ILLINOIS BUSINESS LAW JOURNAL

VOLUME 25
SUMMER 2020

A PUBLICATION OF THE STUDENTS OF THE UNIVERSITY OF ILLINOIS COLLEGE OF LAW

Illinois Business Law Journal

Volume 25, Issue 1 | 2020

© 2020 University of Illinois Board of Trustees

Editors

Matthew Pham
Editor-in-Chief

Prateek Viswanathan
Managing Editor

Clinton Oppong
Articles Editor

Destinee Hekmatpour
Executive Administrative Editor

Joy Wilson
Notes Editor

Student Writers

Diana Bikbaeva
Cody Von Rueden
Zachary Read

Soha Abdurrahman
Benjamin Kovach
Stephen Beemsterboer

ILLINOIS BUSINESS LAW JOURNAL

VOLUME 25 SUMMER 2020

PART I: BRAVE NEW WORLDS

THE RISE OF ESG INVESTING:
How Aggressive Tax Avoidance Affects
Corporate Governance & ESG Analysis
By: Jacob Fonseca 1

CONVENIENCE V. CONFIDENTIALITY:
The California Consumer Privacy Act and
the Limits of its Private Right of Action
By: Zachary Read 19

CREATED TO CREATE:
Why AI-Created Works Should be
Copyrightable as Works Made For Hire
By: Diana Bikbaeva 31

PART II: REIMAGINING

A HORSE WALKS INTO A BAR:
Comparing Easterbrook's Criticized Cyberlaw Analogy to
the Study of Alcoholic Beverage Law & Regulation
By: Mark Edward Blankenship Jr. 41

COPPA KILLED THE VIDEO STAR:
How the Youtube Settlement Shows that
COPPA Does More Harm Than Good
By: Stephen Beemsterboer 63

DIAMONDS IN THE DUST:
Why Lawyers Make the
Ideal Candidate for CEO
By: Soha Abdurrahman 91

PART III: BUSINESS TIME

Is Opportunity Zone Investing
Attractive to Wealthy Investors?
By: Daniel Pessar 103

KNOW WHEN TO HOLD 'EM, KNOW WHEN TO FOLD 'EM:
How Professional Sports Leagues Should Monetize
Data in the Era of Legalized Sports Gambling
By: Benjamin Kovach 119

SMART PLAYERS NEED SMART CONTRACTS:
How Blockchain and Smart Contracts
Can Revolutionize the Sports Industry
By: Cody von Rueden 131

Dedicated to ông ngoại.

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

THE RISE OF ESG INVESTING: HOW AGGRESSIVE TAX AVOIDANCE AFFECTS CORPORATE GOVERNANCE & ESG ANALYSIS

❖ ARTICLE ❖

Jacob Fonseca *

i. ABSTRACT 2
I. INTRODUCTION 3
II. ESG INVESTING: HISTORY & DEFINITION 3
  A. History 3
  B. Definition 5
  C. Prominence in Today's Markets 6
III. AGGRESSIVE TAX AVOIDANCE BY CORPORATIONS 8
  A. Defining Tax Avoidance 8
  B. The "Double Irish, Dutch Sandwich" 9
  C. Case Study: U.S. Technology Companies 12
IV. IMPACT ON ESG SCORE & FINANCIAL PERFORMANCE 16
  A. Effect on Governance 16
  B. Correlation Between ESG Score & Financial Performance 17
V. CONCLUSION 18

* J.D. University of Connecticut School of Law (2020); M.B.A. University of Connecticut School of Business (2020).

i. ABSTRACT

Environmental, Social, and Governance (ESG) investing is arguably the most popular and fastest growing investment strategy of the twenty-first century. This rise in sustainable investing has coincided with an increasing scrutiny of companies that utilize aggressive tax avoidance strategies. In response to this growing scrutiny, ESG rating agencies and institutional investors have penalized companies that pursue these strategies, although the direct effect that these strategies have on ESG scores and analysis remains empirically unclear. First, this paper explains the history of and surge in ESG investing and its place in today's markets. Second, it details one of the most prominent aggressive tax avoidance strategies used by U.S. corporations—the "Double Irish, Dutch Sandwich." With the recent closure of this strategy via tax reform, this paper examines the past use of the Double Irish, as well as the replacement strategies employed by large U.S. technology firms, such as the "Single Malt" and the "Green Jersey" strategies. Finally, this paper explores the negative effects that aggressive tax avoidance may have on a company in a time when socially conscious investing is at an all-time high.

I. Introduction

Environmental, Social, and Governance (ESG) Investing has emerged as one of the most exciting investment strategies of the past two decades. Since its evolution from the social impact investment movement of the 1980s, ESG investment and its rise to prominence has fundamentally impacted laws, regulations, corporate policies, and business practices. In essence, an ESG investment strategy analyzes company value by taking into account a list of factors that fall under three categories: environmental, social, and governance. Recently, the Governance category has grown in relevance due to an increased public scrutiny of corporate tax avoidance strategies used by some of the largest U.S. companies. The primary method in which companies are able to avoid taxes and achieve an effectively low tax rate is through the manipulation of the complex legal and tax relationships between the U.S. tax code, international tax laws, and bilateral tax treaties.

Ireland, for example, is synonymous with aggressive tax avoidance strategies because of its favorable tax laws, and it has continued to play an important role in tax avoidance strategies. Perhaps the most well-known strategy is called the Double Irish, Dutch Sandwich ("Double Irish") which once allowed multinational corporations to shift money through multiple subsidiaries to lower their tax burden and store money in offshore accounts. Despite new Irish tax laws ending the Double Irish strategy officially in 2020, recent reports suggest that companies have enacted replacement strategies that provide alternative means of tax avoidance. One industry in particular, U.S. Big Tech, has received the brunt of public scrutiny due to its ubiquitous use of aggressive tax strategies.

The public scrutiny of a company's obligation to pay taxes has caused ESG rating agencies and institutional investors to penalize companies that pursue aggressive tax avoidance strategies. Although it is not yet known how these strategies have affected ESG analysis and scoring, the mere use of any tax avoidance strategy can negatively impact companies as a result of public disapproval and censure. Furthermore, with the increase in public scrutiny of multinational firms and their aggressive tax avoidance strategies, companies such as the U.S.'s big technology firms may begin to see negative financial consequences in the form of lower sustainability ratings, less investments inflow, and removal from institutional investment pools.

II. ESG Investing: History & Definition

A. History

ESG investing is the integration of environmental, social, and governance factors into the investment process and analysis. This investment strategy was born out of the Social Responsibly Investing (SRI) movement that rose to prominence in the 1980s and 1990s.[1] The origins of SRI can be traced back to ancient biblical times when religious law would provide

1. Blaine Townsend, *From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing*, Bailard Wealth Management (June 2017) https://www.bailard.com/wp-content/uploads/2017/06/Socially-Responsible-Investing-History-Bailard-White-Paper-FNL.pdf?pdf=SRI-Investing-History-White-Paper.

followers with guidelines for ethical investment.[2] In North America, the proponents of SRI investing were the civil rights activists, women's rights activists, and religious organizations that became growingly concerned with the issues of the late 1960s and 1970s such as the Vietnam War, the mistreatment of African Americans, and women's inequality.[3] The few investment firms that took part in SRI investing at the time did so with the intention of avoiding the so-called "sin stocks," which included industries that were considered unethical or immoral.[4] For example, companies that may have mistreated women, refused to sell to African Americans, or supported the war in Vietnam would be barred from these SRI firms' investment pools.

In 1971, two United Methodist Church members named Luther Tyson and Jack Corbett founded the Pax World Funds, the first socially responsible mutual fund in the United States.[5] Over a decade later, shareholders pressured corporate firms to divest from South African investments due to the anti-apartheid movement, and growing environmental concerns led to the founding of the U.S. Sustainable Investing Forum in 1984.[6] By 1994, twenty-six sustainable funds were available to investors, and world leaders signed the Kyoto Protocol in an attempt to address climate change, which signaled a growing concern over society's impact on the environment.[7] As societal issues evolved with the start of the new millennium, so too did SRI investing. Global warming, the gender wage gap, workforce diversity, LGBTQ rights, shareholder rights, and executive pay are just some of the issues that are now at the forefront of society's mind.

ESG investing was born in 2004 when the UN Secretary, General Kofi Annan, launched the Global Compact Initiative ("GCI" or "Initiative"), which continues to be "a voluntary initiative based on CEO commitments to implement universal sustainability principles and to take steps to support UN goals."[8] In that same year, the Initiative produced a report titled: "Who Cares Wins."[9] It was in this report that the acronym "ESG" was first used; the report made recommendations on how to "better incorporate environmental, social and governance ESG factors" into the research, analysis, and management of investments.[10] A year later, members of the UN Environmental Programme Financial Initiative, along with the international law firm, Freshfields Bruckhaus Deringer, co-authored a report widely referred to as the "Freshfields Report."[11] This report argued that ESG factors were relevant in investment analysis "so as to more reliably predict financial performance."[12] Together, the

2. *Id*.
3. Jess Liu, *ESG investing Comes of Age*, MORNINGSTAR (Feb. 13, 2020), https://www.morningstar.com/features/esg-investing-history
4. *Id*.
5. *Id*.
6. I*d*.
7. I*d*.
8. UNITED NATIONS GLOBAL COMPACT, https://www.unglobalcompact.org/about.
9. UNITED NATIONS GLOBAL COMPACT, *Who Cares Wins* (August 2004), https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf.
10. *Id* at 2.; George Kell, *The Remarkable Rise of ESG*, FORBES (July, 11 2018) https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/#14bb83491695.
11. UNITED NATIONS ENVIRONMENT PROGRAMME FINANCE INITIATIVE, *A legal framework for the integration of environmental, social and governance issues into institutional investment* (October 2015) https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf.
12. *Id*.

Who Cares Wins and Freshfields Report identified the three categories of growing societal concerns and argued each category's financial importance in investing. Since then, consumers and firms increasingly made investment decisions based on these three sustainability factors throughout the 2010s. By 2019, ESG investing reached an all-time high, with ESG funds recording a record-breaking inflow of $20.6 billion total new assets, almost four times greater than the previous year.[13]

B. *Definition*

Specific definitions of ESG are wide-ranging since what constitutes an environmental, social, or governance factor can be subjective and highly debatable. However, the financial industry has generally acknowledged a broad and uniform definition of "ESG investing"—i.e. "the research and investment strategy framework that evaluates environmental, social, and governance factors as non-financial dimensions of a security's valuation, performance, and risk profile."[14] Furthermore, most investors accept that ESG factors, although not part of the traditional financial analysis, may have concrete financial relevance, which is evidenced by the increasing use of an ESG score to evaluate company value as well as the overall increase in ESG funds available on the market. As opposed to the SRI strategy of avoiding sin stocks, ESG investing follows traditional financial analysis and tries to find value in companies that may not be immediately apparent.

Today, most public companies are evaluated and given an ESG score by third party providers, such as Bloomberg, MSCI, Thomson Reuters, and DowJones.[15] For example, one third party provider, Sustainalytics, provides ESG scores to the popular financial news website, Yahoo Finance.[16] The ESG rating methodology varies greatly amongst these third-party providers. Most, if not all, of these providers use a range of factors or indicators and collect public information related to ESG factors in order to apply a score to each company.[17] The number of factors used by each provider also varies greatly; for example, MSCI uses thirty seven factors in their analysis, while Bloomberg uses one hundred and twenty factors.[18] However, the most common way in which these factors are conveyed is by grouping them together into the three broader areas of the environment, social, and governance factors.

The "E" in ESG investing considers the wide range of environmental and climate risks that threaten the world. While the concerns are vast, some of the main areas of apprehension regarding the environment include greenhouse gas emissions, waste management, energy

---

13. Greg Iacurci, *Money moving into environmental funds shatters previous record*, CONSUMER NEWS AND BUSINESS CHANNEL (Jan. 14, 2020), https://www.cnbc.com/2020/01/14/esg-funds-see-record-inflows-in-2019.html; Akane Otani, *ESG Funds Enjoy Record Inflows, Still Back Big Oil and Gas*, WALL STREET JOURNAL (Nov. 11, 2019), https://www.wsj.com/articles/top-esg-funds-are-all-still-invested-in-oil-and-gas-companies-11573468200

14. MATTHEW SHERWOOD & JULIA POLLARD, RESPONSIBLE INVESTING: AN INTRODUCTION TO ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INVESTMENTS (1st ed. 2018).

15. Betty Huber et al., *ESG Reports and Ratings: What They Are, Why They Matter*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (July 27, 2017) https://corpgov.law.harvard.edu/2017/07/27/esg-reports-and-ratings-what-they-are-why-they-matter/.

16. Leslie P. Norton, *Yahoo Adds Sustainability Company Data*, BARRON'S (Feb. 2, 2018) https://www.barrons.com/articles/yahoo-adds-sustainability-company-data-1517599809.

17. Huber et al., *supra* note 1.

18. *Id*.

sustainability, and biodiversity.[19] Companies that neglect to manage or reduce the negative externalities that their practices and policies have on the environment will likely score poorly in the Environmental portion of their ESG score.

Similar to the environmental factors, there is a wide range of metrics that may constitute social factors of ESG. Some of the more common social factors are human rights standards, workforce diversity, and labor relations.[20] These factors are playing an increasingly important role in the way the public perceives firms. An example of this is that a company's reputation may be harmed if, directly or indirectly, it knowingly benefits from the use of child labor.[21]

Even more important than environmental and social issues is the category of governance, which has become the leading area of concern that institutional investors take into account when making investment decisions.[22] Some of the leading governance issues are executive compensation, lobbying, audit structure, and board composition.[23] Additionally, a company's tax strategy is an issue that falls under the governance analysis.[24] Many have argued that aggressive tax avoidance strategies can "create corporate governance risk, lead to material fines, damage corporate and brand reputation and . . . deprive governments of funding needed to provide services to communities."[25] As news regarding multinational companies and their tax strategies continue to materialize, taxation and its avoidance has become increasingly important in the governance portion of ESG analysis.

C. Prominence in Today's Markets

Individual investor demand is the driving force behind ESG Investing. A recent survey by Morgan Stanley showed that 85% of individual investors in the U.S. are interested in sustainable investing.[26] In response to this demand, a growing number of money managers and institutional investors have incorporated ESG criteria into their investment analysis and decision-making processes.[27]

---

19. Usman Hayat & Matt Orsagh, *Environmental, Social, and Governance Issues in* Investing*: A Guide for Investment Professionals*, CFA INSTITUTE (Oct 2015) https://www.cfainstitute.org//media/documents/article /position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx.

20. *Id*.

21. An example of this is an ongoing lawsuit against Apple, Google, Microsoft, Dell, and Tesla for the use of child labor in the Democratic Republic of Congo. Michelle Toh, *Apple, Google, Microsoft, Dell and Tesla are sued over alleged child labor in Congo*, CNN (Dec. 18, 2019) https://www.cnn.com/2019/12/17/tech/apple-microsoft-tesla-dell-congo-cobalt-mining/index.html.

22. *Id*.

23. *Id*.

24. Deborah Paul & T. Eiko Strange, *Tax and ESG*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Feb. 22, 2020) https://corpgov.law.harvard.edu/2020/02/22/tax-and-esg/.

25. *Id*.

26. MORGAN STANLEY, *Individual Investor Interest Driven by Impact, Conviction and Choice*, (Sept. 2019) https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainableinvesting/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf.

27. US SIF: THE FORUM FOR SUSTAINABLE AND RESPONSIBLE INVESTMENT, *Report on US Sustainable, responsible and Impact Investing* Trends, (Oct. 31, 2018) https://www.ussif.org/files/Trends/Trends%202018 %20executive%20summary%20FINAL.pdf.

Worldwide sustainable investments—which largely includes ESG investments—rose to over $30 trillion by 2018, marking a 34% increasing from 2016.[28] In the United States, sustainable investments reached $12 trillion by the beginning of 2018 according to a report by the US SIF Foundation.[29] This represents one fourth of the $46.6 trillion in total U.S. assets under professional management.[30] Furthermore, as previously mentioned, ESG investment funds recorded a record inflow of assets the past year, leading to a total of $137.3 billion in funds by the end of 2019.[31] That same year, nine of the largest ESG mutual funds outperformed the popular S&P 500 Index, with three of the funds producing one year total returns over 35%, compared to the S&P 500's one year total return of 31.49%.[32]

ESG investing has become so prominent that it has even prompted some governments to address investment regulation. Due to the rapid growth in ESG and other forms of sustainable investing, most governments have been slow to adapt and the sector remains lightly regulated. However, European Union legislators have recently passed regulations that establish requirements for ESG disclosures. A new EU law coming into effect in 2021 sets uniform rules on how firms should inform investors about the risks and opportunities that ESG investing presents.[33] EU financial firms that claim to pursue ESG strategies will now be required to detail the impact of their investments.[34] This is meant to avoid so-called "greenwashing" whereby asset managers and funds falsely claim to support ESG strategies in order to attract a growing pool of conscious investors.[35]

In contrast to the EU, the U.S. federal government has yet to address ESG regulations and disclosure requirements, despite petitions from institutional investors and academics.[36] Notwithstanding federal action, some state legislatures have begun to address ESG investing. For example, California, New York, Colorado, Connecticut, the District of Columbia, Maine, Maryland and Oregon have all incorporated ESG principles into their pension funds and have instituted guidelines for sustainable investing.[37] Furthermore, some states have gone a step further and created laws regarding ESG investing. In 2019, Illinois signed the Sustainable Investing Act into law, which requires all public state agencies that manage public funds to implement responsible investment policies, of which ESG factors are a part.[38]

---

28. GLOBAL SUSTAINABLE INVESTMENT ALLIANCE, *The Global Sustainable Investment Review 2018*, (2019) http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf.

29. US SIF *supra*, note 27.

30. *Id*.

31. Iacurci *supra*, note 13

32. Mathieu Benhamou et al., *The Biggest ESG Funds Are Beating the* Market, BLOOMBERG (Jan. 29, 2020) https://www.bloomberg.com/graphics/2020-ten-funds-with-a-conscience/.

33. Francesco Guarascio, *EU rules on responsible investments to kick in from 2021:* document, REUTERS (Nov. 4, 2019) https://www.reuters.com/article/us-eu-regulations-sustainablefinance/eu-rules-on-responsible-investments-to-kick-in-from-2021-document-idUSKBN1XE1U3.

34. *Id*.

35. *Id*.; https://www.merriam-webster.com/dictionary/greenwashing

36. In 2018, law professors Cynthia Williams and Jill Fisch, along with institutional investors that represented over $5 trillion in combined assets, submitted a petition to the SEC that called for disclosure standards for all U.S. publically traded companies, under which these companies would be obligated to disclose ESG risks tied to their operations. Alana L. Griffin et al., *Institutional Investors Petition the SEC to Require ESG Disclosures*, AMERICAN BAR ASSOCIATION (Jan. 11, 2019) https://businesslawtoday.org/2019/01/institutional-investors-petition-sec-require-esg-disclosures/.

37. UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, *Retirement Plan Investing*, (May 2018) https://www.gao.gov/assets/700/691930.pdf.

38. Illinois Sustainable Investing Act §5(b), 30 ILCS 238/100 (2020).

III. AGGRESSIVE TAX AVOIDANCE BY CORPORATIONS

A. *Defining Tax Avoidance*

A distinction is commonly made between *tax mitigation*, *tax evasion*, and *tax avoidance*. *Tax mitigation* refers to the use of existing tax law to achieve tax advantages that are intentionally provided to corporations and are in accordance with the policy behind the legislation.[39] This is often viewed as general tax planning or 'non-aggressive tax planning.' Examples of *tax mitigation* include accruing the tax benefits intentionally given to various forms of business organizations such as the "pass-through deduction" of S corporations in the United States, or the establishing of a business in a Special Economic Zone to receive tax advantages.[40] These opportunities often result in lower tax obligations that are intended by and transparent to the legislative bodies that provided them. Furthermore, *tax mitigation is* generally accepted by the public as a legitimate and ethical tax strategy.

Tax evasion is an act of fraud, concealment, or misrepresentation committed in order to avoid the application of tax laws.[41] For example, corporations that underreport or misrepresent their income to the Internal Revenue Service by falsifying income records, overstating deductions, omitting income, or hiding money through the use of offshore accounts are evading taxation. In contrast to tax mitigation, tax evasion is the use of illegal means to avoid paying taxes and is punishable under Section 7201 of the Internal Revenue Code.[42]

Tax avoidance refers to the use of existing tax law to achieve tax advantages that are not intentionally provided by lawmakers and are not in accordance with the policy behind the legislation.[43] The practice of tax avoidance tends to fall between tax mitigation and tax evasion. In contrast to tax mitigation, tax avoidance is often labelled as an illegitimate and unacceptable practice that is criticized by the public. In contrast to *tax evasion*, *tax avoidance* is achieved through what is mostly considered legal use of tax laws.[44] It should be noted that some commentators label tax avoidance as potentially illegal, though most accept it as a legal practice. For the purposes of this paper, tax avoidance is generally considered to be a legal practice that is viewed negatively by the public and may be considered illegal by those who find it to be a particularly egregious misuse of tax law. In other words, tax avoidance "complies with the letter but not with the spirit of the law and leads to unexpectedly low tax rates."[45]

The topic of this paper revolves around corporate practices collectively known as *aggressive tax avoidance*. Similar to the term tax avoidance, aggressive tax avoidance and its strategies are not clearly defined but may be considered to be corporate activities that "[take]

---

39. KAREN BROWN ET AL., A COMPARATIVE LOOK AT REGULATION OF CORPORATE TAX AVOIDANCE 1 (Karen Brown, 2nd ed. 2012).
40. I.R.C. §199A.
41. https://www.amazon.com/Comparative-Regulation-Corporate-Avoidance-Gentium/dp/9400723415
42. I.R.C. §7201.
43. Zoe Prebble & John Prebble, *The Morality of Tax Avoidance*, 43 CREIGHTON L. REV. 693, 702-03 (2010).
44. *Id*.
45. Partin Petrin*, Corporate Tax Avoidance – The Problem of Aggressive Tax Planning* (2018), 16.

advantage of the technicalities of a tax system or mismatches between two or more tax systems for the purpose of reducing tax liability."[46] As this definition implies, an aggressive tax avoidance strategy may take advantage of a single country's tax system, or of two or more countries' tax systems through their international tax provisions and treaties. Aggressive tax avoidance strategies often consist of profit-shifting schemes, international arbitrage, and tax inversion.

B. The "Double Irish, Dutch Sandwich"

Arguably the most notorious strategy of aggressive tax avoidance is the Double Irish, Dutch Sandwich. This corporate tax strategy was being used by U.S. companies as early as the 1990s. However, in 2014, the EU pressured Ireland to address the abuse of its tax code and close this infamous scheme.[47] Despite the official closure of the Double Irish, Dutch Sandwich in January 2015, existing users of the strategy were given until January 2020 to phase out tax structures affected by the new regulation. For example, Google continued to use the Double Irish, Dutch Sandwich until December 2019.[48]

For analytical purposes, the "Double Irish, Dutch Sandwich" will be broken down into two distinct strategies—the Double Irish and the Dutch Sandwich—that are used together to create the ultimate tax avoidance strategy. The Double Irish strategy begins with a U.S. corporation creating an Irish subsidiary ("S1") that is registered as a tax resident of Bermuda or some other tax-haven country.[49] The S1 is designed to hold intangible property rights, such as intellectual property, which generate substantial income for U.S. technology companies.[50] The U.S. parent company transfers their intangible property to the S1 for an arm's length price to comply with the U.S. tax code.[51] The S1 is then in control of the intangible property rights and agrees to collect all of the parent company's European income attributable to the property.

At this point, the S1 has become a "dual resident"—i.e. a Bermudan tax resident under Irish tax law, and an Irish tax resident under U.S. tax law.[52] The default rule in Ireland is that a company incorporated in Ireland will be treated as an Irish resident for tax purposes.[53] However, under exceptions found in Ireland's Finance Act of 1999, Irish law allows the tax residency of a company to be determined by the jurisdiction in which the company is managed and controlled—in this case, Bermuda.[54] As a result, the S1 would not be subject to any corporate income tax for purposes of Irish taxation because, according to Irish law, it is only subject to corporate tax in Bermuda, where the corporate tax rate is zero.

---

46. European Commission, *Commission Recommendation of 6 December 2012 on aggressive tax planning (2012/772/EU)*, Official Journal of the European Union, 2.
47. Sam Shechner, *Ireland to Close Double Irish Tax Loophole*, THE WALL STREET JOURNAL (Oct. 14, 2014) https://www.wsj.com/articles/ireland-to-close-double-irish-tax-loophole-1413295755.
48. Richard Waters, *Google to end use of 'double Irish' as tax loophole set to* close, FINANCIAL TIMES (Jan. 2 2020) https://www.ft.com/content/991f11ae-2c51-11ea-bc77-65e4aa615551.
49. Stephen C. Loomis, *The Double Irish Sandwich: Reforming Overseas Tax* Havens, 43 St. Mary's L. J. 825, 837 (2012).
50. *Id*.
51. I.R.C. § 482 (2006).
52. Loomis *supra*, note 48, at 837-838.
53. Finance Act 1999, S 23A(1)(a) (Ireland).
54. Finance Act 1999, s 23A(3) (Ireland).

In contrast to Irish law, the United States tax code states that the residence of an entity is determined by the jurisdiction in which the entity is formed; owner residence and place of management are irrelevant.[55] Furthermore, nonresidents will only be taxed by the U.S. on their U.S. source income that is effectively connected with a U.S. trade or business.[56] This means that in the above case the U.S. will view the S1 as an Irish resident and would not tax it on any non-U.S. income. There are two relevant rules, however, that were introduced to mitigate U.S. corporations' ability to shift its operations to a foreign subsidiary and avoid being taxed by the U.S. so easily—the Foreign Base Company Sales Income rule and the Foreign Personal Holding Company Income rule.[57] These two rules are part of the Subpart F provisions of the Federal Tax Code, and were established to eliminate the deferral of U.S. tax on certain categories of foreign income.[58]

Under the Foreign Base Company Sales Income rule, any income that a foreign subsidiary earns will be taxable by the U.S. when (1) the subsidiary does not materially participate in the generation of the income; and (2) the subsidiary buys or sells personal property from or to a related party.[59] As a result, the income received by S1 would ordinarily be taxed by the U.S. because it bought the intangible property rights of the parent company.

The second relevant rule of Subpart F is the Foreign Personal Holding Company Income rule. This rule taxes the "dividends, interest, royalties, rents, and annuities" that are earned by a foreign subsidiary.[60] Thus, the subsequent part of this tax strategy would be taxable under U.S. law.

As a single Irish subsidiary that is 'managed and controlled' in a tax haven like Bermuda, our S1 will pay no Irish or Bermudan corporate tax, but it will be subject to U.S. corporate tax under the Foreign Base Company Sales Income rule of Subpart F. This U.S. tax obligation is what necessitates the forming of a second Irish subsidiary by the S1—hence the term, Double Irish.

Unlike the S1, this second subsidiary ("S2") is treated as a resident in Ireland for Irish tax purposes because it is effectively managed and controlled by the main Irish subsidiary, S1.[61] Furthermore, the S2 has the option to *not* be considered an entity under U.S. law through 'check the box' rules.[62] A 'check the box' election is an entity classification that is made to the IRS.[63] For domestic and non-U.S. entities, there is the option to be classified as a "disregarded" entity.[64] This classification allows for the S2 to be disregarded as a separate entity from its sole owner, S1. Therefore, the S1 and S2 are considered a single entity under U.S. tax purposes.[65] As a result, the non-U.S. income generated by the S2 would no longer be

---

55. I.R.C. § 7701
56. I.R.C. §937
57. Joseph B. Darby III & Kelsey Lemaster, *Double Irish More than Doubles the Tax Savings: Hybrid Structure Reduces Irish, U.S. and Worldwide Taxation,* PRAC. U.S./INT'L TAX STRATEGIES, May 15, 2007, at 2.
58. *Id*.
59. I.R.C. § 881
60. I.R.C. § 954(c)
61. Finance Act, s 23A(1)(a) (Ireland).
62. Internal Revenue Service, *Overview of Entity Classification Regulations (a/k/a Check-the Box)*, (Sept. 24, 2017) https://www.irs.gov/pub/int_practice_units/ore_c_19_02_01.pdf
63. *Id*.
64. *Id*.
65. *Id*.

taxed under the Foreign Base Company Sales rule because it did not buy or sell any property from a related party (i.e. the S1), since both subsidiaries are considered a single entity.

Once this structure between the parent company and two subsidiaries is established, the S1 grants a sublicense of the intangible property rights it received from the parent company to the S2.[66] This means that all income arising outside of the U.S. from the use or sale of this intangible property will be attributable to the S2. In turn, the S2 then pays substantial royalties to the S1 in exchange for its use of the intangible property.[67] Payments made between the two Irish subsidiaries are then ignored for U.S. tax purposes as being made internally within a single Irish entity; therefore, the Foreign Personal Holding Company rule fails to apply. Only the royalty payments will be subjected to a small Irish withholding tax.

In summary, the S2 generates income from all non-U.S. customers and reduces this income by deducting the royalty payments it makes to S1.[68] All remaining income is taxed at Ireland's 12.5% corporate tax rate and is not taxed by the U.S. under the Foreign Base Company Sales Income rule.[69] Furthermore, the royalty payments made by the S2 to the S1 are not taxed under the Foreign Personal Holding Company rule because the two subsidiaries are viewed as a single entity. Thus, the money the S2 receives from non-U.S. sources is taxed at a relatively low rate and is then moved to the S1 via the royalty payments, where it is parked in its Bermudan offshore bank accounts and remains tax-free until the parent company wishes to use the money.

Users of the Double Irish may add an additional layer of tax avoidance through the use of a third subsidiary—i.e., the Dutch Sandwich. Under this scheme, the parent company incorporates this third subsidiary ("S3") in the Netherlands and uses it solely to funnel royalty payments from the S2 to the S1.[70] Rather than the S1 granting a sublicense to the S2, the S1 grants the sublicense to the S3 who then grants it to the S2.[71] In contrast to the Double Irish, the income from royalties collected by the S2 is transferred first to the Dutch subsidiary, the S3, and is then transferred to the main Irish subsidiary, the S1. The benefit of putting this Dutch subsidiary between the two Irish subsidiaries is the replacement of a higher Irish withholding tax on royalty payments with a lower Dutch withholding tax.[72] In accordance with the EC Directive 2003/49, "interest and royalty payments made by a corporation in one European Union member state to a subsidiary in another European Union member state will not be taxed provided the beneficial owner of the payment is a company or a permanent establish in another member state."[73] Thus, the Double Irish, Dutch Sandwich effectively allows the royalty payments to move from the S2 to the S1, without incurring a higher Irish withholding tax.

66. Loomis *supra*, note 48, at 838-839.

67. *Id*.

68. *Id* at 839.

69. *Id*.

70. *Id*.

71. *Id*.

72. *Id*.; James Fryer, *The Price Isn't Right: Corporate Profit Shifting Has Become Big Business*, THE ECONOMIST (Feb. 14, 2013) https://www.economist.com/special-report/2013/02/14/the-price-isnt-right.

73. Directive 2003/49 on the Taxation of Cross-Border Interest and Fair Royalty Payments in the European Union, OJ L 157, P. 0049—0054, Article 1.

Once a U.S. company wishes to use the profits residing in its offshore bank accounts, the money is repatriated back to the United States. The repatriation of profit by an offshore subsidiary incurs federal income tax under the U.S. Federal Tax Code. However, companies often exploit several loopholes in the tax code to avoid the usual tax consequences of this transaction.[74]

The Double Irish, Dutch Sandwich officially came to an end after years of multinational firms taking advantage of its complex structure. U.S. technology firms, in particular, have benefitted from the lowered tax obligations; and it was their use of the strategy that attracted the increasing amount of political and public concerns that ultimately led to the ending of the Double Irish, Dutch Sandwich. Despite this, these firms only recently ended their use of this strategy, and have since adopted new aggressive tax avoidance strategies that are similar to the Double Irish, Dutch Sandwich.

C. Case Study: U.S. Technology Companies

As mentioned above, the property used by the Irish subsidiary to generate non-U.S. income must be intangible or intellectual property. Due to this, most major U.S. tech companies have been identified as having used the Double Irish, Dutch Sandwich. A report published in December 2019 by the Fair Tax Mark, a tax transparency group advocating for ethical tax policies, accused the Silicon Six—Google, Facebook, Microsoft, Apple, Amazon, and Netflix— of collectively avoiding more than $100 billion in global tax over the past decade.[75] Specifically, the report noted that four companies of the Silicon Six used the Double Irish, Dutch Sandwich (or the simpler Double Irish) strategy to avoid taxes. The four companies were Google, Facebook, Apple, and Microsoft.[76]

The profit-shifting tax strategies of the world's largest advertiser, Google, were so notorious that the term "Google tax" is used to refer to anti-avoidance provisions introduced in the United Kingdom and Australia.[77] Google stood out amongst the other Big Tech firms because it continued to use the Double Irish until January 2020 whereas most companies ended their use of the tax strategy prior to the deadline.[78] The company was rather transparent about its use of the tax strategy, stating in its 2018 10-K, "[s]ubstantially all of the income from foreign operations was earned by an Irish subsidiary."[79] The company has since moved all of its intellectual property back into the United States, suggesting an end to aggressive tax strategies employed by the company. However, it is likely that Google will follow other big tech firms who have since dropped the Double Irish strategy in favor of other

---

74. *Id*.; I.R.S. § 881
75. Fair Tax Mark, *The Silicon Six and their $100 Billion Global Tax Gap*, (Dec. 2019) https://fairtaxmark.net/wp-content/uploads/2019/12/Silicon-Six-Report-5-12-19.pdf.; Chloe Taylor, *Silicon Valley giants accused of avoiding over $100 billion in taxes over the last decade*, CONSUMER NEWS AND BUSINESS CHANNEL (Dec. 2 2019)
76. CONSUMER NEWS AND BUSINESS CHANNEL *supra*, note 70.
77. Frank Yan, *The "Google tax": What it is, and Why We Should Be* Cautious, TAX FOUNDATION (Dec. 7, 2015) https://taxfoundation.org/google-tax-what-it-and-why-we-should-be-cautious/.
78. Waters *supra*, note 47.
79. George Turner, *How much profit are Google, Apple, Facebook, Cisco and Microsoft making in the UK*, TAXWATCH (Nov. 6, 2018) https://www.taxwatchuk.org/how_much_profit_are_the_tech5_making/quoting.

aggressive tax avoidance schemes.[80] In the past decade, Google paid approximately 10.2% in taxes on its worldwide accumulate profit of $176.6 billion.[81]

Facebook is the second largest global advertiser and also uses the Double Irish, Dutch Sandwich strategy.[82] In 2012, Facebook paid only €1.9 million in taxes on over €1.7 billion in profit in Ireland and avoided paying any state or federal taxes in the United States, sparking greater controversy regarding corporate use of aggressive tax avoidance strategies.[83] "Public debate on tax avoidance in the UK reached its interim high point in 2013, when 1,062 articles on tax avoidance mentioning Google or Facebook were printed in British newspapers."[84]

Due to political and public pressures, Facebook announced in 2017 that the company would no longer record advertising revenue via its international headquarters in Dublin, Ireland—a move that would end the availability of the Double Irish, Dutch Sandwich.[85] Instead, the company now records revenue locally according to the country to which the revenue is attributable.[86] Facebook's CFO, Dave Wehner, claimed that the decision was meant to provide greater transparency to governments and the public, who have criticized multinational firms and their avoidance of taxes.[87] Despite the apparent move away from aggressive tax avoidance strategies, Facebook reportedly "has the lowest foreign current tax charge ratio of the Silicon Six over the [past] decade, at just 5% of profits."[88] Furthermore, Facebook still faces a lawsuit from the IRS that claims Facebook owes $9 billion in taxes due to the use of the Double Irish.[89]

In 2017, a UK charity called Christian Aid published a report that showed the quick replacement of the Double Irish, Dutch Sandwich with a new tax strategy called the "Single Malt."[90] The charity claimed that "several major multinationals, including Microsoft, were already putting in place alternative structures" to exploit Ireland's tax system and treaties.[91] The Christian Aid report details the Single Malt replacement:

> The new Irish tax residency rules mean that Irish-registered companies can no longer be tax-resident in the 'classic' zero-tax havens like Bermuda and the British Virgin Islands. However, it still allows Irish-registered companies to be tax-resident[s] in other jurisdictions, including European ones, with which

---

80. Waters *supra*, note 73.

81. FAIR TAX MARK, *The Silicon Six and their $100 billion global tax* gap, (Dec. 2019) https://fairtaxmark.net/wp-content/uploads/2019/12/Silicon-Six-Report-5-12-19.pdf.

82. *Id.*; CHRISTIAN FUCHS, THE ONLINE ADVERTISING TAX AS THE FOUNDATION OF A PUBLIC SERVICE INTERNET: A CAMRI EXTENDED POLICY REPORT 25 (2018), https://www.jstor.org/stable/j.ctv5vddk0.6?seq=7 #metadata_info_tab_contents.

83. Jamie Smyth, *'Double Irish' limits Facebook's tax bill to 1.9m in Ireland,* FINANCIAL TIMES (Dec. 5, 2013) https://www.ft.com/content/ca64f938-5dc0-11e3-95bd-00144feabdc0

84. FUCHS *supra*, note 81, at 25.

85. Julia Fioretti, *Facebook to book advertising revenue locally amid political pressure*, REUTERS (Dec. 12, 2017) https://uk.reuters.com/article/%20us-facebook-tax/facebook-to-book-advertising-revenue-locally-%20amid-political-pressure-idUKKBN1E61X2.

86. *Id*.

87. *Id*.

88. FAIR TAX MARK *supra*, note 74.

89. Richard Rubin, *Facebook and IRS Prepare for $9 Billion U.S. Tax Court Fight*, WALL STREET JOURNAL (Feb. 8 2020) https://www.wsj.com/articles/facebook-and-irs-prepare-for-9-billion-u-s-tax-court-fight-11581177600

90. CHRISTIAN AID, *'Impossible' structures: tax outcomes overlooked by the 2015 tax Spillover analysis*, (2017) https://www.christianaid.ie/sites/default/files/2018-02/impossible-structures-tax-report.pdf.

91. *Id*.

> Ireland has a tax-treaty. Some of these jurisdictions provide a low or no tax environment for royalty income as effectively as the 'classic' Caribbean tax havens. Moreover, since such structures use jurisdictions with which Ireland has tax treaties lowering or removing withholding taxes on cross-border income, such structures are actually simpler than older Double Irish structures, because they do not require a "Dutch Sandwich" . . . Most of Ireland's double tax treaties reduce or cancel outbound withholding tax on royalties, with the need to exploit the EU rules.[92]

Effectively, the main subsidiary of a parent company, the S1 in our above scenario, switches its tax residence from a tax haven like Bermuda to countries with which Ireland has a favorable tax treaty. This continues to allow the S1 to receive royalties from the S2 with little or no tax imposed. Furthermore, the new tax residency of the S1 allows it to disregard any tax on royalty payments from the S2 to the S1, thereby removing the need for the Dutch Sandwich.

The Christian Aid Report details the use of the Single Malt by Microsoft and its recently purchased company, LinkedIn.[93] Prior to being bought out by Microsoft, LinkedIn operated a Double Irish tax strategy.[94] After Microsoft took over in 2016, LinkedIn created a new structure through the use of Irish subsidiaries to reap the same benefits offered by the Double Irish well past 2020. In March 2017, Microsoft—via LinkedIn—registered LinkedIn IP Holdings I Unlimited Company, an Irish subsidiary.[95] The new Irish subsidiary is directed by the head of international tax at Microsoft, Glenn Coswell, and has claimed its place of business as an office in Valetta, Malta, thereby making LinkedIn IP Holdings I Unlimited Company a tax resident of Malta.[96] A tax treaty between Ireland and Malta then allowed for this new Irish subsidiary, acting as an S1, to receive royalty payments from another subsidiary (the S2) with minimal or no tax.[97] The use of Malta for its tax residency, along with the lack of need for a Dutch Sandwich, is how the term "Single Malt" was coined.

In response to Microsoft and other companies' use of the Single Malt, the Irish government amended their tax treaty with Malta to prevent the continued use of this aggressive tax avoidance strategy.[98] After the closing of the Single Malt, which was Microsoft's initial response to the closing of the Double Irish, the company has reportedly structured itself to benefit from the "Green Jersey"—another tax avoidance strategy that has also been used by Apple since 2014.[99]

Apple claims that it is the world's largest taxpayer; however, the Fair Market Tax report estimates that while Apple paid $93.8 billion in income tax this decade on profits of $548.7

---

92. *Id*.
93. *Id*.
94. *Id.*
95. *Id*.
96. *Id*.
97. *Id.*
98. Tom Maguire, *Ireland and International tax after Davos*, DELOITTE (Feb. 10, 2019) https://www2.deloitte.com/ie/en/pages/tax/articles/ireland-and-international-tax-after-davos.html; Hamza Ali, *Ireland Discovers It Isn't So Easy Shake Tax Haven Image*, BLOOMBERG (Sept. 6, 2019) https://news.bloombergtax.com/daily-tax-report-international/ireland-discovers-it-isnt-so-easy-to-shake-tax-haven-image
99. David Chance, *Why Google might still benefit from Irish tax breaks,* INDEPENDENT (Jan. 3, 2020) https://www.independent.ie/business/why-google-might-still-benefit-from-irish-tax-breaks-38830700.html.

billion, "the cash tax paid as a percentage of profit is still a relatively low 17.1% at the time when the federal headline rate of tax in the United States was 35% for seven of the nine years under examination."[100] The tech company was able to pay this relatively low tax rate by taking advantage of the Double Irish during its dying years, and through its subsequent use of the Green Jersey.

In 2017, the German newspaper, *Suddeutsche Zeiting,* received more than 13.4 million leaked documents from the Bermudian law firm Appleby.[101] This group of documents has since been labeled the "Paradise Papers" and exposes hundreds of individuals and companies who use offshore jurisdictions to minimize their tax burden with the help of Appleby.[102] With the International Consortium of Investigative Journalists ("ICIJ") overseeing the investigation, over one hundred media outlets were given the documents to examine and report.[103]

Appleby's clients included "princesses, prime ministers, and Hollywood stars, as well as corporate giants: Apple, Nike, Facebook, and Glencore…"[104] The report was especially revealing in regards to Apple, whose CEO Tim Cook stated before the U.S. Senate Permanent Subcommittee on Investigations in May 2013, "we do not depend on tax gimmicks . . . we do not stash money on some Caribbean island."[105] The Paradise Papers revealed that by the end of 2014, after Ireland announced it would be disallowing the use of the Double Irish structure past 2020, Apple had settled on an island in the English Channel—Jersey—to be its new tax haven in a newer Double Irish tax structure.[106] This was because the grandfathering provisions that allowed companies to continue to use the aggressive tax strategy until 2020 applied "not just to companies in existence….but also any new ones created up until the end of 2014."[107]

Along with the grandfathering of Double Irish users, Apple took advantage of the Capital Allowances for Intangible Assets ("CAIA") profit shifting strategy, which was introduced in Ireland's Finance Act 2009.[108] The CAIA allows companies to claim a tax allowance for the depreciation of intangible assets, such as intellectual property, as a write-off against taxable income over fifteen years.[109] The write-off is capped at 80% of the assets value.[110] The

---

100. FAIR TAX MARK *supra*, note 76.

101. BBC, *Paradise Papers: verything you need to know about the* leak, (Nov. 10, 2017) https://www.bbc.com/news/world-41880153; Michael Forsythe, *Paradise Papers Shine Light on Where the Elite Keep Their Money*, NEW YORK TIMES (Nov. 5, 2017) https://www.nytimes.com/2017/11/05/world/paradise-papers.html; Bill Chappell, *The Paradise Papers: Revelations Spring From Leaked Records of World's Wealthy*, NATIONAL PUBLIC RADIO (Nov. 6, 2017) https://www.npr.org/sections/thetwo-way/2017/11/06/562349277/the-paradise-papers-revelations-spring-from-leaked-records-of-worlds-wealthy.

102. Sources *supra* note 99

103. *Id*.

104. Will Fitzgibbon & Dean Starkman, *The 'Paradise Papers' And the Long Twilight Struggle Against Offshore Secrecy*, INTERNATIONAL CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Dec. 17 2017) https://www.icij.org/investigations/paradise-papers/paradise-papers-long-twilight-struggle-offshore-secrecy/.

105. Simon Bowers, *Leaked Documents Expose Secret tales of Apple's Offshore Island Hop*, INTERNATIONAL CONSORTIUM OF INVESTIGATIVE JOURNALISTS (Nov. 6, 2017) *https://www.icij.org/investigations/paradise-papers/apples-secret-offshore-island-hop-revealed-by-paradise-papers-leak-icij/.*

106. *Id*.

107. *Id*.

108. Martin Brehm Christensen & Emma Clancy, *Exposed: Apple's Golden Delicious Tax Deals,* EUROPEAN UNITED LEFT – NORDIC GREEN LEFT (June 21, 2018) https://emmaclancy.files.wordpress.com/2018/07/apple-tax-structure-and-rate-post-2014.pdf.

109. *Id.*

110. *Id.*

European United Left/Nordic Green Left group of European Parliament detailed Apple's use of the CAIA in a 2018 report, and they named the aggressive tax avoidance strategy the "Green Jersey."[111]

In 2015, Apple used the CAIA by having its Irish subsidiary purchase approximately $300 billion in intangible assets from a company subsidiary in Jersey.[112] This allowed Apple to write-off the $300 billion expense against its future Irish profits, which essentially constituted all of its international profits. Furthermore, the $300 billion in allowances was effectively doubled because the Irish subsidiary then deducted the interest payments made on intra-group loans that were obtained to purchase the intangible property.[113] These interest payments also allowed large amounts of capital to flow from Apple's Irish subsidiaries to its off-shore Jersey subsidiaries.[114] The result was a company paying for its own intellectual property with its own money, and receiving tax benefits from both the depreciation of the intellectual property and interest payments on the loan. The effect of the CAIA and Green Jersey has been a replication of the "effect of the Double Irish regarding the effective tax rate paid by multinational corporations trading in IP."[115]

IV. IMPACT ON ESG SCORE & FINANCIAL PERFORMANCE

A. Effect on Governance

An email that was circulated between the senior partners of Appleby noted that "Apple is extremely sensitive concerning publicity."[116] This is not surprising considering the increased scrutiny Apple and other U.S. technology companies have been receiving for their tax practices. For example, Facebook received a shareholder resolution in 2018 that asked the company to "endorse a set of principles to guide its tax policy and ensure that such principles consider the impact of its tax strategies on local economies and public services."[117] This is reflective of not only shareholder concerns, but a broader societal concern that companies are not paying an appropriate amount of taxes. There has also been extensive research done in the past decade that questions the role of corporate social responsibility in aggressive tax avoidance strategies.[118]

As a result of increased scrutiny, rating agencies like MSCI have reduced the ESG scores of companies that face legal action regarding tax issues, pay lower effect tax rates than estimated, or have obscure tax structures.[119] Furthermore, institutional investors have

---

111. *Id*.
112. *Id.*
113. *Id*.
114. *Id*.
115. *Id*.
116. BBC, *Paradise Papers: Apple's secret tax bolthole revealed*, (Nov 6, 2017) https://www.bbc.com/news/world-us-canada-41889787.
117. Richard Phillips, *Facebook Facing Shareholder Scrutiny for Its Offshore Tax Avoidance*, INSTITUTE ON TAXATION AND ECONOMIC POLICY (May 30, 2018) https://itep.org/facebook-facing-shareholder-scrutiny-for-its-offshore-tax-avoidance/.
118. Kayal Munisami, *The Role of Corporate Social Responsibility in Solving the Great Corporate Tax Dodge*, 17 FLA. ST. U. BUS. REV. 55 (2018); Christina HJI Panayi, *Is Aggressive Tax Planning Socially Irresponsible*, 43 Intertax 544 (2015).
119. Aliya Ram, *MSCI takes aim at corporate tax avoidance*, FINANCIAL TIMES (Nov. 13, 2016) https://www.ft.com/content/b12b120c-a80b-11e6-8b69-02899e8bd9d1.

integrated taxation issues into their own ESG analysis using sustainability reports, annual reports, online publications, leaked documents, and ESG scores from rating agencies.[120] Although society may view corporate tax practices as legally acceptable, the public may not consider such activity responsible, sustainable, or ethical. But, while aggressive tax avoidance practices have affected ESG scores and rating analysis, the extent of this effect is unclear.

The direct relationship between taxation and sustainable investing, and more specifically ESG investing, is an "unexplored area of research."[121] In an interview with several institutional investors, researchers found that all investors expect companies to meet a minimum requirement to comply with the tax laws of its state of incorporation. However, while some investors monitor the effective tax rate of companies in their ESG analysis, it was unclear how far aggressive tax planning could go "before [such activities] would adversely affect investments in the firm or lead it to be excluded from the investors' portfolio."[122]

Although the direct consequences remain empirically unclear, "the role of taxation is expected to increase in ESG analysis carried out" by rating agencies and institutional investors.[123] The negative impact that aggressive tax avoidance may have on a company's image and reputation is one of the driving forces behind poor ESG scores and analysis; this is even more true of companies that lack transparency in their tax strategies.[124] For the Silicon Six—which are constantly scrutinized by the public, the media, and U.S. state and federal government and are continually threatened by negative press via headlines, research, and lawsuits—aggressive tax avoidance schemes are dangerous practices that pose serious risks to a company's brand and value.

B. Correlation between ESG Score & Financial Performance

There is significant data suggesting a relationship between ESG ratings and financial performance of companies. A research study in 2015 analyzed over two thousand academic empirical studies on this relationship; the report found that approximately 90% of the studies supported the argument that "the business case for ESG investing is empirically very well founded."[125] Institutional investors and rating agencies share this belief as well; Goldman Sachs stated in a report that "there is a growing consensus that integrating material ESG factors correlated to long-term financial returns." Furthermore, MSCI has found that companies with higher ESG ratings produced a higher average return over the last five years.[126] Additionally, when attempting to identify which ESG categories have a dominate

---

120. Reijo Knuutinen & Matleena Pietilainen, *Responsible Investment: Taxes and Paradoxes*, 2017 Nordic Tax J. 135, 142 (2017).

121. *Id* at 135.

122. *Id* at 142.

123. *Id* at 144.

124. *Id*.

125. Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence from more than 2000 Empirical Studies*, 5 J. OF SUSTAINABLE FIN. & INV. 210, 210.

126. GOLDMAN SACHS, *Sustainable Finance Innovation Forum 2018*, (Nov. 2018) https://www.goldmansachs.com/insights/pages/sfi/key-takeaways-2018.pdf; Panos Seretis & Meggin Thwing Eastman, *Enhancing Economic Value with ESG*, MSCI (Feb. 2018) https://chicorywealth.com/wp-content/uploads/2018/05/Enhancing-Economic-Value-with-ESG.pdf.

influence on corporate financial performance, Governance factors had the highest positive correlation, followed by Environment and then Social.[127]

Rating agencies and institutional investors are increasingly considering tax planning and strategies as a crucial part of their ESG scoring analysis. As mentioned above, the extent to which aggressive tax avoidance strategies directly affect Governance scores and ESG analysis is empirically uncertain. However, societal concerns and the possibility of superior financial performance are driving the growth of investor interest in ESG investing, and Governance—which includes taxation criteria—is the most important catalyst for this trend. Ultimately, aggressive tax avoidance strategies negatively affect companies in two ways—it's 'bad publicity' and, more concretely, it leads to lower ESG ratings. As a result, companies should be urged to reconsider their use of such strategies, particularly now, as ESG investing is growing exponentially as the world's one of the most important investing strategies.

V. CONCLUSION

ESG investing has risen in the past decade as one of the most popular forms of sustainable investing. Furthermore, a growth in public concern over aggressive corporate tax avoidance practices has coincided with ESG's rise to prominence. Despite the closing of one of the most notorious tax avoidance schemes—the Double Irish, Dutch Sandwich—U.S. companies have found new ways to avoid their tax obligations for their international profits. Specifically, U.S. technology companies have used new strategies, such as the Single Malt and Green Jersey, to save billions in taxes and hold it in offshore accounts in countries like Bermuda or Jersey.

Society's concern with these companies and their illusive tax practices is reflected through ESG ratings and analysis implemented by rating agencies and institutional investors. The exact effect that these practices have on ESG scores and investment decisions remains unclear and is an area that requires greater research. However, considering the popularity of ESG investing and its strong ties to financial performance, it is possible that firms such as Google, Facebook, Microsoft, and Apple may face adverse effects for their aggressive tax avoidance practices in the form of lower investment inflow or exclusion from ESG-driven portfolios. As a result, Big Tech should carefully weigh their use of aggressive tax avoidance by prudently balancing the short-term gain of tax savings with the long-term damage that such strategies can have on public image and ESG scores.

---

127. PRINCIPLES FOR RESPONSIBLE INVESTMENT, ESG & Corporate Financial Performance: Mapping the global landscape, (Dec. 2015) https://institutional.dws.com/content/_media/K15090_Academic_Insights_UK _EMEA_RZ_Online_151201_Final_(2).pdf.

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

CONVENIENCE V. CONFIDENTIALITY: THE CALIFORNIA CONSUMER PRIVACY ACT AND THE LIMITS OF ITS PRIVATE RIGHT OF ACTION

❖ NOTE ❖

Zachary Read *

I. INTRODUCTION

The rapid development of 'emerging technologies,' such as IoT devices, has created a wealth of functional benefits for consumers and businesses alike.[1] Technology has created what people want most: convenience.[2] However, the countless conveniences created by new technologies have been accompanied by security and privacy concerns as well.[3] Companies such as Amazon have made retail transactions easier than ever for consumers by having products advertised according to personalized tastes and facilitated through efficient, 'one-click' purchases.[4] However, personal identifiers such as contact information, purchase history, and credit card information have also been exposed to data breaches.[5] While consumers want the benefits that Amazon's services provide, there is a growing concern over keeping personal information secure and private.[6] Regulatory bodies have struggled with

1. *See* James McArthur, *6 Ways On How Technology Has made Our Life Easier*, ENGADGET (Oct. 17, 2016), https://www.engadget.com/2016/10/17/6-ways-on-how-technology-has-made-our-life-easier/; Mehedi Hasan, *Top 20 Emerging IoT Trends That Will Shape Your Future Soon*, UBUNTUPIT, https://www.ubuntupit.com/top-20-emerging-iot-trends-that-will-shape-your-future-soon/.
2. J. Walker Smith, *Is the Convenience of Technology Worth the Security Risks?*, AMERICAN MARKETING ASSOCIATION (April 25, 2018), https://www.ama.org/marketing-news/is-the-convenience-of-technology-worth-the-security-risks/.
3. *See id.*
4. *See id.*
5. John E. Dunn, *Data of Millions of eBay and Amazon Shoppers Exposed*, NAKED SECURITY (Mar. 12, 2020), https://nakedsecurity.sophos.com/2020/03/12/data-of-millions-of-ebay-and-amazon-shoppers-exposed/
6. *See generally Public Opinion on Privacy*, ELECTRONIC PRIVACY INFORMATION CENTER, https://epic.org/privacy/survey/

*J.D. Candidate, Class of 2022, University of Illinois College of Law.

how to best address these concerns without stifling tech companies' ability to innovate and use data to provide greater services to consumers.[7]

In the United States, the most recent attempt to balance business interests and consumer concerns has come from California, in the form of the California Consumer Protection Act (the "CCPA," or the "Act"), which went into effect January 1, 2020.[8] The Act has created a seemingly robust set of rights for consumers to know what information businesses have about them, what is being done with that information, and how they may request to delete such information.[9] However, the CCPA has also left businesses confounded on how to properly comply with the Act because of its amorphous reasonableness standard.[10] As the Act continues to proliferate into the ordinary course of business, courts should adopt a clear reasonableness standard that aids administration and business planning.

Part II of this Note will discuss the motivation for enacting the CCPA and who the Act applies to. Part III of this Note will discuss the rights and obligations provided by the CCPA and address compliance concerns for businesses. Part IV of this Note will argue that courts should resolve impending disputes by implementing a reasonableness standard informed by California Department of Justice guidelines and industry frameworks. Part V will conclude.

II. Background

The CCPA seeks to address a growing fear over how companies may manipulate, monetize, and further utilize consumer personal data.[11] Personal information that is collected allows businesses to make sophisticated inferences about who consumers are, what they want, and what they are likely to do.[12] This information helps determine what consumers are doing, but also helps in influencing consumer behavior for future transactions.[13] These potential uses raise many concerns elaborated on below.

A. Consumer Concerns

On one hand, consumers are afraid of their behavior becoming a commodity to be traded, their choices being disempowered, and their personal autonomy being violated.[14] On the other, consumers also want the convenience and utility benefits produced by big data collection.[15] The CCPA has attempted to mitigate these conflicting interests and empower

---

7. Stewart Wolpin, *CES Panelists: Federal Law Needed to Balance Privacy and Innovation*, TWICE (Jan. 9, 2020), https://www.twice.com/industry/ces/ces-2020-panelists-federal-law-needed-to-balance-privacy-innovation.

8. Richi Jennings, *CCPA, California's GDPR, confuses and confounds*, TECHBEACON (Jan. 2, 2020), https://techbeacon.com/security/ccpa-californias-gdpr-confuses-confounds.

9. *See* Sara Morrison, *California's new privacy law, explained*, VOX (Dec. 30, 2019, 6:50 PM), https://www.vox.com/recode/2019/12/30/21030754/ccpa-2020-california-privacy-law-rights-explained.

10. *See* Jennings, *supra* note 8.

11. *See* Jacob Silverman, *How Tech Companies Manipulate Our Personal Data*, N.Y. TIMES (Jan. 18, 2019), https://www.nytimes.com/2019/01/18/books/review/shoshana-zuboff-age-of-surveillance-capitalism.html.

12. *See id.*

13. *Id.*

14. *Id.*

15. Larry Alton, *5 Ways Big Data Benefits Consumers*, CUSTOMERZONE360 (June 26, 2015), https://www.customerzone360.com/topics/customer/articles/405714-5-ways-big-data-benefits-consumers.htm#.

consumers by providing ways to find out what companies know about them and decide for themselves what is done with that information.[16]

The need for new legislation in this area is largely a result of the influx of massive amounts of consumer data and security breaches related to that data.[17] More than 90% of the world's collected data appeared in just the past two years and most of this information has been collected without consumers' explicit permission by such means as wearable technology and online forms.[18] This collection is exacerbated because modern consumer "contracts" have largely been delivered through unintelligible boilerplate where consumers are rarely, if ever, reading privacy policies.[19] Accordingly, the collection, storage and sale of personal information has been imposed on consumers without any real sense of cooperative communication or mutual understanding.[20] As a result, consumers are concerned they are giving up rights they would not have relinquished if given notice—an issue addressed by the CCPA through mandatory disclosure provisions.[21] Through its opt-out and deletion request provisions, the CCPA has also provided ways for consumers to retake control of personal information that was unknowingly relinquished.[22]

B. Who is subject to the CCPA?

The CCPA imposes rules regarding how certain for-profit companies doing business in California collect, store, and use California consumers' personal information.[23] Under the Act, companies subject to its provisions include for-profit entities that do business in California, collect consumers' personal information, and determine how that information is used.[24] Businesses must also meet at least one of the following thresholds: (1) an annual gross revenue in excess of twenty-five million dollars; (2) alone or in combination with others buy, sell, or otherwise use for a business purpose the personal information of 50,000 or more consumers, households, or devices; or (3) derive fifty percent or more of its annual revenue from selling consumers' personal information.[25]

Such businesses include Facebook, the social media giant with a 2019 gross revenue of 70.7 billion that collects a wealth of California residents' personal information through its popular social media applications.[26] Some commentators have suggested that large

---

16. *See* Michael Fertik, *CCPA Is A Win For Consumers, But Businesses Must Now Step Up On CX*, FORBES (Jan. 27, 2020, 5:40 PM) https://www.forbes.com/sites/michaelfertik/2020/01/27/ccpa-is-a-win-for-consumers-but-businesses-must-now-step-up-on-cx/#4bfda6e65574.
17. *See id.*
18. *See id.*
19. *See generally* Robin Bradley Kar & Margaret Jane Radin, *Pseudo-Contract and Shared Meaning Analysis*, 132 HARV. L. REV. 1135 (2019).
20. *See id.*
21. *See* CCPA § 1798.130(a)(5).
22. *See* CCPA § 1798.120(a)-(c).
23. Ian Mclin, *Sweeping New California Data Privacy Law Takes Effect*, JD SUPRA (Mar. 4, 2020), https://www.jdsupra.com/legalnews/sweeping-new-california-data-privacy-45158/
24. *See* California Consumer Protection Act ("CCPA") §1798.140(g) (2018).
25. *Id.*
26. *See Facebook's Annual Revenue from 2009 to 2019*, STATISTA *https*://www.statista.com/statistics/268604/annual-revenue-of-facebook/; *See also* Queenie Wong, *CCPA: What California's New Privacy Law Means for Facebook, Twitter Users*, CNET (Jan. 3, 2020), https://www.cnet.com/news/ccpa-what-californias-new-privacy-law-means-for-facebook-twitter-users/

companies such as Facebook will not be impacted by the Act because of their first-party relationships with consumers combined with the fact they do not "sell" personal information in the traditional sense.[27] However, the CCPA defines the "sale" of personal information broadly, including data transfers that result in the company receiving any monetary or valuable consideration.[28] The CCPA also reaches companies like Facebook by directly addressing large-scale political ad targeting disclosure and personal information use such as the Cambridge Analytica scandal.[29]

Smaller actors in the online advertising world and their business practices are likely to be affected by the Act as well.[30] For example, Drawbridge is a company that uses data such as IP addresses and GPS-derived locations to find out multiple devices a particular consumer owns to serve advertisements across each device.[31] This "cross-device targeting and attribution" practice is a common practice of modern digital advertising that falls subject to the Act's prohibitions.[32] In addition, "data onboarding" practices by companies such as LiveRamp will also be subject to the CCPA.[33] This practice joins offline purchases with online advertising by taking personal data such as names, addresses, and phone numbers from in-store retail purchases and combining that information with data from publishers such as email newsletters and dating sites to identify consumers and market other products directly.[34] With its breadth of prohibitions and provisions, the CCPA will have significant impact on behemoths like Facebook and Amazon, as well as mid-sized companies such as Drawbridge and LiveRamp.

The CCPA's definition of consumers under the Act is much more straightforward: a consumer is a natural person who is a California resident, as defined by the California Code of Regulations.[35] This includes (1) every individual who is in the State for other than a temporary or transitory purpose and (2) every individual who is domiciled in the State who is outside the State for a temporary or transitory purpose.[36] Any of these Californians qualify for the protections of the CCPA and its private right of action, but will have to wait until July 1, 2020 for courts to evaluate whether the practices of a specific company are consistent with this new legislation.[37] When that time comes, courts will need to develop an equitable reasonableness standard.

27. *See* Antonio Garcia Martinez, *Why California's Privacy Law Won't Hurt Facebook or Google*, WIRED (Aug. 31, 2018), https://www.wired.com/story/why-californias-privacy-law-wont-hurt-facebook-or-google/

28. *See* Scott Ikeda, *Facebook Refuses to Change Web Tracking Practices, Believes That CCPA Does Not Apply to Them*, CPO Magazine (Jan. 6, 2020), https://www.cpomagazine.com/data-protection/facebook-refuses-to-change-web-tracking-practices-believes-that-ccpa-does-not-apply-to-them/

29. *See* Alvin Chang, *The Facebook and Cambridge Analytica Scandal, Explained With a Simple* Diagram, VOX (May 2, 2018), https://www.vox.com/policy-and-politics/2018/3/23/17151916/facebook-cambridge-analytica-trump-diagram

30. *See* Martinez, *supra* note 27.

31. *See id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. CCPA § 1798.140(g)

36. 18 CCR § 17014 (1954) ("Who are Residents and Nonresidents").

37. Gary Guthrie, *New California Privacy Law May Require Facebook to Completely Change How It Does Business*, CONSUMERAFFAIRS (Feb. 19, 2020), https://www.consumeraffairs.com/news/new-california-privacy-law-may-require-facebook-to-completely-change-how-it-does-business-021920.html

III. Analysis

The enactment of the CCPA has sparked the need for new procedures for businesses to participate in the California market. Such procedures include updating privacy policies, implementing security protections, and facilitating consumer requests.[38] Additionally, because California is the world's fifth largest economy, the many companies that desire to participate in that market will make the effect of the CCPA exceedingly unlikely to remain localized.[39] Accordingly, the CCPA itself affects out-of-state companies,[40] and similar regulations are likely to be implemented in other states as well.[41]

The expense of updating policies and procedures to comply with the CCPA has been estimated to cost businesses a total of $55 billion in initial charges; a cost that will likely be passed on, even if indirectly, to consumers themselves.[42] This cost ranges from approximately $50,000 for companies with fewer than twenty employees to $2 Million for companies with greater than 500 employees.[43] Much of these charges stem from technology and operations costs associated with implementing compliance procedures as well as more detailed training and recordkeeping requirements.[44]

A motivating factor for businesses to comply with the CCPA is the private right of action granted by the Act that creates significant fines (between $100 and $750 per consumer, per incident) for failure to implement *reasonable* security measures.[45] For example, a data breach affecting one million California consumers may result in statutory damages between $100 million and $750 million; these potential damages dwarf almost every previous large data breach settlement in the United States.[46] Therefore, even though the cost of compliance is high, the risk of massive penalties for security breaches is even greater. Companies will be motivated and well-advised to implement those security measures that would be deemed reasonable should a dispute arise. To provide clarity, either the California courts or amendments to the CCPA regulations should adopt a clear and equitable reasonableness standard as it relates to security procedures.

---

38. *See* Anna Attkisson, *How California's Consumer Privacy Act Will Affect Your Business*, BUSINESS NEWS DAILY (Dec. 31, 2019), https://www.businessnewsdaily.com/10960-ccpa-small-business-impact.html
39. *See* Fertik, *supra* note 16.
40. Andrew R. Lee, *How the California Consumer Privacy Act Could Impact Your Business*, THE NAT'L LAW REV. (Nov. 20, 2019), https://www.natlawreview.com/article/how-california-consumer-privacy-act-could-impact-your-business.
41. Jedidiah Bracy, *With the CCPA now in effect, will other states follow?*, INT'L ASS'N OF PRIVACY PROF'LS (Jan. 2, 2020), https://iapp.org/news/a/with-the-ccpa-now-in-effect-will-other-states-follow/.
42. *See id.*
43. Aly McDevitt, *CCPA Compliance Costs Projected to Reach $55B*, COMPLIANCE WEEK (Oct. 8, 2019 11:40 AM), https://www.complianceweek.com/data-privacy/ccpa-compliance-costs-projected-to-reach-55b/27847.article
44. *See id.*
45. *See* CCPA § 1798.150(a)(1).
46. *See* Jaime B. Petenko, *The California Consumer Protection Act and 'Reasonable Security': A Game Changer*, MCDERMOTT WILL & EMERY (Jan. 9, 2020), https://www.mwe.com/insights/the-california-consumer-privacy-act-and-reasonable-security-a-game-changer/.

A. What is Personal Information?

With the enactment of the CCPA, Californians are given an expanded set of rights regarding the collection, sale, and storage of their personal information.[47] Under the Act, personal information includes any information that either directly or indirectly identifies, relates to, or describes a particular consumer or household.[48] The CCPA provides an extensive, but non-exhaustive, list of information capable of identifying a consumer or household.[49] This includes varying types of personal information such as biometric data and contact information, as well as electronic network activity information such as browsing history and geolocation data.[50]

The CCPA further expands the scope of what information is covered to include any information that is reasonably capable of being associated with or could reasonably be linked to a particular consumer or household.[51] What is reasonably capable of being associated with a particular consumer or household is in some circumstances ambiguous. Part of this ambiguity is because the purpose for which information is used could inadvertently make something reasonably capable of identifying a consumer. For example, a system of satellites determining the location of city buses set up by a transportation agency could make it possible to track those buses in real time and offer a better service with more accurate bus schedules.[52] This data would relate to the buses, not the drivers, however, the system could also be monitoring if the bus driver is respecting speed limits and following appropriate itineraries, and therefore may be capable of being associated with the individual driver.[53]

There is room for debate as to (1) what constitutes personal information; (2) what kind of nexus must exist between the information and the consumer or household; and (3) whether an individual consumer or household to which that information is associated with can be identified under the CCPA.[54] Future disputes easily arising over whether information a consumer is requesting should be disclosed or deleted satisfies the three elements above and can fall under one of the categories of information that is excluded from the scope of the Act: (1) de-identified data; (2) aggregated consumer information; or (3) certain types of publicly available information.[55] Businesses are likely to assert that the information they have collected or sold is not *reasonably* capable of association because burdensome steps would be needed to make an association with an individual or household.[56]

---

47. *See* California Consumer Protection Act §§ 1798.100, 1798.105, 1798.110, 1798.115
48. CCPA § 1798.140(o)(1).
49. *See id.*
50. *See id.*
51. *See id.*
52. Lydia de la Torre, *What is "Personal Information" Under CCPA?*, California Lawyers Association ((https://calawyers.org/antitrust-ucl-and-privacy/what-is-personal-information-under-the-california-consumer-privacy-act/
53. *Id.*
54. *See id.*
55. *See id.*
56. Mark Smith, *ANALYSIS: Five Wins for Business in CCPA Amendments?*, BLOOMBERG LAW (Sep. 23, 2019, 5:46 AM), https://www.bloomberglaw.com/product/privacy/document/X70ISN8S000000

B. Consumer Rights, Business Obligations, and Exceptions Under the CCPA

The principal rights consumers acquire in relation to their personal information include the right to: (1) know what personal information is being collected about them and request that information be deleted; (2) know whether their personal information is sold or disclosed and to what types of third parties; (3) opt out of having their personal information sold to or shared with third parties; (4) access a copy of their personal information; and (5) equal service and price, even when they exercise any of the aforementioned rights.[57] Businesses are required to comply with the Act through obligations that correspond to these consumer rights.[58] Among other requirements, businesses are primarily required to (1) make required disclosures; (2) respond to verified consumer rights requests; (3) respond to sales or disclosure opt-out requests; (4) refrain from discrimination; and (5) implement reasonable security practices and procedures.[59] While the Act imposes these obligations on businesses, it also provides for circumstances under which those businesses are not required to comply with consumer requests.[60] Information that is required for businesses to (1) uphold legal obligations; (2) maintain security and existing functionality; (3) protect free speech; (4) conduct research; and (5) allow for internal, expected, and lawful uses, are excluded from the scope of business obligations under the CCPA.[61]

While some businesses have made deletion requests and opt-out forms user-friendly using reasonably conspicuous forms,[62] other businesses have made the opt-out and deletion request mechanisms so confusing or difficult to navigate that consumers are unable to achieve what the CCPA is set out to accomplish.[63] For example, some companies are using what are called "dark patterns," a type of user interface design that tries to trick users into making certain choices, often against their best interests.[64] Dark pattern design can be used in a number of ways,[65] but the key element is the use of manipulative timing to exploit content-overloaded consumers into skimming material they are presented with,[66] e.g. using brightly colored "agree and continue" or "Okay, looks great!" buttons, while opt-out buttons and privacy policies often comprise greyscale text on a grey background.[67]

Exceptions and exemptions help businesses balance their interests against consumers' privacy concerns,[68] but could also contribute to legal disputes over many issues, including how information is classified.[69] While these classifications are not always abundantly clear, it seems compliance with certain CCPA provisions may yet have unforeseen implications for

57. *See* Morrison, *supra* note 9.
58. *See id.*; *See also* CCPA §§ 1798.125, 1798.130, 1798.135, 1798.150.
59. *See* Morrison, *supra* note 9; *See also* CCPA §§1798.125, 1798.130, 1798.135, 1798.150. (business obligations?)
60. *See* CCPA § 1798.105(d)(1)-(9).
61. *See id.*; *See also* SIXFIFTY, *CCPA Deletion Exemptions*, https://www.sixfifty.com/ccpa-exemptions/.
62. Such as those created by OneTrust, https://www.onetrust.com/.
63. *See* Zack Whittaker, *California's new privacy law is off to a rocky start*, TECHCRUNCH (Feb. 8, 2020, 11:00 AM), https://techcrunch.com/2020/02/08/ccpa-privacy-law-rocky-start/
64. *See id.*
65. Natasha Lomas, *WTF is dark pattern design?*, TECHCRUNCH (July 1, 2018, 12:52 PM), https://techcrunch.com/2018/07/01/wtf-is-dark-pattern-design/.
66. *See id.*
67. *Id.*
68. *See* SIXFIFTY, *supra* note 61.
69. *See* de la Torre, *supra* note 52.

anticipated or pending litigation, e.g. a legal obligation (such as discovery requests) of a business could require denial of an otherwise compulsory deletion of consumer information.[70] Further, while companies intentionally attempting to influence consumer "choice" by using methods such as dark pattern design raises many concerns, amorphous "reasonableness" standards applied to personal information and security procedures under the CCPA[71] do not help companies respond in a consistently meaningful way on the whole.

Numerous disputes are likely to arise from the complex interaction of these new consumer rights, business obligations, and exceptions, e.g. how information is classified and consequently what must be disclosed or deleted and by what procedure;[72] what constitutes a 'sale' of personal information;[73] and even constitutional issues regarding the regulation of interstate commerce.[74] However, because the private right of action in the event of a security breach is the most obvious risk for private litigation[75], this Note focuses on what should amount to *reasonable* security practices and procedures.

C. Reasonable Security and the Private Right of Action

The private right of action under the CCPA includes the availability of statutory damages if a consumer's "nonencrypted and nonredacted personal information" is "subject to unauthorized access and exfiltration, theft, or disclosure as a result of the business's violation of the duty to implement and maintain *reasonable* security procedures."[76] Thus, plaintiffs may have a cause of action against companies who fall victim to data breaches under either a theory of a statutory violation or negligence per se.[77]

However, the reasonableness standard as it relates to CCPA compliance is as of yet ill-defined, and companies have varying interpretations of what compliance actually requires.[78] Some businesses have begun to implement the 'core considerations' of the CCPA on a global level.[79] These efforts aid compliance while signaling to all consumers that their privacy is valued by the company.[80]

---

70. *See* Allison Douglis & David Saunders, *How the CCPA impacts civil litigation*, INT'L ASS'N OF PRIVACY PROF'LS (Jan. 28, 2020), https://iapp.org/news/a/how-the-ccpa-impacts-civil-litigation/.

71. *See* Smith, *supra* note 56.

72. *See* de la Torre*, supra* note 52.

73. *See* Tim Peterson, *'We're not going to play around': Ad industry grapples with California's ambiguous privacy law*, DIGIDAY (Dec. 19, 2019), https://digiday.com/marketing/not-going-play-around-ad-industry-grapples-californias-ambiguous-privacy-law/.

74. Amy Miller, *Definition of 'sale' looms as enforcement issue for landmark California privacy law*, MLEX MARKET INSIGHT (Dec. 30, 2019), https://mlexmarketinsight.com/insights-center/editors-picks/area-of-expertise/data-privacy-and-security/definition-of-sale-looms-as-enforcement-issue-for-landmark-california-privacy-law.

75. Jessica B. Lee, Wook Hwang, Susan E. Israel, & William Grosswendt, *CCPA: A Spotlight on the Litigation Risks*, LOEB & LOEB LLP (Jan. 2, 2020), https://www.loeb.com/en/insights/publications/2020/01/ccpa-a-spotlight-on-the-litigation-risks

76. *See* Kevin Benedicto, W. Reece Hirsch, Mark Krotoski, Carla Oakley, & Gregory Parks, *Preparing for the CCPA Private Right of Action For Certain Security Incidents – Morgan Lewis Practical Advice on Privacy: Guide to the CCPA*, JD SUPRA (Jan. 6, 2020), https://www.jdsupra.com/legalnews/preparing-for-the-ccpa-private-right-of-12835/.

77. California Practice Guide: Privacy Law Constitutional/Common Law Privacy chapter 2(5)(a)(1)(a)-(b) "private right of action and other theories"; "meaning of reasonable security procedures"

78. *See id.*

79. *See* Mark Smith, *ANALYSIS: Microsoft to Extend CCPA Nationwide; Should You?*, BLOOMBERG LAW (NOV. 18, 2019, 1:00 PM), https://www.bloomberglaw.com/product/privacy/document/XKNVVD0000000

80. *See id.*

The lack of guidance as to the proper reasonableness standard set out in the CCPA will provide a breeding ground for litigation over the applicability of provisions of the Act as discussed above.[81] In response, courts should adopt a reasonableness standard informed by trade usage and recent trends in privacy law.

IV. RECOMMENDATIONS

Given that enforcement of the CCPA will begin in July 2020,[82] companies have little time to comply with the Act's regulations. Inevitably, the ambiguity within the Act as to what constitutes reasonable security of consumer information will lead to disputes and courts will have to develop a consistent standard of reasonableness for adjudicating CCPA complaints. While the CCPA does not define "reasonable security," the California Civil Code does provide some guidance,[83] noting that security procedures and practices should be appropriate to the nature of the information.[84] This suggests that what may be appropriate security for one type of information may not be appropriate for another. However, no California statute has yet defined how to determine what would be sufficiently appropriate in any given situation.[85] Drawing this line in data breach cases is likely to be a fact-specific inquiry, and some courts have noted that because of complex technical issues, expert testimony may be required.[86]

Nevertheless, reasonableness should be determined as a matter of law if a company makes a showing of (1) compliance with the twenty data security controls published by the Center for Internet Security (CIS); and (2) compliance with the National Institute of Standards and Technology cybersecurity framework ("NIS Framework"). This test would allow courts to at least determine what is clearly *not* reasonable and what clearly *is* reasonable.

A. Center for Internet Security Controls

The California Department of Justice ("DOJ") released a data breach report in 2016 that identified the "the minimum level of information security that all organizations that collect or maintain personal information should meet."[87] This report included twenty data security controls published by the Center for Internet Security (CIS).[88]

The report included basic controls, such as inventory and control of hardware assets and software assets; continuous vulnerability management; controlled use of administrative privileges; and maintenance, monitoring and analysis of audit logs.[89] Further, they include

---

81. *See* Smith, *supra* note 56.
82. *See* CCPA § 1798.185(c).
83. *See* Petenko, *supra* note 46
84. California Civil Code § 1798.81.5(c) "Security procedures and practices with respect to personal information about California residents" (2020)
85 *See Supra* note 77.
86. *See In re Anthem Litig. (ND CA 2018) 327 FRD 299, 315; See also In re TD Ameritrade Account Holder Litig. (ND CA 2011) WL 4079226, *5 (citing "complex technical issues" requiring ""substantial expert testimony" as one justification for approving class action settlement in data breach cases.).*
87. *See* supra note 46
88. *Id.*
89. *Id.*

foundational controls such as email and web browser protections; malware defenses, data recovery capabilities, controlled access based on the need to know, and account monitoring and control.[90] Lastly, organizational controls such as incident response and management and penetration tests and red team exercises were also included.[91] The DOJ noted that failure to implement all of these controls constitutes lack of reasonable security.[92] This determination was made after a DOJ review of 657 data breaches revealed that many could have been prevented or corrected more rapidly had the basic CIS security measures been implemented.[93] To the point of reasonableness, the CIS recommendations emphasizes that the benefits of implementing the controls outweigh the costs in the event of a breach. This is true even for smaller businesses since the controls are intended to be scalable to organizations of all sizes.[94]

However, this guidance from the DOJ only tells litigants that implementing these controls is necessary rather than sufficient to establish reasonable security. Accordingly, when courts are presented with disputes under the CCPA's private right of action, the CIS controls should be the first step of the court's analysis: if the company has failed to implement them, there was no reasonable security, and if the controls were implemented, the court should proceed to see what additional measures, if any, were implemented by the company.

B. Satisfactory Frameworks for Reasonableness

While the standard set forth by the CIS controls provides a minimum, many businesses should decide to implement elements from other industry recognized information security frameworks, such as the National Institute of Standards and Technology cybersecurity framework (the "NIST" framework).[95] The NIST framework, routinely updated and on its fifth revision, is a catalog of twenty security and privacy control groups and outlines controls for federal information systems and organizations.[96] These controls seek to (1) provide both public and private organizations with guidance and safeguarding measures to make information systems more resistant to cyberattacks; (2) protect the confidentiality, integrity, and availability of the organizations' information system; (3) limit the negative impact of cyber-attacks when they occur; and (4) make these information systems more survivable and resilient in general.[97]

Alternatively, other companies have been implementing security standards published by the International Organization for Standardization (the "ISO27001" framework).[98] The ISO27001 framework applies to all types of organizations and uses a risk management

90. *Id.*
91. *Id.*
92. *Id.*
93. CAL. ATT'Y GEN., California Data Breach Report, 32 (Feb. 2016), https://oag.ca.gov/sites/all/files/agweb/pdfs/dbr/2016-data-breach-report.pdf
94. *Id. at 31.*
95. Ronald Sarian, *What Are "Reasonable Security Procedures" Under The CA Consumer Privacy Act?*, JD SUPRA (Jan. 16, 2020), https://www.jdsupra.com/legalnews/what-are-reasonable-security-procedures-42839/
96. Katharina Gerberding, *NIST, CIS/SANS 20, ISO 27001 – Simplifying Security Control Assessments*, HITACHI SYSTEMS SECURITY (Sept. 5, 2017), https://www.hitachi-systems-security.com/blog/nist-cissans-20-iso-27001-simplifying-security-control-assessments/
97. *Id.*
98. *Id.*

framework to identify, analyze, and address an organization's information risks to protect against cyberthreats and data breaches.[99]

While the ISO27001 framework is less technical and focuses on risks for organizations of all shapes and sizes,[100] the NIST framework is more security control driven with a wide variety of groups to facilitate best practices related to federal information systems.[101] Both are useful for data security and risk management and both have the added benefit of being updated over time.[102]

Further, these standards are considered to be the gold standards of security[103] and if a company fulfills the requirements for their certification, courts should deem the company as having implemented reasonable security procedures and practices as a matter of law. The NIST and ISO27001 offer much more comprehensive approaches to data security than does the baseline CIS controls.[104] However, these security measures are costly, time-consuming to implement, and may be more than what is needed for smaller companies[105] whereas larger companies are more likely to have the ability to assume the cost of implementing more stringent controls. Nonetheless, implementing either of these standards combined with compliance with the CIS controls should be seen by courts as an outer limit that evidences reasonable security procedures and practices and adjudicate middling attempts on a case-by-case basis with assistance from expert witnesses and consideration of company size.

C. Other Privacy Statutes

Alternatively, courts could look to compliance with other privacy regimes to determine reasonableness. Many companies have implemented elements of reasonable security through their efforts to comply with other information security requirements such as the EU's General Data Protection Regulation ("GDPR").[106] Courts adjudicating reasonable security under the CCPA could take guidance from the GDPR because it is in some ways a more stringent standard for consumer privacy than the CCPA,[107] and decide that if a company has complied with the GDPR, their security procedures and practices are reasonable for purposes of the CCPA as well.

However, while these compliance efforts can be helpful and indeed show good-faith attempts at protecting consumer information, compliance with another continent's set of security requirements is unnecessary to show compliance with the CCPA.[108] For example, provisions of the CCPA specifically exclude several categories of personal information from its scope (e.g. publicly available information), while the GDPR does not exclude specific

---

99. *Id.*
100. *NIST vs. ISO: What's the Difference?*, RECIPROCITY, https://reciprocitylabs.com/resources/nist-vs-iso-whats-the-difference/.
101. *Id.*
102. *Id.*
103. *See* Sarian, *supra* note 95; *See also* Gerberding, *supra* note 96.
104. *See* Cal. Att'y Gen., *supra* note 93.
105. *See* Sarian, *supra* note 95.
106. *See id.*
107. *See* Geoffroy De Cooman, *GDPR and CCPA compliance: The 5 differences you should know*, PROXYCLICK (Oct. 7, 2019), https://www.proxyclick.com/blog/gdpr-and-ccpa-compliance-5-differences
108. *See id.*

categories of personal data from its scope of application.[109] Additionally, the CCPA also excludes several specific processing activities from the definition of "selling," for example, where a business shares personal information with a service provider that is necessary for a "business purpose," as defined in the CCPA.[110] Conversely, the GDPR does not exclude this type of processing activity.[111] As a result of these dissimilarities there could be circumstances where a company discloses personal information to a third party for a business purpose that would be in compliance with the CCPA, yet would create security concerns under the GDPR. Further, the GDPR provides for certain legal grounds on which a company may collect personal information, while the CCPA does not provide for such limitations as an initial matter and instead functions as a quasi-consumer consent mechanism.[112] Accordingly, applying GDPR compliance in a wholesale manner may be too burdensome in certain circumstances because the two statutes cover different types of information and different processing methods of that information.

In resolving forthcoming disputes, courts should apply a reasonableness standard that sets the minimum standard set forth by the CIS controls[113] as a benchmark and a further showing of NIST framework compliance[114] or ISO27001 certification[115] to constitute reasonable security as a matter of law. Compliance with GDPR provisions could be helpful in adjudicating a company's security measures but will not be dispositive in many cases because of the substantive differences in breadth and scope between the two regimes.

V. CONCLUSION

Legislation such as the CCPA is a much-needed effort to address issues of consumer privacy while balancing business interests such as innovation. However, the rush to its enactment[116] has created ambiguity and confusion that will lead to legal disputes that risk heavy penalties for businesses involved.[117] To aid in resolving forthcoming disputes, courts should adopt a reasonableness standard that uses the CIS controls as a benchmark and compliance with the NIST or ISO frameworks as clearly evidencing reasonable security procedures and practices. While this field is ever-changing and updates may be required as future frameworks are developed, this test is easily administered and would provide businesses with much-needed clarity for compliance.

---

109. *See Comparing privacy laws: GDPR v. CCPA* at 11, DATAGUIDANCE & FUTURE OF PRIVACY FORUM (Last accessed May 28, 2020) https://fpf.org/wp-content/uploads/2018/11/GDPR_CCPA_Comparison-Guide.pdf (accessed through https://iapp.org/resources/article/comparing-privacy-laws-gdpr-v-ccpa/)

110. *See id.* at 12.

111. *See id.*

112. *See id.* at 23.

113. *See* Petenko, *supra* note 46.

114. *See id.*

115. *See id.*

116. *See* Jennings, *supra* note 5.

117. *See* Benedicto, et. al, *supra* note 16.

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

CREATED TO CREATE: WHY AI-CREATED WORKS SHOULD BE COPYRIGHTABLE AS WORKS MADE FOR HIRE

❖ NOTE ❖

Diana Bikbaeva *

I. INTRODUCTION

Artificial intelligence (AI) is no longer confined to science fiction terms. From self-driving cars[1] and contract reviewing software[2] to automatic novel writers[3] and artists,[4] AI increasingly infiltrates our lives, creating monetary value[5], purportedly taking jobs,[6] and becoming of undoubtedly growing interest to businesses. While being itself copyrightable, AI has become capable of creating works "of its own." AI has become capable of writing creative songs[7] and making original paintings.[8] Such works would be undisputedly subject to copyright if created by human authors. With the economic potential in such works,[9] a

1. *See* Tesla, *Autopilot,* TESLA.COM, https://www.tesla.com/autopilot (last visited April 11, 2020).
2. *See* Beverly Rich, *How AI is Changing Contracts*, HARVARD BUSINESS REVIEW, https://hbr.org/2018/02/how-ai-is-changing-contracts (last visited April 11, 2020).
3. *See* Adario Strange, *Japanese Team Helps A.I. Program Pass First Round of Novel Writing Contest,* MASHABLE, https://mashable.com/2016/03/26/japan-a-i-novel/ (last visited April 11, 2020).
4. *See* ING, *The Next Rembrandt*, https://www.nextrembrandt.com (last visited April 11, 2020).
5. *See* Gil Pres, *63% Of Executives Say AI Leads To Increased Revenues And 44% Report Reduced Costs,* FORBES, https://www.forbes.com/sites/gilpress/2019/11/29/63-of-executives-say-ai-leads-to-increased-revenues-and-44-report-reduced-costs/#7ba4b47914b3 (last visited April 11, 2020). The first AI work sold at Christie's for $432,500, *see Is Artificial Intelligence set to Become Art's Next Medium?* CHRISTIE'S, https://www.christies.com/features/A-COLLABORATION-between-two-artists-one-human-one-a-machine-9332-1.aspx (last visited April 11, 2020).
6. *See* Gil Pres, *Is AI going to be a Jobs Killer? New Reports About the Future of Work,* FORBES, https://www.forbes.com/sites/gilpress/2019/07/15/is-ai-going-to-be-a-jobs-killer-new-reports-about-the-future-of-work/#1b56cef3afb2 (last visited April 11, 2020).
7. *See* Shimon: Now a Singing, Songwriting Robot, GEORGIA TECH, https://www.news.gatech.edu/2020/02/25/shimon-now-singing-songwriting-robot (last visited April 11, 2020).
8. *See A 'New' Rembrandt: From The Frontiers Of AI And Not The Artist's Atelier,* ALL THINGS CONSIDERED, https://www.npr.org/sections/alltechconsidered/2016/04/06/473265273/a-new-rembrandt-from-the-frontiers-of-ai-and-not-the-artists-atelier (last visited April 11, 2020).
9. *See supra* note 5.

* Master of Laws (2020), University of Illinois College of Law.

question arises about the legal regime of works created by AI. Namely, who (if anyone) should take credit for and hold copyright in AI-created works?

AIs are complex systems involving software, written by programmers, that are "taught" to recognize patterns from vast learning materials and create products independent from human input to various degrees. This Note will dwell upon works created mostly (if not entirely) by AI. This Note argues that the copyright in AI-created works should initially vest in persons responsible for arranging the AI (depending on the situation, programmers, their respective employers or other persons). To be consistent with the constructs of American copyright law, the *work made for hire* doctrine should be applied.

Part II of this Note will explain the issue of copyright in AI-created works, then move on to introduce the theoretical bases for copyright protection in general, and finally provide insight into the existing law and practice pertaining to the issue concerned. Part III of this Note will analyze the current legal landscape and apply it to the issue of AI and authorship. Finally, Part IV will recommend amendments to the existing legislation to extend copyright protection to AI-created works through the model of the works made for hire doctrine. Part V will conclude.

II. Background

The issue of authorship in works created by computer systems is not a new one. In 1965, Abraham Kaminstein raised this question in the Register of Copyrights, but put forward no clear solution:

> As computer technology develops and becomes more sophisticated, difficult questions of authorship are emerging . . . It is certain that both the number of works proximately produced or "written" by computers and the problems of the Copyright Office in this area will increase. The crucial question appears to be whether the "work" is basically one of human authorship, with the computer merely being an assisting instrument, or whether the traditional elements of authorship in the work . . . were actually conceived and executed not by man but by a machine.[10]

Since then, the "purely theoretical" question has turned into one of immediate practical value. Although there are numerous definitions pertaining to diverse AI algorithms, AI can generally be defined as "computer systems able to perform tasks normally requiring human intelligence, such as visual perception, speech recognition, decision-making, and translation between languages."[11] The scenario of AI-created art concerned in this Note is roughly the following: a software developer (most likely a team) writes software that is programmed to learn from (analyze patterns in) the voluminous data inputted into the system in order to

---

10. The Copyright Office, *Sixty-Eighth Annual Report Of The Register Of Copyrights* (1965).

11. *See Meaning of* artificial intelligence *in English*, LEXICO, https://www.lexico.com/definition/artificial_intelligence (last visited April 11, 2020).

produce new results not evident from the initial software code, but *based on* the analysis of the underlying inputted data, but *substantially different* from it.[12]

At this time, the U.S. Copyright Office (hereinafter "USCO") only registers a copyright in works of human authorship.[13] Therefore, under existing law, works wholly created by AI will most likely enter the public domain, which provides no reward for developers of AI who invest significant creative resources into bringing complicated computer systems to "life." The existing American case law seems not to have encountered the issue of copyright attribution in AI-created works yet, and the lack of clear regulation may dangerously lead to the creation of inconsistent case law that will not consider this important issue.

A. Theoretical Underpinnings of Copyright Law

In modern copyright law, there are four leading doctrines explaining the necessity of copyright protection: altogether they are the Utilitarian,[14] Labor (Lockean),[15] Moral Rights,[16] and Personhood (Hegelian) theories.[17] Modern American copyright law serves two main purposes: (1) enabling authors to recoup the costs of creating their works; and (2) encouraging the dissemination of works by their authors who are assured that their work will not be unfairly taken advantage of.[18] This *utilitarian* rationale dominates in the American copyright law[19].

B. Copyrightability prongs under American law

U.S. copyright law is governed by the U.S. Constitution, the Copyright Act of 1976, and the relevant derivative case law. In order to be eligible for copyright protection, a work must satisfy several criteria, including those of fixation in any tangible medium of expression, originality, and authorship.[20] Issues of AI authorship are mainly concerned about originality and authorship.

---

12. Shlomit Yanisky-Ravid, *Generating Rembrandt: Artificial Intelligence, Copyright, and Accountability in the 3a Era-the Human-Like Authors Are Already Here-A New Model*, MICH. ST. L. REV. 659, 676 (2017)

13. U.S. Copyright Office, *Compendium of U.S. Copyright Office Practices,* § 101 (3d ed. 2017), 50. Note that the USCO Compendium bearing such a conclusion does not have a binding effect and can possibly be overridden by any new regulation, at 8.

14. Julie E. Cohen, *Copyright as Property in the Post-Industrial Economy: A Research Agenda*, WISC. L. REV. at 141, 143 (2011).

15. Margaret Jane Radin, *Property and Personhood*, 34 STAN. L. REV. 957, 1004 (1982).

16. Jane C. Ginsburg, *A Tale of Two Copyrights: Literary Property in Revolutionary France and America*, 64 TUL. L. REV. at 991, 992 (1990).

17. Wendy J. Gordon, *A Property Right in Self-Expression: Equality and Individualism in the Natural Law of Intellectual Property*, 102 YALE L. J. at 1533, 1544-45 (1993).

18. Julie E. Cohen et al., Copyright in a Global Information Economy 7 (Wolters Kluwer, 4th ed. 2015).

19. *See* Jeanne C. Fromer, An Information Theory of Copyright Law, 64 EMORY L.J. 71, 73 (2014).

20. Copyright Act of 1976 17 U.S.C. § 102 (2018). See Roth Greeting Cards v. United Card Co., 429 F.2d 1106 (9th Cir. 1970), *Durham Indus., Inc. v. Tomy Corp.*, 630 F.2d 905 (2d Cir. 1980).

1. Originality

The *originality* prong requires that a work must (1) be created independently, rather than copied from another existing work;[21] and (2) should "entail a minimal degree of creativity."[22] As established in Alfred Bell & Co. v. Catalda Fine Arts, Inc., a work must be distinguishable from other existing works.[23] In that case, mezzotint engravings based on, but distinguishable from, other works in the public domain were found copyrightable. Under Feist Publications, Inc. v. Rural Telephone Service Co., the court held that in order to be copyrightable, works should display some minimal level of creativity.[24] In that case, white pages were denied copyright protection on the grounds that they lacked creativity in the selection, coordination, or arrangement of facts (phone numbers and addresses rendered in the alphabetical order). According to Feist, the originality bar is extremely low and is met even when the work is similar to another pre-existing one, provided that the "similarity is fortuitous, not the result of copying."[25]

2. Authorship

Under the Copyright Act of 1978, only works of *authorship* can be granted protection.[26] Authorship is not defined anywhere in the Act or case law.[27] The USCO's practice has thus far construed it to mean *human* authorship.[28] Existing law and practice have refused copyright protection in strictly mechanical works (such as entirely random production of fabric designs by a computer program)[29] and strictly natural works (such as a selfie taken by a monkey).[30] In instances where the work is not (or is claimed not to have been) entirely created by a human being, the case law requires that in order to be copyrightable, the work should at least be given its final form by a natural person.[31]

3. Work Made For Hire Doctrine

The Copyright Act contains a work made for hire doctrine (hereinafter, "WMFH") that by default vests the copyright in a work prepared by an employee within the scope of their employment and, in enumerated cases, commissioned works, in the employer/ordering

---

21. *Feist Publications, Inc. v. Rural Tel. Serv. Co.*, 499 U.S. 340, 345 (1991), *see Alfred Bell & Co. v. Catalda Fine Arts, Inc.*, 191 F.2d 99 (2d Cir. 1951); *Roth Greeting Cards v. United Card Co.*, 429 F.2d 1106 (9th Cir. 1970), see Nimmer, Melville B. Nimmer On Copyright : A Treatise on the Law of Literary, Musical and Artistic Property, and the Protection of Ideas § 2.01 (1978) (LEXIS Advance).

22. *Feist*, at 348.

23. *Alfred Bell*, at 102.

24. *Feist*, at 348.

25. *Id.* at 345.

26. 17 U.S.C. § 102(a) (2018).

27. *See supra, Compendium of U.S. Copyright Office Practices,* at 50.

28. *Naruto v. Slater*, 888 F.3d 418 (9th Cir. 2018).

29. *See supra, Compendium of U.S. Copyright Office Practices,* at 50, 63.

30. *Naruto*, supra note 28.

31. *Urantia Found. v. Maaherra*, 114 F.3d 955 (9th Cir. 1997). In this case, a book of religious teachings claimed to have descended from a divine source was granted copyright because it was arranged by people.

party.[32] The WMFH doctrine is a legal fiction, which for the purposes of economic practicability[33] circumvents the default rule that copyright initially belongs to the immediate factual author.[34] Despite its broad reach under the WMFH doctrine, the employer nevertheless cannot exercise the already statutorily limited[35] "moral" rights to protection of works from distortion, destruction, or misattribution.[36]

III. ANALYSIS

This Note thus far has reviewed the doctrinal bases for recognizing copyright and the approaches to copyrightability existing in modern practice. Next, this Note will apply these legal underpinnings to the situation where AI, in itself based on the underlying copyrightable software, creates sufficiently original works. The goal of this analysis section is to justify the copyright protection of AI-created works and to argue that the existing fundamentals of copyright law will not be disrupted by the introduction of new express policies in this regard.

A. Policy considerations: justification of copyright

In order to understand whether policy reforms are necessary, we will look into the theoretical underpinnings of copyright law, and namely, why copyright protection exists in the first place. American copyright law (as with American intellectual property law in general) is primarily based on the *utilitarian theory* of law and economics.[37] This means that the purpose of copyright protection is largely to financially incentivize authors to create, and investors/publishers to invest in creative processes, thus promoting "the progress of … useful arts"[38] and to motivate willingness to assume the responsibility for possible intellectual property law infringements.[39]

The cost of AI development is difficult to estimate but is no doubt immense.[40] Such costs include research and development, data scientist labor, and machine training that takes a long time and consumes tremendous amounts of computing power (for example, just training a single model of OpenAI's word-predicting GPT-2 cost up to around $40,000 in energy consumption).[41] In order to foster the creation of AI systems, its arrangers should not only be able to recoup their costs, but also profit from their use.

---

32 17 U.S.C. § 201(b) (2018).; *Community for Creative Non–Violence v. Reid*, 490 U.S. 730, 737–38 (1989).

33. Catherine L. Fisk, Authors at Work: The Origins of the Work-for-Hire Doctrine, 15 Yale J.L. & Human. (2003), at 70.

34. 17 U.S.C. § 201(a) (2018).

35. Colleen Fielkow, Clashing Rights Under United States Copyright Law: Harmonizing an Employer's Economic Right with the Artist Employee's Moral Rights in a Work Made for Hire, 7 DEPAUL J. ART, TECH. & INTELL. PROP. L. 218 (1997), at 8.

36. *See Carter v. Helmsley-Spear, Inc.*, 71 F.3d 77 (2d Cir. 1995).

37. Donald S. Chisum et al., *Principles of Patent Law 50* (3d ed. 2004) ("[T]he predominant justification for American intellectual property law has been ... utilitarianism.").

38. U.S. Const., art. I § 8.

39. Garrett Hardin, *The Tragedy of the Commons*, SCIENCE, 1243, 1243-48 (1968) (arguing that ownership is efficient to retain property).

40. *See* Robert Krajewski, *Costs Of AI Development - What You Need To Take Into Account?* IDEAMOTIVE, https://www.ideamotive.co/blog/costs-of-ai-development (last visited April 11, 2020).

41. *Id*, *see also* Karen Hao, Training a Single AI Model Can Emit As Much Carbon As Five Cars in Their Lifetimes. MIT TECHNOLOGY REVIEW, https://www.technologyreview.com/2019/06/06/239031/training-a-single-ai-model-can-emit-as-much-carbon-as-five-cars-in-their-lifetimes/ (last visited May 17, 2020).

Under the existing law, although the cost of putting together AI systems is great, and AI-created works can be valuable, the creation of art-generating AIs might not be sufficiently incentivized.[42] Copyright protection would present an additional economic motivational factor for the development of art-creating AI. Thus, reforming the existing law to extend copyright protection to AI-created works is necessary and will be in tune with the dominant utilitarian doctrine adopted by American copyright law.

B. Copyrightability of AI-created works

Under the Copyright Act of 1976, copyright protection is granted only in (1) "*original* works (2) of *authorship*."[43] This Note will now examine each of these copyrightability requirements in detail to prove that AI-generated works can satisfy them.

1. Originality

As extensively supported by case law, the *originality* prong requires that a work must (1) be created independently, rather than copied from another existing work,[44] and (2) should "entail a minimal degree of creativity."[45] The originality bar is extremely low[46] making it easily met by AI systems.[47] Although AI is "trained" using huge databases of pre-existing art in the process of machine learning (ML), the resulting works are different and unpredictable from both the computer code and the inputted art.[48] This process is not much different from that described in the famous creativity manifesto—aimed at human authors—called *Steal Like an Artist*. "Every artist gets asked the question, 'Where do you get your ideas?' The honest artist answers, 'I steal them.'"[49] "New" art is almost inevitably at least partially influenced by all the pre-existing artwork experienced by the author. "There is no new thing under the sun. Is there any thing [sic] whereof it may be said, see, this is new? It hath been already of old time, which was before us."[50]

2. Authorship

Under the Copyright Act of 1978, only works of *authorship* can be granted protection.[51] Although it is not directly specified in the Act, both the case law[52] and USCO practice[53] have

42. Pamela Samuelson, Allocating ownership rights in computer-generated works, 47 U. PITT. L. REV., 1185 (1985). *See also* Robert C. Denicola, Ex Machina: Copyright Protection for Computer Generated Works, 69 RUTGERS UL REV., 251 (2016).

43. 17 U.S.C. § 102(a) (2018). *See supra Roth Greeting Cards*.

44. *See supra* note 21.

45. *Feist*, at 348.

46. *Feist,* at 345.

47. 17 U.S.C. § 102(a) (2018). *See* Marcus Hutter, Universal Artificial Intelligence: Sequential Decisions Based On Algorithmic Probability 125-26, 2 (W. Brauer, G. Rozenberg & A. Salomaa eds., 2005).

48. Ryan Calo, *Robotics and the Lessons of Cyberlaw*, 103 CALIF. L. REV. 513, 532, 538 (2015).

49. Kleon, Austin. Steal Like an Artist: 10 Things Nobody Told You About Being Creative, 2012. Reference to *learning* from the pre-existing art, not plagiarizing.

50. Ecclesiastes 1:8, 9. King James Version.

51. 17 U.S.C. § 102(a) (2018).

52. *See supra, Compendium of U.S. Copyright Office Practices,* at 50.

53. *Naruto*, supra note 28.

so far construed it to mean *human* authorship, while strictly mechanical "works" are refused copyright protection.[54] The established practice can dangerously lead to there being no copyright in the works created by AI because of the lack of an immediate human author. In the most optimistic set of events, the legal status quo will create contradicting case law as to the possibility of copyright protection in the AI-created works, leaving the people behind the AIs without the sufficient incentive to develop art-creating AI systems.

However, the existing law and practice were formed in the times when computers, let alone AI, either did not exist yet or were incapable of producing artwork that would satisfy the originality criterion. As confirmed by Congress, the term "works of authorship" was purposefully left undefined to provide for flexibility in the view of future (including technological) developments.[55] Therefore, it should not disrupt copyright law if the human authorship requirement is relaxed for qualifying AI works.

Arthur R. Miller once wittily noted that "behind every robot there is a good person."[56] Every AI system too was once created by human authors of the software (and taught by data scientists, etc.). Even if we consider that AI operates independently from the humans who created or are running it, and the authorship in the works cannot be strictly and directly attributed to those people, there still exists a "sufficient nexus to human creativity"[57] in the resulting works, however remote. Thus, it is necessary and not disruptive to the existing American copyright doctrine to recognize AI-created works as "works of authorship."

C. Applicability of the work made for hire doctrine

AI-created work should be a work of authorship protectable by copyright law. It is logical to grant copyright in AI-created works to the persons who made it all possible, i.e. the persons who wrote the software code for the AI. Although this "remote" attribution of authorship in AI-created works to the AI software programmers may seem unknown to copyright law, it is in fact strikingly similar to the already existing work made for hire doctrine, under which copyright in specified types of commissioned works vests in the employer or the organizer of the creative process, and not the immediate author.[58] Application of the WMFH doctrine to AI-created works would solve a number of issues because it: justifies the automatic vesting of the copyright not in the immediate author, but in the "employer"; eliminates the moral rights issue;[59] and circumvents the identity/entity issue of the immediate author (namely, "can the AI be deemed a legal entity?").

---

54. *See supra* note 29.

55. *Garcia v. Google, Inc.,* 786 F.3d 733, 741 (9th Cir. 2015)55 *See* 1 Nimmer on Copyright § 2.03. *See* H.R. REP. NO. 1476, 94th Cong., 2d Sess. 116 (1976), *reprinted in* 1976 U.S.C.C.A.N. 5731, 5731.

56. *The Semiconductor Chip Protection Act of 1983: Hearings on S. 1201 Before the Subcomm. on Patents, Copyrights and Trademarks of the Senate Comm. on the Judiciary,* 98th Cong., 1st Sess. 86 (1983), at 88 (statement of Arthur R. Miller, Professor of Law, Harvard Law School).

57. *See supra* Urantia Foundation, at 958.

58. Annemarie Bridy, *Coding Creativity: Copyright and the Artificially Intelligent Author,* 2012 STAN. TECH. L. REV. 5, at 26.

59. See supra note 36.

D. Who should own the copyright to AI-works?

If AI-created art is granted copyright protection, a question of authorship attribution logically arises. In the absence of statutory regulation, the creators of the art-generating AI are often the ones receiving profits from the use of such art,[60] which suggests that the allocation of copyright can be subject to contractual agreement. However, the establishment of a default policy rule would provide for greater protection and legal predictability.

It should be noted that art-creating AI algorithms vary greatly,[61] and a case-by-case analysis should be conducted to determine which copyright allocation would be the most reasonable and just. This Note proposes to follow the British approach of granting copyright in computer-generated works to persons "responsible for arrangement necessary for creation"[62] which in the case of "strictly AI-generated" works would mean the software programmers who created the AI. It is also worth mentioning that granting authorship to the AI itself is not practicable. AI systems do not need the incentive to create works (they are already programmed to)[63] and lack independent will or legal capacity to enforce any such rights.

IV. RECOMMENDATIONS

As proven in the analysis above, it is necessary to economically incentivize the development of art-creating AI systems by granting copyright in such art to the persons behind such AI systems. Works created by AI merit copyright protection, and the persons responsible for the implementation of an AI system, which in most cases would mean the software developers, should be deemed the authors.

This Note recommends that the WMFH doctrine should extend to give AI authorship to those who made the AI. Application of the WMFH doctrine would best serve the justification for copyright protection for AI-created works because it grants copyright protection to the person organizing/commissioning the work made by another within the pre-defined scope of the task. However, the current WMFH doctrine would not yet allow for this since the relationship between the AI and the programmer does not fall squarely into the employer-employee categories described in the Copyright Act § 101(1).[64] As suggested by the Supreme Court, the WMFH doctrine applies only in instances where the Congress has expressed a clear and explicit intent for it to apply.[65] Because of the nature of the WMFH doctrine, combined with the Supreme Court's jurisprudence on the matter, any expansion of this doctrine to AI-created works would need explicit statutory basis[66] and would best be done through Congressional change.

---

60. Margot E. Kaminski, *Authorship, Disrupted: Ai Authors in Copyright and First Amendment Law,* 51 U.C. DAVIS L. REV. 589, 594 (2017).
61. Id.
62. U.K. Copyright, Designs & Patents Act 1988, c. 48, § 9(3). (Eng.)
63. Pamela Samuelson, *Allocating Ownership Rights in Computer-Generated Works*, 47 U. PITT. L. REV. 1185, 1199 (1986).
64. *See supra* Annemarie Bridy, at 27.
65. Shlomit Yanisky-Ravid, at 715.
66. Id.

Additionally, § 101(1) should be amended to include computer-generated works into the definition of WMFH. Such an approach is in tune with the most recent technological developments and has already been taken in other common law countries such as the U.K.[67] and New Zealand.[68] Therefore, it is advisable to include into § 101(1) definition of WMFH the third instance of such works:

A work made for hire is . . . (3) an otherwise qualifying for copyright protection, work generated by a computer in circumstances where there is no human author of such work. A person (persons) by whom the arrangements necessary for the creation of the work are undertaken will be deemed the initial author(s).

V. Conclusion

The emergence of works of art created by AI poses an important issue of copyright allocation in such works. Specifically it calls into question whether copyright law should be limited to human-created works of art. Although the existing legal landscape does not yet allow for human copyright ownership in AI-created works, it makes the most sense to amend the existing regulation by extending the WMFH doctrine in the view of the underlying utilitarian purpose of copyright law.

67. U.K. Copyright, Designs & Patents Act 1988, c. 48, § 9(3).

68. New Zealand Copyright Act of 1994 5(2)(a), available at: http://www.legislation.govt.nz/act/public/1994/0143/latest/whole.html#DLM345638 (last visited April 11, 2020).

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

A HORSE WALKS INTO A BAR: COMPARING EASTERBOOK'S CRITICIZED CYBERLAW ANALOGY TO THE STUDY OF ALCOHOLIC BEVERAGE LAW & REGULATION

❖ ARTICLE ❖

Mark Edward Blankenship Jr. *

I. INTRODUCTION 43
II. WHAT IS THE LAW OF THE HORSE? 44
A. *Easterbrook's View: Cyberlaw as Multidisciplinary Dilettantism* 45
B. *Lessig's View: What Cyberlaw Can Teach* 45
1. The Four Modalities of Constraint 46
2. Interrelationships Between Law, Social Norms, Architecture, and Markets 46
C. *Mariotti's Three-Dimensional View of Cyberspace* 46
III. ALCOHOL & OUTSIDE APPLICATIONS OF LAW OF THE HORSE 47
A. *Environment and Climate Change Adaptation* 47
B. *Sports and Entertainment Law . . . and the Horse* 48
C. *Law and Entrepreneurship* 49
IV. WHAT CAN ONE LEARN FROM ALCOHOLIC BEVERAGE LAW? 49
A. *Alcohol and its Places* 51
1. Tied-Houses 53
2. Prohibition, Speakeasies, and Bootlegging 54
3. The Three-Tier System and State Regulation 55
B. *Alcohol as a Good* 56
1. Distinction from Food and Drug 57
2. Peculiarities of Wine, Beer, and Liquor Industries 57
3. Lawyer Competency 58
C. *Alcohol and Mediums* 59
1. Labeling & Branding 60
2. Advertising 61
3. Technology and Media 61
V. CONCLUSION 62

* Juris Doctor, The University of Kentucky J. David Rosenberg College of Law (2019); B.A., *magna cum laude*, Georgia Southern University (2015).

Acknowledgements: I began writing this article while social distancing and I first want to express my sincere thoughts and prayers to those affected by the Covid-19 pandemic. May we as a Nation be able to seek hope during these tumultuous times. I want to thank Professors Allison Connelly, Melynda Price, and Brian L. Frye for inspiring me in my legal writing, Professor James Donovan for his instruction on cyberlaw during my 3L year, and my friends and family for their love and support. Lastly, I dedicate this article to the Tourette Association of America.

I. INTRODUCTION

Bar and nightclub consultant Jon Taffer described alcohol establishments as "part of America's fiber", which is arguably true to this day and age.[1] Between 2008 to 2018, the number of breweries in the United States rose from 1,574 to 7,450. Additionally, in 2018, 8,391 wineries were established in North America, 7,762 of which were in the U.S.[2] As a result, the concept of alcoholic beverage law has become a niche area of practice.[3] Continued Legal Education panels[4] and boutique firms[5] have recently appeared across the country specializing in alcoholic beverage law. With this apparent need for beer and wine attorneys and legislative advancement, one may think that more law schools would make developments to help facilitate this need.[6]

So far, some institutions have. In 2019, the University of Kentucky J. David Rosenberg College of Law founded a student organization called the Bourbon Legal Society.[7] The first casebook on "craft beer law" will be published this year.[8] And some universities in

---

1. *Nightclub King Jon Taffer Sets A High Bar*, NPR (Dec. 1, 2013 5:34 PM ET), https://www.npr.org/2013/12/01/247515926/reimaging-the-american-nightclub; CPA Speakers Bureau, *Jon Taffer - CBA Speakers Bureau*, YOUTUBE (Nov. 7, 2013), https://www.youtube.com/watch?v=O0utYUr31AU.

2. Jan Conway, *Total number of breweries in the United States 2012-2018*, STATISTA (Apr. 17, 2019), https://www.statista.com/statistics/224157/total-number-of-breweries-in-the-united-states-since-1990/. According to the report, there were approximately 7,450 breweries in the U.S. in 2018. Breweries are categorized as craft, large craft, and other non-craft breweries. Craft breweries include microbreweries and brewpubs. *Id*. *National Beer Sales & Production Data*, BREWERS ASSOC., https://www.brewersassociation.org/statistics-and-data/national-beer-stats/ (last visited April 10, 2020); *How Many Wineries Are There in the United States?*, USA WINE RATINGS (Mar. 9, 2018), https://usawineratings.com/en/blog/insights-1/how-many-wineries-are-there-in-the-united-states-37.htm.

3. *See Wine, Beer & Spirits Law*, PILLSBURY WINTHROP SHAW PITTMAN LLP, https://www.pillsburylaw.com/en/services/sectors/wine-beer-and-spirits-law.html (last visited April 10, 2020); Lindsey A Zahn, *Navigating the Challenges of a Regulated Industry*, *in* WINE AND BEER LAW: LEADING LAWYERS ON NAVIGATING THE THREE-TIER SYSTEM AND OTHER REGULATIONS ON ALCOHOLIC BEVERAGES 33, 47–48 (Thompson Reuters/Aspatore 2016); Daniel Croxall, *Helping Craft Beer Maintain and Grow Market Shares With Private Enforcement of Tied-House and False Advertising Laws*, 55 GONZ. L. REV. 167 (2019)

4. *See e.g.* LexVid, *CLE: Brewery & Distillery Law Series Part 1*, YOUTUBE (Jan. 13, 2015), https://www.youtube.com/watch?v=9kT9uBIvbyA&t=3680s; *Alcohol 101: Alcohol Beverage and Distribution Law*, LAWLINE (May 5, 2015), https://www.lawline.com/course/food-beverage-agriculture-part-7-alcohol-101; *Homebrewing & Craft Beer Laws*, LAWLINE (May 7, 2019), https://www.lawline.com/course/homebrewing-craft-beer-laws; *Shaping American Alcohol Law: Cowboy Saloons, Al Capone and the Rise of Craft Beer*, LAWLINE (May 18, 2016), https://www.lawline.com/course/shaping-american-alcohol-law-cowboy-saloons-al-capone-and-the-rise-of-craft-beer.

5. *See e.g.* THE CRAFT BEER ATTORNEY, https://craftbeerattorney.com/ (last visited April 10, 2020); BRISTOW BEVERAGE LAW, https://www.bristowbeveragelaw.com/ (last visited April 10, 2020).

6. *See* LexVid, *supra* note 4; Zahn, *supra* note 3, at 34, 40–48; *see also* Clare Abel, *Staying in Compliance with the Wine, Beer, and Liquor Industry's Three-Tier System*, *in* WINE AND BEER LAW: LEADING LAWYERS ON NAVIGATING THE THREE-TIER SYSTEM AND OTHER REGULATIONS ON ALCOHOLIC BEVERAGES 7, 11–15 (Thompson Reuters/Aspatore 2016); James M. Seff & Carrie L. Bonnington, *A General Introduction to Alcohol Beverage Laws and Regulations*, *in* WINE AND BEER LAW: LEADING LAWYERS ON NAVIGATING THE THREE-TIER SYSTEM AND OTHER REGULATIONS ON ALCOHOLIC BEVERAGES 81, 89–94 (Thompson Reuters/Aspatore 2016).

7. It should be noted that despite its name, the student organization does however represent all interests among the beer, wine, and spirits law industry in the Commonwealth. *See Bourbon Legal Society*, BBNVOLVED, https://uky.campuslabs.com/engage/organization/bourbonlegalsociety (last visited April 17, 2020). Interestingly, the state of Kentucky is also recognized for its peculiar beverage crossover of "bourbon-barrel aged beer." *See e.g.* Bailey Loosemore, *The 5 Best Places to Try Some of Kentucky's Bourbon Barrel-Aged Beer*, COURIER J., https://www.courier-journal.com/story/life/food/spirits/beer/2018/06/12/best-kentucky-bourbon-barrel-aged-craft-beer-beweries/693547002/ (last updated July 26, 2018, 12:49 PM ET).

8. *See Daniel Croxall*, MCGEORGE SCHOOL OF L., https://www.mcgeorge.edu/profiles/faculty/daniel-croxall (last visited April 10, 2020); DANIEL CROXALL, CRAFT BEER LAW AND PRACTICE (Carolina Acad. Press 2020). Another book specifically on

California have even taught "wine law" within the past few years.[9] While all of these efforts are indeed commendable, it begs the question: Do any of these efforts illuminate the entire alcoholic beverage law and regulation framework?

First off, why should this matter? Well, legal scholars may have a "long face" about the idea of teaching a course on craft beer law or the like, for fear that the subject would be too shallow to where it misses any unifying principles, and be ultimately doomed to fail. This concern derives from a curriculum debate that began almost twenty five years ago by Judge Frank H. Easterbrook when he criticized the idea of cyberlaw by comparing it to teaching the Law of the Horse.[10] Despite its opposition to teaching specialized fields of law, Easterbrook's analogy has been relied upon in support of teaching other fields of legal study, such as equine law, cryptolaw, health law, and more.[11] While much legal scholarship has been written particularly aimed toward craft beer law[12] or wine law[13], this article will take a different approach by analyzing the evolution of the Law of the Horse analogy and applying it to advocate for the study of alcoholic beverage law and regulation as a whole, rather than craft beer law or wine law specifically.

II. WHAT IS THE LAW OF THE HORSE?

The Law of the Horse was introduced in 1996 by Frank H. Easterbrook at a conference on the Law of Cyberspace as an intentionally narrow nonfield of law and witty analogy to describe cyberlaw.[14] Various scholars over time have analyzed the Law of the Horse in explaining their opposing stance on why studying cyberlaw is critical.

"beer law" has also been written, but was mainly intended as an instruction guide for brewers. *See generally* JOHN SZYMANKIEWICZ, BEER LAW: WHAT BREWERS NEED TO KNOW (First Printing 2017).

9. *See Richard Mendelson*, U.C. BERKELEY SCH. L., https://www.law.berkeley.edu/our-faculty/faculty-profiles/richard-mendelson/ (last visited Apr. 17, 2020) ("He is a Lecturer in Wine Law at UC Berkeley, School of Law, where he directs the Program on Wine Law and Policy. He also lectures on a variety of vineyard and wine law topics at UC Davis Graduate School of Management and as part of the University of Aix-Marseille and the University of Bordeaux."); *Beverage Law*, BRIAN F. SIMAS L. OFF., https://www.simaslawfirm.com/ (last visited Apr. 17, 2020).

10. *See generally* Frank H. Easterbrook, *Cyberspace and the Law of the Horse*, 1996 U. CHI. LEGAL F. 207; Lawrence Lessig, *The Law of the Horse: What Cyberlaw Might Teach*, 113 HARV. L. REV. 501 (1996); Renato Mariotti, *Cyberspace in Three Dimensions*, 55 SYRACUSE L. REV. 251 (2005); BELLIA ET AL., CYBERLAW: PROBLEMS OF POLICY AND JURISPRUDENCE IN THE INFORMATION AGE (West Acad. Pub., 5th ed. 2018).

11. *See generally* Joan S. Howland, *Let's Not "Spit the Bit" in Defense of "The Law of the Horse": The Historical and Legal Development of American Thoroughbred Racing*, 14 MARQ. SPORTS L. REV. 473 (2004); J.B. Ruhl & James Salzman, *Climate Change Meets the Law of the Horse*, 62 DUKE L.J. 975 (2013); Darian M. Ibrahim & D. Gordon Smith, *Entrepreneurs on Horseback: Reflections on the Organization of Law*, 50 ARIZ. L. REV. 71 (2008); Jerrold Tannenbaum, *What Is Animal Law?*, 61 CLEV. ST. L. REV. 891 (2013); Carla L. Reyes, *Conceptualizing Cryptolaw*, 96 NEB. L. REV. 384 (2017); M. Gregg Bloche, *The Emergent Logic of Health Law*, 82 S. CAL. L. REV. 389 (2009).

12. *See. e.g.* Croxall, *supra* note 3; Shivani Patel, *The IP of IPAs: A Look into Trademark Infringement in the Craft Beer Industry*, 26 J. INTELL. PROP. L. 249 (2019); Brian D. Anhalt, *Crafting a Model State Law for Today's Beer Industry*, 21 ROGER WILLIAMS U. L. REV. 162 (2016).

13. *See e.g.* Kevin J. Fandl, *Regulatory Policy and Innovation in the Wine Industry: A Comparative Analysis of Old and New World Wine Regulations*, 34 AM. U. INT'L L. REV. 279 (2018); Alana Lenore Joyce, *Wine Online: Fermenting the Role of Third Party Providers from California to New York*, 48 U.C. DAVIS L. REV. 2035 (2015); Laura Zanzig, *The Perfect Pairing: Protecting U.S. Geographical Indications with a Sino-American Wine Registry*, 88 WASH. L. REV. 723 (2013).

14. *See* Easterbrook, *supra* note 10, at 207–08; Ruhl & Salzman, *supra* note 11, at 985–86; Ibrahim & Smith, *supra* note 11, at 71–74.

A. *Easterbrook's View: Cyberlaw as Multidisciplinary Dilettantism*

The Law of the Horse was not necessarily intended to discourage converting lawyers into one-trick ponies per se. Rather, the analogy stemmed from Gerhard Casper's belief that law schools should teach courses limited to subjects that illuminate the entire law for two reasons. The first reason was that Casper rejected multidisciplinary dilettantism because it was viewed as a cross-sterilization of ideas which prompted one to "[combine] two fields about which [one may] know little and get the worst of both worlds."[15] The second reason was that Casper believed the best way to learn the law applicable to specialized endeavors is to study general rules.[16] As Easterbrook emphasized:

> Lots of cases deal with sales of horses; others deal with people kicked by horses; still more deal with the licensing and racing of horses, or with the care veterinarians give to horses, or with prizes at horse shows. Any effort to collect these strands into a course on "The Law of the Horse" is doomed to be shallow and to miss unifying principles.[17]

Thus, Easterbrook viewed cyberlaw as another form of multidisciplinary dilettantism that simply required combining intellectual property law with computer networks. His rationale was based upon: a) the uncertain duration of cyberspace; b) the falling behind in matching law to well-understood technology already in existence; and c) the ability to easily classify behavior under current legal principles.[18]

B. *Lessig's View: What Cyberlaw Can Teach*

Three years later, the *Harvard Law Review* published an article by Professor Lawrence Lessig regarding his stance on the Law of the Horse as applied to the study of cyberlaw. In it, Lessig agreed with Easterbrook that courses in law school should illuminate the entire law. However, unlike Easterbrook, he believed that "there [was] an important general point that comes from thinking particularly about how law and cyberspace connect." In doing so, Lessig raised the question of what cyberspace was.[19] Interestingly, Lessig rejected the idea that cyberspace was "unregulable" territory. Instead, he theorized that cyberspace is unique due to its code, its own software and hardware, and thus by understanding its interactions with law and behavior, one can understand how cyberspace can be regulated.[20]

---

15. *See* Easterbrook, *supra* note 10, at 207–08; Ruhl & Salzman, *supra* note 11, at 985–86.

16. Easterbrook, *supra* note 10, at 207.

17. *Id.*

18. *Id.* "Error in legislation is common, and never more so than when the technology is galloping forward. Let us not struggle to match an imperfect legal system to an evolving world that we understand poorly."

19. Lessig, *supra* note 10, at 502, 505–06; *see also* Mariotti, *supra* note 10, at 252.

20. Lessig, *supra* note 10, at 503, 505–06. As Lessig stated: "Many believe that cyberspace simply cannot be regulated. Behavior in cyberspace, this meme insists, is beyond government's reach. The anonymity and multijurisdictionality of cyberspace makes control by government in cyberspace impossible. The nature of the space makes behavior there *unregulable*. This belief about cyberspace is wrong, but wrong in an interesting way. It assumes either that the nature of cyberspace is fixed — that its architecture, and the control it enables, cannot be changed — or that government cannot take steps to change this architecture. Neither assumption is correct. Cyberspace has no nature; it has no particular architecture that cannot be changed. Its architecture is a function of its design . . . " *Id.* at 505; *see also* Ibrahim & Smith, *supra* note 11, at 79.

1. The Four Modalities of Constraint

Lessig believed that there are four modalities of constraint within the behavior of regulation that are shared by both cyberspace and real space. Law is the first modality of constraint that orders people to behave in certain ways and threatens punishment if they do not. Thus, law regulates—it "tells [people] not to buy certain drugs, not to sell [certain goods] without a license," etc.[21] The second modality are social norms, which also regulate. Unlike the law, social norms are enforced by the community instead of the government.[22] Thirdly, the modality of markets regulates by price, which can also affect individual and collective behavior.[23] Finally, there is the modality of architecture, the physical world as one finds it, even if it was already in existence when discovered.[24] Lessig emphasized that one can best understand the study of cyberlaw by studying cyberspace's own four modalities of constraint, how they collaborate in regulation, and their cumulative effects.[25]

2. The Interrelationships Between Law, Social Norms, Architecture, and Markets

To emphasize the synergy between cyberspace and its four modalities of constraint, Professor Brett Frischmann highlighted three lessons drawn from the Easterbrook-Lessig debate on why one should study cyberlaw. First, he noted that cyberlaw requires the study of complex relationships between various legal sub-disciplines.[26] Second, Frischmann noted that cyberlaw is interdisciplinary in that it requires the study of various disciplines outside of the law. He illustrated that Lessig not only emphasized how cyberlaw requires critical legal study of different modes of regulation, such as law, social norms, markets, and architecture, but he implicated that cyberlaw additionally requires to some degree, the study of social sciences, economics, and technology.[27] Finally, Frischmann emphasized how cyberlaw "forces critical (re)examination of balances struck by existing social arrangements, often involving competition and at times incommensurable values."[28]

C. Mariotti's Three-Dimensional View of Cyberspace

Attorney Renato Mariotti, like many scholars who have advocated for various course subjects, took a somewhat rejectionist stance on the Law of the Horse.[29] First, he argued that just because a particular field fails to illuminate the entire law, does not mean it lacks any value.[30] Second, while he agreed with Easterbrook that "focusing exclusively on a particular

21. Lessig, *supra* note 10, at 506–07.
22. *Id*. at 507.
23. *Id*.
24. *Id*.
25. *Id*.
26. BELLIA ET AL., *supra* note 10, at 13.
27. *Id.* at 14.
28. *Id.*
29. *Compare* Mariotti, *supra* note 10, at 298–99 *with* Ruhl & Salzman, *supra* note 11, at 1013–14, Bloche, *supra* note 11, at 395, Ibrahim & Smith, *supra* note 11, at 84, *and* Cheryl B. Preston & Eli W. McCann, *Unwrapping Shrinkwraps, Clickwraps, and Browsewraps: How the Law Went Wrong from Horse Traders to the Law of the Horse*, 26 BYU J. PUB. L. 1, 15–16 (2011).
30. Mariotti, *supra* note 10, at 298–99.

object is not a good principle for a field of study", he believed Easterbrook was incorrect in characterizing cyberspace as an object like a horse.[31] Nevertheless, he believed that Lessig was only partially correct when he described cyberspace as a place.[32]

Instead, Mariotti theorized that in order to fully understand cyberlaw, the concept of cyberspace should be viewed three-dimensionally: as a place, a medium, and a good all at the same time, with its dimensions cutting across traditional subject matters and methods of analysis, as Frischmann noted.[33] For instance, he believed computer programmers, or "code writers" as Lessig described them, were like any other market actor in that their designs and business decisions are shaped by consumer demand in order to maximize profits.[34] Additionally, Mariotti illustrates one of Lessig's works about an internet newsgroup to demonstrate that the internet functions not only as a space where people can gather, but also as a method of communication.[35] Finally, Marrioti emphasizes the multidimensional conceptualization of cyberspace by citing to the many alternative views on how cyberspace should be viewed.[36] Many cases involving cyberspace have adopted this three-dimensional view through the use of argumentative analogies.[37]

III. ALCOHOL & OUTSIDE APPLICATIONS OF THE LAW OF THE HORSE

As previously mentioned, various scholars have analyzed the Law of the Horse in relation to various other areas of law.[38] However, there are three particular analyses that are worthy of discussion for their similarities to alcoholic beverage law that help reinforce such law as a distinct legal field.

A. Environment and Climate Change Adaptation

Scholars have argued that climate change adaptation is a distinct area of law, not substantively but procedurally.[39] To them, climate change is a process that intersects along many substantive fields. While discrete *substantive* climate change issues are likely to match up well with some existing field of law, none of such fields alone or in any combination are well equipped to *procedurally* manage climate change adaptation.[40] Additionally, the emergence of environmental justice and its separation from environmental law as two distinct

31. *Id.*
32. *Id.* at 253.
33. *Compare id*. at 298–99 *with* BELLIA ET AL., *supra* note 10, at 13.
34. Mariotti, *supra* note 10, at 275.
35. *See id.* at 280–82.
36. *See generally id.* at 261–68.
37. *See e.g.* American Broadcasting Cos., Inc. v. Aereo, Inc., 573 U.S. 431 (2014) (comparing a video-on-demand service to "a copy shop that provides its patrons with a library card"); Mainstream Loudoun v. Board of Trustees of the Loudon County Public Library, 2 F. Supp. 783 (E.D. Va. 1998) (demonstrating that the Defendants likened the Internet to that of a "vast Interlibrary Loan system", while Plaintiffs had argued the Internet acted more like "a set of encyclopedias, and the Library Board's enactment of the Policy to a decision to "black out" selected articles considered inappropriate for adult and juvenile patrons"); *see also* Intel Corp. v. Hamidi, 71 P.3d 296, 309–10 n.7 (Cal. 2003).
38. *See supra* note 11 and accompanying text.
39. Ibrahim & Smith, *supra* note 11, at 1018–19.
40. *Id*.

legal fields have been relied upon to advocate for climate change adaptation as a distinct legal field.[41]

B. Sports and Entertainment Law . . . and the Horse

The Law of the Horse has been raised in the concept of Sports & Entertainment Law as well.[42] This might come as no surprise that the entertainment industries have had a strong presence within the area of cyberlaw, such as with peer-to-peer filesharing.[43] But if there is a sport that takes a peculiar stance on the Easterbrook analogy, it is the sport pertaining to the horse itself—equine law.[44] According to Professor Joan Howland, equine law and cyberlaw share many crucial similarities: (a) they are highly regulated by statutes, case law, and administrative restrictions and rulings; (b) they share critical issues, such as contracts, securities, tax, labor, gaming, licensing, and those involving search and seizure; and (c) they are regulated by the same modalities of constraint introduced by Lessig.[45] However, Howland notes an important characteristic of equine law and thoroughbred racing that makes them distinct from cyberlaw: its history.[46]

Throughout history, horse racing was a popular sport in Britain that at one point faced scrutiny amongst Christian church leaders and a period of decline.[47] By the mid-seventeenth century, horse racing eventually became both a sport and social gathering.[48] While horse racing became a popular sport when it was introduced to America, it did receive some of the same religious scrutiny.[49] Horse racing throughout the colonies became a sport for every social class, not just the elite, but faced somewhat of a reversion after the Revolutionary War [50] and again after the Civil War.[51] Between the Gilded Age and the Great Depression, horse racing was immersed in controversies of corruption, such as doping, illegal gambling, and fraudulent races, as well as a resurgence in conservative religious values, that altogether banned the sport in various parts of the country for quite some time.[52] However, systems were eventually put in place in order to preserve the integrity of the sport. These systems

41. *Id*. at 980–82, 989, 996–1002, 1019, 1026.

42. *See* Amanda G. Ciccatelli, *Is There Such a Thing as "Entertainment Law"?*, IP WATCHDOG (June 21, 2017), https://www.ipwatchdog.com/2017/06/21/is-there-such-a-thing-as-entertainment-law/id=84707/; Mitchell N. Berman, *"Let 'em Play" A Study in the Jurisprudence of Sport*, 99 GEO. L.J. 1325, 1330 n.21 (2011); *cf.* Joseph H. Sommer, *Against Cyberlaw*, 15 BERKELEY TECH. L.J. 1145, 1156–57 (2000). *See generally* Sherman J. Clark*, Why Sports Law?*, 28 STAN. L. & POL'Y REV 151 (2017).

43. Peer-to-peer file sharing, like the VCR, was a method of distribution that caused great concern within the entertainment industries. *See* BELLIA ET AL., *supra* note 10, at 406. *See generally* Sony Corp. of Am. V. Universal City Studios, Inc., 464 U.S. 417 (1984); A&M Records, Inc. v. Napster, Inc., 239 F.3d 1004 (9th Cir. 2001); Metro-Goldwyn Meyer Studios, Inc. v. Grokster, Ltd., 545 U.S. 913 (2005); Arista Records LLC v. Lime Group LLC, 715 F. Supp. 2d 481 (S.D.N.Y. 2010).

44. *See generally* Howland, *supra* note 11.

45. *See id.* at 475–76, 506–07.

46. *Id.*

47. *Id*. at 476, 479.

48. *Id*. at 482.

49. *Id*. at 483–85.

50. *Id*. at 485, 488–91.

51. *Id*. at 494–95.

52. *Id*. at 495–96.

included pari-mutuel betting, as well as the creation of state racing commissions, the Thoroughbred Racing Association, and the Thoroughbred Racing Protective Bureau.[53]

C. Law and Entrepreneurship

Instead of analyzing the law's limits as a regulator, the study of law and entrepreneurship has been proposed for its legal relevancy and distinctiveness.[54] According to scholars, entrepreneurship is a distinct field because it reveals how the law deals with novelty as applied to opportunities.[55] It involves new products or services, new ways of organizing, and new geographic markets.[56] As the novelty of opportunities increase, so do the unique challenges presented to the legal system, which in turn can lead to the greater need for distinctive legal rules or legal practices to govern that opportunity.[57]

IV. WHAT CAN ONE LEARN FROM ALCOHOLIC BEVERAGE LAW?

Alcohol and its establishments have made a significant impact in American history. Yet despite this, alcoholic beverage law has yet to stand out as a particular subject in law school curriculums. Meanwhile other legal specializations such as music law, equine law and sports law have caught on.[58] More politically involved specializations such as those pertaining to religion, race, slavery, and gender have been even more engrained in legal studies, U.S. laws, and the Constitution.[59] While studying alcoholic beverage law might not be as impactful as some of the other specializations mentioned above, alcohol will continue to be an important industry in the modern world, much longer than five years for sure.[60] Thus, there will be a need that can be addressed and a historical industry that can be catered to through a specialized legal lens.[61]

Granted some alcoholic beverages, such as bourbon have made much more of an impact in America than others.[62] And while "Law and the Craft Beer" might sound fun and intriguing, the methodologies employed in the course—particularly studying the regulation of

---

53. *See id*. at 495–506.

54. Ibrahim & Smith, *supra* note 11, at 84, 89.

55. *Id*. at 84.

56. *Id*.

57. *Id*. *See generally* sources cited *supra* note 43.

58. *See e.g.* OUTLINE DEPOT, https://www.outlinedepot.com/Home/Classes (last visited Apr. 16, 2020). Vanderbilt University Law School does offer a course though on Marijuana Law and Policy. Like alcohol, marijuana has also been described as highly regulated and "virtually synonymous with prohibition." Other law schools have followed a similar approach. *See also Course Information: Marijuana Law and Policy*, VAND. L. SCH., https://law.vanderbilt.edu/courses/341 (last visited Apr. 16, 2020); *Law Courses Catalog: Cannabis Law & Policy*, LEWIS & CLARK L. SCH., https://law.lclark.edu/courses/catalog/law_413.php (last visited Apr. 16, 2020); *Cannabis Law & Policy Project*, U.WASH. SCH. L., https://www.law.uw.edu/academics/programs/cannabis-law-policy-project (last visited Apr. 16, 2020). *Cf.* Danielle Cortez, *Craft Beer and Marijuana Cohesiveness Is Possible: How One Can Learn from the Other's Regulatory Madness*, 12 OHIO ST. BUS. L.J. 159 (2018).

59. *See generally* U.S. CONST. amends. I, XIII, XIV, XIX.

60. *See* discussion *infra* Sections III.A & III.B.

61. *See supra* note 6 and accompanying text; *see also* Ruhl & Salzman, *supra* note 11, at 981 ("Law of implies something more, that there is a need for the legal system to respond to change from outside by changing inside at a more fundamental level."); Ibrahim & Smith, *supra* note 11, at 76 ("In our view, a new field of legal study is justified when a discrete factual setting generates the need for distinctive legal solutions.").

62. *See* BRIAN F. HAARA, BOURBON JUSTICE: HOW WHISKEY LAW SHAPED AMERICA 1–7, 147–48 (Potomac Books 2018).

a specific alcoholic beverage regarding how "American" it is—still appears too shallow of an approach. It does not illuminate the entire subject of alcohol regulation nor does it navigate the three-tier system, which will be discussed later. Such a narrow subject can leave practitioners with only an understanding of their jurisdiction's beer laws, which may be different from their wine laws, with no explanation as to why that is.[63] An equivalent to this study would be that of *sculpture law*: the licensing, tax, right of publicity, insurance, and tort issues pertaining to sculptures instead of copyright protectable artworks as a whole.[64] Thus, specifically studying craft beer law or wine law loses credibility as an individualized subject of law, and echoes more of the concerns outlined in the Law of the Horse analogy. Therefore, studying the regulation of wine, beer, and spirits as a whole can give a better sense of a more unified legal specialization.[65]

Yet there are two issues with taking Lessig's argument against the Law of the Horse in relation to cyberlaw and applying it to why one should study alcoholic beverage law. First, Lessig has equated cyberspace, not only as a place, but also as a jurisdiction. In Lessig's own words, cyberspace was "the most significant new jurisdiction since the Louisiana Purchase."[66] By contrast, a tavern cannot be viewed as its own jurisdiction, though one may quip that during the Colonial times it probably could have been.[67] Second, Mariotti is correct in that a "Law of X" should not be viewed one-dimensionally in terms of its place. There is no "Law of the Holy Ground", but there is Law and Religion, Church and State, and also Canon Law. There is no "Law of the Plantation", but there is Agricultural Law and Environmental Law. And there is no "Law of the Polling Place", but there is nevertheless Election Law. In a sense, the course subject is the thing that is being preserved or offered to the public (not in a contractual sense) along with its implied places and mediums.[68]

This paper proposes that teaching alcoholic beverage law requires a hybrid approach of Mariotti's Three-Dimensional View and Lessig's four modalities of constraint. In other words, effectively teaching alcoholic beverage law would require studying the regulation of alcohol in terms of it being a good, its mediums, and its places, in relation to the laws, social norms, markets, and architecture that affect it. In addition, alcohol regulation requires studying historical context in encouraging the development of novel and creative beverage products while navigating through a sort of archaic procedural framework, that affects not only licensing and unfair competition practices, but also franchise, intellectual property, zoning, landlord-tenant, and First Amendment laws.[69]

---

63. *See* LexVid, *supra* note 4; Seff & Bonnington, *supra* note 6, at 82, 84.

64. *Compare* SZYMANKIEWICZ, *supra* note 8 *with* LEONARD D. DUBOFF ET AL., ART LAW IN A NUTSHELL (West Acad. Pub., 5th ed. 2017), MARSHALL A. LEAFFER, UNDERSTANDING COPYRIGHT LAW (LexisNexis, 5th ed. 2010) *and* 17 U.S.C. § 102(a).

65. *See* Ruhl & Salzman, *supra* note 11, at 986. *Cf.* Stacy Hostetter, *The Privilege of Obscenity: The Slant on Bad Frogs and Flying Dogs,* 12 BUFF. INTELL. PROP. L.J. 99, 100 (2018).

66. Mariotti, *supra* note 10, at 252; LAWRENCE LESSIG, CODE AND OTHER LAWS OF CYBERSPACE 217 (1999).

67. *Compare* discussion *infra* Section III.A with Mariotti, *supra* note 10, at 256–57.

68. *See generally* Mariotti, *supra* note 10, at 275–76, 280–82, 297–300; OUTLINE DEPOT, *supra* note 57.

69. *See* N. Davey Neal, *Current and Future Issues Facing Local Brewers and Vinters*, *in* WINE AND BEER LAW: LEADING LAWYERS ON NAVIGATING THE THREE-TIER SYSTEM AND OTHER REGULATIONS ON ALCOHOLIC BEVERAGES 51, 52 (Thompson Reuters/Aspatore 2016); Eric Anderson, *Hogtied by Regulation: Alcohol Brands Beware This Super Bowl*, ADAGE (Jan. 26, 2018), https://adage.com/article/special-report-super-bowl/hog-tied-regulation-alcohol-brands-beware-super-bowl/312090; LexVid, *supra* note 4; Zahn, *supra* note 3, at 34, 42.

Tun Tavern; Philadelphia, PA (Est. 1686–1781)

A. Alcohol and its Places

According to Taffer, the second public building ever built in America was a bar (the first was a church), the Declaration of Independence and the U.S. Constitution were both conceived in a public house, Thomas Jefferson was America's first vinter, and in the 1800s Congress made whiskey the official spirit of America.[70]

John Greenwood, *Sea Captains Carousing in Surina* (1755)

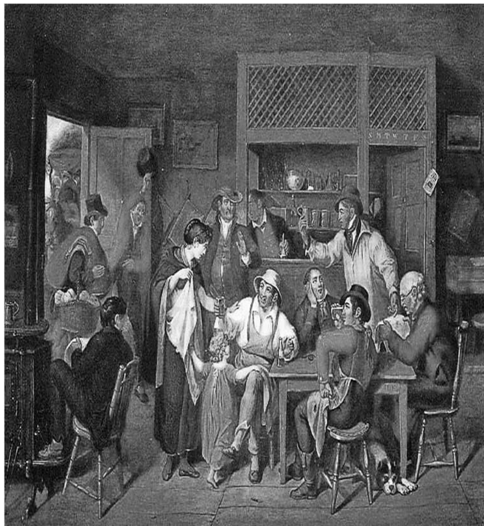
Public houses and taverns were not just places to drink. They served as clearinghouses, testbeds for revolutionary ideas, social hubs for like-minded individuals and travelers, eateries, entertainment venues, as well as meeting places for assemblies and courts. Sometimes, they served as scenes for the depictions of social life and historical events.[71]

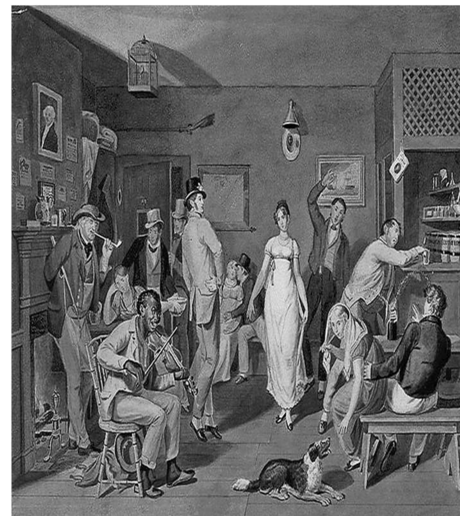
---

70. CPA Speakers Bureau, *supra* note 1; *see also* Steve Hendrix, *The Bender That Began America: Bar Tab Shows Framers Celebrated a Newly Finished U.S. Constitution and a Future President*, CHI. TRIBUNE (Feb. 22, 2018, 7:44 AM), https://www.chicagotribune.com/nation-world/ct-george-washington-bar-tab-20180222-story.html; Eric Milzarski, *How Washington Spent Thousands on Alcohol in a Single (Crazy) Night*, WE ARE THE MIGHTY (Sept. 04, 2018, 03:09 PM EST), https://www.wearethemighty.com/history/george-washinton-bar-tab; Salvatore Colleluori, *The Colonial Tavern, Crucible of the American Revolution*, WAR ON THE ROCKS (Apr. 17, 2015), https://warontherocks.com/2015/04/the-colonial-tavern-crucible-of-the-american-revolution/.

71. Colleluori, *supra* note 70. *See also* Steven Struzinski, *The Tavern in Colonial America*, 1 GETTYSBURG HIST. J. 29, 29–38 (2002); NANCY MAVEETY, GLASS & GAVEL: THE U.S. SUPREME COURT AND ALCOHOL 13 (Roman & Littlefield Pub. Group, Inc. 2019).

Washington Taking Leave of his Officers, Francis's Tavern; Broad St., NY (Dec. 4, 1783).





John Lewis Krimmel, *In an American Inn* (1814)
Barroom Dancing (1820)

Thus, unlike cyberspace, alcohol and its establishments have been apparent for centuries. But as will be explained further, alcohol faced religious scrutiny, corruption, and a short period of prohibition (a failed one at best) before its regulation became revamped, similar to that of thoroughbred racing.[72]

72. *See* discussion *supra* Section II.B.

1. Tied-Houses

Although some of its earlier functions were eliminated, the American tavern continued to thrive as a social gathering place for creative and like-minded individuals, and still does today. The White Horse Tavern, for example, which became later known for its famous literary and artistic patrons, continues to remain the second oldest pub in New York City.[73] However, one of alcohol's biggest breaking points, began near the 1890s.

White Horse Tavern in 1961, New York, NY (Est. 1880)

With the improvement of refrigeration and the help of improved transportation, tied-houses began appearing.[74] These were bars that, although were ostensibly run by an independent retailer, were required to buy some or all of its beer from a particular brewery/manufacturer. In exchange the brewery would provide the retailer equipment, materials, and help with business and financial planning.[75] As the brewing industry became more industrialized and breweries focused more heavily on maximizing profits, widespread drunkenness and alcohol's other negative effects on the family unit, marriage, and spiritual salvation began to rise, especially during World War One.[76] Additionally, tied-houses affected the markets due to their intense competition with one another, to the point where saloons were driven out of business.[77] As a result, the U.S. enacted the Eighteenth Amendment, which led to the Prohibition era.[78]

---

73. *See* THE WHITE HORSE TAVERN, http://www.whitehorsetavern1880.com/ (last visited April 19, 2020).
74. SZYMANKIEWICZ, *supra* note 8, at 183–84.
75. *Id.*; Neal, *supra* note 69, at 52–53; Seff & Bonnington, *supra* note 6, at 84–85.
76. SZYMANKIEWICZ, *supra* note 8, at 186–88; LexVid, *supra* note 4.
77. SZYMANKIEWICZ, *supra* note 8, at 186–88; Neal, *supra* note 69, at 53; Seff & Bonnington, *supra* note 6, at 84–85.
78. U.S. CONST. amend. XVIII; SZYMANKIEWICZ, *supra* note 8, at 186–88.

Prohibition agents destroying a bar

Women's Temperance Movement

2. Prohibition, Speakeasies, and Bootlegging

Arguably, Prohibition can be described as a failure.[79] When Prohibition took effect, bootlegging and private distilling operations started occurring. Private, unlicensed barrooms—nicknamed "speakeasies" for how low you had to speak the password to gain entry so as not to be overheard by law enforcement—also became venues for alcohol consumers. While they did cater to female patrons, jazz musicians, and ballroom dancing, they also became the subjects of organized crime from syndicate figures like Al Capone.[80]

Pictured in middle: Al Capone (1899–1947)

79. Seff & Bonnington, *supra* note 6, at 88; Andrew D'Aversa, *Brewing Better Law: Two Proposals to Encourage Innovation in America's Craft Beer Industry*, 165 U. PENN. L. REV. 1465, 1473 (2017).

80. *The Speakeasies of the 1920s*, PROHIBITION: AN INTERACTIVE HIST., http://prohibition.themobmuseum.org/the-history/the-prohibition-underworld/the-speakeasies-of-the-1920s/ (last visited Apr. 16, 2020); Ian Harvey, *Prohibition and Speakeasies in the US*, VINTAGE NEWS (Jan. 30, 2017), https://www.thevintagenews.com/2017/01/30/prohibition-and-speakeasies-in-the-us/; LexVid, *supra* note 4.

Furthermore, when the U.S. fell in the Great Depression, one of the strategies of rectification was to once again allow for the sale of beer, wine, and liquor and tax such products. And on February 20, 1933, President Herbert Hoover passed the Twenty First Amendment which repealed the Eighteenth Amendment and granted the states broad authority to regulate alcohol within their borders. Legal saloons and bars opened almost immediately, pre-existing illegal bars operated legally, and speakeasies vanished almost as fast. [81]

In 1935, Congress adopted the Federal Alcohol Administration Act (FAAA), which became the principal federal authority in governing the alcohol beverage industry.[82] Section 205 of the FAAA grants the Alcohol and Tobacco Tax and Trade Bureau (TTB)—formerly the Bureau of Alcohol, Tobacco, and Firearms (ATF)—the authority to adopt and enforce regulations regarding unfair competition and unlawful practices, such as exclusive outlets, tied houses, commercial bribery, and consignment sales.[83]

3. The Three-Tier System and State Regulation

Most importantly, the U.S. government proposed to the states a general architectural framework of regulation known as the three-tier system. It essentially regulates the *places* of the alcoholic beverage industry, listing them in three categories: (1) manufacturers, (2) wholesalers, and (3) retailers. Manufacturers cannot sell their products to individuals for purchase and sale. Instead they must sell their product to the wholesaler, who will then sell it to the retailer, i.e. a tavern, restaurant, liquor store, etc., or depending on their respective state laws, they may self-distribute under certain circumstances.[84] Wholesalers deal not only with distribution, but also marketing and the retailer's order fulfillment.[85]

It is important to note that the TTB takes on the role of licensing manufacturers and wholesalers, collecting revenue and ensuring that only licensed manufacturers are producing alcohol.[86] However, because of the vested broad powers states have in regulating alcohol within their borders, states have predominantly split into two regulatory systems: (1) control states, where the state government itself maintains some amount of control over the production, distribution, or retail sales of alcohol; and (2) license states, where license systems are implemented to allow private companies to distribute and sell alcohol to

81. Abel, *supra* note 6, at 9; LexVid, *supra* note 4; Harvey, *supra* note 80; Luke Basha, *It's Still 1970 Somewhere: How North Carolina's Small Craft Breweries Hope to "Craft Freedom" From Antiquated Statutes Friendly to Distributors and National Macrobreweries*, 18 WAKE FOREST J. BUS. & INTELL. PROP. L. 340, 350–52 (2018); David R. Scott, *Brewing Up A New Century of Beer: How North Carolina Laws Stifle Competition in the Beer Industry and How They Should Be Changed*, 3 WAKE FOREST J. L. & POLICY 417, 418–19 (2013).

82. *See* 27 U.S.C.A §§ 201 *et seq.*; Seff & Bonnington, *supra* note 6, at 82

83. *See* 27 U.S.C.A. § 205. The TTB resides within the Department of the Treasury. 27 C.F.R.; Seff & Bonnington, *supra* note 6, at 82.

84. LexVid, *supra* note 4; SZYMANKIEWICZ, *supra* note 8, at 192–94; Basha, *supra* note 81, at 352–53; Seff & Bonnington, *supra* note 6, at 83. In a sense, the three-tier system follows a similar framework as that of a corporation, which has three organs: shareholders, directors, and officers. *See also* MELVIN ARON EISENBERG & JAMES D. COX, BUSINESS ORGANIZATIONS: CASES & MATERIALS 269–70, 300 (West Acad., 11th ed. 2014).

85. Basha, *supra* note 81, at 352.

86. Seff & Bonnington, *supra* note 6, at 83; SZYMANKIEWICZ, *supra* note 8, at 191.

consumers.[87] Furthermore, local county, parish, and city ordinances can also affect the architecture of alcohol regulation, sometimes to the extent that they conflict with state regulation.[88]

There have been recent means of circumvention that have left the alcohol industry in a bind. In *Granholm v. Healm*,[89] the Supreme Court did allow wineries to break through the three-tier systems and sell directly to consumers. However, the Court still held that the three-tier system was still intact.[90] This change in architecture and the law may have not only impacted wine's perception to the public, but it arguably affects the market by giving wineries unfair advantages over craft breweries and distilleries.[91] One thing is paramount regarding state regulation: if it is not rooted in what the people of each state sincerely desire at this moment, it will not succeed regardless of how logical and complete it appears as a statute.[92]

B. Alcohol as a Good

It is a given that alcohol is a good—but it is not just any good. Firstly, alcohol is the only currently regulated and commercially traded commodity specifically mentioned in the Constitution. In fact, it is mentioned twice.[93] Secondly, alcohol is one of three commodities where franchising laws are treated differently.[94] Thirdly, alcohol has been regarded as recession-proof. These three distinctions show that alcohol is a unique good that will continue to exist.[95] According to a 2010 poll from the Gallup organization, alcohol consumption had generally remained consistent within the course of time regardless of economic conditions, though consumption did rise following the 2008 financial crisis.[96] At the same time, the rise in consumption can be a drawback, since excessive alcohol use can have devastating effects to the public, just like the kind that occurred during Prohibition.[97]

---

87. *See e.g.* John G. Mackie, *Local Regulation of Wine and Beer Producers in California*, *in* WINE AND BEER LAW: LEADING LAWYERS ON NAVIGATING THE THREE-TIER SYSTEM AND OTHER REGULATIONS ON ALCOHOLIC BEVERAGES 19 (Thompson Reuters/Aspatore 2016); Neal, *supra* note 69, at 53–57; Zahn, *supra* note 3, at 35–42, 46–47.

88. SZYMANKIEWICZ, *supra* note 8, at 242–47; Abel, *supra* note 6, at 12, 14–15; Seff & Bonnington, *supra* note 6, at 83–84, 88; Zahn, *supra* note 3, at 40–42.

89. 544 U.S. 460 (2005).

90. *Id.*

91. *See* Justin P. Weinberg & O. Joseph Balthazor Jr., *Stop Letting Wine Crash the Wedding: Craft Beer Consumers Are Sophisticated Buyer*, 8 CYBARIS 61 (2017); Seff & Bonnington, *supra* note 6, at 87–88; Neal, *supra* note 69, at 55–57.

92. *See* RAYMOND B. FOSDICK & ALBERY L. SCOTT, TOWARD LIQUOR CONTROL ix (Ctr. Alcohol Pol'y 2011).

93. U.S. CONST. amends. XVIII, XXI; *see* Seff & Bonnington, *supra* note 6, at 88; D'Aversa, *supra* note 79, at 1472–73.

94. SZYMANKIEWICZ, *supra* note 8, at 184–86, 279–80; Barry Kurtz & Brian H. Clements, *Beer Distribution As Compared to Traditional Franchise Law*, 33 FRANCHISE L. REV. 397 (2014).

95. *Compare* Easterbrook, *supra* note 10, at 207 *with* Seff & Bonnington, *supra* note 6, at 92 ("Alcohol has been said to be a recession-proof product because people who drink will always do so.") *and* Eric Rosenberg, *5 Recession Resistant Industries*, INVESTOPEDIA, https://www.investopedia.com/articles/investing/100115/5-recession-resistant-industries.asp (last updated Dec. 13 2019).

96. Neal, *supra* note 69, at 57; Frank Newport, *U.S. Drinking Rate Edges Up Slightly to 25-Year High*, GALLUP (July 30, 2010), https://news.gallup.com/poll/141656/drinking-rate-edges-slightly-year-high.aspx. *But see* Thomas Pellechia, *2019 U.S. Alcohol Consumption to Increase While Population Growth Stagnates*, FORBES (Jan. 2, 2019, 10:28 AM EST), https://www.forbes.com/sites/thomaspellechia/2019/01/02/2019-u-s-alcohol-consumption-to-increase-while-population-growth-stagnates/#4d9f9d0166bc.

97. *See* Roni A. Elias, *Three Cheers for Three Tiers: Why the Three-Tier System Maintains Its Legal Validity and Social Benefits After Granholm*, 14 DEPAUL BUS. & COMM. L.J. 209, 218–20 (2015).

Furthermore, the social uses of alcohol, like the Internet, can even affect court interpretation.[98]

1. Distinction from Food and Drug

One might be quick to make an Easterbrook-like argument about alcohol law being analogous to the Law of the Horse. Alcohol has sometimes been characterized as a food, so it would seem reasonable to simply apply food and drug law to alcohol. While some products, such as gluten free beers, can be additionally regulated by the Food and Drug Administration (FDA), the main regulating authority for alcoholic beverages is the TTB. The TTB is heavily procedural, regulating alcohol acquisition, label approval, advertising, licensing, formula approval, excise tax payments, and more.[99] By contrast, the FDA primarily affects alcohol regulation only in terms of *food safety*. While the FDA arguably does have an interest in regulating, supervising, and inspecting alcohol production facilities, the notion that the FDA would take over the TTB's role seems to have dissipated. For instance, both the TTB and FDA have agreed that merely adding coffee to beer, did not make it food for FDA purposes.[100]

2. Peculiarities of Wine, Beer, and Spirits

As mentioned earlier, a state's beer laws for instance can differ slightly from their wine laws. Each beverage can be governed and categorized by multiple factors such as their alcohol content by volume (ABV), other ingredient composition, place of manufacture, and more.[101] Thus, each of these beverages can receive different treatment, making careful study necessary, especially as new beverage creations are introduced.[102] Yet it is permissible to study one type of subindustry with more emphasis than another, depending on each state's particular laws and markets. Since such specialized characterizations can be done in entertainment law, why should alcohol regulation be viewed any differently?[103]

Nonlegal practices pertaining to alcohol production, distribution, and/or retail are important as well. Similar to how a cyberlaw practitioner would learn nonlegal practices, such as economics and computer technology, or how a music entertainment lawyer would learn music theory and music history, alcoholic beverage law also encourages one to study

---

98. *Compare* MAVEETY, *supra* note 71, at 1–4, 297–98 *with* cases cited *supra* note 37.

99. *Compare* Easterbrook, *supra* note 10, at 208 *with* Abel, *supra* note 6, at 13, Zahn, *supra* note 3, at 44, Seff & Bonnington, *supra* note 6, at 91, SZYMANKIEWICZ, *supra* note 8, at 191–228, *and* Robert Cattanach & Gabrielle Wirth, *Top Ten Pitfalls in Brewery and Winery Acquisitions*, *in* WINE AND BEER LAW: LEADING LAWYERS ON NAVIGATING THE THREE-TIER SYSTEM AND OTHER REGULATIONS ON ALCOHOLIC BEVERAGES 69, 71 (Thompson Reuters/Aspatore 2016)

100. SZYMANKIEWICZ, *supra* note 8, at 199–200; LexVid, *supra* note 4.

101. *See* Zahn, *supra* note 3, at 34–38, 42–45; SZYMANKIEWICZ, *supra* note 8, at 191–94, 198–202; Tammy Lam, *Brew Free or Die? A Comparative Analysis of U.S. and E.U. Craft Beer Regulations*, 23 CARDOZO J. INT'L & COMP. L. 197, 203–204 (2014).

102. *See generally* Weinberg & Balthazor Jr., *supra* note 91; Tracy Jong & Luis Ormaechea, *Trends to Note in Alcoholic Beverage Trademark Law That Can Impact the Decision Making Process for Businesses at Critical Points in the Alcoholic Beverage Product Life Cycle*, 12 BUFF. INTELL. PROP. L.J. 19, 35 (2018); Neal, *supra* note 69, at 56–57.

103. *Compare* SHERRI BURR, ENTERTAINMENT LAW IN A NUTSHELL (West Acad. Pub., 4th ed. 2017) *and* COREY FIELD, ENTERTAINMENT LAW: FUNDAMENTALS AND PRACTICE (Cognella Acad. Pub. 1st ed. 2018) *with* Weinberg & Balthazor, *supra* note 91; Scott, *supra* note 81; Mackie, *supra* note 87; Neal, *supra* note 69, at 56–57, *and* Abel, *supra* note 6, at 38–40.

how beer, liquor, and wine is made. For instance, many brewery/brewpub startups begin with the practice of home brewing.[104] Potential clients in the beer and wine industry start out as hobbyists who overtime develop creative aesthetics in the same way a home studio music producer does.[105] Additionally, learning about brewing also brings about beneficial agricultural knowledge[106] as well as the fundamentals of marketing[107] and economics.[108]

3. Lawyer Competency

While this portion of analysis might seem a bit out of place, as members of the legal profession, it is crucial to understand the ramifications alcohol can have on one's legal practice. Under the Model Rules of Professional Conduct, a lawyer has a duty of competency.[109] While alcohol may be a fun niche of a legal practice, it is equally important that alcohol should be engaged with responsibly and ethically.[110] Alcohol has been theorized as being a gateway drug due the following factors: (a) alcoholics are more likely to try other substances due to their personality; (b) Alcohol alters the brain, leading to a higher chance of addiction to other drugs; and (c) there is a clear progression pathway leading from alcohol to other substances.[111] Furthermore, alcohol and drug abuse can lead to violent behavior and possible criminal activity, both of which are detrimental to the legal field as a whole.[112] In this regard, alcoholic beverage law acts similarly to cyberlaw in a legal ethics context. A lawyer's use of technology impacts their communication with a client or another attorney and how discoverable evidence, money, or other property is maintained or distributed. Likewise, a lawyer's mental capacity affected by alcohol can have identical impacts.[113] Regardless of

---

104. *See* LexVid, *supra* note 4; *How to Brew*, AM. HOMEBREWERS ASSOC., https://www.homebrewersassociation.org/how-to-brew/ (last visited Apr. 16, 2020); *see also* Christopher J. Fraga, *A Room with a Brew: A Comparative Look at Homebrewing Laws in Japan & the United States*, 72 U. MIAMI L. REV. 1239 (2018).

105. *Compare* LexVid, *supra* note 4 *with* Adam Dachis, *The Basics of Music Production, Lesson 1: Set Up Your Home Studio,* LIFEHACKER (May 13, 2013, 12:00 PM), https://lifehacker.com/the-basics-of-music-production-lesson-1-set-up-your-h-499088482 *and CHAPTER 1: The 9 Home Recording Studio Essentials for Beginner*, E-HOME RECORDING STUDIO, https://ehomerecordingstudio.com/home-recording-studio-essentials/ (last visited Apr. 16, 2020).

106. *See* Zahn, *supra* note 3, at 44–45. *See generally* Mackie, *supra* note 87.

107. Seff & Bonnington, *supra* note 6, at 89–94. *See The Menu to Success*, JON TAFFER, https://jontaffer.com/the-menu-to-success/ (last visited April 20, 2020).

108. Elias, *supra* note 97, at 220–25.

109. *See* MODEL RULES OF PROF'L CONDUCT r. 1.1 (AM. BAR ASS'N 1983) ("A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."). Additionally, a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client. *See also* r. 1.16.

110. *See* Seff & Bonnington, *supra* note 6, at 94.

111. *See* Carol Galbicsek, *Drinking and Drugs*, ALCOHOL REHAB GUIDE, https://www.alcoholrehabguide.org/alcohol/drinking-drugs/ (last edited July 24, 2019); *Connection Between Alcohol and Drugs*, ALCOHOL REHAB, https://alcoholrehab.com/drug-addiction/connection-between-alcohol-and-drugs/ (last visited Apr. 15, 2020).

112. Galbicsek, *supra* note 111; ALCOHOL REHAB, *supra* note 111; *see also* Shelley Ross Saxer, *"Down with Demon Drink!": Strategies for Resolving Liquor Outlet Overconcentration in Urban Areas*, 35 SANTA CLARA L. REV. 123, 124–25 (1995).

113. *Compare supra* notes 109–112 and accompanying text *and* Ken Armstrong, *What Can You Do With a Drunken Lawyer?*, MARSHALL PROJECT (Dec. 10, 2014, 10:50 AM), https://www.themarshallproject.org/2014/12/10/what-can-you-do-with-a-drunken-lawyer *with* RYAN GARCIA & THADDEUS HOFFMEISTER, SOCIAL MEDIA LAW IN A NUTSHELL 357–398 (West Acad. Pub. 2017) *and* CHRISTINE E. BROUCEK, EDISCOVERY FOR THE LEGAL PROFESSIONAL 147–57 (Wolters Kluwer 2020).

the shifting views on alcohol as a good and its use, alcohol's effect on the legal competencies of attorneys as well as judges is crucial to understand.[114]

Additionally, placing such an emphasis on the effects of alcohol on a lawyer's competent representation would potentially help law students avoid a substance abuse issue before it even starts and exacerbates beyond graduation. According to a study conducted by the American Bar Association and the Hazelden Betty Ford Clinic, one in three lawyers say they have a drinking problem, and twenty eight percent of them suffer from depression. Among those who reported problem drinking, twenty seven percent say their problems started in law school.[115]

Thus, alcohol as a good, and not just an area of abstract legal study, can have effects worthy of study on a lawyer's competency to practice, social life, work productivity in law firms and courts (the architecture of the law), and the legal market as a whole.[116]

C. Alcohol and Mediums

Studying alcohol regulation in terms of its mediums is also crucial. According to Webster's Dictionary, the term *medium* can have two different meanings. The first definition is "something in a middle position." In a sense, wholesalers fit this definition. They act as an intermediary between large and powerful manufacturers and small independent retailers.[117] A retailer such as a tavern can perhaps be a medium too, since such establishments act as middlemen between the manufacturer and a consumer. This can be true when one thinks about the causal chain in strict products liability for example.[118] Thus, like cyberspace, manufacturers and retailers can be both the places and mediums of Alcoholic Beverage Law.[119]

But mediums can also be defined as means of transmission or conveyance.[120] The plural form of the word medium is *media*, which comprise of "channel[s] or system[s] of communication, information, or entertainment . . . publication[s] or broadcast[s] that carr[y] advertising, or . . . mode[s] of artistic expression or communication.[121] Here, the federal government can also be construed as media and plays a crucial role in the labeling and

114. MAVEETY, *supra* note 71, at 12.

115. Butler Center for Research, *Substance Use Disorders Among Legal Professionals*, HAZELDEN BETTY FORD FOUNDATION (March 16, 2017), https://www.hazeldenbettyford.org/education/bcr/addiction-research/substance-abuse-legal-professionals-ru-317; Nancy Rapp, *Problem Drinking Among Lawyers and Law Students*, ENJURIS, https://www.enjuris.com/students/lawyers-and-alcoholism.html (last visited Apr. 5, 2020); Staci Zaretsky, *The Struggle: Law Students Suffer From High Rates Of Depression And Binge Drinking*, ABOVE THE L. (May 12, 2016), https://abovethelaw.com/2016/05/the-struggle-law-students-suffer-from-high-rates-of-depression-and-binge-drinking/?rf=1.

116. *Compare* discussion *supra* Section III.C.3 *and* Elias, *supra* note 97, at 209–10, 218–20 *with* Lessig, *supra* note 10, at 506–07.

117. *Compare Medium*, MERRIAM-WEBSTER DICTIONARY [hereinafter MERRIAM WEBSTER], https://www.merriam-webster.com/dictionary/medium (last visited Apr. 20, 2020) *with* Paul Knettel, *Constitutional Mixologists: Muddling the Analysis of Protectionist Alcoholic Beverage Laws After Granholm v. Heald*, 93 WASH. U. L. REV. 1071, 1093 (2016), Basha, *supra* note 81, at 352, SZYMANKIEWICZ, *supra* note 8, at 262, *and* D'Aversa, *supra* note 79, at 1475.

118. *See generally* RESTATEMENT (SECOND) OF TORTS § 402A (1965).

119. *See* Mariotti, *supra* note 10, at 260–62.

120. MERRIAM WEBSTER, *supra* note 117 (emphasis added).

121. *Id.* (emphasis added). These mediums can also be considered channels of interstate commerce. *See generally* U.S. CONST. art. I., § 8, cl. 3; Gibbons v. Ogden, 22 U.S. 1 (1824).

advertising of alcoholic beverages.[122] Furthermore, after *Granholm* held that states may not use the Twenty First Amendment to create preferential treatment for in-state products to the detriment of interstate products in direct opposition to the Dormant Commerce Clause,[123] "states have been forced to get creative when exerting their police powers to still rightfully regulate [alcohol] in a commercial world that has stopped looking at state, national, and technological borders in the alcohol trade." Below are examples of mediums where analyzing the dissimilarities in regulation between all types of alcoholic beverages, from sake to kombucha, and other modalities of constraint within regulation is critical.[124]

1. Labeling and Branding

Labeling and branding convey the identity, authenticity, and viability of manufacturers and their products to wholesalers, retailers, and consumers. They communicate whether a bottle of sparkling wine is truly Champagne, whether a particular hard cider is 5% ABV, and so forth. These media can run into various intersections at both the federal and state level.[125] A product's label must be approved by the TTB before it can be sold or distributed. For that to happen, a Certificate of Label Approval (COLA) must be obtained containing descriptive information about the manufacturer and its product(s). Obtaining a COLA and TTB label approval can function similarly to how a corporation begins formation by filing articles of incorporation.[126] Labels can be rejected by the TTB at any time for their content, such as whether they include false or misleading statements, obscene or indecent material, or disparaging remarks of a competitor's product.[127] The FDA also has guidelines pertaining to alcohol-product naming and packaging.[128] During the branding phase, manufacturers face four critical decisions: (1) selecting and adopting a mark to represent them; (2) deciding whether to register that mark with the USPTO or rely on common law trademark protection; and (3) deciding how to use the mark; and (4) deciding how to enforce the mark against competitors and infringers. If not careful, manufacturers, especially those that are stable and highly profitable, can run the risk of entering into hefty trademark disputes with disparate results. Trademark disputes can even occur between different types of alcoholic beverages, making dissimilarity absolutely essential in the start of an alcoholic beverage business.[129]

---

122. See 27 U.S.C.A. §§ 213 et seq.; Neal, *supra* note 69, at 55.

123. 544 U.S. 460 (2005); Seff & Bonnington, *supra* note 6, at 87–88.

124. Zahn, *supra* 3, at 34–48; Neal, *supra* note 69, at 54–55; Hostetter, *supra* note 65, at 100; LexVid, *supra* note 4; Paul Knettel, *supra* note 111, at 1072–73.

125. *See generally*, Jong & Ormaechea, *supra* note 102; Weinberg & Balthazor Jr. *supra* note 91; Hostetter, *supra* note 65; SZYMANKIEWICZ, *supra* note 8, at 240–41, 249–61; Zahn, *supra* note 3, at 34–48; Jeff Ikejiri, *The Grape Debate: Geographic Indicators vs. Trademarks*, 35 SW. U. L. REV. 603 (2007).

126. *Compare* Will Kenton, *Articles of Incorporation*, INVESTOPEDIA, https://www.investopedia.com/terms/a/articlesofincorporation.asp (last Feb. 21, 2020) *with* SZYMANKIEWICZ, *supra* note 8, at 250–55.

127. 27 C.F.R. § 4.39 (2016); SZYMANKIEWICZ, *supra* note 8, at 256; Jong & Ormaechea, *supra* note 102, at 23–24.

128. *See* Jong & Ormaechea, *supra* note 102, at 24–25; LexVid, *supra* note 4; SZYMANKIEWICZ, *supra* note 8, at 257–60.

129. *See generally* Jong & Ormaechea, *supra* note 102; Weinberg & Balthazor Jr., *supra* note 91; Seff & Bonnington, *supra* note 6, at 84.

2. Advertising

Advertising can be a medium for alcohol retailers, whether it be via radio, outdoor murals, or the Superbowl.[130] Beers like Corona or Landshark, through their advertising, convey feelings of paradise and escape.[131] Certain classes of alcohol, such as wine or bourbon, can convey feelings of sophistication and luxury. Such connotations are clear in magazines[132] and even television commercials, such as the one showcasing mixed-martial artist Conor McGregor's Proper No. Twelve Irish whiskey.[133] While a state cannot diminish a retailer's First Amendment right to free speech in its advertisements,[134] both the state and the TTB do have roles in confirming that advertisements include the required information that corroborates with the products package label and avoids prohibited statements.[135]

3. Technology and Social Media

Craft breweries, distilleries, and wineries have a goal of reaching the public. But the rise in technology and social media apps can put a damper on this. While online grocery shopping and food delivery apps like GrubHub and Postmates are novel ways technology has reached consumers, they can involve potential complexities for the alcoholic beverage industry.[136] Also, due to tied-house laws, commercial bribery from manufacturers is prohibited. In other words, a manufacturer may not provide something of value to a retailer in exchange for consideration or purchasing product. This includes sponsoring giveaways, offering promotional merchandise to retailers, and providing free taxi, Uber, or Lyft rides home from bars and restaurants during special events, even if the supplier's only motivation is to keep intoxicated drivers out of their vehicles and off the streets for purposes of public safety.[137]

---

130. *See* Mariotti, *supra* note 10, at 262; Neal, *supra* note 69, at 54; Anderson, *supra* note 69; *Mural Advertising*, MATRIX MEDIA (Jan. 2, 2013), https://www.matrixmediaservices.com/mural-advertising/; Joshua M. Bernstein, *The 10 Coolest Murals You'll Find at Breweries*, BON APPÉTIT (June 10, 2015), https://www.bonappetit.com/drinks/beer/slideshow/murals-breweries.

131. Kim Banson MediaWorks, *CORONA Commercial Compilations*, YOUTUBE (Mar. 9, 2008), https://www.youtube.com/watch?v=XToHkp3mVZ8; Dan Evans, *Landshark Beer Commercial*, YOUTUBE (Sept. 17, 2015), https://www.youtube.com/watch?v=687Snfg1cHg.

132. *See* LUXURY ASIA MAG., https://luxuryasiainsider.com/ (last visited Apr. 16, 2020); *Wine Bar Sophistication Comes Home*, LUXURY LIVING INT'L, http://luxurylivingmag.com/1-must-have-wine-lovers/.

133. Proper Whiskey, *Proper No. Twelve – Challenger*, YOUTUBE (Jan. 13, 2020), https://www.youtube.com/watch?v=DGIu8Z-ksSI; Boxing Extravaganza, *Proper 12 Twelve Whiskey Commercial Conor McGregor*, YOUTUBE (Sept. 30, 2018), https://www.youtube.com/watch?v=XKA__-8B-W4.

134. *See* Neal, *supra* note 69, at 54; 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484 (1996).

135. SZYMANKIEWICZ, *supra* note 8, at 262–71; Cattanach & Wirth, *supra* note 99, at 74.

136. Seff & Bonnington, *supra* note 6, at 89–92. These apps are convenient for both consumers and businesses, especially during Covid-19. *See e.g.* Scott Broom, *Why Maryland is Keeping the Liquor Flowing as an 'Essential' Business During The Coronavirus Crisis*, WUSA9, https://www.wusa9.com/article/news/health/coronavirus/maryland-allows-liquor-alcohol-sales-as-essential-business-during-coronavirus-shutdown/65-4755ad80-8e68-493a-8632-751d817628d3 (Mar. 24, 2020 8:27 PM EDT); Jackie Dove & Alina Bradford, *The Best Food-Delivery Apps for 2020*, DIGITAL TRENDS (Apr. 13, 2020), https://www.digitaltrends.com/home/best-food-delivery-apps/.

137. Seff, *supra* note 6, at 89–92; SZYMANKIEWICZ, *supra* note 8, at 262–66. *See also* Anderson, *supra* note 69.

V. Conclusion

Alcohol is one of the biggest commodities in American history and will continue to be for many years to come. While "Craft Beer Law" may be way too specific and the "Law of the Brewery" would be as ineffective and too factually concrete as the "Law of the Horse" or "Law of the Coffeeshop,"[138] alcoholic beverage law can still be studied as a discrete legal topic through a three-dimensional view of the heavily regulated industry in terms of goods, places, and mediums. What makes alcoholic beverage law a peculiar subject is that 1) it shares similarities with entrepreneurship and thoroughbred racing, especially in terms of history, policy, and corruption; 2) it is more individualized procedurally than substantively; and 3) it departs from cyberlaw by recognizing Lessig's four modalities of constraint in something already familiar.

Law, social norms, markets, and architecture relating to alcohol and its establishments have significantly changed since Colonial times, have become fields worthy of specialization, and can hopefully continue to change for the better. There is no doubt that error in legislation may be common, especially as technology gallops forward. Fortunately, scholars, practitioners, and other participants should possess plenty of historical context to help the alcoholic beverage industry evolve and enjoy its benefits responsibly.[139]

---

138. *Cf.* Mariotti, *supra* note 10, at 256–57, 268–73, 297–300.

139. *See* Easterbrook, *supra* note 10, at 215–16; Zahn, *supra* note 3, at 34; Seff & Bonnington, *supra* note 6, at 94.

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

COPPA KILLED THE VIDEO STAR: HOW THE YOUTUBE SETTLEMENT SHOWS THAT COPPA DOES MORE HARM THAN GOOD

❖ ARTICLE ❖

Stephen Beemsterboer *

I. INTRODUCTION 64
II. BACKGROUND 64
  A. History of COPPA 64
  B. Youtube COPPA Violation Settlement 65
III. ANALYSIS 67
  A. The Requirement that Websites Segment Out Children is Ironically the Fundamental Problem with COPPA 67
    1. Segmentation by Age 67
    2. Segmentation by Content 70
  B. The Costs of COPPA Far Outweigh the Benefits 73
    1. COPPA's Supposed Benefits are Theoretical and Largely Elusive 73
    2. COPPA Negatively Impacts Small Business 76
    3. COPPA Reduces the Supply of Child-Friendly Content 79
    4. COPPA Drives Children to Age-Inappropriate Content 80
    5. COPPA Implicates First-Amendment Concerns 81
  C. Current Efforts to Expand COPPA Fail for the Same Reasons 83
IV. PROPOSAL 83
  A. Implement General, Age-Neutral Privacy Regulations 83
  B. Reinforce Measures that Protect the Physical Safety of Minors 85
  C. Empower and Entrust Parents to Moderate their Children's Online Activity 86
V. CONCLUSION 89

*J.D. Candidate, Class of 2022, University of Illinois College of Law.

I. Introduction

The Children's Online Privacy Protection Act of 1998[1] ("COPPA") purportedly protects children on the internet,[2] but the reality is that the law is woefully ineffective at this goal and yet terribly burdensome for website operators (and now, people who upload silly videos to YouTube). The Federal Trade Commission ("FTC"), the agency tasked with enforcing COPPA,[3] announced a whopping $170 million settlement with YouTube in September 2019,[4] with a message that focused more on bragging about the unprecedented size of the financial sum than any tangible benefit the settlement would provide for the well-being of children on the internet.[5] The settlement marks a shift in COPPA enforcement in which the FTC will begin targeting website users rather than the website itself.[6]

This note will argue that, after two decades and countless changes in society and the digital landscape,[7] it is time to completely rethink COPPA and replace it with a more workable and effective piece of legislation. Part II discusses the background of COPPA and the settlement between YouTube and the FTC. Part III analyzes the failures of COPPA using the YouTube settlement as a case study. Part IV proposes a solution which better serves the stated goals of COPPA while both expanding privacy protections and lowering the overall burden on website operators. Part V will conclude.

II. Background

A. History of COPPA

COPPA was passed in response to growing concerns throughout the 1990s about the safe use of the internet by children.[8] In particular, COPPA was aimed at "(i) [the] overmarketing to children and collection of personally identifiable information from children that is shared with advertisers and marketers, and (ii) children sharing information with online predators

1. 15 U.S.C. §§ 6501–05 (2018).

2. Anita L. Allen, *Minor Distractions: Children, Privacy and E-Commerce*, 38 Hous. L. Rev. 751, 767 (2001) ("COPPA was designed to protect the informational privacy of children and their families from excessive and unwanted disclosures of personal information.").

3. 15 U.S.C. § 6505(a) ("Except as otherwise provided, this chapter shall be enforced by the [Federal Trade] Commission under the Federal Trade Commission Act (15 U.S.C. 41 et seq.).").

4. Press Release, Fed. Trade Comm'n, Google and YouTube Will Pay Record $170 Million for Alleged Violations of Children's Privacy Law (Sep. 4, 2019) [hereinafter Settlement Press Release], https://www.ftc.gov/news-events/press-releases/2019/09/google-youtube-will-pay-record-170-million-alleged-violations.

5. *FTC Press Conference on Settlement with Google / YouTube*, Fed. Trade Comm'n (Sep. 4, 2019) [hereinafter *Press Conference*], https://www.ftc.gov/news-events/audio-video/video/ftc-press-conference-settlement-google-youtube ("The $170 million judgment is thirty times larger than the largest COPPA civil penalty the FTC has ever previously obtained. It is three times larger than any privacy penalty assessed against Google anywhere else in the world. And it is ten times larger than the civil penalties we have obtained in all of our thirty-one prior COPPA cases combined.").

6. The FTC notes that this is the first time a *platform* has been liable for the content its users post, but, as a result of the settlement holding YouTube liable as a platform, the FTC will begin directly targeting YouTube users. *Id.*

7. Lauren A. Matecki, Note, *Update: COPPA Is Ineffective Legislation! Next Steps for Protecting Youth Privacy Rights in the Social Networking Era*, 5 Nw. J. L. & Soc. Pol'y 369, 370 (2010) ("Ten years after the passage of COPPA, the landscape of the Internet, particularly with regard to children and adolescents, has changed dramatically.").

8. Matecki, *supra* note 7, at 369.

who could use it to find them offline."[9] COPPA was implemented by the FTC through its Child Online Privacy Protection Rule,[10] which took effect April 21, 2000.[11]

In general, COPPA regulates the collection of personal information from children and applies to websites[12] "directed to children" and those whose operators have "actual knowledge" of child users.[13] Children are identified as individuals under the age of thirteen.[14] The five key requirements of the act are notice, parental consent, parental review, security, and limits on the use of games and prizes.[15] In order to legally collect covered personal information from a child, a website operator must first obtain "verifiable parental consent" in a form that varies based on the intended use of the information.[16] The FTC's most recent amendments to the COPPA rule took effect in 2013 and clarified that the regulations are applicable to web services and mobile apps and that "personal information" includes geolocation data, device identifiers, and media containing the voice or image of a child.[17]

B. YouTube COPPA Violation Settlement

In September 2019, the FTC, acting with the Attorney General of New York, announced that it reached a settlement with YouTube and parent company Google in response to allegations that the services "illegally collected personal information from children without their parents' consent," in violation of COPPA.[18] The companies agreed to pay $34 million to New York and $136 million to the FTC, the latter penalty being "by far the largest amount the FTC has ever obtained in a COPPA case since Congress enacted the law in 1998."[19]

The complaint lodged against YouTube accused the company of using persistent identifiers to track users across the internet, collecting data which fell within the definition of

---

9. Melanie L. Hersh, Note, *Is COPPA a Cop Out? The Child Online Privacy Protection Act as Proof That Parents, Not Government, Should Be Protecting Children's Interests on the Internet*, 28 FORDHAM URB. L.J. 1831, 1854 (2001).

10. 16 C.F.R. § 312 (2020).

11. Hersh, *supra* note 9, at 1854.

12. Though this note will primarily refer to "websites," the law also applies to web services and mobile apps. *Complying with COPPA: Frequently Asked Questions*, FED. TRADE COMM'N (Mar. 20, 2015) [hereinafter *COPPA FAQ*], https://www.ftc.gov/tips-advice/business-center/guidance/complying-coppa-frequently-asked-questions ("The Rule applies to operators of commercial websites and online services (including mobile apps) . . . .").

13. 16 C.F.R. § 312.3 (2020) ("It shall be unlawful for any operator of a Web site [sic] or online service directed to children, or any operator that has actual knowledge that it is collecting or maintaining personal information from a child, to collect personal information from a child in a manner that violates the regulations prescribed under this part.").

14. *Id.* § 312.2.

15. Laurel Jamtgaard, *Big Bird Meets Big Brother: A Look at the Children's Online Privacy Protection Act*, 16 SANTA CLARA COMPUTER & HIGH TECH. L.J. 385, 388 (2000).

16. 16 C.F.R. § 312.5 ("An operator is required to obtain verifiable parental consent before any collection, use, or disclosure of personal information from children, including consent to any material change in the collection, use, or disclosure practices to which the parent has previously consented."); Matecki, *supra* note 7, at 377–78 (footnotes omitted) ("[T]he Rule enacts what is referred to as a 'sliding scale' of consent; that is, the efforts that website operators must take to ensure that parental consent is legitimate are proportional to the degree to which the personal information will be used. Under this test, e-mail verification of parental consent is justified when the website operator does not provide information to third parties, but a 'higher' method of consent (such as a print and mail form) would be necessary for activities that could pose a greater risk to children.").

17. Gianna Korpita, *It's Small World After All: How Disney's Targeted Advertisements Implicate COPPA*, 19 J. HIGH TECH. L. 407, 415–16 (2019).

18. Settlement Press Release, *supra* note 4.

19. *Id.*

"personal information" under COPPA.[20] YouTube ran afoul of the law because it never obtained parental consent to collect this information, even though it was aware that children were using the service.[21] YouTube used this information to display targeted ads to users (including children), purportedly earning "millions of dollars."[22]

YouTube's noncompliance stems from positioning itself as a general audience site whose terms prohibit users under the age of thirteen.[23] If legitimately enforced, this would have placed YouTube outside of the scope of COPPA.[24] However, the FTC and New York Attorney General took issue with this assertion because certain "channels"[25] and videos were apparently "child-directed," and in some instances YouTube marketed itself as a popular destination for children.[26] Moreover, beyond the fact that portions of the site could be deemed "child-directed," the complaint against YouTube alleged that the site fell within the scope of COPPA because the company, per the text of the rule, had "actual knowledge that it [was] collecting or maintaining personal information from a child."[27]

Pursuant to the settlement agreement,[28] YouTube was required to implement changes on its platform that would bring it into compliance with COPPA going forward.[29] The changes, which YouTube announced on the same day the FTC issued its press release,[30] required the company to "develop, implement, and maintain a system that requires creators[31] to identify their child-directed content on the YouTube platform."[32] These changes went into effect in early 2020.[33] Marking content as "child-directed" allows YouTube to "treat data from anyone watching children's content on YouTube as coming from a child, regardless of the age of the user."[34] Accordingly, the service "limit[s] data collection and use on videos made for kids," consistent with the minimal amount allowed by COPPA (without obtaining parental consent).[35] In practice, this means that YouTube no longer serves personalized ads and has removed commenting, notification, and other functionalities entirely from child-directed content.[36]

---

20. *Id.*; Complaint for Permanent Injunction, Civil Penalties, and Other Equitable Relief at 15, *FTC v. Google LLC*, No. 1:19-cv-2642 (D.D.C. Sep. 4, 2019) [hereinafter Complaint], https://www.ftc.gov/system/files/documents/cases/youtube_complaint.pdf.

21. Settlement Press Release, *supra* note 4.

22. *Id.*

23. *Id.*

24. *See supra* text accompanying notes 12–14.

25. *See infra* note 31.

26. Settlement Press Release, *supra* note 4.

27. Complaint, *supra* note 20, at 6; 16 C.F.R. § 312.3.

28. Stipulated Order for Permanent Injunction and Civil Penalty Judgment, *FTC v. Google LLC*, No. 1:19-cv-2642 (D.D.C. Sep. 4, 2019) [hereinafter Settlement], https://www.ftc.gov/system/files/documents/cases/172_3083_youtube_coppa_consent_order.pdf.

29. Settlement Press Release, *supra* note 4.

30. *An update on kids and data protection on YouTube*, YOUTUBE OFFICIAL BLOG (Sep. 4, 2019) [hereinafter *YouTube Blog Post*], https://youtube.googleblog.com/2019/09/an-update-on-kids.html.

31 "YouTubers," "creators," or "channel owners" are users who produce and upload video content onto YouTube. A "channel" is a creator's collection of videos. *What is a YouTube Creator?*, MEDIAKIX, https://mediakix.com/blog/what-is-a-youtube-creator-definition/ (last visited Mar. 22, 2020).

32. Settlement Press Release, *supra* note 4.

33. Todd Spangler, *What You Need to Know About YouTube's New COPPA Child-Directed Content Rules*, VARIETY (Jan. 3, 2020), https://variety.com/2020/digital/news/ftc-rules-child-directed-content-youtube-1203454167/.

34. *YouTube Blog Post*, *supra* note 30.

35. *Id.*

36. *Id.*

III. Analysis

A. The Requirement that Websites Segment Out Children is Ironically the Fundamental Problem with COPPA

Ironically, virtually all of COPPA's shortcomings can be traced to its premise of singling out children. COPPA's regulations apply only to websites that knowingly cater to children, whether intentionally or not.[37] Websites whose content is "child-directed" are presumed to be dealing with children and must comply,[38] as do websites which have identified users that are children.[39] Therefore, a website may segment users who are subject to COPPA protections based on the age of the user or the theme of the content. Theoretically, a website may treat children and non-children differently on the same website, but, in practice, most sites exclusively cater to children (in which COPPA would apply) or bar children entirely (at least in theory, in which COPPA would not apply).[40]

However, many websites have a general appeal and therefore fall into a grey area: they are not necessarily intentionally directed towards children, they ostensibly prohibit children, and they ignore the reality that many children use them nonetheless.[41] The FTC's action against YouTube signals the agency's intent to crack down on other websites that fall into this grey area and are willfully flouting the requirements of COPPA.[42] But YouTube's old approach (segmenting by age, albeit in name only) and their new, settlement-mandated approach (segmenting by content) both demonstrate the flaws of singling out children in the first place.

1. Segmentation by Age

Segmentation by age is, unsurprisingly, achieved by using an individual's age to classify her as a child or not and tailor the experience accordingly. As had been the policy of YouTube prior to the settlement, for a large swath of websites, the "experience" tailored to children is simply a complete bar.[43] Age may be discerned by asking for the user's birthdate or inferred from information such as a school grade level.[44] However, age segmentation is

---

37. *See* 16 C.F.R. § 312.3.

38. *Press Conference*, *supra* note 5, at 17:06 ("Where the content is directed to children, we are presuming the users are twelve and under.").

39. 16 C.F.R. § 312.3 (identifying "any operator of a Web site [sic] or online service directed to children, or any operator that has actual knowledge that it is collecting or maintaining personal information from a child").

40. Matecki, *supra* note 7, at 370 ("[T]he practical effect of COPPA causes websites simply to ban users twelve and under.").

41. *Id.* at 371 (noting that "many websites operate outside of COPPA regulations by making empty attempts to ban users under the age of thirteen").

42. The FTC has previously noted circumstances in which general audience websites must comply with COPPA. *See, e.g.*, *COPPA FAQ*, *supra* note 12 ("[COPPA] applies to operators of general audience websites or online services with actual knowledge that they are collecting, using, or disclosing personal information from children under 13.").

43. Matecki, *supra* note 7, at 370 ("[T]he practical effect of COPPA causes websites simply to ban users twelve and under.").

44. Jamtgaard, *supra* note 15, at 395–96 (internal quotation marks omitted) ("The FTC will be on the lookout for web sites who do not ask for age but who ask for information that conveys the same idea. The FTC will examine closely sites that do not directly ask age or grade, but ask 'age identifying' questions such as what type of school do you go to: (a) elementary; (b) middle; (c) high school; (d) college.").

often implemented simply by prompting the user to confirm she is at least thirteen or accept terms of service that stipulate the same.[45] Whatever the case may be, segmentation by age is hopelessly ineffective because it is arbitrary and unworkable (either by virtue of the ease with which users can falsify their age or the inordinate burden imposed by implementing a more effective solution).

First, segmentation by age is arbitrary. The basis for which Congress adopted thirteen as the age in which internet users no longer need the protections afforded by COPPA is tenuous.[46] Many commentators point out that teenagers (individuals between thirteen to seventeen years old) are particularly susceptible to revealing personal information on the internet, especially with the rise of social media.[47] Additionally, children develop and mature at different rates based on a host of factors from biological to socioeconomic.[48] A binary approach ignores individual circumstances and deprives both parents and children of the opportunity to make informed decisions about the information and services they wish to access.[49] While parents are theoretically included in the decision-making process via parental consent mechanisms, there is no option catering to parents who prefer that their children have unfettered access to the internet generally or access to specific services which prohibit children, save for the blessing to falsify parental consent or age.[50]

Second, most methods to segment by age are, in fact, easy to falsify. As mentioned above, the easily falsifiable age verification methods include asking for a birthdate or simply

---

45. Hersh, *supra* note 9, at 1869 ("To verify age, many websites merely ask a user to check a box indicating whether he or she is over the age of thirteen."); Shannon Finnegan, Note, *How Facebook Beat the Children's Online Privacy Protection Act: A Look into the Continued Ineffectiveness of COPPA and How to Hold Social Media Sites Accountable in the Future*, 50 SETON HALL L. REV. 827, 834–35 (2020) (noting that, instead of explicitly verifying age, Instagram's "terms and conditions restrict the use of [its service] to users who are at least thirteen years old").

46. Allen, *supra* note 2, at 759, 772 (footnotes omitted) ("Although the FTC states that the age of thirteen is the standard for distinguishing adolescents from young children who may need special protections, it fails to state why it assumes that only young children 'may not understand the safety and privacy issues . . . and are particularly vulnerable.' . . . [COPPA] draws a line of dubious justification between teenagers and 'tweenagers.' A number of younger children will be as able as many teenagers when it comes to circumventing the requirements of the statute. Some children under thirteen are no more or less in need of parental control than teenagers. Thus the statute seems morally arbitrary."); Metcki, *supra* note 7, at 399–400 ("While the FTC argues that children under the age of thirteen are particularly vulnerable and in need of special protections online, the expanded abuse of young people's personal information, along with other dangers from over-sharing online since COPPA's enactment, have proven that such vulnerabilities are not limited to young people under thirteen. . . . Teenagers, like children, may not be able to grant meaningful consent to the use of their personal information online under the current framework.").

47. Matecki, *supra* note 7, at 399–400 ("Given the social pressures teens face to interact online, and the prevalence of social networking sites as a means of communication, it is no longer accurate to assume that teenagers are protected from the risks of dissemination of personal information online."); Allen, *supra* note 2, at 759 ("[O]ne study suggested that teenagers may be a bigger problem for online disclosures of private information about their households than children under thirteen."). The FTC acknowledges that teens may need special protections as well, but the cutoff age of thirteen is fixed in the statute and cannot be changed directly by the FTC. *See COPPA FAQ*, *supra* note 12 ("Congress determined to apply the statute's protections only to children under 13 . . . . Although COPPA does not apply to teenagers, the FTC is concerned about teen privacy and does believe that strong, more flexible, protections may be appropriate for this age group.").

48. *See generally* Kimberly G. Noble, *Socioeconomic Inequality and Children's Brain Development*, AM. PSYCHOL. ASS'N (Oct. 2016), https://www.apa.org/science/about/psa/2016/10/socioeconomic-brain-development.

49. Hersh, *supra* note 9, at 1858 ("[G]overnment regulation of the Internet does not allow parents to have enough control over what their children see or hear, and this kind of control has been constitutionally placed in their hands.").

50. Allen, *supra* note 2, at 764 ("Parents cannot waive the protection entailed by certain COPPA requirements and prohibitions."); Hersh, *supra* note 9, at 1871 ("[S]ome parents would prefer to have their children lie about their ages than to give out their credit card numbers to verify their permission, as required by COPPA."); Amy Iverson, *Facebook and Instagram are Cracking Down on Underage Users*, DESERET NEWS (Jul. 26, 2018) https://www.deseret.com/2018/7/26/20649741/facebook-and-instagram-are-cracking-down-on-underage-users (noting that, with respect to Facebook, "many parents have lied for their kids to get around the age requirement and create accounts").

prompting the user to verify she is thirteen or older.[51] "Best practice" suggests that these methods should prevent a user from hitting the back button and simply entering a different choice upon realizing they are too young to access the website.[52] Ironically, such a technique would require the website to place a persistent identifier to keep track of the user's age and continue to block access.[53] Legitimate adults could be obstructed from using the website if they inadvertently clicked the wrong option when attempting to sign up. However effective such methods would be in restricting children from particular sites (tech-savvy children can simply clear their cookies and try again), children will quickly learn that they can simply falsify their age when signing up on websites in the future.[54] Similarly, children will easily figure out how to circumvent parental consent mechanisms that ask for a parent's email address to obtain consent.[55] These ineffective verification mechanisms are the basis for the prevalence of websites that are purportedly restricted to users thirteen or older yet teeming with children; these sites are effectively compliant with COPPA if it cannot be proven that the operators have "actual knowledge" of their very real child users.[56]

Third, methods that more effectively verify age are unduly burdensome. Accurately verifying a user's age and verifying parental consent are essentially the same problem: the information must be authenticated such that it is virtually impossible for a child to falsify or circumvent.[57] In the context of parental consent, the FTC originally proposed verification by means of a signed form that was mailed or faxed, a phone call, or a credit card transaction.[58] However, these methods pose a significant financial burden for website operators, are slow and cumbersome for users, and actually do very little to hamper the efforts of a determined child.[59]

Age segmentation methods that are truly effective would require a user to present a document such as government-issued identification or provide private information that can be independently verified by a third-party agency or service—tragic irony for a regulation predicated on the importance of privacy.[60] If COPPA was strictly implemented and enforced based on an effective form of age segmentation on all "general audience" websites (those in a

51. *See supra* notes 44–45 and accompanying text.

52. *COPPA FAQ*, *supra* note 12 ("[C]onsistent with long standing Commission advice, FTC staff recommends using a cookie to prevent children from back-buttoning to enter a different age.").

53. *Id.*

54. Matecki, *supra* note 7, at 387 ("[Commonly used age-]screening methods are technologically ineffective, as computer-savvy children often know how to circumvent these attempted roadblocks.").

55. Hersh, *supra* note 9, at 1870 ("Many children have realized that all they need to do is open an e-mail account under a parent's name, and give permission to themselves.").

56. Matecki, *supra* note 7, at 386-87 (footnotes omitted) ("[W]ebsites now often use age-screening methods to prohibit users under the age of twelve. . . . The ease of age falsification leads to a situation where children may share personal information on a website which seeks to operate outside of COPPA restrictions because it 'officially' doesn't allow underage users."); *see also supra* note 54.

57. Theoretically, parental consent should also confirm the relationship between the child user and her purported parent or guardian, but that particular concern was entirely lacking in the materials consulted for this note.

58. Matecki, *supra* note 7, at 377.

59. Children may be able to send in a forged form via fax or mail, call a hotline posing as their parent, obtain access to their parent's credit card, or have a credit card of their own. Hersh, *supra* note 9, at 1871.

60. Matecki, *supra* note 7, at 400 ("Identifiers such as social security or driver's license numbers could be used to verify age; however, the issue then becomes whether or not these extra verification measures pose an even greater risk to privacy, as websites would then be required to maintain large databases of children, teenagers', and their parents' most sensitive information."); Hersh, *supra* note 9, at 1871 (footnotes omitted) ("[P]arents are not happy supplying their credit card numbers in order to verify their adult status. This exposes them to the same privacy risks as the ones from which they are trying to protect their children.").

grey area in that they attract children as well as adults, like YouTube), all users (regardless of age) would either be required to submit a nontrivial amount of private information in a cumbersome sign-up form before using the website or sacrifice some level of functionality, compromising the prized efficiency, interactivity, and anonymity of the internet, and likely raising constitutional issues on First Amendment grounds.[61] Considering these issues, segmentation by age fails for being ineffective or unworkable, depending on the method.

2. Segmentation by Content

The various weaknesses of the "segmentation by age" approach are likely why the FTC imposed a "segmentation by content" strategy upon YouTube. However, this approach is not without its own issues. This approach, reflected in the changes prescribed by the YouTube settlement, is implemented by selectively adhering to COPPA's data-collection regulations when the content being accessed is directed towards children.[62] This is effectively a hybrid approach for general audience websites that, while not child-directed as a whole, nonetheless attract children and therefore should comply with COPPA provisions on sections of the site which deliver content deemed to be "child-directed." This is the first time the FTC has mandated such a content classification strategy.[63] Ultimately, this kind of segmentation is flawed because classifying content as "child-directed" is too subjective, necessarily impacts adults seeking the same content, and is a backwards approach in terms of the overall benefit to children.

First, segmentation by content is incredibly subjective and messy. The term "child-directed" suggests the standard is based on the content creator's subjective intent to target children, but the guidelines offered by the FTC[64] and acknowledged by YouTube's new approach to handling "child-directed" content[65] indicate this standard is actually objective, based on what children typically find attractive.[66] Since the "child-directed" standard is based

61. *See infra* Part III.B.5. *See also* Ashcroft v. ACLU, 542 U.S. 656, 682–83 (2004) (footnotes omitted, emphasis added) ("In addition to the monetary cost, and despite strict requirements that identifying information be kept confidential, the identification requirements inherent in age screening may lead some users to fear embarrassment. Both monetary costs and potential embarrassment can deter potential viewers and, in that sense, the statute's requirements may restrict access to a site. But this Court has held that in the context of congressional efforts to protect children, restrictions of this kind do not *automatically* violate the Constitution."); Reno v. ACLU, 521 U.S. 844, 876–77 (1997) (footnote and citation omitted) ("As a practical matter, the Court also found that it would be prohibitively expensive for noncommercial—as well as some commercial—speakers who have Web sites to verify that their users are adults. These limitations must inevitably curtail a significant amount of adult communication on the Internet.").

62. Settlement, *supra* note 28.

63. *Press Conference*, *supra* at note 5 (noting that the settlement requires measures above and beyond COPPA which no other company is currently subject to).

64. *See* Kristin Cohen, *YouTube Channel Owners: Is Your Content Directed to Children?*, FED. TRADE COMM'N (Nov. 22, 2019) https://www.ftc.gov/news-events/blogs/business-blog/2019/11/youtube-channel-owners-your-content-directed-children.

65. *See Set Your Channel or Video's Audience*, YOUTUBE HELP (last visited May 30, 2020) https://support.google.com/youtube/answer/9527654.

66. The FTC provides a list of factors pertaining to characteristics of the content which are used to determine if it is child-directed, which indicates that the standard is not based on subjective intent of the creator. The FTC also suggests a heuristic which is reminiscent of a "reasonable person" objective standard: "if you've applied the factors listed in the COPPA Rule and still wonder if your content is 'directed to children,' it might help to consider how others view your content and content similar to yours." Cohen, *supra* note 64.

on vague guidelines and not a bright-line rule, it can be difficult to determine the scope.[67] While websites like Club Penguin[68] or Webkinz[69] are undoubtedly made for kids, and fall squarely within the definition of "child-directed," other websites, e.g. a breakfast cereal brand marketing site, are less obvious.

The issue becomes more pronounced when applying the "child-directed" standard to discrete pieces of content, as is necessary with this segmentation approach. It's not hard to see how videos never intended to be for children could be ensnared by the standard.[70] Video games are popular among children, but they have wide appeal among adults as well.[71] Would a video made by an adult video game player with the expectation that it would be viewed by other adults be considered child-directed?[72] What about a video about Legos, suitable for ages four to ninety nine?[73] A new smart phone unboxing video?[74] Crafting tutorials or nature documentaries?

Not only does the generalization about what type of content children like overzealously captures content of general appeal, it ignores the reality that children's interests are neither monolithic nor static.[75] What is interesting to some children may not be interesting to others, echoing the issues with arbitrarily defining a child as an individual under the age of thirteen in the first place.[76] Moreover, what is interesting to most kids today may no longer be in just a matter of months.[77] Additionally, content which, at first blush, appears to be "child-directed" based on the guidelines could actually be inappropriate for children. Adult-oriented cartoons

---

67. The FTC admits, "[t]he determination of whether content is child-directed will be clearer in some contexts than in others." Cohen, *supra* note 64. *See also* Spangler, *supra* note 33 ("even attorneys who have worked in the area for years say it's not a clear-cut process").

68. *See* Sarah Perez, *Club Penguin is Shutting Down*, TECHCRUNCH (Jan. 31, 2017) https://techcrunch.com/2017/01/31/club-penguin-is-shutting-down/.

69. *See* WEBKINZ, https://www.webkinz.com/ (last visited Mar. 22, 2020).

70. *See, e.g.*, Makena Kelly & Julia Alexander, *YouTube's New Kids' Content System Has Creators Scrambling*, VERGE (Nov. 13, 2019, 3:06 PM), https://www.theverge.com/2019/11/13/20963459/youtube-google-coppa-ftc-fine-settlement-youtubers-new-rules ("Some of YouTube's most popular categories falls into a gray area for the policy, including gaming videos, family vlogging, and toy reviews."). *But see* Cohen, *supra* note 64 ("First, unless you're affirmatively targeting kids, there are many subject matter categories where you don't have to worry about COPPA. . . . Second, just because your video has bright colors or animated characters doesn't mean you're automatically covered by COPPA.").

71. *See 2019 Essential Facts About the Computer and Video Game Industry*, ENT. SOFTWARE ASS'N, https://www.theesa.com/esa-research/2019-essential-facts-about-the-computer-and-video-game-industry/ (last visited Mar. 22, 2020).

72. According to the FTC, "if your content includes traditional children's pastimes or activities, it may be child-directed." Cohen, *supra* note 64. Are video games a traditional children's activity?

73. *LEGO® Large Creative Brick Box*, LEGO, https://www.lego.com/en-us/product/lego-large-creative-brick-box-10698 (last visited Mar. 22, 2020).

74. Unboxing videos have caught the attention of lawmakers because of their appeal to children, but does that make them child-directed? *See* Simon Books, *YouTube Unboxing Videos for Kids Could Face New Limitations with Proposed Law*, MOMS (Mar. 8, 2020), https://www.moms.com/youtube-unboxing-videos-new-limitations-proposed-law/.

75. *See, e.g.*, *Encouraging Your Child's Interests*, LANE KIDS (Apr. 10, 2013), https://www.lanekids.org/encouraging-your-childs-interests/; Lauren Lowry, *What Makes Your Child "Tick"? Using Children's Interests to Build Communication Skills*, HANEN CTR., http://www.hanen.org/Helpful-Info/Articles/What-Makes-Your-Child-Tick-.aspx (last visited May 30, 2020).

76. *See supra* Part III.A.1.

77. *See generally* Tamika S. Laldee, *Fads and Children: The Early Culture of Consumption*, SYRACUSE UNIVERSITY HONORS PROGRAM CAPSTONE PROJECTS (2006) https://surface.syr.edu/honors_capstone/632 (analyzing fads among children).

and video game content that feature crass commentary are some examples which merely scratch the surface.[78]

Second, segmentation by content needlessly interferes with adult internet use. By making the dubious determination that a piece of content is child-directed and therefore stripped of certain functionalities for COPPA compliance, adults are universally but needlessly impacted when accessing such content.[79] This affects access of not only the wide range of content that is arguably not actually "child-directed" (but might be classified as such nonetheless) but also access of genuinely child-directed content. Plenty of content that is meant for kids is enjoyed by nostalgic adults.[80] There is little reason to prevent adults from freely consenting to the type of data collection proscribed by COPPA in connection with their interaction with content that has been classified as "child-directed," whether accurately or not.

Third, segmentation by content based on the "child-directed" standard is arguably backwards. As a preface, COPPA's privacy-based objective focuses on information *received from*, rather than *delivered to*, children. But use of this standard to classify content by YouTube is primarily meant to protect itself from further COPPA violations rather than provide any meaningful protection to children.[81] Children will still be tracked and delivered targeted ads on any other video on the platform not marked as "child-directed," and, as discussed, the diverse interests of children will inevitably lead many to view such content anyways.

Instead of employing this new content labelling system to classify content that is *appropriate* for children, enabling filtering software to limit access to inappropriate content (admittedly a different objective), the "child-directed" standard targets only content *meant* for children (and poorly at that). Child-directed content is stripped of features to comply with COPPA, but less appropriate content is feature-rich, fully accessible to children, and still rife with the features prohibited by COPPA.[82] Indeed, the "child-directed" classification would be wholly ineffective if used to filter content because it might simultaneously include some inappropriate content (improperly identified as "child-directed," as noted above) and exclude some child-appropriate content (consider, for example, a video of a classical music performance: appropriate for children but nonetheless not directed towards children).

---

78. *But see* Cohen, *supra* note 64 ("While many animated shows are directed to kids, the FTC recognizes there can be animated programming that appeals to everyone."). Also note that the classification is only between "made for kids" and "not made for kids," so a decidedly adult video and a general audience, "all ages" video, if properly tagged, fall into the same category.

79. As indicated by YouTube in its initial statement, child-directed content will be handled consistently regardless of the age of the user. *YouTube Blog Post*, *supra* note 30 ("[W]e will treat data from anyone watching children's content on YouTube as coming from a child, regardless of the age of the user.").

80. *See, e.g.*, Comment to Cohen, *supra* note 64 ("What about . . . [c]artoons that are directed towards children but that may not only appeal to children[,] such as My Little Pony, which has many adult and teen fans? . . . Adults can like kid stuff too.").

81. By implementing this system in accordance with the settlement, YouTube is able to shift the onus *and* liability of content classification onto creators. The FTC has made it clear that its attention will turn to the creators themselves. Kelly & Alexander, *supra* note 70 ("In its September order, the FTC made it clear that it could sue individual channel owners who abuse this new labeling system. Crucially, those lawsuits will fall entirely on channel owners, rather than on YouTube itself. Under the settlement, YouTube's responsibility is simply to maintain the system and provide ongoing data updates."). *See also* Makena Kelly, *Google Will Pay $170 Million for YouTube's Child Privacy Violations*, VERGE (Sep. 4, 2019, 9:41 AM), https://www.theverge.com/2019/9/4/20848949/google-ftc-youtube-child-privacy-violations-fine-170-milliion-coppa-ads (noting that FTC commissioner Rebecca Kelly Slaughter dissented to the settlement in part because "the agency requires too little of [YouTube] in disciplining creators who mislabel their content").

82. Kelly & Alexander, *supra* note 70 ("[C]hild-directed videos will no longer include a comments section, click-through info cards, end screens, notification functions, and the community tab . . . .").

Overall, segmentation by content does little to further the supposed goals of COPPA with respect to the protection of children and instead frustrates the free use of the internet by adults.

B. The Costs of COPPA Far Outweigh the Benefits

The practical benefits of COPPA are, at best, questionable, but the costs are real and substantial. Since COPPA is largely ineffective because of the various issues stemming from segmenting out children, any benefits, which are debatable even under the best circumstances, are not realized by the law in practice. Yet, whether there are benefits or not, there are still enormous costs that affect children, parents, other adults, website operators, and now YouTubers.

The cost-benefit comparison is starkly apparent from the YouTube settlement. The FTC spent a great deal of their press conference bragging about the size of the settlement and how aggressive they plan to be towards users who upload videos on YouTube.[83] Conspicuously absent was a clear indication of how exactly kids will be better off after this settlement. In fact, as this note will go on to discuss, they may well be worse off.

1. COPPA's Supposed Benefits are Theoretical and Largely Elusive

When COPPA was first enacted, the principal concern was protecting children from sharing personal information that would allow child predators and marketers to directly contact them.[84] In terms of child predators, the concern was that these people would be able to find children in person and abuse them.[85] As the TV show "To Catch a Predator" with Chris Hansen confirms, those individuals are definitely out there, and this concern was and still is valid.[86] In terms of marketers, the concern was that children would be enticed (by promotions, games, etc.) to give out personal information that could then be used to deliver advertisements to their email accounts or homes.[87]

The safety of children remains a paramount concern, but it is unclear whether COPPA makes any difference. Of course, website operators should be expected to limit their collection of data that could facilitate contacting or locating a child if fallen into the hands of a predator. However, not a single FTC settlement in the 20-year history of COPPA has rested on even an accusation that the website's violations have resulted in predatory danger to

---

83. *See supra* note 5.

84. Hersh, *supra* note 9, at 1854 ("COPPA was designed to tackle two problems: '(i) overmarketing to children and collection of personally identifiable information from children that is shared with advertisers and marketers, and (ii) children sharing information with online predators who could use it to find them offline.'").

85. *See* Matecki, *supra* note X, at 374 ("[T]he FTC was concerned with the safety risks that could arise from children sharing their personal information online. By 1997, the FBI and Department of Justice had begun to take a more proactive role in alerting the public to the risks of meeting sexual predators online.").

86. *See To Catch a Predator (TV Series 2004–2007) - Plot Summary*, IMDB, https://www.imdb.com/title/tt3694654/plotsummary (last visited May 30, 2020). *But see* Joan Bertin et al., *Should Cyberspace be a Free Speech Zone?*, 15 N.Y.L. Sch. J. Hum. Rts. 67, 103–04 (1998) ("The number of confirmed cases where the Internet facilitated pedophilia is extraordinarily small, but has become the focal point for anxiety about this new medium, and where it may take us.").

87. *See* Matecki, *supra* note 7, at 374 ("In addition to safety concerns, the FTC also was concerned with the collection of personal information from children by commercial websites seeking such information for marketing purposes.").

children.[88] And, as the failings of "segmentation by age" illustrate, many services where children might share personal information are still easily accessible to them—and that's just considering the websites that feign COPPA compliance.[89] In the vast, international network that is the internet, there are countless completely noncompliant websites, and the FTC has only limited resources to police those based within the United States and limited authority to police those based abroad.[90]

The marketing angle of COPPA was and is questionable. Marketing is fundamental to the success of businesses: both those engaged in marketing and those which rely on advertising revenue.[91] Providing free services on the internet (like YouTube), which children and adults alike benefit from, is impossible without advertising revenue.[92] The FTC acknowledges this and does not suggest that marketing to children is prohibited completely—only those practices which would run afoul of COPPA, such as "behavioral" marketing that, without parental consent, tracks the activity of individual users as they use the service.[93] Hence why YouTube will continue to run advertising on "child-directed" videos; the difference is that these ads will be "contextual," based on the content of the video rather than based on behavioral data of the individual user.[94] In terms of children, it is hard to see how this will make much of a difference. If videos are marked as "child-directed," and advertisers will be able to target based on that criteria and the content of the video, there remains plenty of latitude to target children and particular subsets thereof.

The relative merits or criticisms of behavioral marketing aside, restricting the practice does not fairly fall within the scope of COPPA. Critics allege that behavioral marketing allows businesses to prey on the psychological weaknesses of children.[95] While this may be a valid concern, it's important to note that this criticism predates the proliferation of behavioral marketing and has been lodged against the practice of marketing to children in any form (including the still-legal and arguably necessary practice of traditional contextual

---

88. *See History of COPPA Violations*, PRIVO, https://www.privo.com/history-of-coppa-violations (last visited May 30, 2020).

89. *E.g.* Matecki, *supra* note 7, at 381 ("An estimated 1.7 million users under the age of thirteen created user accounts on Xanga by checking the over thirteen box following this prompt."); *id.* at 396 ("A study in the United Kingdom found that more than a quarter of eight to eleven year olds online have a profile on a social networking website.").

90. Kelly & Alexander, *supra* note 70 ("The FTC is a small agency and doesn't employ nearly enough staffers to tackle every COPPA failure that gets uploaded to YouTube. (Chairman Joe Simons has repeatedly called for more money to address the staff shortage.)"). *But see COPPA FAQ*, *supra* note 12 ("Foreign-based websites and online services must comply with COPPA if they are directed to children in the United States, or if they knowingly collect personal information from children in the U.S. The law's definition of 'operator' includes foreign-based websites and online services that are involved in commerce in the United States or its territories.").

91. Matecki, *supra* note 7, at 397 (noting that social media sites "use a legitimate business model which relies on advertising revenues to support their products").

92. *Id.* at 389 (footnotes omitted) ("Internet providers and website operators argue that personal information for the use of behavioral targeting ads is a necessary predicate to useful, free Internet services. Websites generate profits and cover costs of operation through such advertisements, and as such are able to operate such sites free of cost.").

93. *See COPPA FAQ*, *supra* note 12 (noting what forms of advertising are permitted under COPPA).

94. Kelly & Alexander, *supra* note 70 ("Once a video is labeled as kids' content, all personalized ads will be shut off, replaced with 'contextualized' advertising based on the video itself.").

95. Comments in re FTC Proposal to Amend COPPA Rule to Respond to Changes in Online Technology, CTR. DIGITAL DEMOCRACY ET AL., at 14 (Dec. 23, 2011) [hereinafter CDD Comments], https://www.democraticmedia.org/sites/default/files/COPPA%20Rule%20Comments%20of%20Children%27s%20Privacy%20Advocates.pdf ("Given children's limited cognitive abilities and the sophisticated nature of contemporary digital marketing and data collection, strong arguments can be made that behavioral targeting is an inappropriate, unfair, and deceptive practice when used to influence children under 13.").

marketing).[96] Additionally, since data used for behavioral marketing is typically (and should be) anonymized,[97] and since the practice can be used to effectively target and influence adults,[98] the use of COPPA—legislation concerned with the *privacy* of *children*—to push an anti-behavioral-marketing agenda is misplaced.[99] COPPA was tellingly motivated in large part by a 1996 report by the Center for Media Education which actually warned about tracking-based behavioral targeting and its purported impact on children,[100] yet the drafters of COPPA didn't see fit to address this particular issue.[101] Furthermore, with its concept of "verifiable parental consent," COPPA emphasized the importance of parental control over children's behavior. But, fundamentally, marketing serves to influence consumer behavior, and parents already maintain plenary control over their financially dependent children's participation in the market (to the extent they exert their control).[102] It is also worth noting that behavioral targeting can be particularly valuable for addressing laudable objectives, such as youth intervention in terms of nicotine addiction, drug use, and other pressing societal ills, but COPPA prohibits these altruistic applications as well.

Other legitimate harms posed to children by the internet, such as cyberbullying,[103] access to inappropriate content,[104] and excessive "screen time,"[105] are conspicuously neglected by COPPA.[106] Because COPPA is focused on what a child sends (i.e., personal information) on the internet rather than what she receives, the act is ill-suited to address any of the above concerns. Limiting a child's screen time also has little to do with the collection of personal information from children. Additionally, determinations about the proper amount of screen time and appropriateness of content are highly dependent on characteristics of the individual

---

96. *See generally* Blandína Šramová, *Children's Consumer Behavior*, INTECHOPEN (Nov. 21, 2017), https://www.intechopen.com/books/consumer-behavior-practice-oriented-perspectives/children-s-consumer-behavior (tracing child-focused marketing to the 1960s); *How Marketers Target Kids*, MEDIASMARTS, https://mediasmarts.ca/digital-media-literacy/media-issues/marketing-consumerism/how-marketers-target-kids (last visited May 30, 2020) (providing background on the history of leveraging psychology to more effectively market to children).

97. *But see* Paul Ohm, *Broken Promises of Privacy: Responding to the Surprising Failure of Anonymization*, 57 UCLA L. REV. 1701 (2010).

98. *See, e.g.*, *Behavioral Marketing: A Closer Look at What Gets Consumers Clicking*, NEIL PATEL: BLOG, https://neilpatel.com/blog/behavioral-marketing/ (last visited May 30, 2020).

99. However, this author concedes that there is value in using any available tool to advance an agenda and even if the changes are incremental.

100. CENTER FOR MEDIA EDUCATION, WEB OF DECEPTION 11 (1996), https://www.democraticmedia.org/sites/default/files/field/public-files/2020/cmewebofdeception1996.pdf ("Using individualized advertising, based on intimate knowledge of each child's interests, behavior, and socio-economic status, will give online marketers unprecedented powers to tap each child's unique vulnerabilities."); Hersh, *supra* note 9, at 1853–54 ("This study prompted a Federal Trade Commission ('FTC') investigation of online marketing practices that ultimately lead to the enactment of COPPA."). The Center for Media Education was the predecessor of the Center for Digital Democracy. CTR. DIGITAL DEMOCRACY, https://www.democraticmedia.org/ (last visited May 30, 2020).

101. CDD Comments, *supra* note 95, app. B, at 13 ("[T]he COPPA Rule does not directly address behaviorally targeted advertising . . . .").

102. *See How Marketers Target Kids*, *supra* note 96.

103. *See generally What Is Cyberbullying*, STOPBULLYING.GOV (May 7, 2020), https://www.stopbullying.gov/cyberbullying/what-is-it.

104. *See generally What Parents Need to Know About Inappropriate Content*, INTERNET MATTERS, https://www.internetmatters.org/issues/inappropriate-content/learn-about-it/ (last visited May 30, 2020).

105. *See generally* Jennifer F. Cross, *What Does Too Much Screen Time Do to Children's Brains?*, NEWYORK-PRESBYTERIAN HOSP.: HEALTH MATTERS, https://healthmatters.nyp.org/what-does-too-much-screen-time-do-to-childrens-brains/ (last visited May 30, 2020).

106. Cyberbullying and excessive screen time, to be fair, were not yet prominent concerns at the time COPPA was enacted, and content filtering was avoided due to the prior two attempts at legislation. *See infra*, note 151 and accompanying text.

child and the philosophies of her parents.[107] As such, parents are better equipped and should be entitled and entrusted to exercise proper discretion in this area—more so than legislators or website operators employing blanket regulations that lack nuance.

Overall, COPPA fails at providing any meaningful protection for children. And yet, despite the theoretical and elusive nature of the supposed benefits, the costs of the regulations are tangible and substantial.

2. COPPA Negatively Impacts Small Businesses

COPPA is difficult and expensive to properly comply with. When COPPA went into effect, "[s]maller websites began to feel the increased burden of COPPA compliance, as separate costs were required to hire legal teams to write expansive privacy polices [sic], and to enforce privacy requirements in chat rooms and message boards."[108] The cost of COPPA compliance "could reach upwards of $200,000 per year" (in early 2000s dollars) according to some estimates.[109] This reflects merely the costs of complying with COPPA, but sites may face additional financial burdens due to the law.

Even after attempting compliance, websites run the risk of fines if the FTC concludes they have violated the rule's poorly defined guidelines. As discussed, what counts as a website "directed to children" is not perfectly clear. For websites that do not consider themselves to be child-directed, simply banning users twelve and younger may not shield them from liability.[110] Similarly, what counts as "verifiable parental consent" (outside of the prohibitively costly and slow methods suggested by the FTC)[111] is also not clearly defined, as evidenced by settlements the FTC has reached with companies that attempted to comply with COPPA in good faith.[112] Since most bigger websites do take steps to comply with COPPA now, "the FTC's strategy in seeking enforcement has shifted from targeting sites that were merely not compliant with COPPA to seeking enforcement against sites that attempted to meet COPPA's standards but were deemed ineffective."[113] From a financial standpoint, the FTC can levy fines in excess of $42,000 *per violation* (though the FTC asserts that it does take into account the relative size of the offending business so as not to completely jeopardize its survival).[114]

---

107. *See, e.g.*, *What Parents Need to Know About Inappropriate Content*, *supra* note 104 ("What you think is inappropriate material for your child will probably differ from your child's view or that of other parents. It will also depend on your child's age and maturity level.").

108. Matecki, *supra* note 7, at 382.

109. *Id.*

110. Jamtgaard, *supra* note 15, at 394 ("If [a website is] considered 'directed to children,' statements meant to dissuade participation by children will not matter - all users will need to demonstrate that they are an adult or, if a child, that they have their parental consent before the site can collect information from them . . . .").

111. Matecki, *supra* note 7, at 385("[Some methods of parental consent contemplated by COPPA (print and mail forms, faxing signatures, and telephone hotlines) were not viable or cost effective options.").

112. *Id.* at 380 ("[E]nforcements against Hershey's and UMG illustrate the difficulty for website providers in interpreting COPPA's vague statutory requirements as to what actually constitutes sufficient parental consent.").

113. *Id.* at 379.

114. Cohen, *supra* note 64 ("The Rule allows for civil penalties of up to $42,530 per violation, but the FTC considers a number of factors in determining the appropriate amount, including a company's financial condition and the impact a penalty could have on its ability to stay in business.").

Small businesses do not have the resources to ensure proper compliance, which gives an anticompetitive advantage to well-established businesses and others entering the market with a sizable financial backing. "Websites have been forced to spend inordinate amounts of money to comply with COPPA regulations, and many start-up websites simply do not have these funds."[115] Internet regulations like COPPA present a barrier to entry for new companies. In the context of the General Data Protection Regulation ("GDPR"), a broader internet privacy regulatory scheme from the European Union that is cut from the same cloth as COPPA, one commentator warned that the law has "increased the market share of larger tech companies" and, instead of promoting more competition, serves to "merely enshrine existing giants."[116] This is because "[w]hile large players may [be able] to shift resources to handle such hefty burdens, regulations are particularly costly for newer emerging players who lack the personnel and financial resources to absorb such costs."[117] While Congress has begun to scrutinize the inordinate power wielded by big tech companies, the ability to comply with COPPA remains an anticompetitive advantage enjoyed by these larger entities in the child-focused market and beyond.[118]

In the case of YouTube, the platform has led to a cottage industry of video production. Countless so-called "creators" have established careers by parlaying their YouTube channels into small businesses that generate revenue from advertising and brand sponsorships.[119] These small businesses now find themselves caught in the crosshairs of the FTC's COPPA enforcement crusade as a result of the YouTube settlement, which, in itself, acutely demonstrates how disparate the impact of COPPA can be between large and small businesses.[120] Despite the FTC's landmark $170 million settlement, the reality is that it will make little impact on YouTube's bottom line.[121] However, the new "child-directed" classification scheme is likely to decimate the income of many family-friendly creators: some estimates place the ad revenue loss for videos marked as "child-directed" at upwards of 90%.[122] On top of that, creators are now subject to the possibility of fines from the FTC.

---

115. Hersh, *supra* note 9, at 1865.

116. Jennifer Huddleston, *Preserving Permissionless Innovation in Federal Data Privacy Policy*, 22 J. INTERNET L. 1, 24 (2019).

117. *Id.*

118. *See, e.g.*, Makena Kelly, *All the Ways Congress is Taking On the Tech Industry*, VERGE (Mar. 3, 2020), https://www.theverge.com/2020/3/3/21153117/congress-tech-regulation-privacy-bill-coppa-ads-laws-legislators; Adi Robertson, *Sonos and Tile Execs Warn Congress that Amazon, Google, and Apple are Killing Competition*, VERGE (Jan. 21, 2020), https://www.theverge.com/2020/1/21/21070812/sonos-tile-basecamp-popsocket-congressional-hearing-amazon-google-apple-competition; *see also infra* note 120.

119. Jim Salter, *The FTC's 2020 COPPA Rules Have YouTube Creators Scared*, ARS TECHNICA (Jan. 6, 2020) ("[P]eople have built entire careers around the production of popular, well-loved content both for children and for 'child-hearted adults'—and those people have no control over how their viewers' data is harvested and used, nor do they have enormous legal teams to beat settlements down into 'pocket change' territory as YouTube did.").

120. *Id.; see also* Spangler, *supra* note 33 (noting that, unlike small-time creators, "[t]he likes of Disney and ViacomCBS have armies of lawyers to navigate YouTube's new requirements"); Press Conference, *supra* note 5, at 18:09 (discussing an alleged double-standard of enforcement that favors larger companies).

121. *Id.* ("The $170 million in fines that YouTube paid is, compared with parent company Alphabet's staggering $38.9 billion quarterly revenue, chump change.").

122. Salter, *supra* note 119; *see also* Spangler, *supra* note 33 ("Socratica Kids, a small channel that produces educational science videos, in November announced that it was ceasing operations because it would lose upwards of 95% of its ad income under the new YouTube rules.").

The settlement is designed to shield YouTube from future COPPA liability, shifting the burden to individual content creators and directly exposing them to financial and legal risk.[123] As long as YouTube complies with COPPA data-collection regulations on videos marked as "child-directed," they will not face any penalty for a video that the FTC considers to be made for kids but is improperly classified.[124] According to the FTC, creators are considered "operators" under the COPPA rule and are subject to compliance and the risk of fines.[125] As a result of YouTube's new content classification system prescribed by the settlement, complying with COPPA from the standpoint of a creator means properly tagging videos (or entire channels) as "child-directed" when appropriate.[126] Creators that are deemed to have improperly classified their videos could face a fine of up to $42,530 per violation (apparently per improperly tagged video).[127] In theory, a person could face a fine of well over the annual median personal income in the United States[128] just for uploading a single kid-friendly video to YouTube and failing to mark it as "child-directed."[129] Most troubling of all is that these hefty fines are contingent upon correctly interpreting and applying the vague and problematic "child-directed" standard. Aside from very rough guidelines, neither YouTube nor the FTC will help decide whether a video is "child-directed," characterizing such assistance as "legal advice."[130] Creators, instead, should consult an attorney about the videos they upload.[131]

Whether creators should (or even could) actually be held individually liable under COPPA is debatable. Holding website *users* liable under COPPA, rather than the website itself, is uncharted territory.[132] It is possible that a creator, if targeted by the FTC, could challenge their alleged liability under COPPA in court since there is no legal precedent with which to interpret the COPPA rule's definition of "operator" in this new context. However, fearing steep legal fees on top of the FTC's fine if defeated in court, creators may prefer to just negotiate a settlement with the FTC. Regardless, the threat is real: the FTC has made it perfectly clear that it plans to go after creators, callously characterizing these individuals,

---

123. Press Conference, *supra* note 5 ("YouTube, as a general audience platform, is not directly strictly liable under COPPA for the content of the videos uploaded by others to its platform, unless it has actual knowledge that the content is child-directed."); *id.*, at 43:50 (conceding that there is a higher risk for content creators than for the platform itself); Spangler, *supra* note 33 ("YouTube is putting the burden of complying with COPPA on creators. If the FTC determines a channel has violated the law (by mislabeling its YouTube content), civil penalties of up to $42,530 per violation are allowed . . . .").

124. *See* Press Conference, *supra* note 5 (explaining that an "actual knowledge" standard applies to YouTube, whereas a "strict liability" standard applies to creators). *See also COPPA FAQ*, *supra* note 12 ("COPPA covers operators of general audience websites or online services only where such operators have *actual knowledge* that a child under age 13 is the person providing personal information.").

125. Cohen, *supra* note 64 ("If a channel owner uploads content to a platform like YouTube, the channel might meet the definition of a 'website or online service' covered by COPPA, depending on the nature of the content and the information collected.").

126. *Id.* ("YouTube and Google agreed to create a mechanism so that channel owners can designate when the videos they upload to YouTube are – to use the words of COPPA – 'directed to children.' The purpose of this requirement is to make sure that both YouTube and channel owners are complying with the law.").

127. *Id.*

128. *Real Median Personal Income in the United States*, FED. RES. BANK ST. LOUIS (Sep. 10, 2019), https://alfred.stlouisfed.org/series?seid=MEPAINUSA672N (indicating a figure of $33,706 for 2018).

129. *See supra* note 114 and accompanying text.

130. Cohen, *supra* note 64 ("If you're still unsure about how COPPA applies to you, consider contacting an attorney . . . "); *Determining If Your Content is "Made for Kids,"* YOUTUBE HELP (last visited May 30, 2020) https://support.google.com/youtube/answer/9528076. ("We provide some guidance on what is considered 'made for kids' below, but we cannot provide legal advice. If you are unsure whether your videos meet this standard, we suggest you seek legal counsel.").

131. *See supra* note 130.

132. *See supra* note 6.

many of whose livelihoods currently depend on their YouTube income, as "fish in a barrel."[133] One may wonder, should COPPA really be wielded as a weapon against individuals just trying to make a living through producing content for children on account of some attenuated, theoretical harm? Since the crux of COPPA is the collection of data, as the actual website operator and data collector, liability rests more appropriately on multi-billion-dollar YouTube than the individual content creators—without whom such outsized profits would be a chimera.[134]

3. COPPA Reduces the Supply of Child-Friendly Content

After COPPA first went into effect, instead of making an effort to serve children, many websites simply became restricted to those "thirteen or older"[135] and others removed their child-friendly content.[136] When Disney restricted its chatrooms to visitors thirteen and older, it lamented, "[r]egrettably, the overbearing scrutiny and disparity of interpretation of law and guidelines by federal regulators and advocacy groups may ultimately result in fewer and fewer options for kids to interact on the Web."[137] The negative impact on businesses means less competition, and less competition means fewer choices of services and content for children. After COPPA took effect, less investment was designated for new child-directed projects due to the complexity, expense, and liability of attempting a COPPA-compliant business.[138] Indeed, COPPA significantly compromises the financial incentive to operate child-directed websites. Websites often generate their revenue from advertising or monetizing the data they collect, and COPPA restricts both funding sources when children are involved.[139] Subscription-based profit models are rarely effective, but, when they are, economically disadvantaged children suffer by losing access to a service that would otherwise have been offered for free.[140]

This consequence is readily apparent with YouTube, where the supply of children's content is expected to suffer due to the imposed changes.[141] Many content creators have announced an intent to cease production of their videos altogether, and some have completely

---

133. Press Conference, *supra* note 5, at 15:15.

134. *See supra* notes 119–121.

135. Matecki, *supra* note 7, at 400 ("When COPPA created protections only to users under the age of thirteen, website operators adopted age screening mechanisms to purportedly ban underage users from their sites.").

136. Matecki, *supra* note 7, at 383 ("[W]ebsites had an incentive to remove content for children in order to avoid the financial burden of COPPA compliance.").

137. Hersh, *supra* note 9, at 1866.

138. Ben Sperry, *What's the Point of COPPA?*, TRUTH ON THE MARKET (Nov. 20, 2013), https://truthonthemarket.com/2013/11/20/senator-markeys-do-not-track-kids-act-of-2013-raises-the-question-whats-the-point-of-coppa/ (recognizing the "foregone innovation and investment in children's media" caused by COPPA).

139. Tianna Gadbaw, *Legislative Update: Children's Online Privacy Protection Act of 1998*, 36 CHILD. LEGAL RTS. J. 228, 230 (2016) ("Targeted advertisements usually provide more revenue for websites because they are more relevant to users."); *supra* notes 16, 111 (discussing "verified parental consent," which would be required to collect meaningful data that could be monetized, and the impracticality of obtaining such consent).

140. Hersh, *supra* note 9, at 1870–71 (footnote omitted) ("Attempts at implementing subscription-based models have also failed because parents are generally unwilling to pay."); Gadbaw, *supra* note 139, at 230 ("To make up for this revenue loss, developers may increase the number of advertisements shown to children or move away from advertisement-based income models to fee-based income models. This will impact the quality of free applications and websites available to children.").

141. "The most plausible scenario is you're going to see tens of thousands of YouTube creators just go away." Spangler, *supra* note 33 (quoting Jim Dunstan, "general counsel at technology policy think tank TechFreedom").

closed down their channels.[142] For creators that produce content for children, the loss of a majority of advertising revenue eliminates the incentive to continue their craft on YouTube.[143] Creators that produce content not specifically geared towards children worry their content could be deemed "child-directed" nonetheless and face fines from the FTC.[144] Needing a lawyer to help navigate whether a video might be considered "child-directed" might just not be worth the cost or hassle, especially considering even some experienced lawyers are not confident in their ability to apply the vague standards of COPPA.[145]

YouTube anticipated this exodus from its platform. In its announcement of the post-settlement changes, YouTube pledged $100 million to establish a fund to finance "the creation of thoughtful, original children's content."[146] However, it isn't clear which creators will benefit and to what extent—or whether the fund will ever be replenished.[147] It seems plausible that the fund will favor well-established creators who, over time, have amassed an audience while developing their identity and work to polish their programming with better equipment and expertise.[148] If true, those trying to break into the child-focused market are, yet again, disadvantaged.

4. COPPA Drives Children to Age-Inappropriate Content

In practice, COPPA has the unintended effect of diverting children to less appropriate content. With fewer choices that are designed for them, children will be left seeking other options: those that are *not* designed for them. Because of COPPA's provisions, sites not meant for children are inevitably easier to access and more feature rich. For instance, a child-directed website that properly implements COPPA's "verifiable parental consent" requirement merely presents a child with more obstacles to use the service. Why jump through those hoops when other sites are easier to access and possibly offer better features?

Since COPPA limits what sites can do when children are involved, certain features may be outright prohibited, or a website's diminished ability to generate revenue under COPPA could result in fewer or lower quality features offered. This is borne out by YouTube's offering

142. *E.g.*, Socratica Kids (@SocraticaKids), TWITTER (Nov. 14, 2019), https://twitter.com/SocraticaKids/status/1195156921256251392 ("We will no longer be making videos for our Socratica Kids YouTube channel."); @Lockstin, TWITTER (Nov. 19, 2019), https://twitter.com/Lockstin/status/1196925745525772288 ("No joke, I AM going to quit YouTube in February based on how much COPPA is enforced in January.").

143. *See, e.g.*, Socratica Kids, *supra* note 142 ("Socratica Kids is made by a small team of educators and puppeteers who love making SMART + FUN videos for your kids. . . . Our channel was growing, and we made our videos as a labor of love to spread STEM knowledge to our youngest viewers. But we can't go on making videos for free, and we certainly can't ask the people who work with us to work for free. . . . By removing targeted ads from kids' content on YouTube, revenue for kids' channels may drop by as much as 95%. We are effectively out of business.").

144. *E.g.* Todd Spangler, *YouTube Creators Worried and Confused Over New Kid-Video COPPA Rules, Potential Fines*, VARIETY (Nov. 22, 2019), https://variety.com/2019/digital/news/youtube-coppa-rules-children-videos-fines-1203413642/ ("'This COPPA shit is terrifying,' Danielle Pitts (aka Doopie), a YouTube animator and voice actor, tweeted this week. 'My videos aren't directed to children but I can still get fined $42k for marking my videos as meant for adults because it isn't mature enough? Because it can easily be mistaken?? I'm heartbroken. YouTube was my dream.'").

145. *See, e.g.*, Spangler, *supra* note 33 ("[E]ven attorneys who have worked in the area for years say it's not a clear-cut process.").

146. *YouTube Blog Post*, *supra* note 30.

147. *See* Salter, *supra* note 119 ("[The fund] seems unlikely to help creators . . . who make 'child-hearted' content for general audience consumption.").

148. *See id.*

following the settlement: child-directed content has been stripped of key features.[149] Children, missing the interactive elements that have been removed, may seek and find them on non-child-directed videos. Additionally, the incentive to falsify age information when signing up for a "thirteen and up" website could lead to recommendations and advertising that are not age appropriate, such as alcohol, gaming, and adult content.[150] Not only does this overall phenomenon expose children to a greater possibility of encountering content that is plainly inappropriate, it completely eliminates the supposed protective measures of COPPA since those measures do not apply to videos and websites not meant for children. In short, COPPA merely incentivizes children to go where COPPA does not apply.

5. COPPA Implicates First-Amendment Concerns

Though COPPA has resisted constitutional challenge for two decades, First Amendment rights are arguably still impacted—perhaps now more than ever. It is helpful to note that COPPA was preceded by two attempts aimed at protecting children on the internet, and both of these laws were struck down as unconstitutional.[151] The key difference between COPPA and its predecessors is that these earlier laws targeted indecent content and a child's access thereto.[152] As restrictions on free speech, the courts strictly scrutinized the laws by weighing the chilling effect against the state interest and availability of less restrictive means to that end.[153] While similarly rooted in protecting children on the internet, COPPA, of course, centers around the issue of privacy rather than censoring content.[154] However, some commentators have noted that COPPA undermines the free speech rights of children and has a censoring effect nonetheless.[155]

With the YouTube settlement, the FTC is reimagining COPPA in a way which mirrors the fatal flaws of the earlier legislation. With those laws, the Court took issue with the vague standard used to classify the proscribed speech, the deterrent effect on protected speech, impeding access to information by adults, and the availability of less restrictive alternatives

---

149. Spangler, *supra* note 144 ("[A] whole slew of other features that depend on user data will be disabled, including: comments, channel branding watermarks; the 'donate' button; cards and end screens; live chat and live chat donations; notifications; and 'save to playlist' or 'watch later' features.").

150. *See supra* notes 51–54 and accompanying text.

151. "The Communications Decency Act of 1996 was the first substantial attempt by the government to regulate the Internet with respect to the protection of children. . . . The Supreme Court [held] . . . that Congress violated the First Amendment by attempting to regulate content on the Internet. The Court found the statute was overbroad and lacked the precision needed to statutorily limit the First Amendment." Hersh, *supra* note 9, at 1847–48 (citing Reno v. ACLU, 521 U.S. 844, 874 (1997)). The following year, Congress passed the Child Online Protection Act, which was eventually struck down on First Amendment grounds as well. *Id.* at 1848–50.

152. *Id.* at 1837 ("The two major attempts to protect children from accessing pornographic material on the Internet, CDA and COPA, were both found unconstitutional.").

153. *Reno v. ACLU*, 521 U.S. 844, 871–72, 874 (1997) ("[T]he CDA is a content-based regulation of speech. The vagueness of such a regulation raises special First Amendment concerns because of its obvious chilling effect on free speech. . . . [T]he CDA effectively suppresses a large amount of speech that adults have a constitutional right to receive and to address to one another. That burden on adult speech is unacceptable if less restrictive alternatives would be at least as effective in achieving the legitimate purpose that the statute was enacted to serve.").

154. *See supra* note 2.

155. *E.g.* Allen, *supra* note 2, at 769 ("COPPA's requirements are not specifically designed to deny children access to content, but, as civil libertarians observe, that is one of their effects."); Gadbaw, *supra* note 139, at 230 ("One major critique is that COPPA violates children's right to freedom of speech and expression.").

for furthering the governmental interest.[156] The standard here, as discussed, is also vague. Although the "child-directed" standard has been applied for two decades under COPPA, its application under YouTube's compulsory content classification system is a marked departure from earlier applications. Previously, the standard has only been used to classify entire websites or services and, while vague, is more practicable in this context than applied to discrete pieces of content.[157] Additionally, in classifying whole websites, the unintended restrictions on adults, who are less likely to use child-oriented sites, are less pronounced.

COPPA, as applied in the YouTube settlement, has a far greater restrictive effect on adults and therefore deserves stricter scrutiny under the First Amendment. The effect cuts both in terms of adult users who post videos (i.e., creators) and those who view them. The content classification scheme restricts the protected speech of creators because it stifles the reach of their message[158] and has a deterrent effect on engaging in such speech due to fear of steep fines from misclassification[159] (combined with arbitrary enforcement of the vague "child-directed" standard)[160] and the financial disadvantage of posting child-directed content.[161] From the perspective of viewers, all child-directed content is stripped of certain functionality no matter the age of the viewer, particularly the comments section, which offers a public forum for viewers to engage with each other and with the creator.[162] Such a "burden on adult speech is unacceptable if less restrictive alternatives would be at least as effective in achieving the legitimate purpose that the statute was enacted to serve."[163] Considering the ineffectiveness of COPPA in achieving its general goal of protecting children and the existence of alternatives that would likely be more effective and less restrictive,[164] it is quite possible that the FTC's application of COPPA in the manner used in the YouTube settlement could be deemed unconstitutional.

---

156. *Reno*, 521 U.S. at 874 ("We are persuaded that the CDA lacks the precision that the First Amendment requires when a statute regulates the content of speech. In order to deny minors access to potentially harmful speech, the CDA effectively suppresses a large amount of speech that adults have a constitutional right to receive and to address to one another. That burden on adult speech is unacceptable if less restrictive alternatives would be at least as effective in achieving the legitimate purpose that the statute was enacted to serve.").

157. There are still grey areas when it comes to entire sites or services, but classifying an entire site as "directed to children" (which often has voluminous pages, text, visuals, services, messaging, advertising, etc. with which to base an assessment upon) seems inherently more feasible than a single video (or even a collection of videos) that merely has an appeal to children. *See supra* Part III.A.2.

158. Salter, *supra* note 119 ("[V]ideos marked 'for kids' will have no notifications, no comments, will not be searchable, [and] will not be suggested or recommended . . . ."); Spangler, *supra* note 33 ("YouTube . . . will exclude videos tagged as made for kids from search results.").

159. *See supra* notes 125–129 and accompanying text; *cf.* Reno, 521 U.S. at 872 ("The severity of criminal sanctions may well cause speakers to remain silent rather than communicate even arguably unlawful words, ideas, and images.").

160. *See Reno*, 521 U.S. at 872 ("As a practical matter, this increased deterrent effect, coupled with the 'risk of discriminatory enforcement' of vague regulations, poses greater First Amendment concerns . . . .").

161. *See, e.g.*, Socratica Kids (@SocraticaKids), TWITTER (Jan. 13, 2020, 2:05 PM), https://twitter.com/SocraticaKids/status/1216813635508428800 (sharing a graph which shows that its average advertising revenues precipitously dropped to zero following the changes on YouTube with respect to "child-directed" videos). *See also* Simon & Schuster, Inc. v. Members of N.Y. State Crime Victims Bd., 502 U.S. 105, 115 (1991) ("[A] statute is presumptively inconsistent with the First Amendment if it imposes a financial burden on speakers because of the content of their speech.").

162. *See supra* note 158; *see also* Reno, 521 U.S. at 875 (cleaned up) ("The Government may not reduce the adult population to only what is fit for children.").

163. *Reno*, 521 U.S. at 874.

164. *See infra* Part IV.

C. Current Efforts to Expand COPPA Fail for the Same Reasons

Recognizing that COPPA has faced plenty of criticism in its twenty-year history, there have been numerous efforts to modify the law. So far, aside from the FTC's evolving strategies for enforcing the law,[165] the only official change has come via its amended rule which took effect in 2013.[166] More recently, the FTC made a public call for comments to reevaluate its COPPA rule, which closed in late 2019.[167] In the past year, there have been at least four proposed bills which attempt to augment the children-oriented internet protection scheme of COPPA: COPPA 2.0,[168] the KIDS Act,[169] the PROTECT Kids Act,[170] and the Kids PRIVCY Act.[171] But rather than discuss the merits of any proposed legislation individually, it is enough to say that each is predicated on segmentation by age and therefore suffers from the same fundamental flaw as COPPA itself.

IV. PROPOSAL

All of this is not to say that children's privacy on the internet is an unattainable goal. But a lot has changed technologically since COPPA took effect in 2000,[172] so it is logical to revisit its objectives and offer a fresh approach that is better adapted to today's society and digital landscape. It is possible to not only preserve but build upon the original objectives of COPPA in a way which produces more effective results and lessens the overall burdens and side-effects posed by such regulations.

A. Implement General, Age-Neutral Privacy Regulations

Congress should adopt internet privacy regulations that apply protections to all users regardless of age. As this note highlights, the fundamental failure of COPPA is that its applicability is contingent upon age. Removing this distinction closes the loophole which enables websites to skirt privacy regulations,[173] eliminates the need to classify content (or

165. *See supra* text accompanying note 113.

166. *See supra* text accompanying note 17.

167. *FTC Seeks Comments on Children's Online Privacy Protection Act Rule*, FED. TRADE COMN'N (Jul. 25, 2019) [hereinafter *FTC Request for Comments*], https://www.ftc.gov/news-events/press-releases/2019/07/ftc-seeks-comments-childrens-online-privacy-protection-act-rule.

168. Makena Kelly, *New Privacy Bill Would Give Parents an 'Eraser Button' and Ban Ads Targeting Children*, VERGE (Mar. 12, 2019), https://www.theverge.com/2019/3/12/18261181/eraser-button-bill-children-privacy-coppa-hawley-markey.

169. *Senators Markey and Blumenthal Introduce First-of-Its-Kind Legislation to Protect Children Online from Harmful Content, Design Features*, ED MARKEY: NEWS (Mar. 5, 2020), https://www.markey.senate.gov/news/press-releases/senators-markey-and-blumenthal-introduce-first-of-its-kind-legislation-to-protect-children-online-from-harmful-content-design-features_.

170. Mallory Jones et al., *Bipartisan Legislation Aims to Expand Federal Protections for Children's Online Privacy*, JD SUPRA (Jan. 16, 2020), https://www.jdsupra.com/legalnews/bipartisan-legislation-aims-to-expand-91935/.

171. Allen St. John, *Bill Introduced to Strengthen Kids' Online Privacy Law*, CONSUMER REPORTS (Jan. 30, 2020), https://www.consumerreports.org/privacy/bill-to-strengthen-kids-online-privacy-law/.

172. *Ashcroft v. ACLU*, 542 U.S. 656, 671 (2004) ("The technology of the Internet evolves at a rapid pace."); *FTC Request for Comments*, *supra* note 167.

173. *See supra* notes 41, 56.

entire websites) based on the ambiguous "child-directed" standard,[174] avoids the various issues of age verification,[175] and resolves the free-speech-related issues discussed here.[176]

In many cases, a general privacy regulatory scheme would either reduce or leave unchanged the burden on a website operator in the absence of COPPA. Since COPPA took effect, two major general privacy regulatory schemes were introduced that apply to a large swath of the websites that would be subject to a United States-based scheme, including that subset which is subject to COPPA. The General Data Protection Regulation (GDPR) went into effect in 2018, affecting websites that serve citizens of the European Union,[177] and the California Consumer Privacy Act (CCPA) went into effect in 2020, affecting websites that serve citizens of California.[178]

The two schemes overlap in many respects[179] and mimic most of the objectives of COPPA[180]—only without respect to age.[181] These include notice,[182] consent,[183] review,[184] and security,[185] plus additional protections that go beyond COPPA.[186] However, the differences between the laws[187] mean that website operators potentially have to navigate and juggle the varying provisions of GDPR, CCPA, and COPPA simultaneously, depending on their audience. A general privacy regulation at the federal level could strive for parity with GDPR wherever possible, preempt CCPA,[188] and obviate COPPA, leaving effectively a single privacy framework for websites to follow.[189] While a such a regulation would inevitably place a new burden on some websites that were not subject to any of the other three

174. *See supra* Part III.A.2.

175. *See supra* Part III.A.1.

176. *See supra* Part III.B.5.

177. Matt Burgess, *What is GDPR? The Summary Guide to GDPR Compliance in the UK*, WIRED UK (Mar. 24, 2020), https://www.wired.co.uk/article/what-is-gdpr-uk-eu-legislation-compliance-summary-fines-2018.

178. Gilad Edelman, *California's Privacy Law Goes Into Effect Today. Now What?*, WIRED (Jan. 1, 2020, 7:00 AM), https://www.wired.com/story/ccpa-guide-california-privacy-law-takes-effect/.

179. Aleksandra Popova, *The Fine Line Between Identifiers Capable of Identifying and "Identifiable Information,"* 24 SUFFOLK J. TRIAL & APP. ADVOC. 255, 262 (2019) ("[T]he CCPA is considered the first regulation in the U.S. to attempt to match the GDPR's broad definitional scope of what type of information is covered under PII while also granting consumers extensive rights to control that information.").

180. *See supra* text accompanying note 15. Only one of the five major objectives (the use of games and prizes to manipulate children) is missing from these two schemes.

181. However, both pieces of legislation include special parameters covering minors. *Comparing Privacy Laws: GDPR v. CCPA*, DATAGUIDANCE & FUTURE PRIVACY F. 19–20 (2018) [hereinafter *Comparing Privacy Laws*], https://fpf.org/wp-content/uploads/2018/11/GDPR_CCPA_Comparison-Guide.pdf.

182. *Comparing Privacy Laws*, *supra* note 181, at 28 ("Both the GDPR and the CCPA include prescriptive provisions with regards to the information organizations must provide to individuals when collecting and processing their personal information.").

183. *Id.* at 30 ("Both the GDPR and the CCPA guarantee a right for individuals to ask organizations to cease the processing, and selling respectively, of their data.").

184. *Id.* at 31 ("Both the GDPR and the CCPA establish a right of access, which allows individuals to have full visibility of the data an organization holds about them: they can obtain details about the data being processed, but also copies of the data items themselves.").

185. *Id.* at 39 ("Both the GDPR and the CCPA provide individuals with a cause of action to seek damages for violation of privacy laws with regard to security measures violations and data breaches.").

186. Both GDPR and CCPA extend additional rights, such as the right to request deletion of personal information, the right to exercise protected rights free from discrimination by the operator, and the right to data portability (to export personal data or transfer it to another service). *Comparing Privacy Laws*, *supra* note 181, at 26, 33–35.

187. *See generally Comparing Privacy Laws*, *supra* note 181.

188. *See generally Gade v. Nat'l Solid Wastes Mgmt. Ass'n*, 505 U.S. 88, 98 (1992) (discussing types of preemption).

189 *But see* W. Gregory Voss, *Obstacles to Transatlantic Harmonization of Data Privacy Law in Context*, 2019 U. ILL. J.L. TECH. & POL'Y, at 405 (discussing the history of data protection regulations around the world and the prospects for reaching parity across nations).

laws,[190] it would reduce or leave unchanged the burden of many others as a result of the consolidation of provisions and simplification of standards.[191]

B. Reinforce Measures that Protect the Physical Safety of Minors

Special care should still be given to ensuring the physical safety of minors, as was a primary concern in enacting COPPA. Children face genuine threats from sexual predators and human traffickers, and these threats are inexcusably magnified when personal information which helps to locate or contact a child is exposed.[192] Websites should be held accountable for ensuring that the collection of sensitive information pertaining to children is limited,[193] properly secured, and disclosed only with utmost care.

While data security is an important concern for every website operator and user, data security practices must strike a balance between the burden to the operator and the potential harm to the user.[194] Elaborate requirements can be prohibitively expensive and stifle innovation.[195] With this in mind, the risk tolerance and rigidity of required precautions surrounding data handling is often relative to how sensitive the data is. For example, stricter regulations (and thus heavier burdens) are currently imposed in some sensitive situations, such as with "health records under [the] Health Insurance Portability and Accountability Act (HIPAA), banking information under the Graham-Leach-Bliley Act, and credit information under the Fair Credit Reporting Act."[196]

A new privacy scheme could draw from these laws to inform the data collection and handling requirements with respect to sensitive children's data. However, unlike COPPA's expansive definition of "personal information,"[197] the regulations should be tailored to address only data that poses a real threat to children if exposed: that which would allow a predator to locate or contact a child.[198] With that in mind, only information that could be reasonably thought to belong to a child and could facilitate contact should fall within the scope. For instance, a general audience website whose data provides no indication of which

190. However, many states are likely to follow California's lead, thereby ensnaring still other websites (not to mention, piling on additional provisions that must be juggled by some websites already subject to any of the other privacy regimes). *See* Kim Hart & Margaret Harding McGill, *States Will Be the Battlegrounds for 2020 Tech Policy Fights*, AXIOS (Jan. 2, 2020), https://www.axios.com/states-2020-tech-policy-fights-f467033d-c5f2-4467-a256-ee894c62190d.html ("Industry watchers expect to see privacy legislation come up in New York, Washington and Illinois in 2020.").

191. Ideally, new legislation would eliminate ambiguous standards like "child-directed" and provide clear guidance for how websites can comply with the law.

192. *See supra* text accompanying notes 85–86.

193. A recurring theme with privacy regulation is requiring operators to limit their collection of personal data to that which is necessary to operate the service. *See, e.g.*, *Comparing Privacy Laws*, *supra* note 181, at 19; *COPPA FAQ*, *supra* note 12 (discussing limiting data collection pursuant to "activities necessary for the site or service to maintain or analyze its functioning").

194. Thus far, this need for balance is demonstrated by a number of stricter but narrowly applied privacy laws, which "have been targeted at areas where the risks of potential harm from exposure of the information is considered great enough to favor restriction at the expense of potential benefits like more experimentation and innovation." Huddleston, *supra* note 116, at 18.

195. *E.g.* Huddleston, *supra* note 116, at 18 ("According to a survey by PwC, over 80 percent of companies, including many based in the United States, spent more than $1 million preparing for GDPR and more than 40 percent spent more than $10 million."); *see supra* note 194.

196. Huddleston, *supra* note 116, at 18.

197. *COPPA FAQ*, *supra* note 12 (enumerating what is considered personal information).

198. *But see* International Computer Science Institute, *There is No Anonymity on the Internet*, TEACHING PRIVACY, https://teachingprivacy.org/theres-no-anonymity/ (last visited Jun. 1, 2020) ("[D]ata mining and inference techniques . . . can be used to match anonymized users to their real identities with a high degree of accuracy . . . .").

users are children versus which are adults, or a website whose data does not provide any means to make contact with its users, could be outside of the scope. Additionally, COPPA's arbitrary definition of "child" should be supplanted by the more widely used distinction of legal minors as individuals under the age of eighteen.[199]

C. Empower and Entrust Parents to Moderate their Children's Online Activity

Parents should be not only empowered but entrusted with decision-making pertaining to their child's use of the internet.[200] A criticism of CDA and COPA was that neither allowed a parent to make their own decisions about what content was appropriate for their child.[201] COPPA attempted to address this shortcoming with its "verifiable parental consent" provision, but this too has fallen short since: parental consent mechanisms are either prohibitively cumbersome or ineffective;[202] easy-to-falsify age verification mechanisms circumvent consent;[203] parents are given no option to provide blanket consent;[204] and parents of teenagers are completely neglected.[205]

As a foundation, legislation should promote education pertaining to safe internet practices for children, with involvement from parents.[206] Just as a law would be limited in its effectiveness to protect a child from the dangers of talking to a stranger on the street, attempts to restrict internet usage have limited efficacy for the safety of children online.[207] Recognizing that, no matter the precautions, there is always the possibility that a child may encounter a malicious actor online (just like on the street), children should be educated about the risks of sharing personal information online and interacting with strangers. Additionally, technologically adept children will inevitably find ways to circumvent restrictive measures, further limiting their efficacy.[208] Education could help children make informed and responsible decisions about their online activity, with or without the presence of restrictive

199. UNICEF & YOUTH POL'Y LABS, AGE MATTERS! AGE-RELATED BARRIERS TO SERVICE ACCESS AND THE REALISATION OF RIGHTS FOR CHILDREN, ADOLESCENTS AND YOUTH 1 (2016) https://agemattersnow.org/downloads/YPL_Age_Matters_Final_Report_Oct2016.pdf.

200. Matecki, *supra* note 7, at 400. ("In implementing COPPA, the FTC argued for measures that would return parents to their traditional role as gatekeepers of what information children access and what information others access about their children.").

201. *See, e.g.*, Reno, 521 U.S. at 845 ("The CDA differs from the various laws and orders upheld in [the aforementioned] cases in many ways, including that it does not allow parents to consent to their children's use of restricted materials . . . .").

202. *See supra* note 57–59 and accompanying text.

203. *See supra* note 55 and accompanying text.

204. *See supra* note 50 and accompanying text.

205. *See supra* note 46–47 and accompanying text.

206. Dorothy A. Hertzel, Note, *Don't Talk to Strangers: An Analysis of Government and Industry Efforts to Protect A Child's Privacy Online*, 52 FED. COMM. L.J. 429, 449 (2000) ("[P]rotecting a child's privacy online would first require educating parents about the dangers their children confront in the Internet world. However, this education is not only for those Internet literate parents. The education would consist of a campaign . . . to alert parents about the information collection practices and the resulting risks."). The government must make every effort to reach parents who are less technologically literate and those with fewer resources. *See, e.g.*, Hersh, *supra* note 9, at 1871 (criticizing the FTC for targeting its COPPA educational sessions primarily at technologically literate parents). *See also* Ashcroft v. ACLU, 542 U.S. 656, 669 (2004) (quoting United States v. Playboy Entm't Grp., Inc., 529 U.S. 803, 824 (2000)) ("[A] court should not presume parents, given full information, will fail to act[.]").

207. "[M]any advocate that the most effective solution to protecting children online is through the old school approach: education. These advocates feel that by simply educating parents and children about what is happening online, we can better protect children then [sic] any provision in COPPA." Gadbaw, *supra* note 139, at 231.

208. *See* Gadbaw, *supra* note 139, at 230 ("Critics posit that children can easily outwit even the more advanced age verification technologies and get around many parental consent processes.").

"guard rails," and could come both in the form of school instruction and in encouraging parents to have this kind of conversation with their children.[209]

On top of education, there are mechanisms that can assist parents in taking a more proactive role in their child's online activity which are more effective and less burdensome on website operators than the provisions in COPPA. Another criticism of CDA and COPA, which actually factored largely into their demise, was the availability of filtering software that could control access not at the sending end (the website) but at the receiving end (the device).[210] Filtering mechanisms greatly reduce the burden placed upon website operators and place more control in the hands of the parents and other adults.[211] At the time, a filter-based approach was criticized for its cost to parents,[212] its limited accuracy,[213] and lack of parental control on some manners of online access (computers at schools, libraries, a friend's house, etc.).[214] Nevertheless, even at the time, a congressional report indicated that filtering was a more effective approach than age verification.[215]

Twenty years later, filtering technology has only become more viable. Whereas when COPPA was introduced, children accessed the internet exclusively from computers, some of which were not necessarily in the parents' control (e.g. in a school or library),[216] today, most internet usage by children is from a mobile device or laptop, which is most likely to be provided and controlled by the parent.[217] Virtually all operating systems and devices have some built-in form of parental control, and choices abound for free and low-cost parental control software.[218] With the advent of artificial intelligence and machine learning, filtering

209. Hersh, *supra* note 9, at 1874 ("The answer is, therefore, to cease formal regulations, and to focus more on educating parents, mentors, and teachers. These people will have the most influence over children . . . .").

210. *See, e.g.*, *Ashcroft*, 542 U.S. at 667 ("Filters are less restrictive than COPA. They impose selective restrictions on speech at the receiving end, not universal restrictions at the source.").

211. "[The District Court] noted that '[t]he record before the Court reveals that blocking or filtering technology may be at least as successful as COPA would be in restricting minors' access to harmful material online without imposing the burden on constitutionally protected speech that COPA imposes on adult users or Web site operators.'" *Id.* at 663 (quoting ACLU v. Reno, 31 F. Supp. 2d 473, 497 (E.D. Pa. 1999)). However, such control in the hands of parents is not always a good thing. *See, e.g.*, Bertin et al., *supra* note 86, at 88–89 (footnotes omitted) ("Among those most threatened by [filtering] software are gay, lesbian and bisexual and transgendered youth. The resources available on the Internet - again, the Web sites, the chat rooms and educational resources - are literally lifesaving to these young people, many of whom live in isolation, both geographically and emotionally.").

212. *Ashcroft*, 542 U.S. at 685 (Breyer, J., dissenting) ("[F]iltering software costs money. Not every family has the $40 or so necessary to install it.").

213. *Id.* at 668 (plurality opinion) ("Filtering software, of course, is not a perfect solution to the problem of children gaining access to harmful-to-minors materials. It may block some materials that are not harmful to minors and fail to catch some that are.").

214. *Id.* at 685 (Breyer, J., dissenting) ("[F]iltering software depends upon parents willing to decide where their children will surf the Web and able to enforce that decision. . . . [M]any . . . children will spend afternoons and evenings with friends who may well have access to computers and more lenient parents.").

215. *Id.* at 668 (plurality opinion) ("[The Commission on Child Online Protection] unambiguously found that filters are more effective than age-verification requirements.").

216. *See supra* note 214.

217. *See* Jamie Ducharme, *Kids Are Spending More Time on Mobile Devices than Ever Before*, TIME (Oct. 19, 2017), https://time.com/4989275/young-children-tablets-mobile-devices/; PEW RES. CTR., MOBILE FACT SHEET (2019), https://www.pewresearch.org/internet/fact-sheet/mobile/.

218. Michelle Crouch, *A Guide to Parental Controls by Device*, PARENTS, https://www.parents.com/parenting/better-parenting/advice/a-guide-to-parental-controls-by-device/ (last visited Jun. 2, 2020); Jon Martindale, *The Best Free Parental Control Software for PC, Mac, iOS, and Android*, DIGITAL TRENDS (Apr. 14, 2020), https://www.digitaltrends.com/computing/best-free-parental-control-software/; Neil J. Rubenking & Ben Moore, *The Best Parental Control Software for 2020*, PCMAG (Apr. 6, 2020), https://www.pcmag.com/picks/the-best-parental-control-software.

software continues to become more and more sophisticated and accurate.[219] Similarly, parents concerned about the marketing efforts aimed at their children can make use of various ad-blocking tools at their disposal.[220]

Congress, in cooperation with the tech industry, can take additional steps that would give parents more granular control over their child's online activity. A standard could be developed in which websites could optionally send a content rating that would be used by filtering software to control access on a child's device.[221] Additionally, filter software could be configured by the parent to send data to the website about what standardized types of functionality should or should not be enabled on the site (e.g. commenting, uploading, direct messaging, etc.), and, in responding to the web request, the website would automatically indicate which of those preferences, if any, it will honor.[222]

Since implementing the standard would be optional on the part of the website, the burden on the website operator is voluntary and contingent upon whether they wish to cater to users browsing behind filter software. The filter software could presumptively block access to any website which does not implement the standard (or will not honor the preferences), thereby offering an incentive for websites to comply or risk losing traffic. Parents could manually authorize access to certain websites on an individual basis regardless of its use of the standard, in addition to configuring the filter software to employ one or more community-

---

219. Terri Coles, *How AI Can Help Filter the Worst of the Web*, ITPRO TODAY (Jun. 30, 2019), https://www.itprotoday.com/data-analytics-and-data-management/how-ai-can-help-filter-worst-web.

220. Andrew Chaikivsky, *Want to Protect Against Websites That Spy on You? Get an Ad Blocker*, CONSUMER REPORTS (Feb. 15, 2018), https://www.consumerreports.org/digital-security/to-protect-against-websites-that-spy-on-you-get-an-adblocker/.

221. The World Wide Web Consortium, the primary organization responsible for promulgating web standards, has previously proposed various standards to cater to filtering technology and manage an individual's privacy preferences as early as 1997, including PICS, POWDER, and P3P. *Privacy*, W3C, https://www.w3.org/standards/webdesign/privacy (last visited Jun. 2, 2020); *Platform for Internet Content Selection (PICS)*, W3C (2003), https://www.w3.org/PICS/. These standards were never widely adopted by the industry, and it has been proposed that they be declared obsolete. Philippe Le Hegaret (@plehegar), *Proposal to Obsolete PICS*, CC/PP*, POWDER*, GITHUB (Aug. 31, 2018), https://github.com/w3c/transitions/issues/86. The key difference with the proposal here is the involvement of Congress to promote (and, perhaps in some cases, compel) use of such technology.

222. The concept of sending ancillary information to a web server along with the request for a particular resource ("request headers") and receiving ancillary information from the server along with the requested resource ("response headers") is an integral part of the HTTP standard upon which the web is built. *See HTTP Headers*, MDN WEB DOCS (Apr. 27, 2020), https://developer.mozilla.org/en-US/docs/Web/HTTP/. In fact, this concept has already been employed to give users the ability to instruct websites that they don't wish to be tracked, which is effectively just one of many user preferences that could be established for a broader, kid-focused privacy scheme. *HTTP Headers: DNT*, MDN WEB DOCS (May 21, 2020), https://developer.mozilla.org/en-US/docs/Web/HTTP/Headers/DNT (detailing the header sent by the user's device to indicate tracking preference); *HTTP Headers: Tk*, MDN WEB DOCS (Mar. 23, 2019), https://developer.mozilla.org/en-US/docs/Web/HTTP/Headers/Tk (detailing the header sent by the web server indicating its tracking behavior). Similar headers exist for indicating preferred languages, *HTTP Headers: Accept-Language*, MDN WEB DOCS (Dec. 9, 2019), https://developer.mozilla.org/en-US/docs/Web/HTTP/Headers/Accept-Language, and for indicating a preference for lower data usage, *HTTP Headers: Save-Data*, MDN WEB DOCS (May 31, 2020), https://developer.mozilla.org/en-US/docs/Web/HTTP/Headers/Save-Data. A related concept allows users to configure their devices to send preferences to a website related to its visual display, such as requesting a "dark mode," Andy Clarke, *Redesigning Your Product and Website for Dark Mode*, STUFF & NONSENSE (Nov. 2, 2018), https://stuffandnonsense.co.uk/blog/redesigning-your-product-and-website-for-dark-mode, or requesting fewer animations (especially for users with vestibular disorders), Eric Bailey, *An Introduction to the Reduced Motion Media Query*, CSS TRICKS (Apr. 24, 2019), https://css-tricks.com/introduction-reduced-motion-media-query/. While honoring such preferences is currently voluntary, the web development industry continues to embrace the philosophy that web services should cater and adapt to the varying needs, preferences, and forms of access (e.g. mobile phone vs. desktop computer) among users, which is exemplified by efforts to promote better accessibility considerations for disabled users. *See* Oyetoke Tobi Emmanuel, *Why Web Accessibility Is Important and How You Can Accomplish It*, MEDIUM (Feb. 7, 2018), https://medium.com/fbdevclagos/why-web-accessibility-is-important-and-how-you-can-accomplish-it-4f59fda7859c (recognizing concurrent justifications for following web accessibility practices, which could mirror those for a privacy protection scheme as proposed here, including altruism, good business sense, and legal mandate).

curated "white lists" that would grant access to websites that have been prescreened by fellow parents or family interest groups.[223] The filter software could also connect to a parent's mobile device, allowing a child to send her parent an ad hoc request to access a website, giving the parent the opportunity to review the website and instantly grant or deny access from anywhere.[224] Congress, for its part, can take steps to make filter software freely available, promote its use, and facilitate drafting and adoption of standards within the industry.[225]

Filtering technology of this kind is feasible, and it would empower parents to make precise decisions that more effectively cater to the individual needs and characteristics of their children while simultaneously reducing the burden and liability for website operators.

V. CONCLUSION

COPPA has been a failure, and it continues to do more harm than good. Its goals of protecting children on the internet are laudable and attainable, but it is time to completely rethink the approach. With the cooperation of the tech industry and parents, Congress can reach its goals with a solution that is much more effective and workable and that maximizes the benefits among all players.

---

223. Critics may note that the internet consists of an ever-changing patchwork of billions of websites, posing a daunting, if not impossible, task of monitoring or rating the entire breadth of information. But, as a general proposition, this limitation is far more problematic with a "blacklist" strategy of filtering content (where "bad" sites are blocked, creating essentially an endless game of whack-a-mole) than with a "whitelist" strategy (where "good" sites are expressly permitted). The caveat is that "good" sites may be blocked until added to the "whitelist," but the danger of access to "bad" content is effectively eliminated. However, the "whitelist" would ideally work in tandem with an artificial-intelligence-based filter to ensure certain sites are permitted, at the discretion of the parent, to manually (and preemptively) override instances where the machine-based filter might be overzealous in its blocking.

224. Such a mechanism would realize the unattained objective of COPPA's "verifiable parental consent."

225. *Cf. Ashcroft v. ACLU,* 542 U.S. 656, 658 (2004) (citation omitted) ("Congress may act to encourage such use by giving strong incentives to schools and libraries and by promoting the development of filters by industry and their use by parents.").

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

DIAMONDS IN THE DUST: WHY LAWYERS MAKE THE IDEAL CANDIDATE FOR CEO

❖ NOTE ❖

Soha Abdurrahman *

I. INTRODUCTION

One might expect that after completing three years of law school the next step would be to enter into a law firm and practice law until retirement. Yet that idea is changing. Lawyers are no longer just becoming lawyers.[1] In reality, lawyers are using their degree for so much more—and one destination for them is all the way at the top: Chief Executive Officer (CEO). This paper acknowledges that lawyers that become CEO make a difference. But it is not due to external factors, but rather the skill sets innate to lawyers that allow them to get to the top.

II. BACKGROUND

A. The Path

The unique skill sets of lawyers have set them apart as professionals who can become leaders of organizations. This skill set is often seen in U.S. presidents, where a majority had a legal degree.[2] But even more than the political field, lawyers thrive in the business sector as well, specifically as CEO. A CEO, or Chief Executive Officer, is a an individual at the top of the organization who, along with his C-Suite, work to shape the organization and achieve success in the present but also invest in the long term for the company.[3] Lawyers in the role

1. Leanne Fuith, *Creating the Lawyer as Business Leader*, 43 MITCHELL HAMLINE L. REV. 1095, 1096 (2017), https://open.mitchellhamline.edu/cgi/viewcontent.cgi?article=1106&context=mhlr.
2. Kevin H. Michels, *Our Hidden Value*, 53 U. LOUISVILLE L. REV. 1, 19 (2014)
3. A.G. Lafley, *What Only the CEO Can Do*, HARV. BUS. REV. (May 2009), https://hbr.org/2009/05/what-only-the-ceo-can-do.

*J.D. Candidate, Class of 2022, University of Illinois College of Law.

of CEO were common as they were able to meet the job requirements of a CEO. In fact, Harvard Law used to produce more CEOs than its business counterpart. [4]

The most common way of getting to the position of CEO was to start off as a lawyer in a firm and gain enough experience to move into general counsel positions.[5] The general counsel position allowed lawyers to gain a deeper understanding of the non-legal side of their business.[6] As general counsel, a lawyer transforms into not just an individual involved with the legal side of the company but the operational side as well, essentially making such positions a training ground for future CEOs.[7] Often times, the general counsel is tapped into for a non-legal position in the company with the potential to grow.[8] This opportunity is pretty common as lawyers in executive positions make up 44% of major companies.[9] As these lawyers gain more experience on the operational side of their companies, they also gain opportunities to move up the corporate ladder. Other times, partners at major firms are tapped into by an organization due to the outside counsel's familiarity with the company.[10] From here on out these lawyers either become CEOs or try to move up the corporate ladder from their executive positions to CEO. However, despite starting at different points, one thing that makes all of these lawyers similar is that they have gained a firm understanding of the organization before being asked to lead.

From a lawyer's perspective, lawyers make a move into leadership because they want the challenge of going from being merely an advisor to a decision maker.[11] They aim to become CEOs because they have a drive that makes them want to be more than just a lawyer. They also get the opportunity to become more creative and look for solutions outside of a client's demands.[12] Lawyers, after spending time in law firms, also prefer to think more long-term about their future and where they want to retire.[13] The benefits and work of a CEO calls out to the above considerations, sometimes moreso than that of more senior law firm positions.[14]

B. The Problem

Although lawyers can make it to the top, the perception of lawyers and their negative stereotypes have contributed to a small number of lawyers turned CEOs.[15] As shown in

4. Larry Smith, *Lawyer-CEOs: No Predictable Attitudes Concerning Legal Function*, OF COUNSEL, July 20, 1992, at 28.
5. Irene Taylor, *Crossing Over: Lawyers as Corporate Executives*, FINDLAW, (March 26, 2008), https://corporate.findlaw.com/litigation-disputes/crossing-over-lawyers-as-corporate-executives.html.
6. Ben W. Heineman Jr., *Resolving the Partner-Guardian Tension: The Key to General Counsel Independence*, 42 DEL. J. CORP. L. 149, 156 (2017).
7. David Felicissimo, *A Seat at the Head of the Table: From Lawyer to CEO?,* ACC DOCKET, July/August 2017, at 24.
8. Mark Curriden, *Ceo, Esq. Why Lawyers Are Being Asked to Lead Some of the Nation's Largest Corporations*, A.B.A. J. May 2010, at 30.
9. Adair Morse ET. AL., *Executive Lawyers: Gatekeepers or Strategic Officers?*, 59 J.L. & ECON. 847, 847 (2016).
10. Taylor, *supra* note 5.
11. *Id*.
12. Felicissimo, *supra* note 7.
13. Taylor, *supra* note 5.
14. *Id*.
15. Smith, *supra* note 4.

Exhibit A, JDs only made up a small fraction of Fortune 500 CEOs.[16] Looking deeper, Exhibit B shows that there were only 9 lawyer-CEOs among the Fortune 100, as per 2019.[17]

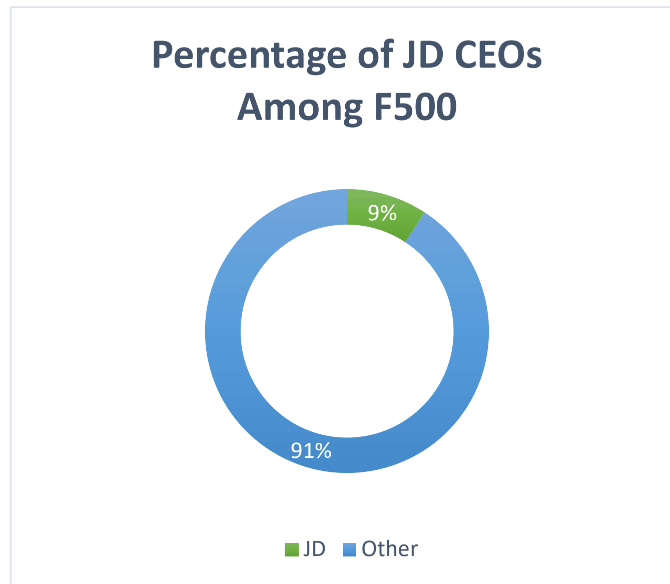


Exhibit A

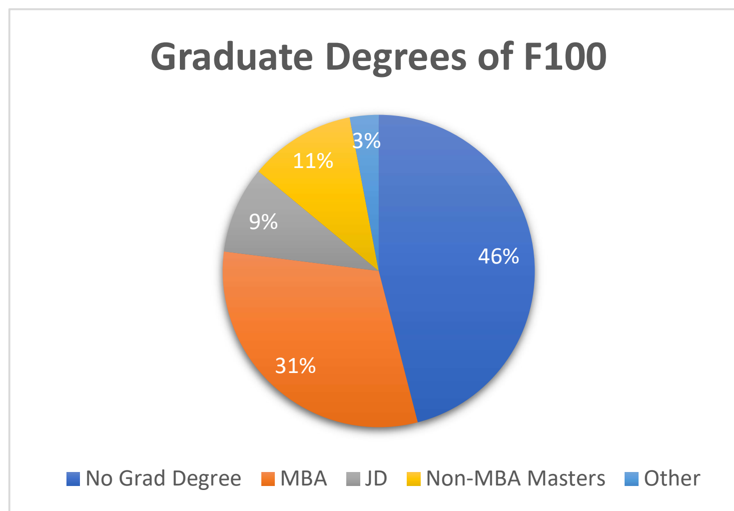


Exhibit B

16. Menachem Wecker, *Where the Fortune 500 CEOs Went to Law School*, US NEWS & WORLD REPORT, (June 26, 2012, 7:00 AM), https://www.usnews.com/education/best-graduate-schools/top-law-schools/articles/2012/06/26/where-the-fortune-500-ceos-went-to-law-school.

17. Kimberly A. Whitler, New Fortune 100 CEO Study: The Top Graduate Schools Attended By Fortune 100 CEOs, Forbes, (Sep 28, 2019,03:03pm), https://www.forbes.com/sites/kimberlywhitler/2019/09/28/new-fortune-100-ceo-study-the-top-graduate-schools-attended-by-fortune-100-ceos/#1519a16c2719.

The negative reputation of lawyers mainly stems from the view that they are too cautious and risk averse.[18] Other times people rationalize that lawyer-CEOs are only needed in industries with high regulations or when a company is facing legal trouble.[19] It is true that lawyer-CEOs are slightly more common in utility companies that deal with a large number of regulations and insurance companies that deal with contract selling.[20] Yet there are still some companies that take lawyers as CEOs outside of the utility and insurance industry.[21] Despite all of this, the negative perception of lawyers takes away of from the fact that lawyers make great leaders.[22] When given the opportunity lawyers can become "dynamic and persistent" leaders.[23] They have a skill set with factors that make them adaptable to the demands of CEO positions. They are not simply useful in times when a company is in legal need.[24] Rather their distinctive perspective allows them to bring immeasurable benefit to the organization in which they lead.

C. The Benefit

Lawyers bring to a company a different outlook on looking at problems and coming to solutions. They approach a problem much differently than someone who has a business background. This unique point of view has led to positive benefits for companies in which lawyers hold high positions. For instance, lawyers as directors increase firm value by as high as 9.5%.[25] More specifically, in a study conducted by the Harvard Business School of 3500 CEOs within which 9% had a JD, lawyer-CEOs decreased their companies' litigation by anywhere between 16 to 74%.[26] Lawyer CEOs have also helped rise firm value in high growth firms with large litigation.[27] They can also enhance shareholder wealth by maximizing the use of their skills as well.[28]

Besides numeric value, there is a deeper reason as to why lawyers-CEOs are beneficial. Naturally, a CEO spends about 25% of her time considering legal issues.[29] This is due to the fact that the business industry as a whole has become increasingly complex as laws change and regulation fluctuates. Furthermore, industries are increasingly converging and blurring the line between what is considered law and what is considered business.[30] Therefore, lawyers who are able to navigate this duality become invaluable to organizations. Lawyers also have the ability to understand that the law can be so much more than a constraint. Instead, lawyer CEOs can find ways to have the law add value to a firm as a competitive

---

18. Michels, *supra* note 2, at 20.
19. Bill Mordan, *Lawyers As Ceos*, ACC DOCKET, May 2007, at 108, 108.
20. Smith, *supra* note 4.
21. *See* Curriden, *supra* note 8, at 35.
22. Michels, *supra* note 2, at 24.
23. Robert C. Bird, *Law, Strategy, and Competitive Advantage*, 44 CONN. L. REV. 61, 90 (2011).
24. Michels, *supra* note 2, at 24.
25. Lubomir P. Litov ET. AL., *Lawyers and Fools: Lawyer-Directors in Public Corporations*, 102 GEO. L.J. 413, 414 (2014).
26. M. Todd Henderson *Do Lawyers Make Better CEOs Than MBAs?*, HARV. BUS. REV. (8/24/2017), https://hbr.org/2017/08/do-lawyers-make-better-ceos-than-mbas.
27. *Id*.
28. Constance E. Bagley, *What's Law Got to Do with It?: Integrating Law and Strategy*, 47 AM. BUS. L.J. 587, 587 (2010).
29. Bird, *supra* note 23, at 64.
30. Michels, *supra* note 2, at 19.

advantage.[31] They can turn regulations into opportunities and protect the organization's resources.[32] Taking these benefits into consideration, it seems logical to tap into lawyers as a source of leadership for corporations.

III. Analysis

Lawyers are different than other professionals climbing up the corporate ladder but three specific factors stand out to make lawyers better candidates to lead an organization. The first is the education that the lawyers receive—the skills that lawyers learn in communication and analysis are useful for CEOs to effectively communicate better solutions with shareholders and other executives. Secondly lawyers make better corporate players because of their ability to analyze legal risks—while normally seen as a negative characteristic, understanding legal risks is actually beneficial in our increasingly complex world. Lastly, lawyer CEOs are incredibly valuable for their ability to combine their legal knowledge with their business acumen to create unique competitive skillsets.

A. Education

In distinguishing a lawyer as a viable choice for an effective corporate leader, the educational component of a lawyer is the foundation to which the other factors are supported by. After all, legal education creates lawyers not just by imparting skills onto them but by introducing a whole new way of thinking.[33] A lawyer's education can be split into two categories: praxis knowledge and normative knowledge.[34] Praxis knowledge are the lawyer's practical capabilities such as how to analyze issues and the capacity to learn in different circumstances.[35] Praxis knowledge is often linked to applying the law. On the other end, normative knowledge is the ability to navigate through competing interests and issues to reach optimal solutions.[36] It is the combination of these two that when applied make a lawyer a worthwhile choice for CEO.

1. Praxis Capabilities

Praxis knowledge is what lawyers are routinely used to; it is the ability to research and apply information. In learning this, lawyers are taught through a case method.[37] This means that students receive a problem with a solution that is already given, but the student has to figure out how that solution was met and conversely why that solution was not met.[38] This differentiates to typically business-oriented students that are more accustomed to balancing

---

31. Bagely, *supra* note 28, at 588.
32. Bird, *supra* note 23, at 69.
33. Smith, *supra* note 4.
34. *See* Michels, *supra* note 2, at 1 (discusses the praxis and normative capabilities of lawyers).
35. *Id.* at 3.
36. *Id*. at 1.
37. Richard A. Kaplan, *Toward Better Communications Between Executives and Lawyers*, Utah B.J. July/August 2011, at 18.
38. *Id*.

singular interests.[39] Furthermore, the method taught to business school students have students making decisions and rigidly sticking to their decisions. The method that lawyers learn from allow them to look at problems from both sides, and be objective in understanding why a certain answer works for a certain problem.[40] This method of thinking pushes a lawyer to have a more disciplined thought process.[41]

Law schools have also taught their students a baseline understanding of the business world, and some go further by teaching more advanced concepts like transactions and deal-making.[42] Though this education does not guarantee that every law student has the requisite skill set to take on business functions, it at least allows for a good starting point for law students to grow. More particularly, law schools with curriculums that focus on public policy and business law help mold lawyers into effective business leaders.[43] As government regulations increase, every member of organizations have to increasingly deal with business operations; law schools have listened and created curriculums that allow law students to learn and be better suited for this change.[44] The praxis knowledge given by law schools has integrated business topics to make their students more prepared for the business world.[45]

Legal training, both in school and practice, also prepares lawyers to delve into and analyze problems typically faced by CEOs in particular. Lawyers by nature are known to look at problems from every angle. CEOs need to similarly break down issues and analyze every corner of their business, which include outside factors that more junior members may not need to consider.[46] The transition from business employee to CEO is immense since it requires a shift from years of singular problem solving to a position that requires multifactored and multidisciplinary solution building. Here, lawyer-CEOs are much more valuable because they are able to look past the single thought of profit maximization[47] and understand what exactly problems consist of in order to get to better solutions.

It is true that the process of analysis could become a burden in decision making when CEOs have to make quick decisions.[48] Yet lawyers have been shown to thrive in situations of high pressure and with vast amounts of data.[49] Part of what law school teaches its students—and an essential function of the court system—is to make complex decisions in a short amount of time in regard to public policy based on limited available information.[50] As such, lawyers are even more so prepared for CEO roles due to their ability to employ their complex problem solving skills under pressure.[51]

39. *Id*.
40. Mike France & Louis Lavelle, *A Compelling Case For Lawyer-CEOs*, BLOOMBERG NEWS, 88, 90 (December 12, 2004, 11:00 PM), https://www.bloomberg.com/news/articles/2004-12-12/a-compelling-case-for-lawyer-ceos.
41. Smith, *supra* note 4.
42. Fuith, *supra* note 1, at 1097.
43. Curriden, *supra* note 8, at 33.
44. Bagely, *supra* note 28, at 633.
45. Curriden *supra* note 8, at 33.
46. *Id*.
47. Felicissimo, *supra* note 7, at 25.
48. Heineman, *supra* note 6, at 161.
49. Felicissimo, *supra* note 7.
50. Curriden, *supra* note 8, at 33.
51. Felicissimo, *supra* note 7, at 29.

2. Normative Capabilities

Lawyers are naturally used to working within given boundaries. A lawyer works to understand her client's request and work within that request to reach to the end goal.[52] In order to understand what the client wants—the lawyer asks questions and grapples with different opposing factors to get to the client's end goal and also guide the client into taking the right path.[53] To do this, lawyers apply normative reasoning to balance competing tensions between many parties. This position that many lawyers face is very similar to the positions faced by CEOs.[54] Specifically, CEOs are in a position to achieve the goal of multiple parties such as their employees, their board of directors, and the public as a whole. For instance, the board is worried about compensation and the public image of the company.[55] The public is worried about how socially conscious companies are.[56] A lawyer-CEO can use normative capabilities from their experience to wrestle with these different competing interests. It is these normative capacities that play a central role in decision and policy making.[57]

The development of normative capabilities comes from lawyers who have conversations and reflections on different ideas over the course of their career.[58] Lawyers have plenty of these opportunities through reading cases, crafting direct and opposing arguments between multiple parties, and developing greater theories and narratives.[59] These opportunities start in law school but grow as lawyers begin their real practice. The compounding of these ideas allows a lawyer to tell stories with coherent themes. Similarly, lawyer-CEOs have the ability to use normative capacities to get their normative point across. When a lawyer-CEO is able to communicate her position and tell the story she wants to tell, it assists in the success of achieving the company's objectives.[60]

A roadblock that lawyers may face in their normative reasoning is in properly communicating their ideas. This can be overcome through how lawyers learn to understand one's audience.[61] Lawyers have many opportunities to learn and adjust the way they question and communicate rigorously with clients—making lawyers progressively better at reaching client and stakeholder objectives.[62] These further communication skills allow lawyer CEOs to actually apply their normative reasoning with clear and sufficient facts and background delineated through conversations and research. Once effective communication is established, normative reasoning can be applied to reach tactical and strategically informed decisions and use them to grow a successful company.[63]

---

52. Michels, *supra* note 2, at 17.
53. *Id*.
54. *Id*. at 1.
55. Mordan, *supra* note 19.
56. Michels, *supra* note 2, at 21.
57. *Id*.
58. *Id*. at 32.
59. *Id*. at 11.
60. Mordan, *supra* note 19.
61. Kaplan, *supra* note 37.
62. France & Lavelle, *supra* note 40.
63. Michels, *supra* note 2, at 21.

B. Risk Management

While a lawyer-CEO's praxis reasoning, normative reasoning, and communication skills play a vast role in her success, so too does her ability to manage risks. Indeed, risk analysis is inherent in a lawyer's practice and becomes a major pillar in her work.[64] In a business setting, risk management skills provide an increased advantage to a lawyer turned CEO and the organization. These skills provide positive outcomes to the organization and assist decision making in crucial times. Despite the negative connotations of risk management, especially in the context of lawyers, risk management ultimately becomes a benefit for the organization in the long run.

The cultivation of risk analysis happens early on in a young lawyer's profession. Legal training provides lawyers with the capabilities of analyzing risks before determining whether the client should go forward with an action or not.[65] Lawyers learn early on what to look for when making decisions. They make sure to look for all the possible options before making a decision, which includes many factors not considered in simple business contexts.[66] Additionally, lawyers learn to make decisions in difficult and uncertain situations. More specifically, lawyers thrive in unfamiliar situations and they often use risk analysis as a tool to overcome these situations.[67] This specialized way of risk management sets lawyers apart from individuals with a business background who have trouble making decisions when there is uncertainty and unfamiliarity with a situation.[68] These risk management skills help guide lawyer-CEOs through difficult situations. Furthermore, lawyer-CEOs have used their risk management skills to positively respond to changes and evolving uncertainty. For instance, with the passing of the Sarbanes-Oxley Act, companies that had lawyer-CEOs experienced a positive market response since their CEOs' legal backgrounds helped them sift through the increasingly complex legal and regulatory framework.[69]

These risk analysis skills as applied to a business context also provide organizations benefits on a macro-level. In industries with high regulations, lawyer CEOs are successful because they have a better understanding of the business within those legal obstacles.[70] Stringent legal enforcement and high compliance in an industry would effectively make the lawyer-CEO a prized asset in a company.[71] Yet the industries with high regulations are not the only industries that benefit from risk analyzing lawyer-CEOs. Indeed there has been a push towards risk management outside industries that deal with high regulations.[72] As the business world and the law start blurring together, the benefit of a lawyer at the top of the pyramid goes up as well.[73] An individual with experience in both business and law can handle the blurry line between these two fields, especially more so than a CEO with a non-

64. Fuith, *supra* note 1, at 1097.
65. Henderson, *supra* note 26.
66. Felicissimo, *supra* note 7, at 27.
67. *Id*.
68. Mordan, *supra* note 19.
69. Henderson, *supra* note 26.
70. France & Lavelle, *supra* note 40.
71. Henderson, *supra* note 26.
72. Curriden, *supra* note 8, at 33.
73. *Id*.

legal background. This is seen easily when looking at the numbers of lawyer-CEOs who reduce corporate litigation anywhere between 16 to 74%.[74]

However lawyers are still criticized for being risk adverse and overly cautious.[75] It is true that lawyers, especially at law firms, must find risks and break them down.[76] As such, lawyers may be seen as less aggressive in accrual and recognizing revenue at a much slower rate as compared to their competitors.[77] Yet a lawyer-CEO's risk management skills do not make her averse to all risk. Rather, studies show that lawyer-CEOs have the same stock purchasing habits as regular CEOs.[78] Moreover, individuals in non-legal roles should also be considering the kinds of risks lawyers are accustomed to when looking at business solutions.[79] Lawyer-CEOs are not risk averse, rather they are simply risk managing in the same way other business roles should. As such, lawyers constrained by the law actually have an advantage since their specialized knowledge of risk allows them to reach innovative solutions.[80] In the CEO context, it becomes a competitive advantage to be able to come up with innovative solutions in constraining situations. Risk is innate to the position of CEO, and a lawyer who is able to clearly understand and work around risk becomes a perfect match for that position.

C. Potential

Lawyers also have good potential to grow into the position of CEO. While education plays a major factor, the ability for lawyers to learn effectively throughout their entire career plays the greatest role in becoming CEO. Lawyers can grow into leadership positions because they have the ability to familiarize with new ideas and topics at a rapid pace. Secondly, they have the ability to adapt to a myriad of different situations and learn to work within those situations. By successfully transporting these factors to the business world, a lawyer can grow into the position of CEO.

Lawyers, by nature, are quick to pick up information. As laws and circumstances change, lawyers are required to learn new ideas and arguments for all the issues pertaining to their field. This skill is taught to them early on in their professional career through continuing legal education (CLE) requirements. In applying this to a corporate setting, the willingness, drive, and necessity to pick up information about a company and its operations, as well as the legal topics surrounding the business, are beneficial in making lawyers great CEOs.[81] It is this ability to learn that puts lawyer-CEOs on the same playing field as regular CEOs before even taking on the position.

A lawyer's potential to grow also comes from the fact that they are adaptable. Early in their career, lawyers learn how to do their job by actually going out and working. Education

---

74. Henderson, *supra* note 26.
75. Ben W. Lewis, et al., *Difference in Degrees: CEO Characteristics and Firm Environmental Disclosure*, 35 STRATEGIC MANAGEMENT J. 712, 715 (2014).
76. Felicissimo, *supra* note 7, at 27.
77. Henderson, *supra* note 26.
78. Joel Kaidesoja, *Lawyer CEOs and Corporate Risk-Taking* Aalto Univ. 1,60 (2018).
79. Bagely, *supra* note 28, at 633.
80. *Id*. at 593.
81. France & Lavelle, *supra* note 40.

teaches the necessary praxis, normative, and communication skills, but the real education is done through on the job training. Through this, lawyers learn to be quick and adaptable on legal work outside the law school. Additionally, lawyers become confident in rapidly familiarizing themselves to new information, often through uncontrollable changes and circumstances from courts, markets, and third parties. This often leads lawyers to face legal issues in different industries, fields, and contexts, eventually turning them into multifaceted experts.[82] Transferring this skill to the corporate world, lawyers learn to adapt to the nature of their companies and the many different issues concerning them. Lawyers learn to adapt to the culture and values of the organization, an important feature in understanding the organization. Lawyers also adapt to the barrage of new problems that companies eventually face, making them efficient leaders that bring a competitive advantage to the company.[83]

Learning and adaptability often close the gap between lawyers and those with a non-legal background. Though there are some knowledge gaps and obstacles to adapting, the responsibilities of CEOs are nothing out of the ordinary for many lawyers.[84] For instance, CEOs have to understand how to manage conflict between parties and their diverse interests in the company.[85] Lawyer-CEOs are well prepared for this responsibility. A combination of a lawyer's praxis, normative, and communication skills mentioned above create a unique and ideal skill set that is capable of balancing diversity and complexity to reach optimal solutions.

IV. Recommendations

Lawyers are well-suited to be CEOs and those that have reached that position have made positive impacts to their companies and industries. Yet despite meeting the requisite bar to become CEO, lawyer-CEOs are still lacking. Lawyers continue to be a large pool of untapped potential. In order to address this problem and to push lawyers into becoming CEOs, there are two recommendations that should be implemented. For one, there needs to be an increase in mentoring of lawyers to help hone skills and entertain the possibility of becoming a CEO. Secondly, there needs to be a change in the perception of lawyers by the business world as a whole. The combination of these two steps opens up a pathway for more lawyers to rise to the top and bring about the positive impacts that they are capable of enacting.

A. Guiding the Next Generation

Lawyer often have the skills to become CEOs, but they will need assistance from mentors to help guide them along the way. Taylor writes that mentorship can be seen as an almost critical success factor for lawyer-CEOs.[86] This statement, while broad, is true—mentors are essential in showing lawyers the possibilities available to them and are thus resources to help lawyers see the role of CEO as attainable and worthwhile.

---

82. Smith, *supra* note 4.
83. Bird, *supra* note 23, at 68.
84. Michels, *supra* note 2, at 23.
85. *Id*. at 21.
86. Taylor, *supra* note 5.

Mentors often play a role in the molding of a lawyer. They help lawyers hone their skills to adapt to the business sector. They assist in helping the lawyer to think differently or approach problems in a different solution. Other times they push lawyers to think about the big picture rather than just on the one goal in front of them. In accordance with this, mentors in the business sector, lawyer or not, become vital because they have the knowledge and experience to guide young lawyers. They offer advice and wisdom to lawyers trying to get to CEO.

Mentors also become important resources when moving up the corporate ladder. Their connections and network become the lawyer's way to be recognized. The recommendation of a mentor can often lead to opportunities for lawyers to move in a non-legal capacity. Other times mentors can provide the reference to organizations for lawyers in executive positions. These mentorships often influence the path of a lawyer and vouch to individuals in the organizations about the capabilities that lawyers have.

While law schools and firms have a mentorship program, there are rarely any instances of mentors training lawyers to enter into a position in a non-legal capacity. For one, there are not that many lawyer-CEOs to guide other lawyers. This void of mentors makes it harder for a lawyer to get to the top as they have to learn to hone their skills on their own. As a result, lawyers in non-legal positions need to take a step forward and vouch for the capabilities that lawyers have. The impact and training of lawyers early on in seeing CEO as a possible career path influences skills and connects lawyers to those experienced in the business world. It is important to nurture the idea of lawyers becoming CEOs in young lawyers so they can meet a mentor that can help them hone their skills for the position if they so desire.

B. Making a Seat at the table

While lawyers have the skills to rise to the top, they still need an opportunity to demonstrate those skills. Often times, the pressure of prejudice makes it difficult for lawyers to rise into management and break into the inner circle. Mentors assist them, but there is still a gap due to the perception of lawyers ingrained in those within an organization. As mentioned in this note, various stereotypes make it difficult for lawyers to display their skills. Yet by normalizing the idea of lawyers as leaders changes the perception and opens up opportunities for lawyers.

Lawyers are seen as individuals who say no often and generally as deal breakers. They often get boxed into the role of lawyer and are relegated to only dealing with legal issues. This boxed in persona leads to a waste of good resources for an organization. However, by opening up positions to lawyers in more than just a legal capacity leads to a changed perception by those around them. Others start to view lawyers as problem solvers who can work on non-legal issues. This in turn also allows them to work in the business operations of things. As Kaplan puts it, the experience for lawyers to work on other projects in non-legal capacities essentially becomes training grounds for lawyers to become effective executives and even more so to be worthwhile candidates for CEO for that company.[87] Kaplan is correct

87. Kaplan, *supra* note 37.

in stating that lawyers get a lot of their skills and their potential to grow by being able to learn and work with those around them in a non-legal capacity.

Secondly, perceptions change by easing communication between the legal sector of the company and the rest of the organization. Lawyers are often seen as the untouchable part of the company that are only present to deal with legal issues. Yet by creating an effective communicative environment between the lawyers of the company and other individuals, the lawyer becomes an approachable individual for those in the non-legal sector of the company. Fuith writes how changing the communication between lawyers and those within a business sector allows for lawyers to adapt to the way people with a non-legal background speak and vice versa.[88] This two-way communication change also builds trust and allows lawyers the opening to build relationships with those outside the legal sector. A change in communication leads to the change in perception of lawyers among those within the organization. This also leads to those individuals naturally creating an opportunity for a lawyer to partake in non-legal issues within a company—an opportunity for lawyers to showcase their skills that make them valuable beyond being just a lawyer.

Changing perceptions is not an easy process. Rather it takes time and different opportunities to make lawyers more approachable. It would require more of an input from lawyers in a non-legal capacity. It also requires more opportunity for the business operation side of companies to communicate with the legal departments. Steps such as this are a long process but end up with positive results in the end. This process makes lawyers trustworthy to the greater workforce and helps others realize their potential. It also opens up doors for lawyers to move into non-legal capacities because of the skills they have demonstrated to their coworkers. This relationship essentially becomes the foundation of lawyers moving into the position of CEO.

V. Conclusion

It is time to rethink the idea that lawyers are not good corporate leaders. Once prejudices are overcome and lawyers are given a seat at the table, they can become effective leaders in an organization. Their blend of talents makes them an asset for any organization to gain a competitive advantage in the industry, making them worthy of taking on the high level responsibilities of CEOs.

88. Fuith, *supra* note 1, at 1107.

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

IS OPPORTUNITY ZONE INVESTING ATTRACTIVE TO WEALTHY INVESTORS?

❖ ARTICLE ❖

Daniel Pessar *

ABSTRACT 104
INTRODUCTION 105
I. THE QUALIFIED OPPORTUNITY ZONE LAWS ARE STRUCTURED TO INCENTIVIZE INVESTORS TO BRING NEW CAPITAL INTO DESIGNATED AREAS 106
A. *Investments involving large and simple asset purchases or improvements are best-suited to the QOZ rules* 108
B. *Some investors will enjoy a windfall by receiving QOZ incentives in projects that do not advance the purpose of the laws* 109
II. BUT BECAUSE MANY WEALTHY INVESTORS BENEFIT FROM THE ABILITY TO INDEFINITELY DEFER CAPITAL GAINS, QUALIFYING OPPORTUNITY ZONE INVESTMENTS ARE USUALLY NOT ATTRACTIVE 110
A. *Opportunity zone investing involves a variety of risks and an uninviting threshold decision for investors who do not have to realize capital gains* 111
B. *Many wealthy investors have several avenues for preserving indefinite capital gains deferral, making the QOZ investment decision less attractive* 112
III. AND EVEN THE BENEFITS FOR INVESTORS WHO CANNOT EASILY ACCESS INDEFINITE DEFERRAL HAVE BECOME LESS ATTRACTIVE 115
A. *In the current low income tax, low interest rate environment, QOZ investing is less valuable* 116
B. *And to the extent that QOZ investing is less valuable for investors, fund operators and developers face a higher cost of capital overall and benefit less* 116
CONCLUSION …..117

* J.D. Candidate, Class of 2020, Harvard Law School. I am grateful to Harvard Law School Professors Thomas Brennan and Stephen Shay for their helpful comments and warm encouragement.

ABSTRACT

In the media, in state capitals, and even in Congress, the super-rich are frequently cited as the biggest economic winners from the opportunity zone laws passed as part of the 2017 Tax Cuts and Jobs Act. Although high net worth investors can access the tax benefits more easily than others can, a closer look at the law and regulations reveal that the wealthiest taxpayers are usually less incentivized than other wealthy investors to participate in Qualified Opportunity Zone (QOZ) investing. The QOZ tax benefits are significant, promising capital gains tax exclusion on new QOZ investments. But high net worth investors have more access than others to indefinite deferral mechanisms, making capital gains exclusion less valuable. QOZ investments requires capital gains realization and, by tax year 2026, capital gains recognition, presenting current costs in exchange for future tax benefits mostly available ten years after the investment is made. Even though the QOZ laws are designed to provide tax benefits to any investor with capital gains, the investors best-positioned to benefit are those with realized gains who lack access to indefinite capital gains deferral. And in the current low tax and low interest rate environment, even those investors may not find QOZ investing attractive.

INTRODUCTION

When the Joint Committee on Taxation (JCT) of the U.S. Congress presented revenue estimates for the 2017 Tax Cuts and Jobs Act, it limited its report to a 10-year projection window,[1] as required by the budget process.[2] One of the many line items it evaluated was the creation of the new Qualified Opportunity Zone (QOZ) program, codified in Internal Revenue Code Sections 1400Z-1 and 1400Z-2. But the QOZ law, created to encourage the investment of new capital in low-income communities,[3] promises most of its tax incentives after an investor's qualifying investment is held for at least ten years, beyond the horizon of the JCT's report. Further compounding the opacity of the law is the lack of robust reporting requirements by investors and the somewhat technical nature of the regulations. Because the law's benefits and budgetary impact are difficult to project, there continues to be significant speculation surrounding the extent to which the law will make a mark on low income communities and on the federal budget. A frequent criticism of the QOZ laws is that the law helps wealthy taxpayers without providing sufficient benefit to the public in return.[4]

While certain media outlets,[5] members of congress,[6] and state lawmakers[7] have objected to the structure of the opportunity zones law, the Treasury regulations advance a clear purpose "to provide specified tax benefits to owners of QOFs [Qualified Opportunity Funds] to encourage the making of longer-term investments of new capital, through QOFs and qualified opportunity zone businesses, into one or more QOZs [Qualified Opportunity Zones] and to increase the economic growth therein."[8] To the extent that this mission is achieved, wealthy investors are meant to benefit financially. The QOF owners mentioned in the statement of purpose are almost certain to be wealthy taxpayers because in order to access the QOZ tax benefits, investors must realize capital gains within the 180 days preceding the QOF investment.[9] Thus, investors interested in reaping the tax benefits must have access to capital

---

1. *Estimated Budget Effects of the Conference Agreement for H.R. 1, The "Tax Cuts and Jobs Act"*, Joint Committee on Taxation, December 18, 2017 JCX-67-17, https://www.jct.gov/publications.html?func=startdown&id=5053
2. "The current budget process also requires the Joint Committee staff to generate revenue estimates of tax legislative proposals over a 10-year period, often referred to as the "budget window."" Joint Committee Revenue Estimation Process, The Joint Committee On Taxation, https://www.jct.gov/about-us/revenue-estimating.html
3. 85 FR 1941
4. This is a concern expressed with regard to countless other tax expenditures as well. For a useful framework for assessing the different kinds of tax expenditures and who they benefit, see David M. Schizer, Limiting Tax Expenditures (2015), Tax Law Review.
5. The New York Times has focused on the windfall received by a select few billionaires. See e.g., *Opportunity Zones — for Billionaires* (Nov. 16, 2019) https://www.nytimes.com/2019/11/16/opinion/trump-tax-opportunity-zones.html
6. "Opportunity Zones were supposed to help uplift low-income communities and those living in poverty, but instead we are seeing them benefit billionaires and their luxury projects." *Congresswoman Rashida Tlaib Introduces Bill to Repeal Controversial Opportunity Zones* (November 22, 2019) https://tlaib.house.gov/media/press-releases/congresswoman-rashida-tlaib-introduces-bill-repeal-controversial-opportunity
7. *See, for example*, HB 4010 A, a bill proposed in the Oregon House of Representatives and recommended by committee but adjourned because of a failure to reach quorum after a Republican walkout. Although Oregon income tax generally uses federal income tax as a starting point for calculation, the bill seeks to reduce the extent of the QOZ capital gains exclusion for Oregon tax purposes.
8. 85 FR 1907. Internal Revenue Code § 1400Z-1 governed the process by which state governors decided which census tracts would receive the QOZ designation. By summer 2018, the Treasury Department had effectively finished the QOZ certification process. See *Treasury, IRS Announce Final Round of Opportunity Zone Designations* (June 14, 2018) U.S. Department of the Treasury https://home.treasury.gov/news/press-releases/sm0414
9. For example, an investor interested in making a qualifying $15 purchase in a Qualified Opportunity Fund will need to realize $15 in capital gains 180—or fewer—days before purchasing the QOF interest. This might occur if the investor sold $40 in

and capital gains, two resources unlikely to be held by the lower to middle percentiles of American households.[10] Moreover, because the wealthiest Americans tend to have the most capital and capital gains, they are positioned to receive the richest tax benefits.[11]

But although the wealthiest investors might have the most capital and capital gains available to benefit most under this uncapped program,[12] the opportunity zone incentive structure may not actually incentivize participation by the wealthiest taxpayers in the United States. Relative to the average investor, wealthy taxpayers are less likely to trigger capital gains realization, a necessary condition for opportunity zone benefit eligibility. Furthermore, wealthy investors have more access to indefinite gains deferral mechanisms than the average investor. Corporate reorganizations, partnership property distributions, and like-kind exchanges are just a few examples of how wealthy investors can dispose of property without triggering a taxable event.

This paper will evaluate the opportunity zone benefits within the framework of wealthy investor decision making and will argue that QOZ investing is not beneficial to most high net worth investors despite the widespread sentiment to the contrary. Part I will include a review of the opportunity zone incentives. Part II will contain a discussion of indefinite capital gains deferral and some of the ways wealthy investors can access this benefit. Part III will argue that even wealthy investors without access to indefinite deferral may not be incentivized to make QOZ investments. Although the tax benefits are attractive to these investors, the current low tax, low interest rate environment makes the tax-deferred, long-term, opportunity zone investments less beneficial to most investors.

I. THE QUALIFIED OPPORTUNITY ZONE LAWS ARE STRUCTURED TO INCENTIVIZE INVESTORS TO BRING NEW CAPITAL INTO DESIGNATED AREAS

The opportunity zone laws provide tax benefits to investors making equity investments into Qualified Opportunity Funds (QOFs), entities which must maintain substantially all of their assets invested in Qualified Opportunity Zone (QOZ) property. Whether the QOF held assets directly ("qualified opportunity zone business property") or through another entity ("qualified opportunity zone stock or qualified opportunity zone partnership interest"), substantially all of the assets owned by the qualifying entities must be located in QOZs, designated census tracts located in every U.S. state, the District of Columbia, and five U.S. territories. Investments are only eligible for tax benefits if they are made within 180 days of a

---

assets with a $25 basis, an investment representing a $15 gain.

10. "Approximately 33 percent of U.S. households own taxable investment accounts, 29 percent own only retirement accounts, and 38 percent do not own any investment accounts. Households that own taxable investment accounts are more affluent and financially knowledgeable than households with only retirement accounts, which are in turn more affluent and financially knowledgeable than the households without investment accounts." Gary Mottola, *A Snapshot of Investor Households in America* (September 2015), FINRA Investor Education Foundation https://www.sec.gov/spotlight/fixed-income-advisory-committee/finra-investor-education-foundation-investor-households-fimsa-040918.pdf

11. Wealthy investors also have access to the investment and legal advice necessary to evaluate the risks and rewards of QOZ investments as compared to other options.

12. One example of a capped program is the New Markets Tax Credit. Through 2018, the Department of the Treasury's Community Development Financial Institutions (CDFI) Fund awarded approximately $50 billion in allocations. This amount, which translated to a potential reduction in investor tax liability of approximately $20 billion. The QOZ program, as designed, could cost many times that number without any special authorization or allocation.

capital gains realization event.[13] Thus, the law is designed to unlock gains held on investors' balance sheets and to incentivize investors to direct those funds into investments in these QOZs. Investors making qualifying investments can elect to defer the gains from the capital gains realization until tax year 2026 unless any action triggers gains recognition before that point.[14] The QOZ investment itself, once held for at least ten years, can qualify for a step up in basis to fair market value at the time of disposition. This benefit, an exclusion of capital gains, offers an enormous potential benefit to investors.[15] An investor with a 40% marginal tax rate and a $100 million capital gain from the QOZ investment, would save $40 million in federal income tax.[16]

Tangible property purchased as part of a qualifying opportunity zone investment falls into one of two categories: first use property or substantially improved property. The former is property that has never been used before being put into service in the QOZ, such as brand new machinery. The latter is property that was previously used inside or outside of a QOZ but has substantial funds invested into improving the asset. Under the regulations, property can qualify as substantially improved if one dollar in improvements was invested for each dollar spent on purchasing the asset.[17] In the case of real property, one of the main exceptions to the general rule is that assets can qualify as substantially improved as long as one dollar of improvements was invested for each dollar allocated to the purchase price of the building, a subset of the total purchase price of the property which includes land.[18] The regulations anticipate investments in operating businesses, real estate,[19] and other assets, yet certain types of investments are better suited for the benefits—the large and simple investments that can absorb large amounts of qualifying equity with limited risk and a limited compliance burden.

A. *Investments involving large and simple asset purchases or improvements are best-suited to the QOZ rules*

The QOZ regulations are flexible in terms of the type of capital investment that qualifies for tax benefits. Investments can be made in businesses and in real estate, in purchased

13. There are some exceptions to this 180 day rule. For example, partners in a partnership that sells assets and allocates gain can enjoy an 180 day period starting from the end of the tax year rather than from the asset sale date. See §1.1400Z2(a)-1(c)(8)(iii)(A).

14. In addition to this deferral benefit, certain investors can receive some capital gains exclusion on the initial gain: 10% if held for at least five years by year end 20206 and 15% if held for at least seven years by that time. See §1400Z-2(b)(2)(B). Events which trigger earlier gains recognition include liquidation of a QOF, certain distributions to QOF partners, and the transfer of a qualifying investment by gift. See §1.1400Z2(b)-1(c).

15. Significantly, this benefit depends on the investment growing significantly in value, a state of affairs that cannot be taken for granted.

16. It should be emphasized here that the QOZ program is only a deferral and exclusion of federal income taxes. Although some states have parallel laws that create a similar effect for state income taxes, the laws and regulations created by Congress and the Treasury Department relate only to federal income taxes.

17. *See* §1400Z-2(d)(2)(D)(ii) and §1.1400Z2(d)-2(b)(4).

18. IRS Revenue Ruling 2018-29. Thus, an $80 property allocated $55 to the building and $25 to the land needs to receive only $55—and not $80—in qualifying improvements in order to constitute eligible property under the law.

19. The final regulations even allow certain non-capital purchases to be counted towards the substantial improvement investment requirement. "For example, suppose a QOF purchases a nonoriginal use building in a QOZ for $1 million, makes $950,000 in improvements to the building that bring that building into good condition for that local market, and purchases $50,001 of furniture or equipment for use within the building. This building would not meet the substantial improvement test under the proposed regulations but it would meet it under the final regulations." 85 FR 1945.

property or leased property, on owned land or leased land, through simple QOF entities or through more sophisticated and potentially more liquid entities like qualifying REITs, and with plenty of room for activity outside of opportunity zones as well.[20] The laws also require very little reporting by the QOFs about their investments. The recently-updated QOZ reporting form, IRS Form 8996, requires QOFs to report the census tracts in which QOZ tangible property is located, the value of investments held in each census tract, and the EIN numbers of QOZ businesses located in each census tract.[21]

Property eligible under the QOZ laws must be used in a trade or business, a requirement meant to prevent QOZs from becoming tax-advantaged warehouses for valuable tangible and intangible property.[22] Although start-ups receive special benefits in the final QOZ regulations,[23] real estate or operating businesses requiring large capital investments are best suited for the QOZ benefits because they are easy and quick to execute relative to developing a brand new business in a QOZ. Execution speed is important because capital must be invested in QOFs by mid-2027 in order to be tax advantaged upon QOZ project disposition. Investors may also want to invest funds in the QOF before the QOF invests the funds in the business, a possibility subject to generous but limited time periods before the unspent capital disqualifies the investment's eligibility under the law.[24] Examples of QOZ investments announced to date include alternative energy projects such as solar panel farms, new real estate development projects, and manufacturing plants such as a $50 million feed mill for a poultry producer.[25]

And there is another critical reason for execution to happen quickly. Penalties accrue to QOFs that do not have an adequate percentage of qualifying property as a percentage of their assets.[26] Testing periods occur every six months but QOF investments can qualify for a thirty one month working capital safe harbor during which a business entity ("qualified opportunity zone business") can be treated as if it qualified under the relevant asset testing standards, even if a small percentage of its assets were invested in opportunity zones at the time.[27] This safe harbor exists because businesses or real estate development projects take time to be built and developed. Certain projects may need a longer period of time to develop and some entities can be eligible for a second safe harbor, but that safe harbor requires another round of eligible capital in order to receive tax benefits from all invested equity. Excessive cash or cash equivalents on hand can result in triggering penalties because neither constitute qualifying property.[28] Although the regulations provide for the possibility of safe harbor tolling in certain cases of government delays—like in a complex real estate development—the

---

20. Subject to specific definitions for amounts of property and amounts of time, most a QOF's qualifying property must be located in a QOZ most of the time, facilitating significant activity outside of QOZs. Indeed, all customers and most employees can be located outside of a QOZ with the owner-QOF still qualifying for benefits.

21. *See* Part VI of IRS Form 8996. No information about specific addresses, jobs created, or engagement with the community is required.

22. For example, laboraties developing innovative drugs to be patented and licensed for commercialization over the long term.

23. See discussion at 85 FR 1923.

24. See §1.1400Z2(d)-1(d)(3)(v) for the requirements of the working capital safe harbor and the related discussion below.

25. *Filing frenzy shows companies lining up for opportunity zones* (Dec. 12, 2019) Bloomberg, https://www.pionline.com/investing/filing-frenzy-shows-companies-lining-opportunity-zones

26. *See* §1400Z-2(f).

27. *See* §1.1400Z2(d)-1(d)(3)(v).

28. *See* §1.1400Z2(d)-1(d)(3)(iv) for the general limitations on cash and cash equivalents held by QOZ businesses.

applicable cases are quite limited.[29] Therefore, while startups benefit from a longer safe harbor window provided in the final regulations,[30] the limited timeframe to deploy capital in order to comply with QOZ rules poses a risk to investors hoping to enjoy the tax benefits and avoid penalties. Large, simple projects can facilitate the most tax-advantaged capital investment by investors with the least amount of risk.

B. *Some investors will enjoy a windfall by receiving QOZ incentives in projects that do not advance the purpose of the laws*

As with many tax incentive programs, some QOZ taxpayers will enjoy a windfall for receiving a tax benefit for investments they would have made anyway, a circumstance that does not advance the purpose of the law. For example, two redeveloped properties in the Hackensack, New Jersey downtown area were completed in 2019 after years of planning and construction. 210 and 214 Main St were then put on the market[31] before any leasing or operations commenced at the property so that a QOZ investor could ensure that the assets would be qualifying property.[32] This "first use" designation is just one example of a tax benefit which did not stimulate any new investment. This type of investment is also attractive to investors because the timeliness issues of QOF capital investment are hardly relevant.[33] Although the initial investors could not enjoy tax benefits for the project because eligible property could not be purchased before 2018, the project may have enjoyed a higher exit price because it could be sold to investors interested in a QOZ-compliant project.[34] This kind of project is attractive to QOZ investors because development budgets, construction delays, and other compliance complexities existing in QOZ developments would not be a part of the business plan for any newly developed property being purchased.[35]

Although there are other examples of windfalls generated by the QOZ laws,[36] Congress

---

29. "In general, the final regulations make clear that, if a governmental permitting delay has caused the delay of a project covered by the 31-month working capital safe harbor, and no other action could be taken to improve the tangible property or complete the project during the permitting process, then the 31-month working capital safe harbor will be tolled for a duration equal to the permitting delay." 85 FR 1926.

30. A 62-month safe harbor was introduced in the final regulations for start-up businesses. See Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v).

31. Joshua Burd, *C&W: Buyer wanted for 126-unit rental project at historic Hackensack site* (June 3, 2019), Real Estate NJ, https://re-nj.com/cw-buyer-wanted-for-126-unit-rental-project-at-historic-hackensack-site.

32. The final regulations provide an example illustrating this allowance and makes clear that this kind of investment is consistent with the law's purpose: "The construction of new buildings in economically disadvantaged communities, which are acquired for the purpose of introducing new businesses into such communities, clearly achieves the policy goals underlying section 1400Z-2 and should be encouraged," 85 FR 1909. "[T]he original use of tangible property in a qualified opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization, or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner." Treas. Reg. § 1.1400Z2(d)-2(b)(3)(i)(A)

33. All or most of the investor's equity investment would constitute qualifying property from day one with no execution or compliance risk required in the coming months or years.

34. A higher price would require an investor for whom the qualifying investment status was valuable. This will be discussed at length below.

35. The QOF should be able to purchase the building, whether directly or through other entities, and enjoy simple reporting and guaranteed compliance with all of the QOZ laws. In addition, because the law allows for a certain percentage of non qualifying property to be held by the compliant QOF, investors can overfund the QOF making the purchase by a certain degree and enjoy the tax benefits (tax deferral and partial exclusion) for those additional funds as well.

36. For example, the designation of certain wealthy and economically vibrant areas, like parts of Manhattan, as QOZs, a fact pattern critics say represents the failure of the laws. In these areas, development was likely feasible or even planned without the

directed the Secretary of the Treasury to prescribe anti-abuse rules in order to prevent efforts to game the system.[37] This powerful tool, combined with a long-term horizon for the QOZ tax incentives makes for a strong deterrent against investments that are designed to satisfy the technical rules but do not at all increase economic growth in QOZs. One example of how such a scenario could play out involves land banking. Investors might purchase land in a QOZ that they believe will appreciate in value in the coming decades, put minimal investment such as asphalt and parking booths in order to develop a parking business, and thus satisfy the substantial improvement rules because of the lack of required investment corresponding to the land value.[38] In the final regulations, the Treasury Department declined to include anti-speculation rules "because [when] a significant purpose for the acquisition of the land is to hold the land for speculative investment, the anti-abuse rule functions to recharacterize the transaction so that the taxpayer may not receive the benefits of section 1400Z-2."[39] The prospect that the anti-abuse tools might be utilized in a broad set of circumstances will certainly chill many kinds of business behavior and limit many investors from enjoying tax benefits without making the kind of investments anticipated by Congress and the Treasury Department.

II. But Because Many Wealthy Investors Benefit from the Ability to Indefinitely Defer Capital Gains, Qualifying Opportunity Zone Investments Are Usually Not Attractive

All investing involves taking risks and making assumptions about the future. Investors consider investments by assessing their own risk tolerance and investor profile but also by comparing the costs and benefits of various options. To investors who have made the decision to realize gains, investing in a QOF offers the benefits of tax deferral and exclusion to investors willing to invest for at least ten years and pay the capital gains tax by 2026. But high net worth investors may not need to realize gains and thus may face a different calculus. These investors must decide whether to realize gains, which will lead to the payment of taxes by 2026, for the opportunity to invest in an often-riskier asset promising tax benefits. As discussed below, some high net worth investors do not stand to benefit from these tax benefits because they foresee alternative avenues to capital gains tax avoidance. And even those high net worth investors who can appreciate the QOZ tax benefits still face the question of whether to trigger the required gains needed in order to make a qualifying investment.[40]

QOZ incentives and investors or developers likely enjoyed a windfall, much like in the way benefits are enjoyed from a favorable change to zoning codes. The party capturing the upside differs based on the specific situation. Parties that might benefit include the existing owners of the property, new investors purchasing the property, and the developer planning to manage a QOZ improvement or construction project. Of course, as discussed below, most property owners in QOZs will not enjoy any increase in values from the QOZ program.

37. *See* §1400Z-2(e)(4).

38. "[T]he Treasury Department and the IRS note that land does not need to meet the original use requirement or the substantial improvement requirement to be treated as qualified opportunity zone business property," 85 FR 1915.

39. 85 FR 1933

40. The law allows for investors without gains to make investments in QOFs as well but those investments would not qualify for the tax benefits. See §1400Z-2(e).

A. Opportunity zone investing involves a variety of risks and an uninviting threshold decision for investors who do not have to realize capital gains

The opportunity zone incentives were created in order to encourage long-term investments in areas not generally attractive to investment. Despite the promise of tax deferral and tax exclusion, opportunity zone investments feature many risks that wealthy investors do not otherwise face in their portfolios. Firstly, geographic and demographic concerns are meaningful for many QOZ investments. Many QOZs feature communities with low household incomes, low rates of educational attainment, and high crime rates. Many QOZs are also located far away from commercial centers and do not have robust economic drivers of their own.

Second, because QOZ investments must be held for ten years in order to receive most of the program's promised tax benefits, investors must take extra care in weighing the program's costs and benefits as compared to their alternative investment options. Moreover, the ten years will likely serve only as a minimum investment term because the tax benefits are beneficial to the extent that fair market value is higher than the project's basis. If the QOZ property is not well-positioned for disposition at the ten year mark, or if the broader market environment is not favorable at the time, it might take many years before the QOF decides to exit the investment and elect to make the step up in basis allowed by § 1400Z-2(c).[41] This situation contrasts starkly with most other investments which tend to be more liquid.[42]

Finally, the opportunity zone law is new and thus, despite robust regulations, represents uncertainty. The new law presents compliance risks such as the possibility that a lack of proper asset tracking or regulatory compliance results in a denial of tax benefits when investors are ready to dispose of the investment after ten or twenty years. Even if the long term tax benefits are received, reporting errors could result in penalties which reduce the overall investment return.[43] The risks can stay with the investors even while investment operators or developers impose compliance costs. Fund operators have reportedly charged QOZ investors additional fees to defray the compliance and reporting costs involved in QOZ investments while refusing to take responsibility—in the form of a contractual duty—for a compliant outcome.

But there is a more significant barrier to investment in QOFs than the QOZ-specific risks featured in the investments. Wealthy investors interested in QOZ investing have a threshold requirement to make that is not attractive: capital gains realization.[44] One of the most

---

41. The final regulations anticipate that some investors may not exit for decades and that there might need to be a provision for a step-up in basis absent disposition before a certain date: "The Treasury Department and the IRS will continue to consider... how best to value investments in QOFs absent a sale or exchange between unrelated persons by December 31, 2047." 85 FR 1895.

42. To the extent that a secondary market will develop for QOF interests, QOZ investments might also be quite liquid. However, a transaction taking advantage of this liquidity will require the loss of the tax benefits if executed within ten years (unless the funds are reinvested in another qualifying QOF investment, see 85 FR 1866.). Moreover, given the relatively small pool of QOF investors and the discount generally applicable to private equity fund interests, investors will probably have to provide a meaningful discount to value in order to sell their QOF interests quickly. (The final regulations estimate QOZ activity to involve between 5,500 and 12,000 QOFs. See 85 FR 1943.)

43. *See* e.g., §1400Z-2(e).

44. "[T]he final regulations clarify that deferral of a gain under section 1400Z-2(a)(1) and the section 1400Z-2 regulations generally is available only for capital gain that would be subject to Federal income tax but for the making of a valid deferral election under section 1400Z-2(a)(1) and the section 1400Z-2 regulations." 85 FR 1872.

important ways wealthy investors grow their wealth is by avoiding the need to realize gains, allowing gains to continue to compound over the long term. While investors with smaller portfolios might need to sell assets in order to pay for emergency expenses, finance major lifecycle events, or to take advantage of new investment opportunities, wealthy investors can more easily hold onto their assets and enjoy the luxury of inaction. By not facing the liquidity pressures that many other investors face, high net worth investors can focus on the longer-term estate planning implications of their actions.[45]

Selling assets involves several costs including research costs involved in choosing a new investment, as well as the transaction costs involved in the sale of one investment and the purchase of another. Perhaps most significantly, capital gains realization can trigger a tax event that might have never come up. Because Internal Revenue Code Section 1014 allows for a step-up of basis for appreciated assets passed by a deceased investor to inheritors, the deferred tax bill can be completely avoided as long as no gains recognition occurs before that time. And when gains need to be realized, wealthy investors often have ways to avoid gain recognition, deferring taxation further into the future with the hope that, at passing, the tax can be avoided forever with a step-up in basis.

B. Many wealthy investors have several avenues for preserving indefinite capital gains deferral, making the QOZ investment decision less attractive

Internal Revenue Code section 1001 triggers capital gains recognition—and the resulting taxation—upon the sale or other disposition of property. Unrealized "paper" gains held by investors for years or decades may finally be taxable when appreciated stocks, real estate, or other assets are sold. The decision might be made by an investor who is no longer interested in owning a particular asset or asset class, or by the general partner of a project who is able to trigger a sale over the objections of the limited partnership investor.

But several avenues for deferral are available to many wealthy investors.[46] First, partnerships can serve as vehicles for investors to effectively exchange appreciated assets for others without facing tax recognition.[47] Likewise, corporate reorganizations transactions allow for investors to parlay an appreciated asset into a different asset without gains recognition. Finally, as discussed below, real estate investors have a special tool available to them for indefinite capital gains deferral: section 1031 like-kind exchanges. These tools and others involve a range of expertise and cost but the wealthiest investors tend to have the benefit of sophisticated advisors who can recommend and execute a variety of transactions and warn against potential pitfalls. As well, the large sums of money involved in wealthy investors' transactions can justify the advisory fees that expensive transactions require and would not be worthwhile for investors with fewer assets.[48]

---

45. Financial advisors are often compensated when transactions occur, a conflict of interest with investors interested in tax-advantaged inaction. This state of affairs makes many high net worth individuals suspicious of making costly changes to their portfolio.

46. Strategic trust structuring including strategies for fragmenting ownership and ways to enjoy valuation discounts is one of many ways that investors can reduce their tax liability.

47. Investors would wait seven years before distributing contributed appreciated property, consistent with § 704(c)(1)(B). Partnership tax anti-abuse rules and the requirements of § 737 would also serve to limit maneuverability.

48. Simple like-kind exchanges are often accomplished for a few hundred dollars in fees paid to a Qualified Intermediary

Because wealthy investors have a special ability to indefinitely defer capital gains with regard to their real estate holdings, property owners are particularly disincentivized to participate in QOZ investing. This is not consistent with the state of affairs expressed in the media, which cite landlords as major beneficiaries of the QOZ laws. Most property owners in opportunity zones have not received any benefits and never will.[49] There have certainly been high-profile exceptions to this generalization, such as the prime development sites that wound up in designated opportunity zones.[50] Nevertheless, most real estate investments do not qualify under the QOZ laws because they do not involve the necessary value-add strategy. Even though an early revenue ruling by the IRS clarified that real estate investments require less value-add investment than other asset classes,[51] even this level of investment is very rare in real estate investments. A property worth $100 with a building worth $60 might return $8 in profit each year, after considering repair and maintenance costs on the building. And while a major purchase like a roof or boiler replacement might need to happen every fifteen years or so, it is unlikely that the price tag will rise above the amount received in one year's profits. In contrast, a qualifying real estate investment would involve $60 in upgrades, making the QOZ investments most relevant for ground-up construction and gut-rehab projects for which the upgrade portion of the developer's budget can easily exceed the required threshold.

Property owners are also unlikely to opt for QOZ investments when they realize capital gains as part of a sale of property. This is because Internal Revenue Code section 1031 offers indefinite deferral to property owners who enter into qualifying like-kind exchanges of property. Although the 2017 Tax Cuts and Jobs Act eliminated like-kind exchanges for several types of property, one asset class—real estate—remains as a beneficiary under the law. The 1031 exchange has several time-sensitive rules by which investors can use a Qualified Intermediary (QI) to facilitate a qualifying exchange. Even though virtually all like-kind exchange buyers and sellers are not entering into a bilateral exchange agreement, a QI can allow for a seller of property to select from an almost endless assortment of replacement properties and acquire new property without recognizing gains on the relinquished property.[52] And indefinite deferral, as mentioned above, often has I.R.C. section 1014 as the ultimate goal, a tax benefit which is triggered when the real estate investor passes away.

---

that facilitates the transaction (in addition to transaction fees for the sale and purchase transactions). However, there are layers of sophistication that can be involved in these transactions which can provide additional flexibility or benefit to investors such as negotiating acquisition or disposition terms to improve like-kind exchange flexibility, reverse exchanges, and construction 1031 exchanges.

49. QOZ property is only more valuable as a result of the new laws to the extent that investors will enjoy tax benefits by investing in that property. Those benefits are only available if certain rules are met including (1) that the investor realized gains within the 180 days before making the qualifying investment in a QOF, (2) that the investment involves the purchase of new property or the substantial improvement of existing property, and (3) all of the structuring and compliance rules are met. These conditions make the overwhelming majority of properties irrelevant to the law because they are either existing, stabilized properties—with little room for large investment—or too small to justify the administrative requirements of the law.

50. For example, the select few billionaires whose large development sites in Florida, Nevada, Michigan, and elsewhere, became even more valuable when they were included in QOZs.

51. IRS Revenue Ruling 2018-29 created a lower investment threshold for substantially improving real estate than the general rule presented in §1400Z-2(d)(2)(D)(ii). A $80 property with value allocated $55 to the building and $25 to the land needs to receive only $55—and not $80—in qualifying improvements in order to constitute eligible property under the law.

52. A large office building can be exchanged for two small strip malls; five small apartment buildings can be exchanged for two large warehouses; etc.

The particular requirements of the QOZ program can also present challenges to investors, including those in the real estate industry.[53] First, the short-term deferral offered by QOZ investments can also present problems to investors, especially those in the real estate industry. The tax year 2026 capital gains recognition creates a "phantom tax," which comes due without any corresponding cash distribution from the investment. Many landlords cannot easily access the funds required to satisfy this tax liability because their net worth is tied up in illiquid real estate holdings.[54] As well, the long-term investment horizon of the QOZ program contrasts sharply with the flexibility of like-kind exchanges which are not limited to QOZ geographies nor to the types of projects that can qualify under the QOZ regulations. The investments purchased in like-kind exchange transactions are often "triple net" properties which feature long-term tenants like national retailers with leases requiring the tenant to pay for all of the property's expenses. However, triple net properties will rarely qualify under the QOZ substantial improvement or new property requirements because they generally do not involve substantial improvement to the property. A fund could however develop a new location for a triple net tenant but the QOZ regulations have made clear that creating and managing triple net properties does not constitute an active conduct of a trade or business, a requirement under the QOZ laws.[55] Even though the regulations allow for a portion of qualifying property to be tenanted by a triple net tenant, the ease and flexibility of QOZ investments are still dramatically lower than those made consistently with section 1031.[56]

Because wealthy investors tend to have a portion of their portfolio in real estate, the like-kind exchange is an example of an indefinite deferral tool available to a broad range of wealthy investors. According to 2017 IRS estate tax data, taxpayers with an estate larger than $20 million in value had an average of around 15% of that estate in real estate while taxpayers with estates smaller than $20 million tended to have between 20% and 25% of the estate in real estate.[57] And like-kind exchanges are valuable for these investors even when properties do not appreciate in value. Depreciation deductions taken to reduce taxable income, an important benefit available to real estate investors, reduce taxable basis resulting in depreciation recapture taxes triggered by a realization event. Like-kind exchanges results in a basis carryover to a new investment and tax deferral for the investors.

In a world that can seem full of uncertainty, capital gains deferral offers wealthy investors

---

53. As discussed above, QOZ tax benefits relate to the equity invested in QOFs and not to the projects themselves. Thus, there are real estate and operating business investments in QOZs, including opportunities that could satisfy the QOZ rules, that investors and operators decide not to organize as QOF investments in order to remain free of the QOZ requirements. Taking this appraoch is especially feasible when the investors involved do not stand to gain much more from the QOZ tack, such as a project that can be purchased in a like-kind exchange and might involve a slower renovation schedule than required in a QOZ context depending on the health of the local economy.

54. Real estate transactions are expensive, involving legal fees, inspection fees, financing fees, and transfer taxes, among other costs. This fact, and the due diligence most investors require before purchasing property (each building with its unique geography, condition, features), makes it difficult to sell property quickly for its full value.

55. "Merely entering into a triple-net-lease with respect to real property owned by a taxpayer does not constitute the active conduct of a trade or business by such taxpayer." Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iii)(B).

56. In addition to the capital gains tax exclusion, another benefit offered by QOZ investments over like-kind exchanges is the more modest investment requirement. While the amount of a QOZ investment corresponds to the amount capital gain generated from the sale of an appreciated asset, the amount that must be invested in a qualifying like-kind exchange is the entire sales amount, a sum that can far exceed the gain.

57. *Estate Tax Returns Filed for Wealthy Decedents, Filing Years 2008–2017*, Publication 5332 (Rev. 12–2018), Internal Revenue Service, https://www.irs.gov/pub/irs-pdf/p5332.pdf

comfortable familiarity. Instead of getting involved in a new kind of tax-advantaged investment, however promising, the investor can opt for inaction, a strategy that may have worked for the investor for decades (and possibly for friends and family members for even longer). And when some event prompts a realization event, there are avenues for continuing the deferral of gains recognition which do not necessitate a large tax payment in the near term. QOZ investing might benefit a wealthy investor who plans to trigger recognition at some point in the coming decades—paying some tax now to obtain tax-free recognition in ten or twenty years is a great move, all other conditions remaining the same. But most investors take a longer view, hoping for a step-up in basis at the end of their life, making capital gains avoidance permanent.[58]

III. AND EVEN THE BENEFITS FOR INVESTORS WHO CANNOT EASILY ACCESS INDEFINITE DEFERRAL HAVE BECOME LESS ATTRACTIVE

Although investors with the ability to defer capital gains indefinitely are less likely to make QOZ investments, investors unable to defer their capital gains recognition now have an attractive way to invest. By investing in a QOF within 180 days of capital gains realization, investors can enjoy several years of capital gains deferral and longer-term tax benefits from the new investment.[59] Investors with smaller portfolios are most likely to benefit since they are more likely to increase their liquidity probably through selling appreciated assets. As mentioned above, such investors may also have fewer avenues for indefinite capital gains deferral as compared to high net worth individuals. The fact that the final regulations assume "that a QOF will on average have [ten] investors"[60] may also signal the wealth profile of most QOF investors. If the QOFs created before the December 2019 promulgation of the final regulations were generally funded by high net worth individuals, it is likely that fewer investors would have been involved. A smaller number of investors would have probably sought to fund the tax-advantaged equity on their own.

The best candidates for QOZ investing are probably those investors who planned for deferral but did not successfully consummate the requirements for such a transaction. Faced with unexpected tax recognition, those investors might scramble to invest in a QOF for the near or long term. For example, real estate investors planning for a like-kind exchange have strict due dates for identifying replacement properties that they might acquire as part of the exchange. But paperwork issues, contract issues, and due diligence, among others, could result in a failed exchange. These investors may still be within the 180 day investment window for QOZ investing and might be interested in some measure of deferral and the prospect of the long-term tax exclusion.

However, even those investors might think twice before making a QOZ investment given

58. The final regulations do not provide for a double benefit to investors who pass qualifying QOF investments to their inheritors at passing: "Because a taxpayer's basis in its qualifying investment is zero except as otherwise provided in section 1400Z-2(b)(2)(B) and section 1400Z-2(c) (which concerns qualifying investments held for at least 10 years), the Treasury Department and the IRS have determined that section 1014 does not apply to adjust the basis of an inherited qualifying investment to its fair market value as of the deceased owner's death." 85 FR 1891.

59. QOZ investments held for ten years can qualify for capital gains exclusion. I.R.C. §1400Z-2(c) provides for the basis of qualifying investments held for ten years or more to be stepped up to fair market value on the date of sale or exchange.

60. 85 FR 1943.

the current low tax and low interest rate environment. Compounding the risks and uncertainties that come along with QOZ investing, the broader investing environment presents current investors with fewer expected benefits from the QOZ laws. And with those reduced benefits to investors comes a higher cost of capital and less benefit to fund operators and developers who had expected high demand from QOZ investors at a low cost of capital.

A. In the current low income tax, low interest rate environment, QOZ investing is less valuable.

In the current low income tax environment, deferral benefits might be offset in whole or in part by increased taxes in the future. "The final regulations clarify that gain recognized pursuant to section 1400Z-2(b)(1) and the section 1400Z-2 regulations is subject to taxation at the applicable Federal income tax rates for the year of inclusion, not of the year of deferral."[61] To the extent that upcoming federal elections could result in changed tax rates, the consensus is that those rates will rise to support a ballooning national debt and an expensive welfare state. Investors may prefer to forgo the potential long-term tax benefits in order to save on taxes in the short term.

Another headwind to QOZ investing is the low interest rate environment. To the extent that rates get closer to zero, investors receive less benefit from the QOZ tax deferral offered until tax year 2026. There may still be benefits[62] including increased financial flexibility[63] and the ability to invest funds that would otherwise be used to pay the tax, but the funds available to taxpayers until the tax year 2026 due date will earn lower returns on average and the deferral will therefore be less valuable to investors. But even more importantly than the short-term returns available to investors are the long-term returns. Investment return is a function of price and high asset prices translate to lower expected returns. The current low interest rates fuel inexpensive borrowing, putting upward pressure on prices. This results in lower expectations for the asset price growth which fuels QOZ tax benefits. A QOF investment that has not grown much in value over the course of a ten or twenty year holding period will not have much tax benefit to investors.[64]

B. And to the extent that QOZ investing is less valuable for investors, fund operators and developers face a higher cost of capital overall and benefit less

When new capital is brought into QOZs in a way that stimulates economic growth, the QOZ law has fulfilled its purpose as understood by the Department of the Treasury "to provide specified tax benefits to owners of QOFs to encourage the making of longer-term investments of new capital, through QOFs and qualified opportunity zone businesses, into

61. 85 FR 1891.

62. For a discussion of the benefits of deferral, and especially indefinite deferral, in a low-interest environment, see Thomas J. Brennan and Alvin C. Warren Jr, *Realization and Lock-In When Interest Rates Are Low* (August 22, 2016), Tax Notes.

63. For example, providing more time to the taxpayer to ensure enough liquidity to pay the tax without borrowing funds at high interest rates or selling assets at an inopportune time. This is especially relevant in cases like the QOZ tax year 2026 recognition requirement, when taxpayers face "phantom" taxes due in tax years without corresponding income generated by the investment.

64. See §1400Z-2(c). Operating income from QOF investments is taxes like any non QOF investment.

one or more QOZs and to increase the economic growth therein."[65] And even though the incentives were developed for investors, fund operators and developers stood to gain as well to the extent that QOF investments were demanded by investors. More competition for QOF interests translates into a lower negotiated return structure for investors and more returns (representing less risk) for operators.

But the incentive structure described above is not attractive to many kinds of wealthy investors, especially those with access to the most resources required for participation in QOZ investing. It may be no surprise then that the "the Treasury Department and the IRS project that between... 55,000 to 120,000 investors in QOFs will eventually be affected by the final regulations"[66] a number which represents a small minority of high net worth households in the United States.[67] And to the extent that these investors do not see great opportunity in QOZ investing as compared to other investment opportunities, the cost of capital for QOZ developers and operating partners will track that of similarly situated projects, reducing the benefits that they enjoy from the QOZ laws.[68]

CONCLUSION

The wealthiest investors in the United States have access to the capital, capital gains, and advice necessary to invest heavily in QOZ investments. If they were to do so, many billions of dollars in capital could be brought into QOZs, representing new and renewed buildings, new machinery and equipment, and new businesses. Upon disposition, excluded gains would represent billions of dollars in tax savings for these investors. But these investors are generally inclined towards inaction with regard to their investment portfolio in order to avoid any costly realization or recognition of gains before their assets transfer to their estate. By reducing the transaction costs and taxes involved in changing their portfolios, such investors enjoy compound gains on a larger nest egg each year.

Even when these investors want to dispose of assets, they have strategies that can allow for continued gains recognition deferral. For example, certain corporate reorganization rules and like-kind exchanges can allow for the exchange of certain assets for others without costly gains recognition. For wealthy investors who can benefit from these transactions, the benefits of QOZ investing are somewhat reduced because the temporary gains deferral available is even less attractive than the indefinite deferral available through other avenues. But more importantly, the threshold costs of QOZ investing—required gains recognition by 2026—are charges that do not need to be incurred by these investors. While other investors face gains recognition in the year of gains realization, these investors have ways to avoid recognition.

---

65. 85 FR at 1907

66. 85 FR at 1943

67. According to New York University economist Edward Wolff, in 2016 there were 635,800 households with a net worth equal to or exceeding $10 million in 1995 dollars. See Table 3 in Edward N. Wolff, *Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?* Working Paper 24085 (November 2017), National Bureau of Economic Research, https://www.nber.org/papers/w24085.pdf

68. Real estate developers and private equity professionals are often cited as key beneficiaries from the QOZ laws. Even though the QOZ laws are structured to benefit investors and not the developers and operators implementing business plans with investor funds, those professionals would benefit greatly from a lower cost of capital available from QOZ investors eager to advance QOF projects. However, to the extent that QOZ investments are not very attractive to investors, the cost of capital is unlikely to be significantly affected by the laws, removing most of the benefits available to real estate development and private equity firms.

And even investors who can either pay capital gains taxes or invest in QOZ investments may opt to pay the tax. In the current low tax environment, deferring capital gains recognition until tax year 2026 might result in significantly higher taxes for those taxpayers. As well, the low interest rate environment makes deferral less valuable in terms of the returns that could be generated during the deferral period. Even further, the risk profile of QOZ investments, the compliance burden, and the liquidity requirements all serve as a costly backdrop which discourage investors from making opportunity zone investments. And to the extent that investor appetite is diminished, the benefits received by fund operators and developers able to facilitate qualifying QOF are reduced.

Investors facing capital gains recognition who are comfortable enough with QOZ investment risks stand to benefit from the generous tax benefits available at disposition. It is true that many QOZ projects lack current profitability and operate in areas with high rates of crime and high unemployment rates, but many financially successful projects outside of QOZs also feature these characteristics. For these investors, the QOZ incentives will tip the scale in favor of investing. And while the required long-term investment horizon and the requirement to have capital gains available makes the QOZ investments accessible only to wealthier Americans, the wealthiest are unlikely to participate in force.

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

KNOW WHEN TO HOLD 'EM, KNOW WHEN TO FOLD 'EM: HOW PROFESSIONAL SPORTS LEAGUES SHOULD MONETIZE DATA IN THE ERA OF LEGALIZED SPORTS GAMBLING

❖ NOTE ❖

Benjamin Kovach *

I. INTRODUCTION

"You got to know when to hold 'em, know when to fold 'em."[1] When Kenny Rogers first sung those words in his 1978 hit song, *The Gambler*, he immortalized the struggle of gamblers everywhere.[2] Incidentally, he also described the conundrum that professional sports leagues find themselves in today. Following the invalidation of the federal ban on sports wagering, professional sports leagues in the United States, particularly the National Basketball Association ("NBA"), are eager to obtain a portion of the sports wagers themselves.[3] This note will argue that the NBA should shift its focus from lobbying legislatures, a largely unsuccessful initiative, to strengthening its data licensing efforts, where the league has already seen success.

The NBA has voiced and attempted a number of approaches to secure legalized gambling profits, including the following: claiming an actual intellectual property interest in game data and statistics;[4] lobbying for legislation mandating a percentage of all sports wagers go to the

1. KENNY ROGERS, THE GAMBLER (United Artists Group 1978).

2. *Id.*

3. Matt Bonesteel, *If sports gambling is legalized, the NBA wants in on the profits*, THE WASHINGTON POST (Jan. 25, 2018 10:41 AM), https://www.washingtonpost.com/news/early-lead/wp/2018/01/25/if-sports-gambling-is-legalized-the-nba-wants-in-on-the-profits/ ("And ideally, the NBA would like a cut of any money wagered on professional basketball games in the United States.").

4. Adam Candee, *NBA's Adam Silver On Sports Betting: 'The Integrity Fee Is Something That We Are Entitled To'*, LEGAL SPORTS REPORT (Jun. 1, 2018 5:40 PM), https://www.legalsportsreport.com/20904/nba-commissioner-adam-silver-talks-sports-betting/ (paraphrasing NBA Commissioner Adam Silver, "…games are the intellectual property of the league, for which [the NBA] should receive money.").

*J.D. Candidate, Class of 2022, University of Illinois College of Law.

sports leagues themselves[5] or that sportsbooks are required to use only directly from the leagues;[6] and licensing official NBA data to data analytics companies[7] and sportsbooks.[8] Part I of this note will describe the general basics of sports betting and the sports betting economy. Part II of this note will detail and analyze the aforementioned attempts the NBA has taken to monetize sports betting for themselves. Further, Part II will show the financial and legal reasons why the NBA has been moderately successful in its data licensing approach but unsuccessful in gaining traction with its intellectual property claims or legislative lobbying. Finally, part III of this note will suggest some routes the NBA can take to strengthen the value of its data licensing, primarily by following current trends in the sports gambling market and creating more sports wagering products and data in-house.

II. Background

In 2018, the U.S. Supreme Court decided *Murphy v. NCAA* and invalidated the federal ban on sports gambling.[9] Prior to *Murphy*, the Professional and Amateur Sports Protection Act ("PASPA") made it unlawful for a state to operate or authorize "… betting, gambling or wagering scheme[s] based…" on sports.[10] The Court held that this statutory construction amounted to Congress issuing orders directly to state legislatures and was an unequivocal violation of state sovereignty and the Constitution's anticommandeering rule.[11] Remaining portions of the Act were not severable from the unconstitutional provisions, rendering PASPA entirely void.[12] In the wake of *Murphy,* state legislatures were free to act as they saw fit, and twenty three states have responded by fully legalizing sports gambling, including Illinois in March, 2020.[13]

Sports wagers can be separated into four general categories: standard bets, future bets, in-play bets, and prop bets.[14] A standard bet is the most basic form of sports betting; it is simply a wager placed on the final outcome of a game. "I bet the Cavaliers will beat the Warriors tomorrow" is an example of a standard bet.[15] A future bet is also simple in concept, but hinges on an outcome that is both further in the future and contingent on events between now and then. The following is a future bet, "I bet the Cavaliers will win the NBA championship

5. *See* Brett Smiley and Jill Dorson, *The Many Ways the NBA Has Embraced Legal Sports Betting*, SPORTS HANDLE (Oct. 22, 2019) https://sportshandle.com/nba-sports-betting-evolution/ (explaining that the NBA is lobbying for a mandated "fee" or "royalty" that all sportsbooks must pay to the NBA).

6. *Id.* (explaining that the NBA is lobbying state legislatures to enact legislation that would mandate the use of "official" data directly from the NBA itself or from select 3rd-party partners).

7. Sam Carp, *NBA claims US first with betting data distribution deals*, SPORTSPRO (Nov. 28, 2018), https://www.sportspromedia.com/news/nba-betting-odds-sportradar-genius-sports-data.

8. Sam Carp, *US major league first as NBA signs US$25m betting deal with MGM*, SPORTSPRO (July 31, 2018), https://www.sportspromedia.com/news/nba-signs-betting-deal-mgm-25-million.

9. *Murphy v. Nat'l Collegiate Athletic Ass'n*, 138 S. Ct. 1461, 1484-85 (2018).

10. *Id.* at 1465.

11. *Id.* at 1478.

12. *Id.* at 1484-85.

13. Ryan Rodenberg, *United States of sports betting: An updated map of where every state stands,* ESPN (May 1, 2020), https://www.espn.com/chalk/story/_/id/19740480/the-united-states-sports-betting-where-all-50-states-stand-legalization.

14. *How to bet sports – The different types of wagers*, GAMBLING SITES, https://www.gamblingsites.com/sports-betting/introduction/bets-wagers/.

15. *Id.*

next year."[16] An in-play bet is exactly as it sounds; it is a bet that is made after a game has already begun and is in play. An example of an in-play bet would be betting on the Cavaliers at halftime to win even though they are down by twenty points.[17] Lastly, a prop bet is a bet that is not directly tied to the final outcome of the game.[18] A common example would be betting on the total number of points a basketball player will finish with.[19] Increasingly, sportbooks, or "books" for short, are offering prop bets that are only loosely attached to the game itself, such as a bet on how long the national anthem prior to the Super Bowl will last.[20]

In-play bets, due to their very nature, require immediately accessible and accurate game data.[21] When a team scores, for example, a sportsbook needs to immediately update the betting odds for that game accordingly, or else a smart bettor would be able to place a bet based on the old score, potentially to the book's detriment.[22] With most books offering betting odds on hundreds of games a month it is not practicable for a book to offer in-play odds for each game without the help of automized data—the small group of oddsmakers a book typically employs could not humanly keep up and employing a team of oddsmakers large enough to keep up would be too costly.[23] Accordingly, books have increasingly turned to massive data aggregation and analytics companies.[24] The data analytics companies gather data directly from sports leagues themselves, other non-league sources, or a combination of the two.[25] Through the use of finely tuned proprietary algorithms, the analytics companies then supply the books with continuously updated betting odds for all games, typically for a monthly fee.[26]

III. Analysis

The NBA has expressed a possible intellectual property claim in its game data as well as lobbied for legislation mandating a percentage fee to be paid to the league[27] or the use of its

16. *Id.*
17. *Id.*
18. Steve Petrella, *What Is a Prop Bet? Sports Betting Definitions*, Action Network (Feb. 1, 2020 7:48 am), https://www.actionnetwork.com/education/prop-bet.
19. *Id.*
20. *Id.*
21. *See* James Glanz and Agustin Armendariz, *When Sports Betting Is Legal, the Value of Game Data Soars*, The New York Times (Jul. 2, 2018), https://www.nytimes.com/2018/07/02/sports/sports-betting.html (speaking about how important access to fast data is for in-play sports betting, a statement by sports data lawyer Steven Burton, "For betting, it's the difference between having value and having no value at all.").
22. *See generally* Matt Rybaltowski, *Here's How Much 'Official' League Data Actually Costs*, Sports Handle (Mar. 12, 2019), https://sportshandle.com/sports-betting-official-data-cost/ (describing a scenario where a sportsbook did not timely update its odds for an in-play bet).
23. *See Id*. (explaining that it is not possible for teams of oddsmakers to maintain multiple up to date in-play betting odds, a statement by Jason Simbal, Vice President of Risk Management at sportsbook CG Technology, "…it's not scalable… You can only do so many…." Explaining that sportsbooks could not afford to employ the number of oddsmakers needed to keep up with a large amount of multiple in-play betting games, "…most sportsbook operations do not have the financial wherewithal to physically monitor dozens of contests at once.").
24. *See Id.* (stating that sportsbooks now generally use automated data solutions for in-play betting odds, "Instead, [sportsbooks] turned to liv-data feeds that spit out the raw probabilities of a betting result through an automated system.").
25. *See generally Id.*
26. *See generally Id.*
27. *See* Bonesteel, *supra* note 3.

official league data.[28] These approaches have had little[29] to no success, due to a lack of legal standing[30] and ineffective leverage[31] for lobbying. The NBA has found success with a third approach, data licensing, as the league has genuine value to offer to offer partners with that approach.[32]

NBA Commissioner Adam Silver has said that he views the league as the "intellectual property creators" of the NBA's game data and statistics.[33] Silver wants to use this logic to rationalize the league collecting a percent of all wagers placed on NBA games.[34] Unfortunately for Silver and the NBA, the federal court system seems to be steadfast in their view that there are no legal protections for game statistics whether that be an intellectual property right, like copyright,[35] or a right of publicity.[36]

A. Game Statistics Are Not Copyrightable

First, in *Feist Publication, Inc. v. Rural Telephone Service Company, Inc.,* the Supreme Court's holding affirmed a commonly understood reading of the Copyright Act of 1976—that facts are *not* copyrightable.[37] Rural Telephone Service Company (Rural) was a telephone service provider that also published a telephone directory.[38] The directory largely consisted of alphabetized lists of Rural's subscribers' names, addresses and telephone numbers.[39] Feist Publication, Inc. (Feist) published a larger telephone directory that was essentially a compilation of many surrounding telephone districts, the idea being that having all of that information combined into one common resource was a useful service.[40] Feist created its directory in part by using Rural's directory information against Rural's wishes.[41] Rural subsequently sued Feist for copyright infringement.[42]

Rural's argument centered on the idea that because Rural put work into creating the directory, Rural should thus be entitled to copyright it.[43] The Court directly addressed the

---

28. *See* Smiley and Dorson, *supra* note 5.
29. *See generally* Joe Lemire, *Illinois Passes Sports Betting Bill With Official Mandate, In-Venue Kiosks*, SPORT TECHIE (June 3, 2019), https://www.sporttechie.com/illinois-sports-betting-bill-official-data-in-venue-kiosks/ (stating that Illinois and Tennessee are the only two states that have enacted sports betting laws that include a royalty or fee to be paid to professional sports leagues).
30. *See Feist Publications, Inc. v. Rural Tel. Serv. Co.*, 499 U.S. 340, 344 (1991); *C.B.C. Distribution & Mktg., Inc. v. Major League Baseball Advanced Media, L.P.*, 505 F.3d 818, 824 (8th Cir. 2007) [hereinafter *C.B.C. v. MLB*].)
31. *See generally* Martin Derbyshire, *Missouri Has A Better Idea Than Paying Sports Betting Integrity Fees*, PLAY USA (Feb. 20, 2020), https://www.playusa.com/missouri-sports-betting-integrity-fees/ (describing how the Missouri state legislature felt sports leagues had not made a compelling case for why a sports betting law should allot a percentage of wagers to be paid to the leagues rather than to a public good such as infrastructure fund).
32. *See* Carp, *supra* note 7 (stating that the NBA has entered into a data licensing deal with data analytics companies); *See also* Carp, *supra* note 8 (stating that the NBA has entered into a data licensing deal with MGM Resorts).
33. Candee, *supra* note 4.
34. *Id.*
35. *See Feist*, 499 U.S. at 344.
36. *See C.B.C. v. MLB*, 505 F.3d at 824.
37. *Feist*, 499 U.S. at 344.
38. *Id.* at 342.
39. *Id.*
40. *Feist*, 499 U.S. at 343.
41. *Id.*
42. *Feist*, 499 U.S. at 344.
43. *Id.*

previously common misconception that "copyright was a reward for the hard work that went into compiling facts."[44] The Court held that the focus on effort, or "sweat of the brow" for copyrights is flatly wrong.[45] The Copyright Act of 1976 states that the basis for copyright is originality, not effort, and facts are never original.[46] Further, the Act is clear that while a compilation of facts may be copyrightable, a copyright does not extend to the facts themselves.[47] A compilation still needs to meet the originality requirement in its own right, and even when it does, it is the organization or formatting of the compilation that is protected, not the facts contained in the compilation.[48]

Just as in *Feist*, where Rural did not have a copyright claim for the data contained in its telephone directory, neither does the NBA have a copyright claim over its game statistics.[49] Rural and the NBA are running into the same problem: copyrightability is based on originality, not the amount of work that went into creating a work.[50] Game statistics and data seem to very plainly be facts, which are accordingly not eligible for copyright.[51] Even if the NBA were to successfully argue that it had a database of statistics that was originally formatted enough to earn a copyright, that copyright would still not extend to the game statistics within the database.[52]

B. Right of Publicity Claims and the Courts

In *C.B.C. Distribution and Marketing, Inc. v. Major League Baseball Advanced Media, L.P.,* the Eighth Circuit held that first amendment rights superseded Major League Baseball's argument that its game statistics were protected by a right of publicity.[53] C.B.C. Distribution and Marketing, Inc. ("CBC") was a purveyor of fantasy sports, [54] a form of entertainment very close to gambling.[55] Fantasy sports involve players selecting professional athletes to bring on to their fictional or fantasy team.[56] The performance of the fantasy team is based on the performance of the actual players in games they actually play.[57] In essence, the most successful fantasy teams will be those with players who perform the best and record the best statistics in actual professional games.[58]

---

44. *Feist*, 499 U.S. at 352.
45. *Id.* at 354.
46. 17 U.S.C. § 102(b).
47. 17 U.S.C. § 103(b).
48. *Feist*, 499 U.S. at 356, 358.
49. *See id.* at 363.
50. *See id.* at 354; *See also* 17 U.S.C. § 102(b).
51. *See* 17 U.S.C. § 102(b).
52. *See* 17 U.S.C. § 103(b).
53. *C.B.C. v. MLB*, 505 F.3d at 824.
54. *Id.* at 820.
55. *See generally* Justin Moyer, *Sorry, daily fantasy sports is gambling, not a game of skill, Nevada says*, THE WASHINGTON POST (Oct. 16, 2015 2:39 AM), https://www.washingtonpost.com/news/morning-mix/wp/2015/10/16/nevada-sorry-fantasy-sports-is-gambling-not-a-game-of-skill/ (stating that Nevada state regulators have declared fantasy sports the same thing as sports betting in the past).
56. *See* Justin Sablich, *A Beginner's Guide to Playing Fantasy Football*, NEW YORK TIMES (Aug. 24, 2017), https://www.nytimes.com/2017/08/24/sports/fantasy-football-draft-guide-beginners.html.
57. *Id.*
58. *Id.*

Major League Baseball ("MLB") offered CBC the right to promote the MLB's own fantasy sports offerings on CBC's website in exchange for a commission.[59] CBC continued to operate its own fantasy games that used MLB player names and statistics and then sought a declaratory judgment that the MLB did not have a right to seek a licensing fee.[60] The MLB argued it was entitled to seek a licensing fee based on its players' rights of publicity.[61] A right of publicity is a protection that seeks to prevent a person's likeness from being used for commercial purposes without her consent.[62] The Eighth Circuit held that even though there was a valid claim for right of publicity, it was superseded by "CBC's first amendment rights in offering its fantasy baseball products . . . "[63]

America's strongly held freedom of speech would also seem to prevent the NBA from enjoying a legal protection on NBA game data and statistics.[64] *C.B.C.* established that a company offering fantasy sports has a first amendment right to professional game statistics that takes precedence over any right of publicity the related professional athletes may have.[65] Given how similar fantasy sports and sports betting are[66], this same logic, first amendment rights trumping right of publicity for a fantasy sports operator, would seem to very clearly apply to sports wagering as well. In either case, the NBA does not seem to have a legal protection for its game statistics.

Perhaps in a tacit acknowledgement that it does not have any existing legal protections for its game statistics, the NBA has sought to ensure a share of sports wagers through another legal mechanism—statutory protections.[67] The league has heavily lobbied both state and federal legislatures, urging both to consider two different statutory schemes: a mandate that all sportsbooks pay one percent of all wagers placed back to the appropriate professional league (known as an "integrity fee");[68] or a mandate that sportsbooks be required to use only data and statistics directly from professional sports leagues (known as an "official data" requirement).[69] Thus far, the lobbying for the integrity fee has failed entirely while the official data approach has been met with very limited success.[70]

---

59. *C.B.C. v. MLB*, 505 F.3d at 821.

60. *Id.*

61. *Id.*

62. Restatement (Third) of Unfair Competition § 4 (1995).

63. *C.B.C. v. MLB*, 505 F.3d at 824.

64. *See Id.*

65. *C.B.C. v. MLB*, 505 F.3d at 824.

66. *See* Moyer, *supra* note 55.

67. *See* Smiley and Dorson, *supra* note 5 (stating that the NBA is "at the forefront of lobbying" for "official league data" mandates and integrity fees).

68. Bonesteel, *supra* note 3 (statement by Dan Spillane, then NBA senior vice president and assistant general counsel) ("…we believe it is reasonable for operators to pay each league 1 percent of the total amount bet on its games.").

69. Smiley and Dorson, *supra* note 5 (explaining that the NBA has lobbied for legislation that would require sportsbooks to use "official league data").

70. *See* Derbyshire, *supra* note 31 (stating that Missouri would have been the first state to seriously consider paying a integrity fee, but decided against it, meaning no states thus far have included an integrity fee in its sports wagering legislation); *See also* Lemire, *supra* note 29 (stating that only two states have passed sports wagering legislation that requires a version of an official league data requirement, meaning the NBA's lobbying has been successful in only two out of twenty three states so far).

C. Lobbying Efforts for Integrity Fees and Official Data Mandates

Integrity fee lobbying has not been successful on a federal[71] or state level.[72] The sole Congressional sports wagering bill that has been introduced, the Sports Wagering Market Integrity Act of 2018,[73] does not include an integrity fee.[74] The Act, after being introduced by now retired Senator Orrin Hatch and current minority leader Chuck Schumer, stalled without making any meaningful progress.[75] Twenty-three states have now passed legislation legalizing sports wagering,[76] and none of them contain an integrity fee either.[77]

The fee was an ambitious ask by the NBA, as any attempt by the league to obtain a portion of the sports wagering market would be expected to be met with opposition by sportsbooks. The books' lobbying effort here, however, was particularly fierce due to the amount the NBA was pushing for.[78] While one percent may not seem like much on its face, the NBA asked for one percent of *all wagers placed*, which is estimated to account for a whopping one fifth of an average book's profit.[79]

Further, if legislatures are going to account for a percentage of the sports betting to go elsewhere, they seem to prefer it go back to the states themselves.[80] Missouri, for example, has expressed this desire but has not yet made a final decision on a sports wagering statute.[81] An initial sports wagering bill was introduced with the one percent integrity fee but an alternative bill has since been introduced that removes the integrity fee altogether and replaces it with a half percent fee to be used to maintain a state infrastructure fund.[82] Alternatively, New Jersey, with its distinctive nuance, simply called the idea of an integrity fee insulting.[83]

The league's other lobbying approach, an official data requirement, has been met with very limited success.[84] The aforementioned Sports Wagering Market Integrity Act notably did not include an integrity fee but did include the official data requirement.[85] The cosponsor of that bill, Senator Schumer, has possibly enlisted the help of Senator Hatch's replacement,

---

71. *See* generally John Brennan, *Federal Sports Betting Bill Has 'Integrity' In The Title And Data In The Details*, SPORTS HANDLE (Dec. 19, 2018), https://sportshandle.com/federal-sports-betting-bill-introduced/ (stating that no federal legislation has been passed to regulate sports wagering and the current proposed bill does not include an integrity fee).

72. Lemire, *supra* note 29 (explaining that no state sports wagering legislation thus far includes an integrity fee).

73. S.2793, 115th Cong. (2018).

74. Brennan, *supra* note 71.

75. *See* Brett Smiley, *Report: Romney To Carry Federal Sports Betting Bill Torch With New York's Schumer*, SPORTS HANDLE (Sep. 6, 2019), https://sportshandle.com/romney-schumer-sports-betting-federal-bill-report/.

76. Rodenberg, *supra* note 13 (twenty three states have legalized sports betting).

77. *See* Lemire, *supra* note 29 (no state sports wagering laws have included an integrity fee).

78. *See* Bonesteel, *supra* note 3 (explaining that the NBA's desire for an integrity fee was met with "skepticism that bordered on hostility".).

79. *Id.* (stating that, as of 2016, one percent of all wagers placed would amount to roughly twenty percent of an sportsbooks' profits).

80. *See generally* Derbyshire, *supra* note 31 (explaining Missouri's legislature amended its sports wagering bill to replace the sports league integrity fee in favor of a percentage of wagers going to a state infrastructure fund).

81. *Id.*

82. *Id.*

83. *Id.* ("In fact, New Jersey went as far as to call the idea insulting.").

84. *See* Brennan, *supra* note 71 (stating that no federal legislation has been passed to regulate sports wagering and the current proposed bill does not include an integrity fee); *See also* Lemire, *supra* note 29 (no state sports wagering laws have included an integrity fee).

85. Brennan, *supra* note 71 (the Act does not include an integrity fee).

Mitt Romney, to either reintroduce the old sports wagering bill or introduce an entirely new one.[86] Out of the twenty three states that have legalized sports wagering,[87] only two—Tennessee and Illinois—have included an official data requirement of some sort.[88] Both states require official data to be used for in-play bets.[89] Illinois also requires official data to be used for prop bets.[90]

The low success rate in state lobbying to add official data requirements to bills legalizing sports gambling, less than ten percent, can seemingly be chalked up to a lack of compelling argument by the NBA. The league has noted that official data is the fastest data available and helps "ensure the accuracy and consistency of betting outcomes for fans."[91] These arguments do not seem to pass muster. While faster data speed could be more desirable to a sportsbook, that is hardly a reason to statutorily mandate it for all books. The claim that official data will help ensure accuracy and consistency is not well supported itself, since Nevada, which was exempted from PASPA,[92] has successfully maintained sports wagering for decades without any such requirements.[93]

The lack of persuasive reasoning in favor of official data is underpinned by the difficulty of enforcing the measure. When the outcome of a professional sporting event is widely known, how can the communication of data be realistically controlled? An absurd attempt at enforcement in the English Football League is illustrative of the difficulty.[94] Here, a fan was enjoying a live soccer match while occasionally texting friends and family updates on the game.[95] The man was approached by an undercover security officer and told that if he did not stop texting information about the soccer game, including any information about whether a goal was scored, when the goal was scored, and who scored it, he would be ejected from the stadium.[96] The encounter was a result of the fact that the EFL had entered into a deal that made Genius Sports the exclusive provider of EFL betting data.[97] The security check was an effort to stop any information about the game from being disseminated—an attempt to stop data from being communicated not just to stop data from being given to sportsbooks but to any individual that might use the information to place an in-game bet.[98] It is unlikely any such enforcement could be put in to force in the U.S with the country's strongly held notions

---

86. Smiley, *supra* note 75.
87. Rodenberg, *supra* note 13 (twenty three states have legalized sports wagering).
88. Lemire, *supra* note 29 (stating that only Illinois and Tennessee sports wagering bills have included an official data requirement).
89. *Id.*
90. *Id.*
91. *Official League Data*, LEGAL SPORTS REPORT (Feb. 14, 2020 1:42 PM), https://www.legalsportsreport.com/official-league-data/.
92. 28 U.S.C. § 3704.
93. *See generally* Joe Williams, *Nevada sports betting: Is legal sports betting available in Nevada?*, USA TODAY SPORTSBOOK WIRE (Apr. 25, 2020, https://sportsbookwire.usatoday.com/2020/04/25/nevada-sports-betting-is-legal-sports-betting-available-in-nevada/ (stating that Nevada legally operated sports wagering operations since 1949).
94. Lee Jarvis, *EFL apologises to Hull fan who was told to stop texting at game*, YAHOO SPORTS UK (Aug. 12, 2019), https://sports.yahoo.com/efl-apologises-for-spot-check-asking-a-hull-fan-to-stop-texting-100012785.html.
95. *Id.*
96. *Id.*
97. Sam Carp, *Genius Sports lands Premier League betting data*, SPORTSPRO (May 9, 2019), https://www.sportspromedia.com/news/premier-league-betting-data-genius-sports-dataco-efl-spfl.
98. Jarvis, *supra* note 94.

of free speech. *C.B.C.* showed that U.S. courts have been loath to grant sports leagues any protection over game data, largely due to the conflict with the first amendment.[99]

D. Licensing Official Data

That leaves the NBA's final approach at monetizing legalized gambling—the licensing of official data to both data analytics companies and sportsbooks directly. After PASPA was struck down by *Murphy*,[100] the NBA agreed to non-exclusive official data licensing deals with two data analytics companies, Genius Sports and Sportsradar.[101] Both companies are in the aforementioned business of using algorithms to produce betting odds, which are then sold to sportsbooks.[102] The benefit to both sides here is clear—the NBA is monetizing its data, and Genius Sports and Sportsradar are getting the fastest data available, surely a boon to companies whose own value is in providing betting odds to sportsbooks as quickly as possible.

The league also struck a deal directly with sportsbook MGM Resorts (MGM).[103] The deal included the NBA providing real time data to MGM as well as the NBA granting MGM the right to use league trademarks in conjunction with their sports wagering outfit.[104] The deal is non-exclusive so the NBA is free to enter into similar agreements with other books.[105] This deal is not so different from a standard licensing deal, where a company with valuable branding allows another company to pay for the use of that branding.[106] To be clear, the value to MGM here seems to lie entirely with marketing. MGM's sportsbook is estimating that it is worth paying the NBA for the right to say, "MGM uses official NBA data" and to use team logos and the like within its books. This was all but confirmed when MGM's online sports betting arm,[107] a few months after the NBA deal, signed another deal with data analytics company Sportsradar establishing Sportsradar as the exclusive data supplier for MGM's online sports betting operation.[108]

In summary, the NBA has voiced and attempted a number of approaches to monetize sports wagering. Case law appears to indicate the league has no intellectual property interest[109] or any other legal protection for its data.[110] Attempts to lobby for an integrity fee

---

99. *See C.B.C. v. MLB*, 505 F.3d at 824.
100. *Murphy*, 138 S. Ct. at 1484-85.
101. Carp, *supra* note 7
102. *Id.*
103. Carp, *supra* note 8.
104. *Id.*
105. *Id.*
106. Scott Hervey, *Six Key Points in Negotiating Brand Licensing Agreements*, THE IP LAW BLOG (Apr. 16, 2012), https://www.theiplawblog.com/2012/04/articles/trademark-law/six-key-points-in-negotiating-brand-licensing-agreements/ (explaining that the fundamental purpose of a licensing agreement is "…to give a third party the right to benefit from the goodwill and economic value associated with an established mark.").
107. Joss Wood, *MGM Resorts And GVC Striking $200 Million Sports Betting Partnership*, LEGAL SPORTS REPORT (Jul. 30, 2018 5:30pm), https://www.legalsportsreport.com/22352/mgm-gvc-us-sports-betting-partnership/.
108. Hilary Russ, *Sportradar to provide U.S. sports betting data to MGM-GVC joint venture*, REUTERS (Nov. 8, 2018), https://www.reuters.com/article/us-usa-gambling-sport-data/sportradar-to-provide-u-s-sports-betting-data-to-mgm-gvc-joint-venture-idUSKBN1ND223.
109. See Feist, 499 U.S. at 344.
110. *See C.B.C. v. MLB*, 505 F.3d at 824.

have been unsuccessful,[111] and lobbying attempts to require official data use have seen very limited success.[112] The best and remaining alternative lies in the league's data licensing efforts, where it has already seen the most success.

IV. RECOMMENDATIONS

The NBA's approaches garnering legal protection for its game data, through both the courts[113] and legislatures, have been largely met with resistance[114] and outright rejection.[115] The clear path forward for the league is to focus its efforts on game data licensing and how it can strengthen the value offer of its data licensing. To that end, the league should focus on two of the most rapidly growing sports wagering trends, in-play[116] and prop bets, and developing its own products and data to serve those bets.[117]

A. The NBA Can Further Monetize the Growing Popularity of In-play Bets

The league is in the sole position to offer the fastest data to analytics companies and fast data is the most valuable resource for in-play betting.[118] Sportsbook executives believe that, while only an estimated ten to twenty percent of bettors have placed in-play bets, [119] in-play betting is one of the fastest growing categories of wagers and possibly the future of sports wagering entirely.[120] The expected bright future for in-play betting is due to its ability to offer continued betting options throughout a game, even for blowouts, which is desired by both the sportsbook and the bettor.[121]

---

111. *See* Derbyshire, *supra* note 31 (stating that Missouri would have been the first state to seriously consider paying a integrity fee, but decided against it, meaning no states thus far have included an integrity fee in its sports wagering legislation); *See also* Brennan, *supra* note 71 (stating that no federal legislation has been passed to regulate sports wagering and the current proposed bill does not include an integrity fee).

112. *See* Lemire, *supra* note 29 (stating that only two states have passed sports wagering legislation that requires a version of an official league data requirement, meaning the NBA's lobbying has been successful in only two out of twenty three states so far).

113. *See Feist*, 499 U.S. at 344; *See C.B.C. v. MLB*, 505 F.3d at 824.

114. *See* Derbyshire, *supra* note 31.

115. *See* Lemire, *supra* note 29.

116. Frank Schwab, *Super Bowl LIV betting: The next frontier in sports betting? In-game wagering*, YAHOO SPORTS (Feb. 1, 2020), https://sports.yahoo.com/super-bowl-liv-betting-the-next-frontier-in-sports-betting-ingame-wagering-170223545.html (explaining the anticipated trajectory of in-play betting, a statement by Scott Butera, MGM President of Interactive Gaming, "In-game betting in the U.S. I think [is] very much the future." Further explaining that Butera expects in-play betting will eventually "mirror the popularity [in-play betting] hold in Europe" where it is very popular).

117. Joan Mantini, *Digital Sports Tech Unveils Player Props Data Feed*, US BETTING REPORT (Apr. 3, 2019), https://usbettingreport.com/sports-betting/digital-sports-tech-unveils-player-props-data-feed/ (explaining the increasing popularity of prop bets, a statement by Ari Lewski, executive director at analytics company Digital Sports Tech, "[Prop bets] as a betting segment continues to grow at a steep trajectory and is fast becoming an integral part of any sportsbook's offering.").

118. *See* Glanz, *supra* note 21 (speaking about how important access to fast data is for in-play sports betting) (statement of Steven Burton) ("For betting, it's the difference between having value and having no value at all.").

119. Brett Smiley, *The Rise And Excitement of In-Play Betting, Explained By Expert*, SPORTS HANDLE (Dec. 13, 2017), https://sportshandle.com/in-play-sports-betting-expert-analysis/ (explaining that roughly "10-20%" of bettors place in-play bets when playing at a physical sportsbook).

120. Schwab, *supra* note 116 (estimating the future of in-play betting, a statement by Scott Butera, MGM President of Interactive Gaming) ("In-game betting in the U.S. I think [is] very much the future.").

121. Smiley, *supra* note 119.

How in-play betting benefits both bettors and books can be illustrated by a simple hypothetical: Here, a bet is placed on the Cavaliers to win and they fall behind by forty points nearly immediately. The Cavaliers have almost no chance of winning and without in-play betting, the bettor and sportsbook have no reason to place more bets. In-play betting, however, would give the bettor a chance to recover money, by betting on the other team to win, for example. That is good for the bettor, as she would otherwise have no way to continue to invest in the game and no way to recoup money. In-play betting gives the bettor a chance to turn a nearly guaranteed loss into a win, or at the very least, to mitigate loss. That is equally good news for the sportsbook, as books are always looking for ways to increase the number of bets placed and the amount of money wagered.[122]

As described above, the complexity of in-play betting means that books have no choice but to purchase real-time updated betting lines from analytics companies.[123] The NBA, rather than pushing for a tenuously supported legislation that requires league data to be used, should lean on the reality that it has the fastest data available in the market. In the short term the league can continue to leverage its market best data speed in licensing deals with analytics companies. In the long term the NBA would be best served by developing its own in-house analytics department. If the league were able to develop effective betting odds algorithms of its own, it could cut out analytics companies altogether and offer the fastest data stream possible to sportsbooks directly. The combination of the fastest data possible, reliable betting algorithms, and the cache of the NBA's name and brand offers unparalleled value. As a bonus, the NBA would largely obviate the need to push for official data legislation, as they would have the most competitive sports wagering data offering on the market.

B. A New Opportunity for NBA Data Licensing – Prop Bets

Prop bets are a growing focus for sportsbooks for the same reason as in-play betting—they are an avenue for books to bring in more bets, and thus more money.[124] Because prop bets are not tied to the ultimate outcome of a game, they give bettors a way to bet on a game that they do not anticipate will be competitive.[125] Prop bets originated in this very way.[126] Super Bowls were, for a time, often ending in blowouts and sports books wanted to develop a way to still get people to bet.[127] The solution was the prop bet, entirely unrelated to which team won or lost the game.[128] Further, while there is a somewhat finite number of bets that can be tied to the outcome of a game, the number of prop bets possible is really only limited by a sportsbook's creativity. The same logic undergirding in-play bets is at play here. More

122. *Id.*

123. Rybaltowski, *supra* note 22 (explaining that it is not possible for teams of oddsmakers to maintain multiple up to date in-play betting odds, a statement by Jason Simbal, Vice President of Management at sportsbook CG Technology, "…it's not scalable… You can only do so many…").

124. Mantini, *supra* note 117 (prop bets are growing "at a steep trajectory").

125. *See generally* Gary Rotstein, *Super Bowl Prop Bets Now As Popular As Their Inspiration: Refrigerator Perry*, US BETS (Jan. 27, 2020), https://www.usbets.com/super-bowl-prop-bets-popular-refrigerator-perry/.

126. *Id.* (describing the creation of prop bets, a statement by Jay Kornegay, then vice president of race and sports operations for Westgate sportsbook, "We started thinking of [prop bets] as a way to keep people interested in the [Super Bowl] to the very end because so many were blowouts at the time.").

127. *Id.*

128. *Id.*

betting opportunities are good for bettors and, of course, more opportunities are always favored by books as well.

The NBA can take advantage of this prop bet boom by creating new data that is not publicly available, and thus can only be offered by the league. A straightforward application of such prop bets could be player movement statistics. By having players wear accelerometers, perhaps sewn onto jerseys or embedded onto wearable devices such as Apple Watches, the NBA can begin to gather a host of in game information.[129] The league would be able to collect statistics such as how fast players move, how high they jump, and how far they travel over the course of a game.[130] Any of these statistics could very simply be offered as a prop bet. Which player do you think will run the fastest at tonight's game? Which player do you think will jump the highest during tonight's game? Player movement statistics are just one example of an exclusive statistic the league could develop. The larger point is that exclusive statistics are extremely valuable as no other sports wagering data source can offer them.

Unlike game statistics which, as discussed above, can be recorded by any person watching the game, these statistics would only be known by the NBA. The added value to a potential NBA data license could be significant—a sportsbook would have the choice of either using the NBA's data, or not getting access to that league exclusive data, and thus prop bet opportunities, at all.

V. CONCLUSION

In the U.S., sports gambling is a booming business, to the tune of $17.6 billion since the overruling of PASPA in 2018.[131] The NBA has led the charge amongst the professional sports world in getting a piece of the financial pie through the monetization of its game data and statistics. The league's claims of intellectual property rights[132] and legal protections[133] in its data however are unpersuasive and its attempts to lobby for integrity fee[134] and official data requirements have been ineffective.[135] The league has made strides in data licensing to analytics companies[136] and sports books alike.[137] For the league, the most logical step forward therefore is to bring as much work as it can in house, both by creating its own betting algorithm and by creating exclusive game data, to further strengthen the value of its data licensing offer.

---

129. *See generally* Ryan Goodrich, *Accelerometers: What They Are & How They Work*, LIVE SCIENCE (Oct. 1, 2013), https://www.livescience.com/40102-accelerometers.html (explaining that accelerometers can be used to determine what direction and how fast an object is moving).

130. *See Id.*

131. US Sports Betting Revenue And Handle, Legal Sports Report (Feb. 6, 2020, 12:31pm), https://www.legalsportsreport.com/sports-betting/revenue/.

132. *See Feist*, 499 U.S. at 344.

133. *See C.B.C. v. MLB*, 505 F.3d at 824.

134. *See* Derbyshire, *supra* note 31 (no state sports wagering legislation includes an integrity fee); Brennan, *supra* note 71 (no federal sports wagering has been passed and the only bill introduced does not include an integrity fee).

135. *See* L*emire*, *supra* note 29 (only two out of twenty three states sports wagering bills include an official data requirement).

136. Carp, *supra* note 7 (stating that the NBA entered data distribution deals with analytics companies Genius Sports and Sportsradar, becoming the first U.S. sports league to sign a betting data distribution deal).

137 . Carp, *supra* note 8 (stating that the NBA signed a deal with MGM Resorts to provide MGM with official NBA data).

VOLUME 25 SUMMER 2020

ILLINOIS BUSINESS LAW JOURNAL

SMART PLAYERS NEED SMART CONTRACTS: HOW BLOCKCHAIN AND SMART CONTRACTS CAN REVOLUTIONIZE THE SPORTS INDUSTRY

❖ NOTE ❖

Cody von Rueden *

I. INTRODUCTION

"Smart Contracts" are a critical component of many platforms and applications being built using blockchain or distributed ledger technology.[1] Simply put, smart contracts are lines of code that are stored on a blockchain and automatically execute when predetermined conditions are met.[2] The benefits of smart contracts are most apparent in business collaborations, in which they are typically used to enforce some type of agreement so that all participants can be certain of the outcome through speed, accuracy, security, and savings.[3] Many multinational companies have already jumped onto the blockchain bandwagon and are working on their own projects to stay ahead of the competition.[4] For instance, major technology providers like IBM and Microsoft are offering block chain solutions to enterprise clients.[5] Tech start-ups too are aggressively capitalizing on the boom by building new products and services that depend on blockchain technology, which amassed to more than $3.25 billion in funding through token sales in 2017.[6] However, despite blockchain finding its adoption in several industries, for some reason, the sports industry has never been under

1. Stuart D. Levi & Alex B. Lipton, *An Introduction to Smart Contracts and Their Potential and Inherent Limitations*, Harvard Law School Forum on Corporate Governance, (May 26, 2018), https://corpgov.law.harvard.edu/2018/05/26/an-introduction-to-smart-contracts-and-their-potential-and-inherent-limitations/.
2. Nigel Gopie, *What are smart contracts on blockchain?*, IBM, (July 2, 2018), https://www.ibm.com/blogs/blockchain/2018/07/what-are-smart-contracts-on-blockchain/.
3. *Id.*
4. Roger Aitken, *Smart Contracts On The Blockchain: Can Businesses Reap The Benefits?*, Forbes, (Nov. 21, 2017), https://www.forbes.com/sites/rogeraitken/2017/11/21/smart-contracts-on-the-blockchain-can-businesses-reap-the-benefits/#20a5cdaa1074.
5. *Id.*
6. *Id.*

*J.D. Candidate, Class of 2022, University of Illinois College of Law.

the paradigm of blockchain services.[7] When it comes to applying blockchain to the sports industry, the most interesting applications include direct investment in athletes, clubs, and sports management practices; allowing for a more accessible and transparent reputation management for teams, leagues, and individual athletes; and a general reduction in middlemen through automation to make contract negotiation more efficient.[8] It is time for the sports industry to "huddle up," because industry leaders will be surprised to know that smart contracts can find usage and purpose through blockchain technology.[9]

This note will discuss the inexorable incorporation of the use of smart contracts into the trillion dollar-sports industry, specifically, athlete representation. By implementing smart contracts into an agent's business practice, transactions will be processed digitally and automatically, allowing the player to focus on his or her athletic performance on the field, court, or ice while enabling the agent to provide a secure and streamlined process for his or her client. Part II of this Note will discuss the background and concept behind Bitcoin, Blockchain, smart contracts, and the traditional contract in the sports industry. Part III will analyze why implementing smart contracts in the sports industry will be advantageous to agents, teams, and third-party sponsors. Part IV recommends how to incorporate smart contracts into standard player contracts and third-party sponsorship deals, and the impact it will have on the industry. Finally, Part V will conclude.

II. BACKGROUND

A. What is Bitcoin?

Bitcoin can be understood as a "digital dollar" and is the first of a new kind of asset called "cryptocurrency," a decentralized form of digital cash that eliminates the need for traditional intermediaries to make financial transactions.[10] Bitcoin is powered through a combination of peer-to-peer technology (working on networks of individuals) and software-driven cryptography (the science of passing secret information between senders and receivers).[11] This creates a currency backed by code rather than tangible items or trust in central authorities.[12] Like traditional fiat currency, the price of Bitcoin fluctuates based on supply and demand, but to a much greater extent.[13] People are now converting Bitcoin into "tokens," which companies issue during an Initial Coin Offering (ICO).[14] An ICO allows investment in a company by purchasing tokens with their Bitcoin.[15] A "token" is a representation of any

---

7. Maria Garcia, *5 Best Use Cases Of Blockchain Application For The Sports Industry*, Medium, (May 19, 2019), https://medium.com/@garcia_maria/5-best-use-cases-of-blockchain-application-for-the-sports-industry-3b42c328dca1.

8. Sam Mire, *Blockchain For The Sports Industry: 11 Possible Use Cases*, Disruptor Daily, (Nov. 8, 2018), https://www.disruptordaily.com/blockchain-use-cases-sports/.

9. Garcia, *supra* note 7.

10. Kevin Voigt, *What Is Bitcoin, and How Does It Work?*, nerdwallet, (June 18, 2019), https://www.nerdwallet.com/blog/investing/what-is-bitcoin/.

11. *Id.*

12. *Id.*

13. Joshua Bernstein, *SMART CONTRACT INTEGRATION IN PROFESSIONAL SPORTS MANAGEMENT: THE IMMINENCE OF ATHLETE REPRESENTATION*, 14 DPLJSL 88, 90 (2018).

14. *Id.*

15. Samantha Radocchia, *How Is Ethereum Different From Bitcoin?*, Forbes, (September 14, 2017), https://www.forbes.com/sites/quora/2017/09/14/how-is-ethereum-different-from-bitcoin/#5a94fbff502b.

fungible tradable good such as currency or loyalty points.[16] Just like shares of stock in an initial public offering, token prices go up and down based on their supply and demand.[17] Therefore, a token is an abstraction representing ownership of an underlying tradable asset.[18] As a result, due to the unique nature of virtual currencies, transacting through bitcoin over fiat currencies offer many inherent advantages including: user autonomy, discretion, peer-to-peer focus, elimination of banking fees, mobile payments, and accessibility.[19]

B. What is Blockchain?

Blockchain is the trading medium of cryptocurrency, the most popular being Bitcoin.[20] Blockchain technology commenced as a means of operating cryptocurrency transactions.[21] A cryptocurrency blockchain encodes debits and credits to cryptocurrency accounts and stores them as transactions "in blocks."[22] Contrary to centralized record-keeping systems, each node in the system evaluates the transaction and maintains its own ledger of all transactions in a decentralized form.[23] The decentralized ledger system reduces the risk of hacking and altering information, since a majority of the nodes must verify a change in data for the ledger to legitimize the alteration.[24]

Beyond cryptocurrency, dozens of industries use blockchain because of its potential to revolutionize day-to-day activities and record keeping. Shell, for example, is working with technology and finance partners on a platform for the trade and settlement of crude oil.[25] Walmart uses blockchain to create a food traceability system, and insurance giant AXA now offers flight insurance via blockchain technology.[26] Corporations are attracted to blockchain technology because the decentralized blockchain ledger allows multiple nodes to keep identical records of given transactions.[27] This decentralized record-keeping system creates a system of extreme transparency that eliminates the need for a third party, solves-double spending problems, and is more resistant to hackers.[28] Sports & entertainment companies, therefore, may benefit from blockchain ledgers to reduce traditional problems such as ticket fraud and the withholding of proper payments in a contract.[29]

---

16. Bernstein, *supra* note 13, at 90-91.
17. Radocchia, *supra* note 15.
18. Bernstein, *supra* note 13, at 91.
19. Nathan Reiff, *What Are the Advantages of Paying With Bitcoin?*, Investopedia, (Jan. 12, 2020), https://www.investopedia.com/ask/answers/100314/what-are-advantages-paying-bitcoin.asp.
20. Tsui S. Ng, *Blockchain and Beyond: Smart Contracts*, A.B.A BUS. L. TODAY (Sept. 2017), https://www.americanbar.org/groups/business_law/publications/blt/2017/09/09_ng.html.
21. Max Raskin, *The Law and Legality of Smart Contracts*, 1 GEO. L. TECH. REV. 305, 317 (2017).
22. *Id.* at 318.
23. J. Travis Laster & Marcel T. Rosner, *Distributed Stock Ledgers and Delaware Law*, 73 BUS. L. 319, 321 (2018) (defining a node as a computer on the network which keeps its own copy of the ledger).
24. *Id.*
25. Justin Biel, *The Companies Using Blockchain Now, and What Yours Can Do to Stay Ahead*, Growwire, (Oct. 18, 2019), https://www.growwire.com/companies-using-blockchain.
26. *Id.*
27. Morgan N. Temte, *BLOCKCHAIN CHALLENGES TRADITIONAL CONTRACT LAW: JUST HOW SMART ARE SMART CONTRACTS*, 19 WY. L.R. 87, 90 (2019).
28. *Id.*
29. *Now Playing: Transparency in Media, Entertainment and Advertising with IBM Blockchain*, IBM, https://www.ibm.com/blockchain/industries/advertising-media (last visited Mar. 8, 2020).

C. An Illustrative Example: Winning payouts

Let's take a simple, yet pressing example that is affecting many athletes in sports today. Typically, tournament champions, or athletes entering into a new contract with their respective club or third-party sponsor, have to wait a couple of weeks or months before they get their winnings or payment. However, with the use of blockchain technology, athletes can be paid automatically and instantaneously. Major League Triathlon saw the benefit of blockchain technology and bitcoin in its October 2018 Triathlon in North Carolina.[30] The prize for the event was $36,000 with a bonus pool of $20,000 for teams placing first through third in the nine-team league.[31] Once the winning teams were identified, Major League triathlon instructed winners on how to use mobile-to-mobile transfer with their smart phones.[32] Through the use of blockchain technology and bitcoin, Major League Triathlon was able to put their winning teams on the podium, and pay the winners right then.

D. What Are Smart Contracts?

Coinciding with blockchain is the concept of smart contracts. Smart contracts are self-enforcing agreements that exchange promises or consideration between parties based on a transparent set of rules using predefined inputs.[33] In other words, a smart contract is a legal contract that is represented and executed, at least in part, by automated software.[34] Smart contracts are intended to work in concert with blockchain technology to enforce transactions and are a step beyond typical electronic contracts in that the actual agreement is embodied in computer code. Here, pieces of code, sometimes referred to as software agents, perform certain tasks when pre-defined and mutually agreed conditions embedded in the smart contract are met.[35] Parties "sign" the smart contract using cryptographic security an deploy it to a distributed ledger, or blockchain. Smart contracts' use of distributed ledger functionality together with automated contractual triggers ensure that transactions are completed in a secure and accurate manner, reducing the need for complex regulation oversight.[36] Smart contracts use blockchain to ensure that once the parties execute the contract, the transactions contemplated by that contract are accurate and cannot be avoided by any party without the other parties' consent.[37] This secure and instant contract execution is where smart contracts attract enormous popularity. For example, because smart contracts are self-executing based on predetermined conditions, smart contracts will stop execution if a predetermined condition

---

30. John Conroy, *How Blockchain is Changing Sports*, Sports Travel Magazine, (Dec. 10, 2019), https://www.sportstravelmagazine.com/how-blockchain-is-changing-sports/.
31. *Id.*
32. *Id.*
33. Scott A. McKinney, Rachel L. Landy & Rachel Wilka, *SMART CONTRACTS, BLOCKCHAIN, AND THE NEXT FRONTIER OF TRANSACTIONAL LAW*, 13 WA. J.L.T.A. 313, 321 (2018).
34. *Id.* at 322.
35. *Smart Contracts and Distributed Ledger--A Legal Perspective*, ISDA (Aug. 2017), https://www.isda.org/a/6EKDE/smart.
36. McKinney, *supra* note 33, at 321.
37. *Id.* at 323-324.

is not met.[38] On the contrary, if conditions are met, the smart contract will automatically execute.[39] The financial industry is an area where smart contracts are efficiently executed because of its data driven surroundings and quantitative measurable items.[40] The finance industry—just as the sports industry—is driven by data, and calculations are used to determine contract goal achievement.[41] Thus, due to the close relationship between the sports industry and the financial industry, smart contracts can be extremely advantageous in executing professional athlete contracts.[42]

E. The Traditional Contract in the Sports Industry

Professional athletes rely on sports agents to represent them in most business and legal aspects of their career.[43] Here, the use of traditional contracts play a vital role. Contracts in sports are subject to the same principles of contract formation as any other form of employment agreement.[44] To be legally enforceable, a contract—both traditional or smart—must have the following attributes: (1) offer, (2) acceptance, (3) consideration, (4) intent, (5) capacity, and (6) lawful subject matter.[45] Specifically, express contracts—where the agreement of the parties is evidenced by their words, whether spoken or written—represent the industry norm in sports.[46] Since smart contracts—like express contracts—work best when you can ask quantitative questions like amounts, date, time, and other measurable items, smart contracts have the capability to improve traditional standard player and third-party contracts in the sports industry.

III. ANALYSIS

The overarching interest in smart contracts results from its secure and instant contract execution. Therefore, implementing smart contracts into the sports industry, specifically standard player contracts and third-party sponsorship deals, will be extremely advantageous to all parties involved. Disputes between agents, general managers, sponsors, and coaches are typical in the industry. Not only will the implementation of smart contracts help solve these issues, but smart contracts will also simplify the contract drafting process, and eliminate contract disputes in the sports industry. For instance, disputes can be eliminated with the enforcement of the smart contracts depending on the predetermined conditions actually being met.[47] Since smart contracts are self-executing based on predetermined conditions, once

---

38. Bernstein, *supra* note 13, at 95.
39. *Id.*
40. *Id.* at 92.
41. *Id.*
42. *Id.*
43. James Masteralexis, Lisa Masteralexis, & Kevin Snyder, *Enough Is Enough: The Case For Federal Regulation Of Sport Agents*, 20 JEFFREY S. MORAD, SPORTS L.J. 69.
44. *Sports Contracts--Basic Principles*, U.S. Legal, https://sportslaw.uslegal.com/sports-agents-and-contracts/sports-contracts-basic-principles/ (last visited Mar. 8, 2020).
45. *Id.*
46. *Id.*
47. Bernstein, *supra* note 13, at 101.

those conditions are met, payment is transferred automatically.[48] Conversely, if the pre-determined conditions are not met, the transaction will not be initiated or completed.[49] Instead of costly litigation to solve these problems, a smart contract stops execution—i.e. someone does not get paid if the pre-determined conditions are not met.[50] Thus, the automatic execution of smart contracts based on predetermined conditions will help prevent parties from withholding proper payments and will deter parties from demanding invalid payments.[51] The use of smart contracts will streamline the athlete contract process, allowing for a secure way of transacting large amounts of money.[52] Further, the decentralized ledger will allow athletes to have immediate access to their funds upon completion of the predetermined condition. Fraud can easily be detected because the open-source nature of the ledger provides a safety measure which enables every transaction to be recorded and uploaded to the blockchain.[53] Blockchain and smart contracts can decrease the chance of fraud, and players and agents can be assured that transactions are secure. Finally, since a smart contract can replace a traditional contract associated with a professional athlete in practically any situation of the business, smart contracts can assist with general contractual obligations that the agent handles including, player insurance agreements, player endorsement deals, marketing deals, and other additional terms. Thus, smart contracts will fast track the professional athlete contract process, allowing for a secure way of transacting large amounts of money in standard player contracts and third-party sponsorship deals.

IV. RECOMMENDATION

A. Incorporating the Infrastructure

A working blockchain system that incorporates the use of smart contracts cannot be successful without the correct infrastructure. Smart contracts need to confer with the data uploaded to the blockchain to inquire whether the predetermined conditions have been met; thus, it is imperative to ensure that the blockchain contains the data necessary to execute the smart contract. Although smart contracts are implemented on various blockchains, the most efficient use of smart contracts are on Ethereum's blockchain.[54] Ethereum is a decentralized platform, with its own blockchain and coin. Ethereum is a ledger technology that companies are using to build new programs. However, Ethereum is far more robust than Bitcoin, which allows for the use of smart contracts.[55] Therefore, once the data is encrypted on a blockchain such as Ethereum, the smart contract will be able to predetermine whether conditions are met.[56] Once this is accomplished, there are numerous potential opportunities for agents and

48. *Id.* at 95.

49. *Id.*

50. Terry Brock, *Business advantages of blockchain smart contracts*, bizjournals.com (2017), https://www.bizjournals.com/bizjournals/how-to/technology/2017/09/business-advantages-of-blockchain-smartcontracts.html.

51. Bernstein, *supra* note 13, at 95.

52. *Id.*

53. *Advantages and Disadvantages of Decentralized Blockchains*, World Crypto Index, https://www.worldcryptoindex.com/advantages-disadvantages-decentralized-blockchains/ (last visited Mar. 8, 2020).

54. Radocchia, *supra* note 15.

55. *Id.*

56. *Id.*

teams to incorporate blockchain technology and the use of smart contracts into their business practices. First, through blockchain technology, the use of smart contracts can be used in both the standard player contract and player performance incentives. For example, imagine that a professional player and his team have a deal in place under a smart contract to sign a 2 year contract at $1,000,000 Average Annual Value (AAV). Through the smart contract, the transaction will only occur when the predetermined conditions are met. Here, the smart contract will pull the data—in this case the AAV and 2 year term—from the blockchain. Once the predetermined condition is met—in this case signing and completing the deal—the transaction is fulfilled and the player will automatically and instantaneously receive funds during the regular season on specified dates according to each leagues' scheduled terms. Additionally, imagine that the same player will receive a $200,000 bonus if he scores 30 goals per season. Once the player scores his 30th goal of the season, the transaction will automatically recognize the meeting of the predetermined condition of the smart contract. The smart contract will identify the 30th goal from the blockchain, and since the predetermined condition is met, the transaction is fulfilled, and the $200,000 bonus is instantly transferred to the player. On the contrary, if the player only reached the 29-goal mark, then the transfer will not occur and the player will not receive the bonus. This example can be applied to any player incentive structure: such as a $250,000 bonus for winning the Stanley Cup.

The same form of transaction can be implemented into player endorsement deals, sponsorships, and player appearances. Suppose that the same player described above enters into a player appearance deal with a large corporation. In this situation, assume that the corporation will pay the player $100,000 if he signs autographs for customers and fans at 5 company signing events. Here, the smart contract will pull the amount of appearances the player attends from the blockchain, and once the predetermined condition is met—the five appearances—the transaction is fulfilled and the funds from the corporation will be transferred to the player instantaneously.

B. The Impact

By replacing the traditional contract with the use of smart contacts in standard player agreements, player incentive contracts, and sponsorship deals, the automatic transfer allows the athlete to have access to his or her funds instantaneously once the predetermined condition is met, rather than waiting weeks or months to receive payment. This process will also save owners, general managers, players, and agents, time and effort because of the guaranteed outcome by committing themselves to be bound by the rules and determinations of the underlying code. The automated contracts avoid the pitfalls of agents and general managers manually filling out heaps of forms, and the higher efficiency of smart contracts result in more value-generating transactions processed per unit of time. Smart contracts can drastically cut down on efficiency lost to gaps in communication between the agent and general manager; and the transparent, autonomous, and secure nature of the self-executing agreement removes any possibility of manipulation, bias, or error. Finally, smart contracts have the ability to offer protection to agents and sports management leaders who currently lack the time, financial resources or knowledge to access the traditional legal system for petty

issues.[57] By no means is this Note suggesting that smart contracts should replace agents and attorneys. Agents and attorneys will still be in high demand to help draft standard player and third-party contracts, and negotiate the terms with professional teams and sponsors on behalf of their clients. Additionally, each player contract that the agent handles may be dealing with millions of dollars with individualized contract terms depending the quality and projected valuation of the player. Thus, there will still be a need to personalize these smart contracts depending on the athlete's desired terms of the deal, and to negotiate these terms with the team's general manager and owner. However, by implementing smart contracts into the agents business practices, transactions will be processed digitally, instantaneously, and automatically, allowing for the player to focus on his or her athletic performance on the field, court, or ice; while enabling the agent to provide a secure and streamlined process for his or her client.

V. CONCLUSION

Players are constantly looking to improve their athletic performance, and the same can be said for leaders in the business of sport. Although traditional contracts have played a vital and historic role, if the sports industry wants to continue to grow, leaders should look to incorporate smart contracts. Smart contracts align with the goals of the sports industry: to increase profits, efficiency, and success. By incorporating smart contracts into the business of sport, players can continue to focus on their performance, while agents, organizations, and third-parties, can protect the players' assets, alleviate disputes, and revolutionize a trillion-dollar industry.

57. Jon Southurst, *Ex-Rugby Star: Smart Contracts Could Prevent Legal Disputes in Sport*, CoinDesk (2015), https://www.coindesk.com/ex-rugby-star-smart-contracts-prevent-legal-disputes-sport/.