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CORPORATE EXPENDITURES IN SUPPORT OF, OR AGAINST POLITICAL CANDIDATES: HAS THE LEGAL LANDSCAPE CHANGED AFTER THE BCRA AND *CITIZENS UNITED*?

by

Glen M. Vogel*

"I think we are at a very critical time in this country. I can tell you beyond a shadow of a doubt that uh, the Hillary Clinton that I know is not equipped, not qualified to be our commander in chief."[1]

The public's ability to discuss and debate the character and fitness of presidential candidates is at the core of the First Amendment's prohibition that, "Congress shall make no law . . . abridging the Freedom of Speech."[2] Despite the existence of this fundamental right, articulated so eloquently in our founding document, in November 2002, Congress made political speech a felony for one class of speakers – corporations and unions.[3]

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Under the McCain-Feingold Campaign Finance Reform Law ("McCain Feingold law"), corporations and unions faced monetary penalties and up to five years in prison for broadcasting candidate-related advocacy during federal elections.[4]

Outlawing political speech based on the identity of the speaker appears to collide with the fundamental principles set forth in the First Amendment. On January 10, 2010, the United States Supreme Court addressed this collision in *Citizens United v. Federal Elections Commission*.[5]

In one of the most controversial decisions in decades, the Supreme Court, in *Citizens United*, invalidated the portions of the McCain-Feingold law that dealt directly with corporate expenditures in support of political candidates.[6] This decision set off an eruption of political debate and fierce partisanship.[7] Some legal scholars and journalists called the decision "wrongheaded" and claimed the decision was made in "bad faith."[8] Still others characterized Justice Kennedy's majority opinion as "more like the ranting of a right-wing talk show host than the rational view of a justice with a sense of political realism."[9] The *New York Times*, in several editorials, blasted the Court and called the decision "disastrous,"[10] "terrible,"[11] and "reckless."[12] In fact, the decision sparked so much controversy that President Obama "called out" the Court and specifically referred to *Citizens United* during his State of the Union Address in January 2009.[13] According to President Obama, "the Supreme Court reversed a century of law that I believe will open the floodgates for special interests – including foreign corporations – to spend without limit in our elections. I don't think American elections should be bankrolled by America's most powerful interests, or worse, by foreign entities…."[14]

The Court's decision in *Citizens United* unleashed a torrential wave of criticism from the media along with raising

new questions and concerns from corporations who were unsure about how this decision impacted the rules governing the area of corporate expenditures and it left many companies afraid to run afoul of the law since there are criminal penalties at stake.[15] Businesses are afraid to use their funds in support of candidates since they are unsure what, if anything, the Court invalidated and what restrictions remain in place when it comes to corporations expending their own funds in support of political parties and/or campaigns.

In order to effectively analyze the impact of the Court's holding in this controversial 5-4 decision, this article will discuss the following: Part I will discuss the case law and regulatory history of campaign finance law in the United States over the past one-hundred years; Part II will look at the campaign finance law at issue in *Citizens United* (the McCain-Feingold law) and some of its critical components; Part III will look at the background of the *Citizens United* case and the Court's holding along with some of its practical implications; Part IV will examine some lesser discussed aspects of the decision as well as the issues that have been misinterpreted by the media; and Part V will offer some conclusions.

A HISTORY OF CAMPAIGN FINANCE LAW

Citizens United was not the first time that the issue of corporate involvement in federal campaigns was debated by litigants or addressed by Congress.[16] Corporations and unions have long faced limits on direct contributions to political campaigns.[17] The first restrictions on corporate involvement in the political process goes back more than a century[18] and was enacted to limit what sponsors considered to be the corporate corrupting influence on the political marketplace.[19]

The start of the 20th century, often identified as the gilded age[20], is known as a period of enormous economic and industrial growth in America. The largest and most influential businesses at the time were railroads, banks, and steel companies owned by the super-rich industrialists and financiers such as Cornelius Vanderbilt, John D. Rockefeller, Andrew W. Mellon, Andrew Carnegie, Henry Flagler, and J.P. Morgan.[21] All of these men were attacked as "robber barons" by critics, who believed they cheated to get their money and that, because of their wealth, they were able to gain tremendous influence over politicians, Congress, and even the Presidency.[22]

The concept of having Congress address the problem of corporate political influence all started with President Theodore Roosevelt's State of the Union address after the 1904 election.[23] Roosevelt was outspoken in his opposition to corporate influence on politics and suggested an outright ban on all contributions by corporations to avoid even the appearance of corruption or influence.[24] Two years later, in 1907, Congress passed the Tillman Act, which prohibited corporations from making any contributions for the purposes of influencing a federal election's outcome.[25] While banning political contributions to candidates, the Tillman Act was silent on the issue of corporations expending their funds on their own in support of or against a candidate.[26] An *independent* expenditure is money spent by a corporation or union in support of a candidate in a manner uncoordinated with any political party or the candidate himself.[27]

While direct contributions to candidates by corporations have been illegal since 1907, it was not until 1947 and the passage of the Taft-Hartley Act that Congress specifically prohibited independent expenditures made in support of a candidate by a corporation or labor union.[28] Immediately after Congress passed the Taft-Hartley Act, President Harry S.

Truman questioned its constitutionality, particularly the independent contributions ban, when he vetoed the bill stating that it was a, "dangerous intrusion on free speech."[29] The bill eventually passed despite the President's opposition, and it did not take long for the Supreme Court to comment on the validity of the statute's new restrictions on corporate expenditures.[30] In 1948, in *United States v. CIO*[31], the Court did not specifically address the constitutionality of the independent expenditure ban; however, four justices in dissent remarked that they had "the gravest doubt" about the constitutionality of the prohibition.[32] Almost a decade later, in *United States v. Automobile Workers*, the Court would take a closer look at the constitutionality of the Taft-Hartley Act's corporate expenditure ban.[33] Here, even though the court held that the expenditure ban, as-applied to the specific facts of the case, appropriately prohibited a union television broadcast that specifically advocated for congressional candidates, the Court never specifically ruled on the constitutionality of the statute as a whole.[34] Again, in dissent, three justices argued that the Court should have addressed the constitutional question and, had it done so, they would have found the ban on independent expenditures unconstitutional.[35] Justice Douglas, in his dissent in the *Automobile Workers* case stated that:

> Some may think that one group or another should not express its views in an election because it is too powerful, because it advocates unpopular ideas, or because it has a record of lawless action. But these are not justifications for withholding First Amendment rights from any group – labor or corporate…. First Amendment rights are part of the heritage of all persons and groups in this country. They are not to be dispensed or withheld merely because we or the Congress thinks the person or group is

worthy or unworthy.[36]

Over the next two decades, the constitutionality of the ban on expenditures would get bantered about or commented upon in *dicta*, but it would never be fully addressed by the courts.[37]

After the Watergate scandal in the early 1970's, Congress took another look at the myriad of issues surrounding the federal campaign finance system and attempted to resolve those issues with the passage of several amendments to the Federal Election Campaign Act of 1971 ("FECA").[38] FECA, originally passed in 1971, along with its 1974 Amendments, is essentially the foundation upon which the most recent campaign finance laws were built.[39] FECA, among other things, established new contribution limits for individuals, political parties, and political action committees ("PACs") and established filing requirements for both contributions and expenditures.[40] While controversial[41], the 1974 Amendments to FECA were Congress's attempt to restore the public's confidence in the integrity of the electoral system and to remedy the loopholes and problems that were identified after the Watergate scandal.[42] Essentially, FECA imposed three different restrictions on corporations' and labor unions' efforts to influence elections.[43] They imposed contribution limitations and banned independent expenditures[44], they imposed fundraising restrictions, and they limited the contributions to political committees and PACs.[45] They also imposed disclosure requirements on PACs for contributions based on the amount contributed, the nature of the contributor, and the contribution's proximity to an election.[46]

Buckley v. Valeo

Shortly after FECA was amended, the Supreme Court reviewed the constitutionality of the new statutory limitations

on campaign contributions and expenditures in *Buckley v. Valeo*.[47] In *Buckley*, the Court was asked to address three major issues: the constitutionality of the limits on direct contributions to candidates, the constitutionality of the independent expenditure ban, and the constitutionality of the disclosure requirements.[48] When the Court examined the provision limiting the amount an individual may expend in support or defeat of a particular candidate, it held, "the governmental interest in preventing corruption and the appearance of corruption is inadequate to justify . . . [the statute's] ceiling on independent expenditures."[49] The Court remarked, "the concept that government may restrict the speech of some elements of our society in order to enhance the relative voice of others is wholly foreign to the First Amendment…."[50] Based upon this First Amendment analysis, the Court applied the strict scrutiny test and held that the limitation on independent expenditures was unconstitutional.[51] The Court pointed out that, "the independent expenditure ceiling . . . fails to serve any substantial governmental interest in stemming the reality or appearance of corruption in the electoral process."[52] Oddly, even though the Court invalidated the independent expenditure limitation provision for individuals, it did not consider the constitutionality of the separate ban on corporate and union independent expenditures.[53]

First National Bank of Boston v. Bellotti

Less than two years after *Buckley*, the Court struck down a state-law prohibition on corporate independent expenditures related to referenda issues in the case of *First National Bank of Boston v. Bellotti*.[54] In *Bellotti*, two national banking associations and three business corporations wanted to spend money to publicize their position on a proposed state constitutional amendment that would have permitted the

legislature to impose a graduated individual income tax.[55] The statute at issue prohibited the corporations from making contributions or expenditures "for the purpose of . . . influencing or affecting the vote on any question submitted to the voters…."[56] Any corporation or corporate officer, director, or agent who violated the statute could be subject to a monetary fine and up to a year imprisonment.[57] The Supreme Court rejected the state statute's prohibition of corporate expenditures related to issue advocacy on the principle that the government does not have the power to ban corporations from speaking on political issues.[58]

> "We thus find no support in the *First Amendment* . . . or in the decisions of this Court, for the proposition that speech that otherwise would be within the protection of the *First Amendment* loses that protection simply because its source is a corporation…."[59]

While the *Bellotti* decision did not address the constitutionality of the State's ban on corporate independent expenditures in support of individual candidates, the Supreme Court has offered that had the issue been analyzed, it would have invalidated the ban on the premise that the First Amendment does not permit restrictions on political speech merely because the speaker is a corporation.[60]

Austin v. Michigan Chamber of Commerce

It was not until 1990, in *Austin v. Michigan State Chamber of Commerce*[61], that the Court finally addressed the issue of corporate independent expenditures head-on. In *Austin*, the Michigan Chamber of Commerce sought to use its general treasury funds to run an advertisement in a local newspaper in support of a candidate who was attempting to fill

a vacancy in the Michigan House of Representatives.[62] Section 54(1) of the Michigan Campaign Finance Act prohibited corporations from making contributions and independent expenditures in connection with state candidate elections.[63] Worse yet, any violation of the prohibition on corporate independent expenditures was punishable as a felony.[64] The Chamber of Commerce initiated an action seeking injunctive relief against enforcement of the Act claiming the prohibition on corporate independent expenditures was unconstitutional and violated the First and Fourteenth Amendments.[65]

While the *Buckley* and *Bellotti* cases were not controlling – because neither case directly addressed the constitutionality of prohibiting corporate independent expenditures in support of a candidate – the Austin Court circumvented the traditional First Amendment analysis utilized in those cases and identified a new governmental interest in limiting political speech: an anti-distortion interest.[66] The Court posited that the Michigan statute at issue was aimed at a "different type of corruption in the political arena: the corrosive and distorting effects of immense aggregations of wealth that are accumulated with the help of the corporate form…."[67] The Court held that, corporate wealth could unfairly influence elections when it is used in the form of independent expenditures, and as such, the State had a "sufficiently compelling rationale to support its restriction…."[68]

Before *Austin*, the Supreme Court had never held that Congress could prohibit independent expenditures for political speech based on the speaker's corporate identity.[69] Thus, the Court's decision in *Austin* was at odds with the longstanding position that believing a particular group "too powerful" is not a basis upon which to deny or withhold First Amendment rights, even if that group is corporate or labor union in form.[70] *Austin* was a notable diversion from the Court's recognition

that First Amendment rights and protections extend to everyone, even corporations.[71] Shortly after *Austin*, Congress took advantage of the judicial support for banning corporate and union independent expenditures and enacted the McCain-Feingold law ("BCRA").

McConnell v. Federal Election Commission and Federal Election Commission v. Wisconsin Right to Life, Inc.

Immediately after the BCRA was enacted, it faced its first challenge in the courts in *McConnell v. Federal Election Commission.*[72] In *McConnell,* multiple plaintiffs asserted that section 203 of the BCRA was an unconstitutional restriction on free speech because the statute's prohibition of "electioneering communications" was applied to more than just express advocacy.[73] The Court rejected this argument and held that section 203 was facially constitutional because the rationale for regulating corporate independent expenditures that were express advocacy could also be applied to ads that are "*the functional equivalent of express advocacy.*"[74] The Court based its holding in *McConnell* on the presumption that these types of expenditures could have the same kind of "corrosive and distorting effect" on the electorate as the expenditures specifically prohibited under *Austin*, and extending that restriction would serve the government's compelling interest in countering those effects.[75] Even though the Supreme Court did not elaborate on the definition of "functional equivalent," they based their opinion on the district court's determination that the BCRA targeted only broadcast ads because those ads are the most effective form of communicating an electioneering message and therefore posed the greatest risk of corruption.[76]

Even though the Court declared § 203 to be facially constitutional with regard to the McConnell ads, it opened the door to future "as-applied" challenges and remarked that such

challenges could be successful on a case-by-case basis.[77] The first successful as-applied challenge came four years later in *Federal Election Commission v. Wisconsin Right to Life, Inc.*[78] Wisconsin Right to Life (WRTL), a non-profit corporation, wished to use its general treasury funds to pay for television advertisements on the issue of the US Senate filibuster of Bush administration judicial nominees.[79] The ads were to be broadcast during the period prohibited by the BCRA – the period immediately preceding the reelection of Wisconsin Senator Russ Feingold.[80] WRTL admitted that some of the funds to be used for the ads had come from corporate donors.[81]

The Supreme Court did not issue a majority opinion in *WRTL*. Rather, the Court splintered into three lines of reasoning. The opinion that is considered the lead opinion, written by Chief Justice Roberts and joined by Justice Alito, provided that the determination in McConnell – that section 203 could constitutionally prohibit ads that were the "functional equivalent" of express advocacy – was still valid.[82] However, Justice Roberts elaborated on that interpretation by stating that, "a court should find that an ad is the functional equivalent of express advocacy only if the ad is susceptible of no reasonable interpretation other than as an appeal to vote for or against a specific candidate."[83] When this new test was applied to the ads to be broadcast by WRTL, the Court found that they were not the functional equivalent of express advocacy because they took a position on a legislative issue and urged the public to contact their representatives rather than specifically advocating for or against a candidate.[84] Importantly, the ads didn't "mention an election, candidacy, political party, or challenger" or "[take] a position on a candidate's character, qualifications, or fitness for office."[85] Justices Scalia, Thomas, and Kennedy disagreed with the functional equivalency test utilized by Justice Roberts, but concurred with Roberts' determination that section 203 was

unconstitutional as applied to WRTL's ads.[86] As a result of their concurrence, Justice Robert's test was identified as the holding in the case.[87] Shortly after the *WRTL* case was decided, the FEC promulgated federal regulations to codify Justice Roberts's rationale.[88]

As a result of the Court's holdings in *Austin*, *McConnell*, and *WRTL*, when the Court was asked to evaluate the validity of a statutory restriction on corporate speech in *Citizens United*, it was faced with two separate but conflicting lines of precedent: the pre-*Austin* line that repeatedly struck down restrictions on free speech based on the speaker's corporate identity and a post-*Austin* line that said it would be acceptable to limit the speech of corporations and unions in certain circumstances. Before looking at how the Court resolved this dilemma, it is important to review the specific sections of the McCain-Feingold statute that were at issue.

THE MCCAIN-FEINGOLD CAMPAIGN FINANCE REFORM LAW

In 2002, Congress passed the Bipartisan Campaign Reform Act[89] ("BCRA"), otherwise known as the McCain-Feingold Act. The McCain-Feingold Act was one of the most far-reaching overhauls of campaign finance law since the 1970's and in broad terms, it banned unlimited corporate donations to national political party committees, put limitations on advertising by organizations not affiliated with parties, and banned the use of corporate and union money for "electioneering communications" – ads that name a federal candidate – within 30 days of a primary election or 60 days of

a general election.[90] The sponsor of the bill, John McCain, stated that the BCRA,

> ". . . seeks to reform the way we finance campaigns for federal office in three major ways. First, BCRA prohibits the national political parties from raising or spending "soft money" (large contributions, often from corporations or labor unions, not permitted in federal elections), and it generally bans state parties from using soft money to finance federal election campaign activity. Second, it increases the hard money contribution limits set by the 1974 amendments to the Federal Election Campaign Act ("FECA"). Finally, the new law prohibits corporations and unions from using soft money to finance broadcast campaign ads close to federal elections (though corporations and unions can finance these ads with hard money through their political action committees), and it requires individuals and unincorporated groups to disclose their spending on these ads. The law represents the most comprehensive congressional reform of our federal campaign finance system since FECA was enacted and amended in the 1970s."[91]

By passing the BCRA, Congress was hoping to stop the unregulated flow of soft money and return the world of campaign finance regulation to its pre-Watergate position where there were defined prohibitions and limits on contributions to political parties.[92] The BCRA was the end result of "a protracted six-year legislative and political struggle"; however, as President Bush was signing the bill into law, the first wave of more than a dozen lawsuits challenging

its constitutionality were already crashing upon the Supreme Court's shores.[93] Since the BCRA's enactment, the Supreme Court has heard several cases addressing various campaign finance issues regulated therein, but none of these cases have been as controversial or had the impact on campaign finance law as *Citizens United*.

The specific BCRA provisions at issue in *Citizens United* were sections 201, 203 and 311[94], all of which served as amendments to the Federal Election Campaign Act of 1971 ("FECA").[95] Section 203 of BCRA regulates using corporate funds for "electioneering communications."[96] In general, an electioneering communication was identified as a "broadcast, cable, or satellite" communications made within 60 days of a general election or 30 days of a primary election.[97] Section 203 continues by restricting corporations and labor unions from funding electioneering communications from their general funds except under certain specific circumstances, such as get-out-the-vote campaigns.[98] Even though certain types of "electioneering communications" are permissible, they are subject to BCRA's disclosure and disclaimer requirements that are delineated under sections 201 and 311.

Section 201 of BCRA contains a donor disclosure provision for electioneering communications.[99] Persons who disburse an aggregate of $10,000 or more a year for the production and airing of electioneering communications are required to file a statement with the Federal Election Commission (FEC).[100] The statement must include the names and addresses of persons who have contributed in excess of $1,000 to accounts funding the communication.[101]

BCRA's section 311 contains a disclaimer provision for electioneering communications.[102] If the candidate or the candidate's political committee did not authorize the

electioneering communication at issue, then the organization responsible for the communication must disclosure that the organization "is responsible for the content of this advertising."[103]

CITIZENS UNITED & *HILLARY: THE MOVIE*

Citizens United is a non-profit corporation with an annual budget of about $12 million.[104] The corporation acquires the majority of these funds via donations from individuals; however, it receives donations from for-profit corporations as well.[105] In January 2008, Citizens United released a 90-minute documentary examining the record, policies, and character of the then-Presidential Democrat primary candidate Hillary Clinton.[106] The documentary, called *Hillary: The Movie*, examined "Hillary Clinton's political background in a critical light"[107], and mainly focused on "five aspects of Hillary's political career: (1) the firing of certain White House staff during her husband's presidency, (2) retaliation against a woman who accused her husband of sexual harassment, (3) violations of finance restrictions during her Senate campaign, (4) her husband's abuse of presidential pardon power, and (5) her record on various political issues."[108] The film was to be released in theaters and on DVD; however, Citizens United desired a broader distribution and arranged to have the movie broadcast on cable through video-on-demand.[109]

Since the documentary was to be broadcast during Clinton's presidential primary campaign, Citizens United was aware that its movie and advertising might be considered electioneering communications and would be subject to BCRA's sections 201, 203 and 311.[110] As a preemptive strike, Citizens United sought an injunction to block the FEC from enforcing those sections on the grounds they violated the First

Amendment to the U.S. Constitution.[111] To Citizens United's disappointment, the broadcast was banned when the Federal Elections Commission declared that the broadcast would violate various provisions of the BCRA.[112] Since the BCRA's drafters anticipated the likelihood of lawsuits questioning its validity[113], it contains a provision that specifically addresses constitutional challenges to its various prohibitions.[114] This provision requires that these claims be brought before a three-judge panel of the United States District Court for the District of Columbia.[115] Appeals from this court go directly to the United States Supreme Court.[116] As a result of these jurisdictional restrictions, Citizens United went to the District Court for injunctive relief but its application was denied.[117] Citizens United immediately appealed to the Supreme Court.

Supreme Court Elects to Examine the BCRA on its Face

When analyzing the numerous arguments presented in *Citizens United*, the Court determined that "in the exercise of judicial responsibility," it needed to examine the validity of the BCRA on its face, and not on the narrower grounds suggested by the litigants and the holdings of earlier decisions, because to do so would lead to further litigation and, in the interim, political speech would be chilled.[118] The Court rejected Citizens United's as-applied challenges based on the finding that the documentary *Hillary The Movie* was the functional equivalent of express advocacy because it was essentially a "feature-length negative advertisement that urged viewers to vote against Senator Clinton for President."[119] The Court further rejected the contention that it should create an as-applied exception for documentary films because to do so would require it to redraw constitutional lines for different types of media,[120] which could have the unintended result of chilling political speech.[121]

The Court correctly noted that if it applied the test established in *Austin* (the anti-distortion test), instead of examining the statute on its face, it could "produce the dangerous, and unacceptable, consequence" of banning political speech emanating from media corporations.[122] While noting that media corporations were technically exempt from the corporate expenditure ban set forth in section 441b[123], the Court observed that media corporations also accumulate immense wealth with the help of the corporate form and that "the views expressed by media corporations often 'have little or no correlation to the public's support' for those views."[124] As the Court went on to observe, the "line between the media and others who wish to comment on political and social issues has become far more blurred" with the advent of the Internet, blogs, and cable television, and the decline of traditional print and broadcast media.[125] Within the context of this dilemma, the Court recognized that making distinctions between media corporations and non-media corporations would be difficult at best.[126] Analyzing the statute on case-by-case basis could have the unfortunate result of exempting a corporation that owns both media and non-media businesses, while simultaneously, a wholly non-media corporation could be forbidden to speak even though it may have the same interests.[127] Such a result cannot be squared with the First Amendment.

Last, after the Court examined the morass of existing legislation, FEC advisory opinions, explanations and justifications, and FEC regulations governing the universe of campaign finance, it concluded that the existing complicated regulatory scheme acted as a prior restraint on speech in the harshest of terms.[128] As such, the Court determined that the proper adjudication required it to finally consider the facial validity of section 441b of the BCRA, and whether courts should continue to adhere to *Austin* and the relevant portion of *McConnell*.[129]

Justice Kennedy's First Amendment Analysis

The First Amendment provides that, "Congress shall make no law . . . abridging the freedom of speech."[130] It is undisputable that free speech is an "essential mechanism of democracy" because one of its many benefits is that it affords citizens the opportunity to hold their elected officials accountable.[131] As such, the "*First Amendment* 'has its fullest and most urgent application' to speech uttered during a campaign for political office."[132] The Supreme Court has already recognized that the "discussion of public issues and debate on the qualifications of candidates are integral to the operation of the system of government established by our Constitution."[133] Thus, in this context, if the First Amendment is to mean anything, it must mean that the government is not permitted to fine or imprison citizens or associations of citizens merely for engaging in political speech.[134]

Recognizing the above to be true, it is a natural progression to hold that political speech must be protected from laws that are designed to either intentionally suppress it, or do so inadvertently.[135] For it is political speech, emanating from diverse sources, that provides the voters with some of the information necessary to decide which candidates to support.[136] Every first-year law student learns that laws that burden speech, even political speech, will be subject to "strict scrutiny" review by the Court.[137] In order to successfully make it past this review the government will be required demonstrate that the law "furthers a compelling interest and is narrowly tailored" to promote that interest.[138] In *Citizens United*, the Supreme Court recognized that on rare occasions it has upheld a "narrow class of speech restrictions" that do infringe on a speaker's First Amendment rights; however, in all these cases, the Court found a compelling governmental interest.[139]

The Court did not find a compelling interest in *Citizens United*.[140] Justice Kennedy observed that the Court has a long history of holding that corporations are entitled to the rights recognized under the First Amendment.[141] These rights include political speech.[142] First Amendment protections do not vanish merely because the speaker is a corporation. As the Court correctly recognized, "speech restrictions based on the identity of the speaker are all too often simply a means to control content."[143] "The concept that the government may restrict the speech of some elements of our society in order to enhance the relative voice of others is wholly foreign to the First Amendment."[144] Here, the Court recognized that the FEC set in place a complicated process whereby it, and it alone, would select what political speech is safe for dissemination to the public, and in so deciding, it employed a series of subjective and ambiguous tests.[145] Such a scheme would act as a prior restraint and an unprecedented governmental intrusion on the right to speak, the likes of which cannot be sustained.[146]

By taking the right to speak from some and giving it to others, the Government deprives the disadvantaged person or class of the right to use speech to strive to establish worth, standing, and respect for the speaker's voice.[147] "The Government may not by these means deprive the public of the right and privilege to determine for itself what speech and speakers are worthy of consideration."[148] Moreover, the Court recognized that upholding the statute and allowing the government to ban corporations from engaging in political speech could result in suppression of speech in other media such as books,[149] blogs, or social networking websites.[150] The government's interest in leveling the political influence playing field between individuals and corporations was unconvincing when one considers that a "mere 24 individuals contributed an astounding total of $142 million" during the 2008 election.[151]

Simultaneously, other like-minded citizens who have organized under the corporate form were prohibited from having their voices heard. The Court rightly concluded that the First Amendment is part of the foundation for the freedom to exchange ideas, and the public must be able to use all kinds of forums to share those ideas without fear of governmental reprisal.[152]

WHAT DOES THE CAMPAIGN FINANCE LEGAL LANDSCAPE LOOK LIKE POST-*CITIZENS UNITED*?

As mentioned at the outset of this article, *Citizens United* caused an eruption of criticism about the holding's impact on the world of campaign finance and the potential corruptive influence of corporations and unions on the political process.[153] Critics of the decision should take some comfort in the reality that *Citizens United* will likely have less of a negative impact, if at all, than originally feared.

First, while some early supporters of the BCRA touted that its provisions barred corporations and unions from funding political ads[154], in reality, the BCRA merely required that corporations and unions finance the ads through their PACs or similar voluntarily financed segregated funds.[155] PAC's were exempted under the BCRA, and even though they were complicated to create and manage, they did afford corporations a forum to participate in the political process.[156] So, as long as corporations and unions collected campaign funds from their members with the member's informed consent, these entities could continue to influence elections and some experts even expected the number of ads to increase after the passage of the BCRA.[157] Moreover, even though corporations and unions are no longer prohibited from engaging in independent expenditures in support of or against

political candidates, their participation in elections remains highly regulated. For example, direct contributions by corporations and unions are still prohibited under federal law and under the laws of 24 states.[158] A corporation or union still cannot donate corporate money directly to, or coordinate their political spending with, candidates for political office.[159] The laws requiring specific notices or disclaimers on political advertising remains untouched by *Citizens United*.[160] There is still a myriad of disclosure laws governing independent expenditures and electioneering communications on the part of corporations and unions.[161] Thus, even if a corporation or union were to independently expend funds in support of a candidate, money that is donated to the corporation for the purpose of financing said expenditures would be subject to the disclosure laws.[162] And last, despite President Obama's declaration that foreign entities will now have greater influence on American elections, foreign corporations and their subsidiaries are still subject to the existing spending bans.[163]

What has not been widely discussed is that *Citizens United* has spawned a new wave of litigation concerning several other aspects of the BCRA. For example, two federal courts issued campaign finance law decisions in the spring of 2010 that can trace their origins back to *Citizens United*. In *SpeechNow.Org v. FEC*[164], the D.C. Circuit Court of Appeals was asked to weigh in on the constitutionality of the BCRA's contribution limitations and disclosure requirements as applied to contributions to a PAC. The court held that, since the expenditures themselves do not corrupt, it should follow that; contributions to groups that plan to make those expenditures will not lead to corruption either.[165] But this unfettered right to donate to a group like SpeechNow does not extend to the right to donate to an actual political party. As such, "under current law, outside groups – unlike candidates and political parties – may receive unlimited donations to both advocate in favor of

political candidates and to sponsor issue ads."[166] This particular dilemma was raised in the second case – *Republican National Committee v. FEC*.[167] In the *Republican National Committee* case, the RNC challenged the BCRA's soft-money ban claiming that it had the right to raise and spend unlimited amounts of money on all kinds of election-related issues[168] and that the ban discriminates against the national political parties.[169] The court held that plaintiffs' claims were at odds with the Supreme Court's holding in *McConnell* and that the Court's recent decision in *Citizens United* did not disturb the part of *McConnell's* holding that addressed the constitutionality of BCRA's limits on contributions to political parties.[170]

There are also several new issues that have been raised as a result of the holding in *Citizens United*. When President Obama "dressed down" the Supreme Court in his State of the Union address in 2009, he, along with other critics conveniently failed to mention the group that benefitted the most from the decision – labor unions.[171] Skeptics could argue that this is because nine out of ten dollars spent on elections by unions goes to the Democrats – Obama's party.[172] It is interesting that the majority of the criticism of *Citizens United* comes from the political left, and while they lament the decision's impact as it relates to corporations, those same critics often fail to mention the impact on union participation in the electoral process. Unions admittedly spent approximately one half billion dollars in the 2008 election, a figure that dwarfs the spending of corporations.[173]

In addition, while critics of the decision claim the majority "piously claim it's about free speech,"[174] they have sat silent, or in some cases applauded, as the Supreme Court relies on First Amendment jurisprudence in cases about Internet pornography[175], flag burning[176], topless dancing[177], cross-burning[178], and even the creation, sale, or possession of films

depicting animal torture for purposes of sexual arousal.[179] To hold that such conduct described in these cases is worthy of constitutional protection, yet simultaneously support the idea that a corporation that expends its funds in support of a political candidate should be exposed to criminal liability seems irreconcilable. Last, while political pundits and scholars have criticized the ability of corporations to use their vast wealth to allegedly influence elections, they rarely express the same concern for the sudden rise of wealthy individuals who are using their own millions to either buy an elected position for themselves or use it to influence the outcome of others.[180] Recent political candidates like Mayor Michael Bloomberg in New York, California Gubernatorial candidates Arnold Schwarzenegger and Meg Whitman, New Jersey Governor John Corzine, the Kennedy and Bush families, Connecticut Senate candidate Linda McMahon and Florida Senate candidate Jeff Greene, and billionaires George Soros and Rupert Murdoch, just to name a few, have all used their own immense financial resources in an effort to influence the electorate.

While many critics focus on corporations making sizable expenditures on behalf of a candidate, they lose focus of the reality that the public's participation in the political process has changed with the advent of the Internet. For example, given the success of Internet fundraising in the 2008 presidential election, it is likely that in future elections, aggregations of smaller individual donations will actually outweigh the spending of corporations.[181] In his 2008 Presidential campaign, Barack Obama raised close to a half-a-billion dollars via Internet donations to his campaign.[182] Of the 6.5 million donations received by Obama, 6 million were for $100 or less, with the average on-line donation being $80.[183] According to the Federal Election Commission, the total sum of individual donations of $200 or less to all political

candidates in the 2008 election exceeded that of contributions from individual donors who gave more than $2,000.[184] In fact, to simplify and hopefully enhance this trend, some experts have suggested new ways for individual citizens to contribute to campaigns by way of a tax credit.[185] The proposal provides that each American should be allowed a limited federal tax credit that could only be applied if the money is donated to a federal candidate during election years.[186] It is further posited that, if the tax credit could be collected electronically in the form of a credit card, debit card, or directly from a bank account, the simplicity would increase participation and could result in candidates paying more attention to mainstream issues.[187]

CONCLUSION:

Citizens United, while controversial, marks the end of more than twenty years of erosion of the First Amendment rights of corporations and unions, particularly on the issue of political speech. As Justice Kennedy stated, one of the hallmarks of the First Amendment is that it should not be applied based on the identity of the speaker.[188] The idea that a speaker who engages in the political process can be imprisoned for his or her conduct is the antithesis of what freedom of speech is all about and sadly brings to mind regrettably similar acts in our history such as the Alien and Sedition Acts.[189] As noted above, there is likely to be very little change in corporate political activities after *Citizens United* because corporations have been participating in the political process despite the existence of the BCRA. They just had to do so through their PACs. After the dust settles, if Congress still believes that it is wrong to allow corporations and unions to use independent expenditures in support of or in opposition to a candidate for political office, they can certainly take appropriate action to

address the problem – so long as that action is not unconstitutional.

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[1] Dick Morris, as quoted in Hillary: the Movie.

[2] U.S. Const. amend I.

[3] Bipartisan Campaign Reform Act of 2002, 2 U.S.C. § 441b; (known as the McCain-Feingold Campaign Finance Law).

[4] See 2 U.S.C. § 437g.

[5] *Citizens United v. Fed. Elections Comm'n*, __ U.S. __, 130 S. Ct. 876, 175 L. Ed. 2d 753 (2010).

[6] See *Citizens United*, 130 S. Ct. at 917.

[7] Discussing the President's gratuitous remarks directed at the Supreme Court Justices and Justice Alito's head-shaking response, legal experts have remarked that, "they have never seen anything quite like it, a rare and unvarnished showdown between two political branches during what is usually the careful choreography of the State of the Union address." Robert Barnes, *In the Court of Public Opinion, No Clear Ruling*, WALL ST. J., Jan. 29, 2010 at A01.

[8] Ronald Dworkin, *The Devastating Decision*, N.Y. REV. BOOKS, Feb. 25, 2010 at 39.

[9] Richard L. Hansen, *Money Grubbers: The Supreme Court Kills Campaign Finance Reform*, SLATE (Jan. 21, 2010); available at http://www.slate.com/id/2242209/pagenum/all (last visited Mar. 22, 2011).

[10] Editorial, *The Court's Blow to Democracy*, N.Y. TIMES, Jan. 21, 2010 at A30.

[11] Editorial, *The Court, Money and Politics*, N.Y. TIMES, Apr. 20, 2010 at A20.

[12] Editorial, *The Court and Free Speech*, N.Y. TIMES, Apr. 24, 2010 at A18.

[13] See *e.g.*, *Free Speech For Some*, WALL ST. J., May 3, 2010 at A20; *see also* Charlie Savage and Sheryl Gay Stolberg, *Obama Says Liberal Courts May Have Overreached*, N.Y. TIMES, April 30. 2010 at A15; see also *Address Before a Joint Session of the Congress on the State of the Union*, 2010 DAILY COMP. PRES. DOC. 55 (Jan. 27, 2010).

[14] Barack Obama, *Remarks by the President in State of the Union Address* (Jan. 27, 2010); availale at http://www.whitehouse.gov/the-press-office/remarks-president-state-union-address; the full speech is available at

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http://www.gpo.gov/fdsys/pkg/DCPD-201000055/pdf/DCPD-201000055.pdf. (last visited Mar, 22, 2011).

[15] 2 U.S.C. § 437g

[16] Kirk J. Nahra, *Political Parties and the Campaign Finance Laws: Dilemmas, Concerns and Opportunities,* 56 FORDHAM L. REV. 53, 60-61 (Oct. 1987) (describing the history of campaign finance regulation as a study in Congressional confusion).

[17] In February of 2010, while giving a speech at a Florida law school, Justice Clarence Thomas noted that Congressional regulation of the involvement of corporations in elections dates all the way back to 1907. See Adam Liptak, *A Justice Responds to Criticism From Obama*, N.Y. TIMES, Feb. 4, 2010, at A17.

[18] The Tillman Act of 1907, Pub. L. No. 59-36, 34 Stat. 864 (Jan. 26, 1907).

[19] Robert H. Sitkoff, *Management and Control of the Modern Business Corporation: Corporate Speech and Citizenship: Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1128 (Summer 2002).

[20] Mark Twain coined the term "Gilded Age," in part, to describe the rampant corruption associated with this era. See THE PANTAGRAPH, Sept. 21, 1998 at A1.

[21] See *id.* (noting that famed Cleveland industrialist Mark Hanna is quoted as saying, "There are two things that are important in politics. The first is money and I can't remember what the second one is.").

[22] M. McCabe, *It's No Wonder Ordinary Folks Are Anxious*, THE CAPITAL TIMES, July 2, 2010.

[23] Theodore Roosevelt, *State of the Union Address*, 40 Cong. Rec. 96 (1905).

[24] See *id.* Roosevelt is quoted as saying "All contributions by corporations to any political committee or for any political purpose should be forbidden by law; directors should not be permitted to use stockholders' money for such purposes; and, moreover, a prohibition of this kind would be, as far as it went, an effective method of stopping the evils aimed at in corrupt practices acts." See *id.* available at Infoplease.com, http://www.infoplease.com/t/hist/state-of-the-union/117.html#ixzz15k81gcSD. (last accessed Mar. 22, 2011).

[25] Tillman Act of 1907, Pub. L. No. 59-36, 34 Stat. 864 (Jan. 26, 1907).

[26] See *generally*, Tillman Act, Pub. L. No. 59-36, 34 Stat. 864.

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[27] 2 U.S.C. § 431(9)(A)(1988). Expenditures are: "(i) any purchase, payment, distribution, loan, advance, deposit, or gift of money or anything of value, made by any person for the purpose of influencing any election for Federal office; and (ii) a written contract, promise, or agreement to make an expenditure."

[28] See Labor Management Relations Act (Taft-Hartley), Pub. L. No. 80-101, 61 Stat. 136 (1947)
(codified as amended in scattered sections of 29 U.S.C.).

[29] Veto of the Taft-Hartley Labor Bill, 1947 PUB. PAPERS 288, 296 (June 20, 1947).

[30] Andrew T. Newcomer, *The "Crabbed View of Corruption": How the U.S. Supreme Court Has Given Corporations the Green Light to Gain Influence over Politicians by Spending on Their Behalf*, 50 WASHBURN L.J. 235, 273 (FALL 2010) (arguing that the Supreme Court in *Citizens United* should have ignored the First Amendment implications, and instead, upheld the corporate independent expenditure ban because it supports the government's important interest in preventing corruption).

[31] *United States v. CIO*, 335 U.S. 106 (1948).

[32] *U.S. v. CIO*, 335 U.S. at 121 (quoting from the dissenting opinion of justices Rutledge, Black, Douglas, and Murphy). In this case, the Court did not look at the constitutionality of the statute as a whole because it held that the statute did not apply to the particular publication at issue – a labor union weekly periodical that endorsed a congressional candidate.

[33] *United States v. Automobile Workers*, 352 U.S. 567 (1957).

[34] See *Auto Workers*, 352 U.S. at 591.

[35] See *Auto* Workers, 352 U.S. at 593. The dissent stated that the ban on expenditures based on the belief that corporations and unions were "too powerful" was not sufficient grounds for denying "First Amendment rights from any group…." *Id.* at 597.

[36] *Automobile Workers*, 352 U.S. at 597 (Douglas J., dissenting).

[37] See *Pipefitters v. United States*, 407 U.S. 385 (1972) (failing to address the constitutionality of the ban while simultaneously reversing a conviction for the expenditure of union funds for political speech).

[38] Trevor Potter, *Campaign Finance Reform: Relevant Constitutional Issues*, 34 ARIZ. ST. L.J. 1123, 1124 (Winter 2002).

[39] Kevin Madden, *Turning The Faucet Back On: The Future of McCain-Feingold's Soft-Money Ban After Davis v. Federal Election Commission*, 59

A. U.L. Rev. 385, 391 (Dec. 2009) (discussing the history of modern campaign finance law).

[40] See *id.* at 391-94; see also, Federal Election Campaign Act Amendments of 1974, Pub. L. No. 93-443, § 101, 88 Stat. 1263, 1263 (amending 2 U.S.C. § 441a (1971)).

[41] See Melvin I. Urofsky, *Money and Free Speech: Campaign Finance Reform and the Courts* at 49.

[42] See Joseph E. Cantor, *Campaign Financing in Federal Elections: A Guide to the Law and its Operation, in Campaign Financing in the United States: Issues and Laws*, 55, 63 (Auguste V. Anschutz ed. 2002)

[43] Federal Election Campaign Act Amendments of 1974, Pub. L. No. 93-443, 88 Stat. 1263 (1974) (codified in various sections of 2 U.S.C. and 18 U.S.C.).

[44] 2 U.S.C. § 441a.

[45] 2 U.S.C. § 441b(a)(b).

[46] 2 U.S.C. §§ 434(b)(3)(F), 434(c)(1), 434(a)(6)(A), and 434(b)(3)(A).

[47] *Buckley v. Valeo*, 424 U.S. 1 (1976) (consolidating a number of cases brought by various challengers to the FECA Amendments).

[48] See *Buckley* 424 U.S. at 13-14 (stating that the critical constitutional questions presented are whether the specific legislative bans on contributions and expenditures interfere with First Amendment freedoms or violates the Fifth Amendment because it discriminates against non-incumbent candidates and minor parties ability to raise funds).

[49] *Buckley*, 424 U.S. at 45.

[50] 424 U.S. at 48-49 (stating that the First Amendment was designed to '"secure the widest possible dissemination of information from diverse and antagonistic sources', and to 'assure unfettered exchange of ideas for the bringing about of political and social changes desired by the people."') quoting *New York Times v. Sullivan*, 376 U.S. 254, 266 (1964); *Associated Press v. United States*, 326 U.S. 1, 20 (1945); *Roth v. United States*, 354 U.S. 476, 484 (1957).

[51] *Buckley*, 424 U.S. at 50.

[52] *Citizens United*, 130 S. Ct. at 902, citing *Buckley v. Valeo*, 424 U.S. at 47-48.

[53] *Citizens United*, 130 S. Ct. at 902. (emphasis added).

[54] *First National Bank of Boston v. Bellotti*, 435 U.S. 765 (1977).

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[55] *Bellotti*, 435 U.S. at 767-769.

[56] MASS. GEN. LAW ANN., ch. 55 § 8 (West Supp. 1977).

[57] *Bellotti* 435 U.S. at 768.

[58] See *id.* at 784-785.

[59] *Id.* at 784.

[60] *Citizens United*, 130 S. Ct. at 903.

[61] *Austin v. Michigan State Chamber of Commerce*, 494 U.S. 652 (1990).

[62] *Austin*, 494 U.S. at 656.

[63] Michigan Campaign Finance Act, 1976 Mich. Pub. Acts 388; MICH. COMP. LAWS § 169.254(1) (1979).

[64] *Austin*, 494 U.S. at 656; *citing* MICH. COMP. LAWS § 169.254(5).

[65] *Austin*, 494 U.S. at 656.

[66] *Austin*, 494 U.S. at 660. (stating that it was upholding the restriction on independent expenditures by corporations regardless of "whether this danger of 'financial *quid pro quo*' corruption may be sufficient . . ." to warrant such a ban because corporate wealth can unfairly influence elections). *Id*. at 659-60.

[67] *Id.*

[68] *Id.*

[69] *Citizens United*, 130 S. Ct. at 903.

[70] *Id.* at 901, citing *United States v. Automobile Workers*, 352 U.S. 567, 597.

[71] *Bellotti, supra* note 54*,* at 778, n. 53 (citing *Linmark Associates, Inc. v. Willingboro,* 431 U.S. 85, 97 S. Ct. 1614, 52 L. Ed. 2d 155 (1977); *Time, Inc. v. Firestone,* 424 U.S. 448, 96 S. Ct. 958, 47 L. Ed. 2d 154 (1976); *Doran v. Salem Inn, Inc.,* 422 U.S. 922, 95 S. Ct. 2561, 45 L. Ed. 2d 648 (1975); *Southeastern Promotions, Ltd. v. Conrad,* 420 U.S. 546, 95 S. Ct. 1239, 43 L. Ed. 2d 448 (1975); *Cox Broadcasting Corp. v. Cohn,* 420 U.S. 469, 95 S. Ct. 1029, 43 L. Ed. 2d 328 (1975); *Miami Herald Publishing Co. v. Tornillo,* 418 U.S. 241, 94 S. Ct. 2831, 41 L. Ed. 2d 730 (1974); *New York Times Co. v. United States,* 403 U.S. 713, 91 S. Ct. 2140, 29 L. Ed. 2d 822 (1971) *(per curiam); Time, Inc. v. Hill,* 385 U.S. 374, 87 S. Ct. 534, 17 L. Ed. 2d 456 (1967); *New York Times Co. v. Sullivan,* 376 U.S. 254, 84 S. Ct. 710, 11 L. Ed. 2d 686; *Kingsley Int'l Pictures Corp. v. Regents of Univ. of N. Y.,* 360 U.S. 684, 79 S. Ct. 1362, 3 L. Ed. 2d 1512 (1959); *Joseph Burstyn, Inc. v. Wilson,* 343 U.S. 495, 72 S. Ct. 777, 96 L. Ed. 1098 (1952)); *see, e.g., Turner Broadcasting System, Inc. v. FCC,* 520 U.S. 180, 117 S. Ct. 1174, 137 L. Ed. 2d 369 (1997); *Denver Area Ed.*

Telecommunications Consortium, Inc. v. FCC, 518 U.S. 727, 116 S. Ct. 2374, 135 L. Ed. 2d 888 (1996); *Simon & Schuster,* 502 U.S. 105, 112 S. Ct. 501, 116 L. Ed. 2d 476; *Sable Communications of Cal., Inc. v. FCC,* 492 U.S. 115, 109 S. Ct. 2829, 106 L. Ed. 2d 93 (1989); *Florida Star v. B. J. F.,* 491 U.S. 524, 109 S. Ct. 2603, 105 L. Ed. 2d 443 (1989); *Philadelphia Newspapers, Inc. v. Hepps,* 475 U.S. 767, 106 S. Ct. 1558, 89 L. Ed. 2d 783 (1986); *Landmark Communications, Inc. v. Virginia,* 435 U.S. 829, 98 S. Ct. 1535, 56 L. Ed. 2d 1 (1978); *Young v. American Mini Theatres, Inc.,* 427 U.S. 50, 96 S. Ct. 2440, 49 L. Ed. 2d 310 (1976); *Gertz v. Robert Welch, Inc.,* 418 U.S. 323, 94 S. Ct. 2997, 41 L. Ed. 2d 789 (1974); *Greenbelt Cooperative Publishing Assn., Inc. v. Bresler,* 398 U.S. 6, 90 S. Ct. 1537, 26 L. Ed. 2d 6 (1970). This protection has been extended by explicit holdings to the context of political speech. See, *e.g., Button,* 371 U.S., at 428-429, 83 S. Ct. 328, 9 L. Ed. 2d 405; *Grosjean v. American Press Co.*, 297 U.S. 233, 244, 56 S. Ct. 444, 80 L. Ed. 660 (1936).

[72] *McConnell v. Fed. Election Comm'n*, 540 U.S. 93 (2003).

[73] See *McConnell*, 540 U.S. at 205-06.

[74] See *id.* at 206 (emphasis added).

[75] *Id.* at 205.

[76] See *McConnell v. Fed. Election Comm'n*, 251 F. Supp. 2d 176, 569-71 (D.C. Dist. 2003). The district court noted that forms of media that required viewers to "opt-in" or "make a choice to… watch the program" would mostly reach voters already predisposed to those views and would reach far fewer undecided voters than a broadcast ad. See *id.* at 571, 646. For the *McConnell* district court, this was a "critical distinction" that separated communications that posed a great risk of corruption (broadcast ads) from those that did not (viewer choice media). See Brief for Appellant, at 24-25.

[77] See *Fed. Election Comm'n v. Wis. Right to Life Inc.*, 551 U.S. 449, 460 (2006) (noting that the holding in *McConnell* left the door open for future "as applied" challenges to the constitutionality of section 203).

[78] *Wis. Right to Life, Inc.*, 551 U.S. 449 (2007).

[79] See *id.* at 458-59.

[80] See *id.* at 460.

[81] See *id.* at 458-59.

[82] See *id.* at 465, 482 (Roberts, C.J., plurality opinion).

[83] See *id.* at 469-70 (reasoning that this must be an objective test that focuses on the substance of the advertisement and not on amorphous

considerations of intent and effect, or other contextual factors that might illustrate the corporation's reasons for running the ad).

[84] See *id.* at 476; see also *Citizens United*, 130 S. Ct. at 889-90.

[85] *Id.* at 470.

[86] *Id.* at 483-504.

[87] *Citizens United v. Fed. Election Comm'n*, 530 F. Supp. 2d 274, 278 n.10 (D.D.C. 2008) (quoting *Marks v. United States*, 430 U.S. 188, 193 (1977)). The parties in the Citizens United case agreed in the district court that Justice Roberts's rationale was the "governing test for the functional equivalent of express advocacy." *Id.* This gave authoritative weight to Justice Roberts's test based on the principle that "when a fragmented Court decides a case and no single rationale explaining the result enjoys the assent of five Justices, the holding of the court may be viewed as that position taken by those Members who concurred in the judgments on the narrowest grounds."

[88] See 11 C.F.R. § 114.15 (2007).

[89] McCain-Feingold Campaign-Finance Reform Act, Pub. L. No. 107-155, 116 Stat. 81.

[90] See *Citizens United*, 130 S. Ct. at 887.

[91] John McCain, *Introduction: Symposium on Campaign Finance Law*, 34 Ariz. St. L.J. 1017 (Winter 2002).

[92] See Madden, *supra* note 40 at 387; see also 2 U.S.C. § 441i(a)(1).

[93] See Richard Briffault, *The Future of Reform: Campaign Finance After the Bipartisan Campaign Reform Act of 2002*, 34 Ariz. St. L.J. 1179, 1180 (Winter 2002) (noting that not only did the new act face constitutional challenges, but it also was under attack and being marginalized by rules adopted by the FEC that could ultimately lead to further lawsuits).

[94] Bipartisan Campaign Reform Act of 2002 ("BCRA"), Pub. L. No. 107–155, 116 Stat. 81 (2002).

[95] Pub. L. No. 92-225, 86 Stat. 3 (1972). Federal election law is codified in Chapter 14 to Title 2 to the United States Code (U.S.C.); see also the Federal Election Commission publication *Federal Election Campaign Laws*.

[96] See 2 U.S.C. § 434(f)(3)(A)(i).

[97] See *id.*

[98] See 2 U.S.C. § 441b(b)(2).

[99] 2 U.S.C. § 434(f)(1) & (2).

[100] See *id.*

[101] *Id.*

[102] 2 U.S.C. § 441d.

[103] See *id.*

[104] *Citizens United*, 130 S. Ct. 876, at 886-887 (2010).

[105] *Id.*

[106] *Id.*

[107] See *Id.* at 890.

[108] See Aaron Harmon, *Hillary: The Movie Corporate Free Speech or Campaign Finance Corruption*, 4 DUKE J. CONST. LAW & PP SIDEBAR 331 (2009).

[109] *Citizens United*, 130 S. Ct. at 887.

[110] See *id.* at 888.

[111] *Id.*

[112] *Id.*

[113] See John McCain, *Introduction: Symposium on Campaign Finance Reform*, 34 ARIZ. ST. L.J. 1017 at 1018 (Winter 2002) (noting that "fortunately, the law ultimately provides for expedited review in the Supreme Court….").

[114] 2 U.S.C. § 437h

[115] See *Id.*

[116] See *Id.*

[117] *Citizens United v. FEC,* 530 F. Supp. 2d 274 (D.D.C. 2008).

[118] *Citizens United*, 130 S. Ct. at 888-94.

[119] *Id.*, at 889-90.

[120] See *id.* at 890-91. The Court also reasoned that an as-applied analysis would result in other types of media running to the courts to determine if § 441b's restrictions applied to their activities and would "chill political speech" until such determinations would be made. See *id.* at 891. The Court also elected not to extend the holdings in *Fed. Election Comm'n v. Massachusetts Citizens for Life (MCFL)*, which exempted non-profit corporations that receive minimal funding from for-profit corporations because it would require the Court to sever a portion of the BCRA, and it

would result in future case-by-case determinations, 479 U.S. 238, 263 (1986). See *Citizens United* at 891-92.

[121] See *Citizens United*, 130 S. Ct. at 892.

[122] See *id.* at 789.

[123] See 2 U.S.C. §§ 431(9)(B)(i), 434(f)(3)(B)(i).

[124] See *Citizens United* 130 S. Ct. at 790 (citing *Austin*, 494 U.S. at 660).

[125] See *Citizens United*, 130 S. Ct. at 905-06.

[126] See *id.* at 906.

[127] See *id.*

[128] See *id.* at 895 (pointing out that there are unique and complex campaign finance rules for 71 distinct entities, subject to 33 different types of political speech, with 568 pages of FEC regulations and 1,278 pages of explanations and justifications for the regulations, followed by 1,771 advisory opinions).

[129] See *id.*

[130] U.S. Const. amend. I.

[131] *Buckley v. Valeo*, 424 U.S. 1 at 14-15 (1976).

[132] *Citizens United*, 130 S. Ct. at 898 (citing *Eu v. San Francisco County Democratic Central Comm.*, 489 U.S. 214, 223 (1989) (quoting *Monitor Patriot Co. v. Roy*, 401 U.S. 265, 272 (1971)).

[133] *Buckley*, 424 U.S. at 14.

[134] *Citizens United*, 130 S. Ct. at 904.

[135] *Id.* at 898.

[136] *Id.* at 899.

[137] *Id.* at 888.

[138] *Wisconsin Right to Life Inc. v. Federal Election Comm'n*, 546 U.S. 410, 464 (2006).

[139] *Citizens United*, 130 S. Ct. at 899, citing *Bethel School Dist. No. 403 v. Fraser*, 478 U.S. 675, 683, 106 S. Ct. 3159, 92 L. Ed. 2d 549 (1986) (protecting the function of public school education); *Jones v. North Carolina Prisoners' Labor Union, Inc.,* 433 U.S. 119, 129, 97 S. Ct. 2532, 53 L. Ed. 2d 629 (1977) (furthering "the legitimate penological objectives of the corrections system" (internal quotation marks omitted)); *Parker v. Levy,* 417 U.S. 733, 759, 94 S. Ct. 2547, 41 L. Ed. 2d 439 (1974) (ensuring "the capacity of the Government to discharge its [military] responsibilities" (internal quotation marks omitted)); *Civil Service Comm'n v. Letter Carriers,* 413 U.S. 548, 557, 93 S. Ct. 2880, 37 L. Ed. 2d 796 (1973)

("[F]ederal service should depend upon meritorious performance rather than political service").

[140] See *Citizens United*, 130 S. Ct. at 899.

[141] *Id.* at 899-900.

[142] See *id.* at 900.

[143] *Id.* at 899.

[144] *Automobile Workers*, 352 U.S. at 597 (Douglas, J., *dissenting*).

[145] *Citizens United*, 130 S. Ct. at 896.

[146] *Id.* at 895-96.

[147] *Id.* at 899 (words of Kennedy).

[148] *Id.* at 899.

[149] *Citizens United*, 130 S. Ct. at 904.

[150] *Id.* at 913.

[151] *Id.* at 908.

[152] *Id.* at 917.

[153] See *supra* notes 9-14.

[154] See *e.g.,* George F. Will, *Political Ads a Freedom of Speech,* TIMES-UNION (Albany), Dec. 21, 2002, at B5.

[155] See § 203(a), 116 Stat. at 91 (prohibiting corporations and unions from financing electioneering communications outside of PACs); § 201(a), 116 Stat. at 88 (defining "electioneering communication"); see also Trevor Potter, *Campaign Finance Reform: Relevant Constitutional Issues*, 34 ARIZ. ST. L.J. 1123, 1131 (Winter 2002) (noting that corporations and unions could still run campaign ads as long as they were funded by voluntary contributions from employees, shareholders, or union members instead of using the corporation's general funds).

[156] *Citizens United*, 130 S. Ct. at 897 (acknowledging that PACs were a separate association from the corporation but pointing out that they were burdensome alternatives that were expensive to operate and were still subject to extensive regulation).

[157] See *Special Report: Bipartisan Campaign Reform Act,* 70 U.S.L.W. 2684 (Apr. 30, 2002) (discussing how corporate and union attempts at electoral influence will not be stopped by the BCRA but merely re-routed through their PACs). See generally, Samuel Issacharoff & Pamela S. Karlan, *The Hydraulics of Campaign Finance Reform,* 77 TEX. L. REV.

1705 (1999) (recognizing the inevitable flow of political money to channels that remain open after regulation).

[158] National Conference of State Legislatures; http://www.ncsl.org/default.aspx?tabid=19607 (noting that one state bans political activity by unions, nine ban corporate political activity, and 14 ban political activity by both corporations and unions).

[159] See *Citizens United*, 130 S. Ct. at 909 (noting that Court did not overrule the ban on contributions).

[160] Jan Baran, *Citizens United v. FEC: Independent Political Advertising by Corporations*, 2010 EMERGING ISSUES 4875 (Feb. 22, 2010).

[161] See *Citizens United*, 130 S. Ct. at 915-17

[162] See *id.* (finding no constitutional impediment to the application of the disclosure laws set forth in the BCRA).

[163] See 2 U.S.C. § 441e (providing that foreign nationals are banned from contributing to or expending funds in support of political candidates or parties); see also Randy E. Barnett, *Obama Owes the High Court an Apology*, THE WALL ST. JOURNAL, Jan. 29, 2010 at A13.

[164] See *SpeechNow.org v. Federal Election Commission*, 599 F.3d 686 (D.C. Cir. 2010)

[165] See *id*. at 694; see also, Adam Liptak, *On Campaign Finance, Rulings For Advocacy Groups and Against Parties*, N.Y. TIMES, Mar. 27, 2010 at A13.

[166] *Republican National Committee v. Federal Election Commission*, 698 F. Supp. 2d 150, 160n5 (D.C.D.C. 2010).

[167] 698 F. Supp. 2d 150 (D.C. Dist. 2010).

[168] The RNC claimed it wanted to “raise and spend unlimited soft money in order to (1) support state candidates in elections where only state candidates appear on the ballot; (2) support state candidates in elections where both state and federal candidates appear on the ballot; (3) support state parties' redistricting efforts following the 2010 census; (4) support "grassroots lobbying efforts" aimed at educating and mobilizing voters around "legislation and issues"; (5) pay the fees and expenses attributable to this case and "other litigation not involving federal elections"; and (6) pay maintenance and upkeep expenses associated with the RNC's headquarters. See 698 F. Supp. 2d at 154-55.

[169] See *id.*

[170] See *id.* at 153; citing *Citizens United*, 130 S. Ct. at 910-11.

[171] Steven J. Law, *Organized Labor and Citizens United*, WALL ST. JOURNAL., Mar. 11, 2010 at A15 (noting that Labor unions spent approximately a half a billion dollars in the 2008 election, significantly more than any group representing business).

[172] See *id.*

[173] See Steven J. Law, *supra* note 172 (noting that while public companies have to deal with the pursuit of profits and the desires of shareholders, unions have very little holding them back from engaging in political action).

[174] E.J. Dionne, *Supreme Court Ruling Calls for Populist Revolt*, THE WASH. POST, Jan. 25, 2010; *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/01/24/AR2010012402298.html. (last visited Mar. 22, 2011)

[175] *Ashcroft v. ACLU*, 542 U.S. 656 (2004); (invalidating the Child Online Protection Act (COPA), 112 Stat 2681-736, codified at 47 U.S.C. § 231).

[176] *Texas v. Johnson*, 491 U.S. 397 (1989).

[177] *California v. LaRue*, 409 U.S. 109 (1972).

[178] *Virginia v. Black*, 538 U.S. 343 (2003).

[179] See *U.S. v. Stevens*, __ U.S. __, 130 S. Ct. 1577 (2010); see also Bradley A. Smith, *Newsflash: First Amendment Upheld*, THE WALL ST. JOURNAL, Jan. 22, 2010; http://online.wsj.com/article/SB10001424052748704509704575019112172931620.html. (last visited Mar. 22, 2011).

[180] Charles Krathammer, *The U.S. House of Lords*, THE WASH. POST, Dec. 19, 2008 at A35.

[181] See Richard M. Eisenberg, *The Lonely Death of Public Campaign Financing*, 33 HARV. J.L. & PUB. POL'Y 283, 332 (Winter 2010).

[182] See Jose Antonio Vargas, *Obama Raised Half a Billion Online*, THE WASH. POST, Nov. 20, 2008; http://voices.washingtonpost.com/44/2008/11/20/obama_raised_half_a_billion_on.html. (last visited Mar. 22, 2011).

[183] See *id.*

[184] Federal Election Commission Report on Presidential Campaign Finance for the 2008 Presidential Election located at: http://www.fec.gov/DisclosureSearch/mapApp.do. (reporting that the total sum of donations of $200 and under was $428,170,699 while the sum of the

donations of $2000 or greater was $419,369,983). (last visited Mar. 22, 2011).

[185] Bruce Ackerman and David Wu, *How to Counter Corporate Speech*, THE WALL ST. JOURNAL, Jan. 27, 2010 at A13 (proposing that if each citizen had the chance to contribute "democracy dollars" in the form of a tax credit, that the aggregation of donations would likely dwarf the sums spent by corporations).

[186] See *id.*

[187] See *id.*

[188] See *Citizens United*, 130 S. Ct. at 899.

[189] 1 Stat. 596 (1798).

U.S. SUPREME COURT MAKES IN OFFICIAL—THUMBS UP ON MANDATORY ARBITRATION/THUMBS DOWN ON CLASS ARBITRATION (*AT&T MOBILE, LLC v. CONCEPCION)*

by

J.L. Yranski Nasuti, J.D., LL.M.*

In 1925, Congress passed the Federal Arbitration Act (FAA)[1] in order to overcome judicial hostility to arbitration proceedings. Today the U.S. Supreme Court no longer bears animosity to this particular form of alternative dispute resolution. On the contrary, the majority of the current Court "rigorously enforces" mandatory arbitration agreements whether they have been negotiated at arms length between merchants or have been presented to employees and consumers in standard form contracts. In the recent case of *AT&T Mobile, LLC v. Concepcion* (*AT&T Mobile)*,[2] the Court once again upheld a mandatory arbitration clause--but a mandatory arbitration that also contained an anti-class action provision--on the grounds that the savings clause of the FAA preempts the application of a state law regarding unconscionable contracts.

I. BACKGROUND

In February 2002, Vincent and Liza Concepcion did what many people do everyday—they entered into a wireless service agreement. The provider of services in their case was Cingular Wireless (which was subsequently acquired by AT&T in 2005 and renamed AT&T Mobility LCC in 2007). The agreement,

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which was executed at the provider's retail store in Carlsbad, California, was a common "bundled" transaction in which each of the Concepcions received a "free" cell phone in exchange for agreeing to a two year service contract. The provider subsequently charged the Concepcions $30.22—for sales tax based on the full retail value of the "free" phones.[3]

The original agreement between the Concepcions and Cingular was a standard form contract that included a single page statement of "Terms and Conditions." Among the terms was a mandatory arbitration clause that also prohibited class actions. The arbitration clause was located near the bottom of the page in a paragraph that also stated the provider's limited liability under the plan. The word "ARBITRATION," which was capitalized and in bold, was followed by a sentence instructing the consumer to "read this paragraph carefully."[4] The paragraph went on to state that the parties would "negotiate in good faith to settle any dispute or claim arising from or relating to this Agreement" . . . and if the parties "do not reach an agreement within 30 days, instead of suing in court," the parties "agree to arbitrate any and all disputes and claims arising out of this Agreement."[5] A subsequent provision stated that the parties "agree that no Arbitrator has the authority to (1) award relief in excess of what this agreement provides; (2) award punitive damages or any other damages not measured by the prevailing party's actual damages; or (3) order consolidation or class arbitration."[6] The only exception to the mandatory arbitration rule was if either party elected to file a complaint in small claims court.[7]

The Concepcions renewed their wireless agreements with Cingular (and its successor, AT&T) on a number of occasions. With each of the subsequent contracts, the Concepcions were given a current statement of the "Terms of Service." All of those statements included a "change-in-terms" clause that

allowed the provider to unilaterally amend the terms and conditions of the agreement at any time so long as the provider notified the customers of the changes either in their monthly bills or separately.[8] In December 2006, two months after the Concepcions had renewed their wireless contract, AT&T notified its customers that it had exercised its right under the "change-in-terms" clause to revise the agreement's arbitration policy. The amended arbitration provisions were much more explicit and, AT&T would subsequently argue, much more favorable to the consumer.

The revised agreement still required disputes to be resolved in either small claims court or through individual (but not class-wide) arbitration hearings. In addition it introduced six significant changes. The first was the establishment of a new premium payment term requiring the provider to pay the customer $7,500 in the event that the arbitrator's actual award was less than $7,500 but greater than the provider's last written settlement offer prior to selection of the arbitrator.[9] The second was AT&T's promise to pay double the amount of customer's attorney fees and reimburse any of the attorney's reasonable expenses accrued while investigating, preparing, and pursuing the client's claim in arbitration—but only if the arbitrator awarded the customer more that the provider's last written settlement offer.[10] The third prohibited the provider from seeking attorneys' fees and expenses--even if it prevailed in arbitration and even if it had the right to do so under the law.[11] The fourth allowed punitive damages to be awarded to the extent allowed in court.[12] The fifth provided that the customer had the exclusive option of deciding whether the arbitration would be conducted in person, by telephone, or based solely on submission of documents--so long as the claim was for $10,000 or less.[13] Finally, it specified that arbitration would take place in the county of the customer's billing address.[14]

II. PREVIOUS LITIGATION IN CALIFORNIA

The Concepcions were not the only dissatisfied California consumers to have entered into similar wireless service agreements with their cell phone providers. In late 2004 and early 2005, Elizabeth Voorhies accepted a bundled transaction with Cingular (through its agent Go Wireless) and Jennifer Laster accepted one with T-Mobile. Each was given a "free phone" and then charged for the sales tax on its full retail value. In May 2005, Voorhies, Laster, and an additional plaintiff, Andrew Thompson, filed complaints against their providers in the California Superior Court.[15] While Thompson's case was dismissed without prejudice, the other two where removed to the U.S. District Court for the Southern District of California under the Federal Class Action Fairness Act of 2005 (CAFA).[16] In August 2005, Voorhies and Laster filed an amended complaint on behalf of themselves and all other consumers who had entered into similar bundled transactions, received free phones, and been charged for the sales tax.[17] The complaint alleged that the providers had engaged in violations of California's False Advertising Law (FAL),[18] the Unfair Competition Law (UCL),[19] and the Consumer Legal Remedies Act (CLRA).[20] The providers responded by filing motions to compel arbitration and to dismiss the amended complaint pursuant to §12(b)(6) of the Federal Rules of Civil Procedure. The Court denied the motion to compel arbitration on the grounds that the arbitration agreements were both procedurally and substantively unconscionable under California contract law. The motion to dismiss the amended complaint was granted without prejudice since the plaintiffs, in their UCL and FAL claims, had failed to allege reliance on the providers' misrepresentations when making their decisions to accept the cell phones. The CLRA claim, on the other hand, was dismissed with prejudice for

failure to comply with statutory notice requirements set forth in California Code § 1782.[21]

In December 2005, AT&T and T-Mobile (who were later joined by the other defendants) appealed the Court's denial of their motion to compel arbitration and moved to stay the proceedings pending the outcome of the appeal. The plaintiffs then filed a second amended complaint—to which the defendants responded by filing an instant motion to dismiss. The Court denied the defendants' motions to compel arbitration and to dismiss the second complaint but granted their motion to stay the proceedings pending the appeal.[22]

The Concepcions filed their own lawsuit against AT&T in the U.S. District Court for the Southern District of California in March 2006. Their complaint alleged that AT&T's practice of charging sales taxes for phones that were advertised as "free" constituted fraud. The following September, the U.S. District Court consolidated the Concepcions' case with the *Laster* putative class action lawsuit.[23]

In August 2007, before the U.S. Court of Appeals for the Ninth Circuit had ruled on the lower court's denial of the defendants' motion to compel arbitration in the *Laster* case, it released its decision in the case of *Shroyer v. New Cingular Wireless.*[24] The issue in *Shroyer* was whether the binding arbitration clause and class arbitration waiver in Cingular's standard service contract were enforceable. The three judge panel concluded that, under California law, the provisions were both unconscionable and unenforceable. The appellate court also ruled that the FAA did not preempt the state law relating to unconscionable contracts.[25] Since the class arbitration waiver at issue in the *Shroyer* case was substantially identical to the one at issue in *Laster*, the Court of Appeals asked the parties in *Laster* to submit letter briefs discussing the effect of

the *Shroyer* decision on their pending appeal.[26] At that point, all of the defendants except T-Mobile agreed to voluntarily dismiss their appeals. After the Circuit Court affirmed the lower court's decision to deny T-Mobile's motion to dismiss, T-Mobile filed an unsuccessful writ of certiorari with the U.S. Supreme Court. In the meantime, the District Court lifted the stay that had been placed on the *Laster* case while the appeal had been pending.[27]

III. IMPACT OF *SHROYER* ON *AT&T MOBILE*

In March 2008, AT&T filed a motion to compel the Concepcions to submit their dispute to the mandatory individual arbitration procedure that was outlined in AT&T's revised wireless agreement of December 2006.[28] According to AT&T, the class arbitration waiver in the amended agreement was not only "substantially distinct" from the waiver considered in the *Shroyer* case but it also provided a sufficient substitute for any class action relief that its customers had waived. The Concepcions responded with two arguments. The first was that the terms of the 2006 revised arbitration provision were inapplicable since the amendments had only been added after the Concepcions had filed their lawsuit. The second was that even if the revised terms relating to arbitration and class actions were applicable they were still unconscionable and, therefore, unenforceable under California law. While the District Court ruled that federal and California law both allowed AT&T to base its claim on the revised terms,[29] it denied AT&T's motion to compel arbitration on the grounds that California contract law did not allow an unconscionable contract provision to be enforced.[30] It concluded instead that although the AT&T consumer agreement was only marginally a contract of adhesion[31] and even though the premium damage clause provided an incentive for consumers to pursue small claims in arbitration,[32] the arbitration provision did not

sufficiently deter AT&T from retaining the benefits of its wrongful conduct and continuing that conduct with impunity.[33]

AT&T presented three main arguments when it filed its appeal with the U.S. Court of Appeals. The first was that the decision in *Shroyer* was inapplicable since AT&T's amended premium payment provision did not have the practical effect of rendering AT&T immune from individual claims. The second was that the amended arbitration clause was neither unconscionable nor unenforceable. The third was that the FAA preempted California's unconscionability law.[34] A three judge panel unanimously rejected each claim and affirmed the lower court's decision.

The Ninth Circuit's de nova review of the motion to compel arbitration began by reaffirming the holding of the California Supreme Court in *Discover Bank v. Superior Court.*[35] In that case, the state court had ruled that a class action waiver in a mandatory arbitration provision was unconscionable if it was part of a consumer adhesion contract "in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money."[36] The Court of Appeals held that, under state law, AT&T's premium payment provision did not negate the unconscionability of the class action waiver. Although it was true that the provision would penalize AT&T if it low-balled an offer, it still did nothing to provide incentives to individual customers to pursue small claims.[37] The Court concluded that the FAA did not preempt California's unconscionability law since the state law did not stand "as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[38] California law did not undermine the FAA's purpose of placing

arbitration agreements on the same footing as any other contract since class arbitration waivers in adhesion contracts and class action waivers in other contracts would both be voided if found to be unconscionable.[39] As to the second purpose of the FAA, the promotion of efficient and expeditious resolution of claims, the Court reaffirmed its previous holding in *Shroyer* in which it concluded that when large numbers of consumers sought compensation based on similar claims, a class arbitration proceeding was actually simpler, cheaper, and faster for the consumers as well as the defendant company.[40]

IV. *AT&T MOBILE* AND THE U.S. SUPREME COURT

Business and consumer groups both knew that a great deal was at stake when the U.S. Supreme Court granted the writ of certiorari to hear the case (now under the heading of *AT&T Mobility LLC v. Concepcion et ux.)* Yet even after oral arguments had concluded, it was still unclear where the nine justices stood on the three most compelling issues—whether there was any reason in this particular case for not continuing the general policy of favoring arbitration agreements, whether there was a specific justification for allowing class action waivers in consumer arbitration agreements, and whether the FAA preempted the California law on unconscionability. It was not until April 27, 2011, when Justice Antonin Scalia began to deliver the decision of the Court that it became evident that consumers who entered into standard form contracts containing mandatory arbitration agreements and class action waivers had lost in a very big way.

The U.S. Supreme Court, in a 5-4, decision reversed the Ninth Circuit's judgment and remanded the case. Justice Scalia's opinion was joined by Chief Justice Roberts and Justices Anthony Kennedy, and Samuel Alito. Justice Clarence Thomas delivered a concurring opinion and Justice Stephen

Breyer issued a dissenting opinion that was joined by Justices Ruth Bader Ginsburg, Sonya Sotomayor, and Elena Kagan. The focus of all three opinions was the interpretation of §2 of the FAA—which the Court, in an earlier decision, had characterized as "the primary substantive provision of the Act."[41] Section 2 states that: "A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[42] It was the interpretation of the second part of this section—the savings clause—on which the justices disagree.

A. Majority Opinion

According to Scalia, the primary issue before the Court was "whether the FAA prohibits States from conditioning the enforceability of certain arbitration agreements on the availability of classwide arbitration procedures."[43] To resolve that issue it was necessary to determine whether California's rule regarding unconscionability (as articulated in the *Discover Bank* case) was covered by the FAA's savings clause. Scalia began his analysis of that issue only after reaffirming the Court's previous holdings that Section 2 of the FAA reflects a "liberal federal policy favoring arbitration"[44] and the "fundamental principle that arbitration is a matter of contract."[45] As a consequence, arbitration agreements were on equal footing with any other contracts and should be enforced according to their terms—unless, under the terms of the savings clause, they were found to be unenforceable "upon such grounds that exist at law or in equity for the revocation of any contract." It was at this point, that Scalia delivered a decision that greatly limited the scope of the savings clause especially with regard to consumer arbitration agreements.

Scalia acknowledged that the FAA's savings clause allowed an arbitration agreement to be invalidated by "“generally applicable contract defenses, such as fraud, duress, or unconscionability" but not by defenses that apply only to arbitration or derive their meaning from the fact that an agreement to arbitrate is at issue."[46] He then addressed the validity of the *Discover Bank* holding that classified collective arbitration waivers as unconscionable only when they were included in consumer contracts. Under California statutory law, a court may either refuse to enforce any contract that was "unconscionable at the time it was made" or "limit the application of any unconscionable clause."[47] In the *Discover Bank* case, the California Supreme Court found that a class action waiver in a consumer adhesion contract typically applied to disputes that involved small sums of money and a party with superior bargaining power who included the waiver in the contract in order to cheat large numbers of consumers out of individually small sums of money. The waiver was unconscionable because it exempted the non-consumer party to the contract from its own fraud or willful injury to the consumer party.

Scalia presented two alternative possibilities for deciding the outcome of the case. If California's unconscionability doctrine and policy against exculpation were grounds "that exist at law or equity for the revocation of a contract," then they were applicable under the FAA's savings clause. On the other hand, if it turned out that these generally applicable doctrines had been used to disfavor arbitration, they were preempted by the FAA.[48] Scalia chose the second theory to rule against consumers and in favor of business. He hypothesized that a state could not target consumer arbitration agreements as unconscionable or unenforceable simply because they deprived the consumer of judicially monitored discovery or did not abide by the Federal Rules of Evidence or did not

allow for a trial by jury. Such actions would clearly be seen as obstacles to the accomplishment of the stated purposes of the FAA. Similarly, if the "overarching purpose" of the FAA was "to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings,"[49] then "requiring the availability of classwide arbitration interfere[d] with fundamental attributes of arbitration and thus create[d] a scheme inconsistent with the FAA."[50]

Scalia referred to §§2, 3, and 4 of the FAA to support his position that the principal purpose of the FAA was to ensure that private arbitration agreements were enforced according to their terms. Section 2 stated that, subject to the savings clause, arbitration agreements were "valid, irrevocable, and enforceable." Section 3 required litigation of arbitral claims to be stayed pending arbitration of those claims "in accordance with the terms of the agreement." Finally, §4 instructed courts to compel arbitration "in accordance with the terms of the agreement" so long as the "making of the arbitration agreement or the failure . . . to perform the same" was not at issue. Scalia reasoned that parties to an arbitration agreement may specify the issues to be arbitrated,[51] select the rules of arbitration,[52] and limit with whom a party may arbitrate its dispute.[53] This ability to design particular arbitration processes according to the needs of different kinds of disputes reduced the cost at the same time that it increased the speed of dispute resolution.

In his dissenting opinion, Breyer quoted the case of *Dean Witter Reynolds Inc. v. Byrd*[54] in which the Supreme Court "reject[ed] the suggestion that the overriding goal of the Arbitration Act was to promote the expeditious resolution of claims." Scalia claimed that the dissent's use of that particular quote was misleading. Although it was true that the Court in *Dean Witter* stated that the purpose of the FAA was to "ensure judicial enforcement of privately made agreements to

arbitrate,"[55] it also pointed out that "this is not to say that Congress was blind to the potential benefit of the legislation for expedited resolution of disputes."[56]

In the present case, Scalia found no conflict between the two goals of the FAA—the enforcement of private agreements and the encouragement of efficient and speedy dispute resolution—in enforcing the terms of the AT&T arbitration clause. He did, however, see a conflict between the FAA's promotion of arbitration and California's *Discover Bank* rule. The *Discover Bank* rule interfered with arbitration the same way a state law rule that required the parties to exhaust administrative remedies before proceeding to arbitration frustrated the objective of the FAA.[57] Although the California rule did not require class-wide arbitration in all consumer contract cases, it did have the same practical result. The application of the rule was limited to adhesion contracts where the damages were predictably small and the consumer alleged a scheme to cheat consumers. Scalia, however, noted that most consumer contracts were adhesion contracts, that the idea of a small claim was very relative, and that all the consumer had to do was allege a scheme to cheat. As a result, most consumers would have the option to resolve their disputes through bilateral arbitration or through class arbitration. Given that option, Scalia speculated that a consumer would have difficulty finding a lawyer who would be willing to handle an individual arbitration claim when the possibility of a class action existed. Businesses, on the other hand, would have less incentive to use arbitration for individual claims when faced with exposure to the inevitable class arbitration.

In order to illustrate the problems arising from class arbitration, Scalia referred to the recent case of *Stolt-Nielen v. AnimalFeeds Int'l. Corp.*[58] in which the Supreme Court held that an arbitration panel had exceeded its authority under the

FAA when it imposed class procedures that arose from policy judgments and not from the terms of the arbitration agreement or the interpretative principals of contract law. The basis for the decision was the Court's conclusion that the "changes brought about by the shift from bilateral arbitration to class-action arbitration" were "fundamental."[59] In class actions parties may be absent, additional and different procedures may be needed, there is the potential for a loss of confidentiality, and, it is likely that there will not be many arbitrators knowledgeable in the procedural aspects of class certification.

Scalia then focused on the three problematic differences between bilateral arbitration and class action arbitration. The first was the loss of the primary advantage of arbitration—its informality. In bilateral arbitration, the parties "forgo procedural rigor and appellate review" in exchange for "lower costs, greater efficiency and speed, and the ability to choose expert adjudicators to resolve specialized disputes."[60] In class action arbitration, the arbitrators must certify the class and determine how discovery for the class will be conducted before they can even begin to consider the merits of the claims. Scalia cited a study by the American Arbitration Association (AAA) reporting that, on the average, it took six months to resolve an individual consumer arbitration claim on the merits (four months if the arbitration was conducted by documents only.)[61] Of the 283 class arbitration cases opened as of September 2009, 121 remained active, 162 had been settled, withdrawn, or dismissed, and not a single one had resulted in a final award on the merits. The median time from filing to settlement, withdrawal or dismissal of class arbitration cases that were no longer active was 583 days.[62]

The second difference between bilateral and class action arbitration cases was that class arbitration required procedural formality similar to that found in the Federal Rules of Civil

Procedure in order to protect the interests of all members of the class.[63] Scalia noted that many procedural problems facing arbitrators in class action cases had certainly not been anticipated by the drafters of the FAA since class actions had not even been available at the time the statute was enacted.

The final difference, which seemed to be particularly important to Scalia, was the fact that class arbitration greatly increased the risks to defendants. The defendants were aware that it was inevitable that errors might occur in informal arbitration procedures which could not be corrected through an appeal process. But, it was an infrequent cost that they were willing to pay in exchange for not having to incur the expenses of going to court. That cost-benefit analysis changed, however, when the inevitable error no longer involved a relatively small individual claim but claims of a sizeable class of plaintiffs. In those instances, even the chance of an error might pressure a defendant into settling claims which, on the merits, might have been questionable. An important issue in a class action case involves the certification of the class. Under the FAA, the only time that a court may vacate an arbitral award was if it "was procured by corruption, fraud, or undue means"; "the arbitrators were guilty of misconduct in refusing to postpone the hearing . . . or in refusing to hear evidence pertinent and material to the controversy[,] or of any other misbehavior by which the rights of any party have been prejudiced"; or if the "arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award . . . was not made."[64] While certification decisions were reviewable, under the FAA review was limited to the misconduct of the arbitrators and not on an error in applying the law. Under the circumstances, Scalia doubted whether a defendant would agree to class arbitration with no means of review or whether Congress would want state courts to place the defendant in such a position.

Scalia acknowledged that many of the small dollar claims that individual consumers had against AT&T would never be pursued without the benefit of a class action option. That result by itself, however, did not justify allowing a state to require a "procedure that is inconsistent with the FAA, even if it is desirable for unrelated reasons."[65] The only thing that mattered was the fact that California's rule on unconscionability "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[66]

B. Concurring Opinion

Justice Thomas' concurring opinion focused on the issue of whether the *Discover Bank* rule was, under the savings clause of the FAA, a "groun[d] . . . for the revocation of any contract." Thomas' textual reading of §2 limited a court's ability to revoke an arbitration agreement only on the basis of an illegally (such as fraud or duress) in the formation of the agreement.[67] The fact that a particular state law defense applied "to any contract" was not by itself sufficient to revoke the arbitration agreement if that defense represented nothing more than a state's public policy against arbitration. It was significant to Thomas that while §2 states that arbitration provisions in contracts are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract," it "does not parallel the words "valid, irrevocable, and enforceable" by referencing the grounds as exist for the "invalidation, revocation, or nonenforcement" of any contract."[68] The omission allowed him to conclude that the exception in the savings clause did not apply to any contract defense but only to a subset of those defenses. Although Thomas acknowledged that courts have referred to the concepts of revocability, validity, and enforceability interchangeably, he found it significant that

Congress only chose to include the concept of revocability in the savings clause.

To understand the meaning of the savings clause, Thomas turned to §4 of the FAA (which specified that if a court was satisfied that the making of the agreement for arbitration or the failure to comply was not an issue, it must order arbitration according to the terms of the agreement.) He concluded that if §2 was read harmoniously with §4 then the only grounds for revoking an arbitration agreement under §2 would be those relating to the making of the agreement—and not other defenses—such as public policy—that were unrelated to the making of the agreement.[69]

Under the *Discover Bank* rule, the class action waiver in a consumer contract of adhesion was unconscionable because it was unlawfully exculpatory—and contrary to public policy. But, the *Discover Bank* rule did not concern itself with the making of the arbitration agreement. There was no claim of fraud, duress, or delusion on the part of the consumer.[70] It was the terms, conditions, and practices contained in the arbitration agreement that the California court held to undermine public policy. And, that public policy reason was an unacceptable ground for refusing to enforce an arbitration agreement since it had nothing to do with whether the contract was properly made.

C. Dissenting Opinion

Justice Breyer's dissenting opinion reveals a frustration with the majority's interpretation of the savings clause of the FAA. According to the minority opinion, "grounds as exist at law or in equity for the revocation of any contract" would surely include the *Discover Bank* rule. In the *Discover Bank* case, the California court, interpreting §§ 1668 and 1670.5(a) of the

California Civil Code, concluded that a class action waiver in a consumer contract was exculpatory and unconscionable when: 1. the consumer contract was an adhesion contract, 2. the disputes between the parties were predictably for small amounts of damages, and 3. it was alleged that the party with the superior bargaining power had carried out a scheme of deliberately cheating large numbers of consumers out of individually small sums of money.

The *Discover Bank* rule did not invalidate all class action waivers in consumer contracts—only those which offended the more general principle of unconscionability. That principle did not target arbitration agreements since it applied equally to class action litigation waivers as well as class action arbitration waivers. It was, under the terms of the savings clause, a valid ground on which to refuse to enforce an arbitration agreement that exists "for the revocation of *any* contract." (Emphasis added.)[71]

Breyer found no inconsistency between the *Discover Bank* rule and the basic purpose behind the FAA. Although the House Report in support of the original bill emphasized the costliness and delays of litigation, the expeditious resolution of claims through arbitration was not Congress' overriding goal in enacting the FAA. The purpose of the FAA was to ensure the judicial enforcement of arbitration agreements in commercial contracts and admiralty contracts by placing them "upon the same footing as other contracts."[72]

The minority opinion was critical of the majority's claim that the *Discover Bank* rule was an obstacle to the objective of the FAA since it would increase the complexity of arbitration procedures and discourage parties from entering into arbitration agreements.[73] While the California rule might, in some instances, invalidate an unconscionable anti-class

arbitration contract term, it did not follow that that would increase the complexity of the arbitration procedures. Breyer also rejected the suggestion that applying the *Discover Bank* rule was just as unacceptable as requiring arbitration agreements to provide for the ultimate disposition by a jury, a judicially monitored discovery, and the use of the Federal Rules of Evidence.[74] Class action arbitration was consistent with arbitration and was well known in California and elsewhere. Even the American Arbitration Association had characterized class arbitration as "a fair, balanced, and efficient means of resolving class disputes."[75]

Breyer challenged the majority's assumption that individual, rather than class, arbitration, was a fundamental attribution of arbitration. He found no basis for such a claim in the legislative history. While it was true that at the time the FAA was enacted, arbitration procedures had not yet been fully developed,[76] there was evidence to suggest that as Congress was considering the legislation it thought of arbitration primarily in the context of merchants who "sought to resolve disputes of fact, not law, under customs of their industries, where the parties possessed roughly equivalent bargaining power."[77] This would suggest that a compelling Congressional concern had been that the bargaining power be roughly equivalent in the arbitration process. If that were the case, consumer class arbitration, which helps to level the playing field with merchants, would be consistent with that objective.[78]

The minority opinion also rejected the claim that the incentives to include a mandatory arbitration clauses in contracts would disappear if potential defendants knew that the result might be complex class arbitration. On the issue of incentives, Breyer argued that the relevant comparison was not between bilateral arbitration and class action arbitration but

between class arbitration and judicial class actions.[79] In such a comparison, parties would not necessarily be discouraged from including mandatory arbitration clauses in contracts. One incentive for agreeing to arbitration is that it saves time. While class arbitration may be more time consuming than bilateral arbitration, it is still less time consuming than the average class action litigation. Similarly, if speed in resolving a dispute is an objective of the FAA, AAA statistics have suggested that "a single class proceeding is surely more efficient than thousands of separate proceedings for identical claims."[80] The dissent found no empirical support for the majority's claim that there is a disincentive for parties to submit high stack claims to arbitration.[81] It also pointed out that even though contract defenses might "slow down the dispute resolution process," that was something that federal arbitration law treated as a state law matter--unless the defense was being used to disfavor arbitration.[82]

Scalia had highlighted the practical disadvantages of class arbitration—it greatly increased the risks to the defendants and might pressure defendants into settling questionable claims rather than face the chance of a devastating loss. Breyer, on the other hand, emphasized the countervailing advantages of class arbitration. The first was that without the possibility of a consolidated arbitration, many small dollar claimants would simply abandon their claims. The second was that tenacious parties, such as the Concepcions, would have difficulty finding attorneys to represent them in proceedings involving small claims and even smaller fees. As Breyer noted, "The *realistic* alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or fanatic sues for $30."[83]

In his review of U.S. Supreme Court cases, Breyer found no "meaningful" support for many of the majority's legal

conclusions. Instead he found precedents that authorized complex arbitration procedures,[84] upheld nondiscriminatory state laws that slowed down the proceedings,[85] and refused to strike down a state statute that treated arbitration on par with judicial and administrative proceedings.[86] Other cases reaffirmed that the basic objective of the FAA was to treat arbitration agreements "like all other contracts'[87] and not to immunize them from judicial challenges in a way that elevated the arbitration agreement above other forms of contracts.[88]

The dissenting opinion concluded with a brief discussion of a basic premise of federalism— "that Congress does not cavalierly pre-empt state-law causes of action."[89] Breyer noted that the savings clause of the FAA clearly recognized that the states had a role of determining if there were grounds at law or in equity for revoking a particular arbitration contract. Consequently, the Court failed to honor federalist principles when it ignored the specific language of the savings clause and struck down the California law.

IV. CONCLUSION

The *AT&T Mobility v. Concepcion* case may very well become a milestone case not because of the legal reasoning that the Supreme Court used to interpret the savings clause or because of its predictable reaffirmation of the arbitration process. On the contrary, it may be remembered as the case that not only changed the future of consumer class action arbitration but also the future of consumer class action litigation in the United States.

Soon after the Supreme Court heard oral arguments in the *AT&T Mobility* case, the *Wall Street Journal* and the *New York Times* presented the public with two views of what was at stake. The editors of *The Wall Street Journal,* referring to the

case as "the $30 bonanza," conjured up a fantasy dream for business . . . "[i]magine if class action lawsuits become a historical curiosity like spiked hair and platform shoes. While we would never underestimate the resilience of trial lawyers, a case heard by the Supreme Court . . . could put a damper on the class action bonanza."[90] The *New York Times*, on the other hand, referred to the *AT&T Mobility* case as the "latest in the arbitration war—a battle over whether the United States will increasingly have a privatized system of justice that bars people from enforcing rights in court and, if so, what will be considered fair in that system. It would be grossly unfair for the court to let the corporation get away with what it wants to in *AT&T Mobility v. Concepcion*—a case that involves a small amount of money and a huge principle."[91] In the end the $30 bonanza was not a windfall for trial lawyers and consumers—but a gigantic bonanza for business. In this case the winners did take all.

The majority opinion focused on what would happen if the class action arbitration clause was invalidated. Businesses would have less incentive to include arbitration clauses in adhesion contracts. A few losses to individual claimants were one thing—but a single loss to a larger class of consumers was perhaps too risky. Under those circumstances, businesses might find the litigation process preferable to the arbitration process (with its limited discovery possibilities, flexible rules of evidence, and limited possibility of review). What the Court chose not to consider was what business would do if the provision prohibiting class actions was upheld. One consequence of the Supreme Court's decision in *Circuit City Stores, Inc. v. Adams*[92] was the increased use of mandatory arbitration clauses in employment contracts. After the *AT&T Mobility* decision, it would not be far-fetched to anticipate two strategic moves by business. The first would be to amend employment application forms and contracts to include class

action waivers as well as mandatory arbitration clauses. The second would be to redraft all types of consumer sales contracts to include mandatory arbitration clauses with class action waivers. The end result might not only be the demise of class action arbitration but also individual and class action litigation for cases involving claims by consumers and employees.

Although things do appear bleak for employees and consumers seeking to invalidate mandatory arbitration with anti-class action clauses, there is still the possibility of change. Soon after the Supreme Court issued its decision in *AT&T Mobility,* Representative Henry Johnson (D-GA) and Senator Al Franken (D-MN) introduced a bill in Congress that was intended to invalidate a number of the Court's recent decisions involving arbitration. The Arbitration Fairness Act of 2011[93] would prohibit employers and businesses from including pre-dispute mandatory arbitration clauses in employment and consumer contracts where the subsequent conflicts involve statutorily protected civil rights. The likelihood that the current Congress will pass the bill is quite slim. There is also the possibility that the U.S. Supreme Court itself might revisit its current policy in favor of mandatory consumer arbitration clauses when it decides the case of *CompCredit Corp., et al. v. Greenwood, et al*.[94] Unfortunately discussion by the justices during oral arguments indicated that their decision is going to be a reiteration of majority's support of pre-dispute arbitration agreements. One final possibility is that the Consumer Financial Protection Bureau (CFPB), under the provisions of the Dodd-Frank Act, might be able to limit the future use of arbitration agreements (at least as they apply to consumer financial products such as credit cards, auto financing, installment loans, and checking and deposit accounts.) Congress authorized the CFPB is authorized to study the use of mandatory arbitration clauses in consumer contracts and, if it

was found to be in the public interest and would protect consumers, issue regulations prohibiting the use of mandatory arbitration agreements.[95]

The Roberts' Court has demonstrated in case after case that it is indeed "the Corporate Court." Its willingness to enforce a mandatory arbitration clause that prohibits class actions by consumers is a lopsided decision in favor of business interests. Consumers and employees have no real bargaining power when they enter into standard form contracts that preclude litigation. They know that they are in a "take it or leave it" position. This is even more so now that the Court has concluded that a claim of substantive unconscionability will not be allowed to frustrate what it understands to be the higher goal of the FAA.

ENDNOTES

[1] 9 U.S.C. 1 *et seq.*.

[2] 131 S. Ct. 1740; 563 U.S. ____ (2011).

[3] *Laster. v. T-Mobile USA, Inc.,* 2008 U.S. Dist. LEXIS 103712 (S.D. Cal., Aug. 11, 2009), 5.

[4] *Id*. at 5.

[5] *Id*. at 5-6, citing Berinhout Decl., Exh. 11.

[6] *Id*. at 6.

[7] *Id*. at 6-7, citing Berinhout Decl., Exh. 16.

[8] *Id*. at 6.

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[9] *Id*. at 7, quoting Berinhout Decl., Exh. 2. It should be noted that under the California Code of Civil Procedure § 116.221, $7,500 is the maximum claim that can be brought in a small claims court. *Laster and Concepcion. v. AT&T Mobility LLC,* 584 F. 3d 849, 853 (2008).

[10] *Id*. at 8, quoting Berinhourt Decl., Exh. 2.

[11] *Id*. at 8, quoting Berinhourt Decl., Exh. 2.

[12] *Id*. at 8.

[13] *Id*. at 8.

[14] *Id*. at 8.

[15] *Id*. at 11.

[16] 28 U.S.C. §§ 1711, *et seq*..

[17] *Supra* note 3, at 12.

[18] Cal. Bus. & Prof. Code § 17500, *et seq.*

[19] Cal. Bus & Prof. Code § 17200, *et seq.*

[20] Cal. Civ. Code §1770, *et seq.*

[21] *Supra* note 3, at 12-13.

[22] *Id*. at 13.

[23] *Id*. at 13.

[24] 498 F.3d 976 (9th Cir., 2007).

[25] *Id*. at 978.

[26] *Supra* note 3, at 14.

[27] *Id*. at 14.

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[28] *Id*. at 15.

[29] *Id*. at 17-18.

[30] *Id*. at 43. The District Court relied on the three prong test articulated in the case of *Discover Bank v. Superior Court,* 36 Cal. 4th 148; 113 P. 3d 1100 (June 27, 2005) to conclude that the class waiver in the consumer contract was in fact unconscionable and, therefore, unenforceable under California law.

[31] *Id*. at 29.

[32] *Id*. at 37.

[33] *Id*. at 42.

[34] *Supra* note 9, *Laster* at 852.

[35] *Supra* note 30. *Discover Bank* involved a claim by a California credit cardholder that Discover Bank had misrepresented the time at which it would begin to charge late fees. The adhesion contract between the bank and its credit card customers included a class action waiver that the California Supreme Court ruled to be unconscionable and unenforceable based on its three prong test.

[36] *Supra* note 9, *Laster* at 854, quoting *Discover Bank*, *supra* note 30.

[37] *Id*. at 855-856.

[38] *Id*. at 857, quoting *Shroyer, supra* note 24, at 987.

[39] *Id*. at 857-858, citing *Shroyer* at 989-991.

[40] *Id*. at 858, citing *Shroyer*, at 990.

[41] *Supra* note 2, at 1745, quoting *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.,* 460 U.S. 1, 24, 103 S. Ct. 927 (1983).

[42] 9 U.S.C. §2.

[43] *Supra* note 2, at 1744.

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[44] *Id.* at 1745, quoting *Moses H. Cone Memorial Hospital, supra* note 41, at 24.

[45] *Id*. at 1745, quoting *Rent-Center, West, Inc. v. Jackson,* 561 U.S. ____, 130 S. Ct. 2772, 2776 (2010).

[46] *Id*. at 1746.

[47] Cal. Civ. Code Ann. § 1670.5(a) (West 1985).

[48] *Supra* note 2, at 1747, citing *Perry v. Thomas,* 482 U.S. 483, 492, 107 S. ct. 2520 (1987), in which it was noted that the FAA could preempt state grounds traditionally thought to exist "at law or in equity for the revocation of any contract."

[49] *Supra* note 2, at 1748.

[50] *Id.* at 1748.

[51] *Id.* at 1748, citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymounth, Inc.,* 473 U.S. 614, 628, 105 S. Ct. 3346 (1985).

[52] *Id*. at 1749, citing *Volt Information Systems, Inc. v. Board of Trustees of Leland Stanford Junior University,* 489 U.S. 468, 479, 109 S. Ct. 1248 (1989).

[53] *Id*. at 1749, citing *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.,* 559 U.S.____, ____, 130 S. Ct. 1758 (2010).

[54] 470 U.S. 213, 219 (1985).

[55] *Id*. at 219.

[56] *Id*. at 220.

[57] *Supra* note 2, at 1749, citing *Preston v. Ferrer,* 552 U.S. 346, 357-358 (2008).

[58] *Supra* note 53.

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[59] *Supra* note 2, at 1750, quoting *Stolt, supra* note 53, at 1776.

[60] *Id* at 1751, quoting *Stolt*, at 1776.

[61] *Id*. at 1751, citing AAA, Analysis of the AAA's Consumer Arbitration Caseload, online at http://www.adr.org/si.asp?id=5027.

[62] *Id*. at 1751, citing Brief for AAA as *Amicus Curiae* in *Stolt-Nielsen,* O.T. 2009, No. 09-1198, pp. 22-24.

[63] *Id*. at 1751.

[64] 9 U.S.C. §10.

[65] *Supra* note 2, at 1753.

[66] *Id*. at 1753, quoting *Hines v. Davidowitz,* 312 U.S. 52, 67, 61 S. Ct. 399 (1941).

[67] *Id*. at 1753.

[68] *Id*. at 1755.

[69] *Id*. at 1754-1755.

[70] *Id*. at 1756.

[71] *Id*. at 1757.

[72] *Id*. at 1757.

[73] *Id*. at 1758.

[74] *Id*. at 1758, referring to Scalia's examples, *id*. at 1747.

[75] *Id.* at 1758, quoting Brief for AAA, *supra* n. 62, at 25.

[76] *Id.* at 1759.

[77] *Id*. at 1759.

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[78] *Id*. at 1759.

[79] *Id*. at 1759.

[80] *Id*. at 1759, quoting Brief for AAA, *supra* note 62, at 24.

[81] *Id*. at 1760, citing a series of publicized arbitration cases that resulted in settlements of $500 million, $1.5 billion, and $833 million.

[82] *Id*. at 1760.

[83] *Id*. at 1761.

[84] *Id*. at 1761, citing *Mitsubishi Motors, supra* note 51, at 629.

[85] *Id*. at 1761, citing *Volt*, *supra* note 52, at 477-479.

[86] *Id*. at 1761, citing *Preston*, *supra* note 57, at 355-356.

[87] *Id*. at 1761, citing *Buckeye Check Cashing, Inc. v. Cardegna,* 546 U.S. 440, 447 (2006); *Vaden v. Discover Bank,* 556 U.S. 49, 64 (2009); *Doctor's Associate, Inc. v. Casarotto,* 517 U.S. 681, 687 (1996); *Allied-Bruce Terminix Cos. v. Dobson,* 513 U.S. 265, 281 (1995); *Rodriguez de Quijas v. Shearson/American Express, Inc.,* 490 U.S. 477, 483-484; *Perry, supra* note 48, at 492-493, note 9; *Mitsubishi Motors, supra,* note 84, at 627.

[88] *Id*. at 1761, citing *Prima Paint Corp. v. Flood & Conklin Mfg. Co.,* 388 U.S. 395, 404, note 12 (1967); *Marchant v. Mead-Morrison Mfg. Co.,* 252 N.Y. 284, 299, 169 N.E. 386, 391 (1929).

[89] *Id*. at 1762.

[90] *The $30 Bonanza,* WALL STREET JOURNAL, November 11, 2010, http://wsj.com/article/SB10001424052748704635704575604342012494842.html.

[91] *The Arbitration War,* N.Y. TIMES, November 27, 2010, at A18.

[92] 532 U.S. 105 (2001).

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[93] H.R. 1873; S. 987.

[94] No. 10-948; 615 F. 3d 1204; 2010 U.S. App. LEXIS 17128 (9th Cir., 2010). In this case, the Court must decide if a mandatory arbitration clause in a consumer contract trumps an explicit statutory right to sue that was created under the Credit Card Accountability, Responsibility and Disclosure Act of 2009.

[95] Kate Davidson, *High Court Gives Banks A Win, But Will It Last?,* 176 AMERICAN BANKER 1 n. 66 (April 28, 2011).

HOW THE LEGAL ENVIRONMENT AFFECTS EARNINGS MANAGEMENT

by

John Paul[*]

INTRODUCTION

Earnings management has been on the rise. The recent corporate accounting scandals involving large well-known companies such as Enron, WorldCom, Xerox and Tyco – all audited by large accounting firms – suggest serious deficiencies in the accounting standards and corporate governance and regulatory systems designed to guide and monitor the financial information process.[1] While large firms may have received more media attention, financial statement fraud occurred more frequently in smaller companies (companies with total assets of less than $100 million) than larger ones.[2]

Since earnings management has been on the rise, a definition of earnings management is in order. Earnings management is when managers alter their entities' accounting and financial information by using their discretion in financial reporting and transaction structuring.

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Firm-specific data corroborates the use of earnings management by corporations. The number of earnings restatements by listed companies, often after admitted irregularities, has tremendously increased in the last several years.[3] In addition, the frequency of firms beating analyst's earnings forecasts has increased sharply in the 1990s, suggesting earnings management as a possible cause.[4] Lev and Zarowin provide evidence that the usefulness of reported earnings, cash flows, and equity values has been deteriorating for two decades.[5]

One common form of earnings management is the use of discretionary accruals.[6] Under accrual-basis accounting, transactions that change a firm's financial statements are recorded in the same periods in which the events occur. Under the accrual basis, revenues are recognized when earned rather than when the cash is actually received and expenses are recognized when incurred rather than when the cash is paid. On an accrual basis, information presented reveals relationships likely to be important in predicting future results.

Under cash-basis accounting, revenues are recorded only when received in cash and expenses are recorded only when paid in cash. Cash-basis accounting does not properly match earned revenues with expenses and is not in accordance with Generally Accepted Accounting Principles. Cash basis accounting is justified for individuals and small companies because they usually have few receivables and payables but most companies use accrual-basis accounting.[7] Accruals, in particular, are the non-cash items that determine regular accounting income.[8]

By their very nature, accruals require subjective judgments and estimation. Before they are realized, accruals are difficult for auditors to objectively verify.[9] Determining what

component of accruals is discretionary is also difficult but empirical models have been developed to measure discretionary accruals.[10]

Researchers have found many incentives for using discretionary accruals as a form of earnings management. Many corporate contracts use accounting information as a means of assessing whether the contract terms are being followed. For example, in some employment contracts, firm managers do not receive any bonuses in years where their firms suffer losses or where certain earnings targets are not met.[11] These types of contracts provide incentives for managers to inflate earnings in order to receive the maximum amount of compensation that may be available to them.

There are also regulatory incentives for using discretionary accruals. In the United States some industries, such as the banking, insurance and utility industries, face regulation that is specifically tied to numbers. In particular, banks are required by regulation to maintain certain capital adequacy requirements while utility companies are rate-regulated and allowed to earn only a normal return on invested assets. These regulations provide incentives to manage the financial statement variables.[12] Evidence indicates that banks close to minimum capital requirements recognize abnormal realized gains on securities portfolios.[13]

This leads to the issue of how a fraud-based legal ruling would impact the managerial incentive for earnings management using discretionary accruals. Arguably, a ruling would decrease the incentive for using discretionary accruals since firm managers would not want to go through the ordeal of another legal action; yet, it can also be argued that such a ruling may provide more incentives for managers to use discretionary accruals since the legal case has been concluded

and the managers are faced with trying to place the corporation into a more favorable light in the eyes of stakeholders (i.e., creditors, stockholders, employees).

This study empirically examines how fraud-based legal rulings impact discretionary accruals. The results indicate that the magnitude of a firm's discretionary accruals decreases in response to the issuance of a favorable fraud-based legal ruling and increases in response to the issuance of an unfavorable fraud-based legal ruling.

RESEARCH DESIGN

A sample of firms facing fraud-based legal rulings was selected by searching the Commerce Clearinghouse Federal Securities Law Reports for the years 1982 to 2007. Accounting data needed to estimate accruals[14] was obtained from the Compustat Industrial Quarterly database.

The main proxy for client managers' reporting flexibility are the income-increasing discretionary accruals estimated using the Modified Jones model because while other models may provide better results in certain manipulation tests, the Modified Jones model is consistently better overall for measuring discretionary accruals and in detecting earnings management than other models are.[15] The Modified Jones model estimates discretionary accruals (**DISCRETIONARY_ACCRUALS**) as the prediction error from firm-specific ordinary least square regressions:

$$\text{(1) } \mathbf{TOTAL_ACCRUALS_{it} = A_0 + A_1(\Delta\ REV_{it} - \Delta\ REC_{it}) + A_2(PPE_{it}) + \varepsilon_{it}}$$

where:

$TOTAL_ACCRUALS_{it}$ = Δ Current assets$_t$ – Δ Cash$_t$ – Δ Current liabilities$_t$ + Δ Current portion of long-term debt$_t$ – Depreciation and amortization expense$_t$;
A_0 = the intercept or an item of the regression equation indicating the criterion score when all the predictor variables are zero[16];
$\Delta\ REV_{it}$ = revenues in year t less revenues in year t-1;
$\Delta\ REC_{it}$ = receivables in year t less receivables in year t-1;
PPE_{it} = gross property, plant and equipment in year t;
ε_{it} = prediction errors;
i = 1..n firm index; and
t = 1..T(i) year index for the number of years included in the estimation period for firm i.

DISCRETIONARY_ACCRUALS are the prediction errors (ε_{it}) from applying the Modified Jones model to estimate normal accruals in the year of the legal ruling:

(2) $$DISCRETIONARY_ACCRUALS_{it} = TOTAL_ACCRUALS_{it} - A_0 + A_1(\Delta\ REV_{it} - \Delta\ REC_{it}) + PPE_{it}$$

The discretionary accruals model specifies four control variables and two categorical variables. The four control variables represent earnings growth, firm growth, firm leverage and firm size. The two categorical variables are independent dummy variables used to account for the effect that the filing of a legal action and the issuance of a legal ruling have in predicting the dependent variable of discretionary accruals.

EMPIRICAL RESULTS

Table 1 summarizes the mean, standard deviation as well as the minimum and maximum values for the dependent and independent variables categorized by type of ruling – favorable and unfavorable. Table 2 summarizes the value of the regression coefficients, which indicate how much change occurs in the dependent variable of discretionary accruals for a one-unit change in the particular independent variable.

Table 1 reveals that the firms that received unfavorable rulings had a wider range of discretionary accruals when compared with the firms that received favorable rulings. Table 2 reveals that the companies with unfavorable rulings increased the use of income-increasing discretionary accruals by 80.27% [(72.1394 – 40.0185)/40.0185%] in the period after the issuance of the unfavorable legal ruling when compared to the period before the issuance of that ruling while the companies with favorable rulings decreased the use of income-increasing discretionary accruals by 96.26 percent [(12.9523 – 346.7699)/346.7699%] in a direct comparison of the (RULING = -1) and (RULING = 0) variables.

These results indicate that when companies prevail in fraud-based legal actions against them, they are more likely to decrease the use of discretionary accruals while companies that lose in fraud-based legal actions against them are more likely to increase the use of discretionary accruals. Perhaps the companies with favorable rulings are relieved at the fact they have won the fraud-based legal action and decrease the use of discretionary accruals so they won't have to face another such action again. Furthermore, the companies with unfavorable rulings now have to deal with a loss of trust among corporate stakeholders as a result of losing the legal action and use

discretionary accruals in order to provide a more impressive financial picture of the company so as to minimize the impact of the unfavorable ruling.

TABLE 1: DESCRIPTIVE STATISTICS FOR COMPANIES WITH FAVORABLE AND UNFAVORABLE RULINGS		
Companies with Favorable Rulings Sample = 27 Companies		
Variable	**Minimum**	**Maximum**
FEarnGrowth	-887.6204	130.6226
FGrowth	-0.8064516	8.709299
FLeverage	0	7.31992
FSize	-0.1432711	5.979368
DiscAccr	-21,455.4	22,146.85
Companies with Unfavorable Rulings Sample = 42 Companies		
Variable	**Minimum**	**Maximum**
FEarnGrowth	-1,598	92.17647
FGrowth	-0.9851179	4.738058
FLeverage	6.849315	21.1
FSize	-1.920819	5.922928
DiscAccr	-44,445.42	32,965.52

TABLE 2: REGRESSION COEFFICIENTS FOR THE RULING VARIABLES		
RULING TYPE	**RULING = -1**	**RULING = 0**
Favorable	346.7699	12.9523
Unfavorable	40.0185	72.1394

CONCLUSION

The use of earnings management has been on the rise for the past two decades. Earnings management is when managers alter corporate financial reports by exercising their discretion over accounting and financial issues. The use of discretionary accruals is a popular form of earnings management because they are difficult for independent auditors to verify since they involve subjective managerial estimates. Empirical models have been developed to measure the discretionary component of accruals.

Since there are empirical models that can measure discretionary accruals, the next step is to determine the incentives for the use of discretionary accruals. Studies of possible incentives include contractual and regulatory incentives among others. This study examines the incentives of firms to use discretionary accruals after they have received fraud-based legal rulings from a court or enforcement authority.

For the purposes of this study, a discretionary accrual model was formulated to test whether the magnitude of a firm's

discretionary accruals increases or decreases after the issuance of a fraud-based legal ruling. The results indicate that overall, the magnitude of a firm's discretionary accruals decreases in response to the issuance of a favorable fraud-based legal ruling and increases in response to the issuance of an unfavorable fraud-based legal ruling.

It would seem that a firm that has received an unfavorable legal ruling may have no choice but to continue to use discretionary accruals in order to reduce its political visibility. According to the political cost hypothesis, [17] a firm's reported earnings may increase its political visibility, which increases that firm's regulatory costs, bookkeeping costs, taxes and wage claims. As a result, a firm that has been issued an unfavorable legal ruling may use discretionary accruals to reduce its costs and political visibility among the stakeholders.[18]

In light of this study, independent auditors may need to address certain issues when dealing with firms that have just received fraud-based legal rulings. They should carefully examine managerial decisions that involve subjective estimates such as the Allowance for Bad Debts (or Allowance for Doubtful Accounts) to see if these decisions were made recently. The independent auditors should ask for extensive documentation and detailed explanations to support subjective managerial estimates. If these estimates appeared to have changed around the time the legal ruling was issued, the auditors should investigate further into the reasons for this change and why it coincided with the legal ruling.

Overall, this study provides useful information about the impact of the legal process on earnings management and the reliability of financial statements. An examination of the role that litigation plays in the accounting information process is necessary in order to increase the quality of such information

especially in a world characterized by increasing amounts of litigation.

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OFF-DUTY EMPLOYEE FRATERNIZATION INVADES THE OFFICE: A CASE STUDY OF DOSIS PHARMACEUTICALS

by

Nancy Lasher* and Donna Steslow**

INTRODUCTION:

Managers continue to struggle with defining appropriate interpersonal conduct between employees, and taking action when dating and relationships cross the line into a hostile work environment. Likewise, employment law attorneys are increasingly faced with giving advice in these situations and defining what is legal and illegal. Providing a scenario in the workplace involving a relationship between an administrative assistant and a professional can illustrate to business majors some of the issues raised in workplace relationships.

This case involves employment law and HR issues arising out of an affair between two employees at a pharmaceutical plant. The case is based upon an actual situation; however, the names of the parties, some of the descriptive facts, and the type of manufacturing plant have been changed for reasons of confidentiality. The affair ends badly and the tension and animosity between the male engineer and female administrative assistant is affecting the morale of the entire

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department. The twist in this case is that the female is the active "pursuer," and is rumored to have engaged in multiple relationships with co-workers. The male employee, however, is the one facing disciplinary action by his supervisor and the HR Director.

This case would be appropriate for presentation in an undergraduate or graduate Business Law/Legal Environment course, an Employment Law course, or a Human Resource Management course. The case is divided into three sections: The "A" case is written from the perspective of the engineer facing disciplinary action; the "B" case is written from the perspective of the HR Manager, who must decide how to resolve the problem, and the Epilog contains a brief description of what actually occurred. Discussion questions and suggested responses are contained in the Teaching Note.

This case presents the opportunity to teach about the following Employment Law related topics:

- Sexual Harassment (both quid pro quo and hostile environment harassment)
- Employment at Will
- Employee Dress Codes
- Employee Non-Fraternization Policies
- Issues Specific to Unionized Employees
- Using Employer Equipment for Personal Matters
- Gender Discrimination

Given all of the topics this case potentially covers it may at first appear too complicated for an introductory level course; however the many issues involved allow the instructor to touch on as few or as many of the legal issues raised in this case as the instructor deems appropriate. Since this case is based on an

actual workplace occurrence it demonstrates to students that workplace issues rarely revolve around just one area of law. The case's authenticity as well as the numerous subjects it covers will draw students in as they spot many issues that may have been or will be covered in class.

Use of case studies in a business law course provides students the opportunity to examine real-world problems in the business, to identify the issues involved, and to suggest possible solutions.[1] The various employment law issues contained in this scenario encourage students to analyze and apply critical thinking skills as future employees and managers. Dosis Pharmaceuticals enables professors to utilize active learning[2] techniques by presenting a complicated employment scenario, the resolution of which by the company may be judged by students as less than ideal.

DOSIS PHARMACEUTICALS CASE VERSION A:

Steve O'Connell walked forlornly out of his boss' office. He had been summoned to a meeting with the Vice President of Engineering, Jerome Davis, and the Director of Human Resources, Ann Thomas, concerning a complaint which had been filed against him. Steve could not believe what was happening. Not only was his marriage in serious trouble, now his job was in jeopardy. Both troubles were related- they were the result of an affair with a co-worker, Sherri Martino. Sherri was an administrative assistant in the Engineering Department at Dosis Pharmaceuticals. At the meeting, Steve was told that the Human Resources manager, in consultation with Davis, would have to decide what action needed to be taken as the result of Sherri's complaint.

Steve was employed as a manufacturing support engineer at the Dosis Pharmaceuticals plant for three years. When he was

hired, his predecessor made a comment about "staying away" from Sherri Martino unless it was absolutely necessary to work with her, and even then to limit his contact to a minimum. Steve quickly knew why. Sherri was in her late forties, married, and was the only woman in the engineering department. She seemed to enjoy that role. Sherri dressed in short skirts, low-cut tops, and constantly joked and flirted with the men in the department. Her conversations were laced with off-color remarks and innuendo. None of the male engineers specifically complained to management or HR about Sherri's behavior, although a few of them privately voiced their disgust and unease. Although not certain, it was rumored that Sherri engaged in a string of affairs with several engineers, sometimes leaving the building at lunch and allegedly driving to a secluded park nearby for a "rendezvous." Steve had heard her on several occasions call over her cubicle to another engineer, asking for a shoulder rub.

Steve did not intend to become involved with Sherri. He was five years younger, and a married father of two boys. One day, Steve had an argument with his wife on the phone after he told her he had to work late. Sherri overheard the discussion, and began to pay attention to Steve by complimenting him and asking him questions about his work. Eventually, they ended up socializing at a local restaurant celebrating a co-worker's retirement, and Sherri asked Steve for a ride home. Against his better judgment he agreed, because Sherri lived on his way home and she seemed a bit tipsy. This is the night the affair began.

After about a month and a few clandestine meetings, Steve realized he was in way over his head, and ended the affair with Sherri. Sherri was furious. She always liked to be the one to end the affair and move on to a new conquest. It became obvious to everyone in the engineering department that the

interaction between Sherri and Steve was frosty and hostile. Sherri complained to Jerome Davis about work she had to do for Steve, and asked that she not have to have any direct interaction with him. This was impossible, since she processed all of the requisition forms and other corporate paperwork. Even though Steve thought they had kept the affair secret, it was clear that his co-workers suspected it, and maybe even heard about it from Sherri. Steve felt like a fool, and hoped that eventually it would settle down.

Unfortunately, things deteriorated even more. Steve's wife received an "anonymous" letter disclosing the affair. She threatened to leave and seek a divorce. The pastor of Steve's church also received a letter. Steve coached the church boys' basketball team on which his son played. He was trying to save his marriage, he was humiliated, and he was furious. After meeting with his pastor to explain the situation, and seek guidance, he sent an angry text to Sherri stating: "I know what you did and you're in trouble now." The text was sent on his company-issued phone. Sherri angrily texted him back: "We'll see who's in trouble-LOL."

Two days later, Steve was meeting with Jerome Davis. Davis had received some complaints that the atmosphere in Engineering was becoming increasingly unpleasant. Sherri had now filed a complaint with HR and showed the text Steve had sent to her. Steve explained that Sherri had texted him as well and was certain that she was behind the letters to his wife and pastor. The HR Director told him that there was no way to verify those allegations; Sherri did not have a company-issued phone, and there was no way to trace the letters. As for Sherri's previous conduct, there were never any formal complaints filed. All that is documented is Steve's text on his company issued cell phone, which Sherri said she perceived as a threat. Jerome was sympathetic to Steve's plight- he knew of the

rumors about Sherri, and Steve's employment ratings were always stellar. He had saved the company large amounts of money working on developing more efficient manufacturing processes. Sherri was a member of the labor union representing the plant's manufacturing workers and clerical staff. She was supervised by the manager of the administrative staff, and not by the engineering department, so Jerome did not have authority to directly discipline her.

Steve was now awaiting a decision by HR regarding his fate. He felt that it was extremely unfair that a consensual affair would only have consequences for him. He was not even the one who initiated the relationship, and now he was the one who might lose his job. He hoped that he would be able to salvage his career at Dosis.

DOSIS PHARMACEUTICALS CASE VERSION B:

Ann Thomas, H.R. Manager for Dosis Pharmaceuticals, had a big problem on her hands. One of the company's top engineers had apparently been sexually involved with his department's administrative assistant, ended the relationship, and now the administrative assistant had filed a complaint claiming that she felt threatened.

Steve O'Connell was an engineer in Dosis Pharmaceuticals manufacturing support department. He had been with the company for three years and always received top ratings on his yearly salary reviews. His redesign of certain manufacturing processes had saved the company a significant amount of money. Sherri Martino was the administrative assistant in manufacturing support and the only woman working in that department. Sherri was a member of the union which represented the manufacturing and clerical workers. Steve

reported to the Vice President of Engineering, Jerome Davis, while Sherri reported to the manager of the administrative staff.

Sometime over the past several months Steve and Sherri became involved in an extra-marital affair. Although Steve said it was never his intention to become involved with Sherri in this way it somehow happened. Ann strongly suspected that this was not Sherri's first affair with someone in the Dosis engineering department but she couldn't prove that, and besides, she could only deal with the facts that were immediately before her in this matter.

Steve said that it all began one night after a party for a colleague at a local restaurant. Sherri asked Steve for a ride home and Steve agreed because it appeared that Sherri might have had too much to drink. Sherri had been paying attention to Steve ever since she overheard Steve have an argument with his wife over the phone, but then again Sherri flirted with all of the men in the department at one time or another. Sherri also tended to dress provocatively—short skirts and low cut blouses, but since Sherri wasn't supervised by engineering, there was nothing the department could do about this. It was on this ride home that the affair began, but within a month Steve regretted his actions and ended it. However, according to Steve, Sherri didn't take this well and her behavior toward Steve became angry—she even asked Davis to tell Steve not to give her any work to do (impossible since she was the only department Administrative Assistant and she handled matters such as supply requisitions).

Not long after the relationship ended Steve's wife received an anonymous letter in the mail telling her of the relationship. Steve's wife told Steve she wanted a divorce. A second letter was sent to Steve's pastor at the church where Steve coached the basketball league that one of his two sons played in. After

discovering that not one, but two letters had been sent, Steve sent an angry text to Sherri saying, "I know what you did and you're in trouble now." Steve used his company issued cell phone when he sent that text. Sherri didn't have a company phone so she texted Steve back a reply on her personal phone: "We'll see who's in trouble-LOL." However, the company had no way to trace either the letters or the origin of the text that Steve received. In the meantime Sherri had filed a complaint against Steve with Jerome Davis saying she felt threatened. Ann and Jerome now had a decision to make: what to do about Steve? Even though Steve and Sherri's affair may have happened "off the clock" it was definitely impacting what happened during work hours. Ann strongly suspected that Sherri was not innocent in this situation, but the only evidence of wrongdoing she had was the text that Steve sent to Sherri. If the company failed to take action Sherri might file a complaint with the EEOC alleging a hostile work environment, or file an unfair labor practice claim with the union. Ann had much to think about and a decision to make.

EPILOG (WHAT ACTUALLY HAPPENED):

Steve O'Connell was reassigned to a company office in another town. The new position he was "offered" was considered a demotion in terms of the level and salary range. Sherri suffered no adverse employment action.

TEACHING NOTE:

Suggested Teaching Organization:

The cases are designed to be taught in one of two ways:

1. A portion of the class reads the A case, and simultaneously the other portion of the class reads

the B case; then discussion ensues. Then the actual result in the Epilog is read and discussed.

2. The class reads and discusses the A case; then the B case is read and discussed; then the actual result is discussed.

Discussion Questions:

1. To the extent that the affair between Steve and Sherri is distracting the other employees in the department, is this a problem for Dosis? Why?

An employer has legitimate business interests in preventing the type of conduct engaged in between Sherri and Steve, even if it is consensual and there is no distraction to the other employees. It could be perceived by other employees that Sherri is receiving preferential treatment from Steve, even though she does not directly report to him. This could eventually result in a morale problem for the whole office and affect productivity.[3] The added element of distraction to the other employees would create an even greater justification for disciplinary action.

It may be noted that even when the relationship is not between a supervisor and a subordinate, employers should not discipline only one employee in the relationship and not the other, because the disciplined employee may claim gender discrimination (favoritism of one gender over the other).[4] Another type of favoritism actionable under Title VII occurs when an individual involved in a relationship with a superior in the workplace receives preferential employment treatment over someone who is not involved with the superior. A co-worker not involved in the romantic relationship has a legally

recognizable claim for gender discrimination for the reason that the relationship engendered favorable treatment. [5]

Thus, there are many reasons why an employer may be concerned about workplace romance and take steps to prevent or at least monitor them.

2. Is there an issue with Steve using his work issued cell phone to communicate with Sherri? Explain.

Steve's use of the company issued cell phone may generate a discussion of employer monitoring of company-issued electronic equipment. Many employers now provide company-issued devices so that employees are easily accessible for work-related communication. Many employees use work-issued cell phones for personal calls as well. As long as the employer announces that this equipment is subject to monitoring, there is no "reasonable expectation of privacy," even if the equipment is used by the employee at an off-site location.[6] Accordingly, Steve could not claim that the employer invaded his privacy or claim wrongful termination based on invasion of privacy. As an at-will employee (see question 6 below), disciplinary action against Steve would most likely be upheld.

3. What would you do if you were the HR Manager? Should adverse employment action be taken? Who is more "guilty," or do you think both participants in the affair are equally at fault?

The HR manager has to carefully balance the interests of the employees involved with the interests of the company while taking care to not incur liability for actionable adverse employment action. In this situation, a carefully crafted non-

fraternization policy clearly communicated to employees may have helped. It may be mentioned that drafting a clear policy regarding employee fraternization and enforcing this policy equitably can provide considerable legal protection to employers.[7] However, many employers choose not to put non-fraternization policies in place and deal with situations on a case-by-case basis. Even without a formal non-fraternization policy in place, an employer should be proactive in discussing the relationship with the employees involved and reminding them about the company's sexual harassment and anti-nepotism policies.[8] Discussion of the pros and cons of enacting a non-fraternization policy may ensue.

Regarding who is more "guilty" in this situation, that may depend upon the perspective. In terms of engaging in the affair, both Sherri and Steve are "consenting adults." In terms of employee misconduct, it may be suggested that Steve may be considered more "guilty," at least in terms of proof, because he used a company-issued cell phone to communicate with Sherri and therefore had no reasonable expectation of privacy as discussed in #2 above. Sherri may have sent letters or called, but she did not use company issued equipment and it might be difficult to prove she sent the anonymous notes. Sherri and Steve also both contributed to the "frosty" atmosphere in the office after the affair ended, and perhaps Sherri's supervisor could have become involved in order to address Sherri's refusal to do work for Steve.

4. Is this a hostile work environment situation? Why or why not? Can Steve claim a hostile environment because of Sherri's post-affair conduct? What about Sherri's choice of clothing?

In terms of hostile work environment, there are several distinct issues. First, is Steve the victim of hostile work environment sexual harassment after the affair? Next, what about the co-workers and their exposure to the affair and its aftermath? Would they have a hostile work environment claim? Finally, is Sherri a victim of sexual harassment because of Steve's text to her?

Class discussion here may revolve around general types of conduct which constitute hostile work environment under the law. Regarding Steve's possible claim of hostile work environment, it may be difficult to claim that the tension and animosity after the break-up is sexual in nature, since not speaking and refusing to do work does not rise to the level of severe and pervasive conduct required in these situations (see question 9 below). Likewise, Steve's text to Sherri: "I know what you did and you're in trouble" does not contain anything of a sexual nature and may or may not be sexual harassment. However, the text may be troublesome to the HR manager because it may be interpreted as a threat or "ordinary" harassment warranting disciplinary action against Steve.

Awareness of the affair itself by employees in the department may not be hostile work environment sexual harassment, but Sherri's pattern of off-color jokes and innuendo may rise to the level of actionable conduct (although nobody complained). Point out the distinction between "hostile" in the legal context of "hostile work environment" sexual harassment and the use of the word "hostile" in the case meaning "unpleasant" or "unfriendly."

Another type of hostile work environment case which may be discussed under these facts is the so-called "bystander injury" type in which a third party witnessing hostile work environment harassment sues under Title VII.[9] Generally, these

cases involve instances in which the bystander witnesses unwelcome advances towards a co-worker. It would be difficult to establish this type of claim when the sexual relationship being witnessed is consensual and welcomed as is the case here.[10]

An additional cause for concern would be the potential liability to which the employer is exposed should the consensual relationship end as in this situation. For example, one of the employees involved in the relationship may claim sexual harassment for the reason that the other party is stalking, making unwelcome advances, or coercing him or her to remain in the relationship.[11]

As far as Sherri's choice of clothing, whether or not there is a company dress code could be an issue.[12] Employers are free to enact dress codes as long as they do not impose an "unequal burden" based on gender.[13] Since Sherri is the only female employee in the department, an employer would have to take care in drafting a dress code, since males and females dress differently.[14] Enactment and even-handed enforcement of a dress code could eliminate potential hostile work environment claims by coworkers who find Sherri's choice of clothing sexually provocative, offensive, or inappropriate.

5. Why are employers concerned about employees' off-duty conduct? Isn't it their (the employees') own private life? Should employers be able to discipline their employees for off-duty fraternization?

Employer ability to regulate or limit certain types of employee off-duty conduct, including dating, involves law from a variety of sources. First is the concept of "employment at will," which could justify an employer's decision to

terminate an employee for any reason which is not an exception to the doctrine.[15] Balanced against the at-will doctrine is the employee's right to privacy stemming from common-law invasion of privacy tort theories,[16] the right to privacy in the U.S. Constitution,[17] and by state statute (commonly called "lifestyle discrimination statutes") in approximately one-half of the states.[18] Employers have legitimate business interests in avoiding potential liability and maintaining employee morale and productivity as stated previously. Even in states where adverse employment action is statutorily prohibited for engaging in certain off-duty conduct such as "recreational activities," courts have upheld legitimate disciplinary action based on dating between employees.[19]

An interesting parallel exists between the off-duty conduct in this case (dating) and the recent prohibitions against employee smoking (even at home) which employers are imposing. The legitimate business interests of the employers in both situations may be compared and contrasted.[20]

Returning to the facts in the case, it may be pointed out that in addition to the off-duty conduct, the affair and its aftermath was "brought into" the workplace by the participants. Therefore, the contemplated disciplinary action against Steve was not only due to the off-duty relationship. Action was taken when animosity between Sherri and Steve permeated the office and affected the entire department.

6. How does the administrative assistant's union membership fit into the scenario?

Most employees in the United States are employed "at will".[21] This means that either the employer or the employee can terminate the employment relationship at any time for any legal reason. Illegal reasons for terminating employment

include an employer firing an employee for a reason that violates Title VII of the Civil Rights Act of 1964[22] (prohibiting discrimination based on race, color, national origin, religion and gender), or the Americans With Disabilities Act[23] (where an employee can perform the essential functions of the job with or without reasonable accommodation), or under a state law exception to the at-will doctrine (for example, a public policy exception to the employment at will doctrine would be firing an employee for serving jury duty).[24]

Some employees have employment contracts and cannot be terminated, nor can the employee terminate the relationship, during the term of the contract. Premature termination is a breach of contract.[25]

As of 2009, 13.6 percent of US workers were covered by collective bargaining (union) agreements.[26] Under a collective bargaining agreement, employers must follow the process outlined in the contract for taking disciplinary action (including discharging) an employee. Thus, it is highly significant that Sherri is covered by a union agreement in this situation. Assuming that Steve is employed at will it is easier for the employer to discipline Steve for inappropriate conduct related to the workplace. In order to discipline Sherri, a union representative will become involved on Sherri's behalf and the procedures negotiated in the agreement will have to be followed. The union may challenge the need for any type of action against Sherri as inappropriate under the circumstances. Thus, it is more complicated for Dosis to take action against Sherri than against Steve.

7. An administrative assistant is involved with an engineer. She is unionized and doesn't report to Steve but could this be construed as a supervisor-subordinate situation? She is

refusing to do work for him. Can we imply a non-fraternization policy here given principal-agent law?

Since Steve assigns work to Sherri, Steve can be considered a supervisor even though Sherri does not report to him. Under principal-agent law the principal (the employer) is responsible for the conduct of the agent employee that occurs within the scope of employment. Under sexual harassment law an employer is strictly liable for a supervisor who commits quid pro quo sexual harassment. Since Sherri received no benefits and suffered no loss of workplace benefits this would be categorized as hostile environment harassment (if in fact harassment did occur).[27]

The employer principal may still be liable for a supervisor's actions under hostile environment sexual harassment if the employer did not exercise "reasonable care to prevent and correct promptly any sexually harassing behavior" and the employee availed him or herself of the procedures the employer has in place to report and investigate the harassment[28] (this is the Ellerth-Faragher defense). Under these circumstances, a
non-fraternization policy should be implied to protect Dosis as the employer. That could shift the balance to Steve as the supervisor being judged more at fault.

8. What would you put into a non-fraternization policy?

The most obvious prohibitions in an employer's non-fraternization policy would be that an employee cannot report to someone he or she is related to, whether by marriage or some other family relationship.[29] The next decision an employer needs to make is whether there should be an outright ban on all work place dating (which would include co-worker equals as well as supervisors and subordinates) or whether,

given principal-agency law, only supervisor-subordinate relationships should be prohibited. Any limitations on conduct outside of the workplace have to be balanced again an employee's privacy.[30] Additionally, given the long hours expected in the US workplace, work may be the primary source for an employee to form social relationships.[31]

Given the potential for liability for sexual harassment under principal agency law, as well as the potential for workplace disruption due to office chatter and co-worker jealousy and speculation over whether a raise or promotion may have been given to a co-worker not based on merit but based on a relationship with a supervisor, Dosis may choose to put a non-fraternization policy in place that prohibits supervisor-subordinate dating relationships. Dosis will have to decide whether to ban all supervisor-subordinate relationships or just those relationships in which the subordinate reports to the supervisor. Additionally, Dosis will have to decide whether, for the purposes of this policy, Dosis will distinguish between relationships where either or both employees are married to other people or whether Dosis will implement a ban on supervisor-subordinate relationships irrespective of employee marital status.

Penalties for violating this policy can include demotion, reassignment of one or both employees, and termination. Dosis will have to be nondiscriminatory in assigning penalties. If Dosis regularly reassigns or terminates male but not female employees who violate this policy Dosis could face a Title VII gender discrimination lawsuit.[32] The better approach would be to have a policy where supervisors who become involved with subordinates face consequences since supervisor involvement puts the employer at risk under principal-agency law.

9. Would you feel differently if this were a man "coming on" to various women in the company?

When "sexual harassment" is mentioned people often assume that the perpetrator must be a male and the victim a woman. As this case demonstrates, women as well as men can be harassers. In judging whether hostile environment sexual harassment has occurred, the courts use a "reasonable victim" standard. This standard differs from the "reasonable person" standard in that it recognizes that the "reasonable person" standard is often reflective of a male viewpoint. The "reasonable victim" standard looks at the perceptions of a reasonable woman (or man if the harassee is male) in the harassee's shoes to determine whether hostile environment sexual harassment has occurred. "Conduct that many men consider unobjectionable may offend many women."[33]

Using the reasonable victim standard, the following factors must be present for actionable hostile environment sexual harassment:

1. The harassing behavior must be unwelcome by the harassee.
2. The harassment must be based on gender.
3. The harassment must be sufficiently severe or pervasive to create an abusive working environment.
4. The harassment must affect a term or condition of employment.[34]

If the employer has actual or constructive knowledge and does not act to remedy the situation then the employer is liable. Based on the mysterious letters that are sent to Steve's wife and pastor and Sherri's conduct toward Steve once the relationship has ended the students may conclude that Steve is the victim of hostile environment harassment.

Another issue to discuss is how the students would feel if this were a man "coming on" to a man or a woman "coming on" to a woman. While Title VII does not protect someone from discrimination based on affinity orientation, *Oncale v. Sundowner Offshore Services, Inc.* held that same gender sexual harassment is actionable when a hostile environment exists even if the perpetrator and victim are of the same gender, as long as the harassing activity is based on gender.[35]

10. If Sherri were punished but not Steve, how would you feel? Do you think Steve is being punished so that it does not look like the company is discriminating? Why do the supervisor and HR Manager only act against Steve if they know the rumors about Sherri?

This question may be discussed either before or after the Epilog is presented. When this case was presented to an Employment Law class, the class overwhelmingly stressed that given the consensual nature of this relationship Steve and Sherri were equally culpable. Therefore, both employees should have faced workplace consequences.

Unfortunately the HR manager feels constrained in acting against Sherri because of the lack of concrete proof against her. Combined with Sherri's union membership, it may have been easier to address the situation through Steve. This underscores the realities of employment decisions: employment law must be applied taking into account the facts and realities of the workplace.

This does not change the fact that Sherri's behavior is disruptive and inappropriate to the workplace. Her behavior goes beyond socially acceptable workplace banter. Sherri

should be warned about her conduct and be required to attend sexual harassment training.

CONCLUSION:

When this case was piloted in one of the co-author's upper level Employment Law classes, students were engaged and enthusiastic. The co-author divided the class into two groups, and had one group read the A case and the other the B case. A student assistant led the A case group in a discussion of the questions, while the co-author led the B group through the discussion questions.

Both groups had similar reactions to the questions and seemed to focus on the need for an official company policy on employee fraternization and the need for a dress code. In group B the co-author pointed out that dress codes tend to disproportionately impact women but this did not change the students' strident response that a dress code would have perhaps prevented what occurred in this case.

Both groups were also clear that Dosis Pharmaceuticals needs to have a policy on employee fraternization. The students felt that co-worker dating should be allowed as long as it does not impact what happens in the office. The students did feel that the policy should prohibit supervisor-subordinate dating (but not friendships). The students felt that it was immaterial whether the parties involved in dating relationships were married or single.

Even without an official policy, the students felt that the relationship between Steve and Sherri was inappropriate because even though Steve did not officially supervise Sherri he did give her work to do and thus a supervisory relationship could be implied. The students believed that Steve and Sherri

were equally at fault; Steve for using a company issued cell phone for personal business, and Sherri for bringing the relationship into the office by being aloof toward Steve and refusing to do work for him. The groups felt that it was unfair to punish one employee and not the other and that Steve should have been sent to a training class but not demoted. Finally, both groups understood that the collective bargaining agreement complicated the issue of disciplining Sherri.

These observations reinforce the original purpose of the creation of this case: students were able to critically analyze the facts and apply employment law concepts to the scenario through this active learning exercise. The case is brief enough for students to read and retain, and the facts presented generated interest and discussion. The varied legal issues in this case will assist the employment law instructor in coverage of key concepts typically covered in the course.

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[1]*See* Tammy W. Cowart and Wade M. Chumney, *I Phone, You Phone, We All Phone with iPhone: Trademark Law and Ethics from an International and Domestic Perspective,* 28 J. LEGAL STUD. EDUC. 331, 332 (2011) (discussing the benefits of case studies in business law classes).

[2]*See* Larry DiMatteo & T. Leigh Anenson, *Teaching Law Through Theory and Context: Contract Clauses in Legal Studies Education,* 24 J. LEGAL STUD. EDUC. 19, 20 (2007) (describing the use of active learning techniques in a legal studies course).

[3]Rebecca J. Wilson, et al., *Romantic Relationships at Work: Does Privacy Trump the Dating Police?* DEF. COUNS. J., January 2003, at 78, 79.

[4]*Id.* at 80.

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[5]*See* Mary Anne Case, *A Few Words in Favor of Cultivating an Incest Taboo in the Workplace,* 33 VT. L. REV. 551, 553-54 (2009) (referring to Equal Employment Opportunity Commission Guidelines).

[6]*See* Marisa Anne Pagnattaro*, What Do You Do When You Are Not at Work?: Limiting the Use of Off-Duty Conduct as the Basis for Adverse Employment Decisions,* 6 U. PA. J. LAB. & EMP. L. 625, 634-35 (2004) (discussing employee's off site use of employer's computer in the case of Smyth v. Pillsbury Co., 914 F. Supp. 97 (E.D. Pa. 1996)).

[7]Wilson, *supra* note 3, at 86-87.

[8]Amy M. Scott, *When Cupid Strikes in the Office,* BENEFIT PLAN REV., Feb. 2008, 26, 27.

[9]*See* Leibovitz v. New York City Transit Auth., 4 F. Supp 2d 144 (E.D.N.Y. 1998); Christopher M. O'Connor, *Stop Harassing Her or We'll Both Sue, Bystander Injury Sexual Harassment* 50 CASE W. RES. L. REV. 501 (1999).

[10]*Id.* at 536-37.

[11] Wilson, *supra* note 3, at 80.

[12]When this case was presented to an Employment Law class, the issue of dress codes in the workplace was raised.

[13]Robert K. Robinson, et al., *Employment Nondiscrimination Act: Implications for Employers,* 19 S. L. J. 109, 113 (2009).

[14]*Id.*

[15]*See* James Sonne*, Monitoring for Quality Assurance: Employer Regulation of Off-Duty Behavior*, 43 GA. L. REV.133, 133-37, 144-45 (2008).

[16]Pagnattaro, *supra* note 6, at 630-640.

[17]Wilson, *supra* note 3, at 81.

[18]*See* Pagnattaro, *supra* note 6, at 646-670 (discussing the laws of California, New York, Connecticut, Massachusetts, Colorado, and North Dakota, and cases interpreting these statutes).

[19]*See* McCavitt v. Swiss Reinsurance America Corp., 237 F. 3d 166 (2d Cir. 2001) (plaintiff denied a promotion and allegedly terminated due to dating a co-worker; held not to be "legal recreational activities outside work hours" protected by New York statute); *See also* New York v. Wal-Mart Stores, 621 N.Y.S. 2d 158 (App. Div. 3d 1995).
[20]Pagnattaro, *supra* note 6, at 641-45.
[21]Sonne, *supra* note 15, at, note 56 (2008).
[22] 42 U.S.C. § 2000 et. seq. (2010). (Hereafter referred to as "Title VII.")
[23] 42 U.S.C. § 12101 et. seq. (2010).
[24]For a summary of exceptions to the employment at will doctrine see James A. Sonne, *supra* note 15, at 157-160.
[25]*Id.* at 142.
[26]US Census Bureau, Statistical Abstract of the United States: 2011, Table 665 (2011).
[27]Meritor Sav. Bank, FSB v. Vinson, 477 U.S. 57, 64-65 (1986).
[28]Burlington Industries, Inc. v. Ellerth, 524 U.S. 742, 765 (1998).
[29]*See* Scott, *supra* note 8, at 26-27.
[30]*See* Wilson, supra note 3, at 86-87.
[31]For a discussion on benefits of allowing workplace romance, see C. Boyd, *The Debate Over the Prohibition of Romance in the Workplace,* 97 J. BUS. ETHICS, 325 (2010).
[32]See Sanguinetti v. United Parcel Service, 114 F.Supp.2d 1313 (S.D. Fla. 2000), in which plaintiff supervisor brought an action for discrimination under Title VII and lost summary judgment motion as the court found he was not similarly situated to female employees who either reported harassment or violated no-dating policy, but the risk of a lawsuit still remains to employers who do not have a gender neutral policy for dealing with violations of a non-fraternization policy.
[33]Ellison v. Brady, 924 F.2d 872, 878 (9th Cir. 1991).

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[34]*Id.* at 875-876. *See also* Oncale v. Sundowner Offshore Services, Inc., 523 U.S. 75 (1998), and DAWN D. BENNETT-ALEXANDER & LAURA P. HARTMAN, EMPLOYMENT LAW FOR BUSINESS 417 (6th ed. 2009).
[35]*Oncale,* 523 U.S. at 80.