Southern.[70] The ICC's decision was upheld by the District Court for the Western District of South Carolina.[71] It was not until three years later when the Supreme Court found that the ICC had overstepped its jurisdiction that P&N was free to expand without governmental interference.[72] By then, the damage was done. Innovation in the Piedmont region of South Carolina had been

64. Carl W. Condit, *The Pioneer Stage of Railroad Electrification*, 67 TRANSACT. AM. PHIL. SOC'Y 1 (1977) (discussing the early years of the electric railroad in 1905 Brooklyn).

65. *Piedmont*, 30 F.2d at 427.

66. *Id.*

67. *Id.*

68. *Id.* at 428.

69. *Id.* at 422–23. Suits by competing railroads seeking to stop new railroads or extensions of existing railroads were common. *See* Chicago Junction Case, 264 U.S. 258 (1924) ("Leave to intervene can be granted only to one entitled under the act to complain to the Commission. The right to complain was broadly bestowed by Congress. From its inception the Commission has construed liberally this right to complain.") (citations omitted).

70. *Piedmont*, 30 F.2d at 423; *see also Bars P.&N. Road Extension*, N.Y. TIMES, Apr. 16, 1928, at 41.

71. *Piedmont*, 30 F.2d at 423.

72. Piedmont & N. Ry. Co. v. United States, 280 U.S. 469 (1930); *High Court Gets Rail Cases*, BARRONS, Oct. 20, 1930, at 7.

delayed by three years.[73] This outcome was representative of problems around the nation.[74] During the period from 1920 to 1940, while the number of large railroads (defined as greater than 5,000 miles of track) remained constant at approximately fifteen, the number of small railroads (defined as less than 5,000 miles of track) that could challenge the large railroads fell by half, from 1,083 to 559.[75] Politically-connected business—the railroad cartel—successfully consolidated power by excluding entrepreneurial firms with the help of the federal government.

B. *The Motor Carrier Act of 1935*

During the Great Depression, the true competitive challenge to the railroad cartels came from the infant trucking industry, or motor carriers.[76] Motor carriers made a phenomenal advance in the years from 1919 to 1935, the years following the First World War.[77] The number of trucks providing transportation services grew forty-fold, from 85,600 in 1914 to 3,480,939 in 1930.[78] This growth was largely due to the innovation of small firms that offered improved speed, flexibility of services rendered, and lower fares.[79] In response to this new competitive threat, the railroad cartels again lobbied the government for more industry-protecting laws and regulations.[80] The result was the Motor Carrier Act of 1935.[81] The Motor Carrier Act forbade motor carriers from operating without a certificate of public convenience and necessity.[82] Consider the case of *Maher v. United States.*[83] Dan E. Maher ("Maher") was an existing carrier,

73. *See High Court Gets Rail Cases,* BARRONS, Oct. 20, 1930, at 7 (explaining that as of October of 1930, Piedmont & Northern was still litigating the appeal on remand).

74. W. N. Leonard, *The Decline of Railroad Consolidation,* 9 J. ECON. HIST. 1, 10 (1949).

75. *Id.* at 10 tbl. 1. Amazingly, rather than being upset at the growing lack of competition, commentators of the day complained that the reductions were simply not the right kind—they were the result of abandonment, not consolidation. They argued that the abandonment of these smaller railroads was inevitable and that the Commission should have had more power to force consolidations of the smaller into the large. *Id.*

76. Legislation, *Federal Motor Carrier Act, supra* note 15, at 945.

77. *Id.* at 945 n.2.

78. *Id.* at 945.

79. *Id.* at 947.

80. CASTANADA, *supra* note 54, at 8.

81. Motor Carrier Act of 1935, Pub. L. No. 74-225, § 206(a), 49 Stat. 543 (1935) (codified as amended at 49 U.S.C. §§ 502–07, 522, 523, 525, 526, 315, 31502–04 (2008)).

82. Motor Carrier Act § 206; EARL LATHAM, THE POLITICS OF RAILROAD COORDINATION 1933–1936 232–33 (1959).

83. Maher v. United States, 23 F. Supp. 810, 811 (D. Or. 1938), *rev'd,* 307 U.S. 148 (1938).

who had transferred passengers and freight along Highway 99 on the west coast since 1931.[84] Despite the fact that Maher's activities predated passage of the Motor Carrier Act, Maher was still required to apply for a certificate of convenience and necessity from the ICC.[85] Just as they had done in *Piedmont*, railroads that competed with Maher seized the opportunity to try to put Maher out of business and intervened in the action, arguing that Maher's service would duplicate their own.[86] Like they had done in *Piedmont*, they argued that Maher's service was not needed.

Pursuant to the Motor Carrier Act, the ICC had the power to grant (or withhold) permission to motor carriers to operate based on whether the ICC deemed the service to be demanded by public convenience and necessity.[87] Alternatively, a motor carrier could be grandfathered pursuant to Section 206 of the Act.[88] Under the latter option the ICC would grant a certificate

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84. *Id.* at 812.

85. *Id.*

86. *Id.*

87. The Motor Carrier Act Section 207 states:

> (a) Subject to section 210, a certificate shall be issued to any qualified applicant therefor authorizing the whole or any part of the operations covered by the application, if it is found that the applicant is fit, willing, and able properly to perform the service proposed and to conform to the provisions of this chapter and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, to the extent to be authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise, such application shall be denied: *Provided, however,* That no such certificate shall be issued to any common carrier of passengers by motor vehicle for operations over other than a regular route or routes, and between fixed termini, except as such carriers may be authorized to engage in special or charter operations.

Motor Carrier Act of 1935, Pub. L. No. 74-225, § 206(a), 49 Stat. 543 (1935) (codified as amended at 49 U.S.C. §§ 502–07, 522, 523, 525, 526, 315, 31502–04 (2008)).

88. Motor Carrier Act Section 206 states:

> (a) No common carrier by motor vehicle subject to the provisions of this chapter shall engage in any interstate or foreign operation on any public highway, or within any reservation under the exclusive jurisdiction of the United States, unless there is in force with respect to such carrier a certificate of public convenience and necessity issued by the Commission authorizing such operations: *Provided, however,* That, subject to section 210, if any such carrier or predecessor in interest was in bona fide operation as a common carrier by motor vehicle on June 1, 1935, over the route or routes or within the territory for which application is made and has so operated since that time, or if engaged in furnishing seasonal service only, was in *bona fide* operation on June 1, 1935, during the season ordinarily covered by its operation, except in either instance as to interruptions of service over which the applicant or its predecessor in interest had no control, the Commission shall issue such certificate without requiring further proof that public

reasoning that the operation from some past time is conclusive evidence that "public convenience and necessity will be served by continued operation."[89] Because Maher's business predated passage of the Motor Carrier Act in 1935, he filed with the ICC an application based on Section 206, "to operate as a common carrier by motor vehicle of passengers and their baggage over U.S. Highway No. 99, between Portland, Oregon and Seattle, Washington, and intermediate points thereof."[90] Those opposing Maher, including the railroads, argued that Maher shifted from an irregular schedule to a regular schedule after the passage of the Motor Carrier Act in 1935, and as such could not be granted permission to operate pursuant to Section 206.[91] The ICC agreed that the scope of the grandfather clause was limited to extent of prior operations,[92] denied the application and ordered that Maher cease and desist his operations.[93]

Maher appealed, but the Supreme Court upheld the ICC's determination, prohibiting Maher from further operation, stating:

> Invoking the "grandfather clause," the appellee sought from the Commission a certificate authorizing continuance of his regular service between the fixed termini of Portland and Seattle on U.S. Highway 99. But the Commission found that the regular operation over this route had only been instituted on May 29, 1936. Theretofore, and including the crucial period prior to June 1, 1935, the appellee had been engaged in quite different services from those for which it asked a certificate—namely, "an irregular, so-called 'anywhere-for-hire'

> convenience and necessity will be served by such operation, and without further proceedings if application for such certificate was made to the Commission as provided in paragraph (b) of this section and within one hundred and twenty days after this section shall take effect, and if such carrier was registered on June 1, 1935, under any code of fair competition requiring registration, the fact of registration shall be evidence of bona fide operation to be considered in connection with the issuance of such certificate. Otherwise the application for such certificate shall be decided in accordance with the procedure provided for in section 207(a) of this chapter, and such certificate shall be issued or denied accordingly.

Motor Carrier Act § 206.

89. Note, *The "Grandfather" Clause in Federal Motor Carrier Regulation*, 43 COLUM. L. REV. 207, 208 (1943).

90. *Maher*, 23 F. Supp. at 812.

91. *Id.* at 812–13.

92. Note, *Public Utilities: Are the Rights under Grandfather Clause Limited to the Extent of Prior Operations*, 30 CAL. L. REV. 101, 102 n.4 (1941–1942).

93. *Maher*, 23 F. Supp. at 812–13.

> operation in Oregon with occasional trips to points in Washington" over any route adapted to a particular trip, but using at least for part of the distance U.S. Highway 99 on trips to Washington. These irregular operations were discontinued after the appellee's regular route was established. Applying these findings, which are binding here, the Commission ruled that the appellee did not bring himself within the privilege of the "grandfather clause." In making this application of the statute, the Commission properly construed it.[94]

Maher was enjoined from further operations.[95] This was a win for the railroads. They now had one less business to compete against. It is also just one of many instances of the ICC stifling the infant trucking industry in favor of the railroads by "narrowly interpret[ing] the 'grandfather clause' ... so as to deny certificates and permits to operating truck lines."[96] Again, politically-connected business—the railroad cartel—successfully consolidated power by excluding entrepreneurial trucking firms with the help of the federal government.[97]

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94. Maher v. United States, 307 U.S. 148, 154–55 (1939). *Maher* was in accord with the decisions of other courts that limited the grandfather clause to the scope of the prior operation:

> In *Motor Transit Co. v. Railroad Commission*, the carrier attacked an order of the Railroad Commission limiting its operation to the through routes used during the grandfather period and refusing to allow local service between intermediate points. It contended that operation prior to the grandfather date gave it unlimited rights, vested by the legislature and completely beyond the power of the Commission to touch. The court rejected this argument, saying, "To hold that by the operation of a through line on that date petitioners were given a franchise to operate to any extent that they, in their judgment, might see fit, limited solely by the restriction that operations must be between the same termini and over the same route, would be to materially decrease the power of the commission over these lines and thus overlook the primary purpose of the enactment which was to give to the commission, in the interest of the public, the fullest power possible to regulate the operation of auto stage companies."

Public Utilities, *supra* note 92, at 103–04 (1941) (discussing Motor Transit Co. v. R.R. Comm'n, 189 Cal. 573 (1922)).

95. *Maher*, 307 U.S. at 154–55.

96. Samuel P. Huntington, *The Marasmus of the ICC: The Commission, the Railroads, and the Public Interest*, 61 YALE L. J. 467, 498 (1952) (citing Vedder Oil Contract Car. App., 1 M.C.C. 758 (1936); McDonald v. Thompson, 305 U.S. 263 (1938); and Gregg Cartage & Storage Co. v. United States, 316 U.S. 74 (1942)).

97. It is also true of the time, that even where certain motor carriers were approved, their operations were restricted in terms of geography or commodity so as to protect markets dominated by the railroad cartels. *See* Huntington, *supra* note 96, at 498.

C. *The National Industrial Recovery Act of 1933*

New Deal cooperation between the federal government and politically-connected business was not limited to propping up the railroad cartels. The National Industrial Recovery Act of 1933 (NIRA)[98] extended protections to over 500 industry-centered cartels under the guise of "bring[ing] 'order' to the existing 'chaotic and overly competitive' United States economy."[99] The NIRA delegated to the various cartels (usually organized as industry trade associations) the power to write codes of fair competition.[100] The "Code of Fair Competition for

98. NIRA Section 1 provides:

> A national emergency productive of widespread unemployment and disorganization of industry, which burdens interstate and foreign commerce, affects the public welfare, and undermines the standards of living of the American people, is hereby declared to exist. It is hereby declared to be the policy of Congress to remove obstructions to the free flow of interstate and foreign commerce which tend to diminish the amount thereof; and to provide for the general welfare by promoting the organization of industry for the purpose of cooperative action among trade groups, to induce and maintain united action of labor and management under adequate governmental sanctions and supervision, to *eliminate unfair competitive practices*, to promote the fullest possible utilization of the present productive capacity of industries, to avoid undue restriction of production (except as may be temporarily required), to increase the consumption of industrial and agricultural products by increasing purchasing power, to reduce and relieve unemployment, to improve standards of labor, and otherwise to rehabilitate industry and to conserve natural resources.

National Industrial Recovery Act, Pub. L. No. 73-67 § 1, 48 Stat. 195 (1933), Title I *invalidated by* Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935) (Title II expired in June, 1935).

99. William L. Anderson, *Risk and the National Industrial Recovery Act: An Empirical Evaluation*, 103 PUB. CHOICE 139, 141 (2000); Cole & Ohanian, *supra* note 19, at 784 ("By 1934, NRA codes covered over 500 industries, which accounted for nearly 80 percent of private, nonagricultural employment.").

100. Note, *Some Legal Aspects of the National Industrial Recovery Act*, 47 HARV. L. REV. 85, 85 n.2 (1933). The NIRA stated in relevant part:

> Sec. 3. (a) Upon the application to the President by one or more trade or industrial associations or groups, the President may approve a *code or codes of fair competition* for the trade or industry or subdivision thereof, represented by the applicant or applicants, if the President finds (1) that such associations or groups impose no inequitable restrictions on admission to membership therein and are truly representative of such trades or industries or subdivisions thereof, and (2) that such code or codes are not designed to promote monopolies or to eliminate or oppress small enterprises and will not operate to discriminate against them, and will tend to effectuate the policy of this title
>
> . . . .
>
> (b) After the President shall have approved any such code, the provisions of such code shall be the standards of fair competition for such trade or industry or subdivision thereof. Any violation of such standards in any transaction in or affecting interstate or foreign commerce shall be deemed an unfair method of competition in commerce within the meaning of the Federal Trade

the Iron and Steel Industry" [101] (Steel Code) is representative of the other codes. The Steel Code was approved by FDR on August 19, 1933.[102] Written by the American Iron and Steel Institute, the Steel Code guaranteed the dominance of the historical steel manufacturers and its members—the steel cartel.[103] Prominent in the Steel Code was price fixing.[104] The Steel Code provided that each steel manufacturer must file a base price with the Institute.[105] The lowest filed price was the price for the entire industry.[106] If a small enterprise wanted to

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> Commission Act, as amended [chapter 2 of this title]; but nothing in this title [chapter] shall be construed to impair the powers of the Federal Trade Commission under such Act, as amended [chapter 2].

National Industrial Recovery Act § 3 (emphasis added).

101. Exec. Order No. 6254 (Aug. 19, 1933), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=14506.

102. *Id.* It reads as follows:

> An Application having been duly made, pursuant to and in full compliance with the provisions of Title I of the National Industrial Recovery Act, approved June 16, 1933, for my approval of a Code of Fair Competition for the Iron and Steel Industry, and hearings having been held thereon and the Administrator having rendered his report together with his recommendations and findings with respect thereto, and the Administrator having found that the said Code of Fair Competition complies in all respects with the pertinent provisions of Title I of said Act and that the requirements of clauses (1) and (2) of subsection (a) of Section 3 of the said Act have been met:
>
> Now, THEREFORE, I, Franklin D. Roosevelt, President of the United States, pursuant to the authority vested in me by Title I of the National Industrial Recovery Act, approved June 16, 1933, and otherwise, do adopt and approve the report, recommendations and findings of the Administrator and do order that the said Code of Fair Competition be and it is hereby approved.
>
> FRANKLIN D. ROOSEVELT.

Id.

103. *See, e.g.*, Jonathan B. Baker, *Identifying Cartel Policing Under Uncertainty: The U.S. Steel Industry, 1933–1939*, 32 J.L. & ECON., Oct. 1989, S47, at S71 ("[T]he steel code successfully facilitated collusion by ensuring that cooperation was a dominant strategy for all producers."). *See generally* Christopher R. Leslie, *Trust, Distrust, and Antitrust*, 82 TEX. L. REV. 515, 664–67 (2004) (discussing the ways cartels used the Steel Code, and the National Recovery Act generally, to effect price-fixing and collusion).

104. *Some Legal Aspects*, *supra* note 100, at 102 n.121 (citing Code for the Iron and Steel Industry, art. VII, schedule E (price fixing provision)).

105. *Some Legal Aspects*, *supra* note 100, at 97 n.80 (citing Code for the Iron and Steel Industry, art. IX (requiring that prices be reported to the Institute)); John Knight Holbrook, Jr., *Price Reporting as a Trade Association Activity, 1925 to 1935*, 35 COLUM. L. REV. 1053, 1061 (1935); Malcolm P. Sharp, *Title I of the National Recovery Act*, 1 U. CHI. L. REV. 320 (1933); *Two Price Rises in Steel Weighty*, N.Y. TIMES, Sept. 4, 1933, p. 17; *Text of Eastman Letter on Rail Price Costs and Rates*, WALL ST. J., Oct. 30, 1933, at 8 (arguing that the NIRA was nothing more than government sanctioned price fixing); *Rail Bid Collusion Laid by Eastman to Four Concerns*, N.Y. TIMES, Oct. 29, 1933, at 1; *Letters Alluded to by Eastman*, WALL ST. J., Oct. 30, 1933, at 10.

106. Holbrook, *supra* note 105, at 1061 n.40; Sharp, *supra* note 105, at 325. The steel industry was not alone in such price fixing:

sell steel for less to capture market share (perhaps because it found a way to be more innovative and efficient), it would have to file a lower price with the Institute ten days in advance, giving the large businesses plenty of time to match the lower price.[107] "The gain from a price cut—attracting additional customers—thus could be offset immediately by other cartel members, diminishing the incentive for the cut in the first place."[108] The result was less price-cutting, and, it follows, higher prices for the consumer.[109]

> While the National Industrial Recovery Act, 48 Stat. 195, was in effect, a Code of Fair Competition for the Tag Industry was promulgated February 1, 1934. The Code Authority consisted of the Executive Committee of the Institute and such other persons as the Administrator for Industrial Recovery designated. Under the Code, a so-called 'open-price plan of selling' was prescribed, under which each member of the industry was required to file a schedule of his prices and terms of sale; manufacturers who did not file such a schedule were 'deemed to have filed a schedule conforming * * * with the schedule * * * on file which states the lowest price and the most favorable terms.' It was provided that no filed schedule 'shall be such as to permit the sale of any product at less than the cost thereof' to the filing member, determined in a manner thereinafter prescribed. Further, it was provided that no member of the industry 'shall sell such product for less than such price or upon terms or conditions more favorable' than stated in his filed price schedule. A revised schedule might be filed at any time, but such revision was not to become effective until seven days after the date of filing, 'provided, however, that an increased price may become effective at such earlier date as the member filing the same shall fix.' Petitioners concede that these price-fixing provisions of the Code would have been illegal except for the exemption from the anti-trust laws contained in the National Industrial Recovery Act.

Trade Mfr.'s Inst. v. FTC, 174 F.2d 452, 454 (1st Cir. 1949).

107. Holbrook, *supra* note 105, at 1065 n.58.

108. Jason E. Taylor, *Cartel Code Attributes and Cartel Performance: An Industry-Level Analysis of the National Industrial Recovery Act*, 50 J. LAW & ECON. 597, 603 (2007).

109. This sort of "open price filing discourages competition by revealing firms' pricing policies to rivals, allowing them to match the price or otherwise 'retaliate' against a price-cutting firm." Jason E. Taylor & Peter G. Klein, *An Anatomy of a Cartel: The National Industrial Recovery Act of 1933 and Compliance Crisis of 1934*, 26 RES. ECON. HIST. 235, 238 (2008). Consider:

> In a market where sellers are few, a price reduction that produces a substantial expansion in the output of one will result in so substantial a contraction in the output of the others that they will quickly respond to the reduction. If, for example, there are three sellers of equal size in a market, a 20 percent expansion in the output of one will cause the output of each of the others to fall not by 0.2 percent but by 10 per-cent, a contraction the victims can hardly overlook. Anticipating a prompt reaction by his rivals that will quickly nullify his gains, the seller in a concentrated market will be less likely to initiate a price reduction than his counterpart in the atomized market. Oligopolists are thus "interdependent" in their pricing. They base their pricing decisions in part on anticipated reactions to them. The result is a tendency to avoid vigorous price competition.

Richard Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 STAN. L. REV. 1562 (1969) (summarizing the argument of Prof. Donald Turner).

Neither was price fixing the only pro-cartel provision in the Steel Code. It also provided "none of the members of this code shall initiate the construction of any new blast furnace or open hearth or Bessemer steel capacity,"[110] and prohibited each member of the cartel from selling superior steel from that of its larger competitors.[111] These provisions ensure that each steel company maintains its current market share by prohibiting increases in production.[112] Seventy-five years later, with the benefit of hindsight, it is clear that these laws promote stagnation and stifle entrepreneurs, as Burton W. Folsom, Jr., points out:

> The whole NRA, by carving up markets among existing producers and by fixing prices and wages, assumed all industry was stagnant and unchanging. In fact, almost no industry fit that model. In steel, for example, when Andrew Carnegie founded what became Carnegie Steel, in 1872, he was the smallest producer in America—and England far outsold the United States in the World Steel Market. Rails were the main steel product, and the price of rails was about $56 a ton. In 1872, however, unlike in 1933, markets, prices, and wages were not fixed; they were fluid and the American customer was the winner. Carnegie, for example, cut costs by using the Bessemer process and open-hearth method of making steel; he innovated in accounting with double-entry book-keeping; he was daring in sales by bidding for contracts and assuming that economies of large scale could help him fulfill contracts profitably. Unlike his competitors, if Carnegie found a cheaper way to make rails, he would rip out a factory and rebuild the improved version immediately. As a result, in 1900 Carnegie was the largest steel producer in the United States and larger than all the major steel producers in England put together. He could make steel rails at $11.50 per ton. Competition in price and product helped Carnegie and all consumers of steel.[113]

110. Taylor, *supra* note 108, at 609 (*quoting* The Iron and Steel Code, article V, sec 2).

111. *Some Legal Aspects*, *supra* note 100, at 110 n.180 (citing Code for the Iron and Steel Industry, Schedule H (D and L)).

112. *Some Legal Aspects*, *supra* note 100, at 110 n.180 (citing Code for the Iron and Steel Industry, Schedule H (D and L)).

113. FOLSOM, *supra* note 20, at 46 (citing HAROLD LIVESAY, ANDREW CARNEGIE AND THE RISE OF BIG BUSINESS 150, 165–66 (1975)).

D. *The New Deal as Failed Economic Policy*

1. The Cole and Ohanian Study

FDR claimed that New Deal economic programs like the MCA and NIRA would lift America out of depression. However, as demonstrated by the cases of *Piedmont* and *Maher* above, New Deal economic policies were ill-suited to spur economic growth.[114] This anecdotal evidence is supported by a groundbreaking study by economists Harold L. Cole and Lee E. Ohanian at UCLA.[115] Cole and Ohanian start by pointing out that the recovery from the Great Depression was long and weak.[116] GDP, "which was 39 percent below trend at the trough of the Depression in 1933, remained 27 percent below trend in 1939."[117] They argue that this weak recovery is odd given the doubling of the monetary base (printing money), increased productivity, and increased banking output after 1933.[118] The economy should have recovered rapidly.[119] Even prior to the Cole and Ohanian study many suspected that the New Deal's support for politically-connected business—by permitting collusion and suspending antitrust laws—was the culprit for the length and depth of the Great Depression.[120] But Cole and Ohanian set out to prove this theory through quantitative evaluation.[121] By comparing a competitive model (i.e., free market capitalism) and a cartelization model (i.e., government supported collusion) to actual data from the New Deal period, they conclude that FDR's New Deal prolonged the depression by three years, that is to say, if the government did nothing the Great Depression would have ended in 1936 rather than 1939.[122] The study concludes, "Not only did the adoption of [the NIRA] coincide with the persistence of depression through the late

114. *See supra* Part I.A.

115. Cole & Ohanian, *supra* note 19, at 814.

116. *Id.* at 781.

117. *Id.*

118. *Id.*

119. *Id.*; *see also* Harold Cole & Lee Ohanian, *The Great Depression in the United States from a Neoclassical Perspective*, FED. RES. BANK OF MINNEAPOLIS Q. REV., Winter 1999, at 2.

120. Cole & Ohanian, *supra* note 19, at 781.

121. *Id.*

122. *Id.* at 781 n.1, 808, 810.

1930s, but the subsequent abandonment of these policies coincided with the strong economic recovery of the 1940s."[123]

2. Posner's Critique of New Deal Economic Policies

Likewise, law and economics scholarship supports the above indictment of the New Deal. Richard Posner argued that FDR's New Deal economic policies resulted from a fundamental misunderstanding of the role of competition and an overreliance on the expertise of government bureaucrats.[124] Posner states:

> The view of the great depression as rooted in the excesses of competition and curable by reducing competition is discredited. Of course, when demand declined during the depression much of the existing industrial capacity, geared as it was to supplying a larger demand, became temporarily excess. But limiting competition would not have increased purchasing power and therefore demand; it would just have impaired the efficiency of economic activity at its reduced level. Nonetheless, the cartel remedy for depressions was tried in the early New Deal statutes, such as the National Industrial Recovery Act, which authorized industries to fix minimum prices.[125]

Posner uses the railroads to illustrate his case.[126] He points out that in the case of railroads, government approves the major players in certain monopolies (or more precisely, oligopolies) in return for internal subsidies.[127] That is to say, the government protects the railroad's monopoly, and in return the railroad agrees to provide service to rural communities at a loss funded by monopoly profits.[128] Once the railroad is serving rural communities—communities that it would not be profitable to serve under free competition—a symbiotic relationship is created between railroad and the government.[129] The railroad now has a strong argument that the regulators "should use their

123. *Id.* at 813.

124. Posner, *Natural Monopoly*, *supra* note 20, at 621 & n.156; *see also* Posner, *Social Norms*, *supra* note 20, at 563 (stating that the New Deal was rule by expert); Richard A. Posner, *Rational Choice*, *supra* note 20, at 1572.

125. POSNER, *supra* note 39, at 628.

126. Posner, *Natural Monopoly*, *supra* note 20, at 609.

127. *Id.* at 608.

128. *Id.*

129. *Id.* at 607–08.

control over new entry to preserve its monopoly despite changed conditions of cost and demand."[130] The railroad can "denounce prospective entrants into its monopoly markets as 'cream skimmers' who, by competing away the firm's monopoly profits, would cut the ground out from under its subsidized customers in other markets."[131]

Posner also turns his sights on FDR's argument that barriers to entry are necessary to prevent "cutthroat competition" and "foolish overproduction" that lead to excess supply and losses.[132] Such barriers are redundant, as entrepreneurs will not enter a saturated market:

> If a prospective entrant realizes there is room for only one firm in the market, it will not enter unless confident of being able to supplant the existing monopolist. If it enters in the mistaken belief that the market will support more than one seller or that it is more efficient than the incumbent, it will soon be eliminated either by bankruptcy or by being acquired (presumably at a low price, reflecting its poor prospects) by the incumbent. So long as a single firm can meet the market's entire demand most efficiently, one can be reasonably confident that the market will shake down to a single firm, at least if there are no undue inhibitions on price competition or merger."[133]

On the other hand, barriers to entry tend to prolong monopoly long after the rational factors that have led to it have receded, by protecting the monopolist.[134] As such, Posner points out that government imposed barriers to entry are detrimental; like Cole and Ohanian above, he argues that allowing the free market to function without government control will lead to a better result.[135] On the other hand, regulatory restrictions on entry exacerbate the problem of monopoly by "[raising] the price that a rational monopolist can fix without encouraging entry."[136] If a

130. *Id.* at 608.

131. *Id.* Posner posits as an example "a great many business enterprises had been attracted to the West in reliance on the low rates [offered by the railroad], and they had sufficient influence with Congress and the Interstate Commerce Commission not only to prevent the needed revision in rail rates but also to bring trucking under regulation, lest truck competition completely erode the railroads' pattern of preferential rates." *Id.*

132. Posner, *Natural Monopoly*, *supra* note 20, at 612–13.

133. *Id.*

134. POSNER, *supra* note 39, at 628.

135. Posner, *Natural Monopoly*, *supra* note 20, at 612–13.

136. *Id.* at 615.

railroad knows that no entrant can challenge it if it raises prices, it will do so.[137] Posner's argument is elegant in its simplicity: the costs of attempting to regulate competition—in this case by restricting entry—are greater than the benefits.[138] He concludes that while it offends "that monopolies based on public franchise should be free to charge whatever the market will bear, it follows not that monopolies should be regulated."[139] And "[i]t is precisely regulation that, by limiting entry into the markets of monopolists," makes the matter worse.[140]

3. FDR Admits that New Deal Economic Policies Failed

Let me be clear, I am not arguing that FDR *intended* to prolong the Great Depression by limiting competition. I think he actually believed that the free market and cutthroat competition were to blame for the country's economic troubles. However, it is evident that whatever his intent, New Deal economic policies did little to end—and likely made worse—the economic downturn that dominated the 1930s. In fact, in a stunning admission largely ignored by historians and

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137. *Id.* at 612–13.

138. Legislation should not be passed where it will make an inefficient situation less efficient. *See* POSNER, *supra* note 39, at 628; Richard Craswell, *In That Case, What Is the Question? Economics and the Demands of Contract Theory*, 112 YALE L.J. 903 (2003). What is efficiency? Possible answers include: "efficient production, efficient exchange, Pareto efficiency, national income maximization, wealth maximization, [or] utility maximization." NICHOLAS MERCURO AND STEVEN G. MEDEMA, ECONOMICS AND THE LAW 68 (2d ed. 2006) (quoting ROBERT COOTER, LAW AND ECONOMICS 1283 (1988)). Alternatively, there is Pareto Efficiency, through which at least one person can be made better off without making anyone else worse off. Consider:

> In a voluntary trade, both parties are better off than before the trade—"value" is increased. In monetary transactions, as long as a buyer is willing and able to pay an amount which a seller is willing to accept, value could be increased by the trade—that is, by his behavior each party indicates that he thinks his situation has improved. When no more such trades can be made, the situation is "efficient."

C. Edwin Baker, *The Ideology of the Economic Analysis of Law*, 5 PHIL. & PUB. AFF. 3, 4–5 (1975) (citing RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 628 (Boston 1972)); *see also* Herbert Hovenkamp, *The First Great Law and Economics Movement*, 42 STAN. L. REV. 993, 994 (1990). This is dependent upon principles of neoclassical economics' assumption that all actors act rationally (having full information) to maximize efficiency. James R. Hackney, Jr, *Law and Neoclassical Economics: Science, Politics, and the Reconfiguration of American Tort Law*, 15 LAW & HIST. REV. 275, 318 (1997).

139. Posner, *Natural Monopoly*, *supra* note 20, at 541 (1970) (responding to Swindler, *Comments on the Case for Deregulation*, 22 STAN. L. REV. 519, 521 (1970)).

140. *Id.*

economists,[141] in 1938, FDR spoke against the collectivist premise underlying his very own New Deal and admitted that the NIRA's support of cartels increased economic stagnation and unemployment.[142] Speaking to the issues of cartel, FDR stated, "the American economy has become a concealed cartel system . . . . The disappearance of price competition is one of the primary causes of present difficulties."[143] Speaking to the impact of cartelization and price fixing on unemployment, FDR admitted, "it is no accident that in industries, like cement and steel, where prices [were fixed], payrolls have shrunk as much as 40 and 50 per cent in recent months."[144] FDR continued, "Nor is it mere chance that in most competitive industries where prices adjust themselves quickly to falling demand, payrolls and employment have been far better maintained."[145] In fact, unemployment at the time that FDR was speaking was 19.1 percent, worse than the 14.3 percent figure of the year before.[146] *Mea culpa.*

II. THE TROUBLED ASSET RELIEF PROGRAM

Part II compares FDR's New Deal to TARP. Part II.A argues that the use of TARP to support GM repeats a fundamental mistake of FDR's New Deal—supporting politically-connected businesses and stifling competition. Part II.B will argue that despite the foregone conclusion, President Obama was willing to exponentially expand President Bush's TARP support of GM in return for a *quid pro quo.* The Obama Administration pressured the Treasury to expand its investment in GM, and then leveraged the Treasury's 60.8 percent ownership stake into an agreement on the part of GM to implement a business plan in line with a broader social policy—transforming the American automobile industry into one that produces environmentally-

141. *But see* Cole & Ohanian, *supra* note 19, at 793 (pointing out FDR's admission that New Deal economic policies failed); Randall Morck & Bernard Yeung, *Dividend Taxation and Corporate Governance,* 19 J. ECON. PERSP. 163, 175–76 (2005) (same).

142. Franklin D. Roosevelt, Message to Congress on Curbing Monopolies (Apr. 29, 1938), *reprinted at* 32 AM. ECON. REV. 119, Appendix A.

143. Cole & Ohanian, *supra* note 19, at 793.

144. Roosevelt, *supra* note 142.

145. Roosevelt, *supra* note 142.

146. Richard J. Jensen, *The Causes and Cures of Unemployment in the Great Depression,* 19 J. INTERDISC. HIST. 553, 557, table 1 (1989).

friendly cars and trucks.[147] This is a transformation that continues to this day.

A. *The Bush Bailout*

The GM bailout began, not with the Obama Administration, but with the lame-duck presidency of George W. Bush. In the fall of 2008, GM sought financial assistance from the federal government.[148] GM CEO Rick Wagoner testified before Congress "that without federal assistance, [GM would] not have the cash necessary to continue operations."[149] The House of Representatives was open to the request, concluding that "action in the form of financial aid to the domestic automobile industry is necessary to stabilize the economy."[150] The resulting legislation, the Auto Industry Financing and Restructuring Act, passed the House of Representatives on December 10, 2008.[151] However, the bill failed to muster support in the Senate amidst a more sober belief that in a free market, firms with poor business plans should be allowed to fail; as Senator McConnell stated in opposition "[n]one of us want to see (American automakers) go down, but very few of us had anything to do with the dilemma that they've created for themselves."[152] H.R. 7321 never became law.[153]

Upon defeat of H.R. 7321, President Bush—keeping the Oval Office warm until President-elect Obama could move in—used the already established TARP program to prevent what he feared would be the collapse of GM.[154] The use of TARP was

147. *See* discussion *infra* Part II.C.

148. Bill Vlasic & David Herzenhorn, *Detroit Chiefs Plead for Aid, to Little Avail*, N.Y. TIMES, Nov. 19, 2008, at A1.

149. U.S. GOVERNMENT ACCOUNTABILITY OFFICE (GAO), GAO-10-151 TROUBLED ASSET RELIEF PROGRAM: CONTINUED STEWARDSHIP NEEDED AS TREASURY DEVELOPS STRATEGIES FOR MONITORING AND DIVESTING FINANCIAL INTEREST IN CHRYSLER AND GM 9, fig. 1 (Nov. 2009), *available at* http://www.gao.gov/new.items/d10151.pdf. GM was not alone. Chrysler CEO Bob Nardelli testified that "without immediate bridge financing support, Chrysler's liquidity could fall below the level necessary to sustain operations." Vlasic & Herzenhorn, *supra* note 148, at A1.

150. H.R. 7321, 110th Congress (2008).

151. *Id.*

152. Halimah Abdullah, *Auto Bailout's Defeat Shows Senate Minority Leader McConnell Still Has Leverage*, MCCLATCHY-TRIB. NEWS SERV., Dec. 13, 2008.

153. Nicholas Johnston & John Hughes, *Senate Rejects Auto Industry Bailout*, BLOOMBERG, Dec. 11, 2008.

154. David Shepardson, *Bush, Treasury Want to Prevent Auto-Collapse*, DETROIT NEWS, Dec. 13, 2008 ("'Given the current weakened state of the U.S. economy, we will consider other options if necessary—including use of the TARP program—to prevent a collapse

against the advice of President Bush's own Secretary of the Treasury, Hank Paulson, who was "'opposed to using funds from TARP because he has said the $700 billion are designed to bolster the financial sector.'"[155] The Senators who had just finished defeating H.R. 7321 were even more incensed, in an open letter they rebuffed the President, "'Congress never voted for a federal bailout of the automobile industry, and the only way for [TARP] funds to be diverted to domestic automakers is with explicit congressional approval.'"[156] The letter concluded, "'tempting as it is to step in with a federal bailout, American taxpayers cannot afford to save every company facing financial peril.'"[157]

Hank Paulson was correct to oppose the expanded use of TARP by President Bush; using TARP funds to support GM finds no basis in law.[158] The original legislative intent of TARP was for the Treasury to purchase toxic assets such as mortgage backed securities from banks.[159] It nowhere mentions the automotive industry. The portion of the EESA establishing TARP reads:

> The Secretary is authorized to establish the Troubled Asset Relief Program (or "TARP") to purchase, and to make and fund commitments to purchase, *troubled assets* from any *financial institution*, on such terms and conditions as are

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of troubled automakers,' White House spokeswoman Dana Perino said in a written statement, referring to the Troubled Assets Relief Program, which has sent billions of dollars to troubled financial firms.").

155. Vicki Needham, *White House Not Yet Ready to Back Auto Aid*, ROLL CALL, Dec. 16, 2008.

156. *Id.*

157. *Id.*

158. Archit Shah, *Emergency Economic Stabilization Act of 2008*, 46 HARV. J. ON LEGIS. 569, 583 (2009).

159. Brent J. Horton, *In Defense of Private-Label Mortgage-Backed Securities*, 61 FLA. L. REV. 827, 873 (2009) (discussing use of TARP funds to purchase private-label MBS from GMAC); *see also* William F. Stutts & Wesley C. Watts, *Of Herring and Sausage: Nordic Responses to Banking Crises as Examples for the United States*, 44 TEX. INT'L L.J. 577, 614 n.221 (2009) ("TARP's scope, in an atmosphere of significant political turmoil, was later expanded further beyond the apparent original intent of purchasing mortgage related assets, to provide a method of funding for U.S. car manufacturers."); David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 FORDHAM J. CORP. & FIN. L. 709, 759 n.202 (2009). The first program established pursuant to TARP was the Capital Purchase Program, established October 14, 2008. Press Release HP-1207, U.S. Dept't of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008). In January 2009, Secretary of the Treasury Henry Paulson implemented the Targeted Investment Program (TIP). *See* Press Release HP-1338, U.S. Dep't of the Treasury, Treasury Releases Guidelines for Targeted Investment Program (Jan. 2, 2009). TIP carried forth the original intent of TARP by allowing the Treasury to purchase troubled assets. *See id.*

> determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary.[160]

In addition:

> The term "troubled assets" means—
> (A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and
> (B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.[161]

And finally:

> The term "financial institution" means any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State, territory, or possession ... , and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government.[162]

A plain reading of the foregoing legislative language makes clear that TARP funds were intended to be applied only to purchase "troubled assets" (mortgages and mortgage-backed securities) from "financial institutions" (banks), not to bail out the automotive industry.[163] Gary Lawson of Boston University explains that the contrary argument is bizarre, requiring the reader to "stop at the words 'any institution' in the definition of

160. Emergency Economic Stabilization Troubled Asset Relief Program, 12 U.S.C. § 5211(a)(1) (2008) (emphases added).

161. *Id.* § 5202(9).

162. *Id.* § 5202(5).

163. Shah, *supra* note 158, at 583. Thus, under TARP we saw the creation of the Capital Purchase Program (CPP) to bolster the balance sheets of, among others, Bank of America, Bank of New York Mellon, CitiGroup, Stanley, State Street, and Wells Fargo. Ahn P. Nguyen & Carl E. Enomoto, *The Troubled Asset Relief Program (TARP) and the Financial Crisis of 2007–2008*, 7 J. BUS. & ECON. RESEARCH 93 (2009). And the Systemically Significant Financial Institution Program (SSFI) to assist insurer AIG. William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, *passim* (2009).

'financial institution' and say that automakers are institutions, so end of story."[164] But such an interpretation ignores the fact that

> "institution" appear[s] in a definition of "financial institution," [and that all of] the (non-exhaustive) examples given in the statute all have something to [do] with finance, the two hundred pages of statute surrounding this definition deal with financial matters, and the context in which the statute was enacted fairly screams that "financial institution" means institutions that are in some important sense financial.[165]

Lawson concludes that "the financing arms of the automakers—which have obtained loans of their own apart from the initial $17.4 billion—would qualify as financial institutions. Pawn shops might [even] make it in. But automakers are no more 'financial institution[s]' under this statute than I am."[166] Despite the foregoing, President Bush unwisely directed that the Treasury make loans to GM under the auspices of TARP in the amounts of $13 billion.[167] A move that President Bush now admits was a mistake.[168]

Setting aside the legality (or propriety) of using TARP funds to support GM, the next logical question is: did the federal action create a barrier to entry, strengthening politically-connected business in a manner reminiscent of the New Deal? The short answer is, "yes." The use of taxpayer funds to purchase a 60.8 percent interest in GM is a subsidy.[169] While not as obvious a barrier to entry as the New Deal's licensing requirement for new firms, "[a subsidy] is a capital investment that the competitive market does not support . . . . [It creates] a barrier to entry by non-subsidized competitors . . . by infusing [the existing business] with cash untethered to performance."[170]

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164. Gary Lawson, *Burying the Constitution Under a TARP*, 33 HARV. J.L. & PUB. POL'Y 55, 70 (2010).

165. *Id.* at 71.

166. *Id.*

167. CONG. OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTO. INDUS. 3 (Sept. 9, 2009) [hereinafter SEPTEMBER OVERSIGHT REPORT].

168. Joseph Curl, *Bush Warns of the Dangers of Too Much Government*, WASH. TIMES, Nov. 13, 2009, at A1.

169. A "subsidy" is "a grant of money made by government in aid of the promoters of any enterprise, work, or improvement in which the government desires to participate." BLACK'S LAW DICTIONARY (8th ed., 2004); *see* Paul Ingrassia, *The Sinking Saab*, WALL ST. J., Nov. 27, 2009 (describing GM's "taxpayer-subsidized bankruptcy").

170. Reilly v. Hearst Corp., 107 F. Supp. 2d 1192, 1209 (N.D. CA. 2000); *see also* New York State Dairy Foods, Inc. v. Ne. Dairy Compact Commission, 198 F.3d. 1, 24 (1st Cir.

The question largely depends on what the subsidized firm does with the cash infusion. Consider *Safir v. United States.*[171] Mr. Safir was president of the Atlas Moving and Storage Company from 1939 to 1968 and "from 1955 to 1968, he was president of the Weissberger Moving and Storage Company, which was one of the largest moving companies in New York."[172] Safir formed Sapphire Steamship Lines, Inc. (Sapphire Lines) in 1965 in an attempt to break into the market for carrying household goods for military families, both domestically and across the North Atlantic.[173] Safir was trying to break into a very exclusive club, dominated by a group of six shipping firms comprising the Gulf American Flag Berth Operators (the Shipping Cartel).[174] The Shipping Cartel benefited from a generous federal subsidy, and upon Sapphire Lines entering the market collectively reduced its rates to below what the market would bear for eleven months, compensating for the loss with the federal cash infusion.[175] After Sapphire Lines was forced into bankruptcy, the Shipping Cartel raised their rates again.[176]

The logical end of the government erecting a protective barrier to entry around GM is that other firms will be squeezed out, because they simply cannot compete with a government-backed GM.[177] GM has access to taxpayer funded loans that

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1999) ("The pooling mechanism is in effect a subsidy and compensatory payment which is a barrier to the entry of milk into the Compact region."); Ejan Mackaay, Comment, *Legal Hybrids: Beyond Property And Monopoly?* 94 COLUM. L. REV. 2630, 2634 n.6 (1994).

171. 616 F. Supp. 613 (E.D.N.Y. 1985).

172. *Obituary, Marshall P. Safir, 75, Shipping Executive,* N.Y. TIMES, Mar. 30, 1995 *available at* http://www.nytimes.com/1995/03/30/obituaries/marshall-safir-75-shipping-executive.html.

173. *Sapphire Steamship Sues to Halt Subsidy of Ship Operators,* WALL ST. J., June 25, 1968, at 23.

174. *Sapphire Steamship Was Conspiracy Target, Federal Agency Rules,* WALL ST. J., Dec. 13, 1967, at 13.

175. *Court Review Ordered of Subsidy Payments to Shipping Consortium,* WALL ST. J., Oct. 1, 1969, at 12.

176. *Id.*

177. While this Article concentrates on prospective entrepreneurial firms, it is likewise important to consider that in addition to preventing prospective firms from competing, a barrier to entry may also remove existing firms from the marketplace as well. Thus, at least one notable economist argues:

> Auto producers whose products American consumers find most appealing have been notably missing from the roster of bailout recipients. Our subsidies instead have gone to the poor performers, firms whose past management decisions proved faulty. As a result the bailout has created moral hazard problems, inadvertently handicapping the progress of stronger, non-subsidized producers.

accrue interest at a mere five percent per year.[178] This is during the same summer that other bridge loans for businesses going through reorganizations ranged around ten percent, if they could be obtained at all.[179] The billions of dollars saved on interest alone are a competitive advantage that can be used for additional research, marketing, or even to lower product prices below that of GM's competitors. This can mean the difference between being a winner and loser in a competitive market.[180] Already, GM is using the Treasury supplied taxpayer dollars to compete against other auto makers. GM "announced that . . . it

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THOMAS D. HOPKINS, NAT'L TAXPAYERS' UNION, THE AUTO BAILOUT—A TAXPAYER QUAGMIRE—ISSUE BRIEF 175 (2009). As such, we must ask what effect the federal cash infusion into GM will have on those competitors, such as Ford Motor Corporation, that did not take a cash infusion? Ford has shown great resilience in the face of anticompetitive behavior (see the discussion of the *Selden* lawsuit above), but whether it can compete in the face of a government subsidized GM and Chrysler remains to be seen.

178. LIBOR plus 300 basis points, with a LIBOR floor set at 2%. The Term Sheet for the GM loan provides:

> Each Advance shall accrue interest at a rate per annum equal to (i) the sum of (x) the greater of (A) three-month LIBOR and (B) the LIBOR Floor, plus (y) the Spread Amount, multiplied by (ii) the outstanding principal balance of such Advance. The Interest Rate shall be determined on the Closing Date and reset on each Interest Payment Date . . . .

Press Release, U.S. Dep't of Treasury, Indicative Summary of Terms for Secured Term Loan Facility (Dec. 19, 2008), *available at* http://www.treas.gov/press/releases/reports/gm%20final%20term%20&%20appendix.pdf. The LIBOR floor of 2% was implicated because the three-month LIBOR as of Dec. 2008 was 1.08% and has since fallen to .23%.

179. Kevin Fung, *Masonite Plan Gets Confirmed*, DAILY DEAL, June 1, 2009 ("The loan will be secured by first-priority liens on all the assets of a reorganized Masonite and mature in December 2013. The interest rate is set at LIBOR plus 700 basis points, with a LIBOR floor of 3%, or prime plus 600 basis points, with a prime floor of 5%."); Richard Kellerhals, *Credit Suise, GE Ready Quebecor Exit Facility*, BANK LOAN REP., Pg. 1 Vol. 24 No. 22, June 1, 2009 (LIBOR plus 600 bps with a floor of 3%); Kevin Fung, *Stock Building Supply Wins DIP Approval*, DAILY DEAL, May 28, 2009 (LIBOR plus 700 bps with a LIBOR floor of 3%); John Blakely, *ION Media Wins DIP Approval*, DAILY DEAL, May 22, 2009 (LIBOR plus 1200 bps with a LIBOR floor of 3.5%); John Blakely, *Successful Shopping*, DAILY DEAL, May 21, 2009 (LIBOR plus 1200 bps with a LIBOR floor of 1.5%).

180. Stephen Moore & Dean Stansel, *Ending Corporate Welfare as We Know It*, CATO Policy Analysis No. 225, May 12, 1995. The CATO Institute pointed out:

> Corporate welfare creates an uneven playing field. Business subsidies, which are often said to be justified because they correct distortions in the marketplace, create huge market distortions of their own. The major effect of corporate subsidies is to divert credit and capital to politically well-connected firms at the expense of their politically less influential competitors. Those subsidies are thus inherently unfair. Sematech, for example, was reportedly launched to promote the U.S. microchip industry over rivals in Japan and Germany. In practice, Sematech has become a cartel of the large U.S. chip producers—such as Intel—that unfairly handicaps the hundreds of smaller U.S. producers.

Id.

will offer $1,000 to Toyota owners toward a down payment on a GM vehicle and up to $1,000 to help to pay off current leases early."[181] One Toyota dealer was shocked that the U.S. government would throw its weight behind a competitor, "[o]ne day, U.S. Toyota dealers woke up to find that their government owned their competitor, . . . [n]ow, our tax dollars are being used against us. Our government has a major conflict of interest."[182]

B. *The Obama Bailout*

The Obama Administration compounded the Bush Administration's mistake by expanding the use of TARP funds to fundamentally restructure GM.[183] President Obama doubled the amount of cash available to GM and directed the Treasury to provide "$30.1 billion under a debtor-in-possession financing agreement to assist GM through [a] restructuring period."[184] The purpose of the bridge loan was to allow GM to fund day-to-day operations during the reorganization period.[185] With the commitment for a $30.1 billion bridge loan in place, at the direction of the Obama Administration GM drafted a Chapter 11 plan of reorganization and filed for bankruptcy on June 1, 2009. On July 10, 2009, New GM acquired substantially all of Old GM's assets.[186] Old GM retained those assets that were a liability.[187] At that time, the "Treasury converted most of its loans . . . to 60.8% of the common equity in New GM and $2.1 billion in preferred stock."[188] As of the date of this Article, the Treasury now owns 60.8 percent of New GM.

C. *GM Returns the Favor*

What did the Obama Administration receive as a *quid pro quo* for financing GM's Chapter 11 restructuring? A clue to the

181. Peter Whoriski, *Toyota Faced Pressure from U.S. Officials before Announcing Recall*, WASH. POST, Jan. 28, 2010, at A19.

182. David Falchek, *Scranton Toyota Dealer Blames Politics*, TRIB. BUS. NEWS, Mar. 5, 2010 (quoting Greg Gagorik).

183. CONGRESSIONAL OVERSIGHT PANEL, *supra* note 167, at 3.

184. U.S. DEP'T OF THE TREASURY, TROUBLED ASSETS RELIEF PROGRAM EIGHTH TRANCHE REPORT TO CONGRESS 4 (Oct. 7, 2009).

185. Kane, *supra* note 10, at A01.

186. U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 149, at 7, 9 & fig. 1.

187. U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 149, at 7, 9 & fig. 1.

188. U.S. DEP'T. OF THE TREASURY, *supra* note 184, at 4.

answer lies in a statement made by Rahm Emanuel, President Obama's Chief of Staff: "[Y]ou never want a serious crisis to go to waste. . . . [An economic crisis is] an opportunity to do things that you think you could not do before."[189] Indeed, President Obama himself stated in a speech to the Business Council that he wanted to "use this crisis as a chance to transform our economy . . . [and] put people to work building wind turbines and solar panels and fuel-efficient cars."[190] And so it follows, in return for financial support from the Treasury, GM became receptive to cooperation in the implementation of a broader social goal theretofore unobtainable, creating an American auto industry purposed to be environmentally friendly. Historically, Washington loses when it tries to "green" the automobile industry.[191] Consider the cap-and-trade legislation that recently floundered in the senate.[192] It joins a long list of recent failures to pass environmental legislation: the America's Climate Security Act,[193] Climate Stewardship and Innovation Act,[194] Low Carbon Economy Act,[195] Electric Utility Cap and Trade Act,[196] and the Improved Passenger Automobile Fuel Economy Act.[197] As such, under the cover of economic emergency, the Obama Administration seized the opportunity to stretch the legal limits of TARP, implementing the first step in a broader social goal of an environmentally-friendly manufacturing base, molding GM into "a 21st century auto [maker] . . . manufacturing . . . fuel-efficient cars and trucks."[198]

189. Carney, *supra* note 25, at A18 (quoting Rahm Emanuel, White House Chief of Staff).

190. Obama, *supra* note 24.

191. *See generally* Ian Talley, *Senate to Put Off Climate Bill Until Spring*, WALL ST. J., Nov 18, 2009, at A.4; Jennifer A. Dlouhy, *Global Warming Battle Heats Up Cap-And-Trade Plan May Be In For A Hard Time In Senate Hearings*, HOUSTON CHRONICLE, Dec. 3, 2009, at 1.

192. Talley, *supra* note 191, at A.4; Dlouhy, *supra* note 191, at 1.

193. S.2191, 110th Cong. (2007) (Reduces greenhouse-gas emissions by 63%). It was referred to the Committee on Environment and Public Works, where it died.

194. S.280, 110th Cong. (2007) (allowing for carbon trading). It was referred to the Committee on Environment and Public Works Subcommittee on Private Sector and Consumer Solutions to Global Warming and Wildlife Protection, where it died.

195. S.1766, 110th Cong. (2007) (reducing carbon emissions). Introduced in Senate. This bill never even made it to committee.

196. S.317, 110th Cong. (2007) (cap and trade). Introduced in Senate. This bill never even made it to committee.

197. S.183, 110th Cong. (2007) (setting Café standard of 40 mpg). This bill was referred to the Committee on Commerce, Science, and Transportation, where it died.

198. President Barack Obama, Remarks by the President on the American Automotive Industry, Grand Foyer, White House (Mar. 30, 2009).

1. A Treasury-Appointed Board of Directors

A receptive board of directors is integral to implementing a government-approved business plan, one that requires the production of environmentally-friendly vehicles. With a 60.8 percent equity interest, the Treasury was in a position to reconstitute GM's board of directors.[199] First, GM CEO Rick Wagner stepped down after an Oval Office meeting with President Obama and was replaced by CEO Fritz Henderson.[200] Wagner was not alone, as Treasury moved to replace a large portion of the GM board of directors.[201] Treasury named Edward Whitacre chairman of the board on June 9, 2009.[202] On July 20, 2009, Treasury named Daniel F. Akerson, David Bonderman, Robert D. Krebs, and Patricia F. Russo to the board.[203] Amazingly, none of the Treasury-named directors have

199. Nick Bunkley, *G.M. Adds 5 Directors and Announces Several Top Level Retirements*, N.Y. TIMES, July 24, 2009, at 34.

200. John Stoll & Greg Hitt, *U.S. Moving to Overhaul Ailing Auto Industry*, WALL ST. J., Dec. 8, 2008, at A1 (President Obama made clear that any restructuring must make the industry more "environmentally friendly"); Sheryl Gay Stolberg & Bill Vlasic, *U.S. Lays Down Terms for Auto Bailout*, N.Y. TIMES, Mar. 30, 2009, at A1 ("The decision to ask G.M.'s chairman and chief executive, Rick Wagoner, to resign caught Detroit and Washington by surprise, and it underscored the Obama administration's determination to keep a tight rein on the companies it is bailing out—a level of government involvement in business perhaps not seen since the Great Depression."). When asked whether GM's move toward manufacturing environmentally-friendly automobiles was directly attributable to pressure from the Obama Administration, Treasury-appointed CEO Fritz Henderson was diplomatic:

> CAROLINE HEPKER, MEDIA, BBC: You talked a lot about green products and trying to move forward in terms of embracing more fuel efficient cars. You've also talked about the government staying out of GM's business, but President Obama has been very firm really about talking about more fuel efficient vehicles. Will there be pressure on you to come out with a new greener vehicle for the United States sooner?
>
> FRITZ HENDERSON: Well . . . I think the technologies that we're investing in, whether it's the Volt, whether it's hybrid technology, whether it's basic research, is all important for us to get that accomplished. So I think our objectives both as a firm as well as to the market are in alignment with what not only President Obama, but I think most governments around the world would view the importance of having more fuel efficient vehicles. I don't think it's unique simply to the United States.

Press Conference, General Motors (June 1, 2009), *available at* http://www.gm.com/restructuring/docs/GM-Transcript-2009-06-01T16-15[1].pdf.

201. Bunkley, *supra* note 199.

202. Katie Merx & Mike Ramsey, *Opel Tops GM's Agenda As Whitacre Leads First Meeting*, FIN. POST, Aug. 3, 2009, *available at* http://www.financialpost.com/m/story.html?id=1855803.

203. Bunkley, *supra* note 199.

experience in the automotive industry.[204] On the other hand, what many of these directors have in common is openness to transforming GM into a firm that produces cars and trucks that are more environmentally-friendly. Consider that Fritz Henderson stated following his appointment, "[t]oday marks the beginning of what will be a new company, a New GM, dedicated to building the very best cars and trucks, highly fuel-efficient, world-class quality, green technology development, and with truly outstanding design";[205] and following his appointment, Edward Whitacre trumpeted GM's new "commitment to green technology . . . [f]rom vehicles that are gas-friendly to those that are gas-free."[206]

2. Contractual Obligations to Produce Environmentally-Friendly Vehicles

Of course, a receptive board of directors alone does not get the Obama Administration to its goal. When GM presented its Chapter 11 Restructuring Plan, it solidified its commitment to produce advanced technology vehicles.[207] In the Restructuring Plan, under the heading Federal Requirements, Domestic Manufacture of Advanced Technology Vehicles, GM agrees to the following:

> General Motors fully understands and appreciates the challenges to energy security and the climate from increased global consumption of petroleum. . . . [It will] invest heavily in alternative fuel and advanced propulsion technologies during the 2009-2012 timeframe. This investment is substantially to support the expansion in hybrid offerings, and

204. Martin Zimmerman, *GM Picks Ex-Chief of AT&T as Chairman*, LOS ANGELES TIMES, June 10, 2009, at B1 (discussing Whitacre's lack of auto-industry experience); David Shepardson, *GM's Latest Shakeup*, DETROIT NEWS, July 24, 2009, at B9 ("none has experience in the auto industry").

205. Sharon Silke Carty, *The Pieces Come Together Today For A Smaller, Leaner GM*, USA TODAY, July 10, 2009, at 1B.

206. Katie Collins, *GM Chairman Rolls Into Seguin*, GAZETTE-ENTERPRISE, Nov. 11, 2009. Appointee Patricia F. Russo advocates "developing energy-efficient products and managing in the most environmentally sound way." Patricia Russo, *Success Requires Imagination, the Right Business Plan, and the Right Environment*, 73 VITAL SPEECHES OF THE DAY 223 (2007). In her role as Alcatel–Lucent's CEO, Russo approved of her corporations's "dedicat[ion] to ecosustainability" and "corporate social responsibility." ALCATEL–LUCENT, CORP. SOC. RESPONSIBILITY REPORT 2007, *available at* http://www.alcatel-lucent.com/wps/DocumentStreamerServlet?LMSG_CABINET=Docs_and_Resource_Ctr&LMSG_CONTENT_FILE=Corp_Governance_Docs/RA_DD_GB_WEB.pdf.

207. GENERAL MOTORS CORP., 2009–2014 RESTRUCTURING PLAN 21 (2009).

> for the Volt's EREV technology. The Company is developing these and other technologies, . . . consistent with its objective of being the recognized industry leader in fuel efficiency.[208]

The Plan continues by highlighting actions already taken in response to the loan agreement:

> [GM agreed] to construct a new manufacturing facility in the United States to build Lithium-Ion battery packs for the Chevrolet Volt. Lithium Ion batteries are an essential technology for electric vehicles to be viable and, more generally, an important energy storage capability for this country in the long run.[209]

And in accord with its obligations:

> The Company has already submitted two Section 136 applications to the Department of Energy in support of various 'advanced technology' vehicle programs contained in General Motors product portfolio, which include some of the alternative fuel and advanced propulsion investment described above. These two requests combined total $8.4 billion, and a third application is planned for submission by March 31, 2009.[210]

D. *The Propriety of Government Imposed Corporate Social Responsibility*

Is it proper for GM's new board of directors to implement broader social policy at the insistence of the Obama Administration? Concerned by what they view as a political usurpation of GM to achieve a social end, [211] some politicians

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208. *Id.* at 21–22.

209. *Id.* at 22.

210. *Id.*

211. U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 149, at 24–25 (discussing concern over "external pressures [from politicians] to focus on public policy goals over focusing on its role as a commercial investor"). The independent GAO has warned against such interference:

> Experts emphasized the importance of Treasury resisting external pressures to focus on public policy goals over focusing on its role as a commercial investor. For example, some experts said that Treasury should not let public policy goals such as job retention interfere with its goals of maximizing its return on investment and making Chrysler and GM strong and viable companies. They said that this is especially important because making the companies financially strong and competitive may require reducing the number of employees. Nevertheless, one expert suggested that Treasury should consider public policy goals and include the value of jobs saved and other economic benefits from its investment when calculating its return, since these goals, though not important to a private investor, are critical to the economy.

attempted to settle the debate legislatively; one proposed bill would "guarantee that the companies are run not as political pawns but as profit-making entities seeking to maximize shareholder value."[212] The relevant portion of the TARP Recipient Ownership Trust Act of 2009 provides that any ownership interest acquired by Treasury shall be transferred to a limited liability company, which shall hold such ownership interest in trust for the benefit of the American tax payer.[213] The managers of the LLC must be independent of the United States government and shall "have a fiduciary duty to the American taxpayer for the maximization of the return on the investment of the taxpayer made under the Emergency Economic Stabilization Act of 2008, in the same manner and to the same extent that any director of an issuer of securities has with respect to its shareholders under the securities laws and all applications of State law."[214] The law did not pass and never became part of TARP.[215]

> As long as Treasury maintains ownership interests in Chrysler and GM, it will likely be pressured to influence the companies' business decisions. Treasury has said that it plans to manage its investment in Chrysler and GM in a commercial way. Yet Treasury faces external pressures, such as to prioritize jobs over maximizing its return. For example, Congress is currently considering a number of bills to restore automotive dealers' contracts terminated in restructuring, and Treasury officials noted that they receive frequent calls from Members of Congress expressing concern about dealership closings.

Id.

212. George Will, *Obama's State Capitalism*, WASH. POST, Aug. 23, 2009, at A21 (discussing the TARP Recipient Ownership Trust Act of 2009, S. 1280, 111th Cong. (2009)).

213. TARP Recipient Ownership Trust Act of 2009, S. 1280, 111th Cong. § 3(a) (2009).

214. *Id.* at § 3(c)(3). *But see* Auto Industry Financing and Restructing Act, H.R. 7321, 110th Cong. § 2 (2008). It took the exact opposite approach. It had more to do with promoting a broader social interest—environmentally friendly industry—for GM. The first stated purpose of H.R. 7321 was "to ensure that such authority and such facilities are used in a manner that . . . results in a viable and competitive domestic automobile industry that minimizes adverse effects on the environment." The second purpose is to "enhance[] the ability and the capacity of the domestic automobile industry to pursue the timely and aggressive production of energy-efficient advanced technology vehicles." Those purposes are placed before preserving and promoting the jobs of American workers.

215. The Committee on Banking, Housing, and Urban Affairs has yet to act on the bill. They are wielding their "blocking power"—"if committee members disfavor the bill for any reason, they can do nothing and allow the bill to languish in committee." Brent J. Horton, *How Corporate Lawyers Escaped Sarbanes–Oxley: Disparate Treatment in the Legislative Process*, 60 S.C.L. REV. 149, 171 (citing Roberta Ramoner, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance* 196 (YALE UNIV. INT'L CNTR FOR FIN., Working Paper No. 04-37, 2004)).

The above political conflict mirrors the academic conflict as to whether wealth maximization should be trumped by social responsibility. One of the best debates on the issue is between Professor Lynn Stout of UCLA and Jonathan Macey of Yale.[216] On the side of social responsibility, Professor Lynn Stout of UCLA argues in *Why We Should Stop Teaching* Dodge v. Ford, that a corporate board of directors should promote a broader social purpose, not just maximize shareholder wealth.[217] Specifically, she is against the recurring appearance of *Dodge v. Ford* in the classroom and before the bench and bar.[218] In *Dodge v. Ford*, a shareholder, John Dodge, brought an action to compel Ford Motor Company to declare a dividend in 1916.[219] Since Ford's formation in 1903, "[t]he cars it manufactured met a public demand, and were profitably marketed."[220] The company was so successful that it paid special dividends to its shareholders as follows: "December 13, 1911, $1,000,000; May 15, 1912, $2,000,000; July 11, 1912, $2,000,000; June 16, 1913, $10,000,000; May 14, 1914, $2,000,000; June 12, 1914, $2,000,000; July 6, 1914, $2,000,000; July 23, 1914, $2,000,000; August 23, 1914, $3,000,000; May 28, 1915, $10,000,000; and October 13, 1915, $5,000,000."[221] Even with the foregoing special dividends, Ford had cash on hand on July 31, 1916, of $52,550,771.92.[222] Thereafter, declared Henry Ford, there would be no further special dividends.[223] Ford's reasoning was blunt. He rejected any fiduciary obligation to maximize shareholder wealth, arguing that as "the stockholders had received back in dividends more than they had invested they were not entitled to receive anything additional."[224] Ford wanted to use the cash to further social ends, employing more employees, paying his employees more, and subsidizing the price of his Model-T so that more Americans could put one in

216. Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L. & BUS. REV. 163 (2008); Jonathan R. Macey, *A Close Read of an Excellent Commentary on* Dodge v. Ford, 3 VA. L. & BUS. REV. 177 (2008).

217. Stout, *supra* note 216, at 166.

218. *Id.* (discussing Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919)).

219. *Dodge*, 170 N.W. at 683.

220. *Id.* at 670.

221. *Id.*

222. *Id.*

223. *Id.* at 671.

224. *Id.*

their driveway.[225] Altruistic as Ford's purpose was, the court could not escape the underlying reality that Ford's first duty was to Ford's shareholders.[226] The court stated:

> There should be no confusion. . . . [a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of [the] directors is to be exercised in the choice of means to attain that end, and does not extend to . . . other purposes.[227]

It is the above positive statement of law that Professor Stout finds objectionable. Professor Stout begins her critique of *Dodge v. Ford* by declaring that it is bad law, that it was a "mistake," a "doctrinal oddity."[228] But as Professor Macey points out:

> The case is not a doctrinal oddity. *Dodge v. Ford* still has legal effect, and is an accurate statement of the form, if not the substance, of the current law that describes the fundamental purpose of the corporation. By way of illustration, the American Law Institute's ("ALI") *Principles of Corporate Governance* ("Principles"), considered a significant, if not controlling, source of doctrinal authority, are consistent with *Dodge v. Ford's* core lesson that corporate officers and directors have a duty to manage the corporation for the purpose of maximizing profits for the benefit of shareholders. Specifically, section 2.01 of the *Principles* makes clear that "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.[229]

This longstanding statement of shareholder primacy as positive law is reflected in most state corporate codes, that provide that a "'Corporation' . . . means a corporation for *profit*."[230] In fact, many states provide that a board of directors can only consider social responsibility "when doing so does not harm shareholder[] [wealth] in any demonstrable way."[231]

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225. *Id.*

226. *Id.* at 684.

227. *Id.*

228. Stout, *supra* note 216, at 166.

229. Macey, *supra* note 216, at 178.

230. N.Y. BUS. CORP. LAW § 102 (McKinney 2008) (emphasis added); *see also* MODEL BUS. CORP. ACT § 1.40(4) (1979).

231. Macey, *supra* note 216, at 179. These corporate constituency statutes "only serve[] to underscore the primacy of the obligation to direct efforts at enhancing economic value of firm because they would be superfluous if it was already well-

However, Professor Stout is undeterred, and argues that if a corporation wants to make a profit, it should state so in its articles of incorporation:

> [T]hey can easily include in the corporate charter a recitation of the *Dodge v. Ford* view that the corporation in question "is organized and carried on primarily for the profit of the stockholders." In reality, corporate charters virtually never contain this sort of language. Instead, the typical corporate charter defines the corporate purpose as anything "lawful."[232]

I will simply counter that the reason corporate charters state that the entity is organized for "any lawful purpose," rather than "for the profit of the shareholders," is that the latter statement is made clear by 400 years of European (and later American) business and legal tradition.[233] Further, Professor Stout's argument turns the default rule of *Enea v. Superior Court*[234] on its head, and ignores the fact that fiduciary duties—including the duty to maximize shareholder value—exist whether or not the parties involved contract for them. In *Enea*, the defendant argued that he did not have a fiduciary duty to maximize the financial return of a partner absent an agreement establishing such a duty.[235] The court easily rejected that argument, stating:

> Defendants also persuaded the trial court that they had no duty to collect market rents in the absence of a contract expressly requiring them to do so. This argument turns partnership law on its head. Nowhere does the law declare that partners owe each other only those duties they explicitly assume by contract. On the contrary, the fiduciary duties at issue here are *imposed by law*, and their breach sounds in tort. We have no occasion here to consider the extent to which partners might effectively limit or modify those delictual duties by an explicit agreement or whether the partnership agreement in fact required market rents by its terms. There is no suggestion that it purported to affirmatively *excuse*

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understood that directors did not violate their responsibilities to shareholders when considering the needs of other constituencies." Tamara R. Piety, *Against Freedom of Commercial Expression*, 29 CARDOZO L. REV. 2583, 2623–24 n.184 (May 2008). Nor do these statutes "permit managers to benefit non-shareholder constituencies at the expense of shareholders." Macey, *supra* note 216, at 179.

232. Stout, *supra* note 216, at 169.

233. The Dutch East India Company, for example, was founded in 1602 to make a profit. *See* Christine Lucassen, *Amsterdam Bourse Gets Renewed Lease of Life*, HET FINANCIEELE DAGBLAD (English Edition), Oct. 31, 2001.

234. 34 Cal. Rptr. 3d 513 (Cal. Ct. App. 2005).

235. *Id.* at 516.

> defendants from the delictual duty not to engage in self-dealing. Instead, their argument is predicated on the wholly untenable notion that they were entitled to do so unless the agreement explicitly declared otherwise.[236]

In short, Professor Stout's article is best read as arguing for a normative position, what the law should be, not what the law is. However, in my opinion, it is unwise to impose social responsibility on existing corporations, because social responsibility is an amorphous concept that can be shaped to fit any political agenda. On the other hand, most corporations have done just fine for their millions of shareholders (and by implication, the nation) by following the shareholder wealth model to which Professor Stout objects. Despite the forgoing arguments against forcing social responsibility upon corporations, it appears that the Obama Administration is usurping GM's board of directors to implement a political agenda. Let me be clear, while I am not opposed to GM *choosing* to shift to a more environmentally-friendly business plan, I do question the propriety of the federal government *forcing* that decision.[237]

E. *Other Proffered Justifications for the GM Bailout*

The Obama Administration argues that a federal bailout will make GM more competitive.[238] However, the foregoing assertion corrupts the very essence of competition, twisting it beyond any form recognizable to Adam Smith or Milton Friedman. Competition requires that some businesses fail. "The failure of some participants sweeps away the least innovative and/or poorly managed companies."[239] Yet failure is impossible where a company is propped up by a never ending supply of taxpayer dollars.

Perhaps the Obama Administration uses the term "more competitive" to indicate that top-down bureaucratic control will result in a better business plan for GM. That would be in accord with the House of Representative's belief that it can write a

236. *Id.* at 518–19 (citations omitted).

237. *See* George F. Will, *The Obama Doctrine*, THE OREGONIAN, Aug. 24, 2009.

238. Obama, *supra* note 198.

239. Richard W. Rahn, *The Necessity of Failure*, WASH. TIMES, Mar. 24, 2010, at B04.

better business plan than GM's prior board of directors.[240] H.R. 7321 stated that "errors in the business model of domestic automobile manufacturers, and emergency economic circumstances, . . . has led to the possibility of the failure of the domestic automobile industry, which failure would have a systemic adverse effect on the economy."[241]

However, several factors inevitably make top-down bureaucratic control of business inefficient.[242] The most prominent problem is "political" management.[243] As one commentator stated:

> Since control of the organization, the functions, and, most important, the funds of the department is [sic] tightly held by the legislature, influential members of that body necessarily speak with great impressiveness to the administrators proper. Administrative measures designed to create goodwill or secure votes for a Senator in South Carolina unfortunately seldom coincide with sound business practices. Multiply one Senator by a dozen, throw in several score of Representatives, or perhaps substitute state legislators, and then evaluate efficiency! And it is not necessary to impute such selfish and personal motives to get comparable results. Imagine several hundred Congressmen interfering with the management details of an enterprise even with the worthiest of intentions![244]

We already see the foregoing happening with the application of TARP funds to GM. While the Obama Administration promised that it would not interfere with the day-to-day operations of GM, it has proved unable to control its allies in Congress.[245] "Treasury officials noted that they receive frequent calls from Members of Congress expressing concern about dealership closings."[246] Barney Frank—who coincidentally oversees TARP—reversed a prior GM decision to close a plant in Frank's congressional district by directly calling GM's CEO, Fritz

240. H.R. 7321, 110th Cong. (2008). President Obama asked his auto task force to "work closely with GM to produce a better business plan," that relies on "manufacturing the fuel-efficient cars and trucks that will carry us towards an energy-independent future." Obama, *supra* note 198.

241. H.R. 7321, 110th Congress (2008).

242. John McDiarmid, *Can Government Be Efficient in Business?* 206 ANNALS AM. ACAD. POL. & SOC. SCI. 155 (1939).

243. McDiarmid, *supra* note 242, at 156.

244. *Id.*

245. *See, e.g.*, Jared Allen, *Auto Plan Hits Potholes*, THE HILL, June 8, 2009, at 1 (discussing congressional meddling in GM's restructuring plan).

246. U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 149, at 25.

Henderson.[247] The Norton, Massachusetts plant remains open.[248]

Another problem with government control of business is top-down rule by expert. Rule by expert inevitably leads to absurd results. In 1935, the NIRA[249]—the quintessential example of rule by expert—was found unconstitutional in *Schechter Poultry Corp. v. United States.*[250] At issue was one of the NIRA imposed codes that regulated matters as local as what chicken a customer could choose when going to a poultry market.[251] Schecter was convicted of "permitting customers to make selections of individual chickens taken from particular coops and half coops."[252] The give-and-take during Supreme Court oral argument tells us all we need to know about why New Deal rule-by-expert failed:

> MR. JUSTICE MCREYNOLDS: I want to see whether I understand [the arrangement] correctly. . . . These chickens are brought into New York by the carload, and they are taken out and put in coops? [Mr. Heller, arguing for Schecter company, says yes, and he further informs the Justice that there are thirty to forty chickens in a coop.] And if he undertakes to sell them [from the coop] he must have a straight-killing?
> MR. HELLER: He must have a straight-killing. In other words, the customer is not permitted to select the ones he wants. He must put his hand in the coop when he buys from the slaughterhouse and then take the first chicken that comes to hand. He has to take that.
> [Laughter—recorded in the chamber]
> MR. JUSTICE MCREYNOLDS: Irrespective of the quality of the chicken?
> [More laughter in the courtroom]

247. Allen, *supra* note 245 ("Frank's staff said the lawmaker spoke with GM CEO Fritz Henderson and convinced him to keep the Norton, Mass., plant open for at least 14 months.").

248. *Id.* Likewise, interference can come from the executive branch. McDiarmid, *supra* note 242, at 156. Fisker, a maker of plug-in hybrids, received capital from the federal government. *See* Press Release, U.S. Department of Energy, US Energy Secretary Chu Announces $528 Million Loan for Advanced Vehicle Technology for Fisker Automotive (Sept. 22, 2009), *available at* http://www.atvmloan.energy.gov/public/fisker.pdf. Vice President Joe Biden made sure that in return for the capital, Fisker agreed to use a plant located just 4 miles from his house. *See* Neil King, Jr., *Venture Capital: New VC Force*, WALL ST. J., Dec. 14, 2009, at A1.

249. National Industrial Recovery Act, Pub. L. No. 73-67, 48 Stat, 195 (1933) (formerly codified at 15 U.S.C. § 703–710).

250. 295 U.S. 495 (1935).

251. *Id.* at 550.

252. *Id.* (quotations omitted).

> . . . Suppose it is a sick chicken? [He is told that a buyer *was* free to reject a sick chicken.] Now can he break up those coops and sell them, half a dozen chickens to one man, and half a dozen to another man?
> MR. HELLER: He cannot. He can sell a whole coop, or one-half of a coop . . . . That is all. And when he sells five, or six, or two, or three, he cannot permit the purchaser any selection of the chickens in the coop.
> MR. JUSTICE STONE [intervenes to ask]: Do you mean that there can be a selection if he buys one-half the coop?
> MR. HELLER: No. You just break the box into two halves.
> [Laughter in the Courtroom]
> [Then,] MR. JUSTICE SUTHERLAND [asks]: Well, suppose, however, that all the chickens have gone over to one end of the coop?
> [More laughter in the courtroom][253]

I am sure that whoever came up with the Poultry Code's rule for "straight killing" was an expert, and had the best of intentions, but the result was nevertheless silly. Let's face it, the thought of an expert divining the future of the automobile industry is likewise silly. In 1910, Thomas Edison, who all agree is an expert, proclaimed, "in 15 years, more electricity will be sold for electric vehicles than for light."[254] I am glad Mr. Edison—genius that he was—was not in charge of planning the American economy. All kidding aside, like the NIRA and the Poultry Code, federal government influence over GM is likely to lead to absurd results. Economic prosperity, when it returns, will be despite such expert government intervention, not because of it.

III. *ATLAS SHRUGGED*'S CONTRIBUTION TO LEGAL SCHOLARSHIP

A. Atlas Shrugged*'s Critique of Emergency Economic Legislation*

No critique of emergency economic legislation is complete without recognition of Ayn Rand's literary magnum opus, *Atlas*

253. HADLEY ARKES, THE RETURN OF GEORGE SUTHERLAND: RESTORING A JURISPRUDENCE OF NATURAL RIGHTS 85 (2nd prtg. 1997) (alterations in original).

254. CHRISTOPHER CERF & VICTOR NAVASKY, THE EXPERTS SPEAK: THE DEFINITIVE COMPENDIUM OF AUTHORITATIVE MISINFORMATION 249 (PANTHEON BOOKS 1998). My favorite definition of an "expert" is as follows: "'X' as you know stands for unknown. 'Spurt' can be defined as a drip under pressure. So an expert is an anonymous drip under pressure." Mark Draper, Shall the Family Endure? A Question of Love, *in* 61 Vital Speeches of the Day 1 (Dec. 15, 1994).

Shrugged, a thinly veiled attack on FDR's New Deal.[255] Ayn Rand stated as to her writings, "[w]hen you read [them], you'll see what an indictment of the New Deal [they are], . . . although I never mentioned the New Deal by name."[256] *Atlas Shrugged* can be considered literary support for the assertions contained above. Authors of legal or political fiction need to have a strong grasp of political reality in order to make their work believable. If the work is not believable it will not sell. Ayn Rand's *Atlas Shrugged* sold well.

Author Ayn Rand satirizes FDR's use of the New Deal to support politically-connected business at the expense of entrepreneurial firms.[257] Entrepreneurial firms are the life-blood of the American economy,[258] but as Ayn Rand points out, they are driven out of business by New Deal imposed regulations that bar them from competing in industries dominated by politically-connected business.[259] Thus, in *Atlas Shrugged*, as the National Legislature spawned more laws to protect politically-connected business, "these in turn, generate[d] more havoc and poverty, which inspire[d] the politicians to create more . . . and the downward spiral repeat[ed] itself until the productive sectors of the economy collapse[d] under the collective weight of taxes and [regulation]."[260] In *Atlas Shrugged*, the entrepreneurial firms that survived until the total collapse of the American economy retreated to a hidden Colorado valley, a kind of capitalist Shangri-La where they could reap the rewards of their labor, without the stifling weight of government regulation.[261] For those that remained behind the result was a chaotic dark age (literally):

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255. RAND, *supra* note 2, *passim.*

256. Jennifer Burns, *Godless Capitalism: Ayn Rand and the Conservative Movement*, 1 MOD. INTELL. HIST. 359, 367 (2004) (quoting Letter from Rand to Dewitt Emory, May 17, 1943) (quotations omitted).

257. RAND, *supra* note 2, *passim.*

258. Birch, *supra* note 18, at 65; Efrat, *supra* note 18, at 176 (discussing the importance of small businesses to job creation).

259. RAND, *supra* note 2, *passim.*

260. Stephen Moore, *'Atlas Shrugged': From Fiction to Fact in 52 Years*, WALL ST. J., Jan. 9, 2009, at A16.

261. RAND, *supra* note 2, at 1158. Rand's theory of the entrepreneurial firm being crowded out by the government-supported cartel is mirrored by "'cartel theory,' . . . [a] barriers-to-entry account [that] effectively splits industry into two groups, existing firms and prospective firms, and posits that existing firms will work to secure regulations that will allow them to 'become federal protectorates, living in the cozy world of cost-plus, safely protected from the ugly specters of competition, efficiency and innovation.'"

> Looking down [from the airplane] they could see the last convulsions [of New York City]: the lights of the cars were darting through the streets, like animals trapped in a maze, frantically seeking an exit, the bridges were jammed with cars, the approaches to the bridges were veins of massed headlights, glittering bottlenecks stopping all motion, and the desperate screaming of sirens reached faintly to the height of the plane . . . . The plane was above the peaks of the skyscrapers when suddenly, with the abruptness of a shudder, as if the ground had parted to engulf it, the city disappeared from the face of the earth. It took them a moment to realize that the panic had reached the power stations—and that the lights of New York had gone out.[262]

Rand described the world that followed as consisting of "closed factories and ruins, . . . spiritual emptiness, hopelessness, confusion, dullness, grayness, fear."[263]

Any attempt to summarize a work as intricate as *Atlas Shrugged* is bound to leave more questions than answers.[264] I hope to simplify the matter somewhat by limiting my comments to those portions that lionize the entrepreneurial firm (new firms that create a new product or process),[265] and, more particularly, those portions that describe the entrepreneurial firm's struggle against emergency economic legislation that assists politically-connected business.[266] It is this last topic that I find most interesting—the struggle of the entrepreneurial firm against politically-connected business.

Much of *Atlas Shrugged* is limited to a critique (or satire) of politically-connected business.[267] This critique often looks at the adverse effect on entrepreneurial firms.[268] Consider one of the lesser protagonists in *Atlas Shrugged*, Dan Conway. He is the

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Nicholas Bagley and Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUM. L. REV. 1260, 1291 (2006).

262. RAND, *supra* note 2, at 1158.

263. JOURNALS OF AYN RAND 392 (David Harriman, ed., 1997).

264. CHRIS MATTHEW SCIABARRA, AYN RAND: THE RUSSIAN RADICAL 114 (6th prtg. 1999) (likewise noting the inherent difficulty in summarizing a book as long as *Atlas Shrugged*).

265. D. Gordon Smith & Masako Ueda, *Law & Entrepreneurship: Do Courts Matter?*, 1 ENTREPREN. BUS. L.J. 353, 355–57 (2006) (defining entrepreneur).

266. DONNA GREINER AND THEODORE B. KINNI, AYN RAND AND BUSINESS, i (2001); AYN RAND & ROBERT MAYHEW, AYN RAND ANSWERS THE BEST OF HER Q & A 41 (2005) (speaking out against businesses that use antitrust legislation to gain an unfair advantage over competitors).

267. RAND, *supra* note 2, *passim*.

268. *Id. passim*.

literary embodiment of *Piedmont, Maher,* and *Safir.* He is an entrepreneurial hero who builds the Phoenix-Durango Railroad from running a local milk line to transporting car after car of shale oil from the Wyatt Oil Fields.[269] He upgrades to faster locomotives, better tracks, more lines, always improving.[270] By constant innovation and hard work, the Phoenix-Durango grows into a strong competitor in the southwestern United States.[271] Opposing Dan Conway are Ayn Rand's antagonist cartels, a small group of private firms that seek to maintain their market share in a given industry by using Washington connections to construct regulatory barriers to entry.[272] These cartels resent arm's length competition from the Phoenix-Durango.[273] Consider the angry grumblings of James Taggart, CEO of Taggart Transcontinental Railroad ("TTRR").[274] James complains that the Phoenix-Durango is operating where TTRR has historical priority and as such, is "robbing" TTRR of its market share.[275] According to James, the Phoenix-Durango's actions amount to "destructive competition."[276] Of course, that raises a fundamental question: destructive to whom? James clearly means destructive to the historical dominance of TTRR.[277] Certainly not destructive to all the new employees hired by the Phoenix-Durango, or the businesses that receive efficient service from the Phoenix-Durango.

James seeks to prevent the Phoenix-Durango from competing with his railroad in the southwest.[278] James turns to "his man" in Washington, named Wesley Mouch, to lobby for a series of laws preventing entrepreneurial firms from entering or competing in

269. Wyatt is another of Ayn Rand's protagonists. *Id.* at 292.

270. *Id.* at 9 ("Imagine a thing called the Phoenix-Durango competing with Taggart Transcontinental! It was nothing but a local milk line 10 years ago.").

271. *Id.* at 10, 21.

272. *See* THOMAS SOWELL, BASIC ECONOMICS 102 (2004) (discussing characteristics of cartel).

273. RAND, *supra* note 2, at 10, 21.

274. *Id.*

275. *Id.* at 21.

276. *Id.* at 10. Historically, "destructive competition" is defined as ruinous price cutting, or "price wars" between competitors. Note, *Fixation of Minimum Utility Rates to Prevent Destructive Competition,* 43 YALE L.J. 114 (1933).

277. RAND, *supra* note 2, at 10.

278. It is important to note that Ayn Rand is not against cartels *per se,* but only those that, as in *Atlas Shrugged,* maintain their dominance through legislative action. Rand states, "there isn't a single profession or service of a productive nature that should be a monopoly, enforced by law." AYN RAND ANSWERS 25 (Robert Mayhew, ed., 2005).

markets controlled by railroads with historical priority.[279] In a smoke-filled bar, sipping whiskey from a leaded glass with two perfectly square ice cubes, James begins to make his argument in hushed tones:

> Speaking of progressive policies . . . you might ask yourself whether at a time of transportation shortages, when so many railroads are going bankrupt and large areas are left without rail service, whether it is in the public interest to tolerate wasteful duplication of services and the destructive, dog-eat-dog competition of newcomers in territories where established companies have historical priority.[280]

The National Legislature in *Atlas Shrugged* is more than happy to oblige in return for a *quid pro quo*; they pass a law delegating to the National Alliance of Railroads the power to promulgate binding rules governing all railroad service providers.[281] In turn, the National Alliance of Railroads promulgates the Anti-Dog-Eat-Dog Rule, "the better to enforce the laws . . . passed by the country's legislature."[282] It reads as follows:

> [railroads] are forbidden to engage in practices defined as "destructive competition"; that in regions declared to be restricted, no more than one railroad [will] be permitted to operate; that in such regions, seniority belonged to the oldest railroad now operating there, and that the newcomers, who had encroached unfairly upon its territory, [will] suspend operations within nine months after being so ordered; that the

279. RAND, *supra* note 2, at 47. The "National Legislature" is Ayn Rand's representation of Congress.

280. *Id.* at 47.

281. *Id.* at 75.

282. *Id.* Rand possibly borrowed the phrase "dog-eat-dog competition" from a 1929 speech by President Hoover:

> The very fact that you gentlemen come together for these broad purposes represents an advance in the whole conception of the relationship of business to public welfare. You represent the business of the United States, undertaking through your own voluntary action to contribute something very definite to the advancement of stability and progress in our economic life. This is a far cry from the arbitrary and *dog-eat-dog* attitude of the business world of some 30 or 40 years ago. And this is not dictation or interference by the Government with business. It is a request from the Government that you cooperate in prudent measures to solve a national problem. A great responsibility and a great opportunity rest upon the business and economic organization of the country. The task is one fitted to its fine initiative and courage.

President Herbert Hoover, Remarks to a Chamber of Commerce Conference on the Mobilization of Business and Industry for Economic Stabilization (Dec. 5, 1929) (emphasis added).

> Executive Board of the National Alliance of Railroads [is] empowered to decide, at its sole discretion, which regions are to be restricted.[283]

The law created a barrier to entry, pushing Dan Conway's Phoenix-Durrango out of Colorado and returning to Taggart Transcontinental the market that it argued it was historically entitled to.[284] Conway could have fought the laws; he could have brought suit claiming it was expropriation.[285] If a court upheld the Railroad Association's actions based upon misplaced conceptions of "public welfare," he could appeal, and appeal again; he could keep the Phoenix-Durango alive for years to come.[286] But he refuses to fight back.[287] He dejectedly states—tacitly sanctioning the acts of the Railroad Association's actions—"I'm not sure I would win, but I could try and I could hang onto the railroad for a few years longer, but . . . . No, it's not the legal points that I'm thinking about, one way or the other, it's not that. . . . I don't want to fight it . . . ."[288] In the end, he agrees to his own destruction, to be sacrificed to the collective, stating hopelessly:

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283. RAND, *supra* note 2, at 75.

284. *Id.*

285. *Id.* at 77.

286. *Id.*

287. *Id.*

288. *Id.* "Sanction of the victim" is a common theme in Rand's novels. One of Rand's primary protagonists, John Galt, explains in detail:

> Then I saw what was wrong with the world, I saw what destroyed men and nations, and where the battle for life had to be fought. I saw that the enemy was an inverted morality—and that my sanction was its only power. I saw that evil was impotent—that evil was the irrational, the blind, the anti-real—and that the only weapon of its triumph was the willingness of the good to serve it. Just as the parasites around me were proclaiming their helpless dependence on my mind and were expecting me voluntarily to accept a slavery they had no power to enforce, just as they were counting on my self-immolation to provide them with the means of their plan—so throughout the world and throughout men's history, in every version and form, from the extortions of loafing relatives to the atrocities of collectivized countries, it is the good, the able, the men of reason, who act as their own destroyers, who transfuse to evil the blood of their virtue and let evil transmit to them the poison of destruction, thus gaining for evil the power of survival, and for their own values—the impotence of death. I saw that there comes a point, in the defeat of any man of virtue, when his own consent is needed for evil to win—and that no manner of injury done to him by others can succeed if he chooses to withhold his consent. I saw that I could put an end to your outrages by pronouncing a single word in my mind. I pronounced it. The word was "No."

AYN RAND, FOR THE NEW INTELLECTUAL: THE PHILOSOPHY OF AYN RAND 165 (1961) (reproducing John Galt's speech).

> [T]he whole world's in a terrible state right now. I don't know what's wrong with it, but something's very wrong. Men have to get together and find a way out. But who's to decide which way to take, unless it's the majority? I guess that's the only fair method of deciding, I don't see any other. I suppose somebody's got to be sacrificed. If it turned out to be me, I have no right to complain.[289]

And thus this once exceptional individual, this once extraordinary entrepreneur, sanctions his own destruction to assist the National Legislature and politically-connected business in their misguided crusade to save the collective.[290]

In *Atlas Shrugged*, the worsening economy is simply a cover for the implementation of legislation intended to foster a broader social interest.[291] Once politicians prop up and protect TTRR, they expect it to take a more socially responsible approach.[292] In *Atlas Shrugged*, the preferred social policy was an egalitarian transfer of wealth.[293] At a meeting of the board following the passage of the Anti-Dog-Eat-Dog Rule discussed above:

> A man from Washington sat at the table among them. Nobody knew his exact job or title, but it was not necessary: they knew that he was the man from Washington. . . . The Directors did

289. RAND, *supra* note 2, at 78.

290. *Id.* at 77–78.

291. *See, e.g.*, RAND, *supra* note 2, at 130, 299, 333, 538, 539 (discussing Equalization of Opportunity Act, and Preservation of Livelihood Law).

292. RAND, *supra* note 2, *passim.*

293. *Id.* at 503. This too appears to be a thinly veiled attack on FDR. In 1936 FDR declared that he viewed the world in terms of the "economic royalist" against the worker, and praised a government where it acts as the "embodiment of charity," forcing business to "share the wealth" with the worker. President Franklin D. Roosevelt, Speech before the 1936 Democratic National Convention (June 27, 1936). Indeed, FDR made no secret of his view of businesses as corrupt "money changers." Steven G. Calabresi, *"A Shining City On A Hill": American Exceptionalism and the Supreme Court's Practice of Relying on Foreign Law*, 86 B.U. L. REV. 1335, 1368 (2006). It was in 1941 that Roosevelt proposed expansion of the freedoms set forth in the Bill of Rights, and declared that all Americans are entitled to "freedom from want." President Franklin Roosevelt, Speech, The Four Freedoms (Jan. 6, 1941). From these statements, and his actions, we can conclude that FDR used the New Deal to implement a more equitable distribution of the nation's wealth. For example, in return for government protections, the railroad cartel agreed to provide service to rural communities at a loss. Posner, *Natural Monopoly*, *supra* note 20, at 608. While the Steel Code did much to solidify the authority of the steel cartel, it also contractually bound the cartel to certain maximum hours for workers. *See Some Legal Aspects*, *supra* note 100, at 86 n.6 (citing Code for the Iron and Steel Industry, Art. IV, § 2 (40 hour average, 48 hour maximum)), and a minimum wage. *See id.* (citing Code for the Iron and Steel Industry, Art. IV, §§ 4, 5, and Schedules C, D (25 to 40 cents per hour)). This was accomplished five years before such obligations would be statutorily imposed pursuant to the Fair Labor Standards Act. 29 U.S.C. ch 8.

> not know whether he was present as the guest, the advisor or the ruler of the Board; they preferred not to find out.[294]

The man from Washington was Mr. Weatherby.[295] The irony was thick when Mr. Weatherby told James he would have to raise the wages of employees:

> JAMES: "But, good God, Clem!–I'd be open to court action for it . . . ."
> MR. WEATHERBY [smiling]: "What court? Let [us] take care of that."
> JAMES: "But listen, Clem, you know–you know just as well as I do–that we can't afford it!"
> MR. WEATHERBY [shrugging]: "That's a problem for you to work out."
> JAMES: "How, for Christ's sake?"
> MR. WEATHERBY: "I don't know. That's your job, not ours. You wouldn't want the government to start telling you how to run your railroad, would you?"[296]

That edict was followed by still more edicts that limited how productive the employees could be (no more than the other carriers),[297] edicts that prohibited firing employees, and eventually, edicts that prevented employees from quitting.[298] TTRR had made the proverbial "deal with the devil": it would continue operations, but as a stagnant entity void of free will.[299] The employees became little more than indentured servants, but at least equal ones; after all, is it not best that we take "from each according to his ability," and give "to each according to his needs"?[300] That way, no one goes without.

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294. RAND, *supra* note 2, at 502.

295. *Id.*

296. *Id.* (dialogue structure added). When James states that he could be "open to court action," Rand is likely speaking of a shareholder derivative suit. *See, e.g., Mlinarcik v. E.E. Wehrung Parking, Inc.*, 86 Ohio App. 3d 134 (Ohio Ct. App. 1993) (shareholder derivative suit alleging that certain employees received excessive compensation); Int'l Ins. Co. v. Johns, 874 F.2d 1447 (11th Cir. 1989) (describing how shareholders contended that bonuses and consulting agreements provided to certain employees were excessive and constituted corporate waste).

297. *Id.* at 539.

298. *Id.* at 538.

299. *Id.*

300. KARL MARX, CRITIQUE OF THE GOTHA PROGRAM 27 (Wildside Press 2008).

B. *Satirical Legal Scholarship*

It is important to dispense with the argument that *Atlas Shrugged* adds nothing to our understanding of President Obama's usurpation of emergency economic legislation, or as Whittaker Chambers, writing for the conservative National Review said of *Atlas Shrugged*, "it [is] a remarkably silly book."[301] Dismissing *Atlas Shrugged* as "mere literature" not worthy of consideration ignores its place as satirical legal scholarship that can bring fresh perspective to the ivory tower. I suggest that *Atlas Shrugged* fits within even the most restrictive definitions of both positive and normative legal scholarship—it is positive legal scholarship, observing what the law is, showing the inefficiency of government constructed barriers to entry, and in the end, normative legal scholarship, making prescriptions about what the law should be.

Fiction, specifically satirical attacks on legislation, has a long history in legal scholarship.[302] Satirical legal scholarship takes what can be an abstraction—the law—and places a sometimes ugly face on it,[303] and, in so doing, convinces the reader that the law must change.[304] There are satirical attacks on laws that

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301. Chambers, *supra* note 33.

302. "In the last century, satire played a varying yet visible role in scholarly movements critical of law ranging from legal realism to law and economics, from legal anthropology to critical legal studies . . . transcend[ing] the established political and doctrinal boundaries that defined legal studies." Peter Goodrich, *Satirical Legal Studies: From the Legists to the Lizard*, 103 MICH. L. REV. 397, 399–400 (2004).

303. Peter Goodrich, *The Importance of Being Earnest: Satire and the Criticism of Law*, 15 SOC. SEMIOTICS 48, 48 (2005); *see also* M. H. ABRAMS, A GLOSSARY OF LITERARY TERMS 320 (9th ed., 2009) (defining satire as "the literary art of diminishing or derogating a subject by making it ridiculous and evoking toward it attitudes of amusement, contempt, indignation, or scorn").

304. Goodrich, *Satirical Legal Studies*, *supra* note 303, at 441. Goodrich states:

> [the inversive branch of satirical legal scholarship], is propelled by the desire for change, and the will to overturn the order of things. The . . . primary objective is not directly abasement or aggrandizement but rather an overturning of the extant power and a reversal of positions in the hierarchy. . .
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> To get a little philosophical, the genre of overturning involves what Alain Badiou terms a "logical revolt," meaning that it expresses insubordination, a decline in reverence, a certain disrespect for the order and sanctity of law.

Id. Satire—when well done—leads to reformation, "and in this sense it has always been an important component in movements for abolition or change . . . of law." *Id.* (quoting DANIEL DEFOE, A TRUE COLLECTION OF THE WRITINGS OF THE AUTHOR OF THE TRUE BORN ENGLISHMAN, at fol. A5 (London, Croft 1703)).

would curtail free speech,[305] and on sumptuary legislation (legislation that forbade inordinate expenditures on apparel, food, or furniture).[306]

In *Atlas Shrugged*, James Taggart espouses legal policy, preventing "destructive" competition, but in a way that makes himself, and thus the legal policy, appear at best ignorant and at worst, malevolent. Is this a form of ad hominem argument? Yes, it does attack the messenger rather than the message, but let's face reality, "it is sometimes more effective to sneer, hoot and ridicule one's opponents than to engage them in reasoned legal debate."[307] And as such, in many ways, satire is sometimes more effective than the reasoned balancing of competing policy for purposes of condemning the existing law and causing legal change.[308] Some might counter that Ayn Rand is not funny. This is true. But satire need not be funny. Ayn Rand is more in the Roman tradition of satire. "Its brand of entertainment depends rather on wit. It elicits less a laugh than a smile, and it

305. Rodney A. Smolla, *Report on the Coalition for a New America: Platform Section on Communications Policy*, 1993 U. CHI. LEG. FORUM 149 (1993) (presenting fictional and satirical proposal for "progressive" new legislation designed to legally enforce higher ethical behavior by journalists).

306. Michele Lowrie, *Slander and Horse Law in Horace*, 17 STUD. L. & LIT. 405, 405 (2005); *see* Andrew Petkofsky, *The Canadians Are Coming: For Williamsburg*, RICHMOND TIMES, Oct. 27, 1996, at C-1 ("Recently proposed satirical Canadian legislation seeking compensation to Canadian descendants of Tory loyalists whose property was confiscated after the American Revolution."). There are even satirical attacks on competing forms of legal scholarship. Indeed, satire has a long and distinguished history in the battles fought between legal scholars. *See* Robin West, *Authority Autonomy and Choice: The Role of Consent in the Moral and Political Visions of Franz Kafka and Richard Posner*, 99 HARV. L. REV. 384, 393 (1985) (attack on the law and economics theory of Richard Posner); Arthur Austin, *The Top 10 Politically Correct Law Review Articles*, 27 FLA. ST. U. L. REV. 233, 261–63 (1999); Dennis W. Arrow, *Pomobabble: Postmodern Newspeak and Constitutional "Meaning" for the Uninitiated*, 96 MICH. L. REV. 461, 669 (1997) (attack on postmodern legal scholarship); Dennis W. Arrow, *"Rich," "Textured," and "Nuanced": Constitutional "Scholarship" and Constitutional Messianism at the Millennium*, 78 TEX. L. REV. 149, 150 (1999) (same). As early as 1938, Karl Lewellyn, Professor at the University of Chicago and drafter of the UCC, under the pseudonym D.J. Swift Teufelsdrockh, wrote *Jurisprudence: The Crown of Civilization: Being Also the Principles of Writing Jurisprudence Made Clear to Neophytes*, 5 U. CHI. L. REV. 171 (1938).

307. Charles Yablon, *Failed Lawyers and the Sources of Satire*, 15 GEO. MASON L. REV. 775, 776 (2008).

308. *Id.* ("Lawyers and satirists are basically in the same business; satire, like law, is essentially a juridical enterprise. Both constitute methods of social control. Both impose judgments and condemnations on their subjects, and in doing so, confront vexing questions of fairness and justice. Both utilize sophisticated rhetorical techniques to accomplish their objectives. Indeed, one of the recurring questions posed by theorists of satire is whether satire is better thought of as a supplement to existing legal institutions or as a rival to them.").

makes you think."[309] Both New Deal economic legislation and the laws of *Atlas Shrugged* support cartel behavior by establishing barriers to entry. Ridicule in the latter causes us to view the former in a less-than-positive light.

Further, fiction is more likely to be accepted as legal scholarship where the author is "able to tell stories different from the ones legal scholars usually hear . . . reveal[ing] things about the [legal] world that we [lawyers] ought to know."[310] Certainly Ayn Rand brings an experience that very few legal scholars share: her father's Petrograd pharmacy was nationalized by the Bolsheviks in 1917 (during the October Revolution).[311] Ayn Rand's family fled to the Crimea to escape the Bolsheviks and almost starved (her parents later died in the siege of Stalingrad in 1942-43).[312] She developed a deep disdain for collective rights; in her own words, a collectivist society "demands spiritual subordination to the mass in every way conceivable—economic, intellectual, artistic; it allows individuals to rise only as servants to the masses."[313] Following graduation from the University of Leningrad with a degree from the department of social pedagogy in 1924, Rand came to the United States with hope for a new life where she could express her individuality.[314]

Upon her arrival in the United States Rand became appalled by what she saw as the collectivism inherent in Roosevelt's New

309. Lowrie, *supra* note 306, at 406; *see* Michael Coblenz, *Not for Entertainment Only: Fair Use and Fiction as Social Commentary*, 16 UCLA ENT. L. REV. 265, 278 (2009) ("Many satires are not funny, but the public seems to associate satire with ridicule or an amusing attack on certain aspects of society.").

310. Nancy Cook, Outside *The Tradition: Literature As Legal Scholarship: The Call To Stories*, 63 U. CIN. L. REV. 95, 102 (1994). Richard Posner argued that literary fiction had very little to add to our interpretation of statutes, stating "I conclude that the functions of literature and legislation are so different, and the objectives of the readers of these two different sorts of mental product so divergent, that the principles and approaches developed for the one have no useful application to the other." He continued, "[t]he type of intentionalism that seems, to me at least, the natural and sensible approach to take in reading statutes seems to be a bad way to read literature, and the New Critical approach to literature that I find congenial would be a bad way to read statutes." Richard Posner, *Law and Literature: A Relation Reargued*, 72 VA. L. REV. 1351, 1374 (1986); *see also* William H. Page, *The Place of Law and Literature*, 39 VAND. L. REV. 391, 392–93, 400–07 (1986).

311. SCIABARRA, *supra* note 264, at 71.

312. *Id.* at 92.

313. JOURNALS OF AYN RAND, *supra* note 263, at 106.

314. SCIABARRA, *supra* note 264, at 92.

Deal.[315] Ayn Rand was so opposed to the New Deal that she worked on the 1940 presidential campaign of Wendell Willkie,[316] who decried that "the American people have accepted centralization of government, regimentation of activities and restriction of liberty to a greater extent than ever before in their history . . . the freedoms we have lost must be rewon and restored, not part, but all of them; not sooner or later, but sooner."[317] Rand viewed Willkie as "an outspoken and courageous defender of free enterprise."[318] When Roosevelt won in 1940, Rand was dejected. Unable to change the law through politics she turned to changing the law through literary fiction; beginning with the *Fountainhead*[319] and later *Atlas Shrugged.*[320] Today we have *Atlas Shrugged* as a satire of the New Deal, but more importantly, as a perspective on more recent emergency legislation.

CONCLUSION

Arthur Leff stated forty years ago: politicians "ought to have the political nerve to [act] with some understanding (*and some disclosure*) of what [they] are doing."[321] Today, I echo this call. The Obama Administration is telling the American people that absent government intervention the automotive industry will fail. However, government intervention in industry has been shown time and again to harm the economy by supporting government favored business at the expense of entrepreneurial

315. MIMI REISEL GLADSTEIN, ED., THE NEW AYN RAND COMPANION 11–12. "She grew up in Russia . . . . then in America, she was astonished to discover that the same anti-life ideas that had destroyed Russia were on the rise here. The result seemed to be periods of profound indignation, when she felt that the whole world was dominated by evil and that she was a metaphysical outcast." JOURNALS OF AYN RAND, *supra* note 263, at 20.

316. *See* MIMI REISEL GLADSTEIN, ED., THE NEW AYN RAND COMPANION 11. Willkie's private utility had been put out of business by competition from the Tennessee Valley Authority—A New Deal Project. Rand's affinity for Willkie likely grew out of the fact that while Willkie lost his business in competition with the United States Government, Rand's family lost its business to the Bolsheviks.

317. Ayn Rand, *The Only Path to Tomorrow,* READERS DIGEST, Jan. 1944, at 89.

318. Bill Kaufman, *The Last American Darkhorse,* AMERICAN ENTERPRISE, Jan. 1996, at 73.

319. Jennifer Burns, *Godless Capitalism: Ayn Rand and the Conservative Movement,* 1 MOD. INTELL. HIST. 359, 367 (2004) (quoting Letter from Rand to Dewitt Emory (May 17, 1943)).

320. SCIABARRA, *supra* note 264, at 113. Her actual notes begin with the date January 1, 1945. *See* JOURNALS OF AYN RAND, *supra* note 263, at 390.

321. Leff, *supra* note 29, at 558 (emphasis added).

firms.[322] Barriers to entry in the form of certificates of public need crushed competition in *Piedmont & Northern Railway Co. v. United States*,[323] and *Maher v. United States*.[324] Barriers to entry in the form of subsidies crushed competition in *Safir v. United States*.[325] These anecdotes of government interference resulting in economic harm are confirmed by Professors Cole and Ohanian at University of California, Los Angeles, who concluded that New Deal programs like the NIRA allowed politically-connected business to collude and restrict competition, prolonging the Depression by three years.[326]

President Obama's legal training at Harvard coupled with his tenure at the University of Chicago—famous for its law and economics approach to legislation—guarantees that he is at least aware of the arguments summarized in the preceding paragraph. As such, there must be a non-economic explanation for the Obama Administration subsidizing GM. Circumstances show that in return for financial support, GM agreed to produce more environmentally-friendly cars and trucks. In so doing, GM empowered President Obama to accomplish one of his favored policy initiatives, "put[ing] people to work building . . . fuel-efficient cars."[327]

The *quid pro quo* for financial support became clear almost immediately; soon after receiving a cash infusion from the Treasury, GM acknowledged that it "fully underst[ood] and appreciate[d] the challenges to . . . the climate from increased global consumption of petroleum[,]" and pledged to "construct a new manufacturing facility in the United States to build Lithium-Ion battery packs" and work with the United States Department of Energy to produce "alternative fuel and advanced propulsion" vehicles.[328]

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322. *See* discussion *supra* Part I.

323. 30 F.2d 421 (W.D. S.C. 1929).

324. 23 F. Supp. 810 (D. Or. 1938).

325. 616 F. Supp. 613 (E.D.N.Y. 1985).

326. Cole & Ohanian, *supra* note 19, at 813.

327. Obama, *supra* note 24.

328. GENERAL MOTORS CORP., *supra* note 207, at 21–22. Today, GM is building that $43 million lithium-ion battery plant in Detroit, Michigan, and has accelerated production of the Chevy Volt. Alisa Priddle, *Battery Pack Production to Revive Plant*, DETROIT NEWS, Aug. 14, 2009, at 7B ("The $43 million plant . . . will package battery cells for the Chevrolet Volt and other electric vehicles that showcase GM's new direction. 'This facility represents the reality that we will reinvent the automobile.'"); *GM Building Battery Plant to Supply Chevy Volt*, CHEMWEEK'S BUS. DAILY, Aug. 14, 2009 ("General Motors (GM) says it will invest $43 million to build a lithium-ion battery manufacturing

It is clear that the Obama Administration believes that individual shareholder wealth should take a back seat to the common good, emulating the politicians in *Atlas Shrugged* who reasoned that "the only justification of private property . . . is public service."[329] If that is the case, that is fine—and some may find it laudable—but the Obama Administration should tell us the truth, that they believe the current economic downturn presents an opportunity to implement broader social policy. They may find that the American people are receptive to the truth, and maybe even receptive to the policy.

POSTSCRIPT

Just prior to the publication of this Article, GM released a television commercial claiming that it had paid back the federal government "in full." In the commercial, Ed Whitacre strolls through a busy GM factory and pronounces:

> I'm Ed Whitacre from General Motors. A lot of Americans didn't agree with giving GM a second chance. Quite frankly, I can respect that. We want to make this a company that all Americans can be proud of again. That's why I am here to announce we have repaid our government loan, in full, with interest, five years ahead of the original schedule.[330]

Whitacre concludes as pictures of environmentally-friendly plug-in cars flash across the screen: "[f]rom new energy solutions, to the designs of tomorrow, we invite you to take a look at the new GM."[331] The commercial was apparently made to neutralize the stigma that accompanied the federal bailout of GM. The Obama Administration immediately issued a coordinated statement taking credit for the improvement: "[t]his turnaround wasn't an accident of history. It was the result

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plant [near Detroit], MI. The site, which will produce batteries for use in GM's Chevy Volt electric vehicle, is expected to begin production in late 2010.").

329. Rand, *supra* note 2, at 45.

330. *General Motors Television Advertisement, GM Repaid Government Loan Ahead of Schedule* (broadcast on various television stations beginning April 21, 2010), *available at*, http://media.gm.com/content/media/us/en/news/news_detail.brand_gm.html/content/Pages/news/us/en/2010/Apr/0421_fairfax; *see also*, Ed Whitacre, *The GM Bailout, Paid Back in Full*, WALL ST. J., April 21, 2010, at A19.

331. Whitacre, *supra* note 330.

of . . . decisions made by President Obama to provide GM . . . a lifeline."[332]

However, the foregoing is nothing but an "elaborate TARP money shuffle."[333] First, the source of the payment that allows GM to claim that the Treasury had been paid back "in full" was other "TARP funds currently held in an escrow account."[334] This is because when TARP funds were given to GM "it basically wasn't all given as a lump sum check . . . [s]ome of it was put in what's called an equity capital facility, which they can draw down."[335] GM drew from one source of TARP funds to pay back another—the payment did not come from GM profits as implied.

Second, the claim that GM repaid its government loan "in full" is extremely misleading. It may be true that the Treasury no longer has a debt investment in GM. However, the Treasury's equity investment (in the form of both preferred and common shares) remains unchanged; to be clear, GM paid back only that portion of Treasury loans that were not converted into preferred and common stock as part of GM's Chapter 11 bankruptcy—only $7 billion of the total $50 billion made available to GM.[336] The Treasury still owns 60.8 percent of GM, an equity investment with a face value of $41.5 billion.[337] GM's ability to pay back the Treasury's equity investment depends entirely on its ability to make a public offering or IPO to raise funds. However, it is unlikely that an IPO would raise enough funds to purchase back the Treasury investment.[338] For the

332. Nick Bunkley, *G.M. Repays U.S. Loan, While Chrysler Posts Improved Quarterly Results*, N.Y. TIMES, Apr. 22, 2010, at B3.

333. Letter from Charles E. Grassley, U.S. Senator, to Timothy F. Geithner, U.S. Treasury Secretary (April 22, 2010) (quoting Office of the Special Inspector General for TARP, Quarterly Report to Congress dated April 20, 2010, page 115), *available at* http://grassley.senate.gov/about/upload/2010-04-22-Letter-to-Treasury-Department.pdf.

334. *Id.*

335. *On the Financial Institution Tarp Fee: Hearing Before the S. Comm. on Finance* 111th Cong. (April 20, 2010) (testimony of Neil Barofsky, Special Inspector General for the Troubled Asset Relief Program).

336. OFFICE OF FINANCIAL STABILITY, U.S. DEP'T OF TREASURY, TROUBLED ASSET RELIEF PROGRAM TRANSACTIONS REPORT 15 (2010), *available at* http://www.financialstability.gov/docs/transaction-reports/4-26-10%20Transactions%20Report%20as%20of%204-26-10.pdf.

337. *Id.*

338. David Nicklaus, *GM's 'Paid In Full' Is Short By $53 Billion Automaker Is Still Deep In Debt—To The Taxpayers*, ST. LOUIS POST-DISPATCH, April 25, 2010, at E1.

foreseeable future, the federal government will own—and implement environmental policy through—GM.

THE BEAR HUG THAT IS CRUSHING DEBT-BURDENED AMERICANS: WHY OVERZEALOUS REGULATION OF THE DEBT-SETTLEMENT INDUSTRY ULTIMATELY HARMS THE CONSUMERS IT MEANS TO PROTECT

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I. INTRODUCTION

By strangling the free market and substituting their own judgment for those of the American people, regulators and lawmakers are threatening one of the most important right-now solutions to America's consumer financial crisis. For-profit debt-settlement companies are the only entities that can provide consumers who cannot repay their credit card debts with a viable alternative outside of bankruptcy and the expensive, unhelpful debt-management plans offered by credit card banks and their nonprofit credit counselor allies. Even the opponents of the debt-settlement industry agree that struggling Americans need a way, short of consumer bankruptcy, to cut into the insurmountable debt created by credit card banks' aggressive and unscrupulous lending practices. Because the credit card banks and nonprofit credit counselors cannot provide such an option, America needs the services offered by debt-settlement companies. It may be tempting for lawmakers and regulators to succumb to the relentless campaign against the debt-settlement industry, but this is a campaign supported mostly by anecdotal evidence based on the conduct of a handful of bad actors and fueled by television advertisements that do not adequately represent the industry as a whole. Instead, lawmakers and regulators should recognize the importance of debt-settlement services and focus their attention on preventing misrepresentation and deceptive advertising within the industry, while allowing the *market* to set the fair price and method of payment for debt-settlement services. If they do not, then debt settlement will soon be unavailable, and debt laden consumers will ultimately suffer.

II. AMERICA IS BEING CRUSHED BY CREDIT CARD DEBT

Through unscrupulous lending practices and in the midst of a failing economy, credit card banks have burdened American consumers with an unprecedented amount of debt. Despite some signs that the nation's financial state of affairs may be improving, there is no question that the average American is still suffering through increased joblessness, sinking home values, and a slumping economy. Unemployment continues to hover at

about 10%, and as of February 2010, the number of persons unemployed due to job loss had increased by 378,000 to 9.3 million.[1] In January of 2010, the housing market continued to struggle, and existing home sales were at a seven-month low.[2] During 2009, Americans were less happy and more stressed, and their stress was linked both to the failing economy and their own financial uncertainty.[3]

Were that not bad enough, American consumers now carry more unsecured credit card debt than ever before. As of late 2008, consumer debt was at an all-time high.[4] It is only slightly lowered as of the writing of this Article, holding steady at about $2.5 trillion.[5] The problem is ubiquitous—almost 80% of all households that have credit cards owe more than $10,000 in unsecured credit card debt.[6]

The poor economy, however, has merely exacerbated an extant problem. Rather, it is the longtime use of aggressive and unscrupulous lending practices by powerful credit card banks that has put Americans further into the hole than they have ever been before.[7] Between 2001 and 2008, unsecured credit card debt rose by 30%.[8] At the time, the credit card industry promised Americans that bankruptcy reform would make credit cheaper and more affordable for everyone.[9] Despite this promise, however, bankruptcy reform "profited credit card

1. Press Release, Bureau of Labor Statistics, Employment Situation Summary (Feb. 5, 2010), *available at* http://www.bls.gov/news.release.

2. Press Release, Nat'l Ass'n of Realtors, Existing-Home Sales Down in January but Higher than a Year Ago; Prices Steady (Feb. 26, 2010), *available at* http://realtor.org/press_room/news_release/2010/02/ehs_january2010.

3. Dan Witters, *Americans Less Happy, More Stressed in 2009*, GALLUP, Jan. 1, 2010, http://www.gallup.com/poll/124904/Americans-Less-Happy-Stressed-2009.aspx.

4. Federal Reserve Statistical Release, *Consumer Credit*, G.19 (Feb. 5, 2010), *available at* http://www.federalreserve.gov/releases/g19/20100205/.

5. Federal Reserve Statistical Release, *Consumer Credit*, G.19 (Mar. 5, 2010), *available at* http://www.federalreserve.gov/releases/g19/Current.

6. Ben Woolsey & Matt Schulz, *Credit Card Statistics, Industry Facts, Debt Statistics*, CreditCards.com (2009), http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php.

7. *See* Barbara Kiviat, *How Americans Got into a Credit-Card Mess*, TIME, Aug. 8, 2009, *available at* http://www.time.com/business/article/0,8599,1915015,00.html (containing a Q&A with Charles Geisst, Professor of Finance at Manhattan College, concerning the history of Americans and borrowed money).

8. Robert M. Lawless, *Did Bankruptcy Reform Fail?*, 82 AM. BANKR. L.J. 349, 350 n.3 (2008).

9. Michael Simkovic, *The Effect of BAPCPA on Credit Card Industry Profits and Prices*, 83 AM. BANKR. L.J. 1, 3 (2009).

companies at consumers' expense."[10] Credit has become more expensive, not less,[11] and lenders' actions have caused greater financial stress on their borrowers. In May of 2009, the White House stated, "[F]or too long credit card contracts and practices have been unfairly and deceptively complicated, often leading consumers to pay more than they reasonably expect. Every year, Americans pay around $15 billion in fees."[12]

The consumer credit card banks' egregious and aggressive lending practices led Congress to pass the Credit CARD Act of 2009, which purportedly protects consumers from contracts that package high interest rates with a low introductory APR to lure consumers into signing agreements that they cannot realistically afford.[13] Unfortunately, the Credit CARD Act of 2009 is full of loopholes. Banks can still raise interest rates, as long as they give consumers 45 days notice.[14] Furthermore, the penalty interest rates remain high and banks are charging increasingly more for cash advances.[15] There are already signs that the banks are finding ways to increase consumer debt and erect more and more barriers to debt-free living by increasing penalties and simply lengthening the duration of their bait-and-switch introductory offers.[16] In anticipation of the Credit CARD Act, lenders have already been raising interest rates and penalties, thus increasing the debt load on the average American

10. *Id.* at 1.

11. *Id.* at 14–16, 22 (concluding from an analysis of the data that passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.) caused an increase in credit card rates and the profits of credit card companies). *See also* Credit Card Monitor, *Current Average Credit Card Interest Rates*, Credit Card Monitor (May 15, 2010) http://www.indexcreditcards.com/credit-card-rates-monitor/ (noting that credit card interest rates have increased in response to the passage of recent legislation).

12. Press Release, Office of the Press Sec'y of the White House, Fact Sheet: Reforms to Protect Am. Credit Card Holders (May 22, 2009), *available at* http://www.whitehouse.gov/the_press_office/Fact-Sheet-Reforms-to-Protect-American-Credit-Card-Holders.

13. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. 111-24, May 22, 2009, 123 Stat. 1734 (2009).

14. 15 U.S.C. § 1637(i)(2). This only applies to credit card accounts under an open-end consumer credit plan. *Id.*

15. Zachary Stauffer, *Tricks & Traps of the Card Game*, http://www.pbs.org/wgbh/pages/frontline/creditcards/themes/tricks.html (last visited May 26, 2010).

16. Pew Health Group, *Still Waiting: "Unfair or Deceptive" Credit Card Practices Continue as Americans Wait for New Reforms to Take Effect* 1–3, 6–9 (Oct. 2009), http://www.pewtrusts.org/uloadedFiles/wwwpewtrustsorg/Reports/Credit_Cards/Pew_Credit_Cards_Oct09_Final.pdf

cardholder.[17]

Given that these lenders have crippled many American households, and given that the current economy is making it harder for Americans to pay down their debt, most consumers need help. Sadly, as I will discuss below, most of the options available to consumers who need help with their credit card debt have been manipulated by, or are being indirectly controlled by, the very lenders from whom consumers seek relief. As a result, people who cannot realistically pay off all of their debt—often because of exorbitant interest, fees, and penalties—need the services offered by the debt-settlement industry because that industry is the only independent option through which they can reduce their debt.

III. BANKRUPTCY IS NOT AN OPTION

More consumers than ever cannot, or will not, choose to enter individual bankruptcy when they are unable to pay off their credit card debt. Today, debt-burdened consumers are less likely to file for bankruptcy protection because they: 1) cannot qualify for bankruptcy under the new reformed laws; 2) are discouraged by the procedural hurdles to individual bankruptcy; or 3) are unwilling to live with the stigma associated with bankruptcy. For whatever reason, more individuals are struggling with debt outside of bankruptcy than ever before.[18]

Traditionally, when an individual's debt outgrew their income and they lost all realistic hope of ever repaying their creditors, they could file for bankruptcy. Through Chapter 7, individuals would receive a fresh start so long as they surrendered their assets to the court.[19] Chapter 13, on the other hand, gave the court special powers to forgive or modify portions of the individual's debt obligations, while still requiring the individual to repay as much of the debt as possible.[20] Bankruptcy reform has made these options less available.

17. *Id.* at 1, 25.

18. Lawless, *supra* note 8, at 350–51.

19. Scott F. Norberg, *Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13*, 7 AM. BANKR. INST. L. REV. 415, 420–22 (1999).

20. *Id.* at 423–25.

In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).[21] According to its proponents, it was intended to prevent individuals would could repay their debts from gaming the system.[22] Its supporters, including former President George W. Bush, argued that by forcing those who could pay their debts to do so and preserving bankruptcy for those truly in need, it would lower the cost of credit and help everyone.[23] Unfortunately, BAPCPA has failed.[24] It does not screen those who can pay their debts from those who cannot. Instead, it discourages everyone, regardless of income, from filing for bankruptcy.[25]

As a result of BAPCPA, more consumers in need are struggling outside of bankruptcy for longer periods of time, thus increasing credit card banks' revenue. BAPCPA discourages bankruptcy filings not only by making it harder to qualify for Chapter 7,[26] but also by erecting procedural hurdles to filing, such as mandatory credit counseling, longer waiting periods between permitted filings, and a lot more paperwork.[27] Professor J.J. White from the University of Michigan has described this as a "death by a thousand cuts through low-visibility procedural burdens."[28] The end result is that BAPCPA has made bankruptcy less available for individuals suffering under insurmountable credit card debt.

BAPCPA, however, is not the only reason why bankruptcy is not an option for many consumers. Despite arguments to the contrary, many individuals who likely could qualify for post-reform individual bankruptcy still refuse to do so because of the social stigma attached to bankruptcy.[29] In a recent study,

21. Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.); *e.g.*, 11 U.S.C. § 707 (means test under revised bankruptcy code).

22. Lawless, *supra* note 8, at 351–52.

23. Simkovic, *supra* note 9, at 2–3.

24. Lawless, *supra* note 8, at 385–86; Simkovic, *supra* note 9, at 22–24.

25. Lawless, *supra* note 8, at 353, 385–86.

26. *Id.* at 352 (discussing the imposition of a "means test" that examines expenses and income as determinative for transfer to Chapter 11 or 13); *see* Patricia Sabatini, *New Law's 'Means' Test Just Mean, Bankruptcy Experts Say*, PITTSBURGH POST GAZETTE, Apr. 26, 2005, E-1.

27. 11 U.S.C. §§ 109(h)(1), 521, 727(a)(11), 1328(g) (2006). *See also* Lawless, *supra* note 8, at 380 (restating the new requirements imposed by BAPCPA); Simkovic, *supra* note 9, at 2.

28. Lawless, *supra* note 8, at 380 (citing James J. White, *Abuse Prevention 2005*, 71 MO. L. REV. 863 (2006)).

29. *Id.* at 384.

sociologists concluded that people who file for bankruptcy still experience social stigma, and that society may view—and thus treat—those who file for consumer bankruptcy as deadbeats who "rip off the system."[30] The bankrupt families that were the subject of this study viewed bankruptcy as a failure.[31] If their views are indeed common, then it is more than reasonable to conclude that there are many others with substantial consumer debt who choose not to file for fear of being stigmatized by their peers, friends, and neighbors.[32]

Whether due to social stigma or BAPCPA, as the 2007 Consumer Bankruptcy Project concluded, "it is clear that families are not turning to bankruptcy even when they have great need."[33]

IV. TRADITIONAL DEBT MANAGEMENT IS NOT FOR EVERYONE

Many consumers struggling with debt cannot qualify for the traditional debt management plans offered by nonprofit credit counselors. For years, credit card banks have offered "debt management plans" to those who cannot repay their credit card

30. Deborah Thorne & Leon Anderson, *Managing the Stigma of Personal Bankruptcy*, 39 SOC. FOCUS 77 (2006) (analyzing "face-to-face interviews of 37 individuals from 19 married couples who had filed joint petitions for personal bankruptcy . . . within three months of the couples' bankruptcy filings"). Thorne & Anderson note that the thirty-eighth interviewee "hid upstairs [and declined to be interviewed] because, as his wife said, he was ashamed of their bankruptcy." *Id.* at 80.

31. *Id.* at 93.

> Our findings are clear. Feelings of stigmatization were a pervasive feature of our informants' bankruptcy experiences . . . . Significantly, these comments emerged without specific prodding from the interviewer regarding stigmatization. Further, our informants exhibited many classic techniques documented in previous sociological literature for attempting to manage stigma. They strived to conceal their spoiled identities, especially from particularly significant others. Fearing embarrassment, they avoided interactions with those who might know of their recent failings. . . . [T]hey distanced themselves from stereotypical images of illegitimate bankruptcy filers, provided excuses and justifications for their own bankruptcies, and described their attempts at activities that would enable them, at least partially, to transcend their stigmatized identities.
>
> Our findings contrast with the economic model of personal bankruptcy motivation associated with the loss of stigma argument. . . . While bankruptcy is clearly an act in which economic concerns figure prominently, those who declare bankruptcy do so within a culture context of shame, embarrassment, and assertions of their moral failure. *Id.* at 93–94.

Thorne and Anderson also noted that their findings were consistent with other studies. *Id.*

32. *Id.*

33. Lawless, *supra* note 8, at 386.

debt. These plans are most often offered through nonprofit credit counselors, who act as intermediaries between banks and consumers.[34] After undergoing counseling and budgeting education, an individual who qualifies for a debt management plan makes one monthly payment to the debt management plan provider, who then distributes portions of the payment to each of the consumer's lenders.[35] To make this single payment more affordable, the banks purportedly lower interest rates on the consolidated debt.[36] In the past, banks were willing to eliminate almost all interest for those who qualified for a debt management plan.[37] Recently, however, interest rates on debt that has been consolidated into a debt management plan have steadily risen.[38] The debt management plan drafts payments directly from the individual's checking account, making payments more regular and predictable.[39] If the individuals make all of their payments and do not continue to charge expenses to their credit cards, then they will usually be debt-free within sixty months.[40]

This process appears quite innocuous and on its surface seems to provide struggling consumers with a way to get out of debt. However, nonprofit credit counselors and the debt management programs that they offer do not provide an overwhelming benefit to consumers. Instead, these programs just provide banks with one more chance to squeeze money from nonpaying

34. *Consumer Protection and the Credit Crisis: Hearing Before the S. Comm. on Commerce, Science, & Transportation*, 111th Cong. 10–11 (2009) [hereinafter *Hearing*], (statement of Hon. Pamela Jones Harbour, Commissioner, Federal Trade Commission).

35. *Id.* at 11 n.31.

36. Tara Siegel Bernard, *Weighing the Options with Credit Card Debt*, N.Y. TIMES, May 16, 2009, at B6, *available at* http://www.nytimes.com/2009/05/16/your-money/credit-and-debit-cards/16counsel.html.

37. *Id.*

38. DEANNE LOONIN & TRAVIS PLUNKETT, CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR. INC, CREDIT COUNSELING IN CRISIS: THE IMPACT ON CONSUMERS OF FUNDING CUTS, HIGHER FEES AND AGGRESSIVE NEW MARKET ENTRANTS 22 (Consumer Fed'n of Am. & Nat'l Consumer Law Center, Apr. 2003), *available at* http://www.consumerfed.org/pdfs/credit_counseling_report.pdf ("[C]reditor policies on reducing interest rates vary tremendously. . . . Most major credit card issuers have raised their interest rates in credit counseling or kept them above 9 percent in the last few years, although Chase Manhattan and Providian are notably bucking this trend.").

39. *Id.* at 8 (noting that competition from "newcomers" to the industry has spurred debt-settlement companies to "pioneer[] more business-like methods of making debt management plans convenient for consumers, including flexible hours, phone and Internet counseling, and electronic payments").

40. *E.g.*, Hummingbird Credit Counseling and Education, Debt Management Plans, http://www.hummingbird.org/learning/financialalts/?id=5 (last visited May 26, 2010).

customers. The most important and often hidden fact is that many nonprofit credit counselors are funded by the credit card companies themselves.[41] The credit card companies created the entire industry as an additional way to collect overdue debt.[42] Traditionally, the credit card companies support the nonprofits through regular "fair share" payments made directly to the credit counselors.[43] Nonprofit credit counselors now claim that fair share payments have diminished.[44] However, it seems that the credit cards have simply replaced the controversial fair share payments with large "grants" to the national nonprofit credit counseling companies.[45] Whether through fair share payments or grants, the banks fund the nonprofit credit counselors.[46]

Trusting that these counselors have their best interest in mind because of their "nonprofit" status, consumers walk voluntarily into the lion's den. Nonprofit credit counselors, who have the opportunity to see the individual's budget and spending habits as part of their budgeting and "education" services, may use this information to squeeze as much money as possible out of the consumers on behalf of the credit card companies.[47] In addition to the money they receive from the credit cards, the counselors also keep a sizeable amount of money for themselves through DMP fees.[48] Although some nonprofit credit counselors are genuinely concerned about their clients and focus their efforts on counseling and budgeting, many large regional and

41. *Hearing, supra* note 34, at 33–34 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America); *see also* Mary Kane, *Ties Run Deep Between Subprime Lenders, Financial Literary Groups*, THE WASH. INDEP. Nov. 12, 2009.

42. *Hearing, supra* note 34, at 33 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

43. Hummingbird Credit Counseling and Education, *supra* note 40.

44. LOONIN & PLUNKETT, *supra* note 38, at 10 (citing earlier reports drafted by the Consumer Federation of America and the National Foundation for Credit Counseling).

45. *See Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule* 77 (Nov. 4, 2009) (statement Jane McNamara) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); *Hearing, supra* note 34, at 33 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

46. Allen Mattison, Note and Comment, *Can the New Bankruptcy Law Benefit Debtors Too? Interpreting the 2005 Bankruptcy Act to Clean Up the Credit-Counseling Industry and Save Debtors from Chronic Poverty*, 13 GEO. J. ON POVERTY L. & POL'Y 513, 523–24 (2006).

47. *See* LOONIN & PLUNKETT, *supra* note 38, at 31 (noting potential violations by credit counseling agencies of the restrictions imposed by their nonprofit status and alarming connections with for-profit lenders).

48. *See Legislative Highlights: Pension Reform Charges Airline and Credit Counseling Requirements*, AM. BANKR. INST. J., Sept. 2006, at 8.

nationwide credit counselors are designed to maximize revenue from the credit card banks and consumers.[49]

In either case, nonprofit credit counselors are paid to enroll nonpaying or struggling borrowers into a monthly payment plan that utilizes direct drafts from the borrower's checking account. To many regulators, this may have sounded a lot more like debt collection than nonprofit credit counseling. It is thus no surprise that the FTC and the IRS cracked down on false nonprofit credit counselors who were simply pushing consumers into debt management plans and hiding from tax liability by claiming that they were primarily "educating" consumers.[50] Despite this crackdown, some nonprofit credit counselors continue to defraud consumers.[51]

What is even more troubling is that only about one quarter of the individuals who enter debt management programs successfully complete them.[52] In addition, because a debt management plan requires consumers to pay back all of their principal debt, *plus* a lowered amount of interest to the banks, *plus* a monthly service fee paid to the plan itself, many individuals who are truly struggling with their debt don't even qualify for traditional debt management in the first place.[53] These plans are just too expensive. They do not offer realistic help to struggling consumers.[54]

Given that fewer consumers than ever even qualify for debt management plans, given that only about one quarter of those who even enter into those plans actually finish, and given that the nonprofit credit counselors who sell those plans are no more than an arm of the credit card banks themselves, most consumers cannot, or should not, turn to a traditional debt

49. S. REP. NO. 109-55, at 1–4 (2005).

50. *Id.*

51. Long after the purported house cleaning of the non-profit credit counseling industry, the FTC continued to successfully bring enforcement actions against so-called non-profit credit counselors. *Hearing, supra* note 34, at 11 (statement of Hon. Pamela Jones Harbour, Commissioner, Federal Trade Commission).

52. Robert M. Hunt, *Whither Consumer Credit Counseling?*, BUSINESS REVIEW, Q4 2005, at 9, 13, (noting that "approximately one-half of debt management plans fail after about six months").

53. *Transcript of FTC Debt Settlement Workshop* 6 (Sept. 25, 2008) (statement of Lydia Parnes) ("Although the number of consumers contacting [non-profit credit counselors] about debt has increased by about 33 percent, the percentage of consumers who meet the income requirement for debt management plans is down over 40 percent.").

54. *Hearing, supra* note 34, at 27–43 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

management plan when they are being crushed by credit card debt.

V. DEBT SETTLEMENT IS THE MIDDLE-GROUND OPTION THAT AMERICA NEEDS.

American consumers who cannot or will not enter into bankruptcy and cannot qualify for a traditional debt management plan need the help that only honest debt-settlement companies can provide. The consumers who especially need help are people who, even over several years, do not have enough income to pay off the full balance they owe but do not qualify for bankruptcy after BAPCPA. Respected debt-relief industry leaders and consumer rights' advocates both agree that struggling Americans need a non-bankruptcy way out of debt that does not require them to re-pay their full debt balance since the equivalent principal amount has often been paid in the form of interest.[55] What is puzzling is that the same people who are demanding this option will not admit that debt-settlement offers this middle ground. Perhaps this is because debt settlement's critics are funded by the credit card companies themselves and are thus invested in preventing consumers from having an option that is truly independent from the credit cards.[56] For this reason, Georgetown Law Professor Adam Levitan recently stated that he would trust a for-profit debt-settlement company to assist a consumer with credit card debt before he would trust a nonprofit credit counselor funded by the credit card companies themselves.[57]

If one takes a step back and looks at the entire debt-relief marketplace, it seems clear that a wisely-regulated debt-settlement industry provides the middle-ground solution that America needs. By helping consumers take advantage of the routine willingness of credit card banks to discharge a consumer's entire debt for a lump sum payment totaling far less

55. *See Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule* 143 (Nov. 4, 2009) (statement of William Binzel) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); *Hearing, supra* note 34, at 29 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America, that "Consumers want something that gives them more assistance [than] credit counseling that stops short of bankruptcy").

56. *See supra*, Part III.

57. *Hearing, supra* note 34, at 33–34; *see also* Kane, *supra* note 41.

than the amount owed,[58] debt-settlement companies provide the only service outside of bankruptcy that allows customers to cut into the principle of the debt they owe. Although their critics argue that the debt-settlement industry provides little value to consumers, debt-settlement companies regularly settle their customers' credit card accounts in exchange for lump-sum payments of substantially less than the total amount owed by cardholders.[59] A New York state court recently held that when a debt-settlement company bargains down a consumer's debt, it is indeed providing real value to that consumer.[60] It is thus no surprise that in late 2008 FTC Commissioner Rosch noted that "debt settlement, even at a cost, can play an important role in solving what may seem like insurmountable problems of indebtedness faced by many consumers."[61]

Remarkably, the nonprofit credit counselors and consumer advocates who routinely criticize the debt-settlement industry actually admit that the concept of debt settlement is sound and provides struggling Americans with what they need. At a recent FTC public forum held to elicit commentary from the debt-relief industry and its experts, William Binzel, President of the National Foundation of Credit Counselors (NFCC) and an outspoken critic of the debt-settlement industry, said: "I think there is a consensus in this room . . . that the product of debt settlement in itself, whether we call it debt settlement or less than full balance settlement, whatever that is, there is a

58. *See, e.g., Transcript of FTC Debt Settlement Workshop* 87 (Sept. 25, 2008) (statement of Jack Craven); Jane Birnbaum, *Debt Relief Can Cause Headaches of Its Own*, N.Y. TIMES, Feb. 9, 2008, at C1.

59. RICHARD A. BRIESCH, ECONOMIC FACTORS AND THE DEBT MANAGEMENT INDUSTRY 2–3 (Americans for Consumer Credit Choice, Aug. 6, 2009); *see also* Letter from Richard A. Briesch to FTC (Oct. 27, 2009), *available at* http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00306.pdf (regarding proposed amendment to the Telemarketing Sales Rule number R411001).

60. *People v. Nationwide Asset Servs., Inc.*, 888 N.Y.S.2d 850, 867, 870–71 (N.Y. Sup. Ct., Erie County 2009). This was an especially remarkable holding given that the court found that the debt-settlement company defendant had engaged in consumer fraud. If a debt-settlement company that has been found to have defrauded consumers in the State of New York can still provide value to its customers by reducing their credit card debt, then certainly the other members of the industry can be a real part of the solution to the current economic crisis.

61. *Transcript of FTC Debt Settlement Workshop* 6 (Sept. 25, 2008) (statement of J. Thomas Rosch). I would submit that debt settlement can only be offered "at a cost" and only in a wisely regulated and functioning market can that "cost" be determined. Nonetheless, the Commissioner's statements emphasize that honest debt settlement is indeed part of the solution. *Id.*

consumer need for that."[62] Likewise, Travis Plunkett, of the Consumer Federation of America,[63] who—based only on anecdotes and a handful of enforcement actions against sham debt-settlement companies—has aggressively criticized the debt-settlement industry in front of the Federal Trade Commission, U.S. Senate, and other regulatory and law-making bodies; has been pleading for a debt-relief option short of bankruptcy that will cut into the principal that consumers owe to their credit card banks.[64] Yet, like the nonprofit credit counselors, Mr. Plunkett wants the banking regulators to allow the credit card banks, not the debt-settlement companies, to offer this product in a way that will help their bottom line and allow them to avoid writing off these accounts as losses.[65]

A. *The Banks Will Not Offer a Less-Than-Full-Balance Debt-Settlement Product*

The fact is, however, that neither the banks nor the nonprofit credit counselors[66] will realistically offer a "less-than-full-balance" recovery option to debt-strapped consumers.

If a credit card borrower fails to make his or her minimum payments for six months, they are considered to be in default.[67] Once a borrower is in default, the Office of the Comptroller of the Currency Administrator of National Banks (OCC), which regulates the credit card banks, requires the lenders to write off the defaulted account as a "loss" in their accounting records.[68]

62. *Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule* 143 (Nov. 4, 2009) (statement of William Binzel) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

63. The Consumer Federation of America describes itself as an advocacy, research, education, and service organization, with members who include non-profit organizations. CFA testifies on consumer issues before legislative and regulatory bodies, investigates and provides research on consumer issues, and disseminates information on consumer issues to the public and the media. *See generally* Consumer Federation of America, http://www.consumerfed.org/about/default.asp (last visited May 26, 2010).

64. *Hearing, supra* note 34, at 34 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

65. *Id.* (urging the bank regulators to "quickly create a regulatory path that would allow and encourage issuers to offer reduced principal DMPs").

66. *See infra*, Part IV.B.

67. For a general overview of mark-to-market presorting and Generally Accepted Accounting Principles (GAAP), *see Mark-to-Market Accounting: Practices and Implications: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises*, 111th Cong. 19–58 (2009) (testimony of Kevin J. Bailey, Deputy Comptroller, Office of the Comptroller of the Currency).

68. *Id.*

Once the account is a loss, the bank can do whatever necessary to recover as much of the defaulted debt as possible, including settling the debt or selling it to a collection company or debt buyer for pennies on the dollar.[69] Currently, banks do not admit that they are accepting less than the total amount owed in full discharge of the debt and often try to make it appear as if they are not bargaining with debt-settlement companies, either by selling the debt off to debt buyers who then settle the debt themselves or by settling the debt through affiliates.[70] Yet, having been forced to write off the defaulting accounts as a loss, the credit card companies continue to settle debt when faced with a consumer or a debt-settlement company that is willing to stand their ground and bargain down the debt.[71]

Although the banks could agree right now to offer an institutional "product" to distressed borrowers that would allow them to discharge their defaulted debt by paying less than what they owe, this would be like a bank saying: "We'll give you a credit card and if you charge more than you can repay, then you don't have to pay it all back." It is unthinkable for a credit card company to take this position as a matter of policy. Indeed, it would be bad for the banks, their owners, and their investors. Instead, it seems that, other than through adversarial debt settlement, banks would only offer a less-than-full-balance debt-relief option if they could avoid writing off the defaulted accounts as losses and thus appear more profitable. In a letter to the OCC, the Consumer Federation of America and the Financial Services Roundtable requested that the OCC give credit card companies and nonprofit credit counselors permission to do this very thing.[72]

The OCC, however, voiced concerns that "major lenders and credit counseling agencies ... are failing to differentiate between working with distressed borrowers and a desire to simply acquire forbearance on loss recognition."[73] As a result,

69. Liz Pulliam Weston, *Credit card debt: How to cut a deal*, MSN MONEY, Mar. 5, 2010.

70. *Id.*

71. DEANNE LOONIN & JULIA DEVANTHERY, THE LIFE AND DEBT CYCLE 19 (National Consumer Law Center, Sept. 2006).

72. Letter from Timothy W. Long, Senior Deputy Comptroller, Bank Supervision Policy and Chief Nat'l Bank Examiner, Office of the Comptroller of the Currency, to Scott Talbot, Senior Vice President, The Financial Services Roundtable and Travis Plunkett, Legislative Director, Consumer Federation of America (Nov. 10, 2008) (on file with author).

73. *Id.*

the OCC stated that "banks certainly have the option to offer principal relief as long as the loans are accounted for off-balance sheet [recorded as losses] with any repayment recorded as a recovery."[74] In other words, the OCC said "no." For this reason, it appears that banks will not be able to offer a less-than-full-balance debt-relief option directly to struggling consumers.

B. *Nonprofit Credit Counselors Cannot Offer Debt-Settlement Services*

For this same reason, the nonprofit credit counselors cannot offer a less-than-full-principal debt-relief option either. The only way that a consumer can cut into the principal of the debt that they owe to a credit card lender is for the consumer—alone or with the help of a strong consumer advocate, like a debt-settlement company—to stand up to the credit card company in a truly adversarial posture and bargain for the debt reduction. Nonprofit credit counselors cannot advocate for consumers by taking on the credit card companies, because they are funded and controlled by the credit card companies.[75] Thus, if the credit card companies do not offer a product like debt settlement to struggling borrowers—and they will not, since OCC will not allow it—then neither will nonprofit credit counselors.

Beyond their inability to bite the hand that feeds them, nonprofit credit counselors also cannot offer true less-than-full-principal debt-settlement services because doing so would threaten their nonprofit status. If a tax-exempt nonprofit were to engage in adversarial negotiations with a lender in order to reduce a consumer's debt, the nonprofit would be stepping outside of their recognizable tax-exempt function and engaging in pecuniary activity that would necessarily be subject to corporate taxation.[76]

Therefore, only for-profit debt-settlement companies can provide Americans with the middle-ground debt-relief option that they need.

74. *Id.*

75. *See supra* notes 41–51 and accompanying text.

76. *See* Robert Davis, FTC Public Comment on Notice of Proposed Rulemaking (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

VI. BIASED CRITICISM HAS LED TO OVER-REGULATION OF THE DEBT-SETTLEMENT INDUSTRY

Nonprofit credit counselors and consumer advocacy groups have created a mob mentality when it comes to the debt-settlement industry.[77] Although credit counselors and consumer advocates actually agree that the concept of debt settlement, which they refer to as "less than full principal recovery," is good for the United States,[78] they have somehow turned "debt settlement" into a dirty phrase. Whenever given the opportunity, these groups have demanded that debt settlement be made unlawful. In fact, it seems that the NFCC has been lobbying the Senate, White House and the FTC in an effort to outlaw or severely limit the services that debt settlement can provide to struggling consumers.[79]

State attorneys general, lawmakers, the FTC and other regulators should not give much weight to criticism from the NFCC and other credit counseling companies because the credit card companies indirectly control these nonprofits. Such criticism should also be disregarded because credit counselors believe that if debt settlement did not exist, more consumers would be forced into credit counseling: either through the mandatory counseling required under the reformed bankruptcy provisions or as debt management plan customers. In other words, nonprofit credit counselors compete against debt-settlement companies, and thus their criticism should be taken with a grain of salt.[80] In addition, credit counselors and

77. *See* National Foundation for Credit Counseling: Consumer Alert, http://www.nfcc.org/consumeralert (last visited May 26, 2010) (claiming that debt settlement is not trustworthy without substantiating or supporting these broad stroke conclusions); *see also* South Brooklyn Legal Services, FTC Public Comment on Notice of Proposed Rulemaking, at 1 (Oct. 26, 2009), (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); Susan Grant, FTC Public Comment on Notice of Proposed Rulemaking (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); *Hearing, supra* note 34, at 34–37 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

78. *Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule* 143 (Nov. 4, 2009) (statement of William Binzel) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001); *Hearing, supra* note 34, at 34 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

79. *E.g.*, Lobbying Report of the National Foundation for Credit Counseling Q1–Q4 (2009) (disclosing that the NFCC lobbied the U.S. House, the Senate, the Executive Office of the President, the FTC, and the OCC regarding "regulation of the for-profit counseling and debt settlement industry").

80. When non-profits that are primarily concerned with revenue compete in an established market, the playing field is skewed, and the for-profit players are eventually squeezed out, leaving a monopoly controlled by the non-profits. This is especially

consumer advocates point only to a handful of successful enforcement actions against bad actor debt-settlement companies and anecdotal evidence from consumers when criticizing debt settlement.[81] Yet, they fail to substantiate why their anecdotal conclusions should be applied to all debt-settlement companies across the board and also ignore the real-life stories from individuals who have been saved by debt settlement. One such example was presented by Credit Solutions, Inc. in support of its opposition to pending FTC rules governing debt settlement:

> [Debt settlement] gave us a life line and has been helping us settle our debt by allowing us to save our money in our bank and paying our creditors directly from our bank . . . . We are truly thankful there was a program available when we had no other option except bankruptcy.[82]

Unfortunately, the nonprofit credit counselors' message has taken hold. This general conclusion—that the business model of debt settlement is *per se* unlawful—has found its way into actual complaints filed by state attorneys general.[83] Yet it makes

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troublesome in the area of debt relief because the non-profits are controlled by the credit card companies. Thus, if the non-profits succeed in eliminating debt settlement, consumers will not be able to work with any company that is truly on their side and independent from the credit card companies.

81. *See, e.g.*, Aleksandra Todorova, *Debt Settlement: A Costly Escape*, MSN MONEY, Aug. 6, 2007 (criticizing debt-settlement companies' high drop-out rates via admittedly anecdotal evidence and warning services may be illegal in some states without reference to empirical data or enforcement actions). A recent FTC notice of proposed rulemaking heavily criticized the debt-settlement business model, basing its claims on statements and submissions from the Consumer Federation of America and the NFCC, among others. Telemarketing Sales Rule, 74 Fed. Reg. 41988, 41993–97 (proposed Aug. 19, 2009) [hereinafter Telemarketing Sales Rule] (to be codified at 16 C.F.R. pt. 310). In doing so, the FTC supported its assertions about the debt-settlement industry by repeatedly citing to a small number of enforcement actions that had been brought against bad actors. *E.g., id.* at 41966 nn.108–17 (continually citing FTC v. Debt-Set, Inc., No. 07-00558 (D. Colo. 2007); FTC v. Dennis Connelly, No. 06-701 (C.D. Cal. 2006); FTC v. Innovative Systems Technology, Inc., No. 04-0728 C.D. Cal. 2004); FTC v. Jubilee Fin. Servs., Inc., No. 02-6468 (C.D. Cal 2002)). It is also worth noting that "[a]ll these cases ended in settlement orders." J. Thomas Rosch, Commissioner, Fed. Trade Comm'n, Remarks before the 4th Annual Credit and Collection News Conference 6 n.13 (Apr. 2, 2009). *But cf.* Telemarketing Sales Rule, at 41997 (noting a number of state actions that have resulted in a variety of outcomes).

82. Credit Solutions of America, FTC Public Comment on Notice of Proposed Rulemaking 27 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendment R411001).

83. *See, e.g.*, Fed. Trade Comm'n Notice of Proposed Rulemaking, 74 Fed. Reg. 41988, 41996 (Aug. 19, 2009) (concluding broadly that debt settlement is likely to harm consumers based only on a handful of enforcement actions against bad actors within the industry); Press Release, Ill. Attorney Gen., Attorney Gen. Madigan Continues Crackdown on Debt Settlement Indus. (Sept. 30, 2009) [hereinafter Ill. Attorney Gen.],

no more sense for consumer advocacy groups, regulators, and opponents of debt settlement to write off an entire industry based upon a handful of anecdotes and successful enforcement actions than it does to conclude that *all* nonprofit credit counselors are gaming the system and harming consumers simply because *some* of them are.[84] Regulators and lawmakers should recognize that the same organizations and experts who criticize debt settlement inconsistently admit that the debt-settlement product is good for consumers. What's more, the nonprofit credit counselors who are so eager to criticize the debt-settlement companies would like the opportunity to sell a "less than full principal" debt-relief product themselves.[85]

Proponents of the debt-settlement industry do not defend misleading late night television advertisements, nor do they advocate for regulation that would allow deceptive or misleading advertising.[86] However, they would assert that this often-repeated statement that the debt-settlement business model is inherently wrong[87] or harmful to consumers must be debunked once and for all. To argue that "all debt-settlement companies are bad because some of them are" is to fall prey to the logical

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available at http://www.illinoisattorneygeneral.gov/pressroom/2009_09/20090930.html (concluding broadly that debt settlement is not trustworthy and conspicuously directing consumers to contact the NFCC for a "legitimate credit counseling firm"); Press Release, N.Y. Attorney Gen., Attorney Gen. Cuomo Announces Nationwide Investigation into Debt Settlement Indus. (May 7, 2009) [hereinafter N.Y. Attorney Gen.], *available at* http://www.ag.ny.gov/media_center/2009/may/may7a_09.html (claiming that debt settlement is "inherently flawed" before the investigation had even been completed and suggesting in the same press release that consumers should instead contact a "certified credit counselor").

84. "[T]he IRS has found that many credit counseling organizations operating as tax-exempt charities are now primarily sellers of debt-reduction plans, motivated by profit, and offering little or no counseling or education." Internal Revenue Service, Treas. Dep't, Credit Counseling Compliance Project at 1 (May 15, 2006), *available at* http://www.irs.treas.gov/pub/irs-trege/cc-report.pdf (Of 63 cases examined, the IRS proposed revocation of 32 and actually revoked the non-profit status of 9 non-profit credit counselors).

85. *Transcript of FTC Public Forum on Debt Relief Amendments to the Telemarketing Sales Rule*, at 49 (Nov. 4, 2009) (statement of Jane McNamara) (regarding Proposed Debt Relief Amendment R411001).

86. *Transcript of FTC Debt Settlement Workshop* 137–39 (Sept. 25, 2008) (statement of Wesley Young, Legislative Director, The Ass'n of Settlement Cos.(TASC)) (noting that the position of TASC would be to disallow its members to present advertising resembling a proffered example and that in any case TASC requires its members to provide their customers with full price disclosure prior to their agreeing to enter a debt-settlement program).

87. It appears that this concept has been pushed by, among others, the Consumer Federation of America. *Hearing*, *supra* note 34, at 34 (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

fallacy of accident or *secundum quid.* Besides, this argument would apply equally to the nonprofit credit counseling industry, which has been rife with fraud and abuse.

Sadly, if regulators and lawmakers continue assuming that the business of debt settlement is inherently wrong and should be prohibited altogether, rather than focusing their actions on the opportunists and bad actors that do exist within the debt-settlement industry (just as they exist in the nonprofit credit counseling industry), then consumers will ultimately be harmed. The eradication of the debt-settlement industry will remove the middle-ground option for Americans burdened by debt. Instead, these debtors will be forced to suffer outside of the bankruptcy system for much longer, [88] facing destitution while padding credit card companies' pockets. Or worse, they may consider even more extreme alternatives.[89]

VII. A BETTER SOLUTION: REGULATING ADVERTISING AND MARKET TRANSPARENCY

Regulators and lawmakers should focus on eliminating the bad actors in debt settlement by regulating advertising and the transparency of the debt-settlement market, but must allow the market to set prices through honest and fair competition. As a result of the organized attack on the entire debt-settlement industry, and likely fueled by the unfortunate television advertising that antagonizes debt settlement's critics but does not fairly represent honest industry players, state and federal lawmakers are threatening to eliminate the industry altogether. Several states are either bringing or considering enforcement actions intended to put existing debt-settlement companies out of business altogether. These lawsuits are not only fueled by the rhetoric from the NFCC and the Consumer Federation of America but are also likely motivated by political ambition, as evidenced by the sensationalist press releases from various

88. *See, e.g.*, Ronald J. Mann, *Consumer Bankruptcy & Credit in the Wake of the 2005 Act: Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 398 (showing the declining rates of bankruptcy between 2004 and 2006).

89. United States Organizations for Bankruptcy Alternatives (USOBA), FTC Public Comment on Notice of Proposed Rulemaking 31, n.51 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendment R411001). The USOBA stated "that an incredible 47% of employees surveyed reported that debtors had mentioned suicide as a possible way of addressing their debt problem." *Id.* It is worth noting that this figure was presented without much context, but nevertheless the frequency is striking. *Id.*

regulators.[90] To the extent that these actions are intended only to prevent fraud and misrepresentation and thus to allow consumers to make meaningful choices about what debt-relief options are truly best for them, they are worthwhile. However, it seems that these regulatory actions are not limited to controlling the transparency of a functioning market. Instead, they allege that debt settlement is inherently odious[91] and seek disgorgement of almost all revenues received by these companies, despite the fact that these companies provide real value.[92] These actions are threatening the industry and unfairly burdening the honest firms who are actually helping consumers.

Of greater concern, however, are several proposed or newly-enacted statutes governing the industry that actually cut into the free market and limit the revenues and methods of payment that consumers are willing to provide for debt settlement. These statutes "regulate" debt settlement in one of two ways: either by setting a cap on the fees that can be charged or by banning pre-payment of fees, which the regulators define as fees paid to a debt-settlement company before a customer has settled a credit card account with his or her bank.

Statutes that set a maximum amount that debt-settlement companies may lawfully charge are very troublesome. For instance, a recently passed Oregon statute and its accompanying rules prohibit a debt-settlement company from charging more than sixty-five dollars per month for bargaining down a consumer's debt,[93] a service that takes a substantial amount of time and effort to provide. Even the Uniform Debt Management Services Act (UDMSA), which has been enacted in some form in Colorado, Delaware, Nevada, Rhode Island, Tennessee, the U.S. Virgin Islands, and Utah, threatens the free market because it limits the fees that can be charged to

90. *Supra* note 83 and accompanying text.

91. New York Attorney General Andrew Cuomo stated the debt-settlement industry was "inherently flawed" before his investigation had even been completed. N.Y. Attorney Gen., *supra* note 83.

92. The Attorney General for the state of New York sought disgorgement of all fees paid to the debt-settlement defendant on behalf of New York consumers. People v. Nationwide Asset Servs., Inc., 888 N.Y.S.2d 850, 870–71 (N.Y. Sup. Ct., Erie County 2009). The court denied the request and held that the company was entitled to be paid for reducing its customers' debts and that disgorgement for amounts paid that did not actually exceed the amount of debt originally owed by the customers should not be disgorged. *Id.*

93. OR. REV. STAT. §§ 697.062, 697.692 (2009); OR. ADMIN. R. 441-910-0099 (2009).

approximately 30% of the difference between the original debt and the reduced debt.[94] It appears, however, that the industry is comfortable with the fee caps in the UDMSA, because the market prices set within a functioning marketplace would fall below this amount.[95]

Similarly, if the proposed FTC debt-settlement rules are promulgated as written, then debt-settlement companies nationwide will be forced into the likely unsustainable position of being forced to provide debt-settlement services for free to consumers between the time of enrollment and settlement, notwithstanding the amount of work that the companies perform during that time. Although the FTC's proposed ban on advanced fees[96] is arguably less harmful than arbitrary fee caps, the FTC rules would allow consumers to enroll in debt-settlement programs and then cancel before settlement, thus avoiding any obligation to pay for the services they have received.[97] The moral hazard is obvious: consumers could cancel at the eleventh hour because they had not saved enough money to actually settle or, worse yet—in order to take advantage of the hard work performed by the debt-settlement company—by settling the debt directly with the credit card company themselves. Whatever the reason for such dishonest conduct, the market would be better served by regulation that rewards debt-settlement companies for their work and that simultaneously encourages consumers to participate in the process in good faith. Furthermore, the FTC rules will not preempt any state regulations that cap fees.[98] Thus, in states with an artificially low fee cap, debt-settlement companies would not only be prohibited from receiving fees for the work as they perform it but would also be limited by an arbitrary ceiling on the fees that they charge. Thus, it comes as no surprise that an industry survey reports if the FTC's proposed rules are promulgated, 84% of debt-settlement companies will "almost certainly" be forced out of business because they cannot afford

94. Unif. Debt-Mgmt Serv. Act § 23 (2008).

95. The Ass'n of Settlement Cos., FTC Public Comment on Notice of Proposed Rulemaking 5, 19 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

96. FTC Proposed Rules, 74 Fed. Reg. 41988, 42008–09 (Aug. 19, 2009) (to be codified at 16 C.F.R. pt. 310.4(a)(5)).

97. *Id.* at 42009.

98. *Id.* at 42007 n.225.

the risk associated with providing service for which they may never be compensated.[99]

When regulators interfere with the market by artificially cutting off the revenue stream that consumers are willing to support or by imposing artificial fee caps, they are not protecting consumers. Instead, they are threatening the availability of debt settlement by assuming that consumers cannot decide for themselves whether they will benefit from paying a fair price for debt-settlement services, and paternalistically substituting their own judgment for that of the American public. However, by preventing the market from determining what consumers are willing to pay for these services, these regulations and fee caps will force debt-settlement companies to pull out of restrictive states or shut down altogether.

What is even more troubling is that there appears to be no basis for setting the fee caps that already exist. In many states, legislators have delegated the power to set fee caps to state commissioners who do not support or publish their reasoning for setting unrealistically low caps.[100] Instead, these arbitrary market constraints seem to be based on the belief that debt-settlement services should be provided for free.[101] Perhaps this is a result of the relentless campaign by nonprofit credit counselors, who tout their nonprofit status and criticize debt-settlement companies for making a profit (although the counselors receive almost the same amount of revenue between fees and payments from the credit card companies).

The problem with the idea that debt-settlement services should be offered at no cost is that tax-exempt nonprofits

99. U.S. Organizations for Bankruptcy Alternatives, FTC Public Comment on Notice of Proposed Rulemaking 20 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

100. In a very recent opinion, a Pennsylvania court struck down portions of the Pennsylvania debt-settlement statute because it unconstitutionally delegated too much authority to the state commissioner to set the limitations on how much debt-settlement companies could charge customers for their services. U.S. Orgs. for Bankr. Alternatives v. Dep't of Banking, No. 69 M.D.2009, 2010 WL 653756 (Pa. Commw. Ct. Feb. 25, 2010).

101. In his statements at the September 2008 FTC debt-settlement workshop, FTC Commissioner Rosch endorsed the statement that "debt settlement, *even at a cost*, can play an important role in solving what may seem like insurmountable problems of indebtedness," thus implying that debt settlement should ideally be offered at no cost. *Transcript of FTC Debt Settlement Workshop* 14 (Sept. 25, 2008) (statement of J. Thomas Rosch, Commissioner, FTC) (emphasis added).

cannot offer debt-settlement services.[102] In other words, there is no way to realistically offer "free" debt settlement within the current regulatory scheme. Thus, the only way to make sure that consumers have a meaningful less-than-full-balance repayment option at the fairest price is to allow a robust debt-settlement market to function through fair and transparent competition.[103] Therefore, state and federal regulators should focus on thwarting deceptive and misleading advertising and improving market transparency, rather than proceeding on assumptions that the entire industry should cease to exist or that fee caps selected by those outside of the marketplace can be efficiently set. A robust free market with healthy competition will naturally drive the price of debt-settlement services down to the lowest possible point at which debt-settlement companies can make a reasonable profit. If, on the other hand, governmental regulators pick artificial fee caps and strangle the free market, debt-settlement companies will simply be forced out of business and consumers will be left without an important debt-relief choice.

VIII. CONCLUSION

Lawmakers and regulators must recognize the importance of debt-settlement companies to struggling Americans who cannot find adequate help from nonprofit credit counselors or the bankruptcy courts. Rather than prohibiting these companies from contracting for tender of payment concurrent with their performance of services or arbitrarily capping the fees that debt-settlement companies can charge, these government actors should regulate other aspects of the industry. Specifically, they should focus their attention on preventing misrepresentation and deceptive advertising, while allowing the market to set the fair price and method of payment for debt-settlement services. If regulators instead proceed in enacting regulations as extreme

102. Robert E. Davis, FTC Public Comment on Notice of Proposed Rulemaking 5 (Oct. 26, 2009) (regarding Telemarketing Sales Rule—Debt Relief Amendments, R411001).

103. Regulation has won out over free markets, not because it makes more economic sense, but because it suits the political needs of those in power. Unfortunately, unchecked regulation and the court decisions that support it fail to recognize "the economic nature of contracts, competition, and market forces," because if they had "they would have been much less willing to substitute their own views of fairness for the agreements before them." Henry G. Manne, *The Judiciary and Free Markets*, 21 HARV. J.L. & PUB. POL'Y 11, 34 (1997).

as those discussed above, all debt-settlement companies—the beneficial ones along with the opportunistic—will be driven out of business, and the American consumer will be denied a potentially vital way out of credit card debt.

"HID[ING] ELEPHANTS IN MOUSEHOLES": * THE FTC'S UNWARRANTED ATTEMPT TO REGULATE THE DEBT-RELIEF-SERVICES INDUSTRY USING RULEMAKING AUTHORITY PURPORTEDLY GRANTED BY THE TELEMARKETING AND CONSUMER FRAUD AND ABUSE PREVENTION ACT

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* Am. Bar Ass'n v. Fed. Trade Comm'n, 430 F.3d 457, 467 (D.C. Cir. 2005) (quoting Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 468 (2001)). Circuit Judge David B. Sentelle used this phrase in response to the FTC's argument that by making the Gramm–Leach–Bliley Financial Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338, applicable to "'institutions'" that are "'engaged in the business of financial activity,'" Congress authorized the FTC to regulate attorneys. *Id.* at 467. Judge Sentelle state: "we are reminded repeatedly of a recent admonition from the Supreme Court: [Congress] does not . . . hide elephants in mouseholes." *Id.*

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I. INTRODUCTION

Over the past four decades, the Federal Trade Commission (FTC) has engaged in an aggressive campaign to expand its administrative enforcement and rulemaking authority over businesses and individuals in the areas of consumer protection and antitrust regulation. Sparked by a 1969 American Bar Association (ABA) report that took the agency to task for failing to achieve the ambitious goals of its early twentieth-century designers,[2] the FTC transformed its public perception from toothless in 1969[3] to tyrannical by 1980.[4] During that time the agency developed a strategic policy, which continues to be employed today, of pushing the envelope of its authority in the name of its enormously broad charge to prevent "unfair competition"[5] and "unfair or deceptive acts or practices."[6]

The agency's latest foray into the uncharted and undefined waters of undelegated authority is its initiative to amend the Telemarketing Sales Rule (TSR)[7] to add a wide-ranging set of new regulations[8] targeted at the debt-relief-services industry.[9] Oddly, these proposed new rules were announced to the public shortly after Congress began considering proposed legislation

2. COMM'N TO STUDY THE FED. TRADE COMM'N, AM. BAR ASS'N, REPORT OF THE ABA COMMISSION TO STUDY THE FEDERAL TRADE COMMISSION (1969) [hereinafter ABA REPORT].

3. In 1969, a typical criticism was that the agency was "rudderless; poorly managed and poorly staffed; obsessed with trivia; politicized; all in all, inefficient and incompetent." Richard Posner, *The Federal Trade Commission*, 37 U. CHI. L. REV. 47, 47 (1969).

4. By 1981, Congressional critics accused the FTC of being "'a renegade agency,'" a "'bureaucratic agency that is out to destroy free enterprise,'" and "'a rogue agency gone insane.'" William E. Kovacic, *Congress and the Federal Trade Commission*, 57 ANTITRUST L.J. 869, 870 (1989) (citations omitted).

5. *Id.* at 880.

6. Federal Trade Commission Act of 1914 § 5(a)(2), 15 U.S.C. § 45(a)(2) (2006).

7. FTC Telemarketing Sales Rule, 16 C.F.R. §§ 310.1–.9 (2009). In 1994 Congress authorized the FTC to adopt the TSR in the Telemarketing and Consumer Fraud and Abuse Prevention Act (TCFPA). 15 U.S.C. §§ 6101–6108. This act authorized the FTC to regulate abusive telemarketing. *Id.* § 6102(a)(1) ("The Commission shall prescribe rules prohibiting deceptive telemarketing acts or practices and other abusive telemarketing acts or practices.").

8. FTC Notice of Proposed Rulemaking, 74 Fed. Reg. 41,988 (proposed Aug. 19, 2009) [hereinafter FTC NPRM].

9. *See* discussion *infra* Part III.

regulating the debt-relief industry.[10] Rather than wait for the Legislature's express guidance, the agency has elected to pursue its own rulemaking, purportedly based on its existing regulatory authority. However, the proposed regulations have little to do with telemarketing,[11] begging the question: why would the FTC resort to the TSR as a rulemaking device given its broad rulemaking authority provided by the Magnuson–Moss Warranty Federal Trade Commission Improvement Act?[12]

The answer to this question is both obvious and troubling. The FTC's attempt to sidestep its statutory rulemaking requirements under Magnuson–Moss, and instead use the more expeditious notice and comment provisions of the TSR, raises important constitutional questions. Some might argue that this solution reflects a nimble and pragmatic response to the challenge of effectively regulating businesses in the Internet age. However, another perspective is that the agency has gone too far in its zeal to fulfill its mission and that it routinely engages in the same conduct for which it prosecutes individuals and companies: namely, failing to comply with the law.

This Article examines the background and history of the FTC's late twentieth-century activism leading up to the current Administration. It reviews the basis and limitations of the agency's rulemaking authority, both under the Federal Trade Commission Act of 1914 (FTC Act) and the Telemarketing and Consumer Fraud and Abuse Prevention Act (TCFAPA). This Article also looks at the debt-relief-services industry and the nature of the proposed regulations that have been advanced by

10. In May 2009, Rep. Bobby Rush (D-IL) introduced the "Consumer Credit and Debt Protection Act." *See* Consumer Credit and Debt Protection Act, H.R. 2309, 111th Cong. (2009). The proposed statute would grant the FTC authority to utilize the expedited rulemaking procedures of the Administrative Procedures Act ("APA") concerning consumer credit or debt and would direct the FTC to examine and promulgate rules with regard to debt settlement. The proposed Act would also allow the FTC to seek civil penalties up to $10,000 per violation for "unfair or deceptive acts practices in connection with consumer credit or debt." *Id.*

11. "Telemarketing" is defined in the TSR as "a plan, program, or campaign which is conducted to induce the purchase of goods or services or a charitable contribution, by use of one or more telephones and which involves more than one interstate telephone call." 16 C.F.R. § 310.2(cc).

12. *See, e.g.*, 15 U.S.C. § 2302(b)(1)(A) (2006) ("The Commission shall prescribe rules requiring that the terms of any written warranty on a consumer product be made available to the consumer (or prospective consumer) prior to the sale of the product to him."); *id* § 2306(a) ("The Commission may prescribe by rule the manner and form in which the terms and conditions of service contracts shall be fully, clearly, and conspicuously disclosed.").

the FTC to govern debt-relief-services companies. Finally, this Article examines the application of the TSR rulemaking provisions to the debt-relief-services industry and discusses why the telemarketing statute is unsuitable for the FTC's proposed rulemaking.

II. The History and Background of the Development of the FTC's Late Twentieth-Century Activism

"To many, [the FTC's] comparative inefficiency will seem scandalous, but one could regard it as the agency's saving grace."[13]

The FTC was created by Congress in 1914[14] in response to growing concerns from the public and industry about unfair methods of competition in the channels of interstate trade.[15] The FTC Act created the Commission[16] and prohibited unfair business practices.[17] The Act also granted the Commission authority to institute administrative proceedings against any person, partnership, or corporation that it had reason to believe was using unfair methods of competition in commerce and to issue cease-and-desist orders enjoining violators from continuing the alleged unlawful activities.[18]

The FTC Act declared that "unfair methods of competition in or affecting commerce" are unlawful.[19] However, the statute also granted the Commission authority to establish rules defining the nature of unfair methods of competition in accordance with the usages, customs, and practices of specific industries and businesses.[20] The new Act provided an additional source of protection to business entities that were injured as a result of unfair competition. Before the Act's passage, injured parties were limited to remedies provided in civil lawsuits: seeking injunctive relief or damages in response to unfair

13. Posner, *supra* note 3, at 87.

14. Federal Trade Commission Act of 1914, 15 U.S.C. § 41 (2006).

15. Ralph L. Nelson, Merger Movements in American Industry, 1895–1956, at 37 (1959). From 1898 to 1902, at least 303 firms disappeared annually through mergers. *Id.* at 37 tbl. 14. In the three years prior, only sixty-nine or fewer firms had disappeared annually through consolidations. *Id.*

16. 15 U.S.C. § 41.

17. *Id.* § 45(a)(1).

18. *Id.* § 45(b).

19. 15 U.S.C. § 45(a)(1).

20. *Id.* §§ 57(a)(1)(A)–(B).

competitive practices.[21] The Act gave injured competitors the alternative to seek the assistance of the Commission, which was authorized to impose cease and desist orders that were enforceable by the federal courts.[22]

In 1938, Congress strengthened and expanded the Commission's jurisdiction by adopting the Wheeler–Lea Act of 1938,[23] which amended the Act to add a prohibition against "unfair or deceptive acts or practices in commerce." Wheeler–Lea was the Legislature's response to a series of court decisions holding that before the Commission could prohibit an "unfair" practice, it must prove injury to an actual or potential competitor.[24] The amendment effectively made injury to the public a sufficient basis for Commission action.[25] Additionally, besides retaining the original ban against "unfair methods of competition," the amendment added a prohibition against "unfair or deceptive acts or practices in commerce,"[26] thus laying the foundation of the Commission's consumer protection authority.

Thirty years later, the FTC Act's promise—that the Commission would utilize its powers to control unfair business competition and unfair and deceptive treatment of consumers—had all but vanished. The political atmosphere of the 1960s had inspired challenges to a wide variety of American institutions.[27] The FTC, which had been subjected to ongoing criticism almost since its inception,[28] was once again under attack.[29] Professor

21. Federal Trade Commission, Annual Report of the Federal Trade Commission 16 (1930).

22. *Id.*

23. Act of March 21, 1938, ch. 49, 52 Stat. 111 (codified as amended in scattered sections of 15 U.S.C.).

24. FED. TRADE COMM'N, ANNUAL REPORT OF THE FEDERAL TRADE COMMISSION 2 (1950).

25. *Id.*

26. Ch. 49, sec. 3, § 5(a), 52 Stat. at 111 (codified as amended at 15 U.S.C. 45(a)(1) (2006)).

27. *E.g.*, John Roos, *American Political Life in the 1960s: Change, Recurrences, and Revolution*, 34 REV. OF POL., 44, 44 (1972).

28. Edward F. Cox, a member of the team of young intellectuals known as "Nader's Raiders," identified studies published in 1924, 1949, and 1960 that criticized the FTC for "the staff's focus on trivia without attention to priorities, the related lack of planning and involvement in protracted meaningless litigation, a tolerance for mediocre staff, and a culture of secrecy." Edward F. Cox, *Reinvigorating the FTC: The Nader Report and The Rise of Consumer Advocacy*, 72 ANTITRUST L.J. 899, 900 n.6 (2005).

29. *See, e.g.*, Posner, *supra* note 3, at 87 ("To many, [the FTC's] comparative inefficiency will seem scandalous, but one could regard it as the agency's saving grace.")

Richard Posner's views were typical of those expressed by the FTC's critics. In September 1969, Posner wrote, "The Commission is rudderless; poorly managed and poorly staffed; obsessed with trivia; politicized; all in all, inefficient and incompetent. And—the persistence of all of these criticisms would seem to indicate—largely impervious to criticism."[30] Others complained that the agency needed "some kind of an injection to pep it up so it would fulfill its mission."[31]

In early January 1969, Ralph Nader and his "raiders" released an updated critique of the FTC.[32] Shortly after the Nader report was published, newly elected President Richard M. Nixon responded with a request to the President of the American Bar Association (ABA) for "a professional appraisal of the present efforts of the Federal Trade Commission in the field of consumer protection."[33] The ABA assembled a top-notch commission of FTC practitioners and scholars, which delivered its report in September 1969.[34]

The ABA Report recounted the agency's problems that had been identified in the previous studies, including: "poor management, inadequate planning, weak personnel and cumbersome procedures."[35] The ABA report stated that an FTC bureau chief responsible for recruiting believed "young lawyers are not competent to engage in both trial and investigative work" and that "[the bureau chief] preferred to hire older men—who had been out in the world for ten years or so and had come to appreciate that they were not going to make much of a mark—because they tended to be loyal and to remain with the FTC."[36] The bureau chief gave "less weight" to "law school grades than to other factors."[37] The ABA Commission concluded, "'If there is a formula better designed to avoid hiring

30. *Id.* at 47.

31. *Nomination of Lewis A. Engman to be a Commissioner, Federal Trade Commission: Hearing Before the S. Comm. on Commerce*, 93d Cong. 25 (1973) [hereinafter *Engman Confirmation Hearings*].

32. EDWARD F. COX ET AL., THE NADER REPORT ON THE FEDERAL TRADE COMMISSION 180 (1969).

33. Letter from Richard M. Nixon, President, U.S., to Bernard G. Segal, President, Am. Bar Ass'n (Apr. 18, 1969), *in* ABA REPORT, *supra* note 2, at app. 1, 86.

34. ABA REPORT, *supra* note 2.

35. Kovacic, *supra* note 4, at 877.

36. ABA REPORT, *supra* note 2, at 33.

37. *Id.*

bright and energetic young men, we have not heard of it.'"[38] The ABA Report challenged the Commission to focus its antitrust enforcement activities on "economically significant problems" and "complex, unsettled areas of law and economics." The report exhorted the agency to curtail or eliminate its reliance on "voluntary enforcement strategies" and instead to implement "binding, compulsory techniques."[39]

Some, however, including ABA Committee member Professor Richard Posner, in his dissent to the ABA Report, seriously questioned whether the FTC experiment should not be written off as a failure. Rather than encourage the agency to improve upon its execution of Congress's vision, Posner "essentially proposed the dismemberment and abolition of the FTC."[40]

In addition to initiating the ABA Report, President Nixon also appointed Casper Weinberger as FTC Chairman in 1969.[41] Nicknamed "Cap The Knife," Weinberger immediately implemented planning, recruiting, and organizational evaluation initiatives that launched a cultural transformation at the agency.[42] By 1973, as Congress confirmed a new FTC chairman, legislators were already expressing confidence that the agency had taken significant steps toward revival. Senator Frank Moss said "the Commission has taken on new life beginning with the search for strong and imaginative, rigorous developers and enforcers of the law."[43] Moss expressed his approval that the agency had "stretched its powers to provide a credible countervailing public force to the enormous economic power of huge corporate conglomerates which dominate American enterprise."[44] Senator Ted Stevens exhorted the new chairman to reach further: "I am really hopeful that you will become a real zealot in terms of consumer affairs and some of these big business people will complain to us that you are going too far. That would be the day as far as I'm concerned."[45]

38. Arthur John Keefe, *Is The Federal Trade Commission Here to Stay?*, 56 A.B.A. J. 188 (1970).

39. Kovacic, *supra* note 4, at 874.

40. Cox, *supra* note 28, at 908.

41. *Id.* at 906.

42. *Id.*

43. *Engman Confirmation Hearings*, *supra* note 31, at 4.

44. *Id.*

45. *Id.* at 31.

In 1974, Congress granted the agency additional enforcement authority when it passed provisions in the Trans-Alaska Pipeline Authorization Act,[46] that empowered the FTC to enforce administrative cease and desist orders with federal court injunctions. Section 13(b) of the FTC Act allowed the agency to seek temporary restraining orders and preliminary injunctions and, in proper cases, permanent injunctions "to halt" violations of the FTC Act.[47] In 1975, Congress granted the FTC formal rulemaking authority and provided additional weapons to the FTC's enforcement arsenal in the Magnuson–Moss Act.[48] Later in that year, the same Congress enacted Section 19,[49] cautiously expanding FTC powers by authorizing the Commission to bring civil actions seeking a broad array of legal and equitable monetary remedies where it establishes that a person (1) violated an FTC rule respecting unfair or deceptive practices[50] or (2) engaged in an unfair or deceptive act or practice that was the subject of a previously issued cease and desist order—"which a reasonable man would have known under the circumstances was dishonest or fraudulent."[51]

Armed with more talented and aggressive lawyers and new statutory weapons from Congress, the FTC went on the offensive. Within just five years of the passage of Magnuson–Moss, the zealotry that Senator Stevens had wished for in 1973 was now the prevailing theme of attacks against the agency mounted not only by "big business" but by Congress itself. "Generated by an array of far-reaching FTC law enforcement, rule-making, and data-collection programs, a tidal wave of business opposition to the agency swept over Capitol Hill."[52]

46. Pub. L. No. 93-153, 87 Stat. 584 (1973) (codified as amended in scattered sections of 5, 12, 15, 33, 42, 43, and 46 U.S.C.)

47. *Id.* sec. 408(f), §§ 13(b)(1)–(2), 87 Stat. at 592 (codified as amended at 15 U.S.C. § 57(b)(1)–(2) (2006)).

48. *See, e.g.*, 15 U.S.C. § 2302(b)(1)(A) (2006) ("The Commission shall prescribe rules requiring that the terms of any written warranty on a consumer product be made available to the consumer (or prospective consumer) prior to the sale of the product to him."); *id* § 2306(a) ("The Commission may prescribe by rule the manner and form in which the terms and conditions of service contracts shall be fully, clearly, and conspicuously disclosed.").

49. Magnuson–Moss Warranty–Federal Trace Commission Improvement Act, Pub. L. No. 93-637, sec. 206(a), § 19, 88 Stat. 2183 (1975) (codified as amended at 15 U.S.C. § 57b (2006)).

50. *Id.* § 19(a)(1) (codified as amended at 15 U.S.C. § 57b(a)(1)).

51. *Id.* § 19(a)(2) (codified as amended at 15 U.S.C. § 57b(a)(2)).

52. Kovacic, *supra* note 4, at 870.

Members of Congress accused the FTC of being "'a renegade agency,'"[53] a "bureaucratic agency that is out to destroy free enterprise,"[54] and "a rogue agency gone insane."[55]

In 1980, Congress attempted to reign in the agency with the Federal Trade Commission Improvements Act of 1980,[56] which contained numerous provisions curtailing the FTC's powers.[57] Senator Howard Cannon described the Act's background as follows:

> The real reason that we have proposed this legislation for the FTC is because the Commission appeared to be fully prepared to push its statutory authority to the very brink and beyond. The FTC lost sight of the necessity to listen to the evidence and legal arguments of its opponents. Good judgment and wisdom had been replaced with an arrogance that seemed unparalleled among independent regulatory agencies. The FTC brought this legislation upon itself because its own chairman sought to 'venture in the unchartered [sic] territory' of the Federal Trade Commission Act.[58]

But the genie was now out of the bottle. Beginning in the early 1980s, the FTC shifted its focus to expanding the reaches of its statutory authority through the Judiciary. Exploiting cases that involved egregious wrongdoing by various defendants,[59] the

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53. *Id.* (citation omitted).

54. 126 Cong. Rec. 6,707 (1980) (statement of Rep. Quillen).

55. 125 Cong. Rec. 32,350 (1979) (statement of Rep. Frenzel).

56. Pub. L. No. 96-252, 94 Stat. 374 (1980) (codified as amended in scattered sections in 15 U.S.C.).

57. *See, e.g., id.* sec. 7, § 18(a)(1)(B) (codified at 15 U.S.C. § 57a(a)(1)(B) (2006)) ("[T]he Commission shall not develop or promulgate any trade rule or regulation with regard to the regulation of the development and utilization of the standards and certification activities pursuant to this section."); *id.* sec. 8, § 18(b)(2)(A) (codified at 15 U.S.C. § 57a(b)(2)(A)) ("Prior to the publication of any notice of proposed rulemaking pursuant to paragraph (1)(A), the Commission shall publish an advance notice of proposed rulemaking in the Federal Register.").

58. 126 Cong. Rec. 11,917 (1980).

59. The Director of the Bureau of Consumer Protection recently described this activist strategy as follows:

> [P]art of our job is to be stewards of the statutes that we have to implement. And if we think the law says X, but there isn't a case that establishes X and people are not conforming their conduct to our belief about how the law ought to work, then we should look for a good case to establish X as a governing legal principle. I would define the term 'test case' as a case in which the facts directly and clearly support the legal theory that you are advocating, even if the legal theory has not been accepted by a court prior to that time. And you bring a test case to see whether you can persuade the court to adopt your reading of the law.

agency slowly and meticulously undertook a concerted and deliberate campaign to expand the remedies available under Section 13(b) of the FTC Act without Congressional approval.[60] The Commission understandably found the injunctive remedies available in Section 13(b) to be particularly valuable tools because they enable the Commission "to obtain an order not only permanently barring deceptive practices, but also imposing various kinds of monetary equitable relief (i.e., restitution and disgorgement) to remedy past violations."[61]

The FTC accomplished this unauthorized expansion of Section 13(b) by convincing courts that "equitable" monetary relief could include expanded forms of "restitution" and "disgorgement" against defendants accused of violating Section 5 of the FTC Act, which prohibits "unfair or deceptive acts or practices."[62] The FTC persuaded the courts to make these awards based on two older Supreme Court decisions that authorized the use of the courts' "inherent equity powers" to award monetary relief to enforce compliance with non-FTC-related statutes "in the absence of a clear and valid command" from Congress restricting such powers.[63]

In *FTC v. H.N. Singer, Inc.*,[64] the agency successfully argued that the FTC Act authorized the federal court to utilize the full array of equitable remedies at its disposal in Section 13(b) cases. The FTC pressed the Ninth Circuit to rule (in dicta) that the court's "inherent equity powers" authorized the award of monetary relief in the form of equitable rescission for Section 5 violations.

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59. John Villafranco, *Interview with David Vladeck, Director, FTC Bureau of Consumer Protection*, The Antitrust Source, Vol. 9, Issue 4 (Apr. 2010), http://www.abanet.org/antitrust/at-source/10/04/Apr10-VladeckIntrvw4-14f.pdf.

60. For detailed retelling of the FTC's campaign to expand the reach of Section 13(b) by a former FTC attorney, see David M. FitzGerald, The Genesis of Consumer Protection Remedies Under Section 13(b) of the FTC Act (Sept. 23, 2004), http://www.ftc.gov/ftc/history/docs/fitzgeraldremedies.pdf.

61. FTC Office of the General Counsel, A Brief Overview of the Federal Trade Commission's Investigative and Law Enforcement Authority, http://www.ftc.gov/ogc/brfovrvw.shtm (last visited May 26, 2010).

62. FitzGerald, *supra* note 60, at 16–17.

63. *See* Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288, 291 (1960) (holding that unless a statute actually or by necessary and inescapable inference restricts the Court's jurisdiction in equity, the full scope of the Court's equitable jurisdiction is to be recognized and applied); Porter v. Warner Holding Co., 328 U.S. 395, 398 (1946) (holding that where the public interest is involved the Court's equitable powers are even broader and of a more flexible character).

64. 668 F.2d 1107 (9th Cir. 1982).

Although the *Singer* decision paved the way for subsequent decisions that accepted the argument that Section 13(b) authorized the courts to award monetary relief in Section 5 actions, the new line of cases was flawed from the beginning as a result of several defects in the court's analysis.

First, the only issues that were presented in *Singer* were the trial court's authority to enjoin the defendants from committing further violations of the Franchise Trade Rule, to freeze their assets, and to require an accounting (all of which were consistent with legitimate Section 13(b) objectives of preserving the status quo pending the completion of the FTC's administrative process). There was no need or reason for the Ninth Circuit to reach the question whether any equitable remedies were available under Section 13(b) beyond the injunction, freeze order and accounting issues that were presented. The FTC had separately sought Section 19 relief, which provided for the monetary remedies of rescission, restitution and refund. The court's determination that it had authority to maintain the status quo by ordering the injunction, freeze and accounting based on the legislative intent of Section 13(b) was all that was required where all of the other monetary remedies that were sought by the FTC were expressly provided by Section 19.

Second, the *Singer* court reviewed only enough of the legislative history to make the correct determination that "The purpose of [Section 13(b)] is to permit the Commission *to bring an immediate halt* to unfair or deceptive acts or practices when to do so would be in the public interest."[65] But the court disregarded clear indications of legislative intent when it held that application of the court's equitable powers, including rescission and restitution, was consistent with the stated purpose of the statute. In reaching this decision, the Ninth Circuit failed to consider the more complete analyses of the statutory history performed by the Fifth Circuit in *FTC v. Southwest Sunsites, Inc.*,[66] and the D.C. Circuit in *FTC v. Weyerhaeuser Company.*[67]

Relying on the Ninth Circuit's dicta in *Singer*, the agency continued its campaign to unilaterally expand its power to obtain monetary relief under Section 13(b) in other circuits,

65. 668 F.2d at 1111 (quoting S. Rep. 93-151, p. 30-31) (emphasis added).
66. 665 F.2d 711 (5th Cir. 1982).
67. 665 F.2d 1072 (D.C. Cir. 1981).

often selecting cases involving unrepresented defendants[68] and/or egregiously deceptive and fraudulent conduct.[69] Generally, these cases were brought against the direct perpetrators of those schemes where the consumer loss was directly equal to the defendants' gains.[70] Consequently, the issues regarding statutory interpretation were often not raised at all or the courts were apparently dissuaded by the FTC from closely scrutinizing the agency's authority to obtain monetary relief based on Section 13(b). Had a more careful statutory analysis been performed, the courts should have and likely would have rejected the FTC's assertion that Section 13(b) allows for consumer redress based on: (1) the express language of Section 13(b) itself, (2) the legislative history of the FTC Act and the amendments that added Sections 13(b) and 19(b) in the mid-1970s, and (3) the decisions that first interpreted Section 13(b) after it was amended.[71]

Significantly, the Supreme Court has subsequently refused to imply equitable remedies in statutes where Congress has established—"elaborate enforcement provisions" similar to,

68. *E.g.*, Fed. Trade Comm'n v. Stefanchik, 559 F.3d 924, 931 (9th Cir. 2009).

69. FTC v. Gem Merch. Corp., 87 F.3d 466, 469–70 (11th Cir. 1996) (telemarketers lured customers by misrepresenting terms, conditions and likelihood of winning prizes consumers would receive if they consumer purchased medical alert systems);. FTC v. Pantron I, 33 F.3d 1088 (9th Cir. 1994) (no scientifically reliable evidence (other than "placebo effect") supporting claim that defendant's Helsinki Formula baldness treatment, consisting of a shampoo and conditioner promoted hair growth or prevented hair loss); FTC v. Security Rare Coin & Bullion, 931 F.2d 1312, 1316 (8th Cir. 1991) (marketers misrepresented the value and risk of collectible coins as excellent low-risk investments with superior liquidity and profit potential when in fact the company arbitrarily marked up the price of the coins two or three times the wholesale price, such that the coins would have to double or triple in value before any gain could be realized); FTC v. Amy Travel Service, Inc., 875 F.2d 564 (7th Cir. 1989) (misleading telemarketing of approximately 35,000 travel vouchers from $289 to $328 that actually had little value to consumers); FTC v. World Travel Vacation Brokers, Inc., 875 F.2d 1020, 1026 (7th Cir. 1988) (sold more than 600,000 vacation certificates purporting to provide airfare to Hawaii for $29, yet actually charged consumers hundreds of dollars for full airfare and hotel rates).

70. *See, e.g*, Fed. Trade Comm'n v. Stefanchik, *supra* note 68.

71. A prominent attorney working for Ropes & Gray in Washington, D.C., has recognized that "the Commission's general authority to employ § 13(b) beyond the right to seek injunctive relief remains poised on relatively narrow legal footing." James M. Spears, Comment for Federal Trade Commission, Mar. 29, 2002, at 6, http://www.ftc.gov/os/comments/disgorgement/spearsjamesm.pdf; *see also Government Civil Liberties: Hearing before the Antitrust Modernization Comm.* 13 n.24 (2005) (statement of Kevin Arquit, Partner, Simpson Thatcher & Bartlett), *available at* http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Statement_Arquit.pdf ("While at one time a better case could be made for 13(b) disgorgement authority, there is more recent precedent than *Porter v. Warner Holding Co.*, which casts some doubt on that authority.") (citation omitted).

albeit less clear than, the elaborate enforcement scheme in the FTC Act.[72] The D.C. Circuit has also held that the implied equitable remedy of disgorgement is not available to address "forward-looking" injunctive provisions, such as those contained in the FTC Act.[73] Finally, even the FTC Chairman has acknowledged by implication that Section 13(b) does not authorize the recovery of monetary relief when he cited only to Section 19(b) to support his recent statement to Congress that the Commission "can only obtain monetary relief, including consumer redress and disgorgement of the ill-gotten gains."[74]

Read together, current case law, the express terms of Section 13(b) and 19, the characterizations of Sections 13(b) and 19(b) in other sections of the FTC Act[75], and the applicable and relevant legislative history demonstrate that Section 13(b) was intended to be limited to the plain meaning of its terms—providing the FTC with authority to seek, and the courts with authority to grant *temporary restraining orders, preliminary injunctions and, in appropriate cases, permanent injunctions.* In short, the purpose of Section 13(b) was to provide a mechanism to halt illegal conduct and maintain the status quo, thus allowing the FTC to bring administrative proceedings and, if appropriate, to seek the broader remedies that were made available under the limited circumstances specified in Section 19(b).

Having secured, for the time being, the Judiciary's blessing of its ability to obtain complete relief against FTC Act violators in court, outside of the cumbersome restrictions and limitations set forth in Section 19(b) and the administrative process,[76] the FTC

72. Meghrig v. KFC W., Inc., 516 U.S. 479, 487–88 (1996).

73. United States v. Phillip Morris USA, Inc., 396 F.3d 1190, 1198 (D.C. Cir. 2005).

74. *Proposed Consumer Financial Protection Agency: Implications for Consumers and the Federal Trade Commission: Hearing Before the Subcomm. on Commerce, Trade and Consumer Protection of the H. Comm. on Energy and Commerce* 3–4 (2009) (statement of the Fed. Trade Comm'n).

75. *See* § 16 (codified at 16 U.S.C. § 56) (describing §13(b) as providing for injunctive relief and § 19(b) as providing for "consumer redress").

76. Prior to 1980, virtually all FTC consumer protection enforcement actions were administrative proceedings conducted pursuant to § 5. Compare FTC Annual Report (1970) with FTC Annual Report (2009). By contrast, the most recent data shown on the FTC website reflects only nine pending FTC adjudicative proceedings from 2007 to 2009. Meanwhile, the FTC's annual report dated March 30, 2009 states that from March 2008 through February 2009, the FTC filed 64 actions in federal district courts. THE FTC IN 2009: THE ANNUAL REPORT OF THE FEDERAL TRADE COMMISSION (2009).

has apparently now turned its attention to unilaterally expanding its rulemaking authority.[77]

III. THE FTC'S RULEMAKING AUTHORITY

The FTC's authority to prescribe substantive rules defining the terms "unfair or deceptive acts or practices" emanates from Congress in two forms: (1) a specific delegation of rulemaking authority by Congress in statutes that direct the agency to promulgate rules in support of a specific statutory purpose,[78] and (2) pursuant to the rulemaking authority granted by the Magnuson–Moss Act in Section 18 of the FTC Act.[79]

Due to the restrictions imposed by Magnuson–Moss rulemaking, however, the vast majority of the FTC's substantive rules have been promulgated using "expedited" rulemaking procedures based on express congressional authorizations. Examples of specific statutory delegations include:

- The 2009 Omnibus Appropriations Act, which authorized the FTC to engage in Administrative Procedures Act (APA)[80] rulemaking proceedings relating to mortgage loans,[81]

- The Do-Not-Call Implementation Act of 2003, which allowed consumers to opt-out of receiving calls from telemarketers,[82]

- The Children's Online Privacy Protection Act, prohibiting online marketers from seeking or obtaining personal information from children,[83]

- The Fair and Accurate Credit Transactions Act of 2003, authorizing consumers to obtain free copies of their annual credit reports,[84]

77. *See infra* Part III.
78. *E.g.*, 15 U.S.C. § 6502(b)(1) (2006).
79. *Id.* § 57a(1)(B) (2006).
80. 5 U.S.C. § 553 (2006).
81. Pub. L. No. 111-8 § 626(a), 123 Stat. 524, 677 (2009).
82. 15 U.S.C. § 6153 (2006).
83. *Id.* § 6502(b)(1)(a).
84. *Id.* § 1681s(a)(1).

- The Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, regulating the distribution of commercial electronic correspondence,[85] and

- The TCFAPA, which authorized the FTC to propound rules governing abusive telemarketing activities.[86]

The benefit of such statutory delegations of rulemaking authority, at least in the eyes of the FTC, is that the agency is not required to comply with the requirements of the Magnuson–Moss Act.[87] In each instance, Congress expressly authorized the FTC to utilize the simplified "notice-and-comment" provisions of the APA, substantially shortening the rulemaking process and eliminating many of the constraints that were imposed by Magnuson–Moss.[88] As Commissioner Thomas Rosch put it, "Magnuson–Moss rulemaking proceedings are very cumbersome, and frankly, the [Bureau of Consumer Protection] staff has hated them."[89] In a recent interview, David Vladeck, current Director of the Bureau of Consumer Protection, said, of the Magnuson–Moss procedures, "we are now hobbled with a byzantine, Rube Goldberg-like rulemaking system that is close to useless."[90]

Other than the specific statutes where Congress has expressly authorized the agency to use APA rulemaking procedures, the FTC acknowledges that "Section 202(a) of Magnuson–Moss provides that the Commission's Section 18 authority is its only authority to promulgate rules respecting unfair or deceptive acts or practices."[91] In fact, the staff "hates" the requirements of Section 18 to the extent that FTC Chairman Jon Leibowitz, in an effort to expand the Commission's rulemaking authority, recently appealed to Congress to allow the agency to utilize the

85. *Id.* § 7706(d).

86. *Id.* § 6102(a)(1).

87. *Id.* § 57(a)(1)(B).

88. *Id.* § 57(a)(1)(B).

89. J. Thomas Rosch, Comm'r, Fed. Trade Comm'n, Rip Van Winkle Awakens: Some Reflections on Remedies, Remarks at ABA Antitrust Section Spring Meeting 3 (Mar. 30, 2006), *available at* http://www.ftc.gov/speeches/rosch/060330roschfinal.pdf.

90. Villafranco, *supra* note 59.

91. FED. TRADE COMM'N, OPERATING MANUAL, § 7.2.3.1 (1989).

less "cumbersome" procedures of the APA to perform rulemaking in additional areas beyond those specifically delegated by Congress—such as the mortgage lending industy.[92] The Chairman's appeal illuminates why the FTC prefers the simplified APA rulemaking procedures over the more complex plenary procedures required when the staff seeks to regulate beyond those areas expressly designated by Congress.

The Magnuson–Moss rulemaking provisions require the FTC to:

- Publish a notice of proposed rulemaking in the Federal Register, including the text of and reasons for the proposed rule and invite the response of interested persons;[93]

- Submit notices of rulemaking to the Senate Committee on Commerce, Science, and Transportation and the House Committee on Energy and Commerce;[94]

- Make a determination before issuing any notices of proposed rulemaking if it has reason to believe that the unfair or deceptive acts or practices which are the subject of the proposed rule are "prevalent";[95]

- Provide an opportunity for an informal hearing subject to specific procedural requirements, including the ability for interested persons to present oral and documentary evidence and, if the FTC determines that there are disputed issues of material fact to be resolved,

92. In March 2009, Chairman Leibowitz stated: "The FTC also believes that it could do more to assist consumers if it could use APA [§ 553] notice and comment procedures to promulgate rules for those entities under the Commission's jurisdiction for unfair and deceptive acts and practices related to financial services other than mortgage loans." *Consumer Credit and Debt: The Role of the Federal Trade Commission in Protecting the Public: Hearing Before the Subcomm. on Commerce, Trade and Consumer Protection of the H. Comm. on Energy and Commerce* 22–23 (2009) (statement of the Fed. Trade Comm'n).

93. 15 U.S.C. § 57a(b)(1) (2006).

94. *Id.* § 57a(b)(2)(B).

95. *Id.* § 57a(b)(3). The Act defines an act or practice as "prevalent" where the FTC has (1) "issued cease and desist orders regarding such acts or practices," *id.* § 57a(b)(3)(A), or (2) "any other information available to the Commission [that] indicates a widespread pattern of unfair or deceptive acts or practices." *Id.* § 57a(b)(3)(B).

to present rebuttal evidence and conduct cross-examinations of witnesses;[96] and

- Promulgate a final rule based on the record and provide a statement of basis and purpose that addresses the prevalence of the acts or practices addressed by the rule, the manner and context in which the acts or practices are unfair or deceptive, and regarding the economic effect of the rule on small businesses and consumers.[97]

The Magnuson–Moss procedures also provide for judicial review of the agency's rules by the federal Courts of Appeals[98] and directs that the courts shall set aside any rule that "is not supported by substantial evidence in the rulemaking record"[99] or if the Commission's failure to allow cross-examination or submission of evidence "precluded disclosure of disputed material facts that were necessary for fair determination by the Commission."[100]

IV. THE FTC'S RULEMAKING AUTHORITY UNDER THE TELEMARKETING SALES RULE

On August 16, 1995, the FTC promulgated the Telemarketing Sales Rule pursuant to its authority under the Telemarketing and Consumer Fraud and Abuse Prevention Act (TCFAPA).[101] The FTC views the rule as applying to virtually all "telemarketing," which means "a[ny] plan, program, or campaign . . . to induce the purchase of goods or services or to solicit a charitable contribution" involving more than one interstate telephone call.[102]

In pertinent parts, the TSR requires telemarketers to obtain a consumer's express verifiable authorization and to provide certain material information, such as the total cost of the service,

96. *Id.* § 57a(c)(2).
97. *Id.* § 57a(d).
98. *Id.* § 57a(e)(1).
99. *Id.* § 57a(e)(3)(A).
100. *Id.* § 57a(e)(3)(B).
101. FTC Telemarketing Sales Rule, *supra* note 7, §§ 310.1–8.
102. FTC NPRM, *supra* note 8, at 41,989.

before the consumer pays for the goods or services.[103] The TSR prohibits telemarketers from misrepresenting—expressly or implicitly—specific categories of information about a telemarketing transaction that is likely to affect a consumer's decision to purchase the goods or services offered.[104] These categories include, among others: (1) the total costs of the services offered; (2) any material restriction, limitation, or condition to purchase, receive, or use the services offered; (3) any material aspect of the performance, efficacy, nature, or central characteristics of the goods or services offered to the consumer, and (4) any affiliations with—or endorsements or sponsorships by—any person, organization, or government entity.[105]

The TSR exempts certain types of calls from its coverage. These include unsolicited calls from consumers, calls placed by consumers in response to a catalog, calls made in response to direct mail advertising, and calls made in response to "general media advertising."[106] "General media advertising" includes television commercials, infomercials, and home shopping programs.[107] Accordingly, the FTC's jurisdiction, under the TSR, does not extend to inbound calls induced by television commercials, radio, and the Internet.[108]

As with other statutory delegations of rulemaking authority, Congress expressly directs the FTC to promulgate rules implementing the TCFAPA using the "notice-and-comment" rulemaking procedures of the APA.[109] The TCFAPA specifically instructs the FTC to "prescribe rules prohibiting deceptive telemarketing acts or practices and other abusive telemarketing acts or practices."[110] The statute further enumerates specific provisions to be included in the TSR, including banning deceptive charitable solicitations,[111] prohibiting coercive or abusive patterns of telephone calls,[112] placing restrictions on

103. 16 C.F.R. § 310.3(a).
104. *Id.*
105. *Id.*
106. *Id.* § 310.6(b)(6).
107. *Id.* § 310.6(b)(5).
108. *Id.*
109. 15 U.S.C. § 6102(b) (2006).
110. *Id.* § 6102(a)(1).
111. *Id.* § 6102(a)(2).
112. *Id.* § 6102(a)(3)(A).

hours when calls can be made,[113] requiring prompt and clear disclosures relating to goods and services sold by telemarketing,[114] and mandating disclosure of the purpose of charitable telemarketing solicitations.[115]

Although the TCFAPA specifically limited the FTC's rulemaking authority to "deceptive *telemarketing* acts or practices and other abusive *telemarketing* acts or practices,"[116] when the FTC adopted the TSR, consistent with strategies it has used previously, the agency knowingly included a minor but important expansion of its delegated authority in the new rules. Moving beyond regulations controlling the appropriate content and execution of telemarketers' communications with consumers, the FTC decided to regulate the nature of certain *fees* that could be charged by companies that engaged in telemarketing. The agency accomplished this objective by expanding upon the "abusive telemarketing acts or practices" identified by Congress in the TCFAPA.

The FTC acknowledged in its Final Notice implementing the TSR that the TCFAPA directed it to include three specific provisions prohibiting "abusive telemarketing practices" that related to consumer privacy.[117] However, the agency decided to supplement these practices with five additional practices that it deemed "abusive."[118] The first two additional practices were undeniably consistent with the statutory purpose of eliminating abusive "telemarketing" practices. The rules prohibited: (1)

113. *Id.* § 6102(a)(3)(B).

114. *Id.* § 6102(a)(3)(C).

115. *Id.* § 6102(a)(3)(D).

116. *Id.* § 6102(a)(1) (emphasis added).

117. FTC Telemarketing Sales Rule Final Amended Rule, 68 Fed. Reg. 4580, 4613 (Jan. 29, 2003) (codified at 16 C.F.R. 310 (2009)). Even the legislative history cited by the FTC in support of these regulations confirms that Congress's rulemaking authority was intended to reach nothing other than privacy issues. *See id.* at 4614 n.395. The Final Notice stated:

> With respect to the bill's reference to 'other abusive telemarketing activities' . . . the Committee intends that the Commission's rulemaking will include proscriptions on such inappropriate practices as threats or intimidation, obscene or profane language, refusal to identify the calling party, continuous or repeated ringing of the telephone, or engagement of the called party in conversation with an intent to annoy, harass, or oppress any person at the called number. The Committee also intends that the FTC will identify other such abusive practices that would be considered by the reasonable consumer to be abusive and thus violate such consumer's right to privacy.

Id. (citing H.R. REP. NO. 103-20, at 8 (1993)).

118. *Id.* at 4614.

"threatening or intimidating a consumer, or using profane or obscene language,"[119] and (2) "causing any telephone to ring, or engaging any person in telephone conversation, repeatedly or continuously with intent to annoy, abuse, or harass any person."[120]

However, the agency added other "advance fee" prohibitions that went far beyond "telemarketing practices" into the realm of regulating the underlying business models themselves.[121] These provisions included bans against "requesting or receiving payment for credit repair services prior to delivery and proof that such services have been rendered,"[122] "requesting or receiving payment for recovery services prior to delivery and proof that such services have been rendered,"[123] and "requesting or receiving payment for an advance fee loan when a seller or telemarketer has guaranteed or represented a high likelihood of success in obtaining or arranging a loan or other extension of credit."[124]

Recognizing that it had stretched the limits of its authority to the breaking point, the FTC attempted to justify these provisions by claiming that the TCFAPA granted the agency "broad authority to identify and prohibit additional abusive telemarketing practices beyond the [Congressionally] specified practices that implicate privacy concerns."[125] Remarkably, the agency relied upon a *Webster's Dictionary* definition of the word "abusive" for this conclusion.[126] Casting a sideways glance to the fact that it had departed from the boundaries of its TCFAPA authority and was now operating in Magnuson–Moss territory, the FTC concluded its detour with an attempt to bolster the end-result with an analysis of the advance fee practices using its "traditional unfairness analysis."[127] Finding that "[a]n important

119. *Id.* at 4613.
120. *Id.*
121. *Id.* at 4613–14.
122. *Id.* at 4613.
123. *Id.* at 4613–14.
124. *Id.* at 4614.
125. *Id.*
126. *Id.* at 4614 n.398.
127. *Id.* at 4614. The FTC's unfairness analysis was originally based on the Supreme Court's decision in *Federal Trade Commission v. Sperry & Hutchinson Co.*, 405 U.S. 433 (1972). In 1981, it was affirmed by the FTC in its Statement of Policy on the Scope of Consumer Unfairness Jurisdiction. Letter from Fed. Trade Comm'n to Sen. Wendell H. Ford & Rep. John C. Danforth (Dec. 17, 1980), *available at*

characteristic common to credit repair services, recovery services, and advance fee loan services is that in each case the offered service is fundamentally bogus,"[128] the agency reached the unsurprising conclusion that "these practices meet the statutory criteria for unfairness."[129] As such, the FTC determined that it was authorized to regulate the timing of fees charged by these services, regardless of whether the advance fees had anything to do with the functional act of "telemarketing."[130]

V. THE DEBT-RELIEF-SERVICES INDUSTRY

American consumers are currently enduring the most difficult financial crisis since the Great Depression.[131] As of January 2009, credit-card debt was reported to have soared to an all-time high of $960 billion.[132] As a result of this dramatic increase in consumer debt, Americans have increasingly turned to debt-relief services for assistance.[133] Two distinct types of debt-relief-service providers have developed as the primary models offering debt-relief services to consumers: non-profit credit counseling agencies (CCAs) and for-profit debt-settlement companies.[134]

A. *Credit Counseling Agencies*

CCAs are traditionally non-profit entities that operate as a liaison between a consumer and his creditor to negotiate a debt-

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http://www.ftc.gov/bcp/policystmt/ad-unfair.htm [hereinafter FTC Unfairness Policy Statement]. Congress codified these principles in § 5(n) of the FTC Act. 15 U.S.C. § 45(n) (2006).

128. FTC Telemarketing Sales Rule Final Amended Rule, *supra* note 116, at 4614.

129. *Id.*

130. *Id.* The FTC stated, "[A]ccordingly, the remedy imposed by the [TSR] to correct them is to prohibit requesting or receiving payment for these services until after performance of the services is completed." *Id.*

131. Liam Dennig, *Obama Leaves Markets in a VIX*, WALL ST. J., Jan. 23, 2010, at B12.

132. Suki Kim, Op-Ed, *Notes from Another Credit Card Crisis*, N.Y. TIMES, May 18, 2009, at A23.

133. FTC NPRM, *supra* note 8, at 41,990.

134. *Id.* at 41,990, 41,993. A third variety of debt-relief service providers, known as "debt consolidation," assists indebted consumers by offering new loans that consolidate the consumer's existing debts into a single loan with the goal of reducing the consumer's interest rate and monthly payments. *Id.* at 41,997. This option is of limited value in the current economic environment where, although interest rates are at historic lows, credit is extremely tight and most consumers who are struggling to meet their monthly payments do not qualify for new loans. In addition, the NPRM states that "[a]ccording to industry sources consulted by Commission staff, there are believed to be fewer than 100 for-profit credit counseling firms operating in the United States." *Id.* at 42,013 n.272. The NPRM proposes to regulate all of these service providers along with the for-profit debt-settlement industry under the proposed TSR amendments. *Id.* at 41,999.

management plan (DMP).[135] The credit counseling model typically begins with an assessment of the consumer's financial situation.[136] Once this analysis is completed, the CCA initiates contact with the consumer's unsecured creditors.[137] By working in cooperation with the consumer's creditors, the CCA determines what, if any, repayment options are available to the consumer based upon her income and total debt.[138] At the end of the negotiations, the credit counselor calculates a new payment schedule, typically with consolidated monthly payments extending over a period of three to five years.[139] During the term of the renegotiated payment schedule, the CCA collects monthly payments from the consumer and distributes appropriate amounts to each creditor.[140] Accordingly, this form of debt settlement may appeal both to consumers, who receive more manageable terms, and to creditors, who are paid the outstanding balances.

In exchange for their services, nonprofit CCAs receive remuneration from both the consumers and the creditors.[141] According to the National Foundation for Credit Counseling (NFCC), on average, consumers pay an upfront fee of $20 to enroll in a DMP and continue to pay a monthly $12 service fee.[142] The consumer's creditors also make a monthly "fair share" contribution to the CCA.[143] The fair share contribution can amount to as much as 15% of the amount received as a result of the DMP.[144]

CCAs have been criticized on a number of grounds. First, the CCA model was originally established as a non-profit adjunct of the credit card industry, assisting creditors to perpetuate and extend their payment flows beyond the point when consumers

135. *Id.* at 41,990.

136. *Id.*

137. *Id.*

138. *Id.* at 41,990–91.

139. *Id.* at 41,990.

140. *Id.* at 41,990–91.

141. *Id.* at 41,991.

142. *Id.* (citing DEANNE LOONIN & TRAVIS PLUNKETT, CONSUMER FED'N OF AM. & NAT'L CONSUMER LAW CTR. INC., CREDIT COUNSELING IN CRISIS: THE IMPACT ON CONSUMERS OF FUNDING CUTS, HIGHER FEES AND AGGRESSIVE NEW MARKET ENTRANTS 13–14 (2003)).

143. FTC NPRM, *supra* note 8, at 41,991.

144. *Id.* (citing LOONIN & PLUNKETT, *supra* note 141, at 10–12).

would naturally default on their loans.[145] Although this relationship has been severed to some extent in recent years, and creditors have steadily reduced the amount of their fair share contributions, CCAs are still viewed as agents of the credit card companies working to ensure that consumers continue to make monthly payments for as long as possible.[146] Second, the CCA model rarely involves a concession by the creditor that reduces the consumer's principal debt.[147] Generally, CCAs only obtain creditor concessions that reduce interest rates on existing debts, and can sometimes obtain a reduction in certain penalties or other fees charged by the credit card companies.[148] Depending upon their income and other financial resources, most indebted consumers can not qualify for DMPs,[149] which require the ability to make ongoing payments over three to five years.[150] Finally, studies have determined that DMP plans suffer from low success rates, with as few as one in five of the consumers that qualify and begin a DMP actually completing the program.[151] These less-than-stellar statistics have attracted both regulatory concern[152] and competition from the for-profit debt-relief industry.[153]

B. *Debt-Settlement Agencies*

In the late 1990s, the for-profit debt-settlement model developed as an alternative to CCAs.[154] As a result of the historic levels of consumer debt and the concomitant increase in demand for debt-relief services following the economic downturn that began in about 2000, for-profit debt-settlement

145. *See id.* ("Beginning in the mid-1960s, creditor banks initiated this model, providing funding for CCAs with the intent of reducing personal bankruptcy filings.").

146. The history and relationship between credit counseling and the banking industry is discussed by Harvey Warren in his book describing his experiences as president of the National Consumer Council, a non-profit organization that offered information about debt settlement to consumers until it was shut down by the FTC and the California Department of Corporations in May 2004. HARVEY Z. WARREN, FOREVER IN YOUR DEBT ch. 6 (2007). *See also, e.g.*, TASC Position Paper, (2006) *available at* http://www.ftc.gov/os/comments/debtsettlementworkshop/536796-00013.pdf.

147. FTC NPRM, *supra* note 8, at 41,990.

148. *Id.*

149. *Id.* at 41,993.

150. *Id.* at 41,990–91.

151. *See, e.g., Pushed off the Financial Cliff,* CONSUMER REPORTS (Jul. 2001). In 2001, the National Foundation for Credit Counseling reported completion rates of 21%.

152. FTC NPRM, *supra* note 8, at 41,990.

153. *Id.* at 41,993.

154. *Id.*

companies now represent a substantial segment of the debt-relief-services industry.[155] The fact that an increasing number of consumers lack sufficient income to qualify for traditional DMPs has also led to the proliferation of for-profit debt-settlement companies to satisfy the growing need for debt relief. As a result, the industry has grown and matured significantly since its origins.

As indicated in the NPRM, for-profit debt-settlement companies are distinct from traditional CCAs in three principal respects. First, for-profits generally advertise their services to consumers through major mediums such as radio, television, and Internet.[156] Interested consumers generally initiate communications with the debt-settlement provider voluntarily by calling the advertised number.[157]

Second, for-profit debt-settlement companies offer to reduce the consumer's debt to a fraction of the principal.[158] Industry surveys indicate that debt-settlement companies often negotiate with debt collectors regarding accounts that are, due to their delinquency status, listed in the creditor's portfolio as losses.[159] Thus, creditors often agree to settle the debt for less than the full principal value in order to minimize losses.[160]

And third, debt-settlement companies offer to alleviate the attendant stresses of debt collection.[161] According to the FTC, many consumers drawn to debt-settlement companies are already behind on their debt payments and thus are subject to annoying debt-collection calls.[162] The debt-settlement companies generally instruct their clients to assign them powers of attorney, and then serve creditors with cease-communication notices.[163] As a corollary, the debt-settlement providers sometimes instruct customers to execute a change of address, substituting the debt-settlement company's address for the consumer's address and redirecting billing statements and collections notices so that the consumer no longer receives

155. *Id.*
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.*
162. *Id.*
163. *Id.* at 41,994.

them.[164] The FTC contends that in this manner, for-profit providers offer consumers the hope of alleviating the stress of debt-collection calls by attempting to interpose themselves between the consumers and the debt collectors.[165]

Debt-settlement companies have generally adopted three major fee models.[166] The "front-end fee model" requires that customers pay a portion of the company's fee within the first three or four months of enrollment and the balance over the ensuing 12 months or less.[167] A second common fee structure, the "flat fee model," provides that the consumer will pay the entire fee over approximately the first half of the total enrollment period.[168] Finally, the "back-end model" requires the consumer to make a relatively small initial payment, nominal monthly payments for the duration of the plan, and then, when and if a settlement is achieved, an amount based on the total amount saved.[169]

VI. FTC'S ASSERTED BASIS FOR HEIGHTENED ENFORCEMENT MEASURES

Over the past decade, the FTC has shifted greater attention to entities operating in the debt-relief-services industry. In what the FTC maintains is a response to growing deceptive and unfair practices by debt-relief-services providers,[170] the Commission has undertaken six civil enforcement actions against CCAs[171] and seven actions against for-profit debt-settlement companies.[172]

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.* at 41,991.

171. Fed. Trade Comm'n v. Express Consolidation, No. 06-cv-61851-WJZ (S.D. Fla. 2006); United States v. Credit Found. of Am., No. CV 06-3654 ABC(VBKx) (C.D. Cal. 2006); Fed. Trade Comm'n v. Integrated Credit Solutions, No. 06-806-SCB-TGW (M.D. Fla. 2006); Fed. Trade Comm'n v. Nat'l Consumer Council, No. SACV04-0474 CJC(JWJX) (C.D. Cal. 2004); Fed. Trade Comm'n v. Debt Mgmt. Found. Servs., No. 04-1674-T-17-MSS (M.D. Fla. 2004); Fed. Trade Comm'n v. AmeriDebt, Inc., No. PJM 03-3317 (D. Md. 2003); FTC NPRM, *supra* note 8, at 41,991–92.

172. Fed. Trade Comm'n v. Debt-Set, Inc., No. 1:07-cv-00558-RPM (D. Colo. 2007); Fed. Trade Comm'n v. Edge Solutions, No. CV-07-4087 (E.D.N.Y. 2007); Fed. Trade Comm'n v. Connelly, No. SA CV 06-701 DOC (RNBx) (C.D. Cal. 2006); Fed. Trade Comm'n v. Better Budget Fin. Servs., Inc., No. 04-12326 (WG4) (D. Mass. 2004); Fed. Trade Comm'n v. Innovative Sys. Tech., Inc., No. CV04-0728 GAF JTLx (C.D. Cal. 2004); Fed. Trade Comm'n v. Nat'l Consumer Council, No. SACV04-0474 CJC(JWJX) (C.D. Cal.

The actions brought against CCAs have generally been based upon fraud-related claims and, in some instances, for violations of the TSR.[173] Against for-profit debt-settlement companies like: "the FTC's actions against deceptive credit counselors, . . . these suits commonly allege the misrepresentation of fees, or the failure to fully disclose them—including the significant up-front fees that are often charged."[174] Additionally, the Commission has alleged that "these defendants falsely promised high success rates, promised unattained results (*e.g.*, settlements for a certain percentage of the total original debt), and misrepresented their refund policies."[175] Further, "the Commission['s] complaints charged that the defendants in these matters failed to warn consumers of the negative consequences of debt settlement, including the accumulation of late fees and other charges, the effect on consumers' credit ratings, and the fact that debt collectors would continue to contact consumers."[176]

Consistent with the FTC's policy of abandoning the administrative enforcement process in favor of bringing civil actions based on Sections 13(b) and 19, the NPRM does not reflect that the agency has issued any cease and desist orders against any CCAs or debt-settlement companies.[177]

VII. SUMMARY OF THE FTC'S PROPOSED AMENDMENTS TO TSR

In its effort to police the debt-services industry, the FTC has apparently decided that additional legal restrictions are needed. The agency has proposed certain amendments to the TSR specifically intended to increase the agency's ability to regulate debt-relief providers.[178] Because the FTC's jurisdiction does not extend to non-profit entities,[179] however, the proposed TSR

2004); Fed. Trade Comm'n v. Jubilee Fin. Servs., Inc., No. 02-6468 ABC (Ex) (C.D. Cal. 2002); FTC NPRM, *supra* note 8, at 41,992.

173. *See* FTC NPRM, *supra* note 8, at 41,992 (stating that the enforcement actions stemmed from deceptive statements, misrepresentation, and violations of the TSR).

174. *Id.* at 41,996.

175. *Id.*

176. *Id.*

177. As discussed *supra* Part III, a record of issuing prior cease and desist orders is one means of meeting the "prevalence" requirement for the agency to conduct rulemaking under § 18. 45 U.S.C. § 57a(b)(3)(A) (2006).

178. FTC NPRM, *supra* note 8, at 42,017–24.

179. The FTC discusses the determination that non-profit entities are not subject to its jurisdiction in the NPRM:

> Section 5(a)(2) of the FTC Act states: "The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations . . . from using

amendments would apply only to for-profit debt-relief entities companies.[180]

The proposed amendments address a wide spectrum of activities engaged in by debt-relief providers. Proposed Section 310.2(m), for example, provides a broad definition of "debt-relief service" to include DMPs, debt-settlement services, and debt-negotiation services.[181] The definition expressly excludes services provided that relate to secured debt and mortgage loans.[182]

The proposed amendments would significantly expand the TSR's coverage of debt-relief providers by eliminating the Rule's current exemption of most *inbound calls* from consumers in response to advertisements[183] and qualifying direct mail solicitations.[184] TSR Section 310.6 presently exempts calls "initiated by a customer ... in response to an advertisement through any medium"[185] and exempts calls "initiated by a

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unfair or deceptive acts or practices in or affecting commerce." Section 4 of the Act defines "corporation" to include: "any company, trust, so-called Massachusetts trust, or association, incorporated or unincorporated, *which is organized to carry on business for its own profit or that of its members* . . . ."

Id. at 11,998 (citations omitted)

180. FED. TRADE COMM'N, ADDITIONAL REPORT TO CONGRESS PURSUANT TO THE DO NOT CALL REGISTRY FEE EXTENSION ACT OF 2007, at 10 (2009).

181. Proposed § 310.2(m) defines the term "debt relief service" to mean:

any service represented, directly or by implication, to renegotiate, settle, or in any way alter the terms of payment or other terms of the debt between a consumer and one or more unsecured creditors or debt collectors, including, but not limited to, a reduction in the balance, interest rate, or fees owed by a consumer to an unsecured creditor or debt collector.

FTC NPRM, *supra* note 8, at 42,017.

182. *Id.*

183. The FTC's TSR compliance guide states that "[t]he Rule generally does not apply to consumer calls made in response to ... television commercials; infomercials; home shopping programs; print advertisements in magazines, newspapers, the Yellow Pages, or similar general directories; radio ads; banner ads on the Internet; and other forms of mass media advertising and solicitation." Federal Trade Commission, Facts for Business, Complying with the Telemarketing Sales Law, http://www.ftc.gov/bcp/edu/pubs/business/marketing/bus27.shtm.

184. "Generally, consumer calls in response to a direct mail solicitation that clearly, conspicuously, and truthfully makes the disclosures required by the Rule are exempt from the Rule." *Id.* "Direct mail advertising includes, but is not limited to, postcards, flyers, door hangers, brochures, 'certificates,' letters, email, facsimile transmissions, or similar methods of delivery sent to someone urging a call to a specified telephone number regarding an offer of some sort." *Id.*

185. 16 C.F.R. § 310.6 (2009). The exemption does not apply to consumer-initiated calls in response to advertisements for investment or business opportunities not covered by the Franchise Rule, credit card protection, credit repair, recovery services, advance fee loans, or instances of "upselling" additional products or services that were not included in the advertisement. *Id.*

customer . . . in response to a direct mail solicitation," including facsimiles and e-mail solicitations that meet certain requirements.[186] The proposed amendments would require for-profit providers that advertise on radio, television, the Internet or by mail, e-mail, or facsimile, who were previously exempt from the TSR's disclosure requirements, to comply with the Rule on all calls, whether outbound or incoming.[187] "As a result, virtually all debt-relief telemarketing transactions would be subject to the TSR if the proposed modifications to the Rule are adopted."[188]

Apart from expanding the Rule's coverage to most inbound calls, the proposed amendments would require debt-relief providers to make six additional material disclosures that are not required of any other telemarketers. These new disclosures include:

> • The amount of time required to achieve the purported results of a DMP or debt-settlement program;[189]
>
> • The amount of money or percentage of each of the consumer's outstanding debts that would have to be accumulated before the debt-relief provider will make settlement offers to each of the customer's creditors;[190]
>
> • A statement that "not all creditors or debt collectors will accept a reduction in the balance, interest rate, or fees a customer owes such creditor or debt collector";[191]
>
> • Notification that, "pending completion of the represented debt-relief services, the customer's creditors or debt collectors may pursue collection efforts, including initiation of lawsuits";[192]

186. *Id.*
187. FTC NPRM, *supra* note 8, at 41,999.
188. *Id.*
189. *Id.* at 42,019.
190. *Id.*
191. *Id.*
192. *Id.*

- That the use of the debt-relief service will likely adversely affect the consumer's creditworthiness, may result in consumers being sued by their creditors, and may increase the amount owed to creditors as a result of the accrual of additional fees and interest;[193] and

- A statement that any "savings a customer realizes from use of a debt-relief service may be taxable income."[194]

Current TSR Section 310.3(a)(4) prohibits "[m]aking a false or misleading statement to induce any person to pay for goods or services,"[195] and Section 310.3(a)(2) prohibits telemarketers from making specified misrepresentations of material information.[196] Yet, despite these existing provisions, which broadly prohibit telemarketers from misrepresenting their products or services, the FTC has decided it should amend the TSR to add additional provisions banning debt-relief providers from making specific misrepresentations regarding their services.

Proposed Section 310.3(a)(2)(x) would specifically prohibit telemarketers of debt services from misrepresenting any material aspect of debt-relief services, including (but not limited to) a laundry list of issues.[197] The proposed amendment would expressly ban, among other things, misstatements regarding the percentage or number of customers that attain the represented results and the amount of time necessary to achieve the represented results.[198]

193. *Id.*

194. *Id.*

195. 16 C.F.R. § 310.3(a)(4) (2009).

196. *Id.* § 310.3(a)(2).

197. FTC NPRM, *supra* note 8, at 42,019.

198. Proposed § 310.3(a)(2)(x) would specifically prohibit misrepresentations regarding, among other issues, the amount of money or the percentage of the debt amount that a customer may save by using such service; the amount of time necessary to achieve the represented results; the amount of money or the percentage of each outstanding debt that the customer must accumulate before the provider of the debt-relief service will initiate attempts with the customer's creditors' debt collectors to negotiate, settle, or modify the terms of customer's debt; the effect of the service on a customer's creditworthiness; the effect of the service on collection efforts of the consumer's creditors or debt collectors; the percentage or number of customers who attain the represented results; and whether a service is offered or provided by a non-profit entity. *Id.* at 42,003.

Finally, and most significantly to the debt-settlement industry, proposed Section 310.4(a)(5) would impose an "advance fee" ban on debt-relief-service providers, similar to the ban imposed in the TSR on credit-repair services, recovery services, and advance fee loan services.[199] The proposed amendment, which would be added to Section 310.4 prohibits:

> [r]equesting or receiving payment of any fee or consideration from a person for any debt relief service until the seller has provided the customer with documentation in the form of a settlement agreement, debt management plan, or other such valid contractual agreement, that the particular debt has, in fact, been renegotiated, settled, reduced, or otherwise altered.[200]

The NPRM expressly refers to the "analytical framework" developed in the original TSR to support the advance fee ban on credit-repair services, recovery services, and advance fee loan services, and claims that the same considerations for prohibiting the imposition of advance fees by those industries also apply to advance fees charged by debt-relief providers.[201] Reprising its analysis in the original TSR,[202] the FTC asserts that although "[t]he Telemarketing Act directs the Commission to include in the TSR provisions to address three specific practices denominated by Congress as 'abusive,' . . . . the Act 'does not limit the Commission's authority to address abusive practices beyond these three practices legislatively determined to be abusive.'"[203] Once again the agency relies on the definition of the word "abusive" in *Webster's Dictionary* as authority for

199. *See* discussion *supra* Part III.

200. FTC NPRM, *supra* note 8, at 42,009.

201. *Id.* at 42,005.

202. FTC Telemarketing Sales Rule Notice of Proposed Rulemaking, 67 Fed. Reg. 4492, 4510 (Jan. 30, 2002) (codified at 16 C.F.R. § 310 (2009)).

203. FTC NPRM, *supra* note 8, at 42,005. Remarkably, the authority for the proposition that "the Act does not limit the Commission's authority to address abusive practices beyond these three practices legislatively determined to be abusive" is nothing more than the agency's own Proposed Rule issued in 2002. *Id.* at 42,005 n.202. In other words, the FTC's supporting authority for this proposition consists of no more than its own prior analysis, which was founded on the definition of the word "abusive" in the 1949 edition of Webster's International Dictionary. FTC Telemarketing Sales Rule Notice of Proposed Rulemaking, *supra* note 201, at 4,511 n.176.

exceeding the scope of Congress's express statutory authorization.[204]

The FTC reprised its application of the Section 5(n) "unfairness" standards,[205] used to justify the original TSR regulation of advance fees, to the proposed debt-relief advance fee ban, determining once again that such a prohibition did not exceed its rulemaking authority.[206] Based upon "the information available to the Commission,"[207] the FTC found that the first unfairness element of substantial injury to consumers had been shown by its determinations that, according to the FTC, debt-relief services (1) provide a "low likelihood of success,"[208] and (2) impose the "significant burden on consumers of front-loaded fees."[209] Ignoring the industry's claim that 35–60% of debt-settlement consumers complete their programs,[210] the FTC based its conclusion that debt relief provides a low likelihood of success primarily on statistics gathered from three FTC civil

204. FTC NPRM, *supra* note 8, at 42,005 n.204. The agency acknowledges once again that the TSA's statutory grant of authority to regulate "abusive practices" was clearly grounded in addressing privacy concerns:

> In determining which conduct should be characterized by the TSR as abusive, the Commission noted that each of the statutorily-denominated abusive practices implicate consumers' privacy. Nevertheless, the plain meaning of the term 'abusive' suggests that no such inherent limitation in the meaning of the term constrains the Commission in crafting the Rule.

FTC NPRM, *supra* note 8, at 42,005.

205. Section 5(n) provides:

> The Commission shall have no authority under this section or section 57a of this title to declare unlawful an act or practice on the grounds that such act or practice is unfair unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. In determining whether an act or practice is unfair, the Commission may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.

15 U.S.C. § 45(n) (2006).

206. FTC NPRM, *supra* note 8, at 42,005.

207. *Id.* at 42,006. Although the NPRM mentions "complaint data, [the FTC's] law enforcement experience, as well as state enforcement efforts, the [debt-relief industry] Workshop [conducted by the agency in September 2008], and additional independent research conducted by Commission staff," the "state enforcement efforts" appear to be limited to the New York Attorney General's action mentioned in footnote 215 and there is no further discussion of the "additional independent research conducted by Commission staff." *Id.*

208. *Id.*

209. *Id.* at 42,007.

210. THE ASS'N OF SETTLEMENT COS., STUDY ON THE DEBT SETTLEMENT INDUSTRY 1 (2007).

enforcement actions[211] and on the unproven allegations contained in a press release issued by the New York Attorney General's office.[212] The agency found a "significant burden" existed on consumers from the fact that the "front-end" fee model is the most prevalent in the industry and that "substantial harm accrues when debt-relief providers charge fees and then fail to provide the represented services."[213] What is missing from the FTC's analysis, however, is any data supporting the prevalence of debt-relief providers taking fees without delivering services. Although the agency found it "telling that nearly all states have now adopted laws that regulate the provision of some or all debt-relief services,"[214] the FTC mentions only one state, North Carolina, which prohibits debt-relief providers from charging advance fees,[215] which seems more telling.

Disturbingly, in support of its claim that consumers experienced low success rates, the FTC once again trotted out one of its favorite statistics about the debt-relief industry, claiming that its civil enforcement action brought against the National Consumer Council (NCC) and other defendants in 2004, "show[ed] that only 1.4% of the consumers that entered defendant's debt-settlement program obtained the promised results."[216] In truth, the NCC case was a bungled prosecution that put a responsible and effective debt-relief program out of business and left nearly 25,000 financially troubled consumers without access to their savings and without the company's assistance.[217] Remarkably, the FTC seized upon a statistic in the court-appointed receiver's report that reflected that very few consumers had completed the debt-relief program.[218] What the FTC repeatedly neglects to disclose is that the reason so few

211. FTC NPRM, *supra* note 8, at 41,995 n.102 (citing Fed. Trade Comm'n v. Connelly, No. SA CV 06-701 DOC (RNBx) (C.D. Cal. 2006); Fed. Trade Comm'n v. Debt Solutions, Inc., No. 06-0298 (W.D. Wash. 2006); Fed. Trade Comm'n v. Nat'l Consumer Council, Inc., No. SACV04-0474 CJC(JWJX) (C.D. Cal. 2004)).

212. *Id.*

213. *Id.* at 42,007.

214. *Id.*

215. *Id.* at 41,996 n.121; *see* N.C. GEN. STAT. § 14-424 (making any person engaged in debt adjusting guilty of a Class 2 misdemeanor). In North Carolina, debt adjusting includes charging advance fees. *Id.* § 14-423(2).

216. FTC NPRM, *supra* note 8, at 41,995 n.102.

217. WARREN, *supra* note 145, ch. 1.

218. Press Release, Fed. Trade Comm'n, Debt Services Operations Settle FTC Charges (Mar. 30, 2005), *available at* http://www.ftc.gov/opa/2005/03/creditcouncel.shtm.

consumers graduated was that the FTC prematurely *shut down* the NCC program after it operated for only thirty-nine months, with all but a miniscule number of consumers spending less than projected thirty-six months required to complete the program.[219] More than half of those who had enrolled in the program were still enrolled and relying on the program to help them settle their debts.[220] The FTC obtained a court order shuttering the company without any notice based upon comparisons to "operational problems, accounting irregularities, and stolen consumer funds" encountered by regulators in previous actions against other debt-settlement companies;[221] however, these comparisons proved to be inapplicable in the NCC case, where the receiver determined that all of the consumer funds were present and properly accounted for.[222] At the time it was terminated by the FTC's action, the program was exceeding its marketing representations by generating average settlements at the rate of 57.3% of their principal debt balances (excluding fees).[223] In consistently quoting the NCC 1.4% completion percentage, the FTC has purposely kept the NCC receiver's findings, which show that debt settlement can provide a substantial benefit for consumers that have the opportunity to complete the program out of the debate.[224] A second unfairness requirement considered by the FTC was whether there are potential countervailing benefits to consumers or competition.[225] The FTC briefly considered the industry's claims that eliminating advance fees would be an unsustainable business

219. Report of Temporary Receiver's Activities, May 3, 2004–May 14, 2004, First Report to the Court, FTC v. National Consumer Council, et. al., SACV 04-0474 CJC (JWJx).

220. *Id.*

221. WARREN, *supra* note 145, ch. 1.

222. Report of Temporary Receiver's Activities, *supra* note 218.

223. *Id.* at 7-8. The receiver's report reflects that "[t]he debt reduction process was promoted to potential and existing consumers as the opportunity to reduce consumer debt by 25% to 50% and then become debt free." Based on the 57.3% settlement rate, the program was saving consumers an average of 42.7%, exclusive of fees. Even after the program fees are deducted, the program generated savings of approximately 20% from their principal balance *as of the start* for consumers who completed the program.

224. When the FTC shut down the NCC and its supporting companies, consumers enrolled in an NCC certified debt settlement program had, according to the court-appointed receiver, settled 40,572 cards totaling $196,451,977 of debt for $80,419,080 at an average settlement percentage of 41.57%. *Id.* When total average savings percentage was still over 33%. *Id.* These numbers did not and do not support the notion that consumers derive no benefit from a properly run debt settlement program.

225. FTC NPRM, *supra* note 8, at 42,008.

model and would create a barrier to entry; that the stream of clients' advance fees is required to pay the marketing and labor costs that occur before and while settlement negotiations occur; and that if debt-settlement companies are not paid until after they complete settlement negotiations, they will be forced into the role of becoming their clients' creditors.[226] However, the agency found that "insufficient empirical data have been presented to substantiate that these purported benefits outweigh what appears to be substantial harm to consumers."[227]

Significantly, the FTC acknowledged that

> at least conceivably, such [an advance fee] prohibition could increase the costs incurred by any legitimate providers of debt relief services, make it impossible for some firms to continue to exist, and reduce the ability of new firms to enter the market. . . . If existing providers' costs are increased, they could be forced to increase the prices they charge consumers for their services in order to remain solvent.[228]

However, the agency's underlying doubts as to whether debt-relief provides any real services or benefits to consumers apparently negated this concern:

> [T]he record lacks any empirical data on whether debt relief companies actually provide the debt relief as represented to consumers. In fact, the federal and state law enforcement record demonstrates that few, if any consumers who pay upfront fees, receive any benefits from the advance fee practices. Thus, any increase in costs resulting from the advance fee ban would be unlikely to outweigh the consumer injury resulting from the current fee practice.[229]

The third unfairness factor considered by the FTC was whether the injury caused by advance fees is one that consumers can reasonably avoid.[230] The reasonable avoidance standard is designed to ferret out those instances where consumers can

> make their own private purchasing decisions without regulatory intervention [and] survey the available alternatives, choose those that are the most desirable, and avoid those that are inadequate or unsatisfactory. However, it has long been

226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.*
230. *Id.* at 42,008 n.235.

> recognized that certain types of sales techniques may prevent consumers from effectively making their own decisions, and that corrective action may then become necessary.[231]

In those circumstances, the FTC has taken the position that rulemaking, enforcement activity, or both, is appropriate.

The FTC based its NPRM determination that consumers cannot reasonably avoid the injury caused by advance fees on the unsupported and circular premises that "the offered services are illusory"[232] and "the promised services are almost never provided."[233] Yet the agency fails to identify any substantial evidence supporting these statements.[234] Without any showing that the debt-relief industry is "fundamentally bogus," as it purported to show with respect to credit-repair services, recovery services, and advance fee loan services when it enacted the advance fee prohibition in the original TSR,[235] the FTC's determination that injury from debt-relief companies cannot be reasonably avoided by consumers is based, at best, on assumption and speculation.

231. FTC Unfairness Policy Statement, *supra* note 126.

232. FTC NPRM, *supra* note 8, at 42,008.

233. *Id.*

234. The FTC's support for its claim that services, "in most cases, are never provided to the vast majority of consumers," is limited to information that was purportedly gathered from FTC enforcement actions. *Id.* at 42,006. As noted, however, in the only example identified by the FTC, which involved the NCC, the FTC's conclusions were unfounded.

235. FTC Telemarketing Sales Rule Final Amended Rule, *supra* note 116, at 4,614.

VIII. THE FTC'S AUTHORITY TO AMEND THE TELEMARKETING SALES RULE TO ADOPT REGULATIONS TARGETED AT THE DEBT-RELIEF INDUSTRY

"Plainly, if we were 'to presume a delegation of power' from the absence of 'an express withholding of such power, agencies would enjoy virtually limitless hegemony . . . .'"[236]

In 2009, the FTC apparently determined that the debt-relief industry was harming American consumers and that its Section 5 authority to prohibit and enforce "unfair and deceptive acts or practices"[237] was insufficient to effectively regulate the industry. In response, the FTC moved to enhance its available tools by utilizing the rulemaking process to curtail the debt-relief industry. Because the FTC staff "hated" the formal rulemaking process provided by Congress in the Magnuson–Moss Act, viewing it as "cumbersome,"[238] the FTC is seeking to shortcut the process by unilaterally and improperly expanding the scope of the TCFAPA to justify issuance of rules governing the debt-relief industry.

The FTC's rulemaking authority under the TCFAPA is limited to remedying abusive telemarketing sales practices.[239] To the extent the FTC's proposed rules legitimately address abusive telemarketing activities, the agency's use of its TCFAPA rulemaking authority is probably appropriate to the extent particular debt-settlement marketing falls within the existing reach of the TSR. Examples of such provisions included among the proposed amendments are the disclosure requirements set forth in Proposed Section 310.3(a)(1)(viii)[240] and the prohibited representations set out in Proposed Section 310.3(a)(2)(x).[241] These proposed amendments, although targeted solely at the debt-relief industry, implement new regulations designed to remedy purportedly abusive telemarketing sales practices, which is clearly within the scope of the authority granted to the FTC by Congress.

236. Am. Bar Ass'n v. Fed. Trade Comm'n, 430 F.3d 457, 468 (D.C. Cir. 2005) (quoting Ry. Labor Exec. Ass'n v. Nat'l Mediation Bd., 29 F.3d 655, 671 (D.C. Cir. 1994) (en banc)).

237. 15 U.S.C. § 45(a) (2006).

238. Rosch, *supra* note 88, at 3.

239. *See supra* Part III.

240. FTC NPRM, *supra* note 8, at 42,019.

241. *Id.*

The FTC's proposed TSR amendments are invalid to the extent they exceed that authority. In *Chevron, U.S.A., Inc. v. Natural Resources Defense Council,*[242] the Supreme Court discussed the standard for reviewing an agency's construction of a statute it administers: "First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[243] In evaluating Congress' intent, the courts utilize "traditional tools of statutory construction," including the terms, legislative history, and purposes of the statute.[244] If the court "ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect."[245]

Both the express language of the TCFAPA and its legislative history make clear that the purpose of the Act was to remedy abusive *telemarketing sales practices* that were causing substantial harm to consumers' financial and privacy interests. Congress entrusted the FTC to utilize its "valuable experience in combating such activities"[246] to "prescribe rules prohibiting deceptive telemarketing acts or practices and other abusive telemarketing acts or practices."[247] To carry out this authority, Congress directed the FTC to establish a "definition of deceptive telemarketing acts or practices which shall include fraudulent charitable solicitations, and which may include acts or practices of entities or individuals that assist or facilitate deceptive telemarketing, including credit card laundering."[248] The legislative history of the TCFAPA reflects that Congress never intended "that telemarketing practices be considered per se 'abusive.' The [House] Committee [on Energy and Commerce] is not interested in further regulating the legitimate telemarketing industry through this legislation."[249]

In its discussion of the kinds of "other abusive practice" that should be prohibited in the FTC's regulations, the House

242. 467 U.S. 837 (1984).
243. *Id.* at 842–43.
244. *Id.* at 843 n.9.
245. *Id.*
246. H.R. REP. NO. 103-20, at 8 (1994).
247. 15 U.S.C. § 6102(a)(1) (2006).
248. *Id.* § 6102(a)(2).
249. H.R. REP. NO. 103-20, at 4.

Committee's report provided a laundry list of "inappropriate practices," similar to the specific provisions that were expressly included in the Act.[250] Beyond those delineated practices, the Committee stated that it "also intends that the FTC will identify such other abusive practices that would be considered by the reasonable consumer to be abusive *and thus violate such consumer's right to privacy.*"[251] As an example of such "other abusive practices," the Committee described a scenario where an aggressive telemarketer randomly calls consumers late at night in an effort to reach people who stay up late at night, disregarding the annoyance caused to the vast majority of consumers that would be awakened by such calls.[252] Significantly, the Committee provided no examples of "other abusive conduct" that supported, in any respect, the adoption of regulations of how or when telemarketers may charge consumers for their products or services.

In *Chevron*, the Supreme Court also set out the second part of the analysis to be applied in the event that a reviewing court determines that Congress's intentions are unclear:

> If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.[253]

In such instances, the court determines "whether the agency's interpretation is a permissible construction of the statute."[254]

250.

> With respect to the bill's reference to 'other abusive practices,' ... the Committee intends that the Commission's rulemaking will include proscriptions on such inappropriate practices as threats or intimidation, obscene or profane language, refusal to identify the calling party, continuous or repeated ringing of the telephone or engagement of the called party in conversation with an intent to annoy, harass, or oppress any person at the called number.

Id. at 8.

251. *Id.* (emphasis added).

252. *Id.*

253. Chevron, U.S.A., Inc. v. Natural Res. Def. Council, 467 U.S. 837, 843 (1984).

254. Mainstream Mktg. Sys., Inc. v. Fed. Trade Comm'n, 358 F.3d 1228, 1250 n.16 (10th Cir. 2004).

In this case, the FTC adopted the original TSR, including the provisions prohibiting credit-repair services, recovery services, and advance fee loan services from charging advance fees, despite evidence that these provisions were inconsistent with the agency's *own* interpretation of the statutory authority that had been granted by Congress under the TCFAPA. This same analysis indicates that the FTC relied on its Section 5 rulemaking authority, rather than the authority granted by Congress in the TCFAPA, to implement the advance fee provisions in the original TSR. Because the FTC failed to comply with the Section 5 rulemaking requirements imposed by Magnuson–Moss when it enacted the advance fee provisions in the original TSR, however, those provisions, as well as the currently proposed amended advance fee provisions, are invalid.

In the Notice of Proposed Rulemaking for the original TSR, the FTC acknowledged several times that the "other abusive telemarketing practices" that Congress authorized the agency to address in Section 6102(a)(2) of the TCFAPA are linked to telemarketing conduct that affects consumers' privacy rights. First, the agency affirmed that its proposed TSR prohibitions against threatening or intimidating a consumer, using profane or obscene language, or causing a consumer's phone to ring repeatedly or continuously to annoy, abuse, or harass the consumer,[255] "are directly consistent with the Act's emphasis on privacy protection."[256] In addition, the FTC included in the Proposed Rules the House Report's unambiguous statement directing the FTC to "identify other abusive practices that would be considered by the reasonable consumer to be abusive and thus violate such consumer's right to privacy."[257]

Finally, and most significantly, the FTC specifically addressed the question of its authority to promulgate rules governing "other abusive practices" that are not related to privacy when it discussed its application of its traditional unfairness analysis to the question of advance fees in the original TSR Proposed Rules. The agency acknowledged that "some of the practices prohibited as abusive under the Act flow directly from the

255. FTC Telemarketing Sales Rule Final Amended Rule, *supra* note 116, at 4613.

256. *Id.* at 4614. The FTC also acknowledged that Congress directed that these specific practices be addressed in the rules.

257. *Id.* at 4614 n.395.

Telemarketing Act's emphasis on protecting consumers' privacy."[258] However, the FTC went on to state that:

> When the Commission seeks to identify practices as abusive that are less distinctly within that parameter, the Commission thinks it appropriate and prudent to do so within the purview of its traditional unfairness analysis, as developed in Commission jurisprudence and codified in the FTC Act. This approach constitutes a reasonable exercise of authority under the Telemarketing Act, and provides an appropriate framework for several provisions of the original rule.[259]

In other words, where the agency's rulemaking exceeded the "parameter" of the privacy concerns addressed by Congress in the statute and the legislative history, the FTC apparently felt compelled to apply its traditional unfairness analysis to ensure that such rules did not exceed its Section 5 authority.[260] Otherwise, if the FTC was confident that its rules prohibiting advance fees did not exceed the rulemaking authority delegated by Congress in the TCFAPA, there would be no reason to engage in the Section 5 unfairness analysis.

IX. CONCLUSION

The FTC's attempt to promulgate debt-relief industry regulations that exceed the authority provided by the TSR is an example of the agency's campaign to expand its authority beyond the limits imposed on it by Congress. The endgame is obvious—the FTC seeks to obtain complete regulatory and enforcement discretion by obtaining the authority to freely engage in APA rulemaking and employ the threat of unlimited Section 19(b) remedies in any enforcement action. Moreover, given the FTC's stated desire to expand the availability of civil penalties beyond the limitations currently imposed by statute,[261] it can only be a matter of time before the FTC moves either to promulgate its own civil penalties or to impose such penalties under its overly inflated interpretation of Section 19(b). In

258. *Id.*

259. *Id.*

260. The agency apparently anticipates and attempts to head off this challenge, stating that "[w]hether privacy-related intrusions or concerns might independently give rise to a Section 5 violation outside of the Telemarketing Act's purview is not addressed or affected by this analysis." *Id.*

261. *See supra* note 59 and accompanying text.

short, the FTC continues "to push its statutory authority to the very brink and beyond."[262]

Despite these coordinated efforts, we anticipate that significant legal challenges will be raised to the FTC's expansionism. Objections to the agency's Section 13(b) strategy have been raised in the District of Columbia, the Northern District of California and the Ninth Circuit, and we fully expect that upon thorough review, the courts will ultimately draw the correct conclusion that the agency was never authorized to obtain expansive Section 19(b) remedies beyond the situations outlined by Section 19(a). Similarly, we expect that if the FTC continues its efforts to promulgate debt-relief industry regulations under the dubious authority of the TSR, rather than wait for express guidance from Congress, the courts will repel such efforts as a violation of the agency's statutory authority.

Given the questionable legal basis supporting the FTC's attempt to amend the TSR, and the interest the debt-settlement industry is receiving from Congress and various state legislatures, it appears that the FTC's aggressive attack on the settlement industry is motivated by political pressure exerted by special interest groups opposing the industry, rather than a genuine concern for consumers suffering a crisis of debt. As Commissioner Rosch acknowledged, there is a place for debt settlement as a tool to address consumer debt issues: the task at hand at this point is to "separate the wheat from the chaff."[263] The FTC's proposed TSR amendment does not address this task. Rather, it lays to waste the entire wheat field. Unfortunately, this scorched earth philosophy is entirely consistent with an agency that appears more focused on expanding its authority and flexing its muscles than it is with ensuring consumers have safe and available options to deal with crushing debt.

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262. *See supra* note 58 and accompanying text.

264. *Transcript of FTC Debt Settlement Workshop* 14 (Sept. 25,2009) *available at* www.FTC.gov/bcp/workshops/debtsettlement/officialtranscript.pdf.

TAX-EXEMPT CREDIT COUNSELING ORGANIZATIONS AND THE FUTURE OF DEBT-SETTLEMENT SERVICES

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I. INTRODUCTION

On July 30, 2009, the Federal Trade Commission (FTC) proposed amendments to its Telemarketing Sales Rule that would significantly impact for-profit providers of various debt-relief services. Set out in a Notice of Proposed Rulemaking, these changes would: (1) mandate certain disclosures about the services being provided, including the cost of those services and the time frame in which debt relief would occur; (2) prohibit misrepresentations concerning the service provider's success rate in obtaining debt relief and its status as a for-profit or non-profit organization; (3) make the Telemarketing Sales Rule applicable to "in-bound" calls, i.e., calls made by consumers in response to advertising by debt-relief service providers; and (4) prohibit "advance fees," meaning that debt-relief providers could collect fees only after rendering the services in question.[1] The Notice of Proposed Rulemaking would define "debt relief service" to include any renegotiation, settlement or alteration of the terms of consumer debt, including reductions in the balance owed, interest rate, or fees.[2] These changes would apply only to for-profit debt-relief service providers, because the jurisdiction of the FTC does not extend to non-profit entities.[3]

For a number of years, for-profit debt-settlement service providers and non-profit credit counseling organizations—many of which are also exempt from federal income tax—have competed to provide services to individuals who are burdened by excessive consumer debt. Such individuals typically have three primary options: bankruptcy, debt management plans, and debt-settlement services.

The alternative of bankruptcy—which has long had many downsides for the debtor such as a long-term adverse impact on the debtor's credit rating—became significantly more problematic as a result of the enactment of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[4] That

1. FTC Telemarketing Sales Rule, 16 C.F.R § 310 (2009).

2. *Id.*

3. *Id.*

4. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (requiring also that debtors obtain credit counseling prior to

Act made it more difficult for many consumers to qualify for relief under Chapter 7 of the Bankruptcy Code, leaving Chapter 13 as the bankruptcy alternative. The Act made changes to Chapter 13 which required many consumers to repay a higher percentage of their unsecured debt than was previously the case, with liability under a plan requiring payments over a future period of three to five years.

Debt management plans should be designed to result in repayment of the full principal amount owed by the consumer. These plans, which are generally provided and administered by non-profit, tax-exempt credit counseling organizations, typically involve extensions of time to pay and, in some instances, concessions by the creditors on interest rates and fees that would otherwise apply.[5] The credit counseling organizations receive "fair share" payments from the creditors that are a percentage of the amount of debt repaid by the consumer debtors.[6] Debt-settlement services, by contrast, involve negotiation by the service provider to reduce the principal amount of the debt in exchange for a lump-sum payment.[7] These services are typically provided and administered by for-profit entities, which are paid fees by the consumer debtors.[8] The relative efficacy of debt management plans and debt-settlement services, and the number of "bad apples" within the two groups of service providers, is sharply controverted by the two camps.[9]

Not surprisingly, non-profit credit counseling organizations generally favor the prospect that the Telemarketing Sales Rule will be expanded as described in the Notice of Proposed Rulemaking, while for-profit debt-settlement providers generally oppose certain aspects of the proposed amendments. In its comments to the Notice of Proposed Rulemaking submitted to the FTC on October 26, 2009, the United States Organizations

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filing for bankruptcy protection, a mandate that produced considerable additional demand for credit counseling services).

5. *See,* UNIFORM DEBT-MANAGEMENT SERVICES ACT Prefatory Note at 1 (Proposed by National Conference of Commissioners of Uniform State Law 2008) (explaining debt management plans generally).

6. *Id.*

7. *Id.*

8. *Id.*

9. *See, e.g.,* Public Forum on Proposed Debt Relief Amendments, http://www.ftc.gov/bcp/rulemaking/tsr/tsr-debtrelief/transcript.pdf (discussing the Notice of Proposed Rulemaking held on November 4, 2009).

for Bankruptcy Alternatives (USOBA), a trade organization representing debt-settlement service providers, noted that it was

> pleased to be able to support the vast majority of the proposed amendments to the TSR. Our support of the amendments to the TSR stops, however, with the proposal of a radical, "advance fee ban." This ban is supported and promoted, not coincidentally, by not-for-profit credit counselers, which are a category of debt resolution providers not covered by the NPRM. Thus, credit counselers compete with the very for-profit debt resolution providers that are targeted by the advance fee ban. USOBA believes that the proposed ban is a form of industry protectionism, plain and simple, designed to favor credit counselors in the marketplace by crippling their competition.[10]

The USOBA Comment argued that:

> the advance fee [ban] would injure consumers by driving reputable debt-settlement companies from the market at a time when U.S. consumers need them most. A survey of USOBA members taken after the Commission released the NPRM found that:
>
> - 84% of USOBA members would "almost certainly" or "likely" be forced to shut down if an 'advance fee ban' as described by the Commission were adopted.
>
> - 95% of USOBA members would "certainly" or "likely" be forced to lay off employees if the advance fee ban were adopted [note that 72% of these USOBA members were 'small businesses' (firms of 25 people or less)].
>
> - 60% of those forced into reductions in their workforce would lay off 25 or more employees (a full 25% would lay off 50 or more workers).
>
> - Regarding effects on consumers, 85% of USOBA members would be forced to stop offering debt relief services to new consumers if an advance fee ban were adopted.

10. Jonathan S. Massey & Leonard A. Gail, Comments of United States Business Organizations for Bankruptcy Alternatives (Oct. 26, 2009) (unpublished comment "In the Matter of Telemarketing Sales Rule – Debt Relief Amendments, R411001"), *available at* http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00215.htm, at 19.

- Existing consumers of 85% of the providers responding would lose their current debt relief services.

- 82% would be forced to reduce or limit services to consumers.[11]

If the warnings sounded by USOBA's survey are correct, and an advance fee ban would drive most for-profit debt-settlement service providers out of business, it is appropriate to consider whether tax-exempt credit counseling organizations—which are not subject to the Telemarketing Sales Rule—could then meet the extensive public demand for debt-settlement services. These tax-exempt organizations would presumably be reluctant to expand their activities into debt-settlement services if doing so would jeopardize their tax-exempt status. This analysis leads to the question that is the focus of this Article: would a credit counseling organization that is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the Code), still qualify for tax exemption if it expanded its activities to include the provision of substantial debt-settlement services?

Placing this question in context requires a summary of the history of tax exemption for credit counseling organizations, particularly the increasingly stringent requirements that the Internal Revenue Service (IRS) and Congress have placed on these organizations in response to the changes in the marketplace for debt-resolution services.

II. THE BACKGROUND OF TAX EXEMPTION AND CREDIT COUNSELING ORGANIZATIONS

Section 501(c)(3) of the Code exempts from federal income tax corporations organized and operated exclusively for charitable, educational, and certain other enumerated purposes, provided that no part of their net earnings inure to the benefit of any private shareholder or individual.[12]

Treasury Regulation § 1.501(c)(3)-1(a)(1) provides that "in order to be exempt as an organization described in

11. *Id.* at 20 (emphasis removed).
12. I.R.C. § 501(c)(3) (2006).

section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt."[13]

Treasury Regulation § 1.501(c)(3)-1(c)(1) states that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in Section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[14]

Certain credit counseling organizations have been recognized as exempt under Section 501(c)(3) for many years.[15] The exempt purpose upon which credit counseling organizations have been granted exemption under Section 501(c)(3) is their educational objective. In the leading ruling by the IRS, the organization in question "was formed to reduce the incidence of personal bankruptcy by informing the public on personal money management by assisting low-income individuals and families who have financial problems."[16] The ruling stated the following:

> The organization provides information to the public on budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications. It aids low-income individuals and families who have financial problems by providing them with individual counseling and, if necessary, by establishing budget plans. Under a budget plan, the debtor voluntarily makes fixed payments to the organization. The funds are kept in a trust account and disbursed on a partial payment basis to the creditors, whose approval of the establishment of the plan is obtained by the organization. These services are provided without charge to the debtor.

13. Treas. Reg. § 1.501(c)(3)–1(a)(1) (2008).

14. Treas. Reg. § 1.501(c)(3)–1(c)(1) (2008).

15. The IRS has recognized the exemption of certain credit counseling organizations pursuant to 501(c)(4). Rev. Rul. 65-299, 1965-2 C.B. 165. Relatively few credit counseling organizations are exempt pursuant to section 501(c)(4), perhaps because certain non-tax legal distinctions turn on whether an organization is exempt specifically under section 501(c)(3) *See, e.g.*, Credit Repair Organizations Act, 15 U.S.C. §1679(a)(3)(B)(i); Zimmerman v. Cambridge Credit Counseling Corp., 409 F.3d 473 (2005). Consequently, this Article will address exemption under section 501(c)(3). The principles discussed herein are generally applicable to section 501(c)(4) organizations as well.

16. Rev. Rul. 69-441, 1969-2 C.B.115.

After granting exemption under Section 501(c)(3) to a group of credit counseling agencies, the IRS determined that this exemption had been issued inadvertently and sought to reclassify those organizations as exempt under Section 501(c)(4).[17] These credit counseling agencies sought and received a declaratory judgment from the United States District Court for the District of Columbia determining that they qualified for exemption under Section 501(c)(3).[18] They functioned in a manner similar to the organization described in Rev. Rul. 69-441.[19] The court found that the agencies had two basic types of programs, which together constituted their principal activities: providing "information to the general public, through the use of speakers, films, and publications, on the subject of budgeting, buying practices, and the sound use of consumer credit and . . . counseling on budgeting and the appropriate use of consumer credit to debt-distressed individuals and families."[20] The court also found:

> As an adjunct to the counseling function described [above], an agency may provide advice as to debt proration and payment, whereby a program of a monthly distribution of money to creditors is developed and implemented. In some of these instances, an agency may be required to intercede with creditors to cause them to agree to accept such monthly payment schedule.[21]

The organizations at issue generally charged a nominal fee in connection with such debt management programs, which fee was waived in instances where its payment would work a financial hardship. Approximately 12% of the professional counselors' time was spent in connection with debt management programs.

The court concluded that the community education and counseling assistance programs were the agencies' primary activities. Their debt management and creditor intercession activities were "an integral part of the agencies' counseling function, and thus are charitable and educational undertakings.

17. Consumer Credit Counseling Serv. of Ala., Inc. v. U.S., 78-2 U.S.T.C. 9660 (D.D.C. 1978); *See also* Credit Counseling Ctrs. of Okla., Inc. v. United States, 79-2 U.S.T.C. 9468 (D.D.C. 1979) (drawing substantially identical analysis and conclusions).

18. *See id.*

19. *See id.*

20. *Consumer Credit Counseling Serv. of Ala.*, 78-2 U.S.T.C. at 9660.

21. *Id.*

Even if this were not the case, the agencies' proper designation as IRC § 501(c)(3) would not be disturbed, as these activities are incidental to the agencies' principal functions."[22]

III. INCREASED SCRUTINY OF CREDIT COUNSELING ORGANIZATIONS BY THE INTERNAL REVENUE SERVICE

In the years since this case, the number of organizations providing counseling and other services to debtors has grown substantially.[23] Many of these organizations sought, and were granted, recognition by the IRS as tax-exempt entities.[24] Beginning in 2002, the IRS intensified its scrutiny of claims for exempt status by such organizations.[25] In a written testimony dated November 20, 2003, for the House Ways and Means Committee's Subcommittee on Oversight, Commissioner of Internal Revenue Mark Everson stated:

> Our information systems reflect over 850 credit counseling organizations that have been recognized as tax exempt under section 501(c)(3). In recent years, the Service has seen an increase in applications for tax-exempt status from organizations intending to provide credit counseling services. Among the more recent applicants, we are finding credit counseling organizations that vary from the model approved in the earlier rulings and court cases. We are seeing organizations whose principal activity is selling and administering debt management plans. Often the board of directors is not representative of the community and may be related by family or business ties to the for-profit entities that service and market the debt management plans. The organizations are supported by fees from customers and from credit card companies, and the fees are much higher than those in the rulings or court cases. Finally, it does not appear that significant counseling or education is being provided. . . .
>
> In 2002, as we saw an increasing number of allegations of credit counseling abuses, we contacted the Federal Trade Commission for assistance in understanding the developments

22. *Id.*

23. David A. Lander, *Essay: A Snapshot of Two Systems That Are Trying to Help People in Financial Trouble*, 7 AM. BANKR. INST. L. REV. 161, 162 (1999).

24. Leslie E. Linfield, *Credit Counseling Update: The "Perfect Storm" Brewing*, 24-APR AM. BANKR. INST. J. 30, 46 (2005).

25. Allen Mattison, *Can the New Bankruptcy Law Benefit Debtors Too? Interpreting the 2005 Bankruptcy Act to Clean Up the Credit-Counseling Industry and Save Debtors from Poverty*, 13 GEO. J. ON POVERTY L. & POL'Y 513, 530 (2006).

> in the industry. Based on the available information, it appears that customers, served solely by the Internet, are provided debt management—not credit counseling. The individual budget assistance and public education programs that formed the original basis for exemption under section 501(c)(3) have changed. In many cases, these services appear to have been replaced by promises to restore favorable credit ratings or to provide commercial debt consolidation services.[26]

Over the next two and a half years, the IRS acted decisively to curb the abuses that Everson described.[27] On May 15, 2006, the IRS issued a news release reporting this progress:

> Over the past two years, the IRS has been auditing 63 credit counseling agencies, representing more than half of the revenue in the industry. To date, the audits of 41 organizations, representing more than 40 percent of the revenue in the industry, have been completed. All of the completed audits have resulted in revocation, proposed revocation or other termination of tax-exempt status.[28]

Everson bluntly concluded:

> Over a period of years, tax-exempt credit counseling became a big business dominated by bad actors. Our examinations substantiated that these organizations have not been operating for the public good and don't deserve tax-exempt status. They have poisoned an entire sector of the charitable community.[29]

In addition to the revocations of exemption for many existing organizations, the IRS became much less likely to recognize exemption in connection with applications by newly formed entities seeking exempt status, granting exemption to only three of the 110 applicants between 2003 and 2006.[30] In many instances, the basis for denial of exempt status was an organization's excessive emphasis on debt management plans. Because the rationale for exemption of credit counseling agencies is a primary educational purpose, instances in which

26. *Nonprofit Credit Counseling Organizations: Hearing Before the S. Comm. On Oversight Comm. On H. Ways & Means*, 108th Cong. (2003) (statement of Mark Everson, Commissioner, Internal Revenue Service).

27. *See* Linfield, *supra* note 24 (discussing the process implemented to curb abuses).

28. Press Release, IRS Takes New Steps on Credit Counseling Groups Following Widespread Abuse (May 15, 2006) (on file with the IRS at IR-2006-80).

29. *Id.*

30. IRS, Credit Counseling Compliance Project, Summary & Results (2006) *available at* http://www.irs.gov/pub/irs-tege/cc_report.pdf.

educational activities were overshadowed by debt management plans understandably resulted in denial of exemption.

The IRS even included credit counseling agencies in its widely publicized, annual "Dirty Dozen" list of tax scams, warning that

> Taxpayers should be careful with credit counseling organizations that claim they can fix credit ratings, push debt payment plans or impose high set-up fees or monthly service charges that may add to existing debt. The IRS Tax-exempt and Government Entities Division is in the process of revoking the tax-exempt status of numerous credit counseling organizations that operated under the guise of educating financially distressed consumers with debt problems while charging debtors large fees and providing little or no counseling.[31]

As Everson mentioned in his 2003 testimony, "fair share" payments from credit card companies are a significant source of financial support for many tax-exempt credit counseling organizations. In a 2004 Chief Counsel Memorandum, the IRS considered the potentially problematic character of the relationships between credit counseling organizations and the credit card companies:

> Although the published rulings have indirectly considered the receipt of fair share payments from creditors as generally consistent with exemption under section 501 (c) (3), the way in which credit counseling organizations and their trade associations have recently been tailoring their operations and standards to attend directly to concerns of credit card companies may also provide evidence to support a substantial nonexempt purpose and/or private benefit argument for revocation of exemption. To develop such arguments, it would be necessary to develop specific facts showing that the public interest and the interests of the low-income recipients of counseling services are being sacrificed in favor of the credit card companies. Whether to develop the facts with respect to benefits to the credit card companies is an examination strategy decision.[32]

One source of concern among tax-exempt credit counseling organizations regarding the relationships between credit

31. Press Release, IRS Announces "Dirty Dozen" Tax Scams for 2006 (Feb. 7, 2006) (on file with the IRS at IR-2006-25).

32. I.R.S. Off. Chief Couns. Mem. 04-31-023 (July 13, 2004).

counseling organizations and credit card companies was the 2003 decision of the Maine Supreme Judicial Court denying charitable tax exemption for property owned by Credit Counseling Centers, Inc.[33] The Maine court's analysis focused on that relationship:

> In the present case, the Superior Court erred in its legal conclusion that CCCS is entitled to a charitable tax exemption. In 1995, CCCS collected $8,801,264 for the creditors of the clients with whom it works; in 1996, it collected $9,877,179; in 1997, it collected $11,933,638; in 1998, it collected $13,146,614; and in 1999, it collected $16,715,565. These creditors normally pay between 8.5% and 9% of the amount collected as a "fair share" contribution to CCCS. The magnitude of the amounts collected for creditors clearly demonstrates that CCCS's business is not "conducted *exclusively* for benevolent and charitable purposes," or that the revenue generated is not "purely incidental to a dominant purpose that is benevolent and charitable."[34]

Even more ominously, the IRS began to cite this Maine opinion in private letter rulings denying tax-exempt status to credit counseling organizations. For example, in a 2004 ruling, the IRS articulated the following as of one of the grounds for denying exemption:

> You provide substantial private benefit to credit card companies in a manner similar to the organization in Credit Counseling Centers v. S. Portland. Fair share is commonly defined as "that amount the organization receives from the creditors for each payment remitted to them." In the absence of any charitable or meaningful educational activities you are operating as a collection agency for these companies. The "fair share" paid by the credit card companies would undoubtedly result in significant savings over the possible costs of not recovering any of the unpaid debt owed them. Thus, these companies clearly realize substantial financial benefits through their business relationship with you. We note that your contract with clients' [sic] provides that if they drop out of the DMP, they are still obligated to pay their debts to the

33. Credit Counseling Ctrs, Inc. v. City of South Portland, 814 A.2d 458 (Maine 2003).

34. *Id.* at 463 (internal citations omitted).

> credit card companies. This illustrates the close business relationship you have with these companies.[35]

IV. SECTION 501(Q)

In the Pension Protection Act of 2006, Congress enacted Section 501(q) of the Code[36] which imposes additional requirements on credit counseling organizations claiming exempt status. The legislative history of Section 501(q) recounts the IRS's heightened scrutiny of credit counseling organizations and explains:

> The provision does not diminish the requirements set forth recently by the IRS in Chief Counsel Advice 200431023 or Chief Counsel Advice 200620001 but builds on and is consistent with such requirements, and the analysis therein. The provision is not intended to raise any question about IRS actions taken, and the IRS is expected to continue its vigorous examination of the credit counseling industry, applying the additional standards provided by the provision.[37]

The legislative history provides a useful summary of the significant additional requirements imposed by Section 501(q):

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer;

2. The organization makes no loans to debtors (other than loans with no fees or interest) and does not negotiate the making of loans on behalf of debtors;

3. The organization provides services for the purpose of improving a consumer's credit record, credit history, or credit rating only to the extent that such services are incidental to providing credit counseling services and does not charge any separately stated fee for any such services;

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35. I.R.S. Priv. Ltr. Rul. 200450039 (Sept. 14, 2004) (emphasis removed); *See also* I.R.S. Priv. Ltr. Rul. 200450036 (Dec. 10, 2004).

36. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1220, 120 Stat. 780, 1086–1088 (2006).

37. Joint Comm. On Taxation, 109th Cong., General Explanation Of Tax Legislation, at 611.

4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;

5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable, allows for the waiver of fees if the consumer is unable to pay, and except to the extent allowed by State law prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on the projected or actual savings to the consumer resulting from enrolling in a debt management plan;

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates) and (c) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees);

7. The organization does not own (except with respect to a section 501(c)(3) organization) more than 35 percent of the total combined voting power of a corporation (or profits or beneficial interest in the case of a partnership or trust or estate) that is in the trade or business of lending money, repairing credit, or providing debt

management plan services, payment processing, and similar services; and

8. The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers. [38]

If these requirements were not enough, Section 501(q) further limits the percentage of a credit counseling organization's revenues that may come from payments by creditors of consumers of the organization attributable to the debt management plan services.[39] For credit counseling organizations in existence when Section 501(q) was enacted, the percentage limits phase in over the four taxable years beginning after the first anniversary of the date of enactment, with the ultimate limitation at fifty percent of revenue.[40] New credit counseling organizations formed after enactment of Section 501(q) are subject to the fifty percent limit ab initio.[41]

V. *SOLUTION PLUS, INC. V. COMMISSIONER*

In 2008, the Tax Court issued a memorandum decision denying exemption to an organization that it determined was formed primarily to sell debt management programs.[42] On its facts, the decision is by no means surprising. The organization's application for recognition of exemption claimed that it was organized for educational purposes and that sales of debt management plans would make up only a minimal part of its activities and revenues.[43] The information and documents supplied by the organization showed quite the opposite, that debt management plans would be the focus and bulk of the entity's activities and would be its principal source of revenue.[44] The IRS denied the application; Solution Plus sought a

38. *Id.* at 611–13.

39. *Id.* at 613.

40. The limit is eighty percent for the first taxable year of the organization, beginning after the date which is one year after the date of enactment; seventy percent for the second such taxable year beginning after such date; sixty percent for the third such taxable year beginning after such date; and fifty percent thereafter. *Id.*

41. *Id.*

42. Solution Plus, Inc. v. Comm'r, 95 T.C.M. (CCH) 1097 (2008).

43. *Id.* at 18.

44. *Id.* at 18–20.

declaratory judgment that this denial was erroneous.[45] In granting summary judgment for the IRS, the Tax Court concluded that Solution Plus was not organized exclusively for either educational purposes or charitable purposes and that it would not operate exclusively for charitable purposes.[46] A key basis for its last conclusion was the fact that the organization's "primary activity would be to provide DMPs to the general public for a fee that it hopes to collect from its customers and from its customers' creditors . . . ."[47]

VI. THE CONSEQUENCE TO CREDIT COUNSELING ORGANIZATIONS OF PROVIDING SUBSTANTIAL DEBT-SETTLEMENT SERVICES

The question addressed by this Article assumes that the organizations in question are credit counseling organizations that are properly exempt under Section 501(c)(3). Implicit in this assumption is that such organizations satisfy the organizational test and that their activities, governance structure, and sources of financial support meet the requirements contained in Section 501(q). The precise question, therefore, is whether such an organization may expand its activities to include providing a substantial amount of debt-settlement services and continue to satisfy the operational test for tax exemption.

The Supreme Court has held that "the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."[48]

Providing debt-settlement services is not inherently charitable or educational. As the IRS noted in denying an application for exemption, "No court or Internal Revenue Service ruling has indicated that the sale of debt management plans and debt-settlement services is a charitable activity."[49] Consequently, providing debt-settlement services would cause an organization to fail the operational test unless the activity is either (i)

45. *Id.* at 1–2.
46. *Id.* at 20, 22.
47. *Id.* at 9.
48. Better Business Bureau v. United States, 326 U.S. 279, 283 (1945).
49. I.R.S. Priv. Ltr. Rul. 200450039 (Sept. 14, 2004).

incidental to the organization's principal and exempt purpose or (ii) integral to the accomplish of such purpose.[50]

For an activity to be incidental, it must be of very small scale, at least relative to the activities of the organization as a whole. Consequently, it is possible that a tax-exempt credit counseling organization could expand its activities to include a minimal amount of debt-settlement services, which might be considered incidental to the organization's principal activities. The more important question, however, involves the provision of a substantial amount of debt-settlement services by a credit counseling organization.[51] By definition, such substantial services could not be incidental.

VII. AN ACTIVITY MUST BE NECESSARY TO BE INTEGRAL

The key question, therefore, is whether providing debt-settlement services would be considered integral to a credit counseling organization's exempt, educational purpose. The Tax Court addressed a similar issue in *Pulpit Resource v. Commissioner.*[52] The stated purpose of the organization at issue was:

> To advance religious preaching through publication of sermons and other resources for ministers, priests, and rabbis, and to apply proceeds to purchase of preaching materials for libraries of selected schools of theology.[53]

The organization published and sold by subscription a quarterly journal called Pulpit Resource that contained sermons, sermon outlines, and articles on preaching techniques.[54] The IRS had denied the organization's application for exemption, reasoning that it operated essentially as a commercial publishing venture that specialized in religious content.[55]

50. *See* Consumer Credit Counseling Serv. of Ala., Inc. v. U.S., 78-2 U.S.T.C. 9660 (D.D.C. 1978) (giving a conclusion on whether the agency met the operational test in question).

51. Because of the great demand for debt-settlement services and the resulting magnitude of this industry, if tax-exempt credit counseling organizations provided only minimal amounts of debt-settlement services, these organizations as a group would meet only a small portion of the aggregate demand. For this reason, the relevant inquiry concerns the provision of substantial debt-settlement services by such organizations.

52. 70 T.C. 594 (1978).

53. *Id.* at 596.

54. *Id.* at 597.

55. *Id.* at 601.

The Tax Court disagreed. After reviewing the case law and setting out the tension between Pulpit Resource's exempt purpose and the "commercial or business hue" of its activity, the court explained:

> [W]e must determine whether the nonexempt commercial aspect of the activity was either so independent of the religious purpose or was sufficiently substantial that it cannot be said that petitioner was "operated exclusively" for religious purposes. . . . If the sale of religious literature was an integral part of and incidental to petitioner's avowed religious purpose, that activity may be considered a part of the religious purpose or objective. We find that it was.
>
> Apparently the only way petitioner could accomplish its objective of disseminating sermons to ministers to improve their religious preachings was by selling Pulpit Resource at a price sufficient to pay for its cost and provide Harris with a reasonable salary. It apparently received few, if any, contributions and a contest for best sermons met with little financial success. There is no evidence that petitioner was in competition with any commercial enterprise conducting the same business activity. The market for petitioner's product was so limited in scope that it would not attract a truly commercial enterprise. [56]

The test of whether a non-charitable activity is an integral part of an exempt purpose is thus a test of necessity: could the exempt objective be accomplished only by the activity in question?[57]

The Tax Court revisited this issue and confirmed its analysis in *Living Faith, Inc. v. Commissioner.*[58] The organization seeking exemption in that case operated a vegetarian restaurant and health food store.[59] Its exempt purpose was to advance the teachings of the Seventh-day Adventist Church concerning the significance of diet—specifically, a vegetarian diet and abstention from tobacco, alcohol, and caffeine—in promoting good health, and the importance of good health in promoting virtuous conduct.[60] The court sought to determine whether the non-exempt commercial aspect of the organization's activity—the sale of health foods—was "so independent of the religious

56. *Id.* at 611 (internal citations omitted).
57. *Id.*
58. 60 T.C.M. (CCH) 710 (1990), *aff'd*, 950 F.2d 365 (7th Cir. 1991).
59. *Id.*
60. *Id.*

purpose, i.e., furthering the dietary and health goals of the Seventh-day Adventist religion" that it caused Living Faith to fail the operational test.[61]

Reviewing the relevant authorities, the court focused on whether the activities at issue were an "essential ingredient" in accomplishing the exemption purpose:

> In each of these rulings, the organization performed services which were *required* in order to further the tenets of a particular religion or *necessary* to enable members of a particular religion to observe its principles. By way of contrast, petitioner herein has not shown that its operations were required to further the dietary teachings of the Seventh-day Adventist Church or necessary to enable members of the Seventh-day Adventist Church to comply with its beliefs.[62]

Confirming *Pulpit Resource*, for an activity to be an integral part of an exempt purpose, it must be strictly necessary for the accomplishment of such a purpose.[63]

It is doubtful that the IRS or a court would find the provision of debt-settlement services to be an integral part of a credit counseling agency's exempt purposes. Such purposes are educational and take the form of either public seminars and publications or one-on-one counseling. The educational goals are to help consumers learn to budget and spend appropriately and to make prudent use of consumer credit. There is no necessary connection between services seeking a lump sum, discounted settlement of debts, and the exempt purpose of educating consumers in budgeting and prudent borrowing.[64] It should be understood that many tax-exempt credit counseling agencies have provided their services to the public without debt-settlement services for decades.[65] Consequently, there is no

61. *Id.* (emphasis added).

62. *Id.* (emphasis added).

63. *See* Pulpit Resource v. Comm'r, 70 T.C. 594 (1978) (holding that an organization that prepared and published sermons for use by various clergy was operated exclusively for an exempt purpose).

64. Arguably, the success of debt-settlement services, while plainly benefiting debtors, might even undermine the lessons of prudence and restraint implicitly stressed in the credit counseling agencies' exempt purposes.

65. A comment submitted to the FTC on December 18, 2009, by the Financial Education and Counseling Alliance (FECA), argued that use of "the less-than-full-balance DMP, an educationally-based alternative to the traditional debt-settlement program" would permit tax-exempt credit counseling organizations to expand into providing debt-settlement services without running afoul of Section 501(c)(3). Financial Education and Counseling Alliance, RE: comment re Telemarketing Sales Rule–Debt

credible support for an argument that providing debt-settlement services is an "essential ingredient," a necessary activity without which the exempt educational purposes cannot be accomplished. As a result, the provision of substantial debt-settlement services by a non-profit credit counseling agency would constitute a substantial, non-exempt purpose, causing the entity to fail the operational test for exemption.

VIII. INHERENT COMMERCIALITY

In addition to testing whether an activity is necessary to accomplish the organization's exempt purpose, courts often focus on whether the activity is so inherently commercial that it cannot be integral to an exempt purpose. This analysis is sometimes phrased as a determination of whether nonexempt commercial purposes predominate with respect to the activity in question. The Tax Court has held that "[c]ompetition with commercial firms is strong evidence of the predominance of nonexempt commercial purposes."[66] Similarly, the Court of Claims explained that providing investment advisory services to the public in exchange for money "places plaintiff in competition with other commercial organizations providing

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Relief Amendments, R411001 *available at* http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00312.pdf. This "new method" seems to be the ivory-billed woodpecker of the debt-resolution forest—more frequently discussed than actually encountered. In response to questions from the FTC, GreenPath, Inc., a member of FECA, acknowledged:

> At this time, only one major creditor offers a less-than-full-balance DMP option. Only a very small number of GreenPath consumers (less than 50) are enrolled in this program, which is provided by that creditor as part of a normal GreenPath DMP (with no additional fees or requirements). *The program does not reduce any principal debt,* but will eliminate a percentage of fees and finance charges. Our understanding is that, since no principal debt is eliminated, the consumer does not have any tax liability."

Letter from Richard A. Bialobrzeski, Director of Government/External Relations and Communication (Jan. 15, 2010) *available at* (http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00321.pdf) (emphasis added). The FECA comment does not explain how "less-than-full-balance DMPs" are essential to the activities of tax-exempt credit counseling organizations in light of their absence from the roster of services that such organizations have long provided. *Id.* Nor does it explain how a program that does not reduce any principal debt would be an adequate replacement for debt-settlement services. *Id.*

66. B.S.W. Group, Inc. v. Comm'r, 70 T.C. 352, 358 (1978). *See also* Airlie Foundation v. I.R.S., 283 F. Supp. 2d 58 (D. D.C. 2003) (relying largely on *BSW Group,* the court concluded that Airlie did not qualify for tax exemption because the entity's charitable and educational activities were incidental to its primary activity of operating a conference center that competed with a number of commercial, as well as non-commercial, entities).

similar services. Plaintiff has chosen to compete in this manner and, as a consequence, plaintiff's activities acquire a commercial hue."[67] The Court of Claims reiterated this analysis in holding that an adoption agency that competed with for-profit agencies did not qualify for tax-exempt status.[68]

Because a variety of for-profit entities, including law firms, have historically provided debt-settlement services, a non-profit credit counseling agency that began offering debt-settlement services would necessarily be competing with commercial firms. Such competition is strong evidence of the predominance of non-exempt purposes in connection with this activity. The manner in which debt-settlement services have been provided up to the present thus creates a significant hurdle to the possibility that provision of such services can be taken over by tax-exempt entities.[69]

IX. IMPERMISSIBLE PRIVATE BENEFIT

In addition to the question of whether providing debt-settlement services would constitute a substantial non-exempt function, the IRS might view debt-settlement services as resulting in an improper private benefit to debtors, which would provide another basis for revocation of exempt status. Private benefit is a separate concept from that of "private inurement": private inurement involves benefit to persons controlling a purportedly tax-exempt entity, while private benefit may cover benefits to outsiders as well as insiders.[70] The presence of either is incompatible with exempt status.

By contrast with debt management plans, which are designed to result in full payment of the amounts owed, debt-settlement services seek to discharge debtors' obligations for less than the

67. American Institute for Economic Research v. U.S., 302 F.2d 934, 938 (Ct. Cl. 1962).

68. Easter House v. U.S., 60 A.F.T.R. 2d 87-5119 (Cl. Ct. 1987).

69. If the for-profit debt-settlement service providers are driven out of business by an advance fee ban, a tax-exempt credit counseling organization that began providing such services might argue that it was not currently competing with commercial businesses. Because the demise of the commercial providers would have resulted from the tax-exempt entities prevailing on the FTC to regulate their competition out of business, a court might not view the tax-exempt entities as having sufficiently clean hands to make such an argument.

70. I.R.S. Chief Couns. Mem. 200431023 (July 30, 2004), *available at* http://www.irs.gov/pub/irs-wd/0431023.pdf; *See also* American Campaign Academy v. Comm'r., 92 T.C. 1053, 1064 (1989).

full principal amount. Accomplishment of this goal results in taxable income to the debtors.[71] The recipients of debt-settlement services are not exclusively impoverished; indeed, many of them are persons of more moderate means who have become overburdened with consumer debt for a variety of reasons. In a number of similar contexts, the IRS and the courts have found the presence of private benefits to preclude exemption under section 501(c)(3).[72]

For example, the Tax Court has denied tax-exempt to an organization that sought to increase charitable contributions to exempt entities by providing tax and estate planning advice to donors, because the court reasoned that the tax and estate planning advice provided a private benefit to donors that was inconsistent with exempt status.[73] Four years later, the Tax Court carried out a similar analysis in denying exemption to an entity that operated for the purpose of promoting litigation to protect pension funds of retired New York City teachers, where a significant factor to the court's finding of impermissible private benefit was the fact that over two-thirds of retirees were not poor.[74] By contrast, the Tax Court found no impermissible private benefit in the case of an organization importing and selling handicrafts where only an insubstantial number of the artisans who made these handicrafts were not disadvantaged.[75]

71. I.R.C. § 61(a)(12) (1984).

72. I.R.C. § 501(c)(3) (2006).

73. Christian Stewardship Assistance v. Comm'r, 70 T.C. 1037 (1978). The IRS employed a similar analysis in concluding that:

> [a]n association of investment clubs formed to enable members and prospective investors to make sound investments by the mutual exchange of investment information, that carries on not only educational activities but other activities directed to the support and promotion of the economic interests of its members, does not qualify for exemption."

Rev. Rul. 76-366, 1976-2 C.B. 144. The basis for this conclusion was that "the association is serving private interests." *Id.* An extreme example of disqualifying private benefit is found in *Ecclesiastical Order of Ism of Am v. Comm'r.* 80 T.C. 833 (1983). In that case, the Tax Court denied tax exemption to an organization that recruited new members by emphasizing the tax benefits of becoming a minister in its "religion" and whose "educational" literature emphasized tax avoidance.

74. Retired Teachers Legal Defense Fund, Inc. v. Comm'r, 78 T.C. 280 (1982).

75. Aid to Artisans, Inc. v. Comm'r, 71 T.C. 202 (1978).

X. STRINGENT APPLICATION OF EXEMPTION REQUIREMENTS TO CREDIT COUNSELING ORGANIZATIONS CONTINUES

Many tax-exempt credit counseling organizations likely welcomed the enactment of Section 501(q). Its provisions provided bright-line guidance that removed the uncertainty and the apparently mounting risk to exempt status arising out of the receipt of "fair share" payments from credit card companies. Since enactment of section 501(q), it has become apparent that this action by Congress did not cause an about-face in the attitude of the IRS toward credit counseling organizations claiming tax exemption.

In a 2008 private letter ruling denying exempt status, the IRS again cited *Credit Counseling Centers, Inc. v. City of South Portland* after a four-year absence from such rulings.[76] Although section 501(q) appears to have solved the problem of what portion of a credit counseling organization's revenues may come from fair share payments, it does not address the argument that credit card companies derive an impermissible private benefit from the activities of organizations with an excessive focus on debt management plans, particularly if the eligibility criteria for such plans appear designed more for the creditors' benefit than the debtors'. The return of allusions to *South Portland* may hint at interest on the part of the IRS to further develope of this line of analysis.

On February 15, 2010, Marcus S. Owens, a former director of the Exempt Organizations Division of the IRS who is now in private practice, took the unusual step of publicly releasing a letter he wrote to Diane Ryan, the Chief of the IRS Appeals Office.[77] Owens wrote to complain of the refusal by the Appeals

76. I.R.S. Priv. Ltr. Rul. 200851024 (Aug. 5, 2008) (citing *Credit Counseling Centers, Inc. v. City of South Portland*, 814 A.2d 458, 460 (Me. 2003)). As in the earlier rulings, this denial of exempt status determined that the applicant:

> [P]rovides substantial private benefits" to credit card companies in a manner similar to the organization in *Credit Counseling Centers v. S. Portland. Id.* at Issue 3. Fair share is commonly defined as "that amount the organization receives from the creditors for each payment remitted to them." In the absence of any charitable or meaningful educational activities, which we have established, you are operating as a collection agency for these companies. The "fair share" paid by the credit card companies would undoubtedly result in significant savings over the possible costs of not recovering any of the unpaid debt owed them. Thus, these companies clearly realize substantial financial benefits through your collection activities.

Id. at 159–160.

77. Tax Analysts Document Serv., Doc. 2010-3163.

Office "to seek Technical Advice regarding whether, in light of the enactment of section 501(q) and the holdings of Consumer Credit Counseling Service of Alabama and Credit Counseling Centers of Oklahoma, debt management programs (DMPs) conducted by credit counseling organizations qualify as a charitable activity." It appears from Owens' letter that both the examining agent and the Appeals Office had concluded that debt management programs do not qualify as a charitable activity.

Notwithstanding Owens' indignation, this should hardly be surprising, as it represents a continuation of the view that the IRS expressed in Private Letter Ruling 200450039.[78] Section 501(q) imposes additional requirements for certain types of organizations that otherwise qualify under Section 501(c)(3).[79] Section 501(q) is not, however, a safe harbor whose requirements, if complied with, make it unnecessary for an organization to meet the various common-law requirements that courts have constructed under Section 501(c)(3).[80] Nothing in Section 501(q) suggests that debt management programs are viewed as a charitable activity. To the contrary, Section 501(q) makes it clear that it applies to "organization[s] with respect to which the provision of credit counseling services is a substantial purpose," i.e., it is the educational, credit-counseling function that is the charitable activity upon which exemption may be

78. I.R.S. Priv. Ltr. Rul. 200450039 (Dec. 10, 2004). As noted above, that ruling states, "No court or IRS ruling has indicated that the sale of [debt management plans and debt-settlement services] is a charitable activity." *Id.* at 148. Similarly, the IRS observed in Chief Counsel Advisory 200431023 that "[d]ebt management, like the adoption services in Easter House, is not a traditionally charitable activity." I.R.S. Chief Counsel Advisory 200431023 (July 30, 2004).

79. Section 501(q)(1) begins: "An organization with respect to which the provision of credit counseling services is a substantial purpose shall not be exempt from tax under subsection (a) *unless such organization is described in paragraph (3) or (4) of subsection (c) and* such organization is organized and operated in accordance with the following requirements: . . ." I.R.C. § 501(q) (2000) (emphasis added).

80. The legislative history of 501(q) says just that with respect to the revenue percentage standards for income from creditors:

> Compliance with the revenues test does not mean that the organization's debt management plan services activity is at a level that organizationally or operationally is consistent with exempt status. In other words, satisfaction of the aggregate revenues requirement (as a preliminary matter in an exemption application, or on an ongoing operational basis) provides no affirmative evidence that an organization's primary purpose is an exempt purpose, or that the revenues that are subject to the limitation (or debt management plan services revenues more generally) are related to exempt purposes.

Joint Comm. On Taxation, 109th Cong., General Explanation Of Tax Legislation, at 613.

based.[81] In addition, Owens' argument that debt management programs themselves constitute a charitable activity is inconsistent with the Tax Court's decision in *Solution Plus.*[82]

Given the apparent unwillingness of the IRS to reverse its longstanding view that the provision of debt management plans is not itself a charitable activity, it seems very unlikely that the IRS would countenance a significant expansion into providing debt-settlement services on the part of entities claiming tax exemption.

XI. CONCLUSION

For the foregoing reasons, the provision of substantial debt-settlement services by credit counseling agencies that are currently exempt under section 501(c)(3) would likely place such organizations outside the exemption provided by section 501(c)(3) of the Code. Few credit counseling agencies would be likely to risk their exempt status, and the freedom from FTC oversight that accompanies it, in order to begin providing significant amounts of debt-settlement services. If the FTC expands the Telemarketing Sales Rule in the ways set out in the Notice of Proposed Rulemaking, and if the advance fee ban then puts a large number of for-profit debt-settlement providers out of business, it appears likely that the significant demand for debt-settlement services among consumer debtors will go largely unmet.

81. I.R.C. 501(q)(2)

82. Owens' letter does not refer to *Solution Plus.* It is perhaps part of what Owens describes as the "unidentified"—and, from our perspective, nonexistent—judicial precedent upon which the Appeals Office relied. Tax Analysts Document Serv., Doc. 2010-3163.

BOOK REVIEW

LAW AND JUDICIAL DUTY. Philip Hamburger (2008).

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I. INTRODUCTION

Philip Hamburger's remarkable study essays nothing less than to provide an alternative legal history of the origins of judicial review. "Almost every day," Hamburger writes, "a judge in the United States holds a statute unconstitutional. This is 'judicial review,' and it often seems the central feature of American constitutional law."[1] As the coolness of this observation suggests, Professor Hamburger feels that the idea of judicial review has been too easily received. It is not in the exercise of judicial review, he suggests, that the proper and principal role of the judge consists.[2] Judges do not sit to strike down laws, and that should not be seen as their proper and principal role. Rather, the true work of a judge is to be found in the active and intelligent fulfillment of "judicial duty."[3]

II. JUDICIAL DUTY AND JUDICIAL REVIEW

Judicial duty is the obligation of a judge to decide cases according to the law of the land.[4] It is not a doctrine of renunciation and restraint. Like judicial review, the ideal of judicial duty contemplates that the judge may, upon occasion, be required to hold statutes unconstitutional.[5] The ideal of judicial duty may be traced into the medieval common law, and it had long supplied a basis upon which judges constructed and limited royal decisions and Parliamentary enactments. Judicial duty was the source of the authority upon which Chief Justice Marshall relied when, in *Marbury v. Madison*, he chose expressly to articulate a power of judicial review.[6] That the newer doctrine has eclipsed the older, Hamburger argues, has

1. PHILIP HAMBURGER, LAW AND JUDICIAL DUTY 3 (2008).

2. *See id.* at 2 (challenging the received history of judicial review, which implies that the justification for judicial review is based upon an understanding of the proper role of the judge).

3. *See id.* (foreshadowing the argument that the proper role of the judge is the fulfillment of "judicial duty").

4. *Id.* at 16, 17.

5. *Id.* at 17.

6. Marbury v. Madison, 5 U.S. (1 Cranch) 137, 177–78 (1803). *See also* Philip Hamburger, *Law and Judicial Duty*, 72 GEO. WASH. L. REV. 13 (2003).

dangerously weakened the constraints under which the common law had successfully operated:

> The point is not simply that judicial review was different and older than traditionally imagined, but rather that there was a more general judicial duty. Instead of having a power specifically relating to constitutional decisions—a power developed through their own exertions and thus of indeterminate duty and scope—the judges had a broader power that was neither more nor less than their duty. This duty was but an aspect of their office, and it required them to decide in accord with the law of the land, including any relevant constitution. The generality of this duty was what gave strength and balance to their constitutional decisions, for it authorized and bound the judges with the same ideals that elevated and confined them in their more mundane decisions. Their duty thus anchored an otherwise extraordinary power within the quotidian exercise of their office, and the result was a judicial power both more authoritative and less dangerous than that which prevails today.[7]

The prehistory of constitutional law, which focused on the origins of judicial review, has been explored by scholars for over a century.[8] Hamburger's emphasis on judicial duty frames the issue in different terms. After reading his study, one approaches with greater circumspection the central operative paragraph upon which *Marbury* turns:

> It is emphatically the province and duty of the judicial department to say what the law is. Those who apply the rule to particular cases, must of necessity expound and interpret that rule. If two laws conflict with each other, the courts must decide on the operation of each.
>
> So if a law be in opposition to the constitution if both the law and the constitution apply to a particular case, so that the court must either decide that case conformably to the law, disregarding the constitution; or conformably to the constitution, disregarding the law; the court must determine which of these conflicting rules governs the case. This is of the very essence of judicial duty.[9]

Hamburger's research has put considerable substance back into this invocation of "judicial duty." If by this Chief Justice

7. HAMBURGER, *supra* note 1, at 617.
8. *Id.* at 2.
9. *Marbury*, 5 U.S. (1 Cranch) at 177–78.

Marshall meant that the power of the judge was an aspect of the office of the judge—that is, if judicial review was a function of judicial duty—it would suggest that judicial power is shaped and constrained by the restraint that accompanies judicial authority. On the other hand, if Marshall was using this language to announce the assertion of a power that would go beyond judicial duty—the traditional understanding of the judge's role—the adoption of judicial review must be understood as a departure. To understand the work of the judge within the context of a tradition of judicial duty illumines, and not necessarily in a positive light, the idea of the judge as the agent of judicial review. Where judges once chose to work from a vantage point within the framework of the laws, it appears to be more arrogant for other judges to insist that they enjoy the power to override the law. And, if *Marbury* marked a determined departure from judicial duty, judicial review lacks the authority that would be conferred by the tradition and continuing practice of common law adjudication.

Hamburger feels that the concept of judicial duty has largely been forgotten.[10] He writes, when the Constitution was drafted:

> the ideals of law and judicial duty were so deeply ingrained that they could simply be taken for granted .... When, for example, the U.S. Constitution mentioned the law of the land and the judges, it did not need to spell out the nature of legal obligation or the office and duty of judges, for such things were obvious.[11]

This has made it difficult to appreciate the origins of judicial review and the change in our understanding of the judges' proper role. Herbert Wechsler's quixotic search for "neutral principles" of constitutional interpretation was fatally misguided because Wechsler insisted that authority for judicial review could, and necessarily had to be, "grounded in the language of the Constitution."[12] What the Constitution does not provide for, Hamburger observes, the Constitution can hardly be counted on to define or restrain.[13] The rules that would govern judicial

10. *Id.* at 16.
11. *Id.* at 618.
12. *Id.* at 12 (discussing Herbert Wechsler, *Toward Neutral Principles of Constitutional Law*, 73 HARV. L. REV. 3, 10 (1959)).
13. *Id.* at 11.

review—were they rightly to be observed—are to be found not in the language of Article III, but in the heritage of judicial duty.[14]

Hamburger's observation on the jurisprudential role of judicial duty reflects a measured admission of what we may have lost and a dogged insistence on what may yet be regained:

> Far from being simply ideas about government, the common law notions of law and judicial duty developed in response to problems arising from human nature, especially as it came to be understood in an increasingly disjointed society. To be sure, the authority of the people and the obligation of the law of the land do not form the only possible solution to the problems arising from discordant reasoning about justice .... Nonetheless, the ideals that formed the common law solution were not merely the arbitrary preferences of a local culture, but were the common law version of a familiar response to one of the most basic features of modernity—the use of legal authority to redress the peculiarly fractured character of humanity in modern circumstances.[15]

In the increasingly complex society produced by modernity, the common law ideals served to provide the order necessary for freedom. As Hamburger observes, "[t]he truth may be whole, but it is apt to be variously perceived in the modern world, and one reason the common law ideals have flourished is that they have avoided the danger of asking discordant individuals, including judges, to decide what is reasonable and just."[16]

To emphasize judicial duty is to ask that judges approach their work in terms of resolving a case in the light of all the laws, both those statutes drafted by the Legislature, and those doctrines formulated by the legal community.[17] This may yield better results for the law and for society than treating as paradigmatic a system that invites the individual litigant to ask the judge to pass judgment on an isolated law. Judicial review approaches judgment as a matter of categorical assertions, and judging as a wilderness of single instances.

Hamburger considers that judicial review has come to be regarded as the centerpiece of American constitutional law because Americans have abandoned the idea that laws might be

14. *Id.* at 9.
15. HAMBURGER, *supra* note 1, at 618.
16. *Id.* at 619.
17. *See id.* at 618.

enacted and applied to unify society, and instead have come to consider that judges sit to second-guess the legislature: to strike down laws that affected parties find objectionable. American post-modern litigiousness demands nothing less from post-modern American law.

III. THE MEDIEVAL ORIGINS OF JUDICIAL DUTY

Hamburger traces the duty of common law judges to its medieval origins. As early as the reign of Edward III, he finds, the perennial debate between realism and idealism had taken shape.[18] In the early weeks of 1345, Judge Roger Hillary asserted that the law "is the will of the justices," only to be corrected by Chief Justice John Stonore: "No, the law is that which is right."[19] Assigning duty and responsibility offered a way of managing the risks of judicial power. Judicial commissions specified the judges' duty: "*facturi quod ad iustitiam pertinet secundum legem, et consuetudinum Angliae,*" to do justice according to the law and the custom of England.[20] In the Elizabethan decades, which saw the creation of the modern common law, any lawyer who read Cicero—and all Elizabethan lawyers read Cicero—would have known that duty and office could define the same obligation.[21] To take up judicial office, thus, inherently obliged the judge to carry out the duties of that position.[22] Sir Edward Coke articulated the connection of judicial office and judicial duty: "Offices are duties, so called, to put the officer in mind of his duty."[23]

18. *See id.* at 135.

19. *Id.* at 134–35 n. 78 (quoting YEAR BOOK, 19 Ed. III, 375, pl. 3 (1345)).

20. SIR EDWARD COKE, THE FIRST PART OF THE INSTITUTES OF THE LAWS OF ENGLAND 442 (Robert H. Small, 1853) (1643).

21. HAMBURGER, *supra* note 1, at 104. Cicero's *De Officiis* was a standard text in the Tudor and Stuart grammar schools, and for some the study proved life-long. William Cecil, Lord Burghley, is said always to have carried on his person a duodecimo edition of *De Officiis*, for consultation in moments of leisure, rather in the same way that Justice Hugo Black customarily carried in his pocket a pamphlet copy of the United States Constitution. *See* EDWARD NARES, 2 MEMOIRS OF THE LIFE AND ADMINISTRATION OF THE RIGHT HONOURABLE WILLIAM CECIL, LORD BURGHLEY 335 (Colburn & Bentley 1830); *see also* Allen D. Boyer, *Sir Edward Coke, Ciceronianus: Classical Rhetoric and the Common Law Tradition*, *in* LAW, LIBERTY, AND PARLIAMENT: SELECTED ESSAYS ON THE WRITINGS OF SIR EDWARD COKE 224, 242–43 n.68 (Allen D. Boyer ed., 2004).

22. HAMBURGER, *supra* note 1, at 112.

23. SIR EDWARD COKE, THE THIRD PART OF THE INSTITUTES OF THE LAWS OF ENGLAND 185 (W. Clarke, 1871) (1681).

The judges bound themselves to follow the wisdom of their profession, not to yield to their individual will.[24] They developed tests of discretion, recognizing the limits within which they could legitimately act.[25] Although sworn to serve and counsel their monarch, they learned to be independent, even to resist royal pressures and blandishments.[26] Coke faithfully served King James I, but, in 1615 when James's Attorney General, Sir Francis Bacon, asked the judges to seriatim approve a new and expansive definition of treason in *Peacham's* case, Coke resisted.[27] Coke found this "auricular taking of opinions . . . new and dangerous."[28] Opinions should be produced in conference.[29] He defined law as the "artificial reason" of the judges, the professional consensus of those learned in the law—a blend of wisdom and craft, perhaps even of art—that could only be ascertained through judicial debate and resolution.[30]

As he reviews the history of judicial duty, Hamburger also takes a sidelong glance at a group whose criticism of the common law lawyers is almost as deeply rooted in history: "the learned critics."[31] There are reflections of contemporary issues in his portrait of the civil lawyers, men whose great patrons were Archbishop Richard Bancroft (1544–1610) and Archbishop William Laud (1573–1645). As Hamburger explains:

> The common law vision of judicial duty often troubled Englishmen whose university education in civil and canon law had left them with a low view of national custom and high expectations for reframing it within academic generalizations. The common law, like other national customs, seemed to them necessarily incomplete, uncertain, unjust, and thus in need of learned explication. Of course, these men with academic visions of law denied that judges should decide on the basis of their personal views, but they tended to doubt whether any judge could decide merely in accord with

24. HAMBURGER, *supra* note 1, at 152.

25. Discretion had also been defined by Coke, who stated, "discretion is to discern by law what does justice." HAMBURGER, *supra* note 1, at 136 (quoting SIR EDWARD COKE, THE FOURTH PART OF THE INSTITUTES OF THE LAWS OF ENGLAND 41 (W. Clarke, 1817) (1681)).

26. *See* HAMBURGER, *supra* note 1, at 152–53.

27. *Id.* at 153.

28. *Id.* (quoting *Letter From Francis Bacon to James I (Jan. 31, 1614), in* 5 LETTERS AND THE LIFE OF FRANCIS BACON 107 (James Spedding ed., 1869)).

29. *Id.*

30. *Id.* at 139–41, 223–24.

31. *Id.* at 116.

> national custom, and they therefore expected even the common law judges to engage in a sort of moral and politic discernment beyond the law of the land—an exercise of judgment by which the judges would render English law more complete and rational.[32]

The learned critics found the common law "necessarily incomplete, uncertain, unjust"[33]—Hamburger stops just short of saying *indeterminate,* the pejorative that the modern academy has so often applied to law. His précis of English legal history offers a parable of modern jurisprudence, where shortcomings in legal doctrine have frequently been invoked as a reason to amend legal doctrine through the application of lessons from other learned disciplines. It also reflects a concern for the independence of the common law, for the ecclesiastical tribunals in which English civilians found employment were institutions through whose powers the English bishops sought to enforce religious and intellectual conformity.[34]

Against such challenges, Hamburger finds, the common law judges successfully maintained the honor of their profession:

> They were not blind to the realities of incompleteness and discretion, but they hoped to limit these realities. Although many of them found it satisfying to observe the relationship of the law of the land to the broader universe of laws, they generally refused to allow academic analysis to undermine their duty or their authority of English law. Their stance can easily be caricatured as a sort of anti-intellectualism—an obstinate blindness to both reality and justice. In fact, the common law posture was a highly effective defense against the threat from academic law, and this defense was essential for limiting government power and preserving liberty.[35]

32. *Id.*

33. *Id.* (emphasis added).

34. It may not be wholly coincidental that in 2002 Hamburger published *Separation of Church and State,* a book that did not shrink from observing that Thomas Jefferson's suggestion of a "wall of separation" between religion and government became a familiar constitutional metaphor because it served so well the ends of those who wished to turn the First Amendment against Roman Catholic believers. *See* PHILIP HAMBURGER, SEPARATION OF CHURCH AND STATE (2002).

35. *Id.* at 611.

IV. THE AMERICAN INHERITANCE OF JUDICIAL DUTY

The core of this book focuses on the jurisprudence of the first years of the American republic.[36] Much of the material reviewed here has become familiar to students of constitutional law—much of the material that Hamburger adds to the debate is new—and the perspective that he develops adds much to the debate.

Long before *Marbury*, Hamburger argues, and in many courtrooms across the new American states in the years prior to *Marbury*, it had been common for judges to rule on constitutional matters.[37] Early constitutional rulings often reflected transatlantic doctrines.[38] A common standard for assessing the validity of local enactments, the test of "law and reason," had been developed in early modern England to assess the validity of local customs and the bylaws of corporate bodies.[39] In the colonies, the test was applied when questions arose about local customs, and proved so useful that courts continued to apply it after the Revolution.[40]

So often had colonial judges been required to measure colonial enactments against colonial charters and English laws, that the courts had developed the doctrine of "manifest contradiction," which allowed for the flexible recognition of practical local rules while preserving the supremacy of the mother country's laws and institutions.[41] This standard also survived to influence the constitutional analyses of St. George Tucker[42] and Alexander Hamilton.[43] Other familiar doctrines

36. *Id.* chs. 10–19.

37. Studies in this area include Mary Sarah Bilder, *The Corporate Origins of Judicial Review*, 116 YALE L. J. 523 (2006); Barbara Aronstein Black, *An Astonishing Political Innovation: The Origins of Judicial Review*, 49 U. PITT. L. REV. 962 (1988); Allen Dillard Boyer, *Understanding, Authority, and Will: Sir Edward Coke and the Elizabethan Origins of Judicial Review*, 39 B. C. L. REV. 43 (1997); Philip Hamburger, *Revolution and Judicial Review: Chief Justice Holt's Opinion in* City of London v. Wood, 94 COLUM. L. REV. 2140 (1994); Hamburger, *supra* note 6, Dudley Odell McGovney, *The British Origin of Judicial Review of Legislation*, 93 U. PA. L. REV. 8 (1944).

38. *See* HAMBURGER, *supra* note 1, at 179–80.

39 *See id.* at 256–57 & n.1.

40. *Id.*

41. *Id.* at 313–16.

42. *See, e.g., Commonwealth v. Caton*, 8 Va. 5 (Sup. Ct. App. of Va. 1782). In *Caton*, St. George Tucker argued "'[i]f any Act' of the General Assembly 'shall be found absolutely & *irreconcileably* [sic] contradictory to the Constitution, it can not admit of a Doubt that such act is absolutely null & void.'" HAMBURGER, *supra* note 1, at 313 & n.71 (discussing Tucker's argument before the Virginia Court of Appeals in *Caton* and referencing the collection of Tucker's papers held at William and Mary College Library).

and methods of interpretation were employed in the new courts, most notably applying "the equity of a statute" to broaden or narrow its terms.[44] In New England, a reading along these lines was employed to free black men who enlisted with the revolutionary forces from slavery: as only freemen were to be enlisted, so it was concluded that to have served in the Continental Army meant that any black veteran had been emancipated.[45]

It is not only in cases in which the courts struck down statutes that one finds early evidence of judges, following their obligation to rule correctly in the light of all the relevant law, exercising constitutional authority.[46] In an early Massachusetts case, when a question of to what extent the commonwealth recognized slavery arose, the Massachusetts Supreme Court relied on the state's Declaration of Rights, saying: "our Constitution of Govmt, by w^{ch} y^{e} people of he Commonwealth have solemnly bound themselves," to hold that slavery had been a recognized "usage" but not authorized by certain superannuated statutes.[47] The constitution had been studied in order to ascertain the state of the law and to support a determination that references to slavery in the law of the state reflected "European usage rather than Massachusetts common law."[48] In another decision, *Whitney v. Peckham*,[49] which involved

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43. *See, e.g.*, THE FEDERALIST NO. 78, (Alexander Hamilton); *See also* HAMBURGER, *supra* note 1, at 312 (discussing Hamilton's views on which law should prevail when there is "evident opposition" between legislative enactments and the Constitution).

44. HAMBURGER, *supra* note 1, at 344.

45. *Id.* at 345 n.35. In South Carolina, perhaps unsurprisingly, judges applied the doctrine to a different end. In 1789, two children, aged four and eight, arrived in the state on a ship from Honduras, whence they had traveled with their slaves. A South Carolina statute of 1788 forbade the importation of slaves. Rather than rule that the slaves should be taken from the children (a conclusion argued for by the Attorney General), the judges concluded that a loose "construction of the statute, consistent with justice and the dictates of natural reason," was necessary to prevent an injustice that would make the law "null and void." The court ruled that the legislature must be presumed to have intended an exception in the case of slaves in transit to South Carolina at the time of the law's passage. The children were allowed to keep their slaves. *Ham v. M'Claws & Wife*, 1 S.C.L. (1 Bay) 91, 91–94 (S.C. Super. Ct. 1789); *See also* HAMBURGER, *supra* note 1, at 344–45 (discussing *Ham*).

46. HAMBURGER, *supra* note 1, at 474–75.

47. *Id.* at 482.

48. *Id.* at 476–83, discussing the *Quock Walker* cases. *See also, e.g.*, Emily Blanck, *Seventeen Eighty-Three: The Turning Point in the Law of Slavery and Freedom in Massachusetts*, 75 NEW ENG. Q. 24 (2002); Robert M. Spector, *The Quock Walker Cases—Slavery, Its Abolition, and Negro Citizenship in Early Massachusetts*, 53 J. NEGRO HIST. 12 (1968); Arthur Zilversmit, *Quok Walker, Mumbet, and the Abolition of Slavery in Massachusetts*, 25 WM. & MARY Q. 614 (1968).

not the rights of slaves to resist capture by slave-owners, but the right of legislators to avoid arrest for debt, the judges again looked to the constitution to gain an understanding of the law.[50] They concluded that the relevant article of the constitution had not repealed a colonial statute that offered members of the legislature immunity from arrest at the time of legislative sessions.[51] As Hamburger observes, the decision to vindicate a statute against constitutional challenge is just as much a constitutional decision as a determination to invalidate the statute.[52]

What appear to be controversies that are limited to purely legal issues often prove to be much more substantial. In the aftermath of the Revolutionary War, Virginia judges held that conditions could not be placed on pardons.[53] On its face, the contretemps that resulted was a quarrel over legal doctrine between the courts and the governor, but the dispute had political and jurisprudential implications as well. Governor Patrick Henry had offered conditional pardons to certain felons, offering to spare each prisoner execution on condition that he agree to spend three years at hard labor.[54] This action by the Governor was consistent with recommendations made by a law reform committee at the time, headed by Thomas Jefferson, which was working toward replacing the harsh traditional punishments with a system of graduated sanctions.[55] The judges' resistance, supported by legislative reluctance to go

49. *See* The Honorable William Cushing, Notes of Cases Decided in the Superior and Supreme Judicial Court of Massachusetts from 1772 to 1789, fols. 51[r]–53[r] (manuscript report in archives of Harvard Law School, Ms. 4083) (discussing *Whitney v. Peckham*, decided by the Hampshire County Supreme Judicial Council, May term 1785).

50. HAMBURGER, *supra* note 1, at 484–86, 486 n.16.

51. *Id.*

52. In North Carolina, in the case of *Bayard v. Singleton*, 1 Mart. 45 (N.C. Super. Ct. 1787), judges delayed decision on a law that prevented Tory landowners from suing to reclaim their confiscated estates. *See* HAMBURGER, *supra* note 1, at 449–61. Despite threats of impeachment, the judges deferred to the legislature, inviting it to revise the law. *Id.* After a delay of two years, the judges finally held the statute unconstitutional, citing "the obligations of their oaths, and the duty of their office . . . ." *Id.* at 459. Hamburger finds that although "*Bayard v. Singleton* is usually taken to show how judges on the eve of the Constitutional Convention were exploring a new judicial power over legislation, it was actually an example of how judges with all too human foibles eventually rose to the level of their ideals." *Id.* at 449–50.

53. HAMBURGER, *supra* note 1, 380–83.

54. *Id.* at 381.

55. *Id.* at 380.

forward, forced the abandonment of these ambitious plans to reform the criminal law.[56]

Episodes in which controversies were addressed by "resolutions of the judges" can be particularly suggestive. Such incidents usually represent junctures at which the judges felt compelled to assert their understanding of their court's authority (in any sense—identity, role, jurisdiction, or power).[57] Because the judges typically asserted their authority against other organs of government, these episodes reflect early decisions on constitutional matters. The best-known judicial resolutions arose in 1792 in a cluster of judicial pronouncements and remonstrances relating to the Invalid Claims Act and its direction that circuit court judges were to rule on claims by disabled veterans.[58] There was nothing unfamiliar about this. Before the Revolution, in Virginia, the Justices of the

56. *Id.* at 380–83; *see also* Kathryn Preyer, *Crime, The Criminal Law and Reform in Post-Revolutionary Virginia*, 1 LAW & HIST. REV. 53 (1983). The judges had previously addressed wartime pardons for Tory partisans that had been granted by the Virginia House of Delegates. HAMBURGER, *supra* note 1, at 487–96; *see also* William Michael Treanor, *The* Case of the Prisoners *and the Origins of Judicial Review*, 143 U. PA. L. REV. 491 (1994).

In the 1780 case of *Holmes & Ketcham v. Walton*, the New Jersey Supreme Court disallowed a statute that required six-man juries in confiscation cases. State v. Parkhurst, 9 N.J.L. 427, 444 (1802) (discussing the unpublished opinion in *Holmes v. Walton*); *see* HAMBURGER, *supra* note 1, at 407–22. The court did not formally assert that the law was unconstitutional—but at the time it was clearly understood that the judges had reached that conclusion. HAMBURGER, *supra* note 1, at 416–20. This precedent has long drawn attention, not least because it seemed to scholars that members of the Constitutional Convention must have known of these decisions and implicitly written into the Constitution an assumption that other judges would follow these examples. *See* Louis Boudin, *Precedents for the Judicial Power:* Holmes v. Walton *and* Battle v. Hinkley, 3 ST. JOHN'S L. REV. 173 (1929); Austin Scott, Holmes v. Walton*: The New Jersey Precedent: A Chapter in the History of Judicial Review and Unconstitutional Legislation*, 4 AM. HIST. REV. 459 (1899). Rhode Island also generated litigation in which the judges' vision of constitutional legislation brought on a conflict with the legislature. *See* JAMES M. VARNUM, THE CASE, TREVETT AGAINST WEEDEN (John Carter, 1787) (discussing the unpublished *Trevett v. Weeden*); *see also* Patrick T. Conley, *Rhode Island's Paper Money Issue and* Trevett v. Weeden, 30 R.I. HIST. 95 (1971); Irwin H. Polishook, Trevett vs. Weeden *and the Case of the Judges*, 38 NEWPORT HIST. 45 (1965); Charles Warren, *Earliest Cases of Judicial Review of State Legislation by Federal Courts*, 32 YALE L.J. 20 (1922).

57. HAMBURGER, *supra* note 1, at 383–91.

58. These resolutions cluster around *Hayburn's Case*, 2 U.S. 409 (2 Dall.) 410 (1792). Chief Justice Marshall was considering this precedent when he took his greatest step.

> It must be well recollected that in 1792, an act passed, directing the secretary at war to place on the pension list such disabled officers and soldiers as should be reported to him, by the circuit courts, which act, so far as the duty was imposed on the courts, was deemed unconstitutional; but some of the judges, thinking that the law might be executed by them in the character of commissioners, proceeded to act and to report in that character.

Marbury, 5 U.S. (1 Cranch) at 171.

Peace of Northampton County had declared that they conceived the Stamp Act to be unconstitutional.[59] In Caroline County, in the same turbulent weeks, J. P. Edmund Pendleton explained to James Madison's father that a declaration that the use of stamped paper was unnecessary was promptly needed, so that the courts could proceed with the business of the people:

> As a majestrate, I thought it my duty to sit, and we have constantly opened court, and I shall not hesitate to determine what people will desire me and run the risque of themselves, and having taken an oath to determine according to law, [I] shall never consider that act as such for want of power (I mean constitutional authority) in the Parliament to pass it.[60]

The connection between following judicial duty and denying the validity of measures that were unconstitutional had already been drawn.

A remarkable range of courts and government bodies were prepared to rule on constitutional issues.[61] In 1784, when the New York state legislature passed the uncompromising Trespass Act—which gave patriots the right to sue for harm to property damaged or occupied during seven years of British occupation and forbade defendants from pleading that the British authorities had authorized their actions—the Mayor's Court of New York City ruled that, if the legislature had passed a law that proved unjust, the courts would imply an exception consistent with the law of nations and allow British authorization to be pleaded.[62]

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59. HAMBURGER, *supra* note 1, at 276.

60. *Id.* at 277.

61. "The duty of the Power I conceive, in all cases, is to decide according to the Laws of the State," wrote James Iredell (whose vision and eloquence are frequently displayed in this book), arguing for the authority of courts to hold statutes unconstitutional. HAMBURGER, *supra* note 1, at 464 (quoting An Elector [James Iredell], To the Public (Aug. 1786), Duke University Rare Book, Manuscript, and Special Collections Library, James Iredell Papers, Box 1). "But it is said, if the Judges have this power, so have the County Courts. I admit it. The County Courts, in the exercise of equal judicial power, must have equal Authority." *Id.* at 379 (quoting An Elector [James Iredell], To the Public (Aug. 1786)). Iredell's letter "To the Public" is also discussed in BRINTON COXE, AN ESSAY ON JUDICIAL POWER AND UNCONSTITUTIONAL LEGISLATION BEING A COMMENTARY ON PARTS OF THE CONSTITUTION OF THE UNITED STATES 256 (Kay and Brother, 1893).

62. HAMBURGER, *supra* note 1, at 348–55; *see also* ARGUMENTS AND JUDGMENT OF THE MAYOR'S COURT OF THE CITY OF NEW YORK IN A CAUSE BETWEEN ELIZABETH RUTGERS AND JOSHUA WADDINGTON 23 (New York: 1784). Materials on this litigation were edited by Henry B. Dawson in the nineteenth century and, more recently, in JULIUS GOEBEL JR., 1 THE LAW PRACTICE OF ALEXANDER HAMILTON: DOCUMENTS AND COMMENTARY 282 (1964).

The Inferior Courts of the counties comprising New Hampshire, were modest institutions but proved anything but humble. They fought tenaciously against what they saw as unconstitutional legislation. New Hampshire's Ten Pound Act of November 1785 allowed a justice of the peace, sitting without a jury, to try any case where the value in question did not exceed £10.[63] This act "was ostensibly designed to ensure 'the recovery of small debts in an expeditious way,' but it might also be said to impose summary process on the collection of small debts."[64] The New Hampshire constitution guaranteed a jury trial where more than 40 shillings was at issue.[65] Many of the Inferior Court judges were not lawyers,[66] but few judges have ever defended the constitution as fiercely as they did: arresting judgments,[67] non-suiting plaintiffs,[68] quashing proceedings,[69] dismissing cases,[70] and even disciplining justices of the peace.[71] The Inferior Courts repeatedly set down in their records that the Ten Pound Statute was "Manifestly Contrary to the Constitution of this State."[72] The judges weathered calls for their impeachment and eventually won repeal of the statute.[73]

Some of these judicial and government bodies were exercising traditional powers. The Court of the Mayor of New York City was modeled on British municipal institutions: Mayor James Duane sat on it with the city recorder and various aldermen.[74] In New Hampshire, by contrast, there was no doubt that revolution was afoot. The judges there broke with established practice by recording the grounds for their decisions. The Ten Pound Act had been adopted during post-war hard times and their campaign against it was waged in a city almost besieged by unemployed veterans.[75]

63. HAMBURGER, *supra* note 1, at 423–24.
64. *Id.* at 423.
65. *Id.*
66. *Id.* at 422.
67. *Id.* at 426.
68. *Id.*
69 *Id.* at 432.
70. *Id.* at 431.
71. *Id.* at 429–31.
72 *Id.* at 428.
73. *Id.* at 422–35; *see also* Richard M. Lambert, *The* 'Ten Pound' Cases *and the Origins of Judicial Review in New Hampshire*, 43 N. H. BAR J. 37 (2002).
74. HAMBURGER, *supra* note 1, at 348.
75. *Id.* at 423.

Previous work in American legal history, Hamburger argues, has accepted too easily that these cases foreshadowed a doctrine of judicial review—indeed, that any legal development of the early Federalist era that bears upon constitutional interpretation represents a footnote to the history of judicial review. Commentators "assume that the judicial creation of judicial review was but a singularly important example of an inevitable judicial discretion over constitutional law."[76] Hamburger challenges both the jurisprudential model of judicial review and the history that has been adduced to support it:

> At a minimum, the evidence calls into question any reliance on the history of "judicial review." The speculation about how judges developed judicial review has always rested on the paucity of evidence—in particular, the shortage of evidence from the 1780s and earlier—but in light of the evidence about law and judicial duty presented in this book, the history of judicial review looks rather dubious. Of course, the sort of judicial power that draws authority from the history of judicial review may nonetheless remain appealing to some observers, but it should stand on its own legs rather than rest on the crutches provided by an imaginative historicizing of modern preconceptions.[77]

"[T]he common law ideals of law and judicial duty can be considered attempts to secure a firm footing at the edge of a chasm of lawlessness," Hamburger writes.[78] "A body that was the final judge"—as some English kings considered themselves, and as Parliament did after them—"might come to view itself as above the law of the land and thus absolute."[79] Contemporary legal theory may be able to prevent abuses of power by the people: the counter-majoritarian bias of the modern course in Civil Rights and Liberties has effectively fenced in the principle of majority rule. Even in this brave new world, however, familiar political temptations remain.

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76. *Id.* at 10. Studies taking such a perspective include CHARLES A. BEARD, THE SUPREME COURT AND THE CONSTITUTION (Paisley Press 1938) (1912); Bradford Clark, *Unitary Judicial Review*, 72 GEO. WASH. L. REV. 219 (2003); Saikrishna B. Prakash & John C. Yoo, *The Origins of Judicial Review*, 70 U. CHI. L. REV. 893 (2003); Jack N. Rackove, *The Origins of Judicial Review: A Plea for New Contexts*, 49 STAN. L. REV. 1031 (1997); William Michael Treanor, *Judicial Review Before Marbury*, 58 STAN. L. REV. 473 (2005); Gordon S. Wood, *The Origins of Judicial Review*, 22 SUFFOLK U. L. REV. 1995 (1988); and Gordon S. Wood, *The Origins of Judicial Review Revisited*, 56 WASH. & LEE L. REV. 787 (1999).

77. HAMBURGER, *supra* note 1, at 617.

78. *Id.* at 620.

79. *Id.*

> [M]any Americans, in their desire to prevent the people from abusing the power above law, have invited their judges to exercise it . . . . In taking up this power, the judges have found sophisticated support in the old academic sensibilities, and not unlike some kings and Parliament when they claimed to be the final arbiter, American judges have acquired a taste for power above the law. Perhaps every society needs this sort of power, but in denying absolute power to Parliament, Americans did not give it to the judges.[80]

V. CONCLUSION

In a work that challenges received ideas concerning judicial review, but nonetheless maintains that judges should measure laws against constitutional provisions, it may be difficult to explain how changes wrought in the law through the obligations of judicial duty would differ from changes imposed on the law from above by judicial review.[81] But the best example of a judge who wrought broad changes in the law, working from within the system of the law and not from a pedestal above them, may be Benjamin Cardozo. Each of Cardozo's great opinions, Karl Llewellyn wrote, left a new precedent "in clear harmony with the authorities—duly explained; *in such harmony that on the point in hand it supersedes them.*"[82] To supersede rather than overrule—that is the mark of a jurist working respectfully within the tradition of the common law. Cardozo's achievement was well worth the labor, and it suggests what judicial duty may accomplish.

The doctrine of judicial review has taken hold of American law as strongly as any of the justices who voted in Marbury might have hoped. Judicial duty has now found an eloquent advocate

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80. *Id.*

81. The power of the judiciary under either approach is a formidable one. The present reviewer believes that what Learned Hand observed about "the authority" of the federal courts "to review the decisions of Congress" applies to judicial duty as well as to judicial review. Hand wrote:

> [S]ince this power is not a logical deduction from the structure of the Constitution but only a practical condition upon [the Constitution's] successful operation, it need not be exercised whenever a court sees, or thinks it sees, an invasion of the Constitution. It is always a preliminary question how importunately the occasion demands an answer.

LEARNED HAND, THE BILL OF RIGHTS 10, 15 (1958). This approach acknowledges the power that a judge can wield, while at the same time it reflects the same respect and self-conscious restraint for which Hamburger argues.

82. KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 443 (1960) (emphasis added).

as well. *It is emphatically the province and duty of the judicial department to say what the law is.*[83] Thanks to Hamburger, those phrases take on a singular new importance. It is no small task to identify in a judicial decision what was always there. The prehistory of judicial review, for more than a century now, has been explored and interpreted by scholars.[84] This book promises to alter the terms of that debate.

83. *Marbury v. Madison*, 5 U.S. (1 Cranch) at 177.

84. *See* HAMBURGER, *supra* note 1, at 2 (summarizing scholarship regarding the history of judicial review).

WILL "EQUAL" AGAIN MEAN EQUAL?: UNDERSTANDING *RICCI V. DESTEFANO*

NOTE

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I. INTRODUCTION

> Ricci *thus leaves the Court with a troubling dilemma it must eventually confront: either retreat from its current colorblind approach to equal protection, or rule disparate impact—a doctrine firmly ensconced in history, precedent, and congressional approval—unconstitutional.*[1]

"This nation was founded on the affirmative premise that 'all men are created equal.'"[2] Without regard to background, education, or lineage, America has stood on the promise of "equality in rights and in obligations"[3] and that "the door ought to be equally open to all."[4] Nearly one hundred years later, Frederick Douglass offered this simple pledge of absolute equality—not pity, not sympathy—as the solution to years of slavery of African Americans.[5] The passage of the Fourteenth Amendment and its explicit mandate that no State shall "deny to any person within its jurisdiction the equal protection of the laws"[6] was the answer to Douglass's plea and was the fulfillment of the Declaration of Independence's promise.[7] Centuries later, the Court's commitment to color-blindness has remained a consistent marker of equal protection jurisprudence.[8]

It is against this background that *Ricci v. DeStefano*[9] will be remembered as the case with the greatest impact on race

1. *The Supreme Court, 2008 Term—Leading Cases*, 123 HARV. L. REV. 282, 283 (2009).

2. Brief for The Claremont Institute Center for Constitutional Jurisprudence as Amicus Curiae Supporting Petitioners at 2, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 507011 [hereinafter Claremont Brief] (citing THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776)).

3. James Wilson, *Of Man, as a Member of Society, Lectures on Law* (1791), *reprinted in* 1 FOUNDERS' CONSTITUTION 555–56 (Phillip B. Kurland & Ralph Lerner eds., 1987).

4. THE FEDERALIST NO. 36, at 259 (Alexander Hamilton) (Benjamin F. Wright ed., 1961).

5. Frederick Douglass, *What the Black Man Wants* (1865), *reprinted in* THE LIFE AND WRITINGS OF FREDERICK DOUGLASS 157–65 (Philip S. Foner ed., Int'l Publishers 1950).

6. U.S. CONST. amend. XIV, § 1.

7. *See* Claremont Brief, *supra* note 2, at 6 ("The Fourteenth Amendment's guarantee of equal protection of the laws to all citizens, regardless of race, was the fulfillment of the Declaration of Independence's promise and the Civil War's sacrifice."); *accord* Plessy v. Ferguson, 163 U.S. 537, 559 (1896) (Harlan, J., dissenting) ("Our constitution is color-blind, and neither knows nor tolerates classes among citizens.").

8. *See infra* note 60 and accompanying text.

9. 129 S. Ct. 2658 (2009).

jurisprudence in recent history.[10] While the Court's adoption of the strong-basis-in-evidence standard as a matter of Title VII statutory construction is noteworthy,[11] *Ricci*'s identification of the conflict between the Constitution's equal protection mandate and Title VII's disparate-impact provision[12] will haunt the Court in future cases.[13]

This Note responds to Justice Scalia's question in *Ricci*: "Whether, or to what extent, are the disparate-impact provisions of Title VII . . . consistent with the Constitution's guarantee of equal protection?"[14] Section II of this Note introduces the events that led to *Ricci* and the case's journey from the district court to the Supreme Court. Section III explores the Court's opinion in *Ricci*, beginning with a discussion of the state of the law before *Ricci* in Section III(a). Section III(b) addresses the facial impact of *Ricci*, discussing both the plaintiff-firefighters' and the Court's adoption of the strong-basis-in-evidence standard. Section III(c) explores the Court's treatment of the Equal Protection Clause as it addressed petitioner's Title VII claims and establishes a foundation for Section III(d)'s inquiry into the constitutionality of Title VII. Utilizing strict scrutiny review, Section III(d) shows that the disparate-impact provision of Title VII is patently unconstitutional and suggests a means of resolution. Section III(e) provides anticipatory rebuttal to several justifications for Title VII's disparate-impact provision. Section IV concludes this Note.

II. CASE RECITATION

A. *The Facts of* Ricci v. DeStefano

The City of New Haven's civil service promotion system requires the City to fill vacancies in classified civil-service ranks

10. *See* David G. Savage, *The Future in Black and White: In the Era of President Barack Obama, Race Relations Still Play Out*, 95-JUN A.B.A. J. 18, 20 (2009) (noting the practical impact of *Ricci*).

11. *Ricci*, 129 S. Ct. at 2678; Kenneth L. Marcus, *The War Between Disparate Impact and Equal Protection*, 2009 CATO SUP. CT. REV. 53, 60–61 (2009) (discussing the strong-basis-in-evidence standard).

12. *See* Marcus, *supra* note 11, at 61 (noting that *Ricci* was the first case to identify this conflict).

13. *See* John P. Elwood, *What Were They Thinking: The Supreme Court in Revue, October Term 2008*, 12 GREEN BAG 429, 432 (2009) (noting *Ricci*'s impact on the future of anti-discrimination law).

14. *Ricci*, 129 S. Ct. at 2682 (Scalia, J., concurring).

with the most qualified individuals, as determined by the results of examinations.[15] After each examination, the New Haven Civil Service Board certifies the applicants that passed the examination.[16] Under the "'rule of three,' the relevant hiring authority must fill each vacancy by choosing one candidate from the top three scorers on the list."[17]

In November and December 2003, firefighters took qualification examinations for lieutenant and captain.[18] The examination results showed "white candidates . . . outperform[ing] minority candidates," prompting the City to open public debate about the examinations.[19] "City officials expressed concern that the tests had discriminated against minority candidates," while Industrial/Organizational Solutions' counsel "defended the examinations' validity" and attributed "any numerical disparity between white and minority candidates . . . to . . . external factors."[20]

The City eventually threw out the examination results.[21] The firefighters who would have been promoted based on their performance sued the City, alleging that, by discarding the test results, the City discriminated against the plaintiffs based on their race in violation of Title VII of the Civil Rights Act of 1964 and the Equal Protection Clause of the Fourteenth Amendment.[22]

B. *The District Court Opinion*

The plaintiff-firefighters and the City made cross-motions for summary judgment in the United States District Court for the District of Connecticut on the Title VII and Equal Protection

15. Ricci v. DeStefano, 129 S. Ct. 2658, 2665 (2009); *see also id.* at 2665–66 (discussing the development process for the promotion tests).

16. *Id.* at 2665.

17. *Id.*

18. *Id.* at 2666. "The results would determine which firefighters would be considered for promotions during the next two years, and the order in which they would be considered." *Id.* at 2664.

19. *Id.* at 2664. Of the "[s]eventy-seven candidates complet[ing] the lieutenant examination . . . 34 candidates passed." *Id.* at 2666. "10 candidates were eligible for . . . promotion to lieutenant. All 10 were white." *Id.* Nine were eligible for promotion to captain, seven of whom were white and two of whom were Hispanic. *Id.*

20. *Id.* Industrial/Organizational Solutions noted the results were consistent with "results of the Department's previous promotional examinations." *Id.*

21. *Id.*

22. *Id.*

claims.[23] The district court granted summary judgment in favor of the City after finding no genuine issue as to any material fact relevant to the outcome of the firefighters' Title VII and Equal Protection claims.[24] It held that the City's desire to avoid making promotions based on a test with a racially disparate impact was not intentional discrimination under Title VII's disparate-treatment provision and was not a violation of the Equal Protection Clause.[25]

C. *The Second Circuit Opinion*

In a summary order from a three-judge panel and later in a per curiam opinion, the United States Court of Appeals for the Second Circuit upheld the judgment of the district court.[26] In a brief paragraph, a narrow majority of the court affirmed "for the reasons stated in the thorough, thoughtful, and well-reasoned opinion of the court below."[27] Notably, six members of the court urged for rehearing en banc, arguing that the district court failed to subject the City's justifications to the "most searching examination," as required by *Adarand.*[28]

D. Ricci *Before the Supreme Court*

i. Justice Kennedy's Majority Opinion

A five-member majority[29] of the Supreme Court overruled the

23. Ricci v. DeStefano, 554 F. Supp. 2d 142, 144 (D. Conn. 2006). The City also "moved for summary judgment on plaintiffs' [additional] claims." *Id.* at 145.

24. *See id.* at 145, 151 (stating summary judgment standard and the finding). The district court also made a similar finding on the plaintiffs' other claims. *Id.*

25. *Id.* at 158–62. The Court noted although the firefighters' evidence and the City's arguments showed that the "City's reasons for advocating non-certification resulted from the racial distribution of the results," the City's actions were race-neutral because the results in their entirety were denied certification, and there was an "absence of any evidence of discriminatory animus toward plaintiffs." *Id.* at 152, 158.

26. Ricci v. DeStefano, 265 F. App'x 106, 107 (2d Cir. 2008) (summary order). After disposition by summary order, one judge requested a poll on whether to rehear the case en banc. After the poll, the original three-judge panel withdrew the summary order and filed the per curiam opinion and denied rehearing. Ricci v. DeStefano, 530 F.3d 87 (2d Cir. 2008) (per curiam). The per curiam order and concurring and dissenting opinions were subsequently filed. *Id.*

27. *Id.* The court additionally noted that because the Board was "trying to fulfill its obligations under Title VII when confronted with test results that had a disproportionate racial impact, its actions were protected." *Id.*

28. *Id.* at 99 (Cabrenes, J., dissenting) (citing Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 223 (1995)).

29. Chief Justice Roberts and Justices Scalia, Thomas, and Alito joined Justice Kennedy to form the majority. Ricci v. DeStefano, 129 S. Ct. 2658, 2663 (2009). Justices

lower court's decision and concluded that race-based actions like the City's are impermissible under Title VII "unless the employer can demonstrate a strong basis in evidence that, had it not taken action, it would have been liable under the disparate-impact statute."[30] The Court did not address whether the City's actions violated the Equal Protection Clause.[31]

The majority began their analysis with the premise that "the City's actions would violate the disparate-treatment provision of Title VII absent some valid defense."[32] The Court found that all the evidence demonstrated that the City did not certify the examination results because of statistical racial disparities,[33] but acknowledged that the City acted to comply with the disparate-impact provisions of Title VII.[34] The Court recognized the need to provide guidance for situations when the disparate-impact and disparate-treatment provisions would be in conflict absent a rule to reconcile them.[35] Finally, the Court noted that in providing such guidance, its decision must be consistent with the important purpose of Title VII—"that the workplace be an environment free of discrimination, where race is not a barrier to opportunity."[36]

The Court then turned to equal protection cases for "helpful guidance" in addressing Title VII,[37] noting that the same interests exist in the interplay between the disparate-treatment and disparate-impact provisions of Title VII.[38] The Court explained that while the present case did not require it to consider whether the statutory constraints under Title VII must be parallel in all respects to those under the Constitution, constitutional authorities are relevant.[39] Based on past holdings that actions based on race comply with the Equal Protection Clause only where there is a "strong basis in evidence" that

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Scalia (discussed *infra* Section II(d)(ii)) and Alito (omitted from discussion) also filed separate concurring opinions. *Id.*

30. *Id.* at 2664.

31. *Id.* at 2664–65, 2681. Because a decision for the firefighters on their Title VII claim would provide the relief sought, the Court considered it first. *Id.* at 2672.

32. *Id.* at 2673.

33. *Id.*

34. *Id.* at 2674.

35. *Id.*

36. *Id.*

37. *See id.* at 2675 ("Our cases discussing constitutional principles can provide helpful guidance in this statutory context.").

38. *Id.* at 2675–76.

39. *Id.* at 2675.

remedial actions were necessary, the Court found that applying the strong-basis-in-evidence standard to Title VII would give effect to both the disparate-treatment and disparate-impact provisions.[40] The Court stated that its holding did not address the constitutionality of the measures taken by the City to comply with Title VII.[41] Further, the Court explicitly did not hold that meeting the strong-basis-in-evidence standard satisfied the Equal Protection Clause.[42]

After adopting the strong-basis-in-evidence standard, the Court found "no genuine dispute" as to whether the "City lacked a strong basis in evidence to believe it would face disparate-impact liability if it certified the examination results."[43] Based on this finding, the Court held that the firefighters were entitled to summary judgment on their Title VII claim, reversed the judgment of the Court of Appeals, and remanded the cases for further proceedings.[44]

ii. Justice Scalia's Concurrence

Justice Scalia wrote a concurring opinion to note that the Court's resolution merely postponed "the evil day on which the Court will have to confront the question: Whether, or to what extent, are the disparate-impact provisions of Title VII . . . consistent with the Constitution's guarantee of equal protection."[45] Continuing the majority's discussion of the intersection of Title VII and the Equal Protection Clause, he highlighted but did not resolve the inherent discrimination mandated by Title VII's disparate-impact provision.[46]

iii. Justice Ginsberg's Dissent

Justice Ginsburg and three other members of the Court dissented from the judgment,[47] first noting that in assessing

40. *Id.* at 2675–76.

41. *Id.*

42. *Id.* at 2676.

43. *Id.* at 2681.

44. *Id.*

45. *Id.* at 2682 (Scalia, J., concurring).

46. *See id.* at 2683 ("The Court's resolution of these cases makes it unnecessary to resolve [the conflict]."). Justice Scalia described this inherent discrimination as "plac[ing] a racial thumb on the scales, often requiring employers to evaluate the racial outcomes of their policies, and to make decisions based on (because of) those racial outcomes." *Id.* at 2682.

47. Justices Stevens, Souter, and Breyer joined Justice Ginsburg in her dissent. *Id.* at

claims of race discrimination, context is determinative.[48] The dissent argued that the City did not violate Title VII because its refusal to certify the promotion tests was motivated by an attempt to avoid liability under the disparate-impact provision of Title VII, not by a discriminatory animus.[49] Further, the dissent argued that the majority ignored evidence of multiple flaws in the tests the City used, the legacy of racial discrimination in fire departments, and the Court's holding in *Griggs*.[50] Because of these factors, the dissent found no Title VII violation in the City's actions.[51]

III. ANALYSIS

The Court's opinion in *Ricci* made clear that the constitutional requirements of the Equal Protection Clause and the statutory requirements of Title VII are often in conflict.[52] Before "thinking about how—and on what terms—to make peace between them,"[53] it is crucial not only to understand the foundational basis of the Equal Protection Clause and Title VII separately, but to identify the complications that arise when attempting to reconcile them. This section will address: (1) the state of the law before *Ricci*; (2) the facial impact of *Ricci* to date; (3) *Ricci*'s impact on the constitutionality of Title VII; (4) the most advisable solution for reconciling the mandates of the Equal Protection Clause and Title VII; and (5) responses to anticipated critiques.

A. *The State of the Law Before* Ricci

> *[T]he law can both contribute to the prevention of discriminatory conduct and exacerbate discrimination. However, when effective, it can play a leading role in ending the propensity of individuals and societies to discriminate.*[54]

Prior to the Court's ruling in *Ricci*, Title VII and the Equal

2689 (Ginsburg, J., dissenting).

48. *Id.* at 2689–90.

49. *Id.* at 2709–10.

50. *Id.* at 2709 (citing Griggs v. Duke Power Co., 401 U.S. 424 (1971)).

51. *Id.* at 2710.

52. *See* Marcus, *supra* note 11, at 54–55 ("Although *Ricci* does not resolve this conflict, it does identify the problem clearly and suggests that a future case will resolve it.").

53. Ricci v. DeStefano, 129 S. Ct. 2658, 2683 (2009) (Scalia, J., concurring).

54. Hugo Rojas, *Legal Responses to Discriminatory Actions: A Comparative Analysis*, 5 LOY. U. CHI. INT'L L. REV. 127, 148 (2008).

Protection Clause were primarily addressed as separate, yet related, tools to end discrimination.[55] By resolving cases with both Title VII and Equal Protection claims on only one ground—finding the employer's action unlawful under Title VII and avoiding the larger constitutional inquiry—the Court had not directly addressed the constitutionality of Title VII under the Equal Protection Clause prior to *Ricci*.[56]

i. Equal Protection Law

The Fourteenth Amendment states that "nor shall any State . . . deny to *any person* within its jurisdiction the equal protection of the laws."[57] Emphasizing "*any person*," the Court has long held that equal protection rights are guaranteed to the individual and are "*personal* rights."[58] Courts and legal scholars have struggled to identify a firm definition for "equal protection," but have generally required like cases to be treated alike and "different cases differently."[59] The Court's equal protection jurisprudence has been historically understood to express the Constitution's overwhelming commitment to color-blindness.[60] The Court's application of strict scrutiny review, which leads to invalidating

55. *See generally infra* Section III(a)(iii) (exploring the pre-*Ricci* intersection between equal protection and Title VII).

56. Brief for the Society for Human Resource Management as Amicus Curiae Supporting Respondents at 11, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 796287 [hereinafter HRM Brief] ("No decision of this Court or other court (of which we are aware) holds that an employer violates Title VII when it refuses to certify test results having an undisputed disparate impact."). However, various circuit courts had ruled on this issue. *See, e.g.*, People Who Care v. Rockford Bd. of Educ., Sch. Dist. No. 205, 111 F.3d 528, 535 (7th Cir. 1997) (holding that avoiding a Title VII disparate-impact claim cannot justify race-based disparate treatment); Dean v. City of Shreveport, 438 F.3d 448, 454 (5th Cir. 2006) (holding that fear of liability cannot immunize discriminatory actions from constitutional strict scrutiny).

57. U.S. CONST. amend. XIV, § 1 (emphasis added).

58. Shelley v. Kraemer, 334 U.S. 1, 22 (1948) (emphasis added) (internal citations omitted).

59. *See generally* Robert John Araujo, *What Is Equality? Arguing the Reality and Dispelling the Myth: An Inquiry in a Legal Definition for the American Context*, 27 QUINNIPIAC L. REV. 113, 118, 151–53 (2009) (internal citations omitted) (exploring present day equal protection jurisprudence).

60. *See, e.g.*, Washington v. Davis, 426 U.S. 229, 239 (1976) ("The central purpose of the Equal Protection Clause of the Fourteenth Amendment is the prevention of official conduct discriminating on the basis of race."); City of Richmond v. J.A. Croson Co., 488 U.S. 469, 518 (1989) (Kennedy, J., concurring) ("The moral imperative of racial neutrality is the driving force of the Equal Protection Clause."). *See generally* ALEXANDER M. BICKEL, THE MORALITY OF CONSENT 133 (Yale Univ. Press 1975) (discussing equal protection jurisprudence). The United States is not alone in holding the principle of nondiscrimination at the highest level within its legal hierarchy. *See generally* Rojas, *supra* note 54, at 130–32 (discussing global equality principles).

government action in all but the rarest circumstances,[61] evidences this commitment to equal protection claims.[62]

The first step of a court's equal protection analysis—identifying whether the action should be subjected to strict scrutiny—ends when the court finds *any* use of race by the government.[63] Strict scrutiny will apply equally to race-based actions against a minority and to those based on a desire to remedy past injuries to minorities.[64] Further, even if the government action can be considered race-neutral in some nominal sense, the action will not be insulated from strict scrutiny if it is shown that the law was motivated by a racial purpose or object.[65] The Court has made clear that all race-based government actions are subject to strict scrutiny,[66] requiring the government to demonstrate that the race-based

61. *See infra* notes 69–76 and accompanying text.

62. *See, e.g.*, Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 224 (1995) (applying strict scrutiny to race discrimination claims); Parents Involved in Cmty. Schs. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 720 (2007) (holding that strict scrutiny applies to racial classifications).

63. Brief for The National Association of Police Organizations as Amici Curiae Supporting Petitioners at 7, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 2809358 [hereinafter Police Organizations Brief] (citing Grutter v. Bollinger, 539 U.S. 306, 326–27 (2003)). However, some have read *Parents Involved* to hold that some actions will not be subjected to strict scrutiny, particularly in the education context. *See* Brief for New York Law School Racial Justice Project as Amicus Curiae Supporting Respondents at 5–6, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 815208 (citing *Parents Involved*, 551 U.S. at 788–89 (assuming facially race-neutral measures that are race-conscious are one of the available options)); Brief for the United States as Amicus Curiae Supporting Vacatur and Remand at 6, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 507014 [hereinafter United States Brief] (stating that race-neutral measures are preferable to racial classifications).

64. The standard of review is not dependent on the race of those burdened or benefited by the classification. *See, e.g.*, *Croson*, 488 U.S. at 494.

65. *See, e.g.*, Hunt v. Cromartie, 526 U.S. 541, 546 (1999) (citing Miller v. Johnson, 515 U.S. 900, 913 (1995)). Equal protection jurisprudence is replete with references to "purpose" and "intent," requiring that a purpose to discriminate be present before a constitutional violation is found. Ralph R. Banks & Richard T. Ford, *(How) Does Unconscious Bias Matter?: Law, Politics, and Racial Inequality*, 58 EMORY L.J. 1053, 1089–90 (2009). In general, any consideration of race in making an employment decision is considered to be "intentional" and to constitute "purpose." *Cf.* Price Waterhouse v. Hopkins, 490 U.S. 228, 240 (1989) (equating consideration of gender to intentional discrimination in the employment context). "The Court has never held that government acts with a discriminatory purpose only when they act with animus towards a racial group." Brief for Law Professors and other Academics as Amicus Curiae Supporting Petitioners at 14, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 564457 (citing Brian T. Fitzpatrick, *Strict Scrutiny of Facially Neutral State Action and the Texas Top Ten Percent Plan*, 53 BAYLOR L. REV. 289, 309 (2001)).

66. *See, e.g.*, Johnson v. California, 543 U.S. 499, 505–06 (2005) (holding that all racial classifications imposed by government must be analyzed under strict scrutiny) (citing City of Richmond v. J.A. Croson Co., 488 U.S. 469, 493 (1989) (plurality opinion)).

action is "narrowly tailored" to achieve a compelling interest.[67]

Through decisions on numerous cases asserting violation of Fourteenth Amendment rights, the Court has indicated the nature of governmental motivations that constitute compelling interests.[68] Race-based decision-making has been described as the "outer limits" of the Equal Protection Clause.[69] While the Court has recognized that a government actor's desire to remedy its own past discrimination may justify remedial resort to racial classifications,[70] the Court has required that the actor first have a strong basis in evidence for its conclusion that remedial action was necessary.[71] Compliance with a federal law is not automatically a compelling interest in itself.[72] Further, the Court has never recognized a compelling governmental interest in avoiding unintentional racial disparities or societal discrimination,[73] or in merely avoiding the threat of litigation.[74] Additionally, the Court has rejected an interest in developing minority role models as justification for race-based action in

67. The burden to meet strict scrutiny review is on the decision maker, not the victim. Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 224–25 (1995); Parents Involved in Cmty. Schs. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 720 (2007).

68. *See infra* notes 78–85 and accompanying text.

69. Police Organizations Brief, *supra* note 63, at 20 (citing *Parents Involved*, 551 U.S. at 744).

70. Grutter v. Bollinger, 539 U.S. 306, 328 (2003). "Until *Grutter*, this Court had identified as a compelling state interest only the remedying of past discrimination . . ." and the "repudiation of *Korematsu* demonstrates the caution with which one should indulge such claims" and the "dangers of blurring the bright-lines of the Fourteenth Amendment." Claremont Brief, *supra* note 2, at 14.

71. *See infra* note 79 and accompanying text (discussing the necessity of actual past discrimination in warranting race-based action). *Cf.* Lomack v. City of Newark, 463 F.3d 303, 307–08 (3d Cir. 2006) (concluding that without evidence of past discrimination by a governmental entity, the use of racial classifications did not satisfy strict scrutiny and is not permitted under the Equal Protection Clause).

72. *See, e.g.*, City of Richmond v. J.A. Croson Co., 488 U.S. 469, 500 (1989) (plurality opinion) ("[S]imple legislative assurances of good intention cannot suffice."). *But see* Brief for Respondents at 50, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 740763 (citing League of United Latin Am. Citizens v. Perry, 548 U.S. 399, 518 (2006)) ("That compliance with a federal statute may serve as a compelling interest is entirely sensible.").

73. *See, e.g.*, *Croson*, 488 U.S. at 492–94 (plurality opinion); Wygant v. Jackson Bd. of Educ., 476 U.S. 267, 288 (1986) (dissenting opinion) (defining "societal discrimination" as "discrimination not traceable to its *own* actions"). *Croson* and similar cases indicate that there can be instances of historical discrimination outside the state's responsibility, where such discrimination occurs naturally rather than as a product of state power. Martha R. Mahoney, *What's Left of Solidarity? Reflections on Law, Race, and Labor History*, 57 BUFF. L. REV. 1515, 1585–86 (2009).

74. *See* Shaw v. Hunt, 517 U.S. 899, 908–09, 943 (1996) (Stevens, J., dissenting) (finding mere threat of liability is not a compelling interest).

employment.[75] However, in the context of education, the Court has found diversity to be a compelling government interest.[76]

The "narrowly tailored" requirement of strict scrutiny analysis ensures that "the means chosen 'fit' the compelling goal so closely that there is little or no possibility that the motive for the classification was illegitimate racial prejudice or stereotype."[77] Strict scrutiny review is said to require "the most exact connection" between justification and classification, but the Court has repeatedly rejected the notion that it is "strict in theory, but fatal in fact."[78] Equal protection cases before the Court have not provided an exact and consistent definition of what actions are "narrowly tailored"; rather, the Court engages in a case-by-case analysis of government action and the offered interest.[79] However, it is clear that at a minimum, "narrowly tailored" requires the classification be "narrowly tailored" "to the interest in question, rather than in the far-reaching, inconsistent and *ad hoc* manner," and be supported by a detailed evidentiary showing.[80]

ii. Affirmative Action Law: Title VII

Section 5 of the Fourteenth Amendment provides that "Congress shall have power to enforce, by appropriate

75. *See Wygant*, 476 U.S. at 276 (plurality opinion) ("Societal discrimination . . . is too amorphous a basis for imposing a racially classified remedy. The role model theory . . . typifies this indefiniteness.").

76. In *Grutter*, the Court recognized a compelling interest in diversity within higher education, identifying an interest in ensuring a broader array of qualifications and characteristics, of which racial or ethnic origin is a single element. Grutter v. Bollinger, 539 U.S. 306, 324–25 (2003). The Court's holding in *Grutter* is limited, as the Court relied upon considerations unique to higher education. Parents Involved in Cmty. Schs. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 725 (2007) (citing *Grutter*, 539 U.S. at 329).

77. *Grutter*, 539 U.S. at 333 (citing Richmond v. J.A. Croson Co., 488 U.S. 469, 493 (2003)). Constitutional law scholars generally construe "narrowly tailored" to mean being only as broad as is necessary to promote a substantial governmental interest that would be achieved less effectively without the restriction. BLACK'S LAW DICTIONARY 1050 (8th ed. 2004); *see also* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 673–74 (3d ed. 2006) (defining "narrowly tailored").

78. Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 202 (1998). *Compare Parents Involved*, 551 U.S. at 720 ("exact") *with Grutter*, 539 U.S. at 326 ("fatal in fact").

79. *Cf. Parents Involved*, 551 U.S. at 723–24 (Kennedy, J., concurring) (comparing *Grutter*, where race was one factor of determination, and the present case, where it was the only factor).

80. *Parents Involved*, 551 U.S. at 786 (Kennedy, J., concurring). In determining whether an explicit racial classification is "narrowly tailored," the Court often considers whether the government actor has considered the availability of race-neutral alternatives to accomplish the purported interest. *Grutter*, 539 U.S. at 339.

legislation, the provisions of [the Fourteenth Amendment]."[81] The scope of "appropriate" has been shaped over time by the views of Justices concerning the best remedy for discrimination, ranging from race-neutral to race-conscious approaches.[82] This section will focus on Congress's remedy to eliminate discrimination in the workplace through Title VII of the Civil Rights Act of 1964.

Title VII prohibits employment discrimination on the basis of race, whether in the form of intentional discrimination (disparate treatment) or in the form of practices that are not intended to discriminate, but in fact have a proportionately adverse impact (disparate impact).[83] The Court has identified "equality of opportunity and meritocracy" as goals of Title VII, noting that the Act does not require the hiring of any person simply because he was formerly the subject of discrimination or because he is part of a minority group.[84] However, the Court has suggested that Congress intended voluntary compliance with Title VII be the desired means of achieving Congress's objectives.[85]

The disparate-treatment provision of Title VII states that it is an unlawful employment practice to fail or refuse to hire, discharge, or to otherwise discriminate against any individual

81. U.S. CONST. amend. XIV, § 5.

82. Chief Justice Roberts recently argued that "the way to stop discrimination on the basis of race is to stop discriminating on the basis of race," starkly contrasting with Justice Blackmun's view that "in order to get beyond racism, we must take account of race." Marcus, *supra* note 12, at 54 (quoting Parents Involved in Cmty. Schs. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 748 (2007) and Plessy v. Ferguson, 163 U.S. 537, 559 (1896)).

83. *See* 42 U.S.C. § 2000e-2 (2008) (outlining unlawful practices).

84. Kenneth R. Davis, *Wheel of Fortune: A Critique of the "Manifest Imbalance" Requirement for Race-Conscious Affirmative Action Under Title VII*, 43 GA. L. REV. 993, 1037–38 (2009) (citing Griggs v. Duke Power Co., 401 U.S. 424, 430–31 (1971)). *See, e.g.*, Local 28 of Sheet Metal Workers' Int'l Ass'n v. E.E.O.C., 478 U.S. 421, 459 (1986) ("[T]here is no requirement in Title VII that an employer maintain a racial balance in his work force." (quoting 110 CONG. REC. 7213 (1964)); Watson v. Fort Worth Bank & Trust, 487 U.S. 977, 993 (1988) ("Preferential treatment and the use of quotas by public employers subject to Title VII can violate the Constitution."); Tex. Dep't of Cmty. Affairs v. Burdine, 450 U.S. 248, 259 (1981) (noting Title VII does not demand an employer give preferential treatment to minorities).

85. *See, e.g.*, Local No. 93, Int'l Ass'n of Firefighters, AFL-CIO C.L.C. v. City of Cleveland, 478 U.S. 501, 515 (1986) (expressing Congress' strong encouragement of voluntary compliance through the enaction of Title VII); Johnson v. Transp. Agency, 480 U.S. 616, 626, 630 n.8 (1987) (same). For the argument that Title VII strongly "encourages" rather than "allows" for compliance, see United Steelworkers of Am. v. Weber, 443 U.S. 193, 204 (1979) ("The very statutory words intended as a spur or catalyst to cause 'employers and unions to self-examine and to self-evaluate their employment practices . . . .'") (internal citations omitted).

with respect to any aspect of his employment because of his race.[86] "On the basis of" is defined with reference to Section 2(m), stating that "an unlawful employment practice is established when the complaining party demonstrates that race . . . *was a motivating factor.*"[87] Where an employee alleges that intentional discrimination caused an employment decision, the claim is analyzed under the burden-shifting framework of *McDonnell Douglas v. Green.*[88] The employee must first establish a prima facie case of discrimination, after which the burden shifts to the employer to present some legitimate, nondiscriminatory reason for the decision, and finally, the burden shifts back to the employee to prove the reason offered by the employer was merely a pretext.[89]

The disparate-impact provision of Title VII addresses the government's interest in identifying and eliminating intentional or unconscious discrimination that cannot be proved through the disparate-treatment provision.[90] The Court has read the disparate-impact provision as designed to address actual, but difficult to prove, discrimination.[91] To implement this provision, four federal agencies have jointly adopted the Uniform

86. 42 U.S.C. § 2000e-2(a)(1) (2008). "[O]therwise to discriminate," as used in Title VII, includes "adjust[ing] the scores of, us[ing] different cutoff scores for, or otherwise alter[ing] the results of, employment related tests . . . ." § 2000e-2(l). Further, it is an unlawful employment practice for an employer to "limit, segregate, or classify" his employees or applicants in any way that would adversely impact the individual's status on the basis of these listed factors. § 2000e-2(a)(2).

87. § 2000e-2(m) (emphasis added).

88. 411 U.S. 792, 802–05 (1973) (outlining the burden-shifting framework for disparate-treatment claims).

89. *Id.* It is noteworthy that no "business necessity" defense is provided for disparate-treatment claims. *Compare* 42 U.S.C. § 2000e-2(a)(1) (2008) (disparate-treatment) *with* § 2000e-2(k)(1)(A)(i) (disparate-impact). Some argue that the *McDonnell Douglas* framework is intended to be flexible and the employer's offered reason should be viewed subjectively, asking whether the employer honestly believed in legitimacy of the reason. Brief for the International Association of Hispanic Firefighters et al. as Amici Curiae Supporting Respondents at 6, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 796286 [hereinafter Int'l Firefighters Brief] (citing BARBARA LINDEMANN & PAUL GROSSMAN, EMPLOYMENT DISCRIMINATION LAW 86–87 (4th ed. 2007)).

90. Marcus, *supra* note 12, at 78.

91. *See, e.g.*, Watson v. Fort Worth Bank & Trust, 487 U.S. 977, 987 (1988) (describing the disparate-impact provision of Title VII as attacking Title VII's core concern, intentional discrimination). Some have argued, however, that Title VII is intended to address "barriers" in employment opportunity, where the "barrier" is not discrimination of the type defined in Title VII. *Cf.* HRM Brief, *supra* note 56, at 7–8 ("Title VII also outlaws practices that . . . erect unnecessary barriers to employment opportunity for minority groups.") (citing Griggs v. Duke Power Co., 401 U.S. 424, 429–31 (1971)).

Guidelines on Employee Selection Procedures,[92] which require employers to conduct a "validity study" to establish the job-relatedness of any employment examination which has an "adverse impact."[93] If the examination has an adverse impact, the Guidelines require the employer to identify an alternative selection device with less adverse impact as a part of the "validity study."[94] Under Title VII's disparate-impact provision, a plaintiff establishes a prima facie violation by showing that the employer uses a facially neutral employment practice that in fact causes a disparate impact.[95] Because the employment practice in a disparate impact claim is facially neutral, the hallmark of a prima facie for such a claim is a statistical disparity—that members of one race have done better than members of another race.[96] The employer's liability is dependent upon the result of its actions, not its state of mind.[97] An employer may defend against liability by demonstrating that the practice is job-related for the position in question and consistent with a business necessity; however, even if the employer makes this defense, the employee may succeed by showing that the employer refuses to adopt an available alternative employment practice with less disparate impact that still serves the employer's legitimate needs.[98] Discrimination is situated as an empirical fact to discover rather than a product of a formal structure of deduction, requiring the plaintiff to produce direct evidence of

92. These agencies are the Department of Justice, Equal Employment Opportunity Commission, Department of Labor, and Office of Personnel Management. *See generally* 43 Fed. Reg. 38290 (1978). For each department's adoption, *see generally* 28 C.F.R. § 50.14 (2009) (Dept. of Justice); 29 C.F.R. § 1607 (2009) (EEOC); 41 C.F.R. § 60-3 (2009) (Dept. of Labor); 5 C.F.R. § 300.103(c) (2009) (Office of Personnel Management).

93. *See, e.g.*, 29 C.F.R. § 1607.3(A), (B) (2009) (EEOC adoption). Under the "four-fifths rule," "[a] selection rate for any race, sex, or ethnic group which is less than four-fifths (4/5) (or eighty percent) of the rate for the group with the highest rate will generally be regarded by the Federal enforcement agencies as evidence of adverse impact." 29 C.F.R. § 1607.4(D) (2009).

94. *See, e.g.*, 29 C.F.R. § 1607.3(B) (2009) (EEOC adoption).

95. 42 U.S.C. § 2000e-2(k)(1)(A)(i) (2008).

96. *See, e.g.*, Int'l Bd. of Teamsters v. United States, 431 U.S. 324, 335 n.15 (1977) (defining disparate-impact claims).

97. *Cf.* Banks, *supra* note 65, at 1073–74 (noting unconscious bias is irrelevant to a question of discrimination under Title VII).

98. *See, e.g.*, Watson v. Fort Worth Bank & Trust, 487 U.S. 977, 998 (1988) (noting the final burden of proof falls on the employer). Some have argued that this "pretext" stage of the disparate-impact model creates an obligation for employers to consider lesser disparate-impact practices on protected groups, suggesting that an obligation exists before each decision is made. HRM Brief, *supra* note 56, at 16–17 (citing Albemarle Paper Co. v. Moody, 422 U.S. 405, 425 (1975)).

discriminatory intent or to eliminate possible nondiscriminatory reasons.[99] The burden of proof on the plaintiff and the "business necessity" test attempt to reconcile equality of opportunity with meritocracy and to ensure that Title VII does not blunt efficiency in the workplace.[100]

iii. The Pre-*Ricci* Intersection Between the Laws

Title VII and similar affirmative action measures were adopted to eliminate discrimination against protected classes, whether the discrimination arises from the effects of past or present practices.[101] The Court has acknowledged another objective of Title VII in line with the Equal Protection Clause: "To protect all individuals, regardless of race, from employment discrimination."[102] Affirmative action entails exactly what the nondiscrimination mandate prohibits—"treating individuals differently on account of race"[103]—resulting in the conflict explored in this Note.

The Court could have solved this conflict by taking the position originally advocated by Justice Rehnquist, that: "[N]o discrimination based on race is benign, that no action disadvantaging a person because of his color is affirmative."[104] Instead, the Court chose a more moderate position and deferred to the spirit of the Act rather than its language,

99. *See* Banks, *supra* note 65, at 1076–79 (contrasting the Court's "empiricist" position under *St. Mary's Honor Ctr. v. Hicks* with the formalism of the *McDonnell Douglas* line of cases) (internal citations omitted); Rosemary Alito, *Disparate Impact Discrimination under the 1991 Civil Rights Act*, 45 RUTGERS L. REV. 1011, 1022 (1993) (arguing the disparate-impact provision should maintain the burden of proof on the plaintiff).

100. Davis, *supra* note 84, at 1037–39.

101. *Id.* at 999. The Uniform Guidelines on Employee Selection Procedure are designed to assist the employer in monitoring the results of selection procedures for disparate impact. *See, e.g.*, 29 C.F.R. § 1607.1(B) (2009) (EEOC adoption). The Court has not held that the Uniform Guidelines are binding. *But see* HRM Brief, *supra* note 56, at 14 (noting the Court has recognized the binding effect of the predecessor of the Uniform Guidelines); Wards Cove Packing Co. v. Atonio, 490 U.S. 642, 657–58 (1989) (observing that the Court has taken note of employers' duty under the Uniform Guidelines to monitor the disparate impact of selection procedures).

102. Davis, *supra* note 84, at 999. Nothing in the Court's decisions prior to *Ricci* suggested that Title VII was designed to loosen the restrictions against state-sanctioned discrimination. Rather, the decisions indicate that the obligation of an employer under Title VII was only intended to extend as far as the Constitution allows. Police Organizations Brief, *supra* note 63, at 23 (citing Johnson v. Transp. Agency, 480 U.S. 616, 628 n.6 (1987)).

103. Banks, *supra* note 65, at 1100–01. *See also* United States Brief, *supra* note 63, at 10 ("Compliance with [Title VII] necessarily requires an employer to consider race.").

104. Davis, *supra* note 84, at 999 (citing United Steelworkers of Am. v. Weber, 443 U.S. 193, 254 (1979)).

holding that Title VII does not condemn "all voluntary, private, race-conscious affirmative action plans."[105] The Court has required that a valid plan meet three requirements: (1) "it must address a manifest imbalance in [a] traditionally segregated job categor[y]"; (2) it "must not unnecessarily trammel the rights of workers" who are not in the protected class; and (3) it must be temporary.[106] Nevertheless, the "race-conscious affirmative action plans" the Court does not condemn[107] cause conflict with the Equal Protection Clause.[108] According to Kenneth Marcus and others, this conflict is best understood in three primary areas: "racial classifications, illicit motives, and racially allocated benefits."[109]

a. *Racial Classifications and Racially Allocated Benefits*

Under the Equal Protection Clause, the Court subjects all racial classifications or allocation of benefits by state actors to strict scrutiny.[110] While Title VII's disparate-impact provisions do not reference particular racial groups or prescribe racial classifications, whether actual or implied, "disparate-impact compliance entails preferential treatment or the use of quotas by public employers."[111] Title VII's text contains no standard of review; however, the Court has interpreted the burden imposed by Title VII as consistent with the ban on discrimination under the Equal Protection Clause.[112] Because of this burden, preferential compliance efforts lead to conflict between Title VII

105. *Id.* at 1001–02 (citing *Weber*, 443 U.S. at 208). Davis notes that the Court conceded that Title VII's prohibition to discriminate because of race in hiring practices "raised a significant question about the legality of any race-based affirmative action plan." *Id.*

106. *Id.* at 1003.

107. *Id.* at 1002.

108. *See* Johnson v. Transp. Agency, 480 U.S. 616, 652 (1987) (O'Connor, J., concurring) ("Employers are 'trapped between the competing hazards of liability to minorities if affirmative action is *not* taken to remedy apparent employment discrimination and liability to nonminorities if affirmative action *is* taken.'") (internal citations omitted). *See also* Marcus, *supra* note 11, at 62 ("[Title VII] conflicts with the Equal Protection Clause to the extent that it . . . classifies people by racial groups.").

109. Marcus, *supra* note 11, at 62.

110. *Id.* at 62–64. *See also* Lauren Klein, Ricci v. DeStefano*: "Fanning the Flames" of Reverse Discrimination in Civil Service Selection*, 4 DUKE J. CONST. L. & PUB. POL'Y SIDEBAR 391, 397 (2009) (noting application of strict scrutiny by other circuits).

111. *See* Marcus, *supra* note 11, at 63 (noting racial quotas may be the cheaper alternative than to determine whether disparities result from policies that are consistent with business necessity or from a discriminatory animus).

112. Roger Clegg, *Unfinished Business: The Bush Administration and Racial Preferences*, 32 HARV. J.L. & PUB. POL'Y 971, 983 (2009).

and the Equal Protection Clause.[113]

b. *Illicit Motives*

Government actions motivated by discriminatory intent are also subject to strict scrutiny under the Equal Protection Clause.[114] The Court has consistently applied this principle not only to those actions that contain express racial discrimination, but also to facially-neutral actions that are motivated by a racial purpose.[115]

Title VII's disparate-impact provision is particularly problematic under the Equal Protection Clause because its purpose is not limited to ascertaining hidden discriminatory intent or unconscious bias.[116] Public resistance to originally included quotas led Congress to remove many of the provisions from the 1991 Act that would have greatly increased the pressure on employers to achieve proportional community representation.[117] However, evidence made available during hearings and following the enactment of Title VII has likely compelled employers to alter the racial composition of their workforce, even where previous discrimination did not lead to current demographics.[118] "[T]he Court ha[s] rejected as 'flawed' the argument that strict scrutiny review [does] not apply" to such actions despite any "need to consider race for purposes of compliance with antidiscrimination law."[119]

Legal scholars have observed that affirmative action measures, including the disparate-impact provision of Title VII, were widely accepted before *Ricci*.[120] "[T]o the extent that the disparate-impact provision is narrowly construed as a means to limit intentional or even unconscious discrimination, the conflict [between Title VII and the Equal Protection Clause] dissolves."[121] However, as evidenced by *Ricci*, the disparate-

113. *See supra* notes 104–09 and accompanying text.

114. Marcus, *supra* note 11.

115. *Id.*

116. *Id.* at 65. Marcus notes that Congressional motives may have included an interest in achieving racial diversity in the workforce. *Id.* at 66.

117. *Id.*

118. *Id.*

119. Marcus, *supra* note 11, at 67.

120. *Id.* at 69–70 ("[B]efore *Ricci*, conflicts between the two provisions were largely decided in favor of disparate impact—and disparate treatment had been construed narrowly enough to avoid the appearance of discord.").

121. *Id.* at 70.

impact provision of Title VII has "grown in ways that exceed [the Act's] core purpose,"[122] necessitating serious consideration under the Equal Protection Clause.

B. *The Facial Impact of* Ricci

> *Five years after it improperly scrapped two exams, and a week after a federal judge ordered it to do so, the [City of New Haven] . . . plans to bring the lists to the fire commission Tuesday to promote fourteen firefighters who have fought [for] promotion since 2004.*[123]

The fourteen plaintiff-firefighters in *Ricci* are the immediate beneficiaries of the Court's ruling, as they will receive long-anticipated promotions.[124] However, the real impact of *Ricci* stretches much further, both in the application of Title VII by lower courts and employers and in Equal Protection jurisprudence.[125] This Section will address the Court's holding read narrowly; *Ricci*'s impact on Equal Protection jurisprudence will be discussed in Section III(c).

In *Ricci,* the Court adopted the strong-basis-in-evidence standard as a matter of statutory construction to resolve any conflict between the provisions of Title VII.[126] The Court limited its statutory holding to future readings of Title VII, noting that its holding did not address the constitutionality of the measures taken by the City in purported compliance with Title VII.[127] Because the Court found no evidence that the tests were flawed because they were not job-related or because other, equally valid and less discriminatory tests were available, the Court found the City's action of discarding the test results impermissible under Title VII.[128]

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122. *See id.* at 69–70 (noting the growth of disparate impact).

123. William Kaempffer, *City Moving to Promote 14 Firefighters,* NEW HAVEN REG., Nov. 30, 2009, *available at* http://www.nhregister.com/articles/2009/11/30/news/new_haven/alnecivilservice.txt. The federal district judge will determine who will be promoted and the type of damages to be awarded in the suit, while a jury will determine the amount of damages. Thomas Macmillan, Ricci*'s Back in Court,* NEW HAVEN REG., Nov. 11, 2009, *available at* http://www.newhavenindependent.org/archives/2009/11/ricci_is_back_i.php.

124. Ricci v. DeStefano, 129 S. Ct. 2658, 2681 (2009).

125. *See infra* Section III(b) & (c) and accompanying text.

126. *Ricci,* 129 S. Ct. at 2663.

127. *Id.* at 2676.

128. *Id.* at 2681. The Court explained that a mere fear of litigation does not meet this standard. *Id.*

Since the Court's ruling in *Ricci*, lower courts have read *Ricci* to reaffirm and emphasize the importance of the disparate-treatment provision of Title VII.[129] Lower courts have additionally stressed that the purpose of Title VII is to promote hiring on the basis of job qualifications, not on the basis of a protected characteristic, emphasizing the priority of the disparate-treatment provision over the disparate-impact provision.[130] In cases with disparate impact claims, lower courts have read *Ricci* to make clear that a statistical disparity will only be a "threshhold showing" in a disparate impact case, and the employee must still show that the employer's action was not consistent with business necessity or that there was an equally valid, less-discriminatory alternative that the employer refused to adopt.[131] Most importantly, lower courts have interpreted *Ricci* to hold that evidence that an employer utilized an affirmative action plan may constitute direct evidence of unlawful discrimination, and in such a case, the relevant inquiry is whether the affirmative action plan is valid under Title VII *and* under the Equal Protection Clause.[132] Lastly, it should be noted that since the Court's ruling in *Ricci*, several black firefighters have filed suit or drafted Equal Employment Opportunity Commission complaints, claiming that the City disproportionately considered the written and oral sections of the test, causing a disparate impact on black firefighters, and the City unjustly denied them promotions.[133]

It is useful not only to examine subsequent lower court rulings for the facial impact of *Ricci*, but also to examine *Ricci*'s

129. *See, e.g.*, United States v. City of New York, 631 F. Supp. 2d 419, 429 (S.D.N.Y. 2009) (citing *Ricci*, 129 S. Ct. at 2672) (emphasizing Title VII's disparate-treatment provision).

130. *See, e.g.*, Jiminez v. Dyncorp Int'l, LLC, 635 F. Supp. 2d 592, 601 (W.D. Tex. 2009) (citing *Ricci*, 129 S.Ct. at 2674 and *Griggs*, 401 U.S. at 434); *cf.* Wil's Indus. Serv., Inc. v. U.S. Steel Corp., No. 2:07 cv 128, 2009 WL 2169663, at *4 (N.D. Ind. July 17, 2009) (emphasizing the "important purpose" that "the workplace be an environment free of discrimination where race is not a barrier to opportunity").

131. *Ricci*, 129 S. Ct. at 2678.

132. *See, e.g.*, Humphries v. Pulaski County Special Sch. Dist., 580 F.3d 688, 694 (8th Cir. 2009).

133. *See, e.g.*, David G. Savage, *Supreme Court to Consider Another Case on Racial Bias in Hiring*, L.A. TIMES, Feb. 20, 2010, *available at* http://www.latimes.com/news/nation-and-world/la-na-court-firefighters21-2010feb21,0,5348715.story; William Kaempffer, *City Facing More Firefighter Suits*, NEW HAVEN REG., Nov. 13, 2009, *available at* http://www.nhregister.com/articles/2009/11/30/news/new_haven/a1-necivilservice.txt (discussing EEOC claims). *See also* Briscoe v. City of New Haven, No. 3:09-cv-1642 (CSH), 2009 WL 5184357, at *1 (D. Conn. Dec. 23, 2009) (denying the City's motion to stay discovery and discussing the potential effect of pending matters in *Ricci* on *Briscoe*).

subsequent readings by legal scholars. Scholars have consistently noted the Court's importation of the strong-basis-in-evidence standard into Title VII from equal protection jurisprudence.[134] Justice Kennedy's opinion has been read to surmise that Congress wanted the courts to establish relevant standards rather than categorically prohibit disparate treatment or disparate impact.[135] Reading *Ricci* and *Parents Involved* together, the Court has established that racially-neutral governmental actions with a predominant racial motive require both strict-scrutiny and disparate-treatment analysis.[136] The Court's discussion of Title VII's encouragement of quotas has also been cited as noteworthy.[137]

Ricci has also resulted in increased scrutiny of all employment practices, specifically decisions based on written examinations or similar forms of testing.[138] This increased scrutiny has brought tremendous uncertainty, as the Court did not establish clear guidelines for employers.[139]

134. Charles J. Ogletree, Jr., *From Dred Scott to Barack Obama: The Ebb and Flow of Race Jurisprudence*, 25 HARV. BLACKLETTER L.J. 1, 37 (2009); Marcus, *supra* note 11, at 60.

135. Marcus, *supra* note 11, at 59 (internal citations omitted). He further notes that Kennedy emphasized that this standard will allow violations of the disparate-treatment provision only in the name of compliance with the disparate-impact provision in limited circumstances. *Id.* at 60–61.

136. *Id.* at 59, 72 (explaining that in *Parents Involved*, Justice Kennedy appeared to argue that race-neutral measures do not trigger strict scrutiny, but in *Ricci*, Justice Kennedy emphasized that the City decided not to certify the results because of racial disparities in performance, and absent sufficient justification, race-based decision making will violate Title VII) (internal citation omitted).

137. *Id.* at 70.

138. Lower courts have noted that *Ricci* should serve as a reminder that designing employment examinations is difficult, requiring consultation with experts and considerations of accepted testing standards. United States v. City of New York, 637 F. Supp. 2d 77, 83 (E.D.N.Y. 2009). *Cf.* Brief for Equal Employment Advisory Council as Amicus Curiae Supporting Respondents at 6, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 815203 ("[*Ricci* has] great importance to the many private sector employees that routinely utilize employment tests as part of their employment selection processes.").

139. *See* Ameet Sachdev, *Supreme Court Case Over Firefighter Promotion Exam Tests Westchester Firm, Founder*, CHI. TRIB., Sept. 20, 2009, *available at* http://articles.chicagotribune.com/2009-09-20/business/0909190187_1_flawed-test-supreme-court-exam (quoting Cheryl Tama Oblander, a Chicago lawyer, who argues that *Ricci* "makes a bigger mess out of testing").

C. Ricci *and the Constitutionality of Title VII*

> *The very radicalism of holding disparate impact doctrine unconstitutional as a matter of equal protection suggests that only a very uncompromising court would issue such a decision. . . . [I]t is no less true that the very incompatibility of current disparate-impact doctrine with equal protection suggest that only a very irresponsible court could uphold the former in a challenge based on the latter.*[140]

The Court's opinion in *Ricci* makes clear that the constitutionality of disparate impact liability under Title VII is far from certain.[141] While the majority avoids this conflict by resolving *Ricci* on a statutory level,[142] Justice Scalia's brief concurrence leaves little doubt of *Ricci*'s impact on the future of equal protection jurisprudence.[143]

Although the majority clearly limits their holding to the Title VII claim,[144] their language is revealing. Notably, the Court makes it clear that no individual should face workplace discrimination because of race,[145] echoing the promise of the Equal Protection Clause.[146] It is also significant that five members of the Court relied upon equal protection jurisprudence in adopting the strong-basis-in-evidence standard.[147] Reaffirming *Croson*, the Court held that a nebulous claim of past discrimination cannot justify the use of a racial quota.[148] The Court did not address whether the statutory

140. Marcus, *supra* note 11, at 83 (citing Richard A. Primus, *Equal Protection and Disparate Impact: Round Three*, 117 HARV. L. REV. 493, 585 (2003)). Marcus argues that we should not prefer that our jurisprudence in this area be compromised. *Id.*

141. *Id.* at 54–55.

142. Ricci v. DeStefano, 129 S. Ct. 2658, 2665–65, 2681 (2009); *See also* Marcus, *supra* note 11, at 54–55 (noting the Court "does not resolve this conflict").

143. *See, e.g.*, Elwood, *supra* note 13, at 432 (noting *Ricci*'s impact in light of Justice Sotomayor's appointment to the Court); Marcus, *supra* note 11, at 54–55 ("[*Ricci*] suggests that a future case will resolve [the question]."); *2008 Term*, *supra* note 1, at 283 ("*Ricci* strongly suggests that Title VII's disparate impact provisions are unconstitutional."). Several scholars have argued that while Justice Scalia's concurrence questions the constitutionality of Title VII, no one should underestimate the Court's ability to avoid that question. Elwood, *supra* note 13, at 432–33; *see also* Erwin Chemerinsky, *Moving to the Right, Perhaps Sharply to the Right*, 12 GREEN BAG 413, 423 (2009) ("[A]t this stage, it is hard to imagine that there would be five votes for such a radical change . . . .").

144. *Ricci*, 129 S. Ct. at 2675–76.

145. *Id.* at 2681.

146. *Cf. supra* Section III(a)(i) (discussing equal protection jurisprudence and the "color-blind" notion).

147. Ricci, 129 S. Ct. at 2675.

148. *Id.* (citing City of Richmond v. J.A. Croson Co., 488 U.S. 469, 500 (1989)). Borrowing equal protection language, the Court further states that fear of litigation is

constraints of Title VII must be parallel in all respects to those under the Constitution, but did warn that constitutional authorities are relevant.[149] This warning not only legitimized the Court's importation of a strong-basis-in-evidence standard into Title VII, but also provides a basis for a future finding that Title VII's disparate-impact provision is unconstitutional.[150]

The Court has never ruled on Justice Scalia's question: "Whether, or to what extent, are the disparate-impact provisions of Title VII . . . consistent with the Constitution's guarantee of equal protection?"[151] Because *Ricci* was decided on a narrow majority, *Ricci*'s concurring and dissenting opinions also provide insight on the future of equal protection jurisprudence.

Justice Scalia's concurrence makes his answer apparent, as he reads the Court's equal protection jurisprudence to hold that the government is strictly prohibited from discriminating on the basis of race.[152] Because of this prohibition, he reasons, the government is surely also prohibited from enacting laws commanding third parties to discriminate on the basis of race.[153] Further, he asserts that Title VII's disparate-impact provision "place[s] a racial thumb on the scales," requiring employers to evaluate the racial outcomes of their policies and to make decisions based on those racial outcomes, and that type of racial decision-making is discriminatory.[154] In his view, neither Title VII's consideration of race on a "wholesale, rather than retail,

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not enough to justify an employer's reliance on race to the detriment of others. *Id.* at 2681.

149. *Id. Cf.* Transcript of Oral Argument at 52, *Ricci*, 129 S. Ct. 2658 (Nos. 07-1428, 08-328) (Roberts, C.J.) (finding the argument "odd . . . that you can violate the Constitution because you have to comply with the statute").

150. *See 2008 Term*, *supra* note 1, at 283 (suggesting *Ricci*'s implications on Equal Protection jurisprudence).

151. *Ricci*, 129 S. Ct. at 2682 (Scalia, J., concurring) ("[*Ricci*] merely postpones the evil day on which the Court will have to confront the question."). *See also, e.g.*, Ogletree, *supra* note 134, at 37 (discussing Justice Scalia's attack on Title VII).

152. *Ricci*, 129 S. Ct. at 2682 (Scalia, J., concurring).

153. *Id.* Justice Thomas has also been noted as a vocal critic of affirmative action measures that violate the legal mandate of color-blindness. Devon W. Carbado & Cheryl I. Harris, *The New Racial Preferences*, 96 CAL. L. REV. 1139, 1174 (2008).

154. *Ricci*, 129 S. Ct. at 2682 (Scalia, J., concurring) (discussing the majority opinion) (citing Pers. Adm'r of Massachusetts v. Feeney, 442 U.S. 256, 279 (1979)). For Chief Justice Roberts and Justice Scalia, setting aside a test simply because one race predominates is far from race-neutral. *See* Transcript of Oral Argument at 36, *Ricci*, 129 S. Ct. 2658 (2009) (Scalia, J.), 54 (Roberts, C.J.). Justice Alito, joined in his concurrence by Justices Thomas and Scalia, also stresses that there are some actions a public official cannot take, including engaging in intentional racial discrimination. *Ricci*, 129 S. Ct. at 2688 (Alito, J., concurring).

level" nor the supposedly benign motive behind the statute can save it from strict scrutiny.[155] For Justice Scalia, the disparate-impact provision sweeps too broadly in its current state to be constitutional under the Equal Protection Clause.[156]

The dissenting members of the Court in *Ricci* take a very different view of the Equal Protection Clause, as their opinion rests on the notion that context matters. Justice Ginsburg argues that equal protection doctrine is of limited utility in construing Title VII, evidencing her belief that the authority for and the scope of Title VII does not stem from the Equal Protection Clause.[157] Her assertion rests on two precedents of the Court: (i) the Equal Protection Clause prohibits only intentional discrimination and does not have a disparate impact component;[158] and (ii) until *Ricci*, the Court has never questioned the constitutionality of the disparate-impact provision.[159] She further argues that observance of Title VII's disparate-impact provision does not require racial preferences and suggests that, as a result, Title VII should not be subjected to the strict scrutiny of the Equal Protection Clause.[160] If Justice Scalia's question was before the Court at the time *Ricci* was decided, at least four members of the Court would likely uphold the constitutionality of Title VII in its entirety, subjecting it to less than strict scrutiny.

Ricci leaves Justice Scalia's question largely unanswered, and it is admittedly difficult to predict the Court's resolution given the splintered nature of the Justices' current writings. *Ricci*, however, makes one point unquestionably clear: The burdens of Title VII must be reconciled with the demands of the Equal

155. Ricci v. DeStefano, 129 S. Ct. 2658, 2682 (2009) (Scalia, J., concurring) (internal citations omitted).

156. *Id.* at 2682. Justice Scalia does, however, cite Richard A. Primus, *Equal Protection and Disparate Impact: Round Three*, 117 HARV. L. REV. 493, 498–99, 520–21 (2003) and *McDonnell Douglas Corp. v. Green*, 411 U.S. 792, 802–03 (1973) to suggest that using Title VII's disparate-impact provisions to "smoke out" actual and intentional discrimination may be permissible. *Cf.* Transcript of Oral Argument at 29, *Ricci*, 129 S. Ct. 2658 (2009) (Scalia, J.) (stating that the disparate-treatment and disparate-impact provisions are "at war with one another").

157. Justice Ginsburg describes the equal protection cases from which the Court draws its "strong basis in evidence" standard as "particularly unsuitable." *Ricci*, 129 S. Ct. at 2700 (Ginsburg, J., dissenting).

158. *Id.* at 2700 (citing *Feeney*, 442 U.S. at 272); Washington v. Davis, 426 U.S. 229, 229 (1976)).

159. *Ricci*, 129 S. Ct. at 2700.

160. *Cf. id.* at 2701 (comparing the facts of *Ricci* to the government actions considered in *Wygant* and *Croson*) (internal citations omitted).

Protection Clause.[161]

D. *The Solution: Strict Scrutiny Application to Title VII*

> *The guarantee of Equal Protection cannot mean one thing when applied to one individual and something else when applied to a person of another color.*[162]

The proper starting point for analyzing the constitutionality of Title VII is identifying the authority of Congress to enact such a law.[163] In a similar context,[164] the Court has found a congressional affirmative action act to be an "appropriate" exercise of power under Section 5 of the Fourteenth Amendment.[165] Similarly, there is little doubt that Title VII is an "appropriate" measure of congressional power.[166] However,

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161. *See Ricci*, 129 S. Ct. at 2682–83 (Scalia, J., concurring) (discussing the conflict between the Equal Protection Clause and Title VII).

162. Regents of Univ. of Cal. v. Bakke, 438 U.S. 265, 289–90 (1978) (Powell, J., joined by White, J.).

163. The Commerce Clause and Section 5 of the Fourteenth Amendment are frequently identified as sources of Congress' authority for Title VII. *See, e.g.*, Brief for the American Civil Liberties Union et al. as Amici Curiae Supporting Respondents at 5, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 815209 [hereinafter ACLU Brief] (citing *Ex parte* Commonwealth of Va., 100 U.S. 339, 345–46 (1879) (Section 5 of the Fourteenth Amendment) and United States v. Darby, 312 U.S. 100, 115–16 (1941) (Commerce Clause)).

164. *See generally* City of Richmond v. J.A. Croson Co., 488 U.S. 469 (1989) (discussing Congress's power to act under the Fourteenth Amendment and Commerce Clause). In *Fullilove*, the Court found the Minority Business Enterprise program at issue to be an appropriate exercise of Congressional power under Section 5 of the Fourteenth Amendment. Fullilove v. Klutznick, 448 U.S. 448, 478 (1980). However, in *Adarand*, the Court noted that the Court's treatment of congressional power in *Fullilove* was not dispositive on the issue of the standard of review the Fifth Amendment requires for an action taken by the Federal Government. Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 222 (1995) (citing *Croson*, 488 U.S. at 491). The *Adarand* Court did however note that *Croson* had some bearing on federal race-based action, indicating that *Fullilove*'s ruling on the "appropriateness" of Congress's action may provide a basis for finding that Title VII is a type of measure "appropriate" under Section 5 of the Fourteenth Amendment. *See generally id.* at 222–23.

165. *See* Fullilove, 448 U.S. at 478 (passing on the constitutionality of the "minority business enterprise" provision of the Public Works Employment Act of 1977). The Court stated:

> Congress had abundant historical basis from which it could conclude that traditional procurement practices, when applied to minority businesses, could perpetuate the effects of prior discrimination. Accordingly, Congress reasonably determined that the prospective elimination of these barriers to minority firm access to public contracting opportunities generated by the 1977 Act was appropriate to ensure that those businesses were not denied equal opportunity to participate in federal grants to state and local governments, which is one aspect of the equal protection of the laws.

Id.

166. *See, e.g.*, ACLU Brief, *supra* note 163, at 6 ("Congress enacted Title VII as part of

while Congress has broad powers under Section 5 of the Fourteenth Amendment to enact "appropriate" legislation, it must do so consistent with the Constitution.[167]

Because the Court has read the Equal Protection Clause to require that every race-based government action be subjected to strict scrutiny,[168] so too must any form of a racial classification by Congress under the Fourteenth Amendment be subject to strict scrutiny.[169] It follows that if Title VII is a proper congressional action, the government must prove (i) a compelling governmental interest, and (ii) that its action was "narrowly tailored" to this interest.

i. Congress's Compelling Interest

The Court has never published an exhaustive list of governmental interests that it will find "compelling," but it has provided significant direction for government actors through past decisions.[170] A government actor's desire to remedy its own past discrimination has been held as a compelling interest, provided the actor first had a strong basis in evidence for its conclusion that remedial action was necessary.[171] However, the Court has *never* recognized a compelling interest in avoiding unintentional racial disparities or societal discrimination,[172] and little authority exists to suggest that compliance with a federal antidiscrimination law is itself a compelling interest.[173]

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the Civil Rights Act of 1964 in light of overwhelming evidence of pervasive inequality in the American job market, ...") (citing United Steelworkers of Am., AFL-CIO-CLC v. Weber, 443 U.S. 193, 202–03 (1979)); *See generally* Wards Cove Packing Co. v. Atonio, 490 U.S. 642 (1989) (addressing Title VII without questioning its constitutionality); Watson v. Fort Worth Bank & Trust, 487 U.S. 977 (1988) (same); Griggs v. Duke Power Co., 401 U.S. 424 (1971) (same). Further inquiry into "appropriateness" under the Commerce Clause is beyond the purview of this Note.

167. *See, e.g., Ex parte Commonwealth of Va.*, 100 U.S. at 345–46 (holding Congress's power to enforce the Fourteenth Amendment includes power to enact "[w]hatever legislation is appropriate . . . *if not prohibited*" by the Constitution) (emphasis added); *Darby*, 312 U.S. at 115–16 (same for Commerce Clause).

168. *See supra* notes 63–64 and accompanying text.

169. Johnson v. California, 543 U.S. 499, 505–06 (2005) (noting that any race-based classification, even those that are benign, automatically receive strict scrutiny review); *But see* ACLU Brief, *supra* note 163, at 36 (citing City of Boerne v. Flores, 521 U.S. 507, 518 (1997) for contention that Section 5 affords Congress considerable leeway to determine necessary actions to "deter[] or remed[y] constitutional violations").

170. *See supra* notes 72–80 and accompanying text.

171. *See* Richmond v. J.A. Croson Co., 488 U.S. 469, 509–10 (1989); Lomack v. City of Newark, 463 F.3d 303, 307–08 (3d Cir. 2006).

172. Wyant v. Jackson Bd. of Educ., 476 U.S. 267, 274 (1986).

173. *But see, e.g.*, ACLU Brief, *supra* note 163, at 11–12 ("[The Court has] repeatedly

Three primary motivations have been offered as the basis for Title VII: (i) to remedy past discrimination;[174] (ii) to eliminate all forms of present discrimination;[175] and (iii) to ensure against future racial disparities in the workplace.[176] Based on the Court's prior rulings, if Title VII is based on a desire to remedy past discrimination in traditionally segregated fields, then it is unquestionably founded on a "compelling" interest.[177] This interest can likely not only extend to discrimination occurring before the passage of Title VII, but also to those actions of employers that occurred concurrently with the passage of Title VII but before the employer took remedial action.[178] However, an interest in proactively ensuring against future racial disparities by employers cannot be a compelling interest, as it is reminiscent of a desire to avoid unintentional discrimination that the Court has never recognized as a compelling interest.[179] To the extent that Title VII is based upon an accepted compelling interest—remedying past and eliminating present actual discrimination—it is only constitutional if it is "narrowly tailored" to this interest.[180]

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assumed that compliance with presumptively valid federal antidiscrimination law is a compelling state interest.") (citing Bush v. Vera, 517 U.S. 952, 977 (1996), Shaw v. Hunt, 517 U.S. 899, 915 (1996), and Shaw v. Reno, 509 U.S. 630, 656 (1993)).

174. *See, e.g.*, Watson v. Fort Worth Bank & Trust, 487 U.S. 977, 986–87 (1988); Davis, *supra* note 93, at 1038 (same).

175. *See, e.g.*, Local No. 93, Int'l Ass'n of Firefighters, AFL-CIO C.L.C. v. City of Cleveland, 478 U.S. 501, 515 (1986) (discussing voluntary compliance); Johnson v. Transp. Agency, 480 U.S. 616, 630 n.8 (1987) (same); ACLU Brief, *supra* note 163, at 6 ("Congress recognized that dismantling the racially stratified employment market was a critical step to achieving broader economic and social equality.").

176. *See, e.g.*, United Steelworkers of Am., AFL-CIO-CLC v. Weber, 443 U.S. 193, 204 (1979) (arguing Title VII was intended to spur "employers and unions to self-examine and to self-evaluate their employment practices"); HRM Brief, *supra* note 56, at 7–8 (discussing Title VII's implications on "barriers to employment opportunity for minority groups").

177. *See supra* notes 70–71 and accompanying text. *See, e.g.*, Grutter v. Bollinger, 539 U.S. 306, 328 (2003).

178. *See Grutter*, 539 U.S. at 328. (discussing remedying "past" discrimination as a compelling interest).

179. *See supra* note 73 and accompanying text. *But see* Tennessee v. Lane, 541 U.S. 509, 520 (2004) ("When Congress seeks to remedy or prevent unconstitutional discrimination, § 5 authorizes it to enact prophylactic legislation proscribing practices that are discriminatory in effect, if not in intent, to carry out the basic objectives of the Equal Protection Clause.").

180. *See, e.g.*, Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 227 (1995); Parents Involved in Cmty. Schs. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 720 (2007). For purposes of further analysis within this section, it will be assumed that proactively ensuring against future racial disparities by employers would not be offered as a compelling interest.

ii. Title VII Is Not "Narrowly Tailored"

For a government action to be "narrowly tailored" as defined by equal protection jurisprudence, it must be no broader than is reasonably necessary to promote a substantial governmental interest that would be achieved less effectively without the government action.[181] The Court will analyze each government action on a case-by-case basis, with past rulings offering limited guidance on the presently considered action.[182] For this reason, Title VII must be analyzed directly against its offered compelling interest, with only minimal emphasis on the Court's treatment of similar acts.[183] Because the disparate-treatment and disparate-impact provisions of Title VII address discrimination differently, it is helpful to analyze each provision separately to determine whether it is "narrowly tailored" to the offered compelling interest.[184]

a. *Title VII: Disparate-Treatment Provision*

The disparate-treatment provision of Title VII makes it unlawful for an employer to discriminate against any individual with respect to any aspect of employment *because of* the individual's race.[185] The burden to prove that an employment decision or action was taken *because of* race is on the plaintiff-employee, requiring that the employee offer tangible evidence of actual discriminatory purpose or intent.[186] The disparate-treatment provision only addresses alleged discrimination where intent or purpose can be proven,[187] and therefore reaches no further than necessary to meet the government's interest in eliminating all past and present discrimination in the workplace.[188] Because the disparate-treatment provision is "narrowly tailored" to the offered compelling interest, it is

181. *See supra* notes 77–80 and accompanying text.

182. *See supra* note 79 and accompanying text.

183. *See id.* (discussing the Court's case-by-case analysis).

184. *Compare supra* notes 86–89 and accompanying text (disparate-treatment provision) *with supra* notes 90–100 and accompanying text (disparate-impact provision).

185. *See supra* note 86 and accompanying text.

186. *See supra* notes 88–89 and accompanying text. A showing of a percentage disparity of minorities treated in a different way by itself will not be enough to satisfy the disparate-treatment provision of Title VII, as the employee must prove the employment action occurred *because of* his race. *Id.*

187. *Id.*

188. *Cf. supra* notes 90–100 and accompanying text (discussing the disparate-impact provision).

constitutional under the Equal Protection Clause.[189]

b. *Title VII: Disparate-Impact Provision*

Title VII's disparate-impact provision provides a remedy for the employee who can show a racially disparate impact in an employment practice, but cannot prove intentional discrimination.[190] The employer's liability under this provision is based on the result of his actions, not his intent or motivation.[191] While the employer may offer proof that he took action out of business necessity, the employee-plaintiff will still succeed if he can show an available alternative employment practice with less disparate impact.[192] Arguably, Title VII does not require employers to hire a person simply because he is a member of a minority group and Congress preferred voluntary compliance to achieve Title VII's goals.[193] Yet, the Uniform Guidelines require employers to proactively conduct "validity studies" to establish the job-relatedness of any employment examination with an adverse impact and, if necessary, to substitute a selection device with less adverse impact.[194]

The disparate-impact provision of Title VII reaches much further than actual, provable discrimination or discriminatory intent that is initially difficult to discover; it reaches those employment actions without any racially-based motivation.[195] The breadth of this provision warrants inquiry into whether it is necessary to accomplish the government's interest in eliminating all past and present employment discrimination.[196] While it is certainly reasonably necessary to view gross statistical disparity as some evidence of intentional discrimination for Title VII purposes,[197] the "validity study" requirement and the

189. *See supra* notes 170–80 and accompanying text.

190. *See supra* notes 90–91, 96–97 and accompanying text.

191. *Supra* note 97 and accompanying text.

192. Watson v. Fort Worth Bank & Trust, 487 U.S. 977, 998 (1988).

193. *See, e.g.*, Johnson v. Transp. Agency, 480 U.S. 616, 630 (1987).

194. *See supra* notes 92–93 and accompanying text.

195. *Watson*, 487 U.S. 977, 986–87 (1988); Ricci v. DeStefano, 129 S. Ct. 2658, 2682 (2009) (Scalia, J., concurring).

196. The "narrowly tailored" analysis might be different if an interest in eliminating all future discrimination in the workplace were established as a compelling interest. However, as discussed previously, that interest is unlikely to be found compelling. *See supra* notes 77–80 and accompanying text.

197. *Cf. Ricci*, 129 S. Ct. at 2682 (Scalia, J., concurring) (suggesting that using Title VII's disparate-impact provisions to "smoke out" actual and intentional discrimination is permissible).

accompanying burden to choose the least disparate employment practice possible is not.[198] Rather, the disparate-impact provision is the type of far-reaching means found unconstitutional by Justice Kennedy in *Parents Involved.*[199] Because the disparate-impact provision is not "narrowly tailored" to the offered compelling interest, it is not constitutional under the Equal Protection Clause.[200]

When Justice Scalia's question is properly before the Court, the Court would be well-advised to strike down the disparate-impact provision of Title VII and spur Congress to re-enact it without its constitutionally-problematic features.[201]

E. *Response to Anticipated Defenses of Title VII*

Many legal scholars have argued against a color-blind approach to equal protection jurisprudence and have been quick to warn against striking down Title VII after Justice Scalia's concurrence in *Ricci.*[202] While probable defenses of Title VII are endless, this Section will address arguments that: (i) a color-blind approach ignores reality; (ii) the Court should not usurp the will of the people as evidenced by Title VII; (iii) Title VII promotes—and the Court should not limit—employer freedom; (iv) diversity is, in itself, a compelling interest; and (v) Title VII's disparate-impact provision is necessary to "smoke out" intentional discrimination.

i. A Color-Blind Approach Does Not Ignore Reality

Opponents of a color-blind equal protection jurisprudence argue that such an approach fails to acknowledge the current state of racial disparity and unequal opportunity in America.[203]

198. The requirement that employers proactively subject every employment practice to a validity test and take action to choose an employment practice with a lesser disparate-impact is not the least restrictive alternative, as the disparate-treatment provision of Title VII was previously found in this Section to be adequate to address past and present employment discrimination. *See* McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802–05 (1973).

199. Parents Involved in Cmty. Schs. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 786 (2007) (Kennedy, J., concurring).

200. *Id.*; Grutter v. Bollinger, 539 U.S. 306, 333 (2003).

201. *See* Marcus, *supra* note 11, at 80–81 (offering "strik[ing] down" the disparate-impact provision as a solution).

202. *See infra* Section III(e) and accompanying text.

203. Reginald T. Shuford, *Why Affirmative Action Remains Essential in the Age of Obama,* 31 CAMPBELL L. REV. 503, 510–11 (2009) (describing the color-blind approach as "turning a blind eye"). Shuford offers evidence that African-Americans and Latinos

They insist that while past affirmative action measures have yielded significant progress, the persistence of racial disparities warrants government intervention that utilizes all measures, including race-conscious ones.[204] Further, they contend that the invocation of color-blindness is equal to racism—that color-blindness is itself selective and based on a history of discrimination.[205]

This argument ignores the message that every race-based government action sends: A politically acceptable burden can be imposed on particular groups on the basis of race.[206] Title VII's disparate-impact provision is a blatant encouragement of race-based preferences in employment decisions[207] when doing so meets a government interest.[208] Title VII does more than make racial discrimination in employment practices unlawful; it requires employers to proactively monitor employment practices for racially disparate outcomes and replace facially-neutral practices with ones that are more apt to have equal outcomes measured by race.[209] This aspect of Title VII indicates a clear mandate for government race-based classifications, and further, for racial preferences.[210]

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suffer disproportionately in employment. *Id.* at 518–19; *See generally* Banks, *supra* note 65 (pointing to disparities in health, employment, education, and incarceration).

204. *See, e.g.*, Shuford, *supra* note 203, at 524 (promoting race-conscious affirmative action measures). However, even those who do not believe that we currently live in a color-blind world argue that such a world is one to which we should aspire. Carbado, *supra* note 163, at 1194.

205. *See* Banks, *supra* note 65, at 1109 (exploring current critiques of a color-blind approach); *Cf.* Carbado & Harris, *supra* note 153, at 1211 (discussing the "racial signifiers" inherent in applications in the university admissions process).

206. *See, e.g.*, Carbado & Harris, *supra* note 153, at 1198 (discussing Justice Stewart's dissent in Fullilove v. Klutznick, 448 U.S. 448, 532 (1980)); Parents Involved in Cmty. Schs. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 742–43 (2007).

207. *Watson*, 487 U.S. at 987. *Cf.* Carbado & Harris, *supra* note 153, at 1139–42 (discussing affirmative action in the context of Michigan's Proposal 2 and California's Proposition 209). *But see* Int'l Firefighters Brief, *supra* note 89, at 5 (claiming that this argument itself, not Title VII, creates further "racial politics").

208. *See supra* notes 174–180 and accompanying text.

209. *See supra* notes 92–94 and accompanying text. In contrast, facially-neutral practices—specifically employment or promotion tests—seek to reward merit and ability. *See generally* Brief for Industrial-Organizational Psychologists as Amici Curiae Supporting Respondents at 10, Ricci v. DeStefano, 129 S.Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 796281 (citing 29 C.F.R. §§ 1607.14(B)(3), 1607.14(C)(4)) (2009) ("It is a fundamental precept of personnel selection that an employment test should be constructed to measure important knowledge, skills, abilities, and other personal characteristics . . . needed for the job."). A focus on racial equality in results undermines this American core value: meritocracy. Carbado & Harris, *supra* note 153, at 1141–42.

210. *See supra* note 92–94 and accompanying text (discussing the Uniform Guidelines).

While, admittedly, America is currently far from being truly color-blind, racial preferences are not the appropriate means to achieve a color-blind world.[211] As articulated by Chief Justice Roberts, the way to stop discrimination is simply to stop discriminating on the basis of race.[212]

ii. Whether Title VII Evidences the Will of the People Is Irrelevant

Proponents of Title VII point to the public's support of affirmative action programs as justification for the Act's legitimacy.[213] However, it is important to recall that a proper analysis of Title VII's constitutionality begins with the strict scrutiny analysis mandated by the Equal Protection Clause, not by asking whether the government action is wanted or publicly supported.[214] Only after Title VII has passed strict scrutiny can the "public support" argument hold any weight and, even then, only if the Court finds that following public opinion is a compelling government interest. Thus far, however, the Court has never recognized bowing to public opinion as a compelling government interest.[215] A simple showing of Title VII's support by the public is therefore not a justification in itself for upholding the Act in the face of a constitutional challenge.[216]

iii. Employer Freedom Cannot Come at the Cost of Constitutionality

Proponents of Title VII argue that the Act places the power of remedying discrimination in the hands of private citizens,

211. *See supra* note 82 and accompanying text. *Cf.* Carbado & Harris, *supra* note 153, at 1194 (noting the argument that "the assertion that race should not matter is a *means* to get us to that *end*") (emphasis added).

212. *See supra* note 82 and accompanying text. *Cf.* Carbado & Harris, *supra* note 153, at 1205 (discussing Justice Harlan's dissent in *Plessy* and pointing to the color-blind nature of the Constitution).

213. *See* Shuford, *supra* note 203, at 525 (claiming "some seventy percent" of Americans support affirmative action).

214. *See supra* notes 168–73 and accompanying text (discussing the Fourteenth Amendment's applicability to Title VII); *supra* Section III(d)(i) (outlining the strict scrutiny review process).

215. Limited authority arguably exists that the Court has found compliance with a presumptively valid federal antidiscrimination law to be a compelling interest. *See supra* notes 77–85 and 173 and accompanying text. However, compliance with a federal antidiscrimination law is very different than following public opinion. This difference is crucial, as the constitutionality of the federal antidiscrimination law itself is at issue.

216 *But see* Mahoney, *supra* note 73, at 1587–94 (exploring the proper relationship between judicial choices and public opinion).

enabling the growth of liberty through a conscientious marketplace.[217] Title VII is said to leave management prerogatives undisturbed to the greatest extent possible.[218] While the ability of employers to proactively end discrimination in the workplace is arguably necessary for the realization of a truly color-blind society,[219] this ability should not take the form of a "blank check to discriminate" against one race for the benefit of another.[220]

As discussed in the previous section, a proper analysis of Title VII's constitutionality begins with strict scrutiny analysis, not with asking whether government action should promote employer freedom. Only if promoting the freedom of employers to end discrimination in their workplace is itself a compelling government interest could this argument in favor of Title VII pass muster.[221]

iv. An Interest in Diversity Does Not Warrant Title VII

Proponents of Title VII seek to extend the Court's equal protection jurisprudence in the education context to the employment context, arguing that diversity itself is a compelling interest.[222] They argue that a diverse workforce promotes cross-

217. *See, e.g.*, Davis, *supra* note 84, at 996–97 (noting the "power of this remedy rests in its source"); Shuford, *supra* note 203, at 530 (highlighting the voluntary nature of Title VII).

218. Brief for Pacific Legal Foundation et al. as Amici Curiae Supporting Petitioners at 10, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 507013 (citing Local No. 93, Int'l Ass'n of Firefighters, AFL-CIO C.L.C. v. City of Cleveland, 478 U.S. 501, 519–20 (1986)).

219. *See, e.g.*, Davis, *supra* note 84, at 996–97 (discussing the benefit of employers actively seeking to end discrimination).

220. *Cf.* Savage, *supra* note 10, at 20 (noting Chief Justice Roberts's questioning that Title VII's disparate-impact provision is a "blank check to discriminate") (internal citations omitted). Private employers arguably have more freedom to discriminate in the workplace than do public employers. *See* Police Organizations Brief, *supra* note 63, at 22 (citing Wygant v. Jackson Bd. of Educ., 476 U.S. 267, 279 (1986)). Because this Note focuses on the constitutionality of Congress enacting Title VII, the ability of private employers to act and Congress's ability to regulate that private action is beyond its purview.

221. *See supra* Section III(d)(i) (outlining the strict scrutiny review process). Resolution of this argument follows the previous analysis outlined in Section III(e)(iv).

222. *See, e.g.*, Davis, *supra* note 84, at 1054 (arguing the workplace offers a "unique setting to advance integration" and diversity). Davis does however recognize the specificity of the Court's rationale for recognizing diversity as a compelling interest in higher education, including the Court's emphasis on the First Amendment. *Id.* at 1051. Proponents of Title VII's disparate-impact provision make a similar argument that an employment decision outcome that reflects the racial consistency of society, not merely intent, matters. *Id.* at 1054. Responding to this argument is beyond the scope of this Note.

racial understanding and even enhanced productivity.[223] However, this diversity justification is based on a belief in racial, ethnic, and gender differences that is fundamentally at odds with Title VII's insistence that individuals be judged individually and without regard to stereotypes.[224]

Further, reading *Grutter* so that the Equal Protection Clause allows discrimination in the name of diversity is hardly justified in the employment context.[225] The *Grutter* Court found that because the mission of a law school is not only to educate students, but also to train students for "work and citizenship" and cultivate future leaders, a "critical mass" of diverse students was necessary for the effective achievement of the law school's mission.[226] *Grutter* made clear that it only stood "for the narrow premise that the educational benefits of diversity can be a compelling interest to an institution whose mission is to educate."[227] For employers such as fire departments, whose mission is not to educate but to ensure public safety, diversity, while desirable, does not rise to the level of a compelling interest[228] necessary to withstand strict scrutiny.[229]

v. The Disparate-Impact Provision Is Not Necessary to "Smoke Out" Discrimination

Finally, proponents of Title VII's disparate-impact provision argue that the provision is "simply an evidentiary tool used to identify genuine, intentional discrimination—to "'smoke out,' as

223. *Id.* at 1051.

224. Clegg, *supra* note 112, at 984–85. The diversity justification is also fundamentally at odds with the promise of the Equal Protection Clause. *See supra* notes 57–62 and accompanying text.

225. *See* Clegg, *supra* note 112, at 984 (arguing *Grutter* is inapplicable).

226. Grutter v. Bollinger, 539 U.S. 306, 331–34 (2003).

227. Brief for the Concerned American Firefighters Association as Amicus Curiae Supporting Petitioners at 7–8, Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (Nos. 07-1428, 08-328), 2009 WL 507010 [hereinafter Concerned Firefighters Brief] (citing *Grutter*, 539 U.S. at 306) (arguing *Grutter*'s holding is "unavailing" in the employment context).

228. *See, e.g., id.* at 7–8 (internal citations omitted). *But see, e.g.*, Petit v. City of Chicago, 352 F.3d 1111, 1114 (7th Cir. 2003) (finding a compelling operational need for a diverse police department in a racially divided major American city). While a detailed study of the duties of firefighting are beyond the purview of this Note, some have argued that a firefighter's mission is concentrating on fighting fires and is therefore much different from the mission of a police officer. Concerned Firefighters Brief, *supra* note 227, at 9.

229. *See supra* Section III(d)(i) (outlining strict scrutiny review process). Resolution of this argument follows the previous analysis outlined in Section III(e)(iv).

it were, disparate treatment."[230] They argue that "there will seldom be 'eyewitness' testimony to the employer's mental processes,"[231] and the best evidence of intent will frequently be objective evidence of what actually happened.[232] As discussed previously, to the extent Title VII holds intentional discrimination unlawful, whether from direct or circumstantial evidence, it is consistent with the mandates of the Equal Protection Clause.[233] However, the aspects of Title VII that stretch beyond intentional discrimination are problematic and because the disparate-impact provision is not "narrowly tailored," it fails strict scrutiny review and is therefore unconstitutional.[234]

Proponents of Title VII make an additional related argument, warning that removing the disparate-impact provision of Title VII will silence legitimate discrimination claims.[235] They argue that the laws regulating discrimination should be flexible rather than overly demanding.[236] While it is certainly important that the Courts continue to provide relief to victims of intentional discrimination,[237] strict scrutiny application is not fatal in fact.[238] Victims of discrimination can find refuge within affirmative action law, but they must do so without infringing on the rights of others and within the bounds of the Equal Protection Clause.

230. *Ricci*, 129 S. Ct. at 2682 (Scalia, J., concurring).

231. U.S. Postal Serv. Bd. of Governors v. Aikens, 460 U.S. 711, 716 (1983). *Cf.* Shuford, *supra* note 203, at 526 (arguing Title VII's purpose is to recognize existing barriers that would otherwise be hidden).

232. Washington v. Davis, 426 U.S. 229, 253 (1976) (Stevens, J., concurring). *Cf.* Banks, *supra* note 63, at 1102 ("[D]isparate impact prohibits those practices whose racially skewed burdens suggest that unconscious bias may have played a role.").

233. *See supra* Section III(d) and accompanying text (examining the disparate-treatment provision).

234. *See supra* Section III(d)(ii)(b) and accompanying text.

235. *See, e.g.*, Banks, *supra* note 63, at 1095 (arguing the absence of the disparate-impact provision in Title VII will make "the hurdle of proving discriminatory purpose . . . so daunting that virtually no claim will surmount it").

236. *See generally* Rojas, *supra* note 54, at 143 (highlighting benefits of a flexible legal system to address discrimination).

237. *Id.* (noting the importance of a welcoming legal system in ending discrimination).

238. Grutter v. Bollinger, 539 U.S. 306, 326 (2003).

IV. CONCLUSION

> *In respect of civil rights, all citizens are equal before the law. The humblest is the peer of the most powerful. The law regards man as man, and takes no account of his surroundings or of his color when his civil rights as guaranteed by the supreme law of the land are involved.*[239]

The framers of the Constitution and of the Fourteenth Amendment had no doubts as to why racial discrimination was morally wrong: "[R]acial discrimination treats the accidental feature of race as an essential feature of the human persona."[240] Further, they knew that if the words "all men are created equal" were to have any meaning, the Fourteenth Amendment's promise of equal protection must apply to every individual, regardless of their race or the purpose for which the government action at issue was taken.[241]

The Court's opinion in *Ricci* leaves little doubt that the Court's commitment to equal protection is no different from that of the original framers.[242] Further, at least a majority of the Court recognizes the conflicting mandates of the Equal Protection Clause and Title VII and the pressing need for reconciliation.[243] When the proper case[244] comes before the Court, the Court would be well-advised to analyze the constitutionality of Title VII under a proper strict scrutiny review.[245] More importantly, if the Court is truly committed to the color-blindness mandated by the Equal Protection Clause and if this nation's promise that "all men are created equal" is to hold meaning, the Court must strike down the disparate-impact provision of Title VII.[246]

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239. Plessy v. Ferguson, 163 U.S. 537, 559 (1896) (Harlan, J., dissenting).

240. Edward J. Erler, *The Future of Civil Rights: Affirmative Action Redivivus*, 11 NOTRE DAME J.L. ETHICS & PUB. POL'Y 15, 49 n.132 (1997).

241. *Compare supra* note 2 and accompanying text (Declaration of Independence) *with supra* notes 57–62 and accompanying text (Fourteenth Amendment). *Cf.* Erler, *supra* note 255, at 49 n.132 (arguing race discrimination violates the principles of the Declaration of Independence).

242. *Compare supra* notes 240–41 and accompanying text (framers) *with supra* Section III(c) (current Court).

243. *See supra* Section III(c) and accompanying text.

244. "Proper" is used in this argument to mean a case which brings forth Justice Scalia's question and where the petitioner's claims cannot be dismissed at a statutory level. *Cf.* Ricci v. DeStefano, 129 S. Ct. 2658 (2009) (holding based on petitioner's Title VII claim and not addressing petitioner's Equal Protection Clause claim).

245. *See supra* Section III(d) and accompanying text.

246. *See supra* Section III(d) and accompanying text.

The way to stop discrimination is simply to stop discriminating on the basis of race. The question, however, is not whether the majority of the Court believes this notion, but whether they are principled enough to apply it.[247]

247. *Cf.* Chemerinsky, *supra* note 143, at 423 ("[I]t is hard to imagine that there would be five votes for such a radical change in the law."); Kimberly J. Robinson, *Resurrecting the Promise of* Brown*: Understanding and Remedying How the Supreme Court Reconstitutionalized Segregated Schools*, 88 N.C. L. REV. 787, 873 n. 529 (2010) ("[G]iven the refusal of the remaining justices to join his concurrence, Justice Scalia might not be able to garner enough votes to make his view the law of the land.").


TEXAS REVIEW OF
LAW & POLITICS