RUTGERS BUSINESS LAW REVIEW

VOLUME 20 FALL 2024 NUMBER 1

ARTICLES

NOTES

ASSIGNMENT OF FRANCHISE AGREEMENTS: BALANCING INTERESTS AND THE CONSEQUENCES OF SECTION 365(C)(1) OF THE BANKRUPTCY REFORM ACT AND JUDICIAL INTERPRETATIONS.

Ulysses N. Jaen

TABLE OF CONTENTS

I. Introduction

Understanding the Lanham Act, the Bankruptcy Reform Act and Assignment of Franchise Agreements

The intersection of trademark law, franchise agreements, and bankruptcy proceedings presents a complex legal landscape that has significant implications for both franchisors and franchisees. At the heart of this intersection lies the Lanham Act [1], the primary federal trademark statute in the United States, which plays a crucial role in governing the use and protection of trademarks within franchise systems. While the Lanham Act is primarily known for its regulation of trademarks [2], its influence extends into the realm of franchise agreements, particularly when it comes to their assignment in bankruptcy contexts.

Current Law

The Lanham Act, codified at 15 U.S.C. §§ 1051-1141n, plays a crucial role in franchise systems by protecting the trademarks that franchisors license to franchisees. These trademarks are integral to the franchise relationship, as they allow franchisees to operate under the franchisor's brand, benefiting from its established reputation and customer recognition.[3] In bankruptcy contexts, Section 365 of the Bankruptcy Code allows a debtor, such as a franchisee, to assume or reject executory contracts, including franchise agreements. However, Section 365(c)(1) introduces a limitation by stating that a debtor may not assume or assign an executory contract if applicable law excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor. [4] The Lanham Act often serves as this 'applicable law,' as it generally prohibits the assignment of trademarks without the owner's consent. This prohibition reflects the principle that trademarks are closely tied to the goodwill of a business and cannot be transferred separately from that goodwill. [5]

The interaction between the Lanham Act and Section 365(c)(1) has led to the significant circuit split in the interpretation of the latter, particularly in the context of franchise agreements. Courts have developed two primary tests to evaluate the assignability of these agreements: the hypothetical test and the actual test. The hypothetical test, adopted by circuits such as the Third, Fourth, and Ninth, takes a restrictive approach by considering whether applicable law would hypothetically prohibit

[1] Lanham (Trademark) Act, 15 U.S.C. §§ 1051-1141n (2012).
[2] Likelihood of Confusion Tests by Circuit, The Billing Life https://www.thebillinglife.com/blog/likelihoodofconfusiontestsbycircuit (last accessed 08/2024).
[3] 15 U.S.C. §§ 1051-1141n.
[4] 11 U.S.C. § 365(c)(1).
[5] Robert W. Emerson, *Franchise Terminations*: *"Good Cause" Decoded*, 51 WAKE FOREST L. REV. 103, 127 (2016).

the assignment of the contract without the non-debtor's consent. If so, the assumption of the contract is also prohibited, regardless of the debtor's actual intent. [6] This interpretation aligns with the Lanham Act's goal of protecting trademark integrity, as it prevents debtors from assuming contracts that could lead to unauthorized trademark use.

Conversely, the actual test, favored by the First and Fifth Circuits, focuses on the debtor's actual intent to assign the contract. Under this test, assumption is allowed if the debtor has no intention of assigning the contract to a third party, providing greater flexibility in reorganization efforts. [7]While this approach can facilitate debtor reorganization by allowing the retention of valuable franchise agreements, it may also lead to situations where terminated franchisees continue using the brand in bankruptcy, potentially diluting the brand's value or confusing consumers.

Franchise agreements are fundamentally built upon the franchisor's willingness to license its trademarks and associated goodwill to franchisees. This licensing arrangement allows franchisees to operate under the franchisor's brand, benefiting from its established reputation and customer recognition. The Lanham Act serves to protect these valuable trademarks from unauthorized use, ensuring that the integrity and value of the brand are maintained across the franchise system.

II. Historical Context and Legislative Intent

A. Origin of Section 365(c)(1)

Section 365(c)(1) was introduced as part of the Bankruptcy Reform Act of 1978,[8] a comprehensive overhaul of the U.S. bankruptcy system aimed at modernizing and improving the efficiency of bankruptcy proceedings. The reform sought to provide debtors with a fresh start while balancing the interests of creditors and other stakeholders. A key component of this reform was the treatment of executory contracts—agreements where both parties have ongoing obligations. [9] Executory contracts can be vital to a debtor's business operations, and the ability to assume or reject these contracts is crucial for effective reorganization. Section 365 was designed to give debtors the flexibility to retain beneficial contracts and shed burdensome ones, thus facilitating a successful reorganization process.

---

[6] *See* In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988); *see* In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004); *see* In re Catapult Entm't, Inc., 165 F.3d 747 (9th Cir. 1999).
[7] Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, 612 (1st Cir. 1995); In re Mirant Corp., 440 F.3d 238, 248 (5th Cir. 2006).
[8] Bankruptcy Reform Act of 1978, Pub. L. 95–598, Nov. 6, 1978, 92 Stat. 2575.
[9] Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 612 (2009).

B. Legislative Intent

The legislative intent behind Section 365(c)(1) was to balance the debtor's need to reorganize with the protection of non-debtor parties' rights. The provision was meant to ensure that non-debtor parties would not be forced to accept performance from a party other than the one with whom they originally contracted unless they consented to such an arrangement. However, the language of Section 365(c)(1) has been criticized for its ambiguity, particularly the phrase "assume or assign." This ambiguity has led to the differing interpretations by courts, contributing to the circuit split. The legislative history indicates that Congress aimed to protect non-debtor parties from being compelled to accept performance from an unfamiliar or potentially unreliable party. At the same time, Congress intended to preserve the debtor's ability to reorganize effectively by allowing the assumption of valuable contracts.

The legislative intent behind Section 365(c)(1) also suggests a desire to protect non-debtor parties from being compelled to accept performance from an unfamiliar or potentially unreliable party. At the same time, Congress aimed to preserve the debtor's ability to reorganize effectively by allowing the assumption of valuable contracts. This dual intent has fueled the ongoing debate over the proper interpretation and application of the provision, highlighting the need for clarity and consistency in its implementation. The ongoing debate reflects broader tensions in bankruptcy law between strict statutory interpretation and the policy goals of facilitating reorganization and providing debtors with a fresh start. This division underscores the need for potential legislative or judicial resolution to establish a consistent and coherent approach to the assumption and assignment of executory contracts in bankruptcy. [10]

The Value of Franchises to the United States and Legal Challenges in Bankruptcy

Franchises play a crucial role in the United States economy, contributing significantly to job creation, economic growth, and consumer choice. The franchise model allows entrepreneurs to operate businesses under established brands, benefiting from the franchisor's reputation, marketing, and operational support. This symbiotic relationship not only fosters business expansion but also stimulates local economies by creating employment opportunities and generating tax revenue. According to the International Franchise Association, franchises contribute over $800 billion to the U.S. economy annually and employ millions of individuals across various sectors, including food services, retail, and hospitality. [11]

---

[10] Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 788 (2002).
[11] International Franchise Association, *Economic Impact of Franchising*, FRANCHISE.ORG, https://www.franchise.org/franchise-information/economic-impact-of-franchising (last visited Aug. 29, 2024).

However, the financial stability of franchise businesses can be precarious, and when a franchisee declares bankruptcy, it introduces a host of legal and financial challenges. One of the primary concerns in such scenarios is the treatment of franchise agreements under bankruptcy law, particularly in light of Section 365 of the Bankruptcy Code[12]. This section allows debtors to assume or reject executory contracts, including franchise agreements, which are often vital to the debtor's business operations and reorganization efforts.

The recent statistics on bankruptcy filings, as reported by the Administrative Office of the U.S. Courts, provide valuable context for understanding the landscape of franchise bankruptcies within the broader economic environment. In the year ending December 31, 2023, total bankruptcy filings increased by 16.8 percent, continuing a rebound after more than a decade of declining totals. This rise includes a significant 40.4 percent increase in business bankruptcies, which encompass franchise operations, highlighting the financial pressures faced by businesses in the current economic climate.

The increase in business bankruptcies, from 13,481 in 2022 to 18,926 in 2023, suggests that franchises, along with other businesses, are navigating challenging economic conditions.[13] These challenges may include rising operational costs, changes in consumer behavior, and the lingering effects of the COVID-19 pandemic. The data underscores the importance of understanding the specific factors contributing to franchise bankruptcies, such as the ability to assume or reject franchise agreements under Section 365 of the Bankruptcy Code.

Franchises, which contribute significantly to the U.S. economy, are particularly vulnerable to economic downturns due to their reliance on consumer spending and adherence to franchisor standards. The ability to assume or reject executory contracts, including franchise agreements, is crucial for franchisees seeking to reorganize under Chapter 11. However, the complexities of Section 365, including the limitations imposed by Section 365(c)(1), can impact a franchisee's ability to retain valuable agreements essential for their business operations.

The recent rise in bankruptcy filings, coupled with the ongoing legal challenges related to the assumption and assignment of franchise agreements, highlights the need for strategic planning and legal expertise in navigating bankruptcy proceedings. As the economic landscape continues to evolve, stakeholders in the franchise industry must remain vigilant and adaptable to address these challenges effectively. This includes understanding the implications of the circuit split over Section 365(c)(1) and advocating for potential legislative or judicial resolutions to provide clarity and predictability in bankruptcy proceedings involving franchise agreements.

[12] 11 U.S.C. § 365(c)(1) (2018).

[13] *Bankruptcy Filings Rise 16.8 Percent,* UNITED STATES COURTS. (JAN. 26, 2024), https://www.uscourts.gov/news/2024/01/26/bankruptcy-filings-rise-168-percent.

Chapter 7 and Chapter 11 bankruptcies

Section 365 of the U.S. Bankruptcy Code applies differently in Chapter 7 and Chapter 11 bankruptcies, primarily due to the distinct objectives and processes involved in each type of filing. The flexibility in Chapter 11 allows debtors to maintain beneficial contracts while reorganizing, but they must still meet the requirements of Section 365(b) to cure defaults and provide adequate assurance of future performance. This difference underscores the distinct purposes of Chapter 7 and Chapter 11, with the former prioritizing asset liquidation and the latter supporting business reorganization.

Under Section 365, debtors or trustees can assume, assume and assign, or reject franchise agreements that have not been effectively terminated prior to bankruptcy, subject to court approval. Franchisors can object to the proposed disposition of their franchise agreements, which adds a layer of complexity to the proceedings. In Chapter 7 bankruptcy cases, executory contracts like franchise agreements are deemed rejected if the trustee does not assume and assign the contract within 60 days after the petition date, as specified in 11 U.S.C. § 365(d)(1). This provision reflects the liquidation focus of Chapter 7, where the goal is to efficiently wind down the debtor's affairs.

In contrast, Chapter 11 proceedings, which aim at reorganization, allow debtors to assume or reject franchise agreements at any time before or upon the court's confirmation of the reorganization plan, according to 11 U.S.C. § 365(d)(2). During this period, the debtor must continue to perform under the contract, including paying post-petition fees, as established in cases like *In re MS Freight Distribution, Inc.*[14] If a debtor rejects a franchise agreement, it is treated as a breach occurring immediately before the bankruptcy filing, entitling the franchisor to rejection damages for breach of contract under 11 U.S.C. § 365(g).To obtain court approval for assuming a franchise agreement, a Chapter 11 debtor must cure all outstanding defaults, provide adequate assurance of future performance, and compensate the franchisor for any actual pecuniary loss resulting from defaults, as outlined in 11 U.S.C. § 365(b)(1).[15] Franchisees face significant

---

[14] In re MS Freight Distribution, 172 B.R. 976, 978-79 (Bankr. W.D. Wash. 1994) (first citing In re Washington Bancorporation, 126 B.R. 130 (Bankr. D.D.C. 1991); then citing In re Far West Corp., 120 B.R. 551 (Bankr. E.D. Cal. 1990); then citing In re Pacific Sea Farms, Inc., 134 B.R. 11 (Bankr. D. Haw. 1991); then citing In re Revco D.S., Inc., 109 B.R. 264 (Bankr. N.D. Ohio 1989); and then citing In re Narragansett Clothing Co., 119 B.R. 388 (Bankr. D.R.I. 1990)) (Finding that "[m]any courts have considered the language of Section 365(d)(3) . . . and have concluded that both the legislative history of that section and the language of the section itself mandate that a lessor be paid interest, late fees, and legal fees incurred in the first 60 days of the bankruptcy case, provided these amounts are obligations of the debtor under the lease.").

[15] "(b)(1) "If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty challenges when seeking to assume and assign a franchise agreement to a third party, especially over the franchisor's objections.

Business Judgment Standard

The "business judgment" standard[16] also plays a crucial role in the decision to assume or reject executory contracts in bankruptcy proceedings. This standard provides a deferential framework for courts to evaluate a debtor's decision to assume or reject a contract, focusing on whether the debtor has a valid business justification for the decision. Under this approach, courts typically grant motions to assume or reject contracts if the debtor demonstrates that the decision is a sound exercise of business judgment.

The business judgment standard allows debtors to retain contracts that are beneficial to their reorganization efforts and reject those that are burdensome. This flexibility is essential for debtors seeking to restructure their operations and maximize the value of their bankruptcy estate. However, when assuming a contract, debtors must satisfy specific conditions set forth in Section 365(b) of the Bankruptcy Code, including curing any defaults and providing adequate assurance of future performance.

The application of the business judgment standard underscores the importance of allowing debtors to make strategic decisions about their contractual obligations to facilitate successful reorganizations. By focusing on the debtor's business rationale, the standard supports the overarching goals of bankruptcy law, which aim to provide

rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and **pecuniary losses** resulting from such default shall be compensated in accordance with the provisions of this paragraph;
(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual **pecuniary loss** to such party resulting from such default; and
(C) provides adequate assurance of future performance under such contract or lease." 11 U.S.C. § 365(b)(1). (Emphasis added).

[16] The business judgment standard influences the decision to assume or reject an executory contract in bankruptcy by generally allowing a debtor's choice if it is a good business decision. The standard is deferential, and courts typically grant motions to assume an agreement if the debtor can show a valid business justification. https://www.justice.gov/jm/civil-resource-manual-60-executory-contracts-bankruptcy#:~:text=Ala.%201995)%20(Bankruptcy%20courts,be%20based%20on%20sound%20business (Last accessed September, 2024).

debtors with a fresh start while balancing the interests of creditors and other stakeholders.[17]

The legal landscape becomes even more complex due to the circuit split over the interpretation of Section 365(c)(1), which governs the assumption and assignment of executory contracts. Courts are mostly divided between the "hypothetical test" and the "actual test," leading to uncertainty in how franchise agreements are handled in bankruptcy proceedings. The hypothetical test, adopted by circuits such as the Third, Fourth, and Ninth, prohibits the assumption of a contract if applicable law would bar its assignment without the non-debtor's consent, regardless of the debtor's intent. [18] This approach can severely limit a debtor's ability to reorganize, as it may prevent the retention of essential franchise agreements.

On the other hand, the actual test, favored by the First and Fifth Circuits, allows for the assumption of contracts unless there is a concrete intention to assign them to a third party. [19] This interpretation aligns more closely with the reorganization goals of bankruptcy, providing debtors with greater flexibility to retain valuable agreements.

A. Hypothetical Test

The hypothetical test interprets the statute strictly, prohibiting assumption if applicable law bars assignment, regardless of the debtor's intent. The test focuses on a strict reading of the phrase "assume or assign," treating them as inseparable actions when the assignment is restricted by law. Courts such as the Third, Fourth, and Ninth Circuits have adopted this test, emphasizing a literal interpretation of the statute. The shift towards a strict interpretation of statutes, particularly in the context of bankruptcy law, reflects a broader judicial trend emphasizing textualism and the literal application of statutory language.

---

[17] Standard of Review by Bankruptcy Court. A debtor's decision to assume an executory contract is subject to review under the "business judgment standard." See, e.g., Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.), 4 F.3d 1095, 1099 (2d Cir. 1993)(citing In re Minges, 602 F.2d 38, 43 (2d Cir. 1979); In re Gardinier, Inc., 831 F.2d 974, 975 n.2 (11th Cir. 1987)(citation omitted); In re Health Sci.Prod., Inc., 191 B.R. 895, 909 n.15 (Bankr. N.D. Ala. 1995)(citing Lubrizol Enters. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1047 (4th Cir. 1985) (Bankruptcy courts must approve a debtor's decision to assume or reject an executory contract "unless there is bad faith or a gross abuse of discretion." In other words, the court must decide "whether the decision of the debtor is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, whim, or caprice.").

[18] Robert W. Emerson, *Franchise Terminations: "Good Cause" Decoded*, 51 WAKE FOREST L. REV. 103, 105-06 (2016).

[19] Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608 (1st Cir. 1995); *In re* Mirant Corp., 440 F.3d 238 (5th Cir. 2006).

This approach prioritizes the plain meaning of the text over broader policy considerations or legislative intent. In the realm of bankruptcy, this shift is exemplified by the interpretation of Section 365(c)(1) of the U.S. Bankruptcy Code, which governs the assumption and assignment of executory contracts. Courts adopting a strict interpretation focus on the explicit language of the statute, often leading to the application of the hypothetical test. This test prohibits the assumption of a contract if applicable law would hypothetically bar its assignment, regardless of the debtor's actual intent or the practical implications for reorganization. Proponents argue that this method preserves the integrity of the statutory framework and respects the separation of powers by adhering closely to the language enacted by Congress.

However, critics contend that such rigidity can undermine the flexibility needed in bankruptcy proceedings to facilitate effective debtor reorganization and balance competing interests. The ongoing circuit split over Section 365(c)(1) underscores the tension between strict statutory interpretation and the dynamic policy objectives inherent in bankruptcy law. Proponents argue that this approach protects the rights of non-debtor parties by preventing any assumption that could lead to an unwanted assignment, thereby maintaining the integrity of the original contractual relationship.[20]

B. Actual Test

In contrast, the actual test allows a debtor to assume a contract unless there is a concrete intention to assign it to a third party. This interpretation, first articulated by the First Circuit, aligns more closely with the legislative intent to facilitate debtor reorganization by allowing the assumption of contracts critical to the debtor's operations, provided there is no intent to assign them to another party. This approach has been adopted by the First and Fifth Circuits, along with several lower courts.

C. Footstar Test

The Footstar test introduces a distinction between a debtor-in-possession and a trustee, permitting the former to assume contracts without consent. Originating from the U.S. Bankruptcy Court for the Southern District of New York, this test aims to reconcile the statutory language with the practical needs of Chapter 11 reorganizations, providing flexibility to debtors while maintaining protections for non-debtor parties.

The uncertainty stemming from this legal ambiguity poses significant risks for both franchisors and franchisees. Franchisors may face challenges in maintaining control over their brand and ensuring compliance with franchise standards, while franchisees may struggle to retain their business operations during reorganization. This uncertainty

[20] David G. Epstein et al., Bankruptcy § 5-15 (1st ed. 1992).

can lead to increased litigation and forum shopping as parties seek judicial clarification on the applicability of Section 365(c)(1) to franchise agreements.

From a financial perspective, the bankruptcy of a franchisee can have ripple effects throughout the franchise system. It can impact the franchisor's revenue streams, affect the financial health of other franchisees, and undermine consumer confidence in the brand. Therefore, resolving the circuit split and establishing a consistent legal framework for handling franchise agreements in bankruptcy is of paramount importance.

While franchises are invaluable to the U.S. economy, the legal and financial challenges that arise when a franchisee declares bankruptcy highlight the need for a coherent approach to interpreting Section 365(c)(1). By addressing these challenges, the bankruptcy system can better support the reorganization efforts of franchisees while protecting the rights and interests of franchisors, ultimately ensuring the continued vitality of the franchise model in the United States.

When a franchisee files for bankruptcy, the treatment of the franchise agreement becomes a critical issue. [21] Under Section 365 of the Bankruptcy Code, the debtor (in this case, the franchisee) has the right to assume or reject executory contracts, including franchise agreements. This provision is designed to give debtors the flexibility to retain beneficial contracts while shedding burdensome ones, thereby facilitating their reorganization efforts. However, this right is not absolute. The automatic stay, as provided under 11 U.S.C. § 362(a), plays another crucial role in bankruptcy proceedings by preventing creditors, including franchisors, from taking enforcement actions against a debtor or the property of the bankruptcy estate once a bankruptcy petition is filed. This includes prohibiting the termination of an active franchise agreement. For a franchisor to pursue remedies against a debtor/franchisee or its property, they must seek relief from the automatic stay "for cause" under 11 U.S.C. § 362(d).

The Automatic Stay

The interpretation of Section 365(c)(1) of the U.S. Bankruptcy Code, which deals with the assumption and assignment of executory contracts, can influence how the automatic stay is applied in the context of franchise agreements. While the automatic stay protects the franchisee's rights under the agreement, Section 365(c)(1) introduces exceptions that can affect the franchisee's ability to assume or assign the contract. This section restricts assumption or assignment if applicable non-bankruptcy law excuses a party from accepting performance from an entity other than the debtor without consent.

[21] Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007).

The application of Section 365(c)(1) can impact the strategic decisions of both franchisors and franchisees during bankruptcy. Franchisors seeking to terminate a franchise agreement or enforce other rights may need to demonstrate "cause" to lift the automatic stay, which can be complicated by the requirements of Section 365(c)(1). Franchisees, on the other hand, may leverage the automatic stay to maintain their business operations while negotiating with franchisors to assume or modify the franchise agreement as part of their reorganization plan.

IV. Implications for Debtor Reorganization

By allowing the assumption of valuable contracts without the need for assignment, the actual test supports the reorganization efforts of debtors. This approach aligns with the fundamental objectives of Chapter 11, which aim to provide debtors with the opportunity to restructure their obligations and continue operations.[22] Debtors may be encouraged to file for bankruptcy in jurisdictions that favor the actual test, as it provides greater flexibility in retaining essential contracts. This could lead to strategic forum shopping, where debtors choose filing locations based on favorable legal interpretations.[23]

V. Impact on Non-Debtor Parties

While the actual test supports debtor reorganization, it may raise concerns for non-debtor parties who wish to maintain control over contract assignments. This decision underscores the need for non-debtors to carefully negotiate contract terms and consider potential bankruptcy implications.

As parties navigate the differing interpretations of Section 365(c)(1), there may be an increase in litigation to resolve disputes over contract assumptions and assignments. This could lead to further judicial clarification and refinement of the legal standards governing executory contracts in bankruptcy.

Once again, in the real world, courts are applying Section 365(c)(1) conflictingly. The First Circuit has consistently applied the "actual test," as evidenced in cases such as *Summit Inv. & Dev. Corp. v. Leroux*[24] *and Institut Pasteur v. Cambridge Biotech Corp.*[25] Under this approach, the court considers the debtor's actual intent to assign the contract,

[22] *See* Jesse M. Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 Duke L.J. 517, 525 (1996).
[23] Daniel J. Bussel & Edward A. Friedler, *The Limits on Assuming and Assigning Executory Contracts*, 74 Am. Bankr. L.J. 321 (2000).
[24] *See* Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, (1st Cir. 1995).
[25] *See* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997).

allowing for more flexibility in reorganization efforts. In contrast, the Third, Fourth, and Ninth Circuits have adopted the more restrictive "hypothetical test." This interpretation, exemplified in cases like *Matter of West Electronics, Inc.*[26], *In re Sunterra Corp., and In re Catapult Entm't, Inc.*[27], prohibits assumption if applicable law would bar assignment, regardless of the debtor's actual intent.

Several circuits remain undecided or have shown a tendency to lean towards one test or the other. The Second Circuit, while officially undecided, has shown a preference for an alternative theory resembling the "actual test," as seen in *In re Footstar*[28]. The Fifth Circuit, in *In re Mirant Corp.*[29], adopted the "actual test" in interpreting a related provision (§ 365(e)(2)), suggesting a potential inclination towards this approach for § 365(c)(1) as well.

The Sixth, Seventh, Eighth, Tenth, and Eleventh Circuits, and the District of Columbia have not definitively ruled on the issue, creating further uncertainty in the application of § 365(c)(1) across different jurisdictions. Some of these circuits, such as the Eighth, have shown a tendency towards the "actual test" in lower court decisions, while others remain entirely undecided.

Section 365(c)(1) of the U.S. Bankruptcy Code significantly impacts the rights of franchisors during a bankruptcy filing by a franchisee. The impact on franchisors is twofold. Firstly, Section 365(c)(1) provides franchisors with a degree of control over who can assume their franchise agreements. If the applicable law, such as the Lanham Act, prohibits the assignment of trademarks without the owner's consent, franchisors can potentially prevent a debtor-franchisee from assuming the franchise agreement if the hypothetical test is applied. This test, adopted by several circuits, considers whether applicable law would hypothetically prohibit assignment, regardless of the debtor's actual intent. This approach aligns with the Lanham Act's goal of protecting trademark integrity, ensuring that franchisors maintain control over their brand and its use.

This provision restricts a debtor' ability to assume or assign executory contracts if applicable law excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor, without consent. The Lanham Act often serves as this applicable law, as it generally prohibits the assignment of trademarks without the owner's consent, reflecting the principle that trademarks are tied to the goodwill of the business.

For franchisors, the hypothetical test, adopted by circuits like the Third, Fourth, and Ninth, aligns with the Lanham Act by prohibiting the assumption of a franchise

---

[26] *See* In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988).
[27]) RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3ss 257 (4th Cir. 2004).
[28] *See* In re Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005).
[29] *See* In re Mirant Corp., 440 F.3d 238 (5th Cir. 2006).

agreement if applicable law would hypothetically bar assignment, regardless of the debtor's intent. This approach provides franchisors with greater control over their trademarks, ensuring they are not used by unauthorized parties during bankruptcy proceedings. Conversely, the actual test, favored by circuits such as the First and Fifth, allows a debtor to assume a contract unless there is a concrete intention to assign it to a third party. While this test supports debtor reorganization, it may lead to situations where terminated franchisees continue using the brand during bankruptcy, potentially diluting the brand's value or causing consumer confusion. The ongoing circuit split underscores the need for a resolution, either through Supreme Court intervention or legislative action, to ensure clarity and predictability in bankruptcy proceedings involving franchise agreements.

For franchisees, the actual test offers more flexibility in reorganization efforts, potentially allowing them to retain valuable franchise agreements that are crucial to their business operations. This can be particularly important for franchisees who have invested significant resources in building their business under the franchisor's brand and rely on the continuation of the franchise agreement for their economic survival. The ability to assume a franchise agreement is often crucial for a franchisee's business operations and reorganization efforts. However, as mentioned, the interpretation of Section 365(c)(1) varies across different jurisdictions due to a circuit split, leading to uncertainty for franchisees.

The complex interplay between the Lanham Act, the Bankruptcy Code, and franchise law underscores the need for careful consideration in bankruptcy proceedings involving franchise agreements. [30] The choice between the hypothetical and actual tests can significantly impact the rights and strategies of both franchisors and franchisees in bankruptcy scenarios. As the legal landscape continues to evolve, stakeholders in the franchise industry must remain vigilant and adaptable to navigate these complex issues effectively.

Hypothetical Case: Assignment of Franchise Affected by Section 365(c)(1)

Background:

Imagine a franchisee, "TechCafe LLC," operating a chain of technology-themed cafes under a franchise agreement with "InnovateFranchises Inc." TechCafe LLC has been struggling financially due to increased competition and declining sales. Consequently, the company files for Chapter 11 bankruptcy to reorganize its debts and business operations. As part of its reorganization plan, TechCafe LLC seeks to assume its existing franchise agreement with InnovateFranchises Inc. to continue operating under the established brand.

---

[30] Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000).

Legal Issue:

The central legal issue revolves around the application of Section 365(c)(1) of the U.S. Bankruptcy Code, which restricts a debtor's ability to assume or assign an executory contract if applicable law excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor, without the non-debtor's consent. In this scenario, the franchise agreement includes a clause that prohibits assignment without InnovateFranchises Inc.'s consent, aligning with the Lanham Act's provisions that protect trademark integrity.

Court's Analysis:

The bankruptcy court must decide whether TechCafe LLC can assume the franchise agreement under Section 365(c)(1). The court considers two primary tests: the hypothetical test and the actual test. Under the hypothetical test, applied by circuits like the Third and Ninth, the court would determine if applicable law (here, the Lanham Act) hypothetically prohibits assignment without consent. If it does, TechCafe LLC cannot assume the contract, regardless of its intent to assign. This approach would likely prevent TechCafe LLC from assuming the agreement due to the non-consensual assignment clause.

Conversely, under the actual test, favored by the First and Fifth Circuits, the court would assess TechCafe LLC's actual intent to assign the agreement. If TechCafe LLC has no intention of assigning the franchise agreement to a third party, the court may allow assumption, facilitating the company's reorganization efforts.

Outcome:

In this hypothetical case, if the court applies the actual test, it may permit TechCafe LLC to assume the franchise agreement, as long as there is no intent to assign it to another party. This decision would enable TechCafe LLC to continue its operations under the InnovateFranchises Inc. brand, supporting its reorganization plan. However, if the court applies the hypothetical test, TechCafe LLC might be barred from assuming the agreement, potentially jeopardizing its reorganization efforts and leading to further financial instability.

Implications:

This hypothetical case illustrates the significant impact of Section 365(c)(1) and the circuit split on franchise agreements in bankruptcy. The choice between the hypothetical and actual tests can dramatically affect a debtor's ability to retain essential contracts, highlighting the need for a consistent legal framework to provide clarity and predictability in bankruptcy proceedings.

Latest Court Example:

The decision by the United States Bankruptcy Court for the Southern District of Ohio in *In re Welcome Group 2 LLC* [31] has added to this ongoing debate by siding with the minority view and applying the actual test, which allowed a franchisee to assume a franchise agreement despite ongoing defaults. This case underscores the complexities surrounding executory contracts in bankruptcy and the potential implications for debtors, creditors, and the broader bankruptcy system.

In the case of *In re Welcome Group 2 LLC*, the United States Bankruptcy Court for the Southern District of Ohio was tasked with determining whether a franchisee could assume a franchise agreement despite ongoing defaults. The franchisee, Welcome Group 2 LLC, was involved in bankruptcy proceedings and sought to retain its franchise agreement as a critical asset for its reorganization efforts. The legal question centered on the interpretation of Section 365(c)(1) of the Bankruptcy Code, which restricts the assumption or assignment of executory contracts if applicable law excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor.

The court applied the "actual test," a minority view among U.S. circuits, which allows a debtor to assume a contract unless there is a concrete intention to assign it to a third party. Judge Mina Nami Khorrami reasoned that the franchise agreement was a valuable asset for the debtor's reorganization and that the franchisee had no intention of assigning the agreement to another party. The court highlighted that preventing the assumption of the contract under these circumstances would undermine the debtor's ability to reorganize, which is a fundamental objective of Chapter 11 bankruptcy proceedings. This decision aligns with the approach taken by the First and Fifth Circuits, which prioritize the debtor's actual intent over hypothetical scenarios that might restrict contract assumption.

The decision in *In re Welcome Group 2 LLC,* contributes to the ongoing circuit split regarding Section 365(c)(1), emphasizing the need for a resolution to provide clarity and predictability in bankruptcy proceedings. By siding with the actual test, the court underscored the importance of allowing debtors to retain essential contracts, facilitating their reorganization efforts. This decision aligns with the approach taken by the First and Fifth Circuits, which prioritize the debtor's actual intent over hypothetical scenarios. The court's ruling underscores the importance of allowing debtors to retain valuable contracts that are essential for their reorganization efforts, aligning with the fundamental objectives of Chapter 11 bankruptcy proceedings.

---

[31] In re Welcome Grp. 2 LLC, 660 B.R. 847 (Bankr. S.D. Ohio 2024).

As of today, the hypothetical test, adopted by circuits such as the Third, Fourth, and Ninth, prohibits the assumption that applicable law would hypothetically bar assignment, regardless of the debtor's intent. This approach often restricts debtors' ability to assume contracts, potentially hindering their reorganization efforts. In contrast, the actual test, favored by the First and Fifth Circuits, allows assumption unless there is a concrete intention to assign the contract to a third party, providing greater flexibility for debtors.

Comparative Analysis of US Jurisdictions

A comparative analysis of how different jurisdictions approach the interpretation of Section 365(c)(1) reveals significant variations in legal reasoning and outcomes. The majority of U.S. Circuit Courts, including the Third, Fourth, and Ninth Circuits, have adopted the "hypothetical test," which takes a more restrictive approach to contract assumption. In contrast, the First and Fifth Circuits have favored the "actual test," allowing for greater flexibility in debtor reorganization. The Footstar test is mentioned as an alternative approach to interpreting Section 365(c)(1) of the Bankruptcy Code. The Footstar test originated from the case *In re Footstar, Inc*. decided by the U.S. Bankruptcy Court for the Southern District of New York in 2005. This test distinguishes between a debtor-in-possession and a trustee, allowing a debtor-in-possession to assume executory contracts without the non-debtor's consent, but not allowing a trustee to do so. While the Footstar approach is discussed as an alternative to the "hypothetical test" and "actual test" for interpreting Section 365(c)(1), only the Bankruptcy Court for the Southern District of New York has recently adopted or applied this test in a ruling.

Global Franchising

Franchise operations include multi-national operations in our globalized economy. The judicial interpretation split extends beyond the United States, with international jurisdictions taking diverse approaches to similar issues in bankruptcy law. For instance, the United Kingdom's Insolvency Act 1986,[32] provides for the disclaimer of onerous property by the liquidator, which can include executory contracts, but does not directly parallel the U.S. approach to assumption and assignment. The European Union's Insolvency Regulation (2015/848)[33] aims to harmonize cross-border insolvency proceedings but leaves significant discretion to member states in handling executory contracts. These jurisdictional differences highlight the complex interplay between

[32] Insolvency Act 1986 is up to date with all changes known to be in force on or before 09 September 2024. Insolvency Act 1986, c. 45 (Eng.), https://www.legislation.gov.uk/ukpga/1986/45/contents.
[33] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings [2015] L141/19 para 49 (the Recast Insolvency Regulation applies to insolvency proceedings that begin on or after June 26, 2017. It replaced the Council Regulation (EC) 1346/2000 on insolvency proceedings).

protecting creditor rights and facilitating debtor reorganization in global bankruptcy practice.

The European Union's Insolvency Regulation (2015/848) and Section 365(c)(1) of the U.S. Bankruptcy Code both address the treatment of executory contracts in insolvency proceedings, but they do so in different legal and regulatory contexts. Understanding these differences is crucial for practitioners dealing with cross-border insolvencies.

European Union's Insolvency Regulation (2015/848)

The EU Insolvency Regulation aims to harmonize cross-border insolvency proceedings within the EU. It establishes a framework for determining jurisdiction, recognizing insolvency proceedings, and coordinating cross-border cases. One of its key features is the focus on the "center of main interests" (COMI)[34] to determine the appropriate jurisdiction for insolvency proceedings. The regulation emphasizes cooperation and communication between courts and insolvency practitioners across member states, facilitating a more integrated approach to insolvency within the EU.

Regarding executory contracts, the EU Insolvency Regulation does not provide specific rules akin to Section 365(c)(1) of the U.S. Bankruptcy Code. Instead, it leaves significant discretion to member states to apply their national laws to executory contracts within insolvency proceedings. This means that the treatment of such contracts can vary significantly across different EU jurisdictions, depending on local insolvency laws.

In contrast, Section 365(c)(1) of the U.S. Bankruptcy Code specifically addresses the assumption and assignment of executory contracts in bankruptcy. It restricts a debtor's ability to assume or assign an executory contract if applicable law excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor, without the non-debtor's consent.

[34] CMS Expert Guide to The Center of Main Interest in Insolvency Law, Cameron McKenna Nabarro Olswang LLP., https://cms.law/en/int/expert-guides/cms-expert-guide-to-finding-comi (last visited Sept. 2024); CMS report which provides an overview of the interpretation by courts in 12 jurisdictions of the 'centre of main interest' (COMI). The EC Insolvency Regulation (EIR) [Council Regulation (EC) No.1346/2000 on insolvency proceedings] stipulates which national law is applicable if insolvency proceedings are opened in a relevant EU jurisdiction. The drafting of Article 3 para 1 of the EIR is such that, under certain circumstances, it allows for the possibility of choosing the national insolvency law that will apply by changing the COMI of a subject debtor. This is also referred to as forum shopping. CMS Expert Guide to the Center Of Main Interest in insolvency law.

Comparative Analysis USA-EU

The EU's approach, which allows for more flexibility and discretion at the national level, contrasts with the more prescriptive U.S. approach under Section 365(c)(1). The U.S. provision's focus on the consent of the non-debtor party reflects a stronger emphasis on protecting the rights of contract counterparties, whereas the EU framework prioritizes harmonization and cooperation across jurisdictions. The differences between these two legal frameworks highlight the challenges faced in cross-border insolvency cases involving executory contracts. Practitioners must navigate varying legal standards and coordinate between jurisdictions to achieve effective outcomes in insolvency proceedings.

Cross-Jurisdictional Legal Challenges

Cross-jurisdictional legal challenges in bankruptcy proceedings and contract law present significant complexities for multinational corporations and legal practitioners. These challenges arise from differing regulatory environments, jurisdictional issues, and data privacy laws across countries. For instance, the swift growth of technology has led to a dramatic shrinking of the global economy, allowing corporations to expand across international borders but also creating hurdles in cross-border eDiscovery and legal compliance.[35]

Jurisdictional restrictions on the cross-border practice of law further complicate the legal landscape, as most jurisdictions continue to enforce regulations that limit the practice of law to individuals admitted locally. This is despite the growing need for legal professionals with expertise across multiple jurisdictions due to globalization and the expansion of multinational corporations. The legal profession faces significant challenges in adapting to these restrictions, which can impede the ability of lawyers to provide comprehensive legal services in cross-border transactions and disputes.

Additionally, data protection regulations vary widely from one country to another, adding another layer of complexity to cross-border legal matters. The collection, review, and production of electronically stored information (ESI) are particularly challenging during cross-border investigations. Different countries have distinct data protection laws, which can impose conflicting obligations on companies operating internationally. For instance, the European Union's General Data Protection Regulation

[35] Melissa B. Jacoby, Article: Bankruptcy Reform and the Financial Crisis, 13 N.C. BANKING INST. 115, 115-21 (2009).

(GDPR)[36] imposes stringent requirements on data handling and transfer, which may conflict with the discovery obligations in U.S. litigation.

These challenges are compounded by the fact that different jurisdictions may have conflicting laws, creating potential contradictions in legal obligations for companies operating across multiple countries. For example, a company may face a situation where compliance with data protection laws in one jurisdiction leads to a violation of discovery obligations in another. This legal conundrum requires careful navigation and strategic planning to ensure compliance with all applicable laws while minimizing legal risks.

The need for harmonization of legal standards and regulations across jurisdictions is becoming increasingly apparent. Legal professionals, policymakers, and international organizations must collaborate to address these challenges, creating frameworks that facilitate cross-border legal practice and ensure consistent application of data protection regulations. Such efforts would not only benefit legal practitioners but also enhance the ability of businesses to operate efficiently and legally in the global marketplace.

VI. Policy Considerations and Implications

The interpretation of Section 365(c)(1) has significant policy implications for both debtors and creditors involved in bankruptcy proceedings.[37] The ability to assume executory contracts is crucial for debtors seeking to reorganize under Chapter 11, as contracts that provide essential goods, services, or revenue streams can be vital to the debtor's business operations and overall reorganization strategy. A restrictive interpretation, such as the hypothetical test, may limit the debtor's flexibility in retaining these valuable contracts, potentially jeopardizing the success of the reorganization and reducing the likelihood of a fresh start. The choice of test can determine the debtor's ability to retain critical contracts, impacting the overall success of the reorganization. Debtors must navigate the complexities of the applicable test in their jurisdiction and develop strategies to maximize their chances of a favorable outcome and their ability to exercise their own judgment.

For creditors, the interpretation of Section 365(c)(1) directly impacts their potential recovery. While a debtor-friendly interpretation like the actual test may facilitate reorganization, it could also compel non-debtor parties to accept performance from a

---

[36] Commission Regulation, 2016/679 of Apr. 27, 2016, On the Protection of Natural Persons with Regard to the Processing of Personal Data and on the Free Movement of Such Data, and Repealing Directive 95/46/EC (General Data Protection Regulation), 2016 O.J. (L119) 1.
[37] Michelle Morgan Harner et al., *Debtors Beware The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. INST. L. REV.. 187, 253-59 (2005).

party they did not originally contract with, potentially affecting the quality or reliability of performance. Balancing these interests is crucial to ensuring that the bankruptcy process is fair and equitable for all parties involved. Understanding the applicable test is crucial for creditors and non-debtor parties to protect their interests.

They must be prepared to negotiate and potentially litigate issues related to contract assumption and assignment, depending on the jurisdiction's interpretation of Section 365(c)(1). Attorneys advising clients in bankruptcy must be well-versed in the circuit split and its implications. They need to craft legal strategies that account for the specific test applied in their jurisdiction and anticipate potential challenges related to contract assumption. The ongoing debate over Section 365(c)(1) also highlights broader policy considerations within bankruptcy law.[38]

One of the fundamental goals of bankruptcy law is to provide debtors with a fresh start by discharging debts and restructuring obligations. However, this goal must be balanced with the need to protect the rights and expectations of non-debtor parties. The interpretation of Section 365(c)(1) reflects this tension, as courts seek to balance these competing interests in a way that promotes fairness and economic efficiency.

The circuit split resulting from differing interpretations of Section 365(c)(1) undermines the uniformity and predictability of bankruptcy law. Debtors and creditors alike benefit from a consistent legal framework that provides clear guidance on the rights and obligations of parties involved in bankruptcy proceedings. Resolving the circuit split and establishing a uniform interpretation of Section 365(c)(1) would enhance the predictability of outcomes and promote confidence in the bankruptcy system.

The debate over Section 365(c)(1) also raises questions about the appropriate roles of the legislative and judicial branches in shaping bankruptcy policy. While courts have developed various tests to interpret the statute, legislative action may be necessary to provide clarity and resolve ambiguities. This interplay between legislative intent and judicial interpretation underscores the dynamic nature of bankruptcy law and the need for ongoing dialogue between lawmakers and the judiciary.

The interpretation of Section 365(c)(1) has far-reaching implications for debtors, creditors, and the broader bankruptcy system. Addressing the challenges posed by the current circuit split requires careful consideration of these policy issues to ensure that bankruptcy law continues to serve its intended purpose of facilitating reorganization and providing a fair and equitable process for all parties involved.[39]

---

[38] David R. Kuney, *Restructuring Dilemmas for the High Technology Licensee: Will "Plain Meaning" Bring Order to the Chaotic Bankruptcy Law for Assumption and Assignment of Technology Licenses*?, 44 Gonz. L. Rev. 123 (2008).
[39] Theresa J. Pulley Radwan, *Limitations on Assumption and Assignment of Executory Contracts by Applicable Law*, 31 N.M. L. Rev. 299, 314 (2001).

Scholarly Critiques and Proposals

Scholarly critiques and proposals for reform emphasize the need for clarity and consistency in the application of Section 365(c)(1).[40] Critics of the hypothetical test argue that it is overly restrictive and undermines the debtor's ability to reorganize effectively, potentially leading to less favorable outcomes for creditors and other stakeholders. The actual test, while more debtor-friendly, has faced criticism for potentially overreaching in favor of debtors, leading to situations where non-debtors are forced into unfavorable contractual relationships.[41]

Proposed amendments to Section 365(c)(1) include clarifying the statutory language to explicitly state that assumption is permissible without assignment unless there is a clear intent to assign. This would resolve the ambiguity that has led to the circuit split and align the statute more closely with its legislative intent. Additionally, some scholars advocate for legislative guidance or a congressional report to provide courts with a clearer understanding of the intended application of Section 365(c)(1).

Potential Legislative Responses to the Circuit Split

The persistent circuit split regarding the interpretation of Section 365(c)(1) of the Bankruptcy Code may prompt Congress to consider legislative action to resolve the issue. One potential approach would be to amend the statute to explicitly endorse either the hypothetical or actual test, providing clear guidance to courts nationwide. Alternatively, Congress could craft a compromise solution that incorporates elements of both tests, balancing the interests of debtors and non-debtor parties.

Such legislation could specify criteria for evaluating when the assumption of an executory contract should be permitted, potentially considering factors like the debtor's intent, the impact on reorganization efforts, and protections for non-debtor parties. Given the significance of this issue for bankruptcy proceedings, any legislative response would likely involve extensive consultation with legal experts, industry stakeholders, and bankruptcy practitioners to ensure a workable and equitable solution.

In response to the challenges posed by the current interpretations, scholars have also proposed various amendments to Section 365(c)(1) to clarify its language and intent.[42] One common proposal is to amend the statutory language to clarify the

[40] Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection"*, 59 U. COLO.. L. REV. 845, 849 (1988).
[41] Laura B. Bartell, *Revisiting Rejection: Secured Party Interests in Leases and Executory Contracts*, 103 DICK. L. REV. 497, 501-502 (1999).
[42] Michael J. Schaefer, Beyond the Garden of Eden: Section 365(c)(1) of the Bankruptcy Code, 11 Bankr. Dev. J. 271 (1995).

relationship between assumption and assignment. By explicitly stating that assumption is permissible without assignment, the amendment could resolve the ambiguity that has led to the circuit split and align the statute more closely with its legislative intent.

Another proposal suggests incorporating explicit criteria for evaluating the impact of assumption on non-debtor parties. This approach would require courts to consider factors such as the importance of the contract to the debtor's reorganization and the potential harm to non-debtor parties, thereby balancing the interests of both sides. Some scholars advocate for legislative guidance or a congressional report to provide courts with a clearer understanding of the intended application of Section 365(c)(1). This guidance could help harmonize judicial interpretations and ensure consistent application across different jurisdictions.

These proposals reflect a recognition of the need for reform to address the challenges posed by the current interpretations of Section 365(c)(1). By clarifying the statute's language and intent, these amendments aim to facilitate effective reorganization while protecting the rights of all parties involved in bankruptcy proceedings.

Judicial Review

The recent overturning of the Chevron doctrine, which previously mandated judicial deference to administrative agency interpretations of ambiguous statutes, presents both challenges and opportunities for the judicial review of the Bankruptcy Code.[43] This shift away from deference means that courts may now engage more directly in interpreting the Bankruptcy Code's provisions, including Section 365, which governs the assumption, assignment, and rejection of executory contracts.

One of the primary challenges arising from this change is the increased burden on courts to interpret complex statutory language without relying on agency expertise. The Bankruptcy Code, particularly Section 365, involves intricate legal and financial considerations that require nuanced understanding. Courts must now independently analyze these provisions, potentially leading to inconsistencies in interpretation and application across jurisdictions. This could exacerbate existing circuit splits, such as those concerning the interpretation of Section 365(c)(1), which deals with the assumption and assignment of executory contracts when applicable law excuses a party from accepting performance from an entity other than the debtor.

[43] The U.S. Supreme Court overturned the Chevron doctrine in the June 28, 2024 case Loper Bright Enterprises v. Raimondo, 45 f.4th 359, (2024). This decision ended a 40-year practice of deferring to federal agencies' interpretations of ambiguous laws. The ruling means that courts will now independently determine if an agency's actions are consistent with the law and intent of Congress. https://www.scotusblog.com/2024/06/supreme-court-strikes-down-chevron-curtailing-power-of-federal-agencies/ (Last accessed September, 2024).

However, the shift away from Chevron deference also presents opportunities for courts to clarify ambiguities in the Bankruptcy Code, providing more consistent and predictable outcomes for debtors and creditors. Without the constraint of deferring to agency interpretations, courts can develop a more coherent body of case law that reflects the legislative intent and policy objectives underlying the Bankruptcy Code. This could lead to a more uniform application of provisions like Section 365, reducing the uncertainty and strategic forum shopping that currently characterize bankruptcy proceedings.

Moreover, the absence of Chevron deference allows for a more dynamic interaction between the judiciary and the legislative branch. Courts can highlight areas of the Bankruptcy Code that require legislative clarification or amendment, prompting Congress to address ambiguities and inconsistencies. This collaborative process can lead to a more effective and responsive bankruptcy system that better serves the needs of all stakeholders involved.[44]

While the overturning of the Chevron doctrine poses challenges for the judicial review of the Bankruptcy Code, it also offers significant opportunities for courts to enhance the clarity and consistency of bankruptcy law. By engaging more directly in statutory interpretation, courts can contribute to a more predictable and equitable bankruptcy process, ultimately benefiting debtors, creditors, and the broader economy.

Recommendations

Suggestions for addressing this issue include a potential Supreme Court review to provide a definitive interpretation of Section 365(c)(1), which would establish a consistent standard across jurisdictions. Alternatively, Congress could amend the Bankruptcy Code to clarify the relationship between assumption and assignment, explicitly endorsing either the hypothetical or actual test or crafting a compromise solution that incorporates elements of both. Courts could also engage in dialogue and collaboration to develop a coherent approach to interpreting Section 365(c)(1), promoting consistency and understanding across jurisdictions. Legal practitioners should stay informed about the latest developments and advocate for reforms that balance the interests of debtors and non-debtor parties, contributing to the ongoing efforts to improve the bankruptcy system.

Section 365(c)(1) of the Bankruptcy Code plays a pivotal role in managing executory contracts during bankruptcy proceedings. This provision allows a debtor-in-possession or trustee to assume or reject executory contracts, which can be crucial for the debtor's reorganization efforts. However, the language of Section 365(c)(1) has led

[44] Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301 (1997).

to significant legal debate and a circuit split, as courts have struggled to interpret its implications for contract assumption and assignment. The provision states that a trustee may not assume or assign an executory contract if applicable non-bankruptcy law excuses the non-debtor party from accepting performance from or rendering performance to an entity other than the debtor or debtor-in-possession, without the non-debtor's consent. This language raises questions about whether a debtor can assume a contract if they do not intend to assign it, leading to the development of hypothetical and actual tests by various courts. The *In re Welcome Group 2 LLC* decision exemplifies the complexities of the current legal landscape and underscores the need for a unified approach to interpreting Section 365(c)(1). By addressing the circuit split and promoting reforms that enhance clarity and consistency, the bankruptcy system can better serve its intended purpose, providing a fair and equitable process for all stakeholders involved.

VII. Conclusion

Addressing the challenges posed by Section 365(c)(1) requires a multifaceted approach that combines further research, legislative action, and judicial collaboration. By clarifying the statutory language and providing guidance on balancing competing interests, the bankruptcy system can better support debtors in their reorganization efforts while protecting the rights of non-debtor parties. Through these efforts, the bankruptcy process can continue to fulfill its role as a vital tool for economic recovery and stability.

The case studies and practical implications of Section 365(c)(1) underscore the importance of a clear and consistent legal framework for managing executory contracts in bankruptcy. By examining real-world applications and their effects on stakeholders, this analysis highlights the need for ongoing dialogue and reform to ensure that the bankruptcy system effectively balances the interests of all parties involved.[45]

The discussion of Section 365(c)(1) reveals the intricate balance that bankruptcy law must strike between facilitating debtor reorganization and protecting the rights of non-debtor parties. The circuit split and ongoing debates underscore the need for clarity and consistency in the interpretation of this critical provision. By addressing these challenges through legislative and judicial reforms, the bankruptcy system can better serve its intended purpose, providing a fair and equitable process for all stakeholders involved.

The challenges posed by Section 365(c)(1) offer an opportunity for stakeholders to collaborate in shaping the future of bankruptcy law. By addressing the circuit split and

[45] David G. Epstein, Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law, 82 Cornell L. Rev. 301 (1997).

promoting reforms that enhance the clarity, consistency, and fairness of the bankruptcy process, the legal community can ensure that the system continues to provide a vital mechanism for economic recovery and stability. Through these efforts, the bankruptcy system can better serve the needs of all parties involved, fostering a more equitable and effective framework for managing financial distress.

The future direction of Section 365(c)(1) will significantly impact the bankruptcy landscape. By addressing the circuit split, enhancing protections for all parties, and promoting consistency and predictability, potential reforms can ensure that the bankruptcy system continues to serve its vital role in facilitating economic recovery and stability. Through a combination of judicial, legislative, and practical measures, the challenges posed by Section 365(c)(1) can be effectively addressed, benefiting debtors, creditors, and the broader economy.

VIII. Future Directions and Potential Reforms

A. Addressing the Circuit Split

The circuit split over the interpretation of Section 365(c)(1) presents a significant challenge to the uniform application of bankruptcy law. Resolving this split is crucial for providing clarity and predictability to all parties involved in bankruptcy proceedings. One potential avenue for resolving the circuit split is through a ruling by the Supreme Court. By providing a definitive interpretation of Section 365(c)(1), the Court could establish a uniform standard that would guide lower courts and ensure consistent application across jurisdictions.

Congress could amend Section 365(c)(1) to clarify its language and intent. By explicitly addressing the relationship between assumption and assignment, legislative reform could eliminate the ambiguity that has led to differing judicial interpretations. Reforms to Section 365(c)(1) should aim to balance the interests of debtors seeking to reorganize and creditors and non-debtor parties seeking to protect their contractual rights. Any reform should consider the importance of allowing debtors to assume valuable contracts essential to their reorganization efforts. Providing clear guidelines on when the assumption is permissible could enhance the debtor's ability to achieve a successful reorganization.

Reforms should also protect the rights of creditors and non-debtor parties by ensuring they are not forced into unfavorable contractual relationships. Establishing criteria for evaluating the impact of assumption on non-debtor parties could help balance these interests. Ensuring consistency and predictability in the application of Section 365(c)(1) is essential for maintaining confidence in the bankruptcy system. Providing judges with training and resources on the interpretation and application of Section

365(c)(1) could promote more consistent decision-making across jurisdictions. Judicial conferences and symposia could facilitate the exchange of ideas and best practices. Developing comprehensive guidance for legal practitioners on navigating the complexities of Section 365(c)(1) could help attorneys better advise their clients and develop effective legal strategies.

Summary of Key Points

The interpretation of Section 365(c)(1) of the Bankruptcy Code remains a contentious issue, with significant implications for debtors, creditors, and the broader bankruptcy system. The circuit split, characterized by differing applications of the hypothetical, actual, and Footstar tests, highlights the challenges of balancing statutory language with the practical needs of reorganization. Each test offers distinct advantages and drawbacks, reflecting the ongoing debate over the appropriate balance between debtor flexibility and non-debtor protections.

The Need for Resolution

The current lack of uniformity in the application of Section 365(c)(1) undermines the predictability and fairness of the bankruptcy process. To address these challenges, a resolution of the circuit split is essential. Whether through Supreme Court intervention, legislative action, or a combination of both, establishing a clear and consistent framework for interpreting Section 365(c)(1) is crucial for ensuring that the bankruptcy system effectively serves its intended purpose.

Call to Action for Stakeholders

-Legislators: Congress should consider amending Section 365(c)(1) to clarify its language and intent, addressing the ambiguities that have led to differing judicial interpretations. Legislative reform can provide the necessary guidance to ensure uniform application across jurisdictions.

- Judiciary: Courts should engage in dialogue and collaboration to develop a coherent approach to interpreting Section 365(c)(1). Judicial conferences and symposia can facilitate the exchange of ideas and best practices, promoting consistency and understanding.

- Legal Practitioners: Attorneys should stay informed about the latest developments in the interpretation of Section 365(c)(1) and advocate for reforms that balance the interests of debtors and non-debtor parties. By developing effective legal strategies and engaging in policy discussions, practitioners can contribute to the ongoing efforts to improve the bankruptcy system.

IX. Appendices

A. Key Cases and Their Outcomes

1. In re West Electronics, Inc. (3d Cir. 1988)
- Test Applied: Hypothetical Test
- Outcome: The court prohibited the debtor from assuming a government contract without consent, emphasizing the statutory language that bars assumption if applicable law prohibits assignment.
2. Institut Pasteur v. Cambridge Biotech Corp. (1st Cir. 1995)
- Test Applied: Actual Test
- Outcome: The court allowed the debtor to assume a license agreement, focusing on the debtor's lack of intent to assign the contract, thus prioritizing reorganization efforts.
3. In re Footstar, Inc. (Bankr. S.D.N.Y. 2005)
- Test Applied: Footstar Test
- Outcome: The court permitted the debtor-in-possession to assume contracts without the non-debtor's consent, distinguishing between the roles of a DIP and a trustee.

B. Legislative Text of Section 365(c)(1)

- Current Language: "The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
(B) such party does not consent to such assumption or assignment."

C. Proposed Amendments to Section 365(c)(1)

- Clarification of Assumption and Assignment: Amend the language to explicitly state that assumption is permissible without assignment unless there is a clear intent to assign, thereby aligning with the actual test's principles.

- Criteria for Balancing Interests: Introduce criteria for courts to evaluate the impact of assumption on non-debtor parties, considering factors such as the importance of the contract to the debtor's reorganization and the potential harm to non-debtor parties.

Summary

The ongoing debate over the interpretation of Section 365(c)(1) of the Bankruptcy Code underscores the complexities and challenges inherent in balancing the rights and interests of debtors and non-debtor parties in bankruptcy proceedings. The circuit split, characterized by the adoption of the hypothetical test by some circuits and the actual test by others, highlights the divergent judicial approaches to this critical provision.

Ultimately, the resolution of the circuit split and the establishment of a coherent framework for interpreting Section 365(c)(1) will require careful consideration of the competing policy objectives of bankruptcy law. By balancing the goals of providing a fresh start for debtors and protecting the rights of non-debtor parties, the bankruptcy system can continue to serve as a vital mechanism for economic recovery and stability.

X. Acknowledgments

In the creation of this law review article, numerous individuals and institutions have contributed their insights, expertise, and support. Their contributions have been invaluable in shaping the research and analysis presented herein.

A. Academic Mentors and Advisors

Dean Emeritus Eugene Milhizer for encouraging the research and writing of legal subjects whenever possible. Your expertise and mentorship have been instrumental in refining the arguments and ensuring a comprehensive analysis of Section 365(c)(1).

B. Research Assistants

- Mr. Jason Jaen for your diligent research assistance in compiling case studies and analyzing judicial opinions across different circuits. Your attention to detail and commitment to thorough research have been essential to the depth of this article.

D. Institutional Support

Dean Czarnetzky, thank you for your continued support and inspiring us to make a difference.

Ave Maria School of Law For providing access to legal databases, research facilities, and a supportive academic environment that has fostered the development of this article.

Veterans Memorial Law Library: For your assistance in sourcing historical legislative documents and relevant case law, which have been crucial to the research process.

Family and Friends: Cathy, Alyssa, Jason & Alysson, and my colleagues at AMSL, thank you for your unwavering support and encouragement throughout the writing process. Your patience and understanding have been invaluable.

This article is a culmination of the collaborative efforts of many individuals, and I am deeply grateful for their contributions. While any errors or omissions remain my own, the insights and support provided by these individuals have greatly enhanced the quality and depth of this work.

Thank you all for your invaluable assistance. Ulysses N. Jaen

Table of Authorities

Cases

- In re Welcome Group 2 LLC, 23-53043 (Bankr. S.D. Ohio July 10, 2024).
- Matter of West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988).
- Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997).
- In re Footstar, Inc. 323 B.R. 566 (Bankr. S.D.N.Y. 2005).
- In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004).
- In re Catapult Entertainment, Inc., 165 F.3d 747 (9th Cir. 1999).
- Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608 (1st Cir. 1995).
- In re GlycoGenesys, Inc., 352 B.R. 568 (Bankr. D. Mass. 2006).
- In re Allentown Ambassadors, Inc., 2007 WL 316674 (Bankr. E.D. Pa. Feb. 5, 2007).
- In re Mirant Corp., 440 F.3d 238 (5th Cir. 2006).
- In re Quantegy, Inc., 326 B.R. 467 (Bankr. M.D. Ala. 2005).
- In re James Cable Partners, L.P., 27 F.3d 534 (11th Cir. 1994).
- In re Pioneer Ford Sales, Inc., 729 F.2d 27 (1st Cir. 1984).
- In re Sunrise Restaurants, Inc., 135 B.R. 149 (Bankr. M.D. Fla. 1991).
- In re Patient Educ. Media, Inc., 210 B.R. 237 (Bankr. S.D.N.Y. 1997).
- In re Golden Books Family Entm't, Inc., 269 B.R. 300 (Bankr. D. Del. 2001).
- Gardner v. Nike, Inc., 279 F.3d 774 (9th Cir. 2002).
- In re O'Connor, 258 F.3d 392 (5th Cir. 2001).

Statutes and Legislative Materials

- Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.
- 11 U.S.C. § 365(c)(1).
- 15 U.S.C. §§ 1051-1141n (Lanham Act).
- 35 U.S.C. § 101 (Patent Act).
- 22 U.S.C. § 1127 (Lanham Act - Trademark Definition).

Scholarly Articles and Books

- Robert L. Eisenbach III, The Section 365(c)(1)(A) Debate: "Actual" or "Hypothetical"? A Circuit-By-Circuit Look, Cooley Godward Kronish LLP (2007).

- Kenneth N. Klee, Legislative History of the New Bankruptcy Law, available at https://via.library.depaul.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=2491&context=law-review.

- Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439 (1973).

Blog Posts and Legal Updates

- Maria Carr, "Ohio court adds to circuit split when considering the assumption of a franchise agreement," McDonald Hopkins, August 14, 2024.

- Likelihood of Confusion Tests by Circuit, The Billing Life, available at https://www.thebillinglife.com/blog/likelihoodofconfusiontestsbycircuit (last accessed August 2024).

Online Resources

- American Bankruptcy Institute, resources on Section 365(c)(1) and bankruptcy law. https://law.abi.org/title11/365.

- U.S. Courts website for information on bankruptcy proceedings and legal interpretations. https://www.uscourts.gov/services-forms/bankruptcy.

Glossary of Legal Terms

- Assumption: The act of a debtor or trustee electing to continue an executory contract or unexpired lease in bankruptcy.
- Assignment: The transfer of rights and obligations under a contract from the debtor to a third party.
- Debtor-in-Possession (DIP): A debtor who retains possession and control of assets while undergoing reorganization under Chapter 11, without the appointment of a case trustee.
- Executory Contract: A contract under which both parties have ongoing obligations that have yet to be fulfilled.

LET THE GAMES BEGIN: GLOBAL ANTI-BASE EROSION (PILLAR 2)

Maria S. Domingo[*]

Abstract

In more recent years, multinational entities have used international tax planning strategies to minimize their worldwide income tax by mastering the various tax regimes of nations, and more specifically, how certain aspects of nations' tax systems can be combined to form effective strategies resulting in significant tax savings. The overarching effect of these strategies is to erode the corporate tax base of many countries. In an effort to prevent MNEs from shifting their profits to low-tax or no-tax jurisdictions, over 145 member countries of the OECD/G20 Inclusive Framework agreed to a two-pillar solution that addresses the tax challenges of the digital economy. As part of the OECD's response to these challenges, Pillar 2 imposes a global 15% minimum level of tax. With billions of dollars at stake, Pillar 2 may provide a much needed revenue source and is expected to generate substantial worldwide tax revenues per year. Moreover, Pillar 2's Global Anti-Base Erosion rules ("GloBE") are intended to deter profit shifting and harmful tax competition between the tax jurisdictions. Governments have already either adopted final legislation or introduced draft legislation of Pillar 2 into their domestic laws. However, both taxpayers and tax jurisdictions face considerable challenges in implementing, sustaining and enforcing the global minimum tax. Specifically, the question remains whether the U.S. government can reach an agreement within its own borders to achieve the delicate balance of simplifying its cross-border tax rules, encouraging U.S. investment and innovation (without relinquishing control of its U.S. tax base) while remaining in compliance with GloBE.

This Article explains the different tax planning strategies used by multinational entities to reduce their tax base (which sparked the movement toward a global minimum tax). This Article analyzes the key provisions of GloBE and corresponding global tax policy considerations and discusses the impact of GloBE on U.S. tax policy including the U.S.'s existing minimum tax regimes and proposals for reform. While the ideals behind GloBE to prevent base erosion profit shifting and the multilateral agreement between more than 145 countries are monumental, without a streamlined process under domestic law and continued support from participating nations, the GloBE rules may prove difficult to sustain in the long run.

[*] Associate Professor, The College of New Jersey, School of Business.

I. Introduction

The Olympic Games are a momentous global event that promotes international cooperation and cultural exchange, encourages competition, and, with success at the games, harbors the potential to reap substantial economic benefits. At the helm of the games is the International Olympic Committee, which serves as the governing body that oversees the planning, decision-making and overall logistics of the games facilitating healthy competition among all participants. The Olympics have brought nations, sovereign states and territories together from around the globe in support of their athletes as they participate in a variety of competitions. Whether in ancient or modern times, the participants set aside their differences in a spirit of multilateral cooperation as they compete for the coveted medals that honor their countries, and along with the notoriety, the potential for the athletes and their respective countries to prosper — as is oftentimes said in competitions, "To the victor belong the spoils."[1]

Undoubtedly inspired by the spirit of the Games, the Organization of Economic Cooperation and Development[2] ("OECD") has orchestrated an unprecedented agreement of multilateral cooperation between more than 145 countries to implement a two-pillar solution in its battle against base erosion and profit shifting. Generally speaking, Pillar 2 imposes a global minimum tax of 15% on in-scope multinational entities ("MNEs").[3] While the Olympics fosters competition, a key purpose of Pillar 2 and the multilateral cooperation among tax jurisdictions is to remove what governments view as harmful tax competition in the proverbial "race to the bottom" of corporate tax rates and to dismantle the waves of base erosion tax planning strategies costing billions in tax revenue.[4] In more recent years, MNEs have used international tax planning strategies to minimize their worldwide income tax by mastering the various tax regimes of nations, and more specifically, how certain aspects (such as territorial taxation, entity classification, debt versus equity, tax havens) of nations' tax systems can be combined to form effective strategies resulting in significant tax "spoils" or savings (i.e., earnings stripping, profit shifting to low or no tax jurisdictions, tax deferral).[5] Although these

---

[1] Dictionary.com, *To the Victor Belong the Spoils*, https://www.dictionary.com/browse/to-the-victor-belong-the-spoils (last visited Sept. 2, 2024); Wikipedia, *SpoilsSystem,*https://en.wikipedia.org/wiki/Olympic_Games (last visited Sept. 2, 2024).

[2] The OECD provides a setting where governments can work to coordinate domestic and international policies including the economic social and environmental challenges of globalization. For example, the OECD has worked to develop normative tax principles that resolve conflicts over multi-jurisdictional claims to tax cross-border income. *See* JOINT COMM. ON TAX'N, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project*, JCX-139-15 (Nov. 30, 2015).

[3] *See infra* Part III. Pillar Two – GloBE.

[4] *See infra* Part IV. Tax Policy Considerations, B. Tax Competition.

[5] OECD, *Addressing Base Erosion and Profit Shifting,* OECD Publishing 43 (Feb. 12, 2013), https://doi.org/10.1787/9789264192744-en. [hereinafter *Addressing BEPS*]; *see infra* Part II. Tax Planning Strategies.

strategies legally comply with the tax rules of each nation, MNEs have melded various aspects of different tax regimes to form favorable results that circumvent the very domestic policies in place (much to the chagrin of local governments).[6] The overarching effect of these strategies is to erode the corporate tax base of many countries[7] and in some instances create "stateless income" where profits can literally be taxed nowhere.[8] With billions of dollars at stake and governments struggling to recover from COVID-19, Pillar 2 may provide a much needed revenue source and is expected to generate approximately $220 billion in worldwide tax revenues per year.[9] Governments have already either adopted final legislation or introduced draft legislation of Pillar 2 into their domestic laws in accordance with their guidelines effective in 2024 (at the earliest).[10] However, both taxpayers and tax jurisdictions face considerable challenges (including administrative complexity, compliance costs, and internal and external pressures) in implementing and enforcing the global minimum tax. Is this unprecedented multilateral cooperation sustainable, then, or will the "games begin"?

The remainder of this article proceeds as follows: Part II provides an overview of tax planning strategies used by MNEs to reduce their tax base (which sparked the movement toward a global minimum tax). Parts III and IV navigates through the key provisions and the tax policy considerations of Pillar 2's Global anti-Base Erosion ("GloBE") rules. Part V discusses the U.S. tax implications including the U.S.'s existing minimum tax regimes and proposals for reform. Lastly, Part VI concludes.

II. Tax Planning Strategies

The OECD has made its mission to ensure that in-scope MNEs pay their share of taxes in the jurisdictions in which they operate and earn profits irrespective of physical presence.[11] The OECD's two-pillar solution deters MNEs from taking advantage of tax gaps in existing international tax law through a multilateral approach that creates a new nexus and global minimum tax floor.[12] The tax gaps or mismatches result from the lack

---

[6] *Id.* at 44.
[7] *Id.*
[8] *See* Edward D. Kleinbard, *Stateless Income,* 11 FLA. TAX REV. 699 (2011).
[9] Press Release, OECD, *Revenue Impact of International Tax Reform Better Than Expected* (Jan. 18, 2023), *but see infra* Part V. U.S Tax Implications, Section D. Joint Committee on Taxation Revenue Estimates.
[10] Daniel Bunn & Sean Bray, *The Latest on the Global Tax Agreement*, TAX FOUND. (July 1, 2024), https://taxfoundation.org/blog/global-tax-agreement/.
[11] *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy,* OECD (Oct. 8, 2021), https://www.oecd.org/content/dam/oecd/en/topics/policy-issues/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf [hereinafter *OECD Statement*].
[12] *Id.*

of coherence between the jurisdictions' domestic tax laws that impact cross-border transactions (e.g., one country may treat an entity as a C corporation while another country deems the same entity as a flow-through entity; one country may classify a financial instrument as debt whereas another country classifies it as equity). Furthermore, some large MNEs have reported lower effective tax rates than GloBE's 15% minimum tax rate[13] while others reported higher than 15% but lower than the current U.S. corporate tax rate of 21%[14] even though most tax jurisdictions' stated corporate tax rate is higher.[15] Through tax strategies, MNEs have directed more profitable functions to low-tax jurisdictions and less profitable functions to high-tax jurisdictions to achieve a lower global effective tax rate.[16] Before analyzing GloBE's tax policy, it is essential to understand certain tax planning strategies that MNEs used to minimize their tax liability, ultimately pushing over 145 countries toward multilateral cooperation and action (at least initially).

The following discussion highlights the key elements of tax strategies MNEs employed to shift profits from high-tax jurisdictions to low-tax or no-tax jurisdictions (thereby maximizing their after-tax earnings and cash flow).[17] MNEs have minimized taxable income in their market countries by avoiding a "permanent establishment" (as currently defined); shifting profits through cross-border transactions; maximizing deductions at the payer level; failing to collect withholding tax at its source; using low-tax, no-tax or preferential tax regimes and/or hybrid mismatch arrangements;[18] and

---

[13] *See* Alphabet, Inc., Annual Report (Form 10-K), at 40 (Dec. 31, 2023) (reported an effective tax rate of 13.9%), https://abc.xyz/assets/43/44/675b83d7455885c4615d848d52a4/goog-10-k-2023.pdf; Apple Inc., Annual Report (Form 10-K), at 24 (Sept. 30, 2023) (reported an effective tax rate of 14.7%), https://d18rn0p25nwr6d.cloudfront.net/CIK-0000320193/faab4555-c69b-438a-aaf7-e09305f87ca3.pdf; HP Inc., Annual Report (Form 10-K), at 40 (Oct. 31, 2023) (reported an effective tax rate of (11.1%), https://d18rn0p25nwr6d.cloudfront.net/CIK-0000047217/b524a587-e7c5-41ec-bd5d-904a7b2aa44a.pdf; Intel Corporation, Annual Report (Form 10-K), at 42 (Dec. 30, 2023) (reported an effective tax rate of (119.8)%), https://www.intc.com/filings-reports/all-sec-filings/content/0000050863-24-000010/0000050863-24-000010.pdf.

[14] *See* Microsoft Corporation, Annual Report (Form 10-K), at 83 (June 30, 2023) (reported an effective tax rate of 19%), https://microsoft.gcs-web.com/static-files/e2931fdb-9823-4130-b2a8-f6b8db0b15a9; Meta Platforms, Inc., Annual Report (Form 10-K), at 78 (Dec. 31, 2023) (reported an effective tax rate of 18%), https://d18rn0p25nwr6d.cloudfront.net/CIK-0001326801/c7318154-f6ae-4866-89fa-f0c589f2ee3d.pdf.

[15] *See* PwC Corporate Tax Rates Table, https://taxsummaries.pwc.com/quick-charts/corporate-income-tax-cit-rates (last visited July 29, 2024) [hereinafter *PwC Corporate Tax Rates Table*].

[16] Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing*, JCX-37-10, 78 (July 20, 2010) [hereinafter *JCX-37-10*].

[17] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report* (Oct. 5, 2015), at 78, https://www.oecd.org/en/publications/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en.html [hereinafter *Action 1 - 2015 Final Report*].

[18] *See* OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report* (Oct. 5, 2015), http://www.oecd.org/ctp/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-

employing tax deferral provisions when they could not achieve full tax avoidance.[19] Specifically, MNEs have used A) transfer pricing, (B) debt leverage and (C) check-the-box tax planning strategies to minimize their effective tax rates. The simplified examples of these strategies that follow illustrate their overall tax effect and how these methods use the digital economy to the MNEs' advantage.

A. *Transfer Pricing*

Transfer pricing is defined as the pricing of goods, services and assets sold between related parties (i.e., owned or controlled by the same parent company such as subsidiaries, affiliates and divisions)[20] taking into account each party's assets used and risks assumed for the transactions.[21] Within an MNE group, there exists no external market constraints regarding pricing. If unfettered, related parties could charge tax-favorable pricing for the transfer of goods and services within the group's supply chain.[22] Thus, the United States (and most U.S. trading partners) require companies to neutrally price intercompany transactions involving the exchange of goods, services and assets in accordance with the "arms-length" principle — that is, the selling company should charge the related buyer the same price that it would otherwise charge an unrelated third party (i.e., market price) in the same or comparable circumstances.[23] Furthermore, if the taxpayer transfers an intangible asset between related parties, then the transfer price must be "commensurate with the income attributable to the intangible."[24] MNE groups, however, have managed to minimize their overall tax burden (worldwide effective tax rate) by using tax strategies to recognize profits in low-tax or no-tax jurisdictions.

MNEs have used transfer pricing structures via contractual arrangements within their affiliated groups to erode their tax base and shift profits among group members from high, low or no-tax jurisdictions[25] with little to no bona fide transfer of economic

2015-final-report-9789264241138-en.htm; Maria S. Domingo, *Hybrid Mismatch. com; Neutralizing the Tax Effects of Hybrid Mismatch Arrangements*, 38 NE. J. LEGAL STUD. 1 (2019).

[19] *Action 1 - 2015 Final Report, supra* note 17, at 78.

[20] Jane G. Gravelle & Mark P. Keightley, CONGRESSIONAL RESEARCH SERV., CRS Report R47174, *The Pillar 2 Global Minimum Tax: Implications for U.S. Tax Policy,* 3 (Sept. 22, 2023).

[21] *Addressing BEPS*, *supra* note 5, at 36.

[22] *JCX-37-10*, *supra* note 16, at 18.

[23] I.R.C. § 482; TREAS. REG. § 1.482-1(b)(1). The purpose of I.R.C. § 482 is to prevent base erosion and profit shifting of taxable income within the U.S.'s purview to a foreign entity via aggressive transfer pricing strategies. I.R.C. § 482 authorizes the Treasury Department to "allocate income, deductions, credits or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance…" *JCX-37-10*, *supra* note 16, at 18; Gravelle & Keightley, note 20, at 3.

[24] *JCX-37-10*, *supra* note 16, at 18.

[25] Gravelle & Keightley, *supra* note 20, at 3.

risk to the group as a whole.[26] Because the subsidiary (in a low-tax or no-tax jurisdiction) has legal ownership of the transferred intangible assets, the MNE group may allocate significant portions of income to the subsidiary, which in turn undervalues the intangibles.[27] Meanwhile the parent company in a high-tax jurisdiction avoids recognizing income from the profit-making activities that it would otherwise be liable for had it claimed ownership of the intangibles.[28] Simply put, MNEs charged transfer prices on intercompany transactions that were higher or lower than market price (depending on the tax jurisdiction) to achieve significant tax savings. The tax benefit is further enhanced when the MNE group can claim expenses incurred to develop the intangible asset as deductions in a high-tax country with the corresponding income recognized in a low-tax jurisdiction.[29] The following examples illustrate the transfer pricing strategies of MNEs.

Example 1[30] *Sale of Intangible Asset*

Company A, which is incorporated in the U.S., develops intellectual property/intangible assets (e.g., copyrights, patents, trademarks, trade names, algorithms, design plans, pharmaceutical/drug formulas, software) and subsequently transfers or licenses to a foreign subsidiary, Company B, the rights to use the intangible assets in a certain geographic location for a price below fair market value. Company B is a resident of a tax haven[31] country (i.e., low-tax or no-tax jurisdiction). Because of the low transfer price, Company A's taxable income is minimized, and Company B's cost of goods sold is lower, which results in higher Company B profits. In other words, if Company A charges Company B a low price for the intangible asset, then Company A's taxable income subject to the U.S. tax rate of 21% is reduced while Company B will report higher earnings (from the reduced cost to acquire the intellectual property and royalty/licensing income derived therefrom) at low-tax or no-tax rates. Thus, Company

---

[26] *JCX-37-10*, *supra* note 16, at 110.

[27] *Action 1 - 2015 Final Report, supra* note 17, at 80.

[28] *Id.*

[29] Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Security and Governmental Affairs, 113th Cong. 18 (2013) (testimony of Stephen E. Shay), https://www.govinfo.gov/content/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf [hereinafter *Shay Testimony*].

[30] Gravelle & Keightley, note 20*,* at 3; Offshore Profit Shifting and the U.S. Tax Code—Part 1 (Microsoft and Hewlett-Packard): Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Security and Governmental Affairs, 112th Cong. 2 (2012) (opening statement of Senator Carl Levin) https://www.govinfo.gov/content/pkg/CHRG-112shrg76071/pdf/CHRG-112shrg76071.pdf [*hereinafter Levin Statement—Part 1*].

[31] *See* OECD, *Towards Global Tax Co-operation, Progress in Identifying and Eliminating Harmful Tax Practices* (Apr. 2, 2001), https://www.oecd-ilibrary.org/taxation/towards-global-tax-co-operation_9789264184541-en; U.S. GOV'T ACCOUNTABILITY OFF., GAO-09-157, INTERNATIONAL TAXATION: LARGE U.S. CORPORATIONS AND FEDERAL CONTRACTORS WITH SUBSIDIARIES IN JURISDICTIONS LISTED AS TAX HAVENS OR FINANCIAL PRIVACY JURISDICTIONS (2008), https://www.gao.gov/products/gao-09-157.

A has eroded its tax base, shifted profits from a high tax jurisdiction to a low-tax or no-tax jurisdiction and minimized its overall tax liability.

Furthermore, Company C, located in the Netherlands pays Company B (in a tax haven country such as Bermuda) royalties to use the intangible property rights that Company B now owns. The royalty payment shifts profits from the higher-tax jurisdiction (Netherlands) to a low-tax jurisdiction (Bermuda).[32]

Example 2[33] *License of the Intangible Asset*

Company A develops intangible property in the United States and licenses the intangible to Company B, a foreign subsidiary that manufactures products in a tax haven. If Company A charges Company B a royalty rate below market price, then Company A recognizes less royalty income at the 21% U.S. tax rate and Company B more of the profits in its low-tax or no-tax jurisdiction.

As illustrated in Example 3 below, cost sharing agreements, in which affiliated group members contribute to the intellectual property's development costs, may further complicate transfer pricing issues.

Example 3[34] *Cost Sharing Agreement*

Company A, a U.S. company, and Company B, a foreign subsidiary organized in a low-tax jurisdiction, enter into a cost sharing agreement to jointly develop a new marketable product. Company A makes available the rights to use and further advance an existing intangible asset while Company B provides cash. Company A has legal title to the developed property and marketing and productions rights in the U.S. and Company B owns the rights to market and produce the product outside of the U.S., i.e., a "split economic ownership." When the companies ultimately sell the product to consumers, neither pays royalties to the other participant in the cost sharing agreement. In essence, the arrangement enables Company A to avoid U.S. taxation by shifting all sales revenue generated outside of the U.S. and concentrating a significant portion of the MNE's profits to an offshore tax haven, Company B.[35]

---

[32] *JCX-37-10*, *supra* note 16, at 108.
[33] *Id.* at 115.
[34] *Id.* at 21.
[35] Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Security and Governmental Affairs, 113th Cong. 5 (2013) (opening statement of Senator Carl Levin), https://www.govinfo.gov/content/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf [hereinafter *Levin Statement—Part 2*]. Company A, however, does receive a buy-in payment (as defined in TREAS. REG. § 1.482-7(b)(1)(ii)) from Company B for its "platform contribution" (i.e., the rights to use its existing intangible asset to develop the newly marketable product). TREAS. REG. § 1.482-7(c)(1)(2024).

As digital technology has evolved to dominate all aspects of the economy, "core intangibles" (i.e., intangible assets at the core of the taxpayer's business) more often than not appear as valuable assets on a company's balance sheet. Unsurprisingly, the transfer price of such assets between related parties and the associated taxes is a hot-button issue. Taxpayers and the IRS can determine the arms-length transfer price of common cross-border transactions involving the sale of "normal" goods or services between related parties with relative ease by comparing the pricing of similar unrelated transactions. It is more difficult, however, for both the taxpayer and IRS to value and apply the arm's-length principle when the taxpayer transfers rights to unique intangible assets to a related party and by extension, royalties, license fees and other payments derived from these core intangible assets.[36] MNEs that own unique intangible assets seldom (if ever) transfer the asset to unrelated third parties.[37] Therefore, the taxpayer could have the tactical advantage in a transfer pricing dispute because the IRS may be hard pressed to argue the terms of an arms-length transfer price where no comparable transaction exists.[38] Moreover, cross-border license agreements often involve collateral agreements (e.g., ancillary services such as administrative, back-office and/or research and development services) that could affect the transfer price.[39] In essence, MNEs have transferred valuable intellectual property rights and intangible assets developed in the U.S. to offshore low-tax or no-tax jurisdictions along with the profits attributable to these rights.[40] The profits, therefore, are recognized by the foreign subsidiary in an offshore tax haven rather than in the U.S. where income is subject to a 21% corporate tax rate.[41]

B. *Check-the-box*

The check-the-box regulations ("CTB") allow U.S. MNEs to declare the tax classification of their entities merely by checking a box on Form 8832 — e.g., an entity can be classified as a flow-through entity or disregarded entity rather than a C corporation or vice versa.[42] The U.S. government originally intended to simplify entity

---

[36] *JCX-37-10*, *supra* note 16, at 19, 110.

[37] *Id.*

[38] *Id.*; TREAS. REG. § 1.482-1(d)(1) (requiring analysis of comparability factors that could affect transfer pricing including "(1) functions; (2) contractual terms; (3) risks; (4) economic conditions; and (5) the property or services transferred." Absent comparable transactions, the IRS has resorted to income-based valuation methods that can involve an inherently challenging discounted cash flow analysis).; *Offshore Profit Shifting and the U.S. Tax Code—Part 1 (Microsoft and Hewlett-Packard)*: *Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Security and Governmental Affairs*, 112th Cong. 61 (2012) (testimony of Hon. William J. Wilkins). https://www.govinfo.gov/content/pkg/CHRG-112shrg76071/pdf/CHRG-112shrg76071.pdf.

[39] *JCX-37-10*, *supra* note 16, at 110.

[40] *Levin Statement—Part 1, supra* note 30.

[41] *Id.*

[42] TREAS. REG. §§ 301.7701- 1 to 3.

classification with the CTB provisions. While achieving this objective, the government also created unintended tax consequences and unwittingly provided MNEs with a powerful and effective tax planning tool by using the CTB regulations to declare foreign subsidiaries as disregarded entities (e.g., flow-through entities, branches) — that is, complex organizational structures including foreign subsidiaries were viewed as one corporation for U.S. tax purposes eliminating intercompany transactions.[43] In conjunction with CTB, MNEs maximized the interplay and mismatches between tax laws in different jurisdictions to minimize their worldwide effective tax rates. For example, MNEs have used disregarded entities via the CTB regulations to avoid tax on royalty payments made by the principal entity to the related party owner of an intangible asset.[44] MNEs have also used CTB to generate tax savings via hybrid entities, i.e., an entity that is treated as a separate legal entity in one country (e.g., C corporation) but disregarded or transparent in another country (e.g., a branch).[45] The following examples illustrate tax planning strategies using CTB.

Example 1[46]

Company A, located in Country A, loans funds to Company B, a subsidiary located in Country B. Company B pays interest expense to Company A. The MNE group uses CTB to treat Company B as a transparent entity in Country A. In other words, Country A treats Company B as a disregarded entity (e.g., branch) while Country B treats it as a non-transparent entity (e.g., a C corporation). The group can then deduct the interest payment in Country B and avoid recognizing interest income in Country A. Because the entity is disregarded in Country A, the transaction is effectively eliminated in Country A and the MNE group as a whole has achieved tax savings by deducting the expense without any corresponding income recognition.

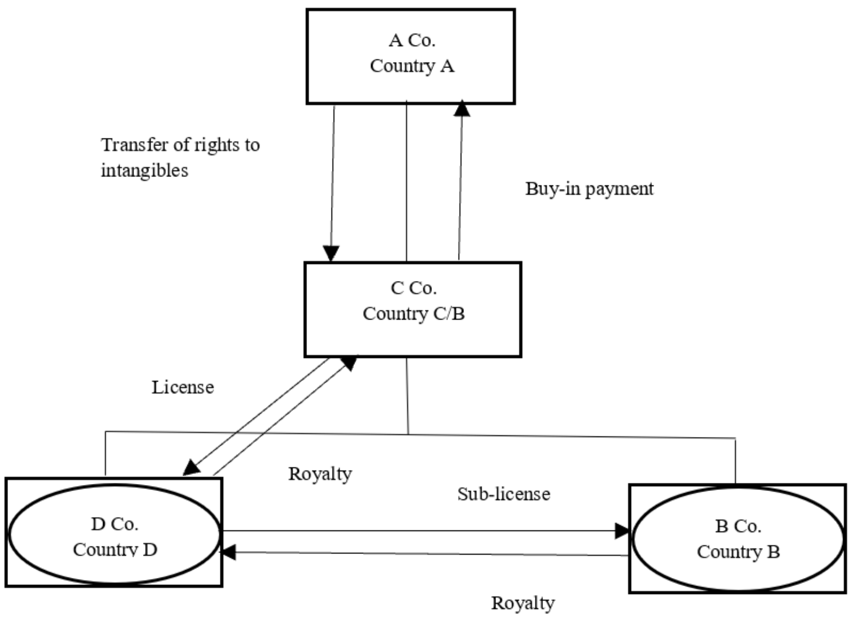
The following example builds on the transfer pricing discussion above and includes elements of transfer pricing, a cost sharing arrangement and check-the-box.

Example 2[47] *(Transfer of intangibles via cost sharing arrangement and check-the-box)*

A Co., a resident of Country A, owns 100% of C Co., a resident of Country C (a tax haven country). C Co, in turn, owns 100% of B Co., a resident of Country B, and D Co., a resident of Country D (a member of the European Union). To avoid the U.S. Subpart F anti-deferral provisions, A Co. files a check-the-box election to treat D Co. and B Co. as branches (i.e., disregarded entities) for Country A purposes. A Co. researched and developed the intangibles (software) in Country A and transfers the intangibles to C Co. under a cost sharing agreement. Pursuant to the cost sharing

[43] *Levin Statement—Part 2, supra* note 35; *Shay Testimony, supra* note 29.
[44] *JCX-37-10*, *supra* note 16, at 19, 104.
[45] *Addressing BEPS*, *supra* note 5, at 40.
[46] *Id.*
[47] *Id.* at 73–76.

agreement, C Co. agrees to make a single lump sum buy-in payment to A Co. and to share the costs of future enhancements to the intangibles. A Co. and C Co. share the ongoing research expenses based on the anticipated benefits from the intangibles they are developing. C Co. licenses all of its rights in the intangibles to D Co. in exchange for royalty payments. D Co. then sub-licenses the intangible to B Co. B Co. deducts the full amount of the royalty payments to D Co. Lastly, Country D's domestic law does not impose withholding tax on royalty payments.



Country A Perspective: Country A fully taxes the buy-in payment from C Co. to A Co. Because of the check-the-box election, Country A treats D Co. and B Co. as disregarded entities and deems C Co. to have earned their income directly. Moreover, Country A disregards the royalty transactions between B Co. and D Co. and thus treats C Co. as if it earned D Co. and C Co.'s revenue and fees directly through active operations.

Country B Perspective: B Co. claims its royalty payments to D Co. as deductions and thus reduces its taxable base in Country B. Furthermore, because B Co. makes royalty payments to a company that is a member of the EU, Country B exempts the royalties from withholding tax.

Country C Perspective: Country C is a tax haven and imposes no corporate income tax. Therefore, C Co.'s royalty income from D Co. is not subject to tax.

Country D Perspective: D Co.'s taxable income is eroded by its royalty payments to C Co. Thus, Country D taxes only the small difference between D Co.'s royalty income from B Co. reduced by D Co.'s royalty payments to C Co. D Co.'s royalty payments to C Co. are not subject to withholding tax under domestic law.

C. *Debt Leverage*

MNEs have generated tax savings by simply borrowing funds in a high-tax jurisdiction and deducting the interest payments attributable to the loan from taxable income subject to applicable limitations.[48] Because the tax savings are directly proportionate to the country's tax rate, a higher tax rate jurisdiction results in greater tax savings.[49] Moreover, MNEs commonly use debt to shift profits from high-tax to low-tax jurisdictions with lenders purposefully located in low-tax jurisdictions.[50] Tax treaties play a key role in an MNE's ability to avoid or limit the withholding tax on interest payments to lenders.[51] MNEs have also used hybrid financial instruments (which embody characteristics associated with both debt and equity)[52] in tax strategies to characterize a transaction as debt in a high-tax country and thereby enable the payer entity to deduct interest expense.[53] Meanwhile, the recipient country characterizes the transaction as equity, and under that country's tax law the corresponding income is tax exempt.[54] The following examples further illustrate MNEs' use of debt to minimize taxes.

Example 1[55]

Company X, a foreign parent company, leverages its U.S. operations. The U.S. entity claims interest expense deductions subject to limitations[56] at the U.S. tax rate of 21%, and the corresponding interest income is recognized by lenders located in low-tax jurisdictions.

---

[48] Gravelle & Keightley, note 20, at 4.
[49] *Id.*
[50] *JCX-37-10*, *supra* note 16, at 109.
[51] *Id.*
[52] *Addressing BEPS*, *supra* note 5, at 40.
[53] *Id.* at 37.
[54] *Id.*
[55] *JCX-37-10*, *supra* note 16, at 109.
[56] I.R.C. § 163(j).

Company A, a subsidiary or parent in a high-tax jurisdiction, borrows funds from Company B, a subsidiary in a low-tax jurisdiction. Company A makes interest payments to Company B and deducts the interest expense in the high-tax jurisdiction, and thereby, generates tax savings.[57]

Example 2[58]

Company A, located in Country A, purchases hybrid financial instruments from Company B, located in Country B. Country A treats the instruments as equity while Country B treats the instruments as debt for tax purposes. Moreover, dividend income is tax exempt in Country A. As a result, Company B deducts the interest expense payments, and Company A has no income recognition for the corresponding receipts. The MNE group achieves tax savings through the interest expense deductions in Country B created by the financial instrument.

Example 3[59]

An MNE creates a finance operation in a low-tax country that funds the operating activities of its group members, Company B and Company C, which are located in high-tax jurisdictions. As a result of the intra-group debt, Company B and Company C pay interest expense to the finance operation and deduct these payments from their taxable income. Because the finance operation is located in a low-tax jurisdiction, the interest income is subject to a nominal tax. Therefore, the MNE group achieves significant tax savings and reduces its overall tax burden.

III. Pillar Two – GloBE

Over the past decade amidst growing concerns about corporate tax avoidance and global tax competition,[60] the OECD has increased its efforts to address the tax gaps and mismatches in existing international tax law that allow certain MNEs to generate significant revenue (e.g., from intellectual property) in a country with little or no taxation.[61] The digital economy has upturned the fundamental principles of international tax law (based on the premise of physical presence, i.e., brick-and-mortar business models) that countries have followed for a century toward a digitalized world (business

---

[57] Gravelle & Keightley, note 20, at 4.

[58] *Addressing BEPS*, *supra* note 5, at 40.

[59] *Id.* at 43.

[60] As of the date of writing, there are a number of countries that offer corporate tax rates below 15%. *See PwC Corporate Tax Rates Table, supra* note 15.

[61] OECD, *Tax Challenges Arising from the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS* (2021), at 3, https://doi.org/10.1787/782bac33-en [hereinafter *Global Anti-Base Erosion Model Rules*].

models with minimum or no physical presence).[62] In an effort to prevent MNEs from shifting their profits to low-tax or no-tax jurisdictions, over 145 member countries of the OECD/G20 Inclusive Framework agreed to a two-pillar solution that addresses the tax challenges of the digital economy.[63] Collectively, the two-pillar solution's key purposes are to reallocate the profit of in-scope MNEs to market jurisdictions worldwide (Pillar 1[64]) and to levy a global minimum tax rate of 15% (Pillar 2).[65] Whereas Pillar 1 creates a new nexus for market jurisdictions, Pillar 2 imposes a 15% minimum tax on in-scope MNEs.[66] Although seemingly straightforward, the implementation, administration and ongoing compliance requirements of Pillar 2 appears quite complex from the perspectives of both the tax jurisdictions and the MNEs. Pillar 2 is intended to stymie the "race to the bottom" corporate income tax competition between jurisdictions vying to attract foreign investment to their local economies.[67] By imposing a coordinated global minimum tax rate of 15%, Pillar 2 establishes a limitation on tax competition (a tax "floor" so to speak) and enables countries to protect their tax bases.[68] In other words, the 15% minimum tax backstops competition among tax jurisdictions regardless of where an MNE chooses to operate or establish its headquarters.

A primary purpose of Pillar 2 is to ensure that in-scope MNEs pay a 15% minimum tax on their book revenues in low-tax or no-tax jurisdictions subject to "carve outs" for activities with substance (e.g., building a hotel or factory) and thus inhibit MNEs from profit shifting and base erosion.[69] Pillar 2 is comprised of two interlocking domestic rules (the Global anti-Base Erosion rules known as "GloBE") for

[62] *Global Anti-Base Erosion Model Rules, supra* note 61, at 3.

[63] The OECD/G20 Inclusive Framework is comprised of approximately 147 countries that have committed to monitoring and peer reviewing the implementation of minimum standards and setting standards required to address tax avoidance from base erosion and profit and shifting. *See* OECD, *Members of the OECD/G20 Inclusive Framework on BEPS* (updated May 28, 2024), *Global Anti-Base Erosion Model Rules, supra* note 61, at 3.

[64] *See* Joint Committee on Taxation, *Background and Analysis of The Taxation of Multinational Enterprises and The Potential Reallocation of Taxing Rights Under the OECD's Pillar One*, JCX-7-24 (Mar. 5, 2024). The purpose of this new nexus is to ensure that in-scope MNEs' revenues are taxed in the jurisdiction where the MNE engages in economic activities and creates value irrespective of its physical presence.

[65] *Global Anti-Base Erosion Model Rules, supra* note 61, at 7.

[66] *Global Anti-Base Erosion Model Rules, supra* note 61.

[67] OECD, *OECD/G20 Base Erosion and Profit Shifting Project: Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (Oct. 2021), at 3 [hereinafter *Two-Pillar Solution*].

[68] *Id.* at 4.

[69] *Global Anti-Base Erosion Model Rules, supra* note 61, at 7; Christos Theophilou, *Deconstructing Pillar Two – Impact on Multinational Enterprises*, BLOOMBERG TAX (Apr. 6, 2022, 3:00 A.M.), https://news.bloombergtax.com/daily-tax-report-international/deconstructing-pillar-two-impact-on-multinational-enterprises.

implementation in a country's domestic tax law[70] and two treaty-based rules.[71] The GloBE rules, which are the focus of this article, include the (1) qualified domestic minimum top-up tax, (2) income inclusion rule (residence jurisdiction) and (3) undertaxed profits rule (source jurisdiction).[72] The OECD provides five key steps that MNEs should follow to implement Pillar 2 and determine the amount of top-up tax liability under GloBE.

A. Mechanics: GloBE's Five Key Steps

GloBE is a system of top-up taxes that MNEs apply at a jurisdictional level. Where an MNE's effective tax rate is below 15%, GloBE then imposes a coordinated top-up tax that raises the total amount of taxes paid on excess profit to the requisite minimum rate. Simply put, in-scope MNEs determine their effective tax rate for each jurisdiction and pay the difference (i.e., top-up tax) between their effective tax rate and 15%. The jurisdiction of the MNE's ultimate parent generally collects the top-up tax. Altogether, the GloBE rules impose a minimum tax floor on domestic companies that invest abroad and foreign companies that invest domestically.[73] Consequently, GloBE would add yet another layer of minimum taxes to the U.S.' existing minimum tax rules (GILTI, BEAT, CAMT[74]), which ensure MNEs pay at least the 15% minimum tax rate on earnings in each country of operation[75] and force U.S. companies to contend with greater compliance burdens than their foreign competition.[76]

---

[70] *Global Anti-Base Erosion Model Rules, supra* note 61.

[71] Pillar 2's treaty-based rules are referred to as the Subject to Tax Rule ("STTR") and the Switch-Over Rule ("SOR"). STTR provides source jurisdictions with the authority to impose a limited source tax on certain related party payments below a minimum tax rate. SOR renders moot a tax treaty provision in conflict with a jurisdiction's authority to apply the income inclusion rule (i.e., the tax treatment "switches" from an exemption method to a tax credit method). OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Subject to Tax Rule (Pillar Two): Inclusive Framework on BEPS* (2023).

[72] *Global Anti-Base Erosion Model Rules, supra* note 61.

[73] Bunn & Bray, *supra* note 10.

[74] *See infra* Part V. U.S. Tax Implications.

[75] Joint Committee on Taxation, *Possible Effects of Adopting the OECD's Pillar 2, Both Worldwide and in the United States* 1, 3 (June 2023), https://www.jct.gov/getattachment/07a143e4-277b-4344-b230-c499a9c16be3/OECD-Pillar-Two-Report-June-2023.pdf [hereinafter *Possible Effects of Pillar 2*]

[76] Daniel Bunn, *Testimony: U.S. International Tax Policies That Support Investment and Innovation*, TAX FOUND (May 11, 2023), https://taxfoundation.org/testimony/us-international-tax-policies-investment-innovation/.

GloBE includes the following three related taxes applied in an agreed rule order that targets MNEs with annual revenues greater than or equal to € 750 million.[77] First, a qualified domestic minimum top-up tax ("QDMTT"), which provides the source country with the first opportunity to impose a top-up tax (and benefit from the tax revenue) on a qualifying MNE's earnings currently taxed below the minimum tax rate.[78] The QDMTT taxes constituent entities on their local profits within the jurisdiction.[79] Second, if the source country does not take advantage of the QDMTT, then the ultimate parent company's residence country can impose the income inclusion rule ("IIR").[80] Pursuant to the IIR, a parent company must include in its taxable income the foreign income of constituent entities that fall below the minimum effective tax rate of 15%.[81] The IRR imposes a top-up tax on the ultimate parent company for its constituent entities' earnings (subject to carve outs for the value of tangible assets and payroll expenses) generated in low-taxed jurisdictions.[82] Third, if neither the QDMTT or IIR applies, then all other jurisdictions where the MNE has constituent entities may impose the undertaxed profits rule ("UTPR") to raise the constituent entities' effective tax rate to 15%[83] (and therein lies the rub for the U.S. as further discussed below[84]). In other words, the UTPR taxes constituent entities whose ultimate parent company or affiliated companies are in low-tax countries (and not otherwise subject to the QDMTT or IIR) by denying deductions or requiring an adjustment to result in an additional tax liability.[85] The members of the MNE group pay the UTPR in proportion to the employees and tangible assets located in their jurisdiction.[86] Because countries can impose the UTPR and reap from the benefit of revenue collection from constituent entities if the source country (QDMTT) and residence country (IIR) do not act, it functions as a backstop to ensure the global minimum tax regime.[87] The remainder of this section describes the steps that MNEs must generally follow to determine their global minimum tax.

[77] *Id; See also* OECD, *Qualified Status under the Global Minimum Tax, Questions and Answers* (June 2, 2024), 1, https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-minimum-tax/qualified-status-under-the-global-minimum-tax-questions-and-answers.pdf (provides an illustration to apply GloBE's agreed rule of order for QDMTT, IIR and UTPR).
[78] *Possible Effects of Pillar 2*, *supra* note 75, at 3.
[79] *Id.*
[80] Gravelle & Keightley, note 20.
[81] *Possible Effects of Pillar 2*, *supra* note 75, at 3.
[82] *Id.*
[83] Gravelle & Keightley, *supra* note 20.
[84] *See infra* Part V. U.S. Tax Implications.
[85] *Possible Effects of Pillar 2*, *supra* note 75, at 3.
[86] *Id.*
[87] Gravelle & Keightley, *supra* note 20, at 6-7.

Step 1 — Identify Constituent Entities Within GloBE's Scope[88]

First, the MNE Group determines whether it is in-scope to begin with, and if so, identifies its constituent entities along with their location. MNEs with consolidated revenue, as reflected in their consolidated financial statements, exceeding € 750 million are considered in-scope for purposes of GloBE. An MNE applies this consolidated revenue test to two of the four fiscal years immediately prior to the tested fiscal year.[89] If an MNE group is in-scope, it then identifies its constituent entities (including all of the group's entities and permanent establishments) along with their location.[90] Certain entities, however, are not considered within scope and therefore excluded[91] from GloBE's operative provisions. A constituent entity's location is generally based on its jurisdiction of tax residence (e.g., place of management, creation, or similar criteria).[92]

Step 2 — Determine GloBE Income[93]

Second, the MNE group calculates each constituent entity's GloBE income or loss by using the constituent entity's financial accounting net income or loss as its starting point.[94] The MNE then adjusts the constituent entity's book income to eliminate certain book to tax differences (e.g., excluded dividends and/or equity gain or loss, disallowed expenses such as illegal payments, stock-based compensation, foreign currency gains and losses)[95] and also excludes international shipping income to determine GloBE income or loss (i.e., GloBE tax base).[96] In accordance with domestic tax treatment, the GloBE income or loss is then allocated between a permanent establishment[97] and main entity or to a flow-through entity's owners subject to applicable local tax treatment.[98]

---

[88] *Global Anti-Base Erosion Model Rules, supra* note 61, at 8–10.

[89] *Id.* at Article 1.1.

[90] *Id.* at Article 1.3.

[91] Excluded entities include governmental entities, international organizations, non-profit organizations, pension funds, and any investment fund or real estate investment vehicle that is an MNE's ultimate parent entity. *Id.* at Article 1.5.

[92] *Id.* at Article 10.3.

[93] *Id.* at 15–21. *See* OECD, *Tax Challenges Arising from the Digitalisation of the Economy –Global Anti-Base Erosion Model Rules (Pillar Two) Examples* (2024), 24–43, https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-minimum-tax/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-erosion-model-rules-pillar-two-examples.pdf [hereinafter *Pillar Two Examples*].

[94] *Global Anti-Base Erosion Model Rules, supra* note 61, at Article 3.1.

[95] *Id.* at Article 3.2.

[96] *Id.* at Article 3.3.

[97] *Id.* at Article 3.4.

[98] *Id.* at Article 3.5.

Step 3 — Determine Covered Taxes: What are Covered Taxes?[99]

Third, the MNE group determines the amount of "covered taxes" attributable to each constituent entity's GloBE income or loss.[100] To calculate the amount of covered taxes, the MNE group uses the current accrued tax expense for book income or loss as its starting point and adjusts the current tax expense for certain timing differences and prior year losses for GloBE purposes.[101] The GloBE rules include defensive mechanisms to preserve the integrity of the effective tax rate calculation such as limiting the amount of deferred tax assets and liabilities recognized to 15%.[102] In certain instances, the MNE group may allocate the covered taxes of one constituent entity to another as needed.[103] Special rules apply for post-filing adjustments to a prior year tax liability (such as an amended return or tax audit adjustment).[104]

Step 4 — Calculate the Effective Tax Rate and Top-up Tax[105]

Fourth, the MNE group calculates the jurisdictional effective tax rate and top-up-tax attributable to each low-taxed constituent entity. The *jurisdictional* top-up tax for each low-taxed jurisdiction (i.e., the jurisdiction's effective tax rate is below GloBE's 15% minimum rate) is calculated as follows:

(1) covered taxes (from Step 3) is divided by GloBE income (from Step 2) to arrive at the effective tax rate;[106]

(2) the minimum rate of 15% minus the effective tax rate equals the top-up tax percentage;[107]

(3) GloBE income (from Step 2) minus the substance based income exclusion[108] equals the excess profit;[109]

---

[99] *Id.* at 22–27. For illustrative examples, *see Pillar Two Examples*, *supra* note 93, at 44–55.

[100] *Global Anti-Base Erosion Model Rules, supra* note 61, at Articles 4.1 & 4.2.

[101] *Id.* at Article 4.4.

[102] *Id.*

[103] E.g., CFC taxes, distribution taxes (withholding taxes), and tax for a permanent establishment, transparent entity or hybrid entity. *Id.* at Article 4.3.

[104] The effective tax rate is recalculated and material additions or reductions to taxes are allocated to a specific jurisdiction and fiscal year(s). *Id.* at Article 4.6.

[105] *Id.* at 28–33. For illustrative examples, *see Pillar Two Examples, supra* note 93, at 56–59.

[106] *Global Anti-Base Erosion Model Rules, supra* note 61, at Article 5.1.

[107] *Id.* at Article 5.2.

[108] The substance based income exclusion is defined as "an excluded routine return on tangible assets and payroll." *Id.* at Article 5.3.

[109] *Id.* at Article 5.2.

(4) excess profit multiplied by the top-up tax percentage minus the qualified domestic minimum top-up tax (QDMTT) equals the jurisdictional top-up tax.[110]

(5) the MNE identifies its constituent entities with GloBE income in the low-taxed jurisdiction and then allocates the jurisdictional top-up tax to such constituent entities in proportion to their GloBE income.[111]

Through this process, the MNE group determines which of its constituent entities are subject to a top-up tax and its parent entity's ultimate tax liability under Step 5.

The GloBE rules include a de minimis exclusion for jurisdictions where the MNE's (1) average GloBE income is below € 10 million and (2) average GloBE income is below € 1 million or a loss using a three-year average basis.[112] GloBE also leaves room for the development of certain safe harbors to limit the administrative and compliance burdens of implementing these rules.[113]

Step 5 — Income Inclusion Rule ("IIR") and Undertaxed Profits Rule ("UTPR")

Income Inclusion Rule[114]

Finally, the MNE group applies the income inclusion rule, which allocates the top-up tax (from Step 4) using a top-down approach subject to a split-ownership rule for shareholders who own less than eighty percent.[115] Pursuant to the top-down approach, the MNE identifies its ultimate parent entity that is liable (because of its ownership interest) for the top-up tax of the group's low-tax constituent entities (from Step 4). If the ultimate parent entity is not subject to the income inclusion rule, Pillar 2 imposes the top-up tax on the next intermediate parent entity in the organizational structure that is subject to the income inclusion rule.[116] The MNE then determines the amount of top-up tax attributed to the parent entities in proportion to their allocable share.[117] A parent entity's allocable share of top-tax is based on its share of the low-taxed entities' profits in accordance with accounting standards.[118]

---

[110] *Id.*
[111] *Id.*
[112] *Id.* at Article 5.5.
[113] *Id.* at Article 8.2.
[114] *Global Anti-Base Erosion Model Rules, supra* note 61 at 11–12. For detailed examples of the income inclusion rule, s*ee Pillar Two Examples, supra* note 93.
[115] *Global Anti-Base Erosion Model Rules, supra* note 61, at Article 2.1.
[116] *Id.*
[117] *Id.* at Article 2.2.
[118] *Id.*

Undertaxed Profits Rule[119]

The undertaxed profits rule serves as a backstop mechanism for the income inclusion rule in instances where the top-up tax was not allocated.[120] For example, if an ultimate parent entity is located in a low-tax jurisdiction or in a jurisdiction where the income inclusion rule does not apply because the country has not implemented Pillar 2. Thus, the UTPR disincentivizes MNEs from relocating their corporate headquarters to jurisdictions that have not adopted the IIR. The undertaxed profits rule requires an adjustment (e.g., denial of a deduction), which raises the subsidiary level's tax so the group entities pay their portion of the residual top-up tax that the income inclusion rule failed to capture.[121] The MNE calculates the UTPR top-up tax for allocation among the UTPR jurisdictions via a two-factor formula based on the net book value of tangible assets and the number of employees that constituent entities located in the UTPR jurisdictions employ.[122] The UTPR top-up tax is collected by denying a deduction (i.e., the adjustment) in the UTPR jurisdiction.[123] Note, the UTPR is delayed to 2026 for jurisdictions with a corporate tax rate above 20%.[124]

B. Agreed Administrative Guidance for the Pillar Two GloBE Rules

In February 2023, the OECD released administrative guidance to ensure that governments implement and apply GloBE to their domestic legislation in a coordinated and administrable manner.[125] The document includes guidance on the recognition of the Global Intangible Low-Taxed Income ("GILTI") under the GloBE Rules and the design of the Qualified Domestic Minimum Top-up Taxes as well as general guidance on the scope, operation and transitional elements of the GloBE Rules. Moreover, the administrative guidance responds to stakeholders' feedback on technical issues (e.g., collection of top up tax in a period where the jurisdiction has no GloBE income, debt releases, and certain tax credit equity structures).

---

[119] *Global Anti-Base Erosion Model Rules, supra* note 61, at 12–13. For detailed examples of the UTPR, s*ee Pillar Two Examples, supra* note 93.

[120] *Id.* at Article 2.5.

[121] *Id.* at Article 2.4.

[122] *Id.* at Article 2.6.

[123] *Id.* at Article 2.4.

[124] Reuven S. Avi-Yonah, *Pillar 2 and United States: What's Next*, TAX NOTES (Jan. 29, 2024), https://www.taxnotes.com/featured-analysis/pillar-2-and-united-states-whats-next/2024/01/26/7j41s.

[125] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)* (Feb. 2023), https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-minimum-tax/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf.

On July 17, 2023, the OECD released the second Administrative Guidance[126] and the GloBE Information Return.[127] The second Administrative Guidance addresses currency conversion, tax credits, the application of the Substance-based Income Exclusion (SBIE), further guidance on the design of Qualified Domestic Minimum Top-up Taxes (QDMTT) and new permanent and transitional safe harbors. The GloBE Information Return provides a standardized information return to facilitate each jurisdiction's compliance and administration of GloBE.[128] The return includes the information tax authorities may need to perform risk assessment and evaluate a constituent entity's top-up tax liability. It also integrates transitional simplified reporting requirements (that permit MNEs to report GloBE calculations by jurisdiction) and will be subject to coordinated filing and exchange mechanisms.

On December 18, 2023, the OECD released its third Administrative Guidance,[129] which further clarifies key aspects of GloBE to facilitate the transition of MNE groups. The third Administrative Guidance addresses the application of the Transitional Country-by-Country Reporting Safe Harbour and clarifies the definition of revenues for purposes of determining whether an MNE Group is within scope, transitional relief to file the GloBE Information Return and notifications for in-scope MNE Groups that have short Reporting Fiscal Years, and a mechanism for allocating taxes arising in a Blended Controlled Foreign Corporation Tax Regime when some of an MNE group's countries of operation are eligible for the safe harbour.

Finally, on June 17, 2024, the OECD released their most recent Administrative Guidance,[130] which addresses how to apply the recapture rule for deferred tax liabilities, how to determine deferred tax assets and liabilities for GloBE purposes versus accounting carrying value of assets and liabilities, cross-border allocation of current and

---

[126] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)* (July 2023), https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-minimum-tax/administrative-guidance-global-anti-base-erosion-rules-pillar-two-july-2023.pdf.
[127] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – GloBE Information Return (Pillar Two)* (2023), https://www.oecd.org/content/dam/oecd/en/publications/reports/2023/07/tax-challenges-arising-from-the-digitalisation-of-the-economy-globe-information-return-pillar-two_10977da1/91a49ec3-en.pdf.
[128] *Id.*
[129] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)* (Dec. 2023), https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-minimum-tax/administrative-guidance-global-anti-base-erosion-rules-pillar-two-december-2023.pdf.
[130] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)* (June 2024), https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-minimum-tax/administrative-guidance-global-anti-base-erosion-rules-pillar-two-june-2024.pdf.

deferred taxes, allocation of profits and taxes with certain flow-through entity structures, and securitization vehicles.

The OECD/G20 Inclusive Framework will issue additional administrative guidance on an ongoing basis.[131]

IV. Tax Policy Considerations

Because certain MNEs can shift taxable income to low-tax or no-tax jurisdictions (as opposed to reporting taxable income where they actually conduct income producing activities), a greater share of the tax burden may befall other taxpayers as jurisdictions attempt to offset shortcomings in tax revenue collections due to profit shifting.[132] Furthermore, domestic entities (e.g., small businesses that operate locally) for which obtaining and implementing complex tax advice are both cost prohibitive and impractical are at a competitive disadvantage with MNEs that engage in profit shifting through cross-border transactions.[133] These strategies save MNEs significant amounts of taxes, and, therefore, cash flow they can use for other purposes that further enhance their competitive edge. Accordingly, GloBE is meant to address two primary tax concerns of the global community: (1) profit shifting and (2) tax competition.

A. Profit Shifting

As discussed in Part II, MNEs' complex structures and planning strategies to shift profits to no-tax or low-tax jurisdictions has alarmed the OECD and global community into taking action against base erosion and profit shifting.[134] Profit shifting is a global collective issue requiring action on the part of stakeholders worldwide — that is, one country cannot single-handedly address profit shifting or the pressures businesses and consumers place on the global economy.[135] Commentators have indicated that the multilateral agreement between over 145 countries to Pillar 2 signals "a profound

---

[131] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)* (2023), www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillartwo.pdf.

[132] *Action 1 - 2015 Final Report, supra* note 17, at 78.

[133] *Id.*

[134] *Id.*; OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy* (2019a), at 24 [hereinafter *Tax Challenges of Digitalisation*].

[135] Kimberly A. Clausing, Peter A. Barnes, Mindy Herzfeld, David M. Schizer, & Cara Griffith, *Debating the Global Minimum Tax: Transcript*, TAX NOTES (Oct. 4, 2023), https://www.taxnotes.com/featured-analysis/debating-global-minimum-tax-transcript/2023/10/12/7hgc7.

dissatisfaction with the status quo" in which the most profitable corporations pay only single digit tax rates and further highlights the importance of protecting the tax base from profit shifting.[136] A key purpose of Pillar 2 is to minimize MNEs' economic incentives to engage in profit shifting.[137] In other words, GloBE serves as the impetus for source countries to increase their corporate tax rate to 15%, and, by doing so, removes the incentive for MNEs to shift profits to low-tax jurisdictions.[138] GloBE could strengthen the OECD's efforts against base erosion and profit shifting. Particularly, tax planning strategies that allocate intangible assets and risks within the corporate group itself would become more costly to implement.[139] Tax planning structures that shift profits from high-tax to low-tax jurisdictions would no longer generate the desired tax savings from international tax arbitrage.[140] GloBE's income inclusion rule, however, could multiply the tax cost of cross-border transactions and affect MNEs' business and operations decisions in global and domestic investment and employment.[141]

B. Tax Competition

Tax competition has driven worldwide corporate income tax rates down as countries vie for revenue streams and investment in their local economies, all of which may not be sustainable tax policy in the long run.[142] By imposing a 15% minimum tax floor, GloBE limits the proverbial "race to the bottom" in which countries offer low-tax to no-tax incentives to attract investment from MNEs and spur economic activity.[143] MNEs' profits will be taxed one time in either the source country (country where the MNE generates income) or residence country (the location of the MNEs' customers or

---

[136] *Id.*

[137] Joachim Englisch, *International Effective Minimum Taxation – Analysis of GloBE (Pillar Two)*, *in* OUP HANDBOOK OF INTERNATIONAL TAX LAW (F. Haase & G. Kofler eds., Oxford University Press, 2021), at 7, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3829104.

[138] Reuven S. Avi-Yonah, *What Does the US Get from Pillar 2?*, SSRN (Mar 22, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4389419.

[139] Englisch, *supra* note 137, at 9-10.

[140] *Id.* at 7.

[141] Bunn & Bray, *supra* note 10.

[142] *See PwC Corporate Tax Rates Table*, *supra* note 15; John Vella, Michael P. Devereux, & Heydon Wardell-Burrus, *Pillar 2's Impact on Tax Competition* (Sep. 28, 2022), at 1, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4203395.

[143] *Tax Challenges of Digitalisation*, *supra* note 134, at 24; Michael P. Devereux *et al*., *The OECD Global Anti-Base Erosion Proposal*, PWC REPORT, OXFORD UNIVERSITY CENTRE FOR BUSINESS TAXATION (2020), at 8, https://www.sbs.ox.ac.uk/sites/default/files/2020-02/OECD_GloBE_proposal_report.pdf; Reuven S. Avi-Yonah & Young Ran Kim, *Tax Harmony: The Promise and Pitfalls of the Global Minimum Tax*, 43 MICH. J. INT'L L. 505 (2022), at 513, 515.

investors) at the minimum tax rate.[144] MNEs must pay this floor of 15% minimum tax (i.e., pay their "fair share") on their total tax paid globally and source countries effectively collect the floor in total tax (which in turn stops the "race to the bottom" among source countries and pressure "to keep up with the Joneses" by lowering corporate tax rates well below their countries' optimal rate).[145] Commentators have argued that GloBE ensures the owners of capital are subject to taxation while decreasing the tax burden placed squarely on labor and helps stabilize the tenuous state of the international tax system.[146] Moreover, GloBE is meant to stymie the unilateral measures (e.g., digital taxes) that some countries may impose to increase or preserve their existing tax base without this mechanism.[147] A proliferation of unilateral tax laws could result in greater uncertainty for MNEs, undermining of investment, double taxation, and trade retaliatory measures among nations.[148] However, commentators argue that the carve outs weaken Pillar 2's effectiveness by providing certain source countries the means to continue engaging in profit shifting and tax competition.[149] Although GloBE attempts to level the playing field and implicitly steers MNEs to place more emphasis on factors other than tax savings in their investment decisions, the GloBE rules are not without its shortcomings.[150]

C. Tax Sovereignty

Commentators and certain jurisdictions have argued that Pillar 2 may jeopardize the tax sovereignty of countries in their ability to determine their own tax rates. In particular, GloBE could constrain jurisdictions whose aim is to raise revenue by taxing

---

[144] GloBE applies "corrective measures" including the income inclusion rule for residence taxation and the undertaxed profits rule (which denies a deduction) and subject to tax rule for source taxation. Avi-Yonah & Kim, *supra* note 143, at 508; *see supra* Part III. Pillar Two – GloBE.

[145] Vella et al., *supra* note 142, at 8, 11.

[146] Press Release, Remarks by Assistant Secretary for Tax Policy Lily Batchelder at the New York State Bar Association's Annual Meeting (Jan. 25, 2022), https://home.treasury.gov/news/press-releases/jy0568; Mindy Herzfeld, *Does the OECD Deal Reset the International Economic Order?*, TAX NOTE FEDERAL (Dec. 20, 2021); https://www.taxnotes.com/content-viewer?rid=7cq20&type=saa&str=bGF1cmVuLmhhZGFtQHJ1dGdlcnMuZWR1&token=71980381-d557-4080-a41a-5a955afe127f&utm_campaign=SAA%20Link&utm_medium=email&_hsenc=p2ANqtz-_k2pR4H6Q74bYoY5RLTxS6qm6mrKJ0KH8g4CivfFQNWxcKwxzWYWX02AriZdtiSeFSQB3y-0ORW_2ES92UZUw6Vq804w&_hsmi=258093040&utm_content=258093040&utm_source=hs_automation; Vella et al., *supra* note 142, at 10–11.

[147] Devereux *et al.*, *supra* note 143, at 1, 9.

[148] *Two-Pillar Solution*. *supra* note 67, at 13.

[149] Avi-Yonah & Kim, *supra* note 143, at 547.

[150] Englisch, *supra* note 137, at 7.

profits from substantive activities within their borders.[151] Furthermore, commentators put forth the notion that countries may offer MNEs subsidies (e.g., government grants, refundable credits) as a means to offset the cost of the minimum tax and attract investment.[152] In other words, jurisdictions may create new subsidies that in effect circumvent GloBE's key purposes to prevent profit shifting and aggressive tax competition.[153] Although some countries may yield to the pressures of tax competition, other countries may view a low-tax or no-tax incentive as their only means to attract investment in their countries if they have little to offer otherwise in non-tax advantages.[154] By raising the bottom from 0% to a minimum tax rate of 15%, countries will have greater flexibility to impose a tax rate higher than 15%.[155] An interesting juxtaposition results where on the one hand GloBE's minimum tax limits certain countries' ability to attract direct investment through low to no tax rates, and on the other, enables countries that would otherwise impose higher corporate tax rates (but for the intense tax competition) to exercise their tax sovereignty.[156] Nonetheless, it is questionable whether the race to the bottom corporate income tax model is a sustainable means of generating tax revenue for the global community given the brave new world of the digital economy.

Although the tax strategies and legal structures may deliberately follow the letter of each country's laws, governments argue that MNEs use of aggressive tax strategies to shift intangible assets and its corresponding income from high-tax to low-tax jurisdictions does not reflect the economic reality of the significant tax savings generated within the group.[157] Specifically, some commentators assert these tax avoidance strategies place domestic U.S. companies at a competitive disadvantage because they are unable to reduce their effective tax rates via offshore tax planning.[158] Meanwhile, other commentators argue that GloBE curtails the competitive disadvantages of smaller U.S. businesses that lack the wherewithal or means to implement BEPs strategies.[159] Nonetheless, these strategies exacerbate the U.S. budget deficit and place the tax burden of revenue lost to these strategies squarely on the shoulders of individual taxpayers and small businesses.[160] To counteract the MNEs measures, tax jurisdictions must consider

---

[151] *Action 1 - 2015 Final Report*, *supra* note 17, at 22–23; *Tax Challenges of Digitalisation*, *supra* note 134, at 36.
[152] Bunn & Bray, *supra* note 10.
[153] Clausing et al., *supra* note 135.
[154] Devereux *et al.*, *supra* note 143, at 19.
[155] Clausing et al., *supra* note 135.
[156] Englisch, *supra* note 137, at 11.
[157] *Levin Statement—Part 1, supra* note 30; *Addressing BEPS*, *supra* note 5, at 40.
[158] *Id.*
[159] Natasha Sarin & Kimberly Clausing, *Opinion Debunking 5 Republican Arguments Against the Global Minimum Tax*, WASH. POST (Aug. 7, 2023, 7:00 A.M.), https://www.washingtonpost.com/opinions/2023/08/07/global-minimum-tax-republican-arguments/.
[160] *Levin Statement—Part 2, supra* note 35 at 2.

how different tax regimes interact between nations and where taxpayers may exploit mismatches to their advantage.[161]

The OECD/G20 Inclusive Framework has worked toward a multilateral approach and cooperation among nations to prevent the adverse tax consequences of base erosion and profit shifting on cross-border trade and investment and create a more level playing field between MNEs and their domestic counterparts.[162] The European Union has already introduced draft legislation or adopted final legislation into their domestic laws for the global minimum tax.[163] Pursuant to the EU directive, each member country with more than 12 in-scope[164] MNE groups must adopt Pillar 2's income inclusion rule in its national laws by the end of 2023 such that the MNEs affected by the legislation commence payment in 2024 and the undertaxed profits rule[165] from December 31, 2024.[166] The EU's adoption of GloBE will significantly impact MNEs and may prompt other countries to adopt some form of its guidelines or revise their domestic tax laws to address the minimum tax.[167] Although the United States considered tax policy changes to align its domestic law with GloBE, Congress ultimately did not pass these changes in the final version of the Inflation Reduction Act of 2022.[168]

V. U.S. Tax Implications

Members of the U.S. Congress have expressed their concerns with a global minimum tax, and it is highly questionable whether Pillar 2 will gain enough support to pass muster in future legislation. Congress must weigh the effect of international tax policy on foreign (outbound) and domestic (inbound) investment, cross- border transactions, advancing foreign policy goals, deterring profit shifting, and more often than not, staunch political pressures in the U.S. and abroad.[169] Although a number of proposals were included in the Build Back Better Act[170] (e.g., revisions to Global

---

[161] *Id.*

[162] *Two-Pillar Solution, supra* note 67, at 20.

[163] Bunn & Bray, *supra* note 10; s*ee also* Stephanie Soong, *U.S. Must Reform GILTI in Line with OECD Pillar 2*, TAX NOTES TODAY (Dec. 19, 2022); Gravelle & Keightley, note 20.

[164] *See supra* Part III. Pillar Two – GloBE, A. Mechanics: GloBE's Five Key Steps, Step 1 — Identify Constituent Entities Within GloBE's Scope.

[165] *See supra* Part III. Pillar Two – GloBE, A. Mechanics: GloBE's Five Key Steps, Step 5 — Income Inclusion Rule ("IIR") and Undertaxed Profits Rule ("UTPR").

[166] *See* Bunn & Bray, *supra* note 10. Member states with less than twelve MNE groups can defer implementing Pillar 2 for six years.

[167] *Id.*

[168] Gravelle & Keightley, *supra* note 20, at 13.

[169] Mindy Herzfeld, *How to Think About How the US Congress Thinks about International Reforms*, 5 B.T.R. 504-505 (2022).

[170] H.R. 5376, 117th Cong. (2021).

Intangible Low-Taxed Income "GILTI") to align U.S. tax law with Pillar 2, Congress ultimately did not enact these proposals in the final version of the Inflation Reduction Act of 2022.[171] Commentators argue that GloBE's fifteen percent minimum tax actually provides Congress with the flexibility to impose tax rates that better align with the U.S.'s fiscal objectives.[172] Commentators also stressed the importance of Congress' more timely involvement in the negotiation process, greater engagement and involvement with the OECD and in future negotiations.[173] Despite the sentiment of multilateral cooperation combined with heightened international political pressure, Congress is unlikely to pass legislation that it views will curtail the U.S. economy and U.S. foreign policy objectives and will fail to advance the economic interests of domestic businesses and its constituents.[174] The Inflation Reduction Act[175] instead adopted a new corporate alternative minimum tax ("CAMT"), and the GILTI and BEAT provisions remain intact. Thus, MNEs are potentially subject to these three minimum taxes with a fourth looming on the horizon under Pillar 2.[176] It is unclear how GloBE's implementation domestically and abroad will interact and coordinate with these existing minimum tax rules. It may result in yet another spiral in an everexpanding web of complexity.

A. *Global Intangible Low-Taxed Income ("GILTI")*

As part of the Tax Cuts and Jobs Act of 2017, the U.S. implemented the taxation of global intangible low-taxed income ("GILTI") to combat profit shifting to low-tax or no-tax jurisdictions. Pursuant to GILTI, a U.S. shareholder parent of a controlled foreign corporation must include global intangible taxable income in its annual gross income for the immediate taxable year. In other words, there is no deferral of such income to a subsequent year. Because intangible assets are highly mobile, a key purpose of this legislation is to deter US MNEs from moving these assets abroad to foreign jurisdictions, and thereby shifting otherwise taxable income generated by these assets. Simply put, GILTI includes income from intangible assets (e.g., copyrights, trademarks, patents) that MNEs hold offshore.

Specifically, the amount of foreign source income characterized as GILTI is calculated as the total active income of the U.S. company's foreign affiliates in excess of 10 percent of the company's depreciable tangible property.[177] In general, a corporation (other business entities, however, are not permitted to do so) may deduct 50 percent of

[171] Inflation Reduction Act of 2022, Pub. L. No. 117-169, § 136 Stat. 1818 (2022).
[172] Sarin & Clausing, *supra* note 159.
[173] Clausing et al., *supra* note 135.
[174] Herzfeld, *supra* note 169, at 525–26.
[175] Inflation Reduction Act of 2022, *supra* note 171.
[176] Bunn & Bray, *supra* note 10.
[177] I.R.C. § 951A(b)(2)(A).

the GILTI and claim a foreign tax credit of up to 80 percent that the corporation paid or accrued in foreign taxes on this GILTI. For tax years beginning after 2025, the deduction is reduced from 50 percent to 37.5 percent. Lastly, the GILTI rules impose a 10.5 percent minimum tax (13.125 percent after 2025) on such income, and thus, increases the parent's regular income tax liability by this amount.[178] The tax on GILTI is determined on an aggregate basis (i.e., income, losses, foreign tax credits) rather than country-by-country such that MNEs can offset income in one country with losses from another country and foreign tax credits from high tax jurisdictions that exceed U.S. tax can reduce US taxes in low-tax jurisdictions.[179] Thus, GILTI is characterized by its cross-jurisdictional blending of income from various jurisdictions and the offset of income with losses.

1. GILTI versus GLOBE

There are several key aspects that differ between the GILTI and GloBE tax regimes.[180] Whereas GloBE's tax base is financial statement income (i.e., book income) on a country-by-country basis, GILTI's tax base is overall taxable income (income, losses and foreign tax credit) under U.S. tax accounting principles.[181] GloBE rules take into account timing differences between tax and financial accounting and provisions for deferred compensation (e.g., stock options).[182] GILTI's tax rate of 10.5% is currently lower than GloBE's tax rate of 15%.[183] GloBE mitigates double taxation through the steps describe above[184] in accordance with the following priority—first, the source country imposes a qualified domestic minimum top-up-tax; second, the parent company's residence country applies the income inclusion rule; or third, countries where related entities operate may deny deductions for payments or use other measures to raise taxes pursuant to the undertaxed profits rule.[185] GILTI, however, permits MNEs to apply an indirect foreign tax credit against U.S. tax subject to an 80% limitation on foreign taxes paid.[186]

According to the Biden Administration's Fiscal Year 2025 Revenue Proposals, the Administration proposed to increase taxation of U.S. MNEs' foreign source income

[178] Jane G. Gravelle, *The 15% Corporate Alternative Minimum Tax*, 9, CONGRESSIONAL RESEARCH SERV., CRS Report R47328 (Jan. 19, 2023).
[179] *Id.*
[180] Gravelle & Keightley, *supra* note 20, at 13–14.
[181] *Id.*
[182] *Id.*
[183] *Id.*
[184] *See supra* Part III. Pillar Two – GloBE, A. Mechanics: GloBE's Five Key Steps.
[185] Gravelle & Keightley, *supra* note 20, at 15.
[186] I.R.C. § 960(d); Gravelle & Keightley, *supra* note 20, at 15.

by removing the 10% carveout for depreciable assets (i.e., tangible and intangible assets are subject to tax), reducing the GILTI deduction from 50 percent to 25 percent; and requiring companies to determine their foreign tax credits on a country-by-country basis.[187] The third criteria in effect prevents companies from netting foreign tax credits for taxes paid in high tax jurisdictions against U.S. tax on income generated in low-tax jurisdictions. However, companies could claim a tax credit of 95 percent (rather than 80 percent) of foreign taxes, and thus, source country taxes of at least 15% (the global minimum tax rate) would be almost entirely creditable against residence taxes.[188]

B. *Base Erosion and Anti-Abuse Tax ("BEAT")*

A primary purpose of BEAT is to impose a minimum tax on MNEs with U.S. operations that shift profits from the U.S. to low-tax or no-tax foreign jurisdictions. BEAT imposes a minimum tax on corporations (except for regulated investment companies, real estate investment trusts and S corporations) with a base erosion percentage of at least three percent and average annual gross receipts of at least five hundred million dollars for the previous three tax years.[189] For purposes of BEAT, the taxpayer calculates its modified taxable income without considering payments made to foreign related parties and certain net operating loss carryovers.[190] First, the taxpayer determines the permissible tax deductions for certain payments it made to foreign related parties during the tax year.[191] Second, the taxpayer divides these deductions by the total deductions the taxpayer is allowed during the tax year yielding its base erosion percentage.[192] Third, the taxpayer determines its modified taxable income for this purpose without regard to permissible tax deductions for certain payments it made to foreign related parties or its net operating losses, multiplied by the base erosion percentage.[193] Finally, the taxpayer multiplies its modified taxable income by the applicable minimum tax rate and subtracts from this amount the taxpayer's regular tax liability and certain tax credits.[194]

[187] Dep't of the Treasury, *General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals* (Mar. 11, 2024), https://home.treasury.gov/system/files/131/General-Explanations-FY2025.pdf (last visited Aug. 13, 2024) [hereinafter *FY 2025 Revenue Proposals*].
[188] Avi-Yonah & Kim, *supra* note 143, at 535.
[189] I.R.C. § 59A(e)(1).
[190] *See* I.R.C. § 59A.
[191] I.R.C. § 59A(d), (c)(2).
[192] I.R.C. § 59A(c)(4)(A)-(B).
[193] I.R.C. § 59A(c)(1).
[194] For tax years beginning after 2025, the BEAT minimum tax rate increases to 12.5%. I.R.C. § 59A(b)(1), (c)(1).

C. *Corporate Alternative Minimum Tax ("CAMT") on Large Corporations*

Effective for tax years beginning after 12/31/22, certain corporations that meet relevant thresholds are subject to the new corporate alternative minimum tax. The statute's purpose is to ensure that certain large corporations pay at least some minimum Federal income tax. In general, the CAMT imposes a 15% minimum tax[195] on applicable corporations with an average applicable financial statement income ("AFSI") in excess of one billion dollars over a tax period of three years.[196] Thus, a corporation uses AFSI to determine first, whether indeed it is an "applicable corporation," and second, the minimum tax base and CAMT liability.[197] An "applicable corporation" is defined as any corporation other than an S corporation, a regulated investment company or real estate investment trust that meets (1) a general average annual AFSI test for one or more tax years prior to the current tax year and (2) ends after December 31, 2021.[198] AFSI is the taxpayer's net income or loss on its applicable financial statements with adjustments for tax policy choices and certain book-tax differences (e.g., tax depreciation, net operating losses).[199] A corporation meets the annual AFSI test for a tax year if the average annual AFSI for its three-taxable-year period (that ends with such tax year) is more than $1 billion.[200] Because of this threshold, it is estimated that the CAMT will affect only a limited number of corporate taxpayers.[201]

An applicable corporation must calculate the CAMT in addition to its regular U.S. Federal income tax and pay estimated tax on any CAMT liability. The taxpayer's tentative minimum tax generally equals 15% of its AFSI minus CAMT foreign tax credits for the year.[202] The applicable corporation must pay any CAMT liability—that is, the excess (if any) of the tentative minimum tax over the sum of the corporation's regular U.S. federal income tax[203] plus any base erosion anti-abuse tax[204] liability.[205] In other words, an applicable corporation must pay the greater of the CAMT or regular federal

195 Although the CAMT 15% tax rate is the same as GloBE's tax rate, the CAMT rules are separate and distinct from GloBE. *See* Gravelle, *supra* note 178.

196 I.R.C. §§ 55, 56A and 59(k)(1)(B)(i).

197 Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 117th Congress*, JCS-1-23, Dec. 21, 2023, at 165 [hereinafter *JCS-1-23*].

198 I.R.C. § 59(K)(1)(A); *JCS-1-23*, *supra* note 197, at 173.

199 I.R.C. § 56A(a); *JCS-1-23*, *supra* note 197, at 165, 166. Note, additional rules apply for a corporation that is part of a multinational group with a foreign parent. *See* I.R.C. § 59(K)(1)(b)(ii), (k)(2); *JCS-1-23*, *supra* note 197, at 173.

200 I.R.C. § 59(K)(1)(B)(i); *JCS-1-23*, *supra* note 197, at 174.

201 *See* Jane G. Gravelle, CONGRESSIONAL RESEARCH SERV., CRS In Focus IF12179, *The Corporate Minimum Tax Proposal* (Aug. 10, 2022).

202 I.R.C. § 55(B)(2)(A); *JCS-1-23*, *supra* note 197, at 165, 178–179.

203 I.R.C. § 55(C).

204 I.R.C. § 59(A).

205 I.R.C. § 55(); *JCS-1-23*, *supra* note 197, at 165, 179.

income tax including any base erosion anti-abuse tax. Accordingly, the taxpayer's federal income tax liability for the tax year is the total of its regular U.S. Federal income tax plus the CAMT, if any (reduced up to 75% by the general business credit).[206] An applicable corporation subject to the CAMT remains as such for subsequent years, unless certain criteria are met.[207] The CAMT also permits foreign tax credits and the taxpayer may carry forward the minimum tax as a credit against its regular tax and BEAT liabilities to future years when the CAMT does not apply.[208]

While GloBE applies a minimum tax separately on a per country basis to forestall tax havens, the CAMT imposes a minimum tax on worldwide income. Furthermore, the CAMT's tax base (adjusted financial income discussed above) used to calculate this minimum tax differs from GloBE's tax base of financial accounting income from the MNE's consolidated financial statements.

D. *Joint Committee on Taxation Revenue Estimates*

The Joint Committee on Taxation ("JCT") summarized the possible effects of countries adopting Pillar 2.[209] The JCT provided a number of scenarios that varied widely in their results. Pillar 2's adoption and implementation by a significant number of countries will most certainly impact MNEs' behavior in response to the requirements as well as their Federal income tax liability and Federal income tax receipts.[210] U.S. tax revenue collection could be affected by (1) jurisdictions taxing foreign source income that the U.S. may otherwise tax and (2) taxing U.S. source income of U.S. MNEs or U.S. subsidiaries of foreign MNEs.[211] First, the JCT presents the range of effects on federal tax receipts if Pillar 2 is enacted by Pillar 2 compliant jurisdictions.[212] The JCT estimates the implementation of Pillar 2 in Pillar 2 compliant countries over the period of 2023–2033 may result in a lower range federal tax revenue loss of $174.5 billion or an upper range federal tax revenue gain of $224.2 billion depending on the profit shifting responses by MNEs to GloBE. Second, the JCT illustrates through five different forecasting scenarios the range of effects on federal tax receipts if non-compliant jurisdictions and/or the U.S. implements Pillar 2.[213] Notably, if the rest of the world implements Pillar 2 in 2025 without the U.S., the JCT projects that the U.S. stands to

[206] I.R.C. § 38; *JCS-1-23*, *supra* note 197, at 179.
[207] I.R.C. § 59(k)(1)(C); *JCS-1-23*, *supra* note 197, at 173.
[208] *See* I.R.C. § 53.
[209] *Possible Effects of Pillar 2*, *supra* note 75, at 11–13. The document also provides a list of selected Pillar 2 enacting jurisdictions.
[210] *Id.* at 5.
[211] *Id.*
[212] *Id.* at 6–8.
[213] *Id.* at 8–10.

lose $122.0 billion in federal tax receipt revenue (predominantly because MNEs could claim larger foreign tax credits) for the period 2023–2033.[214] The U.S. revenue loss is mitigated to $56.5 billion if the U.S. and the rest of the world enacts Pillar 2 in 2025.[215] In contrast, if the rest of the world does not enact Pillar 2 (which realistically is not the case as a number of countries have already adopted or are in the process of implementing Pillar 2[216]) and the U.S. enacts Pillar 2 in 2025, the U.S. according to the JCT projections will enjoy a federal tax revenue gain of $236.5 billion.[217] Commentators have touted the JCT's projected revenue gain or projected revenue loss depending on their position in support of or in opposition to the implementation of GloBE.

E. *Proposals for Reform*

Practitioners and commentators have raised numerous concerns about the implementation of GloBE and its effects on the U.S.'s government coffers and economy. While supporters have emphasized the benefits of GloBE such as the importance of multilateral cooperation, definitive guidance for MNEs, prevention of unilateral measures (such as digital service taxes[218]) and potential increase in tax revenue, critics on the other hand have raised concerns about its complexity (including administrative feasibility and compliance costs), disproportionate impact on U.S. companies, carveouts and subsidies that allow nations to "game the system," failure to adjust the EU 750 million threshold for inflation, and potential for decline in tax revenue. A number of OECD member countries have adopted or plan to implement Pillar 2 domestically.[219] Congress, however, has yet to pass legislation to adopt the global minimum tax, and the likelihood of such legislation remains tenuous. U.S. Treasury Secretary Yellen has defended GloBE and argued that without U.S. adoption of the global minimum tax, U.S. MNEs are vulnerable to other countries that impose their top-up taxes.[220] The following discusses key issues and proposals for reform that directly impact the effect of GloBE and which politicians, academics, practitioners and the like continue to hotly debate.

---

214 *Id.* at 9–10.
215 *Id.*
216 *See id.* at 11–13.
217 *Id.* at 9–10.
218 E.g., Laura Dhillon Kane, *Canada Enacts Digital-Services Tax Amid US Reprisal Threat*, BLOOMBERG, (July 3, 2024), https://www.bloomberg.com/news/articles/2024-07-04/canada-enacts-digital-services-tax-despite-us-retaliation-threat; *Possible Effects of Pillar 2*, *supra* note 75.
219 *PwC Pillar Two Country Tracker*, https://www.pwc.com/gx/en/tax/international-tax-planning/pillar-two/pwc-pillar-two-tracker-full-data-v2.pdf (last visited July 29, 2024).
220 David Lawder, *Yellen Defends Global Corporate Minimum Tax Deal Amid Republican Criticism*, REUTERS, (Apr. 30, 2024, 7:00 AM), https://www.reuters.com/world/us/yellen-us-negotiating-rd-tax-credit-part-global-tax-deal-2024-04-30/.

1. Biden Administration's Revenue Proposals

a. Increase Corporate Tax Rates

Large businesses which are mostly publicly traded companies are generally classified as Subchapter C corporations and thus pay entity-level income tax. In general, shareholders are subject to federal income tax on distributions from the C corporation. To raise tax revenue, the Biden Administration proposes to increase the corporate tax rate from 21% to 28%[221] and the corporate alternative minimum tax rate from 15% to 21%.[222] Furthermore, the GILTI rate would increase from 10.5% to 14%, and ultimately to 21%.[223]

The Biden Administration provides its rationale behind the increase in corporate tax rate and the CAMT rate—that is, the 7% increase would raise revenue for fiscal priorities, enable the U.S. government to tax capital income from shareholder capital investments in domestic C Corporations and require foreign investors to bear a portion of the corporate tax increase.[224] A primary purpose of the CAMT is to minimize the disparity between federal taxable income and book income that large corporations report on their federal income tax returns and audited financial statements respectively.[225] The proposed CAMT rate increase aligns the CAMT with the proposed increase in corporate tax rate and GILTI tax rate.[226]

b. Revise GILTI

The Biden Administration proposes to (1) eliminate the qualified business asset investment exemption of 10% on foreign tangible property eligible for depreciation (e.g., buildings and machinery), (2) reduce a corporate U.S. shareholder's allowable deduction against its global minimum tax inclusion from 50% to 25%, (3) replace "global averaging" with a "jurisdiction-by-jurisdiction" approach to calculate GILTI, (4) reduce the disallowance of foreign tax credits incurred from 20% to 5%, (5) permit the U.S. shareholder to carryover net operating losses within a single jurisdiction, (6) allow the U.S. shareholder to carryover foreign tax credits for ten years within a single

---

[221] *FY 2025 Revenue Proposals*, *supra* note 187, at 2.
[222] *Id.* at 3.
[223] *Id.* at 2.
[224] *Id.*
[225] *Id.* at 3.
[226] *Id.*

jurisdiction[227] and (7) report information and apply failure-to-report penalties separately for each taxable unit under the jurisdiction-by-jurisdiction standard.[228]

The Biden Administration argues that current law enables global blending of income and tax whereby an MNE group can average its high-tax income from a jurisdiction against low-tax income from other jurisdictions, thereby, incentivizing U.S. companies to report their revenue in foreign jurisdictions instead of the U.S.[229] The jurisdiction-by-jurisdiction global minimum tax, however, would deter profit shifting and "help end the race to the bottom on corporate tax rates in a manner that puts the United Sates and other countries on a more level playing field."[230] Commentators also argue that until GILTI is determined on a jurisdiction-by-jurisdiction basis, it cannot effectively deter MNEs from shifting profits out of the U.S. in comparison to Pillar 2 — that is, MNEs may continue to shift profits from the U.S. to low-tax jurisdictions to avoid residual U.S. tax by reducing their aggregate foreign tax rate to equal the GILTI rate.[231] If Pillar 2 applies at the GILTI rate (or more) on a jurisdiction-by-jurisdiction basis, such profit shifting is unlikely to transpire.

c. Repeal and Replace BEAT with UTPR

The Biden Administration proposes to repeal BEAT and replace it with an undertaxed profits rule[232] that aligns with Pillar 2.[233] The UTPR would apply mainly to foreign-parented MNEs that operate in low-tax jurisdictions and have global annual revenue of € 750 million or more in at least two of the previous four years subject to *deminimis* exceptions.[234] Generally speaking, the UTPR would deny domestic group members (domestic corporations and foreign corporations' U.S. branches) U.S. tax deductions to the extent needed to collect the top-up tax of the financial reporting group calculated on a jurisdiction-by-jurisdiction basis—that is, a minimum effective tax rate of 15% in each foreign country the MNE group generates profits.[235] The MNE would then allocate the top-up amount among jurisdictions that have adopted a UTPR and in which the MNE group operates.[236]

---

[227] *Id.* at 28.
[228] *Id.* at 30.
[229] *Id.* at 25–26.
[230] *Id.* at 26.
[231] Avi-Yonah, *supra* note 138.
[232] *See supra* Part III. Pillar Two – GloBE.
[233] *FY 2025 Revenue Proposals*, *supra* note 187, at 33–36.
[234] *Id.* at 34.
[235] *Id.*
[236] *Id.*

The proposal includes a domestic minimum top-up tax that would shield U.S. revenue from another country's UTPR that may come into play.[237] In general, this top-up tax would equal the excess of 15% of the financial reporting group's U.S. profit, over the entire group's income tax paid or accrued for U.S. profits.[238]

The policy rationale indicates these changes would better align U.S. international tax rules with the emerging international tax regime under Pillar 2 (i.e., multiple jurisdictions have adopted at least some part of Pillar 2).[239] The UTPR ensures that an MNE's profits, whether U.S.-parented or foreign-parented, are subject to the minimum tax rate irrespective of where an MNE earns the income.[240] Therefore, the UTPR would prevent MNEs from avoiding the minimum tax rate simply by relocating to a foreign country that has not adopted an income inclusion rule (IIR).[241]

d. Repeal the Foreign-Derived Intangible Income Deduction

The Biden Administration proposes to repeal the deduction from foreign-derived intangible income ("FDII"), which under current law permits a domestic corporation a deduction of 37.5% on its FDII for taxable years beginning after December 31, 2017 and 21.875% for tax years beginning after December 31, 2025.[242] FDII is the domestic company's intangible income derived from foreign markets.[243] The amount of deemed intangible income that qualifies for the FDII deduction equals the domestic corporation's overall income less certain exceptions and reduced by 10% of the corporation's qualified business asset investment. FDII is then calculated as a percentage of this amount derived from the domestic company's exports.[244]

The Biden Administration's rationale suggests that FDII fails to incentivize new domestic investment in research and development, but instead places domestic producers at a disadvantage and provides tax breaks to companies with high export sales as opposed to domestic sales.[245] Furthermore, FDII combined with GILTI encourages companies to locate their plant and equipment offshore.[246] By doing so, companies can

---

[237] *Id.* at 35.
[238] *Id.*
[239] *FY 2025 revenue Proposals,* supra note 187, at 33.
[240] *Id.*
[241] *Id.*
[242] *Id.* at 37.
[243] *Id.*
[244] *Id.*
[245] *Id.*
[246] *Id.*

maximize both their tax-free return under GILTI and tax-favorable deduction under FDII.[247]

2. Harris's Tax Platform

As of the date of writing, presidential candidate Vice President Harris has not disclosed in detail her tax and spending plans and economic policy proposals making it difficult to project the effect on the U.S. deficit.[248] President Biden's most recent budget proposal provides an indicator of Vice President Harris's fiscal policy and will likely serve as a "base line" for the candidate's policy proposals.[249]

3. Trump's Tax Platform

As of the date of writing, former President Trump has not fully disclosed his tax plan, but he has highlighted a number of tax policy strategies from his economic agenda that are key to his current campaign for reelection.[250] For example, he aims to extend the expiring tax provisions (individual, estate and corporate) in the Tax Cuts and Jobs Act of 2017, reduce the corporate income tax rate from 21% to 15%,[251] levy a 10% universal tariff on all imports, increase the current tariffs imposed on Chinese goods to 60%, and exclude tips and retirees' Social Security benefits from federal income tax.[252] Supporters contend that tax reductions in tandem with tariffs will rejuvenate U.S. businesses and manufacturing, which in turn will increase employment and spur the economy.

[247] *Id.*

[248] Jim Tankersley, *Trump's Tax Plan Could Add to Debt Burden. Harris's Plan Tracks Biden's*, N.Y. Times (Aug. 9, 2024), https://www.nytimes.com/2024/08/09/business/trump-harris-taxes-economy.html.

[249] *Id.*; Nana Ama Sarfo, *Kamal Harris's Tax Policy Evolution*, TAX NOTES (Aug. 12, 2024), https://www.taxnotes.com/featured-analysis/kamala-harriss-tax-policy-evolution/2024/08/09/7kkqx; Alexander Rifaat, *Harris to Pursue 28 Percent Corporate Tax Rate*, TAX NOTES (Aug. 20, 2024), https://www.taxnotes.com/featured-news/harris-pursue-28-percent-corporate-tax-rate/2024/08/19/7l4sn; Alexander Rifaat, *Democratic Platform Under Harris Sticks to Biden's Tax Agenda*, TAX NOTES (Aug. 21, 2024), https://www.taxnotes.com/featured-news/democratic-platform-under-harris-sticks-bidens-tax-agenda/2024/08/20/7l4w2.

[250] Erica York, *et. al.*, *Trump's Tax and Tariff Ideas: Details & Analysis*, TAX FOUND. (July 10, 2024), https://taxfoundation.org/research/all/federal/donald-trump-tax-plan-2024.

[251] Andrew Duehren, *Trump Dangles New Tax Cuts, Now for a Larger Voting Group*, N.Y. Times (Aug. 8, 2024), https://www.nytimes.com/2024/08/07/business/economy/trump-tax-cuts.html.

[252] York et al., *supra.* note 250; Duehren, *supra* note 251; Tankersley, *supra* note 248.

Moreover, supporters view tariffs on foreign goods as a significant source of revenue that can serve as a means to counter a decline in tax revenue resulting from tax cuts.[253]

Commentators argue that replacing the federal income tax with tariffs would be harmful to the U.S. economy and could result in a "parade of horribles" including the loss of jobs, increase in inflation and federal deficits, a recession, global trade wars, likely destabilization of the global financial system,[254] and may threaten the broader economic benefits of a globalized economy." [255] Tariffs cannot replace the amount of income tax the government collects each tax year from individual and corporate taxpayers.[256] Indeed, tax cuts combined with tariffs would dramatically widen the income inequality gap by shifting the tax burden from the rich to the poor and middle class.[257] Lower income households tend to spend a larger share of their income on consumption of traded goods versus their wealthier counterparts.[258] Consequently, if the U.S. government maximizes tariffs, then lower to middle class taxpayers stand to lose more of their after-tax income with little to no benefits from tax cuts.[259] Moreover, a global trade war from increased tariffs could potentially undermine any economic growth.[260] Commentators predict that trading partners will in turn retaliate against the tariff increases and that the global trade wars would nullify any benefit from tax cuts, and ultimately impair the U.S. economy.[261]

4. Congressional Proposed (Retaliatory) Legislation

Members of Congress opposed to Pillar 2 have introduced legislation that would effectively neutralize foreign national laws that impose the global minimum tax rules (i.e., IIR, UTPR) on U.S. MNEs.[262] For example, H.R. 3665 Defending American Jobs and Investment Act would raise the tax rate on U.S. source income, and H.R. 4695 Unfair Tax Prevention Act would increase the tax base used to calculate the base erosion and anti-abuse tax. Some members of Congress have also encouraged foreign

---

[253] Ana Swanson et al., *Trump's Proposed Tax Cuts and Increased Tariffs Could Hurt Poorer Households*, N.Y. TIMES, (July 17, 2024), https://www.nytimes.com/2024/07/17/us/politics/trump-tax-cuts-increased-tariffs.html.

[254] Kimberly Clausing & Maurice Obstfeld, *Can Trump replace income taxes with tariffs?*, PETERSON INST. FOR INT'L ECON., (June 20, 2024),), https://www.piie.com/blogs/realtime-economics/2024/can-trump-replace-income-taxes-tariffs; *see also* York et al., *supra*. note 250.

[255] York et al., *supra*. note 250.

[256] Clausing & Obstfeld, *supra* note 254.

[257] *Id.*; Swanson et al., *supra* note 253.

[258] Swanson et al., *supra* note 254.

[259] Clausing & Obstfeld, *supra* note 254.

[260] York, *supra*. note 250.

[261] *Id.*

[262] Gravelle & Keightley, *supra* note 20, at 2; Bunn & Bray, *supra* note 10.

jurisdictions to enact their jurisdiction's own version of U.S.'s GILTI,[263] which taxes foreign-source income.

However, the presidential election now between current Vice President Harris and former President Trump will play a key role in the passage of the global minimum tax agreement under domestic law, and unless the Democratic party gains control of Congress, a political buy-in appears unlikely in the midst of strong opposition.[264]

F. *Conflicting Views*

1. Arguments in Support of GloBE

In the wake of a decline in tax revenue and a collective voice to stem the tide of BEPS, supporters of GloBE have argued for the importance of multilateral cooperation to deter profit shifting to tax havens[265] and "ensure that MNEs pay a fair share of tax wherever they operate."[266] MNEs have advantages over small businesses including a lower effective tax rate and taxing MNEs at the minimum global tax rate would lead to a "fair, efficient playing field."[267] GloBE's minimum tax requirement would reduce the rate differential between high tax jurisdictions and low tax jurisdictions[268] and facilitate the government's collection of taxes on MNEs' highly mobile corporate income.[269] Commentators argue that because countries would apply a minimum tax rate of 15% (rather than 0% or single digit tax rates in a no-tax or low-tax jurisdiction), there should be less competitive and profit shifting pressures and thereby enable governments including the U.S. with more corporate tax policy choices in tax rates (e.g., raise the U.S. corporate tax rate and GILTI rate).[270] These policy changes could result in tax revenue that funds the government's fiscal priorities and reduce other tax rates and deficits.[271]

---

[263] *See supra* Part V. U.S. Tax Implications, A. Global Intangible Low-Taxed Income ("GILTI").

[264] Emma Agyemang & Paola Tamma, *Global Tax Deal under Threat from US Politics and Fraying Consensus – G20 Finance Ministers to Discuss Ways to Save Reforms to Way Multinationals are Taxed*, FIN. TIMES, Feb. 28, 2024.

[265] *Two-Pillar Solution, supra* note 67, at 20.

[266] *See* Council Directive (EU) 2022/2523, 2022 O.J. (L 328) (on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the EU).

[267] Kimberly A. Clausing, *The Revenue Consequences of Pillar 2: Five Key Considerations*, TAX NOTES (July 24, 2023), https://www.taxnotes.com/featured-analysis/revenue-consequences-pillar-2-five-key-considerations/2023/07/21/7gz6k.

[268] Clausing et al., *supra* note 135.

[269] Council Directive (EU) 2022/2523, *supra* note 266.

[270] Clausing, *supra* note 267; Clausing et al., *supra* note 135.

[271] Clausing, *supra* note 267.

Commentators emphasize that a coordinated approach can prevent unilateral measures and trade disputes between nations and provide MNEs with definitive guidance rather than scattered legislation and conflicting interpretations among the various jurisdictions.[272] Furthermore, an MNE group's payment of U.S. tax under a tax regime that complies with GloBE's income inclusion rule is more efficient than if multiple jurisdictions imposed the undertaxed profits rule and collected the top-up tax from the MNE — that is, the difference between filing a global minimum tax return with the U.S. government versus potential multiple local filings in other jurisdictions.[273] Lastly, commentators have argued that the higher GILTI tax rate of 16.406% scheduled for 2026 and the corporate alternative minimum tax of 15% make it "less likely" that foreign jurisdictions can impose a top-up tax under the UTPR on U.S. MNEs.[274]

2. Arguments in Opposition to GloBE

GloBE is not without its many critics. Corporations and practitioners have raised concerns about its administrative complexity and compliance costs for both tax authorities and taxpayers to effectively administer and comply with the rules.[275] Commentators argue that jurisdictions may agree superficially to impose the global minimum tax, and yet to attract and retain investment, offer subsidies in the form of qualified refundable credits that circumvent the very intent of GloBE and engage in fiscal competition.[276] In other words, governments are finding alternative methods to maintain a low effective tax rate that attracts investment and spurs the economy irrespective of the global minimum tax agreement.[277] Pillar 2 provides favorable tax treatment for qualified refundable tax credits,[278] which the rules consider to be corporate

---

[272] OECD *Statement*, *supra* note 11, at 20; Clausing et al., *supra* note 135; Lauren Vella, *Top Treasury Official Argues for US to Adopt Global Minimum Tax (Correct)*, BLOOMBERG TAX (Apr. 5, 2024), https://news.bloombergtax.com/daily-tax-report-international/top-treasury-official-argues-for-us-to-adopt-global-minimum-tax.

[273] Vella, *supra* note 272.

[274] Avi-Yonah, *supra* note 124.

[275] Vella, *supra* note 272.

[276] Alan Cole, *The Fatal Flaw of Pillar Two*, TAX FOUND, (Feb. 27, 2024), https://taxfoundation.org/blog/pillar-two-flaw/; Daniel Bunn, *New Report Identifies Challenges with Global Minimum Tax Implementation in the EU*, TAX FOUND, (May 21, 2024), https://taxfoundation.org/blog/eu-global-minimum-tax-implementation-challenges/; *see also* Clausing et al., *supra* note 135.

[277] The Editorial Board, *The Global Tax Carve-out Parade; Countries Are Exploiting Treasury Secretary Janet Yellen's Scheme While U.S. Firms Pay More*, WALL ST. J. (OPINION) (Mar. 4, 2024), https://www.wsj.com/articles/janet-yellen-oecd-global-tax-carve-outs-pillar-i-pillar-ii-u-s-firms-fd058902.

[278] *PwC Pillar Two Country Tracker*, *supra* note 219, at 3 (discussing that for purposes of GloBE, the Qualified Refundable Tax Credit is considered income, and thus, the credit is included in the denominator of the effective tax rate computation and does not reduce a constituent entity's taxes in the year the entity claims the refund or credit).

income while nonrefundable tax credits could reduce the MNE's effective tax rate and cause it to run afoul of the 15% minimum tax.[279] The subsidies are included as income for purposes of Pillar 2, and therefore, ultimately enable MNEs to remain in compliance with the 15% minimum tax requirement.[280] In essence, governments can offer at least some MNEs the same low effective tax rate available prior to Pillar 2 through refundable tax credits.[281] Meanwhile, U.S. companies are at a competitive disadvantage because the U.S. primarily offers nonrefundable business tax credits[282] (e.g., research and experimentation tax credit, business credits other than business energy credits) that could potentially activate a top-up tax and significantly reduce investment in such activities to which these credits apply.[283] One commentator has argued for the OECD to remove the substance-based income exclusion carveout and the qualified refundable tax credits altogether.[284] Moreover, even if the IRS collects the GloBE information return, it appears likely that many MNEs may still have local filing requirements.[285] As tax legislation increases in complexity, it may adversely impact investment decisions and become more susceptible to lobbying and special interest groups.[286]

Commentators also criticized that GloBE's EU 750 million threshold (which identifies an MNE as in-scope of the rules) must be adjusted for inflation and automatically indexed for inflation in the future.[287] Otherwise, the number of companies subject to GloBE will disproportionately rise over time along with its significant compliance burdens.[288]

GloBE could certainly impact the behavior of the MNEs, and their response could thwart the positive effects of domestic tax policy and incentives for U.S. investment.[289] MNEs could potentially move tangible assets and earnings to countries that comply with Pillar 2 to take advantage of the carve outs, qualifying refundable credits and/or other nontax incentives offered by foreign jurisdictions.

---

[279] The Global Tax Carve-out Parade, *supra* note 277.
[280] Cole, *supra* note 276.
[281] *Id.*
[282] *Id.*
[283] Gravelle & Keightley, *supra* note 21, at 22.
[284] Avi-Yonah, *supra* note 125.
[285] Tim Shaw, *Pillar 2 Work Progressing Despite Lace of US Implementation, Treasury Official Says*, THOMSON REUTERS (Dec. 5, 2023), https://tax.thomsonreuters.com/news/pillar-2-work-progressing-despite-lack-of-us-implementation-treasury-official-says/.
[286] The Global Tax Carve-out Parade, *supra* note 278.
[287] Bunn, *supra* note 277.
[288] *Id.*
[289] Thomas Brosy, *A Primer on the OECD's Global Minimum Tax and How It Could Affect the US*, TAX POLICY CENTER (Mar. 5, 2024), https://www.taxpolicycenter.org/taxvox/primer-oecds-global-minimum-tax-and-how-it-could-affect-us.

In general, the U.S. international tax system taxes the foreign source income of U.S. taxpayers at U.S. income tax rates and prevents double taxation by allowing taxpayers to claim a tax credit for foreign taxes paid on that income subject to limitations. Commentators have suggested that if Pillar 2 deters U.S. resident corporations from shifting profits to low tax jurisdictions, then the U.S. may ultimately increase tax revenue.[290] In contrast, critics argue that controlled foreign corporations will pay higher tax rates in foreign countries because of Pillar 2, and as a result, MNEs could claim larger foreign tax credits against their U.S. taxes.[291] While Pillar 2 may reduce profit shifting and thus increase profits reported domestically, MNEs could claim larger foreign tax credits on their higher foreign taxes paid that may ultimately reduce U.S. tax revenue.[292] Moreover, nonrefundable tax credits present a risk of a top-up tax in that low effective tax rates can expose a constituent entity's income from U.S. operations to the income inclusion rule or U.S. companies' low-tax income within the U.S. to foreign undertaxed profits rules.[293] Simply converting nonrefundable tax credits to refundable tax credits may prove costly to the U.S. Treasury.[294] Thus, while Pillar 2 may provide Congress with more choices on corporate income tax rates, the flexibility comes at a price as it would also pose significant constraints on the U.S. tax base.[295]

The IRS, however, appears to indirectly address this issue in Notice 2023-80[296] in which it announced the Treasury Department and IRS's plan to release proposed treasury regulations that provide guidance on the taxpayers' application of the foreign tax credit rules[297] in conjunction with GloBE. In general, the Notice provides that a taxpayer is not permitted to claim the foreign tax credit under I.R.C. § 901 or the corporate AMT foreign tax credit under I.R.C. § 59(l) for a final top-up tax[298] if under

---

[290] Avi-Yonah, *supra* note 138.

[291] *See Possible Effects of Pillar 2*, *supra* note 75 at 2; Alan Cole, *JCT Analyzes Federal Revenue Effects of Pillar Two*, TAX FOUNDATION (June 22, 2023), https://taxfoundation.org/blog/oecd-pillar-two-revenue-effects-jct/#:~:text=The%20two%20most%20significant%20scenarios,10%20years%2C%20relative%20to%20a (last visited Aug. 15, 2024); Clausing et al., *supra* note 135.

[292] *See Possible Effects of Pillar 2*, *supra* note 75 at 2; Cole, *supra* note 291.

[293] *See* Bunn, *supra* note 76.

[294] *See id.*; *see also* Peter R. Merrill et al., *Where Credit Is Due: Treatment of Tax Credits Under Pillar 2*, TAX NOTES (Mar. 20, 2023), https://www.taxnotes.com/special-reports/credits/where-credit-due-treatment-tax-credits-under-pillar-2/2023/03/17/7g743#sec-4-1-1.

[295] Clausing et al., *supra* note 135.

[296] 2023-52 IRB 1, 1583.

[297] I.R.C. §§ 901, 903.

[298] 2023-52 IRB 1, 1583 (Notice 2023-80 defines the final top-up tax as a foreign income tax (tested tax) that "takes into account: (a) the amount of tax imposed on the direct or indirect owners of the entity subject to the tested tax by other countries (including the United States) with respect to the income subject to the tested tax, or (b) in the case of an entity subject to the tested tax on income attributable to

the foreign tax law any amount of the taxpayer's U.S. federal income tax liability is taken into account in determining the final top-up tax.[299] Although the IRS's intent for this rule may have been for taxpayers to avoid circular calculations when computing their foreign tax credits under U.S. tax law and GloBE, the rule in effect may largely prevent taxpayers from claiming foreign tax credits against their U.S. tax liability for top-up taxes that foreign jurisdictions impose as IIRs[300] (and possibly UTPRs).[301] Thus, pursuant to this guidance, GloBE could subject the foreign earned income of in-scope MNEs to tax incrementally, which arguably conflicts with the basic premise of foreign tax credits — that is, to mitigate double taxation.[302]

The question remains whether the U.S. government can reach an agreement within its own borders to achieve the delicate (and somewhat contradictory) balance of simplifying its cross-border tax rules, encouraging U.S. investment and innovation, but without relinquishing substantial control of its U.S. tax base (via foreign countries' IIR, UTPR delayed to 2026 for jurisdictions with a corporate tax rate above 20%[303]) all the while acting in compliance with GloBE's multilateral cooperation to "level the playing field." Even though Congress may not pass the global minimum tax, other countries have already adopted or are planning to implement Pillar 2, and, consequently, may impose their IIR or UTPR on U.S. earnings of MNEs with a low effective tax rate.[304] Notwithstanding the discord and political contention about adopting GloBE, perhaps Congress can reach a compromise that consolidates the multiple U.S. minimum tax rules (i.e., GILTI, BEAT, CAMT, and potentially Pillar 2) to streamline and provide companies with more certainty, the government with administrative feasibility and, of course, the much sought after tax revenue.[305]

---

its branch in the foreign country imposing the tested tax, the amount of tax imposed on the entity by its country of residence with respect to such income.").

299 *Id.*

300 *See supra* Part III. Pillar Two – GloBE, A. Mechanics: GloBE's Five Key Steps, Step 5 — Income Inclusion Rule ("IIR") and Undertaxed Profits Rule ("UTPR").

301 Kevin Glenn et al., *Global Tax Reform Alert, IRS Releases Notice 2023-80: Top Points for Taxpayers*, DLA PIPER (Dec. 13, 2023), https://www.dlapiper.com/en/insights/publications/2023/12/irs-releases-notice-2023-80.

302 *Id.*

303 Avi-Yonah, *supra* note 124.

304 Clausing et al., *supra* note 135.

305 *Id.*

VI. Conclusion

MNEs' planning strategies have shifted profits and eroded corporate tax bases worldwide and therefrom resulted in significant loss of tax revenue to affected governments.[306] As part of the OECD's response to these challenges, Pillar 2 imposes a global 15% minimum level of tax, which specifically targets the income from intangible assets.[307] GloBE's income inclusion rule negates the incentives for profit shifting, and the undertaxed profits rule and subject to tax rule offsets incentives for tax competition.[308] Nonetheless, MNEs may likely find other means to reduce their effective tax rates below 15%.[309] The question remains as to whether individual countries will continue to support GloBE as jurisdictions grapple with the rules' impact on domestic law, local constituents, and each country's ability to attract foreign investment. If the agreement falters, jurisdictions may likely revert back to an ad hoc patchwork or unilateral measures (e.g., digital taxes) to capture much needed revenue.[310] GloBE's complexity may prove difficult for MNEs and governments to implement and sustain and undoubtedly will result in administrative and compliance costs. While the ideals behind GloBE to prevent base erosion profit shifting and the multilateral agreement between more than 145 countries are monumental, without a streamlined process under domestic law the GloBE rules may place an undue burden on MNEs as they navigate through the complexity of potentially four minimum tax regimes or face the ramifications of noncompliance. Both taxpayers and national tax administrations face considerable challenges in implementing and enforcing the GloBE rules. Thus, it would not be surprising if tax revenues decline and internal pressures mount for jurisdictions to eventually breakaway from the fold. It is abundantly clear that political dynamics within each country and between countries may affect whether Pillar 2 is sustainable in the long run as inevitably MNEs and tax jurisdictions alike will incur additional administrative and compliance costs as they implement the complexities of GloBE. Let the games begin.

---

[306] Gravelle & Keightley, *supra* note 20, at 4.

[307] *Id.* at 5.

[308] Avi-Yonah & Kim, *supra* note 143, 145 (GloBE applies "corrective measures" including the income inclusion rule for residence taxation and the undertaxed profits rule (which denies a deduction) and subject to tax rule for source taxation).

[309] *See* Vella et al., *supra* note 142, at 8, 11.

[310] Clausing et al., *supra* note 135.

On Remand in *Cantero*, the Second Circuit Should Reject Bank of America's Preemption Claim and Hold That New York's Interest-on-Escrow Law Applies to National Banks

Arthur E. Wilmarth, Jr.*

Introduction

In *Cantero v. Bank of America, N.A.*,[1] the Supreme Court vacated and remanded a decision of the Second Circuit Court of Appeals.[2] Bank of America, N.A. (BofA) argued that the National Bank Act (NBA) preempted New York General Obligation Law (NYGOL) § 5-601, thereby exempting BofA from any duty to comply with § 5-601. The Second Circuit agreed with BofA's preemption claim.

NYGOL § 5-601 requires mortgage lenders operating in New York to pay at least 2% annual interest on funds deposited by borrowers in mortgage escrow accounts.[3] The New York statute is a "State consumer financial law" as defined in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[4] Under Dodd-Frank, a state consumer financial law that does not discriminate against national banks is preempted "only if" that law "prevents or significantly interferes with the exercise by the national bank of its powers."[5]

The Second Circuit decided that the NBA preempted NYGOL § 5-601 because the New York statute "would exert control over a banking power granted by the federal

---

*Professor Emeritus of Law, George Washington University Law School, Washington, DC. I would like to thank Stefan Jouret and Matt Lambert for their helpful comments on a preliminary draft of this article. I greatly appreciate the outstanding research assistance provided by Germaine Leahy, Head of Reference at GW Law School's Jacob Burns Law Library. I would also like to thank the Editors of the *Rutgers Business Law Review* for their excellent work in preparing this article for publication. I participated as counsel in drafting briefs filed by two national associations of state financial regulators – the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators – as *amici curiae* in the following cases: *Cantero v. Bank of America, N.A.*, 602 U.S. 205 (2024), *Cantero v. Bank of America, N.A.*, No. 21-400-cv (2d Cir., filed Sept. 3, 2024), and *Conti v. Citizens Bank, N.A.*, No. 22-1700 (1st Cir., filed Sept. 6, 2024). Unless otherwise indicated, this article includes developments through September 30, 2024.

[1] Cantero v. Bank of America, N.A., 602 U.S. 205 (2024) [hereinafter *Cantero*].

[2] *Cantero v. Bank of America, N.A.*, 49 F.4th 121 (2d Cir., 2022), *vacated and remanded*, 602 U.S. 205 (2024). For a detailed critique of the Second Circuit's decision, *see* Arthur E. Wilmarth, Jr., "The Second Circuit's *Cantero* Decision Is Wrong about Preemption under the National Bank Act," 41 *Banking & Financial Services Policy Report* No. 11, at 1 (Nov. 2022) [hereinafter Wilmarth, "Second Circuit's *Cantero* Decision"], https://ssrn.com/abstract=4282872.

[3] *Cantero*, 602 U.S. at 212.

[4] 12 U.S.C. § 25b(a)(2).

[5] *Id.* § 25b(b)(1)(B).

government, so it would impermissibly interfere with national banks' exercise of that power."[6] The Supreme Court vacated and remanded the Second Circuit's decision because it did not conform to "the controlling legal standard" for determining whether § 5-601 "is preempted with respect to national banks."[7] The Supreme Court held that the "controlling legal standard" for deciding cases like *Cantero* is the "prevents or significantly interferes" preemption standard established by the Supreme Court in *Barnett Bank of Marion County, N.A. v. Nelson*,[8] and codified by Congress in the Dodd-Frank Act at 12 U.S.C. § 25b(b)(1)(B).[9]

In *Barnett Bank*, the Supreme Court derived its "prevents or significantly interferes" preemption standard from conflict preemption principles.[10] In *Cantero*, the Supreme Court confirmed that conflict preemption principles govern cases arising under § 25b(b)(1)(B). The Supreme Court explained that "Dodd-Frank ruled out field preemption . . . [and] we know that not all state laws regulating national banks are preempted."[11]

The Supreme Court made clear in *Cantero* that "*Barnett Bank* did not draw a bright line" between state laws that are preempted and those that are not preempted under *Barnett Bank*'s "prevents or significantly interferes" standard.[12] Rather, *Barnett Bank* "sought to carefully account for and navigate this Court's prior [national] bank preemption cases."[13] In the following passage, the Supreme Court described the correct approach for applying *Barnett Bank*'s preemption standard in light of the Court's prior national bank preemption decisions:

> A court applying that *Barnett Bank* standard must make a practical assessment of the nature and degree of the interference caused by a state law . . . with the national bank's exercise of its powers . . . . In assessing

[6] Cantero v. Bank of America, N.A. 49 F.4th at 125. The parties in *Cantero* agreed that national banks have an express power to make real estate loans under 12 U.S.C. § 371(a), as well as an "incidental" power to provide escrow account services in connection with residential mortgage loans. *Id.* at 126.
[7] *Cantero*, 602 U.S. at 209, 213-14, 220-21.
[8] Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25 (1996) [hereinafter *Barnett Bank*].
[9] *Cantero*, 602 U.S. at 213-14; *see also id.* at 221 ("Under Dodd-Frank, as relevant here, courts may find a state law preempted 'only if,' 'in accordance with the legal standard' from *Barnett Bank*, the law 'prevents or significantly interferes with the exercise by the national bank of its powers.' § 25b(b)(1)(B).").
[10] *See Barnett Bank*, 517 U.S. at 31 ("In this case we must ask whether or not the Federal and State statutes are in 'irreconcilable conflict.'"); *id.* at 31-37 (holding that the challenged Florida statute created an impermissible conflict with 12 U.S.C. § 92).
[11] *Cantero*, 602 U.S. at 213; *see also Id.* (stating that, under Dodd-Frank, "federal banking law 'does not occupy the field in any area of State law'") (quoting 12 U.S.C. § 25b(b)(4)).
[12] *Id.* at 221; *see also id.* at 215 ("*Barnett Bank* did not purport to establish a clear line to demarcate when a state law 'significantly interfere[s] with the national bank's exercise of its powers.'").
[13] *Id.* at 221.

> the significance of a state law's interference, courts may consider the interference caused by the state laws in *Barnett Bank*, *Franklin, Anderson,* and the other precedents on which *Barnett Bank* relied. If the state law's interference with national bank powers is more akin to the interference in cases like *Franklin*, *Fidelity*, *First National Bank of San Jose*, and *Barnett Bank* itself, then the state law is preempted. If the state law's interference with national bank powers is more akin to the interference in cases like *Anderson*, *National Bank v. Commonwealth*, and *McClellan,* then the state law is not preempted.[14]

The Supreme Court also observed that "[i]n *Barnett Bank* and each of the earlier precedents, the Court reached its conclusions about the nature and degree of the state laws' alleged interference with the national banks' exercise of their powers based on the text and structure of the laws, comparison to other precedents, and common sense."[15]

The Supreme Court vacated and remanded the Second Circuit's decision because the Second Circuit "did not conduct [the] kind of nuanced comparative analysis" required by *Barnett Bank*'s "prevents or significantly interferes" preemption standard.[16] The Second Circuit erred by adopting an overbroad "categorical test," which did not consider "the magnitude of [the challenged state law's] effects."[17] The Second Circuit's "categorical test" was mistaken because it "would preempt virtually all state laws that regulate national banks, at least other than generally applicable state laws such as contract or property laws."[18] The Supreme Court explained that any such "categorical" or "bright line" test would be contrary to *Barnett Bank*'s "prevents or significantly interferes" preemption standard, which Congress "expressly incorporated" in 12 U.S.C. § 25b(b)(1)(B) when Congress passed Dodd-Frank.[19]

The Supreme Court's decision in *Cantero* requires the Second Circuit, on remand, (1) to "make a practical assessment of the nature and degree of the interference" caused by NYGOL § 5-601 with the "exercise" of national bank "powers," and (2) to perform a "nuanced comparative analysis" of the New York statute's interference consistent with the Supreme Court's evaluations of the state laws that were challenged in *Barnett Bank* and six other Supreme Court decisions identified in *Cantero*.[20] Those six decisions include

---

[14] *Id.* at 219-20.

[15] *Id.* at 220 n.3.

[16] *Id.* at 219-20; *see also id.* at 209 (The Second Circuit "did not apply [the 'prevents or significantly interferes'] standard in a manner consistent with Dodd-Frank and *Barnett Bank*"); *id.* at 221 (The Second Circuit "did not analyze preemption in a manner consistent with Dodd-Frank and *Barnett Bank*").

[17] *Id.* at 213 (quoting 49 F.4th at 131); *id.* at 220-21.

[18] *Id.* at 220-21.

[19] *Id.*

[20] *Id.* at 214-21 (quotes at 219, 220).

(a) three cases holding that state laws were preempted – *Franklin Nat'l Bank v. New York*,[21] *First Nat'l Bank of San Jose v. California*,[22] and *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*,[23] and (b) three decisions holding that state laws were not preempted – *Anderson Nat'l Bank v. Luckett*,[24] *McClellan v. Chipman*,[25] and *Nat'l Bank v. Commonwealth*.[26]

A prominent law firm has suggested that the Supreme Court's decision in *Cantero* "reject[s] . . . a preemption standard that turns on the economic magnitude of a state law's effects on national bank powers."[27] That suggestion is clearly mistaken. As shown above, the Supreme Court disavowed the Second Circuit's "categorical test" for preemption because it ignored "the magnitude of [a state law's] effects" on national banks.[28] As previously indicated, the Supreme Court instructed lower courts to apply *Barnett Bank*'s "prevents or significantly interferes" preemption standard by (i) making "a practical assessment of the nature and degree of the interference caused by a state law" with the "exercise" of national bank "powers," and (ii) performing a "nuanced comparative analysis" of that interference consistent with the Supreme Court's assessments of the interference caused by the state laws that were challenged in seven key precedents identified in *Cantero*.[29] As shown below, each of those seven decisions considered the economic, financial, and competitive effects of the challenged state law on national banks before the Supreme Court determined whether the nature and degree of the state law's interference with national bank powers justified a finding of preemption.[30]

Under 12 U.S.C. § 25b, the Office of the Comptroller of the Currency (OCC) must act on a "case-by-case" basis when it makes a preemption determination under Dodd-Frank's "prevents or significantly interferes" standard, and the OCC must support each preemption determination with "substantial evidence, made on the record of the proceeding."[31] Dodd-Frank's "case-by-case" and "substantial evidence" requirements

---

[21] Franklin Nat'l Bank v. New York, 347 U.S. 373 (1954) [hereinafter *Franklin*].

[22] First Nat'l Bank of San Jose v. California, 262 U.S. 366 (1923) [hereinafter *San Jose*].

[23] Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141 (1982) [hereinafter *Fidelity*].

[24] Anderson Nat'l Bank v. Luckett, 321 U.S. 233 (1944) [hereinafter *Anderson*].

[25] McClellan v. Chipman, 164 U.S. 347 (1896) [hereinafter *McClellan*].

[26] Nat'l Bank v. Commonwealth, 76 U.S. (9 Wall.) 353 (1870) [hereinafter *Commonwealth*).

[27] SULLIVAN & CROMWELL, U.S. SUPREME COURT MAINTAINS ABSENCE OF BRIGHT-LINE STANDARDS IN NATIONAL BANK ACT PREEMPTION 1 (2024), https://www.sullcrom.com/SullivanCromwell/_Assets/PDFs/Memos/US-Supreme-Court-Rules-National-Bank-Act-Preemption.pdf.

[28] *Cantero*, 602 U.S. 205, 213 (2024) (quoting Cantero v. Bank of Am., N.A., 49 F.4th 121, 131 (2d Cir. 2022)); *id.* at 220-21 (rejecting the Second Circuit's "categorical test" for preemption).

[29] *Id.* at 219-21.

[30] *See Cantero* Parts II-IV.

[31] 12 U.S.C. §§ 25b(b)(1)(B), (b)(3), & (c). Dodd-Frank's "case-by-case" mandate requires the OCC to consider "the impact of a particular State consumer financial law on any national bank that is subject to

are not binding on courts. However, those requirements indicate an expectation by Congress that federal authorities would perform a careful, fact-based analysis of the practical impact of a particular state law on national banks before they decide whether a state consumer financial law "prevents or significantly interferes" with the "powers" of national banks. A court's decision to preempt a state consumer financial law would be subject to reversal for "clear error" if the court refused to consider evidence regarding the magnitude of that state law's economic, financial, and competitive effects on national banks, as such evidence would be highly relevant in determining the "nature and degree" of the state law's interference with national bank powers, as *Cantero* requires.[32]

Part I of this article examines NYGOL § 5-601's legislative background and purpose and describes that statute's relatively minor economic and financial impact on national banks. Parts II, III, and IV review the Supreme Court's analysis of the economic, financial, and competitive effects of the state laws that were challenged in *Barnett Bank* and six other cases identified in *Cantero*. As shown in Part V, NYGOL § 5-601 does not prevent or significantly interfere with the exercise of national bank powers. The New York statute's relatively minor impact on the powers of national banks is much less significant than the interference caused by the state laws analyzed in the Supreme Court's seven key precedents, including three decisions that upheld state laws against preemption claims.

As discussed in Part VI, BofA could potentially argue on remand that (i) an OCC regulation, 12 C.F.R. § 34.4(a)(6), preempts NYGOL § 5-601, and (ii) a separate provision of Dodd-Frank, 12 U.S.C. § 25b(b)(1)(C), provides an alternative basis for preempting § 5-601. Part VI demonstrates that those two arguments are without merit and do not support BofA's preemption claim. Accordingly, the Second Circuit on remand should reject BofA's preemption arguments and hold that § 5-601 applies to national banks.

In addition to the Second Circuit's review of BofA's preemption challenge to NYGOL § 5-601 in *Cantero*, the First Circuit will consider a national bank's similar preemption challenge to Rhode Island's interest-on-escrow statute in *Conti v. Citizens Bank, N.A.*[33] On August 22, 2024, following remand from the Supreme Court, the Ninth

that law, or the law of any other State with substantively equivalent terms." *Id.* § 25b(b)(3)(A); *see infra* notes 241-31 and accompanying text (discussing the OCC's duty to comply with Dodd-Frank's "case-by-case" and "substantial evidence" requirements when the OCC issues preemption determinations).

[32] *Cantero*, 602 U.S. at 219-21; *see also* Concrete Pipe & Prods. of Cal., Inc. v. Constr. Laborers Pension Tr., 508 U.S. 602, 622 (1993) ("A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing [body] on the entire evidence is left with the definite and firm conviction that a mistake has been made.") (citation omitted).

[33] C.A. No. 1:21-CV-00296-MSM-PAS, 2022 WL 4535251 (D.R.I., Sept. 28, 2022), *appeal filed*, No. 22-1770 (1st Cir. Oct. 14, 2022).

Circuit reaffirmed its original decision in *Kivett v. Flagstar Bank, FSB*[34] and dismissed a preemption challenge to California's interest-on-escrow law. As shown in Part VII, the First Circuit should reject the preemption challenge to Rhode Island's statute, and the Ninth Circuit acted correctly in denying the preemption challenge to California's law.

I. NYGOL § 5-601 Is a Valid State Consumer Protection Law That Has a Relatively Minor Impact on National Banks.

A. Two District Courts Upheld § 5-601's Constitutionality after Determining that § 5-601 Serves a Valid State Purpose by Ensuring Fair Treatment for Mortgage Borrowers.

The New York legislature passed NYGOL § 5-601 in 1974. In 1975, two three-judge federal district courts upheld the validity of § 5-601 against constitutional challenges in *Jamaica Sav. Bank v. Lefkowitz*,[35] and *Federal Nat'l Mortgage Ass'n v. Lefkowitz*.[36] In *JSB*, which the Supreme Court summarily affirmed,[37] the district court rejected a state-chartered savings bank's challenges to the New York statute under the Contracts Clause and the Fourteenth Amendment's Due Process and Equal Protection Clauses. In *FNMA*, another district court dismissed similar challenges filed by the Federal National Mortgage Association (FNMA) and also denied FNMA's Supremacy Clause claim.

As the Supreme Court explained in *Cantero*, a mortgage escrow account (i) protects the lender "by ensuring that the borrower's insurance and tax bills are timely paid, thus protecting the loan collateral (the home) against tax foreclosure or uninsured damage," and (ii) "helps the borrower by simplifying expenses and budgeting."[38] On balance, the lender is the primary beneficiary of a mortgage escrow account because that account (a) protects the lender's security interest in the mortgaged property by ensuring timely payment of taxes and insurance premiums, (b) is usually part of a mortgage servicing arrangement that provides substantial fee income to the lender, and (c) enables the lender to earn "float" profits by investing the funds deposited by the borrower into the escrow account.[39]

---

[34] No. 21-15667, 2022 WL 1553266 (9th Cir., May 17, 2022), [hereinafter *Kivett I*], *vacated and remanded*, No. 22-349, 2024 WL 3901188 (U.S. June 10, 2024), *on remand*, No. 21-15667, 2024 WL 3901188 (9th Cir., Aug. 22, 2024), [hereinafter *Kivett II*]. (*Kivett I* and *Kivett II* are hereinafter collectively referred to as "*Kivett*.").

[35] 390 F. Supp. 1357, 1364 (E.D.N.Y. 1975) (three-judge court) [hereinafter *JSB*], *aff'd without opinion*, 423 U.S. 802 (1975).

[36] 390 F. Supp. 1364, 1371 (S.D.N.Y. 1975) (three-judge court) [hereinafter *FNMA*].

[37] Jamaica Sav. Bank v. Lefkowitz, 423 U.S. 802 (1975).

[38] *Cantero*, 602 U.S. at 210-11.

[39] *See* How retaining servicing provides a competitive advantage, HOUSINGWIRE (Feb. 14, 2023), https://www.housingwire.com/articles/how-retaining-servicing-provides-a-competitive-advantage/ (reporting that mortgage servicers typically earn a mortgage servicing fee of 0.25% on the principal balances of the mortgages they service); Why Lenders Are Purchasing More MSRs in 2022, PRIVOCORP

Mortgage escrow accounts operate as mandatory savings accounts for borrowers, like the plaintiffs-appellees in *Cantero*, who are obligated to make monthly deposits to prefund the lender's future payments of real estate taxes and property insurance premiums on behalf of the borrowers.[40] The Supreme Court pointed out in *Cantero* that BofA's "mortgage contracts required the borrowers to make monthly deposits into escrow accounts, which [BofA] used to pay the borrowers' property taxes and insurance premiums when those taxes and premiums came due."[41]

As the district court explained in *JSB*, the New York legislature adopted NYGOL § 5-601 to prevent mortgage lenders from generating unreasonable profits by denying borrowers any return on the amounts they deposit into their mortgage escrow accounts. The New York legislature found that most mortgage lenders did not agree to pay any interest on funds held in mortgage escrow accounts, and the legislature passed § 5-601 to ensure that borrowers would receive a reasonable return on the funds they deposited into those accounts:

> [In adopting § 5-601], the state legislature created a remedy to a problem it perceived—the inability of citizens seeking mortgages from mortgage lending institutions to bargain effectively for the use of funds put into the hands of the institutions to secure the mortgaged premises. It is uncontroverted that mortgagors could not have obtained mortgages if they had insisted upon a term in the contracts providing interest. These mortgage agreements—almost all identical—were drafted by the plaintiff [lender] and essentially were offered to potential mortgagors on a take it

(2022), https://privocorp.com/blog/why-lenders-are-purchasing-more-msrs-in-2022/ (explaining that mortgage servicing agreements allow mortgage lenders to diversify their revenues by earning fees and producing "float earnings" on balances held in mortgage escrow accounts); *see also* Hymes v. Bank of America, N.A., 408 F. Supp. 3d 171, 176 (E.D.N.Y. 2019) [hereinafter *Hymes*] ("During the period between when monthly deposits are required and taxes and insurance premiums come due, money belonging to the borrower simply accumulates in escrow. The lender may use this money to generate interest and income for itself, but the borrower has no access to it."), *rev'd sub nom.* Cantero v. Bank of America, N.A., 49 F.4th 121 (2d Cir. 2022), *vacated and remanded*, 602 U.S. 205 (2024).

[40] EECU MORTGAGE SERVICES (information provided by a federally-insured credit union in Fort Worth, TX), https://eecu.org/personal-banking/mortgage-home-equity/resource-center/general-mortgage/understanding-escrow-accounts ("Think of an escrow account as a savings account for your property taxes and insurance."); Dawn Papandrea, What is Escrow?, U.S. NEWS (Dec. 20, 2023), https://money.usnews.com/loans/mortgages/articles/what-is-escrow (reporting that a mortgage escrow account is "basically a savings account," according to David Carey, vice president of Tompkins Mahopac Bank in Brewster, NY); *See* 12 C.F.R. § 330.7(d) (providing that mortgage escrow balances are protected by federal deposit insurance if they are deposited in FDIC-insured banks).

[41] *Cantero*, 602 U.S. at 212.

> or leave it basis. The state legislature properly exercised its power to correct an imbalance in the bargaining relationship.[42]

Thus, § 5-601 was designed "to require that mortgage lending institutions share with their mortgagors the profits which are realized from the investment of monies held by the institutions."[43] After conducting an extensive investigation, the New York legislature "concluded that mortgage lenders could 'well afford to pay' at least two percent interest on escrow accounts."[44] The plaintiff savings bank in *JSB* "offer[ed] no evidence to rebut this finding."[45]

Based on § 5-601's valid legislative purpose to ensure fair treatment of mortgage borrowers, the district court in *JSB* rejected the plaintiff savings bank's challenges under the Contract Clause and the Fourteenth Amendment's Due Process and Equal Protection Clauses. The court held that mortgage lenders "are constitutionally entitled to no more than payment in full" of the principal and interest due on their mortgages together with any contractually-required fees.[46] The court pointed out that mortgage escrow funds (i) are not part of the required payment of mortgage principal and interest, and (ii) are held by mortgage lenders in an agency-like capacity to fund subsequent payments of real estate taxes and home insurance premiums on behalf of the borrowers.[47]

The court held in *JSB* that the plaintiff savings bank could not prevail on its constitutional claims unless "it could prove that to pay the [required] interest to mortgagors it would have to dip into its own general funds if the profits from the escrow accounts could not cover the required payments."[48] The savings bank did not satisfy that burden of proof because it failed to show that it would suffer any loss on its mortgage escrow accounts after paying the interest required by § 5-601.[49]

---

[42] *JSB*, 390 F. Supp. at 1362; *see also Hymes*, 408 F. Supp. 3d at 176 ("By the 1970s, some lenders had begun to exploit . . . mortgage escrow accounts by requiring borrowers to deposit vastly more money than their tax and insurance liabilities demanded. *See* S. Rep. No. 93-866, 1974 U.S.C.C.A.N. 6546, 6548. These lenders could then invest this money for their own benefit, effectively giving themselves an interest-free loan for however long the mortgage escrow account remained in place. [¶] In 1974, Congress and the State of New York responded with consumer protection legislation aimed at curbing different aspects [of] this practice.").

[43] *JSB*, 390 F. Supp. at 1363.

[44] *Id.*

[45] *Id.*

[46] *Id.* at 1363 (quoting Gelfert v. Nat'l City Bank, 313 U.S. 221, 233 (1941)).

[47] *Id.*; *see also id.* (explaining that borrowers paid mortgage escrow funds "to the bank for the specific purpose of paying a third party, either the taxing authority or the insurance company, [and] the money was never intended to belong to the mortgage institution for its benefit").

[48] *Id.*

[49] *Id.* ("The fact that the plaintiff might currently be losing money on its mortgage loans as a whole sheds no light on the escrow account problem. We are concerned only with the profits and losses

In *FNMA*, the court adopted the reasoning of *JSB* in dismissing FNMA's constitutional challenges to NYGOL § 5-601 under the Contract Clause and the Fourteenth Amendment's Equal Protection Clause.[50] The court in *FNMA* also rejected FNMA's constitutional challenge under the Supremacy Clause. FNMA alleged, based on its status as a "federal instrumentality," that the Supremacy Clause exempted it from paying the interest required by § 5-601.[51]

The court agreed that FNMA was a "federal instrumentality" because "FNMA performs a significant governmental function in its secondary mortgage market operations, [and] the federal government has an extensive interest and involvement in mortgage market assistance."[52] However, the court dismissed FNMA's Supremacy Clause claim because § 5-601 did not impose an impermissible "burden" on FNMA. In determining that § 5-601 did not impose "such a burden on the performance of FNMA's function as to invalidate the statute," the court found that the "closest analogy" to FNMA's claim was the preemption claim rejected by the Supreme Court in *Anderson Nat'l Bank v. Luckett*, discussed below in Part IV.A.[53]

The district court in *FNMA* pointed out that, "[a]s in *Anderson*, the state law at issue here does not discriminate against FNMA as a federal mortgage lending institution [and] there is nothing in [the New York statute] which explicitly conflicts with either a federal statute or regulation."[54] The district court also concluded that the "insignificant" burdens imposed on FNMA by § 5-601 did not violate the Supremacy Clause. In reaching that conclusion, the court explained that § 5-601 regulates

> funds which are kept by FNMA for the ultimate benefit of the original homeowner-mortgagor. The purpose of prepaying certain insurance and tax expenses is not to provide FNMA with income but rather to protect the mortgagees' interest in the mortgaged property. [Section 5-601] in no way impairs this purpose. It is also significant that the statute does not regulate how FNMA must keep or invest the escrow funds in its possession. Thus, there is no attempt by the state to interfere directly with the internal management of the corporation.[55]

---

realized specifically from the investment of escrow funds. We find that no such showing [of losses] has been made.").

[50] *FNMA*, 390 F. Supp. at 1367.

[51] *Id.* at 1367-68.

[52] *Id.* at 1368.

[53] *Id.*

[54] *Id.* at 1369 (discussing *Anderson*).

[55] *Id.*

Accordingly, the district court rejected FNMA's claim that § 5-601 imposed an "undue economic burden on the operation and administration of FNMA."[56] The court held that "although the burden [on FNMA] may be somewhat greater than that found in *Anderson*, [§ 5-601] is not so burdensome as to violate the Supremacy Clause."[57]

As shown in Part I.B, NYGOL § 5-601 has a relatively minor impact on national banks and other mortgage lenders doing business in New York.[58] As discussed in Parts IV.A and V, the nature and degree of § 5-601's interference with national banks' power to administer mortgage escrow accounts are much less substantial than the burden imposed on national banks by the Kentucky statute upheld in *Anderson*. In *Anderson*, the Kentucky statute required national and state banks to transfer custody of long-dormant deposits to state authorities. Kentucky's statute did not escheat long-dormant deposits to the state without proof of abandonment. However, as described in Part IV.A, Kentucky's law prevented banks from retaining custody of long-dormant deposits and deprived banks of the opportunity to earn additional profits from investing those deposits.

In contrast to the Kentucky statute upheld in *Anderson*, NYGOL § 5-601 requires mortgage lenders only to "share with [borrowers] the profits which are realized from the investment of monies held" in mortgage escrow accounts by paying at least 2% annual interest on those funds.[59] Unlike that Kentucky law, § 5-601 does not deprive mortgage lenders of control over their customers' funds held in mortgage escrow accounts, and § 5-601 allows lenders to retain all profits derived from investing those funds that exceed the statute's required interest payments.[60]

B. The District Court Determined in *Hymes* That § 5-601 Places a "Minimal" Burden on National Banks and Does Not Conflict with any Federal Statute Governing Mortgage Escrow Accounts.

In *Hymes v. Bank of America, N.A.*,[61] which the Second Circuit reversed in *Cantero*, the district court found that NYGOL § 5-601's "degree of interference" with BofA's power to administer mortgage escrow accounts was "minimal."[62] The district court pointed out that § 5-601 "does not bar the creation of mortgage escrow accounts, or

[56] *Id.*
[57] *Id.*
[58] *See supra* notes 43-49, 54-56 and accompanying text.
[59] *JSB*, 390 F. Supp. at 1363.
[60] *See supra* notes 42-45, 55, *infra* notes 62-65 and accompanying text.
[61] Hymes v. Bank of Am., N.A, 408 F. Supp. 3d 171 (E.D.N.Y. 2019) [hereinafter *Hymes*], *rev'd sub nom. Cantero v. Bank of Am., N.A.*, 49 F.4th 121 (2d Cir. 2022), *vacated and remanded*, 602 U.S. 205 (2024).
[62] *Id.* at 195.

subject them to state visitorial control, or otherwise limit the terms of their use."[63] Complying with § 5-601 "will cost [BofA] money" by requiring BofA to pay a "modest" rate of interest on funds held in mortgage escrow accounts.[64] However, the statute allows BofA to administer mortgage escrow accounts in a manner that is "relatively unimpaired and unhampered by the state law."[65]

As discussed below in Part V, BofA has not shown that the 2% annual interest payment required by § 5-601 would prevent national banks from earning profits on the mortgage escrow accounts they administer. Like the plaintiff savings bank in *JSB*, 390 F. Supp. at 1363, BofA has failed to demonstrate that it would suffer net losses from administering its escrow accounts in compliance with § 5-601. In contrast, a state interest-on-escrow law could become vulnerable to a preemption claim if it required mortgage lenders to pay a much higher interest rate on mortgage escrow balances. As the district court explained in *Hymes*, "[a] state escrow interest law 'setting punitively high rates' on mortgage escrow accounts could very well significantly interfere with national banks' power to administer escrow accounts."[66]

In determining whether § 5-601 significantly impaired the "power" of national banks to administer escrow accounts, the district court in *Hymes* pointed out that the New York statute was consistent with § 1639d(g)(3) of the Truth in Lending Act, as amended by Dodd-Frank.[67] Under § 1639d(g)(3), mortgage lenders must pay interest on funds held in escrow accounts for certain types of mortgages specified in § 1639d(b) – including mortgages that are insured or guaranteed by federal or state agencies – in accordance with "applicable State or Federal law."[68]

Section 1639d(g)(3) does not apply to the mortgages at issue in *Hymes* and *Cantero*. However, the district court found that "Section 1639(d)(g)(3) represents Congress's judgment that mortgage lenders can comply with reasonable state escrow interest laws."[69] Accordingly, the district court concluded that NYGOL § 5-601 did not

---

[63] *Id.*
[64] *Id.* at, 185-86, 195.
[65] *Id.* at 195-96.
[66] *Id.* at, 196 (quoting *Lusnak v. Bank of America, N.A.*, 883 F.3d 1185, 1195 n.7 (9th Cir. 2018), *cert. denied*, 139 S. Ct. 567 (2018)) [hereinafter *Lusnak*]).
[67] 15 U.S.C. § 1639d(g)(3).
[68] *Id.* §§ 1639d(b), (g)(3).
[69] *Hymes*, 408 F. Supp. 3d 171, 198 (E.D.N.Y. 2019); *see also id.* at 196 ("[S]ection 1639d(g)(3) evinces a policy judgment that there is little incompatibility between requiring mortgage lenders to maintain escrow accounts and requiring them to pay a reasonable rate of interest on sums thereby received."); *see also Lusnak*, 883 F.3d at 1194-96 (The "language" and "legislative history" of § 1639d(g)(3) indicate "Congress's view that [state interest-on-escrow] laws would not necessarily prevent or significantly interfere with a national bank's operations," and "creditors, including large corporate banks like Bank of America, can comply with state escrow interest laws without any significant interference with their

create a forbidden "obstacle" to the accomplishment of Congress' purposes expressed in the NBA and other federal statutes – including § 1639d(g)(3) – governing mortgage escrow accounts administered by national banks.[70]

In *Cantero*,[71] the Second Circuit reversed the district court's decision in *Hymes*. The Second Circuit did not agree with the district court's view that the 2% annual interest payment specified in NYGOL § 5-601 was "modest."[72] In addition, the Second Circuit concluded that the NBA preempted § 5-601 regardless of the actual economic, financial, and competitive impact of § 5-601 on national banks.[73] In the Second Circuit's view, "the question is not whether a law's 'degree of interference is minimal,' . . . or 'punitively high'."[74] Instead, the dispositive issue for the Second Circuit was whether the state law "purports to 'control' the [national bank's] exercise of its powers."[75] The Second Circuit emphasized that "[c]ontrol is not a question of the 'degree' of the state law's effects on national banks," and it therefore was not necessary "to assess whether the degree of the state law's impact on national banks would be sufficient to undermine that power."[76]

Thus, in the Second Circuit's view, there was no need to consider § 5-601's economic, financial, and competitive effects on national banks. The Second Circuit promulgated a blanket rule invalidating any state law that "would exert control over a banking power granted by the federal government" because such a law, by its very nature, "would impermissibly interfere with national banks' exercise of that power."[77] The Second Circuit emphasized that its blanket rule would override any state law that is

---

banking powers."). In contrast to the district court in *Hymes* and the Ninth Circuit in *Lusnak*, the Second Circuit declared in *Cantero*, 49 F.4th at 137, that § 1639d(g)(3) "has no relevance to this case" because it did not govern the mortgages involved in *Hymes* and *Cantero*.

[70] *Hymes*, 408 F. Supp. 3d at 198.; 15 U.S.C. § 1639d(g)(3).

[71] *Cantero v. Bank of America, N.A.*, 49 F.4th 121 (2d Cir. 2022), *vacated and remanded*, 602 S. Ct. 205 (2024).

[72] *Id.* at 134 n.8 ("If we were to consider the magnitude of the minimum rate New York has prescribed, we could not endorse the district court's unexplained conclusion that this rate was 'modest.' *Hymes*, 408 F. Supp. 3d at 185. Plaintiffs have not pleaded facts showing that 2% is in fact a 'modest' rate of interest in this context, and indeed, Plaintiffs have offered no response to BOA's contention that this rate is far higher than the prevailing interest rates for the time period at issue."). However, as shown *infra* at notes 202-17 and accompanying text, FDIC-insured depository institutions have produced average yields on earning assets during the past 15 years that were well above § 5-601's required 2% annual interest rate. Thus, there is no indication that national banks would suffer a net loss from administering mortgage escrow accounts if they complied with § 5-601.

[73] *Cantero*, 49 F.4th at 131, 135 ("[T]he question is not how much a state law impacts a national bank, but rather whether it purports to 'control' the exercise of its powers.").

[74] *Id.* at 132-33 (citations omitted); *see also id.* at 134 ("The issue is not whether [New York's] particular rate of 2% is so high that it undermines the use of [escrow] accounts, or even if it substantially impacts national banks' competitiveness.").

[75] *Id.* at 131.

[76] *Id.* at 131, 132.

[77] *Id.* at 125, 132-134.

"usurping control over federally granted powers to a federally created entity," even if that law was not "intrusive in degree" and would not "practically abrogate[] the power."[78]

C. The Supreme Court's Decision in *Cantero* Requires the Second Circuit to Make a "Practical Assessment of the Nature and Degree" of § 5-601's "Interference" with National Bank "Powers," and to Compare § 5-601 with the State Laws Evaluated in Seven Previous Supreme Court Cases.

The Supreme Court vacated and remanded the Second Circuit's decision in *Cantero*.[79] As discussed above, the Supreme Court rejected the Second Circuit's "categorical test" for preemption because it did not conform to the "controlling legal standard" established by *Barnett Bank* and codified by Dodd-Frank.[80] The Supreme Court held that the Second Circuit should apply the governing "prevents or significantly interferes" preemption standard (i) by making a "practical assessment of the nature and degree of the interference caused by a state law" with the "exercise" of national bank "powers," and (ii) by performing a "nuanced comparative analysis" of that interference consistent with the Supreme Court's assessments of the state laws that were challenged in *Barnett Bank* and six other Supreme Court decisions identified in *Cantero*.[81]

As shown in Parts I.B and V, NYGOL § 5-601 has a relatively minor impact on the exercise of national bank powers. As discussed in Parts II-V, § 5-601's interference with the exercise of national bank powers is far less substantial than the nature and degree of interference caused by the state laws that were challenged in seven key Supreme Court decisions – including three state laws that were upheld against preemption claims. Accordingly, the Second Circuit on remand should dismiss BofA's preemption claim and hold that § 5-601 applies to national banks.

II. The Supreme Court's Evaluation of the Florida Statute Preempted in *Barnett Bank*

In *Barnett Bank*, the Supreme Court held that a federal statute (12 U.S.C. § 92) preempted a Florida law. Florida's law prohibited national and state banks from exercising their authority under § 92 to sell insurance as agents from small-town offices

---

[78] *Id.* at 137.

[79] *Cantero*, 602 U.S. at 205.

[80] *Id.* at 209, 213-4, 220-21; *see also supra* note 7-8, 16-19 and accompanying text (discussing the Supreme Court's rejection of the Second Circuit's "categorical test" for preemption and the Supreme Court's confirmation that *Barnett Bank*'s "prevents or significantly interferes" test provides the "controlling legal standard").

[81] *Id.* at 219-21; *see supra* notes 12-26 and accompanying text (discussing the Supreme Court's instructions to the Second Circuit on remand).

located in Florida if the banks were subsidiaries of bank holding companies.[82] Applying conflict preemption principles, the Court held that the dispositive question was "whether or not the Federal and State Statutes are in 'irreconcilable conflict.'"[83] The Court pointed out that "the Federal Statute authorizes national banks to engage in activities that the State Statute expressly forbids," a situation that would "ordinarily" result in preemption unless "the Federal Statute grants banks a permission that is limited to circumstances where state law is not to the contrary."[84] The Court held that § 92 preempted Florida's statute because § 92 "does not condition federal permission [for national banks' exercise of their power to sell insurance] upon that of the State."[85]

Florida's statute severely limited the power to sell insurance that § 92 granted to national banks, as Florida's law prohibited all banks that were subsidiaries of bank holding companies from either acting as or controlling insurance agents in Florida.[86] When *Barnett Bank* was decided in March 1996, more than 75% of U.S. commercial banks were subsidiaries of bank holding companies,[87] and "nearly all U.S. banking assets" were controlled by bank holding companies.[88] Consequently, the restriction imposed by Florida's statute on insurance sales by banks amounted to a near-total prohibition against national banks' exercise of their power to sell insurance in Florida from small-town offices under § 92.

As the Supreme Court explained, the legislative history of § 92 indicated a congressional understanding that "providing small town national banks with authority

---

[82] *Barnett Bank*, 517 U.S. at 28-29 (Under 12 U.S.C. § 92, national banks that are "located and doing business" in towns of 5,000 or less may sell insurance as agents for insurance companies licensed by the relevant state authorities. In 1986, the OCC issued an interpretive letter allowing national banks to sell insurance from branches located in small towns under § 92). *See infra* note 90 and accompanying text. The challenged Florida statute prohibited banks (including national banks) from either acting as or controlling insurance agents in Florida if they were "a subsidiary or affiliate of a bank holding company." *Barnett Bank*, 517 U.S. at 29 (quoting Fla. Stat. § 626.988(2)).

[83] *Barnett Bank*, 517 U.S. at 31.

[84] *Id.* at 31-32.

[85] *Id.* at 34-35.

[86] *Id.* at 29; *see also* Brief for the Petitioner, *Barnett Bank*, *supra* note 8, (No. 93-1837), 1995 WL 668010 (U.S., Nov. 9, 1995), at *9 (stating that Florida's statute "forbids any national bank affiliated with a bank holding company from exercising the authority granted by Section 92 to sell insurance from a small-town branch") [hereinafter Petitioner's Brief in *Barnett Bank*].

[87] *Bank Holding Companies* (Bd. of Governors of the Fed. Res. Sys.) ("Bank Ownership by BHCs December 1980 to December 2012" chart, showing that 76.7% of U.S. commercial banks were owned by bank holding companies in December 1995), https://www.fedpartnership.gov/bank-life-cycle/manage-transition/bank-holding-companies.

[88] Dafna Avraham, et al., "A Structural View of U.S. Bank Holding Companies," FED. RES. BANK OF NY ECONOMIC POLICY REVIEW, July 2012, at 65 (quote), 66 (Chart 1, Panel A), https://www.newyorkfed.org/medialibrary/media/research/epr/12v18n2/1207avra.pdf.

to sell insurance would help them financially."[89] In 1986, the OCC issued an interpretive letter stating that § 92 authorized national banks to sell insurance as agents on a nationwide basis from branches located in small towns. The OCC's letter determined that allowing "small-town branches to sell insurance" would "enhance [national] banks' revenues, diversify their business without creating any threat to their solvency, and increase competition."[90]

Thus, the challenged Florida statute in *Barnett Bank* prohibited most national banks operating in Florida from taking advantage of the economic and financial opportunities offered by 12 U.S.C. § 92. Florida's statute had a negative competitive impact on national banks by preventing most national banks from "competing with insurance agencies."[91] Florida's statute therefore had very significant and highly adverse economic, financial, and competitive effects on national banks doing business in Florida.

III. The Supreme Court's Assessments of State Laws That Were Preempted in Three Other Key Decisions.

A. *Franklin Nat'l Bank v. New York*

The Supreme Court held in *Franklin* that federal banking laws preempted a New York statute. The New York law prohibited commercial banks, including national banks, from using the words "saving" or "savings" in advertising for savings deposits.[92] The Supreme Court determined that New York's statute created a "clear conflict" with provisions of the Federal Reserve Act (FRA) and the NBA.[93] The FRA expressly authorized national banks "to receive time and savings deposits,"[94] and the NBA empowered national banks "to receive deposits without qualification or limitation."[95]

The Supreme Court recognized that national banks "depend upon their success in attracting private deposits."[96] The Court found that New York's law significantly interfered with the express authority of national banks to accept savings deposits as well as their "incidental" power under the NBA to advertise their deposit services.[97] The

[89] *Barnett Bank*, *supra* note 8, at 35.
[90] *NBD Bank, N.A. v. Bennett*, 67 F.3d 629, 632 (7th Cir. 1995) (summarizing the OCC's 1986 interpretive letter); *see also Barnett Bank*, *supra* note 8, at 37 (citing the OCC's 1986 letter).
[91] Petitioner's Brief in *Barnett Bank*, *supra* note 86, at *7-*9, *12 (quote), *15-*21; *see also* Petitioner's Reply Brief, *Barnett Bank*, *supra* note 8, (No. 94-1837) 1995 WL 763730 (U.S., Dec. 28, 1995), at *11, *9 (contending that Florida's statute was an "anti-competitive" law designed to exclude large national banks "from the ranks of those who may sell insurance in Florida").
[92] *Franklin, supra* note 21, at 374-75 n.1, 378.
[93] *Id.* at 375-78 (quote at 378).
[94] *Id.* at 375-76 (quoting 44 Stat. 1232-33 (1927) (codified as amended at 12 U.S.C. § 371 (1952))).
[95] *Id.* at 376 (citing 12 U.S.C. § 24 (Seventh)).
[96] *Id.* at 375.
[97] *Id.* at 375-78 (discussing 12 U.S.C. § 24 (Seventh)).

Supreme Court observed that "[m]odern competition for business finds advertising one of the most usual and useful of weapons," and there was no indication that Congress intended to "preclude the use [by national banks] of advertising in any branch of their authorized business."[98] The Court concluded that national banks "must be deemed to have the right to advertise [their savings deposits] by using the commonly understood description which Congress has specifically selected."[99]

The Supreme Court pointed out that federal statutes granting deposit-taking powers to national banks were part of a broader federal policy to ensure that national banks were "at no disadvantage in competition with state-created institutions."[100] New York's law undermined that policy by restricting the ability of national banks to compete for savings deposits with New York state-chartered savings institutions. New York's statute intentionally discriminated against national banks (and state-chartered commercial banks) in favor of state-chartered savings institutions by allowing only the latter institutions to use the terms "saving" or "savings" in advertising their savings accounts.[101]

The New York state trial court in *Franklin* found that New York's law created a "violent conflict" with the FRA's provision authorizing national banks to accept savings deposits.[102] To support that finding, the New York trial court cited extensive testimony and a public poll, which showed that "the public understands the meaning of the term 'savings account' . . . far better than it understands the meaning of any of the substitute terms" that the New York law allowed national banks to use in advertising their savings accounts, such as "special interest account" or "thrift account."[103] The trial court found that the New York statute's extensive restrictions on advertising imposed a "crippling obstruction" that severely impaired the ability of national banks to attract savings deposits.[104] The trial court also determined that accepting savings deposits was "a necessary part" of the "banking business" conducted by national banks.[105] Accordingly, the trial court concluded that New York's law caused an "*impairment* of [Franklin National Bank's] banking business" by "*restrict[ing]* it 'tremendously' . . . in obtaining 'savings deposits'."[106]

---

[98] *Id.* at 377.
[99] *Id.* at 378.
[100] *Id.* at 375.
[101] *Id.* at 374, 374-75 n.1.
[102] *People v. Franklin Nat'l Bank*, 200 Misc. 557, 568-69, 105 N.Y. Supp. 2d 81, 92-93 (1951), *rev'd*, 281 App. Div. 757, 118 N.Y. Supp. 2d 210, *aff'd*, 305 N.Y. 453, 113 N.E.2d 796 (1953), *rev'd*, 347 U.S. 373 (1954).
[103] *Id.*, 200 Misc. at 561-66, 105 N.Y Supp. 2d at 86-90.
[104] *Id.*, 200 Misc. at 570-71, 105 N.Y. Supp. 2d at 94-95.
[105] *Id.* at 571, 105 N.Y. Supp. 2d at 95.
[106] *Id.*

Two New York state appellate courts disagreed with the trial court's decision. Both courts held that New York's statute did not "unduly" interfere with the power of national banks to accept savings deposits.[107] However, the appellate courts acknowledged that New York's law imposed an "advertising handicap" on national banks,[108] and that Franklin National Bank offered evidence showing that it was "seriously inconvenient" to attract savings deposits without using the words "saving" or "savings" in its advertising.[109]

The U.S. Supreme Court overturned the decisions of both New York appellate courts. The Supreme Court agreed with the New York trial court's conclusion that New York's statute created an impermissible "conflict" with federal banking laws.[110] While the Supreme Court did not refer specifically to the New York trial court's detailed findings of fact, the Supreme Court agreed with the trial court that national banks "depend upon their success in attracting private deposits" and, therefore, "must be deemed to have the right to advertise [their savings deposits] by using the commonly understood description that Congress has specifically selected."[111] The trial court's findings of fact demonstrated that New York's discriminatory statute imposed severe economic, financial, and competitive harms on national banks by (i) significantly interfering with their power to solicit and accept savings deposits and (ii) placing them at a severe disadvantage to New York state-chartered savings institutions in competing for savings deposits.

B. *First Nat'l Bank of San Jose v. California*

In *San Jose*, the Supreme Court held that the NBA preempted a California law. The California statute required all bank deposits that remained inactive for more than twenty years to be escheated to the state. California's law mandated the escheat of those inactive deposits based on "mere dormancy," without any notice or opportunity for hearing, and without "proof that the forfeited accounts had been in fact abandoned."[112] The Supreme Court held in *San Jose* that California's escheat law "directly impair[ed]" and "interfere[d]" with the "plainly granted powers" of national banks to solicit and

---

[107] *People v. Franklin Nat'l Bank*, 281 App. Div. 757, 758, 118 N.Y. Supp. 2d 210, 214, *aff'd*, 305 N.Y. 453, 461, 113 N.E.2d 796, 799 (1953), *rev'd*, 347 U.S. 373 (1954).

[108] *Id.*, 281 App. Div. at 758, 118 N.Y. Supp. 2d at 214.

[109] *Id.*, 305 N.Y. at 461, 113 N.E.2d at 799.

[110] *Franklin*, 347 U.S. at 376-77 (citing the New York trial court's finding of a "conflict" between the challenged New York law and federal banking statutes); I*d.* at 378 (finding a "clear conflict between the law of New York and the law of the Federal Government").

[111] *Id.* at 375, 378; *accord, People v. Franklin Nat'l Bank*, 200 Misc. at 571, 105 N.Y.S.2d at 94 ("[R]eceiving 'savings deposits' is a necessary part of defendant's banking business," and New York's law "*restricts* it 'tremendously' . . . in obtaining 'savings deposits.'").

[112] *Anderson*, 321 U.S. at 250, 251 (discussing the California escheat statute that was preempted in *San Jose*); *see also San Jose*, 262 U.S. at 366-70 (same).

accept deposits.[113] The Court determined that California's escheat statute created an impermissible "conflict" with the NBA by attempting "to qualify in an unusual way agreements between national banks and their customers."[114]

As the Supreme Court subsequently explained in *Anderson*, the California statute's "unusual alteration of depositors' accounts" in *San Jose* was tantamount to a threatened "confiscation" of those accounts.[115] The Court observed in *Anderson* that California's law "alter[ed] the contracts of deposit in a manner considered so unusual and so harsh in its application to depositors as to deter them from placing or keeping their funds in national banks."[116]

Thus, the Supreme Court based its finding of preemption in *San Jose* on its determination that California's escheat law created "an effective deterrent to depositors' placing their funds in national banks doing business within the state,"[117] thereby undermining the "plainly granted powers" of national banks to solicit and accept deposits.[118] Like New York's savings deposit law in *Franklin*, California's escheat statute in *San Jose* imposed severe economic, financial, and competitive harms on national banks by significantly impairing their power to accept deposits. The Court emphasized in *San Jose* that "[t]he success of almost all commercial banks depends upon their ability to obtain loans from depositors," and that ability was severely undermined by California's "unusual" decision to "dissolve contracts of deposit . . . after 20 years" of dormancy.[119]

C. *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*

In *Fidelity*, the Supreme Court held that a regulation issued by the Federal Home Loan Bank Board (FHLBB) preempted a California judicial rule. California's judicial rule severely restricted the ability of mortgage lenders, including federal savings associations, to enforce due-on-sale clauses in their mortgages. Due-on-sale clauses permit a mortgage lender "to declare the entire balance of a loan immediately due and payable if the property securing the loan is sold or otherwise transferred."[120]

In 1976, the FHLBB issued a regulation that granted federal savings associations "unrestricted" authority to enforce due-on-sale clauses. *Fidelity*, 458 U.S. at 146-47, 169 n.22. The FHLBB issued the regulation after determining that state laws limiting the enforcement of due-on-sale clauses endangered "the financial security and stability" of

---

[113] *San Jose*, 262 U.S. at 369-70.
[114] *Id.*
[115] *Anderson*, 321 U.S. at 251.
[116] *Id.* at 250.
[117] *Id.* at 250-51 (discussing *San Jose*).
[118] *Id.* at 250 (quoting *San Jose*, 262 U.S. at 370).
[119] *San Jose*, 262 U.S. at 369-70.
[120] *Fidelity*, 458 U.S. at 145.

federal savings associations by (i) "caus[ing] a substantial reduction of the cash flow and net income of Federal associations" and (ii) "impair[ing] the ability of Federal associations to sell their home loans in the secondary mortgage market."[121]

In 1978, the California Supreme Court adopted a judicial rule, known as the "*Wellenkamp* doctrine," which allowed due-on-sale clauses to be enforced only when "the lender can demonstrate that enforcement is reasonably necessary to protect against impairment to its security or the risk of default."[122] The U.S. Supreme Court held in *Fidelity* that the *Wellenkamp* doctrine was preempted because it created an "actual conflict" with the FHLBB's regulation.[123]

As the Supreme Court explained, "California courts have forbidden a federal savings and loan to enforce a due-on-sale clause solely 'at its option' and have deprived the lender of the 'flexibility' given it by the [FHLBB]."[124] The *Wellenkamp* doctrine "confine[s] a federal association's right to accelerate a loan to cases where the lender's security is impaired," and it "explicitly bars a federal savings and loan from exercising a due-on-sale clause to adjust a long-term mortgage's interest rate towards current market rates"[125] Consequently, the *Wellenkamp* doctrine severely limited "the availability of an option the [FHLBB] considers essential to the economic soundness of the thrift industry."[126]

Given the direct conflict between California's judicial rule and the FHLBB's regulation, the dispositive question in *Fidelity* was "whether the [FHLBB] acted within its statutory authority in issuing the pre-emptive due-on-sale regulation."[127] The Supreme Court held that the Home Owners' Loan Act (HOLA) "invested the [FHLBB] with broad authority to regulate federal savings and loans so as to effect the statute's purposes, and plainly indicated that the [FHLBB] need not feel bound by existing state law."[128] HOLA empowered the FHLBB "to ensure that [federal savings associations] would remain financially sound institutions able to supply financing for home construction and purchase," and the FHLBB's "due-on-sale regulation was promulgated with these purposes in mind."[129] Accordingly, the FHBB "reasonably exercised the

[121] *Id.* at 146 (quoting the FHLBB's 1976 regulation).
[122] *Id.* at 149 (quoting *Wellenkamp v. Bank of America*, 582 P.2d 970, 977 (1978)).
[123] *Id.* at 154-59, 159 n.14 (quote).
[124] *Id.* at 155.
[125] *Id.* at 156.
[126] *Id.*
[127] *Id.* at 159.
[128] *Id.* at 162; *see also id.* at 160 (stating that HOLA "gave the [FHLBB] plenary authority to issue regulations governing federal savings and loans").
[129] *Id.* at 168.

authority, given it by Congress, so as to ensure the financial stability" of federal savings associations.[130]

The savings and loan industry confronted a severe nationwide crisis when the Supreme Court decided *Fidelity*. During the 1980s, most savings and loans struggled to earn profits, and hundreds of them failed, because (i) they were forced to pay significantly higher interest rates on their deposits after the Federal Reserve raised interest rates to fight inflation, and (ii) most of their earnings came from 30-year, fixed-rate residential mortgages with relatively low interest rates.[131] The FHLBB identified the use of due-on-sale clauses as "one of the few contractual tools available to [federal savings] associations . . . to remain financially viable."[132] The Supreme Court assigned significant weight to the FHLBB's determination that "due-on-sale clauses are essential to the financial soundness of federal savings and loans," and the Court pointed out that "preservation of the associations' very existence . . . is one of the functions delegated to the [FHLBB] by Congress."[133] The Supreme Court held that California's judicial rule was preempted because it had extremely adverse economic and financial effects on federal savings associations and threatened their survival by severely limiting their ability to exercise their "essential" power of enforcing due-on-sale clauses.[134]

The Supreme Court applied conflict preemption principles in deciding *Fidelity*, and the Court did not determine whether HOLA created a regime of field preemption.[135] In 1996, the Office of Thrift Supervision (OTS) – the FHLBB's successor agency – issued a regulation declaring that HOLA provided the OTS with field preemption authority over the real estate lending activities of federal savings associations.[136] The Second, and Ninth Circuits subsequently upheld the OTS's assertion of field preemption

---

[130] *Id.* at 170.

[131] *See* Brief for Federal Home Loan Bank Board as Amicus Curiae Supporting Appellants, Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141 (1982)(No. 81-750), 1981 WL 389659 at *9 ("The combination of spiraling interest rates, which increase the cost to savings and loan associations of acquiring money, and the existence of fixed, long-term loan commitments at lower interest rates has placed the entire federal savings and loan system in a precarious financial situation.") [hereinafter FHLBB Amicus Brief in *Fidelity*]; Fed. Deposit Ins. Corp., 1 *History of the Eighties – Lessons for the Future* 167-88 (1997) (providing an overview of the savings and loan crisis of the 1980s), https://www.fdic.gov/resources/publications/history-eighties/volume-1/history-80s-volume-1-part1-04.pdf (last visited Nov. 22, 2024).

[132] FHLBB Amicus Brief in *Fidelity*, *supra* note 131, at *9.

[133] *Fidelity*, 458 U.S. at 170 n.23.

[134] *Id.* at 154-56, 168-70.

[135] *Id.* at 158-59, 159 n.14.

[136] *McShannock v. JPMorgan Chase Bank NA*, 976 F.3d 881, 887-90 (9th Cir. 2020) (discussing the OTS's adoption of 12 C.F.R. § 560.2 in 1996); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L 893, 910 (2011) (same) [hereinafter Wilmarth, "Dodd-Frank"], https://ssrn.com/abstract=1891970.

authority under HOLA.[137] The Second and Ninth Circuits also held that the OTS's regulation preempted the application to federal savings associations of New York's and California's interest-on-escrow laws.[138]

The foregoing decisions of the Second and Ninth Circuit do not have any continuing precedential force following Dodd-Frank's enactment in 2010. Dodd-Frank abolished the OTS and transferred the OTS's regulatory authorities over federal saving associations to the OCC.[139] Congress decided to abolish the OTS after reviewing the agency's abysmal record of regulatory and supervisory failures during the subprime mortgage lending debacle that led to the global financial crisis of 2007-09.[140]

Dodd-Frank established the same preemption rules for federal savings associations under HOLA as the preemption rules governing national banks under the NBA.[141] Under Dodd-Frank, the preemption rules for both federal savings associations and national banks are based on principles of conflict preemption, not field preemption.[142] Additionally, *Barnett Bank*'s "prevents or significantly interferes" preemption standard governs the application of state consumer financial laws to both federal savings associations and national banks.[143]

---

[137] *Flagg v. Yonkers Sav. & Loan Ass'n*, 396 F.3d 178, 182-84 (2d Cir.), *cert. denied*, 546 U.S. 817 (2005); *Silvas v. E*Trade Mortgage Corp.*, 514 F.3d 1001, 1004-05 (9th Cir. 2008); *McShannock*, 976 F.3d at 887-90, 894-95.

[138] *Flagg*, 396 F.3d at 181-84; *McShannock*, 976 F.3d at 885 n.3, 887 n.4, 888-90, 894-95.

[139] 12 U.S.C. §§ 5411-13.

[140] H.R. REP. NO. 111-517 (Conf. Rep.) at 866 (2010), *as reprinted in* U.S.C.C.A.N. 722, 723; S. REP. NO. 111-176, at 16-17, 25-26, 65-66 (2010); *see also* Wilmarth, "Dodd-Frank," *supra* note 136, at 896-98, 901-19, 930 (discussing the OTS's regulatory and supervisory failures that caused Congress to abolish the OTS and transfer the OTS's authorities over federal savings associations to the OCC); U.S. Financial Crisis Inquiry Comm'n, *The Financial Crisis Inquiry Report* at 13, 96-97, 112-13, 173-74, 178, 274, 304-07, 346, 350-52 (Jan. 27, 2011) (criticizing the OTS's regulatory and supervisory failures) [hereinafter FCIC Report], available at https://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

[141] 12 U.S.C. §§ 25b, 1465; *see also* S. REP. NO. 111-176, at 176 (2010) (Dodd-Frank "amends [HOLA] to clarify that State law preemption standards for Federal savings associations and their subsidiaries shall be made in accordance with the standards applicable to national banks.").

[142] 12 U.S.C. §§ 25b(b)(4), 1465(b); *see also Cantero*, 602 U.S. at 213 ("Dodd-Frank ruled out field preemption [for national banks] . . . [and] we know that not all state laws regulating national banks are preempted.").

[143] 12 U.S.C. §§ 25b(b)(1)(B), 1465(a); *see also Cantero*, 602 U.S. at 221 ("Under Dodd-Frank, as relevant here, courts may find a state law preempted 'only if,' 'in accordance with the legal standard' from *Barnett Bank*, the law 'prevents or significantly interferes with the exercise by the national bank of its powers.' § 25b(b)(1)(B).").

IV. The Supreme Court's Evaluations of State Laws That Were Upheld Against Preemption Claims in Three Key Decisions.

A. *Anderson Nat'l Bank v. Luckett*

In *Anderson*, the Supreme Court rejected a national bank's preemption challenge to a Kentucky statute. The Kentucky law required banks to transfer to state authorities deposit accounts that remained dormant (inactive) for ten years (for demand deposits) or twenty-five years (for other types of deposits). Kentucky's statute provided owners of transferred deposits with notice and an opportunity for hearing, and their transferred deposits could not be escheated to the state unless state authorities proved in subsequent judicial proceedings that the deposits had been abandoned. A national bank alleged that Kentucky's statute violated the due process rights of the bank and its depositors and "infringe[d] the national banking laws, . . . which authorize national banks to accept deposits and to do a banking business."[144]

The national bank's preemption claim in *Anderson* relied heavily on *San Jose*.[145] The national bank argued that "if the [Kentucky statute] is sustained, it will open the door to the exercise of unlimited state discretionary power over the deposits in national banks."[146] The bank also maintained that Kentucky's statute unlawfully "interferes with the National Banks' custody of the funds which have been deposited with it [sic]."[147] The bank emphasized the adverse impact of the Kentucky law in divesting national banks of their control over dormant deposits, thereby preventing national banks from investing those deposits in government securities and loans:

> Every dollar of deposit, the custody of which is taken away from the National Banks and vested in the State, reduces, *pro tanto*, the National Banks' ability to buy Government Bonds, or to lend money to borrowers in the prosecution of its Federally authorized business of banking. That certainly interferes with the National Bank's conduct of its business. 'Dormant' deposits are the very ones that can most safely be invested in U. S. Bonds.
>
> To carry out the mandate of the Kentucky Act, National Banks must, *pro tanto*, reduce their cash on hand, or call loans, or sell securities, to enable them to comply annually with the Act.[148]

---

[144] *Anderson*, 321 U.S. at 239-40 (summarizing arguments made by the national bank's counsel).

[145] Brief in Behalf of Anderson Nat'l Bank in *Anderson Nat'l Bank v. Reeves*, 1944 WL 42454, at *1, *26-*29 (U.S., Jan. 18, 1944) [hereinafter Anderson Nat'l Bank Brief].

[146] *Anderson*, 321 U.S. at 249 (summarizing the national bank's argument); *see also* Anderson Nat'l Bank Brief, *supra* note 145, at *20.

[147] Anderson Nat'l Bank Brief, *supra* note 145, at *18.

[148] *Id.*

The Supreme Court rejected the national bank's constitutional challenges to the Kentucky statute in *Anderson*. The Court determined that Kentucky's law "does not deprive [the bank] or its depositors of property without due process of law" and did not create an impermissible conflict with the NBA.[149] The Court pointed out that Kentucky's law "does not discriminate against national banks," as it applied equally to national and state banks.[150] In addition, Kentucky's law did not "infringe or interfere with any authorized function of the [national] bank."[151]

Citing several of its previous decisions, the Supreme Court affirmed that "national banks are subject to state laws, unless those laws infringe the national banking laws or impose an undue burden on the performance of the bank's functions."[152] As the Court explained, "[t]he mere fact that the depositor's account is in a national bank does not render it immune to attachment by the creditors of the depositor, as authorized by state law." A bank deposit is "a part of the mass of property within the state whose transfer and devolution is [sic] subject to state control. . . . It has never been suggested that non-discriminatory laws of this type are so burdensome as to be inapplicable to the accounts of depositors in national banks."[153]

The Supreme Court observed that "escheat or appropriation by the state of property in fact abandoned or without an owner is . . . as old as the common law itself."[154] The Kentucky statute went beyond traditional escheat laws by providing for state custody of dormant bank accounts that had not yet been shown to be abandoned and subject to escheat. However, the Supreme Court found that "the protective custody of long inactive bank accounts for which the Kentucky statute provides . . . in many circumstances may operate for the benefit and security of depositors."[155] The Supreme Court cited a previous decision affirming the authority of states "to protect the interests of depositors from the risks which attend long neglected accounts, by taking them into custody when they have been inactive so long as to be presumptively abandoned."[156]

The Supreme Court determined that Kentucky's reasonable and nondiscriminatory statute did not create any "danger of unlimited control by the state

[149] *Anderson*, 321 U.S. at 247.
[150] *Id.* at 252-253.
[151] *Id.* at 249; *see also id.* at 247-48 ("Nor do we find any word in the national banking laws which expressly or by implication conflicts with the provisions of the Kentucky statutes.").
[152] *Id.* at 248.
[153] *Id.* (citations omitted).
[154] *Id.* at 251.
[155] *Id.* at 252.
[156] *Id.* at 241 (citing *Provident Instit. for Sav. v. Malone*, 221 U.S. 660, 664 (1911)).

over the operations of national banking institutions."[157] The Court explained that its previous decision in *San Jose* was based "on the effect of the [California] statute in altering the contracts of deposit in a manner considered so unusual and so harsh in its application to depositors as to deter them from placing or keeping their funds in national banks."[158] In contrast to California's statute in *San Jose*, which mandated escheat to the state of bank deposits upon "mere proof of dormancy," Kentucky's law required state officials to establish "proof of abandonment" in judicial proceedings after giving notice to the affected banks and depositors.[159]

After examining the Kentucky statute's procedural protections, the Supreme Court concluded that Kentucky's law would not "deter [depositors] from placing their funds in national banks" to any greater degree than other nondiscriminatory state laws that "apply to depositors in national banks," such as state laws governing attachments by creditors, the administration of decedents' estates, and the disposition of missing persons' property.[160] Accordingly, the Kentucky statute caused "no denial of constitutional right and no unlawful encroachment on the rights and privileges of national banks."[161]

B. *McClellan v. Chipman*

In *McClellan*, the Supreme Court rejected a national bank's preemption claim against a Massachusetts law, which prohibited insolvent debtors from making preferential transfers of assets to favored creditors. The national bank argued that the Massachusetts statute would "tend to impair the operations" of national banks by interfering with the banks' express powers to make contracts and accept transfers of real property, either as security for debts previously contracted or in satisfaction of those debts.[162] The bank contended that the Massachusetts law undermined the "stability" of national banks by obstructing their ability to "take additional security for an existing debt," via transfers of real property, "whenever necessary for the protection of [the banks'] property and assets."[163]

The Supreme Court rejected the national bank's preemption claim, finding that it "amounts to the assertion that national banks in virtue of the act of Congress are entirely removed, as to all of their contracts, from any and every control by the state

[157] *Id.* at 249.
[158] *Id.* at 250.
[159] *Id.* at 250, 252.
[160] *Id.* at 252.
[161] *Id.*
[162] *McClellan*, 164 U.S. at 350-56 (summarizing argument of the national bank's counsel) (quote at 350) (citing Rev. Stat. §§ 5136 & 5137 (codified as amended at 12 U.S.C. §§ 24 (Third) & 29)).
[163] *Id.* at 352-53 (summarizing argument of the national bank's counsel).

law."[164] The Court held that the express powers of national banks to make contracts and accept transfers of real estate were subject to the "general and undiscriminating" provisions of the Massachusetts law.[165] The Supreme Court explained that its prior decisions established

> a rule and an exception, the rule being the operation of general state laws upon the dealings and contracts of national banks, the exception being the cessation of the operation of such laws whenever they expressly conflict with the laws of the United States or frustrate the purpose for which the national banks were created, or impair their efficiency to discharge the duties imposed on them by the law of the United States.[166]

Based on the foregoing "rule," the Supreme Court overruled the national bank's claim that "in every case where a national bank is empowered to make a contract, such contract is not subject to the state law."[167] The Court determined that there was "no conflict between the special power conferred by Congress upon national banks to take real estate for certain purposes, and the general and undiscriminating law of the State of Massachusetts subjecting the taking of real estate to certain restrictions, in order to prevent preferences in case of insolvency."[168] The Court dismissed the national bank's argument that the Massachusetts law would have adverse economic and financial effects on national banks, and the Court concluded that

> [n]o function of [national] banks is destroyed or hampered by allowing the banks to exercise the power to take real estate, provided only they do so under the same conditions and restrictions to which all the other citizens of the State are subjected, one of which . . . in case of insolvency seeks to forbid preferences between creditors.[169]

C. *National Bank v. Commonwealth*

In *Commonwealth* – decided six years after the NBA's enactment – the Supreme Court upheld a Kentucky law, which required national and state banks to pay Kentucky's tax on bank shares on behalf of their shareholders. The Supreme Court observed that "[i]t has been the practice of many of the States for a long time to require of its

---

164 *Id.* at 358-59.
165 *Id.* at 358-61 (quote at 361).
166 *Id.* at 356-57.
167 *Id.* at 358.
168 *Id.* at 361; *see also id.* at 358 (finding "no express conflict between the grant of power by the United States to take real estate for previous debts, and the provisions of the Massachusetts law" providing that "the taking of real estate, as a security for an antecedent debt, . . . cannot be done under particular and exceptional circumstances").
169 *Id.* at 358.

corporations, thus to pay the tax levied on their shareholders."[170] The Court pointed out that Kentucky "could undoubtedly collect [its bank shares tax] by legal proceeding, in which the bank could be attached or garnisheed, and made to pay the debt out of the means of its shareholder under its control."[171] Accordingly, Kentucky's law requiring a national bank to pay the bank shares tax owed by its shareholders created "no greater interference with the functions of the [national] bank than any other legal proceeding to which its business operations may subject it."[172]

The plaintiff in error, a national bank, argued that Kentucky's statute was "in substance and in fact, a tax upon the operations of the bank itself."[173] The national bank also contended that Kentucky's law unlawfully compelled the bank to as a "State servant" in performing the "burdensome duty" of collecting Kentucky's bank shares tax from its shareholders "[w]ithout remuneration."[174] Additionally, Kentucky's statute imposed "penalties of a grave and serious character" on the national bank and its officers if they failed to collect Kentucky's tax from its shareholders.[175] Citing *McCulloch v. Maryland*,[176] the national bank argued that national banks, "being instrumentalities of the federal government, by which some of its most important operations are conducted, cannot be submitted to such State legislation."[177]

Commonwealth rejected the national bank's attempt to rely on *McCulloch*. The Supreme Court explained in *Commonwealth* that the "principle" established in *McCulloch*

> has its foundation in the proposition, that the right of taxation may be so used in such cases as to destroy the instrumentalities by which the [federal] government proposes to effect its lawful purposes in the States, *and it certainly cannot be maintained that banks or other corporations or instrumentalities of the [federal] government are to be wholly withdrawn from the operation of State legislation*.[178]

The Court clarified in *Commonwealth* that, under *McCulloch*, national banks and other "agencies of the Federal government are only exempted from State legislation, so far as

[170] *Commonwealth*, 76 U.S. (9 Wall.) at 361.
[171] *Id.* at 362.
[172] *Id.* at 362-63.
[173] *Commonwealth*, 1869 U.S. LEXIS 972, at ***7 (summarizing argument of the national bank's counsel).
[174] *Id.* at ***8, ***9 (same).
[175] *Id.* at ***9 (same).
[176] 17 U.S. (4 Wheat.) 316 (1819) [hereinafter *McCulloch*].
[177] *Commonwealth*, 76 U.S. (9 Wall.) at 361 (summarizing argument of the national bank's counsel); *see also Commonwealth*, 1869 U.S. LEXIS 972, at ***7 (same).
[178] *Commonwealth*, 76 U.S. (9 Wall.) at 361 (emphasis added).

that legislation may interfere with, or impair their efficiency in performing the functions by which they are designed to serve the government."[179]

Commonwealth rejected any broader rule of immunity for national banks from state laws because a broader rule would "convert a principle founded alone in the necessity of securing to the government of the United States the means of exercising its legitimate powers, into an unauthorized and unjustifiable invasion of the rights of the States."[180] The Court defined the NBA's limited scope of preemption in the following passage, which affirmed that national banks

> are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. All their contracts are governed and construed by State laws. Their acquisition

[179] *Id.* at 362. In *Cantero*, the Second Circuit cited *McCulloch* as the primary authority supporting its blanket preemption rule. 49 F.4th at 125, 131-36. As discussed above, the Supreme Court rejected the Second Circuit's "categorical test" for preemption because it did not conform to the "prevents or significantly interferes" preemption standard established by *Barnett Bank* and codified in 12 U.S.C. § 25b(b)(1)(B). *Cantero*, 602 U.S. at 209, 213-14, 219-21; *see also supra* notes 7-26 and accompanying text (discussing the Supreme Court's rejection of the Second Circuit's blanket preemption rule). The Supreme Court did not expressly state in *Cantero* whether *McCulloch* has any continuing relevance to the determination of preemption issues under *Barnett Bank*'s "prevents or significantly interferes" standard. However, the Supreme Court's decision in *Cantero* suggests that *McCulloch* does not have any such relevance because the Supreme Court did not include *McCulloch* among the seven key Supreme Court decisions that courts should consult in applying the "prevents or significantly interferes" standard. *See* 602 U.S. at 214-21.

As I have previously shown, the Supreme Court's decision in *Osborn v. Bank of the United States*, 22 U.S. (9 Wheat.) 738 (1824), makes clear that the broad preemptive immunity granted to the Second Bank of the United States in *McCulloch* and *Osborn* does not apply to modern national banks. Since the enactment of the FRA in 1913, the Federal Reserve has performed all monetary and central banking functions for the nation and has acted as the federal government's fiscal and financing agent. The FRA terminated the public functions that national banks previously performed for the federal government under the NBA as enacted in 1864 (namely, issuing a national currency in the form of national bank notes and purchasing bonds to help finance the federal government's operations). Today's national banks are privately-owned, for-profit corporations and do not perform any public functions for the federal government that are not performed on equal terms by FDIC-insured state banks. Accordingly, today's national banks do not qualify for the broad preemptive immunity provided by *McCulloch* and *Osborn* to the Second Bank of the United States. Wilmarth, "Second Circuit's *Cantero* Decision," *supra* note 2, at 11-15; *see also* Roderick M. Hills, Jr., *Exorcising* McCulloch: *The Conflict-Ridden History of American Banking Nationalism and Dodd-Frank Preemption*, 161 U. PA. L. REV. 1235, 1272-73 (2013) ("Nationally chartered banks [today] do not have a relationship with the federal government remotely resembling that which the Second Bank [of the United States] had. The federal government does not appoint their directors, own their stock, or even review their federal charters according to any predictable standards."); *id.* at 1289-90 (concluding that the preemption standard adopted by the Supreme Court in *Barnett Bank*, and codified by Congress in 12 U.S.C. § 25b(b)(1)(B), "unambiguously rejects . . . broad *McCulloch*-style preemption" of state laws regulating the activities of modern national banks).
[180] *Commonwealth*, 76 U.S. (9 Wall.) at 362.

> and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law. *It is only when the State law incapacitates the banks from discharging their duties to the [federal] government that it becomes unconstitutional.*[181]

The Court concluded that the NBA did not preempt Kentucky's statute because the state law "in no manner hinders [the national bank] from performing all the duties of financial agent of the [federal] government."[182]

In *Atherton v. FDIC*,[183] the Supreme Court – in an opinion written by Justice Breyer, the author of *Barnett Bank* – reiterated the Court's core holdings in *Commonwealth*. *Atherton* pointed out that *Commonwealth* "distinguished *McCulloch* by recalling that Maryland's taxes were 'used . . . to destroy'" the Second Bank of the United States.[184] *Atherton* quoted in full the passage from *Commonwealth*, reproduced above, which recognized the general applicability of state laws to national banks.[185] Based on *Commonwealth* and several subsequent Supreme Court decisions (including *Anderson*), the Court in *Atherton* reaffirmed that "federally chartered banks are subject to state law."[186]

V. A Comparison of NYGOL § 5-601 With the State Laws Evaluated in Seven Key Supreme Court Decisions Demonstrates That § 5-601 Does Not Prevent or Significantly Interfere With the Exercise of National Bank Powers.

The Supreme Court's decision in *Cantero* directed the Second Circuit to perform a "nuanced comparative analysis" of the "nature and degree of [NYGOL § 5-601's] interference" with the "powers" of national banks, consistent with the Supreme Court's assessments of the state laws that were challenged in *Barnett Bank* and six other Supreme Court decisions.[187] As shown below, the comparative analysis called for by *Cantero* reveals that the nature and degree of § 5-601's interference with national bank powers are far less significant than any of the state laws analyzed in those seven decisions. Accordingly, § 5-601 does not prevent or significantly interfere with the exercise of national bank powers and is not preempted under 12 U.S.C. § 25b(b)(1)(B).

Like the state laws upheld against preemption claims in *Anderson*, *McClellan*, and *Commonwealth*, NYGOL § 5-601 does not discriminate against national banks and treats

---

[181] *Id.* (emphasis added).
[182] *Id.* at 363.
[183] Atherton v. FDIC, 519 U.S. 213 (1997) [hereinafter *Atherton*].
[184] *Id.* at 222.
[185] *Id.* at 222-23 (quoting *Commonwealth*, 76 U.S. (9 Wall.) at 362).
[186] *Id.* at 222.
[187] *Cantero*, 602 U.S. at 219-20.

all mortgage lenders equally. Section 5-601's lawful purpose to ensure fair treatment for borrowers is comparable to the legitimate goals of the state laws upheld in *Anderson*, *McClellan*, and *Commonwealth*. As previously discussed, each of those state laws fulfilled a valid state objective – protecting long-dormant deposits in *Anderson*, preventing insolvent creditors from giving preferences to favored creditors in *McClellan*, and collecting a lawful state tax owed by bank shareholders in *Commonwealth*. In addition, those state laws did not significantly impair the ability of national banks to exercise their federally-granted powers.[188]

BofA has failed to demonstrate that NYGOL § 5-601 significantly interferes with the exercise of national bank powers. As the district court determined in *Hymes*, § 5-601 places a "minimal" burden on national banks and other mortgage lenders by requiring them to pay a "modest" rate of interest on their mortgage escrow accounts.[189] The New York statute does not otherwise restrict the terms and conditions of mortgage escrow accounts or affect their administration. The statute does not deprive national banks and other mortgage lenders of control over their borrowers' escrowed funds, and it allows national banks and other mortgage lenders to retain all profits from investing escrowed funds that exceed the statute's required 2% annual interest payment.[190] Section 5-601 does not conflict with any federal statute, and its policy is consistent with 15 U.S.C. § 1639d(g)(3), which requires mortgage lenders for certain types of mortgages to pay interest on customer balances in mortgage escrow accounts in accordance with "applicable" state laws.[191]

As the district court explained in *JSB*, the New York legislature passed NYGOL § 5-601 after conducting an extensive investigation, which showed that mortgage lenders could "'well afford to pay' at least two percent interest on escrow accounts" out of the profits they earned from investing their borrowers' funds held in those accounts.[192] The New York legislature adopted § 5-601 to ensure fair treatment of mortgage borrowers by providing them with a reasonable return on their funds held in escrow accounts, thereby "correct[ing] an imbalance in the bargaining relationship" between mortgage lenders and borrowers.[193]

---

[188] *See supra* Part IV (discussing *Anderson*, *McClellan*, and *Commonwealth*).

[189] *Hymes*, 408 F. Supp. 3d at 195; *see also supra* Part I.B (discussing *Hymes*).

[190] *See supra* Parts I.A & I.B (describing NYGOL § 5-601's terms, purpose, and relatively minor impact on national banks and other mortgage lenders).

[191] *See supra* notes 67-70 and accompanying text (discussing § 1639d(g)(3)).

[192] *JSB*, 390 F. Supp. at 1363.

[193] *Id.* at 1362-63.

NYGOL § 5-601 represents a valid exercise of New York's unquestioned authority to protect consumers.[194] The New York statute requires mortgage lenders to pay a modest and reasonable interest rate on balances that borrowers must maintain in their mortgage escrow accounts, which operate as mandatory savings accounts.[195] The statute's purpose of providing a fair return on borrowers' funds is justified by the significant benefits that lenders receive from mortgage escrow accounts, including greater protection for their security interests in mortgaged properties, the opportunity to earn mortgage servicing fees, and the ability to earn additional profits from investing customer balances in those accounts.[196]

The Second and Ninth Circuits have held that "consumer protection law is a field traditionally regulated by the states, [and] compelling evidence of an intention to preempt [by Congress] is required in this area."[197] The First Circuit similarly recognized that the fields of "banking" and "consumer protection" fall "squarely within the ambit of the states' historic powers," and "any preemption provision [affecting those state powers] must be construed cautiously and with due regard for state sovereignty."[198] In adopting Dodd-Frank, Congress expressed a strong policy in favor of applying state consumer protection laws to national banks. Under 12 U.S.C. § 25b(b)(1)(B), a state consumer financial law is preempted "only if" a court or the OCC determines that the state law "prevents or significantly interferes with the exercise by the national bank of its powers."[199]

NYGOL § 5-601 is also consistent with 15 U.S.C. § 1639d(g)(3), a consumer protection statute that Dodd-Frank amended. Under § 1639d(g)(3), as discussed above, lenders must pay interest on borrowers' funds held in mortgage escrow accounts in accordance with "applicable" state laws for the types of mortgages specified in § 1639d(b). While § 1639d(g)(3) does not apply to the mortgages of plaintiffs-appellees in *Cantero*, that statute reflects Congress's judgment that "creditors, including large corporate banks like Bank of America, can comply with state escrow interest laws without any significant interference with their banking powers."[200]

---

[194] *See New York State Telecommunications Ass'n v. James*, 101 F.4th 135, 148 (2d Cir. 2024) (affirming that "consumer protection law is a field traditionally regulated by the states") [hereinafter *James*].

[195] *See supra* notes 40-47 and accompanying text (explaining that mortgage escrow accounts function as mandatory savings accounts for borrowers, and the New York legislature enacted § 5-601 to provide borrowers a fair return on the amounts they must deposit into those accounts).

[196] *See supra* notes 38-39 and accompanying text (discussing the benefits lenders receive from mortgage escrow accounts).

[197] *James*, 101 F.3d at 148 (quoting *General Motors Corp. v. Abrams*, 897 F.2d 34, 41-42 (2d Cir. 1990)); *Lusnak*, 883 F.3d at 1191 (same).

[198] *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 828 (1st Cir. 1992), *cert. denied*, 506 U.S. 1052 (1993) [hereinafter *Greenwood Trust*].

[199] *See Cantero*, 602 U.S. at 221 (quoting § 25b(b)(1)(B)).

[200] *Lusnak,* 883 F.3d at 1196.

Like the plaintiff savings bank in *JSB*, BofA has not shown that § 5-601 would prevent national banks from earning profits on the mortgage escrow accounts they administer.[201] During the past 15 calendar years, FDIC-insured depository institutions produced average annual yields on earning assets of 5.43% (2023),[202] 3.50% (2022),[203] 2.71% (2021),[204] 3.24% (2020),[205] 4.33% (2019),[206] 4.16% (2018),[207] 3.73% (2017),[208]

[201] *JSB*, 390 F. Supp. at 1363 (explaining that the district court's decision was based on "the profits and losses realized specifically from the investment of escrow funds," and the plaintiff savings bank "offer[ed] no evidence to rebut" the New York legislature's finding that mortgage lenders could "well afford to pay" the 2% annual interest required by § 5-601 out of their profits from investing such funds).

[202] FED. DEPOSIT INS. CORP., 18 *FDIC Quarterly* No. 1, 10 (Tbl. III-A) (2024), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2024-vol18-1/fdic-v18n1-4q2023.pdf.

[203] FED. DEPOSIT INS. CORP., 17 *FDIC Quarterly* No. 1, 10 (Tbl. III-A)(2023), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2023-vol17-1/fdic-v17n1-4q2022.pdf.

[204] FED. DEPOSIT INS. CORP., 16 *FDIC Quarterly* No. 1, 6 (Tbl. III-A), (2022), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2022-vol16-1/fdic-v16n1-4q2021.pdf.

[205] FED. DEPOSIT INS. CORP., 15 *FDIC Quarterly* No. 1, 6 (Tbl. III-A), (2021), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2021-vol15-1/fdic-v15n1-4q2020.pdfhttps://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2021-vol15-2/fdic-v15n2-1q2021.pdf.

[206] FED. DEPOSIT INS. CORP., 14 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2020),https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2020-vol14-1/fdic-v14n1-4q2019.pdf.

[207] FED. DEPOSIT INS. CORP., 13 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2019), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2019-vol13-1/fdic-v13n1-4q2018.pdf.

[208] FED. DEPOSIT INS. CORP., 12 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2018), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2018-vol12-1/fdic-v12n1-4q2017.pdf.

3.50% (2016),[209] 3.40% (2015),[210] 3.49% (2014),[211] 3.68% (2013),[212] 3.96% (2012),[213] 4.32% (2011),[214] 4.70% (2010),[215] and 4.75% (2009).[216] During the first half of 2024, FDIC-insured depository institutions generated an average yield on earning assets of 5.80%.[217]

The foregoing yields on earning assets have been well above the 2% annual interest payment required by § 5-601 during the entire period since 2008. Those figures strongly indicate that national banks doing business in New York would be very unlikely to incur any net losses from administering mortgage escrow accounts after paying the required 2% annual interest out of the earnings they generate from investing borrowers' funds held in those accounts. Moreover, as shown above, national banks receive significant additional benefits from mortgage escrow accounts in the form of greater protection for their security interests in mortgaged properties and the opportunity to earn mortgage servicing fees.[218]

---

209 FED. DEPOSIT INS. CORP., 11 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2017), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2017-vol11-1/fdic-v11n1-4q16.pdf.

210 FED. DEPOSIT INS. CORP., 10 *FDIC Quarterly* No. 1, 6 (2016), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2016-vol10-1/fdic-v10n1-4q2015-quarterly.pdf.

211 FED. DEPOSIT INS. CORP., 9 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2015), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2015-vol9-1/fdic-4q2014-v9n1.pdfhttps://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2015-vol9-2/fdic-1q2015-v9n2.pdf.

212 FED. DEPOSIT INS. CORP., 8 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2014), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2014-vol8-1/fdic-quarterly-vol8no1.pdf.

213 FED. DEPOSIT INS. CORP., 7 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2013), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2013-vol7-1/fdic-quarterly-vol7no1.pdf.

214 FED. DEPOSIT INS. CORP., 6 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2012), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2012-vol6-1/fdic-quarterly-vol6no1.pdf.

215 FED. DEPOSIT INS. CORP., 5 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2011), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2011-vol5-1/fdic-vol5no1-quarterly-final-v1.pdf.

216 FED. DEPOSIT INS. CORP., 4 *FDIC Quarterly* No. 1, 6 (Tbl. III-A) (2010), https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2010-vol4-1/fdic-quarterly-vol4no1-full.pdf.

217 FED. DEPOSIT INS. CORP., *Quarterly Banking Profile* (2d Qtr. 2024), 9 (Tbl. IV-A), https://www.fdic.gov/system/files/2024-09/qbp.pdf#page=1.

218 *See supra* notes 38-39 and accompanying text (discussing the benefits lenders receive from mortgage escrow accounts). Plaintiffs-Appellees in *Cantero* obtained their mortgages from BofA in 2010 and 2016. *Cantero*, 602 U.S. at 212.

Several large national banks – including Wells Fargo, one of the nation's biggest national banks and a leading competitor of BofA – have complied with NYGOL § 5-601 and similar interest-on-escrow laws enacted by California and other states.[219] The compliance of Wells Fargo and other national banks with § 5-601 and similar state laws undermines BofA's claim that § 5-601 significantly interferes with the "exercise" of national bank "powers."

The New York statute's relatively minor burden on national banks is far less significant than the very severe restrictions imposed by the state laws that the Supreme Court found to be preempted in *Barnett Bank*, *Franklin*, *San Jose*, and *Fidelity*. In *Barnett Bank*, the challenged Florida law prohibited most national banks from exercising their federally-granted power to sell insurance from small-town offices.[220] In *Franklin*, the New York state trial court determined that the challenged New York statute – which forbade national banks from using the terms "saving" or "savings" in advertising for savings deposits – imposed a "crippling obstruction" on a "necessary part" of the defendant national bank's "banking business" by "*restrict[ing]* it 'tremendously' . . . in obtaining 'savings deposits'."[221] The Supreme Court recognized in *Franklin* that national banks "depend on their success in attracting private deposits," and the Court found that the New York statute created a "clear conflict" with federal statutes authorizing national banks to accept savings deposits.[222]

In *San Jose*, the Supreme Court determined that the challenged California escheat law "directly impair[ed]" and "interfere[d]" with the "plainly granted powers" of national banks to solicit and accept deposits.[223] The Court concluded that California's escheat law created an impermissible "conflict" with the NBA by attempting "to qualify in an unusual way agreements between national banks and their customers,"[224] as deposits were escheated to the state upon "mere proof of dormancy" and "without any determination of abandonment in fact."[225] The Supreme Court concluded that California's escheat law "alter[ed] the contracts of deposit in a manner considered so

---

219 *Hymes*, 408 F. Supp. 3d at 195 (discussing Wells Fargo's compliance with NYGOL § 5-601). Wells Fargo and other national banks have complied with California's interest-on-escrow law and similar laws enacted by other states. *See Lusnak*, 885 F.3d at 1190; Answering Brief of Plaintiffs-Appellees in *Kivett v. Flagstar Bank, FSB*, 2021 WL 5702573 (9th Cir., Nov. 22, 2021), at *14-*15 [hereinafter Kivett Ninth Circuit Answering Brief]; Brief in Opposition of Respondents to Petition for Writ of Certiorari in *Flagstar Bank, FSB v. Kivett*, 2022 WL 17811345 (U.S. Dec. 13, 2022), at *4.

220 *See supra* Part II (discussing *Barnett Bank*).

221 *People v. Franklin Nat'l Bank*, 200 Misc. at 571, 105 N.Y. Supp. 2d at 94; *see also supra* Part III.A (discussing *Franklin*).

222 *Franklin*, 347 U.S. at 375-78 (quotes at 375 and 378).

223 *San Jose*, 262 U.S. at 369-70.

224 *Id.*

225 *Anderson*, 321 U.S. at 250-51 (discussing California's escheat law in *San Jose*).

unusual and so harsh in its application to depositors as to deter them from placing or keeping their funds in national banks."[226]

In *Fidelity*, the Supreme Court held that a California judicial rule created an "actual conflict" with a valid FHLBB regulation, which gave federal savings associations "unrestricted" authority to enforce due-on-sale clauses in their mortgages.[227] California's judicial rule allowed the enforcement of due-on-sale clauses only in "cases where the lender's security is impaired,"[228] thereby "limiting the availability of an option the [FHLBB] considers essential to the economic soundness of the thrift industry."[229] The Supreme Court held that California's rule was preempted because it undermined the FHLBB's authority "to ensure the financial stability" of federal savings associations.[230]

NYGOL § 5-601 is not preempted under *Barnett Bank*'s "prevents or significantly interferes" preemption standard because § 5-601's relatively minor burden on national banks is far less significant than the very severe burdens imposed by the state laws that were preempted in *Barnett Bank*, *Franklin*, *San Jose*, and *Fidelity*. Section 5-601's relatively minor impact on national banks is also considerably less substantial than the burdens placed on national banks by the state laws that were upheld against preemption claims in *Anderson*, *McClellan*, and *Commonwealth*. In *Anderson*, a national bank argued that a Kentucky statute caused significant economic and financial harm to national banks by requiring them to transfer custody of long-dormant deposits to state authorities, thereby terminating the banks' ability to earn profits from investing those deposits in loans and government securities.[231] In *McClellan*, a national bank contended that a Massachusetts statute undermined the "stability" of national banks by interfering with their ability to "take additional security for an existing debt," via transfers of real property, "whenever necessary for the protection of their property and assets."[232] In *Commonwealth*, a national bank alleged that a Kentucky law forced the bank to act as a "State servant" in performing the "burdensome duty" of collecting Kentucky's tax on bank shares from its shareholders "[w]ithout remuneration."[233]

The Supreme Court rejected the national banks' preemption arguments in *Anderson*, *McClellan*, and *Commonwealth* after determining that the challenged state laws did not discriminate against national banks and did not conflict with federal banking laws. The Supreme Court also found that the challenged state statutes were reasonable

---

[226] *Id.* at 250 (same); *see also supra* Part III.B (discussing *San Jose*).
[227] *Fidelity*, 458 U.S. at 146-47, 154-59, 159 n.14 (first quote), 169 n.22 (second quote).
[228] *Id.* at 155-56.
[229] *Id.* at 156.
[230] *Id.* at 154-56, 168-70 (quote at 170); *see also supra* Part III.C (discussing *Fidelity*).
[231] Anderson Nat'l Bank Brief, *supra* note 145, at *18.
[232] *McClellan*, 164 U.S. at 352-53 (summarizing argument of the national bank's counsel).
[233] *Commonwealth*, 1869 U.S. LEXIS 972, at ***8 (summarizing argument of the national bank's counsel).

laws designed to accomplish legitimate state purposes – protecting long-dormant deposits in *Anderson*, preventing insolvent debtors from making preferential transfers to favored creditors in *McClellan*, and collecting a state tax owed by bank shareholders in *Commonwealth*.[234] Similarly, as shown above, § 5-601 does not discriminate against national banks, does not create a direct conflict with any federal statute, and fulfills a valid state purpose – requiring mortgage lenders to provide a reasonable return to borrowers on the balances they must maintain in their escrow accounts.[235]

In sum, a "nuanced" comparison of NYGOL § 5-601 with the state laws evaluated in the seven key Supreme Court decisions identified in *Cantero* makes clear that § 5-601 does not prevent or significantly interfere with national bank powers and, therefore, is not preempted by 12 U.S.C. § 25b(b)(1)(B).[236] Accordingly, the Second Circuit on remand should dismiss BofA's preemption claim and hold that § 5-601 applies to national banks.

VI. Two Other Potential Legal Issues on Remand in *Cantero* Do Not Support Bank of America's Preemption Claim.

In the final footnote of its decision in *Cantero*, the Supreme Court said that the Second Circuit "may address as appropriate on remand" the following additional issues: (i) "the significance . . . (if any) of the preemption rules" issued by the OCC, and (ii) "the relevance . . . (if any)" of 12 U.S.C. § 25(b)(1)(C), which provides that a state consumer financial law may be preempted by a federal law other than the NBA.[237] As shown below, neither of those sources of law provides any support for BofA's preemption claim.

A. The OCC's Preemption Rule Violates 12 U.S.C. § 25b and Is Not Entitled to Judicial Deference.

BofA previously argued that NYGOL § 5-601 is preempted by 12 C.F.R. § 34.4(a), which the OCC adopted in 2004 and reissued in 2011.[238] Both versions of that regulation provide that a "national bank may make real estate loans . . . without regard to state law limitations concerning: . . . (6) Escrow accounts."[239] As shown below, the

---

[234] *See supra* Part IV (discussing the preemption arguments made by national banks in *Anderson*, *McClellan*, and *Commonwealth* and explaining why the Supreme Court rejected those arguments).

[235] *See supra* notes 40-47 and accompanying text (discussing § 5-601's legislative purpose).

[236] *See Cantero*, 602 U.S. at 219-21.

[237] *Id.* at 221 n.4. The Second Circuit did not decide whether the OCC's regulation had independent preemptive effect. *Cantero*, 49 F.3d at 128 n.5, 139 n.13. The Second Circuit held that BofA "forfeited" its preemption claim based on 12 U.S.C. § 25b(b)(1)(C) because it did not raise that claim until it filed its reply brief. *Id.* at 136 n.9.

[238] *See Cantero*, 49 F.3d at 128 n.5, 139 n.13.

[239] Bank Lending and Operations: Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1917 (Jan. 13, 2004) [hereinafter 2004 OCC Preemption Rule]; Office of Thrift Supervision Integration; Dodd-Frank

OCC's regulation violates 12 U.S.C. § 25b in several respects and therefore does not preempt § 5-601. The OCC's regulation is not entitled to any judicial deference because Congress and the Supreme Court repudiated the 2004 version of that regulation, and the OCC adopted the 2011 version in a manner that was "not in accordance with law."[240]

1. The OCC's regulation violates several provisions of 12 U.S.C. § 25b.

Under 12 U.S.C. § 25b(b)(1), the OCC has authority to issue a regulation or order preempting a state consumer financial law "only if—. . . (B) in accordance with the legal standard for preemption in . . . *Barnett Bank*," the state law "prevents or significantly interferes with the exercise by the national bank of its powers." The OCC may not issue a preemptive regulation or order unless "substantial evidence, made on the record of the proceeding, supports the [OCC's] specific finding regarding the preemption of such [state law] in accordance with the legal standard of . . . *Barnett Bank*."[241]

The OCC must act on a "case-by-case basis" when it issues a preemption rule or order. To satisfy the "case-by-case" requirement, the OCC must consider "the impact of a particular State consumer financial law on any national bank that is subject to that law, or the law of any other State with substantively equivalent terms."[242] In addition, the OCC must "first consult" with the Consumer Financial Protection Bureau (CFPB) and "take the views of the [CFPB] into account" before the OCC determines that "a State consumer financial law of another State has substantively equivalent terms as one that the [OCC] is preempting."[243]

The current version of 12 C.F.R. § 34.4(a), which the OCC issued in 2011, violates several provisions of 12 U.S.C. § 25b. First, the OCC's 2011 rule does not incorporate *Barnett Bank*'s "prevents or significantly interferes" preemption test, as required by the unambiguous terms of 12 U.S.C. § 25b(b)(1)(B). The Supreme Court's *Cantero* decision confirms that *Barnett Bank*'s "prevents or significantly interferes" test provides the "controlling legal standard" for determining whether "a 'State consumer financial law' . . . is preempted with respect to national banks."[244]

The OCC intentionally omitted *Barnett Bank*'s "prevents or significantly interferes" test from its 2011 rule. The OCC's preamble to that rule erroneously asserted that "the Dodd-Frank Act does not create a new stand-alone 'prevents or significantly

Act Implementation, 76 Fed. Reg. 43549, 43569 (July 21, 2011) [hereinafter 2011 OCC Preemption Rule].

[240] 5 U.S.C. § 706(2)(A).

[241] 12 U.S.C. § 25b(c).

[242] 12 U.S.C. §§ 25b(b)(1)(B) & (b)(3)(A).

[243] *Id.* § 25b(b)(3)(B).

[244] *Cantero*, 602 U.S. at 212-13.

interferes' preemption standard."[245] The OCC's 2011 rule is unlawful and void for failing to incorporate *Barnett Bank*'s "prevents or significantly interferes" preemption test. That failure creates a direct and fatal conflict with the plain language of 12 U.S.C. § 25b(b)(1)(B) and the Supreme Court's *Cantero* decision.

Second, like the OCC's 2004 regulation, the 2011 version of 12 C.F.R. § 34.4(a) seeks to preempt fourteen broad categories of state consumer financial laws across the nation, including state laws regulating mortgage escrow accounts.[246] In adopting the 2011 rule's sweeping nationwide preemptions, the OCC did not comply with § 25b's requirements that (i) the OCC must make preemption determinations on a "case-by-case basis," (ii) the OCC must support those determinations with "substantial evidence, made on the record of the proceeding," and (iii) the OCC must consult with the CFPB before preempting "substantively equivalent" laws enacted by more than one state.[247]

The OCC erroneously claimed that its 2011 rule did not need to comply with § 25b's requirements. According to the OCC, the agency's 2011 rule was based on its 2004 regulation, which remained valid after Congress enacted § 25b in 2010.[248] That argument is untenable. Under § 25b(b)(1), a State consumer financial law is preempted "only if" the OCC or a court makes a preemption determination in accordance with § 25b's requirements. As a narrow exception to that explicit mandate, Dodd-Frank included a limited grandfather clause. That grandfather clause preserves the applicability of preexisting OCC regulations and orders to "any contract entered into on or before July 21, 2010, by national banks . . . or subsidiaries thereof."[249]

---

[245] 2011 OCC Preemption Rule, *supra* note 239, at 43555; *see also* Arthur E. Wilmarth, Jr., "Policy Brief: The OCC's Repeated Failures to Comply with the Dodd-Frank Act and Other Legal Authorities Governing the Scope of Preemption for National Banks and Federal Savings Associations," at 7 (Geo. Wash. Leg. Stud. Res. Paper No. 2021-51, Nov. 8, 2021) (discussing the OCC's refusal to adopt *Barnett Bank*'s "prevents or significantly interferes" preemption standard) [hereinafter Wilmarth, "OCC's Repeated Failures"], https://ssrn.com/abstract=3966510. In July 2024, the Acting Comptroller of the Currency acknowledged, "in light of the recent *Cantero* decision," that the OCC "need[s] to develop a more nuanced and balanced approach to *Barnett*." Remarks of Acting Comptroller of the Currency Michael Hsu before the Exchequer Club, "Size, Complexity, and Polarization in Banking," at 15-16 (July 17, 2024), https://www.occ.treas.gov/news-issuances/speeches/2024/pub-speech-2024-79.pdf.

[246] 2004 OCC Preemption Rule, *supra* note 239, at 1917; 2011 OCC Preemption Rule, *supra* note 239, at 43569.

[247] 12 U.S.C. §§ 25b(b)(1)(B) & (b)(3)(A) ("case-by-case" requirement); *id.* § 25b(c) ("substantial evidence" requirement); *id.* § 25b(b)(3)(B) (requirement to consult with CFPB); *see* Wilmarth, "Dodd-Frank," *supra* note 136, at 931-32 (discussing the foregoing requirements); Wilmarth, "OCC's Repeated Failures," *supra* note 245, at 7-8 (describing the OCC's violations of the foregoing requirements when it issued its 2011 preemption rule).

[248] 2011 OCC Preemption Rule, *supra* note 239, at 43557.

[249] 12 U.S.C. § 5553.

As Dodd-Frank's grandfather clause makes clear, the OCC's preexisting preemption rules and orders – including its 2004 regulation – do *not* apply to transactions by national banks *after* July 21, 2010, *unless* the OCC reissues those preemption rules and orders in compliance with § 25b.[250] The OCC's contrary claim would make Dodd-Frank's grandfather clause meaningless, thereby violating "the canon against surplusage [that] is strongest when an interpretation would render superfluous another part of the same statutory scheme."[251]

Third, Dodd-Frank requires the OCC to "conduct a review, though notice and public comment," of each of its preemption determinations at least once every five years.[252] After completing each review, the OCC must issue a notice and report describing the results of its review to the public as well as the OCC's oversight committees in Congress. The required notice and report must state whether the OCC intends to continue, rescind, or amend the preemption determination it reviewed.[253] The OCC has not conducted any review of 12 C.F.R. § 34.4(a) pursuant to § 25b(d), even though that regulation was issued in July 2011.[254]

Thus, 12 C.F.R. § 34.4(a) violates 12 U.S.C. § 25b in several respects and is invalid.[255] The OCC's regulation does not preempt NYGOL § 5-601 because it exceeds the OCC's delegated authority[256] and represents an unlawful attempt by the OCC to engage in "backdoor" preemption.[257]

[250] Wilmarth, "Dodd-Frank," *supra* note 136, at 939-40; Wilmarth, "OCC's Repeated Failures," *supra* note 245, at 8.

[251] *Marx v. General Revenue Corp.*, 568 U.S. 371, 386 (2013); *see also Ysleta Del Sur Pueblo v. Texas*, 596 U.S. 685, 698-99 (2022) (holding that a statute should be construed "so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant") (internal quotation marks and citation omitted).

[252] 12 U.S.C. § 25b(d)(1).

[253] *Id.* § 25b(d)(2).

[254] *See* OCC 2011 Preemption Rule, *supra* note 239; Wilmarth, "OCC's Repeated Failures," *supra* note 245, at 9.

[255] *Bowen v. Georgetown University Hosp.*, 488 U.S. 204, 208 (1988) ("It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress."); *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374-75 (1986) ("[A] federal agency may pre-empt state law only when and if it is acting within the scope of its congressionally delegated authority. . . . . To permit an agency to expand its power in the face of a congressional limitation on its jurisdiction would be to grant to the agency power to override Congress. This we are both unwilling and unable to do."); *see also SEC v. Sloan*, 436 U.S. 103, 119 (1978) ("[A]n agency may not bootstrap itself into an area in which it has no jurisdiction by repeatedly violating its statutory mandate.") (quoting *FMC v. Seatrain Lines, Inc.*, 411 U.S. 726, 745 (1973)).

[256] *Louisiana Pub. Serv. Comm'n*, 476 U.S. at 374 ("[A federal] agency literally has no power to act, let alone pre-empt the validly enacted legislation of a sovereign State, unless and until Congress confers power upon it.").

[257] *See* Catherine M. Sharkey, *Preemption by Preamble: Federal Agencies and the Federalization of Tort Law*, 56 DEPAUL LAW REV. 227, 227-30, 251-52, 258-59 (2007) (criticizing federal agencies for seeking to

2. The OCC's Regulation Is Not Entitled to Any Judicial Deference.

Under 12 U.S.C. § 25b(b)(5)(A), the OCC's preemption rules and orders are entitled to judicial deference only if a reviewing court finds that the OCC's preemption determinations are "persuasive," based on the criteria specified in *Skidmore v. Swift & Co.*[258] Following the Supreme Court's recent decision in *Loper Bright Enterprises v. Raimondo*,[259] all of the OCC's interpretations of federal statutes governing national banks are entitled only to *Skidmore* deference.[260] Under *Skidmore*, 12 C.F.R. § 34.4(a) is not entitled to any deference because Congress and the Supreme Court repudiated the 2004 version of that regulation, and the 2011 version violates several provisions of 12 U.S.C. § 25b, as shown above.

Congress passed Dodd-Frank in 2010, "in response to a 'financial crisis that nearly crippled the U.S. economy.'"[261] The Senate Banking Committee determined that "a major cause" of the financial crisis was the "failure" of the OCC and other federal regulators "to stop abusive lending, particularly unsustainable home mortgage lending."[262] Instead of supporting the states' efforts to combat predatory mortgage lending, the OCC preempted those efforts by adopting 12 C.F.R. § 34.4(a) in 2004.[263] The OCC's 2004 regulation "exempted all national banks from State lending laws, including the anti-predatory lending laws."[264] The Senate Banking Committee strongly criticized the OCC's 2004 rule because it "actively created an environment where abusive mortgage lending could flourish without State controls."[265]

Congress repudiated the OCC's 2004 preemption rule when it adopted 12 U.S.C. § 25b(b)(1)(B). Under that statute, as the Senate Banking Committee explained, "[t]he standard for preempting State consumer financial law would return to what it had been for decades, those [sic] recognized by the Supreme Court in *Barnett Bank v. Nelson*, 517

---

achieve "backdoor federalization" by including unauthorized preemption claims in the preambles to their rules).

[258] Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944) [hereinafter *Skidmore*]; *see Lusnak*, 883 F.3d at 1192 (discussing the limited *Skidmore* deference granted to the OCC's preemption determinations under 12 U.S.C. § 25b(b)(5)(A)); Wilmarth, "Dodd-Frank," *supra* note 136, at 932-34 (same).

[259] Loper Bright Enterprises v. Raimondo, 144 U.S. 2244 (2024) [hereinafter *Loper Bright*].

[260] *Id.* at 2259, 2262, 2267 (majority opinion); *see also id.* at 2309 (Kagan, J., dissenting) (stating that *Skidmore* provides the applicable standard of judicial deference under the majority opinion).

[261] *Lusnak*, 883 F.3d at 1189 (footnote omitted) (quoting S. REP. NO. 111-176, at 2 (2010)).

[262] S. REP. NO.111-176, at 15 (2010) (quoting testimony by Travis Plunkett).

[263] OCC 2004 Preemption Rule, *supra* note 239, at 1911-12, 1917 (codified at 12 C.F.R. § 34.4(a)).

[264] S. REP. NO.111-176, at 16 (2010).

[265] *Id.* at 17; *see also* FCIC Report, *supra* note 140, at 13, 96-97, 111-13, 126 (criticizing the OCC's 2004 regulation for preempting state anti-predatory lending laws); Wilmarth, "Dodd-Frank," *supra* note 136, at 909-19 (same).

U.S. 25 (1996), undoing broader standards adopted by rules, orders, and interpretations issued by the OCC in 2004."[266] The Senate Banking Committee and the House Conference Committee emphasized that Dodd-Frank's codification of *Barnett Bank*'s "prevents or significantly interferes" test in § 25b(b)(1)(B) would establish the governing standard for determining whether a state consumer financial law is preempted by reason of its interference "with a national bank's exercise of its power."[267]

In *Cuomo v. Clearing House Ass'n*,[268] the Supreme Court rejected the OCC's policy rationale for its 2004 preemption rule. The OCC's 2004 rule and a companion regulation declared that state laws applied to national banks only if they provided the "legal infrastructure that surrounds and supports the ability of national banks . . . to do business."[269] *Cuomo* disavowed the OCC's "infrastructure" rationale for its broad preemptive rules because that rationale "can be found nowhere within the text of the statute" and "attempts to do what Congress declined to do: exempt national banks from all state banking laws, or at least state enforcement of those laws."[270]

Granting any deference to 12 C.F.R. § 34.4(a) would severely undermine the states' authority to protect consumers, thereby inflicting great harm on the American public extending far beyond mortgage escrow accounts. The OCC's regulation asserts that real estate loans made by national banks are exempted from fourteen broad categories of state consumer financial laws, including state laws regulating loan-to-value ratios, terms of credit, disclosure, advertising, mortgage origination and servicing, and the use of credit reports.[271] Granting any deference to the OCC's regulation would frustrate Dodd-Frank's goal of empowering the states to provide "new consumer protections as problems arise," thereby furnishing "an important signal to Congress and Federal regulators of the need for Federal action."[272]

Deferring to 12 C.F.R. § 34.4(a) would threaten to return this nation to the disastrous situation that prevailed after the OCC adopted the first version of that

---

[266] S. REP. NO. 111-176, at 175 (2010).

[267] *Id.* at 175-76; *accord*, H.R. REP. NO. 111-517, at 875 (2010) (Conf. Rep.), *as reprinted in* 2010 U.S.C.C.A.N. 722, 731 (Dodd-Frank "revises the standard the OCC will use to preempt state consumer protection laws. It codifies the standard in [*Barnett Bank*] to allow for the preemption of State consumer financial laws that prevent or significantly interfere with national banks' exercise of their powers.").

[268] Cuomo v. Clearing House Ass'n, 557 U.S. 519 (2009) [hereinafter *Cuomo*].

[269] *Id.* at 532 (quoting Bank Activities and Operations, 69 Fed. Reg. 1895, 1896 (Jan. 13, 2004)); *see also* 2004 OCC Preemption Rule, *supra* note 239, at 1912, 1913 (presenting the same "infrastructure" rationale).

[270] *Cuomo*, 557 U.S. at 533.

[271] 12 C.F.R. § 34.4(a). The regulation recognizes the application to national banks of general state laws, such as state laws governing contracts, torts, taxation, and zoning, if such laws are "consistent" with *Barnett Bank*. 12 C.F.R. § 34.4(b).

[272] S. REP. NO. 111-176, at 174-75 (2010).

regulation in 2004. As discussed above, the Senate Banking Committee condemned the OCC's 2004 rule because it "created an environment where abusive mortgage lending could flourish without State controls."[273] Illinois Attorney General Lisa Madigan described the devastating consequences of the OCC's 2004 preemption rule in her testimony before the Financial Crisis Inquiry Commission in 2010. As she explained, after the OCC adopted its 2004 rule, "many of the largest mortgage-lenders shed their state licenses and sought shelter behind the shield of a national charter," thereby hamstringing the states' efforts to stop predatory mortgage lending and enabling "the worst lending abuses in our nation's history."[274]

The Second Circuit should reject any further claim by BofA that 12 C.F.R. § 34.4(a) preempts NYGOL § 5-601. The OCC's regulation is not entitled to any deference, and should be "h[e]ld unlawful and set aside," because Congress and the Supreme Court repudiated the 2004 version of that rule and the OCC adopted the 2011 version in a manner that was "not in accordance with law."[275]

B. 12 U.S.C. § 25b(b)(1)(C) Does Not Provide an Alternative Basis for Bank of America's Preemption Claim.

BofA argued in its reply brief to the Second Circuit that 12 U.S.C. § 25b(b)(1)(C) provided an alternative basis for preempting NYGOL § 5-601.[276] The Second Circuit did not consider that alternative claim because BofA failed to raise it until it filed its reply brief.[277] The Supreme Court indicated, however, that the Second Circuit could consider that claim on remand.[278]

Section 25b(b)(1)(C) provides that a state consumer financial law may be preempted "by a provision of Federal law other than Title 62 of the Revised Statutes." Title 62 of the Revised Statutes includes most of the NBA's provisions. Title 62 does not include 12 U.S.C. § 371, a provision of the FRA that authorizes national banks to make real estate loans. BofA argued in its reply brief that 12 U.S.C. § 371 should be

[273] *Id.* at 16-17.

[274] FCIC Report, *supra* note 140, at 113 (quoting Ms. Madigan's testimony).

[275] *Loper Bright*, 144 S. Ct. at 2261 (quoting 5 U.S.C. § 706(2)(A)); *see also Lusnak*, 883 F.3d at 1192, 1192 n.4, 1193-94 (concluding that the OCC's "preemption conclusions . . . are entitled to little, if any, deference" because the OCC's 2004 and 2011 rules "did not conform to *Barnett Bank*"); *Clark v. Bank of America, N.A.*, 2020 WL 902457 at *3-*4 (D. Md., Feb. 24, 2020) (holding that 12 C.F.R. § 34.4, was "entitled to minimal deference" because the OCC in 2011 "determined that the agency was not bound by Congress's mandate to review state consumer protection laws on a 'case-by-case' basis" and also "did not engage in a substantive reevaluation of preemption, in light of Dodd-Frank").

[276] Reply Brief of Bank of America, N.A. at *4, *25 *Cantero v. Bank of America, N.A.*, (2d Cir., Oct. 4, 2021) No. 21-400 2021 WL 4726982.

[277] *Cantero*, 49 F.4th at 136 n.9.

[278] *Cantero*, 602 U.S. at 221 n.4.

treated as "a provision of Federal law other than Title 62" within the scope of § 25b(b)(1)(C), thereby providing a separate basis for preempting NYGOL § 5-601. BofA's argument is untenable because its preemption claim under § 371 is governed exclusively by *Barnett Bank*'s "prevents or significantly interferes" preemption standard codified in 12 U.S.C. § 25b(b)(1)(B).

In contrast to § 25b(b)(1)(C), the "prevents or significantly interferes" preemption standard codified in § 25b(b)(1)(B) does not contain any reference to Title 62. The lack of any reference to Title 62 in § 25b(b)(1)(B), compared with the explicit reference to Title 62 in § 25b(b)(1)(C), demonstrates that the scope of the "prevents or significantly interferes" preemption standard codified in § 25b(b)(1)(B) is not limited to cases arising under Title 62.[279] The unambiguous terms of § 25b(B)(1)(B) apply to every preemption claim alleging that a "State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers." In addition, § 25b(b)(1)(B) mandates that all such claims must be determined "in accordance with the legal standard for preemption in . . . *Barnett Bank*."[280]

As previously discussed, Congress intended that *Barnett Bank*'s "prevents or significantly interferes" preemption test codified in § 25b(b)(1)(B) would provide the governing standard for determining all preemption claims based on allegations that state consumer financial laws forbid or significantly impair the "exercise" of national bank "powers."[281] Given Congress's decision to codify *Barnett Bank*'s preemption test as the controlling legal standard in § 25b(b)(1)(B), it is highly significant that *Barnett Bank* established that test in a case arising under 12 U.S.C. § 92, which Congress enacted as an amendment to the FRA, not the NBA.[282]

The Supreme Court did not draw any distinction between the FRA and the NBA when the Court adopted its "prevents or significantly interferes" preemption standard in *Barnett Bank*. The Court focused on § 92's reference to the "powers" of national banks, and the Court said that, "[i]n using the word 'powers,' the statute chooses a legal concept that, in the context of national bank legislation, has a history."[283] Thus, § 92's status as a

---

[279] *Barnhart v. Sigmon Coal Co.*, 534 U.S. 938, 952 (2002) ("[W]hen Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (citation and internal quotation marks omitted); *Gallado By and Through Vassaller v. Marstiller*, 596 U.S. 420, 431 (2022) ("[W]e must give effect to, not nullify, Congress' choice to include limiting language in some provisions but not others" of the same statute.).

[280] 12 U.S.C. § 25b(b)(1)(B).

[281] *See supra* notes 266-67 and accompanying text (discussing and quoting H.R. REP. NO. 111-517, at 875 (2010) (Conf. Rep.), *as reprinted in* 2010 U.S.C.C.A.N. 722, 731; S. REP. NO. 111-176, at 175-76 (2010)).

[282] *United States Nat'l Bank v. Indep. Ins. Agents of Am., Inc.*, 508 U.S. 439, 455-63 (1993) (concluding that Congress enacted 12 U.S.C. § 92 in 1916 as an amendment to § 13 of the FRA).

[283] *Barnett Bank*, 517 U.S. at 32.

provision granting a "power" to national banks – not its statutory provenance – caused the Supreme Court in *Barnett Bank* to review its prior decisions dealing with the "powers" of national banks under both the FRA and the NBA as precedents for *Barnett Bank*'s preemption standard.[284]

The Supreme Court in *Barnett Bank* conducted a detailed review of *Franklin*, which upheld a national bank's preemption claim based on provisions of the FRA and the NBA that granted deposit-taking powers to national banks.[285] As the Supreme Court pointed out in *Barnett Bank*, its decision in *Franklin* gave great weight to a provision of the FRA that authorized national banks to accept "savings deposits."[286] As in *Barnett Bank*, the Supreme Court in *Franklin* did not draw any distinction between the power-granting provisions of the FRA and the NBA in performing its preemption analysis.

The plain language of 12 U.S.C. § 25b(b)(1)(B) applies to all preemption claims based on allegations that state consumer financial laws interfere with the "exercise" of "powers" by national banks. That statutory language is consistent with the Supreme Court's equivalent treatment of power-granting provisions of the FRA and NBA in *Barnett Bank* and *Franklin*. Accordingly, the "prevents or significantly interferes" preemption standard in § 25b(b)(1)(B) governs every case involving an alleged conflict between a state consumer financial law and a federal law that grants a "power" to a national bank, regardless of whether that power-granting law is codified in the NBA or in some other federal statute such as the FRA.[287]

To preserve the intended scope of *Barnett Bank*'s governing preemption standard, as manifested in § 25b(b)(1)(B)'s unambiguous terms, the scope of § 25b(b)(1)(C)'s alternative basis for preemption should be limited to federal laws that do not grant "powers" to national banks and are not codified in Title 62 of the Revised Statutes. Read in context with the plain language of § 25b(b)(1)(B), the proper scope of § 25b(b)(1)(C) should be limited to federal laws of general application that do not relate specifically to the "powers" of national banks, such as federal criminal laws, environmental laws, occupational safety laws, and tax laws.[288]

An additional reason to limit the scope of § 25b(b)(1)(C) to federal laws of general application is that § 25b(b)(1)(C) does not authorize the OCC to issue preemptive rules or orders. The OCC is the federal agency responsible for interpreting

[284] *Id.* at 32-35.
[285] *Id.* at 33, 34-35.
[286] *See Barnett Bank*, 517 U.S. at 33 (discussing *Franklin*'s reliance on the FRA's provision that empowered national banks to accept "savings deposits"); *Franklin*, 347 U.S. at 375-79 (emphasizing the importance of the same provision of the FRA).
[287] Wilmarth, "Dodd-Frank," *supra* note 136, at 930.
[288] *Id.*

federal statutes governing the activities and regulation of national banks.[289] If Congress intended § 25b(b)(1)(C) to apply to federal laws that relate specifically to the "powers" of national banks, Congress would have authorized the OCC to issue preemptive determinations under that subparagraph in the same way that Congress authorized the OCC to act under § 25b(b)(1)(B). Once again, the clear differences in language between §§ 25b(b)(1)(B) and (C) mandate the conclusion that only the former subparagraph applies to federal laws that relate specifically to the "powers" of national banks.[290]

Restricting the application of § 25b(b)(1)(C) to federal laws that are not codified in Title 62 and do not relate specifically to the "powers" of national banks would avoid any conflict with the plain meaning and clearly intended scope of § 25b(b)(1)(B).[291] As previously discussed, Congress adopted § 25b(b)(1)(B) to ensure that *Barnett Bank*'s "prevents or significantly interferes" preemption test would be the controlling legal standard for deciding all preemption claims based on allegations that state consumer financial laws interfere with the "exercise" of "powers" by national banks.[292] Accordingly, BofA's preemption claim under 12 U.S.C. § 371(a) is governed exclusively by § 25b(b)(1)(B), as § 371(a) is a power-granting provision that authorizes national banks to make real estate loans.

In sum, the Second Circuit should reject any attempt by BofA to assert an alternative preemption claim under § 25b(b)(1)(C). BofA asserts that NYGOL § 5-601 interferes with the "exercise" by national banks of their "powers" under 12 U.S.C. § 371(a) and § 24 (Seventh). In accordance with the unambiguous terms of § 25b(b)(1)(B), BofA's preemption claims under both statutes must be determined in accordance with *Barnett Bank*'s "prevents or significantly interferes" preemption test codified in § 25b(b)(1)(B).

---

289 *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 256-57 (1995).

290 *See* authorities cited *supra* in note 279.

291 *See Louisiana Pub. Serv. Comm'n v. FCC,* 476 U.S. 355, 370 (1986) (citing "the familiar rule of construction that, where possible, provisions of a statute should be read so as not to create a conflict"); *United States Nat'l Bank v. Indep. Ins. Agents of Am. Inc.,* 508 U.S. 439, 455 (1993) ("Over and over we have stressed that 'in expounding a statute we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.'") (citations omitted).

292 *See supra* notes 266-67 and accompanying text (discussing and quoting H.R. REP. NO. 111-517, at 875 (2010) (Conf. Rep.), *as reprinted in* 2010 U.S.C.C.A.N. 722, 731; and S. REP. NO. 111-176, at 175-76 (2010)).

VII. The First Circuit Should Reverse the District Court's Decision in *Conti*, and the Ninth Circuit Correctly Reaffirmed Its Decision in *Kivett*.

As discussed above, the First Circuit will consider a preemption challenge to Rhode Island's interest-on-escrow statute in *Conti*, and the Ninth Circuit recently reaffirmed its decision rejecting a preemption challenge to California's interest-on-escrow law in *Kivett*.[293] As shown below, the First Circuit should reject the preemption challenge to Rhode Island's statute, and the Ninth Circuit correctly dismissed the preemption challenge to California's law.

A. The First Circuit Should Reverse the District Court's Decision and Hold That Rhode Island's Interest-on-Escrow Law Applies to National Banks.

In *Conti*, the First Circuit will determine whether the district court correctly held that the NBA preempted Rhode Island General Laws (RIGL) § 19-9-2(a).[294] The First Circuit suspended its consideration of the district court's decision until the Supreme Court issued its decision in *Cantero*.[295] The Rhode Island statute requires all mortgage lenders doing business in the state to pay interest on borrowers' funds held in escrow accounts "at a rate equal to the rate paid to the mortgagee on its regular savings account, if offered, and otherwise at a rate not less than the prevailing market rate of interest for regular savings accounts offered by local financial institutions."[296]

The district court held in *Conti* that the NBA preempted RIGL § 19-9-2(a) because that state law "places 'limits' on an 'incidental power' [of national banks] to establish [mortgage] escrow accounts" and "therefore 'significantly interfere[s]'" with that power.[297] Thus, the district court adopted a blanket preemption rule that would override all state consumer financial laws that place "limits" on the exercise of a "power" by national banks.[298] In adopting that mistaken and overbroad preemption rule, the district court relied on the erroneous categorical test for preemption applied by the Second Circuit in *Cantero*[299] as well as a similarly sweeping and invalid approach to preemption adopted by the First Circuit in a 2007 decision.[300]

---

[293] *See supra* notes 33-34 and accompanying text (discussing *Conti*, *Kivett I* and *Kivett II*).
[294] *See supra* note 33 and accompanying text.
[295] *Conti*, *supra* note 33, appeal filed, No. 22-1770 (1st Cir. Oct. 14, 2022).
[296] *Conti*, *supra* note 33, 2022 WL 4535251 at *2 (quoting RIGL § 19-9-2(a)).
[297] *Id.* at *4.
[298] *Id.*
[299] *Id.* at *2-*4 (discussing and quoting the Second Circuit's decision in *Cantero*).
[300] *Id.* at *3-*4 (discussing and quoting *SPGGC, LLC v. Ayotte*, 488 F.3d 525 (1st Cir. 2007)). *Ayotte* held that the NBA preempted a New Hampshire statute. The New Hampshire law prevented national banks

The district court committed reversible error by adopting a blanket preemption rule that directly conflicts with the Supreme Court's decision in *Cantero*.[301] In accordance with the Supreme Court's instructions in *Cantero*, the First Circuit should (i) evaluate the "nature and degree of the interference" that RIGL § 19-9-2(a) creates with the "exercise" of "powers" by national banks, and (ii) conduct a "nuanced comparative analysis" of the Rhode Island statute's "interference" consistent with the Supreme Court's assessments of the state laws that were challenged in *Barnett Bank* and six other Supreme Court decisions identified in *Cantero*.[302]

After conducting the analysis required by *Cantero*, the First Circuit should reverse the district court's decision and uphold the validity of RIGL § 19-9-2(a). The Rhode Island statute places a relatively minor burden on national banks and other mortgage lenders, as it requires them to pay interest on escrow accounts at the same rate they pay on their regular savings accounts, if offered, or at the "prevailing market rate" paid by local financial institutions on regular savings accounts. The interest rate required by § 19-9-2(a) is modest, reasonable, and consistent with the fact that mortgage escrow accounts function as mandatory savings accounts for borrowers.[303]

The interest payment required by the Rhode Island statute is considerably lower than the 2% annual rate required by NYGOL § 5-601 and Cal. Civ. Code § 2954.8(a). The national average rates paid on savings accounts by federally-insured depository institutions and credit unions since 2009 have ranged between a high of 0.47% in March 2024 and a low of 0.04% in March 2021.[304] As shown above, FDIC-insured depository institutions have produced average annual yields on their earning assets since 2009

from selling, through nonbank agents, gift cards worth $100 or less that included administrative fees or expiration dates. *Ayotte* held that New Hampshire's law was preempted because it "regulate[d] the terms and conditions" of gift cards issued by national banks and "limit[ed]" their "power" to sell gift cards through agents under the NBA. 488 F.3d at 531-33. Congress overruled *Ayotte*'s core holding when it enacted Dodd-Frank in 2010. Dodd-Frank includes a provision, 12 U.S.C. § 25b(h)(2), which stipulates that the NBA and 12 U.S.C. § 371 do *not* preempt the application of state laws to nonbank subsidiaries, affiliates, and agents of national banks. Accordingly, *Ayotte* does not have any continuing precedential force after Dodd-Frank. *See* Wilmarth, "Dodd-Frank," *supra* note 136, at 935 & n.318.

[301] *Cantero*, 602 U.S. at 209, 220-21 (rejecting the Second Circuit's "categorical test" for preemption and holding that *Barnett Bank*'s "prevents or significantly interferes" test does not "draw a bright line" between preempted and non-preempted state consumer financial laws).

[302] *Id.* at 219-21; *see supra* notes 12-26 and accompanying text (discussing the preemption analysis mandated by the Supreme Court's decision in *Cantero*).

[303] *See supra* notes 40-41 and accompanying text (explaining that mortgage escrow accounts operate as mandatory savings accounts because they require borrowers to make monthly deposits into their accounts to prefund future payments of real estate taxes and property insurance premiums by lenders on their behalf).

[304] *See National Rates and Rate Caps Previous Rates,* FED. DEPOSIT INS. CORP (October 21,2024), https://www.fdic.gov/resources/bankers/national-rates/previous-rates.html.

ranging between a high of 5.43% in 2023 and a low of 2.71% in 2021.[305] During the first half of 2024, FDIC-insured depository institutions generated an average yield on earning assets of 5.80%.[306]

Thus, national banks doing business in Rhode Island could easily pay the interest required by RIGL § 19-9-2(a) out of the earnings they generate by investing their borrowers' funds held in mortgage escrow accounts. National banks receive significant additional benefits from mortgage escrow accounts, including greater protection for their security interests in mortgaged properties as well as the opportunity to earn mortgage servicing fees.[307]

Like NYGOL § 5-601, RIGL § 19-9-2(a) has a relatively minor impact on the "exercise" of "powers" by national banks. Except for its required modest interest rate, the Rhode Island statute does not interfere with the administration of mortgage escrow accounts. The limited effects of the New York and Rhode Island statutes on national banks are far less significant than the very severe burdens imposed by the state laws that were preempted in *Barnett Bank*, *Franklin*, *San Jose*, and *Fidelity*.[308] Additionally, the relatively minor impacts of New York's and Rhode Island's statutes on national bank "powers" are much less substantial than the burdens created by the state laws that were upheld against preemption claims in *Anderson*, *McClellan*, and *Commonwealth*.[309] As was true for the state laws that were sustained in those three decisions, NYGOL § 5-601 and RIGL § 19-9-2(a) do not discriminate against national banks, do not conflict with any federal banking statutes, and serve a valid state purpose by ensuring that mortgage borrowers receive a modest and reasonable return on the balances they are required to maintain in their mortgage escrow accounts.[310]

Thus, a "nuanced comparative analysis" of RIGL § 19-9-2(a) with the state laws challenged in *Barnett Bank* and the other six decisions identified in *Cantero* demonstrates that the "nature and degree of [§ 19-9-2(a)'s] interference" with the "powers" of national banks is far less significant than any of the state laws evaluated in those seven

---

305 *See supra* notes 202-16 and accompanying text.
306 *Supra* note 217 and accompanying text.
307 *See supra* notes 38-39 and accompanying text (discussing the benefits mortgage lenders receive from mortgage escrow accounts).
308 *See supra* notes 220-30 and accompanying text (comparing NYGOL § 5-601 to the state laws preempted in *Barnett Bank*, *Franklin*, *San Jose*, and *Fidelity*).
309 *See supra* notes 231-35 and accompanying text (comparing NYGOL § 5-601 with the state laws that were upheld against preemption claims in *Anderson*, *McClellan*, and *Commonwealth*).
310 *See supra* notes 288-301 and accompanying text; *see also Greenwood Trust*, 971 F.2d at 828 (affirming that "banking" and "consumer protection" fall "squarely within the ambit of the states' historic powers," and "any preemption provision [affecting those state powers] must be construed cautiously and with due regard for state sovereignty").

decisions.[311] The First Circuit should therefore dismiss Citizen Bank's preemption claim because RIGL § 19-9-2(a) does not "prevent or significantly interfere" with the "exercise" of "powers" by national banks.[312]

B. The Ninth Circuit Correctly Reaffirmed Its Decision Holding That California's Interest-on-Escrow Law Applies to National Banks.

In *Kivett II*,[313] following the Supreme Court's remand of *Kivett I*,[314] the Ninth Circuit reaffirmed its decision that the NBA does not preempt Cal. Civ. Code § 2954.8(a).[315] The California statute "requires '[e]very financial institution' to pay 'at least 2 percent simple interest per annum' on escrow account funds."[316] Thus, California's interest-on-escrow law places the same modest and nondiscriminatory burden on national banks and other mortgage lenders as NYGOL § 5-601.

In *Kivett I* and *Kivett II*, the Ninth Circuit rejected a preemption claim asserted by Flagstar Bank (Flagstar). The Ninth Circuit stated in both opinions that "given our decision in *Lusnak*, Flagstar could not succeed in arguing that § 2954.8(a) was preempted by the NBA."[317] The Ninth Circuit also stated in *Kivett II* that "the Supreme Court's decision in *Cantero* suggests that *Lusnak* was correctly decided."[318] As the Ninth Circuit explained, the Supreme Court's analysis in *Cantero* indicated that "[w]e properly applied the test for preemption from *Barnett Bank* . . . in concluding that no legal authority established that [state interest-on-escrow] laws significantly interfered with national bank powers, and that the text of Dodd–Frank also reflected Congress's view that such laws do not."[319] The Ninth Circuit's opinions in *Kivett I* and *Kivett II* are unpublished and govern only the parties to that case.[320] However, both opinions confirmed the continuing precedential authority of *Lusnak* in the Ninth Circuit.[321]

The Ninth Circuit correctly determined that *Barnett Bank*'s "prevents or significantly interferes" preemption standard does not preempt Cal. Civ. Code § 2954.8(a), for the same reasons that it does not preempt the substantively identical

---

[311] *Cantero*, 602 U.S. at 214-21.
[312] 12 U.S.C. § 25b(b)(1)(B).
[313] *Kivett II*, *supra* note 34.
[314] *Kivett I*, *supra* note 34, *vacated and remanded*, No. 22-349 (U.S. June 10, 2024), 2024 WL 3901188.
[315] *Kivett II*, *supra* note 34, at *1-2.
[316] *Lusnak*, 883 F.3d at 1190 (quoting Cal. Civ. Code § 2954.8(a)).
[317] *Kivett I*, *supra* note 34, at *1; *Kivett II*, *supra* note 34, at *1.
[318] *Kivett II*, *supra* note 34, at *2.
[319] *Id.* (citing *Lusnak* and *Cantero*).
[320] *Kivett I*, *supra* note 34, (citing Ninth Circuit Rule 36-3); *Kivett II*, *supra* note 34, (same).
[321] *Kivett I*, *supra* note 34, at *2; *Kivett II*, *supra* note 34, at *2.

provisions of NYGOL § 5-601.[322] The Ninth Circuit concluded in *Kivett I* and *Kivett II* that "[n]o factual review of Flagstar's record on summary judgment was necessary to determine whether § 2954.8(a) prevented or significantly interfered with Flagstar's banking operations."[323] As shown below, Flagstar's factual submissions in support of its motion for summary judgment failed to provide any persuasive evidence that Cal. Civ. Code § 2954.8(a) prevented or significantly interfered with national bank powers.

During the district court proceedings in *Kivett I*, Flagstar submitted declarations by two employees, who asserted that Cal. Civ. Code § 2954.8(a) "causes significant interference with Flagstar's operations."[324] After deposing Flagstar's employees, the plaintiffs contended that the declarations of Flagstar's employees presented only "conjecture, not fact," based on their "mere speculation regarding how [payment of interest on] escrow accounts *might* relate to Flagstar's underwriting practices, product pricing, or participation in the secondary mortgage market."[325]

Flagstar's employees acknowledged that Flagstar complied with state interest-on-escrow laws, including Cal. Civ. Code § 2954.8(a), for mortgage loans that Flagstar "subserviced" on behalf of third-party holders of mortgage servicing rights. In addition, the employees stated that Flagstar's portfolio of "subserviced" mortgage loans accounted for about 80% of its total mortgage servicing portfolio. Thus, Flagstar chose not to comply with state interest-on-escrow laws only with respect to the 20% of mortgage loans that it serviced for its own account.[326] The plaintiffs maintained that Flagstar "offered no evidence" to show that its compliance with state interest-on-escrow laws for 80% of its mortgage servicing portfolio "interfere[d] in any way with its banking operations."[327]

---

[322] *See supra* Parts I-V.

[323] *Kivett I*, *supra* note 34, at *1; *Kivett II*, *supra* note 34, at *2.

[324] Brief of Appellant, *Kivett v. Flagstar Bank*, 2021 WL 4507608 (9th Cir., Sept. 24, 2021) at *27-*30; *see also* Answering Brief of Appellee, *Kivett v. Flagstar Bank*, 2021 WL 5702573 (9th Cir., Nov. 22, 2021), at *4 ("Flagstar's evidentiary presentation in the cross-motions [for summary judgment] consisted solely of the declarations of two of its employees.").

[325] Answering Brief of Appellee, *Kivett v. Flagstar Bank*, 2021 WL 5702573 (9th Cir., Nov. 22, 2021), at *5 (contending that the conclusions by Flagstar's employees about the adverse impact of California's interest-on-escrow law on Flagstar's mortgage escrow business were based on "mere speculation"); *id.* at *8-*14 (summarizing the depositions of Flagstar's two employees); *id.* at *26 ("Flagstar's witnesses consistently testified . . . that any suggestion of interference in their declarations was conjecture, not fact").

[326] *Id.* at *7-*8, *13-*14.

[327] *Id.* at *14; *see also id.* at *26 ("Given that Flagstar complies with state [interest-on-escrow] laws (including Section 2954.8 in California) except in the roughly 20% of cases where it owns the [mortgage servicing] rights, the absence of any actual factual support for its interference claims is fatal to its position.").

In addition, evidence produced during the district court proceedings in *Kivett I* indicated that the mortgage lending industry's compliance with Cal. Civ. Code § 2954.8(a) "became the all-but universal norm after the [Ninth Circuit issued its] *Lusnak* decision" in 2018, and that "norm" of compliance was followed by leading national banks such as Wells Fargo, JPMorgan Chase, and Citibank.[328] According to the plaintiffs, "Flagstar failed to offer any evidence . . . that this pervasive compliance with state [interest-on-escrow] laws in the [mortgage lending] industry was in fact interfering with banking powers in general."[329]

Thus, the evidentiary record in *Kivett I* did not provide persuasive support for Flagstar's assertion that Cal. Civ. Code § 2954.8(a) "prevents or significantly interferes" with the "exercise" by national banks of their "powers" to extend mortgage loans and administer mortgage escrow accounts.[330] The Ninth Circuit correctly decided in *Kivett I* and *Kivett II* that the NBA does not preempt § 2954.8(a).

Conclusion

For the reasons set forth above, the Second Circuit on remand in *Cantero* should reject BofA's preemption claim and hold that NYGOL § 5-601 applies to national banks. In addition, the First Circuit should hold that the NBA does not preempt RIGL § 19-9-2(a), and the Ninth Circuit correctly decided that the NBA does not preempt Cal. Civ. Code § 2954.8(a).

[328] *Id.* at *14-*15.

[329] *Id.* at *15.

[330] 12 U.S.C. § 25b(b)(1)(B).

A ROUND PEG IN A SQUARE HOLE: HOW AMBIGUITY IN THE VPPA HINDERS ITS APPLICABILITY AMID TECHNOLOGICAL ADVANCEMENTS

Julia Bond

TABLE OF CONTENTS

Introduction

The Video Privacy Protection Act of 1988 emerged as a response to concerns about the privacy of individuals' video rental records.[1] The law was sparked by an incident during the nomination process of Judge Robert Bork to the U.S. Supreme Court: his video rental history was disclosed without his consent.[2] The enactment of the Video Privacy Protection Act (herein "VPPA") aimed to safeguard consumers' privacy by restricting the disclosure of personally identifiable information (herein "PII") related to their video viewing habits; thus, the law prohibits video service providers from disclosing such information without the explicit consent of the consumer.[3]

Three decades after its passage, courts continue to use the VPPA as a foundation of decisions regarding consumer privacy. However, shoehorning this old law into issues stemming from modern technology, coupled with the ambiguity of the term "subscriber," results in uneven application and interpretation of the VPPA in modern contexts. This indicates the necessity of implementing new legislation which more neatly aligns with the evolved state of privacy concerns.[4]

The objective of this note is to address the ongoing uncertainty stemming from the disagreement among judicial circuits regarding the definition of "subscriber" and to underscore the varied legal and legislative consequences across states. Initially, this note will offer an overview of the original intent behind the creation of the VPPA. Subsequently, it will delve into the decades-long ambiguity surrounding the term "subscriber," citing instances of similar fact patterns resulting in conflicting decisions. Following this, an analysis will be provided on the recent divergence of court opinions on what establishes a subscriber relationship *to* video content, versus *adjacent* to video content, and the implications of this confusion in different jurisdictions.

Lastly, this note will explore the plethora of consequences arising from the absence of a precise definition of "subscriber," ranging from heightened privacy litigation over Meta Pixels to broader public policy concerns regarding children's Internet usage. The conclusion will propose potential remedies to this issue, ranging from federal and state legislative efforts to modernize the definition of "subscriber" to preventative measures business and individuals may consider. Overall, this note underscores the necessity for either legislative clarity or intervention from the Supreme Court to reconcile the circuit split and establish a consistent interpretation of

---

[1] Video Privacy Protection Act, 18 U.S.C. § 2710 (1988).
[2] *Developments in the Law — More Data, More Problems*, 131 HARV. L. REV. 1715, 1722 (2018), https://harvardlawreview.org/print/vol-131/the-video-privacy-protection-act-as-a-model-intellectual-privacy-statute/.
[3] Video Privacy Protection Act, 18 U.S.C. § 2710(b)(1)(1998). *But see* 18 U.S.C. § 2710(b)(2) (1998) (listing the exceptions wherein "a video tape service provider may disclose personally identifiable information concerning any consumer").
[4] Video Privacy Protection Act, 18 U.S.C. § 2710(a)(1)(1998).

"subscriber" under the VPPA. The swiftly evolving technological landscape has opened streaming services, social media sites, and other online businesses to liability under the VPPA, but the Act's ambiguous and archaic language prevents reliable application of its decades-old purpose.

Part I: Background

Amidst the contentious Supreme Court nomination of Judge Robert Bork in 1987, reporter Michael Dolan published "The Bork Tapes" in the Washington City Paper.[5] The article, focusing on Judge Bork's video rental history, aimed to define and exploit the correlation between an individual's leisure choices and their character.[6] Dolan challenged Bork's views on constitutional privacy by attempting to throw Bork's own personal rentals into the public arena.[7] Though the disclosed list of Bork's rented videotapes did not contain any films which might call his personal character into question, "The Bork Tapes" triggered bipartisan criticism and underscored the importance of privacy.[8] The subsequent year, in response to growing privacy concerns, Congress enacted the VPPA to restrict the disclosure of video records without the watcher's consent.[9] This legislative effort reflected broader privacy protection statutes of the 1970s and 1980s,[10] emphasizing the need to balance individual privacy rights and public interest. The VPPA aimed to incorporate purpose-specification, use-limitation, and individual-participation principles while recognizing the First Amendment implications of video watchers' privacy, aligning with Congress's commitment to safeguarding constitutional and statutory privacy rights.[11]

---

[5] *Developments in the Law — More Data, More Problems*, 131 HARV. L. REV. 1715, 1722 (2018). https://harvardlawreview.org/print/vol-131/the-video-privacy-protection-act-as-a-model-intellectual-privacy-statute/.
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] Video Privacy Protection Act, 18 U.S.C. § 2710 (1988).
[10] *See* Daniel J. Solove, A Brief History of Information Privacy Law (2006), GW Law Faculty Publications & Other Works, https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2076&context=faculty_publications (Explaining that the Bank Secrecy Act of 1970 "requires banks to retain records and create reports to aid law enforcement investigations, primarily targeting white-collar crimes. Federally insured banks are mandated to record the identities of account holders and maintain copies of financial instruments."; under "the Right to Financial Privacy Act of 1978 . . . the customer typically must receive prior notice of the subpoena, with some exceptions"; and "the Privacy Protection Act of 1980 (limits the search or seizure of work product materials held by individuals engaged in public communication activities, such as journalism. The Act requires a subpoena to obtain these materials, allowing the affected party to contest the request in court and produce the documents without law enforcement officials conducting a physical search of their premises").
[11] *Developments in the Law — More Data, More Problems*, 131 HARV. L. REV. 1715, 1722 (2018).

The VPPA was implemented to "preserve personal privacy with respect to the rental, purchase, or delivery" of audio visual materials.[12] Enacted in response to concerns about the privacy of individuals' video rental and viewing habits, the VPPA's purpose is to protect consumers' privacy in the context of emerging technologies.[13] The key provisions of the VPPA include restrictions on the disclosure of PII related to an individual's video viewing habits without their explicit consent.[14] The VPPA also reflects the need to adapt legal protections to the evolving landscape of media consumption, including the rise of digital streaming services. Overall, by restricting the unauthorized disclosure of video rental information, the VPPA sought to establish a balance between the benefits of technological advancements and the preservation of individual privacy rights.[15]

Organizations ensnared in legal scrutiny under the VPPA face potential consequences such as statutory damages amounting to $2500 per violation, plus attorneys' fees, monetary compensation, and preliminary injunctive measures.[16] Further, class action VPPA lawsuits have led to significant settlements, ranging from $9 million to $92 million.[17] Thus, the consequences of liability under the VPPA are rather severe, and it is therefore crucial for the scope of the scope of the VPPA's application to be well-established by precedent.

Courts have construed that "to be engaged in the business of delivering video content, the defendant's product must not only be *substantially involved* in the conveyance of video content to consumers but also *significantly tailored* to serve that purpose."[18] Additionally, the VPPA has been held to not apply to retail websites which offer video or audio that is merely "incidental" to their business[19] – thus, to be subject to the

https://harvardlawreview.org/print/vol-131/the-video-privacy-protection-act-as-a-model-intellectual-privacy-statute/ (explaining that the "VPPA evinces Congress's desire to prevent government intrusion upon the deliberative space in which citizens read, watch, think, and create. The Senate Report expressed Congress's solicitude for intellectual privacy, describing the protection of "an individual's choice of books and films [as] a . . . pillar of intellectual freedom under the [F]irst [A]mendment") (quoting S. Rep. No. 100-599, at 4 (1988)).

[12] Video Privacy Protection Act, 18 U.S.C. § 2710 (1988).

[13] *Id.*

[14] *Id.*

[15] *Developments in the Law — More Data, More Problems*, 131 HARV. L. REV. 1715, 1722 (2018). https://harvardlawreview.org/print/vol-131/the-video-privacy-protection-act-as-a-model-intellectual-privacy-statute/.

[16] Video Privacy Protection Act, 18 U.S.C. § 2710 (1988).

[17] *VPPA Trends: Considerations for Limiting Exposure*, LEXOLOGY (Jul. 25, 2023), https://www.lexology.com/library/detail.aspx?g=e636eb54-8817-42d5-a97e-c6bd042941d3.

[18] In re Vizio, Inc., Consumer Priv. Litig., 238 F. Supp. 3d 1204, 1221 (2017).

[19] *See* Cantu v. Tapestry, Inc., Case No. 22-cv-1974-BAS-DDL, 2023 U.S. Dist. LEXIS 118474, at *19 (S.D. Cal. July 10, 2023) (holding that "engaged in the business" . . . "connotes 'a particular field of endeavor,' *i.e.* a focus of the defendant's work") (quoting In re Vizio, 238 F. Supp. 3d at 1221 (citing Webster's Third New International Dictionary 302 (1981) (def. 1d)); *see* Carroll v. Gen. Mills, Inc., Carroll v. Gen. Mills, Inc., CV 23-1746 DSF (MRWx), 2023 U.S. Dist. LEXIS 110049, at 9-10 (C.D Cal. June 26,

regulations of the VPPA, videos must be "substantially involved" and not just "incidental" to the business owning the website. Accordingly, this means that "websites that provide video content as well as other media content—including news organizations—are video tape service providers under the VPPA."[20] Of course, "substantially involved" and "significantly tailored" vary by jurisdiction, as the VPPA fails to define these metrics.[21]

The VPPA lacks clarity by failing to define the key terms "subscriber" and "personally identifiable information."[22] This lack of clarity has posed challenges in enforcing the law consistently. The VPPA's lack of clear definitions has led to differing interpretations and legal disputes, thereby diminishing the law's effectiveness in the digital era, where streaming services and new technologies have revolutionized video consumption. Particularly, the absence of a precise definition of "subscriber" has resulted in a circuit split (which mainly stems from the Eleventh[23] and First[24] Circuits), maintaining legal uncertainty for service providers and consumers alike. Consequently, various courts have grappled with determining who qualifies as a "subscriber" under the VPPA—and no consensus has yet been reached.[25]

This circuit split has significant implications for the scope of the VPPA's protections. Inconsistencies in defining "subscriber" affect the determination of which individuals are covered by the law and, consequently, whose data is safeguarded from unauthorized disclosure disallowed by the VPPA. The lack of a uniform standard creates challenges for businesses operating across different jurisdictions, as they may need to navigate conflicting legal interpretations and compliance requirements. The split also highlights the need for legislative clarity in adapting privacy laws to the evolving landscape of digital media consumption. As technology advances and new models of content delivery emerge, the VPPA's effectiveness relies on its ability to provide clear and consistent protection for consumers. The absence of a precise definition for "subscriber" contributes to the ongoing legal uncertainty and underscores the

2023) (holding that the VPPA does not extend to food company using videos as a method of selling its food products).

[20] Golden v. NBCUniversal Media, LLC, 22 Civ. 9858 (PAE), 2023 U.S. Dist. LEXIS 150622, at *10 (S.D.N.Y. Aug. 23, 2023) (quoting Sellers v. Bleacher Report, Inc., Case No. 23-cv-00368-SI, 2023 U.S. Dist. LEXIS 131579, at *6 (N.D. Cal. July 28, 2023)).

[21] *See* Salazar v. NBA, No. 1: 22-cv-07935 (JLR), 2023 U.S. Dist. LEXIS 137982 (S.D.N.Y. Aug. 7, 2023) at *19-20 (holding that the plaintiff "does not qualify as a "subscriber" of goods or services from a video tape service provider because Plaintiff only signed up for email newsletters — newsletters which were not alleged to contain video content and were not necessary to view the videos on the NBA website."). *But see* Jackson v. Fandom, Inc., Case No. 22-cv-04423-JST, 2023 U.S. Dist. LEXIS 125531, at *9 (N.D. Cal. July 20,2023) (holding that the plaintiff's relationship to video content was sufficient for a VPPA claim because she created an account, registered as a user, and supplied her PII).

[22] Video Privacy Protection Act, 18 U.S.C. § 2710 (1988).

[23] *See generally* Ellis v. Cartoon Network, Inc., 803 F.3d 1251 (11th Cir. 2015).

[24] *See generally* Yershov v. Gannett Satellite Info. Network, Inc., 820 F.3d 482 (1st Cir. 2016).

[25] *Id.* at 488.

importance of legislative updates to address these challenges in an era of rapidly changing media consumption habits.

This uncertainty has allowed significant public policy implications and a recent surge in privacy litigation. Thus, legislative clarity is crucial to address these challenges and ensure that the VPPA remains a robust framework for protecting user privacy as the landscape of digital media consumption evolves. This note seeks to emphasize the importance of either legislative clarity or Supreme Court intervention to resolve the circuit split and provide a consistent interpretation of the term "subscriber" under the VPPA.

Part II: The VPPA's Ambiguous Definitions and the Resulting Circuit Split

Since its conception, the VPPA has been "shoehorned"[26] into matters involving evolving technology. The VPPA only applies to "consumers," which are defined as "any renter, purchaser, or *subscriber* of goods or services from a video tape service provider."[27] However, its lack of specification of what the terms "subscriber" or "PII"[28] encompass has caused division among the courts. Subsequent privacy legislation has also failed to particularize who is protected under the VPPA.

Some courts have interpreted the term "subscriber" narrowly, suggesting that only individuals who directly pay for video services, or who enter a contractual relationship with the service provider, can be considered subscribers. The First Circuit has adopted such a narrow interpretation.[29] By contrast, other courts have adopted a broader interpretation, encompassing anyone who has access to the service, regardless of whether they are the direct payer or contractually bound. For example, the Third Circuit has taken to this broader approach.[30]

In line with these two diverging interpretations, two contrasting cases remain the leading authority on the VPPA and subscriber protection: *Ellis v. Cartoon Network, Inc.*

[26] Daniel S. Marvin, *When Old Law Meets New Technology: The Video Privacy Protection Act Comes of Age,* N.Y.L.J., (May 8, 2023, 9:13 AM), https://www.law.com/newyorklawjournal/2023/05/08/when-old-law-meets-new-technology-the-video-privacy-protection-act-comes-of-age/?slreturn=20240222210641.
[27] Video Privacy Protection Act, 18 U.S.C. § 2710 (1988) (emphasis added).
[28] *See* Video Privacy Protection Act (VPPA) of 1988, 18 U.S.C. § 2710(a)(3) (defining PII as information which identifies a person as having requested or obtained specific video materials or services).
[29] Yershov v. Gannett Satellite Info. Network, Inc., 820 F.3d 482, 487-88 (2016) (holding that a user must have a direct, ongoing subscription-type relationship with the service provider to be considered a "subscriber" under the VPPA).
[30] In re Nickelodeon Consumer Privacy Litig., 827 F.3d 262 (2016) (holding that the term "subscriber" in the VPPA could include individuals who downloaded and used a mobile app, even if they did not have a direct subscription relationship with the service provider, thus establishing a more expansive interpretation of "subscriber" which encompassed a wider range of individuals under the VPPA's protections).

and *Yershov v. Gannett Satellite Info. Network, Inc.* Despite having similar facts and being decided within a year of each other, these cases produced opposite holdings and therefore opposite interpretations of "subscriber." This circuit split has contributed to the continued disparity in court decisions regarding privacy to this day, as 2020s cases adopt the *Ellis* and *Yershov* analyses in their decisions on modern technology.

First, the *Ellis v. Cartoon Network, Inc.* court held that downloading a mobile application (herein "app") did not create a subscriber relationship.[31] Ellis, the plaintiff, had downloaded a free Cartoon Network app to watch TV show clips.[32] While the app allowed users to view the app's free content without making a login account and therefore without providing any information to Cartoon Network, the app had an option for users to log in with their television provider to view additional content.[33] Notably, the app did not require users to opt-in and consent to Cartoon Network disclosing PII to third parties.[34] When Ellis viewed clips through this app on his Android smartphone, Cartoon Network sent Ellis's Android ID and video viewing history to a third party data analytics company called Bango.[35] Bango had the capability to "automatically link an Android ID to a particular person by compiling information about that individual from other websites, applications, and sources."[36] Thus, Ellis alleged that his identity was exposed to Bango by Cartoon Network's sharing of his Android ID and viewing records, and he sued Cartoon Network for disclosing his PII as a "subscriber" of Cartoon Network entitled to VPPA protection.[37]

The District Court defined "subscriber" as "more than just visiting [a website]," relying on the Ninth Circuit case *In re Hulu Privacy Litigation*,[38] and also concluded that an Android ID was not PII by drawing from a Tenth Circuit holding that disclosure of

[31] Ellis v. Cartoon Network, Inc., 803 F.3d 1251, 1257-58 (2015) (holding that "[b]ecause Mr. Ellis is not a 'subscriber' under the VPPA," the district court's dismissal of the complaint should be affirmed; however, the Eleventh Circuit Court of Appeals added that the district court concluded that Mr. Ellis was a "subscriber" based on an erroneous interpretation of the analysis in *In re Hulu Privacy Litigation*, which did not establish that merely pleading "more than just visiting [a] website" qualified as subscription.).
[32] *Id. at 1254*.
[33] *Id. at 1253*.
[34] *Id.*
[35] *Id.* at 1254.
[36] *Id.* (quotation marks omitted).
[37] *Id.*
[38] *Id.* at 1257 (quoting In re Hulu Privacy Priv. Litig., No. C 11-03764 LB, 2012 U.S. Dist. LEXIS 112916, at *23 (N.D. Cal, Aug. 10, 2012). *See* In re Nickelodeon Consumer Priv. Litig., 827 F.3d 262, 283 (3rd Cir. 2016) (noting that the *Hulu* court "concluded that static digital identifiers that could, in theory, be combined with other information to identify a person do not count as 'personally identifiable information' under the Act, at least by themselves").

cable of box codes was not disclosure of PII.[39] Because Ellis downloaded the app, used it to watch clips, and had his Android ID and viewing history shared with Bango, the District Court reasoned that he qualified as a "subscriber," and therefore as a consumer as well.[40]

However, in overturning the District Court's holding, the Eleventh Circuit Court of Appeals did not "understand *Hulu* to stand for the broad proposition that persons do not have to log in or register to be considered subscribers."[41] The court reasoned that in the absence of payments, account creation, disclosure of personal information, subscriptions to periodic services, and commitment to establish a relationship which enabled his access to exclusive content, Ellis was not a subscriber.[42] Through *Ellis*, the Eleventh Circuit took a stance on the VPPA's ambiguity and shaped the term "subscriber" for itself: to be a "subscriber" in the Eleventh Circuit, an ongoing commitment or relationship between the user and the entity owning and operating the app was required.[43]

However, the First Circuit interpreted the term "subscriber" very differently in the 2016 case *Yershov v. Gannett Satellite Info. Network, Inc*. In a contrasting decision to *Ellis*, the First Circuit Court of Appeals held that a plaintiff had established a consumer relationship simply by downloading a free app.[44] The facts were very similar to those of *Ellis*: in *Yershov*, the plaintiff downloaded and used the defendant's USA Today Mobile App to read news articles and watch clips.[45] Just as Cartoon Network sent user information to Bango, so did the defendant here send the following to the third party Adobe Systems Incorporated (herein "Adobe"): "(1) the title of the video viewed, (2) the GPS coordinates of the device at the time the video was viewed, and (3) certain identifiers associated with the user's device, such as its unique Android ID."[46] Adobe, like Bango, performed data analytics services by collecting information about consumers' online activity.[47] Using the information supplied by the defendant, Yershov alleged that Adobe was able to identify him despite the absence of his consent to the collection of his PII, and despite his lack of an account on the USA Today Mobile App.[48]

---

39 Ellis v. Cartoon Network, Inc., 2014 U.S. Dist. LEXIS 143078, at *9 (holding "that the disclosure of an Android ID alone, as happened here, does not qualify as personally identifiable information under the VPPA") (citing Pruitt v. Comcast Cable Holdings, LLC, 100 F. App'x 713, 716 (10th Cir. 2004)).
40 *Ellis*, 803 F.3d at 1254.
41 *Id.* at 1257.
42 *Id.* (reasoning that "[i]n our view, downloading an app for free and using it to view content at no cost is not enough to make a user of the app a 'subscriber' under the VPPA, as there is no ongoing commitment or relationship between the user and the entity which owns and operates the app.").
43 *Id.*
44 Yershov v. Gannett Satellite Info. Network, Inc., 820 F.3d 482 (1st Cir. 2016).
45 *Id.*at 485.
46 *Id.* at 484.
47 *Id.*
48 *Id.* at 485.

In contrast to the *Ellis* court's holding, the *Yershov* court concluded that because "PII is not limited to information that explicitly names a person,"[49] the information disclosed by the defendant to Adobe was indeed PII under the VPPA. Accordingly, the court concluded that Yershov was a "subscriber" under the VPPA because Yershov had established a consumer relationship by downloading a free app, which in turn provided his Android ID and GPS coordinates when he viewed a video.[50]

The First Circuit court defended its split from the *Ellis* decision by attempting to distinguish its matter from that at issue in *Ellis*.[51] The *Yershov* court noted that the *Ellis* court construed the term "subscriber" to "involve[] some type of commitment, relationship, or association (financial or otherwise) between a person and an entity," and therefore "payment, registration, commitment, delivery, [expressed association,] and/or access to restricted content" qualified someone as a "subscriber" under the Eleventh Circuit standard.[52] This, the *Yershov* court reasoned, rendered their decision an enhancement of—rather than a deviation from—the Eleventh Circuit's analysis.[53]

Of course, the *Yershov* decision is arguably not at all compatible with the *Ellis* decision. One court found Android IDs and viewing history to constitute PII,[54] while the other found the exact same information to not constitute PII;[55] one found a subscriber relationship to require an ongoing commitment—and such a commitment was not created by downloading a free app[56]—while the other found downloading a free app sufficient to establish a subscriber relationship.[57] The ambiguity of the VPPA

---

[49] *Id.* at 486 (reasoning that "[h]ad Congress intended such a narrow and simple construction, it would have had no reason to fashion the more abstract formulation contained in the statute.").
[50] *Id.*
[51] *Id.* at 489 (stating: "*Ellis* . . . presumed that downloading a mobile device application is the equivalent of adding a particular web site to one's Internet browser as a favorite. . . We do not think that such a presumption is so apparently true as to dictate our reading of the complaint, which concedes no such equivalence.").
[52] *Id.* at 488.
[53] *See* Rancourt v. Meredith Corp., No. 22-cv-10696-ADB, 2024 U.S. Dist. LEXIS 18069, *31 (Mass. Dist. Ct. 2024) (noting that the Yershov court "left several parts of the VPPA unaddressed," enabling ambiguity to continue).
[54] *Yershov*, 820 F.3d at 489 ("[t]o use the App, Yershov did indeed have to provide Gannett with personal information, such as his Android ID. . . We doubt that Congress would have intended that Gannett would have been free in such a scenario to publish Yershov's PII by claiming that he was not a purchaser, renter, or subscriber.").
[55] Ellis v. Cartoon Network, Inc., 803 F.3d 1251, 1255 (2015) (confirming the district court's ruling "that Mr. Ellis' Android ID and video viewing records were not 'personally identifiable information' under the VPPA because they did not, 'in [their] own right, without more, link an actual person to actual video materials.'").
[56] *Yershov*, 820 F.3d at 487 ("Looking at the statute, we first note that if the term 'subscriber' required some sort of monetary payment, it would be rendered superfluous by the two terms preceding it.").
[57] *Ellis*, 803 F.3d at *1258 ("As we have explained, the free downloading of a mobile app on an Android device to watch free content, without more, does not a 'subscriber' make.").

enables these opposite verdicts to coexist, granting different standards in certain jurisdictions versus others.

This circuit split creates legal uncertainty and challenges for businesses and service providers, requiring navigation of conflicting interpretations of the VPPA if they operate in different jurisdictions. The lack of a unified standard for defining "subscriber" has contributed to inconsistencies in the application and enforcement of the VPPA across different circuits. This underscores the need for legislative clarity or potential Supreme Court intervention to resolve the circuit split and provide a consistent interpretation of the term "subscriber" under the VPPA.

Further, the circuit split extends to uncertainty over the definition of PII under the VPPA. First, the *In re Nickelodeon* court held that under the VPPA, PII is limited to information that, *on its own*, identifies a particular person.[58] However, this interpretation marks a more stringent standard for PII than the First Circuit's broad interpretation, which has yielded opposite holdings to *In re Nickelodeon*. For example, in *Yershov*, the First Circuit court held that dynamic IP addresses could be considered PII under the VPPA.[59] This broader interpretation implies that information that may not directly identify a person on its own could still be classified as PII—a direct contradiction to the Third Circuit's more limited concept of PII.[60]

Of course, the circuit split over the definition of PII is closely related to the split over the definition of "subscriber," as both splits contribute to inconsistencies in the application of the law. For instance, a service provider might argue that certain user data does not fall under the narrow definition of PII, or that certain users are not "subscribers" as narrowly defined by the Third Circuit; however, the First Circuit's more broad approach may render this defense futile.[61] The interplay between these circuit splits over "subscriber' and "PII" complicates the legal landscape surrounding privacy

[58] In re Nickelodeon Consumer Privacy Litig., 827 F.3d 262, 287-290 (2016) (admitting that while its analysis of PII under the VPPA "has not resulted in a single-sentence holding capable of mechanistically deciding future cases," the court has resolved its "view [that] [PII] under the [VPPA] [is] "the kind of information that would readily permit an ordinary person to identify a specific individual's video-watching behavior"). *See also id.* at 267 ("In our view, the kinds of disclosures at issue here, involving digital identifiers like IP addresses, fall outside the Act's protections") *But see id.* at n.177(Stating "Pursuant to the First Circuit's reasoning in *Yershov*, if technology were to develop permitting an ordinary person to type an IP address into a search engine and reveal the identity of the person whose computer was associated with that IP address, the same facts alleged here might well result in a different outcome than the one we reach today.").

[59] *Yershov*, 820 F.3d at 486 (reasoning that the VPPA "reasonably conveys the point that PII is not limited to information that explicitly names a person", reflecting the "benefit of the official Senate Report expressly stating that the drafters' aim was 'to establish a minimum, but not exclusive, definition of [PII]'", establishing that "[m]any types of information other than a name can easily identify a person").

[60] *In re* Nickelodeon, 827 F.3d at 290.

[61] *Id.*; *Yershov*, 820 F.3d at 486.

protection under the VPPA, highlighting the need for clarity and consistency in the interpretation and application of key terms within the law.

In 2012, an amendment to the VPPA aimed to address some of these issues.[62] However, it did not provide a comprehensive solution to the ambiguity surrounding the definitions of "subscriber" or "PII." Rather, the 2012 amendment introduced more flexible consent mechanisms for sharing video viewing history, allowing for electronic consent rather than strict written forms.[63] By broadening the definition of "video tape service provider" to include digital platforms, the amendment extended the VPPA's protection to cover online streaming services; however, this was the only definition that received clarification.[64] Moreover, the amendment expanded the duration of consent, enabling consumers to provide ongoing approval for the disclosure of their video habits, which was particularly important for subscription-based streaming services.[65] It also clarified the circumstances under which video service providers could disclose viewing information to third parties, specifying permissible reasons such as billing and service improvement.[66] Further, it reduced civil liability for service providers acting in good faith compliance, offering some protection against unwarranted lawsuits.[67] Overall, the amendment sought to balance privacy concerns with the demands of modern digital media consumption, and therefore sought to update the VPPA to better safeguard individuals' video viewing data while accommodating the growth of online video services.[68]

Thus, while the 2012 amendment clarified "video tape service provider" to encompass evolving technology, it failed to address the crux of the circuit split: the

---

[62] Video Privacy Protection Act Amendments Act of 2012, Pub. L. 112-258, 126 Stat. 2414, (2013).

[63] *Id.*; *see also* Inside Privacy, *The Video Privacy Protection Act Amendments: A Final Analysis,* COVINGTON (Jan. 11, 2013), https://www.insideprivacy.com/united-states/the-video-privacy-protection-act-amendments-a-final-analysis/ (Explaining how prior to the VPPA Amendments*,* obtaining consent for disclosing consumers' personally identifiable information, including video viewing histories, was confusing; the amendments clarified that consent can now be obtained electronically through the internet and can be given in advance for a specified period, up to two years or until the user decides to withdraw consent. Additionally, consumers must have the ability to withdraw their consent either on a case-by-case basis or for ongoing disclosures. Also, the amendments prohibit obtaining consent through disclosures that include other legal or financial obligations of the consumer, ensuring that consent is obtained transparently. Overall, these changes provide much-needed clarity to the VPPA, especially as online video services have become more prevalent, and aim to address evolving consumer privacy concerns in the digital era.).

[64] *Id.*

[65] *Id.*

[66] Video Privacy Protection Act, 18 U.S.C. § 2710(b)(2) (1988).

[67] *Id.*

[68] *Developments in the Law — The Video Privacy Protection Act as a Model Intellectual Privacy*, 131 HARV. L. REV. 1766, 1769 (2018). https://harvardlawreview.org/print/vol-131/the-video-privacy-protection-act-as-a-model-intellectual-privacy-statute/.

definitions of "subscriber" and "PII."[69] This continued lack of clarity raises concerns about the law's ability to protect consumers in an era of rapidly evolving technology and changing business models. The implications of not having precise definitions for these terms include difficulties in determining the scope of the law, potential loopholes for data exploitation, and challenges in adapting the legislation to address emerging privacy concerns as the digital world progresses. As a result, the efficacy of the VPPA in safeguarding individuals' privacy remains a subject of ongoing debate and scrutiny, and these definitions remain contested among varying circuits.

Part III: Establishing a Relationship Between Subscription and Video Content

The VPPA defines a video service provider as "any person, engaged in the business, or in or affecting interstate or foreign commerce, of rental, sale, or delivery of prerecorded video cassette tapes or similar *audio visual materials*."[70] However, identifying whether the relationship between a subscriber and a video service provider is sufficiently close to trigger VPPA protection remains an uncertain issue lacking legislative guidance. Plaintiffs' demonstration of a relationship between video content and their subscription has proven a substantial hurdle to successful VPPA claims in recent years.

A symptom of the lack of legislative clarity surrounding the word "subscriber" in the VPPA is a lack of uniformity in determining whether plaintiffs with subscriptions have subscribed to video content, or merely a service *adjacent* to video content. Recent VPPA cases have turned on plaintiffs' eligibility to be considered subscribers *of video content*; absent legislative guidance on the process for determining the sufficient closeness of this "relationship," courts have reached contrasting holdings.[71]

Thus, there is a burden on each court encountering a VPPA claim to develop its own analysis for whether a plaintiff qualifies as a subscriber, and whether that subscriber-entity relationship is closely related to video content. While the VPPA defines a consumer as a renter, purchaser, or subscriber of goods or services *from a video tape service provider,*[72] this definition fails to provide courts with a scope of characteristics that subscriptions or providers must have to fall into under VPPA protection. As the divide between the circuits persists beyond the confines of *Ellis* and *Yershov*, there is a

---

[69] Video Privacy Protection Act Amendments Act of 2012, 126 Stat. 2414, (2013). (codified as amended at 18 U.S.C. § 2710(b)(2)).
[70] Video Privacy Protection Act of 1988 §2, 18 U.S.C. § 2710(a)(4) (emphasis added).
[71] *See, e.g.,* M.K. v. Google LLC, 2023 U.S. Dist. LEXIS 133602 (2023); Salazar v. NBA, , 685 F. Supp. 3d 232 (S.D.N.Y. 2023) .
[72] Video Privacy Protection Act Amendments Act of 2012, 126 Stat. 2414, (2013) (codified as amended at 18 U.S.C. § 2710(b)(2)) (emphasis added).

heightened need for legislative clarification of how a subscriber relationship is found to be specifically for video content.

Subpart A: Unsuccessful Demonstration of a Relationship Between Subscription and Video Content

In the last year, the cases *Salazar v. NBA*, *Carter v. Scripps Network*, and *Salazar v. Paramount Global* indicated a departure from the traditional legal analyses exemplified in *Ellis* and *Yershov*. These decisions illustrate the vulnerability of plaintiffs' VPPA claims to dismissal on grounds that their subscription, while existent, is not sufficiently related to video content to warrant VPPA protection. Courts have utilized a variety of analyses regarding these "relationships," yielding further disagreement among them.

First, *Salazar v. NBA*[73] highlights the continued confusion surrounding what a subscriber relationship requires to earn VPPA protection. (Notably, *Salazar* is currently on appeal in the Second Circuit; thus, this analysis may change in the near future.)[74] In *Salazar v. NBA*, the plaintiff sued the National Basketball Association (herein "NBA") for lack of disclosure of its privacy policy–which entailed sharing data with third parties (such as Facebook) upon creating an account on NBA.com.[75] NBA.com had a Privacy Policy that stated that the website collected "Personal Information" from users;[76] however, the plaintiff alleged that he was not asked to consent to his PII being shared with third parties, and thus brought a class action under the VPPA.[77] The NBA contended that a subscription to email newsletters was not a subscription to video content, and therefore argued that the claim should be dismissed.[78]

In dismissing the claim, the *Salazar v. NBA* court specifically noted that while the "[d]efendant *purposefully* used Facebook's pixel code on NBA.com and the App, *knew* that [personal viewing information] would be disclosed to Facebook, and financially benefited from it,"[79] the claim failed as the plaintiff was not qualified as a "consumer"

[73] Salazar v. Nat'l Basketball Ass'n, 685 F.Supp. 3d 232 (S.D.N.Y. 2023)
[74] Skye Witley, *NBA Pressed on Escape From Fan Suit Over Data Sharing With Meta*, BLOOMBERG LAW (Apr. 2, 2024), https://news.bloomberglaw.com/privacy-and-data-security/nba-pressed-on-escape-from-fan-suit-over-data-sharing-with-meta.
[75] *Id.*
[76] *Id.* at *3-4.
[77] *Id.*
[78] *Id.* at *19-20 ("Defendant argues that Plaintiff does not qualify as a "subscriber" of goods or services from a video tape service provider because Plaintiff only signed up for email newsletters — newsletters which were not alleged to contain video content and were not necessary to view the videos on the NBA website.").
[79] *Id.* at *6 (emphasis added).

under the VPPA.[80] Further, the court quoted the *Ellis* decision in its analysis of the present subscriber relationship, focusing on the "common thread" of "'subscription' involv[ing] some type of commitment, relationship, or association (financial or otherwise) between a person and an entity."[81] The court reasoned that the VPPA requires subscription to "audio visual materials, not just any products or services from a video tape services provider," and therefore the plaintiff's NBA.com account was ineligible for VPPA protection.[82]

The plaintiff's digital subscription to NBA.com required signing up for an online newsletter and providing an email address, but there was no indication that these newsletters contained videos.[83] Although the plaintiff alleged receiving "emails and other communications from NBA.com," there was no mention of videos within these communications.[84] Additionally, while the plaintiff stated that he indeed used his digital subscription to view videos on NBA.com or the NBA app, there was no assertion that these videos were exclusive to subscribers.[85] Therefore, the court noted that the process of viewing videos on NBA.com did not require a user to be a subscriber or have an account, as evidenced by a screenshot provided in the complaint showing an option to "Sign In" located on the screen; this led to the finding that viewing videos did not necessitate subscription.[86] Moreover, the objectionable process described by the plaintiff involved a user clicking on and watching a video within an article, after which NBA.com allegedly sent the video's content name, URL, and the user's Facebook ID (herein "FID").[87] However, there was no allegation that logging in was required to watch a video, further suggesting that the content accessed was not exclusive to subscribers.[88] Therefore, the court determined that the plaintiff did not meet the criteria to be considered a subscriber under the VPPA, as the provided evidence did not demonstrate a close enough relationship with video content on NBA.com.[89]

---

[80] *Id.* at *20 ("Specifically, Plaintiff argues that he has sufficiently pleaded a VPPA claim as a consumer given that he subscribed to NBA.com newsletters, he provided personal information to do so, and NBA.com provides video services...The Court does not agree with Plaintiff based on the language of the VPPA.").
[81] *Salazar*, 685 F. Supp. 3d at 243 (quoting *Ellis*, 803 F.3d at 1256).
[82] *Id. at 244*.
[83] *Id.*
[84] *Id.*
[85] *Id.* at *24.
[86] *Id.*
[87] Salazar v. NBA, 685 F. Supp. 3d 232, 245 (S.D.N.Y. 2023)*See also* How usernames and user IDs are used on Facebook Profiles, FACEBOOK HELP CENTER (2024), https://www.facebook.com/help/211813265517027 (last accessed on Sept. 27, 2024) (explaining that a Facebook User ID is a numerical string linked to a user's Facebook profile; it exists automatically, regardless of whether the user has created a username, and enables others to view the user's profile, including public information).
[88] Salazar v. NBA, 685 F. Supp. 3d at 245.
[89] *Id.* at 245-46.

Similarly, the *Carter v. Scripps Network* court concluded that the plaintiffs were not "subscribers" under the VPPA because their subscription to the newsletter did not establish that they had subscribed to audio-visual materials specifically.[90] In that matter, HGTV (which was owned by Scripps Network) operated the website hgtv.com, which hosted numerous home and lifestyle videos that attracted approximately 9.9 million monthly visitors.[91] The website allowed users to subscribe to newsletters based on their interests, and the plaintiffs subscribed to at least one newsletter each; the principal purpose of the newsletter was to drive traffic to HGTV's website, linking back to articles and videos.[92] The complaint did not allege that a newsletter subscription was required to view videos on hgtv.com.[93] Rather, each plaintiff had an account on Facebook, to which HGTV allegedly transmitted information, allowing it to identify the videos each plaintiff viewed on hgtv.com.[94] This was facilitated by the Facebook Tracking Pixel and "c_user" cookie, which disclosed information sufficient to identify specific individuals' video-viewing activities.[95] The plaintiffs alleged that, as subscribers to HGTV's newsletters and therefore "consumers" under the VPPA,[96] HGTV violated the VPPA by knowingly disclosing their video-viewing activities to Facebook for audience-building and targeted advertising.[97]

The *Carter* court held that the complaint did not plausibly allege that the plaintiffs viewed video content in their capacity as subscribers of hgtv.com, and therefore they could not be found to be "subscribers" within the meaning of the VPPA.[98] The plaintiffs' status as newsletter subscribers was deemed an insufficient link to allege they were therefore also subscribers to hgtv.com's video services.[99] Reasoning that the newsletters were viewed as advertisements for hgtv.com videos (and not as video content themselves), the court concluded that the plaintiffs were subscribers to newsletters, but

---

[90] Carter v. Scripps Networks, LLC, 670 F. Supp. 3d 90, 98 (2023).
[91] *Id.* at 93.
[92] *Id.* at 93.
[93] *Id.*
[94] *Id.*
[95] *Carter,* 670 F. Supp. 3d at 94 ("For visitors with an active Facebook account, the visitor's browser also transmits a 'c_user' cookie to Facebook, which contains the visitor's unencrypted Facebook ID, among other categories of information. HGTV also enables 'Automatic Advanced Matching,' which permits the Pixel to scan the website for a "recognizable form field" where a user has entered information like first name, last name and email. According to plaintiffs, the Pixel and the c_user cookie disclose information to Facebook that is sufficient for an ordinary person to identify a specific individual's video-viewing activities, including the videos watched.") (in-text citations omitted).
[96] *Id.*
[97] *Id.*
[98] *Id.* at 99-100 (concluding that "[b]ecause the Complaint does not plausibly allege that plaintiffs acted as 'subscribers' when they viewed videos on the hgtv.com, it does not plausibly allege that they were 'consumers' under the VPPA. The claim will therefore be dismissed.").
[99] *Id* at 99.

not subscribers to video content materials.[100] Since the complaint did not allege that newsletter subscriptions were a condition for accessing videos or enhanced the viewing experience, the court dismissed the claim on the basis that the plaintiffs were free to watch hgtv.com videos without any obligation – thus failing to establish a sufficient "subscriber" relationship.[101] As a result, the court granted the defendant's motion to dismiss.[102]

Lastly, the court in *Salazar v. Paramount Global* followed the *Carter* court's reasoning in attempting to define the necessary relationship a subscriber must have with a provider's video content to be protected under the VPPA.[103] In the matter of *Salazar v. Paramount Global*, the plaintiff contended that Paramount Global's installation of the Facebook tracking pixel on its website, 247Sports.com, resulted in the disclosure of their PII to Facebook without their consent.[104] 247Sports.com was a leading platform for recruiting content in college sports; it delivered team-specific news through various online channels and cultivated digital subscribers who registered on the website.[105] Registration required personal details such as email addresses and IP addresses, and in return the plaintiffs were provided access to the site's video media.[106] Paramount Global's utilization of the Facebook tracking pixel enabled Facebook to collect data on digital subscribers, disclosing viewed video media FIDs.[107] The court dismissed the claim, emphasizing that the plaintiffs did not qualify as "subscribers" under the VPPA.[108]

---

[100] *Id.* at *99 (Plaintiffs do not assert that they watched videos embedded in the newsletters themselves. The newsletters may entice or encourage recipients to view hgtv.com videos, but there is no assertion that a newsletter subscription was required to access those videos, functioned as a login, or gave newsletter subscribers extra benefits as viewers. Plaintiffs were free to watch or not watch hgtv.com videos.").

[101] *Id* at 99-100. (holding that due to the dismissal of the subscriber status claim, it did not need to address whether the data transmitted to Facebook (including Facebook ID, IP address, and videos watched) constituted PII under the VPPA).

[102] *Id.* at 100.

[103] Salazar v. Paramount Global, 683 F. Supp. 3d 727, 742 (M.D. Tenn. 2023) (noting that "[t]he court in *Carter v. Scripps Networks, LLC* recently resolved a motion to dismiss involving (alleged) facts materially indistinguishable from those presently before the Court" and thus here, as in *Carter*, the plaintiff's VPPA claim fails because he is "not a 'consumer' within the meaning of the VPPA because (according to the Defendant) he is not a 'subscriber of goods or services from a video tape service provider").

[104] *Id.*

[105] *Id.* ("Plaintiff alleges that Defendant violated the [VPPA] when it installed the Facebook pixel, which in turn has led to the disclosure to Facebook of Plaintiff's personally identifying information.").

[106] *Id.* at 733.

[107] *Id.* ("Defendant installed on 247Sports.com the Facebook tracking pixel ("Facebook pixel"), which is a code that allows Facebook to collect the data of digital subscribers to 247Sports.com who also have a Facebook account. The Facebook pixel discloses to Facebook the digital subscribers' viewed video media including a subscribers' Facebook ID ("FID"). An FID identifies a digital subscriber's Facebook account.") (citations omitted).

[108] *Id.* at 744. (being a subscriber to a newsletter, and not to audio visual material, destroys plaintiffs' VPPA claim).

The court interpreted "subscriber" to mean someone who subscribed directly to audio-visual materials, thereby excluding individuals who merely subscribed to newsletters from sites that *provided* video content.[109]

The recent cases S*alazar v. NBA, Carter v. Scripps Network, and Salazar v. Paramount Global* showcase one side of the deepened fracture in VPPA subscriber-entity relationship interpretation: an emphasis on the necessity of a direct and substantial connection between a plaintiff's subscription and the protected video content. The *Carter v. Scripps Network*, *Salazar v. Paramount Global*, and *Salazar v. NBA* holdings underscore the importance of a uniform analysis in determining the eligibility of plaintiffs to assert VPPA claims, as these three opinions greatly differ from those of other courts.

Subpart B: Successful Demonstration of a Relationship Between Subscription and Video Content

In recent legal battles over privacy rights in the digital age, cases such as *M.K. v. Google, Inc.* and *Jackson v. Fandom, Inc.* highlight the intricate relationship between online platforms, user subscriptions, and the protections afforded by the VPPA. In *M.K. v. Google, Inc.*, a public elementary school student's utilization of Google's educational program during remote learning prompted a lawsuit alleging VPPA violations, thus raising crucial questions about the definition of "subscriber" under the statute. Additionally, in *Jackson v. Fandom, Inc.*, a user's experience on a gaming and entertainment website sparked legal action against data-sharing practices. These cases underscore the complexities of defining subscriber relationships in the digital realm, as they diverge greatly from the analyses in *Carter v. Scripps Network*, *Salazar v. Paramount Global*, and *Salazar v. NBA*.

Foremost, in *M.K. v. Google, Inc.,* public elementary school student M.K. attended school remotely using a Google program due to the ongoing pandemic.[110] The school district assigned M.K. a Google account, enabling him to access online videos on Google's YouTube and slideshow platforms.[111] After M.K.'s teachers complained to his parents that they could see M.K. was watching videos instead of paying attention in classes, M.K.'s parents sued Google for allegedly giving the school district and other third parties access to M.K.'s online activity.[112] The District Court reasoned that M.K.

[109] *Id.*

[110] M.K. v. Google LLC, No. 21-cv-08465-VKD, 2023 U.S. Dist. LEXIS 133602, at *2 (2023).

[111] *Id.* at *2-3.

[112] *Id.* at *3-4. (A teacher alleged that M.K. was browsing YouTube instead of paying attention in class, and then – upon a further allegation that M.K. had sent the teacher an explicit message, which M.K. blamed upon hacking – the school district conducted an investigation wherein it "obtained and reviewed information about the dates and times M.K.'s Google account was accessed, the activities the account user engaged in while logged in to the account, and the IP addresses used to access the account".)

had four hurdles to state a claim under the VPPA: M.K. had to plausibly allege that "(1) Google was a 'video tape service provider,' (2) M.K. was a 'consumer,' (3) Google knowingly disclosed M.K.'s 'personally identifiable information' to 'any person,' and (4) the disclosure was not a permitted disclosure."[113]

The plaintiff alleged that Google was a video tape service provider "because it deliver[ed] audio visual materials similar to prerecorded video cassette tapes."[114] Google did not dispute this classification, but contended that the plaintiff was not a "subscriber" under the VPPA because his Google account was created "as part of his relationship with the [School] District, not a relationship with Google."[115] Like in *Carter*, *NBA,* and *Paramount Global*, the VPPA's silence on what constitutes a "subscriber" or a subscriber relationship specifically to video materials created an issue on which the *M.K.* court had very limited guidance.

Drawing on *Ellis* and *Yershov* as precedent because the Ninth Circuit had not yet addressed the definition of "subscriber" itself, the court concluded that M.K. was indeed a subscriber to Google's services.[116] M.K. alleged that he watched videos while logged into his Google account using a Google-provided application or service, thereby indicating that Google collected information about his viewing activity and associated it with him.[117] Thus, the court reasoned that M.K.'s creation of an account with Google contributed to the establishment of a subscriber relationship, and that the school district's facilitation of that relationship did not undermine M.K.'s status as a subscriber under the VPPA.[118]

Similarly, the matter of *Jackson v. Fandom, Inc.* showed another recent instance of a plaintiff's successful demonstration of having a sufficient relationship between his subscription and video content.[119] Plaintiff Lucinda Jackson, a registered user of the gaming and entertainment website Fandom, alleged that Fandom's data-sharing practices violated the VPPA.[120] To create her account, Jackson provided PII, including her name and email address.[121] Jackson viewed Fandom's prerecorded video content, unaware that Fandom transmitted users' viewing information to Meta Platforms, Inc. using a Meta Pixel, which collected analytical data about users' website usage and enables targeted advertising.[122] By incorporating the Meta Pixel in its website code, Fandom transmitted

---

113 *Id.* at *8 (citing Mollett v. Netflix, Inc., 795 F.3d 1062, 1066 (9th Cir. 2015)).
114 *Id.*
115 *Id.* at *9.
116 *Id.* at *10.
117 *Id.* at *10-14.
118 *Id.*
119 Jackson v. Fandom, Inc., No. 22-cv-04423-JST, 2023 U.S. Dist. LEXIS 125531, at *9 (N.D. Cal. July 20, 2023).
120 *Id.*
121 *Id.* at *1.
122 *Id.* at *2.

user-specific information (including IP addresses, names, email or phone numbers, video titles, and Facebook Profile IDs) to Meta, which owns Facebook and Instagram.[123]

Jackson alleged that Fandom, despite not renting, selling, or delivering video cassette tapes, qualified as a video tape service provider under the VPPA.[124] She argued that Fandom delivered audiovisual materials similar to prerecorded cassette tapes, citing case law that broadly interprets "similar audio visual materials" to include streaming video delivered electronically.[125] Despite Fandom providing free access to its website, courts had previously ruled that video-hosting websites need not charge fees to qualify as video tape service providers.[126]

The court found that Fandom qualified as a video tape service provider under the VPPA, and that Jakson's claim of being a subscriber under the VPPA was plausible.[127] Rather than merely asserting that she viewed videos on a website, Jackson stated that she established a Fandom account, registered as a user, and supplied her PII, including her name and email address, to Fandom; she then utilized Fandom to watch videos.[128] These actions, as detailed in the complaint, were found by the court to adequately support the Jackson's status as a subscriber.

In the ever-expanding digital landscape, cases like *M.K. v. Google* and *Jackson v. Fandom* highlight the opportunity plaintiffs have to successfully allege a subscriber relationship with a video service provider. When juxtaposed with *Salazar v. NBA, Carter v. Scripps Network, and Salazar v. Paramount Global*, the cases *M.K. v. Google* and *Jackson v. Fandom* underscore the lack of uniformity that underlies subscriber relationship analysis, even if the cases arise from similar factual scenarios. The former three cases featured dismissed claims by plaintiffs who subscribed to newsletters but failed to establish a direct link to accessing video content, emphasizing the necessity of a substantive connection between the subscription and protected video materials. These decisions highlight the stringent approach adopted by some courts in defining subscriber relationships within the VPPA's purview. Conversely, *M.K. v. Google* and *Jackson v. Fandom* illustrate instances wherein plaintiffs successfully demonstrated a sufficiently close relationship between their subscriptions and video content, resulting in plausible claims under the VPPA.[129] These latter cases found a student's account creation and utilization of Google's video services established a subscriber relationship, despite the account's origin through the school district, and found that the actions of registering as a user,

[123] *Id.*
[124] *Id.* at *6.
[125] *Id.* (quoting Stark v. Patreon, Inc., 635 F. Supp. 3d 841, 847 (N.D. Cal. 2022).
[126] *Id.* at *7 (citing In re Hulu Priv. Litig., 2012 U.S. Dist. LEXIS 112916 (N.D. Cal Aug. 10, 2012) (holding that a video streaming service may be considered a video tape service provider under the VPPA even if the consumers did not pay for the services provided)).
[127] *Id.* at *8-9.
[128] *Id.* at *9.
[129] *See Google LLC,* 2023 U.S. Dist. LEXIS at *12-16; *see also Fandom, Inc.*, 2023 U.S. Dist. LEXIS at *9).

providing personal information, and accessing video content are indicative of a subscriber status under the VPPA.[130]

Altogether, these cases underscore the divergent interpretations courts employ in assessing subscriber relationships with digital media platforms. While some decisions emphasize that a direct and substantial connection between subscriptions and video content providers warrants VPPA protection, others adopt a more stringent approach which requires plaintiffs to establish a clear link between their subscriptions and the specific audiovisual materials at issue.[131] As technology evolves and digital platforms continue to expand, the need for clarity in defining subscriber-entity relationships under the VPPA remains paramount to ensure adequate and consistent privacy protections for consumers.

Part IV: Impacts of Varying Interpretations of "Subscriber"

The disagreement among different circuits regarding the interpretation of "subscriber" has created uncertainty and varying standards across jurisdictions. Some courts have taken a narrow view, requiring a financial transaction or payment[132] for someone to be considered a subscriber.[133] Others have adopted a broader interpretation, considering factors beyond monetary transactions, such as the provision of personal information or creating an account.[134] The uncertainty surrounding the definition of "subscriber" reinforces the importance of clarifying and updating privacy statutes to address contemporary technologies and practices – whether through legislation or through Supreme Court intervention.

In recent years, individuals and advocacy groups have seized opportunities to challenge businesses over alleged VPPA violations. Companies using tools like the Meta Pixel to collect and share user data without clear consent have become targets for legal action.[135] Recent developments in VPPA case law have introduced a more defense-

[130] *Google LLC,* 2023 U.S. Dist. LEXIS at *12-16.
[131] *See Fandom, Inc.,* 2023 U.S. Dist. LEXIS at *9.; *See also, Google LLC,* 2023 U.S. Dist. LEXIS at *12-16
[132] *E.g., Ellis,* 803 F.3d at *1258 ("As we have explained, the free downloading of a mobile app on an Android device to watch free content, without more, does not a 'subscriber' make.").
[133] *Yershov,* 820 F.3d at 486-487 (holding that a user must have a direct, ongoing subscription-type relationship with the service provider to be considered a "subscriber" under the VPPA).
[134] *See, In re Nickelodeon*, 827 F.3d at 279 (holding that the term "subscriber" in the VPPA could include individuals who downloaded and used a mobile app, even if they did not have a direct subscription relationship with the service provider, thus establishing a more expansive interpretation of "subscriber" which encompassed a wider range of individuals under the VPPA's protections).
[135] *See e.g.* Ambrose v. Boston Globe Media Partners LLC, 2022 U.S. Dist. LEXIS 168403 (denying a motion to dismiss a claim against a multimedia organization offering news and entertainment through its

friendly approach regarding the definition of a "subscriber." Some plaintiffs have found success arguing that subscribing to a newsletter, app, or having an account with a defendant automatically qualifies them as consumers under the VPPA. However, courts across the country have adopted a narrower interpretation: recent decisions, such as *Lamb v. Forbes Media LLC*[136] and *Brown v. Learfield Communications LLC*,[137] have emphasized that mere subscription without any special access to video content does not establish consumer status under the statute.[138] For instance, in *Brown*, the court ruled that plaintiffs who did not demonstrate a viable link between their newsletter subscription and access to video content could not considered subscribers within the VPPA's scope.[139] These rulings effectively limit the circumstances under which a valid VPPA claim may be filed in those jurisdictions, reducing the potential risk for website operators featuring video content from being targeted under the statute.[140]

However, this limitation does not completely clarify what a "subscriber" is, and as a result of the VPPA's unresolved ambiguity surrounding the term, there are various consequences extending beyond the judicial system and affecting legislative efficacy and public policy.[141] The consequences this note addresses are twofold: increased privacy litigation, specifically regarding dispute over Meta Pixels' legality under the VPPA; and public policy concerns.

---

website, bostonglobe.com, for violating the VPPA by disclosing digital subscribers' PII to Facebook, without their consent, via Facebook's Tracking Pixel and Advanced Matching tools).

[136] Lamb v. Forbes Media LLC, No. 1:22-cv-06319-ALC, 2024 U.S. Dist. LEXIS 59355 (S.D.N.Y. Apr. 1, 2024) (holding that the plaintiff was a website subscriber, not an audio visual material subscriber, and therefore the VPPA claim was dismissed).

[137] Brown v. Learfield Commc'ns, LLC, No. 1:23-CV-00374-DAE, 2024 U.S. Dist. LEXIS 15587 (W.D. Tex. Jan. 29, 2024), at *28 (reasoning that the plaintiff subscribed to a newsletter but "was not signing up for audio-visual content," and thus dismissing the plaintiff's claim).

[138] Kristine Argentine, *Is the Video Privacy Protection Act Losing its Allure?*, SEYFARTH (Feb. 7, 2024), https://www.globalprivacywatch.com/2024/02/is-the-video-privacy-protection-act-losing-its-allure/.

[139] *Brown*, 2024 U.S. Dist. LEXIS 15587 at *27-28.

[140] Kristine Argentine, *Is the Video Privacy Protection Act Losing its Allure?*, SEYFARTH (Feb. 7, 2024), https://www.globalprivacywatch.com/2024/02/is-the-video-privacy-protection-act-losing-its-allure/.

[141] *See Brown*,. U.S. Dist. LEXIS 15587 at *29-30 ("[T] here is no denying that the First Circuit's opinion in *Yershov v. Gannett Satellite Info. Network, Inc.*, could lead to an alternative result. There is clearly a Circuit split on this issue and a great deal of inconsistency throughout the federal courts. Indeed, this inconsistency poses consequences to personal privacy in the era of rapid accumulation of data by tech companies. As such, clarity from Congress would be prudent and go a long way in providing courts with a more definite understanding of whether e-newsletter that simply link to publicly accessible videos fall under the VPPA.").

Subpart A: Increased Privacy Litigation in 2023 Regarding Meta Pixels

From 2022 to 2024, many class action cases have been filed regarding Meta Pixels.[142] Several lawsuits claimed that companies utilizing the Meta Pixel on their websites for streaming online video content violated the VPPA by transmitting users' PII to Meta (formerly Facebook).[143] The Meta Pixel is a code snippet designed for websites, enabling the measurement of advertising effectiveness by tracking user actions on the site.[144] It serves various purposes, including ensuring that ads reach the intended audience, targeting new customers or those who have interacted with specific website pages, and optimizing for increased sales.[145] Additionally, the Meta Pixel allows advertisers to set up automatic bidding to target users likely to take desired actions, such as making a purchase.[146] Further, it facilitates the measurement of ad performance by providing insights into user interactions when they view the ads.[147]

An example of Meta Pixel litigation under the VPPA is found in *Ambrose v. Boston Globe Media Partners LLC*.[148] The lawsuit accused Boston Globe of violating the VPPA by integrating Meta Pixel tracking onto sections of its website exclusive to subscribers, which included tracking integrated video views.[149] Following this case, over a hundred class actions were initiated against various online news outlets, streaming services, retailers, and others, primarily based on their use of the Meta pixel on their websites.[150] Eventually, Boston Globe reached a $5 million settlement and the court noted that the plaintiff had presented a viable claim, although the determination of whether the website indeed transmitted PII to Meta would be assessed later.[151]

In the matter of *Martin v. Meredith Corp.*, the court dismissed the argument that the Facebook Pixel version used on People.com (which was operated by Meredith Corp.) only transmitted the FID and the accessed webpage's name, and therefore did not send

---

[142] *Meta Pixel: A New Target for Privacy Litigation*, BUCHANAN (Apr. 6, 2023), https://www.bipc.com/meta-pixel-a-new-target-for-privacy-litigation#:~:text=Video%20Privacy%20Protection%20Act%20of%201988%20(VPPA)&text=These%20lawsuits%20allege%20that%20companies,about%20a%20user%20to%20Meta.
[143] *Introducing Meta: A Social Technology Company*, META (Oct. 28, 2021), https://about.fb.com/news/2021/10/facebook-company-is-now-meta/.
[144] About Meta Pixel, META (last visited Sep. 28, 2024), https://www.facebook.com/business/help/742478679120153?id=1205376682832142.
[145] *Id.*
[146] *Id.*
[147] *Id.*
[148] Ambrose v. Boston Globe Media Partners LLC, No. 21-10810-RGS, 2022 U.S. Dist. LEXIS 168403, at *2 (D. Mass. Sept. 19, 2022) (the plaintiff alleged that the defendant had "disclose[d] digital subscribers' PII to Facebook without the subscribers' permission… [via] Facebook Tracking Pixel").
[149] *The VPPA Class Action – Is This Tide Still Coming In? Or Going Out?*, POLSINELLI (Jan. 24, 2024), https://www.polsinelli.com/publications/the-vppa-class-action-is-this-tide-still-coming-in-or-going-out.
[150] *Id.*
[151] *Id.*

PII as defined by the VPPA.[152] Specifically, the court held that the transmitted information did not relate to whether an individual "requested or obtained specific video materials or services."[153] This decision highlights the complexities involved in applying traditional privacy statutes to modern digital technologies and underscores the ongoing challenges in balancing consumer privacy rights with technological innovation.

Hinging upon the definition of "subscriber," the VPPA's protection regarding disclosure of PII is limited to a shrinking number of plaintiffs. For example, in the matter of *Golden v. NBCUniversal Media LLC*, plaintiff Sherhonda Golden filed a putative class action against NBCUniversal Media, LLC (NBCU), claiming a violation of the VPPA.[154] Golden alleged that NBCU knowingly shared PII with Meta, absent the consent of digital visitors.[155] Today.com's website and newsletter, where users could sign up for email newsletters containing links to Today.com content, required users to provide their PII in the form of email addresses and zip codes.[156] The privacy policy mentioned automatic collection of information, including video content viewed.[157] Today.com used Facebook's tracking pixel to transmit user information to Facebook without disclosure or consent, benefiting financially from this data sharing. Golden signed up for a Today.com newsletter, accessed content through its website and app, and used Facebook concurrently.[158]

---

[152] Martin v. Meredith Corp., 657 F. Supp. 3d 277, 282. 284 (S.D.N.Y. 2023) (the plaintiff, "an 'active subscriber' of People.com who often watches videos on the website", was unsuccessful in asserting his VPPA claim).

[153] *Id.* at 284 (quoting 18 U.S.C. § 2710(a)(3)) (holding that "because the complaint itself shows that the defendants do not disclose information showing that a person has "requested or obtained specific video materials or services." The basis for the plaintiff's claim is People.com's use of the Facebook Pixel. As the complaint alleges, however, the version of the Facebook Pixel used on People.com sends only the Facebook ID and the name of the webpage that a user accessed. The complaint acknowledges that not all of People.com's content pages even include videos. Thus, simply disclosing the name of webpage and an associated Facebook ID leaves off essential information for a VPPA claim, including at least: (1) whether the webpage contains a video; (2) if so, the name of the "specific video materials" on the page; (3) whether there are multiple videos on the page and, if so, which "specific video materials" were requested or obtained by the website visitor; and (4) whether the website visitor "requested or obtained" any videos at all, or instead merely read an article on the webpage. Indeed, from the information disclosed to Facebook by People.com, it would not even be clear if the person associated with the Facebook ID is a consumer of video media.").

[154] Golden v. NBCUniversal Media, LLC, 688 F. Supp. 3d 150 (S.D.N.Y. 2023) (No. 22 Civ 9858 (PAE)).

[155] *Id.* at *1.

[156] *Id.* at *3 (newsletter recipients signed up by provided NBCU with their name, email address, zip code, and IP address, which is "a unique number assigned to all information technology connected devices, which conveys the device's city, zip code, and physical location").

[157] *Id.*

[158] *Id.* at *5.

The *Golden* court held that the disclosure of a user's FID, which could be used to identify a specific person, constituted PII;[159] however, the court also concluded that while Today.com disclosed PII knowingly[160], Golden did not qualify as a "subscriber" under the Act.[161] There was no ongoing commitment or relationship between Golden and Today.com or NBCU regarding the video content.[162] Therefore, because Golden did not qualify as a "subscriber" under the VPPA, she was unable to fight against the sharing of her PII under the VPPA, and the court granted NBCU's motion to dismiss Golden's claim.[163] Hence, the outcome of this matter eventually hinged solely on the court's interpretation of "subscriber"[164] – a process which varies in form and in outcome across the country.[165] Thus, the litigation stemming from consumers' desire for protection from evolving technology like Meta Pixels under the VPPA emphasizes the importance of companies and website owners safeguarding their online video offerings against such claims. This wave of cases filed under the VPPA also highlights the need for more updated legislation which clarifies the scope of who is a "subscriber" and therefore eligible for protection under the law.

Further, much of the recent wave of VPPA claims stems from companies including ad technology across web and mobile platforms; applying pre-Internet

[159] *Id.* at *18 (Holding that the VPPA allows disclosure of personal information if it solely includes names and addresses and does not identify the titles of viewed videos. The current complaint plausibly alleges that the disclosure of URLs identifies the subject matter of the viewed videos, even if specific titles are not mentioned. Thus, the court held that according to established case law, a complaint does not need to specify the exact titles of disclosed videos; the disclosure of user Facebook IDs along with URLs of accessed videos is sufficient).

[160] *Id.* at *19 ("NBCU took affirmative steps to install and program the Facebook pixel to collect and transmit information regarding each visitor's on-demand video viewing, and that it did so to profit from advertising and information services, with the understanding that the pixel would transmit users' information to Facebook. That is sufficient to allege NBCU acted 'knowingly.'") (internal citations omitted).

[161] *Id.* at *28 ("As such, the FAC's allegations regarding the newsletter do not qualify Golden as a "subscriber" under the VPPA.").

[162] *Id.*

[163] *Id.*

[164] *Id.* at *30 (granting NBCU's motion to dismiss the VPPA claim, based on the following reasoning: "because the FAC fails to allege that Golden is a "subscriber" within the meaning of the statute. The contrary holding, on the sparse allegations here, would mean that so long as the provider has been able to access a user's information, the protections of the VPPA should apply, and whatever the user has done to enable such access (here, simply browsing while logged onto Facebook) is thereby sufficient to render her a subscriber.") (internal quotation marks omitted).

[165] *See* Gardener v. MeTV, 2023 U.S. Dist. LEXIS 115810 (plaintiffs' VPPA claim, alleging that MeTV unlawfully disclosed their personal video viewing history and their associated unique Facebook identifications using a Meta Pixel, was dismissed. The court reasoned that the plaintiffs did not qualify as "consumers" under the VPPA because their relationship with MeTV was too insubstantial to meet the statutory definition: anyone could access the videos on the website, absent a login.). *But see* Jackson v. Fandom, Inc., *supra* note 124.

legislation to modern privacy issues leads to uncertain outcomes.[166] Legal clarity remains elusive, especially concerning the classification of businesses and consumers under the VPPA. Despite ongoing litigation, businesses must understand and monitor data collection practices, including tracking activities and interactions with third-party service providers like Meta or Google.[167] VPPA violations pose significant financial risks, with statutory liquidated damages potentially amounting to billions of dollars for large companies.[168] Insurers, particularly those offering cyber policies, face escalating challenges as technology evolves, leading to evolving VPPA claims that may not be covered by traditional media policies but instead fall under cyber policies.[169]

Subpart B: Public Policy Concerns

Recent studies indicate that most Americans are concerned about their right to privacy as artificial intelligence and social media continue to advance. The VPPA has not evolved enough to protect Americans' privacy; new legislation is necessary to restore the nation's faith in privacy protection under the law as they use the ever-growing Internet. In October 2023, the Pew Research Recenter reported that "roughly four-in-ten Americans say they are *very* worried about companies selling their information to others without them knowing" and "Americans are less knowledgeable about data privacy laws today than in the past" – in fact, nearly three quarters of Americans claimed "little to no understanding about the laws and regulations that are currently in place to protect their data privacy."[170]

This concern is highly concentrated in the social media space. The same Pew Research report revealed that 77% of Americans "have little to no trust that leaders of social media companies will publicly admit mistakes regarding consumer data being misused or compromised" or "not sell users' personal data to others without their consent."[171] Further, 71% of Americans polled expressed skepticism "that leaders would be held accountable by the government if they were to misuse or compromise users' personal data" – with "46% say[ing] they have no trust at all in executives of social media companies to not sell users' data without their consent."[172] Thus, in its current state, the

166 Elizabeth Blosfield, *Be Kind, Rewind: How a Blockbuster-Era Law Is Still Being Used in Data Privacy Disputes*, INSURANCE JOURNAL (Jul. 5, 2023), https://www.insurancejournal.com/news/2023/07/05/728668.htm.
167 *Id.*
168 *Id.*
169 *Id.*
170 Colleen McClain, Michelle Faverio, Monica Anderson & Eugenie Park *How Americans View Data Privacy*, PEW RESEARCH CENTER (Oct. 18, 2023), https://www.pewresearch.org/internet/2023/10/18/views-of-data-privacy-risks-personal-data-and-digital-privacy-laws/.
171 *Id.*
172 *Id.*

VPPA has failed to instill public confidence in the government's regulatory and protective power over privacy matters.

The latest surge of VPPA claims targets businesses utilizing Meta Pixel code on their websites, alleging that this code leads to the disclosure of consumer PII to Meta, thus violating the VPPA. These claims have been asserted against various website operators, ranging from news outlets to e-commerce companies, regardless of whether their websites primarily serve video content.[173] Companies found liable under the VPPA may face substantial damages, including actual or liquidated damages of at least $2,500 per affected consumer, punitive damages, attorneys' fees, and other equitable relief, especially considering potential class action lawsuits involving hundreds of thousands of consumers.[174] With the likelihood of VPPA claims continuing to rise due to ongoing legal uncertainties, companies would be well-advised to closely monitor developments in VPPA litigation and evaluate their use of Meta's Pixel or similar tracking technologies.[175] It is also crucial for companies to review and update their policies, privacy notices, and consent procedures to ensure compliance with evolving legal standards and consumer expectations.[176]

Part V: Existing and Pending Legislation

In recent years, a growing concern over digital privacy has led several states to enact legislation which bolsters consumer protections online. These laws endeavor to take a more modern approach to safeguarding Internet users' data, aligning with the principles of privacy championed by the VPPA while adapting to the complexities of newer technology. Multiple states have implemented privacy laws aimed particularly at protecting Internet users' data, thereby strengthening consumers' rights and taking a step towards protecting the right to privacy in this advanced digital age. In fact, eight states' privacy laws will take effect between 2023 and 2026.[177] Among these initiatives, the New

---

[173] Adam M. Leiva& Alexander F. Koskey, *VPPA Claims Are on the Rise – Latest Trend in Consumer Privacy Class Action Litigation*, BAKER DONELSON (Mar. 13, 2023), https://www.bakerdonelson.com/vppa-claims-are-on-the-rise-latest-trend-in-consumer-privacy-class-action-litigation.
[174] *Id.*
[175] *Id.*
[176] *Id.*
[177] Fredric D. Bellamy and Ashley N. Fernandez, *A new era of privacy laws takes shape in the United States*, REUTERS (Nov. 15, 2023), https://www.reuters.com/legal/legalindustry/new-era-privacy-laws-takes-shape-united-states-2023-11-15/ (highlighting the following states' privacy legislation: Iowa (effective Jan. 1, 2025), Indiana (effective Jan. 1, 2026), Montana (effective Oct. 1, 2024), Tennessee (effective July 1, 2025), Texas (effective July 1, 2024), Florida (effective July 1, 2024), Washington (effective July 23, 2023, with most substantive provisions not applying until March 31, 2024), and Oregon (effective July 1, 2024)).

Jersey Data Privacy Act (herein "NJDPA") stands out as a significant step forward in protecting consumer privacy within the Garden State, setting a precedent for other states to follow.

Signed into law by New Jersey Governor Phil Murphy, the NJDPA[178] mandates businesses and online entities to notify consumers about the collection and sharing of personal data with third parties, offering consumers the option to opt out of such practices.[179] The legislation responds to the escalating reliance on digital platforms for various daily tasks, aiming to curb the exploitation of consumer data and defining sensitive data categories by necessitating opt-in consent for their processing and introducing universal opt-out mechanisms for user convenience and privacy.[180] Businesses must adhere to stringent data protection measures and conduct data protection assessments, with violations subject to penalties enforced by the New Jersey Office of the Attorney General.[181] The law, effective January 15, 2025, underscores New Jersey's commitment to bolstering consumer privacy protections despite the VPPA's inability to consistently do so.[182]

While many states have already implemented privacy legislation, a number of federal acts remain pending. Shared video content has become increasingly commonplace online, and a specific concern has developed regarding children's privacy on the Internet.[183] In fact, by the age of twelve, 42% of children use social media;[184] this indicates the emergence of a uniquely vulnerable class of Internet users who are not adequately protected under the VPPA.[185]

For instance, the proposed Clean Slate for Kids Online Act of 2023 seeks to amend the Children's Online Privacy Protection Act of 1998 (COPPA) to allow

---

[178] S. 332, 220th Leg. (N.J. 2024).
[179] *Governor Murphy Signs Legislation Protecting Consumer Data*, STATE OF NEW JERSEY (Jan. 16, 2024), https://nj.gov/governor/news/news/562024/approved/20240116k.shtml?mkt_tok=MTM4LUVaTS0wNDIAAAGQt83Motlu9nB9SUMMGrRmbh9Wf2rB4S3WydioDGh_Z0kCCtL9zVO3RjsPoRJw4EUyKOWhstJL60qzUTZ6aehhT98SZpbON5tBDRVyPkM5EbzM.
[180] *Id.* ("An operator that collects the personally identifiable information of a consumer through its commercial Internet website or online service and sells the personally identifiable information of the consumer… shall clearly and conspicuously post a link, on its commercial Internet website or online service or in another prominently accessible location . . . which enables a consumer, by verified request, to opt out of the sale of the consumer's personally identifiable information.").
[181] *Id.*
[182] *Id.*
[183] S. Matthew Liao & Claudia Passos Ferreria, *Kids Deserve Privacy Online. They're Not Getting It.*, THE ATLANTIC (Sep. 14, 2023), https://www.theatlantic.com/ideas/archive/2023/09/kids-online-data-privacy-tracking-apps/675320/.
[184] *Sharing Too Soon? Children and Social Media Apps*, MOTT POLL REPORT (Oct. 18, 2021), https://mottpoll.org/reports/sharing-too-soon-children-and-social-media-apps.
[185] Video Privacy Protection Act of 1988, 18 U.S.C. § 2710.

Americans the option to delete personal information collected by Internet operators as a result of their Internet activity prior to age 13.[186] (The COPPA Rule, implemented in 2000, mandates that specific websites and online services collecting personal information from children under 13 must notify parents and acquire verifiable parental consent prior to gathering, utilizing, or sharing such information.[187] Additionally, this Rule restricts the types of personal data websites and online services can gather from children, sets limitations on data retention periods, and mandates the implementation of security measures to safeguard the collected data.)[188] The key provisions include defining "delete" as the removal of personal information from retrievable form, making it unlawful for operators to fail to delete such information upon request, and requiring operators to provide notice and to promptly delete personal information collected when they were children.[189]

Additionally, Protecting the Information of our Vulnerable Adolescents, Children, and Youth Act ("PRIVACY Act") seeks to provide similar protections.[190] Representative Kathy Castor reintroduced the Kids PRIVACY Act, aimed at updating COPPA with stronger measures to safeguard children and teenagers online.[191] The bill seeks to hold technology companies accountable for surveillance and targeting practices.[192] Key aspects include banning targeted advertisements to minors, requiring opt-in consent for individuals under 18, and creating a right to access, correct, and delete personal information.[193] It also extends protection to teenagers aged thirteen to seventeen, mandates user-friendly privacy policies, and strengthens FTC enforcement.[194] The bill is supported by various organizations and aims to address the evolving challenges of online privacy for youth.[195]

As states continue to fortify their privacy laws to adapt to the digital landscape, federal legislation remains pending, leaving gaps in protection — particularly for vulnerable groups such as children and teenagers. Efforts such as the proposed Clean Slate for Kids Online Act of 2023 and the reintroduction of the Kids PRIVACY Act by

[186] Clean Slate for Kids Online Act of 2023, S. 395, 118th Cong. (2023), https://www.congress.gov/bill/118th-congress/senate-bill/395/text.
[187] Children's Online Privacy and Protection Act of 1998, 15 U.S.C. §6502(d) (2024).
[188] *FTC Proposes Strengthening Children's Privacy Rule to Further Limit Companies' Ability to Monetize Children's Data*, FED. TRADE COMM'N (Dec. 20, 2023), https://www.ftc.gov/news-events/news/press-releases/2023/12/ftc-proposes-strengthening-childrens-privacy-rule-further-limit-companies-ability-monetize-childrens.
[189] *Id.*
[190] Protecting the Information of our Vulnerable Children and Youth Act, H.R.4801, 117th Cong. (2021), https://www.congress.gov/bill/117th-congress/house-bill/4801.
[191] *Id.*
[192] *Id.*
[193] *Id.*
[194] *Id.*
[195] Press Release, U.S. Rep. Kathy Castor, Rep. Castor Reintroduces Kids PRIVACY Act, (Apr. 24, 2023), https://castor.house.gov/news/documentsingle.aspx?DocumentID=404126.

Representative Kathy Castor underscore the ongoing push to update federal laws like the COPPA and the VPPA to address contemporary privacy challenges. By bridging these gaps and strengthening consumer protections both at the state and federal levels, policymakers can ensure that all individuals, regardless of age, can navigate the digital world with confidence in their privacy and security.

Part VI: Proposed Solutions

In recent years, a surge of VPPA litigation which expanded beyond traditional video services to various sectors like banking, sports, and healthcare established the vulnerability of businesses utilizing emerging technology to VPPA claims, and the growing concerns of individuals regarding their data and its privacy.[196] Plaintiffs involved in VPPA litigation targeted websites with embedded videos and tracking features, leading to numerous class action lawsuits.[197] However, defendants recently began winning dismissals on constitutional and statutory grounds. The VPPA originally aimed to prevent the sharing of video rental records, but it was creatively used by plaintiffs against streaming companies in the early 2000s.[198] However, as VPPA litigation continues and the legislature remains silent on amending the VPPA to evolve with current technology, there are a few defenses businesses may utilize to prevent or fight VPPA claims: challenging the classification of website operators as videotape service providers under the VPPA, and contesting plaintiffs' status as consumers within the VPP's definition. Additionally, the solution of improved legislation—particularly, legislation which aligns more closely with the European General Data Policy Regulation (herein "GDPR")—remains the ideal solution to the inconsistency of analysis across American courts.

The definition of "consumer" under the VPPA continues to be debated, particularly regarding website visitors and subscribers. The VPPA's role in litigation is evolving, which emphasizes the importance of companies staying updated and compliant with privacy precedent as it (ideally) develops alongside technology.[199] Thus, businesses would be wise to take preventative measures to avoid privacy litigation, and individuals would be wise to understand their rights under the VPPA. For businesses, auditing their

---

[196] Emily Kessler, *A Recent Surge of Consumer Privacy Litigation Asserting Violations of the Video Privacy Protection Act (VPPA) Seeks to Hold Companies Liable for Data Sharing in Context of Marketing Analytics*, SEYFARTH (Jan. 25, 2023), https://www.consumerclassdefense.com/2023/01/a-recent-surge-of-consumer-privacy-litigation-asserting-violations-of-the-video-privacy-protection-act-vppa-seeks-to-hold-companies-liable-for-data-sharing-in-context-of-marketing-analytics/.

[197] *Id.*

[198] Video Privacy Protection Act, 18 U.S.C. § 2710 (1988).

[199] *The VPPA Class Action – Is This Tide Still Coming In? Or Going Out?*, POLSINELLI (Jan. 24, 2024), https://www.polsinelli.com/publications/the-vppa-class-action-is-this-tide-still-coming-in-or-going-out.

websites, practicing transparency, and securing consent[200] may enable them to get ahead of privacy violation allegations. Restricting the utilization of pixels and other tracking technologies solely to pages lacking video content, or adjusting their configuration to prevent the dissemination of personally identifiable information to third parties.[201] Enhancing cookie preference centers or similar tools to solicit distinct consent from users before sharing data regarding their video-watching activities.[202] Further, revising websites' privacy policies to provide transparent information on the disclosure of personally identifiable information to third parties, along with detailing the purposes for which such information is utilized, is also an important measure.[203]

The numerous VPPA lawsuits of the last year "seek to impose enormous liability on what has become routine and universal data analytics."[204] Companies that include "video content in brand marketing and advertising analytics could potentially be opening themselves up to a new class of consumer privacy litigation seeking $2,500 in statutory fees per violation, as well as potential punitive damages and attorneys' fees."[205] This has led to the rise of serial litigants who visit various websites using pixel tools, then pursue VPPA claims against the website operators.[206] The potential liability under the VPPA is significant, including liquidated damages on a class-wide basis, punitive damages, attorney fees, and the possibility of related claims under state wiretapping statutes.[207]

Therefore, in recent VPPA litigation, two primary defenses have emerged as particularly effective for businesses. First, defendants have challenged the classification of website operators as videotape service providers under the VPPA.[208] This defense has proven successful for companies whose primary focus is not centered on delivering video content.[209] Second, defendants have contested plaintiffs' status as consumers within the VPPA's definition.[210] This defense acknowledges that the VPPA applies solely to consumers who rent, purchase, or subscribe to the operator's goods or services,

---

200 *See* Daniela Spencer, *Why Blockbuster is Relevant Once More: The Return of the VPPA*, LOEB & LOEB (Dec. 2023), https://www.loeb.com/en/insights/publications/2023/12/why-blockbuster-is-relevant-once-more-the-return-of-the-vppa.
201 *Id.*
202 *Id.*
203 VPPA Trends: Considerations for Limiting Exposure, LEXOLOGY (Jul. 25, 2023), https://www.lexology.com/library/detail.aspx?g=e636eb54-8817-42d5-a97e-c6bd042941d3.
204 Kessler, *supra* note 196.
205 *Id.*
206 Michael J. Stortz et al., *LITIGATION MINUTE: PIXEL TOOLS AND THE VIDEO PRIVACY PROTECTION ACT PIXEL TOOL LITIGATION SERIES: PART TWO*, K&L GATES (AUG 29, 2023), https://www.klgates.com/Litigation-Minute-Pixel-Tools-and-the-Video-Privacy-Protection-Act-8-29-2023.
207 *Id.*
208 *Id.*
209 *Id.*
210 *Id.*

excluding casual website visitors.[211] Accordingly, successful dismissals have occurred where plaintiffs failed to establish a substantial relationship with the business or access to restricted content.[212] Mere website visits or downloading free applications for video content viewing were insufficient grounds for asserting a VPPA claim.[213] Thus, the ambiguity surrounding the term "subscriber" may, whilst being a source of confusion for companies seeking compliance and individuals concerned over privacy, actually be a viable defense for defendant companies facing claims brought by self-proclaimed "subscribers."[214]

Further, in the case of *Carroll v. General Mills, Inc.*, plaintiffs alleged a violation of the VPPA occurred when their video-viewing activity was shared with third parties through pixel code on the defendant's website. [215] The court dismissed the lawsuit, emphasizing the VPPA's requirement that the defendant be a "video tape service provider" engaged in the business of rental, sale, or delivery of prerecorded video materials; General Mills, primarily in the business of food products, did not meet the "video tape service provider" criteria merely by delivering online videos as part of its marketing strategy.[216]

Thus, the *Carroll* decision established a clear defense for companies: posting online videos *incidental* to a company's core business may be outside the scope of the VPPA.[217] Thus, as the definition of "subscriber" continues to create ambiguity for companies seeking to comply with privacy laws, *Carroll* highlights a defense for a certain niche of defendants. Beyond these threshold issues, defendants have pursued other critical defenses, including questioning whether the pixel tool deployed by the website operator captures PII as defined by the VPPA.[218] The determination of what constitutes PII varies across jurisdictions, with some courts adopting broader interpretations.[219]

The lawsuits revolving around the VPPA have also created uncertainty for marketers as they grapple with fitting data and technology into legal frameworks. Currently, scrutiny is highest on data directly linking individuals to the content they

[211] Video Privacy Protection Act, 18 U.S.C. § 2710(a)(1) (1988).
[212] Stortz et al., *supra* note 206.
[213] *Id.*
[214] *Id.*
[215] Carroll v. Gen. Mills, Inc., CV 23-1746 DSF (MRWx), 2023 U.S. Dist. LEXIS 110049, at *1 (C.D. Cal. June 26, 2023) (holding that the matter was dismissed because its core business did not revolve around video content, but instead was centralized around cereals, yogurts, and dog food – its online videos served merely as a peripheral marketing strategy, rendering the company ineligible to be charged under the VPPA).
[216] *Id.* at 9.
[217] *Id.* at 1.
[218] Video Privacy Protection Act, 18 U.S.C. § 2710(a) (1988).
[219] *Id.* For example, the First Circuit considers GPS coordinates and device identifiers as PII, leading to heightened VPPA litigation in its district courts, particularly concerning the deployment of pixel technology.

watch.[220] Obtaining express opt-in consent to share viewership data may provide some clarity for businesses, but definitive answers remain elusive.[221] Despite these legal challenges, advertisers can still effectively reach their target audiences in video environments. Key considerations include seeking legal oversight from compliance teams to navigate data applications and targeting models under legislation like the VPPA.[222] Collaborating with knowledgeable data partners who understand VPPA compliance is crucial for developing actionable strategies.[223] Additionally, since deterministic data that directly links individuals to content remains central to VPPA compliance, advertisers may still use data from viewers who give permission to track what they watch to create models of similar audiences; this would enable them to locate people who are likely to be interested in their ads, making their targeting both more accurate and more VPPA complaint.[224]

Marketers should stay informed about legal developments, especially concerning data use under the VPPA, and be ready to adapt strategies accordingly. Further, websites that wish to put videos behind a log-in section and track the viewership of those videos through any third-party service should institute a policy of obtaining regular express user consent to such tracking.[225] This is an emerging best practice even if no payment is involved and users merely need to create accounts to have access to those sections of the website.[226]

Finally, the United States still lacks a comprehensive federal consumer privacy law akin to the GDPR.[227] The GDPR, established by the European Union in 2018, is the most stringent privacy and security law globally, affecting organizations worldwide that collect data related to EU citizens.[228] It imposes significant fines for non-compliance, emphasizing Europe's commitment to data privacy amidst increasing reliance on cloud

---

220 *Id.*
221 Mitch Eisenberg, *How Advertisers Can Try to Avoid Getting Stuck in VPPA Limbo with Their CTV and Video Data*, STREAMING MEDIA (Jan. 3, 2024), https://www.streamingmedia.com/Articles/ReadArticle.aspx?ArticleID=162018.
222 *Id.*
223 *Id.*
224 *Id.*
225 *Id.*
226 *The VPPA Class Action – Is This Tide Still Coming In? Or Going Out?*, POLSINELLI (Jan. 24, 2024), https://www.polsinelli.com/publications/the-vppa-class-action-is-this-tide-still-coming-in-or-going-out.
227 Jennifer King & Caroline Meinhardt, *Rethinking Privacy in the AI Era,* STANFORD UNIVERSITY HAI (Feb.22, 2024) at 12-13, https://hai.stanford.edu/sites/default/files/2024-02/White-Paper-Rethinking-Privacy-AI-Era.pdf. *See Comparing U.S. State Data Privacy Laws vs. the EU's GDPR*, BLOOMBERG LAW (Jul. 11, 2023), https://pro.bloomberglaw.com/insights/privacy/privacy-laws-us-vs-eu-gdpr/ (containing graphs comparing various US privacy laws to the GDPR, which highlight the broader definitions and stricter regulations which govern EU data).
228 Ben Wolford, *What is GDPR, the EU's new data protection law?,* GDPR.EU (2024), https://gdpr.eu/what-is-gdpr/. (last visited Month, Day Year).

services and frequent data breaches.[229] The guidelines define personal data broadly and outline principles for lawful data processing, emphasizing transparency, purpose limitation, data minimization, accuracy, storage limitation, integrity, confidentiality, and accountability.[230] Additionally, the GDPR mandates strict data security measures, including technical and organizational safeguards and requires organizations to handle data securely, report breaches promptly, and consider data protection in product design.[231] It also imposes stringent requirements for obtaining consent, appointing Data Protection Officers, and granting individuals extensive privacy rights such as the right to information, access, rectification, erasure, restriction, portability, objection, and protection against automated decision-making.[232] Evidently, the GDPR protects privacy with more efficiency and attention to detail than the VPPA; new legislation in the United States which reflects the security measures, personal data definition, and consent requirements championed by the GDPR would be the most ideal solution to the VPPA's ambiguity.

However, the closest attempt to replicating the protections of the GDPR in the United States was the introduction of the American Data Privacy and Protection Act (herein "ADPPA") in 2022, but it did not reach a floor vote.[233] Modeled after the GDPR, the ADPPA aimed to regulate the collection, use, and sharing of personal information.[234] Despite bipartisan negotiations, the bill has yet to be reintroduced, leaving the U.S. with a "patchwork" of laws like COPPA and the VPPA.[235] However, the California Consumer Privacy Act (herein "CCPA")[236] and its 2022 update, CPRA, are significant steps toward legislation similar to the GDPR.[237] The CCPA grants rights of data access, deletion, and portability, alongside opt-out provisions and purpose limitations.[238]

Originally targeting video rental records, the VPPA has evolved, with plaintiffs creatively leveraging it against streaming companies.[239] As litigation continues and legislative amendments stall, businesses face the challenge of compliance. Strategies such as challenging classifications and contesting plaintiff status have emerged as effective defenses.[240] Key court decisions, like *Carroll v. General Mills, Inc.*, have clarified

229 *Id.*
230 *Id.*
231 *Id.*
232 *Id.*
233 American Data Privacy and Protection Act, H. R. 8152, 117th Cong. (Dec. 30, 2022), https://www.congress.gov/bill/117th-congress/house-bill/8152/text.
234 King & Meinhardt, *supra* note 227, at 12.
235 *Id.*
236 Cal Civ Code § 1798.100. (2018).
237 King & Meinhardt, *supra* note 227.
238 *Id.*
239 *See In re Nickelodeon Consumer Priv. Litig.*, 827 F.3d 262, 290 (3d. Cir. 2016) ("companies in the business of streaming digital video are well advised to think carefully about customer notice and consent").
240 *See* Tal S. Benschar and Efrem Schwalb, *Litigation, Professional Perspective - Strategies To Defending VPPA Claims*, BLOOMBERG LAW (Jul. 2023),

boundaries, providing guidance for future claims.[241] However, ambiguity persists; thus, adapting preventive measures, such as auditing websites and enhancing privacy policies, is essential for both businesses and individuals.[242] Amidst these challenges, the absence of comprehensive federal legislation akin to the GDPR leaves the United States in a place of inconsistent and sometimes inefficient privacy protection.[243] Though initiatives like the ADPPA and CCPA are steps toward a more comprehensive and clear privacy policy, the need for legislation aligning with GDPR standards remains an important solution to the VPPA's ambiguity.

Part VII: Conclusion

The ambiguity surrounding the definitions of "subscriber" and "personally identifiable information" in the VPPA has led to a significant circuit split among courts, highlighting the challenges in applying this decades-old legislation to modern technological advancements.[244] This divide has resulted in inconsistent interpretations and enforcement of the VPPA, creating legal uncertainty for both service providers and consumers alike.[245]

The lack of a clear and uniform definition of "subscriber" has been particularly problematic, as courts differ in their interpretation, with some adopting a narrow definition based on direct payment or contractual relationships, while others favor a broader approach that encompasses anyone with access to the service.[246] Similarly, the disagreement over the definition of PII further complicates matters, with some circuits adopting a stringent standard, while others take a more inclusive approach.[247]

The intricate interplay between legal interpretation, technological advancements, and privacy concerns has significantly shaped the landscape of privacy law, particularly concerning the VPPA in 2023 and 2024. The dichotomy between the Eleventh and First

https://www.bloomberglaw.com/external/document/X513MFL0000000/litigation-professional-perspective-strategies-to-defending-vppa (urging defendants in VPPA cases to "carefully analyze what exactly was transmitted to the third party" and to "strongly consider pressing that definition of consumer" set in *Carter v. Scripps Network*).

[241] *See generally* Carroll v. Gen. Mills, Inc., Carroll v. Gen. Mills, Inc., No. CV 23-1746 DSF (MRWx), 2023 U.S. Dist. LEXIS 110049, (C.D. Cal. June 26, 2023).

[242] *See supra* note 237.

[243] *See, e.g.,* the circuit split between Yershov v. Gannett Satellite Info. Network, Inc., 820 F.3d 482 (2016) and Ellis v. Cartoon Network, Inc., 803 F.3d 1251 (2015).

[244] *Id.*

[245] *Id.*

[246] Yershov v Gannett Satellite Info. Network, Inc., 280 F.3d 482 (2016); In re Nickelodeon Consumer Priv. Litig., 827 F.3d 262 (2016).

[247] *Supra* note 58; *contra supra* note 59.

Circuits' analyses, as demonstrated by the *Ellis* and *Yershov* cases, remains pivotal in influencing privacy jurisprudence.[248] However, recent court opinions, exemplified by *M.K. v. Google*, *Jackson v. Fandom, Salazar v. NBA*, *Carter v. Scripps Network*, and *Salazar v. Paramount Global*, have expanded the discourse to consider whether a subscription is to video content or merely adjacent to video content.[249]

Although a 2012 VPPA amendment aimed to address some of these issues by expanding the definition of "video tape service provider" and introducing more flexible consent mechanisms, it failed to provide clarity on the core issues of defining "subscriber" and "PII."[250] As a result, the effectiveness of the VPPA in safeguarding individuals' privacy in the digital age remains uncertain. Therefore, there remains an urgent need for legislative clarity or Supreme Court intervention to reconcile the circuit split and establish a consistent interpretation of key terms within the VPPA. Only through clear and updated legislation can the VPPA effectively protect consumer privacy as technology advances. Failure to address these issues risks undermining the fundamental privacy rights that the VPPA was intended to safeguard, eroding trust in digital platforms and jeopardizing individuals' privacy in an increasingly connected world.[251]

As privacy law continues to evolve, the Eleventh and First Circuits' divergent analyses of the definition of "subscriber" remain prominent authorities for ongoing debates surrounding the scope of liability and the role of intent in privacy litigation.[252] However, the ambiguity surrounding the definition of "subscriber" has far-reaching consequences beyond the judicial system, impacting legislative efficacy and public policy. The consequences include increased privacy litigation, challenges in adapting legislation to address digital privacy issues, and public policy concerns. To address these challenges, legislation like the VPPA should be updated to clarify definitions and adapt to technological advancements. Implementing comprehensive privacy laws at both the state and federal levels and enhancing consumer protections (particularly for vulnerable groups such as children) are also important steps. Additionally, businesses are advised to take preventative measures to avoid privacy litigation by obtaining user consent for tracking technologies, practicing transparency, and revising privacy policies to provide

[248] Carroll v. Gen. Mills, Inc., 2023 U.S. Dist. LEXIS 110049 (C.D. Cal. 2023).
[249] *See generally* M.K. v. Google LLC, 2023 U.S. Dist. LEXIS 133602 (2023), Jackson v. Fandom, Inc., 2023 U.S. Dist. LEXIS 125531 (2023)., Carter v. Scripps Networks, LLC, 670 F. Supp. 3d 90 (2023), and Salazar v. NBA, 2023 U.S. Dist. LEXIS 137982 (2023).
[250] Video Privacy Protection Act, 18 U.S.C. § 2710 (1988).
[251] *See* Daniela Spencer, *Why Blockbuster is Relevant Once More: The Return of the VPPA*, LOEB & LOEB (Dec. 2023), https://www.loeb.com/en/insights/publications/2023/12/why-blockbuster-is-relevant-once-more-the-return-of-the-vppa.
[252] *See*, e.g., the circuit split between Yershov v. Gannett Satellite Info. Network, Inc., 820 F. 3d 482 (2016); *and* Ellis v. Cartoon Network, Inc., 803 F.3d 1251 (2015).

clear information on data practices.[253] Ideally, the legislature would put forth new regulations which mirror the clarity and efficacy of the GDPR.

As businesses and individuals navigate the complex and ever-evolving landscape of privacy law, collaboration between policymakers, businesses, and individuals is essential to ensure that privacy rights and innovation are both protected. Only through continued dialogue and proactive measures can meaningful progress be made in addressing the challenges posed by the VPPA's ambiguity and inapplicability to the modern world.

[253] *Supra* note 206 (enumerating two strategies: challenging the classification of website operators as videotape service providers under the VPPA and contesting plaintiffs' status as consumers within the VPPA's definition).

SHOULD ELECTED OFFICIALS BE ABLE TO TRADE STOCKS IN THEIR CAPACITIES AS LAWMAKERS? THE LATEST ATTEMPT TO END INSIDER TRADING IN CONGRESS FACES AN UPHILL BATTLE

Taylor LaRosa

Abstract

Trust in our elected officials has been on a decline for decades. One point of contention is whether Congressional officials should be allowed to trade stocks when they have access to information that the public does not. Over the past decade, starting with the STOCK Act, many bills have been proposed to reign in Congressional insider trading but all have been unsuccessful. The Ban Stock Trading for Government Officials Act, the focus of this note, is the latest bill to attempt to end insider trading. However, it will likely fail due to being no different than previous bills, Congressmen being unwilling to self-regulate, and possible first amendment issues with an outright ban.

All hope is not lost though, as there are ways to either improve the Ban Stock Trading for Government Officials and future similar bills or attack the issue outside Congress. The best ways to give these self-regulation bills the best chances at being passed is by finding the middle ground. To do so, qualified blind trusts, pre-approval requirements, immediate disclosures, and heavier violations for penalties are all important fixes necessary for either this bill or any future bills. Additionally, in conjunction with those suggestions, outside fixes could include following Congressional trades in real time, strengthening SEC powers and enforcement, and encouraging states to broaden their securities laws.

The very core of laws governing insider trading is to prevent people in power from using information that only they know for their personal benefit. While the Ban Stock Trading for Government Officials Act may not pass, this issue remains solvable and future bills should take note on finding a fair middle ground to make self-regulation more appealing.

TABLE OF CONTENTS

Introduction

With technological advancements making trading on the stock market and obtaining insider information easier, regulation has gotten progressively more difficult. Although past legislation has attempted to reign in the issues addressing elected officials making stock trades, the problem has yet to be solved.

The Ban Stock Trading for Government Officials Act is the latest of a long list of proposed legislation seeking to regain the public's trust in their lawmakers. With the majority of the public in support of regulation, or outright banning, of lawmakers trading stocks in any regard, why has this issue not already been solved? How is this current bill different from the previous bills that were shot down? Could the bill be improved, or is there another avenue to reach the same goal?

This note will address these questions about the Ban Stock Trading for Government Officials Act. Part I will illustrate the history surrounding the controversy and the triggering events that led to the public outcry for change. Part II will outline the details of the bill highlighted in this note. It will analyze the bill by pointing out its relation to past legislation, what it does correctly, and where it falls short. Part III will look to the future, addressing what could be changed about the bill or if this subject could be addressed in areas outside of Congress.

Part I: Background

Insider trading amongst elected officials among elected officials has been a long-contested issue in the United States. Members of the House and the Senate have access to information that the public does not, and if used improperly, could give lawmakers and their families an unfair advantage in the stock market.[1] For example, due to his official position, Sen. Richard Burr (R-NC) had access to classified reports on the severity of the global pandemic and he sold over $1 million in stocks before the markets collapsed in the following weeks.[2] Burr was not charged with any federal securities laws violations related to the trades.[3]

---

[1] Destinee Adams & Leila Fadel, *New Bill Would Fine Congress Members for Trading Stocks and Owning Blind Trusts,* NPR (July 20, 2023), https://www.npr.org/2023/07/20/1188869588/sen-gillibrand-discusses-efforts-to-ban-lawmakers-from-holding-and-trading-stock.

[2] Dan Mangan, *Sen. Richard Burr, Brother-In-Law Spoke on Phone Just Before Stock Sales that are Under Investigation, SEC Says*, CNBC (Oct. 28, 2021, 6:31 PM), https://www.cnbc.com/2021/10/28/sec-probes-possible-insider-stock-trades-by-sen-richard-burr-relative.html [https://perma.cc/E7HJ-FZLJ].

[3] Sarah D. Wire, *Justice Department makes public search warrant targeting Sen. Richard Burr over stock trades*, L.A. TIMES (June 17, 2022, 8:02 PM), https://www.latimes.com/politics/story/2022-06-17/justice-

A national poll by Morning Consult and Politico shows 68 percent of registered voters support banning stock trading for members of Congress. Another survey conducted by the University of Maryland's School of Public Policy found a broad 87 percent of bipartisan majorities favor prohibiting members of the executive and judiciary branches from trading stocks as well.[4]

In 1989, President George H.W. Bush signed an executive order prohibiting employees in the executive branch from engaging in financial transactions using nonpublic government information.[5] Nevertheless In the 1990s, Senators, on average, beat the market by 12 percent a year, whereas U.S. households underperformed by 1.4 percent and corporate insiders only beat the market by 6 percent.[6]

Due to the study showing how Congress's market gains as compared to non-government entities, in 2005 the STOCK Act was first introduced.[7] The Act failed to get traction until after the 2008 financial crisis.[8] Following a 2011 60 Minutes report, highlighting stock trading by members of Congress and suggesting they were not subject to laws barring trading on material non-public information obtained in the course of official duties, the STOCK Act was passed in 2012.[9] The Senate approved the Act by a 96-3 vote, and in the House of Representatives the margin was 417-2.[10]

The STOCK Act sought to address the conflicts of interest in stock trading by members of Congress and other federal officials by requiring them to make public all securities transactions with a value above $1,000 within 30 days of receiving notice of the transaction and within 45 days of the transaction date.[11] Additionally, it mandated the posting of the filings on the internet.[12] Typically, the Act extended to trades made by

department-makes-public-burr-stock-trading-warrant-in-times-lawsuit [https://perma.cc/W8HJ-4WAT].

[4] Destinee Adams & Leila Fadel, *New bill would fine Congress members for trading stocks and owning blind trusts,* NPR (July 20, 2023) https://www.npr.org/2023/07/20/1188869588/sen-gillibrand-discusses-efforts-to-ban-lawmakers-from-holding-and-trading-stock.

[5] *History of Insider Trading, 1611-2012, with an Emphasis on Congressional Insider Trading,* PROCON (June 6, 2013, 3:27 PM), https://insidertrading.procon.org/view.resource.php?resourceID=002391.

[6] Stephen M. Bainbridge, *Insider Trading Inside the Beltway* (UCLA Sch. of Law, Law-Econ Research Paper No. 10-08), July 2, 2010, at 1, https://ssrn.com/abstract=1633123.

[7] *A Brief Legislative History Of The STOCK Act,* FINEPRINT DATA (Oct. 1, 2022), https://fineprintdata.com/a-brief-legislative-history-of-the-stock-act/.

[8] *Id.*

[9] Jason Fernando, *STOCK Act: Meaning, Overview, Criticisms*, INVESTOPEDIA (Aug. 31, 2022), https://www.investopedia.com/terms/s/stop-trading-on-congressional-knowledge-act.asp (citing *Congress: Trading stock on inside information?,* CBS NEWS (June 11, 2012), https://www.cbsnews.com/news/congress-trading-stock-on-inside-information/.

[10] *Id.*

[11] *Id.*

[12] *Id.*

spouses and children of the officials as well.[13] Essentially, the Act attempted to make clear that members of Congress owe a duty to the citizens of the United States not to misappropriate nonpublic information to make a profit.[14]

Unfortunately, the STOCK Act did not live up to its expectations. In 2021, various news organizations identified 55 members of Congress who violated the STOCK Act. No public information was available on whether they'd been assessed the initial $200 fine for a reporting violation, nor as to whether they had paid it, a probe by Insider found.[15]

A proposed amendment to remove the online disclosure requirement passed the House and Senate by unanimous consent, making it more difficult for the general public to view Congress' financial disclosures and track politicians' stock choices.[16] Furthermore, because Congress members routinely find loopholes in the Act or otherwise take advantage of it, no member of Congress has ever been prosecuted under the STOCK Act, despite persistent credible allegations.[17]

Many Congressmen will use their family members to bypass the STOCK Act. For example, in 2020, the public knew that the wife of Rep. Mike Kelly (R-PA) bought stock in an endangered steel manufacturer within a few weeks after the trade. Later, it was revealed that the stock purchase happened after Rep. Kelly gained non-public knowledge that the plant in question would not, in fact, close.[18] More recently, and more famously, Speaker of the House Nancy Pelosi and her husband Paul Pelosi made millions of dollars on trades of Alphabet, Inc., Amazon.com Inc., and Apple Inc. in the weeks preceding the House Judiciary Committee's vote on antitrust legislation that impacted the aforementioned companies.[19]

---

[13] *Id.*
[14] *FACT SHEET: The STOCK Act: Bans Members of Congress from Insider Trading,* THE WHITE HOUSE (Apr. 4, 2012), https://obamawhitehouse.archives.gov/the-press-office/2012/04/04/fact-sheet-stock-act-bans-members-congress-insider-trading#:~:text=Increases%20Transparency%20in%20Financial%20Disclosure,of%20public%20financial%20disclosure%20information.
[15] Jason Fernando, *STOCK Act: Meaning, Overview, Criticisms*, INVESTOPEDIA (Aug. 31, 2022), https://www.investopedia.com/terms/s/stop-trading-on-congressional-knowledge-act.asp.
[16] *A Brief Legislative History Of The STOCK Act,* FINEPRINT DATA (Oct. 1, 2022), https://fineprintdata.com/a-brief-legislative-history-of-the-stock-act/.
[17] Danielle Caputo, Delaney Marsco & Kedric Payne, *The STOCK Act: The Failed Effort to Stop Insider Trading in Congress*, CLC (Feb. 18, 2022), https://campaignlegal.org/update/part-2-stock-act-failed-effort-stop-insider-trading-congress.
[18] *Id.*
[19] Christina Wilkie, *Congress Moves to Ban Members From Trading Stocks as Pelosi Drops Opposition*, CNBC (Feb. 9, 2022, 8:27 PM), https://www.cnbc.com/2022/02/09/congress-moves-towards-banning-members-from-trading-stocks.html [https://perma.cc/U9ME-JMZC].

In addition to the lack of enforcement, the small penalties associated with violations do not incentivize members to comply with the STOCK Act.[20] The penalty for a member of Congress failing to report a financial transaction is a hardly impactful $200.[21]

With the STOCK Act failing in its main goal, several new bills have been introduced in either the House or the Senate to seek some form of control over the issue. The various bills attempted to outright bar members of Congress from trading individual stocks.[22] Although they differ in details, many would force members of Congress to place their investments in a blind trust.[23] These acts included; the Ban Conflicted Trading Act; the TRUST in Congress Act; the Ban Congressional Stock Trading Act; and the Bipartisan Ban on Congressional Stock Ownership Act.[24]

Unfortunately, none of the proposed bills to curtail congressional insider trading gained much traction. Lawmakers have yet to set aside their self-interests and refuse to self-regulate, despite public opinion and lack of public trust.

The Ban Stock Trading for Government Officials Act, the topic of this note, is the latest bill to attempt to curtail the alleged insider trading. However, as history on this topic shows, its survival will be difficult and its proponents have an uphill battle ahead of them.

Part II: Analyzing the "Ban Stock Trading for Government Officials" Act

On July 25, 2023, following a long line of related legislation, the Ban Stock Trading for Government Officials Act was introduced to Congress.[25] The intent behind the bill was to build on the Stop Trading on Congressional Knowledge (STOCK) act, which attempted to combat insider trading by members of Congress and their employees.[26] However, it is unlikely that this bill will be passed like each of its predecessors.

---

[20] Danielle Caputo, Delaney Marsco & Kedric Payne, *The STOCK Act: The Failed Effort to Stop Insider Trading in Congress*, CLC (Feb. 18, 2022), https://campaignlegal.org/update/part-2-stock-act-failed-effort-stop-insider-trading-congress.
[21] *Id.*
[22] Jason Fernando, *STOCK Act: Meaning, Overview, Criticisms*, INVESTOPEDIA (Aug. 31, 2022), https://www.investopedia.com/terms/s/stop-trading-on-congressional-knowledge-act.asp.
[23] *Id.*
[24] *Id.*
[25] Richard Cowen, *Senators Propose Banning Stock Trades for US Congress, President,* REUTERS (July 25, 2023, 6:29 PM), https://www.reuters.com/markets/us/senators-propose-banning-stock-trades-us-congress-president-2023-07-25/.
[26] *Id.*

What does the Ban Stock Trading for Government Officials Act Accomplish?

The main goal of the bipartisan bill is to bar stock trading and stock ownership for members of Congress, the president, vice president, and senior executive branch officials, including their spouses and dependents.[27] Even blind trusts would be prohibited under the bill.[28] The Ban Stock Trading for Government Officials Act includes the following provisions: (1) Bans stock trading and blind trusts; (2) Imposes heavy penalties for executive branch stock trading; (3) Requires reporting of federal benefits; (4) Creates transparency in financial disclosure reports; and (5) Increases STOCK Act transaction report penalties.[29]

First, the act will outright ban all stock trading and the use of blind trusts. Specifically, it "[p]rohibits members of Congress, the president, vice president, senior executive branch members, and their spouses and dependents from holding or trading stocks."[30] While the STOCK Act attempted to curtail insider trading and the appearance of corruption, its failure to do so prompted legislatures to take drastic action.[31] To bolster the STOCK Act, the Ban Stock Trading for Government Officials Act would no longer allow any room for officials to abuse their knowledge or allow their spouses to do so in their place. For members of Congress, noncompliance can lead to a heavy penalty of at least 10 percent of the value of the prohibited investments.[32]

Second, the act will establish heavy penalties specifically upon the executive branch for violating the act. "Executive branch officials must disgorge profits from covered financial interests to the Treasury."[33] An "Automatic Special Counsel fine of not less than the value of the covered investment that was purchased or sold in violation of the ban or up to $10,000, whichever is more."[34] In cases of substantial monetary value

---

[27] Destinee Adams & Leila Fadel, *New bill would fine Congress members for trading stocks and owning blind trusts*, NPR (July 20, 2023), https://www.npr.org/2023/07/20/1188869588/sen-gillibrand-discusses-efforts-to-ban-lawmakers-from-holding-and-trading-stock.

[28] *Id.*; Kirsten Gillibrand*, Hawley Introduce Landmark Bill To Ban Stock Trading And Ownership By Congress, Executive Branch Officials And Their Families,* (July 19, 2023), https://www.gillibrand.senate.gov/news/press/release/gillibrand-hawley-introduce-landmark-bill-to-ban-stock-trading-and-ownership-by-congress-executive-branch-officials-and-their-families/.

[29] *Id.*

[30] *Id.*

[31] Press Release, The White House, *FACT SHEET: The STOCK Act: Bans Members of Congress from Insider Trading,* (Apr. 4, 2012), https://obamawhitehouse.archives.gov/the-press-office/2012/04/04/fact-sheet-stock-act-bans-members-congress-insider-trading#:~:text=Increases%20Transparency%20in%20Financial%20Disclosure,of%20public%20financial%20disclosure%20information.

[32] *See* Press Release*, Gillibrand, supra* note 28.

[33] *Id.*

[34] *Id.*

or extraordinary in nature, it may even be referred to the attorney general with the recommendation of civil action.[35]

Third, the act will require the reporting of any federal benefits.[36] Essentially, it requires members of Congress, senior congressional staff, the president, vice president, and senior executive branch employees to report any time they, a spouse, or a dependent applies for or receives a benefit of value from the federal government.[37] This includes loans, agreements, contracts, grants, and payments, but does not include salary, compensation or tax refunds.[38] It would require reporting that includes payment type, recipient name, date and amount.[39] Failure to file in accordance with the act would result in a $500 fine.[40]

Fourth, the act will create transparency in financial disclosure reports.[41] To do this, there must be public, searchable databases of personal financial disclosure reports and filings reporting of any financial transactions as required by the STOCK Act.[42]

Finally, the act will increase STOCK Act transaction report penalties.[43] The penalty imposed will be raised from $200 to $500 for failure to file STOCK Act transaction reports.[44] All of these new requirements aim to force politicians to perform their elected duties without being blinded by financial gain. There would, in theory, be a general deterrence to make illegal stock trades even by family members. However, like each of the amended bills that came before, the Ban Stock Trading for Government Officials Act is unlikely to have the effects that it desires.

The Ban Stock Trading for Government Officials Act Will Likely Fail Because it is too Similar to Past Bills, Politicians are Unlikely to Self-Regulate, and there May be First Amendment Issues

Although the Ban Stock Trading for Government Officials Act seems, on paper, to solve the age-old problem of insider trading, it will most likely still fall short. Of course, the majority of Americans fully support the bill, or at least any measure to

[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*

prevent congressional insider trading.[45] However, this does not mean that the bill will automatically get passed. The bill will likely not survive because (1) it does not differ from or improve upon any of the prior proposed bills; (2) politicians are unlikely to impose such harsh self-regulations; and (3) there may be First Amendment issues with outright banning stock trading with no exceptions.

A. The Act Does Not Greatly Differ from Prior Attempts to Curtail Insider Trading

The Ban Stock Trading for Government Officials Act is not the first proposed legislation to attempt to build upon the STOCK Act. These acts included; the Ban Conflicted Trading Act; the TRUST in Congress Act; the Ban Congressional Stock Trading Act; and the Bipartisan Ban on Congressional Stock Ownership Act.[46] None of these bills passed.

The Ban Conflicted Trading Act of 2021 would have prohibited Members of Congress and senior Congressional staff from buying or selling individual stocks and other investments while in office.[47] "Instead, Members of Congress can invest in widely held investments, such as diversified mutual funds and exchange-traded funds."[48] The bill subsequently died in the 117th congress.[49]

"The TRUST in Congress Act would [have] prohibit[ed] Members of Congress from trading individual stock while in office by requiring members to put their holdings in a qualified blind trust or divest."[50] Furthermore, the TRUST in Congress Act would have also prohibited lawmaker's spouses and dependent children from trading stock.[51] Again, this bill died in the 117th congress.[52]

The Ban Congressional Stock Trading Act was meant to amend the Ethics in Government Act of 1978 by requiring Members of Congress and their spouses and

---

[45] Destinee Adams, Leila Fadel, *New bill would fine Congress members for trading stocks and owning blind trusts,* NPR (July 20, 2023), https://www.npr.org/2023/07/20/1188869588/sen-gillibrand-discusses-efforts-to-ban-lawmakers-from-holding-and-trading-stock.
[46] Jason Fernando, *STOCK Act: Meaning, Overview, Criticisms*, INVESTOPEDIA (Aug. 31, 2022), https://www.investopedia.com/terms/s/stop-trading-on-congressional-knowledge-act.asp.
[47] *TESTER BACKS LEGISLATION TO BAN STOCK TRADING IN CONGRESS,* https://www.tester.senate.gov/newsroom/press-releases/pr-8885/ (Feb. 7, 2022).
[48] *Id.*
[49] Ban Conflicted Trading Act, H.R. 1579, 117th Cong. (2021).
[50] Danielle Caputo, *Campaign Legal Center Urges Congress to Pass the TRUST in Congress Act,* CAMPAIGN LEGAL CTR. (Jan. 12, 2023), https://campaignlegal.org/update/campaign-legal-center-urges-congress-pass-trust-congress-act.
[51] *Id.*
[52] TRUST in Congress Act, H.R. 7200, 116th Cong. (2020).

dependents to place certain assets into blind trusts, and for other purposes–ensuring they cannot use inside information to influence their stock trades and make a profit.[53] Again, this bill died in the 117th congress.[54]

Lastly, the Bipartisan Ban on Congressional Stock Ownership Act would have banned Members of Congress and their spouses from owning and trading individual stocks, bonds, commodities, futures, and other securities including an interest in a hedge fund, a derivative, an option or other complex investment vehicle.[55] It did not ban common, widely held funds, such as mutual funds and ETFs, as long as those funds did not present a conflict of interest and were diversified.[56] Again, this bill died in the 117th congress.[57]

Each of these bills, like the Ban Stock Trading for Government Officials Act, outright prohibits Members of Congress and their families from trading in individual stocks. However, the prior bills all allowed some sort of loophole: either blind trusts or widely held funds. The current pending bill dispensed with this loophole altogether, allowing neither blind trusts nor widely held funds.[58] But does this really solve the problem of elected officials using insider knowledge for personal gain? No, it does not.

While prohibiting ETFs is an effective measure against insider trading, prohibiting blind trusts may make no difference in the underlying problem. One may think that investing in widely held funds or ETFs is safe, but it still allows individuals to use their insider knowledge to benefit themselves. ETFs are cost-effective, they allow individuals to undertake shadow trading and benefit from the stock price increases of the underlying companies, and they are extremely liquid.[59] Essentially, while an ETF may appear to prevent insider trading, individuals could still use their insider knowledge to gain an unfair advantage.

---

[53] Press Release, Jon Ossof, Senator, *Sens. Ossoff, Kelly Introduce Bill Banning Stock Trading by Members of Congress,* (Sept. 12, 2023), https://www.ossoff.senate.gov/press-releases/sens-ossoff-kelly-introduce-bill-banning-stock-trading-by-members-of-congress-2/#:~:text=Ossoff%20and%20Mark%20Kelly%20.

[54] Ban Congressional Stock Trading Act, S. 3494, 117th Cong. (2022).

[55] Press Release, Pramila Jayapal, Representative, *Jayapal, Rosendale, Buck Introduce Bipartisan Bill To Ban Members of Congress from Owning and Trading Stocks,* (Mar. 21, 2023), https://jayapal.house.gov/2023/03/21/jayapal-rosendale-buck-introduce-bipartisan-bill-to-ban-members-of-congress-from-owning-and-trading-stocks/.

[56] *Id.*

[57] Bipartisan Ban on Congressional Stock Ownership Act of 2022, S. 3631, 117th Cong..

[58] Gillibrand, *Hawley Introduce Landmark Bill To Ban Stock Trading And Ownership By Congress, Executive Branch Officials And Their Families*, (July 19, 2023), https://www.gillibrand.senate.gov/news/press/release/gillibrand-hawley-introduce-landmark-bill-to-ban-stock-trading-and-ownership-by-congress-executive-branch-officials-and-their-families/.

[59] Elza Eglīte, Dans Štaermans, Vinay Patel and Tālis Putniņš, *Using ETFs to Conceal Insider Trading,* THE BLUE CLS SKY BLOG (Mar. 1, 2023), https://clsbluesky.law.columbia.edu/2023/03/01/using-etfs-to-conceal-insider-trading/.

In a blind trust, however, an individual places assets that could otherwise create conflicts of interest into an asset vehicle.[60] Control over the trust and its assets are given to an independent trustee, who may buy and sell assets without the knowledge or consent of the beneficiary.[61] In theory, a public official with a blind trust would be immunized from potential conflicts stemming from the assets held in trust because they would have no knowledge of the impact of official actions on the personal financial interests.[62] Critics of allowing officials to hold blind trusts say that they create a loophole if not governed properly: you'd be able to create any kind of a trust you want to, put anything you want into it, and call it a blind trust, even though there wouldn't actually be any way to prove that it is, in fact, a blind trust.[63] But this loophole could be closed with specificity in the language of the bill. An outright ban of blind trusts would be no different in solving insider trading than allowing highly regulated blind trusts. This bill both goes too far in its efforts–banning every avenue officials may use to invest–while also not making any substantial differences in the prior bills.

Additionally, like the STOCK Act and the other proposed legislation, the Ban Stock Trading for Government Officials Act does not impose steep enough penalties to officials in violation of the act. Specifically in the failure to either file or report any benefit or transaction, increasing the fine from $200 to $500 is seemingly inconsequential.[64] While other aspects of the bill impose heavy penalties on the executive branch, or even other penalties on Members of Congress, this is no different than what has come before.[65]

Typical insider trading laws and insider trading in the corporate context impose much harsher penalties for violators doing the same things the Ban Stock Trading for Government Officials Act is trying to stop.[66] Outside of Congress, "violators of insider trading laws could be ordered to give back the money they received from the sale and repossess stock ownership. The SEC could then add fines on top of this punishment."[67] While the attempts at legislation to curb insider trading in Congress specifically have

[60] *Blind Trusts,* NCSL, https://www.ncsl.org/ethics/blind-trusts (Updated July 20, 2021).
[61] *Id.*
[62] *Id.*
[63] Bryan Metzger, *Nancy Pelosi's Congressional Stock trading Ban Has a Massive Blind Trust Loophole and is Too Broad, Ethics Experts Warn,* BUSINESS INSIDER, (Sept. 28, 2022), https://www.businessinsider.com/nancy-pelosi-stock-trading-ban-blind-trust-loophole-ethics-experts-2022-9.
[64] Press Release, Gillibrand, *Hawley Introduce Landmark Bill To Ban Stock Trading And Ownership By Congress, Executive Branch Officials And Their Families*, https://www.gillibrand.senate.gov/news/press/release/gillibrand-hawley-introduce-landmark-bill-to-ban-stock-trading-and-ownership-by-congress-executive-branch-officials-and-their-families/ (July 19, 2023).
[65] *Id.*
[66] Tessa Campbell, Choncé Maddox, *What Is Insider Trading?*, BUSINESS INSIDER (July 9, 2024, 4:29 PM), https://www.businessinsider.com/personal-finance/insider-trading.
[67] *Id.*

imposed *some* penalties, none have come close to the penalties imposed upon civilians. Because this new bill does not significantly differ from prior attempts to hinder insider trading by government officials, it will unlikely be passed.

B. Politicians are Unlikely to Impose Such Harsh Regulations Upon Themselves

Despite mass outcries from the public, politicians are unlikely to impose harsh regulations upon themselves or establish a body governing its ethics.[68] There were numerous attempts at establishing an independent ethics authority, but most of which were shot down.[69] For example, the Senate Committee on Homeland Security and Governmental Affairs voted against a proposal to establish an independent office to enforce congressional ethics and lobbying laws.[70] Subsequently, the Senate defeated a similar amendment to a pending gift and lobbying reform measure (S. 2349).[71] The 110th Congress also rejected an amendment to establish a Senate Office of Public Integrity.[72]

This reluctance to self-regulate, even in the face of interpreted ethical violations, can even be seen in the Supreme Court. While not elected officials, the Justices of the Supreme Court only recently established its first ever Code of Ethics.[73] Prior to its enactment, Chief Justice Roberts attempted to rebut critics assertions that the Supreme Court should be bound by a code of ethics: stating that "[a]ll members of the court do in fact consult the code of conduct in assessing their ethical obligations…[e]very justice seeks to follow high ethical standards, and the Judicial Conference's code of conduct provides a current and uniform source of guidance designed with specific reference to the needs and obligations of the federal judiciary."[74] Despite the Supreme Court

[68] Destinee Adams & Leila Fadel, *New bill would fine Congress members for trading stocks and owning blind trusts,* NPR (July 20, 2023, 2:46 PM), https://www.npr.org/2023/07/20/1188869588/sen-gillibrand-discusses-efforts-to-ban-lawmakers-from-holding-and-trading-stock.
[69] *Id.*; *see, e.g***.** H.R. 4975, H.R. 4799, H.R. 4948, H.R. 5677, S. 2259, and S.Con.Res. 82. Some of the bills contained only an independent ethics authority; others contained an authority but additionally proposed wider changes, such as gift and lobbying reform.
[70] *Enforcement of Congressional Rules of Conduct: A Historical Overview,* EveryCRSReport.com https://www.everycrsreport.com/reports/RL30764.html#ifn30 (Last visited Feb. 15, 2015).
[71] *Id.*
[72] *Id.*
[73] Josh Gerstein, *Embattled Supreme Court Adopts Code of Conduct,* POLITICO, (Nov. 13, 2023), https://www.politico.com/news/2023/11/13/embattled-supreme-court-adopts-code-of-conduct-00126874.
[74] Adam Liptak, *Supreme Court Weighs Ethics Code as Critics Push for Change,* N.Y. TIMES, (Feb. 9, 2023), https://www.nytimes.com/2023/02/09/us/supreme-court-ethics-code.html.

eventually adopting the Code of Ethics, critics still say that it lacks teeth; only relying on self-governance rather than allowing lower courts to supervise compliance.[75]

To expect Congress to pass a law, stricter than each of its prior failed iterations, requiring self-regulation would be unreasonable. Even if it were to establish some sort of regulatory ethics committee specifically for insider trading, it would be unlikely that this committee would be an unbiased third-party committee. To ask an elected body that is already accused of self-dealing and corruption to pass a bill that could prevent them from profiting from their position is simply naïve. If Congress was unable to pass prior less restrictive forms of the Ban Stock Trading for Government Officials Act, why would they pass a similar, yet harsher, bill? Unfortunately, that is the reality of the current situation.

C. By Outright Banning Members from Trading Stocks, there May be First Amendment Issues

Another problem surrounding the Ban Stock Trading for Government Officials Act is a possible First Amendment issue. The First Amendment protects American citizens from Congress passing any laws abridging their freedom of speech.[76] Here, the issues come in both the Act requiring reports of all federal benefits and the outright ban of stock trading. However, for the sake of simplicity, this can be narrowed solely to the outright ban of stock trading: "If compelling disclosure can prevent confusion, deception, or danger to investors and consumers, it is likely constitutional."[77] Many critics of bills outright banning stock trading for Congress members argue that "America has a 'free-market economy' and that lawmakers 'should be able to participate in that.'"[78]

The Constitution's Speech or Debate Clause may serve as protection if it is interpreted to "make [insider trading] prosecution impossible for [trading on] certain types of information received officially in committee or other legislative settings."[79] The Supreme Court has interpreted the Speech or Debate Clause broadly to protect not just

[75] Josh Gerstein, *Embattled Supreme Court Adopts Code of Conduct,* POLITICO, (Nov. 13, 2023), https://www.politico.com/news/2023/11/13/embattled-supreme-court-adopts-code-of-conduct-00126874.
[76] U.S. CONST. amend. I.
[77] Cydney Posner, *Are the Securities Laws a First Amendment Free Zone?,* COOLEY, (July 16, 2014), https://www.cooley.com/news/insight/2014/are-the-securities-laws-a-first-amendment-free-zone.
[78] *Pros and Cons of Banning Stock Trading in Congress*, CONGRESSIONAL DIGEST (Mar. 1, 2022), https://congressionaldigest.com/pros-and-cons-of-banning-stock-trading-in-congress/.
[79] Stanley M. Brand, *DOJ Drops Investigation into Three Senators for Insider Trading; Burr Probe Continues*, CONVERSATION (May 27, 2020), https://theconversation.com/dojdrops-investigation-into-three-senators-for-insider-trading-burr-probe-continues-134875.

speech and debate, but anything "generally done in a session of the House by one of its members in relation to the business before it."[80]

While this does not mean that members of Congress are fully protected from all fraudulent conduct that could lead to insider trading claims,[81] it simply presents a difficult hurdle to overcome for legislation to not be struck down as unconstitutional. "It may make prosecution impossible for certain types of information received officially in committee or other legislative settings."[82] In the words of George Canellos, the co-chief of the SEC's enforcement division, that when it comes to information that could affect a stock's price "[t]he lines aren't quite as bright and the opportunities for arguments by the defense are greater."[83] With such an easy defense available to Congress members, who can either say that they made the trade based off of public information or the information they got was protected by the Speech and Debate clause, the SEC already has too much trouble prosecuting cases.[84] An outright ban, while making it easier for SEC prosecution, would either run into the same problems or simply be shot down as unconstitutionally limiting speech.

Part III: How Can We Solve the Problems of Insider Trading in Congress?

With the likelihood of the Ban Stock Trading for Government Officials Act passing as it is slim, does that mean that insider trading in Congress can't be stopped? No, it does not, nor should it. Each proposed bill to put an end to insider trading in Congress had flaws and could not find traction, but this problem is not unsolvable. In this part, I will explore two possible options to treat the disease that plagues our nation's leaders: 1.) finding the proper middle ground in fixing the Ban Stock Trading for Government Officials Act and others like it or 2.) seeking answers outside of Congress to govern their actions.

---

[80] Kilbourn v. Thompson, 103 U.S. 168, 204 (1881).
[81] United States v. Rostenkowski, 59 F.3d 1291, 1294 (D.C. Cir. 1995) (rejecting the claim that the Speech or Debate Clause could bar an indictment "alleging generally that Rostenkowski and others had 'devised . . . a scheme' to defraud the United States").
[82] Stanley M. Brand, *Insider Trading by Members of Congress May be Difficult to Prove*, FEDERAL TIMES, (Apr. 2, 2020), https://www.federaltimes.com/opinions/2020/04/02/insider-trading-by-members-of-congress-may-be-difficult-to-prove/.
[83] *Id.*
[84] *Id.*

How Can We Fix Current and Future Proposed Congressional Insider Trading Legislation?

Before giving up hope that any and all legislation proposed will be shot down, we should look to the Ban Stock Trading for Government Officials Act, and other similar legislation, to find ways to make them more appetizing to legislators. The key to making future bills more appetizing, while seeming obvious, is to compromise on a middle ground. The bill must be strong enough to accomplish what it sets out to do to satisfy its proponents while also not being so strict as to scare the opposition.

The modern political climate is extremely partisan and volatile, so much so that any compromise is seen as a major news development.[85] Even for the bill in question, although there are some bipartisan efforts, the negotiation efforts are marked with demands that the opposition are unlikely to agree to. Namely, the bill's proponents insisted that any negotiated bill "must prohibit the trading or owning of individual stocks and require either the divestment of assets, or the placement in blind trusts or mutual or exchange-traded funds, among other priorities listed in the letter."[86] While the idea may seem sound, this attempt at passing the Ban Stock Trading for Government Officials Act is no different from its predecessors.

There are five potential adjustments to be made, aside from an outright ban of stock trading, that may be able to improve the Ban Stock Trading for Government Officials Act or future bills: 1.) qualified blind trust requirement; 2.) pre-approval requirement; 3.) Immediate disclosure; 4.) requirement of a "cooling off" period; and 5.) heavier penalties for violation. An outright ban of all Congressional stock trading may seem ideal, but for now each of these proposed suggestions could advance legislation to where either an outright ban is no longer needed or the political climate will be more accepting of the outright ban.

A. Qualified Blind Trusts

One of the features of the Ban Stock Trading for Government Officials Act is that along with an outright ban of stock trades for officials and their family members,

[85] *See, e.g.*, Paul Bedard, *America Never More Politically Divided Than Under Biden*, WASH. EXAMINER (Apr. 15, 2021), https://www.washingtonexaminer.com/washingtonsecrets/america-never-more-politically-divided-than-under-biden (citing Gallup survey suggesting that "the partisan gap" in U.S. politics recently reached "its widest point" on record).
[86] Justin Papp, *These Lawmakers are Still Invested in Banning Congressional Stock Trades*, ROLL CALL (Jan. 18, 2024), https://rollcall.com/2024/01/18/these-members-of-congress-still-want-to-ban-trading-stocks/.

there would no longer be an exception for qualified blind trusts.[87] Past attempts at tackling this issue described blind trusts as loopholes because "[you would] be able to create any kind of a trust you want to, put anything you want into it, and call it a blind trust, even though there wouldn't actually be any way to prove that it is, in fact, a blind trust."[88] Where those bills failed in their allowance of blind trusts was that the blind trusts could be created outside the existing regulations outlined in the Ethics in Government Act.[89] A qualified blind trust would, in theory, close the loopholes that prior legislation did not notice.

A qualified blind trust includes any trust in which a reporting individual has a beneficial interest in the principal or income and which: 1.) Is certified pursuant to § 2634.407 by the Director; 2.) Has a portfolio as specified in § 2634.406(a); 3.) Follows the model trust document prepared by the Office of Government Ethics; and 4.) Has an independent trustee as defined in § 2634.405.[90] Under § 2634.405(c), there is an important emphasis on whether a trustee is truly independent and able to be involved with the qualified blind trust; essentially the trustee cannot be involved with, nor has ever been involved with, the interested party.[91]

---

[87] Press Release, Gillibrand, *Hawley Introduce Landmark Bill to Ban Stock Trading And Ownership By Congress, Executive Branch Officials And Their Families*, (July 19, 2023), https://www.gillibrand.senate.gov/news/press/release/gillibrand-hawley-introduce-landmark-bill-to-ban-stock-trading-and-ownership-by-congress-executive-branch-officials-and-their-families/.

[88] Bryan Metzger, *Nancy Pelosi's Congressional Stock Trading Ban has a Massive Blind Trust Loophole and is too Broad, Ethics Experts Warn,* BUSINESS INSIDER, (Sept. 22, 2022), https://www.businessinsider.com/nancy-pelosi-stock-trading-ban-blind-trust-loophole-ethics-experts-2022-9.

[89] *Id.*

[90] Qualified Trusts, 5 C.F.R. §§2364.401-414 (2024); *See* 5 USC § 13104(f)(3); § 2634.407(a) states "After the Director approves the independent trustee, the interested party or a representative will prepare the trust instrument for review by the Director. The representative of the interested party will use the model documents provided by the Office of Government Ethics to draft the trust instrument. Any deviations from the model trust documents must be approved by the Director. No trust will be considered qualified for purposes of the Act until the Office of Government Ethics certifies the trust prior to execution; § 2634.406(a) Initial portfolio states 1.) "An interested party may not place any asset in the blind trust that any interested party would be prohibited from holding by the Act, by the implementing regulations, or by any other applicable Federal law, Executive order, or regulation." and 2.) "Except as described in paragraph (a)(1) of this section, an interested party may put most types of assets (such as cash, stocks, bonds, mutual funds, or real estate) into a qualified blind trust."; § 2634.405(a) states that "[a]n interested party must select an entity that meets the requirements of this part to serve as an independent trustee or other fiduciary. The type of entity that is allowed to serve as an independent trustee is a financial institution, not more than 10 percent of which is owned or controlled by a single individual, which is: 1.) A bank, as defined in 12 U.S.C. 1841(c); or 2.) An investment adviser, as defined in 15 U.S.C. 80b–2(a)(11)."

[91] *See* 5 C.F.R. §2364.405(c) ("The Director will determine that a proposed trustee is independent if: 1.) The entity is independent of and unassociated with any interested party so that it cannot be controlled or influenced in the administration of the trust by any interested party; 2.) The entity is not and has not been affiliated with any interested party, and is not a partner of, or involved in any joint venture or other investment or business with, any interested party; and 3.) Any director, officer, or employee of such

If executed properly, the qualified blind trust will prevent the government official from running into a conflict of interest or engaging in insider trading because "they are completely detached from their investment decisions."[92] Once established, an individual gives up the management of assets to an independent trustee, who makes investment decisions without the individual's knowledge.[93] In this situation, "any potential conflicts of interest are resolved because the interested party has no knowledge, control, or management of the assets."[94] Additionally, qualified blind trusts could have built in disclosure requirements and build much needed confidence that our elected officials are not conflicted or using insider knowledge in their stock trades.[95]

While qualified blind trusts seem perfect, critics are not convinced. Chairperson Zoe Lofgren of California described qualified blind trusts as "not workable."[96] His three main concerns with the qualified blind trusts are 1.) "you know what you put in, so it's not really blind;" 2.) "apparently it's very bureaucratic and expensive;" and 3.) "most people don't have enough assets to actually get somebody to establish a qualified blind trust."[97] Ranking member Rodney Davis stated that after speaking to his wife's financial advisor at LPL Financial, making the move to a qualified blind trust would be "cumbersome and expensive" because he "would need a minimum investment of $500,000 to be able to create a qualified blind trust."[98] Donna Nagy, a business law professor at Indiana University's Maurer School of Law, also believes that forcing hundreds of members of Congress to move their assets into qualified blind trusts would be too expensive and wouldn't make sense.[99]

Although two of the main concerns critics are the expense of qualified blind trusts and not having enough assets,[100] this is not the case for all members of congress. The median net worth of members of Congress is over $1 million, compared to the

---

entity: i.) Is independent of and unassociated with any interested party so that such director, officer, or employee cannot be controlled or influenced in the administration of the trust by any interested party; ii.) Is not and has not been employed by any interested party, not served as a director, officer, or employee of any organization affiliated with any interested party, and is not and has not been a partner of, or involved in any joint venture or other investment with, any interested party; and iii.) Is not a relative of any interested party.")

[92] Campaign Legal Ctr., *Pros and Cons of STOCK Act Reform Proposals* at 2 (Mar. 2022) https://campaignlegal.org/sites/default/files/2022-03/Pros%20and%20Cons%20of%20STOCK%20Act%20Reform%20Proposals.pdf.

[93] U.S. S. Select Comm. on Ethics, 114th Cong., Rep. on Qualified Blind Trusts 1 (2015).

[94] *Id.*

[95] *Id.* at 1-2.

[96] Chris Marquette, *Qualified Blind Trust Proposal Receives Chilled Reception at Congressional Stock Hearing*, Roll Call, (Apr. 7, 2022), https://rollcall.com/2022/04/07/qualified-blind-trust-proposal-receives-chilled-reception-at-congressional-stock-hearing/.

[97] *Id.*

[98] *Id.*

[99] *Id.*

[100] *Id.*

national average salary of $57,200.[101] Additionally, the top 30 net worths of Congress members range from 11.5 million to a staggering 200.3 million.[102] While many Congress members gained wealth prior to taking office, they also bolster their wealth substantially through stocks, mutual funds, and ETFs.[103]

The qualified blind trust exception would not necessarily be applicable to all members of Congress, just like how not all members of Congress are suspected of insider trading.[104] What it would do, assuming that the qualified blind trust was set up correctly, would make insider trading much more difficult for the Congressmen who use it. Qualified blind trusts take a step in the right direction for ending insider trading in Congress while also not making too many drastic measures too quickly. With Congressmen unlikely to impose harsh self-restrictions, this addition to the Ban Stock Trading for Government Officials Act, or any future bill, will likely garner more support for being more lenient.

B. Pre-Approval of any Trades

A second method to possibly prevent insider trading that could be added to the Ban Stock Trading for Government Officials Act or future bills could be pre-approval of any trades. A pre-approval requirement would allow members of Congress to own and trade stocks *only* if the specific investments do not create a potential conflict of interest.[105] Ownership and trades of covered investments require the congressional ethics committees to determine if conflicts of interest exist on a case-by case basis.[106]

Under the current anti-insider trading legislation in Congress, "a hypothetical lawmaker could vote for an infrastructure bill and then buy stock in a concrete company. Or they could sit on the Armed Services Committee and legally trade in the stock of defense contractors that receive sizable government contracts."[107] In 2022, at least 97 members of the House and Senate "bought or sold stock, bonds, or other financial assets that intersected with their congressional work or reported similar transactions by their

[101] Kimberly Scott, *DemDaily: The Wealthiest Members of Congress,* DEMLIST (May 15, 2023), https://www.demlist.com/demdaily-the-wealthiest-members-of-congress/.
[102] *Id.*
[103] *Id.*
[104] Chris Marquette, *Qualified Blind Trust Proposal Receives Chilled Reception at Congressional Stock Hearing*, Roll Call (Apr. 7, 2022, 2:59 PM), https://rollcall.com/2022/04/07/qualified-blind-trust-proposal-receives-chilled-reception-at-congressional-stock-hearing/.
[105] *Pros and Cons of STOCK Act Reform Proposals,* CLC (Mar. 2022), https://campaignlegal.org/sites/default/files/2022-03/Pros%20and%20Cons%20of%20STOCK%20Act%20Reform%20Proposals.pdf.
[106] *Id.*
[107] Jay O'Brien, Arthur Jones II, and Eric Ortega, *Citizen Watchdogs Eye Congress' 'Killing it' Approach to Stock Trading,* ABC NEWS, (Nov. 15, 2023). https://abcnews.go.com/Politics/citizen-watchdogs-eye-congress-killing-approach-stock-trading/story?id=104873686.

spouse or a dependent child."[108] The pre-approval requirement would effectively prevent any of those trades from members of Congress that conflict with committees they sit on or are heavily involved with.

A pre-approval requirement does not come without its share of potential problems. The main issue this requirement would run into would be a matter of subjectiveness.[109] This requirement, by itself, would place a subjective determination on whether or not a trade or stock ownership conflicts with the work of the Congress member in question in the hands of an ethics committee.[110] The SEC could also be involved in the pre-approval process, so that any trade made could automatically get reviewed for safety.

While a potential fix could be to have the ethics committee that oversees the pre-approval be the outside party to Congress, or have the SEC itself conduct the pre-approval for any stock trade, this would face issues due to the confidential nature of many legislative decisions. However, as each of these agencies would operate under federal authority, the risk of spreading possible confidential information would likely be less than the risk of Congressional insider trading. To be truly effective, the pre-approval requirement would need to be paired alongside the other suggested additions to any future legislation.

C. Immediate Disclosure

A third method to possibly prevent insider trading that could be added to the Ban Stock Trading for Government Officials Act or future bills could be to require *immediate* disclosure of any stock trades. Under the current legislation, as long as the trade is reported within 45 days, Congressional officials can trade whatever stock they desire, no matter what committee they send on.[111] Even the Ban Stock Trading for Government Officials Act allows for up to 30 days for the government official to disclose their trade.[112] Because market values and stock prices can quickly move up or down depending

[108] Brett Wilkins, *Nearly 100 Members of Congress Reported Stock Trades That Overlap With Committee Work,* Common Dreams, (Sep. 13, 2022), https://www.commondreams.org/news/2022/09/13/nearly-100-members-congress-reported-stock-trades-overlap-committee-work.

[109] *Pros and Cons of STOCK Act Reform Proposals,* CLC, (Nov. 8, 2024), https://campaignlegal.org/sites/default/files/2022-03/Pros%20and%20Cons%20of%20STOCK%20Act%20Reform%20Proposals.pdf.

[110] *Id.*

[111] Jay O'Brien, Arthur Jones II & Eric Ortega, *Citizen Watchdogs Eye Congress' 'Killing it' Approach to Stock Trading,* ABC NEWS, (Nov. 15, 2023), https://abcnews.go.com/Politics/citizen-watchdogs-eye-congress-killing-approach-stock-trading/story?id=104873686.

[112] S. 2463, 118th Cong. (2023-2024): Ban Stock Trading for Government Officials Act of 2023, S.2463, 118th Cong. (2023), https://www.congress.gov/bill/118th-congress/senate-bill/2463/text.

on news stories, government announcements, or market movements,[113] a 30 to 45 day window to disclose trades is essentially meaningless. Furthermore, Congress members seldom follow this extremely lenient disclosure requirement: an investigation by Insider, drawing on reporting from several other news outlets, found that 59 members, or 11%, of Congress have missed filing deadlines.[114]

More immediate disclosure of any stock trade would provide the public with prompt notice of any potential ethical issues, including conflicts of interest or potential insider trading.[115] This increased transparency would shine a bright light on members of Congress who decide to trade stocks and would effectively eliminate the advantage of information over the public. Additionally, the public would immediately be able to emulate the trades to even the playing field and could reasonably infer whether the Congressman made the trades based on insider information.

To truly be effective, the immediate disclosure requirement would need to apply to all stock trades, not just trades worth more than $1,000 as the current regime requires.[116] Theoretically, a lawmaker could "purchase stocks valued under the $1,000 threshold that then appreciate, or make multiple small purchases of stock in a single company," neither of which would require separate transaction reports.[117] An immediate disclosure of *all* stock trades would close this glaring loophole.

While this requirement proposal to the Ban Stock Trading for Government Officials Act would not necessarily eliminate insider trading on its own, it would likely make Congressmen think twice before essentially publicly admitting to insider trading. Immediate disclosure would also eliminate the unfairness that comes with insider trading, and the market would be more stable with more accurate information. However, to truly be effective unlike current legislation, this disclosure requirement would need to be coupled with heavier fines for violation, a cooling-off period, or pre-approval of trades.

---

113 James Chen, *Announcement Effect,* INVESTOPEDIA, (Sep. 15, 2020), https://www.investopedia.com/terms/a/announcment-effect.asp#:~:text=Stock%20prices%20can%20quickly%20move,to%20make%20short%2Dterm%20profits.

114 John Divine, *Congress and Stocks: Notable Trades and an Ineffective Law,* USN, (Apr. 6, 2022), https://money.usnews.com/investing/articles/congress-and-stocks-notable-trades-and-an-ineffective-law.

115 *Pros and Cons of STOCK Act Reform Proposals,* CLC, https://campaignlegal.org/sites/default/files/2022-03/Pros%20and%20Cons%20of%20STOCK%20Act%20Reform%20Proposals.pdf.

116 Chris Marquette, *Qualified Blind Trust Proposal Receives Chilled Reception at Congressional Stock Hearing*, Roll Call, (Apr. 7, 2022), https://rollcall.com/2022/04/07/qualified-blind-trust-proposal-receives-chilled-reception-at-congressional-stock-hearing/.

117 Justin Papp, *Tim Scott Never Disclosed Buying Stocks he Recently said he Owned*, Roll Call, (Sept. 5, 2023), https://rollcall.com/2023/09/05/tim-scott-never-disclosed-buying-stocks-he-recently-said-he-owned/.

D. Requirement of a Cooling-Off Period

The fourth suggestion is the establishment of a cooling-off period for any Congress member attempting a stock trade. In the context of securities transactions, the cooling-off rule refers to SEC regulation M, "which specifies key points in the process of floating stock shares or issuing bond offerings."[118] However, the typical cooling-off rule "refers to the time in between the day the preliminary prospectus is filed with the SEC and the day when the new security is actually available for sale or trade."[119] On its face, it seems that the typical cooling-off rules of the SEC do not apply to the investor, however a similar concept could be established and enforced to prevent insider trading.

This suggestion would essentially function as both immediate disclosure and pre-approval; so, it could either be dependent on those suggestions or a stand-alone requirement. The Congressional official looking to make a trade would indicate that they wished to buy or sell a particular stock, however a certain amount of time would need to pass before that action is actually taken. Ideally, this attempt would be made public so that the free market could see where our elected officials are looking to buy or sell. The market would therefore adjust accordingly and any effect that would come from any non-public information would be diminished. Additionally, this period would also give the SEC another opportunity to review the trade before it is made; the function of the pre-approval requirement. A cooling-off rule thus would erect an additional barrier protecting the market from insider trading.

E. Heavier Penalties for Violation

The fifth and final suggestion to enhance the Ban Stock Trading for Government Officials Act and any future legislation would be to dramatically increase the penalties for violation. Current penalties do nothing to encourage compliance with ethical rules and the STOCK Act, to a point where it is referred to as a "a symbolic gesture of accountability with minimal teeth."[120] Under the current regime, failure to report stock trades starts at a mere $200 fine, "barely a dent in undisclosed transactions that are

---

[118] Gordon Scott, *Cooling-Off Rule*, INVESTOPEDIA (updated Jan. 21, 2022), https://www.investopedia.com/terms/c/coolingoffrule.asp.
[119] *Id.*
[120] John Divine, *Congress and Stocks: Notable Trades and an Ineffective Law,* USN, (Apr. 6, 2022), https://money.usnews.com/investing/articles/congress-and-stocks-notable-trades-and-an-ineffective-law.

frequently worth thousands and millions of dollars."[121] Former counsel for the House Ethics Committee commented on the subject, stating that the "penalties aren't high enough to promote compliance."[122]

Even if an official was found to have violated the STOCK Act, "no public records exist to indicate whether members of Congress who are fined even [paid]."[123] This is in direct contrast to the accountability imposed on the executive branch, which is required to "publicly [release] details about the fines it collects from employees who filed financial documents late."[124]

Despite making progress on increasing the lackluster penalties from the STOCK Act, the Ban Stock Trading for Government Officials Act yet again falls short. To start, the penalty for failing to file personal financial transactions would be increased from $200 to $500.[125] The bill might as well have kept that penalty the same; a $300 penalty increase for failing to report transactions "frequently worth thousands and millions of dollars"[126] is meaningless. To have any effect, failure to report any stock trades should be considered a violation of the act itself, such as: imposing fines upwards of $10,000 or requiring forfeiture of any gains from the trade. By not reporting trades, there is a clear lack of transparency to the public and essentially covers any evidence of insider trading.

The Ban Stock Trading for Government Officials Act does add a penalty, charging members of Congress "at least [ten percent] of the value of the prohibited investments."[127] While charging members of Congress at least ten percent of their illegal trade seems like a stiff penalty on its face, it is yet another drop in the bucket of many

---

[121] Justin Papp, *These Lawmakers are Still Invested in Banning Congressional Stock Trades*, Roll Call (Jan. 18, 2024), https://rollcall.com/2024/01/18/these-members-of-congress-still-want-to-ban-trading-stocks/; *see also We Need Stronger Oversight of Congressional Stock Trades*, CLC, (Jan. 26, 2022), https://campaignlegal.org/cases-actions/we-need-stronger-oversight-congressional-stock-trades.

[122] Chris Marquette, *Qualified Blind Trust Proposal Receives Chilled Reception at Congressional Stock Hearing*, Roll Call, (Apr. 7, 2022), https://rollcall.com/2022/04/07/qualified-blind-trust-proposal-receives-chilled-reception-at-congressional-stock-hearing/.

[123] Danielle Caputo, Delaney Marsco, & Kedric Payne, *Part 2 - The STOCK Act: The Failed Effort to Stop Insider Trading in Congress,* CLC, (Feb. 18, 2022), https://campaignlegal.org/update/part-2-stock-act-failed-effort-stop-insider-trading-congress.

[124] Camila DeChalus, Kimberly Leonard, and Dave Levinthal, *Congress and Top Capitol Hill Staff have Violated the STOCK Act Hundreds of Times. But the Consequences are Minimal, Inconsistent, and not Recorded Publicly,* BUSINESS INSIDER, (Dec. 15, 2021), https://www.businessinsider.com/congress-stock-act-violations-penalties-consequences-2021-12.

[125] Destinee Adams, Leila Fadel, *New Bill Would Fine Congress Members for Trading Stocks and Owning Blind Trusts*, NPR, (July 20, 2023), https://www.npr.org/2023/07/20/1188869588/sen-gillibrand-discusses-efforts-to-ban-lawmakers-from-holding-and-trading-stock.

[126] *We Need Stronger Oversight of Congressional Stock Trades*, CLC, (Jan. 26, 2022), https://campaignlegal.org/cases-actions/we-need-stronger-oversight-congressional-stock-trades.

[127] Destinee Adams, Leila Fadel, *New Bill Would Fine Congress Members for Trading Stocks and Owning Blind Trusts*, NPR, (July 20, 2023), https://www.npr.org/2023/07/20/1188869588/sen-gillibrand-discusses-efforts-to-ban-lawmakers-from-holding-and-trading-stock.

large stock trades. One example of where a ten percent penalty is meaningless is from former Speaker of the House Nancy Pelosi, whose husband "[traded] as much as $81 million worth of assets between 2019 and 2021, including in numerous companies subject to congressional scrutiny."[128] Had the Ban Stock Trading for Government Officials Act been in effect during this period of time and assuming that Pelosi was investigated and charged, a ten percent charge would have gone unnoticed.

Interestingly enough, the Act would force "employees of the *executive branch*…to forfeit their stock profits and face [a] fine of $10,0000 or more, whichever is greater."[129] It is unclear as to why this only would apply to the executive branch and not members of Congress, but this penalty for violation was what the Ban Stock Trading for Government Officials Act needed. Where the current penalties would still allow members of Congress to retain their ill-gotten gains,[130] this suggested penalty would rob offenders of any benefits derived from insider trading. This penalty is also more in line with current insider trading laws outside of the Congressional context. In the civil context, individuals found in violation of insider trading laws could receive heavy fines, be forced to relinquish all gains from the trade, and possibly even repossess the stocks traded.[131] Again, there is no reason as to why Congress members should not be subject to the same punishments under the Act.

A violation of any part of the Act, such as the timely disclosure requirement, should be considered a violation of the act as a whole. Additionally, the penalties should mirror those against regular citizens, or at the very least impose the same penalties the Act wants to impose upon the executive branch. To truly be effective, any penalty imposed would need to be harsh enough to completely deter insider trading or violation of the act as a whole. This suggestion for the Ban Stock Trading for Government Officials Act, or any future bill, would do just that. There would be no benefits to insider trading if any profit gained would be stripped away followed by a heavy fine. However, for maximum effectiveness, the heavier penalties would likely need to be accompanied by the other suggested additions.

Possible Methods to Curb Insider Trading Outside of the Purview of Congress

---

[128] Brett Wilkins, *Nearly 100 Members of Congress Reported Stock Trades That Overlap With Committee Work,* Common Dreams, (Sep. 13, 2022), https://www.commondreams.org/news/2022/09/13/nearly-100-members-congress-reported-stock-trades-overlap-committee-work.

[129] Destinee Adams, Leila Fadel, *New Bill Would Fine Congress Members for Trading Stocks and Owning Blind Trusts*, NPR, (July 20, 2023), https://www.npr.org/2023/07/20/1188869588/sen-gillibrand-discusses-efforts-to-ban-lawmakers-from-holding-and-trading-stock.

[130] *Id.*

[131] Tessa Campbell, Choncé Maddox, *What Is Insider Trading?*, BUSINESS INSIDER (updated Mar. 6, 2024), https://www.businessinsider.com/personal-finance/insider-trading.

Even if the Ban Stock Trading for Government Officials Act or any future bills work in the previously mentioned potential fixes, there is still no guarantee that Congress would elect to adopt this level of self-regulation. It is no secret that Congress is "significantly more opaque…when it comes to the personal financial interests of its members and staffers."[132] After a multitude of attempts at internal reform, Congress has routinely dispensed with any attempt at self-regulation.[133] Maybe the answer lies in looking outward, outside the purview of Congress, to end insider trading and rebuild trust in our elected officials.

Pursuing reform for ethical governance outside of the grasp of Congress will allow for unbiased control over the situation and more of an assurance that actions are being taken. This section will explore three potential routes to combat insider trading outside of Capitol Hill: 1.) track Congressional trading patterns in real time to emulate; 2.) increase authority, involvement, and prosecution by the SEC; and encourage states to expand their securities laws. While each of these suggestions comes with their own set of problems to be addressed, this complicated matter needs creative solutions. Alongside efforts in Congress, each of these potential outside changes should be considered.

A. Fight Fire with Fire: Tracking Congressional Trading Patterns in Real time

One way for the American people to combat the effects and advantages of Congressional insider trading is to simply follow and copy whatever stock trades our lawmakers make. Annual reviews of trades from over 500 members of both the House and the Senate found their portfolios consistently outperforming the S&P 500.[134] According to Unusual Whales, a stock and options new service, in 2023 Congressional "Republicans earned an average of 18 [percent] returns on their trades, while Democrats earned 33 [percent]."[135] These are simply the trades that are made public considering that

---

[132] Camila DeChalus, Kimberly Leonard, and Dave Levinthal, *Congress and Top Capitol Hill Staff have Violated the STOCK Act Hundreds of Times. But the Consequences are Minimal, Inconsistent, and not Recorded Publicly,* BUSINESS INSIDER, (Dec. 15, 2021), https://www.businessinsider.com/congress-stock-act-violations-penalties-consequences-2021-12.

[133] Jason Fernando, *STOCK Act: Meaning, Overview, Criticisms*, INVESTOPEDIA (Aug. 31, 2022), https://www.investopedia.com/terms/s/stop-trading-on-congressional-knowledge-act.asp.

[134] Jay O'Brien, Arthur Jones II, and Eric Ortega, *Citizen Watchdogs Eye Congress' 'Killing it' Approach to Stock Trading,* ABC NEWS, (Nov. 15, 2023), https://abcnews.go.com/Politics/citizen-watchdogs-eye-congress-killing-approach-stock-trading/story?id=104873686.

[135] Marco Quiroz-Gutierrez, *Members of Congress Outperformed the S&P 500—Sometimes by Huge Amounts,* YAHOO FINANCE, (Jan. 3, 2024), https://finance.yahoo.com/news/members-congress-outperformed-p-500-182024981.html#:~:text=Thanks%20in%20part%20to%20some,stock%20and%20options%20news%20service: The top performing traders include notable names such as Rep. Nancy Pelosi (D-Calif.), whose

many Congressmen ignore the reporting requirements of current ethical and securities legislation.[136]

This method is not necessarily new. Websites and accounts on various social media platforms, such as Redditt and Tik Tok, devote themselves to compiling whatever information is available about where members of Congress are placing their finances.[137] Additionally, Subversive Captial worked with Unusual Whales to establish two ETFs that "will follow exactly how Democrat and Republican members of Congress are trading."[138] NANC, after Speaker of the House Nancy Pelosi, will represent the Democratic-tracking ticker while the Republican-tracking ticker will be called KRUZ, after Sen. Ted Cruz.[139]

While this method is all well and good, for it to truly be effective there would need to be immediate disclosure requirements as stated earlier. Following the trades, once made public, is simple enough, but these trades could have been made much earlier than the Congress member disclosed.[140] With the minimal penalties currently in place for late disclosures, or even just being able to wait until the end of the 45 day requirement to disclose, following these trades in "real time" could prove difficult.[141] But if an immediate disclosure requirement was implemented and enforced, this method could even the playing field with those who have access to information that the rest of the population does not.

B. What Can the SEC Do? What Changes Would Need to be Made for the SEC to be Able to Check Congressional Power

The Security and Exchange Commission is currently the principal authority in enforcement of insider trading; specifically, under section 10(b) of the Securities

---

portfolio was up 65% on the year; Rep. Dan Crenshaw (R-Texas), up 38%; and Sen. Susan Collins (R-Maine), up 55%. Rep. Brian Higgins (D-N.Y.) notched the highest returns for 2023 at 238%.

[136] *Id.*

[137] Capitol Trades, https://www.capitoltrades.com/about-us; Smart Insider, https://www.smartinsider.com/politicians/; Timothy Smith, *TikTokers Track Lawmakers' Personal Stock Trades*, (Oct. 20, 2021), https://www.investopedia.com/tiktokers-track-lawmakers-personal-stock-trades-5206454.

[138] Brett Holzhauer, *Some Members of Congress have Above Average Investing Returns — Soon, 2 New ETFs Will Let You Follow Along With Them*, CNBC, (Dec. 10, 2023), https://www.cnbc.com/select/congressional-stock-trading-could-soon-be-tracked/.

[139] *Id.*

[140] John Divine, *Congress and Stocks: Notable Trades and an Ineffective Law,* USN, (Apr. 6, 2022), https://money.usnews.com/investing/articles/congress-and-stocks-notable-trades-and-an-ineffective-law.

[141] *Id.*

Exchange Act of 1934 (Exchange Act).[142] The rule broadly prohibits fraud and deception "in connection with the purchase or sale of any security,"[143] and such violations may be prosecuted by the SEC or by the Department of Justice.[144]

Unfortunately, despite the power given to the SEC, the DOJ, and the STOCK Act, no civil or criminal charges have yet to be filed for Congressional insider trading.[145] Even though in 2019, Representative Chris Collins pled guilty to insider trading charges for tipping material nonpublic information acquired in his role as board member of a publicly traded pharmaceutical company following an SEC investigation,[146] this information was not obtained in his role as an elected official. Even more egregious, shortly after the passage of the STOCK Act, the SEC investigated a congressional staffer on the House Ways and Means Committee for tipping a lobbyist about an upcoming Medicare decision.[147] This investigation was dropped, however, after House lawyers argued that the investigation violated the separation of powers.[148]

More recently, following the heavy stock trading after a confidential briefing on the COVID-19 pandemic in January 2020, the SEC and DOJ investigated several Senators.[149] One of which, former Senator Richard Burr, sold $1.65 million in stock, mainly pertaining to the hospital industry, on February 13, 2020.[150] However, despite a lengthy investigation into former Senator Burr, and his brother-in-law,[151] neither the SEC nor the DOJ took no action for the purported trades.[152] This is but one of many instances in which SEC and DOJ investigations resulted in no action against Congressman accused of insider trading. To date, there has not been a single successful

---

142 15 U.S.C. § 78j(b).
143 17 C.F.R. § 240.10b-5 (2010).
144 Civil penalties for insider trading violation can include injunctive relief, disgorgement, and a fine of up to three times the profits gained or losses avoided by the illegal trading. *See* Stephen M. Bainbridge, INSIDER TRADING LAW AND POLICY 141–44 (2014). Criminal convictions for insider trading can be punished by a five million dollar fine and up to twenty years imprisonment. 15 U.S.C. § 78ff(a).
145 Jason Fernando, *STOCK Act: Meaning, Overview, Criticisms*, INVESTOPEDIA (Aug. 31, 2022), https://www.investopedia.com/terms/s/stop-trading-on-congressional-knowledge-act.asp.
146 *See* Michael D. Guttentag, *"Huh?" Insider Trading: The Chris Collins Story*, 15 TENN J.L. & POL'Y 95, 97, 99 (2020).
147 *See* Lee Fang, *Congress Tells Court that Congress Can't Be Investigated for Insider Trading*, INTERCEPT (May 7, 2015), https://theintercept.com/2015/05/07/congress-arguescant-investigated-insider-trading/[https://perma.cc/5D9E-BCH6].
148 *Id.*
149 Jason Fernando, *STOCK Act: Meaning, Overview, Criticisms*, INVESTOPEDIA (Aug. 31, 2022), https://www.investopedia.com/terms/s/stop-trading-on-congressional-knowledge-act.asp.
150 Tierney Sneed, *SEC is Still Investigating Sen. Richard Burr for Insider Trading, Court Filings Say*, CNN (Oct. 28, 2021), https://www.cnn.com/2021/10/28/politics/burr-sec-investigation-stock-trades/index.html.
151 *Id.*
152 Dan Mangan, *SEC Ends Insider Trading Probe of Ex-Sen. Richard Burr and Brother-In-Law Without Taking Action, Lawyers Say*, CNBC (last updated Mar. 8, 2023).

case against a Congressional official for insider trading based on information they gained in their professional capacity as an elected official.[153]

Investigations by the SEC in most cases run into the issue about whether the information used to make the trade reaches a "degree of material, non-public detail that could lead to insider trading."[154] Even if the Congressional official has access to information that is not public, but is relevant to the stock price, it still may be difficult to distinguish it from public information in an investigation.[155] For example, in the Burr investigation, he claimed that his trade was based on publicly available information about the emerging coronavirus, such as news reports from CNBC.[156]

The lack of any serious civil or criminal enforcement or prosecution from the SEC likely stems from the Congress' influence over the agency. Although the SEC is an independent agency, headed by a bipartisan five-member commission, it was originally established by Congress in 1933, and each member of the controlling commission is confirmed by the Senate.[157] Because the SEC operates under the authority of federal laws, it is directly accountable to Congress despite being a separate entity.[158] Furthermore, Congress has direct control over the SEC's budget,[159] meaning that one could imagine a conflict in trying to prosecute those who control your very existence.

While many advocates of an outright ban of any stock trading for members of Congress is the only solution because of this conflict with the SEC,[160] perhaps a more creative solution is required. This could be done by taking away Congress' power over the SEC, either by placing its affairs under the purview of either the executive or judicial branches or having the agency become more independent; the first option likely being more feasible. If the agency was not controlled by Congress, but rather by the executive or judicial branch, you essentially remove the conflict by stripping Congress' ability to have meaningful entanglement with the SEC.

---

153 Danielle Caputo, Delaney Marsco & Kedric Payne, *Part 3 - The STOCK Act: The Failed Effort to Stop Insider Trading in Congress*, CLC (Feb. 18, 2022), https://campaignlegal.org/update/part-3-stock-act-failed-effort-stop-insider-trading-congress.

154 C. Ryan Barber, *The SEC Could be the Last, Best Hope to Keep Members of Congress from Insider Trading. The Agency Already has one Republican Senator on its Radar*, BUSINESS INSIDER (Dec. 15, 2021), https://www.businessinsider.com/sec-could-enforce-stock-act-keep-congress-from-insider-trading-2021-12.

155 *Id.*

156 *Id.*

157 James Chen, *Securities and Exchange Commission (SEC) Defined, How It Works*, INVESTOPEDIA (Apr. 27, 2022), https://www.investopedia.com/terms/s/sec.asp.

158 *Id.*

159 *See* Carl Ayers, *SEC Chairman Gensler Ask Congress to Increase the SEC's Budget*, REGULATORY COMPLIANCE WATCH (July 23, 2023), https://www.regcompliancewatch.com/sec-chairman-gensler-ask-congress-to-increase-the-secs-budget/.

160 *Barber*, *supra* note 155.

Like the previous suggested fix of mirroring Congressional trades, to be more effective, the SEC would need to rely on other changes to any proposed bill regarding Congressional stock trading; the immediate disclosure requirement, the pre-approval requirement and the harsher punishments for violation. Aside from the potential conflicts stemming from Congressional oversight of the SEC, the main problems with SEC investigation arise from the current weak laws and the blurred lines between public and private information. Immediate disclosure, pre-approval and harsher punishments for violation would remedy these issues.

With immediate disclosure, the trades would almost instantly get on the radar of the SEC. Because the current regime does not properly punish late disclosures and therefore the SEC does not have a chance to investigate the trades straight away. This opens the door to confusion in an investigation. The Congressman could wait to disclose until after a public announcement is made to make it appear as though the trade was in response to that announcement. The longer it takes to disclose would also hinder the investigation. Immediate disclosure would seemingly erase this scenario.

The problems with disclosure also relate to the need for harsher punishments. More specifically, to truly be effective, failure to disclose must be considered a violation of the bill. This would make the SEC's investigation much clearer, being that if a late disclosure would be considered a violation of the bill as a whole, the SEC could fully use its authority to bring civil or criminal charges unencumbered. There would be a clear cause of action even if the trade was disclosed a day late. In that scenario, the SEC could use its discretion on whether they would press charges, but being able to properly enforce the law and prevent insider trading is a fair trade off. In sum, it would give the SEC the much-needed teeth to realistically attack the issue of insider trading.

Lastly, a pre-approval requirement could work with the SEC in two ways: either it would give the SEC investigators more background to trades that it is investigating or the SEC could be the independent body approving the trades. The first option acts similarly to the immediate disclosure requirement and the harsher punishments for violation, as the trading Congressman would immediately disclose their trade and failure to get the proper approval would mean a violation. If the SEC was involved, or was specifically the independent body the Congressmen needed to get approval from, they would justly be involved in every stock trade made. Theoretically, insider trading would be nearly impossible because the Congressman would either get approval for the trade, or if he or she tried to make the trade without going to the SEC first it would clearly be a violation and subject to prosecution.

For the SEC to truly be effective in ending insider trading in Congress, the answer is not as simple as just giving them more prosecutorial power. The goal should instead be to make it easier for the SEC to investigate suspicious trades and shine a brighter light on said trades. It is unrealistic to simply ban all stock trading in Congress, as no bill with such harsh restrictions will likely get passed. SEC needs to be involved and would be most effective in conjunction with other trade restrictions.

C. What Can the States Do? Encouraging States to Expand Their Securities Laws

If federal laws are unable to fully prevent congressional insider trading, we could possibly In addition to federal securities laws under the Securities Act of 1933, states may also have their own forms of securities regulations referred to as "blue sky laws."[161] These laws "typically require sellers of new issues to register their offerings and provide financial details of the deal and the entities involved."[162] These laws do not supersede the SEC, but rather act as an additional safeguard to protect against any illegal securities activity.[163]

Due to the nature of these laws being state laws and not federal broad sweeping laws, there are a few complications with relying on blue sky laws. First, due to the state-based nature of the laws, each jurisdiction could have different filing requirements.[164] This is no surprise as the purpose of federal laws was to prevent this very issue.

Second, there are a few exemptions listed in blue sky laws that allow investors and issuers to bypass certain requirements. The federal securities exemption "applies to securities that are already registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933."[165] Essentially, because the securities already were subject to federal scrutiny, they are deemed safe and acceptable.[166] The private placement exemption applies to "securities that are sold to a limited number of accredited investors, such as high net worth individuals or institutional investors," meaning that the investors are deemed to have sufficient knowledge over the stock.[167]

Lastly, blue sky laws are mainly meant to protect the investor, not necessarily to prevent insider trading or other securities crimes on the investors end.[168] The disclosure

---

[161] Troy Segal, *Blue Sky Laws: Definition, Purpose, How They're Regulated*, INVESTOPEDIA (Nov. 30, 2020), https://www.investopedia.com/terms/b/blueskylaws.asp.
[162] *Id.*
[163] *Blue Sky Laws: Definition and How Regulation Works*, CARTA (June 12, 2023), https://carta.com/blog/blue-sky-laws/.
[164] Segal, *supra* note 161.
[165] The Carta Team, *Blue Sky Laws: Definition and How Regulation Works*, CARTA (June 12, 2023) https://carta.com/blog/blue-sky-laws/.
[166] *Id.*
[167] *Id.*
[168] Troy Segal, *Blue Sky Laws: Definition, Purpose, How They're Regulated*, INVESTOPEDIA (Nov. 30, 2020), https://www.investopedia.com/terms/b/blueskylaws.asp.

requirements under blue sky laws for anti-fraud require the sellers of securities to disclose the details of the securities, not the disclosure of buyers.[169]

While it appears that blue sky laws do not apply to insider trading issues, maybe these laws should be expanded to better compliment federal laws. One suggestion could be to have elected officials at the federal level to register with the securities seller and have disclosure of whatever trades are made by the officials. This would act similarly to the immediate disclosure requirement proposed earlier, but instead of relying on the official to timely disclose their trade the disclosure would come from whichever investment company they used. The seller of the stock would have less of an incentive to hide any stock trades or attempt to bend the rules surrounding federal securities laws as they would have no reason to do so. Additionally, this suggested fix would not step on the toes of any federal law or legislation, but rather it would bolster its effectiveness. At the end of the day, that is the true purpose of the blue sky laws,[170] so expanding their power seems like a logical solution.

Part III: Conclusion

With the public perception of our modern government nearing all-time lows,[171] one would assume that efforts are being made to fix the glaring issues. Politicians and civil servants should not hold elected positions to line their own pockets, rather they should be focused on running our country.[172]

The Ban Stock Trading for Government Officials Act is but one of many proposed bills doomed to fail. It is no different than previous bills attempting the same things, Congress members are unlikely to pass such "harsh" self-regulation, and its broad provisions may run into freedom of speech issues. However, there are several fixes that could be made to the bill, or to any future legislation attacking Congressional insider trading; the use of qualified blind trusts, pre-approval requirements, immediate disclosure, cooling-off periods, and harsher penalties for violators. There are potential solutions outside of Congress as well, namely: mirroring the trades of Congress members, strengthening the SEC's ability to prosecute, and bolstering state securities laws. If Congress is to restore their public image and regain the trust of their voters,

---

169 *Id.*
170 *Id.*
171 *See, e.g.*, Public Trust in Government: 1958–2021, PEW RSCH. CTR., (May 17, 2021), https://www.pewresearch.org/politics/2021/05/17/public-trust-in-government-1958-2021/ [https://perma.cc/6G8X-MYK3] (showing that the trust in government "remains low," with less than one quarter of Americans saying "they trust the government in Washington to do what is right").
172 Terry Lane, *Congressional Stock Trading Ban Proposed Amid High Public Support*, INVESTOPEDIA (July 31, 2023), https://www.investopedia.com/congressional-stock-trading-ban-introduced-7564348.

these proposed fixes would go a long way. Insider trading will always be a hot-button issue where the public is not privy to all the information, but Americans deserve to be represented by politicians who set their own financial goals aside to serve the people.