The DIGEST
National Italian American Bar Association Law Journal

ARTICLES

CASE COMMENTS

ATTENTION SUBSCRIBERS

The Digest invites its readers to submit articles of significance to the Italian-American Community or the legal profession. We are currently accepting submissions for articles to be published in the next edition. Manuscripts should be sent to:

Professor Robin Paul Malloy
Syracuse University College of Law
Syracuse, NY 13244-1030

All submissions should include one manuscript and an electronic copy utilizing Microsoft Word. Citations should comply with the rules contained in *A Uniform System of Citation* (18th ed. 2005). We also request that the author indicate his or her academic credentials and professional affiliations.

THE DIGEST

The Law Journal of the National Italian American Bar Association

The DIGEST
National Italian American Bar Association Law Journal

National Italian American Bar Association

The Digest • Suite 159 • Syracuse University College of Law • Syracuse, NY 13244-1030

Men and Women Sharing a Chosen Profession and a Common Heritage

THE DIGEST

Two-Thousand and Eight

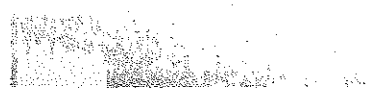
ARTICLES

CASE COMMENTS

Published annually by the members of the NATIONAL ITALIAN-AMERICAN BAR ASSOCIATION, Washington, D.C. Editorial Office: NIABA, 2020 Pennsylvania Avenue N.W., Suite 932, Washington, D.C. 20006. Publication Office: Joe Christensen, Inc., P.O. Box 81269, 1450 Adams St., Lincoln, NE 68501.

Single issue volumes are available through the Editorial Office at a price of $25.00. Rates for bulk copies quoted on request.

POSTMASTER: Send change of address and new subscriptions to THE DIGEST, National Italian-American Bar Association, 2020 Pennsylvania Avenue N.W., Suite 932, Washington, D.C. 20006, at least 45 days before the date of the issues with which it is to take effect. Duplicate copies will not be sent without charge.



Anti-Semitism in Criminal Courts: The Case of the Rhodes Blood Libel

EDWARD J. MAGGIO, ESQ.*

INTRODUCTION

Throughout the development of criminal and evidentiary legal codes in human civilization, courts have developed to become beacons of truth and justice. What few realize is that criminal courts have also been used throughout history for anti-Semitic purposes. Since ancient times, criminal courts and proceedings around the world have been used to accuse Jews of murdering others for the sake of taking a victim's blood. Known as a Jewish blood libel, this legal version of anti-Semitism exists with us even today in various countries around the world.[1] Developing strongly since the medieval period, the Jewish blood libel became a legal way in which Jews could be targeted for removal in a community or for spreading malicious and hateful propaganda against them. In examining the famous case of the Rhodes Blood Libel of 1840, the role of criminal court proceedings as a tool of hatred is clearly demonstrated.

I. BLOOD LIBEL: ORIGINS

It is important to first understand the notion of a blood libel. Blood libels are sensationalized and fictional allegations that a person or group engages in murder, often accompanied by the claim that the blood of the victims is used in various religious rituals or consumed outright for some nefarious purpose.[2] The alleged victims are often young children since they would be easier victims to capture, control and murder. When examining claims of blood libels against Jews, the idea is that Jews must kill Christian boys in compliance with Kosher-Jewish law in order to take their blood for use in matzos during Passover.[3] The

* Edward J. Maggio is an Assistant Professor of Criminal Justice at the New York Institute of Technology. He received his J.D. from New York Law School in 2002, and his M.S. in Criminology & Criminal Justice from Oxford University in 2003. For further information, Edward J. Maggio can be contacted at emaggio@nyit.edu

1. OBSESSION: RADICAL ISLAM'S WAR AGAINST THE WEST (Trinity Home Entertainment 2007); *see also Jane S. Gerber,* Anti-Semitism and the Muslim World, in HISTORY AND HATE: THE DIMENSIONS OF ANTI-SEMITISM 88 (David Berger ed., The Jewish Publication Society 1986).

2. THE BLOOD LIBEL LEGEND: A CASEBOOK IN ANTI-SEMITIC FOLKLORE vii (Alan Dundes ed., The University of Wisconsin Press 1991); Abraham G. Duker, *Twentieth-Century Blood Libels in the United States, in* THE BLOOD LIBEL LEGEND, *supra,* at 233-242; Cecil Roth, *The Feast of Purim and the Origins of the Blood Accusation, in* THE BLOOD LIBEL LEGEND, *supra,* at 261; Alan Dundes, *The Ritual Murder or Blood Libel Legend: A Study of Anti-Semitic Victimization through Projective Inversion, in* THE BLOOD LIBEL LEGEND, *supra,* at 337.

3. Steven Stalinsky, *Passover and the Blood Libel,* THE NEW YORK SUN, Apr. 12, 2006, at Foreign 6.

belief that Christian boys must be ritually slaughtered like kosher cattle is a false and ridiculous notion. The descriptions of torture and human sacrifice in the anti-Semitic blood libel cases in European and Middle-Eastern cases run contrary to many of the teachings of Judaism. In addition, the use of blood (human or otherwise) in cooking is prohibited by the kosher dietary laws.[4] Blood from slaughtered animals may not be consumed, and must be drained out of the animal and covered with dirt.[5] Regardless, such movies and television programming even today in Middle Eastern countries supports the notion that Jews need to kill Christian boys as fact.[6] It is important to note that the Romans claimed the early Christians engaged in blood libel killings. During the first and second centuries, some Roman commentators had various interpretations of the ritual of the Eucharist and transubstantiation and argued that the Christians literally drank blood based on their belief in transubstantiation.[7]

During the medieval period, Jewish blood libel cases brought into European criminal proceedings or before a criminal justice adjudicator began to increase. The first recorded Jewish blood libel criminal case occurred involving a 12th century legend surrounding a young tanner boy known as William of Norwich, as recorded in *The Peterborough Chronicle*.[8] The tale regarding this twelve year-old tanner boy was that his body was found in a sack hidden in a tree, after possibly being crucified, and his side was pierced by his murderers. A converted Jew, called Theobald of Cambridge, confessed (probably under torture) that the Jews took blood every year from a Christian child because they thought that only by so doing could they ever obtain their freedom and return to Palestine; and that it was their custom to draw lots to decide whence the blood was to be supplied. Theobald said that last year the lot fell to Narbonne, but in the year of William's murder, the duty fell to Norwich. When the local sheriff refused to bring local Jews to trial, the community perceived that he was bribed and spread word of this Jewish killing practice.[9] Over the next hundred years, accusations were made all over England that Christian boys were being murdered by Jews. Cases emerged in locations such as: Gloucester (1160), Bury St. Ed-

---

4. *Dietary Laws*, 5 ENCYCLOPEDIA JUDAICA 650-659 (Fred Skolnik & Michael Berenbaum eds., 2d ed., Keter Publishing House 2007).

5. *Id.*; *see also Leviticus* 17:12-13.

6. Umayma Ahmad Al-Jalahma, *Saudi Government Daily: Jews Use Teenagers' Blood for 'Purim' Pastries*, THE MIDDLE EASTERN MEDIA RESEARCH INSTITUTE: SPECIAL DISPATCH SERIES, Mar. 13, 2002, at No. 354; *see also* OBSESSION, *supra* note 1.

7. *See generally* ROBERT LOUIS WILKEN, THE CHRISTIANS AS THE ROMANS SAW THEM 15-25, 48-62 (2d ed., Yale University Press 2003).

8. BRIAN AYERS, ENGLISH HERITAGE BOOK OF NORWICH 48 (Batsford/English Heritage 1994); JAMES PARKES, THE JEW IN THE MEDIEVAL COMMUNITY: A STUDY OF HIS POLITICAL AND ECONOMIC SITUATION 125 (2d ed., Hermon Press 1976); *see generally* John M. McCulloh, *Jewish Ritual Murder: William of Norwich, Thomas of Monmouth, and the Early Dissemination of the Myth*, 72 SPECULUM 698-740 (Jul. 1997).

9. AYERS, *supra* note 8, *at* 48-52; McCulloh, *supra* note 8.

munds (1181), Winchester (1192 and 1232), Norwich (1235), London (1244, 1257, 1276), Northampton (1279) and Oxford (1290).[10] Along with criticism of Jews practicing usury in England, combined with additional false notions of the Jewish religion, King Edward I ordered on July 18th 1290 that all Jews in England were to leave the lands before November 1st; any who remained were declared liable to be executed by royal decree.[11] The impact of Edward I and his royal decree cannot be underestimated in its sociological impact. The banishment of Jews from England likely fostered the notion through the rest of Europe, both in royal courts and in local communities, that Jews did indeed engage in the ritualistic killings of Christians. Throughout the rest of the medieval period, around 150 recorded cases which galvanized local communities in Europe against Jewish residents have been recorded. In almost every case, Jews were murdered, sometimes by a mob, sometimes following torture and a trial.[12] Such cases reflect a lack of physical evidence and more admittance of hearsay as a source of evidence to convict and punish Jewish defendants.[13] Despite the recorded medieval legal record, accusations in which Jewish people were later summarily driven out or killed by their local communities without legal proceedings likely reflects a number of blood libel cases much higher. In terms of what prompted such cases can be explained by a number of possible explanations. It is likely that such accusations were made as a result of unexplained disappearances of children, the suspicions by Christians against their newly arrived Jewish neighbors, the lack of medical knowledge to explain the death of a Christian child, or those in a community who wished to secure the wealth of Jewish citizens in various kingdoms and principalities.

As European criminal law began to become more sophisticated in logic as part of the Enlightenment, the standards of evidence in criminal courts increased such that combined with more knowledge about Jewish culture, Jewish blood libel cases became difficult to prove in legal proceedings. By 1772, few blood libel cases reached European criminal courts.[14] Nevertheless, some periodic legal accusations of ritual murder arose as late as the 19th century.[15] While continental Europe began moving away from allowing local Christians to

---

10. Geoffrey H. Smith & Arnold S. Leese, *The Edict of Expulsion of 1290*, THE HERETICAL PRESS, Aug. 30, 2006, *available at* http://www.heretical.com/British/jews1290.html.

11. JOAN COMAY, WHO'S WHO IN JEWISH HISTORY AFTER THE PERIOD OF THE OLD TESTAMENT 109-110, 246 (Lavinia Cohn-Sherbok ed., Routledge 2002) (1974) ("Although Edward I's 1290 edict of expulsion was not formally revoked as Manasseh [Ben Israel] had hoped, the resumption of open Jewish worship achieved the same practical result. The edict has actually not been revoked to this day.").

12. Duker, *supra* note 2.

13. Duker, *supra* note 2.

14. JONATHAN FRANKEL, THE DAMASCUS AFFAIR: "RITUAL MURDER," POLITICS, AND THE JEWS IN 1840, at 29 (Cambridge University Press 1997).

15. LEON POLIAKOV, THE HISTORY OF ANTI-SEMITISM VOLUME I: FROM THE TIME OF CHRIST TO THE COURT JEWS 60-64 (Richard Howard trans., University of Pennsylvania Press 2003) (1955).

use criminal courts as an offensive weapon against their Jewish neighbors, Middle Eastern kingdoms and the Byzantine Empire continued to allow Christians to accuse their Jewish neighbors.[16] When the Ottoman Empire conquered Constantinople and the Byzantine Empire in 1453, the Jewish blood libel was continually allowed to be brought in Muslim courts and legal proceedings.[17] Throughout the Ottoman Empire from the 15th century onward, it was generally from local Greek-Christian communities that were ethnically and religiously diverse that would likely bring Jewish blood libel charges against their Jewish neighbors.[18]

II. RHODES: AN ISLAND OF CONFLICT

The island of Rhodes has always been an ethically and religiously diverse location, especially in the late 1800s. Rhodes as a location is strategic in terms of military defenses and trade based on its centralized location in the Mediterranean. It was also an island that was destined to have anti-Semitism emerge in some manner as Jews and Christians came into conflict with one another under Muslim rule. When a plague emerged and decimated the island community, the Knights Hospitaller began expelling entire Jewish families from the island, most likely, because they were falsely considered agents who helped to spread the plague and poison wells. However, in the following decades, with a lack of personnel to rebuild island fortifications and defense works, the knights brought over 2,000 captured Jews to serve as slave labor in the redevelopment and rebuilding of military defenses.[19] These same Jewish slaves later assisted the Ottomans in their capture and control of the island, which also increased latent hostility from the local Christian community. As the Ottomans consolidated their control of Rhodes, these Jewish slaves earned their freedom and cultivated a major Jewish center on the island. By the 19th century, a thriving Jewish community with a Sephardic-Jewish center of learning as well as a wealthy merchant class was present on the island.[20] This wealthy merchant and educated class of Jewish citizens likely presented a problem for Greek-Christians on the island who grew bitter or jealous of their relationship with Muslim officials. Thus, the conditions were being set up for an inevitable conflict between the different faiths on the island.

---

16. FRANKEL, *supra* note 14 at 65, 376.

17. *Id.*

18. *See generally* LEWIS BERNARD, THE JEWS OF ISLAM 107-130 (Princeton University Press 1984).

19. Gotthard Deutsch & Abraham Galante, *Rhodes*, JEWISH ENCYCLOPEDIA (2002), *available at* http://www.jewishencyclopedia.com/view.jsp?artid=263&letter=&search=rhodes.

20. MARC D. ANGEL, THE JEWS OF RHODES: The History of a Sephardic Community 21-31 (Sepher-Hermon Press 1978).

III. HOW IT BEGAN

On February 17, 1840, a boy from a local Greek Orthodox Christian family went for a walk in his local neighborhood in Rhodes and never returned home. His mother soon reported the disappearance of the boy to the local Ottoman authorities. Despite a search conducted by the governor-general of the island, Yusuf Pasha, no sign of the boy turned up anywhere. The cry of murder was soon being shouted. Although no evidence of murder or foul play could be obtained or discovered by Ottoman officials, the Greek-Christian community of Rhodes began to assert that the boy was murdered so his blood could be used by Jews in the creation of matzos. Soon an eyewitness emerged to report that "It was firmly believed that the child in question was doomed to be sacrificed by the Jews."[21] The governor-general of Rhodes, under pressure from the local European diplomatic and consular officials who endorsed the local Christian community, began a more intensive search concentrated in the Jewish quarter of Rhodes. Soon two Greek women from the Christian community emerged to report that a Greek-Christian boy was walking towards the city area with four Jewish citizens. The women further claimed that one of the four Jews with the Christian boy was Eliakim Stamboli.[22] Since Jewish citizens often did not mix with Christians except in matters of business, such a report of Jews and a Christian boy together on the island would be considered prima facie evidence of foul play for the Greek-Christian community. Eliakim Stamboli was then arrested following the report of the women, interrogated at length, and subjected to five hundred blows of the bastinado.[23] Six days after the boy originally disappeared, Eliakim Stamboli was now intensely interrogated in the presence of foreign dignitaries. Those present at the torture of Eliakim Stamboli included the governor Yasuf Pasha, the local Muslim judge or qadi, the Greek archbishop, and a number of European officials. The interrogation methods used against Eliakim Stamboli were by no means a simple case of official use of battery to obtain information. Jewish witnesses present at this interrogation noted that Eliakim Stamboli was "loaded with chains, many strikes were inflicted upon him and red-hot wires were run through his nose, burning stones were applied to his head and a very heavy stone was laid upon his breast, insomuch as he was reduced to the point of death following medieval torture practices."[24] Under torture, Eliakim Stamboli confessed to the ritual murder charge of the boy and incriminated other Jews in his community. The floodgate of investigations was thrown open. Soon investigation and accusations began involving members of the entire local Jewish community. Jewish community members were soon tortured by local authorties while the local Chief Rabbi

21. FRANKEL, *supra* note 14, *at* 69.
22. *Id.* at 70.
23. *Id.* at 70-71.
24. *Id.* at 70.

Jacob Israel and Jewish scholars were interrogated as to the validity of blood in matzos.[25] The governor-general Yusuf Pasha soon bowed under pressure from Greek-Christian leaders and the European diplomatic/consular representatives interested in protecting Christians. Yusuf Pasha soon ordered the closing of the Jewish quarter in a quarantine blockade.[26] Despite the interrogations of Jewish suspects on the disappearance of the boy, it is important to note that the Muslim authorities even after were not keen to pursue the ritual blood murder accusation against the suspected Jews along with the entire Jewish community. The local criminal qadi (judge) openly felt that the Jewish community was being targeted by the Greek-Christians on false evidence which led him to initiate further hearings on the case. He soon declared the evidence insufficient to convict the prisoners.[27] The governor Yusuf Pasha, however refused to lift the quarantine-blockade of the Jewish quarter. With subordinate Muslim officials who knew members of the Jewish community were putting pressure on him for restraint in punishment while Christians and European diplomats at the same time were requesting more interrogations and torture, the governor-general found himself in a political dilemma. In early March of 1840 he requested formal orders from his superiors in Istanbul since the affair was involving more European diplomats/consular agents and creating a danger to his political base. Mercy to the Jewish community soon came as a high treasury official visiting the island during a routine official inspection requested the Jewish blockade be lifted immediately.[28]

IV. A CASE OF BAD TIMING

The blockade lifted on the Jews of Rhodes was soon short lived. At the same time, reports began to surface of Jews in Damascus, Syria who ritually killed a Catholic priest by the name of Father Thomas in order to steal his holy blood.[29] Soon the Greek-Christians began demanding that more investigations and new criminal charges be brought. Under pressure from European diplomats and the local Greek community on the island, Ottoman authorities arrested eight new Jewish suspects including the previously questioned Chief Rabbi Jacob Israel along with a new suspect David Mizrahi.[30] With the Damascus allegations, European diplomats at these new interrogations in Rhodes took a major part in the questioning, particularly J. G. Wilkinson, the British consul, Anton Guiliani from Austria and E. Masse from Sweden.[31] In particular they made sure to be

---

25. *Id.* at 72.
26. ANGEL, *supra* note 20, at 38.
27. FRANKEL, *supra* note 14, at 71.
28. *Id.*
29. Charlotte Klein, *Damascus to Kiev: Civilta Cattolica on Ritual Murder*, *in* DUNDES, *supra* note 2, at 182-184; *see also* FRANKEL, *supra* note 14, at 67.
30. FRANKEL, *supra* note 14, at 70-72.
31. *Id.*

present for the torture of the Jewish suspects during this round of investigations and to continue to assert the Jewish blood rituals with Christian blood must be true.[32] Chief Rabbi Jacob Israel was tortured for two days with diplomats laying questions upon him. When Rabbi Israel (an Austrian citizen as well) appealed to the Austrian diplomat present at his torture, he replied "What Rabbi? What do you complain about? So you are not dead yet."[33] The hope that the spiritual leader of the Jewish community would break and confess under torture was dashed as the Rabbi stayed silent on matters involving the Jewish blood libel. The other major suspect, David Mizrahi, was tortured by being suspended and swung from hooks in the ceiling in the presence of the European consuls.[34] Nevertheless, neither Jacob Israel nor David Mizrahi confessed to the murder of the boy and they were released after a few days. The other six Jews remained in prison in early April of 1840.[35]

V. A DESPERATE PLEA

On March 27, 1840, Jewish community leaders of Rhodes soon forwarded a desperate request for help, along with letters from the Jewish community of Damascus and letters from the Jewish community of Istanbul.[36] These letters were all sent together to the Rothschild family in Austria, one of the most powerful Jewish families in Europe with enough political influence to change the tide of discrimination against these isolated Jewish communities. The head of the Rothschild family bank in Vienna at that time, Salomon Mayer von Rothschild, had a very close relationship with the Austrian Chancellor, Klemens von Metternich, since the Rothschild family had funded the financial growth of the Austrian empire and was an asset the empire could not afford to displease. On April 10, Metternich dispatched instructions regarding both the Damascus and Rhodes affairs to Bartolomäus von Stürmer, who was serving as the Austrian ambassador in Istanbul and had direct contact with Ottoman authorities. In his letter to Stürmer, Metternich wrote: "The accusation that Christians are deliberately murdered for some blood-thirsty Passover festival is by its nature absurd . . . ."[37] Soon a general agreement among all members of the European diplomatic corps in Istanbul emerged to intervene in the persecution of Jews in Damascus and Rhodes.[38]

---

32. *Id.* at 71-72.
33. *Id.*
34. *Id.*
35. FRANKEL, *supra* note 14, at 72.
36. *Id.* at 80.
37. *Id.* at 121.
38. *Id.* at 123-127, 160-161.

VI. INTERVENTION

In response to the previous request for order by the Rhodes governor-general Yusuf Pasha's request, the Ottoman Muslim government's orders arrived at the end of April, 1840. The Muslim authorities in Rhodes were ordered to establish an official commission in which both the Jewish community and the Greek communities could publicly present evidence of any foul play or murder at the court in Istanbul in front of non-biased officials. The remaining Jewish prisoners in Rhodes were released pending the outcome of the trial in Istanbul.[39] Anger over the possibility of intervention and acquittals in favor of Jewish citizens of Rhodes soon began to spill into violence in the streets. In the days leading up to the hearings in Istanbul, the Jews in Rhodes suffered assaults from both the Greek-Christian community and the sons of the British and Greek diplomats, angry over the events of the preceding months. When Jewish members of the community complained to governor-general Pasha, the complainants were subjected to public beatings along with an additional five new Jews being arrested. The qadi (judge) soon publicly and politically distanced himself from governor-general Pasha and stated that he investigated and tortured Jewish community members under pressure from European diplomats.[40]

VII. ACQUITTAL OF THE DEFENDANTS

On May 10, 1840, the representatives from both the Jewish and Greek communities appeared in Istanbul. They were further met by the French and Austrian-vice diplomats and the qadi of Rhodes.[41] On May 26, the first investigatory tribunal held its first open court session led by Rifaat Bey who was under a directive from the sultan. The qadi of Rhodes argued that the entire Rhodes affair was instigated by the English and Austrian diplomatic corps in Rhodes.[42] In rebuttal the diplomatic representatives of England and Austria maintained that any investigation on Rhodes was justified since the Jews were guilty according to the written testimony of the English and Austrian diplomats present in Rhodes at the time of the accusations. These European officials, while not completely aware of all the details of the case, were probably maintaining a line of political uniformity in not usurping or embarrassing their colleagues on the island of Rhodes. Finally, after months of testimony from all interested parties, on July 21, 1840 the final findings of the Istanbul commission were released. In its first part, a full acquittal was handed down to the Jewish defendants of Rhodes. The commission further decreed that Yusuf Pasha was to be dismissed from his post in Rhodes. This was because as governor-gen-

---

39. *Id.* at 156-157.
40. FRANKEL, *supra* note 14, at 156-158.
41. *Id.* at 156-157.
42. *Id.* at 161-162.

eral, "he had permitted procedures to be employed against the Jews which are not authorized in any way by the law."[43] In terms of the Jews accused in Damascus of a blood libel, the decree in the Rhodes case helped to spur negotiations in Alexandria from August 4 to August 28, 1840, which ultimately secured the unconditional release and recognition of innocence of the nine prisoners still remaining alive through the efforts of European diplomats and Ottoman officials working together.[44]

VIII. THE SULTAN'S DECREE

The embarrassment of the Rhodes affair, along with the accusations in Damascus, prompted the Sultan to further modernize the cultural understanding throughout his land. Sultan Mahmud II, since 1839, was a modern leader in terms of moving the Ottoman Empire on a more progressive stance in numerous areas. He started the modernization of the empire by preparing the Edict of Tanzimat in 1839, which had immediate effects such as European style clothing, architecture, legislation, institutional organization, legal modernization and land reform.[45] Ushering in what was known as the "Tanzimat" period of reform, it was not a surprise that in 1840 he issued a royal decree (*firman*) denouncing the general belief in Jewish blood libels as false. Citing the ridiculous nature of the Rhodes affair, the royal decree stated that a careful examination of Jewish beliefs and "religious books" had demonstrated that "the charges brought against them . . . are pure calumny. The Jewish nation shall possess the same privileges as are granted to the numerous other nations who submit to our authority. The Jewish nation shall be protected and defended."[46]

IX. AFTERMATH

Despite the progressive stance of the Ottoman Sultan, the belief in the blood libel continued. The results of both the Rhodes and Damascus affairs also led to assaults on Jewish community members and organized pogroms in Jewish villages throughout Russia, the Middle East, North Africa and Europe.[47] Furthermore, blood libel cases continued in Austria, the Middle East, and in Russia against Jewish defendants.[48] In the 21st century, the belief in the blood libel still is permeated throughout the Middle East. Jewish blood libel stories have appeared a number of times in the state-sponsored media of Arab and Muslim

---

43. *Id.* at 161-163.

44. *Id.* at 163-164.

45. FRANKEL, *supra* note 14, at 163-167; *see also Abdul Mejid I*, 1 ENCYCLOPEDIA JUDAICA 244 (Fred Skolnik & Michael Berenbaum eds., 2d ed., Keter Publishing House 2007).

46. FRANKEL, *supra* note 14, at 377.

47. *Pogroms*, 16 ENCYCLOPEDIA JUDAICA 279-282 (Fred Skolnik & Michael Berenbaum eds., 2d ed., Keter Publishing House 2007); *see also* Klein, *supra* note 29, at 180-185.

48. Klein, *supra* note 29, at 180-185.

nations, especially during the television shows and movies shown at night during Ramadan to the local communities.[49] Books in the Middle East also support the validity of the Jewish blood libel concept even today. *The Matzah of Zion*, written by the Syrian Defense Minister Mustafa Tlass in 1986, states that Jews need blood for matzah. The book is in its eighth reprint.[50] The book was cited at a United Nations conference for good reason. Since discussions about the book continue to show on television in the Middle East, or prompt the creation of new television programming involving Jews killing Christians, there exists a possible inspiration for young people to move towards terrorism.[51] In a recent twist on the libel of Jews using blood in matzah, a Saudi newspaper in 2002 claimed that Jews use blood in homentashn, triangular cookies eaten on the Jewish holiday of Purim.[52] Also, some select Middle Eastern nations show television programming in which notable Jews drink the blood of Muslim children in a drink known as "Dra Cola".[53] However, modern and more progressive Arab political leaders and scholars have tried to dispel the Jewish blood libel belief since it certainly can demonize the image of Jews. As young people start to think of Jews as an evil force to be eradicated, it moves them closer towards violence which officials wish to avoid. Some Arab writers have condemned Jewish blood libels outright. Osam Al-Baz, a senior advisor in the Egyptian government, has tried to publicly explain the origins of the anti-Jewish blood libel. He said that Arabs and Muslims have never been anti-Semitic, as a group, but accepted that a few Arab writers and media figures attack Jews "on the basis of the racist fallacies and myths that originated in Europe".[54]

X. CONCLUSION

While the belief in a Jewish blood libel would be considered a ridiculous notion by us today, it is still important to understand its role as a part of the darker aspects of world legal history. As jurists we must be aware that there is always a possibility that a court can be used not for the pursuit of truth and justice, but as a tool for those who have a profound hatred of another group of people.

---

49. OBSESSION, *supra* note 1.

50. U.N. Econ. & Soc. Council [ECOSOC], Comm'n on Human Rights, *Racism, Racial Discrimination, Xenophobia, and all Forms of Discrimination, Question of Violation of Human Rights and Fundamental Freedoms in any Part of the World, Promotion and Protection of Human Rights*, ¶ 6, U.N. Doc. E/CN.4/2004/NGO/5 (Feb. 10, 2004) (*prepared by* Association for World Education).

51. *Id.*

52. Al-Jalahma, *supra* note 6.

53. OBSESSION, *supra* note 1.

54. Osama El-Baz, *Contaminated Goods*, AL-AHRAM WEEKLY ONLINE, January 2, 2003, *available at* http://weekly.ahram.org.eg/2003/619/focus.htm.

Filling the Hedge Fund Regulatory Black Hole: What's Next After *Goldstein v. SEC?*

MICHAEL R. GAICO*

CONTENTS

ABSTRACT

Hedge funds' high risk-tolerance profiles allow them to trade in a broad spectrum of innovative financial instruments and thereby play a critical role in today's financial markets. In recent years, the significant capital that has flowed into hedge funds, as well as several notable failures, has caught the attention of regulators. Given the style of hedge fund risk taking, many believe that new regulation is predictably not a matter of *if*—it's a matter of *when*. In light of the implementation of stronger risk management practices in the adolescent and still-evolving hedge fund industry, this Note proposes that the best method for regulating hedge funds is indirectly through increased oversight of their registered counterparties and creditors. The purpose of this Note is not to oppose any and all further regulation. Rather, it considers what regulatory approaches preserve hedge funds' beneficial effects on financial markets while putting in place policies designed to limit the effects of occasional dramatic losses.

---

* Michael R. Gaico, J.D., 2008, Syracuse University College of Law; B.A., Philosophy, 2004, Washington and Lee University. I would like to thank Professor Christian Day for his feedback and encouragement as well as the editorial staff of *The Digest* for their assistance.

INTRODUCTION

In the 1980s, corporate raiders, as represented by Gordon Gekko, were the models for those seeking to be a master of the universe.[1] In the 1990s, the Internet entrepreneur exemplified how anyone can make millions using only a computer and his or her savvy.[2] Today, hedge funds have become the cultural shorthand for fast money due to their ability to offer investors spectacular returns using secretive trading strategies.[3] However, despite recent popular acclaim, the very private hedge fund industry has been misunderstood by many, including regulators.

Moving into hedge funds has been part of a continuing deliberate diversification into "alternative assets," or investments whose returns do not bear a direct correlation to fluctuations of the stock and bond markets.[4] As part of this trend, the 1990s saw a substantial increase in the number of funds: the industry grew from 610 funds with $39 billion assets under management in 1990 to 3,873 funds with $490 billion under management in 2000.[5] The latest estimate is that there are over 9,000 hedge funds with over $1.5 trillion at their disposal.[6] Further, thanks to complex trading strategies, hedge funds are increasingly punching above their considerable financial weight, accounting for significant trading volumes on the world's largest exchanges.[7] The hedge fund industry will apparently continue to expand as long as investors believe in the ability of fund managers to offer favorable risk-return trade-offs.

However, the success of hedge funds has been interspersed with dramatic failures. For instance, in 1998, due to a world-wide drop in stock and bond prices, well-known Long-Term Capital Management ("LTCM") lost 44 percent of investors' capital in one month, risking that the fund would default on its credit obligations. Given that of its $125 billion balance sheet, $120 billion was borrowed, LTCM's potential default threatened to breakdown financial markets, and the Federal Reserve was forced to intervene and coordinate a bailout of the

---

1. Michael J. de la Merced, *Culturally, Hedge Funds Go Public*, N.Y. TIMES, Dec. 8, 2006, at C1.

2. *Id.*

3. *See id.* (noting the growing representation of hedge funds in popular culture, including references in soap operas, primetime dramas, reality shows, and "Casino Royale," the latest James Bond film, as well as the publication of a "Hedge Funds for Dummies" book).

4. *Rolling In It*, THE ECONOMIST, Nov. 18, 2006, at 75 (noting that the class of alternative assets includes, in addition to hedge funds, private equity, commodities, and real estate, which are all typically regarded as sources of investment returns that do not necessarily move in step with stock and bond markets).

5. *Id.*

6. *No Big Hedge Fund Risk to Markets Seen*, CNNMONEY, Feb. 23, 2007, *available at* http://money.cnn.com/2007/02/23/markets/hedge_funds.reut/index.htm.

7. *Capitals of Capital*, THE ECONOMIST, Sept. 2, 2006, at 61 (noting that some financial experts estimate that hedge funds account for nearly half the trading volume on the world's largest exchanges).

fund.[8] More recently, in September 2006, Amaranth Advisors lost $6 billion (65 percent of its value) in less than a month as a result of risky bets on natural gas.[9] The list of other notable hedge fund scandals and failures includes Bayou,[10] Pirate,[11] and Refco.[12]

Largely in response to the LTCM episode, the Securities & Exchange Commission passed in December 2004, by a 3-2 decision, its Hedge Fund Rule, which imposed on hedge fund managers the Commission's default regulatory regime of mandatory disclosure.[13] In July 2006, the United States Court of Appeals for the District of Columbia in *Goldstein v. SEC* vacated the rule, holding that it was "arbitrary."[14] Thus, the *Goldstein* decision rendered the rule to be a knee-jerk reaction to political pressure on the SEC to "do something" in the aftermath of Enron, WorldCom, and the mutual fund scandals.[15]

Given the amount of money that has flowed into hedge funds, the style of risk taking, and the size of potential losses, many believe that new hedge fund regulation is predictably not a matter of *if*—it's a matter of *when*.[16] Indeed, in

---

8. *Blank Cheques and Balances*, THE ECONOMIST, Sept. 30, 2006, at 87. It is significant to note that the Federal Reserve did not actually invest government funds in the LTCM bailout, but merely organized meetings of LTCM's counterparties, who ultimately undertook the bailout themselves. *See generally* Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, Chapters 7-10 (2000).

9. *Flare-up*, THE ECONOMIST, Sept. 23, 2006, at 83.

10. The founders of Bayou Management LLC essentially used money from new investors to pay old investors. Ianthe Jeanne Dugan, *Failed Hedge-Fund Firm Bayou Sues Investors to Return Money*, WALL ST. J., Sept. 13, 2006, at C7. When the plan collapsed, some $250 million was unpaid. *Id.* The founders subsequently plead guilty to fraud. *Id.*

11. The Securities & Exchange Commission is investigating whether Pirate Capital LLC, one of the nation's leading activist hedge funds, violated securities laws by failing to properly disclose 5 percent or more ownership of a public company. Susan Pulliam, *Pirate Capital Draws SEC Focus*, WALL ST. J, Sept. 26, 2006, at C1.

12. Refco Capital Markets ("RCM"), a prime broker that processed trades for hedge funds, halted activities and froze its accounts after fraud charges were leveled against the firm's former chief executive. Randall Smith, *Refco, Wall Street's New Implosion*, WALL ST. J., Oct. 15, 2005, at B3. RCM's parent company Refco, Inc. was the largest independent commodities broker—it took 36 years to build, but less than five days to begin unraveling. *Id.*

13. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,065 (Dec. 10, 2004) (to be codified at 17 C.F.R. pt. 275 & 279) (describing the provision under which most large hedge fund managers would have had to register under the Investment Advisers Act of 1940 and arguing that their registration meets the intent of Congress to protect all types of investors who have entrusted their assets to a professional investment adviser).

14. Goldstein v. Securities and Exchange Commission, 451 F.3d 873, 884 (D.C. Cir. 2006).

15. *See* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1011 (noting a widespread demand for stiffer securities regulation from politicians as well as the public, which led to a significant increase in the number of enforcement actions and new regulations from the SEC).

16. Jeremy Grant, *Filling the Hedge Fund Regulatory Black Hole*, FINANCIAL TIMES, Nov. 10, 2006 (quoting Tim Mungovan, a partner at Nixon Peabody LLP, remarking that hedge fund regulation in some form is inevitable: "It's not a matter of if, it's a matter of when or how much;" also quoting David Goldstein, a partner at White & Case LLP, stating that the United States is "one [hedge fund] scandal or trading fiasco" away from reinstating the SEC registration rule).

the wake of the *Goldstein* decision, Connecticut Attorney General Richard Blumenthal remarked that hedge funds are in a "regulatory black hole."[17]

While all regulators agree that they need more information on hedge funds, they disagree on what should be the proper regulatory response. In a recent *Wall Street Journal* survey of 41 economists, 23 said that regulation and supervision is too light; 16 said it was "just right"; and two said it was "too tough."[18] In addition, about 60 percent said that hedge funds pose a risk to financial markets.[19] However, the regulatory problem actually posed by hedge funds needs further clarification before an adequate solution may be tailored.

This Note proposes that the best method for regulating hedge funds is indirectly through increased oversight of their SEC-registered creditors and counterparties.[20] It will consider this proposal in terms of the evolution of the hedge fund industry since the LTCM episode. More specifically, it will discuss the development of more effective risk management practices as this adolescent industry continues to mature. Additionally, it will re-evaluate the systemic risk posed to financial markets by hedge fund trading strategies in light of these developments.

In Part I, this Note will provide a brief overview of the hedge fund business model and discuss the particular financial metrics that, as mentioned in the *Goldstein* decision, determine a fund's importance to national markets. In Part II, this Note will analyze the legal and policy grounds of the *Goldstein* decision; discuss how this decision has re-shaped the regulatory debate; and consider current legislative proposals for new hedge fund regulation. This Note will portray mandatory registration as an inappropriate regulatory policy given the nature of the hedge fund business model. In Part III, this Note will suggest that increased market surveillance by the SEC of hedge fund counterparties, combined with regulatory incentives to adopt more effective risk management policies forms the most appropriate policy given hedge funds' actual market impact.

This purpose of this Note is not to oppose any and all further regulation. Rather, it considers what regulatory approaches preserve hedge funds' beneficial effect on financial markets, while putting in place policies designed to limit dramatic losses occasionally caused by hedge fund trading strategies.

---

17. *Id.*

18. Phil Izzo, *Economists See Hedge-Fund Risks*, WALL ST. J., Oct. 13, 2006, at C3.

19. *Id.*

20. *See* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 682 (2000) (favoring limited public regulation and suggesting that the exercise of more diligent market discipline by both hedge funds and those entities that extend credit to hedge funds is needed to protect against systematic loss).

I. HEDGE FUND INDUSTRY OVERVIEW

A brief discussion of the hedge fund industry is necessary before considering what constitutes an appropriate regulatory policy. Section A will discuss the legal structure of hedge funds, and will identify the particular federal securities law provisions which from the regulatory regime that applied before the SEC Hedge Fund Rule and currently applies in the wake of its invalidation by the *Goldstein* decision. It will illustrate that hedge funds, even those which are not registered with the SEC, are by no means unregulated given that they must conduct their businesses within narrow parameters in order to qualify for exemptions from federal securities laws.[21]

Section B will survey hedge fund trading strategies, focusing on the particular financial metrics that, as mentioned in the *Goldstein* decision, determine a fund's importance to national markets. In the process, this section will identify the benefits that hedge funds confer on the markets.

A discussion of the legal structure and the trading strategies of hedge funds will illuminate why the SEC registration rule and current legislative proposals urging its reinstatement are improper responses to the regulatory problem actually posed by hedge funds, the subject matter of Part II of this Note.

A. LEGAL STRUCTURE

While lacking a precise statutory definition, "hedge fund" customarily refers to any pooled investment vehicle that is privately organized; administered by professional managers; and not widely available to the public.[22] Hedge funds typically are organized as limited partnerships in which investors are limited partners and the managers are general partners.[23] All investments are made in

---

21. The Managed Funds Association, *Hedge Funds: Overview and Regulatory Landscape*, *in* HEDGE FUNDS: DEFINITIVE STRATEGIES AND TECHNIQUES 9 (Kenneth S. Phillips & Ronald J. Surz eds., 2005) [hereinafter *Hedge Fund Overview*] (stating that critics of hedge funds should understand that unregulated hedge funds do not exist; while hedge fund managers receive great latitude in conducting their business as a result of registration exemptions, all hedge funds have legal restrictions and limitations).

22. President's Working Group on Fin. Mkts., *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* 1 (1999) [hereinafter President's Working Group I]. The President's Working Group comprises the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve, the Chairman of the Securities and Exchange Commission, and the Chairman of the Commodity Futures Trading Commission. The group issued this report in the aftermath of the events in global financial markets in summer and fall of 1998 that precipitated the near-collapse of Long-Term Capital Management. According to this report, the LTCM episode highlighted the possibility that the excessive leverage of one financial institution can greatly magnify the negative effects of any event or series of events on the financial system as a whole. *Id.* at viii. The overarching goal of this report was to consider whether additional regulations that constrain a hedge fund's use of leverage are needed to guard against a breakdown of the financial markets. *Id.*

23. William Fung & David A. Hsieh, *A Primer on Hedge Funds*, 6 J. EMPIRICAL FIN. 309, 310 (1999) [hereinafter *Primer*]. As general partners, the fund managers usually invest a significant portion of their personal wealth into the fund partnership to ensure the alignment of economic interests among all of the partners, general and limited. *Id.*; *see, e.g.*, Dennis K. Berman, *Pirate Will Close to New*

the interest of the partnership as a whole.[24] Investors who purchase limited partnership interests in hedge funds are typically high-net worth individuals and, increasingly, institutional investors who purchase such interests with the expectation of receiving a percentage of the fund's profits.[25] These investors are by definition already wealthy and/or experienced.[26] Thus, hedge funds are the product of investment agreements among sophisticated parties with aligned economic interests.

Any hedge fund is premised on the belief in a "winning strategy."[27] As such, the high premium on confidentiality of a fund's trading positions precludes organizational forms that must meet a high level of transparency and favors private vehicles that have lower transparency and disclosure requirements.[28] Thus, because they involve sophisticated parties and confidential investment strategies, hedge funds are purposely organized to be exempt from mandatory disclosure requirements under federal securities laws. The following paragraphs discuss the narrow parameters within which hedge funds must conduct their business in order to qualify for such exemptions.

1. *Securities Act of 1933*

Section 5 of the Securities Act of 1933 ("Securities Act") requires that securities be registered with the SEC before they are sold for the purpose of protecting the public.[29] In 1982, the SEC adopted Regulation D to provide a safe harbor from the registration requirements of the Securities Act.[30] Under Regu-

---

Investors as Fund's Investment Staff Shrinks, WALL ST. J., Sept. 29, 2006, at C3 (quoting the manager of Pirate Capital LLC as saying that he and his family have more than 90 percent of their net worth invested in the fund). As such, potential hedge fund investors may consider the extent of management's personal stake as well as its general reputation when deciding whether to invest in a particular fund.

Another benefit of limited partnership organization is the avoidance of double taxation—*i.e.*, the imposition of two taxes on a fund's profits: once at fund level when profits are earned and again at the shareholder level when profits are distributed; double taxation would become an issue if a fund were formed as a limited liability corporation. *Primer*, *supra*, at 318.

24. *See Primer*, *supra* note 23, at 310.

25. Gibson, *supra* note 20, at 683-84. Historically, those who invested in hedge funds were high-net worth individuals. This has changed over the past five years as the majority of assets in hedge funds now belong to institutional investors. Department of Treasury, *Remarks of the Treasury Department's Assistant Secretary for Financial Markets Anthony Ryan*, Mar. 6, 2007, http://www.treas.gov/press/releases/hp296.htm [hereinafter *Ryan Remarks*].

26. *See* 15 U.S.C. § 80a-2(a)51(A) (2008).

27. *Primer*, *supra* note 23, at 317.

28. *Id.*

29. 15 U.S.C. 77e(c) (2008).

30. *Hedge Fund Overview*, *supra* note 21, at 4. Regulation D relies on the safeharbor created by of Section 4(2) of the Securities Act, but simplifies that section's confusing requirements. *Id. See also* Gibson, *supra* note 20, at 689 (noting that Congress enacted Section 4(2) to allow issuers to avoid cumbersome registration requirements when the likelihood that the public would benefit from the registration was remote).

lation D, a hedge fund may be exempt from Section 5 registration requirements by (1) not using any general solicitation, such as newspaper articles, advertisements, seminars, or circulars and (2) not offering or selling securities to more than 35 non-accredited investors.[31] Rule 506 of Regulation D places no limit to the dollar amount of securities that the issuer can offer, nor does it limit the number of accredited investors to whom the issuer can sell securities.[32] Thus, a hedge fund may meet the non-public offering exemption to Section 5 of the Securities Act by limiting their offerings to investors that clearly qualify as accredited investors.[33]

2. *Securities Exchange Act of 1934*

An entity which is "engaged in the business of effecting transactions in securities for the accounts of others" qualifies as a broker-dealer, which must register with the SEC under Section 3(a)(4)(A) of the Securities Exchange Act of 1934 ("Exchange Act").[34] Under Section 3(a)(5)(C) of the Exchange Act, hedge funds are able to avoid the act's rules and regulations by utilizing the "trader" exception to the definition of "dealer."[35] This exception applies to a hedge fund if it (1) is an entity trading securities solely for the fund's own account, rather than as part of a securities business comprised of separate individual client accounts, and (2) does not hold itself out to the public as a broker-dealer.[36]

3. *Investment Advisers Act of 1940*

The Investment Advisers Act of 1940 ("IAA") is an anti-fraud act aimed at protecting the public from abusive practices by people or entities that earn

---

31. *Hedge Fund Overview*, *supra* note 21, at 4.

32. Gibson, *supra* note 20, at 690 ("While Rule 506 of Regulation D does not limit the number of accredited investors, the number of offerees is an important factor in determining whether an offering is non-public.").

33. Regulation D defines eight categories of accredited investors, which generally include banks, insurance companies, directors and executive officers of the fund, and natural persons who have significant annual incomes. 17 C.F.R. § 230.501 (2008). *See* Jacob Preiserowicz, Note, *The New Regulatory Regime for Hedge Funds: Has the SEC Gone Down the Wrong Path?*, 11 FORDHAM J. CORP. & FIN. L. 807, 815 (2006) (noting that the impracticality for hedge funds of accepting unaccredited investors because doing so would require preparing additional prospectus-like material tailored for such investors); *Ryan Remarks*, *supra* note 25 (noting that the majority of hedge fund assets belong to institutional investors, who are "accredited"); Amy Friedman, *Hedge Funds: Still Risky Business*, BUSINESS WEEK, Oct. 17, 2006 ("what was once a market dominated by high-net-worth investors is now dominated by institutional investors"). *See also* Gibson, *supra* note 20, at 690 (discussing how hedge funds can structure their offerings to be exempt from registration under the Securities Act).

34. 15 U.S.C. § 78c(a)(4) (2008). Entities which receive transaction-related compensation and/or hold themselves out as brokers, or assists others in completing securities transactions, must register as broker-dealers under the Exchange Act and follow all of its rules. *Hedge Fund Overview*, *supra* note 21, at 4.

35. *Hedge Fund Overview*, *supra* note 21, at 4.

36. *Id. See also* President's Working Group I, *supra* note 22, at B-4 (discussing the "trader" exception to the definition of dealer).

money by advising others about investing in securities.[37] Registered investment advisers[38] must follow myriad regulations, such as extensive recording keeping requirements and restrictions on performance-based fees.[39]

While hedge fund managers fall within the definition of investment adviser, they may avoid registration under the Private Advisor Exemption of Section 203(b)(3).[40] To qualify for this exemption, a hedge fund manager: (1) must have had fewer than fifteen clients in the preceding 12 months; (2) cannot hold itself out to the public as an investment advisor; and (3) cannot act as an investment advisor to a registered investment company or business development company.[41] The Advisers Act explicitly states that a limited partnership itself is *one* client, rather than counting each limited partner as an individual client.[42] A hedge fund manager qualifies for this exemption as long as she limits her advice to the investment objectives of the limited partnership as a whole, rather than providing individualized advice to any one particular limited partner.[43] The Private Adviser Exemption—more specifically, the proper interpretation of "client" under the IAA—was at issue in *Goldstein*, as will be discussed in Part II.

4. *Investment Company Act of 1940*

Investment companies have to register with the SEC under the Investment Company Act of 1940 ("ICA"), a comprehensive regulatory scheme implemented to protect investors from abusive practices.[44] Domestic hedge funds investing in securities are considered investment companies because their businesses consist of investing on behalf of their shareholders.[45] However, hedge funds can qualify for one of two exemptions to the definition of an investment company found in Sections 3(c)(1) and 3(c)(7) of the Act.

By Section 3(c)(1), a hedge fund is not an investment company for purposes of the Act if it has less than 100 beneficial owners and does not publicly offer

---

37. *See* SEC v. Capital Gain Research Bureau, Inc., 375 U.S. 180, 190 (1963).

38. The IAA defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications and writings, as to the value of securities or the advisability of investing, purchasing, or selling securities." 15 U.S.C. § 80b-2(a)(11) (2008).

39. *Hedge Fund Overview*, *supra* note 21, at 3. Performance-based fees are the percentage of profits that a hedge fund's manager will charge on gains above a specified benchmark or watermark over a one-year period. President's Working Group I, *supra* note 22, at A-1. Performance fees for registered investment advisers must satisfy the "fulcrum rule"—that is, over- and under-performance relative to a benchmark must result in the same amount of positive and negative incentive fees. *Primer*, *supra* note 23, at 316. As such, registered advisers must rebate fees to investors for losses. *Id.*

40. *Hedge Fund Overview*, *supra* note 21, at 4.

41. 15 U.S.C. § 80b-3(b)(3) (2008).

42. 17 C.F.R. § 275.203(b)(3)-1(b)(3) (2008).

43. 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i) (2008).

44. 15 U.S.C. § 80a-7 (2008) (requiring investment companies to register with SEC and allow it to monitor their actions); *see also* SEC v. Advance Growth Capital Corp., 470 F.2d 40, 42 (7th Cir. 1972).

45. Gibson, *supra* note 20, at 694.

its securities.[46] By Section 3(c)(7), a fund that limits its sales only to "qualified purchasers" and does not publicly offer its securities is also excluded from being considered an investment company. Qualified purchasers include: (a) an individual with at least $5 million in investments; (b) specified family-owned companies with at least $5 million in investments; (c) trusts established and funded by qualified purchasers; and (d) any person acting for his or her account or the account of other qualified investors who own and invest more than $25 million.[47] Thus, in order to be exempt from registration under the ICA, a hedge fund must have fewer than 100 limited partner investors and limit its sales of such interests to "qualified investors."

A consideration of the Securities Act, Exchange Act, Investment Advisers Act, and Investment Company Act supports the conclusion that hedge funds, even while unregistered with the SEC, are not unregulated. Indeed, qualifying for exemptions from each act requires that funds conduct their businesses within narrow parameters.

In addition, unregistered hedge fund managers are subject to extensive antifraud provisions of the Securities Act,[48] the Exchange Act,[49] and the Advisers Act,[50] which apply to any offer, sale, or purchase of securities, or any advisory service of such offer, sale, or purchase.[51] Further, hedge funds must establish an anti-money laundering compliance program, as required by Title III of the

---

46. 15 U.S.C. § 80a-3(c)(1) (2008). After the National Securities Market Improvement Act of 1996, a company can own more than 10 percent of a hedge fund's securities and still be considered one beneficial owner of the fund. *Hedge Fund Overview*, *supra* note 21, at 3. Previously, if a company owned more than 10 percent of a hedge fund, the Investment Company Act would have "looked through" that company to all its respective investors so that each investor in the company would be considered an individual owner of the fund for purposes of Section 3(c)(1). *Id.*

47. 15 U.S.C. § 80a-2(a)(51)(A)(i-iv) (2008).

48. While hedge funds may be exempt from registering their shares under the Securities Act because they have engaged in a private offering, they still remain subject to the antifraud provisions of the Securities Act. Gibson, *supra* note 20, at 714 n.208. *See* 15 U.S.C. § 77q (2008).

49. The antifraud provisions of the Securities Exchange Act apply to the sale of a private fund's securities, whether or not the private fund is registered under the Investment Company Act. President's Working Group I, *supra* note 22, at B-13, B-14. *See also* SEC Rule 10b-5.

50. *See* 15 U.S.C. 80b-6 (2008). Hedge fund managers usually fall within the definition of an investment adviser under the Investment Advisers Act, thus subjecting them to antifraud provisions found within the Act, even though they may qualify for an exemption from registration as an investment adviser. Gibson, *supra* note 20, at 714 n. 208.

51. *Hedge Fund Overview*, *supra* note 21, at 6. It is significant to note that of forty-six actions of hedge fund fraud brought between 1998 and 2003, mandatory registration pursuant to the SEC Hedge Fund Rule would almost certainly not have prevented thirty-six violations and would doubtfully have prevented the remaining eight (the final two cases involved registered broker-dealers or investment advisers, in which case the SEC already had full oversight). Justin A. Dillmore, Comment, *Leap Before You Look: The SEC's Approach to Hedge Fund Regulation*, 32 OHIO N. U. L. REV. 169, 183 (2006). Further, twenty three of these cases involved small funds with assets under $25 million or funds which were deliberately established to deceive investors, suggesting that hedge fund fraud comes in the form of garden-variety swindling rather than widespread defrauding of the investing public. *See id.*

USA PATRIOT Act.[52] Finally, the Exchange Act, Investment Company Act, and Investment Advisers Act prohibit advertising to the general public.[53]

B. TRADING STRATEGIES

In discussing the significant market presence of hedge funds, the *Goldstein* court stated that "it is the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics that determines a fund's importance to national markets."[54] This section will identify the specific financial metrics to which the court is alluding, and highlight that hedge funds, apart from some fundamental similarities, pursue varying investment objectives in numerous different ways. Thus, taking note of hedge fund investment strategies is necessary to understanding the difficulty of crafting a one-size-fits-all regulatory solution.[55] In addition, this part will also identify the benefits that hedge funds confer on the markets.

1. *Financial Metrics*

As alternative investments, hedge funds typically set "absolute return" investment targets—*i.e.*, targets calculated independent of any index or the markets in general.[56] In other words, absolute-return hedge fund managers intend to deliver positive returns in all market conditions.[57] As such, what drives hedge performance is not *where they trade* but *how they trade*,[58] and the premium is on developing a successful trading strategy not utilized or known by others.

Hedge funds also characteristically employ dynamic trading strategies, in contrast to the static buy-and-hold strategies of mutual funds.[59] More specifi-

---

52. *See Hedge Fund Overview*, *supra* note 21, at 6 (noting that the PATRIOT Act requires such a program to include internal policies, procedures and controls, a compliance officer, an ongoing employee training program, and an independent audit function; this act's requirements in and of themselves promote a business culture of compliance and well-defined internal controls).

53. *See supra* notes 31, 36, and 41 and accompanying text.

54. *Goldstein*, 451 F.3d at 883.

55. *See* Paredes, *supra* note 15, at 980 (noting that "[m]any people start out skeptical of hedge funds because they do not understand hedge funds' investment strategies, including the complex models that underlie them"); Laura Edwards, Note, *Looking Through the Hedges: How the SEC Justified Its Decision to Require Registration of Hedge Fund Advisers*, 83 WASH. U. L.Q. 603, 608 (2005) ("Hedge funds may be the most misunderstood investment vehicle: at one extreme, hedge funds are considered highly risky investments available only to the very rich, while at the other extreme, some investment advisers claim that hedge funds perfectly complement a traditional investment portfolio.").

56. *Primer*, *supra* note 23, at 321. In contrast to an "absolute return," an investor can set a "relative return" target—that is, a target relative to a particular index, such as the S&P 500, which becomes the benchmark for judging investment performance. *Id.*

57. *Id.*

58. *Id.*

59. *See Goldstein*, 451 F.3d at 875 (noting that exemption from regulation under the Investment Company Act allows hedge funds, unlike regulated mutual funds, to sell short and assume significant debt.) (*citing* 15 U.S.C. 80a-12(a)(1), (3)) (2008).

cally, hedge funds' ability to bet on falling prices ("going short") distinguishes them from "long-only" mutual funds which profit only if share prices increase.[60] In further contrast to mutual funds, hedge funds typically engage in active trading, a practice in which positions are changed with high frequency.[61] Despite the fundamental similarities among hedge funds as alternative investment vehicles that employ dynamic trading strategies, particular trading strategies and risk profiles vary extensively from fund to fund. To illustrate this variety, widely used strategies include: event driven,[62] global,[63] global/macro,[64] market neutral,[65] income,[66] value,[67] and arbitrage[68]—and each strategy defines its investment goals differently.

Hedge funds' main distinguishing characteristic, as the *Goldstein* court noted, is their ability to assume debt, or leverage. Simply put, leverage is the use of borrowed funds to improve a fund's speculative ability and to increase an investment's rate of return.[69] Leverage magnifies a fund's positions, potentially compounding profits as well as losses.[70] Hedge funds obtain leverage in several ways, including short sales,[71] repurchase agreements,[72] and derivative con-

---

60. Paul Stonham, *Too Close to the Hedge: The Case of Long Term Capital Management LP (Part One: Hedge Fund Analytics)*, EURO. MANAGEMENT J., Vol. 17, No. 3, 282, 285 (1999) [hereinafter Stonham I]. Hedge fund strategies typically consist of simultaneously taking both long and short positions in the same stock, thereby "hedging" an investment portfolio, as derived from the expression "hedging your bets." *Id.*

61. President's Working Group I, *supra* note 22, at 5. While hedge funds may lock-in investment capital for long periods of time, they unwind positions in short periods in order to maintain a desired risk-return profile as market prices fluctuate or to attempt to profit from temporary fluctuations in market prices. *Id.*

62. Event-driven funds that take positions on corporate events, such as corporate bankruptcies, reorganizations, and mergers. *Primer*, *supra* note 23, at 319.

63. "Global" is a catch-all category of funds that invest in non-US stocks and bonds, including emerging markets. *Id.*

64. "Global/macro" commonly refers to funds that rely on macroeconomic analysis and speculate on major risk factors, such as currencies, interest rates, stock indices, and commodities. *Id.*

65. "Market neutral" refers to funds that actively avoid major risk factors. Instead, they wager on relative price movements. *Id.* Accordingly, their relative benchmark index is typically treasury bills. Stonham I, *supra* note 60, at 288.

66. "Income" refers to funds that invest with primary focus on yield or current income as opposed to capital gains. Stonham I, *supra* note 60, at 288.

67. "Value" refers to funds that invest in securities perceived to be trading at deep discounts to their intrinsic or potential worth. *Id.*

68. "Arbitrage" involves simultaneously buying and selling identical securities in different markets. BLACK'S LAW DICTIONARY 112 (8th ed. 2004) ("arbitrage"). Arbitrage hedge funds "buy assets whose price has been driven down relative to the price of other related assets while selling the relatively overvalued asset." President's Working Group I, *supra* note 22, at app. A-5.

69. BLACK'S LAW DICTIONARY 926 (8th ed. 2004) ("leverage").

70. President's Working Group I, *supra* note 22, at 4.

71. In a short sale, the seller borrows a security in order to deliver it to the buyer. BLACK'S LAW DICTIONARY 1366 (8th ed. 2004) ("short sale"). Hence, the seller sells a security at today's higher price and will buy it at tomorrow's (anticipated) lower price, retaining the difference as profit. Hedge funds leverage their capital by selling short borrowed securities and using the proceeds to buy a long position. Paul Stonham, *Too Close to the Hedge: The Case of Long Term Capital Management LP (Part Two:*

tracts,[73] as well as direct financing.[74] Of note, hedge funds are "limited in their use of leverage only by the willingness of their creditors and counterparties to provide such leverage."[75]

Hedge funds' use of leverage, combined with illiquid positions whose full value cannot be realized in a quick sale, can potentially make them vulnerable to liquidity risks.[76] For example, a fund's loss of value on trading positions which are greatly amplified through leverage may put pressure on its capital to finance the losses.[77] Thus, in a volatile market, if a hedge fund assumes a high level of leverage, it is more likely to fail because the size of its potential short-term losses can seriously deplete (or wipe out) its net worth, preventing the fund from subsequently making up those losses over the longer term.[78]

Thus, when highly leveraged hedge funds are overwhelmed by market shocks, the outcome may be direct losses inflicted on leverage-facilitating counterparties of those funds.[79] In addition, there may be an indirect impact of potentially more widespread effect. The disappearance of hedge funds may af-

---

Near Collapse and Rescue), EURO. MANAGEMENT J., Vol. 17, No. 4, 382, 385 (1999) [hereinafter Stonham II]. Hedge funds may use the long position as collateral for borrowing the securities being sold short. *Id.* As such, the transaction is self-financing. *Id.*

72. A repurchase ("repo") agreement is a sale of a security, typically a highly liquid instrument such as a U.S. government security, combined with a simultaneous agreement to buy back the same security on a specified future date and commonly at a fixed price above the original sale price. President's Working Group I, *supra* note 22, at 6 n.10. From the perspective of the buyer, such a transaction constitutes a *reverse* repo agreement—*i.e.*, a purchase of a security combined with an agreement to sell it back. *Id.* Accordingly, interest flows from the provider of securities to the provider of funds. *Id.*

73. A derivative is an offshoot financial instrument whose value is a product of the performance of a primary source such as an underlying bond, currency, or commodity. BLACK'S LAW DICTIONARY 475 (8th ed. 2004) ("derivative"). Derivative transactions, such as interest rate swap agreements, create leverage because they require the hedge fund to make payments to its trading counterparty in exchange for receiving payments. Gibson, *supra* note 20, at 687 n.42. Such transactions include a net payment arrangement requiring the trading counterparty that experiences the downside of a future bet to make payments to the other trading counterparty (offset by amounts owed to it). *Id.*

74. Direct financing is obtained through commercial loans from various lending institutions. President's Working Group I, *supra* note 22, at app. D-1.

75. President's Working Group I, *supra* note 22, at 5. Hedge fund counterparties primarily exposed to credit risk are: prime brokers (broker-dealers who clear and settle hedge fund trades); counterparties to derivative contracts and repurchase agreements; and lending institutions that provide direct financing. *Id.* at 5-7. These counterparties manage their credit exposure to hedge funds through a variety of risk management processes and safeguards, including collateral practices, credit limits, and monitoring. *Id.* at 7. Although these practices are effective in managing the credit risk commonly posed by other counterparties, the distinctive trading practices of hedge funds alter the relative importance of traditional control elements. *Id.* at app. D-1.

76. President's Working Group I, *supra* note 22, at 5

77. Stonham II, *supra* note 71, at 384. While the proprietary trading groups of banks and securities firms may take similar positions, these organizations, along with a network of parent firms, have both liquidity sources and independent streams of income from other activities available to offset the riskiness of such positions. President's Working Group I, *supra* note 22, at 5. Given their stand-alone structure, hedge funds lack such ability to offset risks. *Id.*

78. President's Working Group I, *supra* note 22, at 23.

79. *Id.*

fect numerous other market participants who rely on hedge funds to invest in volatile derivatives that parcel out the risks associated with these participants' activities.[80] Therefore, by increasing the chance that problems at one financial institution could be transmitted to numerous other institutions, highly leveraged hedge funds can increase the likelihood of a general breakdown of the financial markets.[81]

Thus, hedge funds are fundamentally similar as an asset class because they set absolute return investment targets and utilize dynamic trading, in contrast to mutual funds. However, hedge funds differ greatly in the particular investment goals they set and trading strategies they employ, especially the extent to which they rely on leverage in executing their strategies.[82] As such, even though hedge funds transact in standard markets, their returns are statistically different due to the unique variation on dynamic trading strategies each fund employs.[83] Thus, "hedge fund" merely denotes a legal structure rather than a particular investment strategy. As the *Goldstein* court indicated, a proper regulatory regime must account for differences among funds and their importance to national markets in terms of several financial metrics, including their use of leverage and particular dynamic trading strategy.[84]

2. *Benefits Conferred on the Markets*

The potential risk posed by a few hedge funds' aggressive use of leverage must be weighed against the benefits that this asset class overall confers on financial markets, namely liquidity and risk allocation.

Hedge funds provide liquidity in several forms. For example, arbitrage hedge funds buy and sell assets against prevailing market sentiment, with the effect of mitigating temporary supply and demand imbalances.[85] In addition,

---

80. *Id.* As a result of certain hedge funds' willingness and ability to bear high risks, far beyond that of most other financial institutions, the disappearance of many hedge funds may cause a significant drop in asset prices. *Id.* For example, due to hedge funds' ability to hold and trade high-risk credit derivatives, their disappearance may cause a contraction of credit and liquidity, heightening the risk of contraction in real economic activity. *Id.*

81. President's Working Group I, *supra* note 22, at 29. The systemic risk is particularly acute because no financial institution has an incentive to alter risk taking absorbed by hedge funds in order to reduce the problem of contagion of that risk taking by other firms. *Id.* at 31.

82. *Id.* at 5 (noting that hedge funds vary greatly in their use of leverage).

83. *Primer*, *supra* note 23, at 323.

84. *Goldstein*, 451 F.3d at 883.

85. President's Working Group I, *supra* note 22, at app. A-5. Arbitrage hedge funds buy the asset whose price has been driven down relative to the price of other related assets while simultaneously selling the relatively overpriced asset. *Id.* Notably, hedge funds conduct arbitrage trades in the Treasury securities market. *Id.* In these trades, a hedge fund constructs an estimated yield curve and accordingly buys Treasuries whose yields are above the curve while selling those whose yields are below the curve, on the conjecture that the anomalous yields will converge to the estimated yield curve. *Id.* at n.8. In the process, such trading strategies smooth out anomalous price variations while mitigating supply and demand imbalances. *Id.*

hedge funds that invest in distressed securities also provide liquidity by investing in companies facing bankruptcy or reorganization whose equity and debt trades at deep discounts due in part to the fact that the majority of institutional investors cannot own below investment-grade securities.[86] Thus, hedge funds' risk-tolerance profiles allow them to create markets for certain securities that may not have otherwise existed.

More importantly, hedge funds' risk-tolerance profiles allow them to play an important supporting role in a financial system in which various risks have been distributed across a broad spectrum of tradable financial instruments.[87] Financial innovation over more than two decades has created a wide range of financial instruments with different types and degrees of risk.[88] These instruments have unbundled the risks involved in financing real economic activity into distinct instruments with varying risk-return profiles.[89] In short, risks are converted into securities, sliced up, repackaged, sold, and sliced up again.[90] Some of the most important and innovative products include asset-backed securities,[91] collateralized debt obligations,[92] and credit default swaps.[93] These increasingly complex financial products have contributed to the development of a far more flexible and hence resilient system than the one that existed just a quarter-century ago.[94]

Collectively, these products enable the largest and most sophisticated banks, in their credit-granting role, to divest themselves of much credit risk by passing it to other institutions with high-risk appetites, such as hedge funds, which continue to be willing to provide credit protection.[95] By investing in the high-risk

---

86. *See* Stonham I, *supra* note 60, at 288.

87. President's Working Group I, *supra* note 22, at app. A-6.

88. *Id.*

89. *Id.*

90. *The Dark Side of Debt*, THE ECONOMIST, Sept. 23, 2006, at 11.

91. An asset-backed security depends on its value on an underlying pool of underlying assets. Assets are pooled to make otherwise minor and uneconomical investments worthwhile, while also reducing risk by diversifying the underlying assets.

92. Collateralized debt obligations ("CDOs") are a type of asset-backed security. A CDO can be thought of as a mutual fund where the owners (*i.e.*, the equity class(es)) leverage their investment by borrowing (*i.e.*, issuing debt) against the portfolio. CDOs in particular allow banks to hedge against their risk and manage their regulatory and economic capital more efficiently. *See In the Shadows of Debt*, THE ECONOMIST, Sept. 23, 2006, at 81.

93. A credit default swap is an agreement between a protection buyer and a protection seller whereby the buyer pays a periodic fee in return for a contingent payment by the seller upon a credit event (such as a certain default) happening in the reference entity.

94. Alan Greenspan, Chairman, Fed. Reserve Board, Economic Flexibility, Remarks to the National Association for Business Economics Annual Meeting (Sept. 27, 2005), *available at* http://www.federalreserve.gov/boardDocs/Speeches/2005/20050927/default.htm.

95. *The Dark Side of Debt*, *supra* note 90, at 11. *See* Paul J. Davies & Richard Beales, *New Players Join the Credit Game*, FINANCIAL TIMES, Mar. 14, 2007, at 25 (noting that, in 1990, hedge funds that focused on fixed income strategies accounted for just over three percent of assets under management in the industry; by the end of 2006, a more varied array of credit-related strategies accounted for almost 7.5 percent of a $1.4 trillion industry).

segments of these products, hedge funds have allowed a larger number of such banks to reduce their risks.[96] Thus, hedge funds themselves contribute significantly to the efficient functioning of today's financial markets.

II. MANDATORY REGISTRATION: SEC RULE AND CURRENT LEGISLATIVE PROPOSALS

This section will discuss regulatory proposals aimed at bringing about the registration of hedge funds under federal securities laws. Section A will discuss how the SEC justified its Hedge Fund Rule for mandatory registration of the managers of most large hedge funds. Next, section B will discuss the *Goldstein* court's invalidation of the SEC rule. Finally, section C will consider current legislative proposals to reinstate the SEC rule.

Overall, this part will reveal that registration, as the *Goldstein* court indicated, is merely a "hook on which to hang more comprehensive regulation of hedge funds" and constitutes an inappropriate regulatory response to hedge funds.[97] A critical view of registration proposals anticipates Part III, which suggests that regulators should focus their attention and resources on oversight of the hedge fund counterparties and creditors rather than on direct regulation of hedge funds themselves.

A. SEC HEDGE FUND RULE

In response to mounting political pressure to "do something" in the aftermath of Enron, WorldCom, and the mutual fund scandals, the SEC has taken an aggressive stance with respect to regulation and enforcement.[98] This has resulted in a significant surge in regulatory measures over the past several years perhaps without precedent in SEC history.[99] The fashion for increased regulation placed the burden on those who opposed more government action into securities markets to prove their position.[100] In this atmosphere, the SEC adopted the Hedge Fund Rule[101] in December 2004, by a 3-2 vote.[102]

---

96. President's Working Group I, *supra* note 22, at 23.

97. *Goldstein*, 451 F.3d at 882.

98. Paredes, *supra* note 15, at 1011.

99. In the last several years, there has been a surge of new compliance and control related legislation, administrative rule-making, enforcement actions, and civil and criminal proceedings that are perhaps without precedent in the post-war period. Counterparty Risk Management Policy Group II, *Toward Greater Financial Stability: A Private Sector Perspective*, July 27, 2005, at 150 [hereinafter CRMPG Report] (the CRMPG is a policy group comprised of 12 of the world's largest commercial and investment banks; the group has issued two reports setting forth a private sector solution to risk management).

100. Paredes, *supra* note 15, at 1011.

101. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054-01 (Dec. 10, 2004).

102. *See* Paredes, *supra* note 15, at 976 (noting that the SEC is an agency that overwhelmingly acts unanimously and, therefore, this close vote illustrates strong disagreement among the commissioners).

Through the rule, the SEC attempted to bring hedge fund managers within the ambit of the Advisers Act by closing the Private Adviser Exemption outlined in Section 203(b)(3). The rule specified that hedge fund managers must now "count as clients the shareholders, limited partners, members or beneficiaries of the fund" in determining whether a fund meets the private adviser exemption by having fewer than 15 clients in the past 12 months.[103] Previously, managers were allowed to count the entire partnership as one client for the purposes of the Advisers Act. Thus, the rule closed the Private Adviser Exemption by requiring advisers to "look through" their funds to count the number of limited partner investors as "clients."[104]

This had the effect of requiring most hedge funds to register. Further, application of the rule triggered regulations that apply only to *registered* advisors. Most importantly, registered advisors had to open their records to the Commission upon request[105] and could not have charged their clients a performance fee unless such clients had a net worth of at least $1.5 million or at least $750,000 under management with the adviser.[106]

The Commission justified its action by citing three key factors: (a) the tremendous growth of the hedge fund industry; (b) the broadening exposure of investors to hedge fund risk; and (c) the growing number of instances of malfeasance by hedge fund advisers.[107] Further, the SEC maintained that requiring hedge funds to register under the Advisers Act will not impose an undue burden on them or interfere significantly with their operations.[108] While the Commission acknowledged that the lack of regulatory constraints on hedge funds has been a factor in the growth and success of this industry, it was not persuaded by arguments that requiring hedge fund advisers to register under the Act, to develop a particular compliance infrastructure in keeping with numerous different federal laws and regulations, or subjecting them to its examination authority will impose undue burdens on them or interfere with their funds' operations.[109]

B. *GOLDSTEIN V. SEC*

The *Goldstein* court held that the SEC rule was arbitrary, reasoning that the Commission failed to justify departing from its own prior interpretation of sec-

---

103. 17 C.F.R. § 275.203(b)(3)-1 (2008).

104. 69 Fed. Reg. at 72,065 (Dec. 10, 2004).

105. 15 U.S.C. § 80b-4 (2008); *See Goldstein*, 451 F.3d at 877 (noting that the rule triggered regulations that previously applied only to *registered* advisers).

106. *See Goldstein*, 451 F.3d at 877 (citing 15 U.S.C. § 80b-5 (2008); 17 C.F.R. § 275.205-3 (2008); 69 Fed. Reg. 72,054, 72,064 (Dec. 10, 2004) (discussing "salutary effect" of this rule is to limit "retailization.")).

107. 69 Fed. Reg. 72,059 (Dec. 10, 2004).

108. *Id.* at 72,059.

109. *Id.*

tion 203(b)(3) of the Advisers Act.[110] More importantly, the SEC rule was not in keeping with congressional intent and judicial precedent.

The *Goldstein* court stated that "Congress did not intend 'shareholders, limited partners, members, or beneficiaries' of a hedge fund to be counted as 'clients.'"[111] The court also noted that the Advisers Act, while it does not expressly define "client," defines an "investment advisor" as someone who *directly* advises others as to investing and that an investor in a hedge fund does not receive direct advice.[112]

In contrast, a hedge fund limited partner made the decision on how to invest when he invested in the fund and does not receive investment advice from the fund's general partners at any subsequent point.[113] This interpretation had been the Commission's view until it issued the new rule, and it was endorsed by the Supreme Court.[114] As such, the *Goldstein* court concluded that a hedge fund manager has no obligation to ensure that each security purchased for the fund's portfolio is an appropriate investment for each individual limited partner.[115] Thus, the Commission did not adequately justify treating *all* investors in hedge funds as individual clients for the purpose of its Hedge Fund Rule.[116] Therefore, the *Goldstein* court vacated the rule, holding it "arbitrary."[117]

Overall, *Goldstein* individualized the SEC's general policy of increased regulation and highlighted that the Hedge Fund Rule does not constitute a legally valid regulatory policy in this instance. Regarding the underlying policy of the rule, *Goldstein* rendered the rule as merely an alternative that may meet a present level of satisfaction for increased regulation, but suggested that it is by no

---

110. *See Goldstein*, 451 F.3d at 883 ("by painting with such a broad brush, the Commission has failed adequately to justify departing from its own prior interpretation of § 203(b)(3)").

111. *Goldstein*, 451 F.3d at 879. The *Goldstein* court noted that, in 1980, Congress added to § 203(b)(3) the following language:

> For purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company . . . shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner. Act of Oct. 21, 1980, Pub. L. No. 96-477, § 202, 94 Stat. 2275, 2290 (1980). *Id.* at 878.

112. *Id.* at 879.

113. *Id.*

114. *Id.* at 880 (noting that the SEC endorsed this interpretation when in 1985 it promulgated a rule with respect to investment companies set up as limited partnerships, and that the Supreme Court embraced a similar conception in *Lowe v. SEC*, 472 U.S. 181 (1985)).

115. *See Goldstein*, 451 F.3d at 880 (noting that hedge fund managers owe fiduciary duties only to the fund, not to the fund's investors, because conflicts of interest will inevitably arise if managers simultaneously owe duties to both the fund and investors).

116. *See Id.* at 883.

117. *Id.* at 884 (noting that, in addition to the Commission's unreasonable interpretation of "client," the Hedge Fund Rule created a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the Advisers Act).

means the best available alternative, given the financial metrics that regulators must consider in identifying a particular hedge fund's importance to national markets.[118] Thus, *Goldstein* shifted the burden of proof onto those who favored increased regulation of hedge funds to better justify their position in support of increased regulation.

C. LEGISLATIVE PROPOSALS

In immediate reaction to the *Goldstein* decision, Congressman Barney Frank, then the Ranking Democratic Member on the House Financial Services Committee and its current Chairman, announced that he will be introducing legislation to authorize the registration of hedge funds.[119] The theory of this proposal is that if the SEC does not have the authority to require hedge fund registration under the Investment Advisors Act, then Congress should grant it.

More specifically, the rule proposal grants to the SEC the authority to limit hedge fund managers' use of the Private Adviser Exemption of the IAA in the following terms:

> (1) AUTHORITY.—The Commission may, by rule or regulation, limit the availability of the exemption provided by subsection (b)(3) [of the Investment Advisers Act], and require the registration under this section, of an investment adviser by requiring that certain shareholders, partners, and beneficial owners of, or investors in, clients of the adviser shall also be counted as clients themselves for purposes of such subsection, as the Commission determines necessary in the public interest or for the protection of investors.
>
> (2) RULE OF CONSTRUCTION.—The treatment of a shareholder, partner, beneficial owner, or investor as a client for purposes of registration under this section shall not affect, and shall not be affected by, the treatment of such persons not as clients for purposes of the section 206 or any other section of this title.

Thus, the bill would authorize the SEC to interpret "client" in a manner that requires registration of advisers to funds that have more than 15 investors, effectively reversing the *Goldstein* decision and allowing for the reinstatement of the original Hedge Fund Rule.

Nevertheless, the utility of registration as a blanket regulatory tool remains unclear. The SEC has indicated an interest in using information collected through registration to develop a centralized database of hedge fund posi-

---

118. *See Goldstein*, 451 F.3d at 883; *See also* Mark Seidenfeld, *Getting Beyond Cynicism: New Theories of the Regulatory State Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 492 (2002) (discussing "satisficing").

119. Press Release, Frank Announces Legislation to Give Federal Regulators Authority Over Hedge Funds (June 28, 2006), *available at* http://financialservices.house.gov/pr06282006.html.

tions.[120] This database would indicate the outstanding credit exposure of individual hedge funds based on routine reporting by funds and their major counterparties.[121]

Such a database, however, is useless in practice because hedge fund managers are nimble and quickly adjust their strategies in response to major market movements. As such, disclosure of positions to regulators is useless for the most part because it would give only a snapshot of the positions taken by hedge funds at a point in the past without any real indication of what any particular hedge fund will do in the future. Further, to be of any value in evaluating a particular fund's credit worthiness, it would have to reveal specific positions. This level of disclosure contravenes the proprietary nature of any fund's trading strategies. Finally, it is questionable whether the SEC would have authority to direct a hedge fund to reduce positions if the Commission determines that its trading strategy potentially poses a systemic risk.[122]

These shortcomings suggest that the SEC should consider policies that leverage market discipline and require hedge fund counterparties to more accurately evaluate the risks posed by particular funds. Obligating market participants to provide more discipline makes "economic sense" because private agents have the best access to information and the strongest incentives to use it effectively—risk of loss.[123] Thus, the SEC should develop a regulatory policy aimed at placing market participants in a better position to check the potential systemic risk posed by particular hedge funds.

III. LEVERAGING MARKET DISCIPLINE

Policymakers tend to view issues in terms of a false dichotomy: "adopt mandates or do nothing."[124] In the case of hedge funds, potential regulatory responses being debated include: (a) direct regulation through exacting disclosure requirements and (b) no additional regulation of hedge funds or related parties and continued reliance on the pre-Hedge Fund Rule regulatory structure.[125]

---

120. *See* SEC Staff Report, *Implications of the Growth of Hedge Funds* 94, n.308 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

121. President's Working Group I, *supra* note 22, at F-4, F-5.

122. *See* Ben S. Bernanke, Fed. Reserve Chairman, Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006), *available at* http://www.federalreserve.gov/Boarddocs/speeches/2006/200605162/default.htm [hereinafter Bernanke].

123. *Id.*

124. Paredes, *supra* note 15, at 1025.

125. Brandon Becker & Colleen Doherty-Minicozzi, *Hedge Funds in Global Financial Markets*, 2000 A.B.A. SEC. ON BUS. LAW 31, *available at* http://www.wilmerhale.com/files/Publication/6a289a59-73ba-4bb7-a1e5-2b2232d858d2/Presentation/PublicationAttachment/d40c0566-7cfc-4381-aa61-d30812777594/Markets.PDF [hereinafter *Global Report*].

The middle ground is indirect regulation of hedge funds through enhanced supervision of hedge fund creditors.[126] Accordingly, regulators' primary task is to guard against a return of the weak lending standards that left lenders overly vulnerable to market shocks in the recent past.[127] This approach aims to promote market discipline, awareness of risk, and prudent risk management as the best means of limiting systemic risk. It represents the often-romanticized but rarely obtained "Goldilocks" regulatory regime that does not go too far or do too little.[128]

This section suggests that this indirect regulatory approach best preserves hedge funds' beneficial effects on financial markets while putting in place policies designed to limit dramatic losses occasionally caused by highly-leveraged hedge fund risk taking through dynamic trading strategies. Section A will discuss the particular risk management policies that the SEC should promote among the registered counterparties of hedge funds. Section B will compare the LTCM episode of 1999 and the Amaranth losses of 2006 to illustrate the general evolution of the adolescent hedge fund industry and the effectiveness of recently implemented risk management practices. This part will suggest that the SEC should more actively promote prudent risk management.

A. RISK MANAGEMENT PRACTICES

In implementing this indirect approach, regulators must ensure that the commercial and investment banks that provide credit to hedge funds improve their due diligence practices with regard to the particular risks posed by individual funds. The bottom line is that disclosure by hedge funds to regulators is no substitute for the release of more robust and customized creditor information to leverage-facilitating counterparties.[129] As such, regulators should clearly communicate their expectations for the quality of information that banks should require of hedge funds and for prudent risk management practices by these counterparties.

---

126. *Id.*

127. *Id.*

128. *See* Paredes, *supra* note 15, at 1025.

129. *Global Report*, *supra* note 125, at 72-73. *See also Global Report* at 62-63 (noting that the first line of defense to market stress will always be the hedge fund management itself). In a report released in February 2007, the President's Working Group stated that market discipline is the most effective mechanism for limiting systemic risk posed by hedge funds. President's Working Group, *Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital*, Feb. 22, 2007, at 3, *available at* http://www.treas.gov/press/releases/reports/hp272_principles.pdf [hereinafter President's Working Group II]. Overall, the report de-emphasized direct regulation by not mentioning it all, choosing instead to focus regulators attention on supervision of hedge funds' leverage-facilitating counterparties. *See generally id.*

1. *Information Sharing*

Hedge funds view banks as "competitors as well as creditors."[130] In light of hedge fund managers' obsession with safeguarding all facets of their proprietary trading strategies, hedge funds provide limited information to their credit-facilitating counterparties. Typically, hedge funds do not distribute any of their measures of perceived market or credit risk vis-à-vis their strategies, limiting their disclosure to overly general information.[131] This prevents banks' credit officers from making a comprehensive credit assessment of any given fund, particularly with respect to leverage.[132]

Nevertheless, banks have high interest in conducting business with hedge funds given the industry's overall success.[133] The nature of this relationship has left banks to have to assess hedge funds' credit quality merely in terms of the reputation of the managers, their track record, and offering circulars.[134] However, these qualitative assessments can be very difficult to compare across entities of uneven sophistication and quality.[135] Indeed, qualitative evaluations are no substitute for better quantitative information that may yield a more accurate risk profile for each individual fund.

As such, in overcoming the competitive pressures between banks for hedge fund business, regulators should coordinate an effort among banks to collectively adopt more stringent credit evaluation procedures across the board. More specifically, regulators should clearly communicate their expectation that banks receive some comprehensive position details from hedge funds.

Some participants (typically larger hedge funds) have even established units with the sole or primary purpose of communicating with credit providers.[136] However, this is not to imply that an industry-wide consensus is emerging on this issue. In fact, there remains considerable variability on disclosure levels, with some hedge funds continuing to be reluctant to share any meaningful portfolio information.[137] Thus, regulators should ensure that banks do not compromise their business selection process as a result of the unwillingness of potential hedge fund clients to provide all necessary information.[138]

---

130. President's Working Group I, *supra* note 22, at D-5.

131. *Id.*

132. *Id.* at D-7.

133. *Id.* at D-15.

134. *Id.* at D-7.

135. CRMPG Report, *supra* note 99, at 46.

136. *Id.* at 45.

137. *Id.*

138. *See* Jeremy Grant & Ben White, *Regulators Quiz Banks on Hedge Fund Risks*, FINANCIAL TIMES, Jan. 10, 2007, at 20 (noting that regulators' concern is focused on hedge funds using margin to invest in exotic and lightly regulated over-the-counter derivatives).

2. *Risk Management Functions*

Hedge fund leverage may have systemic risk implications in terms of the linkages between institutions that characterize the global financial system.[139] By increasing the chance that problems at one financial institution could be transmitted to other institutions, excessive leverage can increase the likelihood of a general breakdown in the functioning of financial markets.[140] Thus, leverage is the main source of the systemic risk posed by hedge funds.[141] Indeed, encouraging better risk management and worrying about leverage are two sides of the same coin.[142]

Leverage, however, is not an independently useful concept for assessing a particular fund's risk profile.[143] The investment and commercial banks that provide credit to hedge funds should utilize a due diligence framework that evaluates the linkages between leverage, liquidity, and market risk in order to develop a complete risk profile for a particular fund.[144] In other words, leverage should be measured relative to a hedge fund's capacity to absorb losses in

---

139. *See* CRMPG Report, *supra* note 99, at 150.

140. President's Working Group I, *supra* note 22, at 29.

141. There have been several ex post analyses of hedge funds' effects on major market events, including the 1987 U.S. stock market crash; the 1992 European Rate Mechanism crisis; the 1993 global bond rally; the 1994 bond market turbulence; the 1994-95 Mexican crisis; and the 1997 Asian currency crisis. *See* William Fung and David A. Hsieh, *Measuring the Market Impact of Hedge Funds*, 7 J. OF EMP. FIN. 1 (2000) (citing several such surveys). These analyses concluded that there is no evidence that hedge funds were able to manipulate markets from their "natural paths" driven by economic fundamentals. *Id.* While the evidence indicates that some highly leveraged trades can lead to market disruptions when they are unwound subsequently, there is no reason to believe that hedge fund trading strategies themselves are the source of systemic risk. *Id.* at 35. *See also* President's Working Group I, *supra* note 22, at A-7 (noting that there is little evidence that hedge funds can "move" markets in directions favorable to themselves).

Cf. Sherry M. Shore, Note, *SEC Hedge Fund Regulatory Implications on Asian Emerging Markets: Bottom Line or Bust*, 13 CARDOZO J. INT'L & COMP. L. 563 (2005) (arguing that hedge fund trading strategies precipitated the Asian Market Crisis).

142. To say that by merely encouraging better risk management by financial institutions, regulators are not worrying about hedge fund leverage sets up a false dichotomy—indeed, worrying about risk management among credit providers means worrying about hedge fund leverage. *Cf.* Roberta S. Karmel, *The SEC at 70: Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 947 (2005).

143. To say that one hedge fund is levered 2-to-1 while another is not levered does not necessarily mean that the levered hedge fund is more risky or likely to encounter liquidity problems. Managed Funds Association, *MFA's 2005 Sound Practices for Hedge Fund Managers* AI-16 (2005) (hereinafter *MFA Sound Practices*). If the levered hedge fund is invested in government securities while the hedge fund that is not leveraged in equities, financial statement-based leverage would lead to erroneous conclusions about the riskiness of the two funds. *Id.* In this sense, financial statement-based measures of leverage are arguably deficient since they convey the least information about the nature and risk of the assets in a portfolio. *Id.*

144. CRMPG Report, *supra* note 99, at 46.

particular market conditions.[145] To this end, regulators should promote stress testing and heightened collateral standards.

a. *Stress Testing*

Regulators should ensure that banks employ an appropriate framework for measuring the risk of loss in a hedge fund portfolio. The Value-at-Risk (VAR) model is one model that provides an all-encompassing market risk measure that incorporates correlations between positions in a portfolio.[146] Such measurements are essential when evaluating a portfolio of positions that are hedged against each other, as is typical of most hedge funds' portfolios.

In addition, regulators must further ensure that banks "stress test" the VAR number by changing the parameters of the overall VAR model.[147] Stress tests reveal what would "happen to the VAR number if the actual values of market factors (*i.e.*, prices, rates, volatilities, etc.) differ from the values used as inputs in the base-case VAR calculation."[148] Thus, stress testing is appropriate in the case of hedge funds because the variability of a hedge fund's financial position as it swiftly reacts to changing market factors makes traditional tools of financial statement analysis less effective in assessing its credit risk.[149] Therefore, creditors must develop methods by which to identify overlapping risks embedded in the complex trades of hedge funds.[150] In addition, stress testing is an important exercise in evaluating hedge funds that trade in recently-developed, exotic over-the-counter derivatives whose performance in a down-market has not been tested.[151]

As part of the stress testing process, banks should expand their models to incorporate the risk that a hedge fund will default completely on its obligations.[152] More specifically, creditors should be concerned about risks that affect illiquid positions that are highly leveraged. A significant rapid loss may serve as a triggering event that causes a hedge fund to liquidate positions in a disor-

145. *MFA Sound Practices*, *supra* note 143, at AI-3.

146. *Id.* at AI-5. "VAR measures the maximum change in the value of the portfolio that would be expected at a specified confidence level over a specified holding period." *Id.* "For example, if the 95 percent confidence level, one-day VAR for a portfolio is $500,000, one would expect to gain or lose more than $500,000 in only 5 of every 100 trading days on average." *Id.*

147. *Id.* at AI-8.

148. *Id.* Among the potential changes in market conditions that should be considered in stress testing are: changes in prices; changes in interest rate structures; and changes in correlations between prices.

149. President's Working Group I, *supra* note 22, at 8.

150. CRMPG Report, *supra* note 99, at 49.

151. *See In the Shadows of Debt*, *supra* note 22, at 81 (noting that the problem, "broadly identified by many regulators, is that not a lot is known about how structured credit products behave in unusual conditions . . . the products have been developed in a decade when interest rates have been low, the appetite for risk has been high, and liquidity ample," and it is hard to know how they will react when down markets return).

152. *Id.*

derly manner to post margin on its loans.[153] Indeed, a fund may reach a "point of no return" when the cash raised from a preliminary round of liquidation does not cover the fund's total credit obligations and forces the fund to continue to liquidate its remaining positions.[154] If this happens, a hedge fund will be caught in an "accelerating, downward spiral" that feeds off of the need for liquidity imposed by creditors; eventually, the fund may not be able satisfy its credit obligations.[155] Thus, regulators should ensure that leverage-facilitating banks subject hedge funds to rigorous credit risk evaluations that do not merely evaluate leverage in isolation but in connection with liquidity and market risk—*i.e.*, in connection with a hedge fund's ability to liquidate its collateral in particular market conditions.[156]

b. *Heightened Collateral Standards*

Regulators should ensure that banks implement more rigorous due diligence practices and accordingly raise their collateral requirements. In the past, lenders have been willing to agree to cross-product and cross-entity collateral techniques, thereby allowing hedge funds to borrow excessively against a limited collateral base.[157] These practices have resulted in hedge funds posting less margin than typically posted by other borrowers.[158] Lax collateral standards for high-risk hedge funds may lead to levels of leverage that create significant systemic risk.[159] Thus, regulators should ensure that banks heighten collateral standards where necessary. Indeed, heightened collateral standards are the key to preventing a point-of-no-return scenario where a hedge fund lacks the liquidity necessary to pay off its creditors when forced to unwind highly-leveraged positions.

In the final analysis, regulators cannot entirely eliminate systematic risk.[160] To try to do so would likely, as Fed Chairman Bernanke has said, "stifle innovation without achieving the intended goal."[161] Rather, regulators should leverage the possibilities of market discipline by hedge fund creditors as a substitute for formal rulemaking.[162] Indeed, the "primary mechanism for regulating excessive leverage and other aspects of risk taking in a market economy is the discipline provided by creditors, counterparties, and investors."[163] Thus, in-

153. *MFA Sound Practices*, *supra* note 143, at AI-13.
154. *Id.*
155. *Id.*
156. *See* Stonham II, *supra* note 71, at 385.
157. CRMPG Report, *supra* note 99, at 53.
158. *Id.*
159. *Id.*
160. Bernanke, *supra* note 122.
161. *Id.*
162. *Id.*
163. *Id.*

creased counterparty risk management is the best course for addressing systematic risk concerns related to hedge funds,[164] and the SEC should devote its resources to promote prudent risk management practices.

B. LTCM AND AMARANTH COMPARED

The question of when regulation is balanced is a value judgment. However, normative values must be informed by factual circumstances. A comparison of the LTCM collapse and recent losses by Amaranth Advisors provides empirical proof that effective counterparty risk management can prevent widespread negative market impact by risky hedge fund trading strategies.

Amaranth's $6 billion one-week loss in September 2006 was the largest in hedge fund history,[165] larger than LTCM's capital loss. The sheer size and speed of Amaranth's losses spotlight the very risky pursuit that hedge fund investing can still be. However, the effect of Amaranth's losses on financial markets was little more than a blip.[166] "The fund did not default on any of its counterparty obligations, and the impact on global financial systems was essentially negligible."[167] A comparison of LTCM with Amaranth suggests what the proper regulatory response to hedge funds should be.

Much of the blame for LTCM's rapid loss in value lay at the door of extreme leverage.[168] Leverage was already 25 times LTCM's capital base of $4.8 billion in January 1998.[169] In other words, "of LTCM's $125 billion in investments, $120 billion was backed by borrowing."[170] By August, however, the ratio of on-balance sheet assets to capital had ballooned to 50:1.[171] Further, "the 50:1 ratio. . .did not even include leverage obtained through off-balance sheet derivatives."[172]

In the early years, LTCM used leverage to amplify its gains: it grossed net returns of 42.8 percent in 1995; 40.8 percent in 1996; and 17 percent in 1997, distinguishing it as one of the highest net-earning hedge funds in the US.[173] However, after 1997, when markets moved against LTCM,[174] the leverage ef-

---

164. *Id.*

165. Amy Friedman, *Hedge Funds: Still Risky Business*, BUSINESS WEEK, Oct. 16, 2006, *available at* http://www.businessweek.com/investor/content/oct2006/pi20061017_639300.htm.

166. *Id.*

167. *Id.*

168. Stonham II, *supra* note 71, at 382.

169. *Id.* at 383.

170. *Blank Cheques and Balances*, *supra* note 8, at 87.

171. Stonham II, *supra* note 71, at 383

172. *Id.* at 385. "The notional value of derivative contracts LTCM had entered into was estimated at $1 trillion." *Id.*

173. *Id.* at 383.

174. In the 1990s, up to 1997, the US, Europe, and Japan enjoyed strong bull markets in equities and bonds. With capital flowing from these countries into emerging markets in South East Asia, Latin America, and Russia, yield spreads between bonds in developed and emerging world tended to nar-

fects worked in reverse, multiplying losses instead of gains, and causing banks to call in collateral to counter the downward valuation of the fund's asset positions.[175]

Meeting its loan obligations required Long-Term to rapidly unwind its positions. Yet, unwinding LTCM's entire complicated portfolio in a short period of time would have constituted a 'fire-sale' in which its assets would have been marked down dramatically,[176] resulting in a severe loss of value for the fund as well as for market participants unconnected with it. Further, because none of the creditor-banks had the whole picture of LTCM's positions, none saw that most of the fund's trades were hedged and tended to offset one another; therefore, each bank was demanding more margin than the fund otherwise would have.[177] Whereas when a typical client defaulted, a reserve would exist in the form of margin money held by lenders, Long-Term could have theoretically dropped all the way to zero given overly-generous credit terms and overlapping collateral pledges.[178] If it defaulted, not much would have been left.

Fearing this default scenario, the Federal Reserve Bank of New York called a meeting in September 1998 at its offices and persuaded 15 commercial and investment banks to contribute $3.5 billion to rescue LTCM.[179] The terms of the Federal Reserve orchestrated rescue called for these banks (nearly all of which were LTCM creditors) to stem the flow of loan repayments and provide needed liquid capital to meet margin calls.[180] Absent this injection of capital, LTCM would not have been able to meet its repayment obligations as loans were rolling over. Instead, the bailout allowed for an orderly sale of assets and repayment of loans over time.

Thus, the Long-Term crisis happened to involve a hedge fund, but the fathers of the crisis were the big Wall Street banks, which let their lending standards

---

row—rising in the former and falling in the latter. LTCM bet that comparative yields would continue to narrow. However, macroeconomic events subsequently caused yields to widen. Namely, the 1997 Asian financial crisis caused by over-extension of Western and Japanese credit led to a serious collapse of investment in Asia. In addition, in 1998, as a result of political and economic uncertainty, the Russian government significantly devalued its debt. Stonham II, *supra* note 71.

175. *Id.* Collateral loans were being marked to market on a daily basis. *Id.* at 385. Thus, as the markets moved heavily against LTCM, banks would call for increasing amounts of collateral payments simultaneous with the fund suffering losses. *Id.*

176. Stonham II, *supra* note 71, at 388 (quoting Alan Greenspan, former chairman of the Federal Reserve Board, on the justification for the government-coordinated recapitalization plan).

177. Lowenstein, *supra* note 8, at 155.

178. *Id.* at 179. What made matters worse was that LTCM was reputed to be borrowing on no collateral and not committing any margin up front. Stonham II, *supra* note 71, at 386.

179. Stonham II, *supra* note 71, at 387. Default was the likely scenario: LTCM's capital base of $4.8 billion in January 1998 hemorrhaged down to $600 million by the time the bailout had been organized in September 1998. *Id.* at 383.

180. *Id.*

grow lax as their wallets swelled up during LTCM's early success.[181] Indeed, the root of this crisis was the favorable credit terms given to LTCM by some banks despite a lack of information about the full scope of the fund's exposures.[182] In managing the LTCM relationship as well as some other hedge fund relationships, banks clearly relied on significantly less information on the financial strength, condition, and liquidity of the hedge fund borrower than is required of other types of borrowers.[183] Indeed, a hedge fund's mere provision of collateral to lenders is no substitute for a thorough credit risk evaluation that considers the fund's liquidity risk—*i.e.*, its ability to liquidate its collateral in particular market conditions.[184]

After LTCM, the SEC intensified its risk-management inspections of larger broker-dealers who lend to hedge funds. Since the LTCM crisis, ongoing improvements in counterparty risk management and the resulting strengthening of market discipline appear to have limited hedge fund leverage and improved the ability of banks and broker-dealers to monitor risk, despite the rapidly increasing size, diversity, and complexity of the hedge fund industry.[185]

The improvement of risk management practices among market participants in this adolescent and still maturing industry is evident in the Amaranth Advisers incident. The seductive commodities "boom and bust" cycle recently hit Amaranth in September 2006.[186] Having made an estimated $1 billion in rising energy prices in 2005,[187] Amaranth took a highly leveraged position in natural gas. This position ultimately cost the fund $6 billion in losses—65 percent of total assets under management ($9 billion).[188] Its losses, however, caused barely a ripple in financial markets, illustrating that risk-management systems have significantly improved since LTCM.[189]

In fact, Amaranth's creditors and counterparties managed to recoup the money they had lent the hedge fund without any notable losses. Amaranth summoned a group of investment banks to its headquarters to negotiate selling its

---

181. Lowenstein, *supra* note 8, at 232 (noting that Walter Weiner, former chairman of Republic National Bank, maintained that banks had no choice—or at least, no choice other than the rare, courageous one of rejecting business: "To enter the club, you had to play by LTCM's rules; the terms were *non-negotiable*—take it or leave it.").

182. President's Working Group I, *supra* note 22, at D-12. While LTCM's debacle could not have threatened the solvency of any U.S. commercial bank, the liquidation of direct exposures in the fund could have significantly impacted quarterly earnings at several banking institutions. *Id.*

183. *Id.* at D-13.

184. Stonham II, *supra* note 71, at 385.

185. Bernanke, *supra* note 122.

186. *Flare-up*, *supra* note 9, at 23.

187. Gretchen Morgenson & Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves*, N.Y. TIMES, Sept. 19, 2006, *available at* http://www.nytimes.com/2006/09/19/business/19hedge.html?ex=1316318400&en=2732df67691f17e9&ei=5088&partner=rssnyt&emc=rss.

188. *Flare-up*, *supra* note 9, at 23.

189. *Blank Cheques and Balances*, *supra* note 8, at 87.

positions, craft bridging loans, and possibly negotiate a take-over.[190] Further, Amaranth transferred its entire energy portfolio to JPMorgan Chase (the fund's futures prime broker) and Citadel, a Chicago-based hedge fund.[191]

Despite its highly leveraged energy portfolio, Amaranth's creditors apparently obtained clear collateral pledges which facilitated an orderly breakup. In contrast to LTCM, loans were not issued in a way in which recovery would be impossible after a significant rapid loss. As such, lenders apparently considered Amaranth's ability to liquidate its collateral in varying conditions in the volatile natural gas market. Further, Amaranth's creditors apparently conducted sufficiently rigorous stress tests that considered the fund's potential default, given the minimal disruption that its actual default caused the financial markets. By contrast, LTCM stress-tested to a maximum of only a 10 percent loss—a "gentle" exercise that proved insufficient.[192] Thus, Amaranth's creditors apparently had conducted a robust quantitative and qualitative assessment of the risk-return estimates on Amaranth's position in the natural gas market.

In the final analysis, LTCM was an exception with regard to the amount of leverage it employed and the lack of information it provided to creditor banks,[193] and it highlighted shortcomings in banks' due diligence and credit risk assessments. Through continually improving market discipline, the risk of a highly levered hedge fund's default having a ripple effect on the markets is being significantly minimized.

As a result of employing risky trading strategies, many hedge funds have liquidated and investors have suffered losses. In fact, 1300 hedge funds have liquidated in the past two years.[194] However, creditors and counterparties have, for the most part, not taken losses.[195] Thus, hedge fund counterparties have adjusted their due diligence to better account for potential default that may sometimes result from risky hedge fund trading strategies. Therefore, continued guidance from the SEC on risk management strategies for counterparties forms the most appropriate regulatory response to hedge funds.

CONCLUSION

In recent years, the significant capital that has flowed into hedge funds, as well as several notable fund failures, has caught the attention of regulators. Given their expanding institutional client base, hedge funds will continue to

---

190. *Flare-up*, *supra* note 9, at 23.

191. Gregory Zuckerman, Clint Riley & Ann Davis, *Moving the Market: Investors in Amaranth Press Return of Funds*, WALL ST. J., Sept. 28, 2006, at C3.

192. Stonham II, *supra* note 71, at 389.

193. President's Working Group I, *supra* note 22, at D-20.

194. Anita Raghavan, *London's Office Envy: Who Would Go Crazy Over a Workspace? Hedge Funds, Naturally*, WALL ST. J., Jan. 10, 2007, at C1.

195. Bernanke, *supra* note 122.

rapidly evolve and mature as an asset class in the foreseeable future. Indeed, they already play an invaluable role in distinguishing the U.S. capital markets as the deepest and most diverse in the world.[196]

To maintain U.S. supremacy in the hedge fund market,[197] any regulatory proposals must balance hedge funds' beneficial effects on the markets with the occasional losses caused by risky trading strategies. At present, continued oversight of hedge fund counterparties and regulatory guidance on credit risk management practices appears to be the optimal approach to limit any market disruptions caused by highly-leveraged hedge fund risk taking.

196. *Buffettology for Wall Street*, THE ECONOMIST, Mar. 17, 2007, at 81 (noting that the U.S. remains home to the largest and most liquid markets but also noting its fading supremacy in light a much-lamented decline in initial public offerings).

197. *Id.* at 82 (noting that the U.S. still leads by a "country mile" in hedge funds).

The Current REIT Market: Evaluating a REIT's Investment Potential

COSIMO A. ZAVAGLIA*

INTRODUCTION

The popularity of real estate investment trusts (REITs[1]) has grown tremendously over the past several years.[2] Over $475 billion is invested in the United States REIT market today.[3] This number continues to rise as the average return of REIT investments outperforms the average return of several competing stock indexes.[4] After setting record high returns in September 2006, the REIT sector found itself up over 18 percent from the previous year, and on track to beat the Standard & Poor's 500 Index for the seventh straight year.[5] The current success of the REIT index in today's declining housing economy can be attributed to several factors, including the changing investment purposes for the use of REITs.

Traditionally, investors used REITs as a low-risk investment vehicle to reduce taxes and achieve long-term financial growth. Usually, the positive performance of long-term financial growth investments is linked to the success of the overall stock market and low interest rates.[6] However, over the past couple of years the REIT index has performed very well in a period of rising interest rates and a declining housing market.[7] This recent phenomenon has many investors mystified and confused over the utility of REITs as an investment tool.[8] REITs, typically used to meet long-term investment goals, are now being used to meet short-term value attaining goals. The riskier use of REITs to meet these

---

* Cosimo A. Zavaglia, J.D., 2008, Syracuse University College of Law; B.S., Industrial and Labor Relations, 2005, Cornell University. I would like to thank Robin Paul Malloy for all of his help and guidance. I would also like to thank my parents, Cosimo and Albina, for their continued love, support and encouragement.

1. THEODORE S. LYNN ET AL., REAL ESTATE INVESTMENT TRUSTS 1011 (1991).

2. Brent W. Ambrose, Michael J. Highfield, & Peter D. Linneman, *Real Estate and Economies of Scale: The Case of REITs; Real Estate Investment Trusts*, REAL ESTATE ECONOMICS, Jun. 22, 2005, at 323; Russell J. Singer, Note, *Understanding REITs, UPREITs, and DOWN-REITs, and the Tax and Business Decisions Surrounding Them*, 16 VA. TAX. REV. 329, 332 (1996).

3. National Association of Real Estate Investment Trusts, *The REIT Story: Dividends and Diversification*, http://www.investinreits.com/learn/reitstory.cfm (last visited Nov. 28, 2007).

4. Andrew Bary, *Follow-up: A Return Visit to Earlier Stories*, BARRON'S, Sept. 11, 2006, at 19 (noting REIT market returned 92.4%, excluding dividends since the end of 2001 to November 2006, when compared to 31.3% returns of the S&P during the same period).

5. *Id.*

6. William J. Bernstein, *Are Value Stocks Riskier Than Growth Stocks?*, EFFICIENT FRONTIER, Dec. 18, 2006, *available at* http://www.efficientfrontier.com/ef/902/vgr.htm (last visited Nov. 28, 2007).

7. Steven Syre, *Real Estate Trusts on Rise*, BOSTON GLOBE, Aug. 29, 2006, at E1.

8. Syre, *supra* note 7.

new investment goals may explain why the index has performed well during the current decline in the housing market.[9]

This Note will examine the success of the REIT index in an ever-changing housing market and evaluate the criteria for selecting REITs as suitable investment opportunities to fulfill both short-term income-generating goals and long-term growth goals. To achieve these purposes, this Note will proceed in several steps. First, it will examine the origins of REIT legislation, the purpose behind its development, and the subsequent amendments that have caused REITs to be attractive to different types of investors. Second, this Note will examine the requirements to operate and qualify for a REIT and the judicial interpretation and rationale behind each requirement. Third, it will introduce a criterion for evaluating REITs. Fourth, based on the criterion for evaluation, it will explain certain factors which have caused the positive performance of REITs in the midst of a declining housing market.

I. INTRODUCTION, PURPOSE, AND HISTORY OF REITS

The success of the REIT industry has followed an unpredictable course since its introduction into the United States market in 1960.[10] REITs were initially developed by investors primarily for the tax advantages and long-term growth potential they provided owners of real property.[11] Over time investors' perception of REITs changed as investors began to view them as profitable investments vehicle for the purpose of achieving both short-term value and conservative long-term growth.[12] The shift in investor perception and use of this investment vehicle can be attributed primarily to legislative changes adopted by Congress throughout the past forty-six years.[13] Congressional changes have relaxed the requirements and qualifications of the REIT structure, and made it easier for investors to use REITs to achieve numerous financial goals.[14]

This section of the Note will examine the evolution and use of REITs from a long-term tax benefit to a profitable long-term and short-term investment opportunity. First, this section will introduce the REIT structure and the different types of REITs available in today's market. Second, this section will examine the original legislative purpose of REIT legislation. Finally, it will examine the legislative history of REITs and demonstrate the way in which continued tailor-

---

9. Bernstein, *supra* note 6.

10. Ryan Toone, Note, *Vehicle Shopping: The Case for a Flexible EuroREIT*, 14 MINN. J. GLOBAL TRADE 345, 348 (2005).

11. Bryan I. Pukoff, *An Introduction to REITs*, 32 TAX ADVISER 532 (2001).

12. *Id.* at 534.

13. *Id.* at 532.

14. *Id.*

ing of its structure by Congress has led investors to change their perception of the role of REITs.

A. INTRODUCTION TO THE U.S. REIT MARKET

REITs were created by Congress to give small-scale investors the opportunity to invest in large-scale income-producing real estate.[15] A REIT is a unique financial arrangement that allows investors to enjoy the overall benefits of a corporation classification with the tax benefits of a partnership.[16] The function of a REIT, from the perspective of a corporate entity, is to provide the advantages of limited liability and transferability of shares, without the costs of double taxation.[17] This may vary from the perspective of an individual investor who may often see their function similar to that of a mutual fund, by allowing investors to pool resources to obtain a corporate tax-free return on capital.[18]

REITs are divided into three categories: Equity, Mortgage, and Hybrid REITs.[19] The vast majority are Equity REITs that invest in and take ownership interest in real estate properties, including apartments, malls, and office buildings, and most often derive income from property rentals.[20] The function and motive of Equity investors differs from the function of real estate development companies mainly because Equity investors acquire and develop real estate properties to operate as part of a dividend-yielding portfolio, while real estate developers usually acquire real estate for the purpose of developing the property and reselling it at a higher cost.[21] Since the inception of REITs into the market, Equity investors have been able to fulfill long-term investing goals through dividend payments from rental income and capital gains from the eventual sale of properties.[22]

---

15. Pukoff, *supra* note 11, at 532; National Association of Real Estate Investment Trusts, *Frequently Asked Questions About REITs*, http://www.investinreits.com/learn/faq.cfm (last visited Nov. 28, 2007) ("A REIT is a company that owns, and in most cases, operates income-producing real estate such as apartments, shopping centers, offices, hotels and warehouses.").

16. Gary J. Purpula & Kevin E. Adler, *Allocating UPREIT Income to Prevent REIT Disqualification*, 13 J. PARTNERSHIP TAX'N 82 (1996).

17. *Id.* at 83 ("Generally organized as corporations, REITs provide investors with the usual advantages of corporate ownership, including limited liability and freely transferable shares.").

18. Singer, *supra* note 2, at 330 ("REITs are basically structured to do for real estate what mutual funds do for investors in securities; namely, allow investors to pool their resources and obtain a return on capital without paying a corporate tax on the gain.").

19. LYNN ET AL., *supra* note 1, at 1042.

20. Lee Ann Obringer, *Types of REITs*, HOWSTUFFWORKS, http://money.howstuffworks.com/reit1.htm (last visited Nov. 28, 2007).

21. *Frequently Asked Questions About REITs*, *supra* note 15.

22. *Id.* ("One major distinction between REITs and other real estate companies is that a REIT must acquire and develop its properties primarily to operate them as part of its own portfolio rather than to resell them once they are developed.").

Today, Mortgage REITs make up less than a quarter of the REIT industry.[23] There are about 40 Mortgage REITs that lend money for mortgages to real estate owners, or purchase existing mortgages or mortgage-backed securities.[24] These Mortgage investors derive their income primarily from the fees and interests they earn from their mortgage loans.[25] Since Mortgage REITs generate revenue directly from interest payments, their success is more vulnerable to changes in interest rates than Equity REITs.[26] The Mortgage REIT market is evenly divided between residential and commercial properties.[27] Typically, investors have been able to use Mortgage REITs to fulfill short-term investment goals when interest rates are expected to fall.[28]

Hybrid REITs combine the operations of both Equity and Mortgage REITs by acquiring both mortgages and property.[29] These Hybrid investors derive their income from a combination of both the dividends and capital gains from real estate property, and interest and fees from held mortgages.[30] There are very few Hybrid REITs in the market today. One possible reason for the limited use of Hybrid REITs may be the difficult challenge of monitoring and balancing the performances of an Equity and Mortgage REIT in one succinct operation. Another reason Mortgage REITs have fallen out of favor with commercial lenders is because commercial lenders are able to offer their clients more tailored and flexible lending alternatives than ever before.

1. *Differences Between Private REITs and Public REITs*

Investors are able to purchase REITs through either private ownership or trade on a public stock exchange.[31] Publicly traded REITs, which are also primarily Equity REITs, comprise over $475 billion of the $487 billion in total assets of the United States REIT industry.[32] Over 200 public REITs are traded on the S&P REIT Index, Morgan Stanley REIT Index, and the Dow Jones/ Wilshire REIT Index.[33] Public Equity REITs provide investors the benefit of

---

23. *Id.*; Orbringer, *supra* note 20.

24. Orbringer, *supra* note 20.

25. *Frequently Asked Questions About REITs*, *supra* note 15.

26. Obringer, *supra* note 20.

27. *Id.*

28. *Id.* ("Mortgage REITs are considered a good speculative investment if interest rates are expected to drop.").

29. LYNN ET AL., *supra* note 1, at 1042.

30. *Id.*

31. National Association of Real Estate Investment Trusts, *Characteristics of Publicly Traded REITs, Non-Exchange Traded REITs and Private REITs*, http://www.investinreits.com/waystoinvest/comparison.pdf (last visited Nov. 28, 2007).

32. *The REIT Story: Dividends & Diversification*, *supra* note 3.

33. Craig L. Israelson & Elicia Hansen, *The REIT Stuff*, FINANCIAL PLANNING MAGAZINE, Oct., 2006, at 129 ("The three major REIT indexes are the Morgan Stanley REIT Index, the S&P REIT Index, and the Dow Jones/Wilshire REIT Index.").

liquidity because investors are able to buy and sell shares on an open exchange with no further obligations.[34]

Private REITs make up close to $6 billion dollars of the United States REIT industry.[35] Today, there are about 800 private REITs in the United States that raise capital from various sources including individuals, trusts, or other entities.[36] Private REITs have fewer regulations than public REITs because they are not required to meet the additional Securities and Exchange Commission regulations that public REITs are required to meet on a regular basis.[37] Furthermore, if a private REIT ever goes public the original investors of the private REIT stand to gain additional value. This is due to the fact that original investors usually have a great deal of capital already tied up in the real estate portfolio and are in a unique position to set the share price and grant themselves shares in anticipation of their REIT going public.[38]

B. ORIGINAL PURPOSE OF REITS

The original congressional purpose behind the adoption of REIT legislation was to provide average investors, with limited financial resources, access to invest in large-scale commercial and residential real estate projects.[39] Congress intended to accomplish this objective by achieving two goals.[40] First, Congress created pooling arrangements which encouraged average investors to participate in a "professionally managed and diversified portfolio of real estate investments."[41] Second, Congress made REITs a passive real estate investment vehicle with corporate tax advantages passing only to investors who substantially limit real estate activities for the properties held within the REIT.[42] To further understand the rationale behind Congress's goals it is important to examine each of these two goals separately.

First, Congress adopted a method of investment consisting of pooling arrangements to provide small investors access to the large-scale real estate mar-

---

34. Obringer, *supra* note 20 ("Because they're traded on an exchange each day, publicly traded REITs are simple for investors to buy or sell and offer great liquidity.").

35. Liz Skinner, *Global REITs Gain Traction Among Investors; Global-REIT Market Pegged at $608 Billion*, INVESTMENT NEWS, Nov. 6, 2006, at 57 ("Last year, about $5.8 billion was invested in private REITs in the United States.").

36. Obringer, *supra* note 20.

37. *Id.* ("Private REITs generally are subject to less regulation, with the exception of guidelines associated with maintaining REIT status.").

38. Skinner, *supra* note 35 (". . . private REITs allow investors to get in at the ground level, aggregate real estate assets and receive value for assembling the portfolio if it goes public . . . .").

39. Pukoff, *supra* note 11.

40. LYNN ET AL. *supra* note 1, at 1024; H.R. Rep. No. 86-2020 (1960).

41. H.R. Conf. Rep. No. 2214, at 8 (1960), reprinted in 1960 U.S.C.C.A.N. 3765, 3769.

42. H.R. Conf. Rep. No. 2214, at 3.

ket.[43] Congress created pooling arrangements, similar to mutual funds, that were expected to provide average investors the advantages traditionally only available to investors with vast financial resources.[44] These advantages include the diversification of investments, professional fund management, and access to large-scale income-producing real estate.[45] Ideally, pooling arrangements allow individuals to contribute capital to a portfolio that is managed by expert investment counsel who take an investor's capital along with the capital from other investors, and invest in various properties in various industries to alleviate risk and provide a steady return. Part III of this Note establishes a criterion to further evaluate the risk and return of a REIT investment.

Second, Congress adopted a passive investment vehicle to ensure that participating investors were not exploiting the REIT arrangement solely to take advantage of its tax benefit.[46] Congress created strict ownership requirements which permitted REITs to only own real estate, and not operate or manage it. These requirements protected shareholders from the risks associated with active business and protected shareholders from other shareholders actively managing the portfolio for their best interest.[47] These strict operational requirements protected shareholders by allowing them to invest in a REIT only if they gave up control of their capital and real estate once it was in the professionally managed REIT arrangement.[48]

Initially, the strict requirements implemented by Congress made it so difficult for investors to participate in the REIT market that this market played a limited role in real estate investment.[49] It was not until Congress made several amendments to the structure of this investment vehicle that the popularity of REITs began to grow and investors began to see them as both an income-producing value investment and a long-term growth investment. By relaxing the require-

---

43. *Id.*; Pukoff, *supra* note 11 ("Congress decided that the only way for investors to invest in large-scale commercial properties was through pooling arrangements, in which small investors pool their capital and share in the benefits of real estate ownership.").

44. H.R. Conf. Rep., *supra* note 42.

45. *Id.* (noting Congress specifically stated that it wanted to provide the average investor the advantages of "spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.").

46. *Id.* (noting Congress stated, "[t]his bill restricts the 'pass through' of the income for tax purposes to what is clearly passive income from real estate investments, as contrasted to income from active operations of businesses involving real estate. . ." and that "any real estate trust engaging in active business operations should continue to be subject to the corporate tax in the same manner as is true in the case of similar operations carried on by other comparable enterprises.").

47. David Einhorn, *Unintended Advantage: Equity REITs v. Taxable Real Estate Companies*, 51 TAX LAW. 203, 204 (1998).

48. *Id.*

49. Pukoff, *supra* note 11 ("REITs played a limited role in real estate investment until the 1990s. In the early years, REITs were constrained, because they were only permitted to own real estate and not to operate or manage it.").

ments to create a REIT and giving investors more flexibility to operate them, they have become a much more attractive investment vehicle.

1. *Historical Legislative Development of REITs*

The United States REIT market has experienced many ups and downs since its introduction into the economy.[50] The first couple of years following the introduction of REITs into the United States stock market was marked by slow growth in terms of assets, earnings, and appreciation with total assets of the entire industry equaling a mere one billion dollars[51] by 1968.[52] During this time, REITs were only allowed to own real estate because Congress believed active management would undermine the goal of creating a passive investment vehicle.[53] Despite this constraint, this market grew rapidly between the years of 1968 and 1974 as a result of a housing boom.[54]

By the mid-1970s industry assets reached record levels of over twenty billion dollars.[55] This period of growth ended as a result of rising interest rates, over-building, and a disastrous recession which caused several REITs to suffer devastating losses and even go bankrupt.[56] This bleak period in the REIT market assuredly led many investors to lose faith in REIT investments and caused total assets of the REIT industry to shrink to about seven billion dollars.[57] Total assets in the REIT market remained at or around seven billion dollars between the years of 1976 and 1983.[58]

By the mid-1980s the declining performance of REITs forced Congress to make sweeping revisions to streamline REIT operations, eliminate certain drawbacks, and open up investment opportunities.[59] Congress passed revisions that had a two-fold effect on the REIT industry.[60] First, Congress eliminated tax shelter-oriented real estate partnerships. This caused several investors to change their perception for investing in REITs from the purpose of receiving a tax benefit to the purpose of gaining a profit.[61] Second, the Tax Reform Act of 1986 permitted REITs to not only own, but also operate and manage most types

---

50. Toone, *supra* note 10, at 348.

51. Samuel H. Williamson, *Five Ways to Compute the Relative Value of a U.S. Dollar Amount, 1790-2005*, MEASURINGWORTH, http://www.measuringworth.com/calculators/compare/result.php (last visited Nov. 28, 2007) (noting $1 billion 1978 dollars is equal to $5.6 billion 2005 dollars).

52. LYNN ET AL., *supra* note 1, at 1040.

53. Pukoff, *supra* note 11.

54. LYNN ET AL., *supra* note 1, at 1040.

55. *Id.*

56. *Id.* at 1040, 1040-A, 1041.

57. *Id.* at 1041.

58. *Id.*

59. LYNN ET AL., *supra* note 1, at 1040.

60. *Id.*

61. *Id.* at 1030 ("Prior to the 1986 Act, many taxpayers invested in real estate primarily for tax reasons; through real estate investments, taxpayers were able to 'shelter' unrelated income . . . the 1986 Act virtually eliminated this type of real estate tax shelter.").

of income-producing commercial properties.[62] This drastic change allowed the operators of REITs more direct control to actively manage their properties and provide their tenants the services of both operation and management.[63]

As a result of Congress's changes, the REIT market grew at a fast rate from the mid-1980s into the next decade. These changes paved the way for the strong position the REIT index holds in the present domestic market and has ultimately changed the way investors use REITs. One of the main driving forces behind the rise in REITs has been Congress's decision to allow them to be internally managed.[64] By eliminating tax shelters and allowing REITs to take a more active role in the operations and management of the REIT property, Congress made REITs a more attractive investment vehicle to investors. More specifically, investors looking for both a short-term or long-term investment opportunity with a strong earning potential could now look to REITs as a more viable investment option.

II. REIT STRUCTURE: REQUIREMENTS FOR QUALIFICATIONS

On top of the legislative changes Congress made to the operation of REITs, they also relaxed many of the strict requirements of forming a REIT, to help make REITs a less complicated and more attractive investment opportunity. Congress's actions helped transform investors' perception of REITs from a simple tax advantage with long-term growth potential to a profitable short-term and long-term value investment. Entities can qualify for REIT status only if they meet strict organizational qualifications, source of income requirements, nature of assets requirements, and distribution of income requirements, on an annual basis.[65]

This section explains Congress's role in relaxing the requirements to form REITs. In order to examine the actions Congress took in relaxing the requirements to form a REIT this section will proceed in several steps. First, it will establish the organizational structure necessary to form a REIT and examine the legally controversial issues associated with this requirement. Second, it will introduce the income source requirements necessary to form a REIT and explain the purposes behind its tests. Third, this section demonstrates the nature of assets requirements and how Congress has categorized the various assets that qualify under this test. Fourth and finally, it will examine the distribution requirements and what steps investors should take to meet these qualifications.

---

62. Pukoff, *supra* note 11.

63. *Id.* at 534.

64. *Id.* at 349 ("During the mid-1980s, Congress altered the REIT landscape and sparked industry growth by enacting legislation that discontinued tax shelter-oriented real estate partnerships. . ." and allowing REITs to become "self-advised. . .active operators of their properties" rather than externally managed "passive owners of real estate.").

65. LYNN ET AL., *supra* note 1, at 1024.

A. ORGANIZATIONAL STRUCTURE REQUIREMENTS

The organizational requirements are set forth in Section 856(a) of the Internal Revenue Code of 1986 (the "Code").[66] In order for a REIT to satisfy the organizational requirement it must: first, be managed by one or more trustee(s) or director(s) for the entire taxable year; second, have beneficial ownership evidenced by transferable shares; third, be classified as a domestic corporation; fourth, not be a financial institution or insurance company; fifth, be beneficially owned by 100 or more persons; and sixth, not have five or fewer persons owning more than fifty percent of the entity.[67] These rigid requirements were designed by Congress to ensure small investors access to the real estate market by prohibiting REITs to be held in the hands of a few wealthy individuals or corporations.[68]

The most legally controversial and troubling organizational requirements for investors are the 100 person beneficial ownership requirement and the five persons/fifty percent requirement.[69] In order to give investors flexibility in meeting the 100 person beneficial ownership requirement, Congress allows them to use some discretion in interpreting the provision.[70] Although the term "persons" is not defined under the 100 person beneficial ownership provision, courts have adopted the definition of "persons" from the Investment Company Act of 1940 to give the same meaning of "persons" under the 100 person beneficial ownership test.[71] Therefore, under the REIT statute, "persons" means a natural person or company, including corporations.[72] Congress provided additional flexibility in meeting the 100 person test when it required REITs to be owned by 100 or more persons for only 335 days of a 12 month tax year, instead of the full year.[73] Furthermore, if investors want to form a REIT within the tax year, Congress will allow it as long as the number of days the REIT has 100 or more

---

66. *Id.* at 2012.

67. *See* I.R.C. § 856(a).

68. Chadwick M. Cornell, Comment, *REITs and UPREITs: Pushing the Corporate Envelope*, 145 U. PA. L. REV. 1565, 1571 (1997).

69. *Id.*

70. Charles E. Wern III, Comment, *The Stapled REIT on Ice: Congress' 1998 Freeze of the Grandfather Exception for Stapled REITs*, 28 CAP. U. L. REV. 717, 723 (2000).

71. *See* UNB Inv. Co. Inc. v. Director, Div. of Taxation, 21 N.J. Tax 354, 367-368 (N.J. Tax. Ct. 2005) ("The term "person" is not expressly defined in I.R.C. § 856, which, at subsection (c)(5)(F), provides that all terms not defined by I.R.C. § 856 shall have the same meaning as when used in the Investment Company Act of 1940, as amended (15 U.S.C.S. § 80a-1 et seq.). I.R.C. § 856(c)(5)(F). Section 2(a)(28) of the Investment Company Act provides that "person" means a natural person or company, 15 U.S.C.S. § 80a-2(a)(28), and Section 2(a)(8) of the same act provides that "company" means, among other things, a corporation. 15 U.S.C.S. § 80a-2(a)(8).").

72. *Id.*

73. I.R.C. § 856(b); Pukoff *supra* note 11, at 532 (noting in order to meet this qualification for a tax year of fewer than 12 months, the proposed REIT must be owned by 100 or more persons for at least 335/365ths of the time. For example, if a REIT is formed for a taxable period of 73 days, it must be owned by 100 or more persons for at least 67 days because 67 equals 335/365ths of 73.).

shareholders is greater than a 335/365 ratio of the total number of days the REIT was formed.[74]

Along with establishing looser standards for the 100 person test, Congress also adopted flexible requirements to make the five person/fifty percent ownership test easier for investors to attain. Congress did this by requiring that a REIT not have five or fewer persons owning more than fifty percent of the entity during the last half of each tax year, with the exception of the first tax year the REIT is formed.[75] To meet this requirement and protect investors from dissolution many REITs try to limit shareholder ownership to 9.9 percent of a REIT's stock.[76] If a shareholder would like more than that amount he or she would have to get a waiver approved by the REIT's board of directors.[77]

B. INCOME SOURCE REQUIREMENTS

In addition to meeting the various organizational requirements, an entity wishing to elect REIT status must satisfy three different income tests.[78] These requirements are designed to ensure REITs are used as vehicles for passive investment.[79] Congress accomplished this goal by disqualifying income derived from quickly turning over property and only counting income sources that are closely related to real estate activities included under the income source test.[80] The Code requires that less than 75 percent of a REITs' gross income be derived from: 1) rents from real property, 2) interest on obligations secured by real property, 3) gain from the sale of interests in real property, other than property held for sale in ordinary course of a trade or business, 4) dividends and gains from a REIT, and 5) other limited sources.[81] The 75 percent test ensures that the bulk of income from a REIT is derived from real estate assets.[82]

Defining the term "rents from real property" has been one of the most legally controversial challenges in fulfilling the income source requirements. Although the Code does not provide an all-encompassing definition of the term, it does offer guidance on how to interpret it by stating that "rent from real property" includes: "(i) rents from interests in real property, (ii) charges for services customarily furnished or rendered in connection with rental or real property, and

---

74. *Id.*

75. Pukoff, *supra* note 11, at 533.

76. *See* Pacific Realty Trust v. APC Invest., Inc., 651 P.2d 163, 165 (Or. Ct. App. 1982) (noting trustees of REIT were afraid of not meeting the five person/fifty percent ownership test, so they passed a by-law limiting the amount of shares a person may own to 9.8 percent of the total outstanding shares.); National Association of Real Estate Investment Trusts, *Forming and Operating a Real Estate Investment Trust*, http://www.investinreits.com/learn/formingareit.cfm#1 (last visited Nov. 28, 2007).

77. *Forming and Operating a Real Estate Investment Trust*, *supra* note 75.

78. LYNN ET AL., *supra* note 1, at 2032.

79. *Id.* at 2033-34.

80. Wern III, *supra* note 69.

81. *See* I.R.C. § 856 (c)(3).

82. LYNN ET AL., *supra* note 1, at 2035.

(iii) rents attributable to incidental personal property."[83] Usually, the Internal Revenue Service (IRS) has taken an expansive view of what fits under the definition of "rents from real property."[84] This has provided investors added flexibility in qualifying some transactions under this term in order to ensure the 75 percent income requirement.[85]

The IRS has helped to clarify Congress's intent on how to define "rents from real property" in several Private Letter Rulings. In Private Letter Ruling 9740032 (July 8, 1997) the IRS declared that in order for payments to qualify as "rents from real property," there must be a landlord-tenant relationship between the REIT and the party from which it collects payments.[86] However, once that relationship is established, the types of payments that qualify as "rents from real property" vary a great deal. For example, both the fair rental value of property that a tenant refuses to vacate at lease end, and attorney fees and costs as a result of a defaulted tenant, have counted as "rents from real property."[87]

In addition to the 75 percent income test, the Code requires a 95 percent and 30 percent income source test. First, at least 95 percent of a REIT's gross income must be derived from: 1) sources described in the seventy-five percent test, 2) dividends or interest from any source, and 3) gain from the disposition or sale of stock or securities.[88] The 95 percent income source test enforces Congress's intent that REITs operate as a passive investment vehicle that provides investors with limited resources the ability to access the real estate market.[89]

Lastly, the Code requires that less than 30 percent of the gross income of a REIT in a given taxable year be derived from sale or other disposition of any of the following types of assets: 1) stock or securities held under a year, 2) other property, if the sale or disposition of such property constitutes a prohibited transaction, and 3) real property held for less than a year, excluding foreclosure property. The 30 percent test is intended to stop REITs from acting as dealers in real estate assets by limiting the amount of property sales they can make in a year.[90] This requirement reduces an investor's ability to quickly buy and sell property, and provides the REIT more stability in its structure.

---

83. *See*, I.R.C. § 856(d).

84. LYNN ET AL., *supra* note 1, at 2047.

85. *Id.*

86. *See* I.R.S. Priv. Ltr. Rul. 9740032 (July 8, 1997) (IRS viewed agreement between tax-exempt lessee and lessor to be a license instead of a landlord-tenant relationship because the "lessee" merely had permission to place and maintain advertisements on wall space, and not entitled to possession of the actual premises.); *See also* PETER M. FASS ET AL., REAL ESTATE INVESTMENT TRUSTS HANDBOOK § 4.04[4][a][ii][A] (2002 ed., West Group 2001).

87. I.R.S. Priv. Ltr. Rul. 9308013 (Nov. 24, 1992).

88. *See* I.R.C. § 856(c)(2); Pukoff, *supra* note 11, at 533.

89. LYNN ET AL., *supra* note 1, at 2034.

90. *See* I.R.C. § 856(c)(3) (2007); LYNN ET AL, *supra* note 1, at 2036.

C. NATURE OF ASSET REQUIREMENTS

An entity wishing to qualify a REIT must also satisfy two nature-of-asset requirements. First, the 75 percent asset test was created to ensure that a REIT's assets are comprised primarily of real estate investments.[91] Second, an asset diversification requirement was created to ensure that all of the REIT's non-real estate assets are diversely invested and therefore less sensitive to fluctuations in the market.[92] In order to further understand the legal ramifications of both of these tests each of them are examined separately.

First, in order to form a REIT Congress requires that at least 75 percent of the value of a REIT's total assets are held in the form of "real estate assets", "cash and cash items", and "government securities" quarterly for each qualifying year.[93] In order to perform the 75 percent test, a REIT must recalculate the value of all its assets at the end of each quarter that property was acquired within.[94] If a REIT fails the asset test it is disqualified unless the failure is due solely to changes in REIT asset value. If a REIT fails the asset test due to an acquisition of assets it cannot be disqualified if it corrects the problem within 30 days of the close of the relevant quarter.[95]

Similar to the income source requirement, the most legally troublesome area of this requirement is the ambiguous definition of "real estate assets." In general, "real estate assets" include real property, mortgages on real property, and shares in other qualified REITs.[96] Furthermore, in interpreting the "interest in real property" source, the IRS has again adopted an expansive liberal approach which provides investors more flexibility in meeting this requirement.[97] The IRS approach to interpret "interest in real property" has resulted in investors including several skeptical asset sources to meet the 75 percent requirement, including stock in a housing cooperative and ownership of a manufactured home.[98]

Second, Congress allows no more than 25 percent of the value of a REIT's assets to be invested in non-REIT securities.[99] The purpose behind this test is to provide diversification of non-real estate investment assets such as cash, cash items, or government securities.[100] Due to the broad language given this provi-

---

91. LYNN ET AL., *supra* note 1, at 2021.

92. *Id.*

93. H. R. REP. NO. 86-2020, at 6 (1960); LYNN ET AL., *supra* note 1, at 2021.

94. Pukoff, *supra* note 11, at 533 ("To perform the 75% test, the REIT must revalue its assets at the end of any quarter during which property was acquired. A revaluation of assets is not required at the end of any quarter during which there has been no acquisition of property . . . .").

95. Pukoff, *supra* note 11, at 534.

96. LYNN ET AL., *supra* note 1, at 2022.

97. *Id.*

98. *Id.*

99. H. R. REP. NO. 86-2020, at 6 (1960); LYNN, ET AL., *supra* note 1, at 2028.

100. LYNN ET AL., *supra* note 1, at 2028.

sion, the IRS has had to clarify, on numerous occasions, what items fall under the definition of "cash items."[101] The IRS has ruled that "cash items" include items such as demand deposits, withdrawal accounts, and certificate of deposits issued in large denominations with maturities of one year or less.[102] Two items which have not been included under the definition of "cash items" are banker's acceptances and repurchase agreements.[103]

Additionally, Congress requires that securities of a single issuer not comprise more than five percent of the REIT's total assets, or more than ten percent of the outstanding voting stock of the single non-REIT issuer.[104] The diversification asset test pushes investors to distribute their non-real estate assets among balanced and diverse portfolios. The end result of such an arrangement is an investment portfolio which is not as susceptible to economic fluctuations in the market.

D. DISTRIBUTION REQUIREMENTS

Finally, REITs are required to distribute a percentage of their income to shareholders. These strict distribution requirements must be met in order to ensure that REITs operate as pass-through entities that provide a steady stream of dividends to shareholders.[105] The most significant distribution requirement that Congress implemented was that at least 95 percent of a REIT's annual taxable income be distributed to shareholders as dividends.[106] If the REIT meets this requirement it is allowed to deduct the amount as dividend-paid deductions and avoid double taxation.[107]

III. EVALUATING THE USE OF REITS FOR DIFFERING FINANCIAL OBJECTIVES

Based on the significant growth of REITs in the past decade, and the numerous advantages that they provide investors, the technical constraints discussed in Part I and II have helped to make REITs a success in the United States economy. Due in large part to the legislative changes in the requirements to form and operate a REIT, investing in the REIT industry remains a popular way individuals and corporations have been able to hold a diversified portfolio of real estate assets.[108] The ability of investors to use the REIT industry to accomplish several financial objects has been one factor that has helped add to the REIT industry's increasing popularity.

---

101. *See* FASS ET AL., *supra* note 85, at § 4.05[1][a].
102. Rev. Rul. 77-199, 1977-1 C.B. 195.
103. Rev. Rul. 72-171, 1972-1 C.B. 208; Rev. Rul. 77-59, 1977-1 C.B. 196.
104. I.R.C. § 856 (c)(5)(B).
105. Wern III, *supra* note 69, at 724.
106. *Id.*
107. *Id.*
108. Pukoff, *supra* note 11.

The purpose of this section of the Note is to establish a criterion for evaluating the usefulness of REITs for investors with different financial objectives. This section will proceed in four steps. First, the different financial planning objectives REITs are able to satisfy will be examined. Second, this section will introduce and describe a top-down analysis to evaluating REITs. Third, it will explain how to perform a bottom-up analysis by evaluating a REIT's past performance and potential earnings. Fourth and finally, this section will examine how investors could use REIT investments to diversify their overall investment portfolios. The final three steps of the REIT analysis could be completed in any particular order. At the conclusion of this section, a potential REIT investor will be able to determine how to invest in a REIT for different financial objectives.

A. DETERMINING FINANCIAL PLANNING OBJECTIVES

Investors can utilize the REIT market to fulfill a myriad of goals and financial objectives. Before investing in a REIT an investor must determine his or her financial planning objectives. Due to the relaxed requirements adopted by Congress, REITs provide investors a powerful investment vehicle to fulfill both short-term value and long-term growth objectives. Once an investor's financial goals are set he or she could follow the three-step evaluation process to determine if a REIT investment is right for him or her. Before this section continues with the evaluation process, it will examine how REITs are able to fulfill various investment objectives.

Investors can utilize REITs to satisfy short-term value goals, long-term growth goals, and for the purpose of diversifying investment portfolios.[109] A REIT is able to meet short-term goals because they are liquid investment that could be bought and sold during dips or rises in the market.[110] If an investor is able to take advantage of a booming REIT sector which yields rising REIT prices, he or she can exploit the market by buying low and selling high. A REIT provides investors the opportunity to achieve long-term growth goals by providing investors ongoing dividend income with the potential for long-term capital gains through share price appreciation.[111] Finally, investors can utilize REITs for the purpose of diversifying their real estate investment portfolio. Typically, REITs lower risk and raise returns for investors because they are

---

109. Obringer, *supra* note 20 ("REITs can provide both current income and long-term appreciation.").

110. *Frequently Asked Questions About REITs*, *supra* note 15 ("... shares of publicly traded REITs are readily converted into cash because they are traded on the major stock exchanges.").

111. *Id.* ("REITs are total return investments. They typically provide high dividends plus the potential for moderate, long-term capital appreciation.").

professionally managed by real estate professionals, and are invested in several properties, rather than a single building.[112]

B. TOP-DOWN ANALYSIS

Once investors determine their financial objective for investing in a REIT they can proceed to the first step in the evaluation process: a top-down analysis. From a top-down perspective REITs can be affected by a number of economic factors including the supply and demand of property, population, job growth, interest rates, and capital market conditions.[113] Usually, when construction builds up a real estate market more rapidly than consumer demand, there is an oversupply of real estate which usually results in increasing vacancy rates, decreasing rental prices, and declining property values which all negatively affect a REIT's net asset value.[114] Usually, in a strong economy, increased "growth in employment, capital investment, and household spending," results in an increased "demand for new office buildings, apartments, industrial facilities, and retail stores."[115]

There are several economic factors which have a two-fold effect on the REIT index. For example, population growth typically increases the demand for apartments resulting in a surge in the purchase of apartment REITs by investors.[116] However, in a market with an already oversaturated supply of apartment building the increase in population may not have as strong an effect in the apartment sector. Typically, rising interest rates, as a result of an improving economy, tend to be good for the REIT index because it usually means people are spending and businesses are renting more spaces.[117] However, rising interest rates as a result of high inflation may have a negative affect on REIT investments because while the rate at which the general level of prices for property is rising, purchasing power to buy that property is falling.[118] Furthermore, lower interest rates could actually be beneficial to REITs, because REIT managers can

---

112. *Id.*

113. David Harper, *What Are REITs?*, INVESTOPEDIA, http://www.investopedia.com/articles/04/030304.asp (last visited Nov. 28, 2007) ("From a top-down perspective, REITs can be affected by anything that impacts the supply of and demand for property. Population and job growth tend to be favorable for all REIT types. Interest rates are, in brief, a mixed bag.").

114. *Frequently Asked Questions About REITs*, *supra* note 15 ("REIT investors often compare current stock prices to the net asset value (NAV) of a company's assets. NAV is the per share measure of the market value of a company's net assets.").

115. *Id.*

116. *Id.*

117. Harper, *supra* note 112 ("A rise in interest rates usually signifies an improving economy, which is good for REITs as people are spending and businesses are renting more space. Rising interest rates tend to be good for apartment REITs as people prefer to remain renters rather than purchase new homes.").

118. *Inflation*, INVESTOPEDIA, http://www.investopedia.com/terms/i/inflation.asp (last visited Nov. 28, 2007).

refinance mortgages to reduce their interest expense and increase their profitability as a result.[119]

When completing the top-down analysis it is important to take into account that the economy is not always equally as strong in all geographical regions.[120] Therefore, it is imperative for REIT investors to examine the real estate portfolios of potential REIT investments to determine whether the properties' geographical locations and diversified holdings pose an increased risk that is not worth pursuing.[121] Furthermore, economic growth may not increase the demand for all property types at the same time. Therefore, it important to follow the level of positive economic activity for particular sectors of the REIT industry and to make investment decisions based on what sectors are performing well.[122] The performance of individual real estate sectors in a changing economy are further examined in Part IV.

C. BOTTOM-UP ANALYSIS

Once investors complete the top-down analysis they could move on to the next step in the evaluation process: a bottom-up evaluation. Investors may choose to complete the bottom-up analysis first. From a bottom-up perspective investors should analyze the business fundamentals of individual REITs including growth in revenue, past performance, business strategies, debt-to-equity ratio, and management make-up.[123] Carefully examining these factors will provide investors a better opportunity to determine which particular REIT to invest in to achieve either short-term value or long-term growth. The growth in the earning potential of REITs comes from several sources, including lower costs to do business and new business opportunities.[124] However, the most significant way for a REIT to raise revenue is to increase rent or maintain high rates of building occupancy.[125]

When examining a REIT with low occupancy rates in their buildings, it is imperative that investors look to management and determine if there is a unique strategy in place for improving occupancy rates or raising rents.[126] Some examples of unique management strategies to improve occupancy rates and raise rents are upgrading building facilities, enhancing building services, and more effectively marketing properties to new types of tenants.[127] If a REIT cannot improve occupancy rates or raise rents, it may be forced into acquisition in

119. Harper, *supra* note 112.
120. *Id.*
121. *Id.*
122. Harper, *supra* note 112; Obringer, *supra* note 20.
123. *Frequently Asked Questions About REITs*, *supra* note 15.
124. *Id.*
125. *Id.*
126. Harper, *supra* note 112.
127. *Id.*

order to fuel growth.[128] In the face of low occupancy rates and rent levels, acquisitions may be seen as very risky because the return from the acquisition must outweigh the cost of financing in order for the acquisition to be successful.[129] REIT managers may not want to tie up more capital in a faltering investment portfolio, preferring perhaps to wait and determine if their properties' occupancy rates will improve with time.

Another important factor to examine when performing the bottom-up analysis is the make-up and structure of a REIT's upper-level management. Usually, an investor can determine a REIT's long-term or short-term strategy by looking at how management and trustees are compensated.[130] If management compensation is based on asset values, management is likely to concentrate on investing in additional properties for long-term growth appreciation.[131] If management compensation is based on dividends or current earnings, the managers have much more of a reason to increase current dividend payments, possibly at the expense of long-term growth.[132]

D. DIVERSIFICATION AND BALANCING ANALYSIS

Once the top-down and bottom-up evaluations are complete, investors should examine how different REIT investments would affect the overall diversification and balancing of their portfolios. Investors looking to diversify their investment portfolios are attracted to several unique characteristics of the REIT industry. A study by Ibbotson Associates, a leading authority on asset allocation, found that REITs provide investors "competitive rates of return, stable levels of risk, and low correlation with the investment returns of other stocks and bonds."[133] These investment characteristics demonstrate that REITs offer a strong and stable source of portfolio diversification.[134] In the past decade alone, in both a booming and faltering housing market, REITs on average have provided investors profitable returns.[135]

Investors are attracted to REITs for several other diversification characteristics. For example, REITs offer investors a high level of current income in the

---

128. *Id.*

129. *Id.* ("Property acquisition and development programs also create growth opportunities, provided the economic returns from these investments exceed the cost of financing.").

130. Harper, *supra* note 112.

131. Obringer, *supra* note 20 ("If compensation is based on the value of the REIT's assets, management is usually concentrating on investing in additional properties for capital appreciation.").

132. *Id.* ("If the basis for determining compensation includes dividends or current earnings, the REIT's management may be motivated to increase dividend yield, possibly at the expense of long-term appreciation.").

133. *Frequently Asked Questions About REITs*, *supra* note 15.

134. *Id.*

135. Syre, *supra* note 7.

form of dividend payments.[136] They also offer investors the opportunity to gain moderate long-term growth in the form of stock appreciation.[137] Furthermore, investors are attracted to the liquidity of public REITs, which can be purchased on the open market, without a required minimum purchase.[138] Finally, investors are choosing to own REITs because they are professionally managed and invested in a diverse portfolio of real estate assets rather than a single property.[139] This factor allows investors to take advantage of the expert advice of real estate professionals and secure a liquid diversified investment that is not as susceptible to economic woes.

IV. PERFORMANCE OF REITS IN A CHANGING ECONOMY

The current success of the REIT index in a faltering housing economy and a period of rising interest rates has many critics confused and mystified.[140] Applying the top-down analysis established in Part III of this Note, it would seem that a weak housing market would result in weaker returns for REITs. However, as previously stated, it is very important to examine specific trends in REIT sectors and be aware of the geographical differences in the real estate market. These factors are often overlooked by investors, but should be given considerable weight in the process of selecting a REIT. The proper analysis of these factors has helped REIT investors successfully achieve their financial goals in the REIT market during an ever-changing economy.

The purpose of this section of the Note is to further examine the evaluation process set up in Part III, and determine how this process will lead to success in REIT investing in the midst of a declining housing market. In the process of examining the criterion established, most specifically the sector and geographical elements discussed in the top-down analysis, this section offers an explanation of the current success of the REIT market. In order to examine the current success of the REIT industry this section will first introduce and examine the different phases of the real estate cycle and each of their effects on REIT investment. Second, it will discuss the importance of examining local economic conditions before investing in a REIT. Third and finally, this section will look to different sectors of the REIT industry and determine if there is a correlation between positive national and local economic conditions and the success of the REIT market in particular sectors.

---

136. *Frequently Asked Questions About REITs*, *supra* note 15 ("Investors typically are attracted to REITs for their high levels of current income and the opportunity for moderate long-term growth.").

137. *Id.* ("Investors typically are attracted to REITs for their high levels of current income and the opportunity for moderate long-term growth.").

138. *Id.* ("Listed REIT shares may be purchased on the open market, with no minimum purchase required.").

139. *Id.*

140. Syre, *supra* note 7.

A. NATIONAL ECONOMIC CONDITIONS

Practically all investors are affected by changing economic conditions to some degree. REIT investors are no different. Nationally, the real estate market fluctuates, as both prices and profits move in and out of cycles which vary in length and severity.[141] Long-term REIT investors may choose to buy and hold REITs as REIT properties move through the various cycles.[142] Short-term REIT investors may want to plan REIT investments in anticipation of a cycle or try to cash in and exploit the success of an individual property sector.[143] Nevertheless, for both short-term and long-term REIT investors, understanding the real estate cycle provides a significant advantage when it comes time to buy or sell a REIT.

There are four phases of the real estate cycle: depression, recovery, boom, and downturn.[144] Depressions are usually accompanied with high vacancy rates, low rent prices, low real estate prices, and very little new construction.[145] Many properties, especially ones that are highly leveraged, are repossessed or foreclosed during a depression.[146] Generally, depressions are followed by a recovery phase. During the recovery phase the economy begins to gradually improve as occupancy rates begin to rise, and rent and property prices stabilize and begin to increase.[147] Although new construction may still be very limited, the increase in housing prices offers a good sign for future construction projects.[148]

The boom phase usually follows the gradual recovery phase. During the boom phase previously vacant rentals become fully occupied, and property owners often have the opportunity to raise rent prices.[149] High occupancy and rising rent prices provide property owners excellent returns.[150] The boom phase results in property prices rising to the point that developers begin new construction projects.[151] During the boom phase, new construction projects are much easier to pursue because both investors and lenders are confident with the mar-

---

141. Jerry Jones, *Investing REITs Through Real Estate Cycles*, BUYINCOMEPROPERTIES, Sept. 18, 2005, http://www.buyincomeproperties.com/artman/publish/Investing_REITs_through_real_estate_cycles.shtml (last visited Nov. 28, 2007).

142. *Id.* ("If you're a long-term conservative REIT investor, you might choose to buy and hold your REITs even as their properties move through their inevitable ups and downs.").

143. *Id.* ("If you consider yourself more of a short-term market timer, you will want to plan your REIT investments either in accordance with a general real estate cycle or with the cycle of an individual property sector.").

144. Jones, *supra* note 140.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.* ("After a while, most vacant space has been absorbed, allowing property owners to boost rents rapidly. With high occupancy and rising rents, landlords are getting excellent returns.").

150. *Id.*

151. *Id.*

ket, and are therefore more open to taking risks and better able to find financing.[152] Eventually, the boom phase turns into a downturn due to rapidly rising property prices and overbuilding.[153] During this phase vacancy rates rise, and rent prices once again begin to decline.[154] An economic recession may begin to set in, and depending upon the severity of overbuilding, an economic depression may result.[155]

B. LOCAL ECONOMIC CONDITIONS

Besides paying close attention to real estate cycles across the country, it is also important to take into account the local economic conditions where the properties of a REIT are invested. Therefore, along with analyzing the real estate market nationally, it is just as important to analyze local economic conditions. As an investor analyzes the local economic conditions it is important to determine whether the economic conditions are favorable for a positive return on investment. This analysis is very important with some experts even arguing that real estate cycles are tied closer to the conditions of the local economy, than to the conditions of the national economy.[156] Regardless of what the experts say, an investor must make themselves aware of the local economic conditions, which can be further demonstrated by the example below.

Within the past decade, Syracuse, located in Central New York, has suffered from a depressed local economy. Employers have been moving south or overseas for a variety of reasons, including lower costs to do business and less stringent government regulations. As a result of more businesses moving out of Central New York, than moving in, there has been a population decline in the area which many assuredly link to job losses. Generally, this decline has led to an increase in the number of vacant households and lower occupancy rates for residential and commercial properties in the Syracuse area.

Going along with this example, there are several effects of a Syracuse-based company, such as Carrier Corporation, moving its manufacturing plant from Syracuse to a city in a southern state. Generally, upon the announcement of the move from Carrier the entire local economy around the southern city will pick up. Moreover, business opportunities open up for the local residents as job opportunities become plentiful. Individuals with families may decide to migrate to that city to find meaningful work. Typically, in this situation, the positive economic growth in the southern city will result in an increase in the local

---

152. Jones, *supra* note 140. ("Developers start flexing their muscles. Investors and lenders feel that they must join the party and provide all the necessary financing.").

153. *Id.*

154. *Id.*

155. *Id.* ("Eventually, this downturn phase may turn into a depression phase, depending upon the severity of overbuilding or the economic recession now the cycle is complete and begins anew.").

156. *Id.* ("Commercial real estate is tied closely not only to the national economy, but also to the local economy.").

demand for housing. Unfortunately, for those living in Central New York the opposite has occurred and there is a higher supply of housing than there is a demand, resulting in an unfavorable market to invest in.

C. SECTOR ANALYSIS

Investors can spend their money in nearly any kind of real estate imaginable including apartment buildings, shopping centers, offices, industrial properties, hotels, self-storage facilities, hospitals, and golf courses to name a few.[157] While investors cannot always rely on disciplined real estate professionals to control the real estate cycles, one aspect they can always count on is facing some cyclicality in the sector they are invested in.[158] Even in periods of economic decline, some sectors within the REIT industry tend to perform better than others. By understanding how and why certain REIT sectors perform in a changing economy, investors will be better able to tailor their REIT investments to achieve their financial goals. Below, this section examines two REIT industries and points out characteristics which influence the performance of these industries in the market.

Shopping mall REITs are one of the most stable real estate investments during a changing economy.[159] First and most important, shopping mall leases usually expire in periods of seven to ten years.[160] As a result, these REITs are less susceptible to declining economic conditions because they have their tenants locked in for a lengthy period of time. These REIT owners should receive a constant income regardless of economic prosperity or decline, unless their tenants default on rent. Longer lease lengths provide shopping mall REITs much steadier rent and occupancy rates than office or apartment REITs.[161] Because office and apartment REITs typically offer shorter lease terms than shopping mall REITs they are more prone to feel the effects of a lack of consumer confidence or rising interest rates.[162]

Despite the success of shopping mall REITs, it is important to realize that several of the REIT sectors are beginning to finally "catch up" to the performance of shopping mall REITs.[163] For example, apartment REITs have per-

---

157. Jones, *supra* note 140. (You can invest your money in nearly any kind of real estate imaginable: apartment buildings, manufactured-home communities, malls, neighborhood shopping centers, outlet centers, offices, industrial properties, hotels, self-storage facilities, hospitals, golf courses-even prisons.); *Frequently Asked Questions About REITs*, *supra* note 15 ("A REIT is a company that owns, and in most cases, operates income-producing real estate such as apartments, shopping centers, offices, hotels and warehouses.").

158. Ryan Chittum, *Mall REITs' Winning Streak Cools; Office, Apartment Sectors Are Hot Now, and Spending By Consumers Is A Concern*, WALL ST. J., Sept. 6, 2006, at B11.

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

163. Chittum, *supra* note 157.

formed extremely well in the current weak single-family housing market.[164] Investment experts believe there is a stronger demand for apartment rentals in a declining single-family housing market.[165] Thus, when these current conditions present themselves again, REIT investors may decide to purchase apartment REITs with the hopes that the higher demand for apartments will result in higher returns. As a result of the current housing market, the increased demand in apartment rentals due to the declining single-family housing market has drastically benefited the apartment REIT sector.[166]

V. CONCLUSION

REITs are an attractive investment vehicle because they offer investors the ability to pursue both long-term growth and short-term value investments. Both of these uses of the REIT arrangement would not be possible if it were not for Congress's decision to change many of the strict REIT requirements. These legislative developments have increased the popularity of REITs and have allowed investors to utilize this investment arrangement to fulfill various financial objectives.

When choosing a REIT, investors must first determine their financial objectives and then follow three steps. First, investors must perform a top-down analysis to get a better perspective of the national economy. Second, investors must perform a bottom-up analysis to examine individual REITs and determine if they have a strong managerial and business structure. Finally, investors must look at their overall financial portfolio and determine how a REIT investment would make it better.

After completing the three step analysis it is important to examine the local economic conditions where the properties of a REIT are invested and look for trends in individual REIT industries. When examining local economic conditions, an investor should try to determine how the current economic conditions will affect his or her investment goals. When examining trends in individual REIT industries, an investor should try to anticipate growth and stock appreciation in particular industries and determine how specific trends will affect his or her short-term or long-term investment goals. Following all of these steps will guide investors down the right path to achieve success in investing in the REIT market.

---

164. Bary, *supra* note 4.

165. *Id.*

166. H. Lee Murphy, *REIT Stocks Defy Expectations*, CRAIN'S CHICAGO BUSINESS, Jul. 7, 2005, *available at* http://vnweb.hwwilsonweb.com/hww/results_single_fulltext.jhtml (last visited Nov. 28, 2007).

A More Level Playing Field: *Permanent Mission of India to the United Nations v. City of New York*, 127 S. Ct. 2352 (2007)

ANTHONY H. RAPA

INTRODUCTION

In *Permanent Mission of India to the United Nations v. City of New York,* the Supreme Court granted certiorari to clarify whether or not the Foreign Sovereign Immunities Act of 1976[1] ("FSIA" or the "Act") provides for federal jurisdiction over the diplomatic mission of a foreign sovereign that refuses to pay property taxes. . . . Relying on the text and legislative history of the FSIA, the Court held that the general provision of immunity codified in the FSIA did not apply to property tax liens, as they amounted to an "interest in immovable property." More importantly, *Permanent Mission of India* provided the Supreme Court with an opportunity to declare a new era in diplomatic relations, one where the foreign sovereign has to play on the same field as everyone else.

I. BACKGROUND

Historically, the U.S. provided the diplomatic missions of foreign sovereigns within its jurisdiction with absolute immunity from suit or liability.[2] This doctrine was first laid out by the Supreme Court in *The Schooner Exchange v. McFaddon*,[3] where Chief Justice Marshall based the Court's decision on the "perfect equality and absolute independence of sovereigns" and "common interest impelling them to mutual intercourse."[4] Although immunity served to foster the use of diplomatic channels as a means of dispute resolution, it also left domestic actors with no legal recourse against foreign sovereigns that failed to honor American laws.[5]

The longstanding principle of absolute immunity was repealed fifty-six years ago when the State Department embraced a less comprehensive view of sovereign immunity.[6] Under this new doctrine of restrictive immunity, foreign sover-

---

1. 28 U.S.C. § 1330(a) (1976).
2. Permanent Mission of India, 127 S. Ct. at 23546.
3. 11 U.S.116 (1812).
4. Andrew C. Udin, Comment, *Slaying Goliath: The Extraterritorial Application of U.S. Antitrust Law to OPEC*, 50 AM. U. L. REV. 1321, 1348.
5. *See id.* (finding in favor of a foreign sovereign's immunity without distinguishing between "public" or "private" acts).
6. Letter from Jack B. Tate, Acting Legal Adviser, U.S. Dept. of State, to Phillip B. Perlman, Acting U.S. Attorney General (May 19, 1952) (reprinted in Alfred Dunhill of London, Inc. v. Republic of Cuba, 425 U.S. 682, 711(1976)).

eigns were still immune from suits related to their public acts (*jure imperii*), but not their private ones (*jure gestionis*).[7] In 1976, Congress passed the FSIA, which codified the restrictive theory of sovereign immunity and made the judiciary the arbiter of foreign immunity.[8]

Today, the FSIA remains the sole means of obtaining jurisdiction over a foreign sovereign.[9] Under the Act, foreign governments are presumptively immune from suit or liability in American courts unless one of seven exceptions applies to the case or controversy.[10] Seeing how the FSIA is concerned exclusively with procedural law, it functions as something of an international long-arm statute that was not intended by its drafters to serve as an affirmative defense to the merits of an action.[11]

II. FACTS

Like many other nations, the Republic of India and the People's Republic of Mongolia maintain diplomatic missions in New York City. The Indian Mission to the United Nations is housed in a twenty-six story building located at 235 East 43rd Street. Owned by the Indian government,[12] the building was designed by Indian architect Charles Correa and is made of red granite and aluminum, emulating the red sandstone architecture of northern India.[13] Approximately twenty of the building's floors contain residential units for diplomatic employees and their families.[14]

Similarly, the Ministry for Foreign Affairs of the People's Republic of Mongolia is housed in a smaller six-story building located at 6 East 77th Street, adjacent to Central Park.[15] Owned by the Mongolian government,[16] several floors of the building are used to house low level employees of the Ministry and their families.[17] None of the resident-employees at either facility held a rank

---

7. *Id.*

8. *See* Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 612 (1992); Asociacion de Reclamantes v. United Mexican States, 735 F. 2d 1517 (Scalia, Circuit Justice, D.C. Cir. 1984) (citing Id. at 137).

9. Argentine Republic v. Amerada Hess Shipping Corp., 488 U.S. 428 (1989).

10. *Permanent Mission of India*, 127 S. Ct. at 2355 (citing 28 U.S.C.S. § 1604 (LexisNexis 2008); Saudi Arabia v. Nelson, 507 U.S. 349, 355 (1993)).

11. Scott A. Rosenberg, Note, *The Theory of Protective Jurisdiction*, 57 N.Y.U.L. REV 933, 1004 (1982).

12. *Permanent Mission of India*, 127 S. Ct. at 2354.

13. Susanna Sirefman, *New York – A Guide to Recent Architecture*, *available at* http://www.galinsky.com/buildings/indiamission/index.htm (last visited Mar. 23, 2008).

14. *Permanent Mission of India*, 127 S. Ct. at 2354.

15. Permanent Mission of Mong. to the United Nations, http://www.un.int/mongolia/emb.htm (last visited Mar. 23, 2008).

16. *Permanent Mission of India*, 127 S. Ct. at 2354.

17. *Id.*

higher or equal to that of ambassador, and all were citizens of their respective countries.

New York City municipal law exempts real property from taxation if it is owned by a foreign government and used exclusively for diplomatic offices or as an ambassador's quarters.[18] For several years, the City of New York ("City" or "Respondent") levied property taxes against the two Missions for the portions of their buildings used to house lower level Ministry employees. However, the Indian and Mongolian governments refused to pay.[19] As of February 1, 2003, the Indian Mission owed the City roughly $16.4 million in unpaid property taxes, and the Mongolian Ministry owed roughly $2.1 million.[20] By operation of City law, the unpaid taxes eventually converted into tax liens held by the City against the two properties.

III. PROCEDURAL HISTORY

On April 2, 2003, the City brought suit against the Indian Mission and the Mongolian Ministry ("Petitioners"), seeking declaratory judgments establishing the validity of their unpaid tax liens.[21] Pursuant to federal law, Petitioners removed their case to federal court and argued that they were immune from the suit under the FSIA.[22]

The City's position was that the Petitioners were not immune because the tax liens implicated one of the Act's seven exceptions.[23] The City argued that the "immovable property" exception to the FSIA not only covers the physical property owned by the sovereigns, but also additional rights in real property, including the tax liens at issue.[24] The District Court agreed with the City.[25] On appeal, the Second Circuit unanimously affirmed the decision of the District Court,[26] and the Supreme Court granted certiorari.

IV. MAJORITY OPINION

The majority agreed with the courts below and held that the FSIA did not immunize the foreign sovereigns from the City's lawsuit to establish the valid-

---

18. *Permanent Mission of India*, 127 S. Ct. at 2354 (citing N.Y. Real Prop. Tax Law Ann. § 418 (McKinney 2000)).

19. *Id.*

20. *Id.*

21. *Id.* at 2355.

22. *Id.*

23. *Id.* at 2356.

24. *Id.*

25. City of New York v. Permanent Mission of India to the United Nations, 376 F. Supp. 2d 429 (S.D.N.Y. 2005).

26. City of New York v. Permanent Mission of India to the United Nations, 446 F. 3d 365 (2d Cir. 2006).

ity of its tax liens.[27] Authored by Justice Thomas and joined by Chief Justice Roberts, Justices Scalia, Kennedy, Souter, Ginsberg, and Alito, the majority held that a tax lien inhibits one of the "quintessential rights of property ownership" - the right to convey one's property - and therefore, implicates rights in immovable property.[28]

In first section of its two-part decision, the majority subjected the Act to a straightforward textualist interpretation. Noting that the statute did not explicitly mention tax liens, the Court then scrutinized the individual words of the immovable property exception in order to ascertain what they meant to the FSIA's authors in 1976.[29] This analysis led the Court to believe that the FSIA's authors understood a valid lien creates in its holder a nonpossessory interest in the immovable property of another.[30] Because this nonpossessory interest is enforceable against subsequent purchasers of the land, the majority reasoned that a property lien has an "immediate adverse effect upon the amount which [could be] receive[d] on sale", thereby constituting a direct interference with the property.[31]

In the second part of the opinion, the majority supported its textualist interpretation by examining two "well-recognized" purposes of the FSIA: the adoption of the restrictive theory of sovereign immunity and the codification of international law at the time of the FSIA's enactment.[32] After noting that the restrictive theory of sovereign immunity had become the world-wide norm in 1976,[33] the majority went on to examine the state of international law at the time of the FSIA's enactment. Citing the most current version of the Restatement of Foreign Relations Law available to the FSIA's authors, the Court concluded that immunity was never intended to encompass "an action to obtain possession of or establish a property interest in immovable property located in the territory of the state exercising jurisdiction."[34]

Both the Petitioners and the City also looked to the Vienna Convention[35] to support their pre-FSIA views on the scope of sovereign immunity.[36] The Peti-

---

27. *Permanent Mission of India*, 127 S. Ct. at 2354.

28. *Id.* at 2356.

29. *Id.* (citing Black's Law Dictionary 1072 (4th ed. 1951)).

30. *Id.* (citing United States v. Security Industrial Bank, 459 U.S. 70, 76 (1982)).

31. *Id.* (citing 5 RESTATEMENT OF PROP. § 540 (1944) "a lien has an immediate adverse effect upon the amount which [could be] receive[d] on a sale, . . . constitut[ing] a direct interference with the property . . . ." Republic of Arg. v. N.Y., 25 N.Y. 2d 252, 262 (1969)).

32. *Permanent Mission of India*, 127 S. Ct. at 2356.

33. *Id.* (citing the Tate Letter, *supra* note 6).

34. *Id.* at 2357 (citing RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE U.S. § 68(b), (1965)) (A foreign sovereign's immunity does not extend to cover actions intended to acquire a property interest in immovable property).

35. Vienna Convention on Diplomatic Relations and Optional Protocol on Disputes, 23 U.S. T. 3227 (1972).

36. *Permanent Mission of India*, 127 S. Ct. at 2356.

tioners argued that "real action[s]" do not include actions for performance of obligations "'deriving from ownership or possession of immovable property" and that property here is held "'on behalf of the sending State for purposes of the Mission."[37] However, the majority (relying on a United Kingdom decision rejecting tax immunity for diplomatic staff housing) disagreed with the petitioners' contentions, and held that the Vienna Convention did not unambiguously support either party.[38] Accordingly, the Court held that the City could go forth with its suit to establish the validity of the unpaid tax liens and remanded the case.[39]

V. DISSENT

The dissent in *Permanent Mission of India* disagreed with the majority's broad interpretation of the immovable property exception, and argued that the FSIA was not meant to provide jurisdiction for suits to establish a foreign sovereign's tax liability.[40] Authored by Justice Stevens and joined by Justice Breyer, the dissent acknowledged that the majority's literal interpretation of the immovable property exception did provide a basis for applying the exception to the case at hand. However, the dissent relied on the "breadth and age" of the Act's general immunity provision and stated that the FSIA's drafters did not intend to "abrogate sovereign immunity in suits over property interests whose primary function is to provide a remedy against delinquent taxpayers."[41]

Along these lines, the dissent opined that a broad reading of the FSIA's immunity principle, and a narrow reading of the exceptions to that principle, was more in line with Congressional intent.[42] Relying on the *amicus curiae* brief of the U.S. Solicitor General as "persuasive authority," the dissent concluded that a tax dispute between a local municipality and a foreign sovereign nation was outside the scope of Congress' intent when it drafted the FSIA.[43]

Finally, the dissent reasoned that by interpreting the FSIA's general immunity provision narrowly, the majority placed sovereign immunity on a slippery slope that would one day lead to the "exception . . . swallowing the rule."[44] The dissent noted that under New York City law, liens are available for any number of civil controversies and may be attached to real property in order to compel a property owner to take action.[45] Justice Stevens wrote that any number of eve-

---

37. *Id.* at 2357.
38. *Id.*
39. *Id* at 2354.
40. *Id.*
41. *Id.* at 2358.
42. *Id.*
43. *Id.* (citing Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944)).
44. *Permanent Mission of India*, 127 S. Ct. at 2358.
45. *Id.* (citing NEW YORK CITY ADMIN. CODE §§ 17-145, 17-147, 17-151(b) (2000); M. Mitzner, *Liens and Encumbrances, in Real Estate Titles* 299, 311-314 (J. Pedowitz ed. 1984).

ryday civil disputes, such as slip-and-falls or landlord-tenant disputes, could then be converted into property liens and used "to pierce a foreign sovereign's traditional and statutory immunity" from suit in American courts.[46]

VI. ANALYSIS

As the FSIA is the sole means of obtaining jurisdiction over a foreign sovereign in the United States, the majority's narrow interpretation of the act's general principal ensures that American citizens, businesses, and municipalities can hold foreign nations accountable for their actions as domestic property owners without having to resort to formal diplomatic channels. Consequently, this decision will no doubt have far reaching implications for foreign sovereign nations that own land in the United States, diplomatic relations, and foreign sovereign immunity.

It is worth noting that the Court's decision may indeed take foreign sovereign immunity in a direction that the FSIA's authors never intended. Above all their other objections, the dissent was clearly more concerned with comity within the international system than anything else. Instead of allowing municipalities and states to compel the payment through judicial actions, the dissent preferred that disputes between sovereign powers be solved by the federal government acting through longstanding diplomatic channels.[47] By allowing domestic courts to exercise jurisdiction over these suits, thereby placing the burden on the foreign sovereign to bear the cost of defending their position, the Court may have cost the U.S. a great deal of money as some foreign powers may feel obligated to respond in kind with likeminded suits in their own courts.

Interestingly enough, this was also the position of the U.S. Solicitor General, which the Court's conservative majority chose to ignore. Although *Permanent Mission of India* was far from a controversial 5-4 decision, one cannot escape the irony that two of the Court's more liberal members came to the defense of the Executive Branch in calling for a political, rather than a judicial solution to the issue. However, in citing the Tate Letter, the majority might argue that it did in fact defer to the judgment of the Executive Branch, albeit one from half a century ago.[48] Nevertheless, by noting that many types of liens may be attached to real property, Justice Stevens, perhaps prophetically, envisioned a world were the FSIA's exceptions would swallow the general rule of immunity codified in the Act. Although this is perhaps an overstatement, foreign sovereigns would in fact bear the burden of defending themselves against suits related to their ownership of property in the U.S.[49]

---

46. *Id.*
47. *Permanent Mission of India*, 127 S. Ct. at 2358.
48. Letter from Jack B. Tate, *supra* note 6.
49. *Permanent Mission of India*, 127 S. Ct. at 2358.

Assuming that the dissent is right, perhaps we should ask ourselves if this even matters. As the majority pointed out, land ownership is not an inherently sovereign function.[50] Nowhere in its decision does the majority suggest that sovereigns be held liable for their public (*jure imperii*) acts in American courts. Indeed, such a conclusion is not even possible under the majority's interpretation if one recalls that their central holding was that the FSIA was a codification of a restrictive, but not altogether *destructive*, theory of sovereign immunity.

It is important to remember, as the majority did, that in passing the FSIA, Congress made the judiciary arbiter of foreign immunity.[51] The Court didn't miss the dissent's point by grounding their decision on a textualist interpretation of various real property terms as opposed to international law and concerns of political comity. Instead, the majority's opinion seems to say that when a foreign sovereign buys an "interest in immovable property" in an American city, it is no longer acting within its "public" capacity. Why then, is that sovereign any different than a foreign individual or corporation that owns real property in an American city?

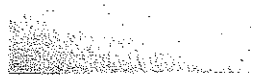
CONCLUSION

By holding that the Indian and Mongolian missions were not immune from the City's suit, the majority's decision in *Permanent Mission of India* appears to signal the end of the era in which consent functioned as the only effective means to acquire jurisdiction over a foreign sovereign that fails to live up to its obligations as a landowner. In today's world, where people and commerce cross international boundaries with ever increasing speed, justice must keep pace. Instead of piercing the sovereign's "traditional" immunity, the majority's decision in *Permanent Mission of India* simply denies foreign sovereigns a right and a privilege they were never intended to possess.

---

50. *Id.* at 2357 (citing *Schooner Exchange*, 11 U.S. at 116 ("A prince, by acquiring private property in a foreign country, may possibly be considered as subjecting that property to the territorial jurisdiction, he may be considered as so far laying down the prince, and assuming the character of a private individual").

51. *See* Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 612 (1992); Asociacion de Reclamantes v. United Mexican States, 735 F. 2d 1517 (Scalia, Circuit Justice, D.C. Cir. 1984) (citing *Id.* at 137).



Balancing Punitive Damages and Due Process: *Philip Morris USA v. Williams*, 127 S. Ct 1057 (2007)

MYRIAM CLERGE

INTRODUCTION

Punitive damages in tort cases serve the same purpose as incarceration in criminal proceedings.[1] Both are designed to deter or reform the defendant from pursuing actions that have caused the alleged harm to the victim and are awarded when compensatory damages are deemed inadequate by the trier of fact.[2] However, quantifying relief and adequate damages remain a debatable issue. Statistical studies by the U.S. Department of Justice found that only two to six percent of civil cases that go to trial are awarded punitive damages, but the size and frequency of damages have increased.[3]

In an attempt to regulate the size of punitive awards, the Supreme Court has declared grossly excessive punitive damages a violation of due process.[4] In *BMW of North America, Inc. v. Gore*[5], the Court ruled that punitive damages must be reasonable and proportional to the reprehensible conduct.[6] In *State Farm Mutual Automobile Insurance Company v. Campbell*[7], the Court held that "few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."[8] Hence, punitive amounts exceeding nine times compensatory damages are more likely excessive.

The question posed in *Philip Morris USA v. Williams* is: how should juries consider harm to others when determining punitive damages? This inquiry leads to another question: what is fair punishment for public harm caused or threatened by well-heeled firms?

---

1. *See* State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 417 (2003) (stating that punitive damages awards "serve the same purposes as criminal penalties").

2. WEST'S ENCYCLOPEDIA OF AMERICA LAW (Gale Group ed., 1998).

3. Steven Ross Johnson, *How Deep Can Juries Dig into a Deep Pocket*, MEDILL NEWS, Aug. 27, 2006, *available at* http://docket.medill.northwestern.edu/archives/003820.php.

4. BMW of N. Am. v. Gore, 517 U.S. 559, 562 (1996) (citing TXO Prod. Corp. v. Alliance Resources Corp., 509 U.S. 443, 454 (1993)).

5. 517 U.S. 559 (1996).

6. *BMW*, 517 U.S. at 597 (stating that lack of proportionality between the size of the award and the underlying punitive damages objectives shows that the award falls into the category of "gross excessiveness"); *Id.* at 581 (explaining there must be "a reasonable relationship between the punitive damages award and *the harm likely to result* from the defendant's conduct").

7. 538 U.S. 408 (2003).

8. *State Farm*, 538 U.S. at 425.

I. FACTS OF *PHILIP MORRIS USA V. WILLIAMS*

In *Philip Morris USA v. Williams*, Plaintiff-Respondent Mayola Williams, widow and Personal Representative of the Estate of Jesse D. Williams, raised a wrongful death suit against Philip Morris Incorporated, the domestic tobacco subsidiary corporation of Philip Morris Companies, Inc.[9] Jesse D. Williams was a 67-year old retired school custodian and father of six who died of lung cancer in 1997 after smoking Marlboro cigarettes for 47 years.[10] Williams took up cigarettes in the 1950s while serving in the Army in Korea.[11] His smoking progressed to three packs a day until his death.[12]

II. PROCEDURAL HISTORY

The Oregon trial jury found that Philip Morris knowingly and falsely led Williams to believe cigarettes were safe and that his death was caused by significant smoking of the defendant's Marlboro cigarettes.[13] As a result, the jury found Philip Morris guilty of negligence.[14] Moreover, the jury concluded that Philip Morris had engaged in deceit and awarded the Williams' estate $821,000 in compensatory damages and $79.5 million in punitive damages.[15] The trial judge ultimately found the damage awards excessive and reduced the respective amounts to $521,485.50 and $32 million.[16]

Both sides appealed the judgment.[17] The Oregon Court of Appeals reversed and reinstated the jury's award of $79.5 million.[18] The State Supreme Court affirmed the appellate court's decision, rejecting the defendant's argument that the roughly 100-to-1 ratio of the award was "grossly excessive".[19] Philip Morris then sought review from the United States Supreme Court, where the judgment of the Oregon Court of Appeals was vacated and remanded to reconsider punitive damages in light of *State Farm Auto. Ins. v. Campbell.*[20]

Upon remand, the Oregon Court of Appeals upheld its original decision.[21] Philip Morris again sought review from the Oregon Supreme Court.[22] Follow-

---

9. Philip Morris USA v. Williams, 127 S. Ct. 1057, 1061 (2007).
10. Swanson Thomas & Coon, *Personal Injury Law*, *available at* http://www.stc-law.com/piwilliams.html.
11. *Supreme Court to Review Philip Morris Case*, BOSTON, May 30, 2006, *available at* http://www.boston.com/business/articles/2006/05/30/supreme_court_to_review_philip_morris_case/.
12. *Id.*
13. *Williams*, 127 S. Ct. at 1061.
14. *Id.*
15. *Id.*
16. *Id.* at 1061.
17. *Id.*
18. *Id.*
19. *Williams*, 127 S. Ct. at 1061.
20. *Id.*
21. *Id.*
22. *Id.* at 1062.

ing the standards set forth in the Court's decision in *BMW North America, Inc. v. Gore,* the State Supreme Court held Philip Morris' reprehensible conduct harmed not just Williams but countless others, and again upheld the jury's punitive damage award.[23] Philip Morris appealed to the United States Supreme Court, which granted certiorari on the issue.[24]

III. SUPREME COURT'S REASONING

Although Philip Morris raised two issues, (1) whether punitive damages could be imposed for harm to non-party victims and (2) whether the Oregon award reasonably related to the plaintiff's harm, the Court limited its holding to the first issue.[25] In a 5-4 decision, written by Justice Breyer, the Court held the Constitution's Due Process Clause forbids a court to punish a defendant for injury inflicted to non-parties.[26] The Court reached its decision by concentrating its argument on the fundamental due process right to fair notice and the functionality of punitive damages.

Unifying its arguments, the Court briefly reasoned that assessing damages for injured nonparty victims "would add a near standardless dimension to the punitive damages equation."[27] Juries would be left to speculate the number of victims and the severity of their injury; affixing uncertain and arbitrary awards that deprive a defendant of fair notice.[28] The Court conceded it made clear in precedent cases that punitive damages may be properly imposed to further a legitimate State interest to punish and deter unlawful conduct, so long as the State provides an adequate punitive damages system that avoids the denial of fair notice and arbitrary punishment.[29] Concisely, the Court concluded that the Constitution's Due Process Clause imparts defendants with proper fair notice of the severity of the penalty that a State may impose.[30]

Next, Justice Breyer argues that no authority exists to support the imposition of punitive damage awards on tortfeasors for harming others.[31] The Due Process Clause prohibits a state from punishing an individual without giving that individual an opportunity to present all defenses.[32] By allowing the jury to award damages to non-party Oregonians for injury caused by Philip Morris' conduct, the Court argues that the defendant was barred from presenting evi-

23. *Id.*
24. *Id.*
25. *Williams*, 127 S. Ct. at 1062.
26. *Id.* at 1060.
27. *Id.* at 1063.
28. *Id.*
29. *Id.* at 1062.
30. *Id.*
31. *Williams*, 127 S. Ct. at 1063.
32. *Id.* (citing Lindsey v. Normet, 405 U.S. 56, 66 (1972)).

dence that strangers to the litigation were not entitled to damages.[33] Furthermore, Justice Breyer acknowledged that the Oregon Supreme Court correctly asserted that the Court had not previously and explicitly held that a jury may not punish the defendant for harm to others.[34] However, the Court held that it would do so in this case.[35]

Finally, although the Court accepted Williams' contention that harm to other parties could be considered in order to demonstrate reprehensibility, it distinguished between consideration for the purpose of calculating damages - which the Court now forbids - and consideration for the purpose of assessing reprehensible conduct - which the Court now permits.[36] Justice Breyer's argument asserts that some reprehensible conduct poses a risk to a few and others to the general public, therefore the jury should be instructed to consider harm to others under the "rubric of reprehensibility" and not the "punishment calculus."[37] Additionally, States should implement procedures to avoid unnecessary and unreasonable risk of jury confusion.[38]

Since the Court found a procedural violation of due process, it did not discuss the substantive issue of excessiveness of the claim since its remand may require a new damage award or a new trial.[39] In dictum, the Court reiterated that as a matter of substantive due process, punitive damages must be evaluated under the guidepost set forth in *BMW of North America, Inc. v. Gore*: "(1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases."[40] Following up, the Court re-emphasized its holding in *State Farm Auto. Mut. Auto. Ins. v. Campbell*, that excessiveness more likely exists where the ratio exceeds single digits.[41]

IV. ANALYSIS

While the majority accepts that punitive awards are quasi-criminal sanctions, they offer no proof of why it should be adjudged differently. Justice Breyer's opinion appears to lay the foundation for the same argument it purports to

33. *Id.* at 1063.
34. *Id.* at 1065.
35. *Id.*
36. *Id.* at 1064.
37. *Williams*, 127 S. Ct. at 1064-65.
38. *Id.* at 1065.
39. *Id.*
40. *Id.* at 1061 (citing *BMW*, 517 U.S. at 575-585 (1996).
41. *Id.* (noting that "[s]ingle-digit multipliers are more likely to comport with due process." (quoting *State Farm*, 538 U.S. at 425)).

avoid.[42] The Court previously acknowledged that the dual purpose of punitive damages awards - retribution and deterrence - are intended to impose criminal sanction for particularly egregious conduct.[43] Correspondingly, Justice Breyer illustrates that an additional penalty may be imposed on criminal defendants for other misconduct, stiffening the punishment for the latest offense because it is a repetitive one.[44] This analogy suggests that other conduct may be considered when calculating punishment. However, Justice Breyer then argues that increasing an award in a civil offense is not the same as imposing a larger imprisonment term for a criminal offense.

On the contrary, there is little difference between either type of sanction.[45] In either context, criminal or civil, direct harm to third parties is not the appropriate measurement - as nonparties may bring lawsuits of their own - instead the jury may consider actual or threatened harm to the public. Since the early eighteenth century, punitive damages have served as a "public remedy" by imposing civil fines or penalties.[46] In *Williams*, the award was payable to the state, thus supporting the dissent's argument that the relevant factor was that no particular third party was considered in measuring the award but the state's interest to punish and deter the defendant's socially reprehensible conduct that placed public safety in jeopardy.[47] Hence, the majority's argument supports the dissenting opinion and yet contradicts itself without justification.

V. IMPLICATIONS

This case could significantly confuse the State's implementation of punitive damages. *Philip Morris* sets a new standard which States are obligated to implement but fails to offer states a procedure or guideline to follow.[48] The Court's model follows that juries may punish for reprehensible conduct and that harm to others may be properly assessed to measure reprehensibility, but that consideration must be withheld when assessing punishment.[49] The question left unanswered by the Court is just how should States structure and implement a procedure which assures that juries are seeking to determine reprehensibility

---

42. *Id.* at 1066.

43. *Williams*, 127 S. Ct at 1066 (Stevens, J., dissenting) (noting that "a punitive damage award, instead of serving a compensatory purpose, serves the entirely different purposes of retribution and deterrence that underlie every criminal sanction." (quoting State Farm, 538 U.S. at 416)).

44. *Williams*, 127, S. Ct. at 1065.

45. *Williams*, 127 S. Ct. at 1066 (Stevens, J., dissenting); *see also* Cooper Indus. v. Leatherman Tool Group, 532 U.S. 424, 432 (2001)).

46. Kimberly A. Pace, *Recalibrating the Scales of Justice Through National Punitive Damage Reform*, 46 AM. U. L. REV. 1573, 1579 (1997).

47. *Williams*, 127 S. Ct. at 1066, n. 1, (Stevens, J., dissenting).

48. *Williams*, 127 S. Ct. at 1064.

49. *Id.*

and not punishing for harm to third parties. This creates a practical problem for states, juries and reviewing courts.

It seems irrational to instruct juries to partially ignore the very element used to measure punitive awards. Harm to others is a necessary factor in determining the reprehensibility of a defendant's conduct; and reprehensibility is unquestionably an important factor in assessing punitive damages. Each element ties into the next; it is only natural that juries will consider harm to others when calculating damages. The majority makes an illusory attempt to separate the interrelated factors. In essence, the new model will create the jury confusion the Court intended to avoid.

Furthermore, the Court declares that federal constitutional law obligates states to implement procedures that provide some protection against the risk of jury confusion.[50] The majority, although giving deference to the states, insists that courts exclude certain evidence and information that would result in juries asking the wrong question - "seeking, not simply to determine reprehensibility, but also to punish for harm caused strangers."[51] However, because it is impossible to separate the implied link between harm to others and punitive damages, it is almost impossible to review how the jury made its decision, thus creating a dilemma for state and reviewing courts. The courts cannot probe into the minds of each juror to gauge their thinking.

Philip Morris was decided very recently, on February 20, 2007, therefore very few cases cite to it. In *Palmer v. Asarco Inc.*, the defendant issued a Motion for Judgment on the Pleading claiming the Oklahoma punitive damages statute was facially unconstitutional under *Philip Morris*.[52] The U.S. District Court for the Northern District of Oklahoma held that *Philip Morris* explicitly gave state legislatures a chance to amend their punitive damages statutes before courts considered the constitutionality of the statute.[53] The U.S District Court in *Metzger v. Am. Fid. Assur. Co.*, followed suit.[54] Hence, the reach of the Supreme Court's holding is not yet evident but its holding will inevitably lead to future substantive due process challenges to large punitive damage awards. At any rate, courts will continue applying the *State Farm* single-digit ratio even though the Court claims it is not a bright-line rule.[55]

---

50. *Id.* at 1065.

51. *Id.* at 1064.

52. Palmer v. Asarco Inc., No. 03-CV-0498-CVE-PJC, 2007 U.S. Dist. LEXIS 13948 , at *6 (N. Okla. Feb. 27, 2007).

53. *Id.* at *8.

54. Metzger v. Am. Fid. Assur. Co., No. CIV-05-1387-M, *2007 U.S. Dist. LEXIS 78703, at *5(W.D. Okla.* Oct. 23, 2007) (The Supreme Court in *Philip Morris* gave state legislatures a chance to amend their punitive damages statutes "before states consider[ed] the constitutionality of state punitive damages statutes"(quoting *Palmer*, 2007 U.S. Dist. LEXIS 13948, at *2)).

55. *State Farm*, 538 U.S. at 425.

VI. FUTURE OF THE SINGLE DIGIT RATIO

Expressly declining to address the substantive limitation of punitive damages awards, the Supreme Court left the determination of excessiveness under the standards devised by the *BMW* and *State Farm* Court.[56] Since the 18th century, punitive damages awards have been apportioned in civil cases, but only recently have the frequency and size become an issue.[57] With the expansion and growth of industries particularly during the 20th century, corporate misconduct has also cultivated. Punitive damage awards were imposed more fervently to curb and deter business transgressions.[58] However, the escalated awards have become a topic for tort reform.[59]

Prior to *Philip Morris*, the Court issued two opinions setting the guideposts for determining whether punitive awards are unconstitutionally excessive. In *BMW North America, Inc. v. Gore*, for the first time, the Court invalidated a state court's award of punitive damages as a violation of due process.[60] Here, the jury awarded Gore $4,000 in compensatory damages and $4 million in punitive damages.[61] The Court overturned the award and set a three point test for a lower court's determination of excessiveness: "(1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases."[62]

The *BMW* decision however, resulted in inconsistent judgments as courts struggled to apply its method. In 2003, *State Farm Mutual Automobile Insurance Co. v. Campbell* announced the single-digit ratio guidepost.[63] In this case, a Utah jury awarded Campbell $1 million as compensatory damages and $145 million as punitive damages.[64] The Court reversed the judgment and declared, in dicta, that "few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."[65] Unfortunately, the single-digit benchmark failed to clarify *BMW*.[66]

---

56. *Williams*, 127 S. Ct. at 1063.

57. American Tort Reform Association, *Punitive Damages Reform*, *available at* http://www.atra.org/show/7343.

58. *See* Pace, *supra* note 46 at 1575 (quoting O'Connor, J.).

59. *Supra* note 57.

60. *BMW*, 517 U.S. at 568.

61. *Id.* at 565.

62. *Id.* at 574-75.

63. *State Farm*, 538 U.S. at 425.

64. *Id.* at 412.

65. *Id.* at 425.

66. *See* Steven L. Chanenson & John Y. Gotanda, *The Foggy Road for Evaluating Punitive Damages: Lifting the Haze from the BMW/State Farm Guideposts*, 37 U. MICH. J. L. REFORM 441, 443 (2004).

Furthermore, the test overlooked the economic reality that wealthy companies view potential tort actions as a cost of doing business.[67] For instance, cigarette manufacturing is a billion dollar industry that sells addictive, poisonous agents to millions.[68] Punitive damages would be one of the dominant factors when accounting the financial position of corporations in this industry, like Philip Morris, and other similarly situated companies that pose harm to the public. Therefore, as long as the benefits outweigh the cost, companies might not be deterred by insubstantial awards.[69] Under the *State Farm* test, awards "can result in punitive awards too meager in size to deter well-heeled prospective tortfeasors from engaging in similar wrongdoing."[70] Thus, the proper measure of punitive damages is the extent the State disproves of the wrongdoer and the financial capacity of those wrongdoers - not a completely objective ratio.

CONCLUSION

Philip Morris obligates states to implement "*some*"[71] procedure instructing the jury how they should assess punitive damages without considering harm to others. However, no guidance was offered to implement its unworkable model. Consequently, until the bewildering standard of *Philip Morris* is implemented in subsequent cases, state courts will review punitive damages awards under the guideposts of *BMW* and the hopelessly objective ratio set by *State Farm*.

---

67. A. Benjamin Spencer, *Due Process and Punitive Damages: The Error of Federal Excessiveness Jurisprudence*, 79 S. CAL. L. REV. 1085, 1101 (2006).

68. David L. Debertin, *Corporate Strategy in the Tobacco Manufacturing Industry: The Case of Philip Morris* 23 REV. OF AGRICULTURAL ECON. 517, 511-523 (2001).

69. *See* Spencer, *supra* note 67.

70. *Id.*

71. *Williams*, 127 S. Ct. at 1065.

The Future of the Dormant Commerce Clause in the Roberts Court: *United Haulers Association, Inc. et al. v. Oneida-Herkimer Solid Waste Management Authority et al.*, 127 S. Ct. 1786 (2007)

CRAIG SWIECKI

INTRODUCTION

One of the most controversial areas of Constitutional Law is the dormant commerce clause.[1] The debate has been very heated when the United States Supreme Court invokes the dormant commerce clause to overturn state and local laws they label as discriminatory or interfering with interstate commerce. Specifically, state and local governments view it as the court interfering with legitimate local concerns. In recent years the dormant commerce clause has played a large role in the areas of waste management and solid waste disposal. Specifically, the case of *C & A Carbone v. Clarkstown,* caused great controversy when the Supreme Court struck down sanitation laws as interfering with interstate commerce.[2] During the last term of the Court this issue re-appeared in the case of *United Haulers Association v. Oneida-Herkimer Solid Waste Management Authority.* A majority of the Court decided in favor of the local governments.[3] They held that the facilities and ordinances in this case were constitutional because they favored a publicly run facility, and not a private one.[4] The decision also created an interesting split on the Court between the Chief Justice in the majority, concurrences by Justices Scalia and Thomas and the dissenting opinion of Justice Alito. The split reveals much on how the Roberts Court views the dormant commerce clause.

I. FACTUAL BACKGROUND AND PROCEDURAL HISTORY

Many counties and municipalities in the United States use "flow control" ordinances to regulate the disposal of solid waste.[5] Flow control ordinances require that all garbage be delivered to a specific processing facility.[6] Localities raise revenue from the solid waste in the form of "tipping fees" which charge

1. Joseph G. Jarret, *Feature Story: Garbage, Garbage Everywhere. . .*, 44 TENN. B.J. 24, 25 (2008).
2. *C & A Carbone Inc. v. Clarkstown,* 511 U.S. 383 (1994).
3. *United Haulers Association v. Oneida-Herkimer Solid Waste Management Authority,* 127 S. Ct. 1786, 1795 (2007).
4. *Id.*
5. *Id.* at 1790.
6. *Id.*

haulers for the disposal of the waste.[7] It is the combination of "flow-control" ordinances and "tipping fees" that have created dormant commerce clause issues. These have become popular as local governments struggled to deal with waste management.

Oneida and Herkimer counties in upstate New York responded to this problem by getting the New York Legislature to create the Oneida-Herkimer Solid Waste Management Authority in 1988.[8] The Authority then contracted with the counties to create a facility for dealing with the area's solid waste.[9] To facilitate the Authority's work the counties passed both "flow-control" ordinances and assessed tipping fees.[10] In short, all private trash haulers were required to bring waste to the government operated processing plant, and pay the assessed fees for disposal.

Private waste haulers have tried to resist these laws in order to make more money by shipping solid waste outside the county.[11] The United Haulers Association filed suit in 1995 in federal court against the Oneida-Herkimer Solid Waste Management Authority and the counties.[12] Their main claim was that the "flow control" ordinances and the tipping fees violated the dormant commerce clause and discriminated against interstate commerce.[13] The Haulers appeared to have strong precedent on their side. In *C & A Carbone, Inc v. City of Clarkstown,* the Supreme Court struck down similar laws that required all solid waste to be processed at a certain local private facility as discriminatory.[14] The interpretation of this case would be the main point of conflict as the case moved through the federal courts.

Initially, the District Court citing *Carbone* ruled for the haulers.[15] The Second Circuit reversed, and distinguished *Carbone* because this was a publicly run facility as opposed to the private facility favored in *Carbone*.[16] The case was remanded to determine if there was a burden on interstate commerce.[17] When the District Court ruled in the county's favor, the United Haulers appealed to the Second Circuit. After the Second Circuit affirmed, in 2006 the U.S. Supreme Court granted certiorari to clarify *Carbone*, and deal with conflicts in other circuits interpreting it.[18]

---

7. *Id.* at 1791.
8. *Id.*
9. *Oneida-Herkimer,* 127 S. Ct. at 1791.
10. *Id.*
11. *Id.* at 1792.
12. *Id.*
13. *Id.*
14. *Carbone,* 511 U.S. at 394.
15. *Oneida-Herkimer,* 127 S. Ct. at 1792.
16. *Id.*
17. *Id.*
18. *Id.*

II. THE MAJORITY AND PLURALITY OPINION OF CHIEF JUSTICE ROBERTS

The main issue before the court was whether the Oneida-Herkimer authority and the accompanying "flow-control" ordinances/tipping fees discriminated against interstate commerce or interfered with it.[19] In order to settle the issue Chief Justice Roberts had to clarify issues stemming from the *Carbone* decision, and his interpretation managed to cause a severe split on the Court. Specifically, the key issue of contention for the Court was the majority carving out a major exception from the *Carbone* holding for publicly run sanitation facilities.[20]

The Chief Justice relied heavily on Justice Souter's dissent in *Carbone*, and his distinction of public and private waste facilities.[21] Souter argued that publicly run processing facilities needed to be treated differently for dormant commerce clause purposes.[22] What caused the issue in the *Oneida-Herkimer* case was that the *Carbone* majority was silent on this point.[23] Chief Justice Roberts gravitated to this silence in his opinion, where he would sharply disagree with the dissenting opinion of Justice Alito.

Chief Justice Roberts found that the Oneida-Herkimer ordinances did not discriminate against interstate commerce because waste management was a traditional local governmental function and the ordinances favored a publicly owned facility.[24] As the Chief Justice wrote, "The flow control ordinances is this case benefit a clearly public facility, while treating all private companies the same."[25] This was different than *Carbone* where government forced all waste into a private processing plant.[26] The Chief Justice then noted several strong policy reasons for this rule. His main reason was that government was responsible for, "protecting the health, safety and welfare of its citizens."[27] This created an exception for a government facility carrying out the traditionally local government function of sanitation. Finally, the Chief Justice cited a fear of court interference with local government, and that the local citizens had a right to decide through their government how to process solid waste.[28] The final part of the opinion is where the rest of Court split from the Chief Justice, and raised several interesting questions for the future of the court on the dormant commerce clause.

---

19. *Id.*
20. *Id.*
21. *Oneida-Herkimer*, 127 S. Ct. at 1792.
22. *Carbone*, 511 U.S. 419-22.
23. *Oneida-Herkimer*, 127 S. Ct. at 1793-94.
24. *Id.* at 1795.
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.* at 1796.

In Part D of the opinion, the Chief Justice continued the dormant commerce clause analysis by applying the *Pike v. Bruce Church Inc.* balancing test. This part of the opinion did not gain a majority of the Court because Justices Scalia and Thomas chose not to join it. The *Pike* test operates by balancing the impact on interstate commerce with the legitimate governmental interest.[29] The Chief Justice found that the Oneida-Herkimer ordinances had a negligible impact on interstate commerce that was greatly outweighed by the public benefit.[30] Chief Justice Roberts even saw these laws as a good way to control solid waste, raise revenue and promote recycling.[31] However, this part of the opinion became a sharp point of disagreement. Specifically, there was split among the majority. Justices Scalia and Thomas agreed on the judgment, but in separate concurrences attacked the whole idea of the dormant commerce clause. Justice Alito disagreed with the majority in total and wrote a vigorous dissent joined by Justices Stevens and Kennedy.

III. JUSTICE SCALIA AND JUSTICE THOMAS CONCURRENCES

Justice Scalia filed a short separate opinion arguing for containing the dormant commerce clause. He argues that the concept is a judicial invasion of state power unjustified by the Constitution.[32] There are only two situations where he would strike down a law. One is a facially discriminatory law, and the other is a law that is very similar to a previously struck down law.[33] Though a short opinion, Scalia shows a textualist split on this issue. Scalia is arguing a position that is a sharp departure from the precedent of the dormant commerce clause. His only reason for joining the judgment appears to be a respect for stare decisis.

In the final paragraph of his concurrence, he breaks with the Chief Justice on the *Pike* Balancing Test.[34] Justice Scalia argues that the test invades the sphere of Congress to regulate interstate commerce and to determine if a state or local law has gone too far.[35] Justice Thomas would pick up where Justice Scalia left off: to attack the dormant commerce clause, and even contradict himself from a previous opinion.

Justice Thomas begins his concurrence by renouncing his vote in *Carbone*, and joined Scalia in attacking the dormant commerce clause.[36] He argues that the, "application of the negative commerce clause turns solely on policy consid-

---

29. *Pike v. Bruce Church Inc.*, 397 U.S. 142 (1970).
30. *Oneida-Herkimer*, 127 S. Ct. at 1797-1798.
31. *Id.* at 1798.
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Oneida-Herkimer*, 127 S. Ct. at 1799.

erations, not the Constitution."[37] In addition his opinion goes further than Scalia by rejecting the majority's reasoning altogether and only concurring in the judgment.[38] Taken with Justice Scalia's opinion there are now two votes on the U.S. Supreme Court that would do away with the bulk of dormant commerce clause jurisprudence.

The concurring opinion of Justice Thomas contains a very striking line that sums up his stance on this issue. He writes, "Many of the above-cited cases (and today's majority and dissent) rest on the erroneous assumption that he Court must choose between economic protectionism and the free market. But the Constitution vests that fundamentally legislative choice in Congress."[39]. Thomas would appear to go further than Justice Scalia suggests, and even do away with precedent on discriminatory state laws.[40] Thomas also renounces the reasoning *Carbone*, and the majority opinion of Justice Roberts saying only Congress could decide if the local solid waste ordinances violated the commerce clause.[41]

The concurrence ends with Justice Thomas comparing the dormant commerce clause to *Lochner v. New York*.[42] He claims that, "The Court's negative Commerce Clause jurisprudence, created from whole cloth, is just as illegitimate as the 'right' it vindicated in *Lochner*."[43] It is interesting that Thomas would make such a strong comparison to denounce the dormant commerce clause, and create a major rift in the newest members of the Court, Chief Justice Roberts and Justice Alito.

IV. JUSTICE ALITO'S DISSENT

In a surprising move, Justice Alito dissented in this case. He also authored a lengthy dissenting opinion arguing for a strict interpretation of the *Carbone* precedent.[44] His argument hit three major points. First, the flow-control ordinances here are no different from the one's struck down in *Carbone*.[45] Second, the majority failed to apply the rules against interstate commerce discrimination properly.[46] Third, the majority was flawed in its reasoning by recognizing a public ownership exception to *Carbone*.[47]

---

37. *Id.*
38. *Id.*
39. *Id.* at 1801.
40. *Id.*
41. *Id.* at 1802.
42. *Oneida-Herkimer*, 127 S. Ct. at 1802.
43. *Id.*
44. *Id.*
45. *Id.* at 1804.
46. *Id.* at 1806.
47. *Id.* at 1807-08.

Justice Alito argues for a strict interpretation of *Carbone*, and flat out rejects the majority rule carving out an exception for publicly owned waste processing facilities. He writes, "The Court relies on the distinction between public and private ownership to uphold the flow-control laws, even though a straightforward application of *Carbone* would lead to the opposite result. The public-private distinction drawn by the Court is both illusory and without precedent."[48] From there Justice Alito discusses dormant commerce clause discrimination precedent, but the bulk of his dissent attacks the reasoning of the majority.

Alito first attacks the loosened rule for laws favoring local government versus private industry.[49] He sees no reason for this distinction. The effect of the law is still to discriminate against interstate commerce and he argues for a strict interpretation of the rule against interstate commerce discrimination from *Philadelphia v. New Jersey*.[50]

His next criticism is against the majority's assertion that solid waste disposal was a traditional local governmental function. Justice Alito noted other cases that attacked this concept as unworkable, most notably *Garcia v. San Antonio Metropolitan Transit Authority*.[51] For Justice Alito this concept is also flawed because, "most of the garbage produced in this country is still managed by the private sector."[52]

The last section of the dissent attacks the majority's claim that the Oneida-Herkimer ordinance treats all private haulers the same. Justice Alito argues that this is irrelevant to the analysis. He claims, "[a]gain, the critical issue is whether the challenged legislation discriminates against interstate commerce."[53] In the end he makes a straightforward argument that the majority uses exceptions unfounded in the dormant commerce clause precedent to uphold the Oneida-Herkimer laws. In summary, what all the opinions in this case do is create more questions than answers.

V. ANALYSIS AND QUESTIONS FOR THE FUTURE

United Haulers Association v. Oneida-Herkimer Solid Waste Management Authority brings up two intriguing questions. First, what is the future of dormant commerce clause jurisprudence? The court first carved out a large exception to the precedent set in *Carbone* by acknowledging an exception for publicly operated waste processing facilities.[54] This exception was a bone of contention for the dissent that wanted a more strict application of the *Carbone*

48. *Oneida-Herkimer*, 127 S. Ct. at 1804
49. *Id.* at 1807.
50. *Philadelphia v. New Jersey*, 437 U.S. 617, 627 (1978).
51. *Oneida-Herkimer*, 127 S. Ct. at 1810.
52. *Id.* at 1811.
53. *Id.*
54. *Id.* at 1795.

precedent. It appears though the Roberts Court is a bit friendlier to local interests than the Rehnquist court. Also, there are Justices Scalia and Thomas who denounced the dormant commerce clause in their concurring opinions. This hostility could spell problems for future dormant commerce clause challenges.

The second main question is what this opinion means for the unity of judicial philosophy on the court? Roberts, Scalia, Thomas and Alito were all split in this opinion. Chief Justice Roberts writing for the majority upheld the Oneida-Herkimer ordinances.[55] Justices Scalia and Thomas concurred in the judgment, but used their opinions to attack the dormant commerce clause. Finally, Justice Alito wrote the dissenting opinion arguing for a strict application of *Carbone*. It was assumed that these four Justices would be a solid block on the Court. A case such as this could be showing us that these four are not in perfect lock step on every issue. These small differences could end up being key for future issues before the court.[56]

Finally, on a practical level this decision will impact how state and local governments deal with waste management.[57] The exception created for publicly run facilities is a powerful exception that will give governments more freedom in passing flow control ordinances, or assessing tipping fees.[58] In addition, local governments who favor local waste disposal facilities will no longer have to fear the impact of the *Carbone* decision on their policies.[59]

CONCLUSION

To summarize this case, the United States Supreme Court broke with recent precedent in finding for the Oneida-Herkimer Waste Management Authority. However, the split of the court, especially Roberts, Alito, Scalia and Thomas leaves many questions for the future. Also, the hostility of Scalia and Thomas to the dormant commerce clause could cause some uncertainty in future cases that tackle the issue. In addition, the victory of local government here could

---

55. Damien Schiff gives another perspective of the Roberts Court. In his article he looks at the impact of what he calls the Chief Justice's "minimalism" view point on environmental law cases. Though he does not discuss *Oneida-Herkimer* directly, he does give a good overview of the impact of judicial philosophy of the current court. Damien Schiff, *Nothing New Under the Sun: The Minimalism of Chief Justice Roberts and the Supreme Court's Recent Environmental Law Jurisprudence*, 15 MO. ENVTL. L. & POL'Y REV. 1, 2 (2007).

56. Another important vote on the current Court is Justice Kennedy. He is considered the swing vote now with the retirement of Justice O'Connor. In this case he joined the dissent of Justice Alito. *Oneida-Herkimer*, 127 S. Ct. at 1803. Charles Whitebread examines the impact of Justice Kennedy on the Roberts Court, and how litigants before the Court may have to write a "Kennedy brief" in order to sway his vote. Charles Whitebread, *The Conservative Kennedy Court—What a Difference a Single Justice Can Make: The 2006-2007 Term of the United States Supreme Court*, 29 WHITTIER L. REV. 1, 3-4 (2007).

57. Jarret, *supra* note 1, at 26-7.

58. *Id.*

59. *Id.*

give other localities more freedom in economic and waste management regulation. Finally, we might have to reassess the different judicial philosophies on the Court, and not view Roberts, Scalia, Thomas and Alito as one solid voting bloc on every issue.

The Evolving Equal Protection Clause: *Parents Involved in Community Schools v. Seattle School District No. 1 et al*, 127 S. Ct. 2738 (2007)

MEREDITH JOHNSON

INTRODUCTION

Parents Involved in Community Schools v. Seattle School District No. 1 (hereinafter "*Parents Involved in Community Schools*") concerned an alleged constitutional violation of the equal protection clause of the Fourteenth Amendment when two school districts used race as an explicit factor in determining a student's eligibility to attend a particular school within a school district. This case comment will provide insight to Justice Thomas' concurrence by referencing supporting historical case law and further expand upon a few of his main propositions. Justice Thomas' propositions include, *inter alia*, the rejection of the dissent's reliance on studies by social scientists, the unfounded fear of resegregation, the student assignment plans being outside the scope of the Court's previously defined compelling interests, and the duty of the Supreme Court of the United States ("Court") to evaluate a compelling interest.[1]

I. FACTUAL BACKGROUND

Parents Involved in Community Schools concerns two school districts, from Seattle, Washington and Jefferson County, Kentucky, independently, who utilized student assignment plans to determine a student's eligibility to attend a particular school.[2] The main issue in these student assignment plans is the use of race to determine if a student could attend a particular school.[3] Since both school districts were using racial classifications to determine a student's eligibility, the Court applied the well-established strict scrutiny test.[4]

The Seattle School District's plan consisted of incoming ninth graders listing their top ten preferences for any of the ten schools in the surrounding district.[5] However, since some schools were selected more than other schools, the Seattle School District used other factors as tiebreakers to determine which students

1. Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1, 127 S. Ct. 2738, 2768-2787 (2007) (Thomas, J., concurring).

2. *Id.* at 2747-2748.

3. *Id.*

4. *Id.* at 2751. *See also* Johnson v. California, 543 U.S. 499, 505-506 (2005); Grutter v. Bollinger, 539 U.S. 306, 326 (2003); Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 224 (1995). *See also* Leslie Yalof Garfield, *The Glass Half Full: Envisioning the Future of Race Preference Policies*, 63 N.Y.U. ANN. SURV. AM. L. 385, 395 (2008).

5. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2747.

should be placed in particular schools.[6] The first tiebreaker was current siblings enrolled in that particular school followed by the racial composition of that respective school.[7] The Seattle School District's objective was to maintain a similar overall racial makeup of the city district where the school was located (within ten percentage points), and therefore, enrolled certain students in particular schools.[8]

The Jefferson County public school system took similar action and created a voluntary student assignment plan within specific geographic clusters.[9] Incoming kindergarteners, first graders, and students new to the district would apply for their primary and secondary choices of surrounding schools and then the assignment plan would take a particular school's racial composition as well as the student's race into account when deciding where to place the student.[10] The plan included a minimum black enrollment of fifteen percent and a maximum black enrollment of fifty percent in order to prevent a racial imbalance.[11] Although very similar student assignment plans are at issue in the two school districts, one major difference is that Jefferson County Public Schools were subject to a desegregation decree in 1973.[12] However, in 2000 the federal government dissolved the desegregation decree in Jefferson County, Kentucky.[13]

II. PROCEDURAL HISTORY

Prior to coming to this Court under a grant of certiorari, the parents of this action challenged the use of racial classifications regarding the oversubscription of high schools.[14] United States District Court for the District of Washington granted summary judgment, and the United States Court of Appeals for the Ninth Circuit affirmed the District Court's decision on a rehearing en banc.[15] Following that action, the parents brought another claim against the use of racial classification regarding student school assignments and transfer applications where the United States District Court for the Western District of Kentucky upheld the school's assignment plans and the United States Court of Appeals for the Sixth Circuit affirmed.[16]

---

6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.* at 2749-2750.
10. *Id.*
11. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2749-2750.
12. *Id.* at 2749. The final order was entered by the District Court in 1975. *Id.*
13. *Id.* The Court distinguished Seattle School District's de facto segregation (segregation by practice but not legally imposed) and Jefferson County Public Schools' de jure segregation (segregation by law). *Id.*
14. 137 F. Supp 2d 1224 (2001); 426 F.3d 1162 (2005); 330 F. Supp 2d 834 (2004); 416 F.3d 513 (2005).
15. 137 F. Supp 2d 1224 (2001); 426 F.3d 1162 (2005).
16. 330 F. Supp 2d 834 (2004); 416 F.3d 513 (2005).

III. BRIEF HISTORICAL PREFACE TO THE EQUAL PROTECTION CLAUSE

Although the Fourteenth Amendment was proposed on June 13, 1866 and ratified on July 9, 1868, the judicial system ignored the equal protection clause of the Fourteenth Amendment for nearly a century as no penalties or remedies were enforced against those who violated a citizen's right to equal protection.[17] It was not until the mid-twentieth century when the landmark cases *Brown v. Board of Education of Topeka, Kansas I* and *Brown v. Board of Education of Topeka, Kansas II* (hereinafter "*Brown "I* and "*Brown II*") collectively took a stand against equal protection violations.[18] As a result of these decisions, the Court observed an increase in the amount of cases alleging equal protection violations.[19] Throughout this time, the Court used the equal protection clause of the Fourteenth Amendment to penalize and remedy those who discriminated against United States citizens and as an additional safeguard to protect those fundamental rights guaranteed to such United States citizens.[20]

The decisions rendered in *Brown I* and *Brown II* are still relied upon today. For example, the decisions collectively played an integral part in the Court's 2007 decision in *Parents Involved in Community Schools v. Seattle School District No. 1*.[21] However, it is important to note that such landmark cases can sometimes have vastly different interpretations. This notion is advanced by the ability of the plurality, concurrences, and dissent in *Parents Involved in Community Schools* to use their own interpretations of the collective decisions in *Brown I* and *Brown II* to advance their respective arguments. For example, the plurality interprets *Brown I* and *II* to prohibit the use of race by school districts when determining the eligibility to attend.[22] In contrast, the dissent reads *Brown I* and *II* to promote integration and diversity in school districts even when using race in efforts to achieve such goals.[23]

---

17. *See* Missouri ex rel Gaines v. Canada, 305 U.S. 337 (1938); Sweatt v. Painter, 339 U.S. 629 (1948); McLaurin v. Oklahoma State Regents, 339 U.S. 637 (1950).

18. Brown v. Bd. of Educ. of Topeka, Kansas I, 347 U.S. 483 (1954); *Brown* v. Bd. of Educ. of Topeka, Kansas II, 349 U.S. 294 (1955).

19. ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 706 (3d ed. 2006).

20. Although the United States Constitution does not provide a safeguard against the federal government for violating the equal protection clause, *Bolling v. Sharpe* held that the equal protection clause applies to the federal government through the due process clause of the Fifth Amendment. 347 U.S. 497 (1954). Thus, the requirements of the equal protection clause are the same whether a violation is alleged against a federal, state, or local actor by using either the Fifth Amendment or Fourteenth Amendment. CHEMERINSKY, *supra* note 19, at 669.

21. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2738.

22. *Id.* at 2758.

23. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2820 (Stevens, J., dissenting).

IV. THE EQUAL PROTECTION CLAUSE ANALYSIS

Under the equal protection clause analysis, there are two possible classifications of any constitutional violation. The first classification is facial where the classification disadvantages racial minorities by categorizing individuals based on characteristics.[24] The second classification occurs when the law is facially neutral, but there is a discriminatory impact to the law or a discriminatory effect from the administration of the law.[25]

Following this classification, the Court must decide upon a level of scrutiny to apply when determining the proper balance between a permissible government objective or interest and an infringement upon an individual's right to equal protection.[26] The Court uses three levels of scrutiny to assess equal protection violations.[27] The lowest level of scrutiny is the rational basis test, which only requires that the government's actions be rationally related to a legitimate government interest.[28] Every law challenged under the equal protection clause must meet at least the rational basis test.[29] The Court uses this test when confronted with such issues as sexual orientation, public morals, and mental disabilities.[30] The Court uses the intermediate level of scrutiny when rendering decisions concerning discrimination against nonmarital children and gender.[31] Under this analysis, the means must be substantially related to an important compelling purpose.[32] This case comment concerns the highest level of scrutiny called strict scrutiny. This test is applicable to all classifications based on race or national origin.[33] The Court has determined that when evaluating an actor's actions, the means in question must be narrowly tailored and necessary to achieve a compelling interest.[34] This is purposely a very difficult standard to obtain as the framers of the Fourteenth Amendment created this provision in

---

24. Strauder v. West Virginia, 100 U.S. 303 (1879). *See also* CHEMERINSKY, *supra* note 19, at 670.

25. Personnel Admin. of Massachusetts v. Feeney, 442 U.S. 256 (1976); Washington v. Davis, 426 U.S. 229 (1976). *See also* CHEMERINSKY, *supra* note 19, at 670.

26. CHEMERINSKY, *supra* note 19, at 671.

27. *Id. See also* Dave Harbeck, *Eliminating Unconstitutional Juries: Applying United States v. De Gross to All Heightened Scrutiny Equal Protection Groups in the Exercise of Peremptory Challenges,* 77 MINN. L. REV. 689, 694 (1993).

28. New Orleans v. Dukes, 427 U.S. 297, 303 (1976); McGowan v. Maryland, 366 U.S. 420, 425-426 (1961); Lindsley v. Natural Carbonic Gas Co., 220 U.S. 61, 78-79 (1911). *See also* CHEMERINSKY, *supra* note 19, at 671.

29. CHEMERINSKY, *supra* note 19, at 672, 677.

30. Romer v. Evans, 517 U.S. 620 (1996); McGowan v. Maryland, 366 U.S. 420 (1961); Schweiker v. Wilson, 450 U.S. 221 (1981).

31. Lalli v. Lalli, 439 U.S. 259 (1978); Assoc. Gen. Contractors of Ca. v. San Francisco, 813 F.2d 922 (9th Cir. 1986). *See also* CHEMERINSKY, *supra* note 19, at 760, 779.

32. Palmore v. Sidoti, 466 U.S. 429, 432 (1984). *See also* CHEMERINSKY, *supra* note 19, at 671.

33. *See* Johnson v. California, 543 U.S. 499, 505-506 (2005); Grutter v. Bollinger, 539 U.S. 306, 326 (2003); Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 224 (1995). *See also* CHEMERINSKY, *supra* note 19, at 671.

34. CHEMERINSKY, *supra* note 19, at 671.

order to protect citizens, specifically African American citizens, from discrimination on the basis of race.[35] However, as the Court has continually proven, race is seldom, if ever, associated with a permissible government objective or interest.[36] It is important to note that the justification behind the equal protection clause is not simply to prevent the ill-treatment of United States citizens, but rather combat the subordination of any individual or group of individuals.

V. LEGAL FRAMEWORK

The petitioner, a nonprofit corporation called Parents Involved in Community Schools, challenges that the student assignment plans violate the equal protection clause because, *inter alia*, such assignments have a discriminatory impact in practice.[37] The Court has previously held that there must be both proof of discriminatory impact and a discriminatory purpose when an act is facially neutral as opposed to when an act is discriminatory on its face. For example, *Washington v. Davis* concerned a police entrance exam that when statistically calculated showed that significantly more blacks and than whites failed the entrance exam.[38] However, the Court held that proof of a discriminatory impact alone was not enough for the Court to establish a discriminatory purpose, and thus elicit the Court's use of strict scrutiny. The Court again reaffirmed this principle in *Mobile v. Bolden* when it held that where there is no proof of discriminatory purpose, the Court will not apply a level of strict scrutiny.[39] *Mobile* concerned an at large election that resulted in only white candidates being elected in a predominately-white community.[40] However, the question has yet to go before the Court whether proving discriminatory purpose proves discriminatory impact. Nonetheless, the opinion in *Palmer v. Thompson* showed that the Court required both when it held that a city's decision to close a segregated pool did not violate the equal protection clause because the decision to close the pool was based on the motivations of those who voted.[41] Therefore, when reading both cases together, it is reasonable to assume that the Court requires proof of both discriminatory impact and purpose for a facially neutral law to be regarded as creating a race or national origin classification. Thus, the petitioner

---

35. STONE ET AL., CONSTITUTIONAL LAW 448 (5th ed. 2005).

36. *See* Johnson v. California, 543 U.S. 499 (2005). The Supreme Court of the United States held that race is not even a permissible government objective when trying to prevent violence. *Id. Johnson* concerned the segregation of different races when assigning inmates to at least double occupancy-housing quarters. *Id.*

37. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2748. There is no issue concerned with standing as the nonprofit corporation is comprised of affected parent's whose own children were negatively impacted by the use of race in the student assignment plans. *Id.* at 2750-2751.

38. Washington v. Davis, 426 U.S. 229 (1976).

39. Mobile v. Bolden, 446 U.S. 55 (1980).

40. *Id.*

41. Palmer v. Thompson, 403 U.S. 217 (1971).

must prove both the discriminatory impact of the use of racial classifications in the respective school assignments and the school's discriminatory purpose in using such assignments, however, when an alleged violation concerns any type of classification based on race or national origin the Court will apply the strict scrutiny test.[42] The application of the strict scrutiny test occurs because "'racial classifications are simply too pernicious to permit any but the most exact connection between justification and classification.'"[43]

Proving discrimination in the school context uses essentially the same analysis. In *Keyes v. School District No. 1*, the schools were not acting under de jure segregation, but the Court held that where the plaintiffs' found that the school authorities were segregating in practice, or undergoing de facto segregation, that was impacting the school system at large, the plaintiffs' established enough proof to shift the burden to the school district.[44] Thus, a presumption was in existence against the entire school system to which they had to prove that such racial composition would have existed if such de facto segregation did not occur. The Court clarified that in a de facto segregation situation, where a facially neutral act has a discriminatory impact or has a discriminatory effect from the administration of such action, the plaintiff must prove both a discriminatory impact and purpose.[45] However, *Dayton Board of Education v. Brinkman* required the same proof of discriminatory impact and purpose in de jure segregation situations.[46]

The Court has held that all racial classification, whether compelled by a federal, state, or local actor, must be evaluated under the Court's strict scrutiny test.[47] In *Adarand*, the Court invalidated a state law that permitted preference to racial minorities in construction contracts.[48] In the majority opinion, Justice O'Connor goes to great lengths to assert that where race is used as a classifier the Court will strictly scrutinize any government action.[49] Justice O'Conner previously stated this argument in *Richmond v. J.A. Croson*, where she explained the potential of stigmatic harm to the minority race.[50] In 1978 the Court decided *Regents of the University of CA v. Bakke*, where a student challenged the University of California at Davis Medical School's practice of reserving sixteen minority slots in a set class of 100 students.[51] With no majority opinion

---

42. *See* Johnson v. California, 543 U.S. 499, 505-506 (2005); Grutter v. Bollinger, 539 U.S. 306, 326 (2003); Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 224 (1995).

43. Gratz v. Bollinger, 539 U.S. 244, 270 (2003) (quoting Fullilove v. Klutznick, 448 U.S. 448, 537 (1980) (Stevens, J., dissenting)).

44. Keyes v. School Dist. No. 1, 413 U.S. 189 (1973).

45. *Id.*

46. Dayton Board of Educ. v. Brinkman, 443 U.S. 526 (1979).

47. Adarand Constructors Inc. v. Pena, 515 U.S. 200 (1995).

48. *Id.*

49. *Id.*

50. Richmond v. J.A. Croson, 448 U.S. 469 (1989).

51. Regents of the Univ. of California v. Bakke, 438 U.S. 265 (1978).

reached, the judgment invalidated the sixteen minority slots, but the Court did not strictly prohibit the use of race as a factor in determining admission to the University.[52] At dispute in *Bakke*, was the level of scrutiny to apply to the University's action.[53] Ironically, only Justice Powell wanted to apply strict scrutiny to the University's action because he believed that race and ethnic qualifiers were inherently suspect for such scrutiny.[54]

VI. PLURALITY'S POSITION ADVANCED THROUGH JUSTICE THOMAS' CONCURRENCE

In *Adarand Constructors Inc*, Justice Thomas, stated that, "[i]n my mind, government-sponsored racial discrimination based on benign prejudice is just as noxious as discrimination inspired by malicious prejudice. In each instance, it is racial discrimination, plain and simple."[55]

Justice Thomas thus agrees with Justice Powell's application of strict scrutiny in *Bakke* and criticizes the dissent, written by Justice Breyer and joined by Justices Stevens, Souter, and Ginsberg, for avoiding such application by relying on unfounded research to support each of the school district's justifications for advancing their respective student assignment plans as a compelling government interest.[56] Justice Thomas is also consistent with his past opinions as he definitively states that race should never be used as a factor in a government interest in a location not subject to de jure segregation.[57] This case comment will discuss four of the main propositions posed by Justice Thomas to expand upon the majority opinion by Chief Justice Roberts and further advance the plurality opinion written by Chief Justice Roberts and joined by Justices Scalia, Thomas, and Alito.[58]

First, Justice Thomas' concurrence rejects the assertions posed by social scientists, which are substantially relied upon by the dissent, for using such research that *proves* that racial integration is beneficial for all students, when in reality there is no conclusive research in the area of study and the subject matter is up for "fervent debate".[59] Studies have shown that there is research to suggest that less racial integration may actually benefit some individuals while other research suggests that there are no educational benefits arising out of ra-

---

52. *Id.*

53. *Id.*

54. *Id. See also* Garfield, *supra* note 4, at 389. Similar to how Justice Powell's concurrence in *Bakke* influenced the future of the applicability of strict scrutiny, Garfield predicts that Justice Kennedy's concurrence in *Parents Involved in Community Schools* may have the same effect in regards to the ability to use race in a compelling interest. *Id.*

55. *Adarand Constructors Inc,* 515 U.S. at 241.

56. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2773-2774 (Thomas, J., concurring).

57. *Id.* at 2791.

58. *See generally Parents Involved in Cmty. Sch.*, 127 S. Ct. 2738.

59. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2773 (Thomas, J., concurring).

cial integration.[60] Furthermore, other studies have shown that in populations isolated by race, those students in the isolated atmospheres benefit enormously from such separation.[61] For example, a predominately-black enrolled school in Seattle, Washington called the African-American Academy reported that their students recorded higher examination grades throughout different grade levels in reading, writing and math.[62] This example provides at least one possible research focus that could support an argument against racial integration or even less racial integration.

It is important to note that social scientific research, as much as any other research, can be manipulated to tell any story that an individual wants to assert. Similar to a lawyer's ability to frame an issue in a positive light for a jury to recognize its faults but inevitably side with his or her position, a statistician can frame a critical issue in a way that is more advantageous to his or her argument. This is also consistent with the practice of politics and framing the critical issues to appeal to a particular constituency.

Second, Justice Thomas criticizes the unfounded fear of resegregation.[63] His concurrence assertively begins by focusing on the lack of danger of resegregation in both the Seattle School District and the Jefferson County public school system. Consistent with the plurality's position, there is no evidence to support anything other than a finding of no substantial difference in the racial composition of either school district if the student assignment plans were not in affect.[64] Justice Thomas makes a clear distinction between racial imbalance and segregation as "[r]acial imbalance is the failure of a school district's individual schools to match or approximate the demographic makeup of the student population at large"[65] and "segregation is the deliberate operation of a school system to 'carry out a governmental policy to separate pupils in schools solely on the basis of race.'"[66] He concludes that "[r]acial imbalance is not segregation, and the mere incantation of terms like resegregation and remediation cannot make up the difference."[67] Alexandra Villarreal O'Rourke clarifies that Justice Thomas found that *Brown I* and *II* "invalidated 'segregation' but not 'racial imbalance,' which can, but does not necessarily, result from past segregation."[68] Preston Green and Joseph Oluwole also note that although Justice Thomas makes a clear dis-

60. *Id.* at 2777.
61. *Id.*
62. *Id.*
63. *Id.* at 2768.
64. *Id.*
65. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2768; Cf. Washington v. Seattle School Dist. No. 1, 458 U.S. 457, 460 (1982).
66. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2768 (quoting Swann v. Charlotte-Mecklenburg Bd. of Ed., 402 U.S. 1, 6 (1971)).
67. *Id.*
68. Alexandra Villarreal O'Rourke, *Picking up the Pieces after PICS: Evaluating Current Efforts to Narrow the Education Gap*, 11 HARV. LATINO L. REV. 263 (2008).

tinction between racial imbalance and segregation, there is only a fear of racial imbalance and not a fear of resegregation.[69]

However, Suzanne Eckes, believes that the Court had an opportunity to advance the strife of those who have been discriminated against and believes that the Court's majority opinion incorrectly decided against the student assignment plans as they were "good faith efforts to diversify K-12 public schools for many years to come."[70] She believes that the future implications of the Court's decision could lead to such prior unfortunate practices as resegregation rather than seizing the opportunity to take a stand against discrimination.[71]

Third, Justice Thomas concludes that the Court's two recognized compelling interests, remedying past discrimination and enhancing diversity in higher education, are not at issue in this case.[72] The plurality opinion and Justice Thomas' concurrence reason that the first compelling interest is not at issue because neither school district is in need of remedying any past discrimination.[73] Both opinions support the notion that there is no evidence to conclude that the Seattle School district practiced any racial discrimination in its past and the Kentucky district court dissolved the previous existing desegregation decree in Jefferson County because it found that Jefferson County " 'eliminated the vestiges associated with the former policy of segregation and its pernicious effects,' and thus had achieved 'unitary' status."[74]

The two most recent cases regarding enhanced diversity are *Grutter v. Bollinger* and *Gratz v. Bollinger*, to which the Court reaffirmed its application of the strict scrutiny test.[75] In *Grutter*, a white applicant was denied admission to a law school where race was a factor used in the admissions process.[76] However, the Court supported the University's use of race as a compelling interest because it was in effort to create a diverse student body with such beneficial effects as cross-racial understanding in efforts to dissolve racial stereotyping.[77] On the other hand, *Gratz* invalidated an affirmative action program that increased an applicant's admission score by twenty points if he or she was a minority student.[78] Thus, since race was used as a sole factor in the admissions process, compared to it just being a factor with no fixed calculation, the under-

---

69. Preston C. Green III and Joseph O. Oluwole, *The Implications of Parents Involved For Charter School Racial Balazing Provisions*, 229 ED. LAW REP. 309, 319 (2008).

70. Suzanne E. Eckes, *Public School Integration and the 'Cruel Irony' of the Decision in Parents Involved in Community Schools v. Seattle School District No. 1*, 229 ED. LAW REP. 1, 9 (2008).

71. *Id.*

72. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2752-2753, 2775-2776 (Thomas, J., concurring).

73. *Id.* at 2752.

74. *Id.* Jefferson County does not propose the justification that there is a need to remedy for past discrimination as a compelling interest. *Id.*

75. Grutter v. Bollinger, 539 U.S. 306 (2003); Gratz v. Bollinger, 539 U.S. 244 (2003).

76. *Grutter*, 539 U.S. at 306.

77. *Id.*

78. *Gratz*, 539 U.S. at 244.

graduate admissions program was invalidated for not providing a compelling government interest.[79] When read together, *Grutter*, *Gratz*, and *Bakke* show that there is a compelling government interest in higher education, but any quantified restriction is not a permissible government interest.[80] Thus, the compelling interest of enhancing diversity in higher education is apparently not applicable because both school districts are not higher education institutions but rather a public high school system and an elementary school system.[81] Furthermore, the school districts used race as a sole measure and the plurality found that the school districts failed to show any consideration of alternative methods to achieve the same desired end.[82]

Suzanne Eckes comments that the student assignment plans were as flexible as those in *Grutter* and involved a combination of factors to achieve the goal of diversity.[83] Additionally, Eckes believes that it was incorrect for the Court to apply the prohibition against unconstitutional quotas as in *Gratz* because of the flexibility within the school districts' plans as found by the Ninth Circuit and the district court in Kentucky.[84] Eckes makes a comparison between the school districts' plans to the plan used in *Comfort v. Lynn School Committee* where the First Circuit held that:

> [The] plan at issue in this case is fundamentally different from almost anything that the Supreme Court has previously addressed. It is not, like old-fashioned racial discrimination laws, aimed at oppressing blacks, nor like modern affirmative action, does it seek to give one racial group an edge over another neither to remedy past discrimination or for other purposes. . .the plan does not segregate persons by race. Nor does it involve racial quotas.[85]

Furthermore, Eckes expresses that she cannot see how a compelling interest for diversity exists for higher education, but not for a K-12 school system, stating that "[i]ndeed, classroom diversity is an important aspect of all levels of education.[86]

Finally, Justice Thomas criticizes the dissent for suggesting that an actor's policies should be determined by a democratically elected representative body, asserting that it is not the role of the judiciary to abdicate its duties of evaluating a compelling interest under the Court's strict scrutiny test for fear of losing the

---

79. *Id.*

80. *Grutter*, 539 U.S. at 306; *Gratz*, 539 U.S. at 244; *Bakke*, 438 U.S. at 265.

81. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2746, 2749. It is important to note that the future of diversity as a compelling interest might be extended beyond higher education as Justice Kennedy's concurrence suggests that race-based measures may be used in particular circumstances, agreeing with the four Justices in the dissent. Garfield, *supra* note 4, at 411.

82. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2760.

83. Eckes, *supra* note 70, at 11.

84. *Id.*

85. *Id.* at 13.

86. *Id.*

Court's ability to safeguard a citizen's right to equal protection.[87] Giving deference to local authorities can easily result in our nation's prior practices of segregation, especially if current social practices within a community determine what qualifies as a compelling interest, hence Justice Thomas' concern with a community evaluating its own alleged compelling interests to see if they are consistent with the Fourteenth Amendment's equal protection clause.[88] Justice Thomas stresses that the dissent's argument for giving deference to the local communities to evaluate their respective considerations for what is a compelling interest is an argument that has a strong similarity to the one used by the segregationists in both *Brown I* and *Brown II* as the segregationists made repeated appeals to societal practice and expectation.[89]

Suzanne Eckes gives the rationalization that a democratically elected school board could be voted out of office if the citizens of the school district did not like how the board members conducted business in practice.[90] However, it is important to note that the idea of a minority trying to vote individuals off the board may be a more difficult proposition than Eckes suggests. She also stresses the importance of local autonomy in efforts to maintain a community and provide public support for the respective public schools in the district.[91] She supports this notion concluding that there should be a presumption that local officials are acting in good faith.[92] Such good faith can be seen, as Eckes believes, in the actions of the Jefferson County public school district in efforts to maintain the diverse student body after the dissolution of the desegregation decree.[93] Justice Thomas would disagree with such deference to officials' good faith as he only found two narrow circumstances where race could be used as a factor in a government decision, segregation of a school by law or when a government agency remedies its own past discrimination.[94]

Justice Thomas comments that such practices as using a democratic component in mimicking today's pluralistic society, is just another route for the school districts to utilize, and the dissent to justify, the use of race balancing. Consistent with Justice Powell's opinion on race balancing in *Bakke*, Justice Powell states that "[p]referring members of any one group for no reason other than race or ethnic origin is discrimination for its own sake."[95] This is also consistent with Justice O'Connor's dissenting opinion in *Metro Broadcasting* on the no-

87. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2778-2779 (Thomas, J., concurring).
88. *Id.* at 2778.
89. *Id.* at 2783.
90. Eckes, *supra* note 70, at 14.
91. *Id.*
92. *Id.*
93. *Id.* at 15.
94. Green III and Oluwole, *supra* note 69, at 319.
95. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2779 (quoting *Bakke*, 438 U.S. at 307(opinion of Powell, J.)) (Thomas, J., concurring).

tion of benign racial classifications stating that "benign carries with it no independent meaning, but reflects only acceptance of the current generation's conclusion that a politically acceptable burden, imposed on particular citizens on the basis of race, is reasonable."[96] Justice Thomas also warns of the fear of a limitless scope of applying such race-based measures as the dissent's argument to build a cooperative relationship between the races will always be at issue.[97] Again dissenting in *Metro Broadcasting*, Justice O'Connor remarks that "[a]n interest 'linked to nothing other than proportional representation of various races . . . would support indefinite use of racial classifications, employed first to obtain the appropriate mixture of racial views and then to ensure that the [program] continues to reflect that mixture.'"[98]

VII. FUTURE IMPLICATIONS

Although there have been immense strides in the fight against racial discrimination, it is important to ensure that an actor cannot purposely revert back to prior unfortunate practices. The government should certainly not set an example by using such discriminatory practices and it is the duty of the Court to ensure that such practices will not be condoned. Chief Justice Roberts concluded his opinion with the notion that, "[t]he way to stop discrimination on the basis of race is to stop discriminating on the basis of race."[99] The decision in *Parents Involved in Community Schools* not to uphold such discriminatory practices as school districts using race as a factor in determining a student's eligibility to attend a particular school advances the Court's effort to apply a color-blind Constitution and ensure citizens their right to equal treatment pursuant to the equal protection clause of the Fourteenth Amendment. Justice Thomas' concurrence cautions that "[i]f this interest justifies race-conscious measures today, then logically it will justify race-conscious measures forever. Thus, the democratic interest, limitless in scope and 'timeless in [its] ability to affect the future,'[100] cannot justify government race-based decision-making."[101]

Although the majority reached a judgment holding that the student assignment plans are unconstitutional as they are in violation of the equal protection clause of the Fourteenth Amendment, only the plurality concludes that race can never be used as a factor in a compelling interest with the exception of remedying de jure segregation.[102] Leslie Yalof Garfield astutely points out that Justice

---

96. *Id.* at 2765 (quoting Metro Broadcasting, Inc. v. FCC, 497 U.S. 547, 609-610 (1990) (O'Connor, J., dissenting).

97. *Id.* at 2779-2780 (Thomas, J., concurring).

98. *Id.* at 2758 (quoting *Metro Broadcasting*, 497 U.S. at 614).

99. *Id.* at 2768.

100. Wygant v. Jackson Bd. of Educ., 476 U.S. 267 (1986).

101. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2780 (Thomas, J., concurring).

102. *Id.* at 2758.

Kennedy's concurrence is a "concurrence in the judgment" but not a concurrence in the reasoning supported by, in this case, the plurality.[103] Therefore, although the particular student assignment plans at issue are unconstitutional, it has yet to be decided if race can ever be used in a compelling government interest. However, when reading Justice Kennedy's concurrence in conjunction with the dissent, it seems that if such a case were to go before the Court, a majority opinion would extend a compelling interest to primary and secondary schools while allowing race as a factor within particular circumstances.[104] Justice Kennedy suggests a number of areas where the use of race could be incorporated into a compelling factor such as "strategic site selection of new schools; drawing attendance zones with general recognition of the demographics of neighborhoods; allocating resources for special programs; recruiting students and faculty in a targeted fashion; and tracking enrollments, performance, and other statistics by race."[105] Justice Kennedy notes that "[t]hese mechanisms are race conscious but do not lead to different treatment based on a classification that tells each student he or she is to be defined by race, so it is unlikely any of them would demand strict scrutiny to be found permissible."[106] Thus, the current opinion is fragile at best, as the thin five to four margin only supports the majority's judgment in the specific case, as another case with a less problematic plan or a change in the composition of the Court, may easily change the reasons supporting the holding of the majority.[107]

Our society must continue to support a color-blind Constitution to make certain not to enable a pre *Brown I* and *Brown II* era by avoiding the consequence of the dissents' opinion that "permits measures to keep the races together and proscribe measures to keep the races apart."[108] It is proper to conclude with Justice Thomas' warning that "if our history has taught us anything, it has taught us to beware of elites bearing racial theories."[109]

---

103. Garfield, *supra* note 4, at 417. Garfield hypothesizes about the possible significance of Justice Kennedy's concurrence and notes that "Justice Powell's plurality opinion in *Bakke* is a good example of where a single Justice's opinion can shape the future of a particular area of law. *Id.* at 417.

104. *Id.* at 412-413.

105. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2792 (Kennedy, J., concurring).

106. *Id.*

107. Garfield, *supra* note 4, at 422-423.

108. *Parents Involved in Cmty. Sch.*, 127 S. Ct. at 2787 (Thomas, J., concurring).

109. *Id.*

NIABA Web Site Options Form

Option 1: E-mail and/or Web Site Link — $25 (one-time charge)

Your listing in the online Membership Directory will include your e-mail address and/or Web Site URL. Clicking on listing will activate direct connection. This will be a completely private communication. NIABA *only provides the links!*

Option 2: Mini Web Site — $300 per year

This feature will function as your very own web site, hosted by NIABA. It includes a Home Page with a direct URL (www.niaba.org/lawfirm), color logo, color picture, e-mail link and link to Service Information Section. Also included in the Mini Web Site is a Service Information Section, which may contain service descriptions, case studies and/or photos and bios of your principals and staff. Additional sections and content updates are available for a nominal charge. All you need to do is provide the pictures and text.

Option 3: Web Site Design

We will design your law firm's Web Site at specially discounted rates for NIABA members. This will be a custom-designed independently hosted Web Site with your own URL (www.yourfirm.com). Links from the NIABA site are included.

TO ORDER NOW please fill out the form below and mail with your check to:
NIABA, PMB 932, 2020 Pennsylvania Avenue, N.W., Washington, D.C. 20006-1846.
Do not send pictures and text until you are contacted. Checks Payable to NIABA.

PLEASE NOTE THAT YOUR E-MAIL ADDRESS WILL NOT BE LISTED UNLESS YOU ARE REGISTERED. THIS IS A SEPARATE FEE FROM THE ANNUAL DUES.

Name _____

Law Firm _____

Address _____

City_____ **State** _____ **ZIP+4** _____

Phone(_____)_____**FAX**(_____)_____

E-Mail _____**URL**_____

Check one:
- ☐ **Register me for Option 1 $25: E-mail and or Web Link**
- ☐ **Register me for Option 2 $300: Mini Web Site (Service covers one full year from date of placement of materials on NIABA site.)**
- ☐ **Contact me with more information on Option 3: Web Site Design**

I affirm that I am a NIABA Member in good standing; and that the information to be placed on the NIABA Web Site for me complies with all rules and regulations regarding Lawyer Advertising for the states in which I am licensed to practice law.

Signed: _____ **Date:**_____

National Italian American Bar Association

2009 Dues Information & Request Form

Please Help Us Update Your File

Name:_____
Last First Middle

Business Address:_____
Number Street Suite

_____
City State Zip + Four

Business Phone:(_____)_____ Fax Number:(_____)_____

E-Mail Address: _____

Home Address:

_____
Number Street Apt. # City State Zip + Four

Home Phone:(_____)_____

Students : Law School:_____ Anticipated Graduation Date:_____

HOW DID YOU LEARN ABOUT NIABA?
___ Local Association ___Website ___*The Digest* Law Journal
___ Other *(explain)* _____

NIABA MEMBERSHIP DUES
Please make your dues check payable to: NIABA.
____ Regular Member ($50) ____Sponsor Member $100 ____Patron Member ($250 or more)
____ Law Student (free)

SCHOLARSHIP CONTRIBUTION
_____ *Yes,* I want to make a contribution to the NIABA Scholarship Fund:
Please make your check payable to: *NIABA SCHOLARSHIP FUND.*
_____ $25.00 _____ $50.00 _____ $100.00 or more _____ Other

Please complete this form with your check(s) and return it to:
NIABA
PMB 932
2020 Pennsylvania Avenue, N.W.
Washington, D.C. 20006-1846

AREA OF CONCENTRATION

(Check no more than three)

Students, retired and judicial members should only check off those areas.

___Judge (61)
___Public Service (60)

___Retired (65)
___Private Co. Affiliation (62)

___Student (64)
___Educator (63)

___Administrative (1)
___Adoption (57)
___Antitrust (2)
___Appellate (3)
___Arbitrator\Mediator (59)
___Banking (4)
___Bankruptcy & Reorganization (46)
___Business Valuations (52)
___Business Tort (53)
___Civil Rights (5)
___Class Actions (47)
___Commodities (6)
___Commercial Litigation (7)
___Construction (8)
___Corporate (9)
___Criminal (10)
___Customs/ Int'l Trade (68)
___Defamation (11)
___Employee Benefits (48)
___Environmental(12)
___Estate Planning (13)
___Family Law (14)
___Franchise (15)
___General Practice (49)
___Health Care (16)
___Immigration (17)
___Insurance (18)
___Investment Banking (58)
___Labor/Mgmt Relations (19)

Malpractice -
___Accountant Malpractice - Plaintiff (28)
___Accountant Malpractice Defendant (29)
___Attorney Malpractice -Plaintiff (25)
___Attorney Malpractice - Defendant (26)
___Medical Malpractice - Plaintiff (22)
___Medical Malpractice - Defendant (23)

___Municipal (30)
___Patent & Trademark (31)

Personal Injury -
___Plaintiff (33)
___Defendant (34)

___Probate (35)

Product Liability -
___Plaintiff (66)
___Defendant (67)

___Professional Disciplinary (37)
___Real Estate (38)
___Real Estate Tax (39)
___Securities (40)
___Social Security (55)
___Tax (41)
___Traffic (50)
___Trade Secrets / Unfair Competition Litigation (51)

Worker's Compensation -
___Plaintiff (43)
___Defendant (44)

___Other (45) *Specify*

_____