GOSSIP, THE OFFICE AND THE FIRST AMENDMENT

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"If you want to be absolutely literal, all human life is speech. Every time a person goes to work all he does is speak. Or write. Or listen to other people speaking. Or eat lunch."
—Supreme Court Justice Stephen Breyer[1]

"…gossip is a valuable aspect of free speech."
—C. Edwin Baker[2]

INTRODUCTION

In 2007 four employees of the town of Hooksett, New Hampshire, were fired for gossiping about a suspected romantic liaison between their boss, the Town Administrator, and a recently promoted town employee. The dismissed employees, all female, became known as the *Hooksett Four*.[3]

The Hooksett Four sued the town and identified themselves publicly, giving numerous interviews in local and national media.[4] The Town of Hooksett responded by issuing a public

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statement explaining and defending the town's actions in firing the four,[5] and subsequently settled with the two plaintiffs who had filed suit in federal court.[6]

Although the cases associated with the Hooksett Four did not make it to trial, they raise interesting questions about the status of gossip as a category of protected speech under the First Amendment in the context of public employment. Private employers are generally immune from liability for abridging the free speech of employees, but the obligations/risks of a government employer are less clear. This review serves to illustrate the limitations of Supreme Court free speech doctrine as applied to this deceptively important category of speech.

WHAT IS GOSSIP?

A review of social science and management literature and numerous court cases indicates that there is much variation in the definition of "gossip." However, paraphrasing Justice Stewart Potter's famous comment -- about another much maligned and discredited form of communication, -- pornography -- despite the difficulty of defining it, most of us know it when we see or *hear* it;[7] or, at least, we think we do.

Hearsay, rumor, and gossip are related concepts. Often in common usage, the three terms are equated. All involve communication of derivative information (to a second party or parties) originally obtained from a third party. Segregating rumor from gossip involves very fine distinctions, for example: "Rumor's foundation is lack of evidence -- without regard for topic; gossip specifies the topic -- the moral doings of humans -- but ignores its factuality."[8] While gossip usually involves an arguably inappropriate disclosure of information, the information it conveys may be factual.[9]

The subject of this paper is, specifically, workplace gossip, which Kurland and Pelled define as "informal and evaluative talk in an organization, usually among no more than a few individuals, about another member of the organization who is not present."[10] They note that The American Management Association distinguished "the grapevine" from gossip, asserting that the former may involve a wide range of topics, but gossip is focused on information about people.[11]

For more than 100 years courts have taken notice of “gossip” in their opinions, but mostly in a dismissive manner, frequently using the phrase “mere gossip” in reference to hearsay statements that are not admissible for evidentiary purposes.[12] In the cases we examined where gossip (or rumor) was central in an employment action, most of the courts did not attempt to define gossip. Rather, they examined the operative definitions of prohibited behavior specified in the employers' written policies.[13] In a few cases, the courts relied on the same dictionary definition. In *Dillon v. Twin Peaks Charter Academy,*[14] the court found it necessary to define “gossip” in an employment action suit where the academy’s code of conduct prohibited “malicious gossip and similar activities” but gave no definition in the code. The judge in *Dillon,* consulting several dictionaries, provided this definition: "Gossip" is defined consistently...as "idle talk" or "rumor," "especially about the affairs of others."[15] The Court in *Fitzgerald v. Stanley Roberts, Inc.*[16] relied on this same definition in a case involving the admissibility of gossip (as hearsay).

In this paper we limit our discussion of gossip to talk (which includes all forms of communication) about the affairs of individuals. We will not apply the dictionary definition, because the term "idle" makes general, commonly held, assumptions about the purpose and intent of gossip that are not always supported in fact. Rather, we will apply Kurland and

Pelled's value-neutral definition: "informal and evaluative talk in an organization, usually among no more than a few individuals, about another member of the organization who is not present."[17]

GOSSIP IN THE OFFICE – MANAGEMENT ISSUES

Formal and informal communication networks exist in all organizations. Formal communication networks are created to manage the content, flow and frequency of information throughout the organization.[18] Methods of formal communication may include meetings, newsletters, employee handbooks, and official company policies. Existing in parallel to, and supplementing the formal communication network, informal communication networks, commonly referred to as "the grapevine," spring up in all organizations. These informal networks are neither planned nor sanctioned by management, and depending on circumstances, may support or conflict with the employers' formal networks.[19] Gossip is widely recognized as a pillar of informal communication networks in organizations, but it has received surprisingly scant attention in management or organizational literature.[20]

Employers often view gossip as eroding employee cohesion and discipline, stealing time, and creating a work environment replete with unreliable information, innuendo, backstabbing, and distrust. Commentators[21] have noted that "popular" business literature tends to promote an overly simplistic and negative view of gossip, ignoring its potential benefits in organizations.[22]

The literature we examined presents a more balanced view, recognizing the positive and negative potential of gossip in organizations. Several authors noted that gossip serves a valuable role in sustaining community/organizational norms, values, and morals, which are not always conveyed adequately through formal communication avenues. [23] Often small groups are more effective at regulating this type of behavior before it comes to the attention of the formal hierarchy and has a larger impact on the organization. [24]

In a study of four organizations, Hafen contends that gossip may promote positive "organizational citizenship behaviors" that benefit the organization or "workplace deviance behaviors" that undermine organizational efforts.[25] Gossip can have positive effects on an organization by communicating rules, values, morals, and organization tradition and history, thus facilitating group cohesion. Hafen discusses how management can benefit from some gossip, i.e., it can be transformed into useful information for organizational regulation when it is relayed to someone in authority in the organization. In this vein gossip about company "heroes" and "anti-heroes" serves as a "kind of social control."[26] Of course, gossip is also used in organizations to resist and undermine authority. Hafen found that gossip is used to resist regulation, “debunking implicitly the organizational creed of placing efficiency and productivity over human relations."[27]

GOSSIP IN THE OFFICE – LEGAL ISSUES

An employee discharged on the basis of originating or spreading gossip may be incredulous that such ubiquitous behavior can be legal grounds for termination. As one reviewer put it, “[G]ossip…appears to be a normal and necessary part of life for all but the rare hermit among us.”[28] One study estimated that as much as 80% of human communication could be classified as gossip.[29]

Although there are not many judicial opinions concerning employees who have been terminated *purely* on the basis of office gossip, gossip has been cited as one of the grounds for termination in at least ten fully litigated cases in the United States in the past twelve years.[30] These are cases where published opinions are available. No doubt there are many more instances, such as the Hooksett Four cases, where the parties settle before trial[31] and incidents where terminated employees do not sue at all.[32] Of course, gossip also can be a form of informal resistance for employees in lieu of, or prior to, pursuing formal grievance or legal redress.

There are several legal approaches available to fired-for-gossip plaintiffs to challenge their termination including the public policy exception to the at-will employment doctrine under the common law, the employment discrimination statutes or hostile work environment theories, and the abridgement of free speech constitutional guarantees. With the common law and statutory theories having been explored in a prior paper,[33] the focus of this paper will be constitutional theories based on free speech.

The First Amendment Issue

While private employers are generally immune from liability for abridging the free speech of employees, that immunity does not necessarily extend to the governmental employer. A government employee retains the option of invoking the First Amendment, to allege that government has punished speech protected by the Constitution.

In the routine discussion of speech protected by the First Amendment, gossip is a category that receives scant attention. The heavy hitters in this area generate significant case law, law review comment, complex theories and ever-expanding hard-cover casebooks. These are the categories that test the boundaries; they include defamation, sedition, obscenity, religious speech and commercial speech. Assuming one is not an absolutist, the business of understanding the free speech guarantee is the business of drawing boundaries around the concept of free speech.

Van Alstyne has analyzed different approaches to understanding those boundaries, particularly categories of speech that are either included or excluded from First Amendment protection.[34] In his review he identifies several frameworks that include a sliding scale of protection for various categories of speech. Political speech is usually under the "most protected" category, while criminal speech occupies the "least protected" zone. In between lie categories such as "private," "social," "aesthetic" and "scientific" speech.[35] The fact that political speech garners the most protection is not hard to explain – for many the key to the value of the free speech guarantee is its contribution to American democracy.[36]

Gossip is not explicitly addressed in Van Alstyne's analysis. Nevertheless gossip may be encompassed by the "social" or "private" categories. As government regulation rarely reaches the social/private, the issue is not one that draws a lot of case law or commentary. Nevertheless it is worth noting that in the Van Alstyne scheme, gossip might be deserving of a relatively high degree of protection.[37] If gossip can be shown to inform/instigate the exposure of corruption in government, then it would appear to veer toward political speech, requiring the most protection. The question of gossip's place in the strata of protected categories remains open, depending in large part on the words and their context.

At the level of the Supreme Court, litigation dealing with the free speech rights of public employees came to the fore in the

1950's and 1960's.[38] In *Pickering v. Board of Education* (1968) the court set new standards regarding the free speech rights of public employees.[39] Pickering was a school teacher who had written to a newspaper criticizing the school board and the superintendent. He was subsequently fired. On appeal the Supreme Court held that his free speech rights had been violated: "…absent proof of false statements knowingly or recklessly made by Pickering, a teacher's exercise of his right to speak on issues of public importance may not furnish the basis for his dismissal from public employment."[40]

Pickering was predicated on a balancing of interests: "The problem in any case is to arrive at a balance between the interests of the teacher, as a citizen, in commenting upon matters of public concern and the interest of the State, as an employer, in promoting the efficiency of the public services it performs through its employees."[41]

Subsequent decisions about the firing of public employees have come out of the *Pickering* mold. Over the course of thirty years the Court has considered a string of cases involving the firing of teachers, a nurse, two assistant district attorneys, and a deputy constable.[42] The Court has had the opportunity to explain the criteria that establish "matters of public concern" (*Connick* and *Rankin*),[43] the burdens on both sides (*Doyle* and *Rankin*),[44] speech conducted specifically in pursuance of job duties (*Garcetti*),[45] and the role of the courts in relation to the "facts" that might justify a termination (*Waters*).[46]

Garcetti, the most recent Supreme Court decision to address the issue of public employee free speech, has generated a significant debate about the reach of the First Amendment.[47] In *Garcetti* the Court held that employee speech made *pursuant to official duties* receives no First Amendment protection. A government employer is free to "exercise ... employer control over what the employer itself has commissioned or created."[48] As gossip of any kind, and more particularly the Hooksett kind, is never commissioned by an employer, the *Garcetti* ruling is too narrow to address the problems created by gossip.

In *Waters v Churchill,* the word "gossip" is never used to describe a conversation between two nurses on a break at work. The employer's allegation was, however, that part of the conversation concerned negative comments about the plaintiff's supervisor who was out of earshot at the time. The Court found that the reason for the plaintiff's dismissal was unclear and therefore it was unable to determine if the speech for which she was terminated was protected speech.[49] Nevertheless, *Waters* reveals the Court, in a plurality opinion, leaning heavily toward deference to the employer's perception of harm in the workplace. Sachs' review of this opinion summarizes the key points:

> Although some speech may not be disruptive and may possibly be of value, the plurality noted that the Court has consistently declined any questioning of decisions made by government employers on matters regarding employee speech.
>
> All this notwithstanding, the plurality stated that the First Amendment should not necessarily be absent from all government employer decisions. …[I]t is often the government employee who knows best the possible problems that plague the particular agency for whom he or she works. Where this is the case, the employee may have a strong interest in airing his or her views on public matters. In such a situation the employer would have to make a "substantial showing that

> the speech is, in fact, likely to be disruptive before it may be punished."
> ….[T]he plurality concluded that employer decision-making would not have an onerous burden placed on it by having courts "look to the facts as the employer reasonably found them to be."
> …. Even if [the employee's] speech addressed a matter of public concern, the potential disruptiveness of the speech as reported "was enough to outweigh whatever First Amendment value it might have had."[50]

While the Court's doctrine has shifted/evolved over time, the focal point remains some "issue of public concern." In all but one of these cases the government employees expressed concern over particular policies and/or individuals in management; there is a bona fide belief that errors have been made that are detrimental to the workplace. The nurse complained about a policy that she believed threatened patient care (the exact nature of her complaints remained in dispute throughout the litigation); the assistant district attorney inquired (via an office survey) about transfer policies and political pressure on prosecutors; the college professor publicly disagreed with the Board of Regents over school policy; and the school teacher disputed the Board of Education's fiscal policy decisions. At first glance there is little in these examples that overlaps with our conception of gossip. However the gap between complaints about office policy and gossip about employer behavior will in some cases, like Hooksett, be very hard to discern.

For the Supreme Court, two criteria are paramount: a) if the speaker, as a citizen, addressed a matter of public concern, and b) whether the employee's interest in expressing gossip outweighs any injury the speech could cause to the government's interest, as employer, in promoting the efficiency of the public services it performs through its employees.[51]

Fired-for-gossip cases are rare in the federal courts. *Waters* might be an exception to that rule, but even in *Waters* the relevance of gossip to the employer's action is disputed. A recent attempt to equate a ban on workplace gossip to prior restraint failed in the District Court. When a public school employee was fired for gossip, the court found as a matter of law that, "…a prohibition against 'gossip' cannot support a First Amendment prior restraint claim…"[52] In state courts, employees in disputes involving gossip also have been unsuccessful. Courts in Rhode Island and Ohio have ruled in favor of government employers on a variety of grounds in two cases where gossip was an element of the dispute.[53] It should be noted that in neither case did the employees invoke free speech rights.

One can readily imagine circumstances where the First Amendment claim is central in a public employment dispute. Returning to the Hooksett Four dispute described *supra*, we see a well-balanced clash between gossiping public employees and outraged town officials. In a public statement on the Hooksett Four,[54] the Town Council noted that the town "suffered from a lack of management continuity for at least four years" with six different individuals in the Town Administrator's office over a four-year period. It further noted that some of these administrators cited "serious personnel problems." In addition, the statement noted that the incidents of gossip were sparked when a woman who was one of the subjects of the gossip worked extra hours in the short-staffed Finance Department.

Had the Hooksett Four raised a federal free speech claim they would have encountered the issues that have dominated in federal cases since *Pickering*:

a) did the employee speak as a citizen on a matter of public concern?

b) did the employee's interest in the expression of gossip outweigh any injury the speech could cause to the government's interest, as an employer, in promoting the efficiency of the public services it performs?

The first question should be answered in the affirmative. As the gossip concerned the public employees' legitimate interest in a situation where another employee may have been improperly promoted (or compensated), the reason for the gossip involves a nascent issue of public interest involving possible corruption, misuse of public funds, conflict of interest and violation of ethics laws. This is all the more important given the history of "serious personnel problems" in the office.

The second part of the test, requiring a balancing of interests, is more difficult to gauge. Is the interest of the Hooksett Four in discussing this issue valuable enough to justify any injury the speech could cause to the town's promotion of the efficiency of the public services it performs through its employees? From the Town Council point of view, the gossip was entirely false and very damaging.

> "[T]he issue was not one of idle gossip, but a conscious and concerted effort to damage reputations, to spread untrue stories with the knowledge that they were not true and evidently to retaliate for some perceived preferential treatment. The rumors, were they believed credible, could have been cause for removal of the Administrator and could have formed the basis for a sexual harassment suit against the

> town. Furthermore, the rumors were also intended to create tumult in the ranks; evident from a phone call that was placed to the home of the employee who was out on medical leave."[55]

From this perspective the injury is grave and the effort to "create tumult" in the workplace hinders the efficiency of public service. Is that injury sufficient to outweigh the interest of the gossipers in airing the allegation?

Given that, in most employment situations, neither side is certain of the truth at the time the gossip is communicated, the balancing of interests becomes extremely context-sensitive. In predicting how courts will read that balance of interests, the *Waters* decision reveals a distinct preference for valuing the employer's interest. The Court held in *Waters,* that "…employer decisionmaking will not be unduly burdened by having courts look to the facts as the *employer* reasonably found them to be."[56] [emphasis added]

The Court, in *Waters,* did not consider the role of gossip as a means of fact-finding in the workplace. Refuting the common belief that gossip leads to unreliable information, Ayim defends gossip as a mode of inquiry with similar standards of fact-finding as those applied in science.[57] Hafen finds that "to gossip is to both contest and wield power, authority, and discipline."[58] Indeed, gossip may be the only means for some individuals who have little power in the formal organization structure to obtain and assert influence.[59]

The following hypothetical situation will serve to illustrate how seemingly "trivial" gossip could deserve the protection of the First Amendment. Imagine that in January 2008 employees in the office of New York Governor Elliot Spitzer have begun to discuss the possibility that he has a mistress. Some employees are aware of questions that are being raised by his advisors about mysterious accounts and expenditures. The gossip includes references to a woman visiting the Governor's hotel room during an out of town trip. None of the employees are aware of any ongoing criminal investigation. Learning about this gossip, the Governor's chief of staff fires an employee who had admitted to spreading the rumor. Several months after the firing, the Governor resigns in disgrace when the press reveals his relationship with a prostitute.[60]

With the benefit of hindsight it is easy to say that the employees were exercising free speech rights in a manner that was admittedly detrimental to the career of one governor, but it was also in fact to the benefit of the state and the *office* of the governor. In hindsight we know that the employees were on to something close to the truth. The difficulty is that, at the time of circulating the gossip, the employees had no way to tell how true the allegations were. No doubt there is a lot of gossip in most places of employment, gossip that circulates with no factual basis, and some of it has negative consequences for the integrity or the efficiency of providing public service. It is in that context that supervisors, such as the chief of staff, have to make a decision about the impact of gossip in the workplace.

CONCLUSION

Gossip is a difficult case. On one hand it relates easily to traditional understandings of the purpose of the free speech guarantee. Free speech fosters democracy and gossip is a democratic form of speech. In some contexts, gossip is an embryonic representation of issues that will come to fruition as corruption allegations or sexual discrimination/harassment allegations. Hence, the connection to "matters of public concern," governance, and politics matters. Free speech also fosters discovery of the truth – and the role of gossip in relation to whistle-blowing activities is doubtless substantial. Finally, free speech is critical to self-realization. Gossip serves a key function in our networks (in and out of the workplace) and helps define our personalities and our values. On the other hand, the destructive impact of gossip is recognized time and again by courts as giving rise to a significant employer interest.

The application of the *Pickering* test adds another layer of difficulty. Rutherglen refers to the "uncertainty inherent in the balancing test" and concludes that "[t]oo few rights leave public employees as second-class citizens and the public itself uninformed about how the government actually operates. Too many rights risk paralyzing the operation of government itself as dissenting employees claim their right to speak out against policies that they have a duty to implement."[61] There is, however, a way to protect more employee speech under current doctrine. The courts should begin to demand more specific evidence of the harm done by employee speech. Mere reference to "promoting efficiency" is no match for demonstrating a diminishment of service to the public. That approach would put more bite in the *Pickering* test and serve to foster the First Amendment rights of employees.

In light of the most recent Supreme Court decisions, we see significant skepticism in the courts about the protection of employee speech in general and gossip in particular, more so in the case of public employment. The inevitability of gossip in complex organizations has not deterred the courts in giving leeway to employers who wish to punish it.

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[1] Stephen Breyer, audio interview with Nina Totenberg for *All Things Considered,* National Public Radio, http://www.npr.org/templates/story/

story.php?storyId=4929668, (at 17:30), (last visited August 17, 2010). We thank Bruce Barry of Vanderbilt University for this quote which opens the first chapter of his book, BRUCE BARRY, SPEECHLESS: THE EROSION OF FREE EXPRESSION IN THE AMERICAN WORKPLACE (Berrett-Koehler 2007).

[2] C. Edwin Baker, *Autonomy and Informational Privacy, or Gossip: The Central Meaning of the First Amendement*, 21 SOCIAL PHILOSOPHY AND POLICY 2 (2004), at 260.

[3] Erika Hayasaki, *4 go through the mill over a rumor - Gossip about their boss cost women their town hall jobs. Now everybody's talking*, LOS ANGELES TIMES, July 24, 2007, http://articles.latimes.com/2007/jul/24/nation/na-rumor24 (last visited August 17, 2010).

[4] *Fired for gossiping, 2 N.H. women sue in federal court*, sunjournal.com, September 23, 2007, http://www.sunjournal.com/node/628630 (last visited August 17, 2010) See also, *Bonsteel v. Hooksett*, No. 1:2007cv00298 (filed September 21, 2007), http://dockets.justia.com/docket/court-nhdce/case_no-1:2007cv00298/case_id-31456/ (last visited August 17, 2010).

[5] *Town issues statement on 'Hooksett Four,'* UnionLeader.com, June 5, 2007, http://www.unionleader.com/article.aspx?headline=Town+issues+statement+on+%27Hooksett+Four%27&articleId=d3d21fdd-e95c-4580-959a-f2406d1514fb (last visited August 17, 2010).

[6] *2 fired Hooksett workers settle federal lawsuit*, THE ASSOCIATED PRESS STATE AND LOCAL WIRE, November 1, 2008 (in return for which "the women agreed to waive any age discrimination claims").

[7] Concurring, in *Jacobellis v. Ohio*, 378 U.S. 184 (1964), Justice Stewart noted the difficulty of defining pornography, but commented that he, nonetheless, knew it when he saw it.

[8] Gary A. Fine, *Rumors and Gossiping* in HANDBOOK OF DISCOURSE ANALYSIS, v.3 at 223-237 (1985).

[9] See, for example, Margaret Holland, *What's Wrong With Telling the Truth? An Analysis of Gossip*, AMERICAN PHILOSOPHICAL QUARTERLY (April 1996) and Maryann Ayim, *Knowledge Through the Grapevine: Gossip as Inquiry* in GOOD GOSSIP at 85-99 (R. GOODMAN and A. BEN-ZE'EV eds., 1994).

[10] Nancy B. Kurland & Lisa Hope Pelled, *Passing the Word: Toward a Model of Gossip and Power in the Workplace*. 25 THE ACADEMY OF MANAGEMENT REVIEW 2 (April, 2000) at 429.

[11] *Id.* at 430.

[12] *Ilsley v. Sentinel Company*, 133 Wis. 20 (1907) (first noted case where the term "mere gossip" was used). Earlier cases such as *Smith v. Tennessee*,

9 Tenn. 228 (1829) have taken notice of gossip in some way in the court's analysis.

[13] See, for example, *Jackson v. Ritter and Wal-Mart, Inc. d/b/a Sam's Wholesale Club*, 1992 U.S. Dist. LEXIS 12114 (1992); *Brinson v. Barden Mississippi Gaming*, LLC, 2007 U.S. Dist. LEXIS 21965 (2007); *State ex rel. Wal-Mart v. Riley*, 159 Ohio App. 3d 598 (2005); *Letner v. Wal-Mart Discount Department Store*, 199 U.S. App. LEXIS 843 (1999); *Cruces v. Utah State Veterans Nursing Home*, 2007 U.S. App. LEXIS 7230 (2007).

[14] *Dillon v. Twin Peaks Charter Academy*, 2008 U.S. Dist. LEXIS 45615 (2008).

[15] *Id*.

[16] *Fitzgerald v. Stanley Roberts, Inc*., 186 N.J. 286 (2006) at 316. ("Thus, if an employee heard gossip that people who complained about work conditions were fired, the evidence might be admissible not to prove that people were in fact fired, but to explain her delay in reporting a problem.") ("…gossip is idle talk or rumor, especially about the personal or private affairs of others.") *Id.* at 315.

[17] Kurland & Pelled, *supra*, note 10 at 429.

[18] Grant Michaelson & V. Suchitra Mouly, *Do Loose Lips Sink Ships? The Meaning, Antecedents and Consequences of Rumour and Gossip in Organizations*, 9 CORPORATE COMMUNICATIONS 3 (2004) at 189.

[19] *Id.*

[20] *Id.* See also, Kurland & Pelled, *supra* note 10 at 428; Hafen, *infra*, note 25 at 223; and Noon & Delbridge, *News From Behind My Hand; Gossip in Organizations*, 23 ORGANIZATION STUDIES 14 (Winter, 1993).

[21] Noon & Delbridge, Id., and Michaelson & Mouly, *supra*, note 18.

[22] For example, Sam Chapman, CEO of *Empower Public Relations*, defines gossip as "negative communications outside the presence of the subject of the communication" and a "productivity killer." Marilyn Gardner, *Some employers get tough on workplace gossip,* CHRISTIAN SCIENCE MONITOR, June 2, 2008, Money & Values, at 13.

[23] See, for example, Noon & Delbridge, *supra*, note 20 and Aaron Ben-Ze'ev, *The Vindication of Gossip* in GOOD GOSSIP at 15, *supra* note 9.

[24] See, for example, Kevin M. Kniffin & David Wilson, *Utilities of Gossip Across Organizational Levels,* 16 HUMAN NATURE 3 (2005). In this study gossip was found to have the effect of rejecting or reforming a nonconforming individual's behavior.

[25] Susan Hafen, *Organizational Gossip: A Revolving Door of Regulation and Resistance*, 69 SOUTHERN COMMUNICATION JOURNAL 3 (Spring, 2004) at 223-224, defines organizational citizenship as "exhibiting behavior that is beyond one's job description ("extra role"), discretionary,

not explicitly rewarded by the organization, and important to the organization's success."

[26] *Id.* at 231.

[27] *Id.*

[28] Diane L. Zimmerman, *Requiem for a heavyweight: A farewell to Warren and Brandeis's privacy tort,* 68 CORNELL L. REV. 291, 334 (1983).

[29] Fiona Macrae, *You'll Never Guess What…We Spend 80% of Our Time Gossiping*, THE DAILY MAIL ONLINE, September 8, 2009, http://www.dailymail.co.uk/sciencetech/article-1211863/Youll-guess--We-spend-80-cent-time-gossiping.html (last visited August 17, 2010) (quoting research study of 300 people by Nicholas Emler).

[30] *Dillon v. Twin Peaks Charter Academy*, *supra*, note 14; *Pelletier v. City of Warwick*, 2008 R.I. Super. LEXIS 4 (2008); *Cruces v. Utah State Veterans Nursing Home*, *supra*, note 13; *Brinson v. Barden Mississippi Gaming*, 2007 U.S. Dist. LEXIS 21965 (Miss. 2007); *State ex rel. Wal-Mart v. Riley*, *supra*, note 13; *Delon v. McLaurin Parking*, 367 F. Supp. 2d 893 (N.C. 2005); *Bisbee v. Cuyahoga Bd. of Elections*, 2001 Ohio App. LEXIS 759 (2001); *Bick v. Harrah's,* 2001 U.S. App. LEXIS 455 (7th Cir. 2001); *Letner v. Wal-Mart*, *supra*, note 13; *Jackson v. Ritter*, *supra*, note 13 (listed by publication date, most recent first).

[31] *The Associated Press* reported that the town subsequently settled with the two plaintiffs who filed in federal court. See, *2 fired Hooksett workers settle federal lawsuit*, THE ASSOCIATED PRESS STATE AND LOCAL WIRE, November 1, 2008 (in return for which "the women agreed to waive any age discrimination claims.").

[32] One example allegedly occurred at a PR firm known as *Empower*, where the CEO claims to have fired three employees for gossip and then imposed a workplace policy of 'zero tolerance' for office gossip. See, Marilyn Gardner, *Some employers get tough on workplace gossip,* CHRISTIAN SCIENCE MONITOR, June 2, 2008, Money & Values, at 13.

[33] See, Rosemary Hartigan and Paula O'Callaghan, *Loose Lips Bring Pink Slips: Fired for Gossip at the Office*, 40 ACAD. LEGAL STUD. IN BUS. NAT'L PROC.__(2009), http://alsb.roundtablelive.org/Resources/Documents/NP%202009%20Hartigan,%20R%20and%20O%27Callaghan,%20P.pdf (last visited August 17, 2010).

[34] WILLIAM VAN ALSTYNE, INTERPRETATIONS OF THE FIRST AMENDMENT (Duke University Press, 1984).

[35] *Id*. at 41-42.

[36] As Justice Frankfurter put it: "I view the guaranties of the First Amendment as the foundation upon which our governmental structure rests,

…. Freedom to speak and write about public questions is as important to the life of our government as is the heart to the human body." *Milk Wagon Drivers v. Meadowmoor Dairies, Inc*., 312 U.S. 287, 301 (1941).

[37] The late free speech scholar Edwin Baker postulated that gossip actually should merit the label "political speech" even more so than campaign speech. See, C. Edwin Baker, *Autonomy and Informational Privacy, or Gossip: The Central Meaning of the First Amendment*, 21 SOCIAL PHILOSOPHY AND POLICY 2 (2004), at 262 ("…any proponent of protecting only or primarily political speech *should* have a hard time ruling out protection of gossip or other presentations of private information") [emphasis in original].

[38] Prior to the seminal *Pickering v. Bd of Education* decision 391 U.S. 563 (1968) the best known legal advice on this issue came from Justice Holmes in his opinion in *McAuliffe v. Mayor of New Bedford* 155 Mass. 216, 29 N.E. 512 (1892). The plaintiff lost his job as a policeman because he had solicited money for a political committee. Justice Holmes, sitting on the Massachusetts Supreme Judicial Court, held "the petitioner may have a constitutional right to talk politics, but he has no constitutional right to be a policeman" 155 Mass. at 220, 29 N.E. at 517. For Justice Holmes the choice of employment simply trumped any assertion of free speech rights.

[39] 391 U.S. 563 (1968).

[40] *Pickering v. Board of Education*, 391 U.S. 563 at 574 (1968).

[41] *Pickering*, 391 U.S. 563 at 568.

[42] Both *Pickering*, 391 U.S. 563 (1968) and *Perry v. Sindermann*, 408 U.S. 593 (1972) involved teachers (both male). A nurse lost her job in *Waters v Churchill*, 511 U.S. 661 (1994), an assistant district attorney lost her job in *Connick v. Myers*, 461 U.S. 138 (1983), another assistant district attorney lost his job in *Garcetti v. Ceballos*, 547 U.S. 410 (2006) and a deputy constable lost her job in *Rankin v. McPherson*, 483 U.S. 378 (1987).

[43] *Connick v. Myers*, 461 U.S. 138 (1983), *Rankin v. McPherson*, 483 U.S. 378 (1987)

[44] *Mt. Healthy City Sch. Dist. v. Doyle*, 429 U.S. 274 (1977), *Rankin v. McPherson*, 483 U.S. 378 (1987)

[45] In *Garcetti v. Ceballos*, 547 U.S. 410 (2006) the Court ruled that the First Amendment allows employees to be disciplined for speech conducted in pursuance of their job duties.

[46] *Waters v. Churchill*, 511 U.S. 661 (1994)

[47] George Rutherglen, *Public Employee Speech in Remedial Perspective,* 24 J. L. & POLITICS 129 (2008), Cynthia Estlund, *Harmonizing Work and Citizenship: a Due Process Solution to a First Amendment Problem*, 2006 SUP. CT. REV. 115, and Lawrence Rosenthal, *The Emerging First*

Amendment Law of Managerial Prerogative, 77 FORDHAM L. REV. 33 (2008).

[48] *Garcetti v. Ceballos,* 547 U.S. 410 at 422 (2006).

[49] "…Churchill has produced enough evidence to create a material issue of disputed fact about petitioners' actual motivation." *Waters v Churchill,* 511 U.S. 661 at 680 (1994).

[50] Keith Sachs, *Comment: Waters v. Churchill: Personal Grievance or Protected Speech, Only a Reasonable Investigation Can Tell*, 30 NEW ENG. L. REV. 779, at 812-818 (1996).

[51] "[T]o be protected, the speech must be on a matter of public concern, and the employee's interest in expressing herself on this matter must not be outweighed by any injury the speech could cause to "`the interest of the State, as an employer, in promoting the efficiency of the public services it performs through its employees.'" *Waters v Churchill* 511 U.S. 661, 668 (1994) quoting *Connick* v. *Myers*, 461 U.S. 138 (1983).

[52] *Dillon v. Twin Peaks Academy*, 2008 U.S. Dist. LEXIS at *6. The Court "decline[d] the invitation to declare speech defined specifically in terms of its personal, unsubstantive nature as falling within that sphere of speech that an employer cannot constitutionally restrain, even if Dillon had been able to establish that she was, in fact, so restrained."

[53] *Pelletier v. City of Warwick* 2008 R.I. Super. LEXIS 4 (2008); *Bisbee v. Cuyohoga County Board of Elections* 2001 Ohio App. LEXIS 759 (2001).

[54] *Town issues statement on 'Hooksett Four, supra*, note 5.

[55] *Id.*

[56] *Waters v. Churchill* 511 U.S. 661, 677 (1994).

[57] Ayim, *supra*, note 9.

[58] *Id*. at 226.

[59] Noon & Delbridge, *supra*, note 20.

[60] Governor Spitzer's resignation in disgrace is factual; the preceding events are strictly hypothetical. See http://www.nytimes.com/2008/03/12/nyregion/12cnd-resign.html?_r=1&scp=2&sq=spitzer%20resignation&st=cse (last visited August 17, 2010).

[61] George Rutherglen, *supra*, note 50 at 167.

CREDIT RATING AGENCIES & FREE SPEECH

by

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INTRODUCTION

The economic crisis that emerged in late 2007 continues to occupy an important place in many political and non-political discussions and can be traced to a number of players. The role many financial institutions, mortgage brokers, appraisers, and speculators played is well documented. Individual borrowers also contributed to this sub-prime lending crisis either knowingly or unwittingly through participation in the fraud committed by other parties. Several experts have put the blame squarely on the politicians who promoted home-ownership as the ultimate measure of success in American society and the government agencies (e.g. Fannie Mae) that were charged with assisting in the process of making these home ownership dreams come true.

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Even the most respected Federal Reserve ex-Chairman, Alan Greenspan, has not escaped criticism on account of his policy of keeping interest rates low for a long time. Recently, some investors and economists have pointed to the pivotal part credit rating agencies played in the meltdown. This paper will examine that role, focusing on whether credit rating agencies should be able to avoid liability by virtue of their traditional protection under the First Amendment, and whether new regulatory reforms designed to curtail conflicts of interest and promote greater disclosure will suffice.

WHAT ARE CREDIT RATINGS & WHY ARE THEY IMPORTANT?

The easiest way to understand credit ratings is to compare them to the grade point averages (GPA) given out by most schools. Earning a GPA of "A" is excellent whereas receiving a GPA of "D" is bad. Each of the major rating agencies have their own categories akin to the As and Bs a student gets in his/her coursework. For example, Standard & Poor's (S & P) gives the highest rating of AAA for a debt issuer with stellar financial performance. A rating of "B" is given to an issuer whose debt issue servicing may be considered speculative. Moody's follows a similar method with Triple A (Aaa) as the best possible rating and a rating of "B1" indicating questionable ability of the borrower to pay interest and principal on the debt in a timely manner.

These ratings are usually paid for by the issuers instead of by the investors of debt. Scannell & Lucchetti report in their 2008 article that about 98 percent of the ratings are paid for by the issuers.[1] Some issuers routinely shop around for a better rating. A high rating can translate into lower interest rate and significant savings over the life of the debt issue. Acceptable ratings can also lead to a larger pool of investors who would be interested in buying these bonds, thereby creating a liquid secondary market. It is not uncommon for the debt issuer to buy additional insurance to make its debt issue with a lower credit rating more acceptable for the prospective investors.[2]

Investors rely on these ratings to get an objective assessment of the debt's quality. Some debt investors who are regulated are prohibited from investing in non-investment grade bonds. "The Federal Reserve defines investment-grade securities as those rated BBB- or higher by at least one of the three principal credit ratings agencies and no lower than that by the others."[3] For banks choosing to invest in non-investment-grade bonds, the penalty comes in the form of higher capital ratios. Prior to the creation of the new derivative products like the Collateralized Debt Obligations (CDOs) and Collateralized Mortgage Obligations (CMOs), assigning a rating to a bond issue was a relatively simple process.

In a traditional credit analysis, the ratings agencies focus on the four major C's of credit. The four C's refer to: capacity, collateral, covenants, and character. The questions about "Capacity" revolve around the issuer's ability to pay back the debt as promised. The ratings analyst may look at a variety of financial and nonfinancial information about the issuing company. Rating agencies examine the historical financial statements, calculate relevant traditional and cash flow based ratios, and compare the issuer's performance over time to its peers, and to the industry in which the issuer operates. In addition, qualitative judgment is used to evaluate several factors which could affect a company's ability to service its debt such as the trends in the industry in which the company operates, its competitive position and any relevant regulatory factors which could impact its operations. The second "C" in the analysis, namely collateral, is based on the examination of the creditors' rights in the event the issuer goes bankrupt or files for a reorganization plan. A study of "Covenants" focuses on any limitations that may be imposed on the borrower's activities. The last "C" refers to the character of the borrower. This part of the evaluation is based on the qualitative judgment of the company's management. A range of factors such as the ownership structure, shareholder rights, public disclosure, and the structure of the board may be used to assign a character score to the issuer.[4]

Ratings have been used by regulators since the thirties, but in the seventies, the Securities Exchange Commission (SEC) gave them new power. There are ten Nationally Recognized Statistical Rating Organizations (NRSROs), including the big three, Standard and Poor's (S&P), Moody's and Fitch. Their role is to channel funds into supposedly safe and secure investments. Issuers *must* obtain a rating, which in turn dictates where banks, insurance companies, money-market funds and the like can place their money. While these regulatory requirements were intended to protect investors, the net effect was to turn the "opinion" rating agencies into essential gatekeepers.[5] Then in the late 1990s, the role of rating agencies underwent a significant change as the newly created derivative products were introduced.

THE NATURE OF DERIVATIVE PRODUCTS AND THE RATINGS GAME

Mortgage-backed securities (also known as CMOs) come into existence when a financial institution puts many of the mortgages they own or bought into an investment pool. These pools are sometimes sliced and diced into different classes of securities with varying levels of risk and return. The risk levels, for example, may be based on the probabilities of default and which class of investors would bear the first x percent of the default. One of the major advantages of securitizations is creation of liquidity which allowed lenders to keep giving out loans after selling the loans already on their books. It was believed that these securities were quite safe as they were backed by several thousand loans and the probability that all these loans could simultaneously default was slim to none.

The ratings given to these CMOs were necessary for the financial institutions to be able to sell them to organizations like pension funds and banks which had restrictions on the securities in which they could invest. As described below, the ratings "game" now being played was quite different from the ratings that agencies previously had issued for bonds of companies like Enron.

For traditional bond issues, the focus is placed on the borrowers' ability to run their business and generate cash flows to pay the interest and principal to the debt investors. All the financial information needed to calculate the relevant ratios is retrieved from the company's audited financial statements. A publicly traded company is required to hire an independent audit firm which certifies that the financial statements follow the Generally Accepted Financial Principles (GAAP) and accurately depict what a firm owes and owns on its balance sheet. The audited income statement looks at the revenue and expense recognition standards followed by the company and produces net income after tax generated by the company over a 12 month time period. The credit rating agencies came under tremendous criticism for holding on to the best possible triple A ratings for Enron bonds just prior to Enron declaring bankruptcy. At that time, ratings agencies claimed that they should not bear any blame because companies like Enron were engaged in fraudulent bookkeeping with total cooperation from their auditors. The "cooked" financial statements painted a significantly better financial picture of Enron compared to the reality. Enron's management, with help from its auditors, had created thousands of Special Purpose Entities (SPEs) whose sole purpose was to take the debt off Enron's balance sheet. The ratings agencies relied heavily on the "window dressed" financial statements certified by the company's auditors, and they successfully defended themselves in court, arguing that they had no reason to independently investigate if Enron had taken deliberate steps to hide debt from its balance sheet.[6]

The ratings assigned to derivative products like the CMOs could not be figured out using the same technique. These securities were backed by thousands of mortgages spread over many geographic locations and borrowers. It was next to impossible to verify the details of each and every mortgage. The practice of continuously slicing and dicing the bundled securities to create more securities exacerbated this problem even more as one mortgage debt might now be backing more than a couple of CMO's. The rating agencies had to get their information from the investment banks that created the pooled securities. The rating agencies also assumed, erroneously, that housing prices would continue their upward movement indefinitely, minimizing the chance of even subprime borrowers defaulting on their loans.

Another significant difference between the processes used for assigning ratings to traditional corporate bonds versus the ratings assigned to structured products lies in the differences in the customer base for these products. The ratings agencies have a lot more control over ratings for bonds as they have many clients with no single client providing a significant source of revenue. On the other hand, derivative securities were put together by only a handful of investment banks whose loss as clients would mean a huge loss of revenue to the ratings agencies. This concentration of clients put tremendous pressure on ratings agencies to assign favorable ratings to some structured products to please their clients.[7]

Investors who relied on these ratings are now seeking to hold the rating agencies responsible for the losses generated by these CMOs & CDOs as the real estate market all over the world went into a freefall leading to simultaneous defaults on thousands of loans. In the past, ratings agencies have successfully argued that their opinions are not actionable and are analogous to that of a stock analyst who issues buy or sell recommendations. Moreover, the worldwide economic conditions are completely unprecedented. Interestingly, legal counsel representing Fitch in its testimony to Congress, called ratings the "World's Shortest Editorial" and claimed that first amendment protection is appropriate.[8]

Nonetheless, plaintiffs are aggressively pursuing fraud and liability theories that question both the traditional First Amendment protection enjoyed by the rating agencies and their government-sanctioned role in "certifying" the safety of the securities they rated. The SEC is likewise moving to curb the conflicts of interest that led to ratings shopping and inflated assessments.

ARE CREDIT RATING AGENCIES ENTITLED TO FIRST AMENDMENT PROTECTION?

A. Are Credit Rating Agencies Journalists?

The process of newsgathering is a protected right under the First Amendment, albeit a qualified one. This qualified right, which results in the journalist's privilege, emanates from the strong public policy supporting the unfettered communication of information by journalists to the public. Ratings put forth by a credit rating agency may qualify as newsgathering under certain circumstances. This is true if the information provided by the credit agency is a matter of public concern and is opinion, not factual.[9]

Statements of fact may be proven, and if false, are subject to defamation or fraud claims, whereas statements of opinion are not provable… "a statement of opinion relating to matters of public concern which does not contain a provably false factual connotation will receive full constitutional protection."[10] As stated in the Enron case, "In other words, if a statement "cannot reasonably [be] interpreted as stating actual facts," it is shielded by the First Amendment.[11] As factors to consider in the determination of whether a statement can reasonably be interpreted as one of fact, the court may examine the language employed, e.g., whether it is "loose, figurative, or hyperbolic language which would negate the impression" that it was a statement of fact, as well as the context of the statement and the "general tenor of the article."[12]

B. Matter of Public or Private Concern?

The information provided by the credit rating agency must be of public concern in order to receive protection. For example in the Enron case, the court pointed out that "The sheer size of the…litigation, not to mention the numerous related criminal actions, attests to the public import of Enron and its sudden collapse in 2001."[13] The court went on to say "that while there is no automatic, blanket, absolute First Amendment protection for reports from the credit rating agencies based on their status as credit rating agencies, the courts generally have shielded them from liability for allegedly negligent ratings for various reasons."[14]

On the other hand, if the matter is one of private rather than public concern, then the court will not protect the credit rating agency. In *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*[15], D&B prepared a credit report concerning Greenmoss Builders that contained the erroneous information that Greenmoss had filed for bankruptcy, when in fact it had not. Upon learning of the error, D&B sent a correction to the five creditors who had received the report, but Greenmoss was not satisfied and sued for libel. In one of the few decisions to so hold, the U.S. Supreme Court emphasized that " '[w]hether ... speech addresses a matter of public concern must be determined by [the expression's] content, form, and context ... as revealed by the whole record.' "[16] Here, the Supreme Court found that the credit report of a private construction contractor was not entitled to First Amendment protection because it concerned "no public issue, ... [but] was speech solely in the interest of the speaker and its specific business audience," since it concerned solely a private plaintiff and was sent to only five subscribers who were under agreement to keep the information confidential.[17] Therefore the report did not involve any "strong interest in the free flow of commercial information" that would "ensure that 'debate on public issues [will] be uninhibited, robust, and wide-open.' "[18]

Similarly, in the case *In re Nat'l Century Fin. Enters, Inc. Inv. Litig.,*[19] the plaintiffs sued Moody's and Fitch for giving National Century notes their highest credit ratings, which the plaintiffs claimed they relied on to purchase the notes. National Century subsequently went bankrupt. The Court found that the notes in question were issued by a privately-held company and "targeted to a select class of institutional investors with the resources to invest tens of millions of dollars in the notes. And the only place that the ratings are alleged to have appeared were in the offering materials given to the select class of investors."[20] Since the ratings were not published to the investing public at large, Moody's and Fitch were denied First Amendment protection.

If the information gathered by the credit agency is not disseminated to the public, but is published for example, on a website, it may not be "public" information. This was the case in *American Savings Bank, FSB v. UBS PaineWebber*[21] holding that no journalistic privilege applied. Here, PaineWebber made investment recommendations to American Savings Bank, based on information that PaineWebber received from Fitch. The matter before the court involved discovery of information provided by Fitch, for which Fitch claimed a journalistic privilege. The court found two factors significant. First, Fitch's primary means of disseminating information to both its subscribers and the public was on its website; and secondly, Fitch performed its ratings based on a private, contractual agreement for a fee. Finding that Fitch rarely performed its services without a fee, the court held that "research conducted for a fee cannot be journalism."[22] In an ancillary case the Second Circuit also held that Fitch was not entitled to a journalistic privilege because, unlike a business newspaper or magazine, which would cover any transactions deemed newsworthy, Fitch only "covers" its own clients. "We believe this practice weighs against treating Fitch as a journalist. This practice, of course, contrasts noticeably with Standard & Poor's practice (as described in Pan Am) of rating nearly all public debt issuances regardless of whether it was hired to do so or not."[23]

C. Can Rating Agencies Claim First Amendment Protection When They Helped to Create the Product They Rated?

David Grace, a noted securities lawyer, made an illustrative comparison between rating agencies and a restaurant critic.[24] If a critic merely goes to a restaurant, eats a meal and then writes a review, he is clearly expressing his opinion. However, if the critic was actually involved in the preparation of the meal in the kitchen then he is not just writing his opinion.[25] In the case of ratings assigned to derivative products, the rating agencies were actually present in the board rooms of investment banks engaged in bundling these securities. Given that vested interest, plaintiffs argue that the rating agencies should lose the protection associated with free speech.

Many angry investors also claim that the ratings are actually products and when these products were consumed (relied upon) by investors they were hurt. As such, rating agencies could be sued on the grounds of selling a defective product much like a manufacture of a toaster that bursts into flames. Indeed, the analysts themselves were unsure about the rating process and the models they were using to come up with ratings for the structured products.[26] It was revealed in Congressional hearings that the debt analysts may have failed to recognize the higher level of risk associated with these derivative products and were engaged in giving out ratings to any issuer who paid for them.[27] As the real estate bubble grew, Moody's, Fitch and S&P doubled their revenues from $3 billion in 2002 to $6 billion in 2007.[28] One recent complaint filed against the big three alleges that they "'failed to conduct due diligence and willingly assigned the highest ratings to …impaired instruments since they received substantial fees from the issuers,'" and that this "cozy relationship" resulted in inflated ratings based on an outdated rating methodology.[29]

D. Applying the First Amendment Shield

Still reeling from the subprime implosion, government and private investors are testing the extent of the First Amendment protection. In the pending case of *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.,*[30] institutional investors King

County, Washington and Abu Dhabi Commercial Bank brought a class action to recover losses stemming from a liquidation of notes issued by a structured investment vehicle. The eight defendants include S&P and Moody's. The rating agencies claimed in their motion for summary judgment that they are entitled to immunity under the First Amendment, but the court disagreed. Noting that under "typical" circumstances the First Amendment normally protects rating agencies subject to an "actual malice" exception, the court relied on the *Greenmoss* and *National Century* cases (*supra*), stating that "where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection."[31] The court also rejected the defendants' argument that their ratings were opinions. The judge found that the plaintiffs had sufficiently alleged that the rating agencies did not genuinely or reasonably believe the ratings they assigned to the rated notes to be accurate or to have a basis in fact. "As a result, the Rating Agencies' ratings were not mere opinions but rather actionable misrepresentations."[32] For the same reasons, the defendants' disclaimers that "(a) credit rating represents a Rating Agency's opinion regarding credit quality and is not a guarantee of performance or a recommendation to buy, sell or hold any securities," were deemed unavailing to protect the defendants from liability for promulgating misleading ratings.[33]

CONGRESSIONAL AND SEC RESPONSES

In addition to First Amendment protection, ratings agencies also have been shielded from liability for everything except fraud under federal securities law.[34] In 2006, Congress passed the Credit Rating Reform Act (CRARA), pursuant to which the SEC liberalized the ground rules whereby a credit rating agency can become an NRSRO. Although that act achieved its goal of expanding the number of NRSROs, it did nothing to prevent the inflated ratings so intertwined with the financial meltdown.[35] Nor did it significantly increase competition, as Moody's, Fitch and S&P still maintain an 85% market share. Relatively weak new rules were enacted, but they still did not tackle the "critic-for-hire" problem.[36]

The SEC's new rules were released in the *Federal Register* on November 23, 2009, and went into effect in June, 2010.[37] When an issuer, underwriter or other offering participant uses a credit rating to market its securities, more credit ratings history and disclosure are required in the prospectus and registration statements. Disclosure must include general information regarding the scope of the credit rating, potential conflicts of interest (such as other services and fees paid to the credit rating agency), and all preliminary or final credit ratings obtained from other credit rating agencies for the same class of securities. The last requirement is designed to help investors identify potential instances of ratings shopping.[38] The SEC has deferred, however, consideration of a rule that would have required NRSROs to report the ratings methodologies and particular credit risk characteristics for structured finance products.[39]

Under CRARA, the substance of credit ratings and the procedure and methodologies by which NRSROs determined those ratings were protected from SEC and state regulation, though there was a narrow exception for state actions brought on tort grounds. The federal preemption defense may come into play as state attorneys general seek redress in the foreclosure crisis. For example, in 2008, Connecticut attorney general Richard Blumenthal filed suit against the credit rating agencies on a fraud theory, alleging violation of Connecticut's Unfair Trade Practices Act.[40]

Pressure to enact stiffer regulations intensified in the months leading up to the passage of the sweeping Wall Street Reform and Consumer Protection Act, signed into law July of 2010 (Financial Reform Act).[41] In December of 2009, the SEC had announced that it was considering rescinding Rule 436(g) which insulated NRSROs from potential liability under Section 11 of the Securities Act for material misstatements or omissions in a registration statement.[42] The Financial Reform Act eliminated the exemption.[43] NRSROs and other credit rating agencies will now be on an equal footing. Companies that include a credit rating in their registration statement will need to obtain the consent of the rating agency for the use of its name in the prospectus, in the same manner as consent is required from auditors. The rationale is clear: when ratings are used to sell securities, investors rely on NRSROs as experts, and they should be subject to the same liability as are other experts, such as auditors. Rescission of Rule 436(g) should cause rating agencies to improve the quality of their ratings and analysis in order to reduce their risk of liability.[44]

The Financial Reform Act embraces many of the provisions that were included in related House and Senate Bills introduced in 2009.[45] The Rating Accountability and Transparency Enhancement Act (the RATE Act), incorporated under Title V, Subtitle B, of the Financial Reform Act, requires the SEC to review credit ratings and methodologies employed by NRSROs. It also directs the SEC to create and enforce rules to prohibit, or manage and disclose conflicts of interest, as well as to establish a compliance office. A critical component of the RATE Act is to modify the scienter requirement in a private action for monetary damages against an NRSRO. It will be sufficient for plaintiffs to state with particularity acts giving rise to a strong inference that the NRSRO knowingly or recklessly failed either to conduct a reasonable investigation of the rated security or to obtain reasonable, independent verification of the factual elements relied on to evaluate credit risk.[46]

Congress also directed the SEC to study and report within a year on (1) a system that assigns NRSROs on a rotating basis to issuers seeking a credit rating; (2) the effect of new requirements on NRSRO registration; (3) credit ratings of different classes of bonds; (4) meaningful multidigit ratings system; and (5) ratings standardization. The Comptroller General must likewise study and report to Congress on the implementation of the RATE Act, including (1) the appropriateness of relying on ratings for use in federal, state, and local securities and banking regulations, as well as for determining capital requirements; (2) the effect of liability in private actions due to rescission of Rule 436(g); (3) alternative means for compensating credit rating agencies that would create incentives for accurate credit ratings; and (4) alternative methodologies to assess credit risk, including market-based measures.[47]

ARE THE PROBLEMS BETTER LEFT IN THE INVISIBLE HANDS OF THE FREE MARKET?

One of the solutions proposed to address this crisis was to do nothing and leave it to market forces to assign a value to the work done by the raters. Not surprisingly, one of the strongest supporters of this solution has been Deven Sharma, President of S & P.[48] He argued that the NRSRO ratings were interpreted by some investors as a "government seal of approval" instead of using them as one piece of additional information they could use to assess risk. If investor rating requirements are removed, newer ratings agencies can enter the market facilitating appropriate flow of capital through the debt ratings.

There is no broad support for such as argument. If history has taught us anything it is that:

- Ratings agencies will continue to have conflicts of interest and analysts will get "routinely bullied" by the companies paying for such ratings.[49]

- Only a handful of rating agencies have been dominating the industry for several decades and without proper reforms there is no room for any new small agency to enter the industry.

- Some experts believe that imposing explicit disclosure requirements may force the agencies to take their debt ratings more seriously. If the disclosure rules pertain to historical facts such as the relationship between the ratings and the actual defaults, this type of information could be fairly easy to file with no major resistance from the agencies. However, if the rules require the agencies to disclose immediately information such as the data & the proprietary methodology used, the raters may be reluctant to comply with the rules as they may not be able to make any money for the ratings. Any disclosure rules imposed on the ratings agencies would necessarily require a reasonable time frame during which the agencies need to complete the necessary paperwork.[50] Such a lag in time would defeat the purpose of extra disclosure as the investors would have already made their decision based on the assigned ratings.

- Requiring additional labels (e.g. S for structured products) may not be helpful, especially if in the future any products are introduced by the investment banks

> under new non-derivative sounding names.[51] Usually rules and regulations lag significantly behind the new changes taking place in the marketplace and do not win at the catch-up game.

In other words, the only viable change that may effectively protect investors is to give them the power to sue the raters under expanded theories of liability.

CONCLUSION

Unlike Enron, where the ratings agencies had no reason to know that the company's managers and auditors were engaged in systematic fraud and manipulation of the company's balance sheet, in the instant cases, the rating agencies were actively involved in structuring the very products they rated. States, institutional and private investors alike were caught in the subprime implosion. The rating agencies should not be allowed to hide behind either the First Amendment or their government-sanctioned status as NRSROs. Courts should hold these agencies responsible for their misrepresentations, and Congress has appropriately responded with strong new regulation and expanded liability for private actions under the Securities Exchange Act of 1934. Rating agencies should be treated as experts and held to the same standard as auditors. The SEC's and Comptroller General's reports to Congress next year on implementation of the RATE Act will be critical in assessing what further steps should be taken to regulate the credit rating system as part of the larger agenda of achieving true financial reform.

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[1] Kara Scannell, Aaron Lucchetti, *Crisis on Wall Street: SEC Tightens Rules for Ratings Firms*, WALL ST. J. Dec. 4, 2008, at C-3.

[2] Financial Industry Regulatory Authority, Inc., *Smart Bond Investing*, at http://apps.finra.org/investor_Information/smart/bonds/305400.asp (Apr. 19, 2010).
[3] *The Rating Racket*, WALL ST. J. June 25, 2008, at A-14.
[4] FRANK J. FABOZZI, FIXED INCOME ANALYSIS, 421-461 (John Wiley & Sons, Inc. 2d ed. 2007).
[5] James Surowiecki, *The Financial Page: Ratings Downgrade*, THE NEW YORKER, Sept. 28, 2009, at 25.
[6] STANLEY B. BLOCK, GEOFFREY A. HIRT, BARTLEY R. DANIELSEN, FOUNDATIONS OF FINANCIAL MANAGEMENT, 10 (McGraw-Hill/Irwin 13th ed. 2009).
[7] On the Media, *Grade Inflation*, NATIONAL PUBLIC RADIO ARCHIVES at http://www.onthemedia.org/episodes/2009/05 (May 29, 2009).
[8] *Id*.
[9] In re Fitch, 330 F. 3d 104 (2d Cir. 2003); American Savings Bank, FSB v. UBS Painewebber, Inc. WL 31833223, 31 Media L.Rep 1444 (S.D.N.Y. 2002).
[10] Milkovich v. Lorain Journal Co., 497 U.S. 1, 18-20 (1990).
[11] *Id.*
[12] *Id.* at 21.
[13] Newby v. Enron Corp. (In re Enron Corp. Sec., Derivative & “ERISA” Litig.), 511 F. Supp. 2d 742 (S.D. Tex. 2005).
[14] *Id*. at 817.
[15] 472 U.S. 749, 761 (1985).
[16] *Id.* quoting Connick v. Myers, 461 U.S. 138, 147-49 (1983).
[17] *Dun & Bradstreet*, 472 U.S. at 759-60.
[18] *Id*.
[19] 580 F. Supp. 2d 630 (S. D. Ohio, 2008).
[20] *Id*. at 640.
[21] 2002 WL 31833223 S.D.N.Y., 2002.
[22] *Id.* at *3.
[23] In re Fitch, Inc., 330 F.3d 104 (2d Cir. 2003). Pan Am Corp. v. Delta Air lines (In re Pan Am Corp.), 161 B.R. 577 (S.D.N.Y. 1993). The court found that Standard and Poor’s had the “requisite newsgathering intent” and therefore the journalist’s privilege applied.
[24] *Grade Inflation*, *supra* note 7.
[25] *Id*.
[26] WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS & WRETCHED EXCESSES ON WALL STREET 331-32 (Doubleday 2009).
[27] *Id*.

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[28] Larry P. Ellsworth and Keith V. Porapaiboon, *Credit Rating Agencies in the Spotlight*, 18 BUSINESS LAW TODAY 1, No. 4 (2009).
[29] New Jersey Carpenters Vacation Fund v. Royal Bank of Scotland Group, PLC, 2010 WL 1172694 at 7-8 (S.D.N.Y. Mar. 26, 2010).
[30] 651 F. Supp. 2d 155 (S.D.N.Y. 2009); *See also* California Public Employees' Retirement System v. Moody's, 2009 WL 3809816 at *3, (N.D. Cal. 2009); and Theresa Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 MINN. L. REV. 140, 147 (2009).
[31] *Abu Dhabi Commercial Bank*, 651 F.Supp. at 174.
[32] *Id*. at 175.
[33] *Id*.
[34] Nagy, *supra* note 30 at 148, *citing* 17 C.F.R. section 230.436(g)(1)(2007) which mandated an express exemption for NRSROs from liability under section 11 of the Securities Act of 1933.
[35] Stephen Barlas and Karen L. Jett, *Corporate Disclosure of Credit Rating Agency Relationships*, STRATEGIC FINANCE BULLETIN, Dec. 2009, p. 22; *See also* the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327.
[36] David Segal, *Rating Agencies' Overhaul Seems to be Losing Steam; Some See Lack of Political Will in Congress*, HOUSTON CHRONICLE, Dec. 8, 2009, at 10.
[37] Rel. No. 34-61050. *SEC Filings Insight*, Vol. 15, Issue 24, December 17, 2009, p. 1.
[38] Ernst & Young, *SEC Proposal: Credit Ratings Disclosure*, No. 2009-45, Nov. 11, 2009.
[39] *SEC Adopts NRSRO Rules and Proposes Additional Rules*, 15 SEC FILINGS INSIGHT 1, 3 (2009).
[40] Ellsworth and Porapaiboon, *supra* note 28 at 3.
[41] H.R. Con. Res. 4173, 111th Cong. (2010) (enacted).
[42] Shearman & Sterling Client Publication, *SEC Proposes Mandatory Credit Ratings Disclosure*, Dec. 2, 2009.
[43] H.R. Con. Res. 4173, *supra* note 41, Title V, Subtitle B: Accountability and Transparency in Rating Agencies Act (Sec. 6012).
[44] Shearman & Sterling, *supra* note 42.
[45] The Rating Accountability and Transparency Enhancement Act (the RATE Act), H.R. 3214, 111th Cong. (2009), and S. 1073, 111th Cong. (2009). Enacted as Title V, Subtitle B, *supra* note 43.
[46] H.R. Con. Res. 4173, *supra* note 43 (Sec. 6003).
[47] *Id*. (Sec. 6013).

[48] Deven Sharma, *Why Rating Requirements Don't Make Sense*, THE WALL ST. J., Jan. 19, 2010, at A-23.
[49] Serena Ng, *Ex-Moody's' Analyst to Testify on Industry's Conflicts of Interest*, THE WALL ST. J., Sept. 24, 2009, at C-3.
[50] Scannell and Lucchetti, *supra* note 1.
[51] Aaron Lucchetti, *Big Credit Rating Firms Agree to Reforms*, THE WALL ST. J., June 6, 2008, at C-3.

IRS PRESSES FOR TRANSPARENCY ON TAX ACCRUALS

By

Martin H. Zern *

The art of taxation consists in so plucking the goose as to procure the greatest quantity of feathers with the least possible amount of hissing.

—JEAN-BAPTISTE COLBERT

I. INTRODUCTION

Recently, the Internal Revenue Service (IRS) announced that corporations and businesses generally will be required to reflect on their tax returns any tax position that is considered inconsistent with Financial Accounting Standard Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes, or similar financial reporting standards.[1] To this end, the IRS has developed a new form (Form 1120 Schedule UTP) that will have to be filed annually by some corporations.[2]

Clearly, the IRS is seeking more transparency from corporations and businesses in general regarding their tax planning ventures, which some may categorize as tax evasion schemes or even scams. No doubt the government's stance is attributable to its need for more revenue and the overall tone of hostility by much of the general public to large corporations in light of the recent – and perhaps continuing – financial crisis. Many believe that corporations are unfairly reducing their tax liability by utilization of aggressive corporate tax shelters that often have no purpose other than tax reduction.

The posture of the IRS in pressing corporations for more transparency seems partly attributable to a recent favorable court decision involving Textron Inc. that considered whether

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the IRS is entitled to review corporate tax accrual work papers. This article will analyze this decision by the First Circuit Court of Appeals. Despite an important IRS victory in this case, IRS Commissioner Shulman noted the IRS will continue to exercise “restraint” in seeking tax accrual work papers, which often include the corporation’s tax reserve amount and assessment of risk on owing more taxes relative to certain transactions. Not so moderate, will be a requirement that taxpayers disclose “uncertain tax positions” with their tax return. All the details are yet to be promulgated by the IRS regarding the factors that tax advisors will have to consider in making a determination as to whether a tax position is uncertain. Of course, there are different degrees of uncertainty. The disclosure of uncertain tax positions would have to be made at the “time of filing” using Schedule UTP.

Commissioner Shulman observed that “[t]oday, we spend up to 25% of our time during large corporate audits searching for issues rather than having a straightforward discussion with the taxpayer about the issues.” According to the Commissioner, the IRS goal is to complete an audit while reducing the time looking for information. Initially, business taxpayers with assets over $100 million that have financial statements prepared under FASB Interpretation No. 48 or similar accounting standards, and which reflect uncertain tax positions, will have to disclose such information when their tax returns are filed. This will extend to taxpayers with assets over $10 million under a 5-year phase in.[3] The Commissioner noted that a “concise” statement of the tax position will suffice.

The Commissioner stated that business taxpayers will not be required to disclose their risk assessment – that is, how strong or weak they regard a tax position -- or how much they reserved on their books. The IRS is taking a "reasonable approach" and that "[w]e could have asked for more – a lot more – but chose not to." By so stating, it appears that the IRS is making a veiled threat to business taxpayers that are not more forthcoming in disclosing potentially uncertain tax positions. Another major reason for seeking more transparency is the IRS goal of becoming more efficient. Obviously, the IRS does not want its auditors spending numerous man-hours hunting for issues that might result in a tax assessment with the time and effort expended to no avail.

II. TEXTRON

On August 13, 2009, the First Circuit Court of Appeals decided *United States of America v. Textron Inc. and Subsidiaries.*[4] The case was appealed from the United States District Court for the District of Rhode Island, which had rendered a decision in favor of Textron, holding that the IRS was not entitled to Textron's tax accrual work papers. The case was appealed to the First Circuit Court of Appeals and initially heard by a three judge panel, which affirmed the District Court 2 to 1. While this would have normally been the end of the case, the government requested a further hearing, *en banc*, which was granted. In a 3 to 2 decision, the First Circuit reversed itself, holding that the IRS was entitled to access to Textron's tax accrual work papers.

The government's persistence in *Textron* is consistent with its efforts in recent years to attack the use by corporations of aggressive, and possibly illegal, tax shelters. The importance of this case to both the IRS and taxpayers can be gleaned from the effort put in by the government in pursuing an ongoing controversy regarding disclosure of tax accrual work papers. Six high-level Government lawyers were involved in the case while Textron was represented by two major law firms. Corporate concern about the case is evidenced by the fact that a law professor, the National Chamber of Commerce Litigation Center, Inc. and the Association of Corporate Council submitted *amicus curiae* briefs on behalf of Textron.[5]

Textron, Inc. is a publicly traded major aerospace and defense conglomerate with well over 100 subsidiaries. It files a consolidated income tax return and is audited regularly by the IRS. As a publicly trade company, its financial statements must be certified by an independent auditor.[6] The financial statements must show reserves to account for contingent tax liabilities and must reflect an estimate of potential tax liability in the event of an IRS audit. The reserves are supported by work papers upon which the independent auditor relies in order to certify that the financial statements are correct.

Textron's tax department lists items in its tax return that if identified and challenged by the IRS could result in an additional tax assessment. Spreadsheets list each debatable item with the dollar amount subject to challenge along with a percentage estimate of the IRS's chances of success. The book reserve is calculated by multiplying the percentage times the questionable item stated in dollars. Work papers, backed up by emails and other notes, support the calculations. The Supreme Court has noted that access to tax accrual work papers would give the IRS the ability to "pinpoint the soft spots" on a company's tax return to support additional tax liability.[7]

The IRS has not automatically requested tax accrual work papers. But as a result of corporate scandals like Enron, it began seeking work papers where it believed that the taxpayer had engaged in certain “listed transactions” the IRS has concluded might manifest tax evasion.[8]

The Textron case evolved from a 2003 audit of its tax returns for 1998-2001, which revealed that in 2001 Textron had engaged in nine listed transactions through one of its subsidiaries involving equipment purchases from a foreign entity with a lease back, on the same day, to the seller. These deals are known as sale-in, lease-out (SILO), transactions, which are listed by the IRS as possibly abusive tax shelters.[9]

Textron had shown its work papers to its outside auditor, Ernst & Young, but refused to show them to the IRS auditors. In response, the IRS issued an administrative summons seeking relevant documents.[10] If only one transaction is questionable, IRS policy is to seek work papers for that transaction. However, where more than one transaction is involved, the IRS policy is to request all the work papers for the tax year.[11] When Textron refused to abide by the summons, the IRS initiated an enforcement action in District Court in Rhode Island.[12] As a defense, Textron asserted attorney-client and tax practitioner privileges, and the qualified privilege for litigation materials under the work product doctrine. The IRS challenged the privilege claims.

At trial, evidence revealed that Textron’s work papers were prepared by its in-house tax lawyers and that outside counsel had been retained to advise Textron on its tax reserve requirements. Textron admitted that in some instances its spreadsheets estimated the probability of IRS success on a challenge to the transaction at 100%. Textron also noted that although its spreadsheets had been shown to and discussed with its outside auditor Textron retained them. Testimony on behalf of Textron asserted that litigation over specific items on its spreadsheets was always a possibility. The IRS agreed but claimed this was unlikely.

The trial court denied the IRS petition for enforcement.[13] It agreed that the IRS had a legitimate reason for seeking the work papers and that Textron waived the attorney-client privilege and the tax practitioner privilege for non-lawyers by showing the work papers to Ernst & Young. Nevertheless, it concluded that the work papers were protected by the work product privilege derived from the Supreme Court decision in *Hickman v. Taylor*[14] and since codified in Rule 26 (b)(3) of the Federal Rules of Civil Procedure. The court concluded that the work papers served to satisfy Textron's outside auditors that its tax reserve was satisfactory so that it could get a "clean" opinion. However, the work papers, which showed estimated hazards of litigation percentages, would not have been prepared "but for" the fact that Textron anticipated litigation with the IRS.

Although it had initially affirmed the District Court decision, after the *en banc* rehearing, the First Circuit reversed holding that the work product privilege did not apply. The court claimed that in so holding it was reaffirming its prior decision in *Maine v. United States Dep't of Interior*.[15]

The court observed that the work product privilege derived from the Supreme Court's decision in *Hickman*, where there was ongoing litigation, and where the focus was on typical papers lawyers prepare for litigation. Often, such material and other items that are planned for use at trial are not obtained from or shared with clients and therefore are unprotected by the attorney-client privilege. *Hickman* dealt with whether an adverse party could inquire into oral or written statements secured by opposing counsel in preparation for litigation that had already commenced. *Hickman* cited a privilege in English courts protecting documents prepared for, but not necessarily only for, assisting advisors in actual or anticipated litigation. Such documents (which might be interviews, memoranda, correspondence briefs, mental impressions, personal beliefs, outlines for cross examination and countless other items) are termed the work product of the lawyer. *Hickman* concluded that the witness interviews were protected by the work product privilege.

The court stated that the IRS was correct in asserting that the immediate motivation for Textron to prepare tax accrual work papers was to establish the tax reserve on its books and get a clean opinion. Further, that no reserve would have been necessary unless there was the possibility of the IRS disputing a transaction. The court observed, however, that the district court did not say the work papers were prepared "for use" in litigation, but only that they would cover liabilities that might be determined in litigation. The court concluded that the failure to make a "for use" finding was clearly erroneous.

The court noted that an IRS expert testified that even if litigation were remote, the work papers would still have to be prepared to support Textron's judgment on the reserves. Furthermore, based on Textron's own experience, it was clear that those issues noted with a high percentage of IRS success would never be litigated. Even an academic supporter of Textron concluded that "it is doubtful that tax accrual work papers, which typically just identify and quantify vulnerable return positions, would be useful in the litigation anticipated with respect to those positions."[16]

The court observed that an experienced litigator would not consider tax accrual work papers as litigation materials. The work product privilege has always been on litigation. The privilege will not be triggered by an assertion that the documents in question could relate to a matter that "might conceivably be litigated." As the Supreme Court stated in *Federal Trade Commission v. Grolier, Inc.*, "the literal language of Rule 26(b)(3) protects materials prepared for any litigation or trial as long as they were prepared by or for a party to the subsequent litigation." [17] In considering whether the work product privilege is applicable, the key inquiry is the function the document serves.[18] The court pointed out that the privilege does not attach simply because the work papers were "prepared by lawyers or represent legal thinking." Only if they are used in or in anticipation of trial are they protected. The court mentioned that lawyers who try cases know the "touch and feel" of work product papers.

Citing its *Maine* decision, the court stated that the privilege does not extend to "documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation." The court concluded that *Maine* supported its decision in the present case. Also, the court referred to the only other circuit court case that it believed addressed the issue of privilege for tax accrual work papers. This was the decision of the Fifth Circuit in *United States v. El Paso Co.*[19] This case also denied work product protection employing a "primary purpose" test. The Fifth Circuit found that the "sole function" of the work papers was to support financial statements.

The First Circuit concluded that there was no evidence that Textron's work papers were prepared for use in litigation or that they would serve any useful purpose in conducting litigation. The work papers were prepared because Textron has a legal obligation as an exchange-listed company to comply with the securities laws and generally accepted accounting principles for its certified financial statements.

The court then addressed Textron's argument that it would be "unfair" for the IRS to have access to its spreadsheets. The court stated that "tax collection is not a game," that there is a public interest in revenue collection, and that if a "blueprint" could be found to improper deductions, the IRS was entitled to see it. The court pointed out that the goal is discovering the truth.

The court also seemed concerned with the practical problem the IRS has in discovering the under-reporting of corporate taxes, which it stated was "endemic." Textron's consolidated return was over 4,000 pages. The IRS requested the work papers only after finding specified abusive transactions. Discovery tools granted to the IRS were deemed to be essential to the collection of revenues.

The court held that the work product privilege was aimed at protecting work done for litigation, and not for preparing financial statements and seeking auditor approval. Further, "IRS access serves the legitimate and important function of detecting and disallowing abusive tax shelters."

The two dissenters asserted that the majority abandoned the First Circuit's "because of" test set forth in its prior decision in *Maine*, which asks whether "in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation." The "because of" test stemmed from the Second Circuit's decision in *United States v. Adlman*.[20] They argued that the majority adopted a new standard, "prepared for use in possible litigation," a test the dissenters opined is even narrower (i.e., less likely that documents would be privileged) than the widely rejected "primary motivating purpose" test used in the Fifth Circuit and specifically rejected by the First Circuit. They further argued that the majority ignored a "tome" of circuit court precedents regarding the work-product doctrine and, consequently, they contravened much of the principles regarding the work-product doctrine.

The dissenters would follow neither the majority's "prepared for use in possible litigation" test, which they argued was a new narrower test, nor the "primary motivating purpose" test of the Fifth Circuit. They believed that the "because of" test in *Maine*, which they claimed was ignored by the majority, was the correct test and one more in line with five other circuit courts of appeals. Furthermore, they claimed that the majority brushed aside the clear text of Rule 26(b)(3), which refers to documents prepared to aid in the conduct of litigation. They also asserted that the majority ignored the findings of the District Court, which were not clearly erroneous.

The minority also disagreed about the majority's reliance on *Maine*. In that case, the state of Maine had sought documents from the Department of the Interior regarding its decision to classify salmon as a protected species. The District Court found some of the documents to be unprotected since the Department had not shown that litigation was the "primary motivating factor" underlying their preparation. On the *Maine* appeal, the dissenters pointed out that "we….repudiated this test and adopted the broader 'because of' test adopted by the Second Circuit."[21] The "because of" test the dissenters argued is appropriate where there is a dual purpose for preparation of the documents: both business purpose and anticipation of litigation. They also asserted that documents should be protected if they are prepared simply *to aid* in litigation – as stated in Rule 26(b)(3) – much less primarily or exclusively to aid in litigation. Preparing a document "in anticipation of litigation," the dissenters believed, was sufficient for it to be protected. They felt that the proper test had been spelled out in

Adlman, which the dissenters opined was adopted by the First Circuit in *Maine*, and that "[t]he majority's opinion is simply stunning in its failure to even acknowledge this language and its suggestion that it is respecting rather than overruling *Maine*."[22]

The dissenters concluded that while the majority's decision might please the IRS and tax scholars that view discovery as a means of combating fraud, the decision threw the doctrine of work product doctrine into disarray, an issue on which circuit courts of appeal are split. They believed that the issue was "ripe" for hearing by the Supreme Court to clarify this important issue.[23]

Textron filed a petition for *certiorari* with the U.S. Supreme Court seeking review of the First Circuit ruling. The importance of the *Textron* case, at least to litigators, is evidenced by the fact that at least eleven interested parties submitted *amicus curiae* briefs to the Supreme Court supporting the appeal.[24]

On May 24, 2010, the Supreme Court declined to hear Textron's appeal, thus letting stand the First Circuit's decision allowing the IRS to demand tax work papers from corporations.[25]

III. CONCLUSION

Since finding the truth is the primary purpose behind all discovery tools, privilege claims must be carefully scrutinized. Concerning tax accrual work papers, the standards promulgated by the courts to determine whether there is protection from discovery requests are the "but for" and "primary use" tests. Textron failed both.

In recent years, there has been considerable pressure for both government and corporations to be more transparent. This is the goal of the IRS when tax collections are down and the government faces large budget deficits. In this regard, the IRS has pressed for disclosure by foreign financial institutions of bank accounts owned by U.S. taxpayers. To avoid more serious penalties, including possible criminal charges, at least 18,000 taxpayers have voluntary disclosed foreign bank accounts. Some foreign banks have reached settlements with the IRS to disclose the names of taxpayers holding accounts in their institutions.

With the approval of both the First and Fifth Circuits behind it, the IRS seemingly could go after tax accrual work papers regularly if it wanted to do so. The decision appears to have created considerable confusion about the parameters of IRS discovery. Also, the decision could have some impact on non-tax litigation. Attorneys may be reluctant to put in writing their candid risk assessment as to the chances of winning or losing since they may not be confident that what they have written will be protected from discovery.[26]

In a subsequent speech to the American Bar Association, Commissioner Shulman stated the IRS is clarifying and strengthening its policy of restraint.[27] He made three points in this regard: (1) Disclosing issues on Schedule UTP would not affect the IRS policy of restraint; (2) Drafts of issue descriptions and information regarding ranking of issues are protected; and (3) the IRS will not seek documents that would otherwise be privileged even though shown to the taxpayer's auditor.

[1] IR-2010-13, Announcement 2010-9. The Announcement was part of Prepared Remarks of IRS Commissioner Doug Shulman to the New York State Bar Association Taxation Section Annual Meeting in New York City on January 26, 2010.

[2] IR-2010-098, Announcements 2010-75 and 76. The Announcements were part of Prepared Remarks of IRS Commissioner Doug Shulman to the American Bar Association in Toronto on September 24, 2010 .

[3] *Id*.

[4] 577 F.3d 21 (1st Cir. 2009); 2009 U.S. App. LEXIS 18103.

[5] The law professor is Professor Claudine v. Pease-Weingenter, Phoenix School of Law.

[6] *See* 15 U.S.C. §§ 781, 78m (2006); 17 C.F.R. § 210 *et seq.* (2009).

[7] *See* United Sates v. Arthur Young & Co., 466 U.S. 805, 812-13 (1983).

[8] *See* Reg. § 1.6011-4(b)(2) (2009).

[9] SILOs allow tax exempt or tax indifferent organizations (e.g., a city owned transit authority) to transfer depreciation and interest deductions, which do not benefit them, to taxpayers who can use the deductions to shelter other income. If the only motive for the transaction is tax avoidance, the IRS could disallow the benefits on the theory that there is no business purpose.

[10] Pursuant to IRC §7602 (2006).

[11] IRS Announcement 2002-63, 2002-27 IRB 72 (July 8, 2002).

[12] *See* IRC §7604(a) (2006).

[13] United States v. Textron Inc., 507 F. Supp. 2d 138, 150, 155 (D.R.I. 2007).

[14] 329 U.S. 495 (1947).

[15] 298 F. 3d 60 (1st Cir, 2002).

[16] Pease-Weingenter, *The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of United States v. Textron*, 8 Houston Bus. & Tax L.J. 337, 346 (2008).

[17] 462 U.S. 19, 25 (1983).

[18] Coastal States Gas Corp. v. Dep't of Energy, 617 F. 2d 854, 858 (D.C. Cir. 1980). (other citations omitted by author).

[19] 682 F. 2d 530, 543 (5th Cir. 1982), *cert. denied*, 66 U.S. 944 (1984).

[20] 134 F.2d 1194, 1202 (2d Cir. 1998).

[21] *Id*.

[22] *Supra* 4 at 38.

[23] *Supra* 4 at 65.

[24] Roger Russell, *Supremes Mull Textron Petition*, Accounting Today, Vol. 24, No. 4, April 19-May 9, 2010, at 10.

[25] *Supreme Court Nixes Textron Appeal in IRS Case*, WebCPA (by WebCPA staff), May 24, 2010, http://www.webcpa.com.; 2010 LEXIS U.S. App. LEXIS 13226.

[26] *Id*.

[27] *Supra* 2.

LEGAL INSIGHTS ON MANDATORY FLU VACCINATIONS

by

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INTRODUCTION

The 2009-2010 swine flu pandemic was an historic health event of global proportion. The first influenza pandemic in over 40 years affected communities in virtually every country throughout the world. Although the recent pandemic has abated, questions regarding how it was handled and the consequences from the response remain unanswered. This article first enunciates, background information about the H1N1 flu, its global reach and subsequent responses by government and public health agencies are discussed. Next the recent controversy over mandatory H1N1 flu vaccination policies for employees, particularly those in health care fields, is examined. The debate in New York State over its Department of Health flu vaccination mandate and potential legal challenges to mandatory flu vaccination policies follows. As a conclusion, managerial suggestions to avoid employee litigation are presented.

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THE SPREAD OF H1N1

According to the Mayo Clinic[1] H1N1, popularly known as swine flu, is a respiratory infection caused by an influenza virus. This new virus, officially called swine influenza A (H1N1), contains genetic material from human, swine, and avian flu viruses. Initial H1N1 symptoms are similar to those of seasonal flu: high fever, cough, sore throat, chills and body aches, fatigue, and the like. However, unlike the common seasonal flu virus, H1N1 spreads quickly and easily to young, otherwise healthy people, rather than to the infirm or elderly. Those particularly at risk include children, college students, pregnant women, and health care workers who provide direct patient care.

Outbreak Timeline

The first cases of H1N1 in the United States, appearing in two children, were confirmed in southern California by the Centers for Disease Control and Prevention (CDC) on April 21, 2009.[2] Three days later, Mexico announced that it had hundreds of cases and 68 people had died.[3] Seventy-five New York City students, some of whom had recently returned from Mexico, were immediately tested for flu-like symptoms; 28 tested positive for H1N1.[4]

On April 26, the U.S. government declared a public health emergency.[5] The CDC advised Americans to postpone nonessential trips to Mexico the next day. There were now 40 confirmed cases in the United States and, within days, H1N1 illness was confirmed in several other countries including Canada, Germany, Israel, Spain, and New Zealand.[6]

By June 1, the CDC reported that more than 10,000 cases of H1N1 were confirmed in the United States. On June 11, 2009, with nearly 30,000 people infected in 74 countries, the World Health Organization (WHO) raised its swine flu alert to its highest level – Phase 6 – signifying widespread human infection and "community level transmission" in two or more regions of the world.[7] This alert was not related to the severity of the illness, but to its rapid and extensive transmission. The H1N1 influenza virus was now a worldwide pandemic.

Notably, no effective vaccine to protect against the H1N1 virus existed at the time of the WHO Phase 6 alert. Simultaneously, the CDC was projecting as many as 90,000 anticipated flu-related fatalities in the United States alone.[8] Given the potential for a pandemic, Margaret Chan, Director General of the World Health Organization, called upon flu vaccine manufacturers to "quickly prepare commercial-scale pandemic vaccine."[9] The H1N1 vaccine became available in October, 2009.

CONTROVERSY OVER MANDATORY VACCINATION POLICIES

Considerable controversy erupted when some health officials sought mandatory vaccination of health care workers. In light of the declared pandemic, the resistance of the H1N1 virus to Tamiflu (the most frequently prescribed medicine for flu treatment), and the widespread exposure that health care workers would face in the event of contagion, some public officials and health administrators felt mandatory vaccination of health care workers was a first line of defense.[10]

New York State became the first state to require that all health care workers be vaccinated. On August 13, 2009, the State Hospital Review and Planning Council adopted an emergency regulation, recommended by the New York State Health Department, requiring seasonal influenza vaccination and H1N1 vaccination, when available, of health care workers in hospitals, outpatient clinics, and home care services.[11] Some hospitals in other states also required vaccination as a condition of employment. MedStar Health system, located in the Washington-Baltimore region, required all its 26,000 employees to get the seasonal flu shot. For the past five years, Virginia Mason Medical Center in Seattle mandated seasonal flu vaccines and subsequently also the H1N1 vaccine.[12] Legal challenges arose in New York, Washington State, and across the nation as health care workers sued over mandatory flu vaccinations.[13] As discussed below, both proponents and opponents of mandatory vaccination policies had reasonable grounds for their respective positions.

Proponents of Mandatory Vaccination

With the onslaught of H1N1 cases, public health officials and employers had good reason to be concerned about its rapid spread. The Centers for Disease Control and Prevention (CDC) estimated that between 34 million and 67 million cases of H1N1 occurred between April and November 14, 2009.[14] In contrast to the typical seasonal influenza, the CDC estimates that on average about 36,000 people die of flu-related causes each year, with 90 percent of deaths usually occurring in people age 65 and older.[15]

Proponents of mandatory vaccination believed such a policy would not only prevent health care workers from contracting the flu, with its associated absenteeism and lost productivity, it would also help prevent health care workers from transmitting flu to patients. Even prior to the H1N1 outbreak, some public health officials were calling for mandatory seasonal influenza vaccination of health care workers as a precautionary measure to protect both health care workers and patients.[16] Only 49 percent of all health care workers in the United States voluntarily take the flu shot each year.[17] A recent study of a large Midwestern health care organization with 26,000 employees found voluntary immunization plans led to low immunization rates while a mandatory vaccination policy increased immunization rates to ninety-eight percent among health care workers.[18]

Opponents of Mandatory Vaccination

On the other hand, opponents cited a number of reasons why they were against mandatory vaccinations. Foremost among these were concerns about the safety of the new H1N1 vaccine.[19] In concert with this view, the Czech Defense Ministry retreated on compulsory vaccination of all armed forces personnel for swine flu after President Václav Klaus condemned the policy. In a widely publicized statement, President Klaus stated,

> It would be justifiable in an acute epidemic situation, but we are clearly not in such a situation. My civic opinion is enforced by the health risks of being vaccinated, which have led to public disagreement among our health professionals. Soldiers cannot be regarded as an experimental sample upon whom vaccinations tests can be practiced without their consent. Therefore, I call on the defense minister and the chief of general staff of the army to consider whether the decision on vaccination should not be left up to individual soldiers.[20]

Other concerns raised were the deaths and incidences of Guillane-Barre syndrome associated with the flu vaccine in 1976 as well as violation of personal freedom.[21]

NEW YORK STATE'S MANDATORY VACCINATION

The June 24, 2009 New York State Register noted that the Department of Health was considering regulatory action requiring health care workers to be vaccinated for influenza. On July 23, the State Hospital Review and Planning Council met to discuss emergency adoption of the immunization requirement.[22] On August 13, 2009, New York State became the first state to require that all health care workers be vaccinated when the State Hospital Review and Planning Council subsequently adopted an emergency regulation recommended by the New York State Health Department. The emergency regulation consisted of the addition of Subpart 66-3 entitled "Health Care Facility Personnel-Influenza Vaccination Requirements" to Title 10 of the New York Codes, Rules and Regulations.[23]

> 66-3 Immunization - Amend the regulations to add Subpart 66-3 to Title 10 to require certain regulated facilities to document as a precondition of employment and annually, immunizations for influenza virus for specified health care personnel employed or affiliated with a health care facility. The requirement is subject to the availability of an adequate supply of the necessary vaccine and exemptions for medical contraindications. In addition, parallel regulatory changes are proposed to Sections 405.3 (hospitals), 751.6 (diagnostic and treatment facilities), 763.13 and 766.11 (home health agencies and programs), and 793.5 (hospices) of Title 10. Any facility defined as a hospital or diagnostic and treatment centers pursuant to PHL Article 28, home care agency within PHL Article 36, or hospice within PHL

> Article 40 will be required to comply with the referenced requirements detailed in Subpart 66-3.[24]

The emergency regulation required seasonal influenza vaccinations by November 30th and H1N1 vaccinations, when available, as a condition of employment for health care workers in hospitals, outpatient clinics, and home care services.[25] Exceptions were allowed where medically contraindicated when a physician determined that vaccination would be detrimental to the health of the individual. The New York State Department of Health followed up with a letter dated August 26, 2009, accompanied by a Question and Answer attachment to all health care administrators informing their health facilities of the particulars of the mandate.[26]

Immediately upon announcement of the emergency regulation, New York health care workers and their unions began to protest and commence litigation. The New York State Public Employees Federation (PEF) requested a temporary restraining order against implementation of the emergency regulation. On October 16, 2009, Judge Thomas McNamara, of the State Supreme Court in Albany, granted a temporary restraining order. Judge McNamara scheduled a hearing for October 30th to determine whether or not to make the restraining order permanent.[27]

In addition to PEF, Suzanne Field, a registered nurse in Dutchess County, filed a petition for a temporary restraining order against the emergency regulation with the Supreme Court of New York, New York County on October 6, 2009.[28] Similar lawsuits were filed by four nurses in Albany and the New York State United Teachers Union.[29]

On October 23, 2009, New York State Health Commissioner Richard Daines announced the suspension of the flu vaccine mandate for health care workers. Citing the shortage of both H1N1 and seasonal flu vaccine, the Commissioner contended that:

> …these circumstances set up a dynamic where health care personnel covered under the regulation might compete for vaccine with persons with underlying risk factors for adverse outcome of influenza infection. In a situation where the choice to vaccinate is between health care personnel and persons at risk, I have always held that patients take precedence. Maintaining the health care personnel vaccination requirement would delay persons in need from being vaccinated. For these reasons, I have determined that there will not be sufficient supplies of either vaccine to meet the intent of the regulation in the 2009-2010 influenza seasons.[30]

LEGAL ISSUES WITH MANDATORY VACCINATIONS

Employers can legally require employees to get vaccinated provided their policy permits medical and religious exemptions. The New York Department of Health pointed out that state courts previously held that health care workers could be required to be vaccinated against rubella and tuberculosis.[31] Despite the legality of mandatory vaccination policies, prudence would dictate that an employer tread carefully and seek legal counsel before instituting one. Mandatory vaccination policies can be challenged on a variety of bases which make such policies a legal mine field. These challenges are discussed below.

Religious Discrimination Claims

Under Title VII of the Civil Rights Act of 1964, employers are legally required to accommodate the sincerely held religious beliefs and practices of their employees. All 50 states also prohibit religious discrimination in employment, as well as many municipalities.[32]

Notably, some religions have objections to the use of modern medicine.[33] Christian Scientists, for example, may choose to rely on prayer rather than medicine as a remedy to health problems. While the church's official position is that their adherents are free to take vaccinations, it nonetheless appears that choosing not to be vaccinated may be equally acceptable to church authorities. As noted on the church's website:

> Generally, a Christian Scientist's first choice is to rely on prayer for healing, and in most cases, this means that a medical remedy is unnecessary. There is no biblical or church mandate to forgo medical intervention, nor do Christian Scientists believe that it's God's will that anyone suffer or die. A Christian Scientist's decision to rely on prayer comes from trust, not blind faith, in God, and from a conviction that God's care continues under every circumstance….. Christian Scientists care about their neighbors and fellow community members and gladly abide by city and state laws or mandates regarding quarantines, vaccinations, and the like. The Christian Science Journal, Christian Science Sentinel, and The Herald of Christian Science also contain

> documented healings of communicable diseases and show the role prayer can play, not just in protecting and healing individuals, but in helping communities as well…[34]

Employees who have strong religious beliefs barring them from taking vaccinations may seek a religious exemption to avoid vaccination. Note that the employee does not have to belong to an organized religion to be accorded legal protection. The Supreme Court expanded the test for defining religious belief in its decision in Welsh v. United States.[35] In that decision, Justice Black held that deeply and sincerely held beliefs that are purely ethical or moral in source and content but that nevertheless impose a duty of conscience meet the statutory definition of a religious belief. The EEOC further elaborated on this issue in its 1980 Guidelines on Discrimination because of Religion in which the EEOC stated that "The fact that no religious group espouses such beliefs or the fact that the religious group to which the individual professes to belong may not accept such belief will not determine whether the belief is a religious belief of the employee or prospective employee.[36]

Thus employees confronted with a mandatory vaccination policy have the legal right to ask the employer for an accommodation for their religious beliefs. Once an employer is put on notice, they have the legal duty to reasonably accommodate the employee to the extent that it does not create undue hardship. The definition of undue hardship is essentially any accommodation that would be unduly costly, extensive, substantial, disruptive, or that would fundamentally alter the nature or operation of the business. Furthermore, the Supreme Court ruled in TWA v. Hardison[37] that the obligation to accommodate religious beliefs and practices is a de minimis one.[38] Note that the de minimis standard is a lower one than that under the Americans with Disability Act. As noted in Ansonia Board of Education v. Philbrook,[39] when an employer offers an employee a reasonable accommodation, it has discharged its statutory duty. Undue hardship only becomes an issue when the employer is not able to offer any accommodation.

To establish a prima facie religious accommodation claim, an employee must establish that: (1) they had a bona fide religious belief that conflicts with an employment requirement; (2) they informed the employer of this belief and requested accommodation; and (3) they were disciplined for failure to comply with the conflicting employment requirement.[40] If the employee establishes a prima facie case, the burden then shifts to the employer to show that: (1) it did offer a reasonable accommodation or (2) it could not accommodate the plaintiff's religious needs without undue hardship.

Americans with Disability Act (ADA) Claims

The EEOC recently issued a guidance on Pandemic Preparedness in the Workplace and the Americans with Disabilities Act.[41] The guidance notes that the ADA protects workers from disability discrimination in at least three ways:

1. It regulates disability related inquiries and medical examinations, including those who do not have a statutorily defined disability.
2. An employer may not exclude an individual from employment for safety and health reasons unless they pose a “direct threat” to themselves or others, with or without reasonable accommodation.
3. The ADA requires employers to reasonably accommodate individuals with disabilities to the extent that it does not create an undue hardship.

Clearly the ADA provides strong protections for employees who do not wish to be vaccinated. Employers are not permitted to ask general questions of an applicant concerning whether they have a disability or about the severity of their disability. This would preclude asking workers to disclose a chronic health condition that would make a vaccination dangerous to a worker. Additionally, if a vaccination was medically contraindicated, such as an employee having an allergic reaction to eggs, the employee would have sound legal grounds to ask for a reasonable accommodation.

In its guidance on pandemic preparedness, the EEOC addresses head on whether an employer has the right under the ADA and Title VII to compel all workers to take the influenza vaccine regardless of their medical conditions or religious beliefs. The EEOC's response was a resounding "no."

> An employee may be entitled to an exemption from a mandatory vaccination requirement based on an ADA disability that prevents him from taking the influenza vaccine. This would be a reasonable accommodation barring undue hardship (significant difficulty or expense). Similarly, under Title VII of the Civil Rights Act of 1964, once an employer receives notice that an employee's sincerely held religious belief, practice, or observance prevents him from taking the influenza vaccine, the employer must provide a reasonable accommodation unless it would pose an undue hardship as defined by Title VII ("more than de minimis cost" to the operation of the employer's business, which is a lower standard than under the ADA). Generally, ADA-covered employers should consider simply encouraging employees to get the influenza vaccine rather than requiring them to take it.[42]

Furthermore, if adverse action were taken against an employee who refused to be vaccinated, the employee could also conceivably bring a claim that they were discharged because they were regarded as disabled. In 2008, the amendments to the Americans with Disabilities Act greatly expanded the definition of disability in favor of broad coverage of individuals.[43]

Other Legal Claims

Other legal avenues remain open to workers who oppose mandatory vaccinations. If the employee is a public employee, they also enjoy constitutional protections in their employer-employee relationship. Employees retain a privacy interest in their own body.[44] It is possible for an objecting state or local public employee to conceivably bring a Fourth Amendment Claim for unwarranted search and seizure.[45] Additionally, they could possibly bring a Fourteenth Amendment claim. Section one of the Fourteenth Amendment states that:

> All persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.[46]

Absent a decree by public health authorities mandating vaccination of all citizens during a pandemic, it is conceivable that a public employee could claim violation of their liberty with a mandatory vaccination policy.

Worker's compensation claims are yet another potential legal recourse for workers subjected to mandatory vaccinations. If the employee suffers an adverse reaction from the vaccine such as a fever, rash or other side effect, they may be able to file a worker's compensation claim.

Common law tort claims are another possible legal recourse. Tort claims such as invasion of privacy or intentional infliction of emotional distress could be filed against the employer.

CONCLUSION

Employers may legally require their employees to take influenza vaccinations if they provide exemptions for religious objections and medical contraindications.[47] If the employer chooses to mandate vaccinations, having employees sign a release prior to vaccination would be advisable.[48] Prudence, however, may recommend not mandating vaccinations given the many possible causes of action for which an employer could be held liable.

A less legally fraught course of action may be to have a voluntary vaccination program with inducements for employees to participate. Employers may undertake such incentives as free or low-cost vaccinations, easy access to flu clinics at the work site, flexible vaccination hours, and education about the advisability of taking the vaccine.

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