UNIVERSITY OF HOUSTON LAW CENTER
CENTER FOR CONSUMER LAW
VOLUME 19, NUMBER 3, SUMMER 2016

Journal of Consumer & Commercial Law

OFFICIAL PUBLICATION OF THE CONSUMER & COMMERCIAL LAW SECTION OF THE STATE BAR OF TEXAS

2016 Data Breach LITIGATION REPORT

Effective Web Marketing

Journal of Consumer & Commerical Law
Volume 19, Number 3
Summer 2016

State Bar of Texas
Consumer & Commercial Law Section

Journal of
Consumer & Commercial Law

VOLUME 19, NUMBER 3, SUMMER 2016

The editors welcome unsolicited lead articles written by practicing attorney, judges, professors, or other qualified individuals. Manuscript length should be approximately 15-30 typed, double-spaced pages. Endnotes should conform to the Sixteenth Edition of A Uniform System of Citation, published by the Harvard Law Review Association.

Manuscripts should be forwarded to:

Richard M. Alderman
University of Houston Law Center
Krost Hall #210
4604 Calhoun Rd.
Houston, TX 77204-6060
alderman@uh.edu

Articles

Recent Developments

2016 Data Breach Litigation Report

A comprehensive analysis of class action lawsuits involving data security breaches filed in United States District Courts

By David Zetoony,* Jena Valdetero, and Joy Anderson*****

Executive Summary

Data security breaches – and data security breach litigation – dominated the headlines in 2015 and continue to do so in 2016. Continuous widely publicized breaches have led to 30,000 articles a *month* being published that reference data breach litigation. Law firms have collectively published more than 156,000 articles on the topic.[1]

While data breach litigation is an important topic for the general public, and remains one of the top concerns of general counsel, CEOs, and boards alike, there remains a great deal of misinformation reported by the media, the legal press, and law firms. At best, this is due to a lack of knowledge and understanding concerning data breach litigation; at worst, some reports border on sensationalism or fearmongering.

While data breach litigation is an important topic for the general public, and remains one of the top concerns of general counsel, CEOs, and boards alike, there remains a great deal of misinformation reported by the media, the legal press, and law firms.

Our firm, Bryan Cave LLP, began its survey of data breach class action litigation four years ago to rectify the information gap and to provide our clients, as well as the broader legal, forensic, insurance, and security communities, with reliable and accurate information concerning data breach litigation risk. The firm is proud that our annual survey has become the leading authority on data breach class action litigation and is widely cited throughout the data security community.

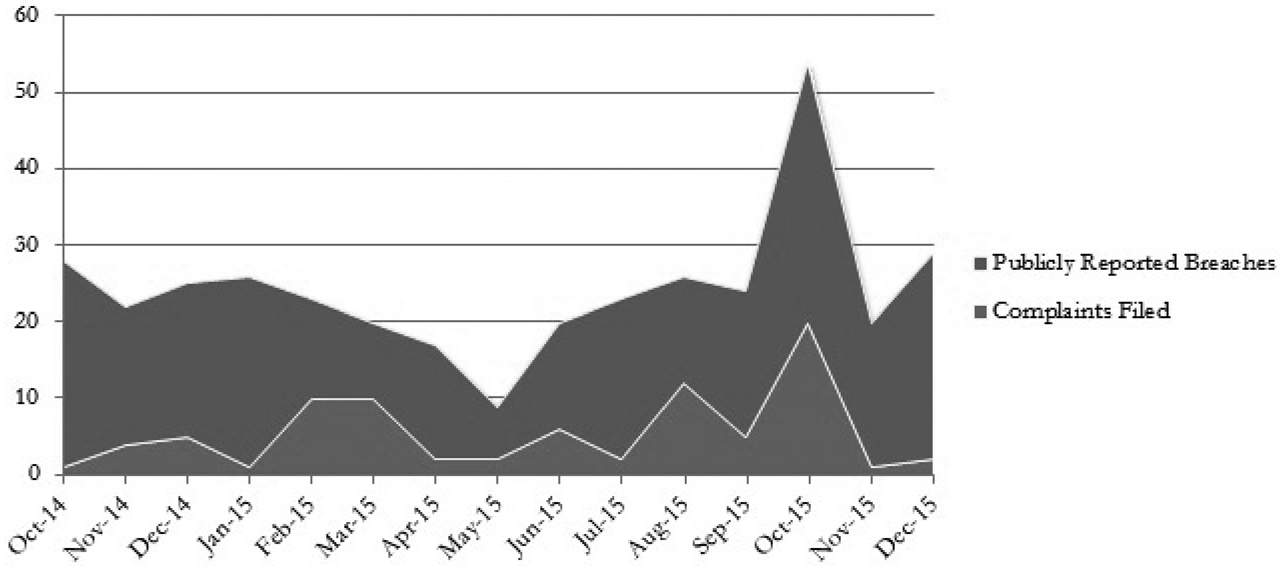
Our 2016 report covers litigation initiated over a 15-month period from the fourth quarter of 2014 through the fourth quarter of 2015 (the "Period").[2] Our key findings are:

- 83 cases were filed during the Period. This represents a nearly ***25% decline in the quantity of cases filed as compared to the 2015 Data Breach Litigation Report*** (the "2015 Report").[3]
- When multiple filings against single defendants are removed, there were only 21 unique defendants during the Period. This indicates a continuation of the "lightning rod" effect noted in the 2015 Report, wherein plaintiffs' attorneys are filing multiple cases against companies connected to the largest and most publicized breaches and are not filing cases against the vast majority of other companies that experience data breaches. As with the overall quantity of cases filed, the quantity of unique defendants also declined as compared to the 2015 Report; approximately ***16% fewer unique defendants were named in litigation***.
- Approximately 5% of publicly reported data breaches led to class action litigation. The conversion rate has remained relatively consistent as compared to prior years. The stability in the conversion rate is explained by a decrease in the number of publicly reported data breaches. While further research would be needed to separate correlation from causation, it appears that ***the decline in the absolute quantity of data breach class action litigation, and the absolute quantity of data breach class action litigation defendants, may be primarily due to a decline in the overall quantity of reported breaches***. At this point, there is no evidence to suggest that the decline in litigation is attributable to other causes (*e.g.,* disinterest by the plaintiffs' bar, lack of success of previous litigation, etc.).
- The Central District of California, the Northern District of Georgia, the Northern District of Illinois and the Northern District of California are the most popular jurisdictions in which to bring suit. ***Choice of forum, however, continues to be primarily motivated by the states in which the company-victims of data breaches are based***.
- Unlike in previous years, ***the medical industry was disproportionately targeted by the plaintiffs' bar***. While only 24% of publicly reported breaches related to the medical industry, nearly 33% of data breach class actions targeted medical or insurance providers.[4] The overweighting of the medical industry was due, however, to multiple lawsuits filed in connection with two large scale breaches. As a result, we do not expect the overweighting of the medical industry for breach litigation to necessarily continue into the coming year.
- There was a ***76% decline in the percentage of class actions involving the breach of credit cards*** as compared to the 2015 Report. The decline most likely reflects a reduction in the quantity of high profile credit card breaches, difficulties by plaintiffs' attorneys to prove economic harm following such breaches, and relatively small awards and settlements in previous credit card related breach litigation.
- While plaintiffs' attorneys continue to allege multiple legal theories, there appears to be some movement toward consolidation. For example, although ***plaintiffs alleged 20 legal theories, that represents a 16% decline from the 2015 Report***, which identified 24 legal theories.
- Favored legal theories continue to emerge. Specifically, while negligence was the most popular legal theory in the 2015 Report, with 67% of cases including a count of negligence, ***nearly 75% of cases now include a count of negligence***.
- Unlike in previous years in which plaintiffs' attorneys focused on breaches of information that was arguably of a less sensitive variety (*e.g.,* credit card numbers), ***plaintiffs' attorneys overwhelmingly focused on breaches in this Period that involved information that is traditionally considered "sensitive,"*** such as Social Security Numbers.

Part 1: Volume of Litigation

A total of 83 complaints were filed during the Period, down 24.5% from the 2015 Report.[5] This is likely the result of fewer breaches affecting the retail industry. In addition, the quantity of litigation loosely correlates with the number of publicly reported breaches in a month. For example, of the months studied in the Period, the highest number of publicly reported data breaches was reported in October 2015. Notably, the greatest percentage of complaints was filed in October 2015 (12%).[6] This can likely be explained by a spike in complaints naming Experian Information Solutions, which publicly reported a breach in the beginning of October 2015. Overall, the data shows an increase in filings naming a particular defendant 30-45 days after a company publicly reports a breach.

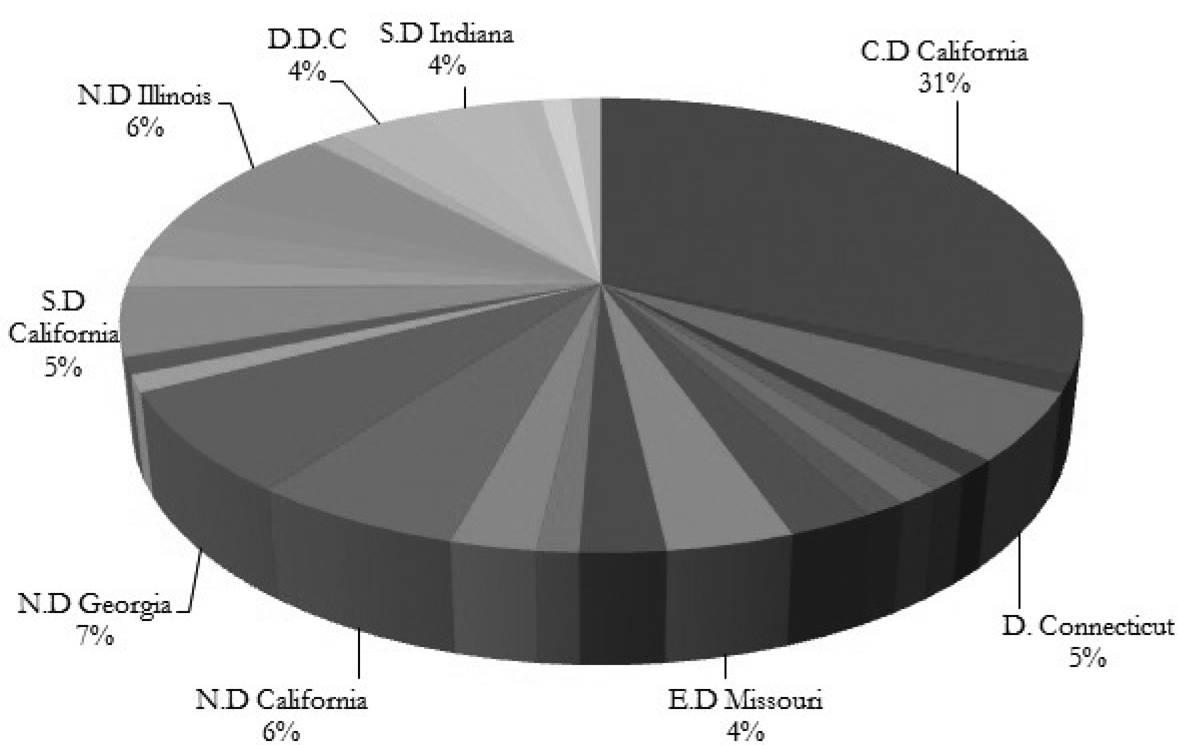
According to the Privacy Rights Clearinghouse Chronology of Data Breaches, 282 breaches were publicly reported during the Period.[7] However, only 83 federal class action complaints were filed during the same timeframe, and these filings related to only 21 unique defendants. As a result, slightly under 5% of publicly reported breaches ultimately led to class action litigation. This is consistent with the rate of data breach litigation identified in the 2015 Report, as well as the rate of data breach litigation identified by other studies during earlier time periods (2006 and 2010). The overall result is that there has <u>not</u> been an increase in the rate of complaint filings when total complaints are normalized by the quantity of breaches.[8] This is also consistent with the estimated rate of complaint filings observed in other legal areas, including personal injury or loss.[9] The following charts provide a breakdown of class action complaints filed with the quantity of publicly reported breaches disclosed during the Period:



Part 2: Favored Courts[10]

The Central District of California appears to be the preferred forum for filing data breach class action litigation, with almost a third of all filings originating in this jurisdiction. However, the high rate may be directly related to multiple class action filings naming Experian and Sony and alleging that the companies are headquartered in California. While Premera and Anthem also had significant complaints filed against them, no particular forum emerged as a preference. This is likely due to the fact that many complaints either named individual Anthem entities as defendants (*e.g.*, there were several complaints brought in the District of Connecticut naming Anthem Connecticut as the defendant) or alleged that Anthem conducted sufficient business in the state such that the jurisdiction was proper.

The following chart provides a detailed breakdown by district of federal class action filings:[11]

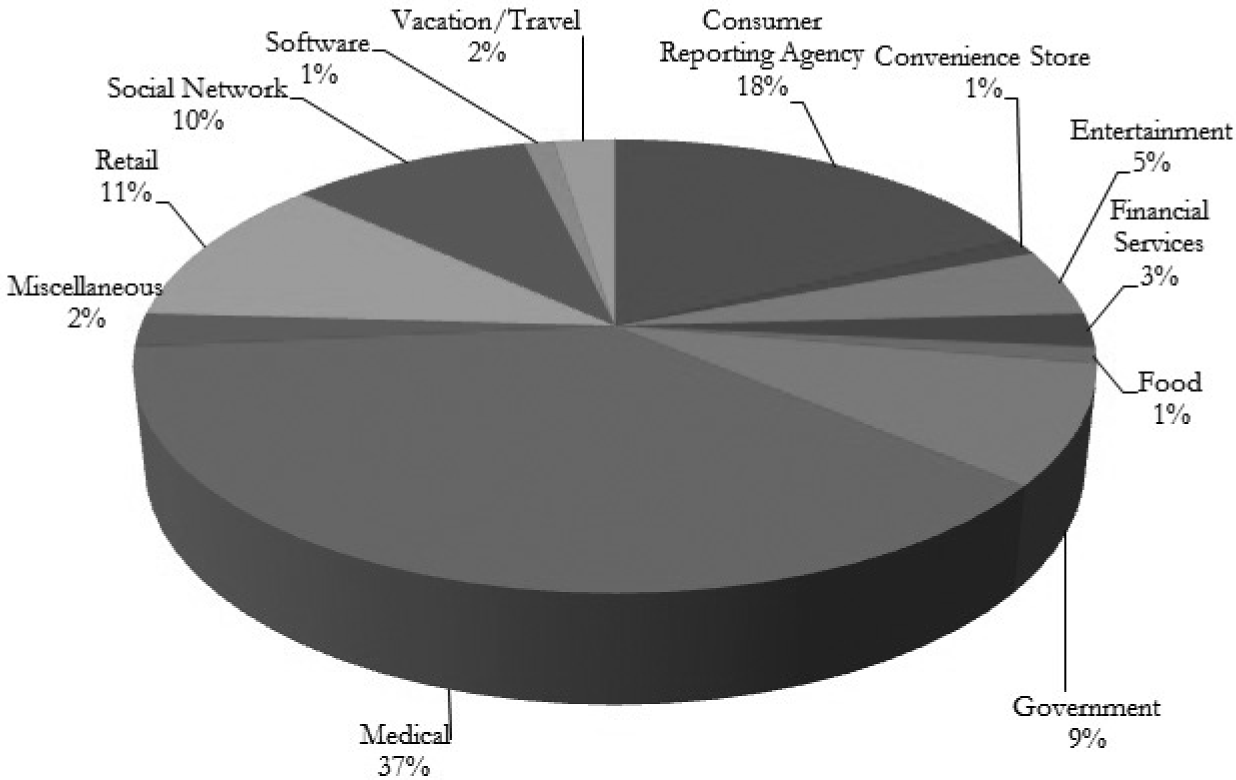


Part 3: Litigation by Industry

The medical industry was the target of the majority of class action complaints (37%), with 31 complaints filed during the Period, a 33% increase from the 2015 Report findings. The retail industry saw only 11% of complaints, down 53% from the 2015 Report.

The second hardest hit industry, Consumer Reporting Agencies, saw a major increase due to several class action complaints naming Experian Information Solutions. The Social Network Industry also emerged as a target of class action complaints, with eight class actions filed against the owners of a dating website. The public sector also received a significant, albeit minority, of class action complaints, with the widely publicized breaches of the Internal Revenue Service and the United States Office of Personnel Management. Other industry sectors were largely ignored by plaintiffs' attorneys.

The following chart provides a detailed breakdown of class action complaint filings by industry sector:

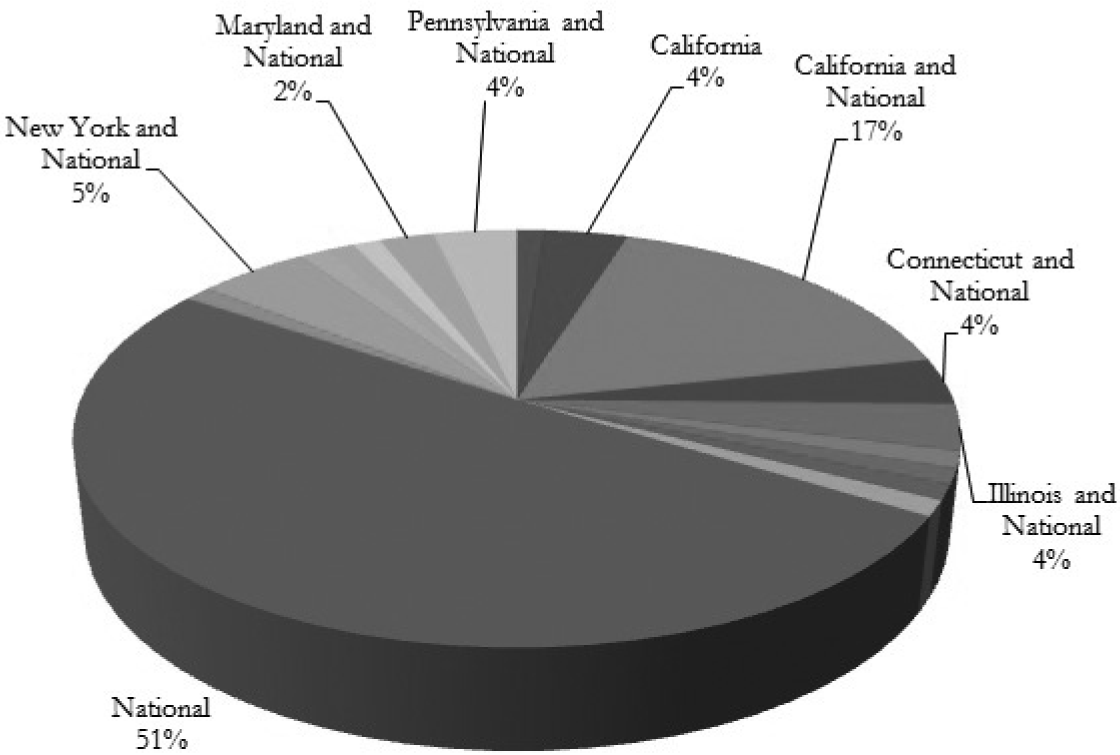


Part 4: Scope of Alleged Class (National v. State)

Access to class action complaints filed in state court differs among states and, sometimes, among courts within the same state. As a result, it is difficult, if not impossible, to identify the total quantity of class action filings in state court, and any analysis that includes state court filings would include a significant and misleading skew toward states that permit easy access to filed complaints. As a result, we purposefully do not include state court filings in our analysis and instead focus only on complaints filed in federal court and complaints originally filed in state court but subsequently removed to federal court under the Class Action Fairness Act ("CAFA").

We find in our dataset a strong preference for class actions that are national in scope. This may mean that plaintiffs' attorneys prefer to allege putative national classes in an attempt to obtain potentially greater recovery. It could also mean, however, that additional complaints that have not been included in our analysis were filed in state court alleging putative classes comprised of single state groups.

Despite the preference for national classes, we see almost half of complaints allege sub-classes tied to residents in specific states, a significant increase from the 2015 Report.[12] The following provides a detailed breakdown of the scope of putative classes:[13]

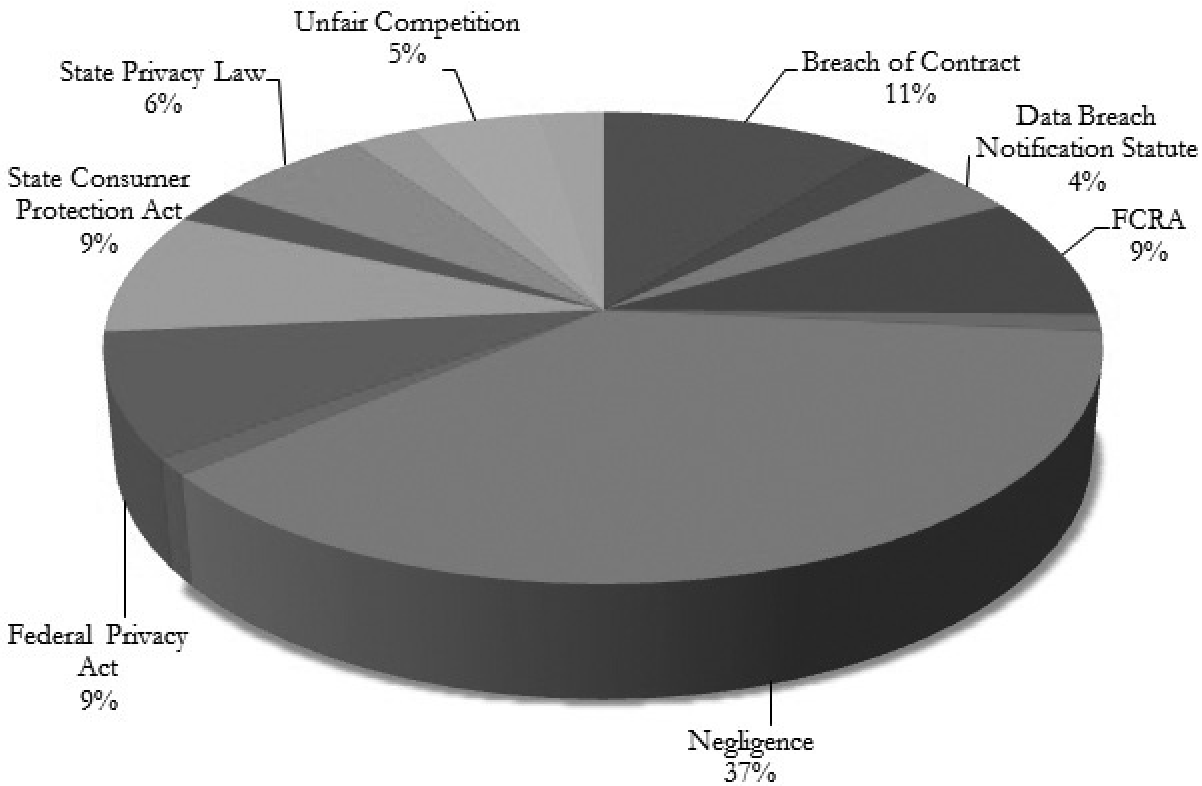


Part 5: Primary Legal Theories

While regulators rely on state data breach notification laws to bring civil investigative demands and enforcement actions, these statutes are less prevalent in the context of class action lawsuits. Violation of data breach notification statutes was not the primary legal theory (the first count alleged in a complaint), with just 4% of plaintiffs alleging a violation of a data breach notification law as their first count. In addition, while plaintiffs continue to allege that companies failed to timely notify impacted consumers of a data breach, as a factual matter, most cases relate to breaches that were, in fact, announced by a company shortly after the company identified the breach.

There is no shortage of alternative theories upon which plaintiffs have brought suit. The predominant theory used by plaintiffs, however, is negligence. Although negligence was the most popular primary theory in the 2015 Report, its predominance has increased more than 14 percentage points so that now more than one third of all class action litigation alleges negligence as the primary theory of recovery.

The following chart provides a detailed breakdown of the primary theory alleged in data breach litigation complaints:[14]

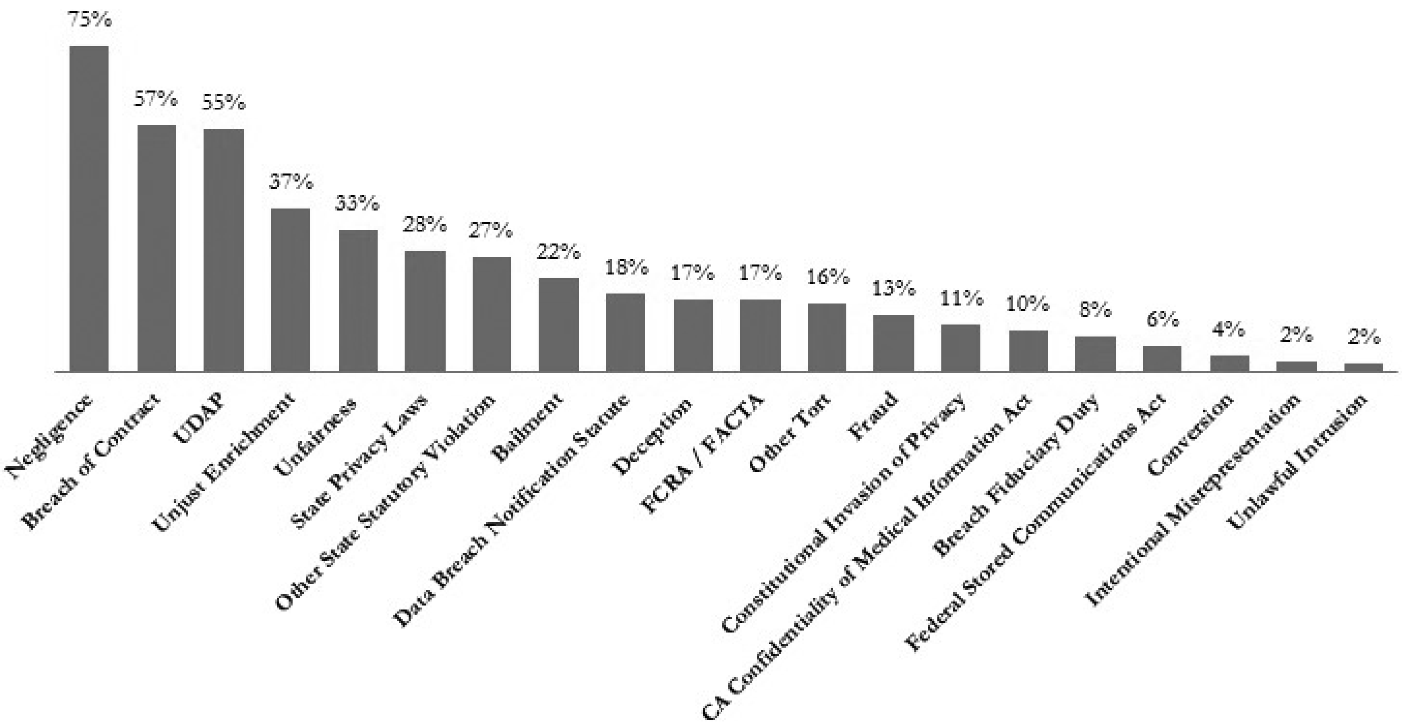


Part 6: Variety of Legal Theories Alleged

As discussed in Part 5, negligence was the leading "primary" legal theory used by plaintiffs' attorneys. Although negligence was the most common theory first put forward by a plaintiffs' attorney, most chose to allege more than one theory of recovery, and many plaintiffs' attorneys included theories sounding in contract, tort, and statute.

As indicated in the table below, although plaintiffs' attorneys show a clear preference for some legal theories – *e.g.,* breach of contract, negligence, and state consumer protection statutes – in total, they have pursued 20 different legal theories of recovery. "Bailment" or the idea that plaintiffs delivered their private information to defendants and therefore defendants owed them a duty to safeguard the information, emerged as a new, and popular, theory and was alleged in 21% of complaints. This can likely be explained by the spike in data breaches involving highly sensitive personal information that was entrusted to a company and the decline in breaches involving credit card information, where this theory would have little application.

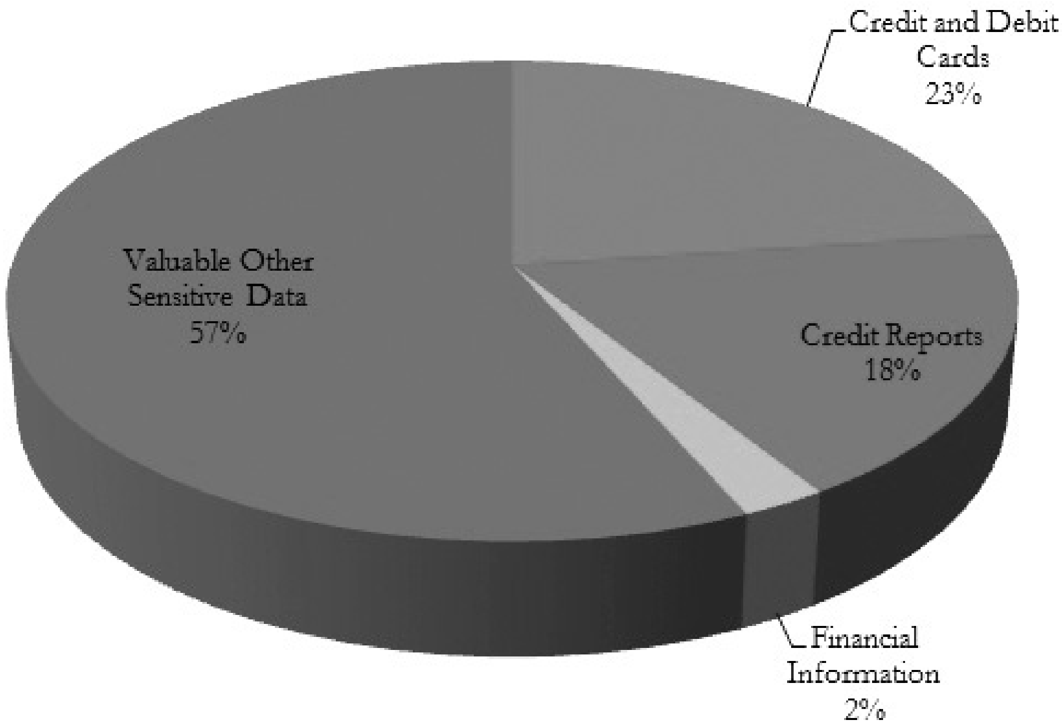
The following chart provides a detailed breakdown of all of the theories utilized by plaintiffs' attorneys in data breach litigation complaints:



Part 7: Primary Type of Data at Issue

In the 2015 Report, plaintiffs' attorneys overwhelmingly focused their resources on breaches that involved credit card numbers. That focus has decreased significantly. The quantity of class actions relating to credit cards has declined by 50 percentage points from 73% to 23%. The decrease in credit card breach class actions is likely the result of fewer high profile retail breaches during the Period, as well as difficulties for plaintiffs' attorneys to prove compensable injury in a credit card related data breach. Specifically, the Fair Credit Billing Act ("FCBA") and the Electronic Fund Transfer Act ("EFTA") dictate that the consumer cannot be held responsible for more than $50 in charges so long as the consumer reports the loss or theft of their card (or the unauthorized activity) within two business days of learning about it.[15] In addition, because many banks and payment card networks now voluntarily waive even the $50, most consumers suffer no financial harm as a result of a breach that involves their credit card.

The following chart provides a detailed breakdown of the type of data involved in data breach litigation:



Part 8: Plaintiffs' Firms
More than 65 plaintiffs' firms participated in filing class action complaints related to data security breaches. Although one plaintiffs' firm filed five class action lawsuits, the majority filed only one or two complaints.

Part 9: Methodology
The data analyzed in this report includes consumer class action complaints that were filed against private entities and government agencies. Complaints that were filed on behalf of individual plaintiffs were excluded.[16]

Data was obtained from the Westlaw Pleadings, Westlaw Dockets, and PACER databases. The sample Period covered the end of the third quarter of 2014 through the end of the third quarter of 2015 (*i.e.*, October 1, 2014-December 31, 2015). Multiple searches were run in order to find complaints that included – together with "class action" the following search terms:

- "security," or "breach" and phrases containing "personal," "consumer," or "customer" at a reasonable distance from the words "data," "information" or it derivations, "record," "report," "email," "number," or "code," or
- "data" at a reasonable distance from "breach,"

Although additional searches were conducted using the names of businesses that were the target of major data breaches (*e.g.*, "Anthem" and "breach") not all of the complaints filed as a result of these data breaches were found using Westlaw (*i.e.*, our search results produced around 31 complaints, while some sources suggest that more than 100 lawsuits were filed against Anthem).[17] The discrepancy may be due in part to the speed at which the multiple filings were consolidated.

All the complaints identified by these searches were read and, after the exclusion of non-relevant cases, categorized in order to identify and analyze the trends presented in this report.

As was the case in our prior whitepapers, state complaints have been excluded so as not to inadvertently over-represent or under-represent the quantity of filings in any state. Complaints that were removed from state court to federal court were included within the analysis.

** David Zetoony is the leader of Bryan Cave's Data Privacy and Security Team. David's practice focuses on advertising, data privacy, and data security and he co-leads the firm's Data Breach Response Team. David.Zetoony@bryancave.com*

***Jena Valdetero is the co-leader of Bryan Cave's Data Breach Response team, which focuses on counseling, compliance, and litigation. In her work in this area, she helps companies take the appropriate actions before, during, and after a data breach.*
Jena.Valdetero@bryancave.com

****Joy Anderson is an associate in Bryan Cave's Commercial Litigation Client Service Group and a member of the firm's Data Privacy and Security Team. Joy.Anderson@bryancave.com*

---

1 Google News Search for "Data Breach Litigation" conducted on March 22, 2016 (covers 30 days); Lexology.com search for "Data Breach Litigation" conducted on March 25, 2016.

2 The study period included October 1, 2014 through December 31, 2015.

3 Complaints filed against Government agencies were excluded from the 2015 report and included in the 2016 report. The decline in overall complaints filed would be even further pronounced if Government agencies were excluded from the 2016 Report. *See 2015 Data Breach Litigation Report: A Comprehensive Analysis of Class Action Lawsuits Involving Data Security Breaches Filed in United States District Courts,* 18 J. Consumer and Commercial Law 90 (2015), http://www.jtexconsumerlaw.com/V18N3/V18N3_Data.pdf, and http://bryancavedatamatters.com/category/white-papers/white-papers-security/.

4 Privacy Rights Clearinghouse estimates that in the Period, 68 of the 282 publicly reported breaches involved the medical industry. *See* http://www.PrivacyRights.org (last viewed March 22, 2016).

5 *See 2015 Data Breach Litigation Report: A Comprehensive Analysis of Class Action Lawsuits Involving Data Security Breaches Filed in United States District Courts*, 18 J. Consumer and Commercial Law 90 (2015), http://www.jtexconsumerlaw.com/V18N3/V18N3_Data.pdf, and http://bryancavedatamatters.com/category/white-papers/white-papers-security/.

6 *See* Privacy Rights Clearinghouse Chronology of Breaches *available at* http://www.privacyrights.org (last viewed March 22, 2016).

7 *Id.*

8 *See* Sasha Romanosky, *et al.,* Empirical Analysis of Data Breach Litigation, (April 6, 2013) at 10-11 *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1986461&download=yes (last viewed March 22, 2016).

9 *Id.*

10 This report does not include complaints filed in state courts. For more information, please see Part 9: Methodology below.

11 The following courts are not labeled in the chart and each represent 2% of the total filings during the Period: Northern District of Alabama, Southern District of Illinois, Southern District of New York, Western District of New York, the District of Oregon, and Eastern District of Pennsylvania. The following courts are not labeled in the chart and each represent 1% of the total filings for the Period: Eastern District of California, District of Colorado, Sothern District of Florida, Northern District of Indiana, District of Kansas, Eastern District of Louisiana, District of Maine, District of Maryland, District of Minnesota, District of Ohio, Northern District of Texas, and Eastern District of Virginia.

12 The 2015 Data Security Report found that only 19% of complaints alleged a subclass.

13 The following scopes of putative classes are not labeled in the chart and each represent 1% of the total filings for the Period: Missouri, Maryland, Oregon, Maine and National, Alabama and National, Kentucky and National, New Jersey and National, Ohio and National and Wisconsin and National.

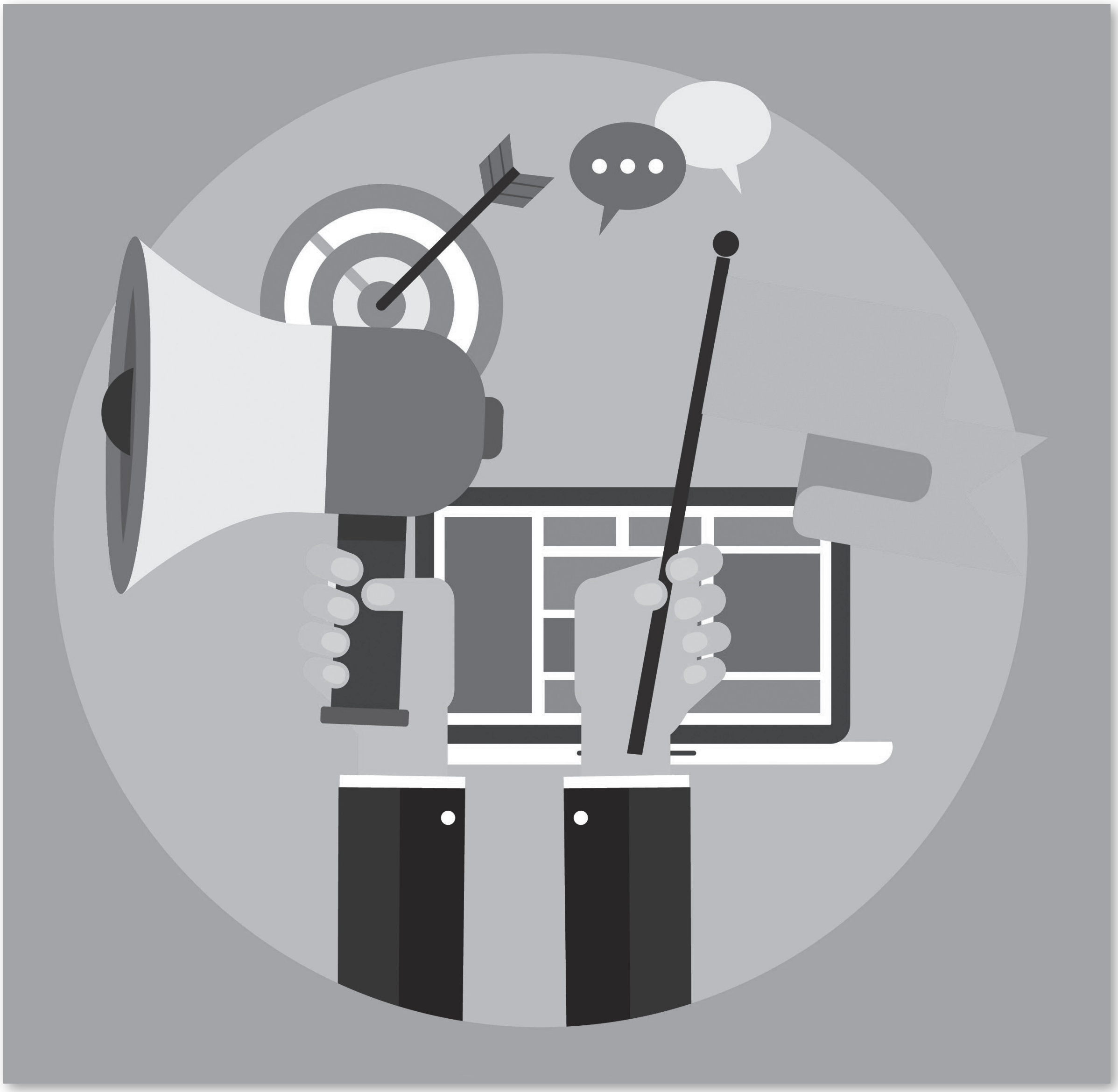
14 The following are not labeled in the above chart and each represent 2% of primary legal theories: Unjust Enrichment, Violation of the Federal Stored Communications Act, State Consumer Record's Acts and the California Confidentiality of Medical Information Act. In addition, the following are not labeled in the chart and each represent 1% of primary legal theories: Fraud and Negligent Misrepresentation.

15 *See* FTC Information Sheet, Lost or Stolen Credit, ATM, and Debit Cards *available at* http://www.consumer.ftc.gov (last viewed April 9, 2015).

16 As referenced above, the 2016 study differs from the 2015 Report in that it includes complaints filed against government agencies.

17 *See MDL Established for Anthem Data Breach Class Actions http://legalnewsline.com/stories/510550820-mdl-established-for-anthem-data-breach-class-actions*.

Effective Web Marketing



Applying Old Understanding to New Tools

By Charles Brown*

As Texas attorneys, we strive to provide quality legal services to our clients. However, doing so presupposes that we actually have clients and, increasingly, that means that we need an effective web presence. We all know that. The trouble is that what constitutes an effective web presence is constantly evolving and staying in front of every trend is beyond the capabilities of most law firms. That is why it is a better approach for most law firms to provide consistent, quality content through the three primary marketing outlets—directories, web pages, and social media. Rather than think of these as entirely new inventions, it is likely more accurate to see them simply as more effective versions of prior tools.

What constitutes an effective web presence is constantly evolving.

For decades, there were a few staples of law firm marketing: directories, brochures, and networking. Those staples are still present; they have simply changed their nature from physical to digital. Those tools have transformed to become internet search engines and directories, websites, and social media. Although the form has changed, the goals have remained the same.

From One Yellow Book to A Thousand Directories

The goal of buying a Yellow Page ad and paying for a Martindale Hubbell listing was simple—when your target audience, whether it be consumers or other law firms, needed to find a lawyer, this is where they would look. So once you made sure that the information in those ads or listings was correct, you were done for the year. For years, this strategy worked. Throughout the 1980s and 1990s, as many as 34 percent of adults looking for legal services utilized print directories[1].

Unfortunately, today, the simplicity of the Yellow Pages and Martindale Hubbell has been replaced by the fluidity and complexity of Google's search algorithm and thousands of specialty directories and websites competing for legal advertising dollars and consumer attention. Further, many smaller web directories will create entries for businesses based on scraped data. This can lead to inconsistency across the web which is a negative signal for many search engines, including Google. So an attorney can no longer simply sign off on a listing in one book or directory and be finished for the year. Now the process is constant and expensive (whether in terms of time or money).

Recall, however, that the goal is simple—to let those looking for you know how to find you. With that in mind, the real goal is to place your firm in the appropriate directories and to make sure that all web directory entries have the same, correct information for your firm.

Thankfully, there are a number of tools that can assist the lawyer who wants to handle this task in house. One such example is Moz Local. For $84.00 per year, Moz Local will push the correct location data to data aggregators across the web. This ensures that the data found on the web for your locations is correct and complete. Another similar tool is Manta's Listing Manager. For $33 per month, Manta's Listing Manager performs a similar service, but hits 50 different directories.

Whether firms use these tools or others, for a relatively small outlay of time and money, firms can reduce the burden of maintaining consistent directory listings across the internet, which is a key indicator of authority for many search engines and necessary when your potential client tries to find your firm.

Which Directories Matter

While these tools ensure consistent entries across the web, they do not tell you where you should consider advertising your firm to maximize your return on investment. In other words, how do you find the digital equivalent of the Yellow Pages and Martindale Hubbell listings for today's legal consumer? The simple answer is to focus on the directory that your potential client will use.

There is no escaping the mental process of putting yourself in the shoes of your potential client and determining their method for locating a lawyer who performs your services. Matching your marketing efforts to your client's needs is the first step to an effective web presence. You might be the lucky law firm that ranks number 1 in Google for "bankruptcy lawyer" but that does not help if your firm specializes in family law. So how do you determine how your potential client would find you?

Step 1: Google Keyword Tool. The Google Keyword Tool serves two primary functions—to give you keyword ideas and to give you insight on the monthly volume of searches for particular keywords. Once you create an account, create a list of keywords that reflect your firm and the types of legal work you are interested in. Google's Keyword Tool will take that list and give you up to 1000 additional keyword ideas. Once you have the list, you can begin to get estimates of both the volume of the search and the competition for the search. It is best to view the competition or keywords on a local level (e.g. Houston) rather than a national or global level if your practice is a local practice. Also, make sure to check on the difference between mobile search and desktop search if that is relevant to your practice area. Now, cull that list down to the top 10 keywords. These are the words that you are going to target.

Step 2: Using Google and Bing, search the internet. Once you have a list of the keywords you want to use to get traffic to your site, the next step is researching what keywords are driving traffic to your competitors' websites. As a law firm, you already know your industry, niche, and target market, so the next step is determining who your competition is. You can do this process yourself, or use an online tool like Raven or Compete.com to help you analyze the data. In the online world, your competitors would include other law firms that are visible on the same or similar search engine results pages as yours. Look for the first five or ten firms that appear in results with yours, and then review their websites. The goal is to find opportunities that your competitors have missed in their digital arsenal.

Step 3: Search for Directories. There are numerous online directories, but some will have better ranking on large search engines like Google and Bing. Among the top search engine performers are Yelp, Manta, and Yahoo! Local Listing. Looking more specifically at the legal industry in Houston, top directories include Avvo, lawyers.com, and justia.com. If there are one or two directories that consistently appear in the search results for your keywords, you should strongly consider advertising in these directories.

Think of your website as your firm's brochure.

What Once Was a Brochure Is Now a Web Page

Once the potential client finds you via web directories or search engines, they are likely going to visit your website. Think of your website as your firm's brochure. Only now, your digital brochure is available to people wherever they are and contains up-to-date information. The humble brochure has become your website and blog.

As with legal directories, the days of set it and forget it are over. Change is required. Many refer to this as blogging, which is consistently adding content to your website. Whether you think of it in terms of blogging or a constantly growing brochure is not terribly relevant. What is critical to success on the web is the idea of consistently adding quality content to your website. Blogging is one of the most effective strategies to improve your search engine visibility and reach consumers. The Texas Bar Association even offers a directory of blogs at blog.texasbar.com.

Success in blogging is no different than any other form of marketing. Your goal is to create quality content. By creating content that speaks to the needs of the consumers and answers questions that they want answered, you will find potential clients. Family law attorneys can reach consumers by creating informative blogs related to topics like co-parenting, changes in child support laws, or tips for an amicable divorce. Similarly, personal injury firms can reach clients by using current, real life news examples of accidents or injuries and then explaining how their firm can help clients in similar situations pursue financial recovery. But remember to focus on your potential client's needs, not your own. Simply posting a prefabricated press release by an awards group is not effective and serves a limited function. Instead, if you provide unique information to your potential clients, the search engines and potential new clients will find you.

Improving Your Website

Just as the text of your brochure is critical to its utility, the text of a website can make the website more useful to consumers and more easily indexed by search engines. So taking the time to ensure that your website has effective content is worth it in the long run.

To start, it is critically important to know what keywords you want your website to focus on. While some firms take the shotgun approach, hoping to get cases in more lucrative areas than they regularly practice in (think truck accidents), a better approach for consumers and for search engines is to focus on your firm's strengths. Then, when a potential client sees your site, they will know that you are an expert in your field and feel comfortable that you are the right lawyer for them. This keyword list should be similar to the list created for the directory project above.

After creating and refining your keyword list, a firm must ensure that a visitor to the website would quickly see those keywords sprinkled throughout the website. The following are some ideas for ensuring that your website focuses on your keywords:

- **Keyword Placement**: There should be a page for each keyword that you would like to focus on. Once you have established the keyword for the particular page, make sure that the keyword appears in the title, headline, URL, and in appropriate places in the body text. Think early and prominent. If the page is about custody disputes, Custody Disputes would be a good title for that page. It should also appear as the URL for that page. As you outline the page, it should probably also appear regularly throughout the text.
- **Focus on the Consumer**: If your page is poorly written or the content is weak, consumers will not remain interested in your website for very long and are not going to be interested in hiring you as their lawyer. By focusing on the potential client, many of the search engine optimization goals will be met naturally. Small law firms looking for a competitive search engine edge should also consider creating their website on a platform that is mobile-friendly[2]. More and more people search from their phones rather than a computer.
- **Add Visuals**: Just as a text-only brochure would be terribly boring, so is a website without pictures or video. Adding these visuals to a website helps in several ways. First, adding photographs or video to a website can build trust among consumers. Photographs help convey the human element of attorneys and law firms, helping our potential clients connect with people within the firm. Similarly, thoughtful, concise videos can help potential clients understand your firm's approach and values.

Networking Is Now Social Networking

Networking is an overused marketing device for the lazy and ineffective. As traditionally practiced, networking consists primarily of haphazardly attending conferences, happy hours, or lunches with people who may, in theory, have work to send you at some unspecified time. It allows lawyers to feel like they are "getting out there" and "beating the bush" but really it accomplishes very little.

Social media networking is no different. Posting on Facebook or Twitter without a plan is not marketing. Instead, a firm must have a well thought out plan and execute impeccably in order to have any success generating consistent work through social media.

To start, a firm must build a follower base that is likely to have work for the firm. It is not effective to have 1000 followers that see your message if none of the followers are decision makers with a legal problem that you can solve. How best can you find followers who might either have legal work for you or know others who will? Mine your former and current client base. Every effort should be made to recruit as many of your current and former clients as you can to follow your social messaging accounts.

Posting on Facebook or Twitter without a plan is not marketing.

Firms should also follow and monitor current and former clients' social media accounts. This can not only give you insight into the current issues impacting your clients, but also help you obtain additional followers with similar backgrounds and interests to your current and former clients.

Social media has the ability to magnify the other efforts firm's make to get their message out to potential clients. However, just like networking in the real world, social media marketing is hard work to do well and time consuming and expensive when done poorly.

Summing It Up

Online marketing is required for law firms. While many can become confused by all of the online marketing options, remembering that today's tools are little more than digital versions of old tools can help focus firms on effective marketing strategies and empower them when they are pitched by vendors who seek to confuse rather than clarify. Just as before, the goal is to make sure that your potential clients can find you and like what they see once they do.

** Charles Brown is the managing partner of Brown, Wharton, & Brothers, a medical malpractice firm based in Houston, Texas. Additionally, he teaches Law Office Management at the University of Houston Law Center.*

---

1 American Bar Association (2011). Perspectives on Finding Personal Legal Services. http://www.americanbar.org/content/dam/aba/administrative/delivery_legal_services/20110228_aba_harris_survey_report.authcheckdam.pdf

2 Hendricks, Drew (2015). 3 Secrets Regarding SEO for Law Firms. http://www.allbusiness.com/seo-for-law-firms-21481-1.html

Consumer Financial Protection Bureau

Proposes Limitations on Consumer Arbitration

On May 5, 2016, the **Consumer Financial Protection Bureau** proposed rules that would prohibit financial companies using mandatory pre-dispute arbitration clauses to deny their customers the right to band together to seek justice and meaningful relief from wrongdoing. The proposed rules also require reporting, to enable the Bureau to monitor the individual arbitration process, providing insight into whether companies are abusing arbitration or whether the process itself is fair.

Here are the remarks of Director Richard Cordray delivered at the field hearing, held in Albuquerque, New Mexico.

Thank you to Albuquerque for the warm welcome you have given us. This is our 34th field hearing since the Consumer Financial Protection Bureau first opened its doors and started traveling the country to listen to the everyday concerns of American consumers. Each one of these field hearings has been valuable for us. They give us insight and substance to inform our work, and they humanize the challenges posed in the financial marketplace. So we thank you all for joining us today. Hearing people's stories, as told by them, sometimes in voices of steely determination, other times through tears as they recount their difficulties and frustrations, leaves an indelible mark on us as we turn back to analyze and address the issues they raise. Let there be no doubt that these sessions motivate us to keep moving forward in our efforts to help make consumer finance markets work better for consumers.

Today we are proposing a new regulation for public comment and further consideration. If finalized in its current form, the proposal would ban consumer financial companies from using mandatory pre-dispute arbitration clauses to deny their customers the right to band together to seek justice and meaningful relief from wrongdoing. This practice has evolved to the point where it effectively functions as a kind of legal lockout. Companies simply insert these clauses into their contracts for consumer financial products or services and literally "with the stroke of a pen" are able to block any group of consumers from filing joint lawsuits known as class actions. That is so even though class actions are widely recognized to be valid avenues to secure legal relief under federal and state law.

We have investigated arbitration, and our research found that very few consumers know anything about these "gotcha" clauses. Even fewer consumers know how they actually work. Based on our research, we believe that any prospect of meaningful relief for groups of consumers is effectively extinguished by forcing them to fight their legal disputes as lone individuals. These battles – frequently over small amounts of money – would often have to be fought against some of the largest financial companies in the world. When faced with the daunting prospect of spending considerable time and effort to recoup a $35 fee or even a $100 overcharge, it is not hard to see why few people would even bother to try.

More recently, many businesses have sought to use arbitration clauses not simply as an alternative means of resolving disputes, but effectively to insulate themselves from accountability by blocking group claims.

The fact is that certain corporate policies and practices can be lucrative to businesses but harm large numbers of individuals only on a minor basis. There was a long time in the history of this country where the legal system struggled for a solution to this problem. Courts and legislative bodies sought to develop a workable mechanism whereby people could band together and aggregate their claims into a single action that could provide accountability and justice within the legal system. Some of these efforts go back hundreds of years, but about a half-century ago, the concept of the modern class action came to fruition in the American civil justice system. As this procedure was refined to allow the courts to handle and process such cases efficiently and fairly, both Congress and the federal courts embraced and approved this approach. So did legislatures and courts in nearly every state. It has proved particularly meaningful in the arena of consumer finance, where companies that violate the law may do small amounts of harm to thousands or even millions of consumers.

It is important to recognize that the legislative and judicial branches of government not only have recognized and validated this mechanism for group lawsuits, but they also tightly control its use in particular cases. Congress and state legislatures have the authority to determine whether any violation of law can give rise to a private lawsuit in the first place, under what conditions, and for what types of relief. If a class action lawsuit is filed, the courts have specific processes for determining whether the claims can proceed in that format or not.

This is notable because for some provisions of the consumer financial laws, Congress has in fact authorized private lawsuits. Thus, over many years of enacting federal consumer financial laws (all of which post-date the adoption of the modern class action procedures in the federal courts), Congress has explicitly determined that such actions further the purposes of those particular statutes. And in so doing, Congress has permitted consumers to bring lawsuits (including class actions) to seek meaningful relief for the harm done them by such violations of law.

These provisions of the consumer financial laws thus provide a right to sue for relief, with one consumer representing the interests of a group who have all been harmed in the same way. If the lawsuit is successful, the company can be made to rectify the problem for all affected customers. It also can be required to clean up its practices moving forward. Yet a mandatory arbitration clause can negate all of this, leaving consumers with few practical avenues to secure adequate relief when they are harmed by violations of the law.

The justification for this approach is found in the Federal Arbitration Act, a statute that dates from 1925. Over time, its application has evolved. At the outset, its primary and virtually sole focus was on business-to-business disputes, in cases where the parties negotiated and agreed that it was in their mutual interest to have their disputes resolved by an arbitrator rather than by the courts. Over the years, arbitration came to be used in other types of disputes as well, such as those between unions and employers. It is generally recognized as one of several methods of "alternative dispute resolution."

More recently, many businesses have sought to use arbitration clauses not simply as an alternative means of resolving disputes, but effectively to insulate themselves from accountability by blocking group claims. For many years, courts wrestled with the question of whether to allow arbitration clauses to be used in this way. Several years ago the Supreme Court concluded that arbitration clauses could in fact block class actions even though the state courts in that case had deemed that result to be unconscionable under state law.

In the past decade, however, Congress has expressed growing concern about whether mandatory arbitration is appropriate in the realm of consumer finance. First in the Military Lending Act, passed in 2007, Congress barred arbitration clauses in connection with certain loans made to servicemembers. In 2010, in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress went further by barring arbitration clauses in mortgages, which make up the largest consumer finance market. In so doing, Congress expanded on a ban that Fannie Mae and Freddie Mac had imposed several years earlier on mortgage contracts they purchased.

Similarly, in the Dodd-Frank Act Congress authorized the Securities and Exchange Commission (SEC) to regulate the use of arbitration clauses in contracts between investors and brokers and dealers. Here Congress was building on work by the Financial Industry Regulatory Authority (FINRA), which has long required that arbitration clauses adopted by its broker-dealer members cannot be used to block class actions by customers. Each of these measures reflects concern about how mandatory arbitration clauses may undermine the welfare of individual consumers (or, in the case of the SEC, investors) in the financial marketplace.

Congress also spoke to our subject today by directing the Consumer Bureau to conduct a study and provide a report to Congress on the use of mandatory arbitration clauses in other consumer financial contracts. Once this work was completed, Congress stated that "[t]he Bureau, by regulation, may prohibit or impose conditions or limitations on the use of" such arbitration clauses in consumer financial contracts if the Bureau finds that such measure "is in the public interest and for the protection of consumers," and such findings are "consistent with the study" we performed. We finished that work a year ago and heard from stakeholders about our findings and analysis. We then put forward an initial framework, subject to further review through our small business review panel process and with others as well. All of this leads up to our proposal today for a potential new rule that would address this issue.

To explain what we are proposing, it is useful to recap the results of our extensive study and report to Congress, which spans 728 pages of findings and analysis. Perhaps the most striking finding from our study is that consumers rarely file individual disputes involving financial products or services in any forum. We believe in part this is because consumers often do not recognize when their rights have been violated. It can be difficult for consumers to know, for example, when they have received inadequate or even misleading information or when they have been subject to discrimination. Even when consumers do feel aggrieved by something their financial service provider has done – for example, by charging an unwanted back-end fee – consumers rarely know whether the company's conduct is unlawful. And for the overwhelming majority of consumers, we believe it simply does not make sense to try to find a lawyer to take issue with a small fee or other such practices.

Our study further found that when individual consumers choose to step forward and bring a class action on behalf of all similarly-situated consumers, such group lawsuits can be an effective way to provide relief when they are allowed to proceed. This includes those who may not realize that their rights have been violated or those who may have felt they simply had to resign themselves to the way they were treated. Indeed, by examining five years of data on several distinct markets, the study found that group lawsuits delivered, on average, about $220 million in payments to 6.8 million consumers per year in consumer financial services cases. Customers were also able to obtain substantial prospective relief by forcing companies to improve compliance and adopt more consumer-friendly practices. Of course, the class action lawsuit is by no means a perfect mechanism for addressing such issues. But class actions do happen to be the most practical solution that has been worked out to date. And the precise parameters of class action procedures have remained constantly subject to further critique, reform, and improvement over time.

The study showed that many companies use mandatory arbitration clauses to block consumers from ever securing any meaningful relief from violations of the law. Tens of millions of consumers use financial products or services that are subject to arbitration clauses. Those clauses deter class action lawsuits from being filed and often prevent those that are filed from moving forward. Yet without group lawsuits, those consumers who feel they may have been wronged are often left with very limited options. They can pursue their dispute with the company individually in arbitration, in small claims court, or sometimes in state or federal court, yet our study showed they rarely do so. They can simply accept the unlawful terms and absorb the harmful treatment, as is too often the case for many consumers. They can pursue some type of informal dispute resolution with the company through complaint lines, which will lead to relief in some instances as a matter of good customer service, but falls far short of any systematic resolution that eradicates unlawful practices. Or they can "vote with their feet" by moving on to another provider, though this is not always possible. Even when it is, there may be less incentive to do so if other companies have also inserted arbitration clauses in their own contracts.

So our study indicated that simply by inserting the magic words of an arbitration clause, financial companies can avoid being held directly accountable for their actions affecting their customers. Of course, the laws may empower certain government officials, such as those of us at the Consumer Bureau, to bring actions to enforce their terms. Yet public resources devoted to this purpose are limited, to the point where we cannot hope to cover the waterfront of consumer financial harm by such means. Indeed, the study found that class actions supplement government enforcement actions and seldom overlap with them. And several state attorneys general have told us they favor limitations on arbitration clauses because their enforcement resources are also limited.

Under the proposed regulation we are releasing today for public comment, companies could still include arbitration clauses in their contracts. For new contracts, however, these clauses would have to say explicitly that they cannot be used to stop consumers from grouping together in a class action. As noted previously, this is the same approach FINRA has taken in regulating similar provisions in certain investor contracts and it does not go as far as Congress did for mortgage contracts or certain credit contracts for servicemembers. In our study, we found that individual arbitrations are not commonly filed in consumer finance matters, and we do not believe we have enough data to justify restricting them further at this time.

If arbitration truly offers the benefits that its proponents claim, such as providing a less costly and more efficient means of dispute resolution, then it stands to reason that companies will continue to make it available. If they do, then companies which retain these more limited arbitration clauses would have to submit claims, awards, and other information to the Bureau. This would enable better monitoring of consumer finance arbitrations to ensure that the process is fair for individual consumers. It would also enable further review of the substantive allegations raised in these arbitration processes to see if they warrant action by the Bureau. Finally, we are considering publishing these materials on our website to promote transparency and enable the public to learn more about the arbitration process.

So the essence of the proposal issued today is that it would prevent mandatory arbitration clauses from imposing legal lockouts to deny groups of customers the right to pursue justice and secure meaningful relief from wrongdoing. From the results of our study, we believe that doing so would produce three general benefits, about which we seek further comment.

First, consumers would have a more effective means to pursue meaningful relief after they have been hurt by violations of consumer financial laws. At the same time, it would stop the same prohibited practices from harming consumers in the future. Many of these laws confer the right to an effective remedy to redress harms consumers suffer from violations of the law. This reflects an important element of personal liberty, that people should have the ability to protect themselves by acting to pursue their rights. But as we have already noted, it may not be practical or worthwhile for consumers to undertake the burden and cost of bringing an individual case just to challenge small fees and charges. Without the opportunity to pursue group claims, they may be effectively cut off from having their grievances addressed.

Second, another important benefit that would potentially flow from our proposal is that it would deter wrongdoing on a broader scale. Although many consumer financial violations impose only small costs on each individual consumer, taken as a whole these unlawful practices can yield millions or even billions of dollars in aggregate harm. Mandatory arbitration clauses that bar group actions protect companies from being held accountable for their misdeeds. Thus, companies have less reason to ensure that their conduct complies with the law. We plainly recognize that this may cause financial companies to incur higher compliance costs and forgo some revenue from engaging in risky behaviors. But we believe that is exactly how accountability should change company behavior.

We believe our proposal would promote consumers' ability to pursue claims, bring greater accountability, and enhance the transparency and fairness of arbitrations.

Put differently, it matters if companies are aware that group lawsuits can lead to relief to thousands or even millions of victims of unlawful practices. The likely result is to create a safer market for current and future customers of that company. That is because the potential for a substantial monetary award often leads a company to rethink its practices by reassessing its bottom line. And the public spotlight on these cases can influence business practices at other companies as well.

Third, by requiring companies to provide the Bureau with arbitration filings and written awards, which we might end up making public in some form, the proposal would enable the Bureau to monitor and assess the pros and cons of how arbitration clauses affect resolutions for individuals who do not pursue group claims. We believe this would improve our understanding and enable policymaking that is better informed. The Bureau would also collect correspondence from administrators about a company's non-payment of arbitration fees and its failure to adhere to the arbitration forum's fairness principles. The purpose here would be to provide insight into whether companies are abusing arbitration or whether the process itself is unfair.

In short, we believe our proposal would promote consumers' ability to pursue claims, bring greater accountability, and enhance the transparency and fairness of arbitrations.

Our democracy allows, encourages, and indeed depends on citizens who band together to demand political or legislative change. Many consumer financial laws likewise presuppose that groups of customers can join together in our legal system to demand changes in unlawful practices that affect them all in common. But our study shows that an important avenue for reform can be cut off by mandatory arbitration clauses that affect millions of consumers. Our proposal would reopen that avenue by ensuring that consumers can take action together if they have been hurt together.

Under our proposed rule, companies would not be able to deny consumers their day in court. Companies would not be able to evade responsibility by blocking groups of consumers from the legal system and reaping the favorable consequences. Everyone benefits from a marketplace where companies are held accountable for treating their customers fairly and in accordance with the law.

Our proposal will be open for public comment for the next three months. We will carefully consider the comments we receive before issuing a final rule. We have found this process is always instructive and enables us to reach sounder conclusions in the end. We look forward to the public comments as well as the initial feedback we will hear today. Thank you.

The Federalist Society for Law & Public Policy Studies

A Panel Discussion Financial Services: Explaining the Next Crisis

Moderator:
HON. EDITH H. JONES, U.S. Court of Appeals, Fifth Circuit

Panelists:
HON. PHIL GRAMM, Senior Advisor, U.S. Policy Metrics; and former United States Senator
FRANK MEDINA , Senior Counsel & Director of Research, Better Markets
KAREN SHAW PETROU , Managing Partner, Federal Financial Analytics, Inc.
PROF. J.W. VERRETT, Assistant Professor of Law, George Mason University School of Law

JUDGE EDITH H. JONES: Ladies and gentlemen, I want to welcome you here to this distinguished panel. As they say in the airlines, we know you have other options available, but we're very grateful you chose this panel, where we have an incredibly knowledgeable group of people on where is the next financial crisis going to come from. As the holder of a small portfolio, I'm very interested in that question. I'm more interested in when, so we will know when we should get out of the market.

We're going to deviate a little bit from the usual Federalist Society format here, in that we're privileged to have former Senator Phil Gramm with us today. I met Senator Gramm when I was a young lawyer still involved in politics and he was a young Texas A&M professor running for Congress. The rest, from his standpoint, is history. He had been a professor at A&M in economics. As you probably all know, he served six years in the House and 18 years in the U.S. Senate, and just to give you an idea—this was back when people could do things in Congress. He was the co-author of the Gramm-Latta Budget, which reduced federal spending, rebuilt national defense, and mandated the Reagan tax cut. He was the co-author of the Gramm-Rudman Act, which actually installed controls on federal spending for the very first time in historical memory. And he was the co-author of the Gramm-Leach-Bliley act, which reversed the Glass-Steagall Act and allowed banks, securities firms, and insurance companies to affiliate as part of financial service holding companies. He is currently a visiting scholar at the American Enterprise Institute. Since leaving Congress in 2004, he worked with UBS and is now with Lone Star Global Acquisitions as its vice chairman, working extensively with sovereign wealth funds and banks to dispose of assets.

Also on our panel and the next speaker is Karen Shaw Petrou. Karen Shaw Petrou was dubbed by the *American Banker* in 2012 the "sharpest mind analyzing the banking policy today—maybe ever." She is the cofounder and managing partner of Federal Financial Analytics, which has been in business since 1985. She is an honors graduate of Wellesley and MIT, received an M.A. at the University of California at Berkeley, and was a doctoral candidate there. She is an expert on banking and financial services regulation. If I were to tell you all of the institutions to which she has given speeches, we would not have time for her talk.

The next speaker is Mr. Frank Medina, senior counsel and director of research of Better Markets. Better Markets is a Washington, D.C. independent, nonpartisan, nonprofit organization to promote the public interest in U.S. and global financial markets. Before going with Better Markets he was the deputy director for the House Financial Services Committee, where he drafted legislation and amendments and wrote reports on major financial regulatory issues. Before that, he was a senior attorney of the SEC. He was also an associate general counsel at Citigroup Inc.

The final speaker is going to be Professor J.W. Verrett from George Mason University. He followed Mr. Medina's tenure on the House Financial Services Committee.

J.W. VERRETT: I did. It was a long episode of the Odd Couple that continues today.

JUDGE EDITH H. JONES: Well, Professor Verrett is also a fellow at the Mercatus Center at GMU. He is on the working group there on financial markets and testifies and briefs Congress. His J.D. and M.A. are in public policy from Harvard Law School. He was a law clerk in the Delaware Court of Chancery, worked in the SEC division of Skadden Arps, and has written numerous publications and had interviews on the subject.

Senator Gramm is going to speak for about 20 to 25 minutes on what he sees as the current challenges to the financial markets globally as well as in the U.S., and then the others will each comment.

SENATOR PHIL GRAMM: Thank you very much. When I came to the Senate, Edith had already been nominated to the Fifth Circuit, but she hadn't been confirmed. And so I have always also remain silent when people have listed her among my great appointments to the federal bench. I've always been proud of you Edith and the great job you've done, and I want to thank you for the contribution you've made.

Let me start by making it clear I'm not going to predict the next financial crisis. I started what I thought was a good principle when I was a young college professor, and that principal was: Never predict something that will either happen or not happen during your lifetime.

And 24 years in Congress probably made me less careful than then I'd been in academics. Thirteen years in business, in investment banking and private equity, have made me cautious again. So here's what I will predict: We will have another recession, and I know exactly what will cause it, and it will be caused by the same thing that has produced every economic correction in the history of the world. And that is, humans are fallible; they make mistakes; those mistakes create imbalance within an economy. If the economy is a free economy, those imbalances trigger a correction, and in our society, that correction is normally known as a recession. In a society that is less free, that is more dominated by government than by markets, these errors that are made simply build up as a dead weight that chokes economic growth. And like old growth on a grapevine that's not pruned, soon the grape becomes nonproductive.

The financial crisis was produced by government policy—government policy that force-fed housing.

We have had 11 recessions and recoveries in postwar America. The average recovery has been 58 months long. We are in the 77th month of this recovery, such as it is. It is the fourth-longest recovery in the postwar period. How close we are to another correction, I don't know. The first eight recessions in postwar America were inventory cycles. They followed exactly the same pattern. People made mistakes. Inventories built up. It was discovered. Retrenchment orders went down the production line. People were laid off. Government did all kinds of things. Politicians gave speeches. Almost none of them had any effect. Generally, they came into effect after the recession was over. We had a recession in 1990 that was hardly worthy of the name. The great thing about the golden era from 1983 to 2007 is the economy grew so rapidly that recessions were almost a non-event. It was memorable because it was the beginning of the sloughing off of white-collar workers, coming from the Information Age. Then we had a tech bubble in 2001, and then the financial crisis in 2007.

The financial crisis was produced by government policy—government policy that force-fed housing. About six months after the recession triggered, I was at the IMF, working for UBS, and I was asked by the head of the People's Bank of China, "Tell me in one sentence what's going on in the American economy." I said, "We gave loans, through public policy pressuring private decision-makers, to people who either couldn't or wouldn't pay loans back." Beginning in '95, and then with the quotas on Freddie and Fannie, we built up 31 million non-prime loans outstanding. We created a huge bubble in housing demand by destroying standards for lending, which had been the hallmarks of Freddie and Fannie, and when the bubble broke, as all bubbles do break, people walked away from houses in record numbers. Those mortgages had been securitized, and under Basle II, almost all of them were rated AAA. Banks could hold them in conduits without holding much in the way of reserves against them, so financial institutions held huge volumes of mortgage-backed securities. They had literally been injected into the arteries of the financial system. And when the bubble broke, housing loans were defaulted. There was uncertainty as to who was broke and who wasn't. The financial system lost the indispensable ingredient of modern finance, and that's confidence. And so the system froze up.

Government did a great job in dealing with that crisis. It's interesting to me that they get no credit whatsoever in most modern discussions of the problem. Look at it this way: They provided $700 billion for TARP. They only used $438 billion, and they got back every penny of it except the money they lent to General Motors, which had nothing to do with the financial crisis. The TARP and the bailout process cost one-tenth what the bailout process cost for the S&L crisis in the 1980s. The Federal Reserve Bank responded, provided massive liquidity, and the economy recovered relatively quickly. By the fall of 2009, we were out of the recession. And that's where the trouble started: in the recovery.

We have experienced the poorest recovery in postwar America by a massive margin. In fact, as compared to the average recovery in postwar America, we are growing at less than half the rate that we should be growing at by post-World War II standards. How did it happen? Well, basically, it had happened because of bad policy. The financial crisis was used as an excuse—as all crises are used for excuses in Washington, D.C.—to implement policies that had nothing to do with the crisis. As a result, today, the government controls the commanding heights of the American economy. Banking is almost a public utility, healthcare is dominated by the government, the energy industry is dominated by the government, and even the Internet is under 1930s-type regulation.

We like to think American exceptionalism is because we're all brilliant and hard-working. It has nothing to do with us. It has everything to do with our system. Americans are ordinary people. It's our system that's extraordinary. But when you change the system, you change the results. You can't have European policies and American growth. We now have European policies, and we don't have American growth.

Now, what is going to happen in the future, and what am I worried about? Well, first of all, when the economy is growing rapidly, recessions are mild, and they're short. That happened in what I would think of as—what we will look back at some day as—a golden age, from 1983 to 2007. We had two little piddly recessions, both of which barely qualified. We are growing so slowly now that almost anything could knock us off kilter and into a recession. What am I worried about the most? I am worried about the ability to get the economy moving. And I am worried about it because of two carryovers from failed policy. In trying to get the economy to grow, the government has run up a massive deficit, and the deficit has more than doubled in the last 7 years. But the cost of servicing that debt has actually declined, because interest rates are almost zero. So what happens in a real, honest-to-God recovery, when people are actually investing in the future of the country? The demand for capital goes up. Interest rates start to rise. But when interest rates start to rise, what's going to happen to the federal deficit? It's going to go up, because the debt level is doubled. In fact, at the average interest rate on federal debt in the postwar era, the deficit would be about $500 billion a year more than it is now. That's as much as we spend on Social Security income maintenance. It's as much as we spend on Medicare. And this is a built in problem. That debt is going to be out there until Jesus comes back.

And what it means is, as the economy starts to recover, the federal deficit and debt will grow. The government will have to borrow more money, competing with the private sector, and what will happen? Interest rates will go up faster than they would have gone up in a normal recovery, threatening to choke that recovery off.

But our problems don't end there. After we had provided the liquidity to stop the recession from progressing further, and the economy had started to recover, we kept injecting liquidity into the system in the name of quantitative easing. On the balance sheet of the Federal Reserve Bank, assets it holds are five times as great today as they were when the recession started. To prevent those reserves from being converted into bank loans and money, and producing potential inflation, the Fed is paying interest on those accounts. In fact, the interest is higher than the treasury rate for short-term Treasuries, higher than the rate at which banks lend to each other. As a result, banks aren't lending to each other.

So what is going to happen when the economy starts to grow? Interest rates are going to go up. And when interest rates go up, banks are going to want to make more loans. They have $19 of reserves for every $1 they're required by law to hold. So the Fed is going to have to raise the interest it's paying on reserves to control the process or sell government securities in the market or sell mortgages in the market. And so when they do any one of those things, what's going to happen to interest rates? Interest rates are going to go up. So when the economy starts to recover—if, God willing, it does—we have two problems that are sitting there waiting to inject themselves into what would otherwise be a story of a happy ending. One is that government borrowing is going to go up as rates go up, because of the explosion of the debt. That's going to mean that rates are going to rise quicker in the recovery when it does come—if it does come—than otherwise, and the Fed is going to have to either sell assets or pay more on bank reserves, either of which will either add to the demand for credit or choke off the supply of credit. What that will mean is that the recovery, if in fact we have a full-blown recovery, will be in danger from the beginning.

The conclusion, I think, is really two things. One is a good-news story. Reagan faced a different, but in some ways similar, situation, in that we were trying to break the back of inflation and very high interest rates when he became President, and so we had a very restricted monetary policy. At the same time, he was trying to get the economy going. His economic program was powerful enough that it overcame both the stagnated economy of the 1970s and the monetary policy that was required to deal with the inflation part of that policy. That's the good news. So it's happened before, in a different way but in a similar way.

My final conclusion is, whoever is President, on January 20th, 2017 at noon, they'd better have one hell of a strong program. If they're going to overcome not only eight years of stagnation but they're going to overcome the debts and the financial overhang of the Fed, they'd better have one hell of a strong program. It's happened before. We did it before. It can be done, but it ain't going to be easy. That's my message.

KAREN SHAW PETROU: It is an honor to speak here today with Senator Gramm, a man whose name graces many of the most important banking and budgetary bills enacted during the decades he represented Texas voters – I know they miss him still. He has just spoken about the macroeconomic risks he believes result from Federal Reserve accommodative-monetary policy. But, there's an even greater danger than misfiring monetary policy: none at all. The new, radically-different structure of the U.S. financial-services market means that the Fed can't tell the economy what to do anymore because banks don't matter anywhere near as much as they used to. You may well say good riddance given the cost of the financial crisis, but a country without a functioning monetary-policy delivery channel where systemic risks increasingly arise outside the reach of prudential regulation is one putting itself at great and unnecessary risk.

My final conclusion is, whoever is President, on January 20th, 2017 at noon, they'd better have one hell of a strong program.

Is this alarmist? I sure hope so. I'm not the only one, though, worrying a lot about the FRB's growing inability to use interest rates and bank reserves to set the economy on its preferred course – a conference held yesterday and today at the Federal Reserve Board itself on precisely this issue shows that the FRB knows it has a problem even though it has yet, sadly, to broach any solutions. The global Financial Stability Board yesterday counted up all the U.S. financial assets housed in most non-banks, logging them in at $14.2 trillion at year-end 2014.[1] That's not small and neither is the risk they pose.

Although describing the conference as a research session, Chair Yellen yesterday said that she would like to better understand how changes in the way U.S. financial intermediation affects monetary-policy transmission. Let me today offer my own thoughts on this critical question and, given how urgent it is, also a few things the FRB can and should do ASAP to save not only its ability to conduct monetary policy, but also the rest of us from preventable systemic crises.

Maybe we could manage without monetary policy if there was another way to short-circuit boom-bust crises – what we've come to call macroprudential regulation. But macropru doesn't work any better than monetary policy. In the real world in which financial institutions live or die, rules have costs and costs have consequences. Regulators believe that costs are manageable and consequences are nothing but beneficial. However, the costs now are so great that combined with other market transformations, they pose significant second-order risks. We've probably corrected for all the causes of the last crisis, but I fear we're sowing the seeds of the next one.

Before I talk about specific regulatory actions and how they have changed the market, let me first point to one example of the best intentions that nonetheless pose grave risk. It epitomizes how even an unimpeachable policy action poses second-order dangers.

The policy actions I mean here aren't so much a single rule, but rather the cumulative impact of all of the new rules and the current, way-tough enforcement environment. Many of these rules – stress-testing, for example – are essential and punishment for crisis-causing behavior was, if anything, too weak. But in practice the new rules and enforcement regime combine with newly-enhanced risk management and better boards to force banks to devote billions not to innovation and enhanced customer service, but rather to model-building, internal investigations, and new information systems.

All these costs – not to mention the time management that boards devote to these critical issues – may well be warranted in theory, but these resources aren't infinite in practice. Can banks really spend the billions they need to promote cybersecurity when billions are being drained to ensure an end to compliance lapses? It's natural to delay discretionary spending when your franchise is on the line from compliance risk, but danger delayed is not danger averted. The more banks spend on risk-management infrastructure, the less they have for resilience as well as innovation, raising their operational-risk profile and giving new entrants far less careful about compliance niceties an additional competitive leg up.

If I walked through the new big-bank rulebook, we'd be here from our lunch now to your dinner later. Let me thus just highlight a few of the most significant standards and the unintended consequences already evident. One reason for the deep impact of these unintended and perverse consequences is the U.S. approach to systemic regulation. Applying tough rules to bank holding companies (BHCs) with assets over the relatively tiny amount of $50 billion means that even traditional, regional BHCs are struggling with the strategic challenge I just discussed and those still to come. Here are just a few examples of good rules gone bad:

- Stress-Testing: The FRB hails this as a hallmark of the post-crisis framework and deservedly so. That tough tests make a meaningful difference is demonstrated by the strength U.S. banks regained after the strict 2009 exercise and macroeconomic growth thereafter. Tepid though it is, it's still far ahead of growth in the EU, which has of course also suffered grievous bank failures resulting in part from lax – I would call them rigged – stress tests. But, our tough tests have a significant consequence – risk correlation. As the Office of Financial Research has found,[2] this could well make individual banks safer, but lead them all to fail at once if the Fed's models miss the mark.
- Capital: This is a lot more stringent now and, again, a good thing too. However, capital isn't free – expected reductions in the cost of capital resulting from faith in big-bank safety haven't materialized because banks have to have capital and non-banks can issue equity or debt securities only when it suits them. Investors should be paying significant risk premiums for the privilege of investing in non-bank start-ups

in areas such as online marketplace lending and payment services. But, pushed by desperate yield-chasing, equities and debts are flowing into all sorts of new-style financial institutions exempt from costly capital, liquidity, and prudential regulation. As a result, these companies will grow – or at least they will until they blow up. Without resilient financial buffers, non-banks simply can't function under stressed market conditions, exiting precisely at the time market stability needs them the most.

- Liquidity: Another hallmark set of rules, these require big banks to hold buckets of "high quality liquid assets" or HQLAs. This means that banks now hold lots of Treasury obligations that reduce overall market liquidity and the bank's ability to hold other assets that promote economic growth. The more HQLAs banks have to have, the fewer available for the rest of the market and the greater the fat-tail risk. Regulators have recognized this risk, but think that "collateral transformation" will solve for it – in short, they are fixing liquidity shortages with structured, opaque transactions with hedge funds and other non-banks.[3] These instruments didn't work out so hot the last time around and I doubt they'll fare any better if market reliance on them grows as banks are forced out. Again, market liquidity may seem sufficient as the good times roll, but then evaporate under stress because non-bank providers of collateral transformation (usually hedge funds) run for cover.
- Resolvability: Who could argue with the benefits of ensuring orderly resolution for big banks once deemed immune from failure? To deal with this, the Dodd-Frank Act demands resolution plans – often called "living wills" – from BHCs with assets over $50 billion even though Janet Yellen last week acknowledged that these may well not be necessary at the smaller end of the systemic spectrum. For the very largest banks, the new resolution requirements are far tougher and now include a requirement for total loss-absorbing capacity (TLAC) debt. For good measure, this applies to the largest foreign banks doing business here. The FRB proposal assumes all of these companies can pay up for this new buffer against taxpayer rescue. This, though, assumes that debt markets and interest rates remain unchanged from the assumptions built into the FRB's cost-benefit analysis. I doubt they will and expect also that large issuances of higher-cost debt will lead big banks to take on more risk. If they don't, they need to shrink. This might seem like a good idea if it weren't for the far less-regulated companies that will take their place.

This matters because U.S. monetary policy is premised on the essential role of banks as the channels through which the FRB's will is exerted on the financial market. This comes from two channels: interest rates and reserves. Each of these assumes that the cost of funds depends on banks and that the reserves banks post with the central bank affect how much money is available for loans. Several new studies, including those presented at the FRB's conference today and a recent one from the Federal Reserve Bank of Boston,[4]demonstrate that reserve balances at the Federal Reserve are significantly distorted by new capital and liquidity requirements. Just before the crisis, banks held $2 billion[5] in excess reserves at the FRB; now they hold $2.6 trillion –not a small change and one with profound monetary-policy impact.[6]

Theory would have it that macroeconomic growth would drain excess reserves because demand for credit would grow, beating the return banks achieve by housing funds with the central bank. However, even as growth has improved, excess reserves grew. The FRB thus has not been able to reallocate reserves to growth.

This might not be as worrisome if the FRB could move market rates, but accommodative policy has lowered only the return on prudent assets like U.S. Treasuries because markets are now whirling yield-chasing dervishes in hopes of sustaining earnings, paying insurance claims, and hoping against hope that pension beneficiaries will enjoy the placid retirements for which they so long toiled. Unable to earn a reasonable rate on prudent assets, exempt from being forced to hold them, and unconstrained by prudential rules, investors are seeking higher-return obligations for which risk premiums are steadily falling. Treasury-market illiquidity is just one symptom of this yield-chasing – banks hold lots of safe obligations because they have to, non-bank investors go for yield, and there simply isn't enough liquidity left in the financial system to absorb shock, especially given the fact that the shocks will first be felt by non-bank investors outside the scope of Federal Reserve liquidity facilities.

Of course, the FRB might figure a way through its monetary-policy maze. Even then, though, we face significant systemic risk from unprecedented causes. If the only damage from new rules is to big banks, then we might all breathe a sigh of relief since the crisis leads many to believe that the biggest banks had it coming to them. Why, then, do all these new rules sow the seeds of the next systemic crisis?

Let's step back and identify the causes of systemic risk:

- solvency crises at the biggest financial companies on which economic growth or market function depend;
- liquidity risk that prevents counterparties from honoring their obligations and, then, creates a cascading series of defaults that lead to doom; or
- operational risk, which results from massive events like cyber-terrorism, infrastructure attacks like the one on 9/11, or a devastating collapse of internal controls.

All of the big-bank rules I mentioned earlier are meant to deal with solvency, liquidity, and operational risk, but each is premised also on two critical backstops: emergency-liquidity support from the Federal Reserve and macroprudential standards that can interrupt boom-bust cycles like the one in U.S. residential mortgages that stoked the 2008 debacle. Even more importantly, these risks now are supposed to be borne by shareholders, management, and creditors – not taxpayers.

However, if market discipline only applies to big banks and emergency backstops don't cover the broad spectrum of systemic-risk financial companies, then we've got the worst of both worlds: resilient banks subject to merciless market discipline competing against non-financial companies whose shareholders enjoy all the reward until taxpayers face risk – think Fannie and Freddie and see why implicit taxpayer backstops without explicit regulation is so deeply worrisome. We are weakening financial-market resilience, issuing lots of rules with scant regard for second-order effect, seeing monetary policy lose its punch, and finding that new rules don't make financial markets safer, they just move the game to new, untested, unregulated fields. Players on these fields not only lack capital, liquidity, and safety-and-soundness rules – they also have no access to the Federal Reserve's backstop liquidity facility. The FRB is now so frightened of it that it is contemplating becoming not just a lender of last resort, but also a market-maker of last resort – in short, a taxpayer-supported safety net for unregulated, high-flying companies without any ability to withstand stress on their own.

Perhaps we have solved for moral hazard at the biggest banks, but what of the rest of the market on which we now increasingly depend? I fear we're in for a new round of too-big-to-fail companies from which shareholders will clear out even faster with their winnings before we all pay not only for their losses, but also for our own. Without monetary policy resulting in sustained growth and normalized interest rates, these moral-hazard risks grow even larger because individuals, companies, and even countries are even less resilient. How safe and sound is that?

JUDGE EDITH H. JONES: On that happy note— we will move to Mr. Medina.

FRANK MEDINA: Thank you for inviting me to be with you today. I really appreciate the offer. I also want to thank J.W. personally. As J.W. hinted, we've had a long, fractious relationship. He's one of my closest friends and also one of my dearest enemies. I also want to apologize to you. I'm not a great public speaker. I've spent the past 8 years writing memos that nobody has read. So this is a bit of a treat for me.

Unfortunately, you're going to be the victims of this experiment. And the last thing I'd like to offer is a bit of a disclaimer. Usually when people turn up from institutions like the Fed or some regulator, they say, "Well, the views I express today don't necessarily reflect the views of the people that I work for." I work for Better Markets. I think my views are consistent with what they have to say, but I will say that my views today may not reflect my views tomorrow. So keep that in mind as you listen to me today.

Because I'm such a terrible public speaker, I've got this PowerPoint. I apologize for inflicting that on you. If I run over, please grab me.

So, J.W. and I, in talking about this conference, said we needed a soundtrack, and we went over a couple of things. J.W. suggested *The Times, They Are A-Changin'*. I think if you listened to Karen Shaw Petrou, you've got an idea that times are changing. I countered with *Joker Man*. I mean, this stuff cannot be believed. I think if you listened to the Senator, you are not sure that things are really as bad as they seem to be, but maybe they are. Because we're children of the '80s, J.W. suggested *The Final Countdown* and then countered with *Eye of the Tiger*, given the Apollo Creed-Rocky Balboa relationship we've enjoyed for so many years. Thinking through that, I think it's the Rolling Stones that we need to think about today, and again, Karen Shaw Petrou hinted at this when she talked about regulation and the benefits and the tradeoffs. Now, granted, she focused more on the costs than the benefits, but I really think that in thinking about the next financial crisis, you need to think about financial regulation and about what makes financial regulation work, and more importantly, what makes it not work.

So this is why financial regulation is so hard. There are three things that we want out of it. The first thing we want is credit formation and capital accumulation. This is the robust economy that Senator Gramm described. I mean, this is really what you want a financial system to do. You want it to generate as much credit as possible so that people can invest in businesses, people can buy houses, people can run up credit card bills. I mean, that's what makes the economy hum. The second thing we want is financial stability. Nobody particularly likes recessions. Nobody likes depressions. The last thing we want is no bailouts. Now, one of the things about 2008—and it's surprising to hear people talk glowingly about TARP—is that nobody liked the idea of bailing out the financial system. Nobody liked the idea that the banks took inordinate risks, failed, and then had to be bailed out at the taxpayers expense.

Ideally, we want the financial regulatory system to give us these three things. There's one small problem: We can only get two of those things at a time. Now, this was my brilliant insight. I've stolen this from a friend of mine, so if you remember nothing else about this talk, remember this chart. There are three things we want: We want credit formation, we want no bailouts, we want financial stability. However, if we do the thing with no bailouts, we let them fail, well, we're going to get no bailouts, we're going to get credit formation, but financial stability is out the window. We're going to have recessions; we're going to have depressions. Similarly, if we are willing to bail out the banks—if we are willing to resort to TARP, if we are willing to resort to multi-trillion-dollar Fed facilities to bail out failing financial institutions—we get credit formation, we get financial stability, but we've lost our no-bailout claim. The last little thing we can do is we can try to really regulate the banks so that they're stable, they're consistent. So we get no bailouts, we get financial stability, but credit formation is affected in some way. You know, ideally, we could get all three things. Realistically, we can only get two at a time.

Serious people get this. There are people that write about the financial regulatory system. Charles A. E. Goodhart is a legend in the field of financial regulation. He's been writing about this for 50 years. You can tell he is serious because he has two middle names. So Charles Goodhart pointed out that if you want safe banks, we can do that. All that we've got to do is raise capital requirements to the roof, insist that the banks fund themselves entirely with capital or a huge amount of capital and long-term debt. We're going to get liquidity ratios in place. We're going to get higher margins for leveraged transactions, mortgage borrowing. This is what Karen Shaw Petrou was talking about. We can make the banks safe. It comes at a price, though. Why haven't we made our banks safer? Is it because we're lazy, incompetent, stupid? No. The problem is that there is a cost to regulation. Right now, we've got banks that are too big to fail, and they do a great job of doing the things that we expect too-big-to-fail banks to do. They generate tremendous amounts of credit. They are crucial in capital formation. The problem is, they're too big to fail. So if we want to make the banks not too big to fail, if we want to make them safe, we can do that, but it's going to come at a price. Bank lending is going to contract, and a creditless recovery becomes more likely.

So that's Charles Goodhart—you know, an academic, somebody who's an expert on financial regulation. Some politicians get this, too. So George Osborne, who is the current conservative Chancellor of the Exchequer, the U.K. Exchequer, says this. And when I see this, I think about the kinds of aspirations we had in the 1980s, when we talked about combining investment banks and commercial banks. We want our financial firms to take risks, to innovate, to create jobs, to fund businesses. We want to be home of the world's largest financial center. That was New York. We want to be home of the world's largest banks. This is George Osborne, Chancellor of the Exchequer, last week. This isn't some vision from 2003, 2007. This is last week. He gets it, though.

But at the same time, we want those banks to be safe. We want markets to be safe. When problems arise, we want the banks to be able to fix them themselves, without turning to us, without turning on the taxpayer to bail them out. *You Can't Always Get What You Want.*

Now this is the part where I talk about the Dodd-Frank Act. I realize that in this room, the Dodd-Frank Act may not have many friends, but J.W. assured me that this would be a friendly conversation, so I'll make this point lightly and move on. The Dodd-Frank Act tried to balance these conflicting needs, right? So credit creation and capital formation. It didn't break up the biggest financial institutions, like some people said should've been done in the wake of the financial crisis. Maybe it should have, maybe it didn't, but the Dodd-Frank Act didn't do that. The second thing it tried to do is it tried to end bailouts. It empowered the FDIC to wind down a failing financial institution and to push those losses onto its creditors, its shareholders, and its counterparties, rather than requiring another bailout. Now, there is a robust debate about whether the orderly liquidation authority, this part of the Dodd-Frank Act, in fact does that. Some people say it's a disguised bailout; some people say we won't know until it happens. Other people, like me, are more optimistic. On paper, in theory, it looks pretty good. You know, when people say, "How can you be sure?" I can't. Like Senator Gramm, I'm not going to predict the future. It looks pretty good to me. If you don't, come up with an alternative.

The last thing is financial stability. In order to prevent a large financial institution from failing and taking the economy down with it, it directs the regulators to set stricter capital and leverage requirements for the nation's largest financial institutions. Liquidity requirements, too, as Karen Shaw Petrou said. Now, the problem is that maybe that does impede credit formation. Maybe that does impede capital accumulation. On the other hand, there are people that say, well, yes, it's a step in the right direction, but it didn't go nearly far enough. The great thing about this debate is that nobody is happy, wherever you are. You know, either it went too far, or didn't go far enough. I think I'm the one person in America who thinks maybe it might be kind of in the right place.

Right now, I've been talking about the theory of financial regulation. Let's step back and see what reality looks like. On this one, it's even hard to figure out what reality looks like because we all have different views. Karen Shaw Petrou described this dystopian view of the banking system, the Fed policy, in the wake of regulatory reform. I'm not sure that I see it quite that way. I think the biggest thing that has happened in the wake of the Dodd-Frank Act is that capital requirements are much higher. Everybody seems to think that capital requirements are important up to a point. There is a huge debate about what the right point is. Before the crisis, people said three percent sounded about right. After the crisis seven percent sounded okay. Their academics who say 20 percent, and that's non-risk-weighted assets. And when you say that in a room full of bankers, you can watch them all turn white.

I think the biggest thing that has happened in the wake of the Dodd-Frank Act is that capital requirements are much higher.

I mean, they're frightened by that. Other people say that 20 percent isn't nearly enough, and we need to go back to the days when banks were capitalized at 50 percent. So it's a debate. You should know that. You should know that this idea that banks should be well-capitalized, everybody agrees with it. The discussion, the debate, the disagreement is what counts as well-capitalized.

But anyway, Tom Hoenig at the FDIC is fond of showing that well-capitalized banks—the ones that pay the higher cost—are the ones are the ones that lend when things get rough. So the thinly-capitalized ones—the ones for whom supposedly credit formation is cheaper—are the ones that stop lending when things get bad.

The second thing that is worth pointing out is that after Dodd-Frank, the economy has grown. Now, as Senator Gramm pointed out, is not growing nearly as fast as anybody would like. There is a lot of dispute and a lot of debate about why it's not growing as fast. As a rule, I agree with Senator Gramm: Post recessions, the economy tends to bounce back quickly. Growth is great. The difficulty is that after financial crises and the recessions they cause, virtually all of the scholarly literature—and I'm looking at people like Kenneth Rogoff and Carmen Reinhart, who are not red-flag-waving Jacobins—say that financial crises are a little bit different. After a financial crisis, after people have borrowed as much as they possibly can, after the economy falls and they have to pay the debt back, economies don't really grow as quickly as they should or as they could. So that's one of the costs of financial crises. But anyway, the U.S. economy is growing, and compared to Europe—and maybe that's not a fair comparison, maybe that's not the right comparison—we are actually doing pretty well. The Fed is now thinking about raising rates in response to a growing economy and improving employment statistics.

Then there's this part, which I'm not quite sure where it fits in the discussion. Now, granted, Karen Shaw Petrou is right: The banking system has changed tremendously. One of the arguments, one of the claims, is that financial regulation has rendered it impossible to make a living as a banker. If you're a bank shareholder, you're suffering. If you're a bank manager, profits are down. In September, there was a report that banks are making record profits, so I'm not sure where this falls in the debate, but it's worth pointing out. Maybe it is possible to have a highly-regulated financial system that is profitable and does the things you expected to. It's open for debate. I'm not going to take a stand one way or the other, but I think it's worth trying to figure out what the facts show us.

All right. So that's the theory. Let's talk about the subject of the conference, which is explaining the next financial crisis. Prediction is hard, especially about the future. We put Senator Gramm up there, too. So we've got Niels Bohr, Nobel prize-winning physicist; Yogi Berra, the greatest Yankee who ever played; Senator Gramm, one of the greatest Senators who ever served. Depending on whether you want to be profound or funny, it depends on who you attribute it to, so I'm not sure which of those people I am today. You can tell me afterwards who you thought I was.

So the first thing that happens after a financial crisis is, we forget. We forget just how terrible it was. We forget all the stupid decisions we made. We forget the decisions to borrow. We forget the bad lending decisions that got us where we are. Whether you think it's the housing crisis and government housing programs that cause the crisis, whether you think it was investment banks that were making bad decisions about who to extend credit to or carving up instruments—we forget. Howard Davies, another great academic concerned about financial regulation, says the strongest bulwark against another financial crisis is fear. Eventually, the fear recedes. And this is why these things keep happening, you know. It's a cycle. We start with shock. There is a financial crisis. Then we get angry about it. We get angry about the bailouts. We get angry about the cost of the financial crisis. And then we forget. We start all over again. So on the one hand it's a tribute to this indomitable American optimism: "Things will always get better." On the one hand, that's something to celebrate. On the other hand, it's something to be wary of.

The second thing that happens is the regulatory cycle will play itself out. I stole this chart from my friends at "FT Alphaville." It's a blog that the *Financial Times* publishes. There's this cycle you can see in response to a financial crisis. At one time, you know, nobody cares. It's not a problem. Things are going well. Subprime? It's great! People are getting the houses they want. Subprime? It's wonderful. We can lend, and we can be really creative about the loans were extending. We can be really creative about the packages we're making. Then things happen. There's a crisis, and we wonder why did this happen? And then we get really crazy about the kinds of requirements and regulations we want to put in. Some of them may be appropriate. Some of them might be overkill. Eventually, the enthusiasm to regulate, the enthusiasm to keep those regulations in place, fades away, and people start asking questions. "What exactly are we getting in return for this regulation? Isn't it really expensive?" Then eventually, we end up more or less in the same place we were. Things are a little different, but the crisis fades, and we end up at the end regulation goes away, and we start the cycle again.

So this is where we are at the end of the financial crisis. John Kenneth Galbraith wrote this in 1990, long before this particular financial crisis. He says at the end of a crisis, what we get is the crash, and then there's anger and recrimination and then this profoundly unsubtle introspection about what we did. There's scrutiny of much-praised financial instruments and practices—the collateralized debt obligations and the tranching and the Basle Accords, and the other sort of things—and then there's talk of regulation and reform. We do that.

But the introspection is short-lived. It's only a matter of time before we shift our attention from the last crisis and the cost of regulation, and we start thinking about the things that we want. We want credit formation. We want capital accumulation. We want to start all over again.

There's this point where we go after the regulatory apparatus by ignoring the fact that there is a trade-off, and one of the things that I'm really grateful for Karen Shaw Petrou having said is that it is a trade-off. Usually when people talk about these things, they only talk about it in terms of one dimension. You know, "Regulation is killing us. There is no benefit to regulation. We need to get rid of it. We need to go back to completely free markets." And you can see this in advertisements. These are some of my favorite advertisements. "You can eat all you want and lose weight." "You can earn millions of dollars right now from the comfort of your own home." "Claim your free gift. Order now." Something for nothing.

When it comes to financial regulation, the Republican candidates need to be specific. If you don't like Dodd-Frank, explain why it doesn't work, explain why you don't like it, and explain what you'd replace it with.

John Cassidy pointed this out in connection with some of the debates that he's seen. He says this. I think it's something that's really worth keeping in mind. There really isn't a whole lot of reward to being honest and realistic. There is no point in taking a nuanced position on complicated subjects such as trade treaties or education policy. You don't want to get involved in detailed policy discussions, because that requires you to balance the benefits against costs. From the candidates' perspective, it's easy: Just bash anything associated with President Obama, promise a chicken or tax rebate in every pot, and fudge the details. Now, this is Cassidy talking about things that aren't related to financial regulation. Yesterday, in the *Washington Post*–and I realize that when you talk about a *Washington Post* conservative blogger, that's a matter of degree.

To most people, it's not in fact a conservative blogger, but Jennifer Rubin, in the blog she has for the post—it's called "Right Turn"—said that when it comes to financial regulation, the Republican candidates need to be specific. If you don't like Dodd-Frank, explain why it doesn't work, explain why you don't like it, and explain what you'd replace it with. And it's focusing on those kinds of details that I think would advance the conversation significantly.

The third thing that happens, we get back to financial innovation. I mean, I love Wall Street. Judge Jones said that I used to be at the SEC, and I realize that I wasn't cut out for the SEC when the first thing I had was an investigation related to Enron. You know, I saw the charge with the special-purpose vehicles, the off-balance-sheet transactions, and my first thought was not that this is evil, not that there's a crime being committed here. My first thought was, "This is brilliant."

It's strange, these transitions you make in life.

So this is what happens. Again, this is John Kenneth Galbraith from 1990. People start innovating. They come up with new ways to package debts. They come up with new transactions. They come up with new ideas. But there's this rule, and it's this, and it's important to remember. In the first place, I wish some day in my life to write a sentence like this. In the second place, it's just tremendously profound. "The rule is that financial operations do not lend themselves to innovation. What we recurrently describe and celebrate is, without exception, a small variation on an established design, one that owes its distinctive character to the shortness of financial memory." We forget, remember? We forget. "The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version. All financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy by real assets."

It's debt. Whether it's the national debt, the government debt that Senator Gramm was talking about, whether it's the debt that we palm off on credit card holders and people that take out mortgages—it's debt. That's going to be the key to the next financial crisis, is debt. You heard it here first: debt. Actually, you heard it second. You said it, right?

And the fourth thing that happens—you know, we forget, we get really innovative, we start borrowing again, and then we get just incredibly proud. So everybody knows this. I feel bad for bringing it up again, but had to be done. Irving Fisher in 1929, a couple of weeks before the Wall Street crash: "Stock prices have reached what looks like a permanently high plateau." A little bit later, Robert Lucas, a really smart guy, a Nobel prize-winning economist, says, "Macroeconomics has solved the central problem of depression prevention for all practical purposes." Now, it's January 2003, his timing's a little better than Fisher's, but he gets shown up eventually. He gets 5-1/2 years, but then he's shown up. Up here you can put all the other things about housing prices can never fall, housing prices will only go up. We just get proud. We forget.

So I'm an optimist. It's about the trade-offs. The trade-offs are difficult. Dodd-Frank in the right place. And I'll end with this one. So Ben Bernanke gets a free lunch with the Financial Times. Every weekend, the Financial Times has lunch with a famous person, an economist, a writer, a journalist, somebody who's done something impressive. And Ben Bernanke has done something impressive. I mean, he was chairman of the Fed during its most trying time. Ben Bernanke was talking about this, and he said, you know, we can't have too much regulation. It's possible that the financial system is so restricted that it doesn't do the things we need it to do. It's not vibrant, it's not dynamic. And he gave this example: "My mentor used to say, 'If you never miss a plane, you're spending too much time in airports.' If you absolutely rule out any possibility of any kind of financial crisis, then probably you're reducing risk too much, in terms of growth and innovation in the economy."

I actually sympathize with that. To me, that makes a lot of sense. The problem is that Ben isn't really thinking about—and I can call him Ben, because he's my neighbor—Ben isn't really thinking about the costs associated with the financial crisis or with missing a plane. Think about this: If the price you pay for missing the plane is spending a year as the guest of Iranian student revolutionaries— maybe it's worth killing an hour or two browsing duty-free.

Even smaller, if the cost of missing a plane is spending another night at your in-laws' maybe you turn up a day early.

It's all about balancing benefits against costs. And eventually, Ben Bernanke gets it. He says in the same interview, if you miss a plane, you'll live. A financial crisis, the last one, we estimated the cost at 20 trillion. Ben Bernanke gets it, you know? So Martin Wolf was having this interview, and I love it, because they talk about who has what, how good the food was, how bad the service was. Martin Wolf gets a double espresso. Bernanke has tea. The interview's coming to an end, and Bernanke says, in light of the economic performance of the '50s and '60s, when the financial system was highly repressed, highly regulated, maybe, just maybe, there's a "possibility that a more repressed financial system would give you a better trade-off of safety and dynamism."

So with that, because I've given up on this and you've had more than enough of me, I'm going to end my remarks, but thank you. I hope you found this helpful.

JUDGE EDITH H. JONES: Professor Verrett.

PROF. J.W. VERRETT: Well, it's a privilege to join all of you today. And as you can see, when Frank and I worked together at the House Financial Services Committee, I owe Frank tuition for a master's degree in financial regulation. Check's in the mail, Frank.

But I had a lot of fun debating with him and learned a tremendous amount during that time. So it's a privilege to be here with Frank; to be here with Judge Jones, whose opinions I've admired; Karen Petrou, who is quoted so often in the *American Banker* that I feel like I know her, so it's good to finally meet her; and Senator Gramm, certainly it's always a privilege to be on a panel with him. And I counted Jeb Hensarling as a mentor of mine, and I know Chairman Hensarling counts Senator Gramm as a mentor, so I guess that makes you my grand-mentor.

I want to begin by doing the opposite of what some folks have done today. I think the best way to become a successful prognosticator is to make lots of predictions—lots and lots and lots of predictions, and you'll get one right eventually, and people will forget all the ones you got wrong. So I'll try to make a bunch of different predictions today and hope that works. Let me start by saying a simple thing that I think is probably on most people's minds in terms of conventional wisdom in Washington about what will be the next, maybe not crisis, in the sense of 2008, but the next discrete, significant, serious financial services events. I think it will be a cyber thing. I know that's not very specific. Let me just go on record with that prediction. It will be some sort of a major cybersecurity event that has some, possibly systemic, consequence associated with it.

Unfortunately, I think that as that instinct develops among regulators, and perhaps among other players in the Washington scene, I think the instinct is that the best way to deal with that problem now is things called best practices, policies, procedures, guidelines, and the promulgation of them by committee. And I have to say I think that that is the absolute wrong approach. That's not going to fix this problem. The only thing that's going to fix this problem is people with PhDs in computer science or people who have hacked something—and I don't count myself among that group—but those people, wanting to get rich, selling defensive strategies to banks. That's the only thing that will prevent and solve this problem. It's going to be a market-based solution, and I think that large financial institutions already have sufficient incentives to try to do their best to meet this problem. So I am very suspicious of speeches by regulators saying that they worked with financial institutions to develop best practices and guidelines on cybersecurity. I think that these regulators have their own cybersecurity issues, maintaining the safety of their own financial data that they collect.

And furthermore, I think that at best, governments role in cybersecurity is to get out of the way. I think two ways they can get out of the way now are, first, get rid of the price controls, okay? And I think the prime suspect in that is the Durbin amendment to Dodd-Frank. I absolutely agree—I think some of Karen's comments were going in this direction,—I think there's going to be a direct link between the Durbin price controls on debit card interchange fees, the fees that retailers charge for are charged when they process your debit card purchases, and cybersecurity safety. And why is that? I think part of the explanation is an institutional economic explanation, that divisions of financial institutions generally tend to track costs with revenues, no division wants to subsidize other divisions, so the divisions that have some of, I think, the worst risks in terms of cybersecurity are going to be the ones paying the costs. So, in that respect, I think that price caps like the Durbin amendment are a huge problem for cybersecurity, and I think that's an element in Dodd-Frank that just had—forget the nuance in Frank's presentation, which was tremendous. I think it had none of that nuance whatsoever, and so I see that as a culprit.

And secondly, if people want a response to cybersecurity problems, I think litigation reform—that would be principally the duty of the Judiciary Committees in the House and the Senate—is also a culprit to think about. I think that right now institutions are a little wary of fully sharing information with their competitors because of litigation risk, both from securities litigation liability and from consumer litigation liability. And I would add also enforcement liability from the CFPB. I think that CFPB's institutional interest is more to get a sizable settlement than to protect and encourage information-sharing about cybersecurity risks. So let me go on record with that prediction and those thoughts about a way to deal with that problem.

Secondly, the second point I want to make about financial crisis, predicting the next crisis. I think that I can safely say that liquidity concerns are becoming an increasing focus for regulators, for market participants. As much of the op-ed pages of the *Wall Street Journal* come from a direction, a conservative, libertarian sort of direction, I think the news reporting in the *Wall Street Journal* is fairly middle-of-the-road. And when you count the stories about liquidity problems in the market, this year, last year, in the wake of the final promulgation of Volcker rule, I think the number of news hits for "liquidity Volcker" goes up exponentially over the past year and a half. I think there's a reason why.

I would agree with the way Frank frames the discussion today about the trilemma. I think that's a terrific framing of the debate about financial services in the post Dodd-Frank era. Where I would quibble with Frank a little bit is with the three sides of that triangle, in that I think that those sides of the triangle are spectrums. They are not light switches. In other words, we can deepen our discussion about the trilemma, and about Dodd-Frank's approach to the trilemma, by understanding it that there are different ways to achieve even implementation of statutory authority within Dodd-Frank. And I certainly think that the Volcker rule is a culprit there. My argument is this: I think that the economic evidence for the link between the Volcker rule, the restriction on the ability of banks to engage in proprietary trading, which also limits the incentives of banks to hold inventories of corporate bonds, is at least as convincing as the argument the other way.

In other words, I think—taking off my partisan hat I used to wear at House Financial Services, putting on my academic hat—I think the evidence is that Volcker is a significant contributor to the liquidity problems we've seen, is at least as convincing as the evidence that it's unrelated. And, frankly, I find the analysis put out by the regulators, particularly the Washington regulators—some of the regional Fed banks have conducted research that's actually fairly open to the link between Volcker and liquidity concerns. Worst of all, I think the analysis from the Office of Financial Research is what I think I would characterize as sort of an "emperor's new clothes" approach to looking at this problem. In other words, realizing that, politically, the OFR director can't criticize Dodd-Frank, can't criticize the Volcker rule, he's unwilling to consider, and their reports have been unwilling to consider at all, the possibility that the Volcker rule's limitation on proprietary trading and their very strict approach to the market-making exemption in Dodd-Frank is having a sizable effect on liquidity at financial institutions.

You know, sometimes I have to look at myself in the mirror and ask myself: Am I being too close-minded? Are my sort of libertarian blinders on? Have I been circumspect enough? And another thing that gives me confidence that picking on Volcker as one of the worst examples in the Dodd-Frank Act, as an attempt to minimize the financial crisis costs that Frank describes and that Better Markets has attempted to estimate, is looking to the prominent Democrat economists who agree with me. So, for example, I hold Dr. Alice Rivlin in very high regard. She is an economist at Brookings. She was vice-chair of the Federal Reserve under President Clinton and also ran CBO and ran OMB. I think she's probably one of the most prominent Democrat economists, and she testified in front of the House that "I wouldn't have favored the Volcker rule. I don't think the Volcker rule had much link to the problems leading up to the financial crisis." And I absolutely agree with her. Chair Yellen has testified that the Volcker rule in proprietary trading was not a primary cause of the financial crisis in the first place.

So in thinking through the trade-offs that I think Frank rightly addresses and rightly frames for us, I would pick on the Volcker rule as a primary culprit—the rule in Dodd-Frank that has very little to do with the problems we're trying to address, both in terms of it not being an adequate prescription for the problems that led up to the '08 crisis, and it being a problem that leads us to the next crisis, which I think will be a liquidity crisis. And I don't think the shadow banking system will make up for liquidity problems, particularly in the corporate bond market, that the Volcker rule will cause. And part of my reason for that is also an institutional explanation, that I think that investment banks that regularly engage in underwriting and that have operations across the financial system, has an incentive to internalize volatility in the corporate bond market. And so they are always going to have an incentive to serve as a market-maker in the markets, that I think hedge funds, and what's been pejoratively described as the shadow banking system, will just never be able adequately to replicate.

So my answer is, just rescind Volcker. I think there's enough evidence to just do a re-promulgation of Volcker. Now, don't get me wrong, my preferred alternative, before you withdraw my Federalist Society membership, is to repeal Volcker. I think that's absolutely the best thing to do. But I recognize, after having done 2 years in the House, going up to the House ready to repeal Volcker during my time there, I've come back a little more seasoned, with a little bit diminished expectations about what is politically possible. I do think that with the turnover in the administration, no matter who wins, I think that a Democratic administration will feel less compelled to just not engage in any discussion about Dodd-Frank, which I think accurately describes the stance of the administration now. And certainly in a Republican administration, I think there's an opportunity to re-address the Volcker rule. And even staying within the confines of the statutory authorization, rethink the market-making exception in the Volcker rule to ensure that banks can adequately minimize these volatility and liquidity problems.

The third point I want to raise is that I think there's a constitutional crisis threatened by the Dodd-Frank Act. One of the things that one of my favorite SEC chairmen, Harvey Pitt, observed was that there's a tendency among regulators—and it's not a nefarious tendency, but it's just an institutional incentive among regulators—is they don't like the notice and comment process. The notice and comment process is very difficult to get through. It's much better as a regulator to use your enforcement powers. It's much easier as a regulator to utilize your enforcement powers to encourage behavior in the market you want to see, because you don't have to worry about notice and comments, you don't have to worry about litigation, and it's much easier to sort of keep it quiet, I think. And we've seen that problem for a long time at the SEC and at the other regulators. I think we've seen that problem on steroids at the CFPB. And it's also, again, not a function of the goodwill of the folks working there. I think it's just an institutional problem that flows from the lack of accountability of that particular institution: the fact that it's not a bipartisan commission, the fact that it's off congressional appropriations, and the fact that its statutory authorization limits the ability of private parties to challenge its rule, which effectively limits judicial review. I think it just continues a constitutional crisis in the administrative state and pushes it forward.

And we've seen another species of this problem at the SEC that I'd also like to highlight. So I've sort of described, I hope, a little bit of the problem of regulation by enforcement that's long been a problem. We see a new problem in the wake of the Dodd-Frank Act, and I would like to name that "regulation by compliance." For example, the Dodd-Frank Act created a hedge fund registration requirement. And there again, I don't think private hedge funds played any role in the financial crisis, and if anything, short-selling by hedge funds helped to keep the financial crisis from getting worse and sticking down bad institutions. Yet we saw a mandatory hedge fund registration requirements included in the Dodd-Frank Act. Proponents of that approach argue that, look, we are not requiring so-called investment company registration. This is just investment advisor registration, a very mild form of regulation of investment advisors under the SEC's authority. And they said, "We are not going to regulate activities. This is not activity regulation. This is just, they send in a short form that tells us who they are and how much they have under assets, and a little bit about their trading. We'll keep the proprietary information in the trading confidential. Don't worry about proprietary concerns. Trust the regulators. But it won't be a sort of substantive regulatory regime that you see in the mutual funds sector."

And I would point folks to a recent speech by Chair White before the Managed Funds Association, just a couple of weeks ago, that gives a slow process of increasing regulation by compliance. We see the Commission's position here, taking a micromanagement approach to the relationship between hedge funds, or private funds, and their investors—their sophisticated, wealthy investors. Thinking through what the Commission believes is the right approach to conflicts of interest, fee regulation at those institutions—all things that were never considered by the original Dodd-Frank authorization of mandatory hedge fund registration. So we have a creeping approach to regulation by compliance that I think furthers a constitutional crisis in the administrative state that began in the Wilsonian era and then just took, I think, a new exponential increase in its rate of growth in the wake of Dodd-Frank.

So on that depressing note— let me offer a little bit of hope, because I think there is hope. First, I offered a couple of prescriptions for how to deal with cybersecurity issues. Make it easy to share threats, even if plaintiff law firms might lose some opportunities for strike suits, I think that encouraging information-sharing between competitors is part of the answer. I think in getting rid of price caps on things like debit cards—I think get rid of the Durban amendments altogether in Dodd-Frank. And I'm also concerned about the CFPB's approach to the provision of overdraft services. And I'm concerned about whatever the next idea is. CFPB wants to essentially institute an implicit price through regulation. I'm worried there. I think government getting out of the way is the answer to cybersecurity worries.

In Volcker, I just don't think the political will is going to be there to get rid of Volcker. However, I think there is, hopefully, political will—and I certainly think there is more than enough administrative authority—to rethink the approach in Volcker, to take a more, and I can't believe I'm saying this, but to take an honest approach to implementing something in Dodd-Frank, the market-maker exception to the Volcker rule, to provide something like a good-faith exception to market-makers, possibly defined as a percentage of revenue. But the problem of Volcker, the problem with the approach in Volcker, the philosophical problem there, is that the Volcker rule says, no proprietary bets by banks. No proprietary betting, no betting on the price of a security, but you can market-make. You can try to build a warehouse of securities to make sure you're ready to fulfill client needs, and to make sure you're there to prevent a volatility just after something like an underwriting, or to help clients to hedge, or to hedge yourself.

The problem with Volcker is, looking at a trade or a series of trades within a financial institution's books, two people can look at the same trade, and one person says, "I see a prop trade," and the other person says, "I see market-making or hedging." It's like an M.C. Escher painting. You've seen the paintings where it looks like one hand is drawing the other, or you look at it one way and it's a rabbit, you look at it another way and it's a duck. That's a fundamental problem in Volcker, so I think the regulators were not sufficiently realistic about that problem in their promulgation of Volcker. And so I think something like a good-faith exception for market-making and hedging is what's appropriate there, so a fundamental rethink of the Volcker rule.

Thirdly, to the problem of regulation by enforcement and regulation by compliance that we see in agencies, and certainly at the CFPB, what I think should be a bipartisan approach is creation of a bipartisan commission and putting the CFPB on appropriations. And I think the Democrats are being incredibly shortsighted, because, not that I'm ready to share it today, but I have a plan in the back of my head for what to do at CFPB if one of my friends gets to be the director there. I mean, I've got a— you know, we've got the plans there. I think Democrats should be interested in the bipartisan commission and appropriations for CFPB, and I'm sort of shocked that they aren't. Maybe a few of them are awakening to that. I think agencies work better when they're bipartisan. Hash it out at the top. I saw it when Frank and I were at the committee: You get to a better idea when you fight it out among two dedicated people who take a different view of something. I think bipartisan commissions work much better, much more effectively, and in a much more circumspect way than directors, particularly directors off appropriations.

I think Democrats should be interested in the bipartisan commission and appropriations for CFPB, and I'm sort of shocked that they aren't.

I also think in terms of structural reform, to help both constitutional problems I see at independent agencies that result from Dodd-Frank and also that predated Dodd-Frank. Look, I'm a lawyer. I believe in the adversary system. I think the best way to get truth out is for two people, again, to hash it out. I don't think we have that in financial services enforcement. I think a combination of the risk aversion by the regulated entities, the fact that they are engaged in such repeated interactions with their regulators makes them incredibly risk-averse, and so I think, more than anything else, ensuring judicial review is important. And I think also within agencies, the best thing we can do is have an independent economics division at the agency to push back on the lawyers. This has worked before at the Federal Trade Commission. I would say the economics division at the FTC is much more empowered than it is at agencies like the SEC, which has an independent regulatory economics division. I can't tell you whether it's worked at the Fed or not, because the Fed doesn't have an independent regulatory economics division. That's surprising, since it's got most of the economists in the industry working for it, but that's the fact. I think you need an independent economics division that can stop the enforcement lawyers and say, "Wait. We are not going in the right direction here. Let's kick it to the top of the agency to get a review before you go forward." I think that's a structural change that can help to make agencies work a lot better.

So with that, some depressing thoughts, a little bit of hope. And, again, I've really enjoyed talking to all of you today.

JUDGE EDITH H. JONES: We have covered a wide array of topics. We are to go until about 2:15, if our panel can bear it. I'd ask Senator Gramm first to make some comments, if you have any comments about the other presentations, and then we'll give them time.

SENATOR PHIL GRAMM: Well, first of all, let me say that my position to Dodd-Frank is not that it is regulating the banking system. Nobody with any sense has called for free banking since the Civil War. My objection to Dodd-Frank is that it was an agenda that had nothing to do with the financial crisis that occurred. It had only one reform that had anything at all to do with subprime lending. Only one. And it was a requirement that the maker of the loan keep a five percent liability, and what do you think happened to it? It was the one part of the law that was never enforced by the regulator. It was an agenda that was waiting for a crisis that could be used to implement a system that had nothing to do with the crisis: the regulation of many financial institutions that were not guaranteed by the taxpayer. This deal about massive taxpayer losses—there weren't any massive taxpayer losses. The crisis was produced by government policy that forced the making of loans that ended up shattering when the housing bubble broke.

The Volcker rule was never anybody's agenda. Volcker was the chairman of the President's commission to recommend ways of strengthening the recovery. The commission never met—I think it went a year without meeting. Volcker started speaking out in unhappiness. He made this proposal to the Banking Committee. The Democrats weren't even for it, but it came law, because the President jumped on it. You know, "Volcker's providing leadership." It's just how things happen magically in the legislative process. So in any case—I must have said something.

It's a really hard balance to strike. I believe in free markets. I also believe that there are points where the government needs to intervene.

In any case, I think what we should have done in response to the financial crisis was to redo the housing industry, to make people have an honest-to-God down payment, to require that you show some ability to pay the loan back, to not securitize subprime loans if people want to make them. And I think that we should have looked at the reserve structure of the banking system. I think there was a justification for greater holding of reserves. I think Basle II turned out to be a mistake because it regulated based on how risky the assets you held were by assuming that governments could figure out what was risky. And, as it turned out, the things that were deemed most non-risky, U.S. mortgages, in a country that since 1946 had never had a year where the price of a house had actually gone down in the aggregate market—that looked fireproof. But it didn't turn out to be fireproof.

And so I think what we should've done on reserves is recognize government did not have the capacity to know what was risky, and require banks and financial institutions that were guaranteed by the taxpayer to have honest-to-God capital and reserves. I think that would've been the right response.

JUDGE EDITH H. JONES: Ms. Petrou.

KAREN SHAW PETROU: Thank you. I would like, I think, to just take a little bit of issue with Frank, despite his really kind comments, because I think he's right on a lot of the policy issues, but I would like to inform that with a bit of a practice perspective, because that's what I do all day long. One of the things we do at my company is, we are retained by financial services firms, sometimes banks, sometimes non-banks, to take an activity, a line of business—mortgage, finance, market-making, asset management, whatever it is—and assume for the moment that interest rates, technologies, etc., are as good as anyone else at what you could call the meteorological effects in the financial markets, what economists like to call exogenous factors. Stuff that happens to everybody, happens to them the same way. And so we model out the business based on the one thing that's going to happen to them, which is the regulatory framework, current and prospective, to see whether or not they can remain competitive and what their likely return, the risk-adjusted return on capital, is going to be, taking those rules and all the costs they have into account. And when you do that, you really see a gigantic shift in the way financial services is being provided, because of the cost of these rules dispassionately. Sometimes we are asked by companies to do this so they can arbitrage the banks. We are agnostics, you know. We just run the numbers, and a lot of the time we run them for banks, who look at their strategy and often redefine it.

And the reason the banks do that is—I think, Frank, that you said they are enjoying record profits. And that's true if you look at it in terms of gross dollars. It is way not true if you look at the thing that matters to the market, which is return on equity. Those were running well into the 20s before the crisis, and often higher. Now they are six, seven percent. That's a very different, and when I, as an investor, look at with whom I want to invest as a shareholder, I would rather have a higher return on equity, because, of course, I then could get more from my money. It's driving the market, that ROE, risk-adjusted return on capital. Whether it's the debt or, most importantly, the equity, it's making the financial market. And because the rules drive that return on capital, the rules are redefining the industry.

As you said, and I agree with Frank absolutely and completely, it's making banks safer. But it's also, I think, ultimately, undermining their long-term resilience, undermining their importance, and therefore really redefining the financial system in ways we still haven't really figure out but I think will be really problematic as the system continues to evolve.

JUDGE EDITH H. JONES: Okay, Frank. Just a couple minutes, please.

FRANK MEDINA: That Karen Shaw Petrou agrees with me on anything at all, I consider to be just this tremendous victory, so thank you.

To address the return on equity point, I agree. I mean, given the opportunity to invest in something that's going to give me 20 percent return on equity versus seven, I'd be a fool not to take the 20 percent. The difficulty is that the 20 percent return on equity reflected the fact that the institution was undercapitalized, and if it failed, it would be bailed out. So I guess the other part of that, making a 20 percent return on equity, if somebody else's bearing the risk—and when I say "somebody else" quote I'm pointing at you, the taxpayer—well, I'd be a fool not to take that.

As far as Senator Gramm's point about the housing industry being at the center of the housing crisis, I agree with him that it was. I'm not quite sure that I agree with him on it being government mandated programs forcing banks to lend to people who couldn't afford to pay or wouldn't pay. There was a period in time where this activity was incredibly profitable. As far as Senator Gramm's points about returning to reasonable down payments, putting restrictions on subprime lending, I actually worked in the House—I should make this clear, I worked for Jeb Hensarling. I was not a Democrat. I'm not a Democrat now. Still a Republican.

I worked for Spencer Baucus in the fall of 2007, and Spencer Baucus, a Republican, had exactly the same concerns, and we wanted to put restrictions on subprime lending to make it safer, to make it less of a threat to the financial system. And we were vilified. I mean, people who believed in the free market said, "If banks are willing to make these loans, and consumers are willing to take them, who are we to interfere?"

So it's hard. It's a really hard balance to strike. I believe in free markets. I also believe that there are points where the government needs to intervene. So please take back my credentials. I'll turn them in willingly, but — that's where I come out.

JUDGE EDITH H. JONES: Go ahead. A couple minutes.

J.W. VERRETT: In Frank's presentation, he raised an interesting puzzle about the FDIC's report of record profits of banks for a number of quarters in the post-Dodd-Frank era. It's an important puzzle, and I think he's right to raise it. Here are my questions I think deserve further study of understanding why that is. And the, let me say the reason why I ask these questions is because I don't care how much money banks are making. I don't care. It doesn't matter to me at all how profitable banks are. I only care about their role in financial intermediation, their link to growth in the economy. That's the only thing that I worry about.

So I wonder why the disconnect between bank profits and lending to lead to growth. There's obviously a disconnect. I think if you combine Senator Gramm's observations with Frank's observations, you see a disconnect. Why? Why is that? How has the relationship between risk and return changed as a result of the wealth of regulations in Dodd-Frank. That's question one for me

Question two for me: the assumptions of bailouts. The moral-hazard subsidy that results from the response to the crisis in '08, and the, from one perspective, healthy change in that, from the FDIC restrictions and the Fed lending restrictions, or unhealthy, depending on your perspective and how significant you think it is. How does that subsidy affect or help, in some way, those record profits?

Thirdly, how are they distributed among financial institutions. If they are weighted toward larger financial institutions, I think there's a story you can tell about compliance costs and Dodd-Frank and the fact that larger institutions can internalize those better than smaller.

So those are just three questions off the top of my head that I think we've got to understand in understanding the implications of those record profits. But I think it's right to raise that as a starting point for discussion.

JUDGE EDITH H. JONES: All righty. We can open the floor for questions, but I would have a couple of just man-on-the-street observations. Well, one is sort of judicial. Professor Verrett indicated that he was sympathetic—or either of these gentlemen, that they thought judicial review would somehow control the excesses of regulation in the financial services system. I say, take another look.

You know, having a B.A. in economics, as I did, doesn't begin to equip one, who has been out of that area practicing law for some years, to address these kinds of issues. I'm also very skeptical that having an economics branch within an agency is going to do anything except get captured by the regulatory agenda on a political basis. I mean, look what the CBO does. They bless everything. They always understate everything. They misrepresent the effect of tax changes, and so on. It doesn't change.

The other question I have about this overarching regulation is about the impact on community banks, which I understand has been very dire, from talking to friends in that area in Houston Texas, which has been a pretty good area for making sound loans for the past few years. But you know you can impose costs on the—it's the old story. The big companies get the benefits, and to some extent they capture benefits of regulation, to the detriment of the small people. It's—I hate to say it—Wall Street versus Main Street, in a way.

And the other point about the CPFB is, I don't understand what mission it had. I mean, it's been given, you know, it's sort of like the "sheriff at high noon" authority.

No control over the budget, very limited judicial control of any sort, or that of Congress, and yet we already had an FTC, and every state has has a Deceptive Trade Practices Act. And so what does it do that wasn't being done before?

But let's turn the floor over to questions.

BERT ELY: Bert Ely, a member of the Federalist Society. First of all, I think it's an excellent panel, and I particularly want to commend Karen's comments about return on equity. If banking is to have all of this capital, it has to be able to earn a market return on it. Otherwise, that capital will go to other industries. So I think that the ROE issue for the banking industry is a critical one.

I have a question, which relates to what is going to cause the next financial crisis, and maybe I direct this primarily to the Senator, and that is, we have had this sustained period of very low interest rates. We know that that is feeding bubbles and not just in housing, but in the corporate sector, too. What is your sense of how this sustained period of low interest rates is going to play out and these bubbles that have formed, once interest rates start to move up? And let's say they move up by two or 300 basis points, that the whole yield curve moves up. Isn't that going to be a possible trigger for the next crisis?

SENATOR PHIL GRAMM: Well, I'm tempted to say I knew the answer to every other question in the world except this one. We are in such uncharted water here that how this is all going to play out, I think, is very, very difficult to predict. I don't see it playing out well. I don't know exactly how it's going to play out, but we have never had anything like banks with $19 of reserves for every $1 they are required by law to hold. We've never had a situation where the Fed is trying to stimulate the economy but is paying banks not to make loans, with interest on deposits at the Fed. How they unwind this, I think, is very difficult to predict. I've spent most of my adult life studying the monetary history of this country, and there is nothing remotely similar to the circumstance, so I'm worried about it. And I think it's going to be difficult to get out of.

Now, can it be overcome? I believe anything can be overcome. Is it going to be very, very difficult? I think yes, it is going to be very, very difficult to unwind all of this. What it's clearly done is, it's allowed the federal government to double the debt of the country and have it never really show up on its income statement. That's what happened. And it did it by buying all of these securities but then paying banks interest not to use the money. So how this all plays out-- I hope I live long enough to see it. I'm eager to know the answer to it, but I don't know the answer to it.

CARL DOMINO: Carl Domino, member, and this is also for the Senator, and this is also on monetary policy. It's on the interaction of globalization and monetary policy. As you know, whenever the FOMC meets, they discuss their dual mandate and reach a decision on where rates should be. Historically, that decision has been based on what's happening in the domestic economy, and that made sense, because, as a general proposition, the world economy and monetary authorities—both in the rest of the world and America—were going the same direction. But in the last few months, we've seen our markets roiled by the prospects of Draghi getting an easy money policy, or more dovish, in Europe, while Yellen is talking about raising rates here. The dollar, as you know has gone from $1.32 to $1.07. It's killed our exporting companies, and with all the money held overseas, the translation effect has ruined corporate earnings.

Do you think, in the upcoming meetings, they need to more carefully consider the impact of their decisions on currency, and could that not create a financial crisis in America as our earnings go into recession?

SENATOR PHIL GRAMM: Well, let me say that there's no question about the—first of all, you need to remember, the Fed does not determine the interest rate. Markets determine interest rates. The Fed can affect the market by buying and selling capital, basically financial assets. So what the Fed says rates will be is important only because it's a leading indicator of what they're likely to do. When they raise interest rates, it's my presumption that they're going to raise the rate they're paying banks to hold reserve accounts at the Fed. That's what I presume. Raising the rates at which banks lend each other—since it's below the rates that the Fed pays them to just hold the money, they're not lending to each other, so it has no impact.

So I guess I've got—let me give you a response question. I think that it will have an impact by signaling that we are beginning to move out of this interest-free era. How much of an impact, I don't know, because the demand for capital is so low, because investment is so depressed as compared to the normal expansion, that we really don't know what the market rate would be. I don't know how satisfying that answer is, but again, this can't go on forever. At some point, things have got to come back to normal. At some point, people are going to want to invest in America. If America is not a good investment, there isn't a good investment in the world. And at some point, the ship is going to right itself, and when it does, the Fed is going to have to really take some dramatic action fast, or else they're going to have real problems in terms of prices. But have they thought all this out? Do they really know exactly what they're doing? That, I'm confident in answering. No, they don't.

J.W. VERRETT: can I add a little quick note to that?

I do worry a little bit about the Fed's participation in reverse repos, participation in reverse about the participation in reverse because I think that it opens up the possibility of a significant increase in Fed influence on the market rate. I hope that we quickly go back to the old process of open market operations, as opposed to paying interest on excess reserves, and particularly as opposed to Fed participation in reverse repos. I mean, it's an untested tool. It opens up serious conflict of interest when the Fed is regulator of its counterparties in that market. Maybe I'm just talking as a Libertarian here, but to me, that's a central-planning nightmare waiting to happen.

TONY COTTO: Hi, Tony Cotto. I represent state insurance regulators and, and in thinking through the next crisis—state regulators are accountable either through election or by their governors. The only thing that scares me more than unaccountable bureaucrats in Washington regulating markets is unaccountable bureaucrats in Basle regulating markets. So I'm wondering if, for any of the panelists, the international specter looming over the U.S. system—do you have any thoughts on that and how that might contribute to future crises?

J.W. VERRETT: Yeah. I do. I absolutely agree with you. I mean the old—

KAREN SHAW PETROU: Actually, we can have a fight, because I disagree, so we'd do that.

So I suspect you are talking about some of the actions at the Basle Committee, and more importantly, the International Association of Insurance Supervisors. And the problem I have with worrying about that—because a lot of their rules deal with some of the actions in the insurance companies that I spend a lot of time on, like securities financing transactions and nontraditional insurance activities. I honestly do not think state rules are well suited for much of that. MetLife, just the day before yesterday, announced that it was opening an asset management operation focusing principally on junk bonds. That's not insurance. A state regulatory framework is not well designed for that.

I just gave a talk two weeks ago to the State Guarantee Associations, talking about how would you handle the failure of a MetLife, of an AIG—not a simple insurance company, but a complex one engaged in cross-border activities, many of which are nontraditional insurance, where issues about policyholder-claims-paying act capacity come into play. I understand the conflict, but I really would urge the state agencies to defend their turf where they are on their strongest ground, but to think through a little bit more what insurance has become and how best to regulate, and even more importantly, resolve that. And some of what the global regulators are saying is, I think, worth a second listen.

Whatever policy we want to have in terms of regulating insurance companies ought to be set by elected officials.

J.W. VERRETT: I can appreciate some of those thoughts, but I wonder if, in lieu of a global rulemaking body, just consideration of the debate about—without taking a side on this debate—the debate about an optional federal insurance charter that was lively pre-Dodd-Frank. That's one way, in a much less onerous way than asset manager designation and MetLife designation, to think about those issues. But I absolutely agree with your criticism of Basle. I mean, it's often said that a camel is a horse designed by committee.

I think in that analogy, Basle risk-based capital requirements are more like a platypus. I mean, I just have a lot of trouble making sense of Basle's approach to risk-based buckets. And just hearing some of the behind the scenes from his some economists from the FDIC who talk about just the fact that the process is not driven by analysis. It's driven by negotiation. It's like a trade negotiation, and I just don't think that works in banking regulation.

FRANK MEDINA: I'm sympathetic to the point you raise. I think one of the big problems with the international regulatory organizations is a lack of accountability and a lack of transparency. I think people that are subject to the regulations ought to know what's going on and ought to know who's participating, ought to know what the basis for the decisions are.

That said, I agree completely with Karen. I think that when you say "insurance company," I want to think about the Mutual Farmers Assurance Company of Missouri, which is where I grew up and the insurance company I know. That's perfectly suited for state regulation, but if you're talking about a behemoth like Karen's describing, then I think there is absolutely a place for international expertise and consideration of the effects on the international financial system. It's different.

SENATOR PHIL GRAMM: I'd like to say something about it. Look, whatever policy we want to have in terms of regulating insurance companies ought to be set by elected officials. I don't understand this system whereby the Feds and the Treasury participate in Europe—in Paris, in fact, perfect place—in setting regulations. They agree to the regulations, they designate entities systemically significant, and then they come back to the United States and take rules that Europeans wrote and implement them in the United States. Now, my view is, Congress should set these rules. And I think something has gone very wrong when we've got international rules being imposed in the United States, and Congress never having any voice in it whatsoever.

I mean, it's sort of the internationalization of a process that's kind of like the Consumer Financial Protection Bureau. The purpose of that bureau is to politicize lending in America. The purpose of that bureau is to have government decide who gets credit and who doesn't get credit. That bureau will make the system less stable, not more stable, and it's not answerable to anybody. But guess what? We win this election, were going to appoint a director to just shut the place down. You made it independent. We can show you how independence works.

And the same is true for Dodd-Frank. We don't have to repeal Dodd-Frank. Dodd-Frank is written like the securities act of '34. In 1934, Congress didn't know anything about financial institutions, so they gave all this power to the regulator. They did the same thing in Dodd-Frank. So what does the Volcker rule rule? It rules whatever the hell you say it rules, and nothing, if you say it doesn't rule it. What does the stress test test? Whatever you say it tests. All of these things are made up by regulators, and they can be unmade by regulators. So this revolution in Dodd-Frank—which Elizabeth Warren, to go back to your point, Edith, thinks is writ from Heaven—is basically established on the sand, because it was never writ to begin with. It simply granted powers, and somebody else can take the same powers. On the Volcker rule, all you've got to do is say you can't engage in trading unless you're a market-maker to some degree in that area, in which case you can do whatever you want to do. I think it's important to know that, before we start cashing in our investments in America. This thing can be fixed, but it's going to be hard to fix.

J.W. VERRETT: And to add, it'll going to require the right nominees. Probably libertarian academics, I think, will be the key.

SENATOR PHIL GRAMM: Well, maybe you ought to be the head of the Consumer Financial Protection Bureau.

JUDGE EDITH H. JONES: It is 2:15, so I think we ought to adjourn. Thank you very much.

---

1 Financial Stability Board (FSB), *Global Shadow Banking Monitoring Report 2015* (November 2015), available at http://www.financialstabilityboard.org/wp-content/uploads/global-shadow-banking-monitoring-report-2015.pdf.

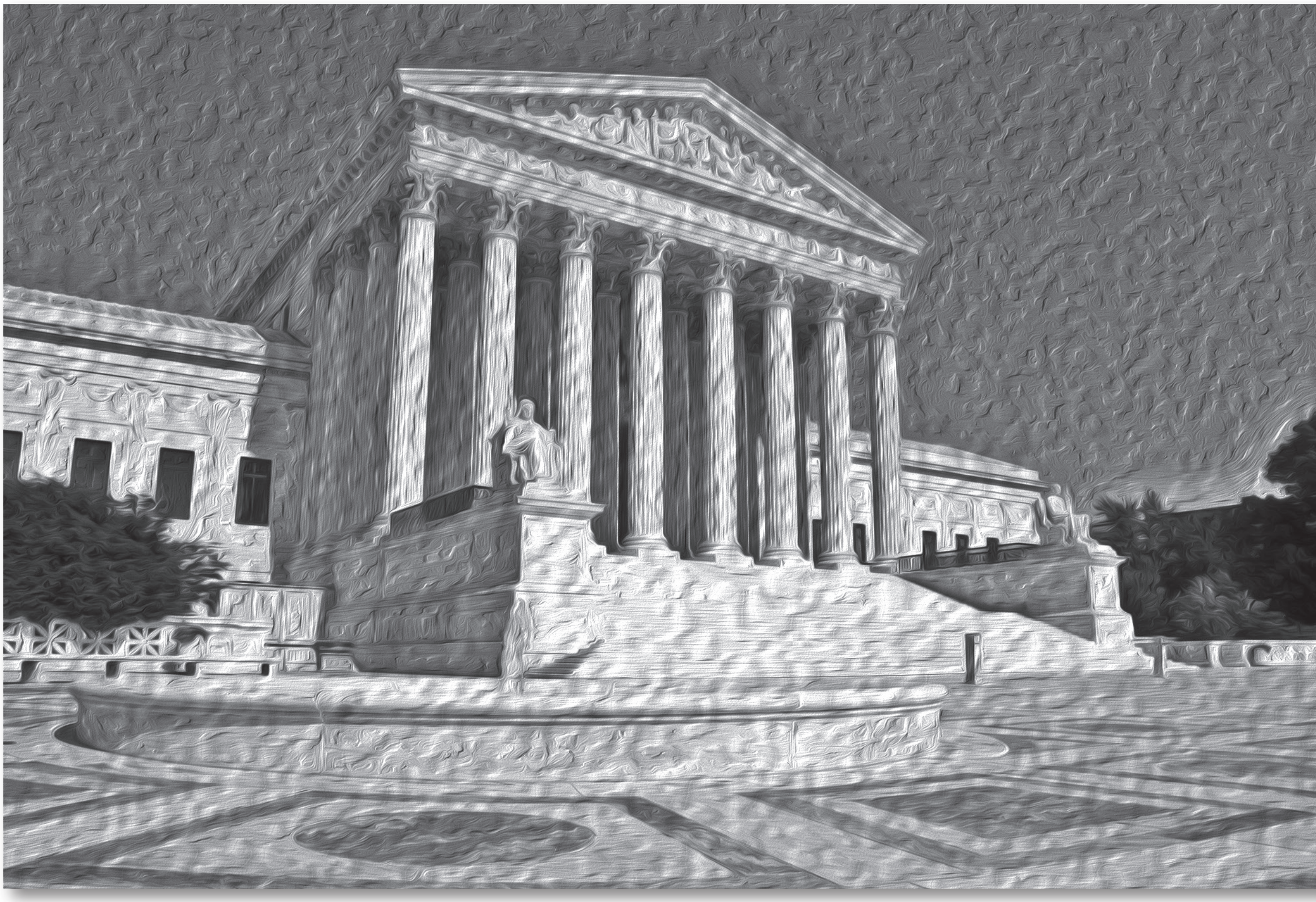
2 Jill Cetina, *Incorporating Liquidity Shocks and Feedbacks in Bank Stress Tests* (July 2015), Office of Financial Research, available at http://financialresearch.gov/briefs/files/OFRbr-2015-06-Incorporating-Liquidity-Shocks-and-Feedbacks-in-Bank-Stress-Tests.pdf

3 Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), Farm Credit Administration (FCA), Federal Housing Finance Agency (FHFA), *Margin and Capital Requirements for Covered Swap Entities*, FDIC (October 2015), available at https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf

4 Joe Peek and Eric S. Rosengren, *The Role of Banks in the Transmission of Monetary Policy* (September 9, 2013), available at http://bostonfed.org/economic/ppdp/2013/ppdp1305.pdf.

5 FRB, *Aggregate Reserves of Depository Institutions and the Monetary Base* (September 2007), available at http://www.federalreserve.gov/releases/h3/20070927/.

6 FRB, *Aggregate Reserves of Depository Institutions and the Monetary Base* (November 2015), available at http://www.federalreserve.gov/releases/h3/current/H3.pdf.



Supreme Court Expands Consumer Protection Under First Sale Doctrine

by Nimroz Ali*

The Supreme Court's recent decision in *Kirtsaeng v. John Wiley & Sons, Inc.* has significantly expanded consumer protection through a refined interpretation of the first sale doctrine.

I. Introduction

First sale doctrine is a common law remedy used to protect consumers, allowing them to re-sell lawfully-made, purchased goods if and when they please. Since its inception in 1909, the first sale doctrine has been periodically modified by subsequent court opinions. However, the Supreme Court's recent decision in *Kirtsaeng v. John Wiley & Sons, Inc.* has significantly expanded consumer protection through a refined interpretation of the first sale doctrine.[1]

II. First Sale Doctrine and Relevant Sections of Copyright Act

The first sale doctrine originates from the Supreme Court's 1908 decision in *Bobbs-Merrill Co. v. Straus*.[2] In *Straus*, the defendant purchased a book from the plaintiff-copyright owner containing a notice that prohibited the purchaser from selling the book for less than $1.[3] At the time, copyright laws allowed the plaintiff the exclusive right "to vend", but the defendant proceeded to sell the book for less than $1. Against the interests of the plaintiff, Justice William Day wrote the majority opinion holding that the plaintiff's right to vend was abrogated when the plaintiff lawfully sold the book to the defendant.[4] Thus, the first sale doctrine was born. Congress later codified the first sale doctrine into the Copyright Act.[5]

Sections 106, 109, and 602(a) of the Copyright Act address the first sale doctrine.[6] Section 106 states the owner of a copyright has the exclusive rights to "reproduce the copyrighted work and to distribute copies of the copyrighted work."[7] According to § 602(a), importing purchased goods "into the United States, without the authority of copyright under this title that have been acquired outside the United States is an infringement of the exclusive right to distribute copies under section 106."[8] Lastly, § 109 embodies the first sale doctrine and states that despite § 106, "the owner of a particular copy lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell that copy."[9]

III. Judicial Development of First Sale Doctrine

Throughout the history of the development of the first sale doctrine, the common issue has been the conflict between the seeming limitations the first sale doctrine in § 109 places on the copyright owner's right to prohibit importation under § 602(a). The following three cases helped develop and refine the first sale doctrine prior to the Supreme Court's decision in *Kirtsaeng*.[10]

In *Sebastian International, Inc. v. Consumer Contacts Ltd.*, the Third Circuit Court of Appeals heard another issue pertaining to the first sale doctrine.[11] In *Sebastian International*, the plaintiff employed the defendant to distribute plaintiff´s products in South Africa.[12] However, instead of distributing the products in South Africa, the defendant re-sold the products in the United States to make a profit. While it was clear that § 109 expressly limited copyright owner´s exclusive rights enumerated in § 106, the main issue was whether § 109 also limited § 602(a).[13] In response to this, the Third Circuit Court of Appeals held that § 602(a) was not a right *in addition* to those expressed in § 106.[14] Instead, the Third Circuit Court of Appeals held that the § 602(a) importation prohibition and the § 106 rights are interdependent and could be read together. In other words, the Third Circuit Court of Appeals concluded that § 109 limited not only § 106 but also § 602(a).[15] Therefore, the plaintiff-copyright owner extinguished his right to prohibit importation, under § 602, when the defendant paid him in the first sale.[16]

In 1997, the heavily contested issue of the first sale doctrine reached the Supreme Court. In *Quality King Distribs., Inc. v. L´anza Research Int´l, Inc.*, the plaintiff manufactured its products within the United States and then sold the products to distributors in the United Kingdom.[17] The foreign distributor then sold the products to Quality King, which imported them back into the United States for a profit. In its opinion, the Supreme Court incorporated the same interpretation of § 106 and § 602(a) as the court in *Sebastian International*.[18] The Supreme Court noted that because § 106 and § 602(a) are to be read together, § 602(a) should also be limited by the first sale doctrine in § 109.[19] Thus, the Supreme Court held that goods manufactured in the United States, purchased abroad, and then imported into the United States are not subject to § 106 importation prohibition. With this, the Supreme Court expanded consumer protection because consumers could now raise the defense of first sale doctrine for both domestically- and internationally-purchased goods.[20]

Although the Supreme Court expanded consumer protection in *Quality King.*, it subsequently limited this protection in 2008, with its holding in the last case addressing this issue before the recent decision in *Kirtsaeng—Omega S.A. v. Costco Wholesale Corporation*.[21] In *Omega*, the plaintiff-copyright owner manufactured its goods outside the United States and the defendant then imported them into the United States.[22] In affirming the opinion of the Ninth Circuit Court of Appeals, the Supreme Court distinguished *Quality King*. While the purchased goods in question were manufactured within the United States in *Quality King*, those in *Omega* were manufactured outside the United States.[23] With this distinction, the Supreme Court held that consumers can only use the defense of the first sale doctrine for lawfully purchased goods that were manufactured *within* the United States.[24] Thus, copyright owners can exercise their importation prohibition right under § 602(a) against consumers who purchase goods manufactured outside the United States. This decision was a huge setback for consumer protection because consumers would not be permitted to use the first sale doctrine as a defense against importation of lawfully purchased goods manufactured outside the United States.[25]

The Supreme Court had a change of heart, however, when it decided *Kirtsaeng*.[26] In *Kirtsaeng*, the defendant purchased plaintiff´s book in Thailand, which was also manufactured in Thailand, imported it into the United States, and then resold it within the United States for a profit. The main issue of *Kirtsaeng* was whether the phrase ¨lawfully made under this title¨ in section 109 placed a geographic limitation on the first sale doctrine, as previous court decisions had stated.[27] Before the Supreme Court heard the *Kirtsaeng*, the Second Circuit Court of Appeals ruled that the word "under" in § 109 indicated that the Copyright Act, and thus the first sale doctrine, did not apply to goods manufactured outside the United States and in places where the Copyright Act has no jurisdiction.[28] Ultimately, the Supreme Court disagreed and held that the word "under" in § 109 of the Copyright Act did not intend to place a geographic limitation on the first sale doctrine. Rather, according to the Court, the language of § 109 indicates that a lawful purchaser is protected under the first sale doctrine as long as the purchased good is "in accordance with" or "in compliance with" the Copyright Act.[29] Additionally, the Supreme Court used § 104 to further define the applicability of the Copyright Act and the first sale doctrine. According to Justice Breyer, § 104 states that works "subject to

The Supreme Court had a change of heart, however, when it decided *Kirtsaeng*.

protection under this title" include works "first published" in any of one of the nearly 180 nations, including Thailand, that have signed a copyright treaty with the United States.[30] As a result, despite the plaintiff's book not being manufactured within the United States, the book was properly copyrighted within the United States and this was sufficient to uphold the protections guaranteed to consumers under the first sale doctrine of the Copyright Act.[31]

With its opinion in *Kirtsaeng*, the Supreme Court greatly expanded consumer protection by allowing consumers to use the defense of first sale doctrine for not only goods manufactured within the United States but also for goods manufactured and first sold abroad.

IV. Workaround for First Sale Doctrine

Although the Supreme Court furthered the cause of consumer protection under *Kirtsaeng*, copyright owners have circumvented the first sale doctrine by utilizing registered trademarks.[32] While *Kirtsaeng* dealt with the issue of copyright protection, it left consumers vulnerable to trademark protections.[33] Therefore, trademark owners can use two separate pieces of legislation to bypass the first sale doctrine of the Copyright Act: the Lanham Act and § 526 of Tariff Act of 1930.[34]

Under the Lanham Act, a merchant can prevent another merchant from using a similar trademark on goods or services without the trademark owner´s consent. Section 43(b) of the Lanham Act allows civil actions to enjoin importation of any goods likely to infringe registered or unregistered trademarks.[35] In addition, § 42 authorizes the U.S. Customs and Border Protection (CBP) to prevent the importation of goods that infringe registered or unregistered trademarks; this applies to both counterfeit and non-counterfeit goods.[36] The CPB reported 24,361 seizures of trademark-infringing merchandise in 2013, an increase from 7,255 in 2004.[37] In fact, John Wiley & Sons, the unsuccessful plaintiff-publisher in *Kirtsaeng*, was granted protection by the CPB to prevent the importation of 11 textbook titles in 2014.[38] Therefore, more copyright owners are using the Lanham Act and its favorable trademark protections to get around the first sale doctrine and, thereby, weaken consumer protection.

Section 526 of the Tariff Act of 1930 offers even more protection for trademark owners, to the detriment of consumers.[39] Under this provision, a trademark owner can block the import of genuine but foreign-made goods even when the imported goods are identical to those authorized for domestic sale.[40] The only exception for consumers under the Tariff Act is that they are allowed to import foreign-made goods without the trademark owner´s consent as long as the consumer is a corporate affiliate or owns the same trademark in the country of manufacture.[41] However, this exception is not likely to pertain to individual consumers. As such, § 526 essentially empowers trademark owners to obtain what the Supreme Court tried to prevent in *Kirtsaeng*.

Furthermore, copyright owners can exploit their rights under § 109(d) of the Copyright Act. This section states that the first sale doctrine defense provided in § 109(a) does not "extend to any person who has acquired possession of the copy or phonorecord from the copyright owner, by lease".[42] In other words, if a copyright owner licenses its product to a consumer, the copyright owner retains title of ownership over that product. Thus, the consumer is prevented from re-selling the purchased product to another person or raising the defense of first sale doctrine in court.[43] Because of this, and the fact that most purchased digital contents, such as e-books and music, are licenses rather than sales, copyright owners are allowed to, yet again, circumvent the first sale doctrine.

The Digital Millennium Copyright Act of 1998 (DMCA) Section 104 Report, a report required by federal statute and the decision in *Capital Records, LLC v. ReDigi Inc*,[44] favor the copyright owner's ability to license goods as a way to circumvent the first sale doctrine and *Kirtsaeng.* The DMCA Section 104 Report states that § 109 of the Copyright Act should not be applied to digital content because there are material differences between physical objects and digital content. The DMCA cited such reasons as digital content being much easier to transfer than material objects and that, unlike material objects, digital content increases the risk of privacy because it does not degrade over time.[45] The U.S. District Court of the Southern District of New York adopted these views in the *Capital Records* case a few weeks after the Supreme Court ruled on *Kirtsaeng*. In *Capitol Records*, the plaintiff-copyright owner sued the defendant-consumer for uploading digital music files to a website in order to sell them to other users. The court held that physical limitations should be placed on the first sale doctrine and, as a result, denied the defendant's use of the first sale doctrine defense.[46] Although the court declared that it lacked the authority to establish the non-applicability of the first sale doctrine to digital content, it laid the groundwork for many future courts to allow copyright owners to circumvent the statutorily-granted and judicially-affirmed consumer rights under the first sale doctrine.

If consumer protection is to be both defended and expanded, further legislation is required, consistent with the Supreme Court's ruling in *Kirtsaeng*.

V. Conclusion

Since 1908, American courts have made great strides in expanding consumer protection under the first sale doctrine of the Copyright Act. The *Kirtsaeng* decision, a landmark case for the first sale doctrine, allowed consumers to use the defense of first sale doctrine not only for goods manufactured within the United States, but also for goods manufactured outside the United States and first sold abroad. *Kirtsaeng* gave consumers the right to re-sell their lawfully purchased goods in the in the international market. Copyright owners, however, can still circumvent *Kirtsaeng* and the first sale doctrine by licensing their products to consumers rather than selling them. Trademark owners can also use trademark protections under the Lanham Act and the Tariff Act to work around *Kirtsaeng*. If consumer protection is to be both defended and expanded, further legislation is required, consistent with the Supreme Court's ruling in *Kirtsaeng*.

**Nimroz Ali is a third-year student at the University of Houston Law Center.*

---

1 Kirtsaeng v. John Wiley & Sons, Inc., 133 S. Ct. 1351 (2013).

2 Construction and Application of ¨First Sale Doctrine¨ in Copyright Law, 75 A.L.R. Fed. 2d 387.

3 Bobbs-Merrill Co. v. Straus, 210 U.S. 339 (1908).

4 *Id.*

5 7 U.S.C. § 109.

6 Construction and Application of ¨First Sale Doctrine¨ in Copyright Law, 75 A.L.R. Fed. 2d 38

7 17 U.S.C. § 106.

8 17 U.S.C. § 602(a).

9 17. U.S.C. § 109.

10 Construction and Application of ¨First Sale Doctrine¨ in Copyright Law, 75 A.L.R. Fed. 2d 387.

11 Sebastian International, Inc. v. Consumer Contacts (PTY), Ltd., 847 F.2d 1093 (3d Cir. 1988).

12 *Id.*

13 *Id.*

14 *Id.*

15 Construction and Application of ¨First Sale Doctrine¨ in Copyright Law, 75 A.L.R. Fed. 2d 387.

16 *Id.*

17 Quality King Distribs. v. L´Anza Research Int´l, 522 U.S. 911 (1997).

18 *Id.*

19 *Id.*

20 *Id.*

21 Costco Wholesale Corp. v. Omega, S.A., 562 U.S. 40 (2010).

22 *Id.*

23 *Id.*

24 *Id.*

25 *Id.*

26 Kirtsaeng v. John Wiley & Sons, Inc., 133 S. Ct. 1351 (2013).

27 *Id.*

28 John Wiley & Sons, Inc. v. Kirtsaeng, 654 F.3d 210 (2011).

29 Kirtsaeng v. John Wiley & Sons, Inc., 133 S. Ct. 1351, 1358 (2013).

30 *Id.* at 1359.

31 *Id.*

32 Mary LaFrance, *A Material World: Using Trademark Law to Override Copyright's First Sale Rule for Imported* Copies, 21 Mich. Tel. & Tech. L. Rev. 43 (2014).

33 *Kirtsaeng*, 133 S. Ct. at 1355-56, 1358.

34 LaFrance, *supra* note 32 at 45.

35 15 U.S.C. § 1125(b).

36 15 U.S.C. § 1124.

37 LaFrance*, supra* note 32 at 62.

38 General Notices, 48 Cust. B. And Dec., no. 7 (Feb. 19, 2014).

39 19 U.S.C. § 1526; K Mart Corp. V. Cartier, 486 U.S. 281, 287-88 (1988); Weil Ceramics & Glass, Inc. V. Dash, 878 F.2d 659, 664 (3d Cir. 1989); 19 C.F.R. § 133.23(a)(2) (2014).

40 *Id.*

41 *Id.*

42 17. U.S.C. § 109(d).

43 *Id.*

44 Sarah Reis, Note and Comment, *Toward a "Digital Transfer Doctrine"? The First Sale Doctrine in the Digital Era,* 109 Nw. U.L. Rev. 173 (2014).

45 *Id.*

46 *Id.*

Consumer News Alert Recent Decisions

Since 2006, the Center for Consumer Law has published the "Consumer News Alert." This short newsletter contains everything from consumer tips and scam alerts, to shopping hints and financial calculators. It also has a section just for attorneys, highlighting recent decisions. The alert is delivered by email three times a week. Below is a listing of some of the cases discussed during the past few months. If a link does not work, it may be necessary to cut and paste it to your browser. To subscribe and begin receiving your free copy of the Consumer News Alert in your mailbox, visit www.peopleslawyer.net.

U.S. SUPREME COURT

California state law prohibiting class action waivers in arbitration agreements is not "valid law" for purposes of interpretation of arbitration clause after Supreme Court's decision in AT&T Mobility v. Concepcion in favor of enforcement of arbitration agreements. The DirecTV service agreement, which was the subject of a California class action, included a binding arbitration clause with a class action waiver. The language indicated that the waiver would be unenforceable if the applicable state law (described in the agreement as "the law of your state") made class action waivers unenforceable. Plaintiffs argued that because California had a state law making class action waivers unenforceable at the time of the filing, the clause allowed such a class, and both the district court and 9th Circuit agreed. The U.S. Supreme Court reversed the decision, holding that the phrase 'law of your state' is not ambiguous and takes its ordinary meaning: valid state law," and that its decision in *AT&T Mobility v. Concepcion* specifically invalidating California's law meant that there was no valid state law barring arbitration. *DirecTV v. Imburgia*, 136 S.Ct. 463 (Dec. 14, 2015). https://supreme.justia.com/cases/federal/us/577/14-462/case.pdf

Supreme Court Holds Offer of Judgment Does Not Moot a Class Action. The United States Supreme Court held that a class-action defendant cannot moot a plaintiff's case by making a pre-class certification offer of judgment that would satisfy the individual plaintiff's personal claims but not those of the class. Such an offer does not moot the individual plaintiff's claim because, if the plaintiff rejects it, the offer is a nullity and does not deprive the court of the ability to grant relief between the parties. In other words, a court can still award whatever damages, injunctive relief, and other relief the plaintiff seeks if the plaintiff proves his claims. Thus, the case does not meet the Supreme Court's definition of mootness, under which a case is moot "only when it is impossible for a court to grant any effectual relief whatever to the prevailing party." If the individual plaintiff's claims are not moot, he can pursue class relief as well, because "a would-be class representative with a live claim of her own must be accorded a fair opportunity to show that certification is warranted." *Campbell-Ewald Co. v. Gomez*, 135 S.Ct. 663 (Dec. 15, 2016). https://supreme.justia.com/cases/federal/us/577/14-857/case.pdf

When an ERISA plan participant wholly dissipates a third-party settlement, plan fiduciary may not bring suit to attach participants separate assets. An ERISA plan participant, Montanile, was seriously injured by a drunk driver. His ERISA plan paid more than $120,000 for his medical expenses. Montanile sued the drunk driver and obtained a $500,000 settlement. The plan administrator sought reimbursement from the settlement. Montanile's attorney refused and indicated that the funds would be transferred from a trust account to Montanile unless the administrator objected. The administrator did not respond and Montanile received the settlement. Six months later, the administrator sued under ERISA 502(a)(3), which authorizes plan fiduciaries to file suit "to obtain . . . appropriate equitable relief . . . to enforce . . .

the plan." 29 U.S.C. 1132(a)(3). The Eleventh Circuit held that even if Montanile had completely dissipated the fund, the plan was entitled to reimbursement from Montanile's general assets. The Supreme Court reversed and remanded for determination of whether Montanile had dissipated the settlement. The court noted that historical equity practice does not support enforcement of an equitable lien against general assets. *Montanile v. Bd. of Trs. of Nat'l Elevator Indus. Health Benefit Plan*, 136 S.Ct. 651 (Jan. 20, 2016). https://supreme.justia.com/cases/federal/us/577/14-723/case.pdf

FEDERAL CIRCUIT COURTS

Fair Debt Collection Act violation occurred when bank freezes consumers account, not went notice is sent to bank. The Second Circuit held that the district court erred in finding that the FDCPA violation "occurred" when defendant sent the restraining notice. Instead, the court held that where a debt collector sends an allegedly unlawful restraining notice to a bank, the FDCPA violation does not "occur" for purposes of Section 1692k(d) until the bank freezes the debtor's account. *Benzemann v. Citibank,* 806 F.3d 98 (2nd Cir. Nov. 16, 2015). http://cases.justia.com/federal/appellate-courts/ca2/14-2668/14-2668-2015-11-16.pdf?ts=1447687805

Section 1641(g) requires a creditor who obtains a mortgage loan by sale or transfer to notify the borrower of the transfer in writing.

Truth in Lending 2009 amendment does not apply retroactively. Plaintiffs filed a putative class action against Wells Fargo and U.S. Bank, alleging federal and state law claims arising out of the modification of the deed of trust for plaintiffs' home. At issue was the retroactivity of 15 U.S.C.1641(g), a 2009 amendment to the 1968 Truth in Lending Act (TILA). Section 1641(g) requires a creditor who obtains a mortgage loan by sale or transfer to notify the borrower of the transfer in writing. The Ninth Circuit held that section 1641(g) does not apply retroactively because Congress did not express a clear intent to do so. The court noted that its holding is consistent with numerous district court decisions. *Talaie v. Wells Fargo Bank,* 808 F.3d 410 (9th Cir. Dec. 14, 2015). http://cases.justia.com/federal/appellate-courts/ca9/13-56314/13-56314-2015-12-14.pdf?ts=1450116142

Amount of mortgage loan not sufficient to establish unconscionability. Plaintiff filed suit against Wells Fargo, alleging that his mortgage agreement, providing him with a loan far in excess of his home's actual value, was an "unconscionable contract" under the West Virginia Consumer Credit and Protection Act, W. Va. Code 46A–1–101. The court agreed with the district court that the amount of a mortgage loan, by itself, cannot show substantive unconscionability under West Virginia law, and that plaintiff had not otherwise made that showing. *McFarland v. Wells Fargo Bank,* 810 F.3d 273 (4th Cir. Jan. 15, 2016). http://cases.justia.com/federal/appellate-courts/ca4/14-2126/14-2126-2016-01-15.pdf?ts=1452886220

Legal error alone is not a sufficient basis to vacate the results of an arbitration in any case. After a dispute arose regarding the ownership of two deceased song writers' music, the parties agreed to arbitration. The losing party unsuccessfully moved to vacate the arbitration award on the ground that the panel had committed legal errors that made it impossible for him to present a winning case. The losing party attempted to apply the Dead Man's Statute, which disqualifies parties interested in litigation from testifying about personal transactions or communications with deceased or mentally ill persons. The Third Circuit affirmed, stating that the arbitrators did not misapply the law and legal error alone is not enough to vacate the results of an arbitration. *Whitehead v. Pullman Group LLC,* 811 F.3d 116 (3rd Cir. Jan. 22, 2016). http://cases.justia.com/federal/appellate-courts/ca3/15-1627/15-1627-2016-01-22.pdf?ts=1453485606

Prevailing party defending an arbitration award in suit to vacate the award is not entitled to costs and attorney fees. The United States Court of Appeals for the Second Circuit was asked to review a district court order confirming an arbitration decision to award costs and attorney fees to the prevailing party. In reversing in part, the Second Circuit vacated the award of costs and attorney fees. The parties agreement provided: "BREACH. Damages for breach of this Charter shall include all provable damages, and all costs of suit and attorney fees incurred in any action hereunder." The second circuit found that this provision authorized a fee award against a party that breached the charter agreement as part of the non-breaching party's damages. Here, there was no finding of a breach of the charter agreement, thus no basis to award costs and attorney fees. *Zurich Am. Ins. Co. v. Team Tankers A.S.,* 811 F.3d 584 (2nd Cir. Jan. 28, 2016). http://cases.justia.com/federal/appellate-courts/ca2/14-4036/14-4036-2016-01-28.pdf?ts=1453993209

Arbitration agreement that forbids arbitrator from applying applicable law unenforceable. Plaintiff filed a putative class action against Delbert alleging that Delbert violated debt collection practices. The district court granted Delbert's motion to compel arbitration under the Federal Arbitration Act (FAA), 9 U.S.C. 4. The Fourth Circuit concluded, however, that the arbitration agreement in this case is unenforceable. The court stated, "The agreement purportedly fashions a system of alternative dispute resolution while simultaneously rendering that system all but impotent through a categorical rejection of the requirements of state and federal law." The agreement provided it was "subject solely to the exclusive laws and jurisdiction of the Cheyenne River Sioux Tribe." And that "no other state or federal law or regulation shall apply to this Loan Agreement." The court concluded that the FAA does not protect the sort of arbitration agreement that unambiguously forbids an arbitrator from even applying the applicable law. *Hayes v. Delbert Services Corp.,* 811 F.3d 666 (4th Cir. Feb. 2, 2016). http://cases.justia.com/federal/appellate-courts/ca4/15-1170/15-1170-2016-02-02.pdf?ts=1454443226

Letters sent to consumer's attorney did not violate fair debt Collection Practices Act. Bravo sued Midland for violations of the Fair Debt Collection Practices Act (FDCPA). Midland agreed to forgive two of Bravo's debts (GE/Lowe's and Citibank/Sears) as part of a settlement agreement. Philipps, an attorney who specializes in consumer litigation, represented Bravo. After the settlement, Midland sent two letters addressed to Bravo at Philipps' office. The letters were received at Philipps' business office and were basically identical. Philipps did not forward the correspondence to his client, but opened and reviewed the content of the letters. Bravo filed another claim under the FDCPA. The Seventh Circuit affirmed dismissal, finding the letters were not continued communication to a consumer. *Bravo v. Midland Credit Mgmt., Inc,* 812 F.3d 599 (7th Cir. Feb. 8, 2016). http://cases.justia.com/federal/appellate-courts/ca7/15-1231/15-1231-2016-02-08.pdf?ts=1454967057

Court finds no manifest disregard of the law. The Second Circuit found that attempts to demonstrate errors committed by an arbitration panel were nothing more than attacks on "an arbitrator's factual findings and contractual interpretation" which "generally are not subject to judicial challenge." In response to the argument that the panel overlooked certain provisions in the MSA limiting damages, the court held that the FAA "does not permit vacatur for legal errors." *Sutherland Glob. Servs. Inc. v. Adam Techs. Int'l SA de C.V.*, 2016 WL 494155 (2nd Cir. Feb. 9, 2016). http://cases.justia.com/federal/district-courts/new-york/nywdce/6:2012cv06439/90629/50/0.pdf?ts=1428915388

No TCPA violation when prior consent is given. Plaintiffs received medical care from Hospital. After plaintiffs did not pay their bills, accounts were transferred to Credit Adjustments, which called plaintiffs' cell phone numbers, despite never having received their contact information directly from them. Credit Adjustments received the numbers from signed Patient Consent and Authorization forms covering "all medical and surgical care," and stating "I understand Mount Carmel may use my health information for … billing and payment … I authorize Mt. Carmel to receive or release my health information, [to] agents or third parties as are necessary for these purposes and to companies who provide billing services." Plaintiffs contend Credit Adjustments violated the Telephone Consumer Protection Act (TCPA), 47 U.S.C. 227(b)(1)(A)(iii), when it placed debt collection calls to their cell phone numbers using an "automatic telephone dialing system" and an "artificial or prerecorded voice." The Sixth Circuit affirmed summary judgment, finding that plaintiffs gave their "prior express consent" to receive such calls. *Baisden v. Credit Adjustments, Inc.*, 813 F.3d 338 (6th Cir. Feb. 12, 2016). http://cases.justia.com/federal/appellate-courts/ca6/15-3411/15-3411-2016-02-12.pdf?ts=1455298249

Manifest disregard of the evidence is not a basis for overturning arbitration award. The appellant argued that the arbitrator failed to weigh evidence properly when it made a finding of fact with respect to the passing of title. The Second Circuit rejected this as a basis of overturning an award based on "manifest disregard of the law," holding that the Second Circuit "does not recognize manifest disregard of the evidence as proper ground for vacating an arbitrator's award." *ISMT, Ltd. v. Fremak Indus., Inc.*, Case No. 15-2086 (2nd Cir. Feb. 24, 2016). https://scholar.google.com/scholar_case?case=12663852039047878192&hl=en&as_sdt=6&as_vis=1&oi=scholarr

Assignee is not liable under the Truth in Lending Act for a servicer's failure to provide the borrower with a payoff balance. The Eleventh Circuit noted that TILA creates a cause of action against an assignee for a violation that is "apparent on the face of the disclosure statement provided in connection with [a mortgage] transaction pursuant to this subchapter." 15 U.S.C. § 1641(e)(1)(A). The court then held that because the failure to provide a payoff balance is not a violation apparent on the face of the disclosure statement it affirmed the dismissal of the plaintiff's amended complaint. *Evanto v. Federal National Mortgage Ass'n,* 814 F.3d 1295 (11th Cir. March 1, 2016). http://cases.justia.com/federal/appellate-courts/ca11/15-11450/15-11450-2016-03-01.pdf?ts=1456860764

Broad agreement language can cause a class or collective arbitration authorization issue to be sent to an arbitrator, even when the agreement is "silent" on those procedures. The Fifth Circuit held that "gateway disputes" in arbitration cases generally are for the court and that procedural questions are for the arbitrator. However, the court recognized that gateway issues may be subject to arbitration when the agreement "clearly and unmistakably" provides for it. The court concluded that broad agreement language can cause a class or collective arbitration authorization issue to be sent to an arbitrator, even when the agreement is "silent" on those procedures.
Robinson v. J&K Administrative Mgmt. Services, Inc., 2016 WL 1077102, Case No. 15-10360 (5th Cir. March 17, 2016). http://cases.justia.com/federal/appellate-courts/ca5/15-10360/15-10360-2016-03-17.pdf?ts=1458257433

Website arbitration clause unenforceable. Sgouros purchased a "credit score" package from TransUnion. After discovering the score was not calculated in a manner used by lenders, Sgouros filed suit, against TransUnion. TransUnion moved to compel arbitration, asserting that the website through which Sgouros purchased his product included an agreement to arbitrate. The district court concluded that no such contract had been formed and denied TransUnion's motion. The Seventh Circuit affirmed after evaluating the website and concluding that TransUnion had not put consumers on notice of the terms of agreement, as required by Illinois law, but actually distracted them from noticing those terms. *Sgouros v. TransUnion Corp.* 2016 WL 1169411 (7th Cir. March 25, 2016). http://cases.justia.com/federal/appellate-courts/ca7/15-1371/15-1371-2016-03-25.pdf?ts=1458937852

Court reduces punitive damages to 1:1 ratio. A federal appeals court has whittled a $25.5 million punitive damages award to $1.95 million in a carbon monoxide poisoning lawsuit out of Wyoming. Reversing much of the lower court's decision, the U.S. Court of Appeals for the Tenth Circuit found that punitive damages in the case were "excessive and arbitrary" in violation of the Fourteenth Amendment's due process clause. *Lompe v. Sunridge Partners*, 2016 WL 1274898 (10th Cir. April 1, 2016). http://cases.justia.com/federal/appellate-courts/ca10/14-8082/14-8082-2016-04-01.pdf?ts=1459540927

FEDERAL DISTRICT COURTS

The Eastern District of New York held that a debt collector, whose telephone call to a debtor is answered by a third party, must refrain from leaving callback information and attempt to call back later. Defendant debt collector telephoned plaintiff about his debt, and a third party responded that "Herschel [the debtor/plaintiff] is not yet in," and asked if he could take a message. The collection agent responded, "Name is Eric Panganiban. Callback number is 1-866-277-1877 ... direct extension is 6929. Regarding a personal business matter." The court determined that this message is a "communication in connection with the collection of a debt" because its purpose is to solicit a call back. For this reason, the message is subject to the Fair Debt Collection Practices Act, which prohibits debt collectors them from leaving a message identifying themselves as such under §1692c(b). *Halberstam v. Global Credit & Collection Corp.,* 2016 WL 154090 (E.D.N.Y. Jan. 12, 2016). http://www.consumerfinancialserviceslawmonitor.com/wp-content/uploads/sites/260/2016/01/27883724_1.pdf

Arbitration provision unenforceable. A District Court in New Jersey recently faced a type of online agreement that did not fit nicely into either the "clickwrap," or "browsewrap" category. Where a contract, sent electronically but signed in hard copy, contains a hyperlink to a separate terms and conditions page, are those separate terms incorporated into the agreement? The court said no. A requirement to arbitrate disputes buried in the online terms and conditions page was not incorporated into a contract where the contract merely stated, "Download Terms and Conditions" near the signature line. *Holdbrook Pediatric Dental, LLC, v. Pro Computer Service, LLC*, 2015 WL 4476017 (D.N.J. July 21, 2015). http://cases.justia.com/federal/district-courts/new-jersey/njdce/1:2014cv06115/309882/8/0.pdf?ts=1437567894

STATE COURTS

An implied warranty may not exist, but if it does, you must give notice. The Arkansas Supreme Court held that it would not rule on whether there is an implied warranty for services in Arkansas, but if there is, the UCC notice requirement applies. The Court stated:

> In any event, it would be premature for this court to decide whether express and implied warranties attach as a matter of law in a contract for services. The parties never briefed the issue, which has far-reaching implications. Commentators and other jurisdictions are split when the contract is for services rather than goods. Thus, our discussion below is limited to whether there is a notice requirement if such warranties exist. Again, taking no position on whether breach of warranty claims should even exist for a contract that is exclusively for services, we hold that if such warranties do exist, the UCC notice requirements apply.

Hartness v. Nuckles, 475 S.W.3d 558 (Ark. Dec. 3, 2015). http://cases.justia.com/arkansas/supreme-court/2015-cv-14-869.pdf?ts=1449165663

Out of state plaintiff may sue out of state defendant under Consumer Protection Act based on instate agent's actions. The Washington Supreme Court was asked to determine whether the Washington Consumer Protection Act (CPA), allowed a cause of action for a plaintiff residing outside Washington to sue a Washington corporate defendant for allegedly deceptive acts. The Court also was asked to determine whether the CPA supported a cause of action for an out-of-state plaintiff to sue an out-of-state defendant for the allegedly deceptive acts of its instate agent. The United States District Court noted an absence of Washington case law providing guidance on these issues. The Washington Supreme Court answered both certified questions in the affirmative. *Thornell v. Seattle Serv. Bureau, Inc.,* 363 P.3d 587 (Wash. Dec. 10, 2015). http://cases.justia.com/washington/supreme-court/2015-91393-5.pdf?ts=1449764833

Arbitration clause in a void contract is still enforceable. Plaintiff purchased a new car from Defendant. Plaintiff filed a lawsuit, alleging that Defendant violated the Missouri Merchandising Practices Act by failing to pass title for her new vehicle. Thereafter, Defendant asked the trial court to enforce the arbitration agreement between the parties. The trial court overruled the motion to compel arbitration on the ground that the contract between the parties was void under Mo. Rev. Stat. 301.210. The Missouri Supreme Court vacated the judgment of the trial court, holding that even though the sale between Plaintiff and Defendant may be void, that question is for the arbitrator to determine, not the trial court. *Ellis v. JF Enters. LLC.* 2016 WL 143281 (Mo. Jan. 12, 2016). http://cases.justia.com/missouri/supreme-court/2016-sc95066.pdf?ts=1452625538

Payday lender waived arbitration by bringing collection suits. A payday loan company provided loans to plaintiffs. The plaintiffs and other borrowers did not repay their loans, prompting lender to file several thousand individual collection actions and secured thousands of default judgments. It was later discovered that the process server hired by Appellant falsified affidavits of service. Plaintiffs sued, alleging lender improperly obtained its default judgments against them and other similarly situated borrowers without their knowledge. Lender moved to compel arbitration based on the arbitration provisions in its loan agreements. The district court denied Appellant's motions, holding that Appellant waived its right to arbitrate by bringing collection actions in justice court and obtaining default judgments based on falsified affidavits of service. The Nevada Supreme Court affirmed, holding that the district court correctly concluded that Appellant waived its right to an arbitral forum where the named plaintiffs' claims all concerned the validity of the default judgments Appellant obtained against them in justice court. *Principal Invs. V. Harrison,* 366 P.3d 688 (Nev. Jan. 14, 2016). http://cases.justia.com/nevada/supreme-court/2016-59837.pdf?ts=1452794865

Implied warranty of merchantability waived. Plaintiff bought a used motor vehicle from defendant for $1,895. The bill of sale indicated that the vehicle was sold "As is As seen." The sale also included a form from the New Hampshire Division of Motor Vehicles (DMV) titled "NOTICE OF SALE OF UNSAFE MOTOR VEHICLE." In his small claims suit, plaintiff alleged, among other things, that the defendant had breached the implied warranty of merchantability when it sold the vehicle to him. Agreeing with the trial court that plaintiff waived this implied warranty, the New Hampshire Supreme Court affirmed. *Roy v. Quality Pro Auto, LLC,* 132 A.3d 418 (N.H. Jan. 26, 2016). http://cases.justia.com/new-hampshire/supreme-court/2016-2014-073.pdf?ts=1453817210

Unavailability of NAF does not invalidate arbitration agreement. The Arkansas Supreme Court held an arbitration agreement was enforceable, notwithstanding the fact that it designated that NAF rules should be followed. The court held that the NAF term was merely an ancillary logistical concern and that section 5 of the FAA applies and provides a procedure for the appointment of a substitute arbitrator. *Courtyard Gardens Health & Rehab. LLC v. Arnold*, 2016 WL 675547 (Ark. Feb. 18, 2016). http://cases.justia.com/arkansas/supreme-court/2016-cv-14-1105.pdf?ts=1455811227

Unavailable forum invalidates arbitration agreement. A borrower entered into a pay-day loan agreement in August of 2012 that contained an arbitration provision mandating that all claims be arbitrated in the National Arbitration Forum (NAF), and under the Code of Procedure of the NAF. However, as of 2009, NAF did not accept consumer arbitrations. The Eleventh Circuit affirmed the trial court's ruling that the arbitration agreement's choice of forum of the NAF was not an "ancillary logistical concern," but was central to the arbitration agreement. Accordingly, the lender could not enforce the arbitration agreement, and the borrower's lawsuit was permitted to proceed in court. *Flagg v. First Premier Bank*, 2016 WL 703063 (11th Cir. Feb. 23, 2016). http://cases.justia.com/federal/appellate-courts/ca11/15-14052/15-14052-2016-02-23.pdf?ts=1456243310

Enforceability of a liquidated damages provision must be analyzed at the time of contracting, not at the end of a project. The Supreme Court of Ohio held that when deciding whether a liquidated damages clause in a public construction contract is enforceable, courts must focus "on the reasonableness of the clause at the time the contract was executed rather than looking at the provision retrospectively … after a breach." *Boone Coleman Constr. Inc. v. The Village of Piketon*, Slip Opinion No. 2016-Ohio-628 (Ohio Feb. 24, 2016). http://cases.justia.com/ohio/supreme-court-of-ohio/2016-2014-0978.pdf?ts=1456322561

Arbitration agreement is unconscionable. The Montana Supreme Court affirmed a finding that an arbitration agreement was unconscionable and unenforceable. The court noted that where a party specifically challenges the validity of the arbitration clause, and not just the entire contract, it is the court that determines the validity of the arbitration clause. It also found that the arbitration provision lacked mutuality of obligation, was one-sided, and contained terms unreasonably favorable to the drafter.
Global Client Solutions, LLC v. Ossello, 367 P.3d 361 (Mont. March 2, 2016). http://cases.justia.com/montana/supreme-court/2016-da-15-0301.pdf?ts=1456956123

The Alaska Supreme Court held that foreclosure counts as "debt collection" and, therefore, firms in the business of foreclosing on homeowners are "debt collectors" subject to the restrictions of the FDCPA.

Foreclosure is "debt collection" covered under the FDCPA. The Alaska Supreme Court held that foreclosure counts as "debt collection" and, therefore, firms in the business of foreclosing on homeowners are "debt collectors" subject to the restrictions of the FDCPA. As the court explained, "foreclosing on property, selling it, and applying the proceeds to the underlying indebtedness constitutes one way of collecting a debt." *Alaska Trustee, LLC v. Ambridge*, 2016 WL 852265 (Alaska March 4, 2016). http://cases.justia.com/alaska/supreme-court/2016-s-14915.pdf?ts=1457114409

Carve out clause does not invalidate arbitration agreement. The California Supreme Court considered the enforceability of an arbitration agreement authorizing the parties to seek provisional relief in a judicial action while still compelling the remainder of the dispute to arbitration. According to the court, the clause carving out provisional relief from the arbitration obligation "which does no more than restate existing law . . . does not render the agreement unconscionable." Moreover, the court reiterated that an arbitration agreement remains enforceable even when it only lists claims that would likely be brought by an employee and does not list claims that might be brought by an employer. *Baltazar v. Forever 21, Inc.*, 367 P.3d 6 (Cal. March 28, 2016). http://cases.justia.com/california/supreme-court/2016-s208345.pdf?ts=1459184425

Employer's motion to compel arbitration denied where arbitration clause not included in employment contract. The New Jersey Appellate Division affirmed the denial of an employer's motion to compel arbitration of age discrimination and wrongful termination lawsuit because the clause was in an employee handbook, which explicitly stated it was not a "contract" with the employee. *Morgan v. Raymours Furniture Co., Inc.,* 128 A.3d 1127 (N.J. Super. App. Div. Jan. 7, 2016). http://law.justia.com/cases/new-jersey/appellate-division-published/2016/a2830-14.html

Legality of contract with arbitration clause is to be determined by court and not by arbitrator. A California Court of Appeal has held that the question of enforceability is for the courts, and not the arbitrators, when the issue is illegality of the contract that contains the arbitration clause. The court noted that under California law, "a challenge to the legality of an entire contract that contains an arbitration provision must be determined by the trial court, not the arbitrator." *Sheppard v. J-M Mfg. Co.*, 198 Cal.Rptr.3d 253 (Cal. Dist. Ct. App. Jan. 29, 2016). http://cases.justia.com/california/court-of-appeal/2016-b256314.pdf?ts=1454094061

DECEPTIVE TRADE PRACTICES AND WARRANTIES

IMPLIED WARRANTY OF MERCHANTABILITY NOT BREACHED

http://law.justia.com/cases/new-hampshire/supreme-court/2016/2014-073.html
Roy v. Quality Pro Auto, LLC 132 A.3d 418 (N.H. 2016).

FACTS: Appellant Jeffrey Roy ("Roy") purchased a used motor vehicle from the Appellee, Quality Pro Auto, LLC ("Quality Pro"). The bill of sale indicated the vehicle was sold "as is, as seen." The sale included a "Notice of the Sale of Unsafe Motor Vehicle" form from the New Hampshire Division of Motor Vehicles to inform Roy that the vehicle would not pass an inspection and was unsafe for operation. Roy signed the form and indicated he did not want a safety inspection conducted. Once Roy discovered the vehicle's dangerously rusted frame, he attempted to get a refund from Quality Pro. Quality Pro refused, asserting the sale was "as is, as shown."

Roy then filed suit alleging Quality Pro breached the implied warranty of merchantability. The trial court ruled in favor of Quality Pro, holding Roy waived the implied warranty of merchantability. Roy appealed.
HOLDING: Affirmed.
REASONING: The New Hampshire Supreme Court engaged in statutory interpretation of the implied warranty of merchantability set forth in RSA 382–A:2–314 and its comments.

The comments explain that the question of when the warranty is imposed depends on the meaning of the terms of the agreement as recognized in the contract. Goods delivered under an agreement made by a merchant in a given line of trade must be of a quality comparable to that generally acceptable in that line of trade under the description of the goods used in the agreement. The comments also state that a contract for used goods "involves only such obligation as is appropriate to such goods for that is their contract description. Because Quality Pro described the vehicle as unsafe and unable to pass inspection within the contract, the fact that the vehicle was unsafe and unable to pass inspection did not constitute a breach of the implied warranty of merchantability. Thus the court held the vehicle was merchantable within the meaning of the parties' contract. Therefore, there was no reason to reach the issue of waiver.

AN IMPLIED WARRANTY MAY NOT EXIST IN SERVICE CONTRACTS, BUT IF IT DOES, YOU MUST GIVE UCC NOTICE

Hartness v. Nuckles, ____S.W.3d____, 2015 WL 7829054 (Ark. 2015).
http://law.justia.com/cases/arkansas/supreme-court/2015/cv-14-869.html

FACTS: Plaintiff-Appellant Ashley Hartness ("Hartness") brought his 1968 Pontiac Firebird to Restoration Plus, a body shop owned by Defendant-Appellee Rick Nuckles ("Nuckles"). Hartness and Nuckles entered into an oral agreement to restore Hartness's vehicle. Hartness picked up his car believing the restoration to be complete; however, he later brought his vehicle back several times to Nuckles to repair defects in the restoration. Upon final delivery, Hartness did not notify Nuckles of further concerns regarding quality of the work. Hartness then filed suit.

Hartness sued for breach of express warranty, breach of implied warranty, money had and received, and conversion. The circuit court held the breach of warranty claims failed for lack of notice. Hartness appealed.
HOLDING: Affirmed.
REASONING: Hartness argued that the UCC notice requirement applies only to warranties for goods. He further argued that because the warranty in this case was for services, the notice requirement did not apply. The Court rejected Hartness's arguments and held that if an express warranty or an implied warranty is created in a contract for services, the UCC notice requirement applies.

A buyer of goods "must within a reasonable time after he discovers or should have discovered any breach notify the seller of the breach or be barred from any remedy."

A buyer of goods "must within a reasonable time after he discovers or should have discovered any breach notify the seller of the breach or be barred from any remedy." Ark.Code Ann. §4–2–607(3)(a)). The court noted that reasonable notice would have given Nuckles an opportunity to cure defects and mitigate damages. As such, the Arkansas Supreme Court affirmed the circuit court's ruling that Hartness's claims for breach of warranty failed for lack of notice.

ECONOMIC LOSS RULE DOES NOT PRECLUDE TORT RECOVERY IF THE INJURY INVOLVES PHYSICAL HARM TO THE ULTIMATE USER OR CONSUMER OR OTHER PROPERTY

IMPLIED WARRANTY ONLY EXISTS IF PUBLIC POLICY JUSTIFIES IMPOSING ONE BASED ON A COMPELLING NEED

MERE BREACH OF CONTRACT IS NOT UNCONSCIONABLE UNDER DTPA

Shakeri v. ADT Security Services, ____ F.3d ____ (5th Cir. 2016).
http://caselaw.findlaw.com/us-5th-circuit/1728474.html

FACTS: Abraham Shakeri and Kahatereh Taji ("Plaintiffs") owned a jewelry store and contracted with ADT Security Services ("Defendant") to create a security system for the store and conduct routine maintenance as needed. Plaintiffs were robbed at gunpoint and suffered various physical injuries during the robbery because the security button malfunctioned.

Plaintiffs originally sued Defendant for negligence, breach of contract, common law fraud, and unconscionable conduct under the Texas DTPA. The lower court dismissed Plain-

tiffs' tort claims and limited their contractual recovery. Plaintiffs received $1,000 against Defendant and appealed. The court of appeals ruled the lower court erred in dismissing the negligence claim but were correct in dismissing the other claims.
HOLDING: Affirmed in part, reversed in part.
REASONING: The court explained that the economic loss rule does not bar all tort claims arising out of a contractual setting. Plaintiff's physical injuries suffered during the robbery give rise to the kind of tort claim not limited by the economic loss rule and is not defeated by the existence of a contract between the parties. Accordingly, the district court erred in dismissing Plaintiff's negligence claim.

Then the court explained that public policy does not justify imposing an implied warranty for service transactions in the absence of a demonstrated, compelling need and there is no compelling need for an implied warranty when other adequate remedies are available to the consumer. Because Plaintiffs had adequate remedies for Defendants conduct in both their negligence and breach of contract causes of action, the court did not recognize an implied warranty in Defendant's repair and modification of the alarm system. Plaintiffs failed to state adequate claims for breach of the implied warranty of good and workmanlike performance.

Finally, the court ruled that the lower court did not err in dismissing the DTPA claim because, where allegedly unconscionable statements were made but where the breach of the contract caused the harm, Plaintiffs could not maintain a claim for unconscionable conduct under the DTPA. Plaintiffs also claimed that Defendant had breached their contract. Plaintiffs were argued that Defendant breached their security contract with the Plaintiffs. The court reasoned that for a DTPA claim to be actionable, it must be more than a mere breach of contract.

DTPA AND INSURANCE CODE CLAIMS BASED ON BAD FAITH ALL FAIL WHEN COMMON LAW BAD FAITH CLAIM FAILS

Broxterman v. State Farm Lloyds, ____F. Supp. 3d ____ (E.D. Tex. 2016).
https://scholar.google.com/scholar_case?case=3565435922025690467&hl=en&as_sdt=6&as_vis=1&oi=scholarr

FACTS: Defendant, State Farm Lloyds ("State Farm") issued a home owner's insurance policy to Plaintiff, Cathy Broxterman ("Broxterman"). After Broxterman's home suffered storm-related damages, State Farm refused to pay the full amount Broxterman claimed State Farm owed under the policy. In her complaint, Broxterman asserted that State Farm failed to adequately compensate her for damages to her home and brought several claims including violations of the Texas DTPA and Tie-In Statutes, violations of the Texas Insurance Code, and breach of the common law duty of good faith and fair dealing.

The court reasoned that extra-contractual tort claims pursuant to the Texas Insurance Code and the DTPA require the same predicate for recovery as a common law duty of good faith and fair dealing and bad faith violation.

State Farm filed for partial summary judgment on Plaintiff's extra-contractual claims. Broxterman voluntarily dismissed her extra-contractual claims for breach of the common law duty of good faith and fair dealing, bad faith, and misrepresentation. The court dismissed these claims with prejudice and specifically focused on the Texas Insurance Code and DTPA claims.
HOLDING: Motion granted.
REASONING: The court found when an insured joins claims under the Texas Insurance Code and the DTPA based a common law duty of good faith and fair dealing, there is no liability on the statutory claims if there is no merit to the common law claim. The court reasoned that extra-contractual tort claims pursuant to the Texas Insurance Code and the DTPA require the same predicate for recovery as a common law duty of good faith and fair dealing and bad faith violation. Because Plaintiff voluntarily dismissed her extra-contractual claims for breach of the common law duty of good faith and fair dealing, bad faith, and misrepresentation, the Court held that the statutory claims must also be dismissed.

RECENT DEVELOPMENTS

CONSUMER CREDIT

TRUTH IN LENDING 2009 AMENDMENT DOES NOT APPLY RETROACTIVELY

Talaie v. Wells Fargo Bank, NA, 808 F.3d 410 (9th Cir. 2015).
http://law.justia.com/cases/federal/appellate-courts/ca9/13-56314/13-56314-2015-12-14-0.html

FACTS: Mohammad and Rosa Talaie ("Plaintiffs") brought a claim against Wells Fargo Bank and U.S. Bank ("Defendants) alleging a violation of §1641(g) of the Federal Truth in Lending Act ("TILA"). TILA was amended in 2009 to require creditors who obtain a mortgage loan by either sale or transfer to notify the loan borrowers of the transfer in writing within 30 days. The transfer at issue occurred three years prior to the enactment of the amendment.

The district court granted Defendants' motion to dismiss the notice claim on the ground that the notice requirement did not apply retroactively. Plaintiffs appealed.

HOLDING: Affirmed.

REASONING: The court cited the decision in *Landgraf v. USA Film Prods* and found all three concerns of retroactive legislation were present in this case. First, the amendment would impair the Defendants' pre-amendment rights to transfer without notice. Second, the statute increased the Defendants' liability for past conduct by making new remedies and increased penalties available to the Plaintiff. Finally, the amendment imposed new duties requiring the provision of notice on a completed transaction.

The court sought to determine if Congress intended the amendment to apply retroactively but found no legislative history or any other compelling evidence to indicate retroactive intent.

FCRA LIMITATIONS PERIOD BEGINS TO RUN WHEN A CLAIMANT DISCOVERS THE FACTS THAT GIVE RISE TO A CLAIM AND NOT WHEN A CLAIMANT DISCOVERS THAT THOSE FACTS CONSTITUTE A LEGAL VIOLATION

Rocheleau v. Elder Living Const., LLC, 814 F.3d 398 (6th Cir. 2016).
http://caselaw.findlaw.com/us-6th-circuit/1726594.html

FACTS: In September 2011, Defendant-Appellee Elder Living Construction, LLC ("Elder Living") ordered a background screening report on Plaintiff-Appellant Richard Rocheleau ("Rocheleau") from First Advantage Screening Solutions, Inc. ("First Advantage"). The report was in response to Rocheleau's application for employment with Elder Living. The search disclosed criminal convictions matched to Rocheleau. First Advantage sent Rocheleau three notices by mail concerning the adverse effects that the report could have on his employment status with his then-employer. Rocheleau admitted that he received the notices by at least the end of September 2011. Elder Living provided a copy of the background report to Rocheleau's employer, who subsequently terminated his employment.

In November 2013, Rocheleau filed suit alleging that Elder Living and First Solutions violated the Fair Credit Reporting Act ("FCRA.") The district court held that the FCRA's two-year statute of limitations barred Rocheleau's lawsuit and granted summary judgment in favor of First Advantage and Elder Living. Rocheleau appealed.

HOLDING: Affirmed.

REASONING: Rocheleau argued that the FCRA's two-year limitations period was tolled because a mandatory three-step dispute resolution process under the statute had not been completed with regard to his complaints. The court rejected that argument because Rocheleau did not dispute the "completeness or accuracy" of his background report. The court applied the fundamental principle that a limitations period begins to run when a claimant discovers the facts that give rise to a claim, and not when a claimant discovers that those facts constitute a legal violation. Thus, Rocheleau's claims were time-barred.

The court applied the fundamental principle that a limitations period begins to run when a claimant discovers the facts that give rise to a claim, and not when a claimant discovers that those facts constitute a legal violation.

SECURED LENDER THAT DOES NOT ACT ON "INQUIRY NOTICE" MAY LOSE SECURITY INTEREST

(In Re Sentinel Management Group, Inc.) Grede v. Bank of New York Mellon Corporation, 809 F.3d 958 (7th Cir. 2016).
https://www.wiappellatelaw.com/wp-content/uploads/sites/12/2016/02/In-re-Sentinel-Management.pdf

FACTS: Frederick Grede ("Trustee") is the trustee of a bankrupt cash-management firm, Sentinel Management Group, Inc. ("Sentinel") that invested its customers' cash in low-risk securities. Sentinel also traded on its own account with borrowed money from the Bank of New York Mellon Corporation and Bank of New York (referred to jointly as "BNYM"). Sentinel improperly pledged its customers' security assets as collateral to secure loans from BNYM, the funds from which Sentinel used to trade on its own account. Federal law required that the customers' securities be held in separate accounts from Sentinel's assets. BNYM's Managing Director, Rogers, was puzzled by the collateral listed for Sentinel, he knew that Sentinel was worth much less than what the bank was claiming as collateral, concluding that the listed collateral must be for somebody else's benefit. Rogers expressed this concern in a message to coworkers. Rogers's suspicion was enough to place him on notice of a possible fraud and so required that he or others at the bank investigate. There was no further inquiry.

Sentinel ultimately accrued $573 million in loan debt with BNYM. After failing to maintain its collateral with BNYM and meet client demands, Sentinel declared bankruptcy, owing BNYM $312 million. BNYM filed a $312 million claim against Sentinel. The Trustee filed an adversary proceeding against BNYM alleging that Sentinel fraudulently used customer assets to finance the loan to cover its house trading activity. The trial court

dismissed the Trustee's claim and the Trustee appealed.
HOLDING: Reversed.
REASONING: The court of appeals agreed with the Trustee's argument that BNYM officials were aware of suspicious facts regarding Sentinel's assets that should have prompted an investigation. The suspicious facts were sufficient to place BNYM on inquiry notice, thus, failure to investigate negated BNYM's status as a secured creditor.

The court held that BNYM should lose its secured creditor status because inquiry notice, while not knowledge of fraud or other wrongdoing, is sufficient knowledge to lead a reasonable person to inquire further—make him suspicious enough to conduct a diligent search for possible dirt. The Managing Director's suspicion was enough, given his position in the bank, to place BNYM on inquiry notice and require an investigation as to how Sentinel secured the loan with very limited capital.

DEBT COLLECTION

VIOLATIONS OF STATE AND LOCAL DEBT COLLECTION STATUTES ARE NOT PER SE ACTIONABLE UNDER THE FDCPA

Gallego v. Northland Group, Inc., 814 F.3d 123 (2nd Cir. 2016). http://law.justia.com/cases/federal/appellate-courts/ca2/15-1666/15-1666-2016-02-22.html

FACTS: Plaintiff-Appellant Gallego ("Gallego") received a letter attempting to collect a debt owed to an entity that did not list the name of a person to call back. The letter, sent by Defendant-Appellee Northland Group, Inc. ("Northland"), indicated that Northland was the collection agency for the debt.

Gallego brought suit on behalf of himself and a class who received the same letter, alleging that the letter's failure to provide a call back name violated two provisions of the FDCPA. Neither of the FDCPA provisions explicitly required a call back name, but the New York City Administrative Code did.

Before Northland filed a responsive pleading, the parties agreed to settle the lawsuit. The court denied the parties' motion for conditional approval of the classwide settlement, stating that the complaint appeared to allege nothing more than a violation of New York City law and did not raise any colorable federal claims. The court subsequently denied Gallego's cross motion for consideration and dismissed the case for lack of subject-matter jurisdiction. Gallego appealed.
HOLDING: Affirmed in part, vacated in part, and remanded.
REASONING: Gallego argued that prohibitions in the FDCPA against "false representation[s], deceptive means," and "unfair or unconscionable means" in effect incorporated the New York City Administrative Code's provisions on debt collection agencies. The court rejected that argument by explaining that there is no indication that Congress intended to incorporate state-or-local-law standards of conduct into the two FDCPA provisions.

There is no indication that Congress intended to incorporate state-or-local-law standards of conduct into the two FDCPA provisions.

The court reasoned that the FDCPA expressly contemplated the existence of state laws that offer protections to consumers that go beyond the FDCPA itself. The court noted that the FDCPA clarified that "a State law is not inconsistent with [the FDCPA] if the protection such law affords any consumer is greater than the protection provided by [the FDCPA]." Thus the court held that violations of state and local debt collection statutes are not per se actionable under the FDCPA.

FAIR DEBT COLLECTION PRACTICES ACT MUST YIELD TO THE BANKRUPTCY CODE WITH RESPECT TO TIME BARRED CLAIMS

Castellanos v. Midland Funding LLC, ____ So.3d ____ (M.D. Fla. 2016).
http://law.justia.com/cases/federal/district-courts/florida/flmdce/2:2015cv00559/314988/23/

FACTS: Ana Castellanos ("Plaintiff") owed credit card debt ("the Debt") to GE Money Bank, succeeded by Midland Funding LLC. In 2014, Plaintiff filed a joint Chapter 13 bankruptcy petition after the statute of limitations to collect the Debt expired. Two weeks later, American InfoSource, on behalf of Midland Funding LLC ("Defendants"), submitted proof of a claim for the Debt in Plaintiff's bankruptcy case.

Plaintiff filed suit alleging that Defendants knowingly filed time-barred proofs of claims, violating the FDCPA by (1) making a false representation of the legal status of a debt, (2) using a false representation and deceptive means to collect a debt, and (3) using unfair and unconscionable means to collect the debt. Defendants filed a Motion to Dismiss.
HOLDING: Motion granted.
REASONING: Defendants argued that even though the FDCPA prohibits filing time-barred proofs of claim, because the Bankruptcy Code permits creditors to do so such conduct cannot constitute an FDCPA violation. Plaintiff argued the court should follow the Eleventh Circuit ruling in *Crawford v. LVNV Funding, LLC,* 758 F.3d 1254, 1262 (11th Cir. 2014), wherein the court held that a time barred proof of claim in bankruptcy court violated the FDCPA.

The court accepted the Defendant's reasoning that where there is an irreconcilable conflict between the FDCPA and the Bankruptcy Code, the FDCPA must yield to the Bankruptcy Code, which provides its own protections for debtors. The court relied on various decisions within the District following this line of reasoning and concluded that the FDCPA does not provide a private right of action against creditors who file time-barred proofs of claim in bankruptcy court.

ALASKA SUPREME COURT HOLDS THAT FORECLOSURE IS "DEBT COLLECTION" UNDER THE FDCPA

Alaska Trustee, LLC v. Ambridge____P.3d_____(Alaska 2016).
http://law.justia.com/cases/alaska/supreme-court/2016/s-14915.html

FACTS: Plaintiff-Appellees Brett and Josephine Ambridge ("Ambridges"), filed suit against Defendant-Appellants Alaska Trustee, LLC and its owner, Stephen Routh ("Alaska Trustee"), alleging Alaska Trustee violated the FDCPA when it failed to include the actual amount of debt owed in its initial communications with the Ambridges while in pursuit of a nonjudicial foreclosure.

The superior court ruled in favor of the Ambridges. Alaska Trustee appealed.

HOLDING: Affirmed in part, reversed in part.

REASONING: Alaska Trustee argued that recovering collateral is a fundamentally different activity than seeking the payment of money, and that the FDCPA is concerned only with the latter. Alaska Trustee also contended that it was not included in the FDCPA's definition of a debt collector.

The court rejected that argument and held that Alaska Trustee was a debt collector because (1) Congress did not explicitly exclude nonjudicial foreclosures in the FDCPA, (2) the FDCPA applied to foreclosures because it constituted a way of collecting a debt, and (3) mortgage foreclosures were not solely governed by §1692a(6) of the FDCPA.

LETTERS SENT TO CONSUMER'S ATTORNEY DID NOT VIOLATE FDCPA

Bravo v. Midland Credit Mgmt., Inc. 812 F.3d 599 (7th Cir. 2016).
http://law.justia.com/cases/federal/district-courts/illinois/ilndce/1:2014cv04510/297243/36/

FACTS: Appellant Katiuska Bravo ("Bravo") sued Appellee Midland Credit Management, Inc. and Midland Funding, LLC ("Midland") for violations of the FDCPA. The initial suit settled in March 2014. Shortly after the settlement, Midland sent two letters in "care of" Katiuska Bravo addressed to her attorney demanding payment on two debts that were resolved in the previous settlement. Bravo filed suit alleging that the letters violated FDCPA §1692(c) which prohibits communication with a debtor if the debt collector knows that the debtor is represented by counsel, and after a consumer has refused to pay a debt owed. Bravo also claimed that the letters violated §1692(e) by making false and misleading statements.

The district court dismissed the complaint for failure to state a claim. Bravo appealed.

HOLDING: Affirmed.

REASONING: Bravo argued that Midland communicated with her in violation of the FDCPA because the letters were directed to her, despite being addressed to her attorney after Midland was notified that Bravo was represented by counsel. Bravo also argued that Midland used "false, deceptive, or misleading representation" because the letters falsely stated that Bravo owed debts that were discharged by the prior settlement.

The court held that the letters sent to Bravo's attorney did not violate the FDCPA because a consumer's name on an envelope does not equate to communication with that consumer when it is sent to the address of an attorney representing the debtor. The court further held there was no violation because the letters made no material threats to the debtor. The court reiterated one of the purposes of §1692c(a)(2) is to provide a legal buffer for the consumer, and a debtor who does not want to be pestered by demands for payment, settlement proposals, and so on, need only tell his lawyer not to relay them.

A consumer's name on an envelope does not equate to communication with that consumer when it is sent to the address of an attorney representing the debtor.

The court found that the standard to prove the use of a "false, deceptive, or misleading representation" to an attorney is whether a *competent attorney* would be deceived, even if he is not a specialist in consumer debt law. The court reasoned that a competent attorney would be able to determine whether Bravo was still in debt after Bravo settled, and therefore the letters were not materially deceptive.

MORTGAGE SERVICER'S OFFER OF FINANCIAL ASSISTANCE TO A DEFAULTED BORROWER TO INDUCE HIM TO VACATE HIS PROPERTY FOLLOWING FORECLOSURE DOES NOT PRESENT A PLAUSIBLE CLAIM UNDER THE FDCPA

Kinlock v. Wells Fargo Bank, ____ F.3d ____ (11th Cir. 2016).
http://media.ca11.uscourts.gov/opinions/unpub/files/201512867.pdf

FACTS: Defendant Wells Fargo Bank ("Wells Fargo") was the servicer on a loan made to Plaintiff Dudley Kinlock ("Kinlock"). The loan was secured by Kinlock's residence. Kinlock defaulted and the property was sold in a foreclosure sale. After the property was sold, Wells Fargo's representative left a letter in Kinlock's mailbox offering various sums of financial assistance if Kinlock vacated the property by a certain date. Next day, the representative posted the letter on Kinlock's front door, and sent the letter to Kinlock via registered mail the following day.

Kinlock filed suit, alleging that Wells Fargo violated the FDCPA by sending letters offering him financial assistance to induce him to vacate his property. The district court dismissed Kinlock's complaint without leave to appeal. Kinlock appealed *pro se*.

HOLDING: Affirmed.

REASONING: The Eleventh Circuit held that Kinlock failed to state a claim against Wells Fargo. Under the FDCPA, a debt collector is prohibited from using "any false, deceptive, or misleading representation or means in connection with the collection of any debt." 15 U.S.C. §1692e. When determining whether a letter is "in connection with the collection of the debt," courts look to the language of the letter, specifically statements that demand payment and mention additional fees if payment is not made. The court noted that while a demand for payment need not be express and may be implicit, Wells Fargo offering to provide Kinlock funds if he would vacate the property was not a demand for payment under the FDCPA.

ARBITRATION

ARBITRATION AGREEMENT THAT FORBIDS ARBITRATOR FROM APPLYING APPLICABLE LAW UNENFORCEABLE

Hayes v. Delbert Services Corp. 811 F.3d 666 (4th Cir. 2016).
http://law.justia.com/cases/federal/appellate-courts/ca4/15-1170/15-1170-2016-02-02.html

FACTS: Appellant Hayes received a payday loan from a lender where Appellee Delbert was the serving agent. The loan document contained an arbitration agreement that subjected Hayes to the exclusive laws and jurisdiction of a Native American reservation purportedly disavowing the authority of any state or federal law.

Hayes filed suit, contending that Delbert's debt collection practices violated federal law and the arbitration provisions were unenforceable. Delbert moved to compel arbitration under the Federal Arbitration Act ("FAA"). The district court granted Delbert's motion. Hayes appealed.

HOLDING: Reversed and remanded.

REASONING: The Fourth Circuit rejected Dilbert's argument that the agreement was enforceable and that Hayes had waived the application of federal law to any federal claims. The court reasoned that although a party to an arbitration agreement may waive certain rights, a party cannot renounce the authority of the federal statutes from which it must remain subject to. Because the arbitration agreement prohibited an arbitrator from applying any applicable law, the arbitration agreement was ruled invalid and unenforceable.

The court noted that the FAA does not extend the freedom to waive a party's federal rights in an arbitration agreement. The court also stated that the FAA does not protect arbitration agreements that explicitly forbid an arbitrator from applying the applicable law.

PAYDAY LENDER WAIVED ARBITRATION BY BRINGING COLLECTION SUITS

Principal Investments v. Harrison 366 P.3d 688 (Nev. 2016).
http://law.justia.com/cases/nevada/supreme-court/2016/59837.html

FACTS: Plaintiff-Appellees, Cassandra Harrison et al. ("Plaintiffs") took out payday loans with Defendant-Appellants, Principle Investments, Inc. et al., d/b/a Rapid Cash ("Rapid Cash"). There was an arbitration provision in each of the Plaintiff's loan agreements. When the Plaintiffs failed to pay back their loans, Rapid Cash filed individual collection actions in justice court against the Plaintiffs and relied on the service affidavits of their service processor, On-Scene Mediations ("On-Scene"), to secure default judgments against each of the Plaintiffs.

An investigation eventually revealed that On-Scene had not served the Plaintiffs and falsified affidavits of service. The Plaintiffs sued Rapid Cash, alleging that Rapid Cash had improperly obtained default judgments against them. Rapid Cash moved to compel arbitration based on the arbitration provisions in its loan agreements. The district court held that Rapid Cash waived its right to arbitration by litigating collection claims against the Plaintiffs to default judgment in justice court. Rapid Cash appealed.

HOLDING: Affirmed.

REASONING: Rapid Cash argued that while it waived its right to arbitrate its collection claims by bringing them in justice court, it had not waived the right to arbitrate the claims the Plaintiffs asserted against them because those claims were separate and distinct from the initial collection claims. Rapid Cash also disputed whether the Plaintiffs had made a sufficient showing of prejudice to justify the finding of a waiver.

The Nevada Supreme Court rejected Rapid Cash's arguments. It reasoned that the Plaintiff's claims in district court arose out of, and were integrally related to, the litigation Rapid Cash conducted in justice court. The court also noted that when Rapid Cash initiated a collection action in justice court, it waived its right to arbitrate by inviting its borrower to appear and defend on the merits of that claim. The entry of a default judgment based on a falsified affidavit of service denied the Plaintiffs an opportunity to appear and defend themselves.

The court explained that allowing the Plaintiffs to litigate their claim to set aside the judgment and be heard on the merits comported with the waiver Rapid Cash initiated. The court also reasoned that if the judgment Rapid Cash obtained was unenforceable because it was the product of fraud or criminal misconduct, it would be prejudicial to the Plaintiffs to require arbitration of claims seeking to set the judgment aside and remediate its improper entry.

NEITHER GROSS MISTAKE NOR MANIFEST DISREGARD OF THE LAW IS SUFFICIENT TO VACATE AN ARBITRATION AWARD

Casa Del Mar Ass'n v. Williams, 476 S.W.3d 96 (Tex. App. 2015).
https://casetext.com/case/casa-del-mar-assn-inc-v-williams-thomas-lp

FACTS: Appellant, Casa del Mar Association, Inc. ("Casa del Mar"), contracted with Appellee, Williams & Thomas, L.P. d/b/a Jamail Construction ("Jamail"), for construction improvements at a condominium complex owned by Casa del Mar. Casa del Mar initiated an arbitration proceeding and asserted claims against Jamail for defects in Jamail's work. The arbitration panel awarded damages based solely upon contractually allocated responsibilities between both parties, determined that each party should bear its own attorney's fees and costs, and denied Casa del Mar's "motion to correct."

Casa del Mar filed a motion to vacate the arbitration award, alleging that the panel erred in the amount of award. The trial court denied the motion . Casa del Mar appealed.

HOLDING: Affirmed.

REASONING: Casa del Mar argued that the arbitration panel's alleged legal errors constituted gross mistake and manifest disregard of the law, and that the trial court erred in not vacating the award on these grounds.

The court rejected that argument by holding that manifest disregard of the law is not a potential basis for vacating the award under both federal and state arbitration acts, and the common law. Casa del Mar did not show that the arbitration panel's award was tainted by a gross mistake that would rise to the level of bad faith and failure to exercise honest judgment in its decision-making, The court held that neither gross mistake nor manifest disregard of the law was sufficient to vacate an arbitration award.

WHERE A PARTY SPECIFICALLY CHALLENGES THE VALIDITY OF THE ARBITRATION CLAUSE, AND NOT JUST THE ENTIRE CONTRACT, IT IS THE COURT THAT DETERMINES THE VALIDITY OF THE ARBITRATION CLAUSE

ARBITRATION PROVISION LACKED MUTUALITY OF OBLIGATION, WAS ONE-SIDED, AND CONTAINED TERMS UNREASONABLY FAVORABLE TO THE DRAFTER

Discover Bank v. Ossello, ____ P. 3d ____ (Mont. 2016).
http://cases.justia.com/montana/supreme-court/2016-da-15-0301.pdf?ts=1456956123

FACTS: Plaintiff Ossello ("Ossello") owed unsecured debt to Bank of America, Discover Bank and Citibank. Ossello then received a solicitation from World Law ("World Law") that if she enrolled in World Law's debt reduction program, World Law would provide her with debt relief services and furnish legal counsel concerning her debt issues. In the course of agreement, Ossello signed Defendant Global Client Solutions' ("Global") Dedicated Account Agreement ("DAA"). After Ossello stopped making payments on her credit card debt, Discover Bank brought a collection action against her.

Ossello filed a third-party complaint suit against Global, asserting that Global used deceptive and fraudulent representations to solicit her participation in illegal debt settlement plan. Global filed motion to dismiss for lack of jurisdiction and to compel arbitration arguing that the DAA contained an arbitration clause. The district court denied the motion finding that the court had jurisdiction to determine the validity of the arbitration clause and that the arbitration clause in the DAA was unenforceable. Global appealed.

HOLDING: Affirmed.

REASONING: Global argued that the district court erred in reserving for itself the authority to determine that the clause was arbitrary and holding the arbitration clause was unenforceable. The Supreme Court of Montana rejected Global's argument and held that Global's purported right to compel Ossello to arbitrate failed because the arbitration clause in the agreement was unconscionable and therefore is unenforceable.

The prevailing rule was where a party specifically challenges the validity of the arbitration and not just the entire contract, the court determines the validity of the arbitration clause unless the parties agree to a delegation provision. The court found the delegation provision did not displace the prevailing rule because it failed to meet the "clear and unmistakable" standard. The delegation provision in the DAA was ambiguous and confusing and did not clearly delegate the arbitrator the determination of the scope or applicability of the agreement to arbitrate.

Also, the court concluded the arbitration clause was unenforceable because it lacked mutuality of obligation, was one-sided, and contained terms unreasonably favorable to the drafter, Global. The arbitration clause allowed Global to sue Ossello in a court of law for breach of the DAA, while Ossello was required to arbitrate all controversies that arose from the breach. The court found that the arbitration clause unreasonably favors Global to the detriment of Ossello and was therefore unconscionable and unenforceable.

LEGALITY OF ENTIRE CONTRACT CONTAINING AN ARBITRATION CLAUSE IS FOR A COURT NOT THE ARBITRATOR

Sheppard v. J-M Mfg. Co., 198 Cal. Rptr. 3d 253 (Cal. Ct. App. 2016).
http://www.courts.ca.gov/opinions/documents/B256314.PDF

FACTS: Appellant, J-M Manufacturing Company, Inc. ("J-M"), hired Appellee, Sheppard, Mullin, Richter & Hampton, LLP ("Sheppard Mullin"), to represent the company in a *qui tam* action. Shepard Mullin was disqualified from the litigation for not obtaining informed consent from either client; Shepard Mullin represented J-M as well as an adverse party in the case in unrelated matters. Sheppard Mullin subsequently filed a lawsuit for services rendered against J-M. and sought specific performance for the arbitration provision of their Agreement. J-M opposed arbitration on the basis that the entire Agreement containing the arbitration provision was illegal and should be void because Shepard Mullin's conflict of interest violated California law.

The court cited California law, which stated that the trial court, not the arbitrator, must determine a challenge to the legality of an entire contract that contains an arbitration provision.

The trial court granted Sheppard Mullin's motion to compel arbitration. At arbitration, a panel of three arbitrators found that the agreement was not illegal. The trial court confirmed the ruling and held the panel did not exceed their powers, in that the Agreement was not illegal or void and the arbitration award did not violate public policy or a statutory right. J-M appealed.

HOLDING: Reversed and Remanded.

REASONING: J-M argued that the trial court should not have confirmed the arbitration award because the court enforced a contract that violated California's public policy, as articulated in the Rules of Professional Conduct for attorneys. The appellate court accepted J-M's argument and held that a challenge to the enforceability of the contract as a whole, rather than a portion of an otherwise enforceable contract, must be decided by the court rather than the arbitrator.

The court cited California law, which stated that the trial court, not the arbitrator, must determine a challenge to the legality of an entire contract that contains an arbitration provision. The court stated that the power of the arbitrator to determine rights under a contract is dependent upon the existence of a valid contract, under which this right might arise. The court also reasoned that the validity of the contract is a judicial question, which cannot be finally determined by an arbitrator.

Thus the court recognized that because J-M asserted the entire Agreement was unenforceable, this challenge was to be decided by the court rather than the arbitrator.

COURT FINDS NO MANIFEST DISREGARD OF THE LAW

Sutherland Global Servs. Inc. v. Adam Techs. Int'l SA de C.V., ______F.3d______(2d Cir. 2016).
http://law.justia.com/cases/federal/district-courts/new-york/nywdce/6:2012cv06439/90629/50/

FACTS: Petitioner-Appellee Sutherland Global Services, Inc. ("Sutherland") contracted with Respondent-Appellant Adam Technologies International SA de C.V. ("Adam") to provide call center support services. The parties' Master Service Agreement ("Agreement") contained an arbitration clause, which Sutherland invoked after Adam failed to pay for services allegedly rendered by Sutherland under the Agreement. A group of arbitrators awarded Sutherland $871,109.44 in damages. The District Court for the Western District of New York granted Sutherland' s petition to confirm the results of the arbitration and denied Adam's motion for reconsideration. Adam appealed.
HOLDING: Affirmed.
REASONING: The Second Circuit looked to the Federal Arbitration Act ("FAA") , which establishes the grounds for vacating an arbitration award, including "where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made." 9 U.S.C. § 10(a)(4).

Adam contended that the arbitration panel exceeded its authority when they deliberately disregarded the terms of the Agreement and New York law by granting an award in the absence of a Statement of Work ("SOW"), as required by the Agreement. The court rejected this argument on the basis that the arbitration panel interpreted the Agreement not to require an SOW as a precondition to Adam's obligation to pay for undisputed amounts. The court also noted that the arbitration panel found, as a factual matter, that Sutherland provided services pursuant to the Agreement. The court determined there was no colorable basis in Adam's argument to go against the general principle that arbitration awards are to be upheld.

Adam then argued that the arbitration panel exceeded its authority by awarding damages exceeding the limit imposed by the Agreement. The court rejected this claim and stated they could not vacate an award for legal errors, nor could they consider Adam's contention that vacatur was warranted because the arbitration panel was improperly constituted. The court determined that the contention was barred by issue preclusion and Adam's remaining arguments were without merit.

UNAVAILABILITY OF NAF DOES NOT INVALIDATE ARBITRATION AGREEMENT

Courtyard Gardens Health & Rehabilitation, LLC v. Arnold, _____S.W.3d____ (Ark. 2016).
http://law.justia.com/cases/arkansas/supreme-court/2016/cv-14-1105.html

FACTS: Malinda Arnold, as personal representative of the Estate of Jessie James Bullock ("Arnold") filed a complaint against Courtyard Garden Health and Rehabilitation, LLC ("Courtyard Gardens"), the nursing home where Bullock resided. The complaint alleged Courtyard Gardens engaged in negligence, medical malpractice, breach, and other violations. Courtyard Gardens filed a motion to dismiss the complaint and compel arbitration under an optional arbitration agreement that was signed upon admission to the facility. The arbitration clause required all claims to be resolved "exclusively by binding arbitration" in "accordance with the National Arbitration Forum Code of Procedure ("NAF"). In response, Arnold argued that the arbitration agreement was unenforceable. Arnold's argument was based on impossibility of performance and unconscionability, because NAF was selected to serve as arbitrator, but unavailable to arbitrate the claim.

The trial court denied the motion to dismiss and the circuit court affirmed on the grounds of impossibility of performance but not on unconscionability. Courtyard Gardens appealed.
HOLDING: Reversed and remanded.
REASONING: Arnold argued that because the arbitration agreement incorporated the NAF code, which required NAF to be the arbitrator, the unavailability of the NAF to arbitrate the dispute made the arbitration agreement unenforceable based on the defense of impossibility of the performance.

The court rejected that argument and held that the NAF term was merely an ancillary logistical concern and that section 5 of the Federal Arbitration Act ("FAA") provides a procedure for the appointment of a substitute arbitrator. Because both petitioner and respondent demonstrated their intent to resolve their dispute through binding arbitration regardless of the availability of the NAF, the reference to the NAF was a mere ancillary concern.

The court rejected that argument and held that the NAF term was merely an ancillary logistical concern.

The court also reasoned the severability clause operates to remove the unenforceable language related to the NAF as arbitrator. Once the language is severed from the agreement the parties must be compelled to arbitrate.

CARVE-OUT CLAUSE DOES NOT INVALIDATE ARBITRATION AGREEMENT

Baltazar v. Forever 21, Inc. 367 P.3d 6 (Cal. 2016).
http://www.courts.ca.gov/opinions/documents/S208345.PDF

FACTS: Plaintiff, Maribel Baltazar ("Baltazar"), signed an arbitration agreement with her employer, Forever 21, Inc. ("Defendant"). The agreement stated that the parties mutually agreed to arbitrate any claim related to the hire, employment, or termination of an employee, including but not limited to claims for; wages, breach of employment contract, discrimination, or harassment.

Baltazar resigned and sued Defendant alleging verbal and physical harassment, race and sex discrimination, and retaliation. Baltazar argued the agreement was substantively unconscionable and unenforceable because it specified claims typically brought by employees and left in doubt whether employer's claims are subject to arbitration. Baltazar argued the agreement was unfairly one-sided because it allowed the employer to litigate an issue.

Defendant moved to compel arbitration and Baltazar opposed the motion on the basis that the arbitration agreement was unconscionable and, therefore, unenforceable. The trial court denied the motion and found the agreement was substantively unconscionable. The court of appeal reversed. Baltazar appealed.
HOLDING: Affirmed.
REASONING: The California Supreme Court noted that the agreement made clear that the parties agreed to arbitrate all employment-related claims. The court stated that the provision clearly covered claims brought by both employers and an employee. The court further reasoned the "including but not limited to" language made clear that the list of claims included in the agreement was not intended to be exhaustive.

The court then distinguished the carve-out clause in the agreement from a differently worded provision in *Pinedo v. Premium Tobacco Stores, Inc.* 85 Cal. App. 4th 774, 102 Cal. Rptr.2d 435, which addressed only employee claims. Thus the court held that the carve-out clause did not alter the substantive scope of the agreement or render the agreement sufficiently unfair to make its enforcement unconscionable.

SUPREME COURT HOLDS PRE-*CONCEPTION* CONTRACTUAL TERM DOES NOT INCORPORATE PRE-*CONCEPTION* CALIFORNIA LAW ON ARBITRATION

DirecTV v. Imburgia, 136 U.S. 463 (2015).
http://www.scotusblog.com/case-files/cases/directv-inc-v-imburgia/

FACTS: Petitioner ("DirecTV") entered into a service agreement with respondents Amy Imburgia and Kathy Greiner ("Imburgia"). The agreement included both a mandatory arbitration clause and a waiver of class action clause, which stated neither party "shall be entitled to join or consolidate claims in arbitration." The agreement also stated that the entire arbitration provision was unenforceable if the "law of your state" makes the waiver unenforceable. Lastly, section 10 of the agreement provided that the arbitration provision was governed by the Federal Arbitration Act ("FAA").

The respondents brought suit against DirecTV and sought damages for early termination fees. The California trial court denied DirecTV's motion to compel arbitration. The California Court of Appeal affirmed the trial court's ruling, finding that the mandatory arbitration provision was unenforceable because California law made the waiver of class arbitration unenforceable.
HOLDING: Reversed and remanded.
REASONING: The Supreme Court noted that California law would have made the class arbitration waiver unenforceable under the *Discover Bank* decision, which found such class arbitration waivers unconscionable. In *Concepcion,* however, the Supreme Court, held that the *Discover Bank* rule stood "as an obstacle to the accomplishment and execution of the full purposes and objectives" of the Federal Arbitration Act. Thus, the Federal Arbitration Act preempted and invalidated the *Discover Bank* rule.

The Court stated that the main issue in the instant case involved whether the words "law of your state" include the *Discover Bank* rule, which was subsequently invalidated by the Court. Further, the Court found that the California Court of Appeals' interpretation of the phrase "law of your state" failed to place arbitration contracts on equal footing with all other contracts. Thus, their interpretation failed to give due regard to the federal policy and was preempted by the Federal Arbitration Act.

MERELY ANSWERING ON THE MERITS, ASSERTING A COUNTERCLAIM (OR CROSS-CLAIM) OR PARTICIPATING IN DISCOVERY, WITHOUT MORE, DOES NOT CONSTITUTE A WAIVER OF THE RIGHT TO ARBITRATE

Hoover General Contractors-Homewood, Inc. v. Key, ____ So. 3d ____ (Ala. 2016).
http://caselaw.findlaw.com/al-supreme-court/1726681.html

FACTS: Plaintiff Gary Key ("Key") contracted with Defendant Hoover General Contractors-Homewood ("HGCH"), a home repair contractor, to repair his house that was damaged by fire. The contract contained an arbitration clause.

Key sued HGCH alleging several claims for defective repairs on the house. HGCH answered Key's complaints, sent a letter to Key's attorney denying failure to perform the repair work, filed a copy of that letter with the trial court, and filed counterclaims against Key. HGCH then moved to compel arbitration pursuant to the clause in their contract, asserting for the first time that an arbitration agreement existed. Key filed an opposition to compel arbitration, arguing that HGCH waived its right to invoke the arbitration clause. The trial court denied HGCH's motion to compel arbitration. HGCH appealed.
HOLDING: Reversed and remanded.
REASONING: Key argued that HGCH waived its right to invoke the arbitration clause because: 1) HGCH did not assert arbitration as an affirmative defense in its initial pleadings and 2) HGCH substantially invoked the litigation process so that Key would be prejudiced if he was forced to arbitrate. The Supreme Court of Alabama rejected Key's both arguments and held the trial court erred in denying HGCH's motion to compel arbitration.

The court explained that a party's failure to assert the existence of an arbitration clause in initial pleadings does not

A party's failure to assert the existence of an arbitration clause in initial pleadings does not bar that party from subsequently invoking that clause.

bar that party from subsequently invoking that clause. The appropriate test for determining whether there has been a waiver of arbitration is whether the party's actions as a whole have substantially invoked the litigation process and whether the party opposing arbitration would be prejudiced if forced to submit its claims to arbitration.

Also, the court found HGCH's individual actions did not substantially invoke the litigation process. Filing an answer typically does not constitute substantial invocation of litigation process. HGCH's assertion of counterclaims also was not to advance litigation and therefore did not a substantially invoke the litigation. Therefore, HGCH's actions did not amount to a waiver of the right to arbitration.

ARBITRATION PROVISION THAT WAS NOT "CLICK-WRAP" OR BROWSE WRAP" UNENFORCEABLE.

Holdbrook Pediatric Dental, LLC, v. Pro Computer Service, LLC,_____F. Supp.3d ______ (D.N.J. 2015)
https://scholar.google.com/scholar_case?case=1792695590810503092&hl=en&as_sdt=6&as_vis=1&oi=scholarr

FACTS: Plaintiff, Holdbrook Pediatric Dental, LLC ("Holdbrook"), entered into an agreement with Defendant, Pro Computer Service ("PCS"). Holdbrook signed a Managed Support Plan. The plan contained a mandatory arbitration clause, separate from the plan in the "Terms and Conditions", contained in a hyperlink sent through an electronic format. Holdbrook sued PCS under the Computer Fraud and Abuse Act and PCS filed a demand for arbitration. Holdbrook argued that it did not agree to the separate "Terms and Conditions" and was not bound by the arbitration clause.

PCS argued that because Holdbrook accepted the clause when its agent signed the Managed Support Plan even though the "Terms and Conditions" were contained in a hyperlink. The trial court denied PCS' motion without prejudice, stating that the court could not conclude based solely on review of the document that Holdbrook had reasonable notice that the agreement encompassed the mandatory arbitration clause within the separate "Terms and Conditions" document.

HOLDING: Motion Denied.

REASONING: The Managed Support Plan was similar to a "clickwrap", where a user must click an icon to assert being bound by the terms of the agreement. Courts have found that parties assent to terms contained in a hyperlink when the consumer is provided "reasonable notice" that additional terms apply to the agreement. This is satisfied by drawing the user's attention to the hyperlink, sufficient to provide reasonable notice that assent to the contract included assent to the additional terms.

The Managed Support Plan did not provide "reasonable notice" to Holdbrook because the hyperlink was placed in isolation. There is no statement that signing the agreement indicated acceptance of the "Terms and Conditions," nor is there an instruction to sign the contract only if Holdbrook agreed to the additional terms. Thus, Holdbrook did not have "reasonable notice" of the "Terms and Conditions".

ARBITRATION CLAUSE IN A VOID CONTRACT IS STILL ENFORCEABLE

Ellis v. JF Enterprises, LLC, ____ S.W.3d ____ (Mo. 2016).
https://scholar.google.com/scholar_case?case=10327589590650936291&hl=en&as_sdt=6&as_vis=1&oi=scholarr

FACTS: Respondent ("Ellis") purchased a car from Appellant ("JF Enterprises"). Upon purchase, Ellis executed an installment contract and signed an arbitration agreement that provided that any dispute between buyer and dealer be resolved by binding arbitration and not by court action.

Ellis filed suit alleging JF Enterprises violated the Missouri Merchandising Practices Act and requested the trial court declare the arbitration agreement void. JF Enterprises filed a motion to compel arbitration but the trial court overruled it on grounds that the contract between the parties was void. The court of appeals upheld the ruling. JF Enterprises appealed.

HOLDING: Vacated and remanded.

REASONING: The court explained that the United Stated Supreme Court has held that the Federal Arbitration Act ("FAA") prohibits state courts from refusing to enforce an arbitration agreement on the ground that the underlying contract was void under state law. Because the FAA makes arbitration agreements severable from the other agreements of the parties, courts may only refuse to enforce an arbitration agreement if the party opposing arbitration brings a discrete challenge to the arbitration agreement – and not merely to the underlying contract – and shows that the arbitration agreement is invalid under generally applicable state law principles. Ellis raised no discrete challenge to the arbitration provision distinct from her challenge to the underlying contract. The arbitration agreement is still enforceable. Thus, whether the underlying contract is void is for the arbitrator to determine.

MISCELLANEOUS

SUPREME COURT HOLDS OFFER OF JUDGMENT DOES NOT MOOT A CLASS ACTION

Campbell-Ewald Co. v. Gomez, 136 U.S. 663 (2016).
http://www.supremecourt.gov/opinions/15pdf/14-857_8njq.pdf

FACTS: Jose Gomez ("Gomez") filed a class action suit against Campbell-Ewald Company ("Campbell") for violation of the Telephone Consumer Protection Act ("TCPA") after receiving a solicitation from Campbell's third-party contractor. Before Gomez reached the class certification deadline, Campbell offered to settle Gomez's individual claim under Federal Rule of Civil Procedure 68. Gomez allowed the settlement offer to lapse beyond the 14-day deadline. Campbell then moved to dismiss the case for lack of subject matter jurisdiction on the grounds that it's offer mooted Gomez's claim by providing him with complete relief.

The trial court denied the motion, and the Ninth Circuit affirmed. Campbell appealed to the U.S. Supreme Court, who granted certiorari.

HOLDING: Affirmed and remanded.

REASONING: The Court rejected Campbell's arguments, reasoning that the settlement bid and Rule 68 offer of judgment had no continuing effect on the case. Even in light of Campbell's offer, the court found that absent Gomez's acceptance, Campbell's settlement offer remained only a non binding proposal.

When the settlement offer lapsed, Gomez's complaint stood unsatisfied, leaving both parties adverse to one another with the same stake in the litigation as they had at the outset. Because Gomez's individual complaint was not made moot by the expired settlement offer, his individual claim continued on during the time it took to determine whether the case could move on as a class action suit.

NO TCPA VIOLATION WHEN PRIOR CONSENT IS GIVEN

Baisden v. Credit Adjustments, Inc. 813 F.3d 338 (6th Cir. 2016).
http://www.ca6.uscourts.gov/opinions.pdf/16a0037p-06.pdf

FACTS: Baisden and Sissoko ("Plaintiffs") received medical care from Mount Carmel Hospital ("Hospital") and signed admissions forms authorizing disclosure of their cell phone numbers for the purpose of billing and collecting payments. After Plaintiffs failed to pay their bills, the Hospital transferred the delinquent accounts to Credit Adjustments ("Defendant"), a collection company. Defendant called Plaintiffs' cell phone numbers despite never having received their contact information directly from them.

Plaintiffs filed suit under the Telephone Consumer Protection Act, alleging Defendant violated the TCPA by using an "automatic telephone dialing system" and an "artificial or prerecorded voice" to place calls to their cell phones because they had not given their numbers to Defendant. The district court granted summary judgment in favor of Defendant, reasoning that Plaintiffs had given their "prior express consent" by providing their contact information to the Hospital. Plaintiffs appealed.

HOLDING: Affirmed.

REASONING: Plaintiffs argued that they did not give their "prior express consent" because they did not provide their cell phone numbers directly to Defendant. The court rejected this argument and held that such consent may be obtained by and conveyed through an intermediary. The court ruled that Plaintiffs' provision of cell phone numbers to the Hospital fit comfortably within the "prior express consent" provision under the TCPA. Thus, the calls placed by Defendant were not TCPA violations.

COURT REDUCES PUNITIVE DAMAGES TO 1:1 RATIO

Lompe v. Sunridge Partners, LLC, ____F.3d____(10th Cir. 2016).
https://scholar.google.com/scholar_case?case=13504315248829778184&hl=en&as_sdt=6&as_vis=1&oi=scholarr

FACTS: Amber Lompe ("Ms. Lompe") was evacuated from her residence at the Sunridge Apartments after a gas company employee detected high levels of carbon monoxide ("CO") from a malfunctioning furnace in her apartment. Lompe was treated for acute CO poisoning and as a result of the incident suffered various neurological conditions including cognitive deficits, chronic headaches, sleep disturbance, and emotional disorders. She was also prescribed a variety of anti-seizure, migraine, mood stabilizing, and sleep stabilizing medications.

Ms. Lompe filed an action against Sunridge Apartments, LLC ("Sunridge") and Apartment Management Consultants L.L.C. ("AMC"), the owner and property manager, respectively, of Sunridge alleging they violated their duty of care. The jury found both Defendants liable for negligence and awarded Ms. Lompe compensatory damages totaling $3,000,000 and punitive damages totaling $25,500,000, of which the jury apportioned $3,000,000 against Sunridge and $22,500,000 against AMC. The Defendants appealed.

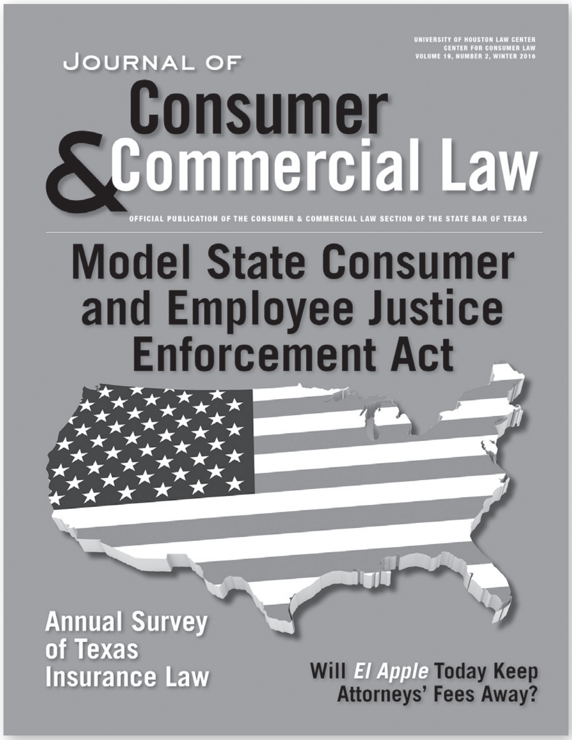
HOLDING: Reversed.

REASONING: The Tenth Circuit analyzed the constitutionality of the punitive damages award under the Due Process Clause. The court noted "three guideposts: (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." *State Farm*, 538 U.S. at 418 (citing *Gore*, 517 U.S. at 575).

> **"When courts have deviated upwards from a 1:1 ratio, the defendant has either intended to cause the substantial compensatory damages or engaged in particularly egregious behavior."**

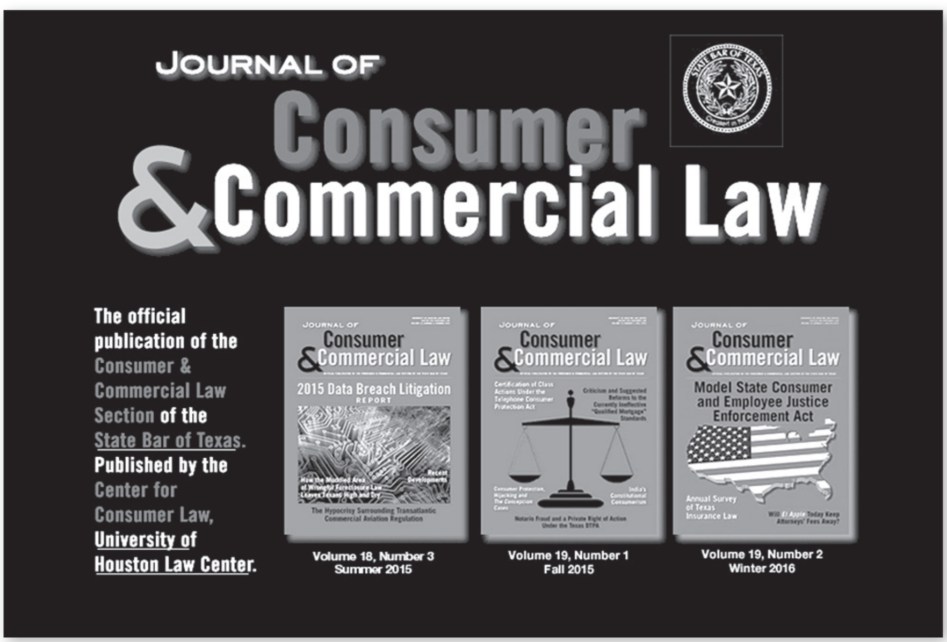
The court noted that since the Supreme Court's decision in *State Farm*, many federal appellate courts have imposed a 1:1 ratio in assessing the appropriate damages award. The court further reasoned, "when courts have deviated upwards from a 1:1 ratio, the defendant has either intended to cause the substantial compensatory damages or engaged in particularly egregious behavior."

Under the first and most important factor of reprehensibility, the court found that there was no evidence that AMC intended to cause harm to Ms. Lompe or to any other person, or that its conduct was "the result of intentional malice, trickery, or deceit." Next, the court explained that Ms. Lompe was awarded substantial compensatory damages that included almost $1 million for emotional distress, and the court's review of civil penalties in comparable cases supported a 1:1 ratio was the appropriate limit of due process. Thus the court determined that a 1:1 ratio of punitive damages to compensatory damages was appropriate to ensure that the punishment imposed on AMC was "reasonable and proportionate" to the harm Ms. Lompe suffered, and satisfy "the State's legitimate objectives" of punishing and deterring future misconduct.



Are you a member of the Consumer Law Section?

It costs just $30 a year and it's the only way to receive the Journal of Consumer & Commercial Law. For more information and to register online, visit the Section's website, http://www.txconsumerlawyers.org



For back issues of the *Journal*, visit the *Journal's* website at: www.jtexconsumerlaw.com

THE LAST WORD

In each issue of the *Journal*, we strive to provide our readers with a wide variety of articles related to the practice of consumer and commercial law. This issue is a perfect example of this variety.

To begin, we publish our second *Data Breach Litigation Report*, an empirical analysis of the extent and severity of data breach litigation. It is followed by the remarks of CFPB Director Richard Cordray regarding the new financial services arbitration rule, limiting the ability of financial service companies to include class action waivers in an arbitration clause. Next, in a change of pace for the *Journal*, is a panel discussion from the Federalist Society's National Conference, discussing the "next" financial crisis. Finally, there is an article on effective web marketing, and a student article discussing the "first sale rule." I think you will agree this is a very diverse collection of articles.

But for many it is the more than 30 cases discussed in the *News Alert* and the 27 case digests in the *Recent Developments* section that are most valuable part of the *Journal*. Clearly, whether you want a comprehensive discussion of issues related to consumer and commercial law or a quick reference to what it going on in the courts, the *Journal* has something for everyone.

I know you will enjoy this issue. And remember, if you have written something you think would be of interest to the *Journal's* readers, please send it to me, alderman@uh.edu.

Richard M. Alderman
Editor-in-Chief