North East Journal of Legal Studies

Volume Thirty-Seven Spring/Fall 2018

ISSN: 1545-0597

NORTH EAST JOURNAL OF LEGAL STUDIES

Volume Thirty Seven **Spring/Fall 2018**

An official publication of the North East Academy of Legal Studies in Business, Inc. © 2017
ISSN: 1545-0597

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NORTH EAST JOURNAL OF LEGAL STUDIES

VOLUME 37 **SPRING/FALL 2018**

ARTICLES

PEDAGOGY

AIRBNB: A DIGITAL PLATFORM FOR SHARING OR EXCLUDING?

by

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INTRODUCTION

Airbnb's meteoric rise to the #7 hotel brand[1] in the 9 years since its founding is both astounding and controversial. Having completely disrupted the travel industry, Airbnb's digital platform has enabled people to make money by renting out their property, but has it also provided the technology for private individuals, acting as Airbnb host surrogates, to practice not so subtle discrimination? This paper will examine the civil rights and fair housing claims brought by Gregory Selden in his class action suit against Airbnb.

The practices of Airbnb's competitors will be compared, and recommendations will be made for eliminating discrimination on such social media platforms.

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BACKGROUND

As of 2016, Airbnb rentals accounted for nine percent of total lodging units in the ten largest US markets.[2] The company claims to have a presence in 34,000 cities in more than 191 countries, with over 2 million listings.[3] After its most recent funding efforts, Airbnb boasts a $30 billion valuation, making it the second most valuable tech startup after Uber.[4] CEO Brian Chesky anticipates that they will earn as much as $3.5 billion a year by 2020. Yet the company has spent less than $300 million of the $3 billion it has raised from outside investors.[5] The secret to its success: Airbnb utilizes the Internet as a vehicle for worldwide commercial exchanges without any middlemen. Its digital platform provides users with connections to willing hosts and efficiently contracts out all the operational and managerial expenses incurred by traditional hotels.[6]

This zero-marginal-cost business model brilliantly eliminates the overhead of owning brick and mortar hotels, including associated sales, occupancy, real estate, franchise and income taxes, as well as the need to hire and pay staff. By off-loading all the customary expenses of hotel services to its huge network of independent hosts, Airbnb effectively bypasses a regulatory licensing regime built up over decades to protect everything from health and safety to labor rights and guarantees of equal access to public accommodations. Perhaps most insidious, the very construction of the Airbnb platform provides the means to undermine anti-discrimination laws. Hosts offer accommodations to the public and then review guest profiles to select a match.[7] The exchange of photos and user identities has played a tremendous role in building trust, accountability, and a sense of safety and "belonging" to the Airbnb "community."[8] Unfortunately, the same technology that promises to connect can also be used to exclude.

Enter Gregory Selden, a 25-year-old African American male. In March 2015, Selden inquired about the availability of a Philadelphia accommodation from an Airbnb host listed with the screen name Paul. Selden was rejected by Paul and told that the spot had been filled, but later the same day he found

Paul's listing on the site indicating that the accommodation was still available. Believing that he was discriminated against because of his race, Selden created two imitation Airbnb "white" profiles to seek accommodation once again from Paul. One had similar demographics as Selden, the second was an older white male. Selden used the two imitation profiles to request accommodations for the exact same dates he had originally sought. From Paul's view, the only information he had was the name, profile picture, location and how long the fake applicants had been members of the Airbnb community. On the same day that Paul rejected Selden, Paul immediately accepted both white imitation Airbnb accounts. Selden contacted Airbnb, but he received no response.[9] His story was remarkably like that of Quirtina Crittenden, an African American business consultant who was featured in an April 2016 NPR segment. She had started the Twitter hashtag, "#airbnbwhileblack."[10] The following month, Selden took his experiment to court, and not surprisingly, to social media platforms. His class action discrimination complaint spurred thousands of retweets from individuals who had suffered the exact same disparate treatment from Airbnb hosts, and #airbnbwhileblack went viral. [11]

On the academic side, three Harvard Business School professors had likewise concluded that discrimination persists and may be exacerbated in online platforms.[12] Their first study in 2014 found that nonblack hosts could charge more than black hosts, and black hosts saw a larger price penalty for having a poor location relative to nonblack hosts.[13] Their second study published in September 2016 corroborated Selden's experience. The professors invented a name that they thought was distinctively "white" sounding and another name that they believed would be interpreted as distinctively "African-American." Their theory was that some Airbnb hosts are inherently racist and when asked to rent their property to an African American, would falsely report the property as unavailable, but report the same property on the same date available to the "white sounding name." Their premise was uncannily accurate. The experiment found that those with African-American names were 16% less likely to be accommodated as a White applicant.[14] The authors concluded that, "inquiries from guests with White-sounding names are

accepted roughly 50% of the time. In contrast, guests with African-American sounding names are accepted roughly 42% of the time."[15] A similar study that surveyed 1200 plus hosts in Boston, Chicago and Seattle found that guests with African-American names were 19% less likely to have their requests to book accepted than guests with Caucasian names.[16]

Selden's case and the Harvard study graphically highlight the racial discrimination that continues to flourish in the United States. In itinerant housing, it exists on a profound level, significantly impacting business and interstate commerce, to say nothing of the demoralizing impact it has on an entire population. Given the range of anti-discrimination laws in the United States, one would assume such discriminatory practices would be banned. Yet because of the blurred lines between what is private and public in the brave new world of social media, little if any law exists to prevent these discriminatory practices from occurring.

The following section will review the three major judicial pronouncements that underpin laws prohibiting racial discrimination at places of public accommodation. Each of these will be discussed from an historical vantage point and then be applied to Selden's claims of violation of Title II of the Civil Rights Act of 1964, section 1981 of the Federal Civil Rights Statute, and the Fair Housing Act.

THE LEGAL ARGUMENTS

The lawsuit by Selden against Airbnb exemplifies the arduous uphill climb plaintiffs face when bringing a lawsuit against Airbnb. As is typical of social media websites, Airbnb makes it a condition of use that all users waive their rights to a trial and instead must use arbitration to settle any disputes. Therefore, to date, Selden's lawsuit has been spent trying to wiggle out of the arbitration clause so that he can get to the substantive legal issues dealing with discrimination. The United States District Court for the District of Columbia, however, ruled that the arbitration clause prevailed, thus barring his action. Selden has appealed.

Assuming for a moment that Selden can prevail on the issue of the arbitration clause, the next formidable hurdle concerns how to classify Airbnb. Is it a hotel? A rental agency or a website provider? As one writer stated, "These questions remain unanswered. Yet policy makers cannot regulate the sharing economy without answering them."[17] To avoid any of the responsibility and liability associated with running hotels, Airbnb describes itself as a community of hosts and users. "Airbnb is not a hotel; it does not operate, own, manage, sell or resell any properties. Nor is Airbnb a hotel aggregator." [18]

Nonetheless, Airbnb does, in some ways, resemble a hotel. The company, not the host, manages payments for rooms, and ensures that guests pay appropriate local hotel taxes. The company, not the host, contracts for insurance against damages to accommodations. Airbnb advertises and brands its alternative experience akin to a hotel. The U.S. hotel industry certainly considers it a peer. In a forthcoming paper, "The New Public Accommodation,"[19] industry analysts argue that Airbnb could be legally considered a hotel because it is replacing hotels, and meets the same consumer needs as a hotel.[20]

In his brief, Selden likened the company to a hotel and its hosts to rental agents or hotel employees.[21] There is an important reason Selden wants Airbnb classified as a hotel: it would then be covered by Title II of the Civil Rights Act. This law provides that places of public accommodation may not discriminate on the ground of race, color, religion or national origin. A place of public accommodation includes such businesses as restaurants, gas stations, exhibition or entertainment venues, and any inn, hotel, motel, or other establishment which provides lodging to transient guests.[22]

Even if Airbnb were to be classified as a place of public accommodation, one notable exception exists that may have a direct impact on Title II's application. The Act explicitly excludes "an establishment located within a building which contains not more than five rooms for rent or hire and which is actually occupied by the proprietor of such establishment as his residence."[23] This exception is commonly referred to as the "Mrs. Murphy exemption" because of a comment by Republican Sen. George D. Aiken of Vermont during Title II's

inception. He suggested that Congress "integrate the Waldorf and other large hotels, but permit the 'Mrs. Murphy's,' who run small rooming houses all over the country, to rent their rooms to those they choose."[24] Thus, those rentals located within a building with four or fewer rooms to let would not come under the auspices of Title II. What Congress had in mind was the typical mid-twentieth century boarding house, not today's city dwellers looking to make money on short-term rentals of apartments in large buildings with multiple units.

If Airbnb were to be classified as a place of public accommodation, Selden would also have to show that its activities affect interstate commerce.[25] Of all the arguments, this would be the easiest to prove. This requirement invokes the power of Congress to "regulate commerce among the states" as set out in the Commerce Clause contained within Article II, §8 of the United States Constitution. While numerous cases exist interpreting the power of Congress to regulate interstate commerce, one seminal case dealing with that power in the context of Title II stands out: The *Heart of Atlanta Motel.*[26]

Originally brought before the United States Supreme Court to challenge the racially discriminatory practices of a motel located in Atlanta, Georgia, the case centered on the application of Title II to a place of accommodation. There was no doubt the motel fell within the public accommodation definition of the statute. The fundamental question remained whether the discrimination affected interstate commerce. Holding that it did, the court found that the motel's location near an interstate in Atlanta with 216 rooms available for rental by transient guests, as well as the owner's solicitation of guests both on the interstate highway and by use of billboards, placed it squarely within the ambit of the statute.[27]

Finding "overwhelming evidence that discrimination by hotels and motels impedes interstate travel" the court stated that the reach of Congress in enacting such legislation "extends to those activities intrastate which so affect interstate commerce or the exercise of the power of Congress over it as to make regulation of them appropriate means to the attainment

of a legitimate end, the exercise of the granted power of Congress to regulate interstate commerce."[28] In short, if the business engages in activity that impacts interstate commerce, then it is within the sphere of Title II. "From the plain language of the statute, it is clear Congress' intent in enacting Title II was to provide a remedy only for discrimination occurring in facilities or establishments serving the public: to conclude otherwise would obfuscate the term "place" and render nugatory the examples Congress provides to illuminate the meaning of that term."[29]

If the paucity of racial discrimination cases since the decision is any indication, the outcome in *Heart of Atlanta* put an end to any question about Title II's application to racial profiling at places of public accommodation that impact interstate commerce. Here Selden's argument is extremely powerful. All of Airbnb's hosts are soliciting business on the Internet, certainly impacting interstate commerce, and serving the public—exactly Title II's target. Selden's hurdle is whether he can get beyond the boarding house exception by either aggregating hosts operating under the Airbnb umbrella and/or arguing that the exception does not apply to individuals utilizing a social media platform to advertise and offer places of public accommodation.

Another legal theory advanced in Selden's complaint is a violation of Title VIII of the Civil Rights Act of 1968, or the Fair Housing Act (FHA). This act prohibits discrimination in housing specifically, usually for longer-term rentals and sales. "It casts a broader net than Title II, including in its protections not only race, color, religion and national origin, but also sex and family condition."[30] Moreover, the Supreme Court has held that there is no requirement under the FHA to show discriminatory intent.[31]

For example, one way in which the Fair Housing Act is a broader provision is that it applies not only to landlords but also to brokers.[32] Currently, a lawsuit pending in the U.S. District Court for the Southern District of New York, alleges that Airbnb acts as a "short-term rental site that is …operating without a real estate broker's license in New York."[33][34] The

class action suit is being brought by "all Airbnb users who have listed or rented properties in New York State over the last six years." [35] They claim that because Airbnb "facilitates, controls and processes payments for rentals through its website after listing and advertising the properties,"[36] that it should be characterized as a broker. A finding that the company is a broker would have significant ramifications for Airbnb, in addition to fines for operating as a broker without a license. The Fair Housing Act allows both actual and punitive damages as well as damages for emotional distress, all conceivable awards to plaintiffs suffering from discrimination.[37]

Finally, Selden also invokes 42 USC 1981, a federal civil rights statute that prohibits racial discrimination in contracting. This statute appears to be the easiest to apply to Airbnb, since every agreement (or denial of accommodation) between a host and a user is contractual. The difficulty of pursuing a remedy under this statute, however, is that a plaintiff alleging a violation must prove that the discrimination by the host was intentional. Selden's fake profile experiment might be sufficient proof.

AIRBNB'S RESPONSE TO SELDEN'S COMPLAINT

Airbnb has mounted a strategic, two front response to the Selden suit. Based on its Terms of Service, the company has a predictably strong defense to Selden's claims, arguing that all disputes must be settled by binding arbitration.[38] On November 1, 2016, the U.S. District Court for the District of Columbia granted Airbnb's Motion to Compel Arbitration and stay the case. The court acknowledged that Airbnb's Terms of Service agreement constitutes an online adhesion contract, but it ruled that by choosing to sign up for Airbnb through the commonplace notification screen, click, and subsequent use of the site, Selden manifested his assent. Furthermore, the court found that Selden's agreement to arbitrate all claims includes statutory civil rights claims, and that the arbitration clause is not unconscionable.[39]

Selden appealed the ruling to the U.S. Court of Appeals for the District of Columbia Circuit, strenuously arguing that

Airbnb's arbitration clause limits class action proceedings and thus the ability of African Americans to obtain the necessary injunctive relief to redress Airbnb hosts' ongoing and widespread discrimination. Airbnb moved to dismiss the appeal as premature since there is no final judgment, only an interlocutory order for arbitration to proceed. Given the plaintiff class' inability to otherwise vindicate statutory rights, Selden responded that the appellate court should exercise pendant jurisdiction and deem the arbitration clause unconscionable and unenforceable.[40] Oral argument has not been scheduled yet.[41]

At the same time, Airbnb has apologetically admitted that the founders weren't fully conscious of possible discrimination when they designed the site, and the company has very publicly taken steps to proactively address these concerns.[42] Airbnb hired former U.S. Attorney General Eric Holder and Laura Murphy, a former American Civil Liberties Union director to advise the company. CEO Brian Chesky released their report in September, 2016, and the company introduced several new rules and procedures. Users must sign an anti-bias community commitment statement and pledge not to discriminate while using the service, and hosts who violate the new policy risk being suspended or removed from the site. Customers who believe they were denied lodging due to discrimination will be guaranteed lodging, though it is not clear how that promise will be implemented. To further guard against racial discrimination, Airbnb plans to reduce the prominence of guests' photos when they book rooms, while enhancing other parts of their profiles.[43] Airbnb also provides potential hosts a new toolkit to create awareness and sensitivity training. The toolkit, designed together with social psychologists, is aimed at helping hosts understand and act against bias.[44]

More significant are changes to the actual design of the website. There are a few tools users can utilize to tackle bias on the website, such as the flag button to report any instances of discrimination and the Instant Book feature which enables travelers to book a listing without waiting for approval from the host. Unfortunately, not all hosts utilize this feature.[45] The

company was set to increase the availability of Instant Book to at least half of its two million listings by January 2017, in addition to adding a feature that automatically blocks any dates offered by a host if they've already rejected a request for those dates. This would likely be the most meaningful change.[46]

COMPARING COMPETITORS

Airbnb's explosive growth and the general acceptance of the sharing economy have spawned competition. Some of these new players are old established companies in the travel industry. For example, Expedia recently purchased Home Away for $3.9 billion. Home Away lists professionally managed properties that are long-term rentals. Home Away attracts vacationers seeking resort locations, while Airbnb serves a wider variety of business and pleasure travelers visiting tourist spots, cities and residential areas.[47] Expedia now also owns Vacation Rentals by Owners (VRBO), which was a pioneer in the industry and was acquired by Home Away in 2006. VRBO operates much like Airbnb.[48]

Trip Advisor, the oldest, largest, and most trusted online travel service, runs Vacation Rentals, which offers a seamless booking experience by eliminating the hassle of multiple bookings. Vacation Rentals has at least 830,000 listings and a presence in 190 countries.[49] Home Away, Vacation Rentals, and VRBO all require some personal, identifying information for an initial booking, including first and last name, but additional "introductory" information is optional, and no picture is requested.

The third significant competitor is Priceline, which owns Bookings.com and Villas.com. Both are vacation rental oriented. Villas.com has over 240,000 rentals worldwide and patrons can utilize filters such as pet friendliness and close-by golf courses.[50] Notably, Booking.com is the only website that offers instant booking. Listings on the website appear to be limited to traditional lodges, hotels, inns, and resorts, not single-family homes or condos.

Another promising competitor is Tansler, a home sharing

platform that functions in a reverse auction style, allowing renters to choose their price, rather than their host. Renters browse the properties in their preferred destination along with their list prices. They then add the properties they like to their auction cart, which is then sent to the hosts. There is a 24-hour period in which hosts can either accept or deny the renter's offered price.[51] This approach eliminates a host's opportunity to discriminate based on a guest's profile.

Other competitors have emerged to cater to specific groups of travelers. KidandCoe.com offers rentals that are child friendly and have children's rooms and amenities. It is geared toward families, but so far it has relatively few properties in each of the cities where it has a presence.[52] Users must send a message to the host explaining their family needs, but no picture is required. Noirbnb and Innclusive (formerly Noirebnb) were both formed in 2016 after their founders experienced discrimination when trying to rent through Airbnb. They are aimed at serving African American travelers and members of other minority groups, such as the LGBT community and travelers of Latino origin.[53] Innclusive requires users to create a profile, including name, gender, language and personal travel and life preferences, though no picture is requested. Noirbnb is still in the early stages of financing and web development. Both companies state that they welcome all who look for an inclusive travel experience, but one can't help wondering if such alternatives may lead to self-segregating sites. (See Appendix 1, "Comparison of Airbnb's Competitors.")

Interestingly, despite the backlash against Airbnb for discrimination claims, none of its competitors require hosts to read about discrimination or sign an agreement stating that they understand that they cannot discriminate based on race, color, ethnicity or national origin. As noted above, many do not have an instant book feature, instead relying on a matching process based on the host's posted materials and the guest's submission of personal information. Providing users with a system to shop for all sorts of attributes that may range from multilingual hosts to food compatibility and child friendly accommodations is certainly advantageous, expanding both choice and

competition. The flip side, however, can be highly undesirable. The seemingly benign requirement for users to submit profiles to enhance the "match," may instead allow hosts to select their guests based on immutable characteristics such as race. Though Airbnb has initiated internal efforts to combat discrimination, it appears that external pressure is necessary to force the entire industry to reexamine and rework its current business model.

CONCLUSIONS AND RECOMMENDATIONS

While Airbnb appears to be taking swift and sincere action to combat the challenge of persistent discrimination, one cannot help questioning their central premise. Celebrating diversity fits nicely with Airbnb's branding and public relation campaign, and was beautifully portrayed in the company's January 2017 Super Bowl ad viewed by millions.[54] But Airbnb's platform created an international community of private individuals who understandably want to maintain the ability to choose their visitors, yet in many cases they are essentially running a hotel. The website allows, in fact invites, hosts to select and rate their guests. As Leigh Gallagher has aptly pointed out in cataloguing the Airbnb story, the resulting discrimination is the very opposite of "belonging" and may be the unintended consequence of 'three white guys' building a platform.[55]

If Airbnb really wants to eliminate bias, the company should completely do away with guest "profiling," including the use of photographs and real biological names before customers can access hosts' accommodations. This is exactly the remedy that Selden is seeking to address the clear disparate treatment and impact African Americans experience on the site. Selden's class action suit will likely be thwarted by Airbnb's arbitration defense, and the legal line between platform and provider will remain untested in the courts. To unequivocally address the new discrimination in the shared economy, Congress would need to amend Title II to cover transactions occurring on social media websites. Absent a change in the legal landscape, it is up to Airbnb and similar online booking sites to design out the discrimination. Airbnb's

failure to voluntarily make these changes leads one to conclude that the company fears many hosts would defect and the brand would lose significant revenue. Ominously, the promise of social media to connect us, may instead foster greater separation. **Appendix 1**

Comparison of Airbnb's Competitors*

Name	**Properties**	**Annual fees**	**Other fees**	**Types of property**
HomeAway	1.2 million	$349 or 8% pay-per-booking fee (10% if overseas)	Booking fee 4-9% of rental cost	Vacation rentals
Vacation Rentals	830,000		Service fee 5-12%	Vacation rentals
VRBO	794,000 as of 2014	$349 rental fee or 10% pay per booking	No guest fees	Vacation rentals
Tansler	Over 50,000	None	Renter's pay a 6% service fee, owners pay 3%	Vacation rentals
Booking.com/ Villas.com	1,157,152 (Booking.com) 240,000 (Villas.com)		No booking fees	Unique vacation rentals for villas.com
Kid and Coe				

Comparison of Airbnb's Competitors*			
Name	**Types of travelers**	**IPO/Financing details**	**Host/Guest Profile**
HomeAway	Tourists/ vacationers	Not publicly traded (Subsidiary of Expedia)	Homeowner can choose who to rent to "make sure they are a good fit for the property"). Traveler and host reviews. Can send message without your picture. No instant bookings.
Vacational Rentals	Vacationers		Can report complaints about requesting payment outside of website, and calendar not accurate. Cannot report issues of discrimination. Little information about hosts. Reviews on hosts. No instant bookings.
VRBO	Vacationers	Subsidiary of Expedia	Same as Vacation Rentals (owned by HomeAway)
Tansler			No information on website, cannot see listings or book anything.
Bookings.com/Villas.com	All travelers but Villas.com is geared towards vacationers	Part of the Priceline group	Instant bookings. Services mostly hotels and inns. Guests can review listings and properties.
Kid and Coe			Guests can review hosts and properties. No instant bookings. Hosts decide who stays at their properties.

ENDNOTES

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[9] Complaint at 4–6, Selden v. Airbnb, Inc., 681 F. App'x 1 (D.D.C. 2017) (No. 16-7139), https://www.pacermonitor.com/public/case/11472767/SELDEN_v_AIRBNB,_INC.

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[12] Benjamin Edelman, et al., *Racial Discrimination in the Sharing Economy: Evidence from a Field Experiment*, AM. ECON. J.: APPLIED ECON., Apr. 2017, at 1–22.

[13] GALLAGHER, *supra* note 8, at 99–100.

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[21] Brief for the Petitioner, Selden v. Airbnb, Inc., 681 F. App'x

1 (D.D.C. 2017) (No. 16-7139), https://www.pacermonitor.com/public/case/11472767/SELDEN_v_AIRBNB,_INC.

[22] "All persons shall be entitled to the full and equal enjoyment of the goods, services, facilities, privileges, advantages, and accommodations of any place of public accommodation, as defined in this section, without discrimination or segregation on the ground of race, color, religion, or national origin**.** (b) Establishments affecting interstate commerce or supported in their activities by State action as places of public accommodation; lodgings; facilities principally engaged in selling food for consumption on the premises; gasoline stations; places of exhibition or entertainment; other covered establishments. Each of the following establishments which serves the public is a place of public accommodation within the meaning of this subchapter if its operations affect commerce, or if discrimination or segregation by it is supported by State action: **(2)** any restaurant, cafeteria, lunchroom, lunch counter, soda fountain, or other facility principally engaged in selling food for consumption on the premises, including, but not limited to, any such facility located on the premises of any retail establishment; or any gasoline station; **(3)** any motion picture house, theater, concert hall, sports arena, stadium or other place of exhibition or entertainment; and **(4)** any establishment (A)(i) which is physically located within the premises of any establishment otherwise covered by this subsection, or (ii) within the premises of which is physically located any such covered establishment, and (B) which holds itself out as serving patrons of such covered establishment." 42 U.S.C. § 2000a (2011).

[23] 42 U.S.C. § 2000a(a) (2011).

[24] Henry Grabar, *The Civil Rights Act Exempts Racist Bed-and-Breakfasts. Does That Cover Airbnb?*, SLATE (June 8, 2016, 2:10 PM), http://www.slate.com/blogs/moneybox/2016/06/08/the_airbnb_racial_discrimination_lawsuit_will_hinge_on_whether_airbnb_is.html.

[25] *Id.*

[26] Heart of Atlanta Motel, Inc. v. United States, 379 U.S. 241 (1964).

[27] *Id.*

[28] *Id*. at 258 (citing M'Culloch v. Maryland, 17 U.S. 316, XXX (1819)).

[29] *Clegg v. Cult Awareness Network*, 18 F.3d 752 (9th Cir. 1994).

[30] Jeremy Quittner, *Airbnb and Discrimination: Why It's All So Confusing*, FORBES (June 23, 2016), http://fortune.com/2016/06/23/airbnb-discrimination-laws/.

[31] Even if the Fair Housing Act applies to Airbnb, however, many other sharing economy businesses like Uber, Lyft, TaskRabbit and Postmates do not involve housing, so discrimination by such businesses would remain unaddressed. *See generally* Aaron Belzer & Nancy Leong, *Can civil-rights law stop discrimination on AirBnb*?, THE WASHINGTON POST (May 1, 2016), https://www.washingtonpost.com/news/monkey-cage/wp/2016/05/01/can-civil-rights-law-stop-racial-discrimination-on-airbnb/?utm_term=.95aed1831601.

[32] Debra Cassens Weiss, *Does Airbnb have a legal responsibility to end bias by its hosts?*, ABA JOURNAL (Aug. 24, 2015, 7:00 AM), http://www.abajournal.com/news/article/does_airbnb_have_a_legal_responsibility_to_end_bias_by_its_hosts.

[33]

[34] Matthew Perlman, *New Suit Claims Airbnb Breaks NY Real Estate Broker Laws*, LAW 360 (Feb. 12, 2016, 1:23 PM), https://www.law360.com/articles/758666/new-suit-claims-airbnb-breaks-ny-real-estate-broker-laws.

[35] *Id.*

[36] *Id.*

[37] Daniel W. Barkley, *Affordable Housing and Community Development Law*, ABA, http://www.americanbar.org/content/newsletter/publications/gp_solo_magazine_home/gp_solo_magazine_index/barkley.html (last visited Nov. 10, 2017).

[38] Motion of Defendant to Compel Arbitration, Selden v. Airbnb, Inc., 681 F. App'x 1 (D.D.C. 2017) (No. 16-7139), https://www.pacermonitor.com/public/case/11472767/SELDEN_v_AIRBNB,_INC.

[39] Selden v. Airbnb, Inc., 681 F. App'x 1 (D.D.C. 2017).

[40] Response of Petitioner to Motion to Dismiss for Lack of Jurisdiction, Selden v. Airbnb, Inc., 681 F. App'x 1 (D.D.C. 2017) (No. 16-7139), https://www.pacermonitor.com/public/case/11472767/SELDEN_v_AIRBNB,_INC.

[41] Selden also faces an uphill battle with the argument concerning the interlocutory appeals as the District of Columbia is in a circuit that has yet to decide whether or not appeals can be taken in such instances.

[42] Greg Bensinger, *Airbnb Promotes Diversity to Prevent Booking Discrimination by Hosts*, THE WALL STREET JOURNAL (Sept. 8, 2016, 3:34 PM), https://www.wsj.com/articles/airbnb-promotes-diversity-to-prevent-booking-discrimination-by-hosts-1473343215.

[43] *Id.*

[44] https://www.airbnb-toolkits.com/my_toolkits?utm_campaign=antibias&utm_source=newsletter

[45] *How Hosts Can Cultivate Unbiased Hospitality*, AIRBNB BLOG (Oct. 23, 2016), http://blog.airbnb.com/unbiased-hospitality.

[46] Danny King, *Airbnb issues a new policy: Zero tolerance of host bias*, TRAVEL WEEKLY (Sept. 12, 2016), http://www.travelweekly.com/Travel-News/Hotel-News/Airbnb-issues-new-policy-Zero-tolerance-host-bias.

[47] Todd Conway, *Airbnb Competitors – Who Are They and What's the Difference?*, http://blog.pillowhomes.com/airbnb-competitors-who-are-they-and-whats-the-difference/ (last visited Nov. 10, 2017).

[48] Stephanie Rosenbloom, Giving Airbnb a Run for Its Money, N.Y. TIMES (Feb. 10, 2015), https://www.nytimes.com/2015/02/15/travel/giving-airbnb-a-run-for-its-money.html?_r=1.

[49] Peter Lane Taylor, *Watch Out, HomeAway and Airbnb: Here's Why TripAdvisor May Be Your Biggest Competition*, FORBES (Dec. 7, 2016, 12:53 PM), https://www.forbes.com/sites/petertaylor/2016/12/07/watch-out-homeaway-airbnb-heres-why-tripadvisor-may-be-your-biggest-competition/#1ea137b3736d.

[50] *Supra* note 49.

[51] Dany Papineau, *29 Airbnb Alternatives & Competitors for Hosts*, AIRBNBSECRETS, http://www.airbnbsecrets.com/airbnb-alternatives/.

[52] *Supra* note 49. [I'm not sure which note this refers to?]

[53] Denver Nicks, *Airbnb Competitors Launch to Serve Black Travelers*, TIME (June 7, 2016), http://time.com/money/4359703/airbnb-competitors-noirebnb-noirbnb/.

[54] Katie Benner, *In Airbnb's Super Bowl Ad, Implied Criticism of Trump's Travel Ban*, N.Y. TIMES (Feb. 5, 2017), https://www.nytimes.com/2017/02/05/technology/airbnb-super-bowl-ad-trump-travel-ban.html.

[55] GALLAGHER, *supra* note 8, at 104.

CAUGHT IN THE TRANSITION: A CAUTIONARY TALE FOR SAME-SEX COUPLES

by

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Matina Mouyos**

I. INTRODUCTION

After the Supreme Court's decision legalizing same-sex marriage in *Obergefell v. Hodges*[1], one would believe that the disparity in the treatment of same-sex versus opposite-sex couples under the law would cease. Yet a series of decisions by New York state courts examining the rights of same-sex couples after the end of their relationships have had unforeseen consequences. These decisions have impacted the areas of estate planning, equitable distribution of property, and parental rights relating to the custody and visitation of the couple's children.

The purpose of this article is to analyze these court rulings and provide guidance to avoid both unexpected and unintended outcomes.

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II. BEQUESTS TO FORMER SPOUSES

New York Estates, Powers and Trusts Law (EPTL) §5-1.4 states that, unless the will expressly states otherwise, a divorce, judicial separation, or annulment of a marriage revokes all dispositions or appointments made by a decedent to a former spouse. The former spouse is treated as having predeceased the testator. This means any bequests to the former spouse, the nomination of the former spouse as executor or trustee, and any appointments of property in the former spouse's favor under a power of appointment are revoked. The revocation is valid even if the will was executed before the marriage.[2] In addition, the former spouse's rights to "in-trust-for" bank accounts (Totten Trusts), life insurance policies, lifetime revocable trusts, and joint tenancies with right of survivorship are also revoked.[3]

Matter of Leyton[4] involves a petition by the decedent's mother and sister to revoke letters testamentary issued to the decedent's former same-sex partner naming him as executor, and to disqualify him as a beneficiary under the will. The decedent and his former partner had entered into a commitment ceremony in New York in 2002, but later separated in 2008. The will was executed on January 11, 2001, prior to the commitment ceremony.[5] If the decedent and his partner had married and then divorced, EPTL §5-1.4 would have barred his former partner from serving as executor and from inheriting under the will. When the Bennett Commission first reviewed this issue in the 1960s, it found it counterintuitive that any testator would provide a gift to a former spouse, and the Legislature agreed.[6] In their petition, the decedent's mother

and sister contended that the former partner was the equivalent of a former spouse, and therefore should be disqualified under the statute.

The petitioners argued that the State of New York "wrongfully and unconstitutionally deprived decedent and his partner the right to marry and subsequently divorce." Therefore, the Surrogate's Court, "as a matter of right and equity" should apply the statutory provisions of EPTL §5-1.4.[7] Conversely, the former partner argued that at the time of the commitment ceremony, the union was not considered a formal marriage in New York State, and the subsequent break-up was not a "separation," "abandonment" or "divorce" as defined by the statute.[8]

The Surrogate noted that the petitioners were asking the Court to retroactively apply New York's Marriage Equity Act, which did not legalize same-sex marriage until 2011. The Court further stated that it is up to the Legislature to decide questions such as this, concluding, "this Court cannot deem the commitment ceremony to have sanctified a marriage," thereby allowing the decedent and his former partner to be deemed divorced."[9] Even after 2011 the decedent and his former partner took no steps to obtain a judicial decree declaring an end to their union. The petition was denied.

While the Court's decision appears to deny the presumed intent of the decedent, this may not true. The decedent died in December 2013 of a heart attack at the age of 52. This was more than five years after the decedent and his former partner had ended their relationship. The couple had been together approximately 10 years prior to their commitment ceremony, and separated six years after the

ceremony, resulting in a 16-year relationship. They stayed on good terms after their separation; they continued to co-own property, bank accounts and credit cards up until the decedent's death. Early in 2013, the decedent attended his former partner's wedding when he married another man, and the decedent acted as the wedding's sole official witness.[10]

The decedent had ample time and opportunity to execute a new will after the romantic relationship between the parties ended, but did not. While the Court's ruling appears to support the decedent's wishes in this case, the opposite may be true in future cases. It is imperative that same-sex couples who never legally marry, then later separate, review and update their estate plans. They cannot rely on the language of EPTL §5-1.4 to revoke all bequests to a former loved one. Only by revising their documents can they be certain that their true wishes will be carried out.

III. EQUITABLE DISTRIBUTION OF PROPERTY

Equitable distribution is the means by which New York allocates marital property between the spouses when a marriage ends. New York's Domestic Relations Law provides that equitable distribution of marital property shall be made in a court action where all or part of the relief granted is a divorce, or upon the dissolution, annulment or declaration of the nullity of a void marriage.[11] This provision authorizes the court to equitably distribute marital property only when the marital relationship is terminated. Absent such a change in marital status, the court is powerless to distribute marital property.

The term "marital property" is defined as all property acquired by either or both spouses during the marriage and before the execution of a separation agreement or the commencement of a divorce action, regardless of the form in which title is held.[12] Excluded from marital property is separate property, which includes property acquired before the marriage or property acquired by bequest, devise, descent or gift from a third party to one of the spouses.[13]

O'Reilly-Morshead v. O'Reilly-Morshead[14] involves a same-sex couple who began their relationship in 2001. In 2002 the couple moved to New York, but before relocating the defendant sold a house that she owned in her own name in Indiana. In June, 2003, the couple entered into a civil union in Vermont. Under the Vermont civil union statute the parties acquired rights, under Vermont law, in property they acquired thereafter.[15] In 2004 the plaintiff purchased a home in New York, which she purchased with her separate property; the defendant was not listed on the deed to the property. In 2006 the couple was married in Canada, and five years later the plaintiff commenced a divorce action in New York seeking equitable distribution of the marital property. The defendant then filed an action for divorce and a counterclaim for dissolution of the civil union, asking the New York court to distribute any "civil union property" under Vermont law.[16]

At controversy is whether either or both of the parties attained legal rights to property acquired by the other party in her own name after the date of the civil union, but before the date of the marriage. At the time of the parties' civil union, Vermont's civil union statute granted couples entering a civil union the same property rights as those extended to couples entering a marriage.[17] Nevertheless at the time these parties

entered into their civil union, Vermont did not recognize their union as a legal marriage. In 2009 Vermont passed a Marriage Equality Act which afforded legal status to same-sex marriages.[18] This Act defines marriage, stating that it includes all "legally recognized unions of two people." Therefore marriages and civil unions, after the Marriage Equality Act, are equivalent unions that can be dissolved by the Vermont courts. To further clarify property rights, the Vermont Supreme Court has intoned that even if joined in a civil union, the property acquired by the parties during the civil union is subject to court distribution, and is referred to as the "marital estate"[19]

While it is clear that Vermont courts have the authority to dissolve the couples' civil union and subsequent marriage, as well as distribute all property acquired by them after the date of their civil union, do New York courts have jurisdiction to do the same? Appeals courts in New York state have held that trial courts can dissolve civil unions under a trial court's general equity jurisdiction.[20] Nevertheless, while authorizing New York courts to dissolve civil unions, no guidance was provided regarding the distribution of property acquired during the course of the civil union.[21] The court in *O'Reilly-Morshead* had to decide whether it could distribute "civil union property" that is outside the scope of "marital property" as defined in the Domestic Relations Law. The mere fact that the court has the power to dissolve the civil union does not dictate that it must apply New York's statutory rules to relief under the dissolution.[22] In that respect, it is important to note that other New York courts have concluded that a civil union is not the equivalent of a marriage in New York.[23] Furthermore the Third Department declined to apply comity and extend New York's system of benefits to a civil union partner stating,

> While parties to a civil union may be spouses, and even legal spouses, in Vermont, New York is not required to extend to such parties all of the benefits extended to marital spouses. The extension of benefits entails a consideration of social and fiscal policy more appropriately left to the Legislature.[24]

The court in *O'Reilly-Morshead* ruled that there was no indication from the legislature or the Court of Appeals that the definition of marital property, which is subject to distribution in New York divorce actions, could be so easily relinquished to other states. This would cause the situs of the marriage, rather than that of divorce, to carry more weight, and the court refused to adopt Vermont's definition of marital property or the marital estate.[25]

A second argument made by the defendant is that a civil union is an "express contract" similar to the marriage contract. As a matter of contract law, the union is subject to termination by a court of general equity, and the court must decide whether to utilize New York or Vermont law as the basis for developing a remedy after termination of the agreement. While the court acknowledged the persuasiveness of this argument, it declined to accept it, stating,

> The failure of the legislature to recognize "civil unions" and the strict definition of "marital property" as the starting point for considering equitable distribution of property prohibit this court from venturing to that conclusion. There is no general

> common law of equity that is equivalent to the statutory creation of an equitable distribution power in the Domestic Relations Law. Equitable distribution of property from a titled party to a non-titled party is only permitted in New York if the parties are married, either under the laws of New York, or other states or nations. The Court of Appeals has repeatedly noted that a "marriage"—of whatever type or from whatever jurisdiction—is the only touchstone for equitable distribution of property in New York.[26]

The Court's decision in this case appears to be an anomaly; it dissolves a preexisting civil union, but only allows equitable property distribution based upon the date of the couple's legal marriage. Some states recognize civil unions as the equivalent of a legal marriage, providing the parties with the same legal rights and responsibilities of a married couple. However, this case serves as a caution to same-sex couples: The jurisdiction in which they entered a civil union may not serve as the controlling law when they wish to terminate their relationship. When seeking court-ordered distribution of civil union property, it is the law of the state granting the dissolution that controls. These couples, while on good terms, may wish to sign an express contract addressing the distribution of civil union property in the event their relationship terminates in the future.

IV. PARENTAL RIGHTS

In New York state, it has long been presumed that a child born of a married woman is the child of the husband. The

presumption is recognized at common law[27] and codified in New York statutes.[28] Both New York's Domestic Relations Law and Family Court Act establish that a child born before or after the marriage shall be deemed to be the legitimate child of the married couple. This is true whether or not the marriage was valid.

Kelly S. v. Farah M.[29] involves a same-sex couple that began their relationship in March 2000. They entered into a registered domestic partnership in California in January 2004, and shortly thereafter decided to start a family. Anthony S., a close friend of both of the parties, agreed to donate his sperm, and Kelly S. became pregnant through artificial insemination. In January 2005, Kelly S. gave birth to I.S., who was legally adopted by Farah M. and is not a subject of this case.

The parties decided to have another child, and Anthony S. again agreed to donate his sperm. This time Farah M. became pregnant by artificial insemination and gave birth to Z.S. on March 24, 2007. The parties were legally married in August 2008 when California first allowed same-sex marriages. That same year they decided to have a third child, and Farah M. became pregnant once more through artificial insemination, with Anthony S. again donating the sperm. Farah M. gave birth to E.S. on April 27, 2009. Both Z.S. and E.S. were given Kelly S.'s surname, and Kelly S. was listed as a parent on the children's birth certificates. In conceiving Z.S. and E.S. the artificial insemination procedure was performed at home by Farah M., rather than by a physician, and the parties did not draft or sign a written consent agreement. Kelly S. did not legally adopt Z.S. or E.S.[30]

In 2012 the parties relocated with the children to New York. Subsequently the parties separated, and Kelly S. moved to Arizona in the summer of 2013, while Farah M. remained in

New York with the three children. In May 2014 Kelly S. filed a visitation petition in the Family Court in Suffolk County, New York, seeking visitation with Z.S. and E.S. The petition alleged that Kelly S. was the mother of the subject children and stated the facts set forth above. The petition further alleged that Kelly S. helped raise the children until the parties separated.[31] In determining parentage the first issue that the court had to decide was whether to use New York or California law. After discussing the doctrine of comity,[32] the court determined that the parties' decade long history and residence in California warranted the application of California law to this matter.

Turning to the facts of this case, the court noted that the parties did not comply with the artificial insemination laws of either California or New York. Therefore, those statutes did not provide a basis for treating Kelly S. as a parent. Nevertheless, after analyzing the presumption of parentage arising under California law for children born of a marriage,[33] as well as the California law for registered domestic partnerships,[34] the court determined that when Z.S. was born in 2007, while the parties were living together in a registered domestic partnership, California law afforded them the same rights and obligations with respect to Z.S. as if they were married spouses. The court concluded that Kelly S. was presumed to be the parent of both Z.S. and E.S. under California law.[35]

At first glance this case appears to create new law in New York, doing away with New York's previous holding in *Matter of Paczkowski v. Paczkowski,*[36] which concluded a non-biological mother does not have standing to seek custody or visitation. In *Paczkowski* the court held that the presumption of parentage does not arise for the non-gestational spouse in a same-sex marriage because there is no possibility that she is the child's biological parent. While it may be an indication of intent to be a parent, as would a non-biological parent's name

on a birth certificate, it does not create a legal parent-child relationship.

While it is true that many states have a "martial presumption of parentage," it is applied differently by the states. In New York, the marital presumption of parentage does not apply to same-sex couples. Therefore, had Kelly S. and Farah M. lived in New York, and conceived and given birth to their children in New York, the outcome of this case would have been vastly different. Kelly S. would have been denied visitation to the children she had helped to raise since their birth. Same-sex families be cautioned: Adoption is the only way to create a legal parent-child relationship that must be recognized in every state.

V. CONCLUSION

Marriage is a vital package of legal rights and responsibilities. Prior to our nation legalizing same-sex marriage, many states permitted same-sex couples to take part in commitment ceremonies or enter civil unions or registered domestic partnerships. These "marriage substitutes" do not afford the parties the same rights and responsibilities of a legal marriage, and may result in unforeseen consequences when a couple seeks to dissolve their relationship. It is time for states to pass legislation to mitigate these unexpected and unintended outcomes.

ENDNOTES

[1] *Obergefell v. Hodges*, 135 S. Ct. 2584 (2015).

[2] *Matter of Knopske*, 165 Misc. 2d 45, 626 N.Y.S.2d 701 (Surr. Ct. Erie Co. 1995).

[3] N.Y. EST. POWERS & TRUSTS LAW §5-1.4 (McKinney 2016).

[4] *Matter of Leyton*, 135 A.D.3d 418, 22 N.Y.S.3d 422 (1st Dept. 2016).

[5] *Id.*

[6] N.Y.L.J., July 13, 2015, at 1 col 2.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] www.artleonardobservations.com/tag/matter-of-mauricio-leyton.

[11] N.Y. DOM. REL. LAW §236B (McKinney 2016).

[12] *Id.*

[13] *Id.*

[14] *O'Reilly-Morshead v. O'Reilly-Morshead*, 50 Misc.3d 402, 19 N.Y.S.3d 689 (Sup Ct., Monroe Co. 2015).

[15] *Id.*

[16] *Id.*

[17] VT. STAT. ANN. tit 15, §1204[d] (2000).

[18] VT. STAT. ANN. tit 115 (2009).

[19] *DeLeonardis v Page*, 188 Vt. 94, 101 n 1, 998, (Vt. 2010).

[20] *Dickerson v Thompson*, 88 A.D.3d 121 (3d Dept. 2011).

[21] *Id.* at 124 n 2.

[22] *O'Reilly-Morshead v. O'Reilly-Morshead*, 50 Misc. 3d 402, 19 N.Y.S.3d 689 (Sup Ct., Monroe Co. 2015).

[23] In *Matter of Langan v. State Farm Fire & Cas*, 48 A.D.3d 76 (3d Dept. 2007) and *Langan v. St. Vincent's Hosp. of N.Y.*, 25 A.D.3d 90 (2d Dept. 2005), the Second and Third Departments noted that the parties had not married and, therefore, the surviving partner was not a "surviving spouse" for purposes of the application of New York's workers' compensation laws.

[24] *Matter of Langan v. State Farm Fire & Cas*, 48 A.D.3d 76, at 79 (3d Dept. 2007).

[25] *O'Reilly-Morshead v. O'Reilly-Morshead*, 50 Misc. 3d 402, 19 N.Y.S.3d 689 (Sup Ct., Monroe Co. 2015).

[26] *Id.*

[27] *Matter of Findlay*, 253 N.Y. 1 (1930).

[28] N.Y. DOM. REL. LAW § 24 and N.Y. FAM. CT. ACT § 417 (McKinney 2016).

[29] *Kelly S. v. Farah M.*, 139 A.D.3d 90, 28 N.Y.S.3d 714 (2d Dept. 2016).

[30] *Id.*

[31] *Id.*

[32] In *Kelly S. v. Farah M.*, 139 A.D.3d 90, 28 N.Y.S.3d 714 (2d Dept. 2016), the court noted that comity is one State's voluntary decision to defer to the policy of another. Such a decision may be perceived as promoting uniformity of decision, as encouraging harmony among participants in a system of co-operative federalism, or as merely an expression of hope for reciprocal advantage in some future case in which the interests of the forum are more critical.

[33] CAL. FAM. CODE § 7611.

[34] CAL. FAM. CODE § 297.5 [d].

[35] *Kelly S. v. Farah M.*, 139 A.D.3d 90, 28 N.Y.S.3d 714 (2d Dept. 2016).

[36] *Matter of Paczkowski v. Paczkowski*, 128 A.D.3d 968, 10 N.Y.S.3d 270 (2d Dept. 2015).

RELIGIOUS EXEMPTIONS AND SAME- SEX MARRIAGE DISCRIMINATION POST TRUMP

by

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After the election of Donald Trump as United States President, many on the religious right believed they would get someone to address their concerns and restore religious liberty, which they perceive to be severely eroded. By the same token, many on the left feared the loss of basic hard won rights for minorities, women and lesbian, bisexual, gay and transgen-dered (LBGT) community members as a result of the election. When the President's Religious Freedom Executive Order[1] was issued on May 4, 2017, which coincided with the date for the National Day of Prayer, many on the left were relieved because it did not contain any of the controversial provisions that they feared it would. On the other hand, many on the religious right viewed the Executive Order as a disappointment because the text did not accomplish very much at all.[2]

This paper examines the expectations of where the Trump administration policies as well as overall religious conservative policy agendas will move the debate between same-sex marriage and religious freedom.

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THE BATTLE TO ERADICATE DISCRIMINATION VS. RELIGIOUS LIBERTY

On June 26, 2015, the U.S. Supreme Court issued its long-awaited decision in the *Obergefell v. Hodges* case.[3] In this historic decision, the high court ruled that the constitution guarantees same-sex couples the same right to marry as heterosexual couples.[4] The decision was a long-sought victory for the LGBT community and its supporters.[5]

Fighting for equal rights with regard to marriage was one of the important battles gay rights advocates wanted resolved. However, there are still other issues. LBGT rights advocates are still concerned about, and fighting to end, discrimination in employment and public accommodations.[6] With some exception, sexual orientation is not a protected class at the federal level[7] and is also not a protected class in many states.[8] With recent announcements, including an executive order announcing that transgendered individuals will no longer be permitted in the military[9] and the Attorney General's amicus brief which argues that Title VII of the 1964 Civil Rights Act does not recognize sexual orientation as a protected class, it is apparent that gay rights advocates will not find support under the Trump administration for eradicating the discrimination that the LBGT community faces.

On July 21, 2014, President Obama signed an executive order which prohibits all federal branches and federal contractors from discrimination based on sexual orientation and gender identity.[10] While President Trump preserved this executive order, he eliminated the companion order that requires companies that contract with the federal government provide documentation of their compliance with various federal laws, including compliance with the executive order that prohibits discrimination on the basis of sexual orientation.[11] Although a federal court in Texas had enjoined the implementation of this executive order, the President's elimination of the order is seen as further proof of this administration's indifference towards the discrimination faced by the LBGT community.

HOBBY LOBBY AND ITS AFTERMATH

In *Burwell v Hobby Lobby,*[12] the U.S. Supreme Court determined that closely-held, for-profit corporations were considered "persons" for purposes of the Religious Freedom Restoration Act (RFRA). As such, they are entitled to exemption from federal laws that unduly burden their religious beliefs. In the aftermath of *Hobby Lobby,*[13] there was speculation about whether granting freedom of religion status to for profit corporations would result in discrimination towards racial minorities, women and/or gays.[14]

Shortly after the decision, the first test came. The state of Indiana Governor Mike Pence, signed a Religious Freedom Restoration Act Law (state RFRA) that included a provision giving for profit corporations the right to refuse service to anyone if that service violates the company's religious beliefs.[15] Although no prior state RFRA legislation contained such a provision, the U.S. Supreme Court's decision in *Hobby Lobby* declares that closely held corporations are "persons" within the meaning of RFRA and explicitly permits these for profit closely held corporations to assert claims of undue burden on religious freedom.[16]

By its language the Indiana law[17] was not limited solely to closely-held corporations. Instead, it could have applied to any corporation no matter what size. Additionally, the Indiana law, unlike other state RFRA laws, did not require state action in order to bring a claim of substantial burden on religion.[18]

There is speculation that the language in the Indiana legislation was inserted as a response to New Mexico's decision in the *Elane Photography v. Willock*[19] case. Although the studio argued that New Mexico's RFRA protected its actions of refusing to photograph a same-sex ceremony, the state Supreme Court held that RFRA did not apply "because the government was not a party."[20]

Protest against Indiana's law was swift and powerful.[21] Many of the largest corporations, including state-domiciled corporations, denounced it as discriminatory.[22] Governments such as the state of Connecticut and cities including San Francisco and Seattle also denounced the law and banned taxpayer monies from being used for

trips to Indiana.[23],[24] Under the weight of a firestorm of protest and pressure, Indiana's RFRA law was amended to remove the potentially discriminatory provisions.[25]

On the heels of the events in Indiana, Arkansas faced a similar situation. It initially passed a law that expanded the definition of "person" to include a business.[26] Arkansas governor, Asa Hutchinson, initially said he would sign the bill, but later announced his intention to veto it.[27] Notably, Arkansas corporate giant Wal-Mart announced its opposition[28] and a revised law that removed the reference to for profit businesses was subsequently signed into law.[29]

Several other states had religious freedom restoration acts pending, including North Carolina and Georgia, but the legislation was put on hold in light of the controversy in Indiana and Arkansas.[30]

According to the National Conference of State Legislators, twenty one states have passed their own religious freedom restoration act statutes (State RFRA) the most recent being Arkansas and Indiana which eventually passed modified and less controversial bills during 2015.[31]

OBERGEFELL DECISION AND INCREASED STATE RFRA CHALLENGES

After the decision in *Obergefell*, many in the religious community, particularly the religious right, began to wonder what would happen to their rights. At the same time, many in the LGBT community wanted assurance that they would not continue to be subject to discrimination.

After *Obergefell* the number of state RFRA bills being introduced intensified. Several states including Georgia,[32] North Carolina,[33] and Mississippi introduced bills.[34] The proposed language in the various bills protected the right to refuse to provide services that violate a person's religious beliefs. These services could conceivably include baking a cake for a same -sex marriage, performing in-vitro fertilization for a single woman, providing contraceptives to men or women, or holding a wedding rehearsal dinner for a same-sex couple. Kentucky, Georgia and North Carolina each faced heavy criticism and protest concerning their proposed bills[35] and in the end, the states passed less controversial state RFRAs.

On its face, some of the measures seemed innocent and appeared to contain standard language that a government shall not substantially burden a person's exercise of their religious belief unless there is a compelling government interest and the least restrictive means is used.[36] The difference between this legislation and similar legislation in prior years is the U.S. Supreme Court's decision in *Hobby Lobby* which stated that a "person" for purposes of the Federal RFRA includes a closely held corporation.

Mississippi's Religious Freedom Bill, H.B. 1523[37] was signed into law despite protests, including by the former First Lady Michelle Obama.[38] It is one of the broadest and includes a preamble ("Section 2") defining its purpose as protecting people with certain religious beliefs including those that believe marriage is between one man and one woman, that sexual relations are for marriage only, and that a person's sex is that which they were born with.[39]

Under Mississippi's bill, those who refuse to provide counseling, surgery, psychological services and the like related to sex reassignment or gender identity transitioning are protected from government action.[40] Also included are provisions protecting persons who provide certain services including florists, bakers, and a host of other wedding service providers.[41] Another broad provision addresses the controversial transgender bathroom issue. [42] Although a federal court declared this Mississippi RFRA law unconstitutional in July 2016,[43] an appeals court later lifted the preliminary injunction placed on the law's implementation stating that the plaintiffs did not have standing to bring the case.[44] The U.S. Supreme Court declined to review the decision.[45]

The cases that follow show the tension between the discrimination concerns of the LBGT community and the concerns of those who fear loss of religious freedom in their business or individual interactions when following their sincerely held religious beliefs.

SAME-SEX MARRIAGE DISCRIMINATION AND RELIGIOUS FREEDOM CASES

Elane Photography, LLC is a New Mexico corporation that specializes in photographing weddings. The couple that owns the company, the Huguenins, have a policy of not photographing events

that communicate messages contrary to the owners' religious beliefs. Elane Photography received a request from Vanessa Willock to have the studio photograph her commitment ceremony to her female partner. Because the studio owners believe that the bible teaches that marriage is between a man and a woman, the company stated that it would not photograph the same-sex commitment or wedding ceremony. Willock found another photographer, but in December 2006, she filed a claim with the New Mexico Human Rights Commission.[46]

The New Mexico Human Rights Act (NMHRA) states that it is an unlawful discriminatory practice for anyone to discriminate or refuse to offer its services to anyone on the basis of, *inter alia*, sexual orientation.[47] The arguments advanced by Elane Photography are similar to those that were later raised in a number of the cases that follow. First, the photography studio argued that it did not discriminate against Willock based on sexual orientation. The Company stated that it would happily photograph gay customers, but not in a context that endorses same-sex marriage. However, the court citing *Christian Legal Soc'y v. Martinez,*[48]stated it was a distinction without merit. Discrimination based on same-sex marriage is equivalent to discrimination based on sexual orientation.[49] As a commercial business that sold goods and services to the public at large, failure to photograph same-sex marriage ceremonies violated state public accommodation laws in the same way as if it had refused to photograph a wedding between people of different races.[50]

Elane's argument that it would willingly offer some photography services, just not a wedding or commitment ceremony, was also rejected. The court analogized it to offering a full menu of goods or services to some and a limited menu of services (appetizers only) to others.[51]

Next, Elane argued that the NMHRA violates the owners First Amendment free speech rights by compelling her to speak by photographing a same-sex wedding with which she disagrees. Elane argued that photography entails expressive speech. However, the court noted that Elane was not required to publicly speak a specific government message. She did not have to display a specific message or even take photographs. Citing *Rumsfeld v. Forum for Academic & Institutional Rights, Inc.*,[52] the court stated that if her business is open to the public she cannot discriminate against certain clients on the

basis of their sexual orientation; and this, the court noted, is different than compelled speech.

The photography studio, the court stated, is not being compelled to facilitate a message that same-sex marriage deserves celebration and approval. It would be different, noted the court, if the studio was required to include photographs of same-sex couples in its advertisements or to display them in its studio.[53]

The court distinguished between a for profit business that is a public accommodation and privately organized parades or private membership organizations such as in *Hurley v. Irish-Am. Gay, Lesbian & Bisexual Grp. of Boston*[54]or *Boy Scouts of Am. v. Dale*,[55]respectively. In the case at hand, it would not be likely that observers would think that Elane Photography's pictures are an endorsement of same-sex marriage or that pictures of a same-sex wedding reflect the views of the studio or the owners. Whereas in the parade context such as Hurley, those watching might think this is the message of the parade organizers.

To Elane's argument that there should be an exemption from anti-discrimination laws for professions that involve creative or expressive conduct, the court gave the example of a Klan member who refuses to photograph an African-American customer's wedding, graduation, newborn child or any other event that would cast that family in a positive light or be interpreted as endorsing African-Americans. That studio would also be a commercial enterprise and a public accommodation prohibited from discriminating on the basis of race or other protected classifications. On the other hand, an African American could decline to photograph a Klan rally since political views and political group membership in organizations such as the Klan are not protected classes.[56]

Finally, although New Mexico also has a RFRA statute (NMRFRA),[57] the court held that it was inapplicable to this case because it does not apply to a suit between private parties. Rather, it applies where the government is a party which was not the case here.[58]

In a concurring opinion, Justice Richard Bosson wrote that the photographers are "compelled by law to compromise the very religious beliefs that inspire their lives. Though the rule of law requires it, the result is sobering… " He went on to say that:

> The Huguenins [the owners] are free to think, to say, to believe, as they wish; they may pray to the God of their choice and follow those commandments in their personal lives wherever they lead…But there is a price, one that we all have to pay somewhere in our civic life.[59]

In a similar case, *Craig v. Masterpiece Cake Shop*, a baker refused to bake a cake for a gay couple's wedding.[60] The baker believes that decorating cakes is a form of art, that he uses to honor God through his artistic talents, and that he would displease God by creating cakes for same-sex marriages."

The Colorado Civil Rights Commission ruled for the couple finding discrimination based on sexual orientation under the Colorado Anti-Discrimination Act. Phillips, the baker, appealed to the Colorado Court of Appeals. That court upheld the Commissions finding of sexual orientation discrimination by a place of public accommodation. In its ruling the court stated that "*Masterpiece* does not convey a message supporting same-sex marriages merely by abiding by the law and serving its customers equally.[61,62]" The Colorado Supreme Court refused to hear the appeal.[63] However, the U.S. Supreme Court granted *certiorari.*[64] *O*ral arguments were heard on December 5, 2017 in addition todiscussing on artistic expression[65] and compelled speech,[66] Justice Kennedy specifically raised the issue of tolerance and respect, including for religious beliefs.[67] The Department of Justice (DOJ) filed an amicus brief in which it stated that forcing Phillips to create expression for, and participate in, a ceremony that violates his sincerely held religious beliefs is an intrusion on his First Amendment rights and application of the public accommodations to Phillips is barred by the First Amendment.[68]

In *Matter of Gifford v. McCarthy,*[69] the New York Supreme Court determined that the owners of a farm violated the state's Human Rights Law when they told Melissa and Jennifer McCarthy that, although the farm was available to the public as a wedding venue, the Giffords would "not hold same-sex weddings." The fines and restitution imposed on the Giffords, totaling $13,000 were upheld and the Giffords were ordered to cease and desist from violating New York's nondiscrimination law. Allegedly, the Giffords stopped hosting

any weddings on the property, rather than provide same-sex weddings as well as heterosexual weddings.[70]

In *State of Washington v. Arlene's Flowers,*[71] Stutzman, a 70 year old florist in the state of Washington refused to provide flowers for a same-sex wedding. After passage of a same-sex marriage law in the state in 2012, a long-time friend and customer who had been in a committed same-sex relationship for eight years came to Stutzman's flower shop in 2013 and asked her to provide flowers for his upcoming same-sex wedding. Stutzman had known this man and had done business with him for about nine years. However, she told him she could not do the flowers for his wedding because of her religious beliefs.

Eventually, the Attorney General of Washington State as well as the two men sued Stutzman in her individual capacity as well as the corporation, Arlene's Flowers and Gifts for violating the state's anti-discrimination laws.[72] As a result of these lawsuits, Stutzman stood to lose her business, her home, and her personal savings.

In February 2017, the Washington Supreme Court ruled that Stutzman discriminated on the basis of sexual orientation, that free speech rights were not violated because the sale of flowers is not expressive conduct and the law was a rational law of general applicability that had a rational basis and therefore had to be followed.[73] Stutzman argues that because she provides flowers no matter the person's sexual orientation, she cannot be liable for sexual orientation discrimination for failing to provide flowers for same-sex marriage ceremonies.[74] Similar to the ruling in *Elane Photography*, the court reiterated the principal that a tax on yarmulkes is a tax on Jews[75]when it stated that "there cannot be a distinction between status and conduct fundamentally linked to that conduct."[76]

With regard to expressive conduct, Stutzman states that she would have been glad to provide the couple with bulk flowers, but arranging the flowers is using her artistic skills and the WLAD statute impermissibly compels her to speak in favor of same-sex marriage.[77]

Two requirements are needed in order to protect conduct as speech. First, there must be an intent to covey a particular message and second, it's likely that people who viewed it would understand that message.[78] Here, an outside observer would not reasonably understand that providing flowers for a wedding expresses support for same-sex

weddings, just as providing flowers for a Muslim or Jewish wedding would not necessarily be an endorsement of Islam or Judaism.[79]

Like *Elane Photography*, Stutzman also argued that there is no compelling government interest in applying the anti-discrimination statute (WLAD) to her since there are other florists that are willing to serve the same-sex couple. The court explains that "the issue is no more about access to flowers than civil rights cases in the 60's were about sandwiches."[80] Instead, public accommodation laws are not simply about access to services. Rather, they serve a bigger purpose which is eradicating barriers to equal treatment of all citizens in the marketplace.[81]

Lexington Fayette Urban Cnty. Human Rights Comm'n v. Hands On Originals, Inc.[82] is a more recent example. Hands On Originals prints customized t-shirts and other items. The Gay and Lesbian Services Organization (GLSO) is a support network and advocacy group for gay, lesbian, bisexual or transgendered individuals. In 2012, GLSO, through its president, attempted to order t-shirts for an upcoming gay pride festival. One of the store owners stated that he could not promote that message which advocated "pride in being homosexual" because of his religious beliefs and therefore, would not design the t-shirts for the festival. The Human Rights Commission ruled that the action was discriminatory in violation of the state public accommodations law.[83] But, both the Kentucky Circuit Court and Appeals Court ruled that the ordinance was unconstitutional as applied to Hands On Originals. The Appeals Court explained that the company was not refusing to design the shirts because the person is of a specific orientation or gender identity. Here, the president who tried to place the order was not same-sex oriented, but heterosexual.[84] Instead, the majority states the t-shirts were an example of pure speech and not conduct closely associated exclusively or predominately with persons of a protected class.[85] The court determined that the company had the right not to promote this pure speech or message because the public accommodations statute does not prohibit the company from engaging in viewpoint censorship.

The case is also noteworthy for its concurring opinion, where a court for the first time noted that *Hobby Lobby* as well as the Kentucky RFRA statute provides protection against laws such as the accommodations statute that substantially burden the free exercise of religion.[86] The concurring opinion stated that the company did not

refuse to print the shirts because people were members of protected classes, but because printing the t-shirts would violate the owners sincerely held religious convictions.[87] It remains to be seen whether other courts will follow similar reasoning and whether a court will rule that religious liberties under *Hobby Lobby* outweigh discrimination statutes.

CONCLUSION

The decision in *Obergefell* did not eradicate the discrimination the LBGT community faces. Similarly, state RFRA laws and the *Hobby Lobby* decision did not eliminate the issues faced by business owners with sincerely held religious beliefs. In the *Hobby Lobby* decision, the majority stated that its decision to grant freedom of religion status to for profit corporations would not provide a shield to corporations to discriminate under the guise of religious freedom. The majority noted that "government has a compelling interest in providing equal opportunity to participate in the workplace without regard to race." But this did not provide reassurance to those concerned about discrimination based on sex or based on sexual orientation and gender identity.

Most courts have held that the businesses involved in these challenges are unlawfully discriminating in places of accommodation. But not all courts have reached that decision. The business owners have argued that to require them to provide services for same-sex marriages is compelled speech and a violation of the First Amendment. They have also argued that being against same-sex marriage is not equivalent to discrimination on the basis of sexual orientation. But the majority of courts have held that the business owners are not engaged in speech, but rather conduct and that conduct must comply with anti-discrimination statutes that require that all customers be treated equally. Also, sexual orientation is violated when same-sex marriage services are denied.

The battle lines have been drawn and the U.S. Supreme Court will likely provide when it decides the *Masterpiece* case.[88]

[1] Promoting Free Speech and Religious Liberty, Exec. Order No. 13,798, 82 Fed. Reg. 21,675 (May 4, 2017), *available at*: https://www.whitehouse.gov/the-press-office/2017/05/04/presidential-executive-order-promoting-free-speech-and-religious-liberty.

[2] Sarah Pulliam Bailey, *Many Religious Freedom Advocates are Actually Disappointed with Trump's Executive Order*, THE WASHINGTON POST (May 5, 2017), *available at*: https://www.washingtonpost.com/news/acts-of-faith/wp/2017/05/05/many-religious-freedom-advocates-are-disappointed-with-trumps-executive-order/?utm_term=.8341fe460b2c.

[3] *Obergefell*, 135 S. Ct. 2584 (2015).

[4] *Id*.

[5] Adam Liptak, *Supreme Court Ruling Makes Same-Sex Marriage A Right Nationwide*, NY TIMES (June 26, 2015), *available at*: http://www.nytimes.com/2015/06/27/us/supreme-court-same-sex-marriage.html?_r=0.

[6] Erik Eckholm, *Next Fight for Gay Rights: Bias in Jobs and Housing*, THE N.Y. TIMES (June 27, 2015).

[7] On April 4, 2017 the 7th Circuit issued a historic ruling that discrimination based on sexual orientation was protected by Title VII in *Hively v. Ivy Tech Community College of Indiana*, 853 F. 3d 339. (7th Cir 2017). *But see, Evans v. GA Regional Hospital*, 850 F. 3d. 1248 (11th Cir 2017) ruling that sexual orientation is not a protected class in a decision issued March 10, 2017 one month before *Hively*. *Christiansen v. Omnicom Group, Inc*., 852 F. 3d 195 (2nd Cir 2017) decided March 27, 2017, could proceed based on failure to conform to gender stereotypes but discrimination based on sexual orientation not covered by Title VII.

[8]Jennifer Callas, *Employment Discrimination: The Next Frontier for LGBT Community*, USA TODAY (August 1, 2015). In 28 states it is legal to fire someone based solely on their sexual orientation or gender identity, but 22 states have laws protecting workers from being fired based solely on sexual orientation or gender identity, *available at*: https://www.usatoday.com/story/news/nation/2015/07/31/employment-discrimination-lgbt-community-next-frontier/29635379/.

[9] Julie Hirschfield Davis and Helene Cooper, *Trump Says Transgender People Will Not Be Allowed in the Military*, THE N.Y. TIMES (July 26, 2017), *available at*: https://www.nytimes.com/2017/07/26/us/politics/trump-transgender-military.html.

[10] Exec. Order No. 13,672, 3 C.F.R. 282 (2014).

[11]Revocation of Federal Contracting Executive Orders, Exec. Order No. 13,782, 82 Fed. Reg. 15,607 (March 27, 2017).

[12] 134 S. Ct. 2751, 189 L.Ed.2d 675 (2014).

[13] *Id*.

[14] *Adam Liptak, Ruling Could Have Reach Beyond Issue of Contraception,* NY TIMES *(*March 27, 2014).

[15] S.B. 101, 119th Gen. Assemb., 1st Reg. Sess. (Ind. 2015) (revised after passage).

[16] The law did not specifically address whether closely-held corporations were protected under the First Amendment's free exercise clause. The decision was limited to whether the corporations were considered persons entitled to exercise a religious belief.

[17] Garrett Epps, *What Makes Indiana's Religious Freedom Law Different?* THE ATLANTIC (March 30, 2015), *available at*: http://www.theatlantic.com/politics/archive/2015/03/what-makes-indianas-religious-freedom-law-different/388997/.

[18] S.B. 101, Specifically, the Indiana law provided: *"*A person whose exercise of religion has been substantially burdened, or is likely to be substantially burdened, by a violation of this chapter may assert the violation or impending violation as a claim or defense in a judicial or administrative proceeding, *regardless of whether the state or any other governmental entity is a party to the proceeding*." (emphasis supplied).

[19] 309 P. 3d 53 (N.M. 2013), *cert. denied*, 134 S. Ct. 1787, 188 L. Ed. 2d. 757 (2014).

[20] *Id*. at 77.

[21]Cara Anthony, *Thousands in Indy Protest Religious Freedom Law*, INDIANAPOLIS STAR (March 28, 2015), *available at*: http://www.indystar.com/story/news/2015/03/28/hundreds-in-indy-protest-rfra-law/70594058/.

[22] Thompson Wall, *Businesses Take a Stand Against Indiana's Religious Freedom Restoration Law*, INC. (March 30, 2015), *available at*: http://www.inc.com/thompson-wall/indianas-new-religious-freedom-act-deterring-big-business.html.

[23] Kristin Toussaint, *Connecticut is First State to Take Stand Against Indiana's Religious Freedom Law*, THE BOSTON GLOBE (March 30, 2015) *available at*: http://www.boston.com/news/nation/2015/03/30/connecticut-first-state-take-stand-against-indiana-religious-freedom-law/bT5FS9bPb5fwOhEspMVFdI/story.html.

[24] *Id*.

[25] IND. CODE §34-13-9-0.7 (2015). The revised language states that no "provider…may deny service to anyone on the basis of race, color, religion, ancestry, age, national origin, disability, sex, sexual orientation, gender identity or United States military service. *See also*, Wesley Lowery, *Governor Pence Signs Revised Indiana Religious Freedom Bill Into Law*, THE WASHINGTON POST (April 2, 2015), *available at*: http://www.washingtonpost.com/news/post-nation/wp/2015/04/02/gov-pence-signs-revised-indiana-religious-freedom-bill-into-law/.

[26] The Religious Freedom Restoration Act, H.R. 1228, 90th Gen. Assemb., Reg. Sess. (Ark. 2015).

[27]Mark Berman, *Arkansas Lawmakers Approve Religious Liberty Bill Despite Firestorm Over Indiana Law*, THE WASHINGTON POST (March 31, 2015), *available at*: http://www.washingtonpost.com/news/post-nation/wp/2015/03/31/after-a-firestorm-over-indianas-religious-law-is-arkansas-next/.

[28] *Id*.

[29] S. 975, 90th Gen. Assemb., Reg. Sess. (Ark. 2015).

[30]Sandhya Somashekhor and Mark Berman, *Indy. To 'Clarify' New Law Decried As Anti-Gay*, THE WASHINGTON POST (March 30, 2015), *available at*: https://www.washingtonpost.com/politics/indiana-to-clarify-religious-liberties-law-decried-as-anti-gay/2015/03/30/1d918698-d6fc-11e4-b3f2-607bd612aeac_story.html?utm_term=.dd6a624d3a48.

[31] National Conference of State Legislators, *Existing Religious Freedom Restoration Acts (as of 2015)*, http://www.ncsl.org/research/civil-and-criminal-justice/state-rfra-statutes.aspx#. *See also*, Brownstein, *State RFRA Statutes and Freedom of Speech*, 32 U.C. Davis L. Rev. 605 (1999)
noting the following states as having State RFRA statutes *See,* Alabama Religious Freedom Amendment, S. 604, 1998 Reg. Sess. (Ala. 1998); New Jersey Religious Freedom Act, A. 903, 208th Leg., 1998 Sess. (N.J. 1998); New Jersey Religious Freedom Restoration Act, S. 321, 208th Leg., 1998 Sess. (N.J. 1998); Virginia Religious Freedom Protection Act, H.R. 668, 1998 Sess. (Va. 1998); Religious Freedom Protection Act, A. 1617, 1997-98 Reg. Sess. (Cal. 1997) (vetoed following enactment); Religious Freedom Restoration Act of 1998, H.R. 3201, 1998 Reg. Sess. (Fla. 1997); Religious Freedom Restoration Act, H.R. 2370, 90th Leg., 1997-98 Reg. Sess. (Ill. 1997); Religious Freedom Restoration Act, S. 1591, 90th Leg., 1997-98 Reg. Sess. (Ill. 1997); Michigan Religious Freedom Restoration Act, H.R. 4376, 89th Leg., 1997 Reg. Sess. (Mich. 1997); Religious Freedom, H.R. 1470, 155th Leg., 2d Sess. (N.H. 1997); Religious Freedom Restoration, S. 5673, 220th Leg., 1997-98 Reg. Sess. (N.Y. 1997); Religious Freedom Restoration Act, R.I. Gen. Laws § 42-80.1-3 (R.I. 1997); South Carolina Religious Freedom Restoration Act, H.R. 5045, 112th Leg., 1997 Reg. Sess. (S.C. 1997).

[32] Ga. Religious Freedom Restoration Act, S. 129 Gen. Assemb., Reg. Sess. (Ga. 2015).

[33] N.C. Religious Freedom Restoration Act, H.R. 348, Gen. Assemb., Reg. Sess. (N.C. 2015), *available at*:
http://www.ncleg.net/Sessions/2015/Bills/House/PDF/H348v0.pdf.

[34]Miss. Protecting Freedom of Conscience From Government Discrimination Act, H.R. 1523, Gen. Assemb., Reg. Sess. (Miss. 2016), *available at*:
http://billstatus.ls.state.ms.us/documents/2016/html/HB/1500-1599/HB1523PS.htm.

[35] For example, ***many large corporations including*** Microsoft, Google, Coca-Cola, Home Depot and the Atlanta Falcons opposed the Georgia bill. Also, the NFL warned that passage of the bill could impact Atlanta's bid to host the Superbowl the following year. *See*, AP, *NFL Warns State of Georgia Over Religious Freedom Bill*, CBS NEWS (March 20, 2016), *available at* http://www.cbsnews.com/news/nfl-warns-state-of-georgia-over-religious-freedom-bill/.

[36] *See, e.g.*, Georgia Religious Freedom Restoration Act.

[37] Miss. Protecting Freedom of Conscience From Government Discrimination Act.

[38]Carly Hoilman, *Michelle Obama Criticizes Mississippi 'Religious Freedom Bill' In Commencement Speech*, THE BLAZE/AP (April 24, 2016), *available at*:
http://www.theblaze.com/stories/2016/04/24/michelle-obama-criticizes-mississippi-religious-freedom-bill-in-commencement-speech/.

[39] Miss. Protecting Freedom of Conscience From Government Discrimination Act.

[40] *Id*.

[41] *Id*.

[42] *Id*. The law includes language that protects procedures concerning access to restrooms, spas, baths, showers, dressing rooms, locker rooms, or other intimate facilities or settings, based upon or in a manner consistent with a sincerely held religious belief.

[43] *Barber v. Bryant*, 193 F. Supp. 3d 677 (S.D. Miss, N.D. June 30, 2016).

[44] *Barber v. Bryant*, 860 F. 3d. 345 (5th Cir. 2017), *cert. denied*, 583 U.S. ____ (2018).
[45] *Id*.
[46] *Elane Photography*, 309 P.3d at 59–60.
[47] Unlawful Discriminatory Practice, N.M. STAT. ANN. § 28-1-7 (1978). Specifically, the statute makes it unlawful for any person in any public accommodation to make a distinction, directly or indirectly, in offering or refusing to offer its services, facilities, accommodations or goods to any person because of race, religion, color, national origin, ancestry, sex, sexual orientation [or] gender identity.
[48] 561 U.S. 661, 689 (2010).
[49] *Elane Photography*, 309 P.3d at 62.
[50] *Id*. at 58.
[51] *Id*. at 62.
[52] 547 U.S. 47 (2006).
[53] *Elane Photography* at 68-69.
[54]515 U.S. 557 (1995).
[55] 530 U.S. 640 (2000).
[56] *Id*. at 72.
[57] N.M. STAT. ANN. §§28-22-1to -5 (2000).
[58] *Id*. at 76 (the statute provides that "A *government agency* shall not restrict a person's free exercise of religion unless…" (emphasis supplied).
[59] *Id.* at 79 (Bosson, R., concurring).
[60] 370 P. 3d 272 (Colo. App. 2015), *cert denied sub nom. Masterpiece Cake Shop v. Colorado Civil Rights Comm.,* No. 2015SC738, 2016 LEXIS 429 (Apr. 25, 2016), *cert granted*, 137 S. Ct. 2290, 198 L. Ed. 2d 723 (June 2017).
[61] *Id.* at 287.
[62] *Id.* at 282. The court distinguished *Masterpiece* from the bakeries involved in *Azucar Bakery, Le Bakery Sensual, and Gateaux, Ltd.,(internal citations omitted)* noting that they did not discriminate against a Christian patron by refusing his requests to create bible-shaped cakes inscribed with messages, including "Homosexuality is a detestable sin. Leviticus 18:2." The bakeries refused the requests because the message was offensive.
[63] *See Masterpiece Cake Shop*, No. 2015SC738 (April 25, 2016).
[64] *Masterpiece*, 137 S. Ct. 2290.
[65] Oral Argument at 7:49, *Masterpiece*, 137 S. Ct. 2290(2017) (No. 16-111), *available at* https://www.supremecourt.gov/oral_arguments/audio/2017/16-111.
[66] *Id*. at 1:40.
[67] *Id*. at 50:33.
[68] Brief for the United States as Amici Curiae Supporting Petitioner at 7, *Masterpiece*, 137 S. Ct. 2290(2017) (No. 16-111), *available at* https://www.documentcloud.org/documents/3988504-SGbriefmasterpiece.html.
[69] 137 A.D. 3d. 30, 23 N.Y.S. 3d. 422 (N.Y. App. 2016).
[70] Sunnivie Brydum, *N.Y. Supreme Court: Upstate Farm Can't Refuse Same-Sex Weddings*, ADVOCATE (Jan. 14, 2016) *available at*: http://www.advocate.com/marriage-equality/2016/1/14/ny-supreme-court-upstate-farm-cant-refuse-same-sex-weddings.
[71] 389 P. 3d. 543 (Wash. 2017).

[72] The suit alleged violation of Washington Law Against Discrimination (RCW ch. 49.60.215) as well as violation of The Consumer Protection Act (RCW ch. 19.86).
[73] *Arlene's Flowers, 389 P 3d.* at 557.
[74] *Id.* at 552.
[75] *Id. at* 553 *(citing, Bray v. Alexandria Women's Health Clinic, 506 U.S. 263, 270* (1993)).
[76] *Id.*
[77] *Id.* at 550, 556.
[78] *Id*. at 557 (*citing Spence v. Washington*, 418 U.S. 405,410-11 (1974) (per curiam)).
[79] *Id.*
[80] *Id*. at 566.
[81] *Id.*
[82] No. 2015-CA-000745-MR, 2017 Ky. App. LEXIS 371 (Ky. Ct. App. May 12, 2017).
[83] Id. at *2 (discussing Local Ordinance No. 201-99 §2-33 ("Fairness Ordinance")).
[84] *Id*. at *6-7.
[85] *Id.*
[86] *Id.* at *8.
[87] *Id*.
[88]Only one gay rights case has been decided by the U.S. Supreme Court post-*Obergefell* and the decision may give us a glimpse at how the court might rule in *Masterpiece*. In *Pavan v. Smith*, the court ruled that states are required to list the same-sex couple on the birth certificate and that the constitution protects the rights of same-sex couples related to marriage. *Pavan v. Smith*, 137 S. Ct. 2075, 198 L. Ed. 2d. 636 (2017), (6-3 decision) (per curiam).

THE FUTURE OF FATCA: CONCERNS AND ISSUES

by

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I. INTRODUCTION

Globalization and technological advancements have contributed to one of the more serious issues in the United States – offshore tax evasion.[1] While it is difficult to estimate the exact amount of revenue losses from offshore tax schemes, the U.S. loses approximately $100 billion per year from offshore tax evasion.[2] This problem was highlighted in 2009 when Switzerland's largest bank, UBS AG, admitted to defrauding the United States by impeding the Internal Revenue Service's (IRS) tax revenue collection from U.S. taxpayers and paid $780 million in fines, interest, penalties and restitution to the U.S.[3] As of 2016, eighty Swiss banks paid more than $1.3 billion in penalties to the U.S. in settlements involving more than 34,000 accounts that held as much as $48 billion.[4]

The U.S. responded to the global problem of offshore tax evasion by enacting the Foreign Account Tax Compliance

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Act (FATCA)[5] into law under section 501(a) of the Hiring Incentives to Restore Employments Act (HIRE), even though the U.S. had many successful attempts at reigning in the foreign banks that facilitated offshore tax evasion.[6] The general purpose of the HIRE Act was to provide tax breaks to small businesses that hire unemployed workers. [7] FATCA was designed to authorize the IRS to collect taxes on American income hidden in foreign nations.[8]

The substantial costs associated with FATCA compliance has proven to be a burden for many foreign financial institutions.[9] Instead of punishing shifty taxpayers and corporations, the IRS misguidedly has placed practically the entire burden on Americans living abroad and on the foreign financial institutions where Americans invest and keep their money. FATCA affects all U.S. citizens who own a foreign financial account, including banking and investment accounts, regardless of where they reside.[10]

This article will examine FATCA through presentations of the: (1) pertinent background that gave rise to the law; (2) essential elements of FATCA; and (3) analysis of the relevant human rights, constitutional and security arguments against FATCA.

II. BACKGROUND

Although U.S. taxpayers had been hiding income offshore for years, the IRS historically had little success finding such income[11]. The primary reason for this failure was that foreign financial institutions (FFIs) didn't report any

information to the IRS. Occasionally, the IRS became aware of an offshore account,[12] but the U.S. taxpayers were effectively on the honor system. Given what has happened since 2007[13], it would appear that many U.S. taxpayers with offshore accounts have not been very honorable.

The loss of revenue supports the argument that offshore tax evasion is a crucial issue facing the U.S. Large sums of money are squirreled away in tax haven jurisdictions such as Aruba, the Cayman Islands and Dubai, whose laws allow some U.S. citizens to evade paying U.S. income taxes.[14] 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.[15]

To detect tax evasion, the IRS pursued U.S. citizens with undeclared bank accounts in foreign banks.[16] But these efforts were largely unsuccessful because FFIs did not fully report U.S. account holders' information.[17] This allowed U.S. citizens to avoid taxes on passive income, including interest, dividends and capital gains by not reporting this income to the IRS.[18]

A. Detecting Tax Evasion: OVCI and QI

During the period 1999 to 2003, two noteworthy events occurred. First, the IRS started to pursue offshore accounts when it (1) obtained credit card data from John Doe summons, [19] and (2) offered its first offshore voluntary compliance initiative (OVCI) in 2003.[20] The OVCI resulted in around 1,300 individuals identifying themselves to the IRS with approximately $75 million collected through July 2003.[21] The knowledge obtained by the IRS from pursuing various

John Doe summons and structuring the OVCI greatly aided the IRS when it pursued offshore accounts in Switzerland starting in 2008.[22]

The second event occurred on January 1, 2001, which was the date the U.S. implemented the Qualified Intermediary (QI) system.[23] Prior to 2001, FFIs did not: (1) collect U.S. tax documentation with respect to any taxpayers; (2) withhold U.S. tax, (3) file information returns with the IRS; or (4) submit to IRS examinations. As a result: (1) a U.S. taxpayer could invest in U.S. source assets with an FFI but the FFI was not required to report anything to the IRS;[24] and (2) U.S. banks were not obtaining adequate documentation from FFIs to document a reduced U.S. withholding tax rate on payments to foreign customers of such FFIs.[25]

By implementing the QI system, the IRS was attempting to address these two problems. As a result, the QI system required QIs to identify their customers. If they were foreign customers, the QI could keep the identity of the customer secret as long as the correct amount of U.S. withholding tax was collected. For U.S. customers, the QI was required to report to the IRS any U.S. source income. To keep the QIs honest, the QI system required an audit by either the IRS or an independent auditor.[26]

While the QI system was a major advancement when compared to the pre-2001 tax evasion environment, it became apparent that it wasn't working well at preventing U.S. taxpayers from using offshore accounts to avoid U.S. taxes. There were several major loopholes that U.S. taxpayers exploited in order to avoid reporting income to the IRS.[27]

The loopholes of the QI system were: (1) that foreign source income was not required to be reported; (2) there was

no requirement to determine the beneficial owner; (3) that FFIs were allowed to exclude certain customers from the QI system; and (4) the QI audit was not really an audit but rather a list of procedures that needed to be performed.[28] These loopholes were on the minds of the IRS, the U.S. Treasury and the U.S. Congressional staff when they proposed and drafted FATCA in 2009 and 2010 in light of the LGT and UBS scandals.[29]

B. The Liechtenstein Global Trust and Union Bank of Switzerland Tax Evasion Scandals

In February 2008, it was publicly disclosed that German tax authorities had purchased customer account information from an employee at the Liechtenstein bank of LGT. This bank had close ties to the Liechtenstein royal family. Apparently, the German tax authorities had shared the information with nations around the world and the IRS initiated an enforcement action against over 100 U.S. taxpayers with offshore accounts at LGT.[30]

In May 2008, an even bigger scandal erupted when the U.S. arrested Bradley Birkenfeld, a former UBS banker who pleaded guilty one month later to assisting U.S. taxpayers evade U.S. tax by using offshore accounts. Birkenfeld's guilty plea included all types of spy-like techniques used by Birkenfeld and his colleagues to avoid U.S. detection. These spy-like techniques included encrypted computers, code words, smuggling diamonds in toothpaste tubes and more.[31]

Reports indicate that Bradley Birkenfeld came forward under the IRS's whistleblower program in 2007 and had been disclosing information to the IRS for several months. However,

he failed to disclose to the IRS and the Justice Department information concerning his largest account, Igor Olenicoff. As a result, despite blowing the whistle on UBS, Birkenfeld was prosecuted and received a sentence of forty months.[32]

On June 30, 2008, the IRS filed a John Doe summons with the U.S. District Court for the Southern District of Florida, requesting that UBS disclose to the IRS all of its U.S. customers that may have been avoiding the payment of U.S. tax. One day later, UBS refused to comply with the summons arguing that under Swiss bank secrecy law, they were not permitted to disclose customer information.[33]

In July 2008, the U.S. Senate Permanent Subcommittee on Investigations (PSI) held publicized hearings on offshore accounts. At these hearings, IRS Commissioner Shulman gave testimony surrounding offshore accounts and the QI system: "Specifically, we are considering changes to the regulations to require QIs to look through certain foreign entities – such as trusts – to determine whether any U.S. taxpayers are beneficial owners. We are also considering a regulation to have QIs report U.S. taxpayers' worldwide income to the IRS in certain cases – not just U.S. source income."[34]

The PSI report found that LGT and UBS assisted U.S. clients in structuring their foreign accounts to avoid QI reporting to the IRS. The report also found that the IRS should broaden QI audits to require bank auditors to report evidence of fraud or illegality.[35] Since the QI system was created through Treasury regulations and FFI contracts, the IRS and the Treasury could have changed the QI rules without legislation. However, since there was a strong desire to impose withholding taxes on financial institutions that were not part of the QI, legislation was needed.[36] This is how FATCA would be conceived.

In August 2009, the IRS and UBS ultimately settled the John Doe summons instead of allowing the Court to decide the conflicts of law issue between U.S. and Swiss law. UBS agreed to disclose information on approximately 4,450 U.S. customers.[37] But given the loopholes and issues surrounding the QI system, there was general agreement among senior IRS officials that something had to be done. This is where FATCA came in.[38]

III. FATCA EPITOMIZED

In 2010, FATCA amended the Internal Revenue Code of 1986 by adding a new Chapter 4.[39] In order to enforce FACTA more easily, the U.S. entered into several intergovernmental agreements (IGA), whereby foreign governments agreed to collect the required information from financial institutions located in their nations and disclose that information to the IRS on an annual basis.[40] While FATCA has several focuses, the most pertinent facet of the law concern FFIs and IGAs.[41]

A. The FATCA Regulation of FFIs

An alarming aspect of FATCA for FFIs is the severe penalty associated with a violation. Any FFI that fails to meet the FATCA reporting requirements will be subject to a stringent 30% withholding tax on all payments of U.S. source income.[42] To avoid this penalty, an FFI must fall into one of two categories: (1) it has an agreement with the U.S. Treasury

Secretary; or (2) it meets certain criteria ensuring that it does not maintain financial accounts owned by one or more U.S. persons or U.S.-owned foreign entities.[43]

As discussed earlier, one of the major problems with the QI system was the ability of the QI to ignore customer accounts. One of the major FATCA design features was to require that a QI have procedures to identify all U.S. customers within the QI and potentially identify all U.S. customers in affiliated FFIs.[44]

For example, assume that a hypothetical foreign bank has 2 million customers throughout the world, but only 1% of such customers are U.S. persons and 2% of the foreign bank's customers have investments in the U.S. In this hypothetical example, FATCA requires the foreign bank to perform detailed customer due diligence procedures on its entire 2 million customer base in order to properly identify the 3% that could be directly impacted by FATCA. If the foreign bank did not perform this customer due diligence effectively, it could be subject to the penalty of 30% withholding tax on all payments of U.S. source income.

This leads to the next problem regarding the payment of the penalty. How would one determine whether a payment to an FFI is attributable to a withholdable payment? The IRS/Treasury has tentatively decided to apply a pro-rata approach.[45] So, if 20% of a FFI's worldwide assets are U.S. assets, then 20% of the non-U.S. source payments to an FFI or a recalcitrant account holder would be subject to the 30% withholding tax penalty. Needless to say, this would lead to a lot of administrative complexity, especially in cases where local laws may restrict the collection of withholding tax on payments that appear to be unrelated to the U.S.

As an alternative, the FFI may elect "to be withheld upon rather than withhold on payments to recalcitrant account holders and nonparticipating FFIs" If an FFI elects this alternative, the IRS will only withhold 30% of all withholdable payments to the FFI that are directly attributable to the recalcitrant account holder and nonparticipating FFI. [46] However, an FFI that elects this option will forfeit any rights it may have under any treaty with the U.S. with respect to any amount withheld as a result of such election – leading to a loss of significant earnings for the FFI even after the FFI has provided all of the lengthy, required information about the account holder.

FATCA also has some loopholes. A FFI does not have to report any depository accounts it maintains belonging to U.S. beneficiaries when the aggregate value of all accounts the FFI maintains is less than $50,000.[47] Nor does a FFI have to report any account held by another FFI that is in compliance with the FATCA reporting requirements. [48] Furthermore, the U.S. Treasury has chosen not to withhold the 30% penalty from FFIs if the beneficial owner is: (1) part of a foreign government; (2) part of an international agency; (3) a foreign central bank; or (4) anyone else whom the U.S. Treasury believes poses a low risk of tax evasion.[49] It is possible that some FFIs may use these loopholes to circumvent FATCA based on their connections and bargaining power.

B. Intergovernmental Agreements (IGAs)

FATCA requires that FFIs enter into agreements with the IRS that require the "participating" FFI to perform identification and due diligence procedures concerning account holders. [50] A different level of diligence is expected with

respect to individual accounts and entity accounts as well as between new and preexisting accounts.[51] FFIs that comply with the due diligence guidelines will be deemed to be compliant with the identifying requirement and not held to the strict liability standard.[52]

When the proposed regulations were released, the U.S. Treasury also released a joint statement with the British, French, German, Italian and Spanish governments regarding an intergovernmental approach that would allow the financial institutions of these nations to report the required FATCA information to their own governments. These respective governments would then report the data to the IRS.[53] The intergovernmental approach framework would include the elimination of the requirement of the FFI to negotiate a separate agreement with the IRS. The U.S. Treasury stressed that these IGAs are an alternative approach to obtaining the information required by FATCA, not an exception.[54] The European Commissioner of Taxation stated that the goal is to develop a Model Agreement that could be used by all of the Member Nations and ultimately lead to automatic information exchange between countries.[55]

The U.S. Treasury is engaged in active negotiations with a number of nations and jurisdictions so it is conceivable that FATCA will become the global standard.[56] More than 80 nations have signed on to the U.S. law.[57] One ramification of these IGAs is that in order for them to be productive, the U.S. will must also provide these nations with information on accounts held in U.S. financial institutions by the residents of these nations. On behalf of the U.S. Treasury, Assistant Secretary McMahon stated that "……bilateral solutions require reciprocity."[58] It is natural to speculate that such an undertaking may lead to information leaks.

The exchange process under FATCA is constantly changing and many are worried about the implications of this everchanging process.[59] There are many increased risks and costs associated with FATCA.

IV. FATCA ISSUES

The FATCA withholding tactics will only bring an estimated $1 billion of lost taxes back to the U.S.[60] While $1 billion may sound like a substantial amount, it pales in comparison to the estimated $99 billion of American taxes that will remain lost every year as well as the extremely high cost of FATCA compliance to FFIs.[61] The estimated cost of FATCA implementation is $100 million per financial institution.[62]

Industry experts estimate that about 900,000 FFIs are subject to FATCA, which means that the total cost of FATCA implementation of $90 billion will dramatically overcome its potential tax savings of $1 billion.[63] With an estimated success rate of 1% and the hefty costs placed on FFIs, many Americans may have their foreign bank accounts closed as a result of FATCA.[64]

FATCA has been met with accusations ranging from claims of unfair treatment, to human rights abuse, to constitutional issues to privacy and security leaks, from within the U.S. and abroad.[65]

A. Unfair Treatment

The nonprofit, nonpartisan, volunteer association with a caucus in Congress, American Citizens Abroad, stated in a letter to the Congressional Ways and Means Committee that it has "received multiple testimonies of Americans residing overseas who have had bank accounts in their country of residence closed, who have been denied entry into foreign pension plans and insurance contracts, who have had mortgages cancelled, who have been pushed off joint-bank accounts held with foreign spouses."[66]

Furthermore, American Citizens Abroad claims that Americans living abroad cannot easily withdraw their money from the closed foreign account and redeposit it with U.S. financial institutions because the Patriot Act discourages U.S. financial institutions from taking on clients living overseas.[67] So "the average American living abroad is shut off from all avenues for personal investment."[68]

In addition to being closed out from financial institutions, Americans living abroad may find it more difficult to become owners in new overseas business ventures due to FATCA's requirement that such ventures be reported to the IRS if at least 10% of the venture is owned by one or more Americans.[69]

B. Human Rights Abuse

In order to implement FATCA, Americans living abroad must be singled out on the basis of their national origin.[70] American Citizens Abroad believes FATCA forces FFIs and foreign governments to discriminate against Americans.[71]

While New Zealand is known for upholding human rights, its government officials have acknowledged their intention to displace human rights in order to comply with FATCA.[72] In a letter published by New Zealand's tax authority, Internal Revenue, the New Zealand government determined that violating the rights of U.S. persons was necessary, given the risk under FATCA of either being shut out of the U.S. investment market or facing the 30% withholding penalty associated with noncompliance.[73]

If FATCA does discriminate against Americans, it would be a violation of the Universal Declaration of Human Rights (UDHR),[74] which as adopted by the United Nations General Assembly in 1948.[75] The UDHR clearly states that no person shall be discriminated against on the basis of national origin and no distinction is made because of the nation a person comes from.[76]

A number of legal cases involving FATCA have already surfaced. In 2014, the Dutch Board for the Protection of Human Rights ruled against FATCA on the basis of nationality discrimination.[77] Also in 2014, several Canadian citizens filed a lawsuit against the Canadian Attorney General in Federal Court in Canada.[78] The Canadian plaintiffs hope to prevent the Canadian government from turning over private bank account information under FATCA from more than one million United States persons and their families who live in Canada.[79] In 2016, Rand Paul and several other plaintiffs filed a suit against the U.S. Treasury and other government agencies over foreign bank account reporting requirements under the Foreign Account Tax Compliance Act; however, an Ohio District Court judge dismissed this suit for lack of subject-matter jurisdiction under Fed. R. Civ. P. 12(b)(1), without prejudice.[80]

C. Constitutionality of IGAs

The U.S. Treasury began implementing IGAs with foreign nations when dealing with the difficulty of implementing FATCA overseas.[81] Since the U.S. Treasury is an administrative agency under the Executive branch, these IGAs are considered executive agreements.[82] Executive agreements are limited in scope; "according to the Restatement of Foreign Relations Law of the U.S., the President may validly conclude executive agreements that (1) cover matters that are solely within his executive power, or (2) are made pursuant to a treaty, or (3) are made pursuant to a legitimate act of Congress."[83]

IGAs were never mentioned as a proviso of the HIRE Act, so technically, the President has no power to form IGAs through the use of executive agreements; this means that the IGAs must go through the Senate treaty making process to legitimately bind the U.S.[84] But since the FACTA IGAs were never brought to the Senate, there is no statutory authorization under which the IRS may enter into them and they are not treaty-based amendments.[85] This indicates that the IGAs have no congressional authorization, which in turn means that they must be sole executive agreements.[86] If the IGAs are sole executive agreements, then they are not binding because the Executive branch does not have the power to enter into such agreements if they are to bind the U.S. globally.[87]

D. Privacy and Security Leaks

FATCA has caused Americans living abroad to be even more afraid of security risks when their personal financial information is reported by non-U.S. financial institutions or foreign government agencies to the IRS.[88] FATCA reporting will include: (1) the name, address and taxpayer identification number of each US account holder at the financial institution; (2) the account number; (3) account balance and value; (4) the account's gross receipts and gross withdrawals or payments; and (5) other account related information requested by the Internal Revenue Service (IRS).[89] The Treasury Inspector General for Tax Administration has voiced concerns with the security of data transmission as required by FATCA.[90]

In September 2014, the IRS issued a fraud alert to all international financial institutions that are complying with FATCA. Scam artists posing as the IRS have fraudulently solicited financial institutions seeking the identities of account holders as well as their financial account information.[91] Financial institutions registered to comply with FATCA, and those in jurisdictions that have an IGA in effect to implement the FATCA provisions through their local governments, have already been approached by parties impersonating themselves as the IRS. The IRS now has reports of incidents from various countries and continents.[92]

The issues of unfair treatment, human rights abuse, unconstitutionality and security are all reasons supporting the repeal of FATCA, especially since the costs of implementing FATCA far outweigh the benefits it may derive.

V. CONCLUSION

While tax evasion is an enormous problem, FATCA is not a solution to the problem. FATCA was primarily created to deal with the weaknesses of the QI system but it has turned out to be a case of overregulation that infringes upon the rights of Americans who live abroad. A strengthening of the QI system may have been enough to adequately address the issue of global tax evasion without the need to create a costly, massive piece of legislation that infringes on the rights of so many and may prove to be a threat to security.

Given the facts that (1) many Americans living abroad have been denied access into their foreign pensions, insurance contracts and bank accounts as a result of FATCA; (2) many Americans may be singled out on the basis of their national origin because of FACTA; (3) the constitutionality of FACTA may be questionable; and (4) scam artists have already obtained personal information about people as a result of the FACTA data transmission, it is clear that FACTA should be repealed.

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[1] *See* OFFSHORE COMPLIANCE INITIATIVE*,* U.S. DEP'T JUST., http://www.justice.gov.ez-pkw[http://perma.cc/U56J-R58J] (Combatting the serious problem of non-compliance with our tax laws by U.S taxpayers using secret offshore bank accounts is one of the Tax Division's top litigation priorities); *see also* Tracy A. Kaye, *Innovations in the War on Tax Evasion,* 2014 BYU L. REV. 363, 364-65 (2014).

[2] JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 1 (2015); Frederic

Behrens, *Using a Sledgehammer to Crack a Nut; Why FATCA Will Not Stand,* 2013 WIS. L. REV. 205, 211 (2013).

[3] Supra note 1.

[4] Kevin McCoy, *U.S. Slaps $1.3B in Penalties on Swiss Banks,* USA TODAY, January 27, 2016 (http://usat.ly/1ROpKw3).

[5] *See* MARNIN J. MICHAELS, INTERNATIONAL TAXATION P6.01[1] (2014) (FATCA is veiled as the funding mechanism for the Hiring Incentives to Restore Employment Act (HIRE Act)).

[6] *See* Kaye, *supra* note 1, at 364 (explaining that the U.S. behaved unilaterally by enacting FATCA in 2010).

[7] 156 Cong. Rec. S1745 (daily ed. Mar. 18, 2010) (statement of Sen. Levin).

[8] Background and Current Status on FATCA, LexisNexis.com (2014), Available at http://www-lexisnexis-com.ez-proxy.brooklyn.cuny.edu:2048/store/images/samples/9780769853734.pdf

[9] Marylouise Serrato, Comments – Financial Services Tax Reform Working Group, Ways & Means Committee (Apr. 4, 2013), available at http://waysandmeans.house.gov//uploadedfiles/american_citizens_abroad_wg_comments_3.pdf.

[10] 26 U.S.C. §§1471-1474 (2012).

[11] *See,* e.g., Letter from Henry Morgenthau, Jr., U.S. Sec'y of Treasury, to Franklin D. Roosevelt, President of U.S. (May 29, 1937), available at http://www.presidency.ucsb.edu/ws/index.php?pid=15413#axzzlqRIOpHZ8 (explaining why tax collections are less than expected). In this letter, Secretary Morgenthau explains that offshore accounts held by U.S. taxpayers are part of the problem.

[12] For example, the IRS occasionally became aware of an offshore account by a whistleblower such as a former spouse or business partner.

[13] *See*, e.g., Staff of S. Permanent Subcommittee on Investigations, Rep. on Tax Haven Banks & U.S. Tax Compliance 9 (July 17, 2008), available at http://www.hsgac.senate.gov/download/report-psi-staff-report-tax-haven-banks-and-us-tax-compliance-july-17-2008. Per the report, UBS had approximately 20,000 (aggregate value of approximately $18 billion) U.S. customers of which only 1,000 (5%) were declared accounts implying that 95% of UBS's accounts may have been evading U.S. tax laws.

[14] Frederic Behrens, Comment, Using a Sledgehammer to Crack a Nut: Why FATCA Will Not Stand, 2013 Wis. L. Rev. 205, 207 (2013).

[15] Shah, Anup. 2013. *Tax Avoidance and Tax Havens; Undermining Democracy.* GLOBAL ISSUES, Article 54.

[16] Id. at 207.
[17] Id. at 206.
[18] Behrens, supra note 16, at 206-07.
[19] *See* Offshore Credit Card Program (OCCP), Internal Revenue Service, http://www.irs.gov/newsroom/article/0,,id=105698.html (providing brief summary of IRS efforts in issuing John Doe summons surrounding credit cards); A John Doe summons is defined as "any summons where the name of the taxpayer under investigation is unknown and therefore not specifically identified." Internal Revenue Service, Internal Revenue Manual § 25.5.7.2 (2011), available at http://www.irs.gov/irm/part25/irm25-005-007.html.
[20] *See* IRS Unveils Offshore Voluntary Compliance Initiative; Chance for "Credit-Card Abusers" to Clear Up Their Tax Liabilities, Internal Revenue Service (Jan. 14, 2003), http://www.irs.gov/newsroom/article/0,,id=105689,00.html.
[21] *See* Offshore Compliance Program Shows Strong Results, Internal Revenue Service (July 30, 2003), http://www.irs.gov/newsroom/article/0,,id=111987,00.html (describing results of 2003 OVCI).
[22] *See* Foreign Account Tax Compliance Act (FATCA), U.S. Dep't of the Treas., http:///www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx (last updated June 9, 2014).
[23] Treas. Reg. § 1.1441-1(5) (2001).
[24] A U.S. taxpayer could also invest in non-U.S. source assets and avoid reporting, but failing to report income form U.S. source assets was significantly more troubling.
[25] Treas. Reg. § 1.1441-1(5) (2001).
[26] Treas. Reg. § 1.1441-1(5) (2001).
[27] J. Richard Harvey, Jr., *Taxation of Offshore Accounts: Insider's Summary of FATCA and Its Potential Future,* 57 Vill. L. Rev. 471, 475 (2012).
[28] Id. at 475.
[29] Id. at 476.
[30] *See* IRS and Tax Treaty Partners Target Liechtenstein Accounts, Internal Revenue Service (Feb. 26, 2008), http://www.irs.gov/newroom/article/0,,id=179387,00.html.
[31] *See* Bradley Birkenfeld: UBS Informant to Begin Prison Sentence Friday, Huffington Post (Mar. 28, 2010), http://www.huffingpost.com/2010/01/04/bradley-ubs-inn410753.html;

Former UBS Banker Sentenced to 40 Months for Aiding Billionaire American Evade Taxes, U.S. Department of Just. (Aug. 21, 2009), http://www.justice.gov.ez-proxy.brooklyn.cuny.edu:2048/opa/pr/2009/August/09-tax-831.html. Some argued that the Department of Justice was too tough on Birkenfeld but the message to future whistleblowers is clear: disclose everything you know, especially if your own hands aren't 100% clean.

[32] Id.

[33] *See* PSI Staff Report, Justice Department Asks Court to Serve IRS Summons for UBS Swiss Bank Account Records, U.S. Department of Justice (June 30, 2008), http://www.justice.gov.ez-proxy.brooklyn.cuny.edu:2048/tax/txdv08579.htm.

[34] Tax Haven Banks and U.S. Tax Compliance: Hearing before the Permanent Subcommittee on Investigations on Homeland Sec. and Governmental Affairs, 110th Cong. 61 (2008) (statement of IRS Comm'r Doug Schulman).

[35] Supra note 33.

[36] Supra note 33.

[37] J. Richard Harvey, Jr., *Taxation of Offshore Accounts: Insider's Summary of FATCA and Its Potential Future,* 57 Vill. L. Rev. 471, 475 (2012).

[38] Id.

[39] 26 U.S.C. §§1471-1474.

[40]FATCA – Archive, U.S. Dep't of the Treasury, http://www.treasury.gov/resource-center/tax-olicy/treaties/Pages/FATCA-Archive.aspx.

[41] 26 U.S.C. §§1471(a).

[42] 26 U.S.C. §§1471(a).

[43] 26 U.S.C. §§1471(a).

[44] I.R.C. § 1471(b)(1)(A).

[45] *See* I.R.S. Notice 2010-34, 2010-17 I.R.B. 612, at § II.

[46] 26 U.S.C. §§1471(b)(3)(C)(ii).

[47] Id. § 1471(d)(1)(B)(ii).

[48] Id. § 1471(d)(1)(C)(i)-(ii).

[49] Id. §1471(f)(3)(1)-(4).

[50] Id. §1471(b)(1)(A), (B).

[51] Treas. Reg. § 1.1471-4(c).

[52] *See* I.R.C. § 1471(a); *see* also I.R.C. § 1471(b)(1)(D)(i); I.R.C. § 1471(d)(7).

[53] Press Release, U.S. Dep't of Treasury, Joint Statement from the U.S., Fr., Ger., It., Spain and the U.K. Regarding an Intergovernmental Approach to Improving Int'l. Tax Compliance and Implementing FATCA (Feb. 8, 2012), available at http://www.treasury.gov/press-center/press-releases/documents/02071%20Treasury%20IRS%FATCA%20Statement.pdf
[54] Id.
[55] Alison Bennett, Semeta Says EU Member States Working Toward Uniform Model Pacts Under FATCA, BNA Daily Tax Rep., May 8, 2012, No. 88, at J-1.
[56] Press Release, U.S. Dep't of Treasury, U.S. Engaging with More than 50 Jurisdictions to Curtail Offshore Tax Evasion (Nov. 8, 2012), http://www.treasury.gov/press-center/press-releases/Pages/tg1759.aspx; *see* also Jeremiah Coder, Extensive FATCA Negotiations Underway, Treasury Announces, 137 Tax Notes 722 (2012).
[57] Robert W. Wood, Canadians File Suit to Block FATCA And Prohibit Handover of U.S. Names To IRS, Forbes (Aug. 12, 2014) https://www.forbes.com/sites/robertwood/2014/08/12/canadians-file-suit-to-block-fatca-and-prohibit-handover-of-u-s-names/#4b6cee3e1ed0.
[58] Press Release, U.S. Dep't of Treasury, Remarks by Acting Assistant Secretary Emily McMahon at the NY State Bar Association Annual Meeting (Jan. 25, 2012), available at http://www.treasury.gov/press-center/press-releases/Pages/tg1399.aspx.
[59] James O'Toole, JP Morgan: 76 Million Customers Hacked, CNN Money (Oct. 3, 2014), money.cnn.com/2014/10/02/technology/security/jpmorgan-hack/?iid=EL.
[60] Marylouise Serrato, Comments – Financial Services Tax Reform Working Group, Ways and Means Committee (April 4, 2013), available at http://waysandmeans.house.gov/uploadedfiles/american_citizens_abroad_wg-comment_3.pdf.
[61] Id.
[62] Robert Wood, FATCA Carries Fat Price Tag, Forbes (Nov. 30, 2011), available at http://www.forbes.com/sites/robertwood/2011/11/30/fatca-carries-fat-price-tag.
[63] Id.
[64] William Byrnes & Haydon Perryman, August FATCA GIIN List Analyzed by Byrnes and Perryman, International Financial Law Prof Blog (Aug. 1, 2014), http://lawprofessors.typepad.com.ez-proxy-

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[65] Marylouise Serrato, Comments – Financial Services Tax Reform Working Group, Ways & Means Committee (Apr. 4, 2013), available at http://waysandmeans.house.gov//uploadedfiles/american_citizens_abroad_wg_comments_3.pdf.

[66] Id.

[67] Id.

[68] Id.

[69] 26 U.S.C. § 1473(2)(A)(i)-(iii) (2012).

[70] Supra note 65.

[71] Peter Frawley, Legislation to Enable Compliance with an Intergovernmental Agreement Between the United States and New Zealand, Internal Revenue (Sept. 23, 2013), http://taxpolicy.ird.govt.nz/sites/default/files/2013-ris-arearm-bill-04.pdf.

[72] Id.

[73] Id.

[74] JOHANNES MORSINK, THE UNIVERSAL DECLARATION OF HUMAN RIGHTS, University of Pennsylvania Press (1999); "More than fifty years after its adoption it now is the moral backbone and the source of inspiration of a whole new branch of international law. From a time when there were virtually no international instruments concerned with the realization of human rights, the post-World War II era has seen the evolution of around two hundred assorted declarations, conventions, protocols, treaties, charters, and agreements, all dealing with the realization of human rights in the world. Of these postwar instruments no fewer of sixty-five mention in their prefaces or preambles the Universal Declaration of Human Rights as a source of authority and inspiration." (Morsink, 19-20); Henry J Steiner and Philip Alston, International Human Rights in Context: Law, Politics, Morals, (2nd Ed.), Oxford University Press, Oxford, 2000. Many international lawyers and legal scholars believe that the Universal Declaration of Human Rights forms part of customary international law.

[75] Universal Declaration of Human Rights Home Page, Office of the High Comm'r for Human Rights (Dec. 8, 1948), http://www.ohchr.org/EN/UDHR/Pages/Introduction.aspx.

[76] Article 2 of the Universal Declaration of Human Rights, United Nations (1948), available at http://www.ohchr.org/EN/UDHR/Pages/Introduction.aspx, states: "Everyone is entitled to all the rights and freedoms set forth in this Declaration, without distinction of any kind, such as race, color, sex, language, religion, political or other opinion, national or social origin, property, birth or other status. Furthermore, no distinction shall be made on the basis of the political, jurisdictional or international status of the country or territory to which a person belongs…."; Article 7 of the UDHR states, "All are equal before the law and are entitled without any discrimination to equal protection of the law. All are entitled to equal protection against any discrimination in violation of this Declaration and against any incitement to such discrimination."

[77] The Isaac Brock Society, Dutch Board for the Protection of Human Rights Rules against FATCA Nationality Discrimination, http://isaacbrocksociety.ca/2014/04/14/dutch-board-for-the-protection-of-human-rights-rules-against-fatca-nationality-discrimination/.

[78] James O'Toole, JP Morgan: 76 Million Customers Hacked, CNN Money (Oct. 3, 2014), money.cnn.com/2014/10/02/technology/security/jpmorgan-hack/?iid=EL..

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[81] Allison Christians, The Dubious Legal Pedigree of IGAs (and Why It Matters), 69 Tax Notes Intl'l 565, 567 (Feb. 11, 2013), available at http://papers.ssrn.com/ez-proxy-brooklyn.cuny.edu:2048/sol3/papers.cfm?abstract_id=2280508.

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[83] Michael D. Ramsey, Treaty Clause, The Heritage Foundation (2012), http://www.heritage.org/constitution/#!/articles/2/essays/90/treaty-clause.

[84] Allison Christians, The Dubious Legal Pedigree of IGAs (and Why It Matters), 69 Tax Notes Intl'l 565, 567 (Feb. 11, 2013), available at http://papers.ssrn.com/ez-proxy-brooklyn.cuny.edu:2048/sol3/papers.cfm?abstract_id=2280508..

[85] Id.

[86] Id.
[87] Id.
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[89] Id.
[90] Id.
[91] Id.
[92] Id.

SHEDDING LIGHT ON DARK POOLS: RECENT REGULATORY ATTEMPTS TOWARD TRANSPARENCY AND OVERSIGHT OF ALTERNATIVE TRADING SYSTEMS

by

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The transfer of ownership of securities has historically been accomplished through the use of public exchanges, such as the New York Stock Exchange ("NYSE") and NASDAQ, which are subject to stringent statutory and regulatory

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regulations. Typically, investors purchase and sell equity securities on exchanges based on current available pricing data. Large purchases or the unloading of shares on the open market may result in a substantial increase or diminution in the price of the shares. Large institutional investors such as mutual funds and the like are wary of making sizeable investments in particular securities because such investments may then cause the securities to fluctuate considerably and the price may be negatively affected.

To address this concern, "dark pools of liquidity" – or, simply "dark pools" – arose as a form of an alternative trading system ("ATS")[1] in an effort to avoid national trading systems. Using dark pools, financial institutions are able to conceal the trades until they are placed. This practice avoids tipping their intentions and avoids a run-up or downturn of the securities prior to the trades.[2] Dark pools now account for more stock trades than the NYSE, although it is worth noting that the NYSE set up a dark pool of its own as a one-year pilot Retail Liquidity Program in 2012.[3] Although the word "dark" in connection with dark pools (as the word "shadow" in shadow banking) connotes seemingly sinister transactions, no such implication should be ascribed to these methodologies of providing liquidity to financial transactions.

The methodologies of using these alternative platforms, abuses, and possible remedial alternatives were highlighted in a number of books, including Scott Patterson's *Dark Pools*[4], which discussed computerized trading algorithms, the history of dark pools, and the systems in place such as the Island, Datek, and Tradebot systems. The "Flash Crash" of 2010 is a

recent example of where, in a matter of a little more than a half hour, the stock market index collapsed, falling about 1,000 points (although the losses were later rapidly regained) due to the errant activity of a singular trader. By using algorithms, the trader allegedly placed many thousands of S&P stock index futures contracts with the intent of later disposing of them. High frequency traders ("HFTs") apparently also were able to take advantage of the wild fluctuations in pricing that came as a result of the manipulation. The crash led to a Report of the Joint CFTC-SEC Advisory Committee, which made a series of recommendations in an endeavor to curb abuses and harm to investors.[5]

The abuses of HFTs were more particularly brought to light by Michael Lewis' *Flash Boys*,[6] whose iconic book was a best seller that was discussed in numerous communications outlets. The book highlighted how the construction of a $300 million, 827-mile fiber-optic link through mountains and rivers from the Chicago Mercantile exchange to NASDAQ gave high frequency trading firms, which most often used dark pools for trading, a significant trading advantage by its slight (1 to 4.5 milliseconds) but vital communication time advantage.[7] The book's release and the uproar that followed led to investigations by the Federal Bureau of Investigation for possible insider trading violations and other violations under the Securities Exchange Act of 1934. Separately, the Securities Exchange Commission ("SEC") undertook an in-depth review of the adequacy and possible need for additional regulatory safeguards to protect investors.[8]

PROS AND CONS OF DARK POOLS

The initial raison d'etre for dark pools was to safeguard investors, particularly those participating in mutual funds and pension plans, from seeing their investments altered by potential adverse price fluctuations brought about by large institutional trades.[9] By utilizing approximately 45 dark pools engaged in trades, the orders placed were anonymous, which came to light some period after the trades had taken place. Using dark pools realized cost savings from exchange trading fees exacted by public exchanges, stability of pricing, and reduction of risk. The HFTs were able to purchase shares a microsecond before a share order, *e.g.*, by pension funds, a microsecond before the public order of shares became public, profiting from the slight rise or fall in the purchase price thereby altering the price of the shares.[10] Nevertheless, there has been much rethinking concerning whether the regulatory permissiveness of dark pools encourages misbehavior that may, in fact, outweigh the alleged advantages of HFTs. The remarkable growth of dark pools, which now constitute 40 percent of all U.S. stock trades, has led some to question whether the negative consequences of dark pool trades outweigh the intended good results.[11]

There are obvious adverse results of dark pools' permissiveness. Investors purchasing or selling shares on "lit" exchanges may encounter a mispricing of the shares inasmuch as large dark trades may substantially impact the price thereof.[12] Based upon the multi-trillion dollar sums of all trades, a small mispricing brings about substantial financial consequences. The volume of such trades inevitably brings

about malfeasance such as: insider trading; diminution of income to public exchanges, such as the NYSE, which are highly regulated; less opportunity for investors utilizing public exchanges; lack of data required from brokers before the execution of a trade; favoritism of valued large institutional traders; and a general lack of information normally made available to individual investors.[13]

There are contrary views, as in any controversial area of research. Haoxiang Zhu of MIT, in an exhaustive mathematical analysis, concluded that rather than being harmful for price discovery, "under natural conditions, the addition of a dark pool concentrates informed traders on the exchange and improves price discovery."[14] He observed that improved price discovery on the exchange coincided with exchange liquidity, that delay costs hamper liquidity traders from crossing from one venue to another, and that dark pool price discovery becomes weaker the longer the information is delayed from the public.[15] In another lengthy mathematical analysis of dark pools concerning the effect of undisplayed liquidity on market quality and fair access to sources of undisplayed liquidity, the authors concluded that dark pool crossing networks increase liquidity only "when it is added to a dealership market where traders cannot compete for the provision of liquidity by submitting limit orders." When a dark pool is added to a Limit Order Book, orders tend to shift to the dark market, which thus offers market participants order migration rather than order creation. The depth and volume deteriorates on the Limit Order Book while total volume increases.[16] High depth and small spread increase traders' use of dark pools.

REGULATION OF DARK POOLS

Regulation Alternative Trading Systems

In 1988, *Regulation Alternative Trading Systems (ATS)* was the first major regulatory enactment governing ATS adopted by the SEC. It permitted ATSs to choose whether to register with the Commission as national securities exchanges or as broker-dealers. It also required ATSs to comply with certain additional requirements, concerning amending their books and records based upon their activities and trading volume.[17] The purposes of the regulation were to strengthen the public markets for securities, while encouraging innovative new markets mainly due to the incorporation of new technologies designed to give investors additional services more efficiently and at a lower cost. The regulation provided a new regulatory framework for ATSs, addressed the disparities affecting investor protection and the markets as a whole due to the heretofore operation as private markets outside the national market system, available only to chosen subscribers regulated as broker-dealers, provided adequate surveillance for market manipulation and fraud due to the ATSs lack of obligation to provide investors a fair opportunity to participate in the ATSs or to treat their participation fairly and ensured that the ATSs are sufficient to handle rapid increases in trading volume, especially in times of market volatility.[18]

The regulation thus provided an incentive for the growth of ATSs by granting an exemption from the onerous regulatory requirements governing stock exchanges. The

statutory definition of an "exchange" under Rule 3b-16 was revised from that of a "market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the function commonly performed by a stock exchange"[19] to mean any organization, association, or group of persons that "brings together the orders of multiple buyers and sellers and uses established, non-discretionary methods…under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade."[20] The Rule excludes systems that perform only traditional broker-dealer activities, *i.e.*, "(1) systems that merely route orders to other facilities for execution; (2) systems operated by a single registered market maker to display its own bids and offers and the limit orders of its customers, and to execute trades against such orders; and (3) systems that allow persons to enter orders for executions against the bids and offers of a single dealer.[21]

To be exempt from registration as an exchange under the ATS Rule, an ATS is required to be registered as a broker-dealer and file an initial operation report and appropriate amendments for major changes.[22] It must also: display subscriber orders, if it has an order volume of five percent or more of a security; provide national securities exchanges the prices and sizes of the highest buy price and lowest sale price of the covered security; establish written standards for granting access to trading on its system; and establish procedures to ensure adequate systems capacity, integrity, and contingency planning wherein the ATS exercises 20 percent or more of trading volume in any single security.[23]

Regulation NMS

The SEC adopted *Regulation NMS* in 2005,[24]which imposed substantive rules to modernize the U.S. equity markets in the light of the expansion of both new and expanded developments therein.[25] It adopted the "Order Protection Rule" that requires trading centers to establish, maintain, and enforce (with exceptions) written policies and procedures to prevent execution of trades at lower prices to those protected quotation displayed at other trading centers. The regulation provides that a quotation must be immediately and automatically accessible to investors. The "Access Rule" provides the requirement of a fair and non-discriminatory access to quotations and a limit on access fees to harmonize the pricing of quotations across different trading centers. It also requires each national securities exchange to adopt policies prohibiting members from acting in a pattern or practice of displaying quotations that lock or cross automated quotations.

A third rule, the "Sub-Penny Rule," prohibits market participants from accepting, ranking, or displaying orders, quotations, or indications of interest in a pricing increment smaller than a penny, except for orders, quotations, or indications of interest that are priced at less than $1.00 per share. The SEC also adopted amendments to the "Market Data Rules" by updating requirements for consolidating, distributing, and displaying market information, as well as amendments to the joint industry plans for disseminating market information that modify the formulas for allocating plan revenues, the so-called Allocation Amendment, and broaden participation in plan governance, the so-called Governance Amendment.[26]

Regulation Systems Compliance and Integrity (SCI)

The SEC adopted *Regulation Systems Compliance and Integrity*,[27] which applies in part to ATSs that trade NMS and non-NMS stocks exceeding a designated volume, to reduce the occurrence of systems issues, to improve the resiliency of systems problems, and to enhance SEC oversight in order to strengthen the technology infrastructure of the US securities markets. It requires that the SCI entities adopt certain policies and procedures to ensure that they have the levels of capacity, integrity, resiliency, availability, and security to maintain their operational capability and promote fair and orderly markets. These entities are: required to take corrective action in the event of systems disruptions and related issues; notify the SEC and market participants of such occurrences; conduct annual internal review of qualified personnel; submit quarterly reports; and maintain certain books and records.[28]

Proposed Regulatory Amendments to NMS ATSs

On November 18, 2015, the SEC proposed rules that would substantially affect ATSs that trade stocks on listed national market system (NMS) stocks on national securities exchanges.[29] The purpose of the proposed regulation is to enhance operational transparency and regulatory oversight of ATSs, which includes dark pools. The regulation requires disclosures on a proposed Form ATS-N, which includes information concerning the trading of NMS stocks, the types of orders and market data used on the ATS and its execution and priority procedures. The disclosures will be made publicly

available on the SEC website to enable market participants to have more complete knowledge of how decisions and actions are made by their brokers and to determine whether to make use of ATSs. The SEC can then make a determination whether or not to qualify ATSs for exemptions under existing regulations from the more onerous requirements of exchanges.[30]

ENFORCEMENT ACTIONS

The major efforts of the regulatory authorities are designed to ensure transparency of trades of securities so that investors have an accurate reflection of the true market price of particular securities.[31] One of the consequences of dark pools' trading in securities is that large traders are able to secure major positions in companies without the knowledge of investors until after purchases, thus avoiding a substantial increase or decrease in the value of the shares that would otherwise take place if accomplished openly.[32] The SEC is cognizant of the manipulation of shares that almost inevitably take place, particularly by individuals or firms trading on inside information.

SAC Capital Hedge Fund

The indictment of individuals of SAC Capital hedge fund, including Matthew Martoma and other employees of the firm, concerning inside information that allegedly enabled the

firm to make very sizeable profits illustrates how dark pool funding enables such firms to reap profits through increases or decreases of large positions in a company before it becomes openly known to the investment community.[33] Martoma, who was SAC Capital's portfolio manager with respect to investment decisions in health care industries, ascertained information that a particular drug to alter Alzheimer's disease was not effective, which then enabled SAC Capital to illegally gain hundreds of millions in profits – and secured a $9 million bonus for Martoma – by shorting 17.7 million shares of Elan and Wyeth stock worth $700 million. He received a nine-year prison sentence and loss of gains and other assets.[34]

Pipeline Trading System

The SEC instituted a series of enforcement actions consisting mainly of cease-and-desist orders coupled with significant fines against a number of firms engaged in activities involving dark pool transactions. The first action taken by the SEC against a dark pool trading platform was against Pipeline Trading Systems and two of its senior officers for failing to disclose to customers that the vast majority of orders received by it were filled by an affiliate of Pipeline. The company settled the action by a payment of $1 million fine by the firm and $100,000 each by its founder and chief executive officer as well as by its former president. Pipeline made alleged false claims that its trading platform was a "crossing network" that matched customer orders with those from other customers, thereby providing "natural liquidity." The alleged falsity consisted of the fact that its parent company owned a trading entity that filled the vast majority of customer orders on

Pipeline's system. Other charges included alleged conflict of interest that resulted from paying the affiliate's traders using a formula that rewarded them in part for giving favorable prices to Pipeline's customers – which information was concealed from its customers – as well as falsely stating it treated all users the same and failing to protect customer's confidential trading information.[35]

Barclays and Credit Suisse

More onerous actions were taken against Barclays Capital Inc. and Credit Suisse Securities (USA) LLC. Barclays Capital Inc. was accused of willfully violating §17(a)(2) of the Securities Act of 1933, §15(c)(3) of the Securities Exchange Act of 1934 and Regulation ATS, Rule 301(b)(2). Section 17(a)(2) of the '33 Act makes it unlawful to obtain money or property by means of an untrue statement of material fact or omission. Section 15(3)(3) of the 1934 Act, and the SEC Rules thereunder, require that a broker/dealer possess risk management controls and supervisory procedures reasonably designed to prevent entry of orders exceeding appropriate pre-set credit or capital thresholds for each customer. Regulation ATS, Rule 301(b)(2) requires certain designated forms be filed at least prior to 20 days before commencing operation as an ATS and when implementing a material change to its operation when such material becomes inaccurate.

Specifically, Barclays was accused of making misleading statements and omissions of material facts concerning the operation of its LX product feature entitled

Liquidate Profiling, which it alleged was a powerful tool to protect against predatory trading. [36] It was also alleged that Barclays failed to establish adequate safeguards and procedures to protect subscribers' confidential information and other related representations of its LX product. [37] As a result, a consent order was entered into by the parties, which prevented Barclays from causing present and future violations of the said Rule of the Exchange Act and included a censure and a fine of $35 million.[38] In the New York Attorney General's complaint, which preceded that of the federal government, the allegations were comparable to that of the U.S. Attorney General, which resulted in an installation of an independent monitor at Barclays to conduct an independent review of Barclays' electronic trading business and further reforms to comply with New York law.[39]

In January 2016, there were two proceedings against Credit Suisse Securities that resulted in comparable orders of cease-and-desist and censure, together with fines of $20 million and $10 million respectively.[40] The allegations concerned alleged obtaining money or property by means of making false statements or omissions thereof; failing to file timely amendments to required forms after implementing a material change to the operation of the ATS; limitation to fair access to services offered by the ATS by applying standards in an unfair or discriminatory manner; and proper executions of orders to buy or sell securities. There are pending or settled a multitude of additional SEC enforcement actions.[41]

The New York State Attorney General ("AG") has been particularly active in initiating proceeds against Barclays and

Credit Suisse. The AG sued the companies under New York's Martin Act,[42] which gives wide-ranging powers to the Attorney General's office to investigate and prosecute securities-related fraud and malfeasance. Section 352-c makes it a crime to commit fraud, deception, concealment, suppression, false pretense, and promise with respect to the purchase or sale of securities, operate falsely as an exchange, and other related offenses. The prosecutions by the Attorney General's Office have evoked controversy in what appears to be overstepping the SEC for conduct ordinarily prosecuted by the SEC. With the new administration commencing January 20, 2017, there is a movement to curtail the powers of states to act against alleged securities fraud. Similarly, allegations made against Credit Suisse resulted in fines and comparable resolution.[43]

Commentators at the Wharton School of Finance and the University of Missouri-Kansas City suggested that the fines represented the cost of poor enforcement of existing laws and the failure to create precedents as deterrents. They opined that regulators should better scrutinize HFT including dark pools in order to identify systemic risks, if any. Regulators, in their views, should not settle cases but rather should fully prosecute the charges alleged even if they should not prevail in order to create precedents to thwart potential future misbehavior. It cited New York State Attorney General's Eric Schneiderman, who stated that Barclays exposed its clients to predatory traders rather than protected them. It failed to police its dark pool and misled subscribers about data feeds.[44]

There are technological efforts by the U.S. government to better gauge when unlawful insider trading takes place.

Thus, it has instituted a national market system plan to create a comprehensive database called the "consolidated audit trail" (CAT), which is designed to enable government regulators to track all trading activity within the U.S. equity and options markets. CAT requirements include compelling self-regulation organizations and broker-dealers to identify all customers and a complete life cycle of all orders and transactions therein. It requires that a plan processor create a central repository that would receive, consolidate, and retain trade and order data; operate, maintain, and upgrade the central repository; and ensure its security and confidentiality of all reported data. [45] It further requires a plan processor to submit certain information about the order including a unique identifier for the customer submitting the order; the identifier of the broker-dealer submitting the order; the date and time of the order or event; and the security symbol, price, size, order type, and other material terms of the order.[46]

ADDITIONAL EFFORTS TO PROVIDE TRANSPARENCY

FINRA requires each ATS to report its weekly aggregate volume information on a security-by-security basis to it. FINRA then makes the information available free of charge to the public on a two-week delayed basis concerning Tier 1 NMS stocks (stocks in the S&P Index, the Russell 1000 Index and certain ETPs) and on all other NMS stocks and OTC equity securities subject to its reporting requirements two weeks after the initial reporting period. The list of FINRA equity ATS firms is set forth in Appendix A. This is a change from its previous policy of making the said information available mainly to professionals, which was based on

voluntary reporting by some ATSs on an aggregate, monthly basis. The goal is to increase market transparency and enhance investor confidence. Included are all dark pools' market facilities and other ATS, which, as of 2014, constituted more than 30 percent of the total of OTC trading in U.S. exchange-listed equities.[47]

The NYSE has proposed a plan to limit trades on dark pools by its "tick size pilot program," which would increase a minimum bid to five cents from a penny with respect to stocks of companies with small market capitalizations. The restrictive change is being reviewed by the SEC, FINRA and BATAS Exchange Inc. have proposed less restrictive measures.[48] NASDAQ has launched a new SMARTS Surveillance for Dark Pools. SMARTS will enable regulators both in the U.S. and globally to better monitor dark trading activities. The program assists Multilateral Trading Facilities, ATSs, Crossing Networks, and market participants engaged in internalizing order flow or trading in dark pools to monitor alleged abusive behavior therein. According to its website, it delivers full cross-market surveillance, unfettered visibility and transparency for dark trading and a means to prevent abusive manipulative behavior that may lead to abuse.[49] It is part of a larger NASDAQ surveillance endeavor for surveillance for marketplaces and regulators, market participants, foreign exchange, and energy.[50]

The regulatory trend towards greater transparency may lead to greater risks, which were the reasons for dark pool origination. Such trend has caused dark pools to undergo a "toxicity assessment" whereby users may become subject to

manipulation by HFTs and others and face potential significant fines for alleged violation of the multiplicity of US federal and state regulations and the increased regulatory oversight by global authorities.[51] Another trend, perhaps having Barclays and Credit Suisse in mind as well as the increasing regulatory oversight, is the launch of Luminex Trading and Analytics LLC in October 2015. Luminex is a dark pool consortium engaged in large block trading of shares originated by T. Rowe Price and Invesco and joined in by Blackrock J.P. Morgan Asset Management, Vanguard, Goldman Sachs Asset Management and numerous other major financial players. Luminex alleges in its website that it is a "dark pool with the lights on." It claims to be the first ATS to launch in an era of complete transparency with 100 percent transparency and compliant with all federal and state regulations. It sought to limit transactions costs and profit-driven conflicts of interests by removing broker-dealers and by limiting pre-trade information.[52]

FUTURE REGULATORY TRENDS

The election of Donald J. Trump as President of the U.S., coupled with a Republican-led U.S. Senate and House of Representatives, have created substantial uncertainty as to whether any or substantial regulatory enactments will be disbanded. As President-Elect stated: "I will formulate a rule which says that for every one regulation, two old regulations must be eliminated." He further advised his transition team to formulate executive actions designed "to restore our laws and bring back our jobs." [53] As in all campaign rhetoric, it is difficult to separate hyperbole from future action, but it

remains clear that the Administration will be conservative-oriented, which most often believes that many regulatory measures act as an impediment to economic growth. Calls to end both the Patient Protection and Affordable Care Act[54] and the Dodd-Frank Wall Street Reform and Consumer Protection Act[55] will likely result in the said Acts be amended rather than repealed. It appears that the authority of the Financial Stability Oversight Council will be substantially diminished and banks will be given much greater freedom from regulations.[56]

An SEC Commissioner, Luis A. Aguilar noted that ATSs will continue to play a major role in the future and identified that the issues include:

(1) Given that average trade sizes on dark pools that trade equities are comparable to the same levels seen on the exchanges, does it differ for large-cap and smaller cap stocks and should block trading be rethought to account for the algorithm-driven trading that dominates the current markets?

(2) Can ATSs attract sufficient liquidity to remain viable without engaging in misconduct and can it survive without high frequency and algorithm traders?

(3) Does the current regulatory structure favor the expansion of dark pools and, if so, should the SEC should limit its growth or curb the volume of orders executed in dark pools as Markets in Financial Instruments Directive II, discussed *infra*, will do for

smaller orders in Europe?;

(4) Are ATSs the best model for block trading and, if not, what other approaches would be better suited? [57]

INTERNATIONAL REGULATION OF DARK POOLS

IOSCO

The International Organization of Securities Commissions (IOSCO) in its *Principles on Dark Liquidity,* set forth its guidance for securities markets authorities concerning dark liquidity. The ostensible purposes for the guidance is to minimize the impact of dark pools and orders on the ability of investors to ascertain the actual price of securities traded by promoting pre- and post-trading transparency by the encouragement of transparency orders. Such measures are designed to mitigate the effect of potential fragmentation of information and liquidity; ensure that regulators have access to adequate information concerning dark pools and dark orders for surveillance and monitoring purposes; and ensure that market participants have sufficient information to ascertain how their orders are handled and executed. The principles are stated in Appendix B.[58]

European Union

Dark pools have accounted for approximately 9.1 percent of stock trades in 2016, or three times the number of trades from 2010.[59] The increase has created concerns among EU regulators, who prefer trades in "lit" markets. The EU enacted Markets in Financial Instruments Directive II (MiFID II/MiFIR), which will come into effect on January 3, 2018 and will impose substantial regulatory limits on such trading venues. Limits to be imposed include four percent of overall trading in an individual security and eight percent of overall volume of each security with exceptions for trades of large orders.[60]

It is expected that dark pools will be affected in significant ways, including the limitation of brokers to cross client orders internally as a result of the closure of Broker Crossing Networks; moreover, in addition to the four and eight percent limitations, execution of orders will be limited at its midpoint.[61] Additional requirements include major increases in the types of financial instruments, entities required to report, and an increase of the number of fields within a transaction report that has to be provided (from 24 to 81).[62] Some commentators have expressed reservations concerning MiFID's alleging that the regulation arose from the financial crisis at the end of the last decade, but that dark pools had nothing to do with the crash. The allegations include the misplaced requirements for transparency that have lost sight of the interest of the ultimate investor; that the impact on price formation is unknown and the imposition of caps was at the behest of demands by the exchange lobby.[63]

Switzerland

Swiss authorities are not bound by the new regulation inasmuch as the country is not a member of the EU. But, it is bound by its Financial Market Infrastructure Act, which imposes no such limits upon its dark pools. Thus, unless the EU interposes an objection to the Swiss Act, Swiss shares traded by EU firms on Swiss@Mid will have an advantage over comparable shares within the EU.[64]

Brexit

The issue arises whether and to what extent dark pool trades will be affected by the United Kingdom's (U.K.) exit (Brexit) from the EU by virtue of a referendum within the U.K. on June 23, 2016. Initially, Morgan Stanley's MS Pool and Deutsche Bank's SuperX, and other major dark pools were compelled to suspend trading, which unlike public exchanges, could not handle the volume of trades immediately after the vote, even though there was a rebound shortly thereafter. Some commentators stated that this was illustrative of the superiority of trades on public exchanges over dark pools.[65]

Hong Kong

Perhaps reflecting the worldwide trend of placing restrictions upon dark pools, Hong Kong imposed new regulations that substantially created greater transparency therein.[66] The Hong Kong Securities and Futures Commission imposed new rules that barred retail investors from trading in dark pools thereby preventing all but large institutional investors, such as fund managers and professional and experienced investors with at least HK $8 million portfolios. The move affected Hong Kong's 15 dark pools, which now requires brokers to prioritize client trades over proprietary orders and exercise operational controls. Other restrictions include the requirement that dark pools must be members of its stock exchange thereby reducing competition with publicly traded securities. Among the dark pool operations affected are those of Goldman Sachs, Morgan Stanley, and Credit Suisse.[67]

Canada

The Investment Industry Regulatory Organization (IIRO) of Canada issued a ruling in 2012 that sought to maintain the integrity of the pricing process by requiring small orders in dark pools to meet certain pricing standards and provide a level of playing field in the same marketplace for dark and lit orders. While acknowledging that there were additional costs as a result of its rules and a significant drop in dark pool trades; nevertheless, the IIRO found that there was

no statistically significant deterioration in market quality.[68] The changes issued by the Organization according to Liquidnet, a global institutional trading network, are: visible order priority, (*i.e.*, these orders had priority over orders from dark pools at the same price and same marketplace) and meaningful price improvement (*i.e.*, order below block size by a dark pool had to be better (one cent) than the displayed quote by one trading increment). Another significant change gave the IIRO the right to designate a minimum size for dark orders. The changes in Canada continued to preserve the execution of large orders by institutional investors, such as long-term pension and other comparable investors. The ability to execute large orders anonymously was not affected by the rules.[69]

CONCLUSION

The financial markets will continue to search for new sources of liquidity to finance the expansion of world trade. As is historically evident, investors and financial market experts will continue to explore a multitude of methodologies to enhance financial benefits by devising schemes to avoid regulatory oversight and operate privately to maximize financial returns. The presidential election of 2016 and the assumption of office by a president who advocates the removal of two regulations for each one created, raises the question of whether there will be a diminishment of regulatory oversight that results in harm to unknowing investors from new schemes designed to maximize the benefits to the principals who create them. It must be left to future developments to determine whether governmental intervention will be required to prevent the economic chaos that occurred in the latter part of the first decade of the new century.

APPENDIX A

FINRA LIST OF EQUITY ALTERNATIVE TRADING SYSTEM FIRMS[70]

ATS Name	ATS ID	Firm Name	Comment
AQUA	AQUA	AQUA SECURITIES L.P.	
GLOBAL OTC	ARCA	ARCHIPELAGO TRADING SERVICES, INC.	
AX TRADING, LLC	AXTN	AX TRADING, LLC	
BARCLAYS ATS ("LX")	LATS	BARCLAYS CAPITAL INC.	
BARCLAYS DIRECTEX	BCDX	BARCLAYS CAPITAL INC.	Used LEHM prior to Jan 26, 2015

BIDS TRADING	BIDS	BIDS TRADING L.P.	
TRADEBOOK	BTBK	BLOOMBERG TRADEBOOK LLC	Ceased on September 1, 2016
APOGEE	APOG	CITADEL SECURITIES LLC	Ceased on April 2, 2015
CITI CROSS	CXCX	CITIGROUP GLOBAL MARKETS INC.	
CitiBLOC	CBLC	CITIGROUP GLOBAL MARKETS INC.	
LIQUIFI	LQFI	CITIGROUP GLOBAL MARKETS INC.	Ceased on November 7, 2016
CODA MARKETS, INC.	PDQX	CODA	f/k/a PDQ ATS

MILLENNIUM	NYFX	CONVERGEX EXECUTION SOLUTIONS LLC	
VORTEX	VRTX	CONVERGEX EXECUTION SOLUTIONS LLC	Ceased on October 1, 2015
CROSSFINDER	CROS	CREDIT SUISSE SECURITIES (USA) LLC	
LIGHT POOL	LTPL	CREDIT SUISSE SECURITIES (USA) LLC	Ceased on December 1, 2016
NXP	DFIN	Dash Financial LLC	
DBOT ATS, LLC	DBOX	DBOT ATS, LLC	
DEALERWEB	DLTA	DEALERWEB INC.	

SUPERX	DBAX	DEUTSCHE BANK SECURITIES INC.	
LEVEL ATS	EBXL	EBX LLC	
FANTEX BROKERAGE SERVICES, LLC	FTEX	FANTEX BROKERAGE SERVICES, LLC	Ceased September 2, 2016
FNC AG STOCK, LLC	FNCA	FNC AG STOCK, LLC	
SIGMA X	SGMA	GOLDMAN SACHS EXECUTION & CLEARING, L.P.	
SIGMA X2	SGMT	GOLDMAN, SACHS & CO	
IEX	IEXG	IEX SERVICES LLC	Ceased September 2, 2016

INSTINET CONTINUOUS BLOCK CROSSING SYSTEM (CBX)	ICBX	INSTINET, LLC	
INSTINET CROSSING	XIST	INSTINET, LLC	Used INCA prior to Jun 16, 2014
IBKR ATS	IATS	INTERACTIVE BROKERS LLC	
POSIT	ITGP	ITG INC.	
JPM-X	JPMX	J.P. MORGAN SECURITIES LLC	
JET-X	JEFX	JEFFERIES EXECUTION SERVICES, INC.	Ceased on April 1, 2016
KCG MATCHIT	KCGM	KCG AMERICAS LLC	
LIQUIDNET ATS	LQNT	LIQUIDNET, INC.	

LIQUIDNET H2O	LQNA	LIQUIDNET, INC.	
LUMINEX TRADING & ANALYTICS LLC	LMNX	LUMINEX TRADING & ANALYTICS LLC	
MERRILL LYNCH (ATS-1)	MLVX	MERRILL LYNCH, PIERCE, FENNER & SMITH INC	Ceased on June 1, 2016
INSTINCT X	MLIX	MERRILL LYNCH, PIERCE, FENNER & SMITH INC	
MS POOL (ATS-4)	MSPL	MORGAN STANLEY & CO. LLC	
MS RETAIL POOL (ATS-6)	MSRP	MORGAN STANLEY & CO. LLC	
MS TRAJECTORY CROSS (ATS-1)	MSTX	MORGAN STANLEY & CO. LLC	

CROSSSTREAM	XSTM	NATIONAL FINANCIAL SERVICES LLC	
OTC LINK ATS	OTCR	OTC LINK LLC	
PRO SECURITIES ATS	PROS	PRO SECURITIES, L.L.C.	
RIVERCROSS	RCSL	RIVER CROSS SECURITES, LP	Ceased on February 1, 2017
BLOCKCROSS	BLKX	STATE STREET GLOBAL MARKETS, LLC	Used PULX prior to Feb 2, 2015
TRIPLESHOT	TSBX	TRIPLESHOT, LLC	Ceased on March 1, 2016
UBS ATS	UBSA	UBS SECURITIES LLC	

USTOCKTRADE SECURITIES, INC.	UST K	USTOCKTRA DE SECURITIES, INC.	
VARIABLE INVESTMENT ADVISORS, INC. ATS (VIAATS)	VIAT	VARIABLE INVESTMEN T ADVISORS, INC.	
XE	WDN X	WEEDEN & CO.L.P.	

APPENDIX B

IOSCO PRINCIPLES ON DARK LIQUIDITY

Transparency to Market Participants and Issuers

Principle 1: The price and volume of firm orders should generally be transparent to the public. However, regulators may choose not to require pre-trade transparency for certain types of market structures and orders. In these circumstances, they should consider the impact of doing so on price discovery, fragmentation, fairness and overall market quality.

Principle 2: Information regarding trades, including those executed in dark pools or as a result of dark orders entered in transparent markets, should be transparent to the public. With respect to the specific information that should be made transparent, regulators should consider both the positive and negative impact of identifying a dark venue and/or the fact that the trade resulted from a dark order.

Priority of Transparent Orders

Principle 3: In those jurisdictions where dark trading is generally permitted, regulators should take steps to support the use of transparent orders rather than dark orders executed on

transparent markets or orders submitted into dark pools. Transparent orders should have priority over dark orders at the same price within a trading venue.

Reporting to Regulators

Principle 4: Regulators should have a reporting regime and/or means of accessing information regarding orders and trade information in venues that offer trading in dark pools or dark orders.

Information Available to Market Participants about Dark Pools and Dark Orders

Principle 5: Dark pools and transparent markets that offer dark orders should provide market participants with sufficient information so that they are able to understand the manner in which their orders are handled and executed.

Regulation of the Development of Dark Pools and Dark Orders

Principle 6: Regulators should periodically monitor the development of dark pools and dark orders in their jurisdictions

to seek to ensure that such developments do not adversely affect the efficiency of the price formation process, and take appropriate action as needed.

ENDNOTES

[1] Regulation Alternative Trading System Rule 300(a), 17 C.F.R. § 200.300, defines an alternative trading system as "any organization, association, person, group of persons, or system: (1) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of § 240.3b-16 of this chapter; and (2) that does not: (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or (ii) discipline subscribers other than by exclusion from trading." Examples include dark pools, electronic communications networks, multiunit auctions, and order matching systems.

[2] The SEC defines dark pools as "a subset of ATSs that, as a general matter, offer trading services to institutional investors and others that seek to execute large trading interest in a manner that will minimize the movement of prices against the trading interest and thereby reduce trading costs." Exch. Act Rel. No. 61358 (Jan. 31, 2010), 75 FR 3593, 3599, Concept Release on Equity Market Structure, cited as footnote 3, Securities and Exchange Commission, Administrative Proceeding, File No. 3-17077, In the Matter of Barclays Capital Inc., (Sept. 23, 2014), https://www.sec.gov/litigation/admin/2014/34-73183.pdf. "Dark liquidity" is the volume of trades that take place therein.\

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[16] Sabrina Buti, et al., *Dark Pool Trading Strategies, Market Quality and Welfare* (December 1, 2015). JOURNAL OF FINANCIAL ECONOMICS, 25-26 (forthcoming), available at SSRN: https://ssrn.com/abstract=1571416 or http://dx.doi.org/10.2139/ssrn.1571416.

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[18] *Id.*

[19] 15 U.S.C. § 78c(a)(1).

[20] Rule 3b-16(a), 17 C.F.R. § 240.3b-16(a).

[21] Rule 3b-16(b), 17 C.F.R. § 240.3b-16(b). For a discussion of the changes, see *supra* note 8, at 9.

[22] Rule 301(b)(3), 17 C.F.R. § 240.3a1-1(b)(1).

[23] *Id.*

[24] Securities and Exchange Commission, *Regulation NMS*, SEC, 7 C.F.R. Parts 200, 201, et al., https://www.sec.gov/rules/final/34-51808pdf.

[25] Edward M. Eng et al., *Finding Best Execution in the Dark: Market Fragmentation and the Rise of Dark Pools*, 12 J. INT'L BUS. & L. 39, 46 2013).

[26] Securities and Exchange Commission, *Regulation NMS*, SEC, 7 C.F.R. 37496.

[27] SEC Regulation Systems Compliance and Integrity, 17 C.F.R. Parts 240, 242, and 249, 2 Fed. Reg. Vol. 79, No. 234 (Dec. 5, 2014).

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[32] Zhu *supra* note 13 at 779.

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[34] U.S. Attorney's Office, S.D.N.Y., *SAC Capital Portfolio Manager Mathew Martoma Sentenced in Manhattan Federal Court to Nine Years for Insider Trading*, NEWS (Sept. 8, 2014), https://www.fbi.gov/contact-us/field-offices/newyork/news/press-releases/sac-capital-portfolio-manager-mathew-martoma-sentenced-in-manhattan-federal-court-to-nine-years-for-insider-trading.

[35] Securities and Exchange Commission, *SEC's Enforcement Program Continues to Show Strong Results in Safeguarding Investors and Markets*, PRESS RELEASE 2012-227, www.sec.gov/News/PressRelease/Detail/PressRelease/1365171485830.

[36] *In the Matter of Barclays Capital Inc.*, SEC ADMINISTRATIVE PROCEEDINGS, File No. 3-17077, (Jan. 31, 2016), https://www.sec.gov/litigation/admin/2014/34-73183.pdf. For a discussion of additional enforcement efforts, see Matthew Freedman, *Rise in SEC Dark Pool Fines*, 35 REV. BANKING & FIN. L. 150 (2015) at 150-62.

[37] *Id.*

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TEACHING LEGAL PRINCIPLES BY USING THE MOVIE "TREASURE OF SIERRA MADRE"

by

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ABSTRACT

The 1948 movie “Treasure of the Sierra Madre” can be a useful tool for teaching legal principles. This paper analyzes the movie and offers suggestions for using the film in a business law class in exploring such concepts as employment law, contracts, partnerships, and joint ventures.

INTRODUCTION

"Treasure of Sierra Madre"[1] is a story of three men who pursue their dream of finding gold in the mountains of Mexico. There are numerous conflicts that arise among the trio but the film can be viewed on another level: as a primer on the principles of business law.

The principal characters are Fred C. Dobbs (Humphrey Bogart), a middle-aged down-on-his-luck American who finds himself penniless in Tampico, Mexico, resorting to panhandling to buy food and a place to sleep. Little better off is Curtin (Tim Holt) who meets Dobbs while sitting on a park bench where Dobbs offers him a cigarette.

With no place to sleep, Curtin and Dobbs spend the night at a men's shelter where they overhear Howard (Walter Huston), an elderly down and outer, talk about gold to be mined in the nearby mountains. While he piques their interest by the lure of potential riches, they think little about it because they lack the wherewithal to finance such an expedition.

Dobbs is still panhandling when he meets Pat McCormick (Barton MacLane), who offers him a job on a construction project which will pay $8.00 per day. Among the men boarding the ferry is Curtin so the men are reunited.

This development presents the first legal issue presented in the movie. Students can be asked to analyze the exchange between McCormick and Dobbs. Clearly McCormick is the offeror and the latter the offeree. The rules of common law contracts apply since this is an employment/services agreement. The per diem payment is low for what turns out to be backbreaking construction work under sweltering conditions. The question to ask is whether Dobbs was under duress when he accepted McCormick's offer since he had no alternative other than begging to survive. Second, did McCormick misrepresent the nature of the work to lure Dobbs and other desperate men to join the construction crew?

While the work is continuing, Dobbs demands to be paid the money that he is owed. McCormick promises to pay

"as soon as the ferry docks." McCormick tells Curtin and Dobbs that they would have no use for the money while they are still working, that they would only gamble it away.

When the ferry docks, Curtin and Dobbs are not paid. McCormick assures the men that he will meet them later and gives Dobbs $10.00 to pay for some liquid refreshment after Dobbs admits he is penniless.

Curtin and Dobbs spend considerable time at the bar and have only $2.50 left after several hours of drinking. McCormick never appears with the rest of the money and the bartender tells them that only the most naïve would believe McCormick's lies and go to work for him.

The two men are back to where they started: finding a rooming house to spend the night.

Some time later, Curtin and Dobbs stumble upon McCormick and a young woman. He asks "Where have you been keeping yourselves? I've been looking all over for you."

The men repair to a bar when MCormick makes more excuses about not being able to pay them. A fight ensues and both men knock McCormick out. Dobbs searches his wallet and takes out the money they are owed. Curtin says that they should leave before the law comes. Clearly, McCormick intended to defraud the men out of their money but students should discuss the illegal means used to collect it.

Shortly thereafter, with their money dwindling, they return to the possibility of prospecting for gold. They find Howard who proposed the idea in the first place. He tells them that they will need more money to buy the supplies they will need for the venture.

Dobbs and Curtin have only $300 between them and Howard is willing to contribute $200.00. As they are lamenting their penurious state, a young boy approaches Dobbs with news that he has won a prize on a portion of a lottery ticket that he had purchased several weeks earlier. Now Dobbs has the money and the men form a partnership. But does their

arrangement constitute such a business entity based on a handshake only? Students can be asked to analyze the men's conversation as to whether it meets the elements of a general partnership. The three men are not making identical contributions to this project.

Is this a joint venture since its object is to explore and mine gold? The relationship does not anticipate a continuing business. Of the three men, Curtin is contributing the least. He only has $150 and admits he knows of gold only what he has seen in jewelry stores and in people's mouths. Howard has $200 that he is willing to contribute and the knowledge of how to mine gold. His expertise surfaces once the expedition begins. When Curtin and Dobbs misidentify "fools gold", Howard corrects them. He also tells them that gold will be found at the highest elevation but that the camp should be placed several hundred yards away so that if they are discovered, they can say that they are hunters. He also advises

them that someone else might come forward with a claim to the land that they are mining. Clearly Dobbs and Curtin are heavily dependent on his knowledge so his value to the enterprise far outweighs the money he has contributed.

Because Dobbs has contributed the most money; his $150 has been supplemented by his lottery winnings, he has the upper hand in the enterprise.

As Howard had predicted, the search for gold sows the seeds of dissention among those who look for it. The first crack in the relationship comes once the trio has mined several thousand dollars' worth of gold and they discuss whether the "goods" as they refer to it, should remain in a common pool or be split up at the end of each day's work. After some discussion, Dobbs demands, that they split the profits on a daily basis which requires that each man find a hiding place that will prevent the others from finding his share. When Howard opines that he is the most honest of the three, Dobbs takes umbrage at the remark.

Despite the fact that Curtin pulled an unconscious Dobbs from a mine collapse, he is suspicious of his companions. He says that because he put in the most money he would be well within his rights to demand more of the proceeds. The students should discuss how this business relationship should have been better structured to avoid the conflicts that would inevitably arise. Some of the problems could have been anticipated like whether to divide the results of the work as they mine it or to wait until the project was completed. There is also some dispute among the men about how long to work. What should be the maximum profits from their efforts? Dobbs again takes the most contentious approach. He wants to work for more, while Curtin and Howard would be content with less. Students should be asked if the amount of profits they would seek should have been settled before they began. The prospectors would conduct their exploration and be satisfied once they reached the agreed upon goal.

A more serious threat to the business relationship is one that the partners could not have anticipated. When Curtin goes to a village for supplies, he meet an American, Jim Cody (Bruce Bennett), who asks what Curtin is doing in that part of the world. Curtin tries to minimize his contact with the inquisitive stranger and tells him that they are hunting big game, a claim that Cody does not believe. Despite Curtin's cool attitude, Cody follows him to the camp where the trio try to convince him that they are hunters but Cody determines that they are mining gold. Dobbs demands that Cody leave immediately but is willing to share supper.

Cody wants to become a partner in their exploration but Dobbs resists the idea. Cody makes it clear that he wants no share of what they have found so far but only what they find going forward.

When the partners retreat to discuss his offer, they discuss three alternatives: Admitting him as a partner on the terms he proposed, rejecting his offer and sending him away,

which raises the specter of his telling others about their strike or officials because they have no legal claim, or disposing of him. The latter choice is Dobbs' solution but Howard cautions that the one who does the killing will forever be under the control of the others. The decision is made: All three load their guns to cooperate in shooting Cody until they are interrupted by an attack of bandits. A bullet from the invaders solves the problem of whether to admit Cody as a new partner to this venture.

Eventually the gold strike plays out and the men are eager to cash in their gold which comes to $35,000 each but Howard insists that they must put the mountain back the way they found it.

Eventually the men leave but are waylaid by natives who want help reviving a child who has been drowned. When Howard succeeds and the child recovers, the natives insist that he stay on but that Dobbs and Curtin can leave. They do so taking with them Howard's "goods" with his reluctant

approval.

Curtin and Dobbs get into an argument. When the latter threatens to take over Howard's share and not meet him in Durango as planned, Curtin objects. This scene should prompt a discussion among students as to the duties that partners have to each other. Chief among them is the fact that partners owe each other a duty of good faith (fiduciary) and a duty to act in the best interests of the business. Students should also be reminded that partners are also agents for each other. Clearly Dobbs is in violation of all of those requirements. Dobbs shoots Curtin and takes off with all the gold. Now Dobbs is in possession of everything for which the three had worked. He plans to go north to cash in but encounters the remnants of the band of bandits who had attacked their camp.

After all their hard work none of the partners have any gold left to redeem and one of them is dead.

The instructor need not show students the entire film. What can be done is to show first the portion of the movie up

to the point where Curtin and Dobbs are hired by McCormick for the construction job. Students can discuss the elements of that employment contract and the failure of McCormick to compensate them as agreed.

The next important legal aspect of the movie is the partnership created by the three men. A class project would divide the students into three groups. Each group would represent one of the men to negotiate a partnership agreement. The instructor can review what each partner has to offer to the relationship and ask each group to make the best possible deal for its client. The topics that should be included in the agreement are the following:

- What is each partner's contribution to the project? How should Howard's expertise be valued?
- How should the proceeds of the exploration be divided? Should it be divided equally among the three even though Dobbs contributed more money that the other

two and Howard has more to offer in the way of expertise?

- Should Howard and Dobbs then enjoy larger shares since they have more to contribute?
- How are decisions to be made? Unanimity or majority rules? In deciding to split the proceeds on a daily basis, Howard was neutral, Curtin wanted to wait until the end but Dobbs wanted the yield divided each day. How should such disputes be resolved?
- What would happen in the event of the injury, death or insanity of one of the partners? Dobbs thought that Howard was crazy. Dobbs betrayed evidence of mental illness.

Would the remaining partners have a duty to give the deceased partner's share to his family or would the surviving partners just split the goods between them?

There was capital investment made by the partners' tools, lumber, weapons etc. How should those items be distributed

once the project ends?

Students should be asked if this partnership agreement needed to be in writing and if any part of the Statute of Frauds is involved. What about admitting a new partner? Usually such decisions require a unanimous vote by the partners. There was no unanimous agreement on allowing Cody into the venture but there was agreement to eliminate the threat that he posed to the project. That decision was illegal. Jim presented a threat to the project after many hours of work involved. What other alternatives might the three men have explored to counter the problem? Could the partners have hired him as an employee to help with the work and compensate him for his labor?

That approach would have ensured that their find would not have been compromised and the partners would have benefited from his services. This would have been a lawful solution to their dilemma. Also, were the three partners put in

economic duress by Jim's demand to join them since there was an implicit threat that he might reveal their presence.

Students should also examine Curtin's suggestion that they make Cody a partner posthumously. He proposed giving a quarter share to Cody's widow and child. Dobbs refused to contribute but Curtin and Howard promised to contribute a portion of their "goods" because had Cody not warned them about the bandits' approach, they would have been killed.

CONCLUSION

In teaching legal concepts, films can be a helpful tool to piquing student interest in applying these principles to fact situations. In an adventure movie like "Treasure of Sierra Madre", the facts are presented in the context of a story of lust for wealth, jealousy and greed.

One of the challenges in instructing 21st century students is that they are a visually-oriented group who respond better to dramatic action than to conventional pedagogy.

Use of film can stimulate discussion among students about the practical problems confronting people who enter a business relationship.

ENDNOTE

[1] Warner Bros. First National Picture NR Running Time 2hrs 6min. 1948.