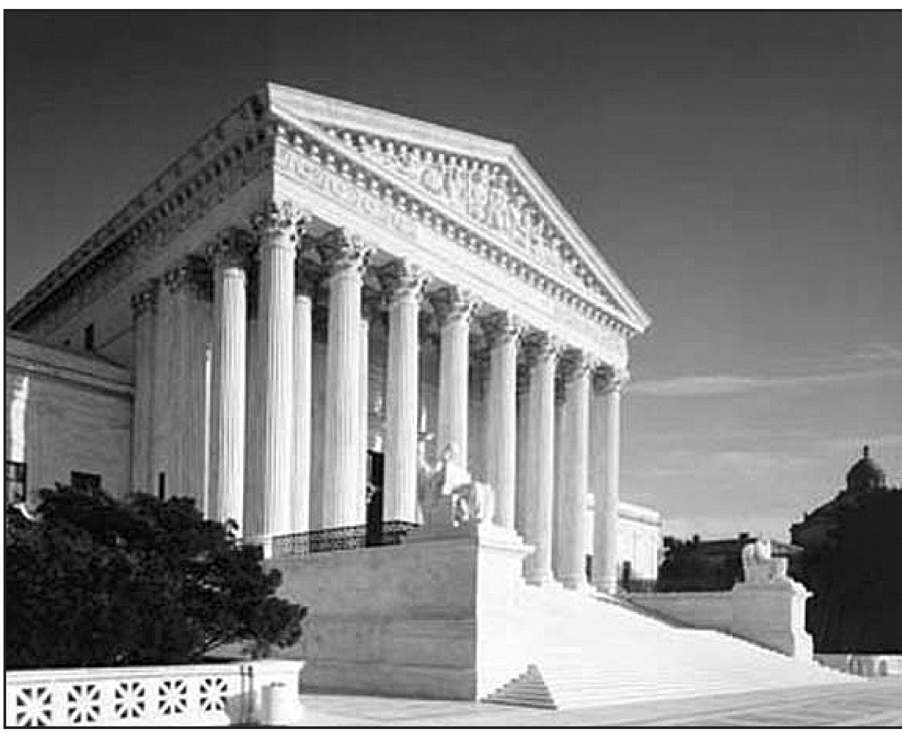
North East Journal of Legal Studies



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FORMAT

1. Papers should be no more than 20 single-spaced pages, including footnotes. Use font 12 pitch, Times New Roman. Skip lines between paragraphs and between section titles and paragraphs. Indent paragraphs 5 spaces. Right-hand justification is desirable, but not necessary.
2. Margins: left and right hand margins should be set at 1 ¼ inches, top margin at 1 ½ inches and bottom margin at 1 ¾ inches.
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ARTICLES

THE BENEFITS OF BENEFIT LLCs

by

Matthew C. McGrath, JD, MBA*

INTRODUCTION

Benefit Companies and Social Enterprise

In recent years many U.S. states, including all northeastern states except Maine, have modified their business entity statutes to permit the formation of benefit companies, and it is currently under consideration in several others.[1] Benefit companies are for-profit businesses and subject to the same tax treatment and organizational structure as other for-profit businesses. The difference is that benefit companies formally declare that their business purposes include both profits and pursuing some benefit to society. The term benefit company includes benefit corporations (Benefit Corporations), benefit limited liability companies (Benefit LLCs) and other comparable entities.[2] The benefit company structure is intended for use by companies seeking to engage in social enterprise.[3]

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The first state to permit benefit companies was Maryland in 2010 and since then the movement has spread steadily throughout the country. As of December 31, 2016, 30 states and the District of Columbia permit Benefit Corporations, but only two of them, Oregon and Maryland, allow Benefit LLCs. Despite the growing interest in Benefit Corporations, there has not been the same interest in also allowing Benefit LLCs. One major proponent of Benefit Corporations expressed the opinion that Benefit LLCs were unnecessary because the flexibility in organizing and operating LLCs makes Benefit LLCs unnecessary to achieve the goals of social entrepreneurs.[4] A list of states permitting various kinds of benefit companies is included in Appendix A.

This paper seeks to provide some basis for deciding whether states should permit Benefit LLCs. Answering this question requires some understanding of the basics of business entity formation, and also the distinctions between Benefit Corporations and Benefit LLCs, both in terms of formation and with regard to how each type of entity is actually being used. The analysis contained in this paper focuses on data for Benefit Corporations in Connecticut and Oregon, and Benefit LLCs in Oregon. Oregon's data was much more easily accessible than that of Maryland, the only other state which permits Benefit LLCs. Also, Connecticut and Oregon provide business entity data in similar formats, which allows for useful comparisons. Statistical analysis was performed on the available data, both overall numbers for each type of entity and information on business activity and whether they are actually achieving the goals of social enterprise.

The research discussed here is of value to parties interested in social enterprise and also to policymakers who are considering what steps to take to promote social enterprise. The specific question addressed is whether Connecticut should permit Benefit LLCs. A proposal to allow Benefit LLCs is currently before the Connecticut General Assembly, and the same question is likely being considered in other states. While other research has focused on the anticipated future utility of benefit entities in promoting social enterprise, this paper looks at available data from actual activity for the two different entity types. Although benefit companies are still a relatively new phenomenon, there is now sufficient history to provide some evidence of the benefits and drawbacks of the different entity forms. This research will not only benefit both business decision makers who may be contemplating the use of a benefit entity, but also persons involved in state government policy making with regard to how the law on benefit entities should work to achieve policy goals, and more specifically on whether states interested in promoting social enterprise should permit the formation of Benefit LLCs.

This paper is divided into three sections: Social Enterprise and Social Entrepreneurship: Theory and Practice, Analysis, and Conclusions and Proposals. The first section contains a discussion of the important topics and concepts. The Analysis section describes the steps taken to identify and assemble relevant information and how it was analyzed to produce relevant information. Finally, the Conclusions and Proposals section provides a summary of the conclusions to be drawn from the data analysis in light of the overall purpose of this paper, as well as proposals for policymakers and other stakeholders to consider when adopting or modifying benefit company legislation.

SOCIAL ENTERPRISE AND SOCIAL ENTREPRENEURSHIP: THEORY AND PRACTICE

The creation and use of benefit company entity forms arises from the concepts of “social enterprise” and “social entrepreneurship.” Many authors have noted that there still no widespread agreement on how to define these terms.[5] However, one broad definition is that "The defining characteristic of social enterprises is that they aim both to make a profit, though perhaps a reduced profit, for equity investors and also to do some social good."[6] This is generally considered to be a more ethical way of doing business. Studies have shown that consumers, investors and entrepreneurs all have a growing interest and occasional preference for social enterprise.[7] Other reports have shown that potential employees want to work for companies that are concerned about society.[8] In addition, social enterprise businesses have the ability to attract investors for whom social causes are a concern, who engage in what is referred to as "socially responsible investing" or SRI. [9]

Conflict with the Profit Maximization Model

While entrepreneurs, investors, customers and potential workers may express an interest in social enterprise, it contains an inherent conflict with one of the bedrock principles of American corporate law, the goal of profit maximization. American courts have typically emphasized the goal of profit maximization as being the primary purpose of engaging in business through a business entity. Well known cases such as *Dodge v. Ford*, *Revlon* and *Unocal* have entrenched this principle.[10] Leo E. Strine Jr., Chief Justice of the Delaware Supreme Court, ridiculed the idea of Benefit Corporations, claiming that they live in a "fictional land where you can take other people's money, use it as you wish, and ignore the best interest of those with the only right to vote."[11] Despite, or perhaps because of, the fundamental principle of profit maximization, people interested in social enterprise have persisted in trying to make the concept work. One of the main ways they have done so is through benefit companies.

Lessons from Other Movements

The growth of social enterprise and benefit companies has been compared to the business and human rights movement (BHR) and the environmental movement.[12] They are similar in that all seek to encourage businesses to consider the interests of other stakeholders. There are also some major differences between the movements. BHR is more closely associated with the actions of larger businesses, especially highly publicized incidents such as the explosion at a Union Carbide plant in Bhopal, India, child labor scandals involving companies such as Nike and working conditions in manufacturing plants in Asia.[13] By comparison, the benefit company movement still consists mostly of newly-formed small or mid-sized businesses, although promoters of benefit companies are trying to make it spread to multinational or publicly traded companies.[14]

One of the lessons that the social enterprise movement has learned is to try to avoid the social enterprise version of "greenwashing." Greenwashing refers to efforts by businesses to get the marketing benefits associated with environmentalism, without actually doing much for the environment.[15] To prevent something similar from happening with benefit companies, the legislation has been drafted to require benefit reports and the use of third party standards, as discussed below.[16]

Arguments Against Benefit Companies

While benefit companies have generally been greeted positively, some have argued that benefit company legislation is unnecessary because companies can engage in social enterprise using traditional corporation or LLC statutory schemes.[17] As is discussed below, there are many corporations and LLCs which have been recognized as social enterprises without being Benefit Corporations or Benefit LLCs. It has even been argued that benefit company statutes are harmful because of the risks of greenwashing and also that consumers may wrongly assume that businesses which have not formally registered with the state as Benefit Corporations or Benefit LLCs cannot be social enterprises.[18] Some argue that while corporate law uses profit maximization as a default rule, it is flexible enough to allow social enterprise as a matter of contract law.[19] Others have focused on the special concerns that benefit company status creates for business managers who have to make decisions that balance both profit and social benefits.[20]

The Low-Profit Limited Liability Company

Another form of social enterprise business entity which has been created in recent years is the Low-Profit Limited Liability Company, also known as L3Cs. However, there are limitations on the business operations of L3Cs which makes this form not usable for the typical social enterprise.[21] The statutes creating L3Cs were specifically designed for use by nonprofit foundations that wish to obtain some kind of return on their contributions.[22] Private foundations are required by the IRS to distribute at least 5% of their assets for charitable purposes, which can include “program related investments.” Such investments can include distributions to entities whose corporate purpose is not primarily to produce profits.[23] L3C enabling legislation is carefully drafted to adhere to the tax code limitations.

The limitations imposed on L3Cs has muted interest in this form of business entity. As of March 2016, only eight states allow L3Cs (not including North Carolina which permitted them in 2010, but then repealed its law in 2014).[24]

Concerns have also been expressed that L3Cs will divert funding from charities.[25]

reSET

The idea for this paper arose from a request for research into these topics by reSET Social Enterprise Trust, a Hartford based non-profit organization that promotes entrepreneurship, especially in the social enterprise sector. reSET was founded in 2007 by Kate Emery. Ms. Emery was the CEO of The Walker Group, Inc., a successful technology services firm that she had founded in 1985. Ms. Emery wanted to restructure The Walker Group's business purpose from the traditional profit maximization model to a model that sought to maximize social contribution.[26] The Walker Group's organizational documents now require that profits must be split equally among employees, the community and shareholders. Out of that experience, Ms. Emery then went on to found reSET.[27] reSET was one of the primary advocates for getting Connecticut to adopt legislation permitting Benefit Corporations and is also advocating for Benefit LLCs. James Woulfe, reSET's former Director of Advocacy & External Affairs worked closely with the Connecticut Bar Association on this effort.

Although the management and owners of The Walker Group, like any business, could demonstrate a commitment to social enterprise using traditional corporate law if there was sufficient support for that, Ms. Emery wanted the commitment to social enterprise to be more firmly entrenched in the company's organizational documents so that future managers or owners could not abandon this commitment. Much of the literature on benefit companies discusses the experiences of profitable businesses that were founded with some type of social enterprise mission, but were later acquired by companies that did not share that mission. Mayer (2014) and others have discussed the examples of the Ben & Jerry's ice cream business, craigslist and other companies that were founded as what would now be called social enterprises, but then struggled to maintain that identity as the business grew or was later acquired by another company.[28]

B Lab

Much of the data for this analysis came from B Lab Company, a Pennsylvania non-profit company and 501(c)(3) charity better known as B Lab. B Lab's sees its mission promoting social enterprise and benefit companies as a "force for good" in the world with goals including "systemic change" and "shared and durable prosperity" by helping stakeholders "Measure What Matters."[29]

B Lab certifies companies as "B Corporations" (commonly abbreviated to "B Corps") if they apply for certification and meet B Lab's standards. Currently B Lab is the only third party certifying benefit companies on a large scale.[30] Thus, data from B Lab's certification process is the only source of sizable data on the actual efforts and practices of benefit companies. It must be noted that B Lab uses the term "B Corp" to specifically refer to companies which it has certified. B Corp certification is not limited to any specific type of business entity. B Corps can be corporations or LLCs as well as other entity types like professional corporations.[31] Furthermore, B Corp certification does not require that the entity is a Benefit Corporation or a Benefit LLC before certification, but benefit company status must be adopted within a few years if it is available in the company's state of formation.[32]

Overview of business entity formation in the United States

Benefit Corporations and Benefit LLCs are formed pursuant to the laws of a particular state, and it is important to keep in mind the state law basis for business formation. Except for a relative handful of organizations created by the US Congress like the Federal Reserve, Red Cross and Boy Scouts, business formation in the United States occurs at the state level. The procedures required to form a business entity vary slightly from state to state. Although most companies are formed in the state where they actually conduct business, entrepreneurs are free to organize in another state if there is some advantage to doing so, such as ease of formation or the availability of a state legal system considered to me more desirable. There is a lively debate in academia about the ways that states compete to attract business formation registrations, with particular focus on Delaware which has succeeded in establishing itself as the most popular state for forming corporations.[33] Some have referred to this as a "race to the bottom" among states to make their corporate laws overly business friendly, or a "race to the top" to implement best practices.[34]

States are able to experiment with various forms of business entity types and different laws on business formation. Over time, states can learn from the experiences of sister states in deciding whether or not to adopt similar changes. The major recent example of this was the limited liability company (LLC) form itself, which was first allowed in Wyoming in 1977. Wyoming's first law on LLCs, Wyoming Statutes § 17-294, was adopted in 1977, although it has been superseded by the current Wyoming Limited Liability Company Act.[35] The other states later adopted statutes permitting LLCs, with some variation form state to state.

The National Conference of Commissioners on Uniform State Law (Uniform Law Commission) is a nonprofit association of commissioners from throughout the U.S. and its territories. Throughout its history the Uniform Law Commission has sought to bring some level of uniformity to state legislation on topics such as business formation. When significant differences exist in certain areas of the law, the Uniform Law Commission typically drafts model uniform acts for consideration by the states. The Uniform Law Commission adopted a Uniform Limited Liability Company Act in 1996, since amended, and all states now allow LLCs.[36]

The experience with benefit companies has had some similarities in terms of expansion to other states. Although the Uniform Law Commission has not yet adopted a model act for benefit companies, B Lab produced a Model Benefit Corporation Legislation and works with state legislators and other interested parties to pursue adoption of benefit company legislation throughout the country.[37]

However, there is no comparable model legislation for Benefit LLCs. The statutes in Oregon and Maryland which allow for benefit LLCs are very different. Oregon adopted a single statutory scheme for Benefit Companies which includes both Benefit Corporations and benefit LLCs.[38] Maryland adopted separate statutory schemes for Benefit Corporations and Benefit LLCs.[39] The lack of consistency and model legislation could be a problem in the future as other states decide whether to allow Benefit LLCs.

Connecticut statutory scheme

Connecticut adopted the Connecticut Benefit Corporation Act in 2014.[40] This was modeled on B Lab's Model Benefit Corporation Legislation but with one significant difference. Unique to Connecticut is the optional "Legacy preservation provision" contained in C.G.S. § 33-1355 *et seq* which is discussed below. Like other states that have followed B Lab's model legislation, Connecticut's law addresses the following main points.

Preliminary Provisions: Includes defined terms and the processes for adoption and termination of Benefit Corporation status. This is also where Connecticut introduces its legacy preservation provision.[41]

Corporate Purposes: Covers the requirements for providing a general public benefit and the option of also requiring a specific public benefit.[42]

Accountability*:* Provides guidance on how corporate directors and officers can demonstrate that they have complied with the obligations to create general or specific public benefits. This is done by considering the effects of decisions on shareholder, employees, customers, community and societal factors, the environment, the short-term and long-term interests of the corporation, and other pertinent factors. The statute clearly references the traditional "business judgment rule" which shields corporate decision makers from liability for the possible detrimental outcome of decisions provided that the decision-maker was reasonable informed, acted in good faith and did so without any conflict of interest.[43]

Enforcement: The Accountability section is also where the statutes describes the "benefit enforcement proceeding" which is the sole means by which some action can be taken if a Benefit Corporation fails to achieve public or private benefits as required or otherwise violates the act. Standing to bring such a proceeding is limited to shareholders holding at least 5% of any class of the Benefit Corporation (2% in the B Lab model legislation), or 10% of all shares of a corporate parent of a Benefit Corporation (5% in the B Lab model legislation), or other persons permitted to do so in the corporation's organizational documents. The act is clear that no one else has standing to bring such a suit. Furthermore, Benefit Corporations cannot be liable for monetary damages for a failure to pursue or create a general or specific public benefit.[44]

Transparency: This portion of the act deals with the adoption of a third-party standard for assessing the corporation's pursuit of general and specific public benefit, and the preparation and availability of a benefit report. B Lab is the best known entity providing this role of the third party standard, and the criteria that the third-party standard is required to evaluate corresponds to the areas assessed by B Lab in its "B Impact Reports," namely Environment, Workers, Customers, Community and Governance.[45]

Benefit Corporations are also required to produce an annual report on its efforts to achieve general and specific public benefits, along with other information such as compensation of directors. The statute specifies that the report does not need to be audited or certified. Benefit Corporations are required to provide the benefit report to shareholders and to post it publicly on the corporation's website if it has one. If it does not have a website, it should be provided free of charge to anyone who requests it. However, there does not appear to be any way for a non-shareholder to do anything about a Benefit Corporation's failure to pursue or achieve public benefits, or to make its benefit report available.[46]

Connecticut's Legacy Preservation Provision: All benefit company legislation, including Connecticut's Benefit Corporation Act, and B Lab's model legislation, emphasize that benefit companies are fundamentally for-profit corporations or LLCs that have chosen to adopt the additional optional status and obligations of being a benefit company.[47]

Subject to shareholder voting requirements, they are also free to terminate benefit company status and to continue as standard corporations or LLCs without any tax event, liquidation or major organizational change. Connecticut, following B Lab's model legislation, requires the affirmative vote of two-thirds of the shares of each class, even nonvoting shares.[48]

Kate Emery, the CEO of The Walker Group, Inc., and other early proponents of Benefit Corporations in Connecticut were concerned about the ability of Benefit Corporations to revoke their status. In response to this concern, Connecticut included an optional legacy preservation provision which can be adopted by a unanimous vote of the shareholders (including holders of nonvoting shares).[49] Any Connecticut Benefit Corporation which adopts a legacy preservation provision has limits on its ability to merge with an entity other than a Benefit Corporation subject to a legacy preservation provision, or to liquidate and distribute its assets except to a charitable organization or another Benefit Corporation that is subject to a legacy preservation provision.[50] The statute prohibits the adoption of a legacy preservation provision prior to 24 months after becoming a Benefit Corporation. Since the Connecticut Benefit Corporation Act became effective just a little over two years prior to this report, data on how many companies will adopt a legacy preservation provision is not yet available.

Election of Benefit Corporation status in Connecticut: Following adoption of the Connecticut Benefit Corporation Act, the Connecticut Secretary of the State of Connecticut modified its Form CIS-1-1.0, the standard form to create a for-profit business corporation, to include a Section 5 which contains a box that can be checked by the organizers.

Currently, the Connecticut Certificate of Amendment form does not contain any specific place where a Benefit

Corporation could indicate its adoption of a legacy preservation provision, but this could be inserted in Section 3 of the form where the text of any amendments is to be described.

Oregon statutory scheme

The Oregon Benefit Companies Act applies to both Benefit Corporations and Benefit LLCs.[51] With the exception of changes necessary for a statute that covers both corporations and LLCs (i.e. references to "governors" which includes both corporate directors and LLC managers), the statute is largely similar to the B Lab model legislation, including comparable sections on the Preliminary Provisions, Corporate Purposes, Accountability and Transparency as discussed above. Oregon benefit companies have similar obligations regarding general and specific public benefits, third-party standard certification, preparation and availability of annual benefit reports, shareholder rights to bring a benefit enforcement action, and protections against monetary liability and claims by non-shareholders for failing to pursue public benefit.

Election of Benefit Corporation status in Oregon: Similar to the formation of a Benefit Corporation in Connecticut, Oregon modified its existing forms of Articles of Incorporation for corporations and Articles of Organization for LLCs to include a checkable box to indicate benefit company status:

In the standard form for Oregon Articles of Incorporation, Section 7 Optional Provisions includes checkable boxes for options relating to the adoption of benefit company status, indemnification of directors, officers, etc. and another one to indicate that something else is attached. Similarly, the standard form for Oregon Articles of Organization contains a Section 9 Optional Provisions with a box that can be checked to indicate the adoption of Benefit LLC status.

By integrating the adoption of benefit company status directly into the standard forms with a check-the-box system Oregon, like Connecticut, has made it extremely easy for a newly formed company to identify itself as a benefit company. Companies which were not founded as benefit companies can adopt this status by amending their Articles of Incorporation or Articles of Organization.

ANALYSIS

Data Collection

The research below focuses on Oregon because it is the only state that permits both Benefit Corporations and Benefit LLCs and which also has accessible data. Other researchers in this area, notably Murray (2016) have commented on the difficulty they experienced in trying to obtain data on benefit companies. The websites for the Oregon Secretary of the State (http://sos.oregon.gov/business/Pages/find.aspx), and Oregon Open Data Portal (data.oregon.gov) provided very accessible data on benefit companies. Maryland is the only other state that permits both Benefit Corporations and Benefit LLCs. However, the websites for the Maryland State Department of Assessments and Taxation, which is the agency where business entity documents are filed, and the Maryland Open Data Portal (data.maryland.gov), did not provide easily accessible information on Maryland benefit companies. The data available from Oregon covers items such as date of formation, entity form (primarily corporations and limited liability companies but small numbers of other types as well, such as professional corporations), date of adoption of benefit company status, and in some cases a self-reported description of business activity.

Information available from B Lab was also analyzed. B Lab is an independent non-profit which seeks to promote social enterprise. B Lab is perhaps the best known actor promoting Benefit company legislation and Benefit companies generally. Importantly for this research, B Lab provides certification reports for companies which document and evaluate their efforts to achieve social enterprise. Benefit company statutes require that companies obtain third party certification of their social benefits. B Lab is the best known entity that provides this service. It is important to note that B Lab certification has not require that the company formally adopted "benefit company" status before obtaining B Lab certification, but certification is contingent upon adopting benefit company status within a few years of formation if it is available in the relevant state.

Analytic Framework

As described above, there are two substantive differences between the statutory schemes and entity formation processes for benefit companies in Oregon and Connecticut, (1) Connecticut's legacy preservation provision which has not yet really come into practical effect yet, and (2) Oregon's allowance of both Benefit Corporations and Benefit LLCs.

Before getting into the data analysis, it is important to note that much of the literature and research on benefit companies has focused on larger companies or how benefit company status can be used in marketing efforts or to attract investors.[52] [53] However, this emphasis on large, profitable and more established companies is not representative of benefit companies as a group. Most businesses in the U.S., even corporations and LLCs, are quite small. According to the U.S. Census, there were a total of 5,775,055 firms in the U.S. in

2013, and 4,567,571 (79%) had fewer than 20 workers. Only 103,900 (1.8%) had over 100 workers.[54] Benefit companies should not be expected to be any different.

It is very difficult to obtain useful data on small businesses, especially those that are relatively new.[55] In December 2014, it was estimated that there were only approximately 1,000 benefit corporations in existence.[56] While the number has grown since then and is changing daily, it is safe to assume that there are at most only a few thousand benefit companies in the entire U.S. By comparison, in 2014 over 169,000 business entities were formed just in the State of Delaware.[57]

Although information provided by businesses in their filings with state governments is generally available, these forms do not require disclosure of very much information. The forms of certificates of incorporation and organization to form corporations and LLCs in Connecticut and Oregon do not require disclosure of business websites or even phone numbers. This is particularly important here because the "Accountability" and "Transparency" requirements of the benefit company statutory scheme relies upon preparation of benefit reports which are not required to be filed with any state government office, but rather are supposed to be available on business websites "if any."[58]

In conducting this research, an attempt was made to identify websites for randomly selected group of non-B Lab certified benefit companies, but the results were so low and unreliable that they are not included in this paper. It is important to keep these facts in mind when analyzing the measurable impacts of the typical benefit company. The absence of references to non-B Lab benefit companies in internet search results is to be expected. The same would be true of similar searches for information on traditional corporations and LLCs founded within the last few years.

As stated above, the purpose of this research was to see if there was available data that would be useful to Connecticut policymakers who are considering the promotion of a bill to allow Benefit LLCs in Connecticut. Only two states, Oregon and Maryland, permit Benefit LLCs and thus provide possible sources for relevant information on the impact that allowing Benefit LLCs would be expected to have in Connecticut. In examining the available relevant data from Oregon and Maryland, it was clear that Oregon had more relevant and reliable data available on the topic, so it was decided to focus specifically on Oregon. Furthermore, recent research shows that although Maryland's Benefit LLC law has been in effect since 2010, as of October 27, 2015 there were only 33 Benefit Corporations and 50 Benefit LLCs in Maryland.[59] The comparable numbers in Connecticut and Oregon, discussed below, are significantly higher considering the time period since legislative adoption.

The following data was assembled from information available through the Connecticut Open Data Portal and the Oregon Open Data Portal respectively, along with information available on B Lab's website for B Lab-certified B Corps.

Descriptive Data: The following charts provide some benchmarks by which to compare Oregon and Connecticut in terms of physical area, population, and business activity.

Comparison of Connecticut and Oregon demographics, active businesses and Benefit Companies as of December 31, 2016.

	CONNECTICUT	**OREGON**	**NOTES**
Population	3,576,452	4,093,465	OR is +

			14.5%
Area, sq. mi.	5,543	93,381	OR is 16X CT
Total Domestic business entities	433,614	225,751	Excludes DBAs* and Non-Profits
New Domestic Business Entities 1/1/10 – 12/31/16	153,688	125,644	Excludes DBAs and Non-Profits
Date that benefit entity law took effect	October 1, 2014 27 months	January 1, 2014 36 months	
Number of Benefit Corps at 12/31/16	82	220	OR had 117 at 27 months
Number of Benefit LLCs	0	849	OR had 506 at 27 months
Total Benefit entities	82	1,069	OR had 623 at 27 months

60

* DBAs are trade names used either by legal business entities instead of the formal name, or unincorporated businesses which are conducting business under an assumed name. These

are commonly described as “doing business as.” In Connecticut, such a business only files a certificate with the local town government. In Oregon, a certificate is filed with the secretary of the state and identified as an ABN for “Assumed Business Name.”

Comparison of Oregon and Connecticut for Domestic For-Profit Business Entities in Existence and Business Creation Activity during the period January 1, 2010 to December 31, 2016

Oregon Data: The following information was obtained from the search function on the Oregon Open Data Portal, data.oregon.gov. For comparison purposes, Assumed Business Name (DBA) entries, as well as foreign business registrations, non-profits and duplicate filings were deleted. Note that in this context “foreign” means formed in another U.S. state.

Oregon Total Number of Domestic, For-Profit, Non-DBA Businesses in Existence on December 31, 2016 was 225,751:

Type	**TOTAL**
Cooperatives	284
Business Corporation	57,770
Business Trust	40
Limited Liability Company	160,022
Limited Liability Partnership	471
Limited Partnership	1,559
Professional Corporation	5,605
	225,751

Oregon New Businesses Formed between January 1, 2010 and December 31, 2016:

Type	**TOTAL**
Cooperatives	48
Business Corporation	17,016

Business Trust	27
Limited Liability Company	106,606
Limited Liability Partnership	158
Limited Partnership	302
Professional Corporation	1,487
	125,644

Oregon Benefit Companies and B Lab Certification: As of December 31, 2016, Oregon had 1,069 Benefit Companies, and 77 B Lab certified companies. However, not all B Lab certified companies are Benefit Companies. Only 24 companies were both Benefit Companies and B Lab certified.

Oregon Benefit Companies in Existence on December 31, 2016: Oregon permitted benefit companies starting January 1, 2014. Within three years a significant number were formed.

Type	**B LAB**	**NOT B Lab**	**TOTAL**
Business Corporation	13	200	213
Limited Liability Company	9	840	849
Professional Corporation	2	5	7
	24	**1,045**	**1,069**

98% of Oregon Benefit Companies are NOT B Lab certified. 79% are LLCs.

Oregon B Lab Certified Companies:

Type	**BENEFIT**	**NOT Benefit**	**TOTAL**
Business Corporation	13	28	41
Limited Liability Company	9	23	32
Non-Profit*		1	1

Professional Corporation	2		2
Individual		1	1
	24	**53**	**77**

*This company appears to be a subsidiary of a non-profits and is classified as such for the purposes of this paper.
69% of Oregon B Lab certified companies are NOT benefit entities.

Out of 77 B Lab certified companies:

- 8 (10%) were formed AFTER the benefit company law came into effect (1/1/14).
- 69 (90%) were created BEFORE the benefit company law.

Of the 8 B Lab certified companies created AFTER benefit company law took effect:

- 2 are benefit companies. 6 are NOT benefit companies.
- 6 are LLCs (including the 2 benefit companies)
- 1 is a professional corporation
- 1 is a DBA for an individual

Connecticut Data: The following data was obtained from the Connecticut Secretary of the State website, Business Starts and Stops Index, and the Connecticut Open Data portal, https://data.ct.gov/portal.[61]

Connecticut Total Number of Domestic, For-Profit, Non-DBA Businesses in Existence on December 31, 2016 was 433,614:

SUBTYPE	COUNT
Corporation	136,694
Domestic Limited Partnership	9,162
Domestic Limited Liability Company	285,149
Domestic Limited Liability Partnership	1,118

General Partnership	231
Domestic Statutory Trust	1,191
Other	69
	433,614

Connecticut New Businesses Formed Between January 1, 2010 and December 31, 2016:
(Domestic, For-Profit, excluding Trade Name registrations).

Type	**TOTAL**
All entity types	**153,688**

Connecticut Benefit Companies and B Lab Certification: As of December 31, 2016, Connecticut has 82 Benefit Companies, and 2 B Lab certified companies. Both of these B Lab certified companies are domestic LLCs that were formed prior to 2014. Thus, neither is a Benefit Company.

Connecticut Benefit Corporations in Existence on December 31, 2016: Connecticut's Benefit Corporation Law took effect on October 1, 2014. By December 31, 2016, the following number of Benefit Corporations were formed.

Type	**B LAB**	**NOT B Lab**	**TOTAL**
Business Corporation	0	80	80
Limited Liability Company	0	0	0
Professional Corporation	0	2	2
	0	**82**	**82**

100% of Connecticut Benefit Companies are NOT B Lab certified.

Connecticut B Lab Certified Companies:

Type	**BENEFIT**	**NOT Benefit**	**TOTAL**
Business Corporation	0	0	0
Limited Liability Company	0	2	2
Non-Profit	0	0	0
Professional Corporation	0	0	0
Individual	0	0	0
	0	**2**	**2**

100% of Connecticut B Lab certified companies are NOT benefit entities. 100% are LLCs.

Comparison of Data from Oregon B Lab Certified B Corps, both Corporations and LLCs: B Lab provides a numerical rating system for companies that seek certification, in the areas of Environment, Worker, Customers, Community, and Governance as well as an Overall score. This data provided criteria by which B Lab certified entities could be compared by reference to entity type (corporation vs. LLC as well as benefit company vs. non-benefit company), business activity and states of formation.

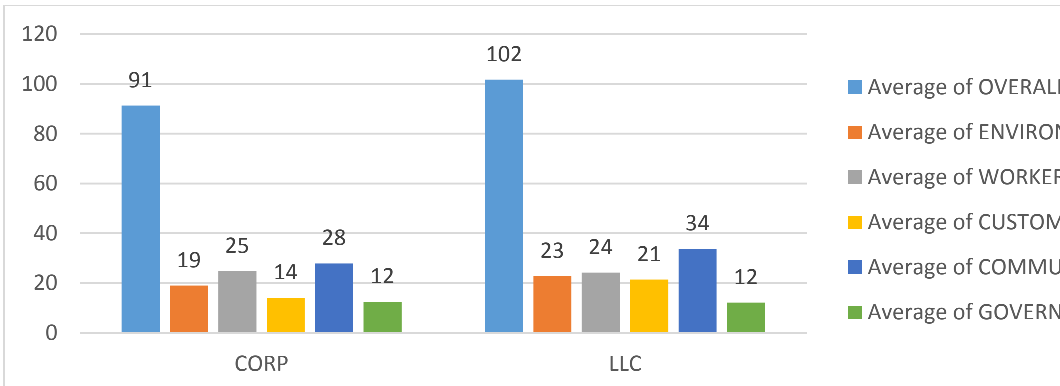
Business entity statutes and regulations do not consistently mandate public disclosure of information beyond basic data such as names, addresses, identification of agents for service of process, and stock issuance numbers. Websites, telephone numbers or even descriptions of business activity are not typically available from business filings accessible through state government websites, especially for recently formed companies. In some instances additional information can be obtained from reports filed later in an entity's existence. Since benefit company status did not become available in Oregon and Connecticut in 2014, there is very little information of that kind that is publicly available in an easily accessible format. For non-B Lab certified benefit companies, an attempt was made to obtain information on business activity and public benefits by trying to locate and then examine company websites. However, this produced very little data to assess the group as a whole.

As of December 31, 2016, there were a total of 77 B Lab certified B Corps in Oregon. Of that number, 41 were Corporations and 30 were LLCs. The remainder were a variety of other types, including an individual, affiliates of a non-profit and one professional corporation. Fifty-three of these entities were not benefit companies and 24 were. There were a total of 1,069 benefit entities, 220 were Benefit Corporations and 849 were Benefit LLCs. Thus, most Oregon benefit companies were not certified by B Lab, and most were LLCs. Of the ones that were certified by B Lab, there were more corporations than LLCs.

This data was supplemented by examining the certification reports issued by B Lab for the B Lab certified Oregon B Corps, both corporations and LLCs. This data was then analyzed using standard PivotChart functions in Excel and showed the following.

Comparison of LLCs and Corporations among Oregon B Lab certified B Corps: Comparing the performance of corporations and LLCs among Oregon B Corps showed the following:

B Lab certification scores for Oregon B Corps, both benefit companies and not benefit companies:



LLCs scored higher (102) than corporations (91).

Results:

Statistical analysis of Oregon's experience with Benefit Corporations and Benefit LLCs clearly shows that allowing Benefit LLCs in Connecticut can be expected to result in (a) a dramatic increase in the number of benefit companies, most of which would be Benefit LLCs, and (b) that these new Benefit LLCs are more likely than Benefit Corporations to actually produce the social benefits that are the goal of social enterprise and the reason why benefit companies exist.

CONCLUSIONS AND PROPOSALS

Conclusions

Benefit companies are still a relatively new phenomenon and a significant number of U.S. states still do not permit them. While there is a growing body of research on the topic, there is still a lack of useful data on most benefit companies. This is due to the short time that most of these companies have been in existence, and the general difficulty in obtaining information from small, privately held companies.

This research was done to specifically address the issue of whether Connecticut should join Maryland and Oregon in permitting Benefit LLCs, in addition to Benefit Corporations. Due to the lack of data available concerning most companies, the best available data came from certification reports issued by B Lab, which is the most prominent company involved in the entire benefit company movement.

Fortunately, enough B Lab certification reports were available for Oregon B Corps to compare corporations and LLCs. While the number of companies examined is relatively small, it did provide some basis for comparison. The data clearly shows that on the major Overall B Lab certification report scale, LLCs score higher on average that corporations.

Perhaps the most striking thing about the data is the very large number of Benefit LLCs in Oregon. At similar time periods following adoption of benefit company legislation (27 months after adoption), the total number of Benefit Corporations in Oregon (117) was comparable to the number of Benefit Corporations in Connecticut (82). However, at that same point in time Oregon had an additional 506 Benefit LLCs. If the creation of benefit companies is seen as desirable, then this data alone supports allowing Benefit LLCs since it has been shown to lead to a vastly increased total number of benefit companies.

Beyond just the relatively large number of benefit companies in Oregon, the data analysis above shows that among Oregon B Corps, the average Overall scores for LLCs (102) was significantly higher than that for corporations (91). While the data sets are limited and further research is needed, the best currently available data shows that LLCs are more effective than corporations in achieving the types of social enterprise benchmarks that are measured by B Lab.

Thus, a statistically supported argument can be made that Benefit LLCs are better than Benefit Corporations in actually achieving social enterprise as measured by B Lab. In short, this research shows that there is a benefit to having Benefit LLCs since LLCs have been shown to surpass Benefit Corporations in actually achieving the public benefits that these entities were intended to promote. For perhaps the first time, this provides data and analysis to support the effort by reSET and others in Connecticut to pursue a modification of Connecticut law to permit Benefit LLCs.

Proposals

The data collection difficulty will continue to be a major impediment to research in this field.[62] There is a relatively simple solution for this. Benefit Company legislation requires benefit companies to post their benefit reports on their websites. However, most states do not require business entities to identify their websites in any filings with the government. If the forms to create business entities and the periodic report forms were modified to include a space to list the company's website, even if this was not legally mandated, voluntary compliance with this would provide a very effective means for researchers to be able to examine the behavior of benefit companies, with no cost to the state other than modification of the form.

As was repeatedly noted throughout this paper, benefit companies are a new and growing field. More companies are being formed all the time, and presumably more companies are seeking B Lab certification all the time. Thus, this paper should be considered a very early analysis of a topic that will require further development.

Appendix A

States that permit Benefit Companies

State	Benefit Law Effective Date	Benefit Corporations?	Benefit LLCs?
Arizona	2014	YES	
Arkansas	2014	YES	
California	2012	YES	
Colorado	2014	YES	
Connecticut	2014	YES	
Delaware	2013	YES	
District of Columbia	2013	YES	
Florida	2014	YES	
Hawaii	2011	YES	
Idaho	2015	YES	
Illinois	2013	YES	
Indiana	2015	YES	
Louisiana	2012	YES	
Maine	Allowed L3Cs in 2011		
Maryland	2010	YES	YES
Massachusetts	2012	YES	
Michigan	Allowed L3Cs in 2009		
Minnesota	2015	YES	
Montana	2015	YES	
Nebraska	2014	YES	
Nevada	2014	YES	
New Hampshire	2015	YES	
New Jersey	2011	YES	
New York	2012	YES	
North Carolina	Allowed L3Cs 2010-2014		
Oregon	2014	YES	YES
Pennsylvania	2013	YES	
Rhode Island	2014	YES	
South Carolina	2012	YES	
Tennessee	2016	YES	
Utah	2014	YES	
Vermont	2011	YES	
Virginia	2011	YES	
West Virginia	2014	YES	

States that have not permitted benefit companies or similar entities:

Alabama, Alaska, Georgia, Iowa, Kansas, Kentucky, Mississippi, Missouri, New Mexico, North Dakota, Ohio, Oklahoma, South Dakota, Texas, Washington, Wisconsin, Wyoming.

ENDNOTES

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[61] The author wishes to specifically acknowledge the assistance of Attorney Seth Klaskin of the Office of The Secretary of the State of Connecticut for his assistance in obtaining this information.

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THE PROFESSORS WHO CONTROL THE OIL PATCH: A CASE STUDY ON THE VIRILITY OF LEGAL SCHOLARSHIP

by

Chase J. Edwards*
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Judge Richard Posner of the U.S. Seventh Circuit Court of Appeals recently made headlines[i] in legal news publications because of comments[ii] he made regarding the role of the legal academy in the nation's court system. In typical Posner style, he pulled no punches: "I don't doubt that law professors are frequently active outside the classroom and that their academic work sometimes addresses practical issues, but what I'd like to see is evidence of impact. Amicus briefs? Working for nonprofits? Blogging? 'Speaking truth to power?' Absurd: speak all you want, professors, power doesn't listen to the likes of you."[iii]

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Nevertheless, Louisiana courts have recently used treatises from ancient scholars Jean Domat (1625-1696) and Marcel Planiol (1853-1931) alongside commentary from contemporary civil law scholars such as A. N. Yiannopoulos and Alain Levasseur to decide the cases of *Eagle Pipe & Supply, Inc v. Amerada Hess Corp* in 2011 and its progeny *Regions Bank v. Questar Exploration & Production Corp*[4] in 2016, likely the most important cases in recent history for the oil and gas industry of Louisiana.

Despite a century of jurisprudential and scholarly analysis of the rights and obligations that exist between landowners and oil producers, no case law addressed the possibility that the language of certain mineral "leases" could actually transfer partial ownership of the land. The arguments for and against the proposition were each cogent, valid, and feasible. "Oil and gas production in Louisiana commenced on a significant scale just over a century ago. Most mineral leases expire as production ends before they reach the 99-year mark. [These] leases may be the first time that this issue has arisen."[5] The court was forced to go back to the basics, and lean on the treatises that all Louisiana lawyers cut their teeth on and the principles of textual interpretation that they established.

Often considered the platypus of jurisprudence, Louisiana operates a "bijural" legal system that has evolved to incorporate many characteristics of the common law while maintaining its civil law roots. However, the lessons of these cases apply equally to all states that recognize "secondary sources" of law.

Section One of this paper recounts the first major battle over mineral rights in Louisiana which sought to dispose of leases by asserting that reconduction of a lease based on continued production violated the requirement for leases to have a term.

Section Two delves into the intervening years of scholarship that addressed the general requirements and prohibitions of the Louisiana Mineral Code. It explores their basis in public policy, and the subtle differences between mineral leases and mineral servitudes in light of the ancient dismemberments of ownership that are inherent in most civil law systems. More importantly, it exemplifies the role of the professorate in developing official Comments to the various codes which are used by judges to interpret the meaning of the law as it is written by the legislature.

Section Three analyzes the doctrine of real and personal rights as expressed in several leading treatises from active and emeritus professors which build on the works of ancient commenters and scholars. These scholarly contributions form the basis of the rulings in both *Eagle Pipe v. Amerada Hess* and *Regions v. Questar*, which represent the first jurisprudential acknowledgments of the doctrinal tenants that have governed Louisiana's billions of barrels of oil and trillions of cubic feet of natural gas for more than a century, and which set critical precedent for the next wave of mineral lease litigation that will attempt to invalidate leases based on the seemingly impenetrable prohibition against leases over 99 years.

The conclusion of this paper recounts the contributions of treatise writers, professors, and practicing academics who help shape the legal landscape, and presents opportunities for professors to prove Judge Posner wrong by affecting change in the law through their work.

LEASES HAVE LIMITS

The first successful oil well in Louisiana was drilled in September of 1901 outside the town of Jennings. This discovery occurred just months after the famous "Spindletop" gushers were drilled less than 100 miles away in Beaumont, Texas. The oil boom that followed has produced more than 25 billion barrels of oil and 200 trillion cubic feet of natural gas from more than 1 million wells. The impact of the mineral industry on Louisiana's economy cannot be overstated. Thus, there is no shortage of litigation regarding ownership of the minerals themselves.

The first wave of litigation came ten years into the boom. Landowners who signed the first mineral leases sought to be released from their agreements in order to re-sign under the more favorable terms that became common as the industry became less speculative. To do this, landowners attacked the various terms[6] included in the leases.

Identifying Perpetual Leases

Louisiana law has always required that a lease have a term. It may not be perpetual or perpetually extendable.[7] This principal, now embodied in Civil Code Article 2678, is derived from Article 2674 of the Civil Code of 1870 – which required a lease be for a "certain time" – and from a long line of Louisiana case law which held that a perpetual "lease" is *nadum pactum*. This line of jurisprudence[8] maintained that any stipulation which allowed a grantee to hold a grantors property under a perpetual lease or option would "take the property out of commerce and be violative of the doctrine of ownership."[9] This principle was ultimately codified in both the Louisiana Civil Code and the Mineral Code.[10] This ended the need for jurisprudential analysis of this requirement, but a study of its reasoning is essential back story for the modern day fight over long-term leases wherein property owners seek to regain control of ancestral land that has been mined for close to a century.

Bristo v. Christine Oil & Gas Company is one of the earliest Louisiana decisions addressing a "perpetual lease."[11] At issue in *Bristo* was a contract purporting to be a sale of the minerals on or in the plaintiff's property and a lease of the land for mining purposes.[12] The contract stipulated that, if a well could not be commenced within a year from the date of the contract and "prosecuted with due diligence, the grant was to become null and void, provided that the grantee might prevent the forfeiture from year to year by paying to the grantor the sum of 10 cents per acre annually until a well was commenced or until shipments from the mines had begun."[13] In considering the validity of the contract, the Court held:

> It may be assumed that the grantee could have acquired a mineral lease for 25 years by drilling a well on the plaintiff's land within the year stipulated in the contract. It is not disputed that the grantee's rights, if he had any, under the contract, were forfeited by his failure to commence drilling a well on the plaintiff's land within the year, unless it be held that the defendant could prevent the forfeiture and keep the option in force indefinitely by paying the stipulated annual rental of 10 cents an acre…Our opinion is that that stipulation in the contract is null for want of a fixed or definite term. Whether it be regarded as a lease or an option, it would be an anomalous contract without a definite term or limitation. To recognize that the defendant has the right, without any obligation, to hold the plaintiffs

> land under a perpetual lease or option, would take the property out of commerce, and would be violative of the doctrine of ownership defined in the second title of the second book of the Civil Code.[14]

The holding of *Bristo* was recited a number of times in cases immediately following its rendition.[15] Hence, judges have adopted the following definitions as indicative of the nature of a perpetual lease. As to a mineral lease, "[t]he lease in perpetuity reprobated by the law is the mere holding by the lessee, indefinitely, of an option to exploit the property, without production of any kind, since the lessee must either develop with reasonable diligence or give up the lease."[16] As to a surface lease, a perpetual lease should be considered as an instrument that would allow the lessee the option of retaining his interest in the property indefinitely without the lessor having the right to terminate the contract by operation of a term.[17]

Habendum Clauses Become Standard Across the Oil & Gas Industry

The purpose of the habendum clause in an oil and gas lease is to fix the ultimate duration of the interest granted to the lessee.[18] A habendum clause essentially predicates the term of the lease based upon the occurrence of a resolutory condition[19] – i.e. the cessation of production in paying quantities. While the Louisiana Mineral Code has long prohibited leases in perpetuity, leases which have stipulated to continue during the existence of a certain condition have been held to be valid.[20] This rule has been applied to both surface leases and mineral leases.[21]

Both *Poole v. Winwell, Inc.* and *Cain v. GoldKing Properties Company* involved surface leases with terms tied to the continued production of oil and gas on property not included within the leased area.[22] In *Poole*, the Louisiana Third Circuit Court of Appeal, which covers the oil-rich southwest portion of the state, turned to the Louisiana Supreme Court's decision in *Busch-Everett Co. v. Vivian Oil Co.*[23] (wherein the Court upheld a mineral lease under a habendum clause) and concluded that "our Supreme Court has upheld a lease with a production term similar to those in the instant case, holding that it is not necessary that the term of a lease be expressed in terms of time, for the lease may be stipulated to continue only during the continuation of a given condition. Accordingly, the term provisions of the leases involved in the instant suit are not at variance with codal requirements." *Cain* was decided soon thereafter in another oil-producing area of the state.[24]

The same concept has long applied specifically to mineral leases. In *Busch-Everett*, the Supreme Court considered the validity of a mineral lease which provided that, should the lessee succeed in "bringing in a second well in paying quantities, then the contract was to continue in full force for two years, *and as much longer as oil, gas, or other minerals can be produced in paying quantities*."[25] (emphasis added) In upholding the lease agreement, the court stated:

> Now as relates to a term:
> It was really more of a condition than a term. The contract was to continue in force as long as the wells produced. That was a condition, which, it may be, plaintiffs could have terminated by obtaining a judicial order to that effect. But a contract of lease (and in this respect we consider the contract one of lease) may be entirely legal without a term, or a term

> may be so indefinite that only the court can determine its date.[26]

The Court expressed a similar opinion in *Sam George Fur Company v. Arkansas-Louisiana Pipeline Company*.[27] At issue therein was a mineral lease with the following provision:

> If the Lessee shall sink a well or shaft and discover oil, gas or sulphur in paying quantities in or under the above described land, then this lease shall remain in full force and effect for ten years from such discovery and as much longer as oil, gas or sulphur shall be produced therefrom in paying quantities.

The Plaintiff challenged the validity of the lease and sought to have the contract canceled on the grounds that the above quoted language essentially established a perpetual lease, and was thus null and void.[28] The Court responded to this argument by stating: "[s]uch a lease is by no means a lease in perpetuity, as the main consideration of the lease is the development of the land, and it is a matter of common knowledge that oil and gas fields cease to produce in paying quantities after the lapse of a certain number of years. The lease in perpetuity reprobated by the law is the mere holding by the lessee, indefinitely, of an option to exploit the property, without production of any kind…"[29]

So, in the first great battle of remorseful landowners versus oil producers, landowners clearly lost. Courts ruled so consistently, during the first decades of oil litigation, that mineral production extended the lifetime of a lease that the Mineral Code was amended to say just that. And, for the rest of the first century of oil production, that was the standard mineral lease.

BUT, SOMETIMES, A LEASE ISN'T A LEASE

The Louisiana Civil Code's first article states that "[t]he sources of law are legislation and custom."[30] Custom, in turn, "results from practice repeated for a long time and generally accepted as having acquired the force of law."[31] Custom is most often developed and cited in the writings of professors who document the year-to-year happenings of business and legal dealings in their scholarly journal articles and treatises.

The concept of prescription[32], which is analogous to a "statute of limitations" in other states, is naturally well-litigated due its dispositive nature in litigation. Provisions in the various codes (Civil, Civil Procedure, Criminal Procedure, etc.) govern the lifetime of a right's existence and the actions that can extend or exterminate that right. The Louisiana Mineral Code supplements the state's Civil Code and covers issues regarding mineral law, including mineral leases.[33]

Article 115 of the Louisiana Mineral Code imposes certain term limitations on the typical mineral lease. The provision provides in relevant part:

> The interest of a mineral lessee is not subject to the prescription of nonuse, but the lease must have a term. Except as provided in this Article, a lease shall not be continued for a period of more than ten years without drilling or mining operations or production. Except as provided in this Article, if a mineral lease permits continuance for a period greater than ten years without drilling or mining operations or production, the period is reduced to ten years.[34]

PROFESSORS AS OFFICIAL COMMENTERS

Each Code within Louisiana Law has Comments, the text of which are not law, but are persuasive authority when judicial interpretation of the law is needed. The Comments do not come from the lawmakers who write the legislation. Instead, they come from the Louisiana State Law Institute which is comprised of law professors, jurists, and practicing academics[35] who meet regularly to provide commentary on existing and pending legislation. In other words, the work of professors is printed alongside the words of legislators. In the recent cases discussed herein, the official Comments played an important role.

The Comments to Article 115 explain that the article generally preserves established law and custom by providing that the interest of the lessee is not subject to prescription; that a lease must contain a term; and that the standard habendum[36] clause will generally satisfy the term requirement. However, the Comments go further in explaining that the requirement that a mineral lease not contain a primary term of more than 10 years is somehow related to the prescription of nonuse applicable to mineral servitudes, which are real rights. The Comments provide:

> [T]here has always lurked in the background of the law applicable to mineral leases the possibility that the court might hold that although a mineral lease is not subject to the prescription of nonuse, it cannot be granted for a primary term greater than ten years. Customarily, primary terms do not exceed ten years… Placing this limitation on the primary term is consistent with the public policy underlying the system of prescription applicable to other mineral rights. The net effect of this limitation in combination with the first sentence [of Article 115] is to free the mineral lease of

> the use rules applicable to servitudes while accomplishing the end of prohibiting all basic forms of mineral rights from remaining outstanding for periods greater than ten years without some form of development…
> Previously, it was not established that the mineral lease either could or could not be granted for a primary term greater than ten years. The danger of providing expressly that they could be granted for primary terms greater than ten years lay in the possibility that there might be widespread evasion of the public policy embodied in the prescriptive rules applicable to other forms of mineral rights. In selling land, the vendor might reserve a paid-up mineral lease with a primary term of thirty years rather than a mineral servitude. Previously, the threat that the court might impose the sort of limitation provided for by Article 115 had a deterrent effect on the widespread granting of long term leases. The removal of that threat might have resulted in subversion of the entire system of prescription. It is therefore provided that the ten-year limitation be imposed. This is viewed as essential to preservation of the mineral property system as a whole.

Scholars Develop the Mineral Servitude Doctrine Into a Real Right for Leaseholders

The Louisiana Supreme Court adopted the Mineral Servitude Doctrine in *Frost-Johnson Lumber Co. v. Salling's Heirs* in 1922.[37] This doctrine precludes the creation of a mineral estate distinct from, and independent of, the full title to the land, and is perhaps the most unusual feature of Louisiana mineral law when compared to the mineral regimes of other states.[38] A mineral servitude conveys the right of enjoyment of land belonging to another for the purpose of exploring for and producing minerals and reducing them to ownership.[39] The Supreme Court has described the conveyance of a servitude as a "dismemberment of the title insofar as it creates a secondary right in the property separate from the principal right of ownership of the land…[and]…effectively fragments the title such that different elements of ownership are owned by different owners." [40]

The works of professor-written treatises are essential to developing an understanding of this subtle, but critical, distinction. "While the jargon of the industry often speaks in reference to the 'term' of a mineral servitude or to a mineral servitude having a 'life' of ten years, in actuality, *a servitude is a real right of unlimited duration*, provided that it does not extinguish in some manner recognized by law."[41] The Mineral Code provides for various modes of extinction of a mineral servitude; however, the most significant cause for extinction is "prescription resulting from nonuse for ten years."[42] Prescription begins to accrue from the date on which the servitude is created, and if the servitude is to be maintained beyond ten years, some use of the right must be made.[43] However, there is *no limitation on the successive 10-year periods which can be triggered by successive use*.[44]

The scholarship clearly indicates that, other than the 10-year prescription of non-use, there is no legally imposed temporal limit on the existence of a mineral servitude yet no cases have ever been cited for this proposition, only the work of scholars.[45]

Leaseholders also found support in the Comments on Mineral Code Article 74, again written by the scholars and professors of the Louisiana State Law Institute, which provide that parties may either fix the term of a mineral servitude or shorten the applicable period of prescription of nonuse or both.[46] If a period of prescription greater than ten years is stipulated, the period is reduced to ten years.[47] The Comments to Article 74 explain:

> In the event of silence as to the term of a mineral servitude, *the right created is permanent or perpetual*, but it is subject to loss by accrual of prescription of nonuse.
>
> It is established by *Hodges v. Norton* and *Bodcaw Lumber Company of Louisiana v. Magnolia Petroleum Company*, that if a term greater than ten years is specified, this fixes the duration of the interest created. It is however, still subject to the prescription of nonuse and will expire prior to the running of the specified term if not used within the legal prescriptive period.[48]

The principals espoused in Article 74 and the comments thereto were, to an extent, addressed in *Hodges v. Norton* and *Bodcaw Lumber Company of Louisiana v. Magnolia Petroleum Company*. In *Hodges v. Norton* the Court dealt with a mineral reservation "for a period of 15-years from and after" the date of its granting.[49] The Court noted that the servitude was "limited in its duration to fifteen years and that, even though the course of prescription was interrupted" the servitude would prescribe at the expiration of the fifteen year term.[50] In *Bodcaw Lumber Co. of Louisiana v. Magnolia Petroleum Company*.[51] The Court considered a mineral servitude "for the term of fifteen years."[52] The Court explained:

> The time limit of fifteen years, within which Bodcaw Lumber Company, or its successors or assigns, might have extracted or removed the oil

> and gas from the land, was inserted in the contract, not for the purpose of extending the time within which the right might be enjoyed, but for the purpose of limiting the time in which it might be enjoyed.

Neither *Hodges* (1942) nor *Bodcaw* (1929) contain an affirmation that a mineral servitude, without some contractual limitation, is a perpetual interest subject to the incidents of extinction set forth in the Mineral Code. In both cases, the Louisiana Supreme Court was addressing conflict over leases in an industry that was still in its infancy. However, commenters and treatise writers adopted these cases as exemplary of how the law should treat these agreements. *Seventy years after Hodges, when the courts had to decide whether or not leases which extended beyond 99 years were valid, it was the inclusion of these cases in scholarly writings which gave them the force of law.*

DESPITE BEING CALLED A "LEASE", SCHOLARSHIP DICTATES THAT A MINERAL LEASE IS A REAL (PROPERTY) RIGHT

According to the rigorous civilian classification system, all rights are either *personal* or *real*.[53] Real rights are referenced throughout the Code, and, while no legislative definition exists, this type of interest is generally described as ownership and its various forms of dismemberment based on the writings of ancient and modern professors and scholars. In the most basic terms, a real right is a right that a person has *in a thing* – i.e. a matter of property law – while a personal right is a right that a person has *against another person* to demand a performance – i.e. a matter of the law of obligations.[54] As explained by Professor Yiannopoulos:

> [D]espite certain similarities, the two species of rights appear to be of a different nature. According to appearances, a usufructuary[55] and a lessee seem to have the use and enjoyment of a house in much the same way. But, technically, the usufructuary has a right in the enjoyment of a house; the lessee has a right against the owner of a house to let him enjoy it. One has a *real right* and the other a *personal right*.[56]

The Mineral Code and its Comments now identify mineral leases as a real right.[57] And while this classification may have been questioned by early Louisiana Supreme Court decisions,[58] the classification of a mineral lease as a real right has become a fixture in Louisiana law.[59] In contrast, it is well settled in Louisiana that under the "civil law concept, a lease does not convey any real right or title to the property leased, but only a personal right."[60] This is a material distinction between mineral leases and surface leases.

The classification of an interest as a "real" or "personal" right is fundamental in civil law systems.[61] Real rights are property rights that confer direct and immediate authority over a "thing" to be enforced against the world.[62] Without a "thing" to which the real right may attach, a real right cannot exist. A personal right does not attach to any particular "thing," it is merely the right of a particular obligee to enforce a particular obligation against a particular obligor. All real rights, including mineral leases, have certain common characteristics that are not exhibited by personal rights absent some special provision to the contrary. These characteristics may be summarized as follows:

1. Real rights always attach to a thing. Personal rights however do not require a specific thing to exist.[63]
2. Real rights may be enforced against the world. Personal rights may only be enforced by the obligee against the obligor who legally or conventionally assumed the obligation sought to be enforced.[64]
3. Real rights follow the thing to which they are attached, thus anyone who takes ownership of a thing encumbered by a real right takes it subject to that right. Personal rights remain with the obligor, they do not follow the thing because they do not attach to the thing.[65]
4. Real rights may be created unilaterally by the holder. Personal rights necessarily require a certain obligee and a certain obligor.[66]
5. Real rights can be abandoned unilaterally by the holder. Personal rights because they involve both a certain obligor and a certain obligee, cannot be abandoned by the obligor without the consent of an obligee.[67]
6. The obligations correlative to real rights can be avoided by dispossession of the thing to which they are attached. Personal rights are not necessarily affected by the transfer of a particular thing.[68]

The division of patrimonial rights into personal and real is inherit in the structure of the Louisiana Civil Code.[69] A personal right is the legal power that a person, the obligee, has to demand from another person, the obligor, a performance consisting of giving, doing, or not doing.[70] As explained by the

Louisiana Supreme Court, a personal right "defines man's relationship to man and refers merely to an obligation one owes to another which may be declared against the obligor."[71] Personal rights are governed by the law of obligations found in Book III of the Louisiana Civil Code, entitled "Of the Different Modes of Acquiring the Ownership of Things.[72]

Personal rights must be contrasted with real rights. A real right should be understood as ownership and its various forms of dismemberment.[73] As explained by the Court, "a real right is synonymous with proprietary interest, both of which refer to a species of ownership. Ownership defines the relationship of man to things and may, therefore, be declared against the world."[74] The various dismemberments of ownership allowed under Louisiana law each confer real rights on the owner or holder of that interest.[75]

Planiol spoke at length on the primary distinction between real rights and personal rights, which he refers to as "right of credit."[76] He explained the importance of the characteristics inherent in real rights by reference to the following examples:

> There are considerable practical differences between [real rights and rights of credit]. Two examples will bring out the nature of the differences.
>
> (1) INSOLVENCY OF A TRADER. All the creditors of an insolvent trader are in the same position. Each of them has his claim to assert against the insolvent, but none of them has special rights to advance against the others. They are all therefore upon a plane of equality. No one of them can prevail over the others. And if we assume, as is the ordinary case, that they are all of them creditors for sums of money, the loss resulting from the insolvency of the common debtor must be divided

among them. Each of them will receive merely a dividend, so much per cent upon the sum due. This result is expressed by saying that the creditors are governed by the law applicable in competitive proceedings, and they are paid, in case of insolvency, *pro rata*.

But another person appears who has a real right. An owner for example, claims as his property merchandise deposited in the insolvent's store; or a second creditor asserts in addition to his claim, a special real right called a pledge or mortgage. These persons have a real right that can be set off against all persons, including the insolvent's creditors. They will, therefore, be able to exclude all these creditors, and keep for themselves either in kind or in value the things that belong to them or which had been pledged to or mortgaged to them. The competitive rule therefore does not apply. They have, as regards the others, a right of preference.

(2) THEFT OF A MOVABLE. When a thing has been stolen, he who is its owner may lay claim to it, that is to say, follow the thief or any other detainer of the thing to reclaim his property. He who is merely a creditor has solely an action in restitution or in indemnification against the person who owed it to him or who permitted it to be stolen. He has no real action that can be set off against everybody. He has a more personal action against the debtor, who alone is responsible to him. *The difference is expressed by saying that the real right confers a right of pursuit which a right of credit does not.* The owner follows, pursues the thing into whatever hands it passes. A creditor cannot follow the thing. He can attack nobody other than his debtor.

> Right of Pursuit and Right of Preference: these are the great advantages of real rights over rights of credit. These are not, as is often said, special attributes, something extrinsic, attached to real rights. They are the very essence of its realness, that is to say the nature opposable to all persons.[77]

CONCLUSION AND PREDICTIONS FOR UPCOMING LITIGATION

Lawsuits 99 Years in the Making

Landowners will continually seek ways to end longstanding mineral leases and servitudes. The latest and greatest hope to wipe the slate clean and regain control of their oil, gas, and minerals is the Louisiana Civil Code's prohibition of leases over 99 years. At stake are thousands of oil and gas leases blanketing a state that has produced over 25,000,000,000 barrels of oil and 200,000,000,000,000 cubic feet of natural gas. Despite the gravity of the situation, the law is silent on whether or not mineral leases are limited by the 99-year prohibition.

However, courts have begun to adopt the writings of legal scholars who assert that these mineral leases, under certain circumstances, may not be leases at all, but, in fact, create an ownership interest in favor of the leaseholder in the form of a mineral servitude. Thus, to apply Louisiana Civil Code Article 2679's conventional 99-year lease limit to a mineral lease would be to completely disregard the structure of the code and the inherit distinction between real rights and personal rights.

The scholarly commentary clearly indicates that a mineral lease is a real right, and it exhibits the major characteristics of such: the mineral lease may follow the land, regardless of transfers of ownership; the mineral lessee may assert his rights against the world just as the proprietor of any real right; the lessee may enjoy directly and draw from the land a part of its economic advantages by appropriating a wasting asset; the lessee has certain rights of preference; and the lessee holds a right that is, in reality, susceptible of a type of possession through exercise.[78]

The first major adoption of this concept was *Eagle Pipe and Supply, Inc. v. Amerada Hess Corp.*, a towering 40-page recitation of civil law tradition written by the Louisiana Supreme Court which contains ***24 citations to treatises, one law review citation, and 22 citations to the Comments of the Law Institute***.[79]

LAW TEACHERS STILL SERVE AS LAW MAKERS

"[Legal scholars] share a language of discourse with important decision makers in the real world, such as judges and legislators. Standard legal scholarship often self-consciously seeks to prescribe real world solutions to real problems."[80]

Contrary to the words of Judge Posner, law professors have an exciting and influential role to play in the development of jurisprudence. Technological advances in the 21st century move far too quickly to await the opinions of an appellate court. In the short term, the work of scholars in trade journals, law reviews, treatises, symposia, and in the media has a direct impact on the business world and helps shape the future of commerce. Over the long arc of time, some bodies of legal scholarship gain the force of law, as happened in the cases above, but every legal scholar has an opportunity to publish work that will inform, educate, and persuade the legislatures and jurist across the nation.

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[i] Above the Law; "Posner And The Law Professor's Search For Meaning". http://abovethelaw.com/2016/06/posner-and-the-law-professors-search-for-meaning/. Last accessed 12/27/16.

[ii] Posner, Richard A.; "The Academy is Out of Its Depth." (June 24, 2016); http://www.slate.com/articles/news_and_politics/the_breakfast_table/features/2016/supreme_court_breakfast_table_for_june_2016/the_bob_mcdonnell_ruling_resulted_in_some_absurd_analogies.html. Last accessed 12/27/16.

[iii] *Id*.

[4] The Plaintiffs in *Regions Bank v, Questar*, alleged that the Benedum Leases had terminated by operation of law as of December 2, 2006. The argument was centered on Louisiana Civil Code Article 2679 which limits the term of a lease to ninety-nine years. Thus, it was alleged, the Benedum Leases terminated ninety-nine years after the date of execution in 1907.

[5] *Regions Bank v. Questar Exploration & Production Corp.*, 184 So.3d 260, 265 (La. App. 2d Cir. 2016).

[6] In this paper, "term" is used as it is used in Civil Law systems to denote the lifetime of a right or obligation.

[7] LSA-C.C. Art. 2678 and Comment(a).

[8] It is a common misconception that Louisiana law does not give weight to jurisprudence. Although Louisiana rejects the concept of *stare decisis*, the civil law concept of *jurisprudence constante*, although rarely seen, serves a similar purpose. *See Eagle Pipe and Supply, Inc. v. Amerada Hess Corp.*, 79 So. 3d 246, 256. ("Under our civilian tradition, we recognize instead that 'a long line of cases following the same reasoning within this state forms *jurisprudence constante.*' This concept has been explained, as follows: '[w]hile a single decision is not binding on our courts, when a series of decisions form a `constant stream of uniform and homogenous rulings having the same reasoning,' *jurisprudence constante* applies and operates with `considerable persuasive authority.' Thus, 'prior holdings by this court are persuasive, not authoritative, expressions of the law.') (internal citations omitted)

[9] *Bristo*, 71 So. 521, 522; *see also*, *Norris v. Snyder & McCormick*, 71 So. 522 (La. 1916); *Liner v. LaCroix*, 588 So. 2d 404 (La. App. 2 Cir. 1991).

[10] LSA-C.C. Art. 2678; La. R.S. § 31:115.

[11] *In re: Bristo*, 71 So. 521 (La. 1916).

[12] *Id* at 521.
[13] *Id*.
[14] *Id* at 522.
[15] *Norris v. Snyder & McCormick*, 71 So. 522 (La. 1916) ("In all other respects the facts of this case are the same as in the case of *Bettie Bristo v. Christine Oil & Gas Co.*"); *Calhoun v. Christine Oil & Gas Co.*, 71 So. 522 (La. 1916) (The defendant has appealed from a judgment annulling a contract purporting to be a mineral lease similar to the contract declared null in the case of *Bettie Bristo v. Christine Oil & Gas Co.*, 71 South. 521, decided today.") *Williams v. McCormick*, 71 So. 523 (La. 1916); *Nervis v. McCormick*, 71 So. 523 (La. 1916); *Parrott v. McCormick*, 71 So. 523 (La. 1916); *Dunham v. McCormick*, 71 So. 523 (La. 1916).
[16] *Sam George Fur Co. v. Arkansas-Louisiana Pipeline Co.*, 148 So. 51, 52 (La. 1933) (At issue was a mineral lease that provided: "If the Lessee shall sink a well or shaft and discover oil, gas, or sulphur in paying quantities in or under the above described land, then this lease shall remain in full force and effect for ten years from such discovery and as much longer as oil, gas or sulphur shall be produced therefrom in paying quantities." The Court held "such a lease is by no means a lease in perpetuity, as the main consideration of the lease is the development of the land, and it is a matter of common knowledge that oil and gas fields cease to produce in paying quantities after the lapse of a certain number of years.")
[17] *Bristo*, 71 So. 521, 522; *Leslie v. Blackwell*, 370 So. 2d 178 (La. App. 3rd Cir. 1979); LSA-C.C. Art. 2679, Comment (a).
[18] Summers, W.L., *The Law of Oil and Gas*, § 14:2 (3rd ed. 2006).
[19] Suspensive and resolutory terms in a lease create an obligation that is conditional. If the obligation may not be enforced until the uncertain event occurs, the condition is suspensive. If the obligation may be immediately enforced but will come to an end when the uncertain event occurs, the condition is resolutory. LSA-C.C. Art. 1767. For example, when Exxon agrees to hire a turnaround company to refurbish a refinery *if* the price of oil drops below $50 per barrel, a suspensive condition exists. Therefore, the obligations created by the contract are suspended and have no force or effect unless and until the price trigger of $50 per barrel occurs. By contrast, Exxon could contract for a company to manage the operations of its refinery *until* the price of oil drops to the same trigger price. In this case, the obligations created in the contract are immediately

in force and exist in perpetuity until the trigger price is reached. This would be a resolutory condition.

[20] *Sam George Fur Co.,* 148 So. 51, 52 (La. 1933(; *Poole v. Winwell, Inc.* 381 So. 2d 926, 930 (La. App. 3rd Cir. 1980); *Cain v. GoldKing Properties Co.*, 408 So. 2d 1364, 1366 (La. App. 1st Cir. 1981).

[21] *Id*.

[22] *Poole*, 381 So. 2d 926 (In *Poole*, the Plaintiff executed two separate surface leases for the purpose of operating an oil and gas gathering facility. The leases provided: "This lease shall continue in force and effect so long as oil, gas, and other minerals are being produced from Sections 9, 16 and/or 41, Townnship 9, North, Range 6 East, Catahoula Parish, Louisiana.") *Cain*, 408 So. 2d 1364 (In *Cain*, the Plaintiff executed a surface lease allowing the defendant to drill a directional well on certain property and conduct other oil and gas related activities thereon to obtain production from under a neighboring parcel. The leases provided that "[t]his agreement shall terminate six (6) months after Lessee no longer needs the surface location or the facilities to be located on the tract therein leased and upon request, Lessee shall execute an agreement formerly terminating and revoking this agreement.")

[23] *Busch-Everett Co. v. Vivian Oil Co.*, 55 So. 564 (La. 1911).

[24] *Cain*, 408 So. 2d 1364 , 1366. (Relying on *Poole* the court reasoned, "[i]n this case, the only reasonable interpretation to be placed on the language fixing the term is "so long as Lessee needs the location to produce, treat and market the production from the well drilled thereon." This is a condition, the existence of which may be easily determined, and which is not entirely dependent on the will of either party. The record reflects GoldKing's present "need" for the location, and that the lease money was timely tendered to plaintiffs. We therefore find that the lease remains in effect and that plaintiffs are not entitled to the relief sought.")

[25] *Busch-Everett Co.*, supra note 23.

[26] *Id* at 566.

[27] *Sam George Fur Co.,* 148 So. 51 (La. 1933).

[28] *Id* at 52.

[29] *Id* (It should be noted that the lease at issue in *Sam George Fur Company* did not obligate the lessee to conduct oil and gas operations on the property. Like the lease agreement in *Saunders v. Busch-Everett Co.*, 71 So. 153 (discussed above) the lessee was allowed the option of paying a certain price to maintain the lease within a certain period without actually

conducting operations on the property. This raises concerns regarding the existence of a potestative condition that could render the contract null. However, even where the lease contains clearly potestative conditions, a different condition arises when the lessee discharges its obligation and the lessor accepts the advantage conferred thereby. For example, in *Sam George Fur Company*, the lessees had developed the property and were operating six producing gas wells at the time suit was brought, and royalties had been paid properly in accordance with the contract. The Court thus held that, the Plaintiff, after retaining such advantages, could not be allowed to repudiate the obligations assumed in the agreement.)

[30] LSA-C.C. Art. 1.; *See* Doerr v. Mobil Oil Corp., 774 So.2d 119, 128 (La. 2000).

[31] LSA-C.C. Art. 3.

[32] *See* LSA-C.C. Art. 3446-3447. (Prescription is the extinction of a title or right by failure to claim or exercise it over a long period. Acquisitive prescription, similar to "adverse possession", applies to property rights while liberative prescription, similar to a "statute of limitations", extinguishes the right to bring a suit or other civil action.

[33] LSA-R.S. 31:2.

[34] LSA-R.S. 31:115.

[35] LSA-R.S. 24:201 *et seq* ("The Louisiana State Law Institute, organized under authority of the Board of Supervisors of the Louisiana State University and Agricultural and Mechanical College, domiciled at the Law School of the Louisiana State University, is chartered, created and organized as an official advisory law revision commission, law reform agency and legal research agency of the state of Louisiana.").

[36] Summers, *supra* note 18.

[37] *Frost-Johnson Lumber Co. v. Salling's Heirs*, 91 So. 207 (La. 1922).

[38] McCollam, John M., *A Primer for the Practice of Mineral Law under the New Louisiana Mineral Code*, 50 Tul. L. Rev. 732, 739 (1976).

[39] LSA-R.S. 31:21.

[40] *Steele v. Denning*, 456 So. 2d 992, 998 (La. 1984).

[41] Patrick H. Martin, *Louisiana Mineral Law Treatise*, §408 (2012).

[42] LSA-R.S. 31:27 & Comments (The first ground stated for extinction of mineral servitudes is prescription resulting from nonuse for ten years. The evolution of a system of terminable mineral interests was one of the principal purposes of the original servitude analogy.)

[43] LSA-R.S. 31:28.

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[44] McCollam, John M., *A Primer for the Practice of Mineral Law under the New Louisiana Mineral Code*, 50 Tul. L. Rev. 732, 745 (1976).
[45] *Id;* Patrick H. Martin, *Louisiana Mineral Law Treatise*, §408 (2012); McDougal III, Luther L., *Louisiana Mineral Servitudes*, 61 Tul. L. Rev. 1097, 1116 (1987).
[46] LSA-R.S. 31:74.
[47] *Id*.
[48] *Id,* Comments.
[49] *Hodges v. Norton*, 8 So. 2d 618, 619 (La. 1942).
[50] *Id* at 622.
[51] *Bodcaw Lumber Co. v. Magnolia Petroleum Co.*, 120 So. 389 (La. 1929).
[52] *Id* at 389.
[53] *See CLK Co., LLC v. CXY Energy, Inc*., 719 So. 2d 1098, (La. App. 4 Cir. 1998); A. N. Yiannopoulos, 2 La. Civ. L. Treatise, Property § 201 (4th ed.).
[54] A. N. Yiannopoulos, 2 La. Civ. L. Treatise, Property § 201 (4th ed.); *Eagle Pipe and Supply, Inc. v. Amerada Hess Corp.*, 79 So. 3d 246 (La. 2011).
[55] *See generally* A. N. Yiannopoulos, *Usufruct: General Principles - Louisiana and Comparative Law*, 27 La. L. Rev. (1967). (In civil law systems that trace their lineage to ancient Roman law, full ownership is actually a bundle of three rights. The owner of the *usus* owns the right to use the property as she sees fit. The owner of the *fructus* enjoys the fruits of the property. This includes literal fruits, such as crops, and civil fruits, such as land rent. She who owns the *abusus* has the right to abuse, destroy, sell, or otherwise alienate the property. A person who owns both the *usus* and *fructus* owns a "usufruct" and is referred to as a "úsufructuary". The person who is left with only the *abusus* is referred to as the naked owner".)
[56] A. N. Yiannopoulos, 2 La. Civ. L. Treatise, Property § 201 (4th ed.).
[57] LSA – R.S. 31:16 (Stating that the "basic mineral rights that may be created by a landowner are the mineral servitude, the mineral royalty, and the mineral lease" and providing that "[m]ineral rights are real rights and subject either to the prescription of nonuse for ten years or to special rules of law governing the term of their existence.")
[58] *Reagan v. Murphy*, 105 So. 2d 210, 212-15 (La. 1958) (In *Gulf Refining Co. of Louisiana v. Glassell*, 171 So. 846 (La. 1936), the Court initially held that mineral leases produced only personal rights and obligations between the parties. Following this decision, the legislature enacted LSA-R.S. 9:1105, which classified oil and gas leases as real rights. In considering the

application of this law, the Court maintained its original position – that a mineral lease produces only personal rights – in *Arnold v. Sun Oil Co.*, 48 So. 2d 369. In light of the *Arnold* decision, the legislature enacted an amendment to 9:1105 which reemphasized the treatment of a mineral lease as a real right and added that the legislative intent was that the provision be applied as a substantive law conveying the benefits relating to the owners of real rights in immovable property to mineral lessees. In response to the argument that the statute affirmatively classified mineral leases as real rights, the Court stated: "[t]his proposition cannot be sustained as there is nothing contained in the amendatory section to indicate such an aim. It is noted, *imprimis*, that the original law does not say that mineral leases are real rights. It declares in substance, that they are to be *classified* as real rights and may be asserted, protected, and defended in the same manner as may be the ownership or possession of other immovable property…Indeed, it is perfectly evident from even a casual reading of the amendment that the Legislature did not intend to change the essence of the contractual rights and obligations between mineral lessees and lessors but only that it sought to place mineral lessees on the same level as landowners in conferring on them 'benefits' of the laws relating to owners of immovable property." The Court went on, "[v]iewed in this light and applied to mineral leases, it is seen that to say the Legislature intended to change the true essence of a mineral lease from a personal contract into a real right would necessarily require the conclusion that the mineral lessee owns the right to explore for the minerals. The corollary of this proposition is that a mineral lessor divests himself of all proprietary interest in the minerals and has only a personal right to enforce the terms of the lease…It becomes obvious, then, that to uphold plaintiffs' claims would serve only to confuse the fundamental law and, perhaps, place many contractual obligations and rights in a state of uncertainty. This we will not do.")

[59] LSA – R.S. 31:16; *Eagle Pipe and Supply, Inc.,* 79 So. 3d 246, 259.

[60] *Richard v. Hall*, 874 So. 2d 131, 145 (La. 2004).

[61] A. N. Yiannopoulos, 2 La. Civ. L. Treatise, Property § 203 (4th ed.).

[62] Ciolino, Dane S., *Moral Rights and Real Obligations: A Property-Law Framework for the Protection of Authors,* 69 Tul. L. Rev. 935, 963 (1995).

[63] *Id* at 964 ("For example, a person may obligate himself to deliver a truckload of river sand to the obligee for a fixed sum of money. That obligation, however, does not relate to any particular truckload of sand

and presumably can be satisfied merely through the delivery of any sand of acceptable quality. In contrast, if a person owns a particular truckload of sand, he owns *that* truckload of sand and not merely any similar quantity of sand. The sand owner's real right of ownership is attached to the sand.")

[64] *Id* at 965 ("For example, if the obligor promised but failed to deliver sand to the obligee, the obligee could sue only his obligor for breach of the obligation. The obligee could not sue the obligor's neighbor or his brother in Paris. In contrast, if anyone absconded with a truckload of river sand owned by another, the owner of that sand could assert his real right of ownership against any possessor.")

[65] *Id* ("For example, if the obligor who promised to deliver a quantity of sand sells a particular truckload to another person, the purchaser of that truckload does not then become obligated to deliver it to the obligee. The personal obligation to deliver a quantity of sand remains with the obligor who failed to perform. In contrast, the owner of a particular truckload of sand has a real right of ownership that follows the sand wherever it may go.")

[66] *Id* at 966 ("For example, neither a conventional obligation assumed voluntarily through a contract, nor a delictual obligation imposed by law as a result of the obligor's tortious conduct, can come into being without a certain obligor and a certain obligee. In contrast, the owner of a tract of land can unilaterally execute a juridical act that places building restrictions on his property that will obligate even unknown future owners. Such restrictions can obligate future owners not only to conform to a general building plan, but also to perform reasonable affirmative acts for the maintenance of that plan.")

[67] *Id* ("For example, a usufructuary can unilaterally abandon his real right in the property and thereby release himself from the obligation to make repairs to the property. In contrast, the holder of a personal right to collect on a debt cannot remit the debt without the consent of the debtor.")

[68] *Id* at 966-67 ("For example, a person who purchases a truckload of sand on credit remains obligated to pay the seller even after he transfers the sand to another. In contrast, the purchaser of a tract of land burdened by a servitude or a building restriction is not obligated to the holder of the real right after he sells the land to another.")

[69] A. N. Yiannopoulos, 2 La. Civ. L. Treatise, Property § 203 (4th ed.).

[70] *Id*.
[71] *Reagan*, 105 So. 2d 210, 214.
[72] *Eagle Pipe and Supply, Inc.,* 79 So. 3d 246, 260.
[73] *Id* at 258-59.
[74] *Id* at 258.
[75] *Id* at 258.
[76] 1 PLANIOL & RIPERT, TREATISE ON THE CIVIL LAW pt. 2, no. 2157, at 276 (La. St. L. Inst. Trans., 12th ed. 1939) (Explaining that the right of credit is very often called a "personal right.")
[77] *Id*.
[78] LSA-R.S. 31:16 and Comments.
[79] *Eagle Pipe and Supply, Inc.*, 79 So. 3d 246, 262.
[80] Robert C. Bird, *Special Report: Legal Scholarship in Business Schools*, 53 Am. Bus. L.J. 9, 28 (2016) (*citing* Jordan H. Liebman, *The 1990 ABLA Research Committee Report: A First Step in the Search for an Organizing Principle*, 9 J. Legal Stud. Educ. 265, 290-91 (1991).)

PROMOTING A NEW SOURCE OF LIQUIDITY FOR SMALL BUSINESSES: AN EXAMINATION OF U.S. REGULATION OF CROWDFUNDING

by

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INTRODUCTION

One of the effects of the 2007 financial crisis in the United States was the highest level of U.S. unemployment since the 1929 Great Depression. This financial disaster caused a major rethinking in Congress: the 2010 Dodd-Frank Act[1] (the "Act") sought to curb the abuses within the financial system with its 1,000 page, multiple titled divisions. The Act sought to regulate perceived abuses and causes of the crisis, particularly by banking institutions, and resulted in a major overhauling of substantive financial sectors. It forbade banks from engaging in

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risk-oriented investment activities including hedge funds, the unsuccessful prohibition of "too-big-to-fail" banks, reform of credit rating agencies, the creation of the Financial Stability Oversight Council[2] to regulate financial sectors of the economy that may create financial danger to overall U.S. financial stability, protection of consumers, and other provisions.

At the same time, Congress addressed the need to foster greater employment opportunities. The legislators lessened regulatory restrictions for new start-up companies so that numerous investors might add their substantial liquidity in relatively small sums for these start-up ventures. In this article, the authors examine the use and abuse of crowdfunding as a vehicle to encouraging financial investment, comparing it to the more traditional roles of angel and venture capital investors. The authors are particularly concerned with the possible abuses and with the regulatory environment that seeks to lessen the fraud that often accompanies diverse financial strategies. This article concludes that continued legislative and enforcement actions are needed both to encourage investors to participate and to protect investors from fraud.

CROWDFUNDING: A U.S. AND INTERNATIONAL PHENOMENON

Crowdfunding refers to investments, other than the more traditional means of raising capital, by a substantial number of persons with respect to particular, mostly new, projects. In past years, such funding often originated from venture capitalists who assumed substantial risks in the hope of attaining more substantial financial rewards from innovative ideas that appeared to have financial merit. Although venture capital funding continues as an important source of capital for newly arising business ventures, crowdfunding has now overtaken venture capital as a major source of financing.

Crowdfunding investment rose from $6.1 billion in 2013 to $16.2 billion in 2014, and a projected $34.3 billion in 2015. Venture capital investments constituted approximately $30 billion in a comparable time frame.[3]

Crowdfunding has its roots several centuries in the past, but it appeared in its current incarnation in 1997 when a British rock band, desiring to accomplish a reunion tour, requested and received funds online from fans. This initiative led to the formation of ArtistShare, a platform connecting creative artists to fans to play a role in the creative process and fund creative artistic activities.[4] It was the first fan funding platform.[5]

Crowdfunding constitutes an investment of capital in order to seek a profit through the efforts of other persons. This practice usually comes within the parameters of the *SEC v. W.J. Howie Co.* test which requires, unless exempted, registration with the Securities and Exchange Commission (SEC).[6] Congress enacted such an exemption in the 2012 of the *Jumpstart Our Business Startups Act* (the "Jobs Act").[7] Title III.[8] The Jobs Act specifically permits an exemption from the substantial filing requirements with the SEC mandated under Section 4 of the Securities Act of 1933 (the 1933 Act")[9].

Benefits of Crowdfunding

The crowdfunding statute specially states that the Jobs Act is "[t]o increase American job creation and economic growth by improving access to the public capital markers for emerging growth companies." In addition, the International Organization of Securities Commissions (IOSCO) lists a number of benefits of crowd-funding: economic growth through new and increasing flows of credit to small and medium enterprises and other users in the real economy; a complement to bank investment; increased leverage through a lower cost basis; portfolio diversification; cost efficiency; convenient; and increased competition in an area traditionally dominated by a few providers.[10]

Risks of Crowdfunding

A number of authors and regulatory bodies note risks inherent in the practice to both investors and to the issuers and promoters of crowdfunding ventures. The list is extensive:

- Fraud, when recipients of moneys convert the funds for personal needs and wants;
- Incompetence of the entrepreneurs, who often have creative ideas but lack ability to translate them into useable products or services and market them successively;
- Inability of the entrepreneurs to compete or protect their intellectual property rights against large, much better funded enterprises;
- Taxation issues, especially when marketed in other countries; regulatory requirements on each level of governmental entities;[11]
- Defaults and high failures of start-up businesses;
- Ultimate lack of liquidity irrespective of sums raised for the enterprise;
- Money laundering and terrorist financing; and
- Platform failure.[12]

It should be noted, in particular, that ideas are not protected by intellectual property statutes unless reduced to patents or copyrights in a fixed and tangible form. There is, then, the pressing danger of theft of such ideas by other prospective entrepreneurs.[13]

U.S. CROWDFUNDING PLATFORMS

There are many hundreds of crowdfunding platforms[14] or methodologies (models) that may be used by persons seeking funding which to date have raised more than $65 billion for startup companies resulting in the creation of over 270,000 jobs by the statutory enactment.[15] The major models of which the first two models are the primary types, may be summarized as follows:

1. *Rewards-based Model:* The rewards-based crowdfunding model offers certain perks to non-accredited investors such as t-shirts, movie passes, free software, and other perks at little cost to investors but without receipt of any ownership in the company.

2. *Equity*-based *Model.* The equity-based model gives accredited investors an opportunity to invest in new companies that have unique offerings with potentially sizeable future monetary returns. The best known example of the equity model is that of Kickstarter.com. Kickstarter was launched in Brooklyn, New York on April 28, 2009 by three individuals taking the form of a public benefit corporation.[16] The company, which has raised over $2.1 billion dollars 10 million people has funded almost 100,000 projects. Its stated mission is to help bring creative projects to life.[17] Among the projects launched include the arts, fashion, music, food, publishing, film, theatre and other noteworthy areas. Other platforms have raised some $10 billion for comparable projects.[18]

3. *Charity-based Model.* This model offers investors moral satisfaction rather than monetary or other such rewards by donations to worthy non-profits seeking to promote social enterprises. An example of charitable crowdfunding is the

website at these authors' university whereby donors are encouraged to contribute donations for a multitude of students' projects and endeavors including undergraduate students' research travel fund, internships in nonprofits and social enterprises, and environmental studies in Cuba.[19]

4. *Peer-to-Peer (P2P) Debt Model.* In the crowdfunding debt-model investors pool moneys into a fund that lends unsecured money online to potential borrowers based on their credit-risk portfolios permitting investors to receive from interest received. The model offers alternatives to borrowers particularly when moneys from banks or mortgage companies become unavailable.

5. *Litigation Model*. The litigation model of crowdfunding provides moneys for purposes of commencing or continuing litigation against companies for perceived wrongdoing and other related alleged malfeasance. Investors receive a stake in the potential result of the litigation. An example of this model is LexShares, wherein the raised capital may be used for litigation expenses such as attorneys' fees, expert witnesses, trial exhibits and court fees investors; working capital for rent, supplies, and other business related expenses; personal expenses for the litigants; and serve as a means of acquiring high quality legal talent that lessen the perceived need to settle cases for less money than the desired outcome.[20]

6. *Product Pre-order Model.* The product pre-order model enables investors to receive products being manufactured before becoming available to the public at a discount price.[21] It has some degree of similarity to the rewards-based model.[22]

U.S. COMPARISON OF CROWDFUNDING TO VENTURE CAPITAL AND ANGEL INVESTMENT

As noted, venture capital was a primary means of raising capital for startup companies or those in their early stages of potential expansion. Crowdfunding is the most current means of doing so, compliments of favorable statutory requirements. The problem addressed by Congress is the requirement of extensive registration provisions under the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "1934 Act"). The 1933 Act mandates that an offer and sale of securities requires that the securities be registered with the Commission unless otherwise exempted. Crowdfunding was permitted by Congress in order to permit numerous small investors to invest or donate small amounts of moneys either in the hope of gaining significant financial advantages or simply to participate in good causes or receipts of certain perks. The Jobs Act removes most prohibitions of general solicitation and advertising that otherwise would make such investments prohibitive due to the extensive costs and expenses related to Securities Acts requirements.

A comparison of the two popular means of attaining funding is illustrated below.

	Crowdfunding	**Venture Capital**
Sources of Funding	Small individual contributions from numerous investors	Moneys from a few wealthy from numerous investors accredited investors
Means of investing	Online through the Internet	Direct investment with firm; offline
Sums that may be invested	Limited to $1 million	Unlimited

Sophistication of investors	Low	High
Share of financial returns	Dependent on platform chosen (equity model may permit but most do not share)	Significant profit or revenue
Registration requirements	Exemption under Securities Act	May require registration and compliance with other requirements under Securities Acts

Angel investors are similar to venture capital investors in that they are ordinarily wealthy investors investing directly with the prospective company but generally differ by becoming financially involved at the onset or early stages of a prospective enterprise while venture capital is ordinarily invested in relatively large sums ($2 million or more) once there is evidence of that the enterprise has commenced and is gaining credibility as one with potential sizeable financial returns. Angel investors assume greater risk but also may demand a greater percentage of equity for the *perceived* additional risk.[23]

U.S. STATUTORY ENVIRONMENT FOR CROWDFUNDING

Prior Securities Exemption Provisions

The 1933 Act was enacted as a result of Congressional investigations that uncovered significant fraud during the halcyon days of the “roaring 20s” when fraudulent securities were commonly sold to unsuspecting investors. With certain major exceptions,[24] the 1933 Act required that investors receive financial information from the issuer in order to better evaluate whether or not to provide capital in the hope of receiving financial profit through the efforts of other persons.

Issuers, generally through their underwriters, brokers, and dealers, provide the relevant information by means of a registration process. Pertinent information of the proposed security is filed with the SEC, created under the Securities Exchange Act of 1934. The investment information is contained in a detailed prospectus and is available to the public on the Commission's website EDGAR.

The Crowdfunding Exemption

With respect to crowdfunding, §302 of Title III amends §4 of the 1933 Act to provide an additional exemption from registration by adding a sixth exemption to §4(a)[25] for:

> transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that—
> (A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than $1,000,000;
> (B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, does not exceed—
> (i) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and
> (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if

> either the annual income or net worth of the investor is equal to or more than $100,000.[26]

Within the crowdfunding exemption, Congress limited financial exposure and possible losses by (1) limiting the amount raised by a startup to $1 million over a 12-month period and (2) restricting individual investments over a 12-month period to either the greater of $2,000 or five percent of the annual net worth of the individual investor if the investor's income is less than $100,000 annually so as to protect less sophisticated investors; or the greater of 10 percent of the investor's annual income if such income is $100,000 or more but not to exceed the an amount sold to investors of $100,000.

SEC Final Rule

Pursuant to the crowdfunding amendment to the 1933 Act, the SEC issued a Final Rule effective May 16, 2016 with 685 pages of the Rule and commentaries detailing the requirements for issuers, intermediaries, and other requirements in an endeavor to limit exposure of unsophisticated investors and provide a framework for the registration which registered funding portals and broker-dealers are required to use as intermediaries.[27]

Limitations on Investments:

The question arises concerning how an intermediary is to determine the net worth of the investor. The final rule provides that the person's annual income and net worth are to be calculated in accordance with the values calculated for determining accredited investor status (in essence, net worth exceeding $1 million and annual income exceeding $200,000[28]). The issuer may rely on the efforts of the intermediary to ensure that the appropriate limits on investments have been met.[29] The exemption applies only to transactions involving the sale or offering of securities that are organized within the U.S., is not an investment company, and is not otherwise ineligible to sell securities.

Requirements Relating to Issuers:

The definition of an issuer varies dependent upon the context in which it is used. In the context of crowdfunding, it is defined under §2(4) of the 1934 Act as "every person who issues or proposes to issue any security" with a number of exceptions not applicable in this context. Title III of the Jobs Act requires an issuer that offers or sells securities to file with the Commission and provide investors and the relevant broker or funding portal and make available to potential investors detailed information concerning the issuer's name, legal status, physical and website addresses, names of directors and officers and persons holding 20 percent or more of the issuer's shares; a description of the business and business plan; material factors concerning risk or speculation; the financial condition certified by the chief executive officer of the issuer for the preceding 12-month period for target offering amounts of $100,000 or less including tax returns and if over $100,000 and under $500,000; financial statements by an independent public accountant and audited statements if over $500,000; a description of the purpose and intended use of the proceeds; the price of the offerings to the public; a description if the ownership and capital structure of the issuer;[30] and numerous other details concerning price structure, return of funds if investment is cancelled, rights of principal shareholders, and other pertinent data. Thus, the degree of information to be filed and given to investors and intermediaries increases exponentially as the target investments increases.[31]

The issuer offering or selling securities has to file an offering statement with the Commission as well as any amendments, progress updates, and an annual report.[32] Advertising by prospective issuers is strictly limited to directing the potential investor to the intermediary's platform and must include a statement of the offering, name of the intermediary, terms of the offering, factual information about the proposed business and location, and how to communicate with the intermediary.[33] Compensation from the issuer to the promoter is permitted but the extent of compensation is to be disclosed through the intermediary.[34] The Final Rule has an appendix displaying the forms required under the rule, to wit, forms for offering statement, progress update, amendments to the offering statement, annual report and amendment, and termination of reporting.

Requirements Relating to Intermediaries:

Investors generally act through intermediaries respecting the sale or purchase of securities. These persons or entities must register with the Commission as either a *broker* defined as "any person engaged in the business of effecting transactions in securities for the account of others"[35] or as a *funding portal* defined as "any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others but does not offer investment advice, solicits purchase or sales of securities or holds or manages such securities".[36] The person or entity must also register with any applicable self-regulatory organization[37] (generally, the Financial Industry Regulatory Authority [FINRA]) and provide disclosures to investors of risks and other educational materials as the Commission may require to ensure that each investor reviews relevant information of the crowdfunding offering, affirms an understanding that the person or entity understands the risks associated with the investment including that of a total loss of the investment and understands the level of risk applicable to the investment, and an understanding of the risk of illiquidity.[38]

Before accepting any investment commitment and additional commitment, the intermediary must have a reasonable belief that the investor satisfies the investor limitations cited above although the intermediary may rely on the investor's representations such as his or her annual income, net worth, and the amount of the investors other investments unless the intermediary has reasons to question the reliability of the representations. The intermediary is required to obtain from the investor a representation that the investor has read the intermediary's educational materials, understands that the entire amount invested may be lost, and that the investor is in a financial position to absorb the loss. Other data to be received from the investor include a completed questionnaire that demonstrates his or her understanding of restrictions on cancelling a commitment to invest or difficulty in reselling the said securities, and the risk of loss that is otherwise not affordable.[39]

Additional provisions relating to intermediaries include the requirement that the Commission take measures to reduce fraud by mandating a background check and regulatory history with respect to each officer, director, and persons holding more than 20 percent of the outstanding equity of every issuer whose securities are being offered under the Jobs Act; provide that all proceeds from the offer may be given and used by the issuer only when the target offering amount is reached and allow investors to withdraw their proceeds if such target is not met; and information collected from investors; and protections relating to promotors, finders, or lead generators.[40] Any director, officer, or partner of the intermediary may not have a financial interest in the *issuer* (defined as "a direct or indirect ownership of, or economic interest in, any class of the issuer's securities") including compensation for services rendered to the intermediary. The intermediary also may not have a financial interest in the issuer unless it receives compensation for services provided respecting the sale or offer for sale of the particular class of crowdfunded securities.[41]

The regulations require that an intermediary take measures to reduce risk of fraud. The intermediary must have a reasonable basis for believing that the issuer has complied with the requirements of the crowdfunding statute; that the issuer has established means to keep accurate records of the holders of the securities it would offer and sell through the intermediary's platform; and deny access to its platform to an issuer which has a reasonable basis for believing that the issuer or officers thereof is subject to a disqualification.[42] The intermediary must assure that the investor has opened an account with the intermediary with consent for electronic delivery and provide all information on its platform and to the investors that is required by the intermediary including: educational materials that explains the process of the offer, risks, types of securities offered, restrictions on resales, limitations on amounts that may be invested and other relevant information; whether promoters have been used and the compensation thereof; and disclosure of compensation of the intermediary.[43]

The intermediary must provide communications channels on its platform to enable persons to communicate with each other and with representatives of the issuer unless the intermediary is a funding platform that does not participate in communications other than to provide guidelines for communication and remove abusive or potential fraudulent communications; permits public access to view the discussions in the communications channels; restricts posting of comments to those who have opened and account with the intermediary on its platform; and requires persons posting comments clearly stating whether he or she is a founder or employee of the issuer engaged in promotional activities or is otherwise compensation for the comments.[44] When an investor receives an investment commitment from and investor the intermediary must promptly provide the investor with the dollar amount of the investment commitment; the price of the securities, if known; the name of the issuer; and the date and time by which the investor may cancel the commitment.[45]

An intermediary that is a registered broker must comply with regulations governing the transmission or maintenance of payments in connections with underwritings. It is a "fraudulent, deceptive, or manipulative act or practice" under Securities Act for any broker or dealer participating in any distribution of securities to accept any part of the sale price of any security being distributed unless (a) the money or other consideration received is promptly transmitted to the persons entitled thereto; or (b) if not to be payable to the person on whose behalf the distribution is made, then the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee or in escrow for the persons who have the beneficial interests therein.[46]

An intermediary that is a funding portal must direct investors to transmit the money or other consideration to a qualified third (registered broker or dealer holding such funds or an insured bank or credit union) which has agreed in writing to hold the funds on behalf of the persons entitled to them. The funds are to be transmitted to the issuer when the aggregate amount of investment commitment achieves the target amount of the offering but no sooner than 21 days after the date on which the intermediary makes publicly available the required information on its platform. If the investment commitment has been cancelled then the funds are to be returned to the investor upon failure to complete the offering. Investors are to receive a confirmation from the intermediary that discloses the date of the transaction type of security purchased, identity, price and number of securities, and other related information.[47]

Special Rules for Registered Funding Portals:

As discussed above, a funding portal is required to be registered with the Commission and become a member of a national securities association (*e.g.*, FINRA). It is exempt from broker registration requirements in connection with its activities as a funding portal.[48] When acting as a crowdfunding intermediary with respect to the offer or sale of securities it may not offer investment advice or recommendations; solicit purchases, sales, or offers to buy the offered securities displayed on its platform; or compensate other persons for such solicitation. It may not hold, manage, possess, or otherwise handle investor funds or securities.

It may, however, determine what terms to allow an issuer to offer and sell securities under its platform; apply objective criteria to highlight offerings on its platform that are reasonably designed to highlight the issuers' offering; provide search functions or other tools investors can use to examine the offerings available through the funding portal's platform; provide communication channels by which investors can communicate with each other and with representatives of the issuer concerning the offerings; advise an issuer about the structure or content of the issuer's offering, including assistance in the preparation of the offering documentation; compensate a third party for referring a person to the funding portal provided the third party does not provide the portal with personally identifiable information of any potential investor and the compensation is not based on the purchase or sale of a crowdfunding security except for compensation paid to a registered broker; pay compensation to a registered broker or dealer in connection with the offer or sale of crowdfunding securities pursuant to a written agreement and such services and compensation comply with the rules of the registered national securities association of which the funding portal is a member; receive compensation from a broker or dealer for services performed by the portal for sale or offer of the said securities; advertise the existence of the funding portal and identify one or more issuers or offerings available in accordance with certain designated criteria; deny access to its platform or cancel an offering of an issuer where it believes there may be fraud or concerns investor protection; accept on behalf of an issuer an investment commitment for the offered crowdfunding securities; direct investors where to transmit funds and remit payments in connection with the said securities; and direct a third party to release proceeds to an issuer upon completion of the crowdfunding offering.[49]

Nonresident Funding Portal Requirements:

A nonresident funding portal is defined as a funding portal incorporated in or organized outside the U.S. or having its principal place of business beyond U.S. borders. Registration by a nonresident funding portal is conditioned upon information sharing arrangement between the Commission and the competent regulator in the nonresident portal's jurisdiction. The said portal must have a designated U.S. agent upon whom any service of process, pleadings or other papers may be served and must maintain appropriate books and records.

Completion of Offerings and Cancellations:

An investor may cancel an investment commitment for any reason up to 48 hours of the deadline identified in the issuer's offering materials. If there is a material change to the terms of the offering or with respect to the information provided by the issuer, then the intermediary is to notify the investor of such change and that the investment commitment is being cancelled unless the investor reconfirms the commitment within five business days of receipt of the notice.[50] If the target offering amount is reached prior to the deadline identified in the offering, the issuer may close the offering before the deadline date provided certain requirements are met, to wit, the offering must remain open for 21 days; notice is given to potential investors of the new deadline; his or her right to cancel the investment up to the said 48 hours of the new deadline offering; and whether any additional investment commitments will be permitted within the 48 hour deadline.[51]

Miscellaneous Provisions Applicable to Funding Portals:

Funding portals are subject to inspections and examinations by the Commission and by registered national securities organizations. Records are to be kept for a period of five years (2 years in an easily accessible place) concerning an investor's purchase or attempts to purchase crowdfunding securities; records relating to issuers for such offerings; communications regarding the platform; records relating to promotion of issuer's securities that use communication channels; notices to issuers and investors; written agreements relating to the offerings; all daily, monthly, and quarterly summaries of transactions effected; organizational documents; and financial recordkeeping and reporting of currency and foreign transactions.[52]

Restriction on Resales and Disqualification Provisions:

Securities issued under the crowdfunding exemption may not be transferred by any purchaser for one-year commencing when the securities were issued unless the securities are transferred to the issuer; to an accredited investor; as part of an offering with the Commission; or to a family member of the purchaser.[53] The crowdfunding exemption is not available to the issuer if it or its predecessor, officers, director, general partner, or managing member, or any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities has been convicted within 10 years before the offering statement of any felony or misdemeanor in connection with the sale or purchase of any security or made any false filing with the Commission or has been enjoined by any court of competent jurisdiction in connection with the purchase or sale of security. The prohibition also applies to such persons who have been suspended or registration revoked, or subject to other bars by the Commission.[54]

CONCLUSION

Crowdfunding is the recognition by the U.S. federal government as well as state and local governments that small businesses (under 500 employees) are the lifeblood of the American economy constituting 28 million in number and generating 65 percent of new employment positions since 1995.[55] With manufacturing jobs having moved to cheaper labor force areas, particularly China, the need to create a replacement has become a priority that both political parties have recognized thus leading to the Jobs Act, which has been emulated by many countries worldwide. Crowdfunding is one of a number of initiatives which government regulators and industry has put forth to assist in the necessary job creation. Interestingly, its scope is well beyond funding new profit-motive businesses but is also the seed for charitable and social concerns. The plusses and minuses discussed in this article make it evident that potential investors must be wary about investing hard-earned money in ventures that may have little chance of success. Nevertheless, with the monetary limitations and relative easing of regulations it is anticipated that crowdfunding is yet another in the proliferation of capital-raising ventures that will inevitably be the source of remarkable success stories as well as cautionary tales of misadventure. The authors await further developments to see which way balance will tip.

ENDNOTES

[1] Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173, July 21, 2010).
[2] The Financial Stability Council was created under Title I, subtitle A of the Dodd-Frank Act.
[3] Massolution, *2015CF: The Crowdfunding Industry Report*, *http://www.crowdso*urcing.org/editorial/global-crowdfunding-market-to-reach-344b-in-2015-predicts-massolutions-2015cf-industry-report/45376. See also commentary by Chance Barnett, *Trends Show Crowdfunding to surpass VC in 2016*, FORBES (June 9, 2015), http://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016/#18e99839444b.
[4] artistShare, http://www.artistshare.com/v4/.
[5] *The History of Crowdfunding*, Fundable (date visited), http://www.fundable.com/crowdfunding101/history-of-crowdfunding.
[6] *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946).
[7] Pub.L. 112-106 enacted into law April 5, 2012.
[8] Section 301 of the Act states that the full title of Title III is the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 or the CROWDFUND Act.
[9] 15 U.S.C. 77d
[10] Eleanor Kirby and Shane Worner, *Crowd-funding: An Infant Industry Growing Fast*, Staff Working Paper SWP3/2104, OICU-IOSCO, 21-22, http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf. NOT SURE IF CITED CORRECTLY
[11] Garry A. Gabison, *Understanding Crowdfunding and its Regulations: How can Crowdfunding help ICT Innovation*, JRC Science and Policy Report, (2015), http://publications.jrc.ec.europa.eu/repository/bitstream/JRC92482/lbna26992enn.pdf.

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[12] OICU-IOSCO, Crowdfunding: 2015 Survey Responses Report, FR29,2015 (Dec. 2015), iv.
[13] Nicholas Wells, *The Risks of Crowdfunding,* Risk Management, RIMS (March 4, 2013), http://www.rmmagazine.com/2013/03/04/the-risks-of-crowdfunding/.
[14] *Platform* is defined as "a program or application accessible via the Internet or other similar electronic communication medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6). Final Rule §227.300 (4).
[15] Martin Zwilling, *Will These 5 Models of Crowdfunding Replace Angel and VC Investors,* Entrepreneur (Feb. 3, 2016), *www.entrepreneur.com/article/242767*.
[16] A "public benefit corporation" is a relatively new type of business corporation form for the purpose of creating a "general public benefit" in addition to business purposes In New York it is governed by Art. 17 of the New York Business Corporation Law. The purposes may be found in New York BCL §1702(e). http://www.dos.ny.gov/corps/benefit_corporation_formation.html. Approximately 20 states recognize public benefit corporations including Delaware, California and New York.
[17] https://www.kickstarter.com/about?ref=nav.
[18] For an excellent review for crowdfunding participants in making their selection of a crowdfunding platform to invest in together with a colorful diagram of possible choices, see Eric Markowitz, *22 Crowdfunding Sites (and How To Choose Yours),* INC., http://www.inc.com/magazine/201306/eric-markowitz/how-to-choose-a-crowdfunder.html.
[19] Pace Crowd Funding, https://crowdfunding.pace.edu/.
[20] LexShares, https://www.lexshares.com/pages/plaintiffs?gclid=CMG22JCku8sCFRMlgQodwSYG1Q
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[22] robotS, Crowdfunding versus pre-orders, Backing the future (Date), http://backersmanual.com/2014/03/01/crowdfunding-is-not-a-pre-order.
[23] SterlingFunder, *Comparison of Crowdfunding, Angel Investors and Venture Capital*, https://www.sterlingfunder.com/page/comparison-of-crowdfunding-angel-investors-and-venture-capital.
[24] Exempt securities include short-term commercial paper not more than 9 months; not-for-profit organizations; insurance products and policies, which are regulated by state insurance departments; common carriers; banks and savings and loan associations; government securities; and securities by a receiver or trustee in bankruptcy with prior court approval with respect to corporate reorganization. Exempt transactions include intrastate offerings as well as those governed by regulation A, Rule 504, Rule 50rule, and Rule 506,
[25] Securities Act of 1933, 15 U.S.C. §77(d)(a)(6).
[26] §4(a)(6) of the Securities Act of 1933.

[27] Securities and Exchange Commission, 17 C.F.R. 200, 227, 239, 240,249, 269, 274 2016.
[28] Rule 17 CF.R. §230.501.
[29] 17 C.F.R. §227.100(a)((2)(ii).
[30] Jobs Act, amended to Securities Act of 1933
[31] Final Rule, §227.201(r).
[32] Final Rule, §227.203.
[33] Final Rule, §227.204.
[34] Final Rule, §227.205.
[35] Securities Act of 1934, §3(a)(4)(A).
[36] Securities Exchange Act of 1934, §3(a) (80). The Final Rule, §227.300 (a)(2) defines *funding portal* as "a broker acting as an intermediary in a transaction involving the offer or sale of securities in reliance on section 4(a)(6) of the Securities Act … that does not: (i) Offer investment advice or recommendations; (ii) solicit purchases, sales or offers to but the securities displayed on its platform; (iii) Compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform; or (iv) Hold, manage, process, or otherwise handle investor funds or securities.
[37] A "self-regulatory organization" is defined under the Securities Act of 1934, §3(a)(26) as "any national securities exchange, registered securities association, or register clearing agency".
[38] Jobs Act, §302(b), which amends the Securities Act of 1933 (15 U.S.C. 77a et seq.) by adding a §4A, Requirements with Respect to Certain Small Transactions.
[39] Final Rule, §227.303(b).
[40] *Id*.
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[42] Final Rule, §227.301.
[43] Final Rule, §227.302(b).
[44] Final Rule, §227.302(c).
[45] Final Rule, §227.302(d).
[46] 17 CFR §240.15c2-4.
[47] Final Rule, §227.302(e)(f).
[48] Final Rule, §227.401.
[49] Final Rule, §227.402.
[50] Final Rule, §227.304(a)(c).
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THE POTENTIAL CONSEQUENCES OF THE GLOBAL TAX RESET

by

John Paul*

INTRODUCTION

Tax avoidance by multinationals as well as the creative use of loopholes, has long been part of the global tax system.[1] However, after the Great Recession (2007 to 2009), many national governments faced extremely tight budgets and extraordinarily high debt burdens[2]; therefore, there was huge political pressure in the United States (U.S.) and Europe to require large profitable multinationals such as Google, Apple and Starbucks to pay their "fair share of taxes."[3]

In response to the pressure, in 2013 the finance ministers of the world's largest nations, known as the G20, initiated the "Base Erosion and Profit Shifting" (BEPS) Project, also referred to as "The Global Tax Reset."[4] BEPS refers to tax planning strategies that exploit gaps and mismatches in tax laws to artificially shift profits to low or no-tax regions where there is little or no economic activity.[5] The

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Organization for Economic Cooperation and Development (OECD) tax experts at the BEPS Project were told to develop principles to “ensure that profits are taxed where economic activities generating the profits are performed and where value is created.”[6] They were also told to complete their work on an accelerated schedule by the end of 2015.[7]

While there is evidence that international tax avoidance and evasion[8] may lead to a loss of billions in tax revenue, which can adversely affect national economies,[9] it is not clear whether BEPS or the Global Tax Reset will alleviate or exacerbate the problem. This paper will examine the history and consequences of international tax avoidance as well as analyze the principles and potential outcomes of the Global Tax Reset.

HISTORY OF TAX AVOIDANCE

The idea of international tax avoidance probably started in the U.S. and the British Empire.[10] The “offshore” phenomenon probably began in the U.S. when states such as Delaware and New Jersey realized they could lure businesses from more prosperous states by offering tax benefits on the condition that those businesses register in their states.[11] Then, the first cases of international tax avoidance occurred in the British Empire in the early 1900s when wealthy individuals started to use offshore trusts in places like the British Channel Islands to exploit the British principle of separation of tax residence and domicile.[12]

By the 1920s, the League of Nations helped design a "Draft Model on Double Taxation and Tax Evasion."[13] After that, the United Nations, and more recently, the OECD have taken the lead in establishing model tax treaties and guidelines that individual nations could adopt in their entirety or modify in accordance with their own needs.[14]

In the 1930s, Switzerland offered "internationally mobile people" residency, only requiring them to pay a fixed, undisclosed amount of tax – not varying with income – each year. Switzerland also contributed to international tax avoidance with the use of banking secrecy, developed at the time of the French Revolution but enshrined in Swiss law in the 1930s.[15] The Swiss felt that these measures gave them an advantage as a small, land-locked nation in a hostile European environment.[16]

At the current time, there are 72 tax havens around the world with almost half of them being British territories, dependencies or Commonwealth members.[17] It appears that the tax avoidance industry always seems to be outpacing the governments. Elected governments take years to develop tax laws but the accounting and law firms always seem to undermine them within months of a public official's budget speech.[18] Many accounting and law firms advise governments on legislative design and enforcement, fueling the suspicion that the tax avoidance industry and national governments are often partners in facilitating international tax avoidance.[19]

COSTS OF TAX AVOIDANCE

Taxes play a critical role in the development of an equitable society.[20] Progressive forms of taxation – income, profit or capital-gains taxes – are the main ways in which wealth is redistributed.[21] Taxes are also a cornerstone of democracy, giving individuals and business a financial stake in society.[22]

Estimating how much tax avoidance and evasion cost the U.S. Treasury is difficult.[23] Some estimate it as being about $50 billion a year.[24] Former IRS Commissioner Rossotti says the uncollected tax gap could be in the range of $250 to $300 billion per year, which is the equivalent of a 15 percent surtax on the honest taxpayer.[25]

In the United Kingdom, it is estimated that there is an annual loss of $170 billion in avoided taxes.[26] Even in a relatively wealthy nation, this sum is exorbitant when public funds are scarce and people are becoming more reluctant to see increased government spending on various programs.[27]

Tax avoidance adversely affects poor nations the most.[28] As an example, Bolivia is sitting on the gas and oil reserves worth billions, yet it is the poorest nation in South America. The contradiction between Bolivia’s grinding poverty and the fact that companies such as British Gas and BP pay relatively little tax for extracting Bolivia’s valuable resources has not been lost on the Bolivian people: protests have toppled two governments in two years.[29] While Bolivia has enormous wealth, millions of Bolivians live in horrible poverty. In El Alto, a quarter of the population have no running water and diseases such as dysentery and diarrhea are rampant.[30]

Multinational companies such as British Gas and BP can afford to pay higher taxes and still achieve high profits – consider the case of Norway.[31] In the 1950s, Norway was one of the poorest nations in Europe. By the 1960s, substantial oil and gas deposits were discovered in the Norwegian continental shelf.[32] The Norwegian government was able to improve the nation's financial position through an efficient tax system. The average government take for a standard 100-million-barrel is 75 percent.[33] This money is placed into the Norwegian Government Petroleum Fund, which subsidizes the welfare state, both now and in the future, after the reserves run out.[34]

Much of U.S. and European development policy in Bolivia focused on aid and debt relief. But raising the tax on extracting Bolivian gas would provide an enormous development fund, similar to the one Norway maintains, without costing the taxpayers a penny.[35] The building of water mains in Bolivia could be funded several times over.[36]

Furthermore, the U.S. provides debt relief of $44 million a year to Bolivia and Bolivia owes the World Bank and the International Monetary Fund over $2 billion.[37] The estimated total value of Bolivia's gas reserves is $250 billion. By imposing a larger tax on the extraction of its gas reserves, Bolivia could pull itself out of poverty with no cost to the U.S. and European taxpayers.[38]

Tax avoidance by multinational corporations are in a unique position to use tax havens to avoid large amounts of tax payments. Vast sums of money are put beyond the reach of tax authorities.[39] The world's wealthiest individuals hold $11.5 trillion offshore. If the earnings of $11.5 trillion were taxed at a rate of 30 percent, it would raise an annual sum of $255 billion, which more than three times the current global annual aid budget.[40]

BEPS – THE GLOBAL TAX RESET

Due to rising economic and political pressures, politicians from Europe and the U.S. strongly supported the accelerated BEPS Project.[41] The Obama Administration signed onto the BEPS Project in the expectation that it would strengthen the U.S. tax base and enable the federal government to hold onto more corporate tax revenues.[42]

The BEPS Project aims to prevent base erosion and profit shifting by having taxes paid in the jurisdiction where profits are generated and value is created (i.e., substance).[43] The BEPS Action Plan, published in 2013, has implemented the following 15 action plans[44]:

1. Address the tax challenges of the digital economy
2. Neutralize the effects of hybrid mismatch arrangements
3. Strengthen the controlled foreign companies (CFC) rules
4. Limit base erosion via interest deductions and other financial payments
5. Counter harmful tax practices more effectively taking into account transparency and substance
6. Prevent treaty abuse
7. Prevent the artificial avoidance of permanent establishment (PE) status

8. Assure that that transfer pricing outcomes are in line with value creation: intangibles
9. Assure that that transfer pricing outcomes are in line with value creation: risks/capital
10. Assure that that transfer pricing outcomes are in line with value creation: other high risk transactions
11. Establish methodologies to collect and analyze data on BEPS and the action to address it
12. Require taxpayers to disclose their aggressive tax planning arrangements
13. Re-examine transfer pricing documentation
14. Make dispute resolution mechanisms more effective
15. Develop a multilateral instrument

While the BEPS Project was initiated by the G20 nations, it effectively also encompassed the other OECD Member States from the beginning.[45] As the project progressed, engagement in discussions was extended to other large, non-OECD nations and representatives from developing nations. The OECD published over 1600 pages in final reports with regard to all 15 BEPS Action items in October 2015.[46] The United Nations, International Monetary Fund, World Bank and OECD are all developing toolkits to assist "low-income nations" in implementing the outcomes of the BEPS Project.[47]

One of the cornerstones of the BEPS Project is Action 13 or Country-by-Country Reporting (CbCR).[48] In general, CbCR is required in the nation where the ultimate parent company has its tax residence. If this nation has not implemented CbCR, multinational enterprises (MNE) may be required to file in the nations where they conduct business. Specifically, Action 13 recommendations require MNEs with global turnover of 750 million euros ($835,845,000) or more in the preceding fiscal year to submit a CbCR report each year in every jurisdiction in which they conduct business.[49] This report would contain financial information with regard to each nation where the MNE operates, such as types of activities conducted, local turnover, taxes paid, assets and number of employees. The primary goal of Action 13 is to align profits with value creation and substance.[50]

On June 28, 2016, the U.S. Internal Revenue Service and the Treasury issued final country-by-country regulations that will apply to U.S persons that are the ultimate parent entities of a MNE that has annual revenue for the preceding annual accounting period of $850,000,000 or more.[51] The regulations will apply to reporting periods that begin on or after the first day of a taxable year that begins on or after June 30, 2016.[52]

PROBLEMS WITH BEPS

While the purpose of BEPS may be to reduce the most egregious forms of tax planning,[53] many believe that it may only exacerbate the problems of international tax avoidance.[54]

The result of the new requirements will be to impose significant new burdens on MNEs because of the administrative difficulties involved in preparing the BEPS templates and dealing with audit activity initiated by nations due to information reported on them.[55] MNEs will also face the administrative requirement of reconciling public financial statements, legal entity books, local tax returns, and the templates.[56]

An additional concern with CbCR reporting is confidentiality – many MNEs and practitioners believe that at least some taxing jurisdictions will make the information reported publicly available or that the information will be leaked to the public[57] For the first time, taxing officials throughout the world will be able to determine how MNEs allocate their income and tax payments to a specific nation and other nations too. The BEPS template will serve as a tool for taxing officials to identify and select companies to be audited.[58] These audits can be used as political leverage against MNEs who don't wish to follow certain objectionable practices in a particular jurisdiction.[59]

This problem can be solved to some extent by requiring nations to establish legal protections to preserve the confidentiality of the CbCR reporting. Also, there could be a legal requirement that the BEPS template will only be used to assess potential high-level BEPS-related risks.[60]

While the administrative burdens required by BEPS are a problem, the biggest problem with BEPS is that tax experts and even the OECD itself agree that the principles on which the current international tax system was designed is based on what the world and companies looked like around a 100 years ago.[61] Today, more than a third of all international trade is intra-company trade – different subsidiaries with an MNE buying goods and services from each other. This allows money to be easily shifted around with big companies, often using subsidiaries in tax havens, so as to avoid paying taxes as much as possible.[62]

Many developing nations see MNEs move money out of their jurisdictions because the current international tax regime makes it perfectly legal to do so.[63] A 2015 study released by the United Nations Conference on Trade and Development estimates that companies owned from conduit companies and tax havens avoid paying $100 billion in taxes each year by shifting profits out of developing nations.[64]

Some of the challenges faced by developing nations, such as transfer mispricing, excessive interest payments on intracompany loans and hybrid mismatches (exploitation of differences between nations' tax laws) are addressed by BEPS. However, the recommendations are (1) resource-intensive (e.g., the transfer pricing recommendations); (2) filled with exemptions that weaken the effectiveness (e.g., intra-company loans); and (3) not designed with developing nations in mind (e.g., minor changes suggested to anti-tax haven legislation).[65] All of this means that it will be difficult for poor nations to implement the BEPS recommendations[66] and even if they do, they probably won't collect that much more tax revenue as a result.[67]

One problem that BEPS does not address is tax competition. While BEPS may broaden the tax base in some nations, it doesn't address the race to the bottom for low corporate income tax rates and big tax giveaways though larger tax exemptions.[68] In fact, BEPS could create even more competition as nations that can no longer offer the kinds of schemes targeted by BEPS will look for other ways to cut their tax rates.[69]

If the tax problems of developing nations are to be addressed, then other solutions are needed. These include: (1) allowing more representation of developing nations on international tax rules; (2) allowing unilateral developing nation actions (e.g., developing national and regional approaches as opposed to the preferred international approaches); and (3) developing national frameworks for how to negotiate tax treaties to ensure that no taxing rights are unfairly handed away.[70]

RECENT INTERNATIONAL TAX REPERCUSSIONS

In recent years, multinational officials have attempted to stamp out sweetheart tax deals that nations strike with global companies, including U.S. tech giants.[71] Taxation is one of the many issues that have placed U.S. tech companies at odds with European officials and a recent notable example of this would be the case of Apple Inc. ("Apple").[72]

In August of 2016, the European Commission ruled that Apple has received illegal state aid through its advanced pricing agreements with Ireland.[73] Apple and Ireland believe the advanced pricing agreements conform to Irish and European Union law and the Irish government has agreed to appeal the ruling.[74]

According to the European Commission ruling, the selective tax treatment of Apple in Ireland is illegal under European Union state aid rules because it gives Apple a significant advantage over other businesses that are subject to the same national tax laws.[75] Consequently, the ruling requires

Ireland to recover the unpaid taxes in Ireland from Apple for years 2003 to 2014 of up to $14 billion, plus interest.[76]

Many see the Apple ruling as an example of the global trend to emphasize substance.[77] Action 5 of the BEPS Final Reports recommends that taxing jurisdictions limit preferential intellectual property regimes to companies that can demonstrate a certain level of substance in the nation.[78] In that regard, the European Commission's ruling against Ireland and Apple focus on the lack of substance with regard to the "main office" allocation of profits.[79]

The U.S. Treasury ("the Treasury") takes a different view on the Apple ruling. The Treasury has stated: (1) that the European Commission's actions undermine U.S. efforts in developing transfer pricing norms and implementing the BEPS project; and (2) call into question the ability of Member States to honor their bilateral tax treaties with the U.S.[80] Furthermore, the Treasury has expressed the concern that adopting new enforcement regimes with retroactive effect will: (1) hinder companies' ability to assess risks and plans for the future; and (2) sets an unwelcome precedent for tax authorities around the world to take similar retroactive actions that could adversely affect both U.S. and European Union companies.[81]

In light of these concerns, many believe that the European Commission's ruling may prompt non-European Union nations to change their taxing regimes in order to lure companies like Apple and others.[82] For example, the United Kingdom could cut corporate tax rates, and make other tax changes, in order to attract major multinational companies. If this occurs, this would validate the Treasury's concerns as various jurisdictions may abandon BEPS in favor of luring multinational corporations, such as Apple, with attractive tax regimes.[83]

CONCLUSION

There is no question that international tax avoidance is a huge problem and many needy people in developed and developing nations are suffering as a result of the tax revenue lost due to tax avoidance schemes. The need to address international tax avoidance is what initiated BEPS – The Global Tax Reset.

While BEPS does address some of the issues of international tax avoidance; overall, it may be creating more administrative burdens without addressing the core issues of international tax avoidance.

In order to more effectively solve the problems incurred by international tax avoidance, developing nations need to be include on a larger scale in the formulation of international tax rules and be allowed to take more unilateral actions based on their current resources and situations. It appears that solutions based on international frameworks never seem to be effective; therefore, allowing more national and regional approaches could lead to a more concise and appropriate solution to the unique tax issues that characterize each nation. The recent European Commission ruling in the case of Apple and Ireland indicates that the European Union may be adopting a more regional approach to addressing international tax issues, thereby undermining BEPS for the time being.

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E.E.O.C. v. ABERCROMBIE & FITCH STORES, INC.[1]— REEXAMINING THE NOTICE REQUIREMENT IN RELIGIOUS ACCOMMODATION CASES

by

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In recent years, the U.S. Supreme Court has addressed a number of cases involving religious claims arising out of the employment relationship. The Court's unanimous decision in the case of *Hosanna-Tabor Evangelical Lutheran Church v. E.E.O.C.*[2] recognized a ministerial exception that allowed a religious organization to avoid liability for the violation of an employee's statutory workplace rights if the employee in question was a "ministerial employee." The more contentious 5-4 decision in the case of *Burwell v. Hobby Lobby*[3] affirmed an employer's claim that government regulations, which required employers (including for-profit corporations opposed to the use of contraceptives for religious reasons) to provide no-cost access to contraception on the grounds, were invalid since they violated the Religious Freedom Restoration Act.[4] More recently, the Court, in the case of *E.E.O.C. v. Abercrombie & Fitch, Inc.*, considered the question of whether a job applicant's Title VII religious discrimination claim could prevail even though the applicant had never informed the employer that she needed a religious accommodation.

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As in *Hosanna-Tabor* and *Hobby Lobby,* the party asserting the religious claim prevailed. But, in this case that party was the employee.

I. FACTS

Samantha Elauf was seventeen years old when she applied for a sales job at an Abercrombie store in the Woodland Hills Mall in Tulsa, Oklahoma.[5] Elauf had purchased Abercrombie clothes in the past and was familiar with the clothing brand. Abercrombie, which self-identifies its brand as one that "exemplifies a classic East Coast collegiate style of clothing,"[6] was so committed to its image that it required all of its employees to adhere to a "Look Policy." Under the "Look Policy," employees were required to wear clothes that were, at the very least, similar to those sold in the stores. The policy also prohibited employees from wearing either black clothing or caps. Any employee who failed to comply with the "Look Policy" would be subject to "disciplinary action . . . up to and including termination."[7]

At the time, Elauf applied for the job, Abercrombie's marketing strategy was somewhat unique in that it did not rely on advertising through traditional media outlets such as print publications and television. It chose instead to create a "holistically brand-based, sensory experience" for its target customers when they entered an Abercrombie store.[8] It was considered crucial to this strategy that the sales-floor employees be more than just people who rang up purchases. Abercrombie consistently referred to its sales staff as "models" and expected them to project the Abercrombie experience for its customers. It was Abercrombie's belief that a "model" who violated the "Look" fail[ed] to perform an essential function of the position, and ultimately damage[d] the brand."[9]

When Elauf interviewed for the job, she was wearing clothes that were consistent with the Abercrombie image . . . except for the fact that she was also wearing a hijab.[10] (Elauf considered herself to be a Muslim and, since the age of 13, had followed the example of her mother and worn a headscarf whenever in public or in the presence of male strangers.[11]) Although Elauf was unaware of the "Look Policy" when she applied for the job, she did approach her friend, Farisa Sepahvand, an Abercrombie employee, to find out whether wearing a black headscarf would present a problem. Sephavand, who did not herself wear a headscarf, discussed the matter with Kalen McJilton, an assistant manager at the store who was acquainted with Elauf. McJilton told Sephavand that he thought Elauf could wear a headscarf so long as it was not black. (Abercrombie models were required to wear clothing similar to those sold by Abercrombie and Abercrombie did not sell black clothing.)[12]

Elauf applied for the job and was interviewed by Healther Cooke, the assistant manager in charge of recruiting, interviewing and hiring new employees. Cooke, following Abercrombie's official interview guide, evaluated Elauf in three categories: "appearance & sense of style," whether the applicant is "outgoing & promotes diversity," and whether the applicant has "sophistication & aspiration."[13] According to the interview guide each candidate had to be rated on a 1-3 scale in each category. In order to qualify for a position as a model, a candidate had to receive a score of two or more in appearance and a total score of more than five. Elauf received a score of two in each category, which according to the "Model Group Interview Guide" meant that she had met company's expectations and amounted to a recommendation that she be hired.

During the interview, Cooke never mentioned the "Look Policy" by name to Elauf. She did, however, explain some of the dress requirements including the requirements that the models had to wear clothes similar to those sold by Abercrombie and that they were not to wear heavy make-up or nail polish. Elauf, in turn, never told Cooke that she was a Muslim, never brought up the topic of the headscarf, never indicated that she wore the headscarf for religious reasons, and never asked for a religious accommodation.[14] Later on Cooke would admit in a deposition that she while she "did not know" Elauf's religion, she had "assumed that she was Muslim" and "figured that was the religious reason why she wore her head scarf."[15]

Cooke had the authority to make hiring decisions for the store in the Woodland Hills Mall without seeking the approval of anyone else at Abercrombie. In this particular case, she decided to first check with her store manager before making the job offer to Elauf since she was not sure if Elauf's headscarf would conflict with the company's "Look Policy." When the manager was unable to give her a definitive answer, she contacted the Randall Johnson, the district manager, who told her not to hire Elauf. In a deposition, Cooke testified that she told Johnson that she thought Elauf was a very good candidate. She also alleged that when she told Johnson that Elauf wore a headscarf for what she believed were religious reasons, he responded by saying ""You still can't hire her because someone can come in and paint themselves green and say they were doing it for religious reasons and we can't hire him.""[16] Cooke further claimed that she had informed Johnson that she thought Elauf was a Muslim, a recognized religion, that she wore the headscarf for religious reasons, and, that they should hire Elauf. According to Cooke, Johnson continued to instruct her not to extend a job offer.[17]

Johnson would subsequently deny that he had been told that Cooke thought Elauf wore the headscarf for religious reasons or that he had made the remark about people painting themselves green.[18] He testified that if there had been any question about whether a hijab constituted a prohibited cap, he would have contacted the Human Resources Department for clarification.[19] But, he did state that he thought the wearing of a hijab would violate the "Look Policy" and that "there was no difference between a yarmulke, head scarf, "[o]r a ball cap or a helmet for all that matters. It's still a cap," and if an applicant asked to wear a ball cap for religious reasons, he "[s]till would have denied them, yes, sir.""[20]

After her conversation with Johnson, and as per his instructions, Cooke redid her original written evaluation of Elauf and downgraded the "appearance and sense of style" score to a 1—which lowered the overall score to a 5.[21] The altered score disqualified Elauf for a position at Abercrombie. Elauf only found out that she would not be hired when her friend, Sepahvand, told her that the district manager had instructed Cooke not to offer her a position because of her headscarf.

II. LOWER COURT DECISIONS

A. U.S. District Court

The E.E.O.C filed a lawsuit on behalf of Elauf and against Abercrombie & Fitch, in the U.S. District Court for the Northern District of Oklahoma, alleging religious discrimination based on Title VII of the Civil Rights Act of 1964 (42 U.S.C. § 2000e-5(f)(1) & (3) and Title I of the Civil Rights Act of 1991 (42 U.S.C. § 1981a). Both parties filed Motions for Summary Judgment. The E.E.O.C.'s motion was based "on the issue of liability or, in the alternative, on one or more elements of its prima facie case and/or on Abercrombie's affirmative defense of undue hardship," and Abercrombie's was based on the assertion that "the E.E.O.C. ha[d] not established a prima facie case, and because an accommodation for Elauf would cause Abercrombie undue hardship."[22]

The District Court began its analysis by making three observations about religious discrimination claims. The first was that 42 U.S.C. § 2000e(j) only applied to those aspects of religious observance and practice of the employee or prospective that an employer was able to reasonably accommodate without undue hardship on the conduct of the employer's business. The second was to indicate that the applicable burden-shifting approach for this kind of case was that of *McDonald Douglas Corp. v. Green*.[23] And, the third was to show how the Tenth Circuit had applied that burden-shifting approach in the case of *Thomas v. National Ass'n of Letter Carrier.*[24] In *Thomas,* the plaintiff had the initial burden of showing that: 1. the plaintiff had a bona fide religious belief that conflicts with an employment requirement; 2. the plaintiff had informed the employer of this belief; and 3. the plaintiff had not been hired because he or she failed to comply with the employment requirement.[25] The burden then shifted to the defendant to: 1. conclusively rebut one or more elements of the plaintiff's prima facie case; 2. show that it had offered a reasonably accommodation, or 3. show that it was unable to accommodate the employee's religious needs reasonably without undue hardship.[26] The Tenth Circuit, in *Thomas,* also noted that there was a significant difference in the burden shifting approach for disability and religious discrimination cases as opposed to other types of discrimination cases:

> In [an ADA or religious failure to accommodate] case, the Congress has already determined that a failure to offer a reasonable

> accommodation to an otherwise qualified disabled employee is unlawful discrimination. Thus, we use the burden-shifting mechanism, not to probe the subjective intent of the employer, but rather simply to provide a useful structure by which the district court, when considering a motion for summary judgment, can determine whether the various parties have advanced sufficient evidence to meet their respective traditional burdens to prove or disprove the reasonableness of the accommodations offered or not offered.[27]

The District Court had no problem concluding that the plaintiff met the requirements, articulated in both *McDonald Douglas* and *Thomas*, for establishing a prima facie case. There was evidence that Elauf wore the headscarf based on her understanding of the Koran. The Abercrombie "Look Policy" prohibited the wearing of head coverings. Abercrombie had notice that the reason Elauf wore the headscarf was because of a religious belief. Finally the defendant did not hire the plaintiff because to wear a headscarf would be in violation of the "Look Policy."[28]

The defendant's rebuttal of the plaintiff's prima facie case had centered on two issues. The first was whether the wearing of a headscarf was based on a bona fide religious belief and whether Elauf, in fact, wore her hijab for a religious reason. The second was whether the notice requirement had been met. In response to the first claim, the District Court cited three U.S. Supreme Court cases. In 1953, the Supreme Court had held that "it is no business of the courts to say . . . what is a religious practice or activity."[29] Twelve year later, the Supreme Court held that an action was a "bone fide religious belief" if it was religious within the plaintiff's own scheme of things and was sincerely held.[30] Thus, the individual's assertion "that [her] belief is an essential part of a religious faith must be given great weight."[31] The most recent of the cited cases went even further and held that if a person's beliefs were religiously based, it was not for the court to question whether those beliefs were "derived from revelation, study, upbringing, gradual evolution, or some source that appears entirely incomprehensible."[32]

It was Abercrombie's claim that women wore hijabs for a variety of non-religious reasons, including cultural and nationalistic ones. The defendant also asserted that the Quran did not explicitly require Islamic women to wear headscarves. In response to the first assertion, the court noted that there was nothing in the record to indicate that Elauf's decision to begin wearing the hijab when she was thirteen was based on any reason other than her religious beliefs. As for the fact that the Quran does not require women to wear head coverings, the district court, citing a Seventh Circuit case,

> [N]ote[d] that to restrict [Title VII claims] to those practices which are mandated or prohibited by a tenet of religion, would involve the court in determining not only what are the tenets of a particular religion, which by itself perhaps would not be beyond the province of the court, but would frequently require the courts to decide whether a particular practice is or is not required by the tenets of the religion. We find such a judicial determination to be irreconcilable with the warning issued by the Supreme Court.[33]

The District Court concluded that even though Elauf did not consider Muslim women to be bad Muslims if they did not wear hijabs, she wore the hijab based on the Quran's teaching that women should be modest. As such, her wearing of the hijab was based on a religious belief.

The District Court also dismissed Abercrombie's challenge to the sincerity of Elauf's religious belief based on the fact that she did not know the street address of her mosque, did not regularly attend Friday services, and did not prayer five times a day every day. In this matter, the court agreed with the Second Court of Appeals that "it was appropriate, indeed necessary, for a court to engage in an analysis of the sincerity—as opposed to the verity—of someone's religious beliefs in . . . the Title VII context."[34] It was legitimate to do a sincerity analysis "to differentiat[e] between beliefs that are held as a matter of conscience and those that are animated by motives of deception and fraud."[35] The District Court limited its sincerity inquiry to the question of whether Elauf believed that she was required to wear the headscarf and not to whether she followed all of the tenets of the Islamic faith. The only accommodation in this case involved the wearing of a headscarf. And, the issue was whether Elauf's motivation was a matter of conscience or a matter of deception and fraud. The District Court rejected Abercrombie's argument that Elauf's sincerity was an issue of credibility—and a matter properly decided by a trier of fact—and concluded that there was nothing in the record to dispute the fact that she wore the headscarf based on a bone fide religious belief.

Abercrombie's more interesting argument involved the issue of whether, under the Civil Rights Act, the company could be liable for failing to reasonably accommodate Elauf if she had not explicitly notified the company that she needed a religious accommodation to wear the headscarf. While the Courts of Appeal in the Eighth, Ninth, and Eleventh Circuits had ruled that the notice requirement could be satisfied if "the employer has enough information to make it aware there exits a conflict between the individual's religious practice or belief and a requirement for applying for or performing a job,"[36] the Tenth Circuit had not addressed this particular matter. The Tenth Circuit had, however, acknowledged that notice was essential to the interactive process leading to accommodation[37] and that it was the employee who ordinarily provided the employer with notice of a need for an accommodation.[38] The District Court concluded, "since the purpose of the notice requirement was to facilitate the interactive process and prevent ambush of an unwitting employer . . . it was enough that the employer has notice an accommodation is needed."[39] Abercrombie did not need to receive an explicit request from Elauf. In this instance, the fact, that Elauf wore her headscarf to the interview and the assistant store manager who interviewed her knew that the headscarf was worn for religious reasons, meant that Abercrombie could not rebut the second element of the prima facie case. Abercrombie had notice that Elauf wore a headscarf based on her religious belief.

Abercrombie's final argument was that even if it did not rebut the prima facie case, it should still prevail on the grounds that it would be an "undue hardship" for the retail firm to accommodate Elauf. Noting that an "undue hardship" constitutes something "more than a de minimus cost"[40] and that the proffered hardship must be actual and not the result of mere speculation,[41] the District Court concluded that Abercrombie's unsubstantiated claim that allowing Elauf to wear a headscarf would have a negative impact on the brand, sales and compliance failed to meet the burden of establishing an undue hardship and denied Abercrombie's motion for summary judgment. The E.E.O.C.'s motion for a partial summary judgment was granted and the case went to trial to determine the issue of damages. The jury awarded $20,000 in damages but denied prospective injunctive relief.

B. U.S. Court of Appeals (10th Circuit)

In its appeal to the Tenth Circuit, Abercrombie argued that allowing Elauf to wear a headscarf would create an undue hardship for the company and require an accommodation that was not based on a sincerely held religious belief. In addition, and, more importantly, the appellant claimed that the company should not be liable for failing to make an accommodation since Elauf had not properly notified Abercrombie that she wore the headscarf for religious reasons and that she needed a religious accommodation. In its de novo review of the record, the appellate court reversed the trial court's denial of Abercrombie's motion for summary judgment, reversed the granting of the E.E.O.C.'s motion for a summary judgment, and remanded the case to the district court instructing it to vacate its judgment and enter one in favor of Abercrombie.

The Circuit Court began by examining the meaning of the term "religion" as it is understood in the context of Title VII of the Civil Rights Act. According to the *E.E.O.C. Compliance Manual*, religion is broadly defined under Title VII and it "includes not only traditional organized religions such as Christianity, Judaism, Hinduism, and Buddhism, but also religious beliefs that are new, uncommon, not part of a formal church or sect, only subscribed to by a small number of people, or that seem unreasonable to others."[42] But, the Compliance Manual also recognizes that "[w]hether a practice is religious depends on the employee's motivation. The same practice might be engaged in by one person for religious reasons and by another person for purely secular reasons."[43] The Circuit Court identified two significant implications stemming from the E.E.O.C.'s general principles for the enforcement of Title VII proscriptions against religious discrimination. The first was that it was possible for an applicant or employee to engage in a practice that was associated with a particular religion, but to do so for cultural or other reasons that were not religious.[44] The second was that unless a person's conduct is based on religious beliefs that have "a distinctive content related to ultimate ideas about life, purpose, and death,"[45] that conduct is outside of the "protective ambit" of Title VII.

The Circuit Court went on to explain that in order to successfully make a claim for a religious accommodation, there must be a true conflict between the employee's religious practice and the employer's neutral policy. The employee must consider the religious practice in question to be inflexible and required by his or her religion.[46] On the other hand, there is no actual conflict, and therefore no need for an accommodation, if the employee neither feels obliged to adhere to the practice nor considers it to be an inflexible practice.

The appellate court held that the discussion about whether an employee has a religious belief or practice that must to be accommodated was one that needed to be initiated by the employee and not the employer. It cited the E.E.O.C. publication, *Best Practices for Eradicating Religious Discrimination in the Workplace*, which cautioned that the employer should "avoid assumptions or stereotypes about what constitutes a religious belief or practice or what type of accommodation is appropriate."[47] This would include insuring that its managers and employees were trained not to make stereotypical assumptions based on a person's religious dress and grooming practices. It was only after the employee puts the employer on notice of a religious conflict that the employer may ask for additional information to determine whether an accommodation was necessary and available.[48]

The Tenth Circuit used its own modified version of the *McDonnell Douglas* burden-shifting approach for religious accommodation cases as it had set forth in *Thomas v. National*

Ass'n of Letter Carriers.[49] That test was the same one presented by the District Court. (In order to establish a prima facie case the employee had to show that he or she had a religious belief that conflicted with an employment requirement; that the employee informed the employer of that belief; and that the employer either failed to hire or fired the employee because of the employee's failure to comply with an employment requirement.) The appellate court, however, focused on the second element of the employee's prima facie case and concluded that Elauf had not informed her employer directly of a particular religious need to wear a headscarf. The E.E.O.C. had tried to argue that there were additional permissible ways for an employer to be put on notice that the employee had a particular religious belief. The court, however, found that even if an employer had some notice that a religious belief existed, the employer would still lack knowledge as to whether the employee considered the religious practice to be inflexible and in conflict with an employment requirement, and, therefore, in need of a reasonable accommodation.[50] In this case, "there is no genuine dispute of material fact that no Abercrombie agent responsible for, or involved in, the hiring process had such *actual* knowledge—*from any source*—that Ms. Elauf's practice of wearing a hijab stemmed from her religious beliefs and that she needed an accommodation for it."[51] The Court of Appeals concluded that most that could be said was that the person who conducted the interview *assumed* that Elauf "wore her hijab for religious reasons and felt religiously obliged to do so—thus creating a conflict with Abercrombie's clothing policy."[52] The assistant manager's subsequent call to the regional manager to find out if wearing a hijab for religious reasons would violate the "Look Policy" was also derived from assumptions about Elauf and not on any actual knowledge that an accommodation would be necessary.

Much of the Circuit Court's rationale for reversing the lower court's decision was based on its conclusion that an employer was only permitted to engage in an interactive religion-accommodation discussion with the employee after the employer had actual knowledge that the employee had a sincere religious belief and that that belief required the employee to follow a religious practice that was in conflict with the employment requirements.[53] One of the court's concerns was that if the employer initiated a conversation with an applicant or employee about possible religious beliefs (without the topic being brought up by the applicant/employee), it could be viewed as non-job related inquiry and, therefore, in violation of the Civil Rights Act. Another concern was that in religious accommodation cases, the employee needed to establish that the actual motivation for following a particular practice was, in fact, of a religious nature. While some people might follow a practice for religious reasons, that does not mean that everyone following that practice is similarly motivated. "A person's religion is not like his sex or race—obvious at a glance. Even if [the person] wears a religious symbol, such as a cross or a yarmulke, this may not pinpoint [*that person's*] *particular beliefs and observances."*[54] An employer need not be familiar with all traditionally religious practices and should not be required to speculate on whether an employee follows such a practice for a religious reason. "Religion is a uniquely personal and individual matter."[55] It is the duty of the employee to give the employer fair warning of employment practices that interfere with his or her religion . . . and, in addition, to inform the employer that the employee considers the religious practice to be inflexible and in need of a reasonable accommodation by the employer.

According to the Tenth Circuit, the employee's affirmative obligation to inform the employer of a need for a religious accommodation is met when the employee or applicant "provide[s] enough information to make the employer aware that there exists a conflict between the individual's religious practice or belief and a requirement for applying for or performing the job."[56] The court saw no justification for granting deference to the E.E.O.C.'s contention that the plain language in its manual could be disregarded when the employer had notice of a religious belief and the need for a religious accommodation from a source that did not involve an explicit communication from the employee. It concluded instead that under a natural reading of the regulation in question, "the employer's obligation to provide a reasonable religious accommodation would be triggered only when applicants or employees explicitly informed the employer of their conflicting religious practice and need for an accommodation."[57]

In a separate opinion that concurred in part and dissented in part, Justice Ebel stated that while the trial court should not have granted the E.E.O.C.'s motion for summary judgment, it also should have left it for a jury to decide whether Abercrombie was liable for religious discrimination. His opinion was based on three conclusions. The first was that the majority's second requirement for establishing a prima facie case (which required showing that Elauf had informed the employer that its "Look Policy" conflicted with her religious beliefs) was inflexible and made no sense under the law and the circumstances of the case.[58] The second was that the plaintiff had, in fact, established a prima facie claim that Abercrombie had failed to reasonably accommodate Elauf's religious practice.[59] And, finally, summary judgment in favor of either party was inappropriate since Abercrombie's evidence contradicted the prima facie evidence and created a triable issue of fact whether the defendant had failed to accommodate the plaintiff's religious practice of wearing a headscarf.[60]

C. U.S. SUPREME COURT DECISION

1. Majority Opinion

The U.S. Supreme Court reversed the decision of the Tenth Circuit and remanded the case for further consideration. The majority opinion was delivered by Justice Scalia and joined by Chief Justice Roberts and Justices Kennedy, Ginsburg, Breyer, Sotomayer, and Kagan. Justice Alito filed a separate concurring opinion and Justice Thomas filed an opinion concurring in part and dissenting in part.

The majority decision focused on one issue--whether an applicant's Title VII disparate treatment claim, which was based on an employer's refusal to hire the applicant in order to avoid having to make a reasonable accommodation for a religious practice, could succeed if the applicant had failed to inform the employer of the need for an accommodation.[61] The majority opinion rejected Abercrombie's claim that the employer had to have "actual knowledge" of the applicant's need for an accommodation and focused instead on whether the employee's need for an accommodation was a motivating factor behind the employer's refusal to hire the applicant.

Not surprisingly, Scalia began the opinion with a textual analysis of Title VII of the Civil Rights Act. For the purposes of the statute, "religion" "includ[ed] all aspects of religious observance and practice, as well as belief, unless the employer demonstrates that he is unable to reasonably accommodate to" a "religious observance or practice without undue hardship on the conduct of the employer's business."[62] In a disparate-treatment claim, the plaintiff must be able to establish three things: 1. the employer "fail[ed] . . . to hire" the applicant; 2. "because of"; 3. "such individual's . . . religion" (including the applicant's religious practice.) In this case "Abercrombie (1) failed to hire Elauf and since the parties concede that (if she sincerely believed that wearing a headscarf was required by her religion) Elauf's wearing of a headscarf was (2) a "religious practice", then the only issue to be decided was whether she was not hired (3) "because of" her religious practice."[63]

The majority opinion noted that while many anti-discrimination statutes include the phrase "because of," they do not necessarily use it in the same way. In most instances, the phrase can, minimally, be interchanged with the traditional standard of "but-for" causation. That, however, is not what occurs in Title VII cases where the meaning of the phrase is relaxed to the extent that it would prohibit allowing a protected characteristic to be a "motivating" factor in an employment decision.[64] As such, the Court concluded that the use of "because of" in 42 U.S.C. §2000e-2(a)(1) "links the forbidden consideration to each of the verbs preceding it; an individual's actual religion practice may not be a motivating factor in failing to hire, in refusing to hire, and so on."[65]

The Court specifically differentiated Title VII cases from cases brought under the Americans with Disability Act of 1990 (ADA).[66] Under the ADA, the requirement to make "reasonable accommodations" only applies when the employer has actual knowledge of the applicant's physical or mental limitations.[67] A similar knowledge requirement is missing for Title VII cases. Under Title VII, knowledge and motivation are considered to be separate concepts. In a disparate treatment case, actions taken by an employer may result in liability when they are based on the employer's motives regardless of what the employer actually knows about the applicant. Consequently, an employer would be liable if the motive for not hiring an applicant is to avoid making a reasonable accommodation—even if that action is based on nothing more than an "unsubstantiated suspicion" that an accommodation would be needed. Conversely, an employer who had actual knowledge of the need for an accommodation would not be liable if the reason for not hiring the applicant was not motivated by a desire to avoid accommodation.[68]

The Supreme Court announced a straightforward rule for disparate-treatment cases. "An employer may not make an applicant's religious practice, confirmed or otherwise, a factor in employment decisions."[69] This was different from the rule followed in the Tenth Circuit that placed the burden on the applicant to inform the employer that there was a religious conflict between the religious practice and the job requirements. Scalia characterized that rule as the product of a flawed statutory interpretation. The lower court had simply added words to the law in order to get a desired result. Although Congress could have included the requirement in the statute, it decided not to do so. It chose instead to prohibit actions "taken with the *motive* of avoiding the need for accommodating a religious practice."[70] (In dictum, the Supreme Court noted that it would leave for future consideration the issue of whether the applicant must show that the employer, at the very least, suspected that the practice in question was a religious practice in order for the motive requirement to be met. The Court was not required to consider it in this instance, since Abercrombie knew, or at least suspected, that the practice was religious.)

The majority opinion concluded with a rejection of Abercrombie's claim that the case was inaccurately argued as a disparate-treatment case rather than a disparate-impact claim. The Court presented two reasons for its conclusion. The first was based on the fact that the definition of religion in Title VII included "all aspects of religious observance and practice, as well as belief."[71] Since a religious practice is a protected characteristic under the statute, discrimination based on that practice would in fact raise a valid disparate treatment claim. The second reason was that the Court rejected the employer's claim that disparate-treatment can only apply to cases where the employer's policies treat religious practices less favorably than similar secular practices. A neutral policy might result in intentional discrimination. But, that is not enough. Under Title VII religious practices are given "favored treatment, affirmatively obligating employers not "to fail or refuse to hire or discharge any individual . . . because of such individual's" "religious observance and practice.""[72] Abercrombie's policy prohibiting headgear was otherwise neutral with regard to all employees. However, without an accommodation, the otherwise-neutral policy discriminated against Elauf because of her religion.

2. Concurring Opinion

Justice Alito's concurring opinion agreed that Title VII did not impose the Tenth Circuit's interpretation of the notice requirement on the applicant. He did, however, assert that Title VII provided for a knowledge requirement by the employer. It seemed obvious to Alito that "an employer cannot be held liable for taking an adverse action because of an employee's religious practice unless the employer knows that the employee engages in the practice for a religious reason."[73] Alito's concern with the majority's approach was that an unknowing employer could be held liable for not hiring an applicant even though the employer honestly thought that the applicant wore the scarf for secular reasons and did not know the applicant was a Muslim. He suggested that it was "entirely reasonable to understand the prohibition against an employer's taking an adverse action because of a religious practice to mean that an employer may not take an adverse action because of a practice that the employer knows to be religious."[74] Intentional discrimination is "blameworthy conduct" for which an employer should be held liable only when there is a knowledge requirement. Alito's concern was that an employer would not even know to begin to consider accommodating a practice if there was no knowledge that the practice was of a religious nature.

Alito concluded by taking exception with the majority's assertion that the plaintiff had the burden of proving that the employer failed to accommodate the religious practice.[75] He argued instead that Title VII specifically states "it shall be an unlawful employment practice for an employer . . . to fail or refuse to hire . . . any individual . . . because of [any aspect of] such individual's . . . religious . . . practice . . . *unless an employer demonstrates that he is unable to reasonably accommodate to [the] employee's or prospective employee's religious . . . practice . . . without undue hardship on the conduct of the employer's business."*[76] (Emphasis added by Alito.) While he concedes that the burden is on the plaintiff to prove that the employer failed to or refused to hire the employee because of a religious practice, he also argues that the burden of proof is on the employer to demonstrate that it was unreasonable to accommodate the employee's religious practice without undue hardship.

3. Opinion Dissenting in Part and Concurring in Part

Justice Thomas concurred with the majority only to the extent that he agreed that there were two causes of action under Title VII—a disparate treatment claim and a disparate impact claim. His far more serious disagreement with the majority rested on his belief that the *Abercrombie* case was, in fact, a disparate impact case.

According to Thomas, intentional discrimination required the employer to treat a person less favorably than others because of a protected trait.[77] Disparate-impact discrimination, on the only hand, "involve[d] employment practices that are facially neutral in their treatment of different groups but that in fact fall more harshly on one group than another and cannot be justified by business necessity."[78] It followed then that Abercrombie did not engage in "intentional discrimination" since it had a neutral dress code policy that did not treat religious practices less favorably than similar secular practices. Absent an accommodation, on the other hand, its policy would fall more harshly on someone who wore headscarves as a religious practice.

Thomas' problem with the majority opinion was that he thought it ignored the relevant statutory text and twisted the meaning of "intentional treatment" to include refusing to give a religious applicant "favored treatment."[79] Thomas contended that inserting the Title VII definition of religion[80] onto Title VII's specific charge that it is illegal "to fail or refuse to hire . . . any individual . . . because of such individual's . . . religion"[81] did not resolve the question of whether Elauf had been rejected "because of her religious beliefs." Thomas identified two possible ways of applying the "because of one's religion" provision in disparate treatment cases. One would make it illegal to base an employment decision on the religious nature of the particular practice of the employee. The other would make it illegal to make an employment decision based on the fact that the employee's practice *happens* to be religious.[82] The problem with the second approach is that it would make the employer liable even though the employer had no discriminatory motive. For Thomas this would result in a strict liability situation that would preclude the employer from asserting a defense that the employer had no idea that the particular practice was, in fact, religious.[83]

While Thomas did not accuse the majority of creating a strict liability option for cases alleging intentional religious discrimination, he did contend that the Court had opted for a compromise that would punish employers "who refuse to accommodate applicants under neutral policies when they act "with the motive of avoiding accommodation.""[84] As a result, the employer in a religious discrimination case based on disparate treatment case might have to demonstrate that his or her actions constituted something more than equal treatment.[85] Thomas applauded the majority for "put[ting] to rest the notion that Title VII creates a freestanding religious-accommodation claim" but disagreed with the Court's "creat[ion] in its stead [of] an entirely new form of liability: the disparate-treatment-based-on-equal-treatment claim."[86]

D. CONCLUSIONS

During oral arguments, Justice Alito presented a hypothetical to the attorney for Abercrombie & Fitch. Four people show up for a job interview. One is a Sikh man wearing a turban. The second is a Hasidic man wearing a hat. The third is an Islamic woman wearing a hijab. And, the fourth is a Catholic nun wearing a habit. Would the applicants have an affirmative obligation to explain to the employer that they dressed the way they did for religious reasons? And, if they did not provide that information to the employer, would the employer (assuming that the applicants *might* need some kind of a religious accommodation) be liable under Title VII for refusing to hire them in order to avoid possible accommodation issues?

The Tenth Circuit clearly thought that a job applicant had an affirmative obligation to inform a prospective employer that there was a need for a reasonable accommodation based on religious beliefs. If the applicant failed to give that information to the employer, the employer would not have an obligation to even raise the issue of reasonable accommodations. Under the Supreme Court's ruling, an applicant could claim disparate treatment even though the applicant failed to provide the employer with actual knowledge of the need for a reasonable accommodation. The only thing that the applicant would have to prove is that the employer's assumption or suspicion of a possible need to accommodate was the motivating factor in denying employment. The Court suggested, at least in oral arguments, that the best practice in situations where the employer has reason to believe that a particular applicant might need a reasonable accommodation would be for the employer to inform the applicant of all the job requirements and then to ask if the applicant would have any problem complying with them. In the *Abercrombie* case, the person who conducted the interview suspected that Elauf wore the headscarf for religious reasons. And, even though she told Elauf some of the particulars about "The Look" policy, she never mentioned that Abercrombie models were prohibited from wearing caps or black clothing. As far as the applicant was concerned, there was no reason to ask for a religious accommodation. What the assistant manager should have done instead was to inform Elauf all of the particulars of "The Look" policy (including the prohibition regarding caps) and then to have asked whether she would have any problem complying with the policy.[87] If Elauf had said that she had no problems with the requirements, then the employer would have had no obligation to enter into a discussion about a religious accommodation. If, on the other hand, Elauf had informed the interviewer that she had a problem because she wore her headscarf for religious reasons, she would have put the employer on notice that there was a need for an accommodation.

In this particular case, the Supreme Court never had to address the question of whether it was possible for Abercrombie to reasonably accommodate Elauf's need to wear a hijab. The legal issue was not whether the employer had refused the applicant's request for a reasonable accommodation. It was simply whether the employer's suspicions that the applicant might need a religious accommodation constituted sufficient notice to meet the second prong of employee's burden of proof in a disparate treatment case. The *Abercrombie* case affirmed that an applicant could prevail, even though the applicant had not informed the employer of the need for a religious accommodation, if the applicant can show that the motivating factor in the employer's decision not to hire the person was the possibility of having to make a religious accommodation. When Justice Scalia announced the Court's decision from the bench, he indicated that it was an easy decision. "Title VII forbids adverse employment decisions made with a forbidden motive whether this motive derives from actual knowledge, a well-founded suspicion or merely a hunch."[88]

ENDNOTES

[1] 575 U.S. ______; 135 S. Ct. 2028 (2015).

[2] 565 U.S. 171; 132 S. Ct. 694 (2012).

[3] 573 U.S. _____; 134 S. Ct. 2751 (2014).

[4] 42 U.S.C. ch. 21B § 2000bb et seq.

[5] Abercrombie is a large retail clothing company in the United States. Its stores include Abercrombie & Fitch, Abercrombie Kids, and Hollister. Elauf applied to work in an Abercrombie Kids store. *E.E.O.C. v. Abercrombie & Fitch Stores, Inc.*, 731 F.3d 1106, 1111 (10th Cir., 2013).

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[6] Id. at 1111, citing Aplt. Opening Br. At 5.

[7] Id. at 1111, quoting Aplee. Supp. App. at 69 (Abercrombie Store Associate Handbook, dated Sept. 2006.)

[8] Id. at 1111, citing Aplt. App. at 70 (Dep. of Deon Riley, taken Mar. 17, 2011. ("Abercrombie has made a name because of brand. It's a fact that you walk into an environment, and its not just the smell or the sound, it's the way the merchandise is set up. It's the lighting. Most of all, it's the stylish clothing . . .")

[9] Id. at 1111-1112 quoting Aplt. Opening Br. at 8.

[10] A hijab is a head covering commonly worn by Islamic women. Elauf's headscarf only covered her hair and differed from other hijabs that also cover a woman's her face, neck, and shoulders.

[11] *E.E.O.C. v. Abercrombie & Fitch Stores, Inc.*, 798 F. Supp. 2d 1272, 1276 (ND. Okla., 2011, citing Dkt. #68, Ex. 2, Elauf Dep., 30: 23-31: 10; 31: 14-16; 32: 7-33: 5.

[12] *Id.* at 1277, citing Dkt. #68, Ex. 2, Elauf Dep., 57: 7-58: 2; 56: 17-57: 12; Ex. 17.

[13] *Supra*, n. 5, at 1113, citing Aplee. Supp. App. At 61 (Model Group Interview Guide, dated June 26, 2008.)

[14] *Id.* at 1113.

[15] *Id.* at 1113.

[16] *Supra*, n. 11, at 1278, quoting Dkt. #68, Ex. 4. Cooke Dep., 107: 14-108: 5.

[17] *Id.* at 1278.

[18] *Id.* at 1278, citing DKT #68, Ex. 5, Randall Johnson Dep., 86: 4-21.

[19] *Id.* at 1278, citing DKT #68, Ex. 5 Randall Johnson Dep., 48: 24-49:10.

[20] *Id.* at 1278, quoting DKT #68, Ex. 5 Randall Johnson Dep., 71: 13-72: 3.

[21] *Id.* at 1279, citing DKT #68, Ex. 4 Cooke Dep., 122: 13-25.

[22] *Id.* at 1275.

[23] 411 U.S. 792, 93 S. Ct. 1817 (1973).

[24] 225 F. 3d 1149 (10th Cir. 2000).

[25] *Supra*, n. 11, citing *Thomas, id.* at 1155.

[26] *Id.* at 1283, citing *Thomas, id.* at 1156.

[27] *Id.* at 1282, quoting *Thomas, id.* at 1155.

[28] *Id.* at 1283.

[29] *Id.* at 1283, quoting *Fowler v. Rhode Island*, 345 U.S. 67, 70; 73 S.Ct. 526 (1953).

[30] *Id.* at 1283, citing *United States v. Seeger*, 380 U.S. 163, 185; 85 S.CT. 850 (1965).

[31] *Id.* at 1283, citing *Fowler*, *supra*, n. 29, at 184.

[32] *Id.* at 1283, quoting *Hobbie v. Unemployment Comm'n of Fla.,* 480 U.S. 136, 144 n. 9, 107 S. Ct. 1046 (1987).

[33] *Id.* at 1284, quoting *Redmond v. GAF Corporation*, 574 F. 2d 897, 900 (7th Cir. 1978).

[34] *Id.* at 1284, quoting *Philbrook v. Ansonia Board of Education*, 757 F.2d 476, 481 (2d Cir. 1985).

[35] *Id.* at 1284, quoting *Philbrook, id.* at 482.

[36] *Id. at* 1285, citing *Dixon v. Hallmark Cos.,* 627 F. 3d 849, 856 (11th Cir. 2010); *Brown v. Polk County, Iowa*, 61 F. 3d 650, 654 (8th Cir. 1995); *Heller v. EBB Auto Co.*, 8 F. 3d 1433, 1439 (9th Cir. 1993); and *Hellinger v. Eckerd Corp.,* Fed. Supp. 2d 1359, 1362 (S.D. Fla. 1999).

[37] *Id.* at 1285, citing *Thomas, supra*, n. 24, at 1155.

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[38] *Id.* at 1285, citing *Smith v. Midland Brake, Inc.*, 180 F. 3d 1154, 1171-72 (10th Cir. 1999) (en banc).

[39] *Supra*, n. 5, at 1186.

[40] *Supra*, n. 11, at 1287, quoting *Trans World Airlines, Inc. v. Hardison*, 432 U.S. 63, 84 (1977).

[41] *Id.* at 1287, citing *Toledo v. Nobel-Sysco, Inc.*, 892 F. 2d 1481, 1492 (10th Cir. 1989).

[42] *Supra*, n. 5, at 1117, quoting *E.E.O.C. Compliance Manual* § 12-I(A)(1).

[43] *Id.* at 1117, quoting *E.E.O.C. Compliance Manual* § 12-I(A)(1).

[44] *Id.* at 1119.

[45] *Id.* at 1119.

[46] *Id.* at 1120.

[47] *Id.* at 1121, at http://www.eeoc.gov/policy/docs/best_practices_religion.html.

[48] *Id.* at 1121.

[49] *Id.* at 1122 , citing *Thomas, supra*, n. 24.

[50] *Id.* at 1125.

[51] *Id.* at 1125.

[52] *Id.* at 1125.

[53] *Id*. at 1131.

[54] *Id.* at 1132, quoting *Reed v. Great Lakes Cos.*, 330 F.3d 931, 935-36 (7th Cir. 2003).

[55] *Id.* at 1132.

[56] *Id.* at 1135, quoting *E.E.O.C. Compliance Manual* § 12-IV(A)(1).

[57] *Id.* at 1140.

[58] *Id.* at 1143.

[59] *Id.* at 1147.

[60] *Id.* at 1151.

[61] *Supra*, n. 1, at 2031.

[62] *Id.* at 2032, quoting 42 U.S.C §2000e-2(a).

[63] *Id.* at 2032.

[64] *Id.* at 2032, citing 42 U.S.C. §2000e-2(m).

[65] *Id.* at 2032.

[66] 42 U.S.C. §12101ff.

[67] *Supra* n. 1, at 2033, citing *id.* at §12112(b)(5)(A).

[68] *Id.* at 2033.

[69] *Id.* at 2033.

[70] *Id.* at 2033.

[71] *Id.* at 2033, quoting 42 U.S.C. §2000e(j).

[72] *Id.* at 2034.

[73] *Id.* at 2035.

[74] *Id.* at 2035.

[75] *Id.* at 2036. See also, *id.* at 2032, n. 2.

[76] *Id.* at 2036. This represents J. Alito's combining of §2000e-2(a) and §2000e(j) of the Civil Rights Act of 1964.

[77] *Id.* at 2037, citing *Ricci v. DeStefano,* 557 U.S. 557, 577, 129 S. Ct. 2658 (2009).

[78] *Id.* at 2037, quoting *Raytheon Co. v. Hernandez,* 540 U.S. 44, 52, 124 S. Ct. 513 (2003).

[79] *Id.* at 2038.

[80] *Id.* at 2038. "The term 'religion' includes all aspects of religious observance and practice, as well as belief, unless an employer demonstrates that he is unable to reasonably accommodate to an employee's or prospective employee's religious observance or practice without undue hardship on the conduct of the employer's business." §2000e(j).

The original Title VII, enacted in 1964, prohibited discrimination "because of . . . religion." It was not until 1972 that the statute was amended to include the current expanded definition of "religion" that also encompasses "religious observance and practice."

[81] *Id.* at 2038, citing §2000e-2(a)(1).

[82] *Id.* at 2038.

[83] *Id.* at 2039.

[84] *Id.* at 2039.

[85] *Id.* at 2039.

[86] *Id.* at 2041.

[87] The inquiry by the employer should be framed in neutral terms. The employer should avoid the stereotypical question: "You're a nun. Do you need to wear the habit?" The more appropriate question would be: "This is our dress code policy. Do you have any problems complying with it?"

[88] Liptak, Adam, *Muslim Woman Denied Job Over Head Scarf Wins in Supreme Court*, NY Times, June 1, 2015.