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# Business Law Brief

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## The Commodity Exchange Act:

*When Is a Trading Facility Not a Trading Facility Under The Act?*

## Health Savings Accounts:

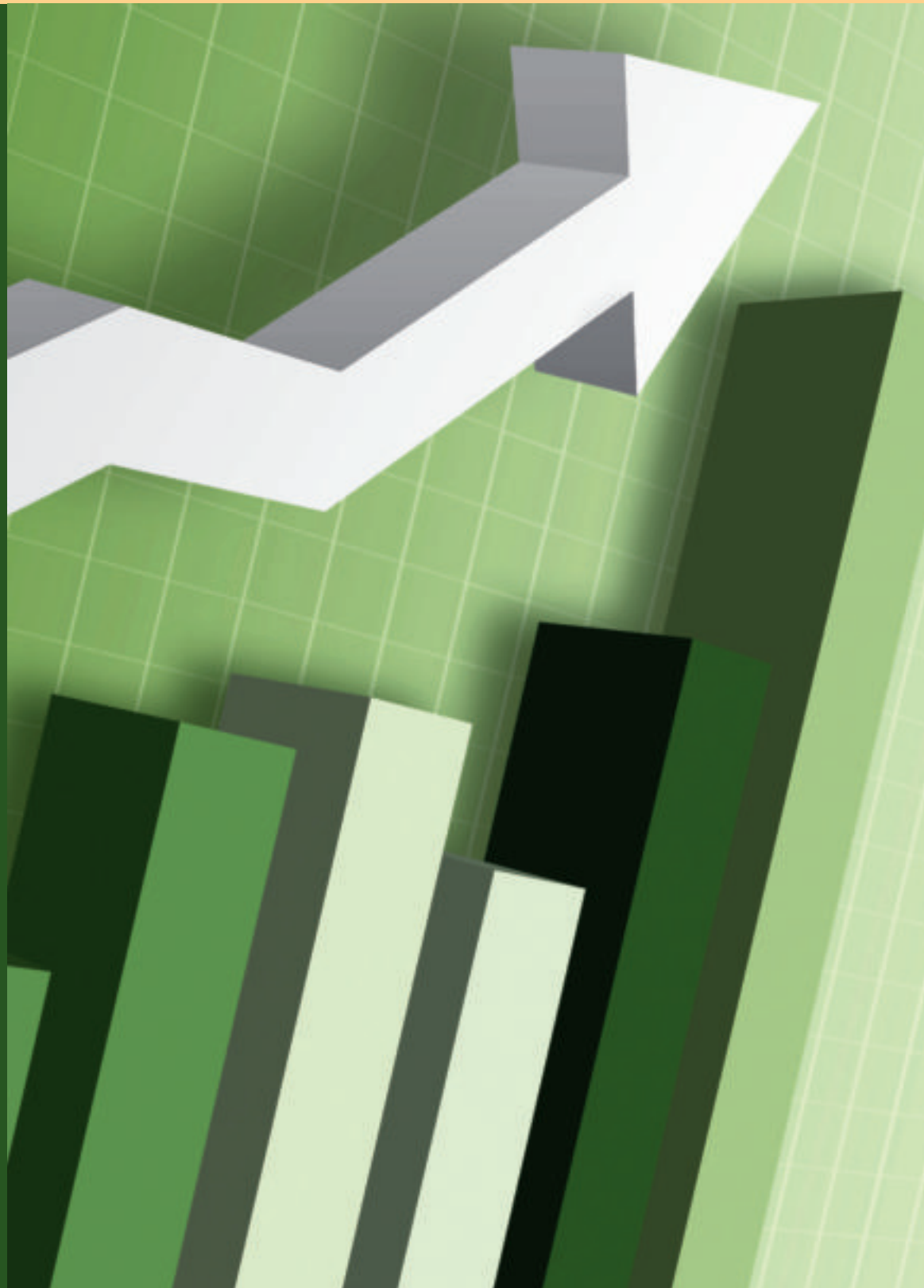
*How They May Change Patients' Experiences with Health Care*

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# When Is a Trading Facility Not a Trading Facility Under The Commodity Exchange Act?

By Elizabeth L. Ritter

**M**ORE THAN A YEAR AGO, the New York Mercantile Exchange (“NYMEX”) began clearing a certain unique type of financial product involving options on crude oil and natural gas inventory statistics. What makes these particular options unusual (as opposed to standard exchange-traded options common to the NYMEX and other futures markets around the world) is the pricing system on which they are traded: the Longitude System® (“Longitude”), developed by a privately-held technology corporation and owned by the International Securities Exchange and Goldman Sachs, Inc., which have been offering these options for several years. Longitude utilizes a Dutch auction-like format, in which prices are derived through the use of a pari-mutuel pricing mechanism, resulting in executable option positions in either oil or natural gas inventory statistics.

At first blush, Longitude appears to be just another trading facility, albeit a sophisticated one, but a trading facility nonetheless. Market participants send in their bids and offers, which are either taken or rejected. Prices are derived from those bids and offers, and positions are entered on behalf of the participants. Certainly sounds like a trading facility . . . or does it?

**At first blush, Longitude appears to be just another trading facility, albeit a sophisticated one, but a trading facility nonetheless. Market participants send in their bids and offers, which are either taken or rejected.**

Enter the Commodity Exchange Act (“CEA”). The CEA provides the basic statutory framework used by the Commodity Futures Trading Commission (“CFTC”) to oversee the com-

modity futures and options industry in the United States. In 2000, Congress amended the CEA in its promulgation of the Commodity Futures Modernization Act (“CFMA”), the most sweeping legislation affecting the derivatives markets since the inception of the CFTC in 1974. In that Act, Congress enacted statutory language to provide legal certainty for over-the-counter (“OTC”) derivatives transactions in exempt and excluded commodities, and to provide regulatory relief for exchange-traded derivatives. The CFMA also amended the CEA to include several new definitions intended to effectuate these objectives, including definitions of the terms “excluded commodity,” “exempt commodity,” and “trading facility.”<sup>1</sup>

## Impact of the CFMA

By all accounts the CFMA has been a resounding success. The flexibility provided to market participants under this new regulatory oversight regime has resulted in unprecedented growth in on-exchange trading volume and product diversification, while at the same time, over-the counter markets have experienced remarkable increases in volume and profitability. In addition, the changes introduced by the CFMA have permitted unparalleled increases in the number of new entities seeking to trade derivatives products under alternative regulatory procedures.

This “supermarket” of regulatory choices is not, however, without detractions attendant to its virtues—the most obvious of which is confusion. For example, when you set out to buy a quart of cottage cheese and find that you are faced with a veritable cornucopia of choices, including small-curd, large-curd, low-fat, super-low-fat, 1%, 2%, and lactose-free, the results can be overwhelming and discouraging. Particularly when you get home and find that you have inadvertently purchased a quart of vanilla yogurt.

In an effort to provide some clarity for derivatives “shoppers,” this article utilizes the current example of a novel financial platform to illustrate the many regulatory choices available under the CEA, and examines under what circumstances those choices may or may not be appropriate. Specifically, this article examines the oil and gas inventory statistics options trading under the Longitude system in light of the statutory provisions of the CEA, as amended by the CFMA, relating to 1) exclusions and exemptions for OTC derivatives; 2) regulatory relief for

exchange-traded products; and 3) new definitions in the CEA for commodities and trading facilities. The article concludes that regulatory relief for these transactions executed on the Longitude system is limited to only one of the new exemptive provisions provided by the CFMA.<sup>2</sup>

This “supermarket” of regulatory choices is not, however, without detractions attendant to its virtues—the most obvious of which is confusion.

### Legal Certainty Provisions of the CFMA

The CFMA amended the CEA to include new Sections 2(d), 2(g), and 2(h). These sections provide exclusions from regulation for excluded derivatives and excluded swaps, and exemptions for transactions in exempt commodities, respectively. Each provision has threshold requirements relating to the specific nature of the transactions and the underlying commodities, the entities on which they’re traded, and the sophistication of the parties. These exclusions/exemptions are briefly described below.

Section 2(d), “excluded derivative transactions,” provides a general exclusion from CFTC regulation for transactions in excluded commodities entered into between eligible contract participants (“ECPs”), not executed or traded on a trading facility. Additional regulatory relief is available under this provision if the transactions are executed on an electronic trading facility, on a principal-to-principal basis between ECPs trading for their own accounts or in a statutorily-defined agency capacity.



Section 2(g), entitled “excluded swap transactions,” also provides a broad exclusion from CFTC regulation for swap transactions in excluded and exempt commodities, if the contract, agreement, or transaction is entered into by ECPs, subject to individual negotiation, and not executed or traded on a trading facility.

Section 2(h), “legal certainty for certain transactions in exempt commodities,” provides two levels of exemptive regulatory relief for transactions in exempt commodities. First, Section 2(h)(1) provides that nothing in the Act, other than antimanipulation and certain antifraud provisions, applies to transactions in exempt commodities between ECPs, not entered into on a trading facility. Second, Section 2(h)(3) provides a similar exemption for exempt commodity transactions, as long as they are entered into between eligible commercial entities on a principal-to-principal basis, and executed on an electronic trading facility.

### New Definitions Included in the CFMA

Germane to this discussion are three new definitions included in the CEA, as amended by the CFMA. They are briefly described, as follows:

- 1 **Excluded Commodity.**<sup>3</sup> The definition of “excluded commodity” in the CEA includes four subsections, each of which provides substantively different classifications and standards for assessing qualification as an excluded commodity. The first subsection catalogs specific types of commodities that are commonly considered to be financial commodities (for example, interest rates, exchange rates, and debt or equity instruments). The second subsection consists of risk measures that are not based on a narrow group of commodities, or measures that are based on commodities with no cash market (for example, an index including a broad range of commodities). The third subsection addresses indices based on prices, rates values or levels not within the control of relevant parties to the transaction (for example, a housing price index or a consumer price index). Lastly, the fourth subsection includes occurrences or contingencies that are beyond the control of the parties to the contract and are associated with some financial, commercial or economic consequence (for example, weather derivatives).
- 2 **Exempt Commodity.**<sup>4</sup> The CEA, in a peculiar bit of legislative draftsmanship, describes an exempt commodity by a negative: it is that which is neither an excluded commodity nor an agricultural commodity. As noted in the preceding paragraph, Congress provided a comprehensive (if prolix) definition of an excluded commodity, and the term agricultural commodity has the benefit of a longstanding CEA definition, as well as the common sense understanding of what it means to be an agricultural

commodity. This leaves the exempt commodity field to mean, one supposes, everything else.

③ **Trading Facility Definitions.** The CFMA amended the CEA to include a specific definition of “trading facility.” The genesis for this definition was, at least in part, driven by the rise of electronic trading platforms and the desire to provide clarity for market participants as to what constitutes an entity that falls under CFTC jurisdiction. Specifically, the CEA now provides that a trading facility means a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system.<sup>5</sup>

The definition also provides for certain exceptions: 1) electronic facilities that enable participants to negotiate terms of and enter into bilateral transactions as a result of communications between the parties, and not from the interaction of multiple bids and offers within a “predetermined, nondiscretionary automated trade matching and execution algorithm”; 2) government securities broker/dealers, to the extent that such entities execute or assist in the execution of government securities transactions; and 3) facilities on which bids and offers, and acceptances of bids and offers, are not binding. The definition specifically provides that clearing of transactions entered into on an entity not otherwise considered a trading facility does not alter the characterization of the entity.

In addition, the CFMA also included a separate definition for “electronic trading facility”<sup>6</sup> which includes “a trading facility that . . . operates by means of an electronic or telecommunications network” and “maintains an automated audit trail of bids, offers, and the matching of orders or the execution of transactions on the facility.”

Lastly, the CFMA amended the CEA to include a definition of the term “board of trade.”<sup>7</sup> Specifically, “board of trade” means “any organized exchange or other trading facility”; “organized exchange,” in turn, is defined as a “trading facility” that has certain specified characteristics.<sup>8</sup>

### Regulatory Relief Provisions of the CFMA

The CFMA instituted a tiered system of market regulation, tailored to particular market requirements. The first level of regulation relates to “designated contract markets” (“DCMs”)<sup>9</sup> — what most people think of when they think of a futures market

exchange, for example the NYMEX or the Chicago Board of Trade. These markets are open to all market participants (retail investors as well as sophisticated institutional investors), and trade in all commodities. As opposed to the prescriptive, one-size-fits-all rules in place prior to the CFMA, DCMs are subject to 18 “core principles” that ensure the markets provide appropriate oversight of trading to protect against fraud and manipulation and to protect the integrity of the marketplace and the transactions executed in the marketplace. The second “tier” of CEA market regulation relates to “derivatives transaction execution facilities” (“DTEFs”), which are limited to ECPs and certain others trading through large futures commission merchants; there are limitations on the commodities that may be traded on these platforms.<sup>10</sup> DTEFs are subject to eight core principles that address market integrity and customer protection issues, tailored to the nature of the market participants and the commodities traded on the facility.

The third level of market oversight instituted under the CFMA is the “exempt board of trade” (“EBOT”) and the “exempt commercial market” (“ECM”).<sup>11</sup> Section 5d allows a “board of trade,” upon notice to the Commission, to operate as an EBOT if: 1) it trades only in commodities that have a nearly inexhaustible supply, a deliverable supply that is sufficiently large, and a cash market sufficiently liquid, such that trading in the commodity is highly unlikely to be susceptible to manipulation, or no cash market;<sup>12</sup> and 2) trading is limited to ECPs.

This provision thus operates essentially as an additional exemption from CFTC regulation; there are no core principles for EBOTs, though EBOT transactions do remain subject to the CEA’s prohibitions against fraud and manipulation. With regard to ECMs, Section 2(h) of the CEA provides regulatory relief for transactions in exemption commodities, as discussed in greater detail below.

### Discussion of Natural Gas and Crude Oil Statistic Options

To get back to the original question, how does the trading of options on natural gas and crude oil inventory statistics on the Longitude system fit into the new regulatory structure and definitions described above? Under what regulatory exclusions or exemptions from the CEA—2(d) excluded derivative transactions, 2(g) excluded swap transactions, 2(h) exempt commodity transactions, or 5d EBOT transactions—if any, are these options executed? The key to untying this Gordian knot of statutory provisions begins with identification of the parties to the transactions, the commodities traded, and lastly, the nature of the facility on which the transactions are executed.



**The key to untying this Gordian knot of statutory provisions begins with identification of the parties to the transactions, the commodities traded, and lastly, the nature of the facility on which the transactions are executed.**

The first query is by far the easiest. These transactions are limited to ECPs, one of the threshold requirements for each of the legal certainty requirements discussed above. So as to the first test—participant sophistication—all of the cited regulatory relief provisions would be applicable.

We lose one of these relief provisions when we move on to our second inquiry: identifying the nature of the commodities traded. Crude oil and natural gas inventory statistics options would appear to fall under the exempt commodity category, inasmuch as they do not meet any of the four subsections of the excluded commodity definition,<sup>13</sup> and they certainly are not agricultural commodities. Therefore, by definition, they must be exempt commodities. The nature of the underlying commodity limits the nature of the regulatory relief available under the CEA: the

Section 2(d) “excluded derivative transaction” provision is inapplicable, as that provision is specific only to excluded commodities. Therefore, we are left with only three regulatory relief provisions—Section 2(g) excluded swap transactions, 2(h) exempt commodity transactions, and 5d EBOT transactions— all of which are potentially available for exempt commodity transactions,<sup>14</sup> as we turn to our last area of inquiry.

Our final query, to determine potential regulatory relief under the CEA, relates to the nature of the transaction facility. Sections 2(g) and 2(h)(1) share the same requirement that the transactions not be executed on a “trading facility.”<sup>15</sup> Section

2(h)(3), by contrast, requires that the transactions be executed on an “electronic trading facility.” Accordingly, whether Longitude is a “trading facility” is critical to a determination of where the entity falls on the CEA’s regulatory landscape.

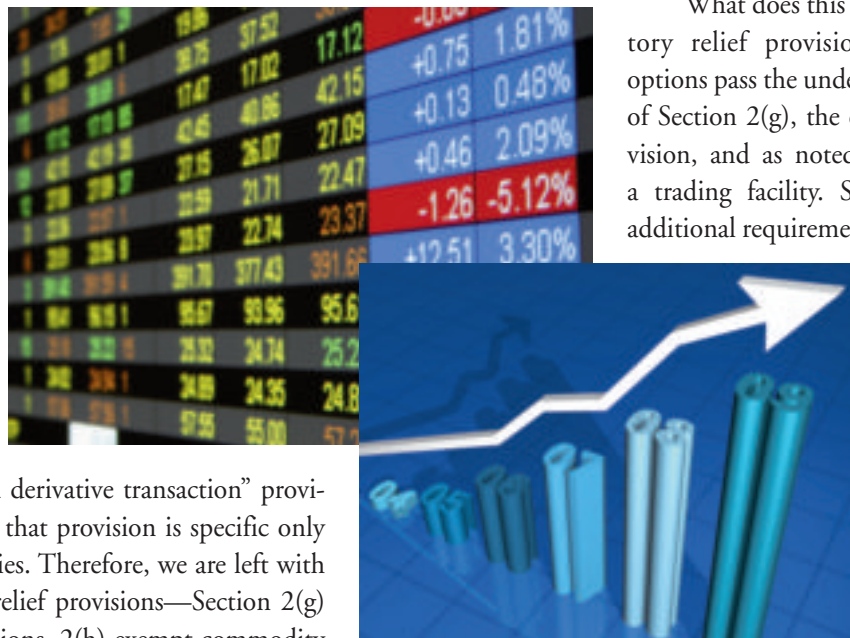
The CEA defines a trading facility as a “physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system.”<sup>16</sup> Longitude does not appear to be a system that permits such “multiple” bid and offer participation. Indeed, it would seem that once the system sets option prices using the pari-mutuel pricing system, Longitude operates as a “dealer” system, with the dealer as the buyer to every option seller and the seller to every option buyer on the system. There is no indication that there is matching of orders on the system: it appears that all orders are entered into with a central counterparty, rather than with “multiple participants” on the opposite side of transactions. Therefore, inasmuch as participants would not appear to be “accepting bids and offers made by other participants,” but rather all orders seem to be entered into with a single central counterparty, this system would not act to match orders among “multiple participants” as contemplated under the CEA’s statutory definition of a trading facility. Accordingly, it follows that Longitude is not appropriately considered a “trading facility” within the meaning of the CEA.

What does this mean for our remaining regulatory relief provisions? The inventory statistics options pass the underlying commodity requirement of Section 2(g), the excluded swap transaction provision, and as noted the Longitude system is not a trading facility. Section 2(g), however, has an additional requirement: that the transactions be sub-

ject to individual negotiation. The Longitude system doesn’t allow for such negotiation; bids and offers are entered into the system and are either accepted or rejected, and no individual negotiation of terms is available to the parties on the system. Therefore, while we made it down to

the wire with this one, like Lucy pulling the football away just as Charlie Brown is ready to kick, we’re forced to conclude that transactions on the Longitude system do not meet the statutory requirements for exclusion under Section 2(g) of the CEA, and regulatory relief is not available under that statutory provision.

As for Section 2(h) exempt commodity transactions, Section 2(h) distinguishes between those transactions in exempt



commodities that are not conducted on a trading facility—Section 2(h)(1) transactions—from those conducted on an electronic trading facility—Section 2(h)(3) transactions. It goes without saying that since Longitude is not a “trading facility,” it cannot be considered an “electronic trading facility” under the CEA, inasmuch as the latter utilizes the former as a premise in its definition. Therefore, trading on the Longitude system fails to meet one of the requirements of Section 2(h)(3), that transactions be executed on an electronic trading facility; accordingly, exemptive relief is not available pursuant to that provision.<sup>17</sup> That leaves us with Section 2(h)(1).

Crude oil and natural gas inventory statistics options executed on the Longitude system appear to satisfy the requirements of CEA Section 2(h)(1). The transactions are entered into between ECPs and are not executed or entered into on a trading facility. Accordingly, it would appear that market participants could rely on this exemption in the CEA in the execution of these transactions. No notification to the CFTC is required pursuant to this section; the provision is self-effectuating. Finally, we’ve come across a provision of the CEA that affords regulatory relief to the crude oil and natural gas options transactions executed on the Longitude system.

If Section 2(h)(1) did not afford the sought-after regulatory relief, the Longitude system would be out of luck, because the only oversight provision left to review—CEA Section 5d EBOTs—isn’t going to get us very far. Although the Longitude system meets the participant and commodity criteria for EBOTs under CEA Section 5d, because it is not a trading facility this provision is not appropriate for transactions executed on Longitude. The EBOT provision begins with the words “[a] board of trade . . . .” As noted above, the definition of “board of trade” is an “organized exchange” or other “trading facility.” The definition of “organized exchange” under the CEA means a “trading facility.” A board of trade, therefore, must be a trading facility, and we have already determined that Longitude is not a trading facility under the CEA; accordingly, Longitude does not qualify as an EBOT.

## Conclusion

The CFMA amended the CEA to provide market participants with numerous choices in the regulatory arena for commodity futures and options. To the extent that the CEA appears to provide rather too many choices in some instances, this article has attempted to outline a method to navigate the numerous and complex regulatory relief provisions of the CEA. As to the specific transactions discussed—options on crude oil and natural gas inventory statistics traded on a platform that does not constitute a trading facility under the CEA—only one statutory provision, Section 2(h)(1), appears to provide self-effectuating regulatory relief from many of the provisions of the CEA. The

Longitude system also does not qualify for regulatory relief as an EBOT in these circumstances inasmuch as these entities presumptively must be trading facilities under the CEA. **BLB**

*Deputy General Counsel, United States Commodity Futures Trading Commission. The opinions expressed in this article are solely those of the author, and are not intended in any way to represent the views of the Commission or any of its Divisions or Offices.*

## ENDNOTES: Elizabeth L. Ritter

- 1 CEA, 7 U.S.C. § 1a(13), (14), (33) (2003).
- 2 The brief walk through some of the CFMA’s key exclusions, exemptions, and definitions in this article should not mask the difficulty inherent in parsing these statutory provisions. These are complex, sometimes overlapping provisions; their meaning, and the ways in which Congress intended them to be interpreted (each in turn and in tandem with the others) is rarely self-evident.
- 3 CEA Section 1a(13), 7 U.S.C. §1a(13).
- 4 CEA Section 1a(14), 7 U.S.C. §1a(14).
- 5 CEA Section 1a(33), 7 U.S.C. §1a(33).
- 6 CEA Section 1a(10), 7 U.S.C. §1a(10).
- 7 CEA Section 1a(2), 7 U.S.C. §1a(2).
- 8 CEA Section 1a(27), 7 U.S.C. §1a(27).
- 9 CEA Section 5, 7 U.S.C. §7.
- 10 CEA Section 5a(b)(2), 7 U.S.C. §7a (requiring that commodities traded on a DTEF generally have “nearly inexhaustible deliverable supply” and be “highly unlikely to be susceptible to the threat of manipulation.”). In addition, there is a commercial trading subset included in this provision, allowing trading in commodities other than enumerated agricultural commodities (except as provided in Section 5(e)(2)), and requiring that trading be limited to eligible commercial entities trading for their own account. CEA Section 5a(b)(2)(F), 7 U.S.C. § 7a(b)(2)(F).
- 11 CEA Section 5d, 7 U.S.C. §7a-3; CEA Section 2(h), 7 U.S.C. §2(h).
- 12 CEA Section 5d(b)(3), 7 U.S.C. §7a-3 (specifying that no trading in futures securities are permitted on EBOTs). Part 36 to the CEA Regulations states specifically that excluded commodities are eligible to be traded on EBOTs (Reg.36.2(a)(2)(i)). In addition, the CFTC has issued orders pursuant to Reg. 36.2(a)(2)(ii) permitting other types of commodities to be traded on EBOTs.
- 13 See *supra* note 3 and accompanying text.
- 14 CEA §5d, 7 U.S.C. § 7a-3 (explaining that determination of whether the underlying commodity test of Section 5d is satisfied is dependent upon whether the exempt commodities can meet the criteria listed in Section 5d(b)(1)(A) – (C) relating to nearly inexhaustible deliverable supply, non-susceptibility to manipulation, or lack of a cash market). There is a question as to whether excluded commodities generally, and excluded energy commodities in particular, could ever satisfy these criteria; the author makes no prognostication in this regard.
- 15 This overlap has created some statutory ambiguity as to whether the exclusion in Section 2(g) somehow “trumps” the exemption of Section 2(h)(1) and the latter’s reservation of CFTC enforcement authority (such as antifraud and antimanipulation authority) with respect to transactions in energy commodities. The better answer appears to be that it does not, as it is an accepted canon of statutory construction that the statute shall not be construed in such a manner as would render any portion of the statute superfluous. *Williams v. Taylor*, 529 U.S. 362, 364 (April 18, 2000).
- 16 CEA § 1a(33)(A), 7 U.S.C. § 1a(33)(A).
- 17 It should be noted that trading on the Longitude system, inasmuch as it is not limited to eligible commercial entities, would fail to pass the requirements of CEA Section 2(h)(3) for that reason, in addition to failing to meet the trading facility requirement.

# How Health Savings Accounts May Change Patients' Experiences with Health Care

By Daniel C. Brown

## Introduction

**A**ERICAN HEALTH CARE is in the midst of an ideological struggle between those who want it to be more influenced by market forces and those who believe it is a right whose costs should be shared by society as a whole. Advocates of consumer driven health care seek to put patients in control of their own care, limited only by the same cost considerations that consumers face in most other sectors of the economy. They claim that if patients have incentives to act like demanding consumers—just as they do when buying a car—they will be more judicious with their consumption of services and force health care providers to become more efficient and improve quality of service. This article explores the leading model of consumer driven health care, Health Savings Accounts (HSAs). It concludes that HSAs will probably be less effective at achieving their stated goals than advocates claim, will nonetheless increase competition in some sectors, and may increase costs for the chronically ill to a degree that should concern policy makers now.

Predominant health care funding models have frustrated patients and failed to contain costs.<sup>1</sup> When managed care plans attempted to deny reimbursements for medical services they deemed exorbitant or unnecessary, legislatures reacted to public resentment by mandating a patchwork of minimum services such as forty-eight hour hospital stays after childbirth.<sup>2</sup> Additionally, many critics of medical care in the United States note that the industry lags behind other sectors in quality control and customer service. Even while many Americans shun the waiting lists and rationing of health care they hear about in Canada and the United Kingdom, they in fact endure delays and inconveniences they would never tolerate if shopping for shoes or a car. Patients in the United States must seek out doctors who

accept their insurance, wait weeks for an available appointment, and finally suffer through inevitable delays in doctors' waiting rooms. Furthermore, medical errors are far more common than many patients find acceptable. Finally, unlike many other technology-intensive sectors of the economy in which prices tend to fall over time, medical services become more and more expensive each year.

Advocates of consumer driven health care see a single cause underlying all these problems: the third party payer approach that has come to support the vast majority of medical care spending in the United States. Whereas in 1960 consumers directly paid 56% of all health care costs, today that number is

down to 15%, with government and private third party payers picking up the difference.<sup>3</sup> Critics argue that so long as it is the resources of a third party—the insurer or government—that are spent as a result of treatment decisions, patients will always have an incentive to overconsume health care services. However, patients will not have the incentive to demand the high quality and efficiency that they would if they were spending their own money.<sup>4</sup> It is meaningless for

third party payers to limit expenditures to “necessary” care only, these critics suggest, because the supply of potentially beneficial treatments is nearly infinite.<sup>5</sup> And they point to the lasik surgery and vision care industries as examples of how the health care sector can become efficient and customer friendly when it must compete directly for consumers' own dollars.<sup>6</sup> Only if patients must truly weigh cost considerations along with other factors will they make resource-prudent decisions and also hold doctors and hospitals accountable for quality and efficiency as they do in other sectors.

Health Savings Accounts are designed to remedy these market failures by giving patients the power and responsibility to

**American health care is in the midst of an ideological struggle between those who want it to be more influenced by market forces and those who believe it is a right whose costs should be shared by society as a whole.**

control expenditures on their own health care. HSA subscribers receive high-deductible insurance policies, so they receive few<sup>7</sup> or no benefits unless their annual expenses exceed the deductible, which averages \$1,654.<sup>8</sup> But plans partially offset the high deductible by giving patients an annual cash-like deposit—averaging \$824<sup>9</sup>—that can only be spent on health-related expenses.<sup>10</sup> The result is that participants must spend up to an average \$830 of their own funds if they expend their entire HSA balance before reaching the annual deductible. However, any HSA balances remaining at the end of the year can be rolled over to the next year and accumulated over time, so the risk that participants will have to draw on their own funds before reaching the annual deductible is highest in the initial years of participation. HSAs are also “portable,” so participants keep their balances even if they change jobs.

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### **Analysis: Do HSAs change spending behaviors?**

Although experience with HSAs is still very limited,<sup>11</sup> a number of studies provide some evidence of whether they in fact affect spending behavior, either by reducing overconsumption or by encouraging patients to demand greater efficiency, convenience, and quality.

#### **Reducing “overconsumption”**

The limited data suggests that adoption of HSAs may tend to reduce overall health care spending, at least somewhat. For example, in one study of three large employers that adopted HSA options alongside traditional plans, Anthony Lo Sasso and colleagues found expenditures of those in the HSA plans were significantly below those in the traditional plans.<sup>12</sup> At the one site where year-on-year data was available, those who enrolled in the new HSA plan had total expenditures that were 30% less than the previous year, when they had been enrolled in traditional plans.<sup>13</sup> At a second site, expenditures for employees in the HSA plan were 50% less than those who remained enrolled in the traditional PPO plan, but data limitations prevented the authors from determining whether those in the HSA plan were

spending less on average than they as a group had spent in previous years.<sup>14</sup> The third site did not report expenditure data.

Other experiences show more modest results. In a study of a single employer by Stephen Parente and colleagues, overall expenditures for those in HSA plans were approximately 3% less than those for Preferred Provider Organization (PPO) participants, but 13% more than participants in a competing Health Maintenance Organization (HMO) offering.<sup>15</sup> Discovery Health, a consumer driven health plan in South Africa, has found that patients submitted claims for 16% fewer prescriptions than those on traditional plans, suggesting that HSA-type schemes discourage patients from requesting or filling prescriptions they view as less necessary.<sup>16</sup>

### **Studies examining shopping behavior**

While the limited data support the possibility that overall expenditures might be reduced under HSA plans, there is very little data to show whether or not HSAs in fact encourage patients to comparison shop to find the best deal for their money. HSA opponents, including Consumers Union’s Gail Shearer, argue that the frequent need for urgent or timely treatment, the control that doctors must exercise over decision-making, and the inadequate information and decision-making ability of consumers make such comparison shopping unworkable.<sup>17</sup> Supporters answer that much of medical care is not delivered on an emergency basis, and that as many as 70 million American patients can and regularly do access medical information on the internet, even using it to challenge their doctors’ preferred courses of treatment.<sup>18</sup>

South Africa’s Discovery Health has found that those on HSA-type plans spend at least 11% less on prescription medications, and 48% of participants had asked their pharmacists about the availability of generic alternatives to more expensive name brand equivalents.<sup>19</sup> While such data is at best anecdotal, it does suggest that participants in HSA plans are more likely to comparison shop for cheaper, equally effective alternatives, at least in the case of pharmaceuticals.



**Another concern is whether patients truly view HSA deposits as their own money.**

On the other hand, such data does not directly refute Shearer's claim either, since drugs are not usually prescribed on an emergency basis, and patients often have the option of asking their pharmacist about generic equivalents after their doctor has made the prescribing decision. And since generics are supposed to deliver the same effective ingredients as their name brand equivalents, the patients' decisions really only turn on one variable: price. It is a far more complex decision—even with the expertise of a well qualified doctor—to choose between a cheaper, less effective drug with serious side effects, and a newer, much pricier alternative with none of those disadvantages. Decisions can be all the more complex with surgical and other alternatives. In such situations, patients might very well simply defer to their doctors' recommendations rather than comparison shop as the consumer driven health care model assumes.

**Do patients view HSA deposits as their own money?**

Another concern is whether patients truly view HSA deposits as their own money. HSAs will only facilitate the consumer driven health care model if patients are as thrifty as they are with their own funds. Since the deposits can only be spent on qualified health-related expenses, patients will only view the HSAs as their own money if they understand and believe that balances can accumulate and be rolled over indefinitely for any future qualified expenses.

At least some of the available data suggest patients may not view the deposits that way. For example, at one of the employer sites in the Lo Sasso study, new participant spending from HSA accounts followed a distinct U-shaped pattern over the calendar year, with expenditures spiking in November and December.<sup>20</sup> In fact, December spending was 60% higher than the monthly average that had remained flat through October.<sup>21</sup> While it would be normal for new participants to have higher than average spending in the initial months due to pent-up demand, there would be little reason for expenditures to spike at the end of the year unless participants did not believe they could truly keep the deposits, especially since 90% of those participants had opted to remain in the HSA plan the following year.

Equally intriguing was a phenomenon in the Parente study, in which HSA plan participants' spending was lower than that of

traditional plan participants overall but nonetheless spiked significantly in the second year.<sup>22</sup> The authors suggest that as HSA balances increase, participants may decide to purchase services that they would not have paid for out-of-pocket.<sup>23</sup> But if they make such sharp distinctions between their own funds and HSA deposits, they may not behave like "consumers" until the deposits have been exhausted. The phenomenon suggests that patients may have a particularly short-term view of the HSA deposits quite distinct from how they view their own out-of-pocket spending. If widely held, such a view would undermine a key underpinning of the HSA model because patients' incentives to curb overconsumption and to comparison shop for health alternatives would be significantly reduced. Employers and plans would likely increase coinsurance requirements of the high deductible insurance component and decrease annual HSA deposits, leaving participants at risk of higher out-of-pocket expenses in order to achieve the shopping behavior on which consumer driven health depends.

**Even if plans and employers could tinker with annual HSA deposit amounts and coinsurance requirements so that patients have strong incentives to economize and comparison shop, and even if the plans were widely adopted, the scale and distribution of health care costs raise questions about how powerful the effects could be system-wide.**

**Health care spending numbers and their limitations on the benefits of Health Savings Accounts**

Even if plans and employers could tinker with annual HSA deposit amounts and coinsurance requirements so that patients have strong incentives to economize and comparison shop, and even if the plans were widely adopted, the scale and distribution of health care costs raise questions about how powerful the effects could be system-wide. The nation's overall expenditures are far from evenly distributed across the population. Instead,

the vast majority of health care spending is attributable to a small minority of the population. Although average spending per patient is \$2,628 per year,<sup>24</sup> 50% of Americans require less than \$350 in services each per year and account for only 3% of nationwide health care spending.<sup>25</sup> At the other end of the spectrum, 10% of Americans are responsible for 71% of all health care spending nationwide,<sup>26</sup> with per capita expenditures ranging from \$4,115 per person per year to more than \$27,914 per person per year for the top 5% of spenders.<sup>27</sup>

**The picture is somewhat less gloomy for the prospects of consumer driven health care’s second theoretical effect—improved efficiency and quality system-wide due to comparison shopping by demanding consumers—but its effects would still likely be limited.**

What does this mean for controlling total health care expenditures? Even assuming that overconsumption is a predominant spending problem and that the HSA model will encourage patients to spend less, the scheme can only be effective until a patient reaches the annual deductible threshold. After that, incentives to spend are roughly the same as or even stronger than they are in the traditional model. Yet, even assuming an annual deductible of \$2,000 per year, which is substantially higher than the average,<sup>28</sup> 88%<sup>29</sup> of all health care expenditures are made on account of patients who require more than that amount every year. For those higher-expense patients, HSAs do not even purport to offer incentives for reduced spending, so it is difficult to see why their expenditures would be reduced.<sup>30</sup>

Consumer driven health care advocate Regina Hertzlinger envisions that “focused factories”—programs focused on costly, unmet health care needs, including management of chronic disease and disabilities—would spring up to reduce costs for higher cost patients as well.<sup>31</sup> The model is based in part on using technology to allow various providers to integrate their care for a single patient, reducing redundant tests and services. Despite the appeal of such predictions, the HSA model simply provides no incentive for such innovation, except to the extent certain services could quickly be brought under the annual deductible threshold. Thus, even though the HSA model might reduce costs for employers and health plans with disproportionately high numbers of low to moderate spenders, it is difficult to see how it could have much effect on overconsumption nationwide.

The picture is somewhat less gloomy for the prospects of consumer driven health care’s second theoretical effect—improved efficiency and quality system-wide due to comparison shopping by demanding consumers—but its effects would still likely be limited. The key in this analysis is the expense of so many medical tests, therapies, and procedures. As health care analyst George Halvorson questions, how many surgical procedures cost less than the \$2,000 assumed deductible?<sup>32</sup> Even routine diagnostic tools such as MRIs, CT scans, chemotherapy, and the like can cost considerably more.<sup>33</sup> If one procedure inevitably brings the patient over the annual deductible threshold, then there is no incentive for her to comparison shop for that procedure or any other subsequent health care in the same calendar year. Competition might cause some providers to reduce their prices for some services, but it is difficult to imagine price reductions so deep and widespread that a

significant number of procedures would be newly brought into the effected range.

The health care goods and services for which economic forces would create new, efficient markets would be limited to those whose annual costs<sup>34</sup> are less than the annual deductible and that are consumed by patients whose total expected expenditures for the year do not exceed the deductible. While this limitation is important to note, it must also be acknowledged that numerous health care goods and services likely meet both criteria. After all, roughly 80% of the population spends less than \$2,000 per year,<sup>35</sup> and certainly numerous minor procedures and



products fall within that price range. Assuming the above-noted concerns over how patients view HSA deposits could be reasonably resolved, then lower-cost, higher-quality, more convenient industries might very well spring up around a whole host of health care products and services, just as has occurred in the vision care and lasik surgery industries. Such innovation would benefit a large segment of the population, including those with no health care coverage at all. It is important to note, though, that despite all these benefits, such changes would not significantly reduce the national scale or growth of health care costs as a whole, nor the efficiency or quality of goods and services whose costs remain above the deductible threshold.

**Perhaps one of the most contentious issues surrounding HSAs is the “adverse selection” problem.**

**Adverse selection: Will HSAs create a death spiral for traditional health plans and increase costs for the chronically ill?**

Perhaps one of the most contentious issues surrounding HSAs is the “adverse selection” problem. The dispute in large part turns on what the proper role of private health plans is, and whether it is more important for the health care system to protect patients from major out-of-pocket expenses or instead to maximize efficiency.

Critics argue that HSAs are really just a tool to let the wealthy shelter more income from taxes. The adverse selection concern arises because HSAs would likely be more attractive to the healthy and wealthy than to the sick and poor.<sup>36</sup> Since HSA plans often charge lower monthly premiums and offer the prospect of deposits that can accumulate over time, those who do not expect to have many medical expenses—such as the 50% of the population who consume less than \$350 in health care per year—would opt for HSAs over traditional plans in the hope of reducing their costs and recouping some of their premiums through accumulated account deposits. Those with chronic or more frequent health care needs would tend to stay with traditional plans, believing they would quickly use up HSA deposits and fearing increased out-of-pocket expenses before the high deductible is met each year. HSAs would be more attractive to the wealthy because they offer a way for employers to offer compensation-like benefits—account deposits—that are shielded from taxation. They also allow taxpayers to shield some of their

own income by contributing part of their salaries to HSAs, over and above the direct contributions made by employers.<sup>37</sup> The tax shelter is of course of proportionately more benefit for those in higher marginal income tax brackets.

The ultimate fear is that if HSAs become a widespread phenomenon, they will attract mainly the participants that formerly contributed their monthly premiums to traditional plans but rarely ever utilized the plans’ benefits. Left in the traditional plans will be those who receive much more in benefits than they ever pay in premiums. A rough analysis of cost distributions over the population, as was discussed above, suggests that HSAs might be a rational choice for approximately 80% of the population, while the spending patterns of the remaining 20% would cause them to prefer to stay with traditional plans. Yet traditional plans manage to survive only because the healthier, low utilizers effectively subsidize the higher utilizers with chronic or catastrophic illness such as cancer or heart disease. Attracting away the low utilizers would cause traditional plans to have to raise premiums drastically until participants’ premiums approached the benefits they receive back as a group.<sup>38</sup> Since few could afford such high premiums, and because at the extreme there would be no reason to pay them, traditional plans would face bankruptcy and shut down. In the end, then, HSAs would not truly be just another “choice,” but would eventually be the only choice. Assuming HSA plans even accept the sicker patients who lose their traditional health coverage, those patients would face significantly higher costs than before HSAs were introduced in the first place.

**The ultimate fear is that if HSAs become a widespread phenomenon, they will attract mainly the participants that formerly contributed their monthly premiums to traditional plans but rarely ever utilized the plans’ benefits.**

HSAs are still far too small a piece of the health care coverage pie to gauge whether these dire predictions would come true. But early evidence does show that adverse selection is occurring.<sup>39</sup> Laura Tollen and colleagues studied more than 10,000

participants in Humana's health care plans and found that while demographic factors such as age, sex, and family size were not good predictors of plan preference, those with low prior utilization (up to 60% less than average) showed a strong tendency to gravitate away from the traditional plan and toward the HSA plan.<sup>40</sup> Lo Sasso's study found a similar trend—HSA plan enrollees had 50% less expenditures in the previous years than the average employee—and also found that those with salaries over \$80,000 were twice as likely to choose an HSA plan.<sup>41</sup> The Fowles study found that those who opted for an HSA plan were less likely to be African American and less likely to have chronic disease or to have visited a physician recently.<sup>42</sup> While these studies were too small to support conclusive judgments about HSAs generally, their consistency with the economic theory provides significant evidence that adverse selection is a serious concern.

Interestingly, instead of denying that adverse selection is likely to occur, advocates of HSAs seem either to downplay its seriousness or even applaud it as fair and rational. For example, Hertzlinger responds to the complaint by characterizing it as *irrelevant to employers* who self-insure and pay all their enrollees' cost anyway.<sup>43</sup> Her point seems to be that even if traditional plans are priced out of existence, chronically ill and high utilizer employees will still be covered under an HSA plan, and their expenses will still fall to self-insured employers anyway. She avoids addressing the impact on those patients who, because of recurring higher utilization, will have to pay their way through the gap between the HSA deposit and the high deductible every year.

HSA advocate Greg Scandlen emphasizes that both adverse selection and moral hazard are insurance induced distortions of market forces and are good examples of why health "insurance" should only cover true risks, rather than more-or-less expected costs.<sup>44</sup> He then defines "risks" as only those services that would be "unaffordable" to the patient, which he presumably means would be those in excess of the annual deductible of \$1,500 to \$2,000.<sup>45</sup> He characterizes costs short of those levels as "known consumption"<sup>46</sup> which should be paid through non-insurance mechanisms such as HSA deposits and out-of-pocket, after-service installment plans. Rather than arguing that adverse selection will not happen, or that it does not threaten an end to traditional plans, advocates seem to argue that the end of traditional plans would be a benefit to the public.

On the other hand, Gail Shearer, a critic of consumer driven health care, sees *cost sharing* as a primary goal of health insurance, regardless of how high or expected one's costs may be.<sup>47</sup> HSAs are a threat, then, in large part because chronically ill and higher utilizers would face increased out-of-pocket expenditures as they spend through the gap every year, while low utiliz-

**Critics view putting individuals at risk of having to pay higher costs—in particular if those costs continue year after year for chronically ill patients—as unacceptable, even if out-of-pocket costs are within the gap ranges contemplated under HSAs.**

ers would "take back" some of their overpayments through account deposits and lower premiums. The disagreement really comes down to a choice between competing ideals. Presumably both sides would acknowledge that the third party payment system distorts market incentives, drives up prices, and reduces efficiency and convenience. To overcome this, advocates of HSAs are willing to have higher utilizers pay more for their own health care consumption and even see such an arrangement as a fairer alternative to shifting their costs to others. Out-of-pocket expenses of up to \$800 per year for ongoing chronic illness care are not that much, they would argue. Furthermore, the government could subsidize such payments for low-income workers without destroying the market forces that consumer driven health care seeks to preserve.<sup>48</sup> And since HSA plans are typically cheaper than traditional plans, they would provide lower cost options for people who otherwise could not afford insurance at all.

**The health care industry continues to exhibit rising costs, rigidity, and inconvenience in an age when other industries are reducing costs and meeting the demands of 24-hour customers.**

Critics view putting individuals at risk of having to pay higher costs—in particular if those costs continue year after year for chronically ill patients—as unacceptable, even if out-of-pocket costs are within the gap ranges contemplated under HSAs. They also fear that over time, employers and plans will reduce HSA deposit amounts as they see many employees accumulating large balances, will increase coinsurance requirements in the high deductible insurance component, and ultimately will seek to drive employees into the individual insurance market by discontinuing group coverage. In such a scenario, as insurers try to price individual plans to risk, the scheme would reduce cost sharing entirely and causing each individual to bear his own health care cost.<sup>49</sup>

### Conclusion

This article has explored the theory and limited available data related to experience with HSAs and has attempted to reconcile opposing ideologies in order to predict likely outcomes if HSAs become widespread. The health care industry continues to exhibit rising costs, rigidity, and inconvenience in an age when other industries are reducing costs and meeting the demands of 24-hour customers. And there are strong reasons to believe that the third-party payer system so prevalent in the United States is the root cause for such inefficiencies, since patients have little incentive to demand cost effectiveness and little leverage to demand improved quality or convenience.

Two key policy issues, then, are whether forcing the chronically ill and other persistently high utilizers into HSA plans is morally and politically acceptable, and whether government would somehow subsidize those with low incomes.

At the same time, it is not clear that HSAs will be able to deliver on all their promises. Limited data on overall cost containment under HSAs shows relatively modest savings. Given how skewed health care spending is across the population, there is reason to doubt that HSAs would have much effect on health

care spending nationwide. At the same time, there are strong reasons to believe that HSAs would significantly increase competition—and would therefore drive down prices while improving quality and convenience—in delivery of certain health care goods and services, as has already occurred in the vision care industry.



Finally, both proponents and critics seem to acknowledge that HSAs represent something other than just another option in the insurance marketplace, should they become widespread. Instead, there is a strong likelihood that traditional plans will cease to exist as low utilizers abandon them in an effort to stop subsidizing high utilizers with their premiums. Two key policy issues, then, are whether forcing the chronically ill and other persistently high utilizers into HSA plans is morally and politically acceptable, and whether government would somehow subsidize those with low incomes. **BLB**

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## ENDNOTES: Daniel C. Brown

- 1 See Julia Appleby, *Workers Bear Brunt of Rising Health Care in '03*, USA Today, Dec. 8, 2003, available at [http://www.usatoday.com/money/industries/health/2003-12-07-healthcosts\\_x.htm](http://www.usatoday.com/money/industries/health/2003-12-07-healthcosts_x.htm) (last visited Sept. 1, 2006) (reporting that employer health care costs increased by only 10.5%, instead of 15% in the previous year, only because employers shifted more of the costs onto employees).
- 2 See *Study OKs Drive-Through Deliveries*, CBSNews.com, Dec. 19, 2002, available at <http://www.cbsnews.com/stories/2002/12/19/health/main533629.shtml> (last visited Sept. 1, 2006) (revealing that a Harvard Medical School study years later found there was no scientific basis for requiring plans to cover longer stays, since the extensions resulted in no decrease in complications).
- 3 See David M. Tuomala, *The Case for Consumer-Driven Health Care*, CONTINGENCIES, May/June 2003, available at <http://www.contingencies.org/mayjun03/commentary.pdf> at 10 (reproducing a graph from the Office of Actuary, Center for Medicare and Medicaid Services to illustrate a dramatic shift in who makes most payments for health care services).
- 4 See Greg Scandlen, *Rethinking the Uninsured*, HEALTH ISSUES at 6 (Sept. 2004) available at <http://www.galen.org/fileuploads/Uninsured.pdf> (last visited Sept. 1, 2006) (accusing the triangular relationship among patients, providers, and health plans of creating inefficiency and administrative waste).
- 5 One commentator suspects that “advances in medical science have reached a point where we can probably spend the entire [gross national product] on health care in useful ways!” Scandlen, *supra* note 4, at 4 (quoting National Center for Policy Analysis president John Goodman).
- 6 See, e.g., Tuomala, *supra* note 3, at 10 (arguing that the vision care industry is highly competitive even though vision care services are provided by skilled professionals and are just as “necessary” as other types of health care). Vision care services have become more affordable and convenient even as technology has advanced precisely because insurers often do not cover elective procedures such as lasik. *Id.* Patients demand convenience and efficiency because they must spend their own funds. *Id.*
- 7 To counteract the incentive to forego routine services such as annual physicals just to save money, many plans fully cover preventive care whether or not the annual deductible is met.
- 8 Meredith Rosenthal & Arnold Milstein, *Awakening Consumer Stewardship of Health Benefits: Prevalence and Differentiation of New Health Plan Models*, 39 HEALTH SERVICES RES. 1055, 1062 (2004).
- 9 *Id.*
- 10 I.R.C. § 223(d)(2) (2003). Participants who withdraw the funds for non-medical expenses must income tax and a withdrawal penalty. I.R.C. § 223(f).
- 11 For example, a 2003 nationwide survey found that only twenty-four out of 680 health plans had participants in a product featuring a health savings account, with a total of 466,039 participants. Rosenthal & Milstein, *supra* note 8, at 1061.
- 12 See Anthony T. Lo Sasso et al, *Tales from the New Frontier: Pioneers' Experiences with Consumer-Driven Health Care*, 39 HEALTH SERVICES RES. 1071, 1088 (2004) (noting that the HSA plans had managed to contain the rate of cost increases overall).
- 13 *Id.* at 1082.
- 14 *Id.* at 1079. Smaller studies routinely present the difficulty of determining to what extent lower expenditures in HSA plans are due to reduced spending by participants compared to before their enrollment in the HSA plan or instead because lower spenders tend to gravitate toward HSA plans generally. *Id.*
- 15 Stephen T. Parente et al, *Evaluation of the Effect of a Consumer-Driven Health Plan on Medical Care Expenditures and Utilization*, 39 HEALTH SERVICES RES. 1139, 1200 (tbl.3) (2004).
- 16 Laura du Preez, *Medical Savings Plans 'Not Just for the Healthy, Personal Fin.*, Jul. 26, 2003, available at <http://www.persfin.co.za/index.php?fSectionId=707&fArticleId=196531> (last visited Sept. 1, 2006).
- 17 *Shifting Health Care Decisions From Employers to Consumers*, House/Senate Joint Economic Committee, 108th Cong. (2004) 2004 WL 354016 (statement of Gail Shearer) [hereinafter *Shearer Testimony*] available at [http://jec.senate.gov/\\_files/Shearer02252004.pdf](http://jec.senate.gov/_files/Shearer02252004.pdf), at 2.
- 18 See *New Remedies: There Must Be a Better Way*, The Econ., Jul. 17, 2004, at 78 (reporting that having gained new access to health information on the internet, Americans are becoming distinctly unhappy about the value for money they get from the health care industry).
- 19 du Preez, *supra* note 16. The same company said it experienced similar results in the United States through its Destiny HSA plan.
- 20 Lo Sasso, *supra* note 12 at 1076-77.
- 21 *Id.*
- 22 Parente, *supra* note 15, at 1204.
- 23 *Id.*
- 24 *Shearer Testimony*, *supra* note 17, at 5.
- 25 Karen Davis, *Consumer-Driven Health Care: Will It Improve Health System Performance*, 39 Health Services Res. 1219, 1223 (2004).
- 26 *Shearer Testimony*, *supra* note 17, at 5 (including a graph showing that average spending for the top 10% reaches \$16,710 per year, which is 71% of the total of all groups' averages).
- 27 Davis, *supra* note 25, at 1223.
- 28 See Rosenthal & Milstein, *supra* note 8, at 1062 (noting the average HSA plan has an annual deductible of only \$1,654).
- 29 *Shearer Testimony*, *supra* note 17, at 5 (supporting the estimation that the top 80% of spenders are responsible for 88% of spending, based on calculations of stated averages).
- 30 See George C. Halvorson, *Commentary—Current MSA Theory: Well-Meaning but Futile*, 39 HEALTH SERVICES RES. 1119, 1121 (2004) (arguing that the average current benefits package is irrelevant to both high spenders and low spenders but is potentially painful for chronic care patients).
- 31 Regina Herzlinger, *Consumer-Driven Health Care: Taming the Health Care Monster*, J. OF FIN. SERVICES PROF., Mar. 2004, available at [http://www.manhattan-institute.org/html/\\_jfsp-consumer.htm](http://www.manhattan-institute.org/html/_jfsp-consumer.htm) (last visited Sept. 1, 2006).
- 32 Halvorson, *supra* note 30, at 1120.
- 33 *Id.*
- 34 That is, the price of consuming the amount of the service or good normally consumed within one year.
- 35 See *Shearer Testimony*, *supra* note 17, at 5.
- 36 See Gail Shearer, *Commentary—Defined Contribution Health Plans: Attracting the Healthy and Well-off*, 39 Health Services Res. 1159, 1159 (2004).
- 37 I.R.C. § 223.
- 38 See *Shearer Testimony*, *supra* note 17, at 6 (predicting that HSAs would send traditional plans into a “premium spiral,” driving out comprehensive coverage all together).
- 39 Davis, *supra* note 25, at 1225.
- 40 Laura A. Tollen et al, *Risk Segmentation Related to the Offering of a Consumer-Directed Health Plan: A Case Study of Humana Inc.*, 39 Health Services Res. 1167, 1182-84 (2004).
- 41 Lo Sasso, *supra* note 12, at 1087.
- 42 Davis, *supra* note 25, at 1225; see Jinnat Briggs Fowles et al, *Early Experience with Employee Choice of Consumer-Directed Health Plans and Satisfaction with Enrollment*, 39 HEALTH SERVICES RES. 1141, 1154 (2004) (noting that the emergence of race as an independent predictor of choice was unexpected, and so far unexplored in the literature).
- 43 Herzlinger, *supra* note 31.
- 44 Scandlen, *supra* note 4, at 5.
- 45 *Id.*
- 46 *Id.* at 7.
- 47 *Shearer Testimony*, *supra* note 17, at 6 (criticizing approaches that sacrifice the notion of sharing one's neighbor's burden in favor of marketplace efficiency).
- 48 See Scandlen, *supra* note 4, at 7 (suggesting there is no reason to use government subsidies to offset premium costs rather than instead using them to soften the blow of high out-of-pocket expenditures on low-income earners).
- 49 *Shearer Testimony*, *supra* note 17, at 5-7 (insinuating that the ultimate goal of consumer driven health care advocates is to eventually remove employers from the role of negotiating group coverage for their employees, instead sending them into the marketplace to fend for themselves individually).

# Hedge Fund Registration:

## THE SHORTCOMINGS OF THE U.S. SECURITIES AND EXCHANGE COMMISSION'S "PRIVATE FUND" DEFINITION

By Jonathan P. Straub, Esq.

### Introduction

OVER THE LAST TEN YEARS, institutional and high net-worth investors embraced “hedge funds” as high-return investment vehicles and as a means of reducing the market risk of their overall investment portfolios. The hedge fund industry has experienced exponential growth in the number of funds available, in the variations of the underlying investment strategies and particularly in assets under management. The increasing prominence and flow of dollars into this asset class coincided, as expected, with heightened governmental scrutiny.

Ultimately, this scrutiny culminated in the U.S. Securities and Exchange Commission's (“SEC”) much-disputed rules and amendments<sup>1</sup> mandating that by February 1, 2006, hedge fund managers had to register as investment advisers under the Investment Advisers Act of 1940.<sup>2</sup> However, under the new rules, many private investment funds can escape the registration requirements because the SEC failed to make an important definitional distinction between a “hedge fund” and other similarly structured investment vehicles. Specifically, these other funds fall outside the scope of registration because their partnership language extends the fund's redemption period beyond two years, the threshold of a “hedge fund” as defined by the SEC. As a corollary to longer lockup periods, this new rule serves to decrease liquidity terms to the detriment of the individual investor.



By eliminating this two-year lockup distinction and elucidating a definition grounded in investment characteristics, the SEC can achieve full hedge fund registration and develop appropriate insight into the dynamics of the industry without placing undue burdens on the funds or their investors. Without comprehensive industry data, policy makers are inadequately informed to determine whether additional regulation is warranted and ill-equipped, if necessary, to implement an appropriate regulatory framework.

**The memory of Long Term Capital Management's ("LTCM") infamous collapse in September 1998 serves as an example of the threat hedge funds pose as a source of systematic risk to the capital markets.**

### Defining a hedge fund

The memory of Long Term Capital Management's (“LTCM”) infamous collapse in September 1998 serves as an example of the threat hedge funds pose as a source of systematic risk to the capital markets. However, the industry has developed a great deal since the implosion of LTCM and the Federal Reserve-brokered bailout of the funds.

The popular misconception of hedge funds is that they are all inherently volatile investment vehicles—relying heavily on global macro strategies and significant leverage to make large directional bets on stocks. In reality, less than 5% of hedge funds are global macro funds, and these alternative investment strategies may or may not use leverage and short selling to “hedge” the portfolio's exposure to market movements.

In tracing the etymology of the phrase “hedge fund,” one sees the difficulty the SEC faces in defining what it is they seek

to regulate. The hedge fund concept originated from the work of Alfred Winslow Jones, who created a single-strategy fund in 1949 that utilized short selling and leverage to hedge exposure to movements in the equity markets.<sup>3</sup> Today, the amorphous term encompasses a multitude of techniques, with investment return, volatility, and risk varying greatly among the different approaches.<sup>4</sup> These strategies have branched out from their roots in equity trading into futures contracts, commodities, derivatives, and currencies, among others, all of which attempt to generate positive returns in a variety of market environments. Defining the term itself is not a new problem, as it has historically meant different things to different people.<sup>5</sup>

Broadly defined, a “hedge fund” has three characteristics: (a) a pooled investment vehicle (b) that is privately organized and (c) not widely available to the public.<sup>6</sup> These funds are formed as separate accounts or commingled investment vehicles administered by a professional investment management firm. Most frequently, hedge funds are organized as limited partnerships or limited liability corporations having a significant position in securities. While these characteristics should normally trigger registration with the SEC as an “investment company” under the Investment Company Act of 1940,<sup>7</sup> hedge funds typically avoid the “investment company” classification by limiting the number of underlying investors.<sup>8</sup>



exceed the performance of a benchmark, such as the S&P 500 Index, most hedge funds strive for an “absolute” return. This absolute approach attempts to achieve positive returns in all market conditions, with little exposure to the systematic movements of the capital markets.

The use of hedge funds is an attractive mechanism for portfolio diversification because the lack of correlation to a traditional performance benchmark can dampen the volatility of the overall investment portfolio. Since varying market conditions require a fund to have flexibility in its investment style to achieve consistently positive returns, a hedge fund partnership agreement will usually authorize the manager to partake in multiple strategies. This flexibility is necessary because it is unlikely that successful strategies in a bull market will also provide positive returns during downturns in the market.<sup>9</sup>

### Recent Growth as Impetus for Registration

Although hedge funds have been around since 1949, the industry experienced its most explosive growth over the past decade. The bull market run of the 1990’s led to tremendous growth in investable assets. But, the subsequent market decline, and expectations of a lower return environment, spurred investors to search for alternative means of achieving higher returns, while also warding off correlation to broad market performance. Hedge funds met both objectives because they had at their disposal a wide array of investment strategies, many of which traditional registered funds were prohibited from employing.<sup>10</sup> Accordingly, sources estimate that the hedge fund industry has grown to approximately 7,000 funds managing almost \$1 trillion in assets, an amount that has increased at a rate of 260% over the past five years.<sup>11</sup> The SEC estimates that this \$1 trillion represents a fifteen-fold increase in the last ten years.

The growth in allocation to this asset class negatively affects its investors. As a greater number of investors chase the top performing funds, individual investors and funds of funds are under increased pressure to secure capacity with top managers.<sup>12</sup> The growth of the industry, coupled with heightened competition for access to prime funds, results in fee structures and redemption terms that are weighted heavily in favor of the hedge fund manager because established managers have more leverage to negotiate the terms of the partnership.

**Broadly defined, a “hedge fund” has three characteristics: (a) a pooled investment vehicle (b) that is privately organized and (c) not widely available to the public.**

Hedge funds are also defined by their structure rather than any distinct investment methodology. Just as investment strategies vary from fund to fund, the risk and return characteristics vary greatly as well. Nevertheless, risk aversion is inherently prevalent among large fund managers because of the management fee structure and the fear of mass redemptions as a result of exorbitant losses. Unlike registered investment companies, which tend to favor a “relative” return approach by seeking to

It is in a manager's best interest to secure longer lock-up periods because they are compensated through both an incentive fee tied to performance as well as through a management fee, which is a flat rate based on assets under management at the fund.<sup>13</sup> While a performance-fee arrangement may ensure that the fund manager's interests are closely aligned with those of the fund's investors, the management fee is guaranteed through the life of the investment, regardless of fund performance. Thus, there is a trend towards longer lock-up periods in the industry.

While investors may infer trends of asset growth, this development cannot be corroborated because there is a lack of reliable or comprehensive knowledge of the industry. Hedge funds are under no obligation to report their performance or assets under management to any third party survey or index provider. Additionally, reported numbers suffer from "survivorship bias;" underperformance is a major reason that funds close and those that perform well are more likely to disclose their information to an outside party. Unfortunately, companies that collect fund data merely pass it on without vetting it through a formal verification process. The result is an inadequate source of data with dubious utility.<sup>14</sup>



### Hedge Funds and the Investment Advisers Act of 1940

The SEC's escalating concerns about the rapid growth of the industry are valid as the SEC has no reliable data on the number of hedge funds or their assets under management, and because the estimates that are available vary greatly.<sup>15</sup> This lack of information compelled the SEC to take regulatory action to

understand growth within the industry, to respond to increases in hedge fund fraud enforcement cases and to address the broad

market's direct and indirect exposure to hedge funds. Accordingly, the SEC's new rules seek the following regulatory objectives: (1) to collect a census of information about the industry; (2) to prevent hedge fund related fraud and (3) to limit the retailization of hedge funds.<sup>16</sup> Achieving these objectives is in the best interest of the industry, the investors and the financial markets. However, the rule adopted by the SEC will not achieve these aims.

The Investment Advisers Act of 1940 requires that investment advisers register with the SEC and disclose pertinent information such as disciplinary history and business practices. Almost all hedge funds satisfy the definition of an investment adviser, but most hedge funds have historically avoided registration by relying on the Act's *de minimis* exemption available to investment advisers with 14 or fewer clients.<sup>17</sup> Under old SEC rules, an investment adviser could count each "legal organization" advised by the adviser as a single client.<sup>18</sup> For example, under the old rules, 499 individual investors could form as a "legal organization" a hedge fund. The fund manager did not have to register with the SEC because they viewed the fund manager as having only a single client, the hedge fund itself. Furthermore, any one of those underlying investors could be yet another hedge fund having 499 investors.

### Shortcoming of the New Rules

The SEC implemented its regulatory scheme by amending the *de minimis* exemption of the Investment Advisers Act, requiring hedge fund advisers to look through any "private fund" under their management and count each investor, or owner of an interest or share in the fund, as a separate client of the adviser. Investment advisers may no longer count any "private fund" as a single client; rather, they must view each underlying investor as a single client counting towards the 14 person threshold.<sup>19</sup> However, the change does not apply to all funds, but rather only those deemed to be a "private fund." Under the new rules, the SEC now defines a "private fund" on the basis of three characteristics:

- ① one that would be subject to regulation under Section 3(a) of the Investment Company Act of 1940, but for the exemption to that definition provided under either Section 3(c)1 or 3(c)7 of that Act;

Although hedge funds have been around since 1949, the industry experienced its most explosive growth over the past decade. The bull market run of the 1990's led to tremendous growth in investable assets.

- ② one that permits its investors to redeem any portion of their investment or ownership interest in the fund within two years of the initial investment or purchase of such interest; and
- ③ one that offers its interests based on the investment advisory skills, ability, or expertise of the investment adviser.<sup>20</sup>

Thus, the registration requirements under the Investment Advisers Act extend only to investment funds with short-term liquidity rights, explicitly excluding private equity and venture capital funds under the supposition that the nature of these investments results in long-term capital commitments.

The obligations of registration do not require affected hedge funds to reveal their investment strategies, disclose portfolio holdings, or prohibit the use of leverage in their portfolios. As most private investment funds satisfy the criteria of elements (1) and (3) above, the sole point of distinction between those private funds required to register and those exempted private funds is the two-year redemption period.

**The current requirements of registration are not particularly arduous to hedge funds, but they are ineffective. In its new rules, the SEC makes no attempt to regulate based on the type of holdings or strategies employed by hedge funds, instead it identifies the redemption period as the defining characteristic of a hedge fund.**

Based on this differentiation, it necessarily follows that the SEC believes there will be no meaningful correlation between the firms with a minimum two-year period of investment and those firms that the SEC felt warranted registration.

Unfortunately, the SEC gives no regard to the recent trend of longer redemption periods imposed by top quartile hedge fund managers. By tying registration to the lock-up period rather than to an underlying investment strategy or type of security, the SEC creates a loophole allowing funds to avoid registration. Hedge fund managers are taking advantage of this oversight. Registration is an administrative and financial burden on the firm and provides no direct benefit to funds or their investors. Thus, the number of new registrants has not approached SEC expectations, as large and small managers alike are not registering, opting instead to extend their lock-up provisions beyond two years or by closing the fund to new investment dollars.<sup>21</sup>

The SEC's decision to include the lock-up loophole has proved disadvantageous to investors as well. Since the loophole leads to more stringent liquidity provisions, it will not curb fraud at an early stage. Deceptive activity may incubate longer before it comes to the attention of investors since an individual investing today will not be able to withdraw funds for at least two years. Furthermore, the scope of the new rule is intended to apply to all hedge funds, thereby allowing the SEC to finally perform a comprehensive survey of the industry. In its current application, however, many funds will escape this industry census because of the loophole.

### Defining the Solution

The SEC could improve the affects of compliance by changing the definition of a "private fund" under § 275 203(b)(3)-1 to emphasize a fund's portfolio characteristics instead of its redemption period.<sup>22</sup> A definition focused on core investment characteristics, such as the marketability of securities held within the portfolio or frequency of trading, would provide

the appropriate level of clarity the industry needs in defining the term "hedge fund." For example, if a fund contained a designated level of marketable securities it would then qualify under the Act as a "private fund."<sup>23</sup> Such distinctions would also allow the SEC to meaningfully distinguish between the traditional hedge funds and private equity/venture capital funds beyond a metric based on the requisite period

of investment, which has proved inadequate. Furthermore, it would be much more difficult for a manager to change its fund's investment strategy than it would be to adjust the redemption period. Such a monumental shift in strategy could ultimately lead to mass redemptions in the fund.

### Conclusion

The current requirements of registration are not particularly arduous to hedge funds, but they are ineffective. In its new rules, the SEC makes no attempt to regulate based on the type of holdings or strategies employed by hedge funds, instead it identifies the redemption period as the defining characteristic of a hedge fund. One of the primary goals of the new registration requirements was to develop a census of the industry. Nevertheless, the poorly constructed language of the rules fails to achieve the Commission's one true aim—quantifying

the size and scope of this rapidly growing segment of the financial markets.

A conclusive “hedge fund” definition based on a fund’s underlying portfolio would prevent hedge funds from skirting registration. The SEC should revisit its recent amendments to the Investment Advisers Act and use the opportunity to

define a hedge fund based on its portfolio’s core investment characteristics rather than its redemption rider, a trait ancillary to the true nature of a private fund. Such a definition would allow the SEC to fully quantify the burgeoning state of the industry and determine whether any further regulation is justly warranted. **BLB**

## ENDNOTES: Jonathan P. Straub, Esq.

<sup>1</sup> See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279) (requiring of certain private investment pools registration with SEC). “The rule and rule amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds, and to enhance the Commission’s ability to protect our nation’s securities markets.” *Id.*

<sup>2</sup> 15 U.S.C. § 80b (2000).

<sup>3</sup> See Philipp Cottier, *The Origin of Hedge Funds*, The Hedge Fund Center, available at [http://www.hedgefundcenter.com/wrapper.cfm?article\\_type=basics&content\\_id=222&content\\_type=articles&aff\\_id=0](http://www.hedgefundcenter.com/wrapper.cfm?article_type=basics&content_id=222&content_type=articles&aff_id=0) (last visited 12/5/2005) (describing Jones’ strategy of combining a long term stake in equity positions with short term positions to reduce market risk from the long positions, which “shifted most of his exposure from market timing to stock picking”).

<sup>4</sup> See *What is a Hedge Fund?*, About Hedge Funds, Magnum Funds, at <http://www.magnum.com/hedgefunds/abouthedgefunds.asp#hedgefund> (last visited 11/20/2005).

<sup>5</sup> See Andrew Holt, *Regulating Hedge Funds Won’t Work*, Portfolio International, Oct. 1998, at <http://www.magnum.com/hedgefunds/articles/1998/981000hf.asp> (highlighting the statement of Dion Friedland’s, chairman of Magnum, a Bahamas-based hedge fund specialist, in response to the U.S. Treasury Department’s call for hedge fund regulation. According to Friedland, “the problem is the word ‘hedge funds’ is used to describe any fund other than a conventional mutual fund or unit trust, money market fund or bond fund . . . It’s a bit like calling all the animals in the zoo crocodiles . . . There is an enormous disparity in styles and they cannot be compared with each other, because they are very different”). The term hedge itself implies that the fund employs hedged positions, which may not always be the case.

<sup>6</sup> See Hearing before the House Banking Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, 1999 Leg. (Mar. 3, 1999) (statement of Lewis A. Sachs, Treas. Deputy Assist. Sec. (Govt. Financial Policy)), available at <http://www.treas.gov/press/releases/rr2991.htm> (outlining primary hedge fund characteristics).

<sup>7</sup> See 15 U.S.C. § 80a-3(a)(1)(A) - (C) (2000) (defining scope of an investment company).

<sup>8</sup> See 15 U.S.C. 80a-3(c)(1) & (c)(7) (2000). See also Staff of the United States Securities and Exchange Commission, *Implications of the Growth of Hedge Fund*, at 11-13 (September 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter *Implications of the Growth of Hedge Fund*] (explaining that funds designated 3(c)(1) are limited to no more than 100 investors, all of whom must be considered “accredited investors,” defined as a natural person whose individual net worth, or joint net worth with spouse, at the time of purchase exceeds \$1 million or individual income in excess of \$200,000 or joint income in excess of \$300,000 in each of the last two years, or an entity owning over \$5 million in discretionary investments. Funds designated as 3(c)(7) are usually limited to 499 investors, all of whom must be considered “qualified purchasers,” defined as a natural person having \$5 million in investments or an entity owning and investing on a discretionary basis over \$25 million. Technically, a hedge fund relying on this exemption may have an unlimited number of qualified purchasers, but they limit the pool to 499 to avoid the registration and reporting requirements of the Securities and Exchange Act of 1934).

<sup>9</sup> See *Implications of the Growth of Hedge Funds*, supra note 8, at 33.

<sup>10</sup> Unlike registered funds, Hedge funds are not limited in their ability to utilize leverage or short-selling strategies, which can potentially generate positive returns in a declining market environment. By short-selling, the investor sells

shares without owning them, anticipating that they will be bought back at a future date at a lower price in the expectation that their price will drop.

<sup>11</sup> United States Securities and Exchange Commission, *Open Commission Meeting*, available at <http://www.sec.gov/rules/final/ia-2333-trans.txt> (2004) (“While no one knows for sure, it is estimated that in the last five years, that hedge fund assets have grown by 260 percent, with assets of approximately \$870 billion in approximately 7,000 funds, and some predict that hedge fund assets by the end of the year will reach one trillion dollars. In the last year alone, hedge fund assets have grown over 30 percent. Hedge funds are one-fifth the size of equity mutual funds, and are growing at a much faster rate”).

<sup>12</sup> See Susan I. Barreto, *All Shook Up*, Accredited Investor, December/January 2005 at 13.

<sup>13</sup> See U.S. Securities and Exchange Commission, *Hedging Your Bets: A Heads Up on Hedge Funds and Hedge Funds of Funds*, available at <http://www.sec.gov/anmswers/hedge.htm>. A hedge fund with \$1 billion under management is more likely to be satisfied with a 1.5% management fee on assets than is one managing \$50 million. The dynamic could also be bringing down the industry’s overall performance as larger managers would be more inclined to employ capital preservation strategies designed to protect guaranteed revenue streams.

<sup>14</sup> See Harry M. Kat, *10 Things That Investors Should Know About Hedge Funds*, *J. of Wealth Management*, Spring 2003, at 72-73.

<sup>15</sup> See *Implications of the Growth of Hedge Funds*, supra note 8, at 1 n.2.

<sup>16</sup> See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,061-064 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275 & 279) (explaining some of the objectives for promulgating the rules).

<sup>17</sup> See 15 U.S.C. § 80b-3(b)(3) (defining an exemption to registration). See also *Implications of the Growth of Hedge Funds*, supra note 8, at 21 (“That section excludes from registration investment advisers that have had fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered investment company.”).

<sup>18</sup> See *Implications of the Growth of Hedge Funds*, supra note 8, at 21 (“[A]n adviser may count a legal organization as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual objectives of its owners.”).

<sup>19</sup> See 17 C.F.R. § 275.203(b)(3)-2(a) (“For purposes of section 203(b)(3) of the Act (15 U.S.C. 80b-3(b)(3)), you must count as clients the shareholders, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an “owner”) of a private fund as defined in paragraph (d) of section 275.203(b)(3)-1, unless such owner is your advisory firm or a person described in paragraph (d)(1)(iii) of section 275.205-3.”).

<sup>20</sup> See 17 C.F.R. § 275.203(b)(3)-1(d)(1) (2004) (defining a private fund).

<sup>21</sup> See Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule*, *Wall St. J.*, Nov. 10, 2005, at C1 (citing several prominent firms that avoided registration, including SAC Capital Management, Citadel Investment Group, Eton Park Capital Management and Lone Pine Capital).

<sup>22</sup> See Letter from Board of Trustees, The Greenwich Roundtable, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, (Sep. 15, 2004), available at <http://www.sec.gov/rules/proposed/s73004/greenwich0915.htm> (commenting “on the proposed rules concerning registration of hedge fund managers”).

<sup>23</sup> See *id.* “A requirement tailored along these lines will separate hedge funds from venture capital and private equity funds, but will not encourage behavior that is clearly disadvantageous to investors.”

# Transnational Corporations, Other Business Enterprises and Human Rights:

## THE RIGHT STEP TOWARD CORPORATE SOCIAL RESPONSIBILITY?

By Sagarika Chakraborty

### Importance of Transnational Corporations

**T**ODAY, TRANSNATIONAL CORPORATIONS (TNC) rule the world in terms of business and economic power. These TNCs are regarded as the money machine for various developed and developing countries.

Transnational corporations evoke particular concern in relation to recent global trends because they are active in some of the most dynamic sectors of national economies, such as extractive industries, telecommunications, information technology, electronic consumer goods, footwear and apparel, transport, banking and finance, insurance, and securities trading. TNCs bring along with them new jobs, capital and technology. Some corporations make real efforts to achieve international standards by improving working conditions and raising local living conditions; they certainly are capable of exerting a positive influence in fostering development<sup>1</sup>.

The social power of TNCs is, however, a different matter. For although their social power is enormous and global, it has been, until recently, far less obvious, rarely acknowledged and minimally regulated. By virtue, specifically, of their economic and political muscle, TNCs are uniquely positioned to affect, positively and negatively, the level of enjoyment of human rights. On these bases, there are an abundance of reasons why the legal regulation of TNCs' activities at all levels is sought, ought to be sought and is sometimes achieved.

### Problem of Violation of Human Rights in TNCs

Some TNCs, however, do not respect minimum international human rights standards and violate such standards by employing child laborers, discriminating against certain groups of employees, failing to provide safe and healthy working conditions, attempting to repress independent trade unions, discour-

aging the right to bargain collectively, limiting the broad dissemination of appropriate technology and intellectual property and dumping toxic wastes. Some of these abuses disproportionately affect developing countries, children, minorities and women who work in unsafe and poorly paid production jobs, as well as indigenous communities and other vulnerable groups.<sup>2</sup>

It must be acknowledged at the outset that foreign direct investment injected by TNCs into developed and developing countries alike can and does bring jobs, capital, and technology. TNCs thereby in effect protect and promote the right to work and to obtain adequate living conditions, along with such basic

rights as health, education, housing and even political freedoms. It is equally certain that human rights abuses by TNCs occur and do so frequently in the economic, social and cultural sphere. Many TNCs, including Nike and The Gap, have been accused of violating their workers' rights to just and favorable work employment by paying unfair and inadequate wages, requiring unreasonable overtime and providing unsafe working conditions. Further-

more, there is ample evidence of the involvement of TNCs in suppressing trade unions and thereby denying workers the right to organize. It has been alleged, for instance, that Coca-Cola in Colombia and Phillips-Van Heusen in Guatemala have been associated with, or are directly responsible for, the systematic intimidation, torture, kidnapping, unlawful detention and murder of trade-unionist employees by paramilitaries operating as both of these corporations' agents.

TNCs in the extractive industries have caused environmental disasters which threaten the right to adequate food and an acceptable standard of living. Royal Dutch/Shell's oil production in Nigeria, and BHP Billiton's copper mining in Papua New Guinea, for example, seriously damaged the environment and

Today, transnational corporations (TNC) rule the world in terms of business and economic power. These TNCs are regarded as the money machine for various developed and developing countries.

Generally, the term “transnational corporation” refers to a corporation with affiliated business operations in more than one country.

the livelihood of peoples in local communities, which depended on fishing and farming. Such instances of a lack of corporate responsibility for, or complicity in, human rights abuses are increasingly widely publicized, especially by non-governmental organizations (NGOs) using the immediacy of global communications. Mounting activism by NGOs, workers and consumers in developed countries in the form of protests, product boycotts and selective purchasing has forced many TNCs to accept some level of human rights responsibility by adopting internal codes of conduct.

### Adoption of the UN Norms

On August 13, 2003, the United Nations Sub-Commission on the Promotion and Protection of Human Rights approved the “**Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights**” (Norms) in its Resolution 2003/16. The Norms represent a landmark step in holding businesses accountable for their human rights abuses and constitute a succinct, but comprehensive, restatement of the international legal principles applicable to businesses with regard to human rights, humanitarian law, international labor law, environmental law, consumer law and anticorruption law.

### Issues raised in adoption

Several issues arose during the drafting process<sup>3</sup> of the Norms: (1) how to define TNCs; (2) whether to include domestic enterprises in the definition and, if so, how to distinguish between domestic and international businesses; (3) how to distinguish between larger and smaller businesses so as to avoid a one-size-fits-all approach; (4) what human rights concepts to include and (5) how to characterize the legal status of the Norms after their adoption by the Sub-Commission.

However, for the purpose of this paper we shall limit the scope of analysis of the issues to only two, namely (1) *how to define TNCs* and (4) *what human rights concepts to include*.

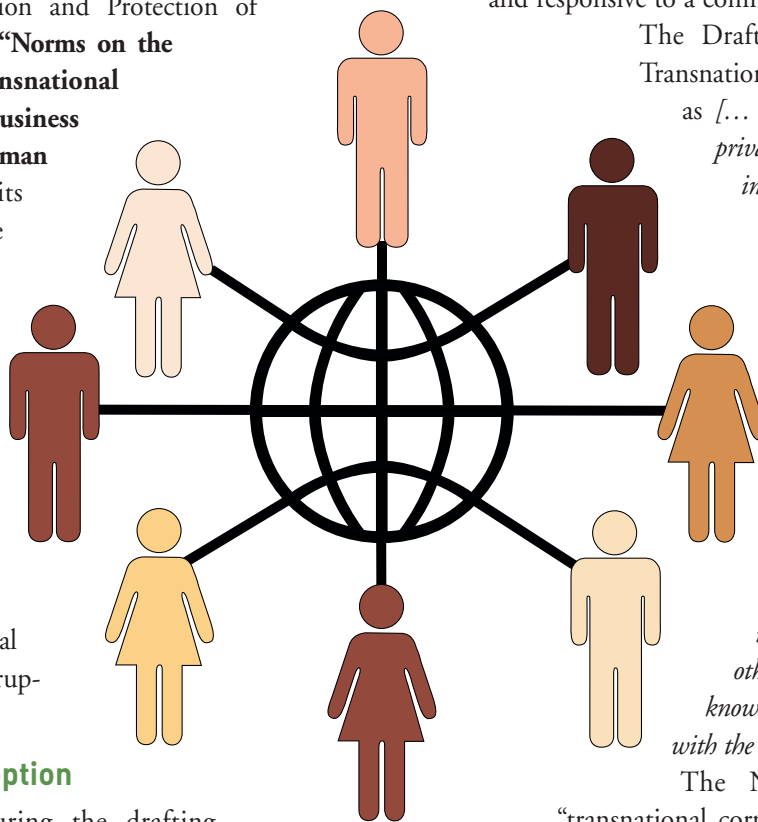
### (1) Defining Transnational Corporations

Generally, the term “transnational corporation” refers to a corporation with affiliated business operations in more than one country.<sup>4</sup> A more specific definition deems an enterprise a TNC if “it has a certain minimum size, if it owns or controls production or service plants outside its home state and if it incorporates these plants into a unified corporation strategy<sup>5</sup>.” According to yet another definition, a TNC is “a cluster of corporations of diverse nationality joined together by ties of common ownership and responsive to a common management strategy<sup>6</sup>.”

The Draft UN Code of Conduct on Transnational Corporations defines a TNC as [... *an enterprise, whether of public, private or mixed ownership, comprising entities in two or more countries, regardless of the legal form and fields of activity of these entities, which operates under a system of decision-making, permitting coherent policies and a common strategy through one or more decision-making centres, in which the entities are so linked, by ownership or otherwise, that one or more of them [may be able to] exercise a significant influence over the activities of others, and, in particular, to share knowledge, resources and responsibilities with the others*.]

The Norms specifically define a “transnational corporation” as “*an economic entity operating in more than one country or a cluster of economic entities operating in two or more countries - whatever their legal form, whether in their home country or country of activity, and whether taken individually or collectively.*”

The Norms, however, do not limit their application to TNCs but also include other business enterprises<sup>8</sup>. The working group defines the phrase “other business enterprise” as “*any*



*business entity, regardless of the international or domestic nature of its activities, including a transnational corporation, contractor, subcontractor, supplier, licensee or distributor; the corporate, partnership, or other legal form used to establish the business entity; and the nature of the ownership of the entity.”<sup>9</sup>*

Hence, even though the Norms define TNCs and focus some attention on transnationals, they are written to include all business entities, regardless of their stated corporate form or the international or domestic scope of their business. Its’ breadth deemphasizes the definition of TNCs and does not restrict the Norms’ scope of application.<sup>10</sup>



#### **(4) Content of the Norms**

The Norms reflect and restate a wide range of human rights, labor, humanitarian, environmental, consumer protection and anticorruption legal principles in addition to incorporating the best practices for corporate social responsibility. Further, the Norms do not endeavor to freeze standards by drawing on past drafting efforts and present practices; they incorporate and encourage further evolution.

The Norms appear to be more comprehensive and more focused on human rights than any of the international legal or voluntary codes of conduct drawn up by the International Labor Organization (ILO), the Organization for Economic Co-operation and Development (OECD), the European Parliament, the UN Global Compact, trade groups, individual companies, unions, NGOs and others. The Norms and Commentary provide for the right to equality of opportunity and treatment; the right to security of persons and the rights of workers, including a safe and

healthy work environment and the right to collective bargaining. The Norms and Commentary also provides for respect for international, national, and local laws and the rule of law; a balanced approach to intellectual property rights and responsibilities; transparency and avoidance of corruption; respect for the right to health, as well as other economic, social, and cultural rights and other civil and political rights,. With respect to each of these subjects, the Norms largely reflect, restate, and refer to existing international norms, in addition to specifying some basic methods for their implementation.

#### **Need for the UN Norms**

Before analyzing the efficacy of the norms in view of human rights, it is important to understand the international community’s need for such norms in order to appreciate why such norms emerged.

First, since the early 1990s there has been a marked increase in the number of cases filed against TNCs for human rights abuses globally and in the United States in particular under the Alien Tort Claims Act. Cases such as *Wiwa v. Royal Dutch Petroleum Co.*<sup>11</sup>, Nike Labour Rights Violation Abroad case<sup>12</sup>, and Rangoon Forced Labour case,<sup>13</sup> illustrate the need for a norm that would ensure TNCs and the international community’s respect for human rights and punishment where this respect was violated.

TNCs operating in today’s global economy face significant challenges arising from diverse cultural as well as political and economic pressures. How a TNC responds to the human rights agenda has a significant impact on its business performance and the public’s perception of such company. For example, Shell International faced criticism from human rights groups for its

**The Norms reflect and restate a wide range of human rights, labor, humanitarian, environmental, consumer protection and anticorruption legal principles in addition to incorporating the best practices for corporate social responsibility.**

mutated response to the Nigerian government’s human rights abuses and execution of nine Ogoni leaders. Talisman Energy was forced to sell its oil development assets in Sudan as a result of pressure from human rights activists and shareholders.<sup>14</sup>

Examples such as cited above have traditionally negatively impacted the TNCs involved. As such, TNCs realized that it is advantageous to have a corporate human rights policy in place

that is comprehensive, transparent, verifiable and consistently applied. To make sound investment decisions, investors often wish to know how a company addresses human rights since an increasing number of investors are concerned with these issues; there is a significant risk therefore posed to a company that neglects these obligations. As such, there arose the need for a comprehensive policy dealing with human rights.

**TNCs realized that it is advantageous to have a corporate human rights policy in place that is comprehensive, transparent, verifiable and consistently applied.**

However, with regard to substantial organizations such as TNCs, it is difficult to understand all the international human rights agreements and how they apply to business. Though international human rights covenants include business (as an ‘organ’ of society), they are designed primarily for governments. The UN Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights help address this confusion and eliminate any ambiguity about the obligations of private sector actors. The Norms are a concise distillation of internationally agreed upon human rights instruments such as the Universal Declaration of Human

Rights, the International Labour Organizations’ core labor conventions and the wide range of other international agreements related to human rights.<sup>15</sup> The Norms help connect the dots for companies between international human rights agreements and the obligations of companies. The Norms provide concrete guidance for companies adopting comprehensive human rights policies covering such areas as equal opportunity, security, rights of workers, respect for national sovereignty, consumer and environmental protection and provisions for implementation.

The key impact of the Norms for TNCs is the clear definition of the role of corporations as promoters of human rights “within their

respective spheres of activity and influence” while affirming the primary role of government in promoting human rights and preventing abuses. The commentaries on each provision are especially helpful in providing guidance to companies designing their own human rights policies and practices consistent with the Norms.

The Norms are therefore a welcome addition to voluntary corporate codes of conduct. While these codes are important in focusing on some human rights issues such as factory conditions for workers, many are not built firmly on the internationally recognized human rights standards that make up the Norms. Some standards are shaped more by the culture of a company than by international human rights conventions. The Norms provide a common template for all companies, establishing the expectations of minimum standards for human rights performance, which can create a level playing field for all companies.

The Norms are built on already agreed upon human rights conventions, covenants as well as treaties and set out the need for clear articulation of the global community’s expectations for corporate behaviour with regard to human rights.

### **The Imperfect Steps—The UN Norms and The Lacunas in Law**

The above analysis illustrates that the Norms represent a progress in the right direction from the prevailing regulatory regimes. However, optimism regarding this progress should not be unbridled. Despite the vital improvements, as compared with previous instruments, the Norms do suffer from serious theoretical and operational shortcomings, both in terms of formulation and implementation of human rights obligations.

Although the Norms revive hope for establishing a legally binding international regime of corporate responsibility for human rights violations, they represent an imperfect step, albeit in the right direction.



The lacuna in the Norms is apparent in the context of (i) human rights obligations and in terms of the (ii) operational hazards.

## (A) Human Rights Obligations

### 1. General Obligations

The Norms begin by laying down general obligations in paragraph 1. The obligations are two-fold: primary responsibility of states and, “within their respective spheres of activity and influence,” the obligation of TNCs to “promote ... [and] secure ... respect [and] ... ensure respect of and protect[ion of] human rights.”<sup>16</sup> The general obligations assume more significance because of two reasons. First, all the Norms that follow are to be interpreted in the light of these general obligations<sup>17</sup>. Second, the appended commentary clarifies that the obligations apply to TCN’s and other business enterprises irrespective of where they operate, whether in a home or host country.<sup>18</sup> The Norms therefore attempt to address an issue which should have been the starting point of any theory of corporate responsibility.

A difficulty may, however, arise in construing what is the “respective spheres of activity and influence” of TNCs, especially when the Norms do not prescribe any guidelines. For example, would a TNCs sphere of activity and influence include the entire supply chain and all the subsidiaries of a TNC? As TNCs and human rights activists are likely to plead for opposing interpretations, this aspect of the Norms requires clarification.

### 2. Rights of Workers

The Norms contain elaborate provisions regarding workers’ rights.<sup>19</sup> TNCs ideally provide a safe and healthy work environment and are mandated to not use forced or compulsory labor which is forbidden by the relevant international instruments, national legislations and international human rights as well as humanitarian law.<sup>20</sup>

With the reference to the provision requiring fair and reasonable remuneration, it is argued that the Norms “leave [the decision] open to anyone to interpret what is an adequate standard of living and a just wage” and allow people to “continue to base their wage criteria on the notion of national<sup>21</sup>” and not international conditions.

### 3. Obligations with Regard to Environmental Protection

The Norms also respond to the growing concern that TCNs exhibit an indifference to sustainable development while making business decisions and formulating both short and long-term policies. Accordingly, TNCs shall carry out their activities in accordance with laws, practices and policies of the country of operation as well as international agreements, principles and standards regarding environmental perseverance. This in turn

will contribute to “the wider goal of sustainable development.” Under the Norms, TNCs are required to assess periodically the impact of their activities on the environment and human health, especially of certain groups such as children, the elderly, women and indigenous peoples.<sup>22</sup>

As TNCs operate in countries of varying levels of development with different environmental standards, the issue arises of whether the TCN should

adhere to the international, home or host country standard. Though the Norms mandate TNCs to observe both international and host country standards, host country standards are non-existent or simply not enforced.<sup>23</sup> International standards are generally so vague and general that it is quite easy to comply with their express language of such standards without adhering to their spirit. In such a scenario, it is worth exploring whether TNCs’ should follow the most strict of home, host country or international standards, irrespective of where the TCN operates and whether a uniform system should be adopted.<sup>24</sup>

As TNCs operate in countries of varying levels of development with different environmental standards, the issue arises of whether the TCN should adhere to the international, home or host country standard.



## (B) Operational Difficulties

Despite making a commendable effort to formulate human rights obligations for TNCs, the Norms contain lacunas which may give rise to several operational shortcomings. Two possible shortcomings are discussed below.

**What is still largely invisible in this picture is the matter of the legal accountability of TNCs, and in particular international legal accountability.**

### 1. Inadequate and Incomplete Reference to International Human Rights Law/Instruments?

The Norms make frequent reference to numerous international treaties, which are negotiated, as well as signed, by states and are directed primarily toward states.

This approach is problematic due to several reasons. At the outset, the approach is circular because instead of laying down ascertainable and guidable human rights standards, the Norms lead the reader to several national and international instruments. In other words, the obligations of TNCs under specific circumstances cannot be determined with reference to the Norms without referring to additional documents. The appended Commentary is tailored to give shape to some of the obligations<sup>25</sup>, however it provides inadequate assistance.

### 2. Operational Hazards of Human Rights Standards

The Norms acknowledge, among other things, the universality of human rights. In the context of TNCs, this means that TNCs should observe the same standards of human rights whether operating in either a home or host country.<sup>26</sup>

It is important to note that TNCs, unlike states, operate in more than one country. As such, what is considered fair and reasonable compensation may vary in different locations in which the TNC is located. For example, fair and reasonable compensation may be different at a factory in India from the United States. Similarly, assuming TNCs should facilitate access to drinking water or the highest attainable standard of health, there may be different standards of acceptable types and levels of water contamination and health care in the locations in which the TNC is located. Such examples, which could be easily multiplied with reference to various provisions in the Norms, demonstrate that there are operational difficulties associated with universal human rights.

Thus, in order to operationalize the abstract universality and/or to ascertain the content of human rights, certain adjustments to local social, political, economic and cultural conditions are to be made.

## Filling the Gaps – The Legal Dimension

What is still largely invisible in this picture is the matter of the legal accountability of TNCs, and in particular international legal accountability. To be sure, there is an established corpus of domestic legal regulation of corporate activities that affect

human rights, including in such areas as criminal law, anti-discrimination, health and safety at work, environmental protection and labor rights.<sup>27</sup>

It must be recognized that there is no transnational regime of human rights law governing the transnational activities of corporations. TNCs have been able to operate in a legal vacuum because international human rights

law imposes no direct legal obligations on TNCs. The orthodox vision of international human rights law generally binds only states because it is principally designed to protect individuals from the excesses of state power. Thus, where infringements are caused by abuse of private power, it is still the state that will be held vicariously liable at international law, if any legal entity is to be held liable at all.

**To the extent that international human rights law does embrace non-state actors, it does so very largely by way of holding states indirectly liable for the direct infringements of others, including corporations.**

### Need of the Hour

The invisibility of TNCs' accountability at the international level, especially under international human rights law, has arisen from the combined consequences of two factors. The first is the fact that historically, international human rights law has developed as a tool to protect individuals from the arbitrary use of power by states, not corporations or other private entities. To the extent that international human rights law does embrace non-state actors, it does so very largely by way of holding states indirectly liable for the direct infringements of others, including corporations. Second, the law of corporations has traditionally been almost exclusively a domestic matter. The human rights responsibilities of corporations under domestic law are not

usually couched in corporations or commercial laws themselves, but in separate anti-discrimination, workplace health and safety, and labor laws. Moreover, except in certain circumstances, these domestic human rights laws are designed to operate intra-territorially only. As a result, the extraterritorial operations of TNCs—the very feature that defines them—are substantially regulated neither by international nor domestic laws with respect to their impact on human rights. Domestic regulation by host states is, of course, theoretically possible.

**Transnational corporations and other large businesses have acquired a significant amount of power since the trend of globalization started to develop. With this increase in power comes an increase in responsibility.**

This apparent legal lacuna is precisely what we argue could and should be filled by the development of international legal obligations imposed on TNCs. The combined force of the inventive use of extraterritorial legislation to restrict the actions of corporations operating overseas and the relaxation of the *forum non conveniens* doctrine, allowing greater access to home state courts for settlement of disputes over alleged human rights violations, offers potential solutions.<sup>28</sup>

These relatively recent developments are an encouraging sign for the prospect of greater direct international regulation, for they show some recognition of the nature of the problem of human rights abuses by TNCs, and

at least some degree of willingness on the part of one state organ—the judiciary—to entertain arguments for new or alternative remedies.

### **Conclusion – Looking Ahead**

Transnational corporations and other large businesses have acquired a significant amount of power since the trend of globalization started to develop. With this increase in power comes an increase in responsibility. The UN Human Rights Norms for Transnational Corporations and Other Businesses help fill a major gap in the international human rights system, which already addresses the responsibilities of governments, individu-

als, and armed opposition groups, but has not yet focused on one category of powerful non-state actors, businesses.<sup>29</sup>

Many companies have acknowledged their human rights obligations and the need to restore confidence in corporate social responsibility. The Norms provide companies that want to be socially responsible with an easily understood and comprehensive summary of their obligations under systems such as human rights law, humanitarian law, international labor law, environmental law, consumer law, and anticorruption law. Accordingly,

the Norms help to establish a level playing field for competition. Clarifying their duties may actually benefit businesses, as a growing body of evidence is demonstrating that compliance with human rights standards enhances a company's bottom line. Consumers are often willing to take the human rights conduct of a business into account in making

their purchasing decisions. Some companies have already expressed support for the Norms and agreed to apply them in their own operations as a way of affirming their commitment to the Universal Declaration of Human Rights.

Further, the Norms can strengthen the will of governments to insist that businesses avoid human rights abuses. Governments faced with the economic power of large companies will be assisted by the Norms in identifying and thus applying

**Many actors, from states to international institutions, academia, media and civil society organs, are engaged in the search for an evolving and effective as well as efficient regulatory framework of TNCs' accountability for human rights violations.**

the minimum international standards that relate to the conduct of such companies.

Many actors, from states to international institutions, academia, media and civil society organs, are engaged in the search for an evolving and effective as well as efficient regulatory framework of TNCs' accountability for human rights violations. The UN initiatives hold a prominent, if not central place in such a quest<sup>30</sup> with the Norms being the most recent, and also to date most promising, effort on the part of the United Nations. The Norms seems to have benefited from the exposure of the infirmities of its predecessor as well as other current regulatory regimes of corporate human rights responsibility.<sup>31</sup> However, cer-

tain lacunae still survive which might hamper the efficacy of the Norms and neutralize the edge that they claim over their counterparts.

Though the Norms revive the hope for establishing a legally binding international regime of corporate responsibility for human rights violations, they represent an imperfect step, albeit in the right direction. It is critical for the efficacy of the Norms that imperfections related to both formulation and implementation of TNCs' human rights obligations are further deliberated upon towards the adoption of the Norms.<sup>32</sup> In sum, it is argued that the Norms should not only deduce human rights obligations of TNCs from state-focal international treaties and maintain a distinction between aspirational and operational standards of human rights, but also establish a robust enforce-

ment mechanism which invokes multiple sanctions. The Norms should also take the lead in responding to hindrances posed by the procedural issues related to forum non conveniens and the liability of a parent corporation for human rights violations by its subsidiaries.

Thus, there is today an ardent need to review the Norms with respect to the laid out lacunas and in the scope of forum non conveniens doctrine, so that the Norms achieve the goal it was framed to achieve. There is a need to correct the imperfect step in the right direction so that targets are achieved, human rights are protected and the world becomes a better place for you, me and the generations to come. **BLB**

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## ENDNOTES: Sagarika Chakraborty

<sup>1</sup> David Weissbrodt & Muria Kruger, *Norms On The Responsibilities Of Transnational Corporations And Other Business Enterprises With Regard To Human Rights*, 97 Am. J. Int'l L. 901 (2003).

<sup>2</sup> *Id.*

<sup>3</sup> UN Doc. A/ CONF.183/9\* (1998), 37 ILM 999 (2004); Luzius Wildhaber, *Some Aspects of the Transnational Corporation in International Law*, 27 Neth. Int'l L. Rev. 79, 80 (2004).

<sup>4</sup> Luzius Wildhaber, *Some Aspects of the Transnational Corporation in International Law*, 27 Neth. Int'l L. Rev. 79, 80 (2004).

<sup>5</sup> *Id.*

<sup>6</sup> Mary Robinson, *Second Global Ethic Lecture*, University of Tübingen, Germany, (Jan. 21, 2002), at <http://www.ireland.com/newspaper/special/2002/robinson> (last visited Sept. 23, 2005).

<sup>7</sup> "Draft UN Code", para. 1(a), *Development and International Economic Cooperation: Transnational Corporations*, UN Doc. E/1990/94; See also Draft United Nations Code of Conduct on Transnational Corporations, May 1983, 23 ILM 626 (1984).

<sup>8</sup> *Id.* at para. 20.

<sup>9</sup> Mary Robinson, *Second Global Ethic Lecture*, University of Tübingen, Germany (Jan. 21, 2002), at <http://www.ireland.com/newspaper/special/2002/robinson> (last visited Sept. 23, 2005).

<sup>10</sup> *Id.*

<sup>11</sup> Aaron X. Fellmeth, *Wiwa v. Royal Dutch Petroleum Co.: A New Standard for the Enforcement of International Law in the U.S. Courts?*, 5 Yale Hum. Rts. & Dev. L.J. 241, 244- 45 (2002).

<sup>12</sup> Lena Ayoub, *Nike Just Does It and Why the United States Shouldn't: The United States' International Obligation to Hold MNCs Accountable for Their Labor Rights Violations Abroad*, 11 DePaul Bus. L.J. 395, 400-11 (1999).

<sup>13</sup> Anita Ramasastry, *Corporate Complicity: From Nuremberg to Rangoon—An Examination of Forced Labor Cases and Their Impact on the Liability of Multinational Corporations*, 20 Berkeley J. Int'l L. 91, 131-36 (2002).

<sup>14</sup> Submission by ICCR's Human Rights Working Group to the UN High Commission on Human Rights, [www.iccr.org/news/press\\_releases/2004/pr\\_hrwgsubmiss100704.htm](http://www.iccr.org/news/press_releases/2004/pr_hrwgsubmiss100704.htm) (last visited Sept. 10, 2005).

<sup>15</sup> Anita Ramasastry, *Corporate Complicity: From Nuremberg to Rangoon—An Examination of Forced Labor Cases and Their Impact on the Liability of Multinational Corporations*, 20 Berkeley J. Int'l L. 91, 131-36 (2002).

<sup>16</sup> Submission by ICCR's Human Rights Working Group to the UN High Commission on Human Rights, [www.iccr.org/news/press\\_releases/2004/pr\\_hrwgsubmiss100704.htm](http://www.iccr.org/news/press_releases/2004/pr_hrwgsubmiss100704.htm) (last visited Sept. 10, 2005).

<sup>17</sup> Surya Deva, *Human Rights Standards and Multinational Corporations: Dilemma Between "Home" and "Rome"*, 7 Mediterranean J. Hum. Rts. 69, 87-89 (2003).

<sup>18</sup> Submission by ICCR's Human Rights Working Group to the UN High Commission on Human Rights, [www.iccr.org/news/press\\_releases/2004/pr\\_hrwgsubmiss100704.htm](http://www.iccr.org/news/press_releases/2004/pr_hrwgsubmiss100704.htm) (last visited Sept. 10, 2005).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> Declaration of the United Nations on the Environment, June 16, 197", U.N. Doc. A/Conf.48/14/Rev.1 (commonly referred to as the Stockholm Declaration); Rio Declaration on Environment and Development, Aug. 12, 1992, U.N. Doc. A/Conf.151/26 (Vol. I).

<sup>25</sup> Submission by ICCR's Human Rights Working Group to the UN High Commission on Human Rights, [www.iccr.org/news/press\\_releases/2004/pr\\_hrwgsubmiss100704.htm](http://www.iccr.org/news/press_releases/2004/pr_hrwgsubmiss100704.htm) (last visited Sept. 10, 2005).

<sup>26</sup> *Id.*

<sup>27</sup> David Kinley & Junko Tadaki, *From Talk to Walk: The Emergence of Human Rights Responsibilities for Corporations at International Law*, 44 Va. J. Int'l L. 931 (2004).

<sup>28</sup> Submission by ICCR's Human Rights Working Group to the UN High Commission on Human Rights, [www.iccr.org/news/press\\_releases/2004/pr\\_hrwgsubmiss100704.htm](http://www.iccr.org/news/press_releases/2004/pr_hrwgsubmiss100704.htm) (last visited Sept. 10, 2005).

<sup>29</sup> David Weissbrodt & Muria Kruger, *Norms On The Responsibilities Of Transnational Corporations And Other Business Enterprises With Regard To Human Rights*, 97 Am. J. Int'l L. 901 (2003).

<sup>30</sup> Corporate Code of Conduct Bill of 2000, H.R. 4596, 106th Cong., <http://thomas.loc.gov/cgi-bin/query/z?c106:H.R.4596> (last visited Sept. 6, 2005); the Corporate Code of Conduct Bill of 2000 (Austl.), <http://parlinfoweb.aph.gov.au/pivweb/Repository/Legis/Bills/Linked/13020235.pdf> (last visited Sept. 6, 2005).

<sup>31</sup> Frieda De Koninck, *How Can We Influence the Practices of Transnational Actors? The "Clean Clothes" Campaign: How Can We Fight for Economic and Social Rights when Faced to Transnational Actors?*, in *Social Alert, Economic, Social and Cultural Rights: A Challenge for Peace and Development in a Global World*, 58-70 (2002), <http://www.paxchristi.net/PDF/DEC06E02.pdf> (last visited Sept. 15, 2005).

<sup>32</sup> Anne-Marie Slaughter, *A Liberal Theory of International Law* AM. SOC'Y INT'L L. PROC. 240, 243 (2000).

# Bankruptcy Courts' Treatment of Severance Agreements Providing for Continued Payments to Former Employees

By Michael J. Lichtenstein

**W**HEN COMPANIES FACE FINANCIAL DIFFICULTIES, management often negotiates severance agreements with employees that require certain payments for an extended period. In exchange, the former employees may agree to sign a non-compete, non-disclosure and non-solicitation agreement or to provide other consideration. For example, rather than pay a 6-figure salary to a senior executive who might be redundant, a company that is downsizing might terminate the employment contract but agree to pay some amount of severance over an extended period of time. If the company's fortunes fail further, resulting in the filing of a Chapter 11 bankruptcy petition, management may desire to escape liability for making continued payments under such severance agreements or under existing contracts with former employees. Unfortunately, under such circumstances, the Bankruptcy Code is not designed to favor the former employee. Many courts have severely curtailed former employees' rights to receive payment in full on account of such severance agreements.

In a Chapter 11 proceeding, a pre-petition severance agreement can be deemed to be executory<sup>1</sup> or non-executory. The consequence of which definition applies is the claim priority to which the former employee may be entitled. In plain English, this may mean a former employee receives either 100 cent dollars or "bankruptcy dollars" (typically less than 100 cents)<sup>2</sup> on account of payments due under the severance agreement. Obviously, a debtor company will usually seek a way to minimize payments to former employees, whereas, former employees would rather be paid in full. Infrequently, a reorganizing company may wish to continue such payments to engender contin-

ued good will from its current employees. Not surprisingly, the scales are tipped in favor of the debtor on this issue,<sup>3</sup> and a former employee faces an uphill battle to convince a bankruptcy court that she is entitled to payment in full on account of her severance agreement with the employer for whom she no longer works. Unfortunately, this may be true whether a contract is deemed to be executory and therefore capable of rejection or not.

Section 365 of the Bankruptcy Code<sup>4</sup> provides that a trustee<sup>5</sup> may assume or reject any executory contract. Most courts defer to the debtor's business judgment in determining whether or not to allow rejection of an executory contract.<sup>6</sup> The rejection of an executory contract enables the non-rejecting party to file an unsecured claim which is deemed to arise as of the date the bankruptcy petition was filed. However, until the court enters an order rejecting the contract, the non-debtor party

to the contract may be entitled to an administrative claim based upon the actual and necessary benefit provided to the estate.<sup>7</sup> Thus, a party to a rejected executory contract, who can demonstrate actual and necessary benefit to the estate, will have a bifurcated claim consisting of an administrative portion for post-petition services through the rejection date (likely to be paid in full) and an unsecured portion for the rejection damages (unlikely to be paid in full).

There is no clear authority on how to treat severance agreements in a Chapter 11 proceeding. Like many bankruptcy issues, the outcome depends on the jurisdiction in which decisions have been made. This is the result of a lack of national binding precedent for bankruptcy courts located across the country. For example, a New York bankruptcy judge has rendered a decision on severance contracts that is directly at odds

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with one written by a Missouri bankruptcy judge. However, despite the differing analysis, the end result has been that courts have been reluctant to achieve a result that allows post-petition payments to former employees on account of severance agreements.

Some courts have been hesitant to classify pre-petition severance agreements as executory. For example, in *In re Spectrum Information Technologies, Inc.*,<sup>8</sup> the debtor contended that certain separation agreements were executory contracts subject to rejection.<sup>9</sup> Before the bankruptcy filing, the debtor entered into separation agreements, agreeing to make certain payments to former employees in exchange for those former employees accepting termination payments, modification of existing stock options and agreeing to comply with confidentiality, non-interference and non-compete provisions and to provide consulting.<sup>10</sup>

The Court noted that several courts have rejected the Countryman test as the sole benchmark for determining whether a contract is executory.<sup>11</sup> Instead, some courts apply a “functional approach” which focuses on any potential benefit to the bankruptcy estate from the assumption or rejection of a contract, rather than the mutuality of obligations.<sup>12</sup> With this goal in mind, but ostensibly applying the Countryman test, the Court in *Spectrum* concluded that the former employees’ contractual obligations did not rise to the level of material future performance.<sup>13</sup> The Court made this determination even as to two former employees whose continuing duties included consulting obligations.<sup>14</sup>

gation is a pre-petition obligation. In other words, the former employee would not be entitled to assert an administrative claim.



On the other hand, in *In re Farmland Indust., Inc.*,<sup>16</sup> the Court applied a different analysis where the debtor sought to reject certain employment agreements of four former executives. The debtor contended that the contracts were executory agreements under which the debtor had continuing severance payment obligations exceeding \$120,000.00 per month.<sup>17</sup> The former employees were obligated to provide consulting services upon demand and to refrain from competition or interference with the debtors’ businesses.<sup>18</sup>

One of the employees argued that his agreement was not executory because he had no remaining material obligations under the agreement.<sup>19</sup>

The Court disagreed, concluding that the agreement of the former president and chief financial officer of a major corporation not to disclose confidential information, not to compete and to assist in claims’ evaluation were highly pertinent and material obligations, even if the person were never asked to do anything else.<sup>20</sup> Therefore, the contracts in question were executory and could be rejected.<sup>21</sup> The Court agreed with the debtor’s business judgment that there was no continuing benefit to the debtor because the former employees were unlikely to provide meaningful services in the bankruptcy proceeding.<sup>22</sup>

The problem with the *Farmland* decision is that it fails to address fully the consequences of rejection. While it is clear that the former employees could file unsecured claims for the rejection damages<sup>23</sup>, the Court did not opine whether the former employees could assert administrative claims for the post-petition pre-rejection period. If the former employees had only unsecured claims, they ended up in the same place as the *Spectrum* former employees, albeit via a different

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The practical result of the Court’s decision in *Spectrum* was that the former employees had no right to a rejection claim, essentially taking away any argument of an entitlement to an administrative claim up to the rejection date. In reaching this conclusion, the Court followed the Fourth Circuit,<sup>15</sup> which held previously that, regardless of the nature of the contract, if the debtor’s only post-petition obligation is to pay money, that obli-

There is a lesson to be learned by future former employees who may be parties to severance agreements with companies that file for bankruptcy protection.

analysis. In one case, the severance contracts were deemed to be executory, whereas in another the contracts with former employees were deemed not to be executory. However, in both cases, all former employees presumably ended up with unsecured claims and both bankruptcy courts determined that there was no continuing benefit to the debtors' estates.

Because the *Spectrum* Court followed the Fourth Circuit's decision in *Stewart Foods*, it is probable that the former employees only had unsecured claims. However, it is possible that in Farmland, although unstated, the former employees could have asserted administrative claims for the period prior to rejection. To do so, they would have needed to demonstrate that they provided an actual and necessary service to the estate.



There is a lesson to be learned by future former employees who may be parties to severance agreements with companies that file for bankruptcy protection. A former employee is better off if a contract is deemed to be executory and subject to rejection. That determination allows a more viable argument that until contract rejection, the employee is entitled to an administrative claim for services provided post-petition to the debtor. When negotiating a pre-bankruptcy severance agreement, the employee should try and include language indicating that any agreement to provide consulting services or to refrain from competition and solicitation are material terms in the agreement. Armed with

such language, a former employee should be prepared to argue that her agreements to act or to refrain from acting provide actual and necessary benefits to the debtor's estate. While this will not guarantee an administrative claim, allowing payment of the severance agreement in full, it

may help the former employee present a credible argument that the bankruptcy estate benefited from the agreement. **BLB**

## ENDNOTES: *Michael J. Lichtenstein*

- <sup>1</sup> While not defined in the Bankruptcy Code, the traditional definition of an executory contract (known as the "Countryman" definition) requires that some performance be due by both parties to a contract. See Countryman, Vern, "Executory Contracts in Bankruptcy," Part I, 57 MINN. L. REV. 439 (1973).
- <sup>2</sup> "little tiny Bankruptcy Dollars which may be worth only ten cents in U.S. Dollars." *In re Child World*, 147 B.R. 847, 850 (Bankr. S.D.N.Y. 1992) (citation omitted).
- <sup>3</sup> The purpose of Chapter 11 is to provide a debtor with breathing room and the opportunity to reorganize.
- <sup>4</sup> 11 U.S.C. § 365.
- <sup>5</sup> In a typical Chapter 11 case, the pre-filing management continues in place and the company operates as a debtor-in-possession which is the functional equivalent of a trustee.
- <sup>6</sup> See, e.g. *In re Food Barn Stores, Inc.*, 107 F.3d 558, 567 (8th Cir. 1997).
- <sup>7</sup> Section 503(b) discusses the allowance of administrative claims.
- <sup>8</sup> 190 B.R. 741, 744 (Bankr. E.D.N.Y. 1996).
- <sup>9</sup> One might expect a debtor to agree that a pre-petition contract was non-executory and therefore that the other party is only entitled to an unsecured claim.
- <sup>10</sup> *Id.* at 745.
- <sup>11</sup> *Id.* at 747. Professor Countryman's widely quoted definition provides that an executory contract is one under which both parties' obligations are so far unperformed that the failure of either party to complete performance would constitute a material breach excusing the other's performance. 57 MINN. L. REV. 439, 460 (1973).
- <sup>12</sup> *Id.*
- <sup>13</sup> *Id.* at 748. This appears to be a result oriented decision, based upon the court's perception of a lack of benefit to the estate. See also *In re Schneeweiss*, 233 B.R. 28, 32 (Bankr. N.D.N.Y. 1998) (covenant not to compete does not constitute material obligation sufficient to render contract executory).
- <sup>14</sup> *Id.* at 751. In the court's view, the consulting obligations were *de minimus* and were not the material purpose underlying the agreements.
- <sup>15</sup> *In re Stewart Foods, Inc.*, 64 F.3d 141, 145 (4th Cir. 1995).
- <sup>16</sup> 294 B.R. 903, 906 (Bankr. W.D. Mo. 2003).
- <sup>17</sup> *Id.* at 912.
- <sup>18</sup> *Id.*
- <sup>19</sup> *Id.*
- <sup>20</sup> *Id.* at 923.
- <sup>21</sup> *Id.*
- <sup>22</sup> 11 U.S.C. § 502(g).

# Podcasting is Catching On, But Can Licensing Catch Up?

By Zehra Naqvi

**P**odcasting is catching on because it facilitates access to information at our convenience. For example, a person who loves a morning radio show that she can never catch because of a time conflict can now simply download the segment for later listening. Another person who missed his evening class the other day dreads going to the library to watch the tape of the class – in fact, the process of finding the tape and then sitting there watching it seems so horrible that he will not end up doing it. With podcasting, the person can download the class lecture directly onto his computer and listen to it from the comfort of his home. Finally, this medium also appeals to the person more concerned with creating information for others' listening. An aspiring radio personality can now make a broadcast and develop a loyal following of listeners.

## The Basics of Podcasting

“A podcast is an audio file archived on the Internet in such a way that it can be automatically accessed by a personal computer, downloaded and transferred to a portable MP3 player, such as an iPod.”<sup>1</sup> Podcasting is essentially a new form of technology, somewhere between webcasting and broadcasting. Because it cannot be classified as one of the existing forms, licensing music for it presents a host of new problems. For recording companies, artists, aspiring broadcasters, and existing radio stations on the verge of podcasting their daily broadcasts, this issue has huge implications.

## Industry Trends and Licensing Issues

Worldwide, the recording industry has faced a plunge in its revenues, resulting in fewer people doing more people's jobs;

when an individual podcaster comes knocking at their door asking to negotiate a direct license for some of their music, he will not likely get their attention.<sup>2</sup> In contrast, webcasters do not have to knock on any doors at all because webcasting is subject to the compulsory licensing arrangement established by the

Digital Millennium Copyright Act (DMCA) of 1998.<sup>3</sup> The difference between podcasting and webcasting is based on the underlying technology and piracy concerns.

Webcasting relies on noninteractive streaming technology which allows one to listen to the music clip without being able to

download it onto one's computer and then fileshare it out later; a typical podcast is more interactive because it has music files

embedded in it and can be downloaded and altered in such a way as to allow for the listener to cut out the segment and fileshare it later.<sup>4</sup> The “interactive” nature of podcasting is what precludes it from the scope of existing statutory licensing arrangements. “With no licenses, no frequencies, and no towers, ordinary people are busy creating audio programming for thousands of others. They're bypassing an entire industry.”<sup>5</sup>

The entire industry will have to wake up soon because the trend is catching on and there is potential for missed licensing revenues. As of July 2005, there were over 15,000 podcasts available through iTunes, with the number of subscriptions up to 5 million.<sup>6</sup> Many current podcasts include indie music because a simple waiver form and

direct licensing free them from any licensing worries. For mainstream radio, however, it is a more complicated matter. If the average radio station manager decided to podcast a half hour segment of their show, they would have to get licensing for each one of the songs they used from the respective recording companies.

Podcasting is catching on because it facilitates access to information at our convenience.



However, as larger companies like Whirlpool, GM, and Pepsi begin to invest in the technology, tailoring or sponsoring programs for their target consumers, recording companies might just renew their interest in licensing issues surrounding podcasting.<sup>7</sup>

**Podcasting is essentially a new form of technology, somewhere between webcasting and broadcasting.**

Under the Digital Performance Right in Sound Recordings Act of 1995 (DPRSRA), “no one may perform a musical recording in a digital transmission without the consent of the copyright owner, usually a record company.”<sup>8</sup> Because podcasting is a digital transmission, the DPRSRA applies to it, but because of the interactive nature of the technology, the DMCA does not currently apply to it.<sup>9</sup> The United States Copyright Office tasked SoundExchange, a nonprofit organization, with “licens[ing], collect[ing], and distribut[ing] public performance revenues for sound recording copyright owners (SRCOs) and artists for noninteractive digital transmissions on cable, satellite and webcast services.”<sup>10</sup> SoundExchange’s website states that SoundExchange does not administer royalties for “interactive performances of sound recordings” or “digital downloads” and that licensing must be arranged directly with the copyright owner.<sup>11</sup> In application, this means that because podcasting does not fall within the current scope of licenses administered by SoundExchange, podcasters have to seek direct licensing arrangements with individual recording companies.

Whatever licensing arrangement is selected, SoundExchange will likely be the one administering it. While there are no current lawsuits by the recording companies against any infringing use by podcasters, some speculate that it is just a matter of “waiting for the right defendant.”<sup>12</sup> In the meantime, the recording industry must decide what type of licensing will work for podcasting and pressure Congress to fold either podcasting into webcasting licensing or come up with a new way of classifying and licensing the technology.

### **Do We Need a Shift in the Technology or a Shift in the Law?**

Does podcasting’s interactive/downloadable nature makes it too dissimilar from webcasting to fit into the same licensing scheme? Two proposed solutions for the licensing problems of podcasting offer completely different perspectives on the technology and the piracy concerns that seem inherent to its nature.

One proposal argues that podcasting can be included in the existing statutory scheme that was originally formulated for webcasting. However, because webcasting licensing is premised on technology that cannot be easily pirated for filesharing, this proposal does not seem to address the industry’s concerns arising from podcasting’s interactive nature. Another proposal essentially makes it more difficult to pirate such downloadable technology. It proposes using digital rights management technology to limit the number of times a podcast can be heard or control the way a user must listen to the broadcast, making it harder to access particular segments for pirating.

To avoid requiring podcasters to seek direct licensing arrangements, Steve Gordon, a prominent entertainment lawyer, proposes including podcasting within the scope of compulsory licensing; he argues that “[t]he DMCA should be amended to accommodate podcasting.”<sup>13</sup> By including it within the existing statutory scheme, podcasters would be spared from having to negotiate individual deals with recording companies and instead simply have to pay SoundExchange a statutorily mandated fee based on the type of licensing they were seeking.<sup>14</sup> Gordon explains that podcasting technology is within the scope and “spirit” of the law because those motivated to pirate the music will do so through other means; he argues that podcasting falls under the Copyright Act’s general definition of a “digital phonorecord delivery” and is thus subject to compulsory licensing.<sup>15</sup>

**As of July 2005, there were over 15,000 podcasts available through iTunes, with the number of subscriptions up to 5 million.**

Gordon states that there are many safeguards in place to address the piracy concerns of the industry and that, as with webcasting, record sales will not necessarily be displaced by the technology.<sup>16</sup> He adds that podcasters would be subject to the same rules as webcasters; for example, they could not play multiple tracks from the same artist in a narrow time window.<sup>17</sup> Though Gordon argues that his proposal would be beneficial to artists because it allows them to obtain a set percentage of the licensing fee, he overlooks the fact that the benefit is actually derived from SoundExchange’s administration of the scheme. If another licensing arrangement was constructed by Congress specifically for podcasting, and similarly administered by

SoundExchange, artists and record labels would enjoy the same benefits that the current scheme offers. The essence of Gordon's proposal is avoiding new legislation and bypassing labels by forcing podcasting to fit into the existing licensing model. This proposal clearly favors podcasters by keeping a familiar licensing arrangement, but does not address the concerns of artists and recording companies in safeguarding their music against piracy.



John Simson, the Executive Director of SoundExchange, presents another alternative.<sup>18</sup> If Congress fails to shift the law by either enacting new legislation or amending existing legislation to accommodate podcasting, the proposal calls for a clearinghouse model administered by SoundExchange in addition to a shift in the technology itself. SoundExchange is able to administer its licensing scheme because of an antitrust exemption granted by Congress that allows it to engage in collective bargaining and rate-setting for compulsory licenses regarding webcasting and other digital transmissions. It has no such exemption for podcasting.

An alternative would be to allow SoundExchange to serve as a clearinghouse on their website for the recording companies to post their individual rates for podcasting licenses. A podcaster would then visit the site, select songs off the SoundExchange database, calculate the rates per label, and then present its final selections and make payment to SoundExchange, which would then distribute the royalties and fees as it does with webcasting.

Concurrently, the podcast would have to be wrapped in such a way that it can only be listened to as an entire program, where the sole benefit of downloading the podcast is to listen to the same program you would have through a regular radio broadcast, but just at your own convenience. It would not allow you to forward or rewind to a particular segment and you could only listen to the download a limited number of times. Because of 1) the digital rights management (limited number of times you could listen to it and inability to rewind/forward it); and 2) storage constraints on iPods and other digital music players, users would probably delete the program and reduce the likelihood of music piracy. This would also make it considerably

harder for those who would exploit podcasting technology for pirating embedded music and therefore address the licensor's music piracy concerns.

In fact, if podcasting technology could incorporate these structural changes, then it might be included under a broad definition of "noninteractive" technology, like webcasting. While Gordon argues that podcasting falls under the statutory scheme under Copyright Act, 17 U.S.C. §115, the real problem lies in the Copyright Act's definition of an "interactive service" under §114(j)(7), which defines an "interactive service" as "one that enables a member of the public to receive a transmission of a program specially created for the recipient, or on request, a transmission of a particular sound recording, whether or not as part of a program, which is selected by or on behalf of the recipient."<sup>19</sup> Simson argues the ability to download, forward, and rewind a podcast makes it subject to this definition, which is exempt from the existing statutory scheme. Additionally, Copyright Act, 17 U.S.C. §114(d)(2)(C)(vi) lists one of nine requirements for a transmission to qualify for statutory licensing, stating:

the transmitting entity takes no affirmative steps to cause or induce the making of a phonorecord by the transmission recipient, and if the technology used by the transmitting entity enables the transmitting entity to limit the making by the transmission recipient of phonorecords of the transmission directly in a digital format, the transmitting entity sets such technology to limit such making of phonorecords to the extent permitted by such technology.

**As podcasting catches on, the recording industry will be forced to improvise a licensing scheme suited to its unique, interactive, hybrid form.**

Because podcasting is essentially a time-shifting technology allowing one to listen to a broadcast at one's convenience, it is not "limit[ing]" the making by the transmission recipient of phonorecords of the transmission directly in a digital format" and is instead "induc[ing]" it, thus falling outside the scope of the statute.<sup>20</sup> If Simson's proposed technology wrapping fundamentally changes the interactive nature of the technology, thus limiting the recipients' ability to download and alter the content, Congress may consider including podcasting under the current statute. By placing technological limits on its interactive nature,

however, we risk compromising the very convenience that is driving podcasting's popularity. Unfortunately, for licensing to work, there needs to be either a shift in podcasting technology or a shift in the law.

Artists would likely support the technological shift proposal since they would get higher percentages of the licensing fees if they come directly from SoundExchange; artists would end up with much less money if the fees are filtered through their recording companies through either the clearinghouse model or direct licensing arrangements.

The difference between the two proposals is that Gordon proposes adding podcasting to the existing statutory scheme without any change to the technology itself, while Simson proposes that the technology would have to be changed to fit the existing model. Because podcasting is a means of downloading and not just a means of hearing a sample of music without the ability to capture it onto hard drives, it is distinct from webcasting and cannot fall into the statutory scheme. While Gordon's proposal seeks to make lives easier for podcasters, it does not assuage the concerns of industry actors and is thus unlikely to be adopted by the industry.

Simson's proposal regarding the technology wrapping of podcasting involves advances which could only be phased in if the license was granted *conditioned* on those changes being made; since many podcasters already have their programs in place without such safety measures, this might involve major changes and no clear enforcement mechanism to ensure compliance with the technological requirements. Additionally, large commercial giants sponsoring podcasts to their target consumers might challenge such limitations on their consumers' ability to access and manipulate the podcasts; it undermines the convenience benefit of the technology by removing consumers' ability to filter out advertisements or replay certain segments.

Unless podcasters can convince Courts to read a narrow definition of "interactive services" so that podcasting falls outside of its purview, the end result must either be a shift in the law in the shape of an entirely new statutory licensing arrangement for podcasting or some version of Simson's proposed alterations to shift the technology to adapt it into the statute.

### To Be Continued...

As podcasting catches on, the recording industry will be forced to improvise a licensing scheme suited to its unique, interactive, hybrid form. Because podcasting allows people to download content onto their computers and iPods while webcasting does not, current podcasting technology does not fit under the current webcasting licensing model and needs an altogether new licensing arrangement. Whether that arrangement is based on digital rights management to wrap the technology to control how the content is heard and thus make it harder to pirate, or whether recording companies use SoundExchange to set up a

clearinghouse model on the existing website, the recording industry cannot afford to let podcasting revenues slip through its fingers. As podcasting increases in popularity on with all types of listeners and businesses, the industry will have to catch up with a shift in podcasting technology or a shift in the law. **BLB**

## ENDNOTES: Zehra Naqvi

<sup>1</sup> Collegiate Broadcasters, Inc., *Podcasting Legal Issues: A and B's of Podcasting (Too Early for C's)?*, available at <http://www.collegebroadcasters.org/podcast.shtml>.

<sup>2</sup> Interview with Mr. John Simson, Executive Director, SoundExchange, in Washington, D.C. (Nov. 28, 2005) ("A podcaster going to a record company will probably be ignored . . . [because] there has been such a dramatic drop in the sale of catalogue records and sale of recordings in general—we're talking about a \$40 billion worldwide industry that's at \$32 billion, so it's dropped 20% in five years [and] you've got 30% fewer people in the US to do 50% more work."); see also Heather Green, Tom Lowry, Catherine Yang & David Kiley, *The New Radio Revolution; From Satellite to Podcasts, Programming is Exploding—But the Fight for Profits Will Be Ferocious*, Business Week, Mar. 14, 2005, at 32.

<sup>3</sup> Steve Gordon, *Issues in Licensing Music for Podcasts*, 21 Ent. Law & Fin. 1 (August 2005).

<sup>4</sup> Interview with Mr. John Simson, Executive Director, SoundExchange, in Washington, D.C. (Nov. 28, 2005).

<sup>5</sup> Heather Green, Tom Lowry, Catherine Yang & David Kiley, *The New Radio Revolution; From Satellite to Podcasts, Programming is Exploding—But the Fight for Profits Will Be Ferocious*, Business Week, Mar. 14, 2005, at 32.

<sup>6</sup> Brian Garrity, *Podcast at the Crossroads*, Billboard, October 1, 2003.

<sup>7</sup> Diane Anderson, *The Pod People*, Adweek, Nov. 21, 2005; *Big Blue Jumps on Podcasting Bandwagon*, The Australian, August 9, 2005, at 32.

<sup>8</sup> Steve Gordon, *Issues in Licensing Music for Podcasts*, 21 Ent. Law & Fin. 1 (August 2005).

<sup>9</sup> *Id.*

<sup>10</sup> *SoundExchange Background*, SoundExchange, available at <http://www.soundexchange.com/about/about.html>.

<sup>11</sup> *SoundExchange FAQ*, SoundExchange, available at <http://www.soundexchange.com/faq.html#a6>.

<sup>12</sup> Cathy Yang, *Podcasters Hit the Copyright Wall; If they Don't Get Permission to Air Protected Music, they Could be Downloading Legal Trouble from the Recording Industry*, Business Week, May 25, 2005.

<sup>13</sup> Steve Gordon, *Issues in Licensing Music for Podcasts*, 21 Ent. Law & Fin. 1 (August 2005).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* (citing the Copyright Act, 17 U.S.C. § 115(d) as defining a "digital phonorecord" as "each individual delivery of a phono-record by digital transmission of a sound recording which results in a specifically identifiable reproduction by or for any transmission recipient of a phonorecord of that sound recording.")

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> Interview with Mr. John Simson, Executive Director, SoundExchange, in Washington, D.C. (Nov. 28, 2005).

<sup>19</sup> *Id.*; see also David Luebbert, *Re: How to Podcast RIAA Music Under License*, Weblog comment, (January 6, 2005) at [http://blog.lextext.com/blog/\\_archives/2005/1/4/225172.html](http://blog.lextext.com/blog/_archives/2005/1/4/225172.html) (discussing whether podcasts qualify as noninteractive or interactive services under the Copyright Act).

<sup>20</sup> David Luebbert, *Re: How to Podcast RIAA Music Under License*, Weblog comment (January 6, 2005) at [http://blog.lextext.com/blog/\\_archives/2005/1/4/225172.html](http://blog.lextext.com/blog/_archives/2005/1/4/225172.html).

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