PUBLISH AND PERISH? HANDLING THE UNREASONABLE PUBLICATION AGREEMENT
Harold Anthony Lloyd.................................................. 127

WHAT SHOULD BE PATENTABLE?—A PROPOSAL FOR DETERMINING THE EXISTENCE OF STATUTORY SUBJECT MATTER UNDER 35 U.S.C. SECTION 101
Andrew Beckerman-Rodau............................................. 145

COMMENT: U.K.’S BINDING SAY-ON-PAY AND ITS SEMI-BINDING NATURE ON THE U.S.
Allison J. McCowan....................................................... 205

YOU CAN’T FIRE ME! STATE COMMON LAW EXCEPTIONS TO EMPLOYMENT-AT-WILL
Kevin P. Harrison.......................................................... 229

AMGEN AND PROVING MATERIALITY IN CLASS ACTION SECURITIES LITIGATION: HOW THE SEVENTH AND NINTH CIRCUIT’S APPROACH TO MATERIALITY OFFERS THE UNITED STATES SUPREME COURT THE CHANCE TO REINFORCE LEGAL MECHANISMS OF CORPORATE GOVERNANCE
Cory H. Howard............................................................ 257
ABOUT THE JOURNAL

The Wake Forest Journal of Business and Intellectual Property Law is a student organization sponsored by Wake Forest University School of Law dedicated to the examination of intellectual property in the legal context. Originally established as the Wake Forest Intellectual Property Law Journal in 2001, the new focus and form of the Journal, adopted in 2010, provides a forum for the exploration of business law and intellectual property issues generally, as well as the points of intersection between the two, primarily through the publication of legal scholarship. The Journal publishes three print issues annually. Additionally, the Journal sponsors an annual symposium dedicated to the implications of intellectual property law in a specific context. In 2009, the Journal launched an academic blog for the advancement of professional discourse on relevant issues, with content generated by both staff members and practitioners, which is open to comment from the legal community. The Journal’s student staff members are selected for membership based upon academic achievement, performance in an annual writing competition, or extensive experience in the field of intellectual property or business.

The Journal invites the submission of legal scholarship in the form of articles, notes, comments, and empirical studies for publication in the Journal’s published print issues. Submissions are reviewed by the Manuscripts Editor, and decisions to extend offers of publication are made by the Board of Editors in conjunction with the Board of Advisors and the Faculty Advisors. The Board of Editors works closely and collaboratively with authors to prepare pieces for publication.

Manuscript submissions should be accompanied by a cover letter and curriculum vitae, and may be sent electronically to wfujipl@gmail.com or by mail to:

Manuscripts Editor
Wake Forest Journal of Business and Intellectual Property Law
Wake Forest University School of Law
P.O. Box 7206 Reynolda Station
Winston-Salem, North Carolina 27109

Copyright © 2013
Wake Forest Journal of Business and Intellectual Property Law

ISSN 2164-6937 (Print)
ISSN 2164-6945 (Online)
BOARD OF ADVISORS

**DANNY M. AWDEH**  
Finnegan Henderson Farabow Garrett & Dunner LLP  
Washington, DC

**CHARLES W. CALKINS**  
Kilpatrick Townsend & Stockton LLP  
Winston-Salem, North Carolina

**KENNETH P. CARLSON**  
Constangy, Brooks & Smith, LLP  
Winston-Salem, North Carolina

**TRIP COYNE**  
Williams Mullen  
Wilmington, North Carolina

**RODREICK J. ENNS**  
Enns & Archer LLP  
Winston-Salem, North Carolina

**EDWARD R. ERGENZINGER, JR., PH.D.**  
Ward & Smith, P.A.  
Raleigh, North Carolina

**JASON D. GARDNER**  
Kilpatrick Townsend & Stockton LLP  
Atlanta, Georgia

**STEVEN GARDNER**  
Kilpatrick Townsend & Stockton, LLP  
Winston-Salem, North Carolina

**ROB HUNTER**  
The Clearing House Payments Company, LLC  
Winston-Salem, North Carolina

**BARBARA LENTZ**  
Professor, Wake Forest University School of Law  
Winston-Salem, North Carolina

**JAMES L. LESTER**  
MacCord Mason PLLC  
Greensboro, North Carolina

**JUSTIN R. NIFONG**  
Olive Law Group  
Cary, North Carolina

**MICHAEL S. MIRELES**  
Professor, University of the Pacific, McGeorge School of Law  
Sacramento, California

**ALAN PALMITER**  
Professor, Wake Forest University School of Law  
Winston-Salem, North Carolina

**ABBY PERDUE**  
Associate Professor, Wake Forest University School of Law  
Winston-Salem, North Carolina

**COE W. RAMSEY**  
Brooks Pierce  
Raleigh, North Carolina

**T. ROBERT REHM, JR.**  
Smith, Anderson, Blount, Dorsett, Mitchell, & Jernigan, LLP  
Raleigh, North Carolina

**SIMONE ROSE**  
Professor, Wake Forest University School of Law  
Winston-Salem, North Carolina
Editor-in-Chief
CHRISTOPHER N. HEWITT

Managing Editor
ALLEN E. ORR

Manuscripts Editor
MARK J. VADERS

Symposium Editor
MATTHEW S. WIGTON

Development Editor
SARAH R. RIEDL

Senior Notes and Comments Editor
TORY I. SUMMEY

Notes and Comments Editors
JOSEPH RYAN RIEGERIX
W. PIERCE HAAR

Executive Articles Editors
LAURA M. ESSEESSE
THOMAS E. MAYSHEW
BRIAN P. McKEON

Articles Editors
CHARITY S. FRANKLIN
MICHAEL J. LEVINE
JOHN P. MANZO

Editorial Staff
C. ROBERT BRUNER
W. NICHOLAS HARPER
KEVIN P. HARRISON

DUSTIN B. HILLSLEY
MARGARET A. MCCALL
ALLISON J. MCCOWAN
LENA W. MUALLA

RACHEL A. STRATTON
M. SKYLER WALKER
ASHLEY E. WELLMAN

Staff Members
ELISE J. ARSENAULT
BRETT M. BECKER
LINDSEY M. CHESSUM
STEPHEN S. DEGROW
CHRISTOPHER R. DI GIROLAMO
CHRISTINE DONNELLY
MEGAN E. DRIGGERS
REBECA E. ECHEVARRIA
LESLIE A. EVANS
SEAN P. GANNAWAY
REBEKAH P. GARCIA

CRAIG G. HARASIMOWICZ
JAMES J. HARRELL
NATHAN G. HARRILL
MEREDITH C. HEARN
ROBERT C. HENDERSON III
CORY H. HOWARD
VICTORIA T. KEPES
CHARLES K. LANE
CLAIRE E. LITTLE
JACOB A. LOPES
MICHAEL R. NORSWORTHY

STEPHEN C. PRITCHARD
ASHLEY E. SADLER
GARIN P. SCOLLAN
CAMERON STANTON
EMILY THORNTON
JOHN W. TOTH
ZACHARY M. UNDERWOOD
CAITLIN E. VAMVAKARIS
CHRISTOPHER M. WASSON
EBBIE S. YAZDANI
BEN REED ZAKARIN

Faculty Advisors
BARBARA R. LENTZ
ALAN R. PALMITER
ABBY PERDUE
SIMONE A. ROSE
PUBLISH AND PERISH? HANDLING THE UNREASONABLE PUBLICATION AGREEMENT

Harold Anthony Lloyd†

I. INTRODUCTION ................................................................. 129
   A. OPENING REMARKS...................................................... 129
   B. OPENING TALE ............................................................ 129

II. ROUND ONE ........................................................................ 130
   A. THE INITIAL FORM....................................................... 130
   B. REVIEW OF THE PROBLEMATIC PROVISIONS............ 132
      1. Assignment of the Copyright................................... 132
      2. The Warranty and Indemnity Provisions ............... 133
      3. Other Provisions of Concern .................................. 134

III. ROUND TWO ..................................................................... 135
    A. MR. CASAUBON’S RESPONSIVE REDLINE DRAFT .... 135
    B. THE JOURNAL’S REVIEW OF MR. CASAUBON’S DRAFT ........................................................................ 137

IV. ROUND THREE .................................................................... 138
    A. THE JOURNAL’S RESPONSE TO MR. CASAUBON’S REDLINE ................................................................. 138
    B. MR. CASAUBON’S REVIEW OF THE PUBLISHER’S REDLINE .................................................................. 139

V. ROUND FOUR ....................................................................... 140
    A. MR. CASAUBON’S SECOND REDLINE .................... 140
    B. PUBLISHER’S REVIEW OF MR. CASAUBON’S SECOND REDLINE ............................................................. 142

† © 2013 Harold Anthony Lloyd, Associate Professor of Law, Wake Forest University School of Law. This article is not intended as legal advice and may not be relied upon as such. Writers and publishers should of course obtain their own legal counsel to review their specific needs and situations. The author would be happy, however, if publishers and writers shared this article with their counsel when seeking such advice. The author would also like to thank his research assistant, Joseph Riegerix, for his helpful assistance with this article and Prof. Michael Kent Curtis for his helpful thoughts.
VI. CONCLUSION ........................................................................................................ 143
I. INTRODUCTION

A. Opening Remarks

Scholarship necessarily suffers when scholars suffer\(^1\) unreasonable restraints on what they may read and express. Publishers also suffer loss when they suffer unreasonable restraints on what they may publish. Both parties therefore have a common interest in opposing one especially foolish area of unreasonable restraint: the unreasonable publication agreement that potentially chills scholarly speech.

This article explores such unreasonable restraint through a hypothetical account of one author faced with a publisher’s continued use of a twenty-year-old unreasonable publication agreement.\(^2\) As we think in stories,\(^3\) I hope this story-telling approach will facilitate exploration of the real interests involved and the real room for compromise in such agreements.

B. Opening Tale

George Eliot’s Edward Casaubon has at long last completed his masterful article, “The Key To All Mythologies.” Mr. Casaubon takes his article to XYZ Publisher Press (“XYZ Press”), which is delighted with the piece. Mr. Casaubon and XYZ Press then spend the next several months editing the piece. Just before the publication deadline, XYZ Press provides Mr. Casaubon with its “standard” publication agreement.

Mr. Casaubon actually reads agreements before he signs them and is deeply troubled by what he sees. First, the agreement transfers Mr. Casaubon’s copyright to XYZ Press. Second, the agreement contains warranties and representations by Mr. Casaubon that only an omniscient being could make. (We will explore examples of such warranties and representations in more detail below.) Finally, the agreement requires Mr. Casaubon to indemnify and hold XYZ Press

\(^1\) The pun is intended. In this sentence and in the next, I mean to use “suffer” in both its common senses: to experience loss and to permit or allow.

\(^2\) Although this hypothetical is just that, i.e., purely a piece of fiction, its relevance should be apparent to most who have had the pleasure of negotiating such agreements.

\(^3\) See ALASDAIR MACINTYRE, AFTER VIRTUE 201 (1981) (“I can only answer the question ‘What am I to do?’ if I can answer the prior question ‘Of what story or stories do I find myself a part?’”). I also use the story form here because stories of drafts are in my opinion essential to a “best practices” approach to legal education. I believe that taking students on such journeys is an essential part of teaching them both legal theory as well as practice.
harmless from any losses XYZ Press may suffer on account of any breach of such omniscient warranties and representations or any losses that XYZ Press may suffer in any way otherwise related to publication of Mr. Casaubon’s article.

Not only does Mr. Casaubon not wish to relinquish his copyright, he is naturally terrified by the potentially-endless liability he would acquire under the agreement. He therefore pushes back, XYZ Press’s lawyers ultimately dig in their heels, and suddenly three needless possibilities become quite real. Mr. Casaubon may not have his article published, XYZ Press may have an empty or much reduced volume, and the world may never see the wonderful “The Key To All Mythologies.”

II. ROUND ONE

A. The Initial Form

Mr. Casaubon and XYZ Press have just finished several months of editing Mr. Casaubon’s “The Key To All Mythologies.” At this point, just days before its press deadline, XYZ Press presents Mr. Casaubon with the following “standard” form that XYZ Press has used for at least twenty years:

Name of Contributor (please print or type): Edward Casaubon

XYZ Publisher Press (“XYZ Press”) is pleased to undertake the publication of your contribution to its journal, XYZ Journal entitled (please print or type): “The Key To All Mythologies” (the "Contribution").

We ask you to assign the copyright, thus granting us all rights for the Contribution, so that you as author and we as sponsor of the Journal may be protected from the consequences of unauthorized use. You will have the right, however, after publication in the Journal, to reprint the Contribution without charge in any book of which you are the author or editor.

Accordingly, the following terms of publication are submitted for your consideration.

Copyright Assignment: Whereas XYZ Press is undertaking to publish the Contribution in its journal, named above, and whereas you desire to have the Contribution so published, now, therefore, for good and valuable consideration, the exchange, receipt, and
adequacy of which you hereby acknowledge, you grant and assign the entire copyright in and to the Contribution to XYZ Press. The copyright consists of any and all rights of whatever kind or nature now or hereafter protected by the copyright laws of the United States and of all foreign countries, in all languages and forms of communication, and XYZ Press shall be the sole proprietor thereof. The Publisher, in turn, grants to you the right to reprint the Contribution in any book of which you are the author or editor, subject to your giving proper credit in the book to the original publication of the Contribution in the Journal. To protect the copyright in the Contribution, the original copyright notice as it appears in the Journal should be in the credit.

Warranty: You warrant that the Contribution is original with you; that it contains no matter which is defamatory or is otherwise unlawful or which invades individual privacy or infringes any proprietary right or any statutory copyright; and you agree to indemnify and hold XYZ Press and its trustees, officers, employees, and agents harmless against any claim to the contrary. Further, you warrant that you have the right to assign the copyright to XYZ Press and that no portion of the copyright to the Contribution has been assigned previously. It is understood that the copyright to the Contribution has not been registered with the Library of Congress, but that in the event such registration has taken place you will promptly transfer the copyright to XYZ Press.

Previous Publication and Permission: You warrant that the Contribution has not been published elsewhere in whole or in part (except as may be set out in a rider annexed hereto and signed by a duly authorized signatory of XYZ Press) and that no agreement to publish is outstanding. Should the Contribution contain material which requires written permission for inclusion in the Contribution, such permission shall be obtained at your own expense from the copyright proprietor and submitted for review to the editor of the Journal with the manuscript.

Proofhandling: You will be given an opportunity to read and correct the edited manuscript and/or proofs,
but if you fail to return them to the editor of the Journal by the date set by the editor, production and publication may proceed without your corrections.

*Subsidiary Rights and Compensation:* It is understood that you will receive no monetary compensation from XYZ Press for the assignment of copyright and publication of the Contribution in the Journal.

If the foregoing terms are satisfactory, please sign and date this Agreement. (All joint authors should sign, and every author's Social Security number and year of birth should be included. Use the other side of this page, if necessary.) Please return the Agreement to XYZ Press immediately. A duly executed copy will be returned for your files.

**B. Review of the Problematic Provisions**

1. *Assignment of the Copyright*

From the outset, Mr. Casaubon is a bit offended by the contract language stating that the requested assignment of his copyright is for his own protection. Mr. Casaubon of course understands that he is not increasing his power to prohibit “unauthorized use” of his work (to use the language of the document draft) to the extent he assigns away his ownership rights. As a practical matter, this unnecessary initial insult to Mr. Casaubon’s intelligence actually inspires him to review the document more carefully than he might otherwise have done.

In so doing, Mr. Casaubon does not understand certain other specific language in the assignment. The language permits him “to reprint the Contribution in any book of which [he is] the author or editor, subject to [his] giving proper credit in the book to the original publication of the Contribution in the Journal.” Parsing this language carefully, Mr. Casaubon finds limited comfort in the privileges it allows. Mr. Casaubon first stumbles over the phrase “to reprint the Contribution.” Does this mean he is only allowed to “reprint” the entire work and not selections from his article?

Mr. Casaubon then wonders what “reprint” means. Does this include, for example, Xerox or scanned copies of the article he might

---

4 A copyright infringement claim should allege, among other things, that the plaintiff has an ownership right in the work allegedly infringed upon. See, e.g., Elektra Entertainment Group, Inc. v. Barker, 551 F. Supp. 2d 234, 238 (S.D.N.Y. 2008).
want to hand out in class or give to his friends? As he studies the language further, Mr. Casaubon concludes that “reprint” mostly likely does not include such handouts since the verb refers to “any book of which [he is] the author or editor.”

This conclusion only raises other concerns. Can he permit others to use his article in future anthologies? It would seem not unless he is the “author or editor” of the anthology. As he considers this further, he wonders how much comfort he can have even where he is clearly the “author or editor.” For example, what if he is the “author or editor” of a magazine in which he wishes to include his article? The reference to “book” in the contract language would not seem to cover inclusion of his article in such a magazine.

Mr. Casaubon also worries that his copyright might in some way cover the very ideas set forth in the article. Mr. Casaubon has included most of his life’s work in the article, work which he plans to continue refining and developing. If his copyright extends to his ideas in the article, would a copyright assignment limit his ability to create and publish future works which in any way involve or touch upon these ideas? Mr. Casaubon quickly researches this point and learns that copyright protection covers the expression of ideas but not the ideas themselves.\(^5\)

This, however, does not comfort Mr. Casaubon. Instead, it merely reframes his concerns. Mr. Casaubon does not live in the world of pure ideas and fears that he may well find it difficult or even impossible to convey his ideas in ways that do not involve his prior expression of those ideas.

Faced with this Gordian knot of “what-if’s,” a frustrated Mr. Casaubon simply cuts this knotty copyright assignment language out of the contract. He replaces it instead with the license language set forth in Section III below.

2. The Warranty and Indemnity Provisions

Although he believes that he alone has found the key to all mythologies, Mr. Casaubon knows that he is not omniscient. He does not believe his article contains any defamatory material, any unlawful material, or any material that invades privacy or other rights including copyrights, but how can he ever know this? What search or searches could he possibly perform that would provide him with such absolute knowledge in all of these areas? Even in the case of copyright, how could he ever know with certainty that no grounds for alleging a

---

copyright violation exist? Not only might he be unaware of (and even unable to discover) the prior expression of some of his ideas, it is also always possible that someone unknown to him has previously used some of his very phrasing in another writing. While independent creation would be a defense, why should this burden fall solely on the author, when the publisher can also do its own due diligence? Why also should the burden fall solely on the author when due diligence itself has limits? Under the common law of copyrights, for example, it is possible that someone may assert a copyright that even the most diligent statutory copyright search would not uncover. How, therefore, can the publisher reasonably ask for any warranty that is not qualified by the author’s knowledge?

The indemnity provision that follows the warranty provisions only exacerbates Mr. Casaubon’s concerns. Not only would the publisher have him warrant things beyond his knowledge, the publisher would have him “indemnify and hold XYZ Press and its trustees, officers, employees, and agents harmless against any claim to the contrary [i.e., any breach of warranty claim].” Of course, careful Mr. Casaubon cannot allow himself to agree to this.

Nor can he ignore even broader problems with the indemnity. The indemnity does not simply cover valid claims. It covers any claims, which therefore means it covers frivolous claims. Why, he asks himself, should he bankroll a defense of frivolous claims against the journal such as claims, for example, that his article has defamed Hera or Zeus or invaded their privacy? He has led a scholar’s life to enlighten himself and others. He will not willingly contract himself into potential bankruptcy for such noble efforts. He therefore simply strikes the warranty and indemnity language in the manner shown in Section III below.

3. Other Provisions of Concern

Prior to submitting his article for publication, Mr. Casaubon posted a copy of his article on SSRN, an on-line research network where others have downloaded copies of the article multiple times. He

---

6 Copyright law requires independent creation instead of novelty. See 17 U.S.C. §101 (2006); Sheldon v. Metro-Goldwyn Pictures Corp., 81 F.2d 49, 54 (2d Cir. 1936) (“[I]f by some magic a man who had never known it were to compose anew Keat’s Ode on a Grecian Urn, he would be an “author,” and, if he copyrighted it, others might not copy that poem, though they might of course copy Keats’s [poem in the public domain].”).

7 Registration is not required to create a copyright, and registration can (with limited exceptions) occur at any time during the copyright’s term. See 17 U.S.C. §§ 102(a), 408(a) (2006).
therefore naturally has concerns with the following language:

You warrant that the Contribution has not been published elsewhere in whole or in part (except as may be set out in a rider annexed hereto and signed by a duly authorized signatory of XYZ Press) and that no agreement to publish is outstanding.

He contemplates preparing a rider disclosing the SSRN posting. However, he notes that the publisher will have to initial the rider and he is not sure how the remainder of the quoted language would apply to continued SSRN postings and downloads. Out of caution, he therefore strikes the language and inserts substitute language as shown in Section III below.

Mr. Casaubon is also concerned about the proof handling section which simply provides that he will be given “an opportunity to read and correct the edited manuscript and/or proofs.” It does not address what happens in the event the publisher and he disagree on an edit. Although he does not like such uncertainty, Mr. Casaubon decides to leave this language alone on the belief that any editing dispute should be resolvable.

Finally, Mr. Casaubon has a problem with the portion of the agreement requiring his social security number. He does not understand why the journal needs that information or why the journal needs the burden and liability of protecting the confidentiality of that information. He therefore strikes that provision and provides the publisher with the redlined draft discussed in Section III below.

III. Round Two

A. Mr. Casaubon’s Responsive Redline Draft

Prior to Mr. Casaubon, the publisher has never received any markups to its “standard” publication agreement. The publisher is therefore a bit shocked to receive the following redline draft:

Name of Contributor (please print or type): Edward Casaubon

XYZ Publisher Press is pleased to undertake the publication of your contribution to its journal, XYZ Journal, entitled (please print or type): “The Key To All Mythologies” (the "Contribution"). We ask you to assign the copyright, thus granting us all rights for the Contribution, so that you as author and we as sponsor of the Journal may be protected from the consequences
of unauthorized use. You will have the right, however, after publication in the Journal, to reprint the Contribution without charge in any book of which you are the author or editor.

Accordingly, the following terms of publication are submitted for your consideration.

License Copyright Assignment: Whereas XYZ Publisher Press is undertaking to publish the Contribution in its journal, named above, and whereas you desire to have the Contribution so published, now, therefore, for good and valuable consideration, the exchange, receipt, and adequacy of which you hereby acknowledge, you grant XYZ Publisher Press the non-exclusive license to print the Contribution and to retain all proceeds received on account of said printing, and assign the entire copyright in and to the Contribution to XYZ Publisher Press. The copyright consists of any and all rights of whatever kind or nature now or hereafter protected by the copyright laws of the United States and of all foreign countries, in all languages and forms of communication, and XYZ Publisher Press shall be the sole proprietor thereof. XYZ Publisher Press, in turn, grants to you the right to reprint the Contribution in any book of which you are the author or editor, subject to your giving proper credit in the book to the original publication of the Contribution in the Journal. To protect the copyright in the Contribution, the original copyright notice as it appears in the Journal should be in the credit. Notwithstanding the foregoing, you retain full ownership of the copyright in the Contribution.

Warranty: You warrant that the Contribution is original with you; that it contains no matter which is defamatory or is otherwise unlawful or which invades individual privacy or infringes any proprietary right or any statutory copyright; and you agree to indemnify and hold the XYZ Publisher Press and its trustees, officers, employees, and agents harmless against any claim to the contrary. Further, you warrant that you have the right to assign the copyright to the XYZ Publisher Press and that no portion of the copyright to the Contribution has been assigned previously. It is understood that the copyright to the Contribution has
not been registered with the Library of Congress, but that in the event such registration has taken place you will promptly transfer the copyright to XYZ Publisher Press.

*Previous Publication and Permission:* The parties acknowledge that the Contribution has been posted on SSRN. You warrant that the Contribution has not been published elsewhere in whole or in part (except as may be set out in a rider annexed hereto and signed by a duly authorized signatory of XYZ Publisher Press) and that no agreement to publish is outstanding. Should the Contribution contain material which requires written permission for inclusion in the Contribution, such permission shall be obtained at your own expense from the copyright proprietor and submitted for review to the editor of the Journal with the manuscript.

*Proofhandling:* You will be given an opportunity to read and correct the edited manuscript and/or proofs, but if you fail to return them to the editor of the Journal by the date set by the editor, production and publication may proceed without your corrections.

*Subsidiary Rights and Compensation:* It is understood that you will receive no monetary compensation from XYZ Publisher Press for this non-exclusive license to publish the assignment of copyright and publication of the Contribution in the Journal.

If the foregoing terms are satisfactory, please sign and date this Agreement. (All joint authors should sign, and every author's Social Security number and year of birth should be included. Use the other side of this page, if necessary.) Please return the Agreement to XYZ Publisher Press immediately. A duly executed copy will be returned for your files.

Never having seen before such a “significant number of changes and amendments” to their “standard” agreement, the publisher forwards the proposed redraft to its legal counsel.

**B. The Journal’s Review of Mr. Casaubon’s Draft**

The journal’s legal counsel understands that the journal does not need an assignment of the copyright to publish the article. Such counsel, however, understandably wants more than a mere revocable
license to publish. Since the horse will be out of the barn once publication occurs, they want the license to be irrevocable. Also, since publication will presumably disperse their journal worldwide, they want clarification of such geographical scope as well. They also recognize that publication may take diverse forms and they wish to clarify this matter as well. As counsel for the publisher has good and reasonable insight in all these areas, these provisions of the contract should be resolvable.

Such counsel, however, is less flexible with respect to the warranty and indemnity concerns of Mr. Casaubon. Here they simply advise the publisher that Mr. Casaubon must warrant that the material submitted for publication is neither infringing, defamatory or otherwise unlawful and that he must furthermore indemnify the publisher against all liability arising out of breach of this warranty.

IV. ROUND THREE

A. The Journal’s Response To Mr. Casaubon’s Redline

In light of its counsel’s advice, the publisher prepares a new redline for Mr. Casaubon. New language in the redline reflects the more specific license advice provided by the publisher’s counsel. However, the publisher simply reinserts the deleted warranty and indemnity language. The new redline thus reads as follows:

Name of Contributor (please print or type): Edward Casaubon

XYZ Publisher Press is pleased to undertake the publication of your contribution to its journal, XYZ Journal, entitled (please print or type): “The Key To All Mythologies” (the ”Contribution”).

License: Whereas XYZ Publisher Press is undertaking to publish the Contribution in its journal, named above, and whereas you desire to have the Contribution so published, now, therefore, for good and valuable consideration, the exchange, receipt, and adequacy of which you hereby acknowledge, you grant XYZ Publisher Press the irrevocable worldwide, royalty-free and fully paid-up non-exclusive license in perpetuity to reproduce and publish print the Contribution in any media, whether now or hereafter known, and exclusively to retain all proceeds received on account of said printing publication(s). Notwithstanding the foregoing, you retain full ownership of the copyright in
the Contribution.

**Warranty.** You warrant to XYZ Publisher that the Contribution is original to you; that it contains no matter which is defamatory or is otherwise unlawful or which invades individual privacy or infringes any proprietary right or any statutory copyright; and you agree to indemnify and hold XYZ Publisher Press and its trustees, officers, employees, and agents harmless from and against any claim to the contrary. Further, you warrant that you have the right to make the non-exclusive license grant to XYZ Publisher Press set forth above.

**Previous Publication:** The parties acknowledge that the Contribution has been posted SSRN.

**Proofhandling:** You will be given an opportunity to read and correct the edited manuscript and/or proofs, but if you fail to return them to the editor of the Journal by the date set by the editor, production and publication may proceed without your corrections.

**Subsidiary Rights and Compensation:** It is understood that you will receive no monetary compensation from the Press for this license to publish and publication of the Contribution in the Journal.

If the foregoing terms are satisfactory, please sign and date this Agreement. (All joint authors should sign, and every author's year of birth should be included. Use the other side of this page, if necessary.) Please return the Agreement to the Press immediately. A duly executed copy will be returned for your files.

### B. Mr. Casaubon’s Review of the Publisher’s Redline

Mr. Casaubon finds the license changes straightforward and acceptable. When he drafted his proposed license language, he did not mean to retain revocation rights, limit the geographical distribution of the publication, or limit the media in which such publication might occur. Mr. Casaubon therefore accepts such language a reasonable clarification of what he originally intended.

Mr. Casaubon is angered, however, by the intransigence on the warranty and indemnity language. His knee-jerk reaction is to return the redline with the inserted language deleted. Upon a bit of reflection, however, he realizes that such a gesture would merely
duplicate the uncreative intransigence that angered him and do little to resolve the remaining disputed issues in the draft.

Mr. Casaubon therefore tries to outline the remaining real concerns of both parties so that he might attempt to find some balance between them. Reflecting upon the matter from his point of view, he finds four matters that disturb him. First, he cannot honestly make warranties and representations about things he does not know. Second, he cannot agree to pay potentially-ruinous financial sums to the publisher. Third, as a matter of principle, he cannot agree to indemnify the publisher for frivolous claims. Finally, also as a matter of principle, he cannot agree to indemnify the purchaser for losses to the extent the publisher itself causes such losses. Once outlined, he realizes that these concerns can be addressed by a liability limitation, by adding a knowledge limitation to his warranties and representations, by limiting his indemnity to valid claims, and by excluding publisher-caused losses from the scope of the indemnity.

Reflecting upon the matter from the publisher’s point of view, Mr. Casaubon believes that there are only three issues of reasonable concern. First, the publisher wants assurance that Mr. Casaubon did not plagiarize the article. Second, the publisher wants some reasonable assurance from Mr. Casaubon that the article contains no defamatory, unlawful or infringing material. Finally, the publisher wants some reasonable degree of financial commitment from Mr. Casaubon in the event of any breach of his warranties and representations. Outlining the parties’ interests in such a way, Mr. Casaubon returns to the draft to see what might be done.

V. ROUND FOUR

A. Mr. Casaubon’s Second Redline

Attempting to balance the warranty, representation and liability concerns of the parties, Mr. Casaubon delivers the following responsive redline draft to the publisher:

Name of Contributor (please print or type): Edward Casaubon

XYZ Publisher Press is pleased to undertake the publication of your contribution to its journal, *XYZ Journal*, entitled (please print or type): “The Key To All Mythologies” (the "Contribution").

License: Whereas XYZ Publisher Press is undertaking to publish the Contribution in its journal, named above, and whereas you desire to have the Contribution so
published, now, therefore, for good and valuable consideration, the exchange, receipt, and adequacy of which you hereby acknowledge, you grant XYZ Publisher Press the irrevocable worldwide, royalty-free and fully paid-up non-exclusive license in perpetuity to reproduce and publish the Contribution in any media, whether now or hereafter known, and exclusively to retain all proceeds received on account of said publication(s). Notwithstanding the foregoing, you retain full ownership of the copyright in the Contribution.

Warranty. You warrant to XYZ Publisher that the Contribution is original to you; that, to your knowledge, it contains no matter which is defamatory or is otherwise unlawful or which invades individual privacy or infringes any proprietary right or any statutory copyright; and, except to the extent caused by any act or omission of the indemnified parties, you agree to indemnify and hold XYZ Publisher Press and its trustees, officers, employees, and agents harmless from and against any valid claim to the contrary. Further, you warrant that you have the right to make the non-exclusive license grant to XYZ Publisher Press set forth above. Notwithstanding the foregoing, however, your aggregate liability for all warranties and matters addressed in this Section 3 shall not exceed the sum of twenty-five hundred dollars ($2,500.00).

Previous Publication: The parties acknowledge that the Contribution has been posted SSRN.

Proofhandling: You will be given an opportunity to read and correct the edited manuscript and/or proofs, but if you fail to return them to the editor of the Journal by the date set by the editor, production and publication may proceed without your corrections.

Subsidiary Rights and Compensation: It is understood that you will receive no monetary compensation from the Press for this license to publish and publication of the Contribution in the Journal.

If the foregoing terms are satisfactory, please sign and date this Agreement. (All joint authors should sign, and every author's year of birth should be included. Use the other side of this page, if necessary.) Please
return the Agreement to the Press immediately. A duly executed copy will be returned for your files.

B. Publisher’s Review of Mr. Casaubon’s Second Redline

The publisher provides its counsel with Mr. Casaubon’s responsive redline. Presumably having had enough of Mr. Casaubon, the publisher’s counsel at this stage imputes sinister motives to Mr. Casaubon. Such counsel advises the publisher that Mr. Casaubon’s insistence on limiting his liability should be a “red flag” that something is amiss. If no one else has raised such obstinate objections to the twenty-year-old form, what other conclusion, they ask, could one reasonably draw? Such counsel therefore advises the publisher in the strongest terms not to accept Mr. Casaubon’s changes to the draft.  

At this point, however, the imminent publication deadline helps the publisher exercise a little common sense and focus on its real goals. The publisher has difficulty applying sinister motives to Mr. Casaubon simply because no one else has questioned those liability provisions. Perhaps Mr. Casaubon is just smarter and more careful than other prior authors. Second, as a matter of simple probabilities, the publisher knows that the form is twenty years old and finds it rather predictable that over a span of twenty years at least one person would question the form. Finally, the publisher looks at the nature of the work involved. It discusses mythologies and not real people. Hera and Zeus, for example, cannot be defamed, have their privacy invaded or have standing to bring a legal action. Considering their counsel over cautious, the publisher makes the “business judgment” to accept Mr. Casaubon’s changes. At last, with some help and some failure from the lawyers, the parties have an agreement and “The Key to All Mythologies” will now see the light of day.

---

8 This is not an unrealistic scenario. I am aware of at least one situation where a publisher’s counsel gave similar advice. I include this twist to demonstrate how negotiations can falter at both the client and lawyer level.

9 Dwindling time is often the sharpest lens.

10 The lawyers’ failure to exercise more diligence at the end of negotiations of course not only risked losing the publication deal, but it may well have resulted in a final agreement less favorable to their client than it might otherwise have been. Arguably, for example, the publisher is worse off with the final liability limitation language than it would have been had the contract simply not addressed author liability. The agreed language not only limits the author’s liability to $2,500.00 for warranties but for all matters addressed in Section 3. This, of course, picks up any kind of liability the author might have in any way involving the article since the article itself is one of the matters addressed in Section 3. In the absence of such a limitation, I personally would never agree to an indemnity as an author.
VI. Conclusion

What can we learn from the twists and turns of this little tale? We can learn that each party to a publishing agreement has a set of clear interests which can be respected by the other.

A savvy author will generally have the following concerns. First and foremost, the author will wish to retain his copyright. Second, the author will want reasonable proofing and editing rights. Third, the author will not wish to make needless warranties and representations or warranties and representations beyond his reasonable ability to make. Finally, a careful author will want reasonable liability limitations. Both parties can do their due diligence and no careful author will want to agree to bear all liability incident to publication. This especially applies to liability for frivolous claims or claims due to the publisher’s fault.11

Turning to the publisher, first and foremost it must have the right to publish the work in reasonably available formats for the contemplated period of time (including any desired right of first publication) and contemplated geographical area. However, this does not require a copyright assignment since these goals can be accomplished by a license agreement.12 The publisher’s needs can therefore be accomplished in a manner consistent with the author’s need to retain the author’s copyright. This area of common dispute should therefore simply disappear from the world of publishing. Second, the publisher will also want reasonable proofing and editing rights. This need not be inconsistent with similar rights of the author and should present no impediment to a final agreement. Third, the publisher will want comfort from the author that nothing is amiss with the piece to be published. In seeking such comfort, however, the publisher should not request impossible or overly burdensome

---

11 According to the Scholarly Publishing and Academic Resources Coalition [hereafter “SPARC”], authors’ basic interests include (1) retaining whatever rights they desire in their work, (2) having the unrestricted ability to use and develop their work, (3) receiving proper attribution when others use their work, and (4) having the choice of publically archiving their work online. Author Rights: Using the SPARC Author Addendum to secure your rights as the author of a journal article, SPARC (2006), http://www.arl.org/sparc/author/addendum. For the reasons discussed above, authors’ retention of their copyrights while granting a license serves all of these goals.

12 See, e.g., Graham v. James, 144 F.3d 229, 236 (2d Cir. 1998) (“A copyright owner who grants a nonexclusive license to use his copyrighted material waives his right to sue the licensee for copyright infringement”); see also Cyndey A. Tune, Copyright Licensing Fundamentals, 950 PLI/PAT 135, 141-42, 144 (2008) (describing copyright licensing generally and non-exclusive copyright licenses specifically).
warranties from the author. A knowledge limitation would seem to balance the publisher’s concerns here with author’s reluctance to make warranties and representations the author cannot reasonably know to be true. In this area, the publisher of course has the right to perform its own due diligence and can perform any extraordinary or other due diligence it wishes to perform. Finally, the publisher will want an author’s warranties and representations to have some practical value. This, of course, is part of the comfort that such warranties and representations are meant to provide. However, this does not require endless potential liability on the part of the author. Insurance\textsuperscript{13} can supplement liability limitations and may provide the publisher with any monetary assurance it needs beyond the liability limitations agreeable to the author.\textsuperscript{14}

All these basic author and publisher concerns are thus fully reconcilable. Unlike the travails of Mr. Casaubon’s “The Key to All Mythologies,” the key to simplifying the publication agreement negotiation process is therefore to begin with a draft more like the last Casaubon draft. Beginning with such a draft is also key to eliminating yet another way unreasonable publication agreements chill expression: time spent negotiating such agreements is of course time not spent on scholarship.


\textsuperscript{14} This is all consistent with SPARC’s summary of a publisher’s three basic interests: (1) “Obtain a non-exclusive right to publish and distribute a work and receive a financial return,” (2) “Receive proper attribution and citation as journal of first publication” and (3) Have the ability to “[m]igrate the work to future formats and include it in collections.” SPARC, supra note 11.
WHAT SHOULD BE PATENTABLE?—A PROPOSAL FOR DETERMINING THE EXISTENCE OF STATUTORY SUBJECT MATTER UNDER 35 U.S.C. SECTION 101

Andrew Beckerman-Rodau†

I. INTRODUCTION .......................................................... 147
II. THE CONTROLLING STATUTE—SECTION 101 .......... 151
III. PATENT LAW: UNDERLYING GOALS AND JUSTIFICATIONS ................................................. 155
IV. THE IMPORTANCE OF PREDICTABILITY ............ 162
V. PREDICTABILITY AND STATUTORY SUBJECT MATTER .............................................................................. 172
VI. PROPOSED TESTS IN ADDITION TO THE MACHINE-OR-TRANSFORMATION TEST .......................... 178
   A. STATEMENT OF THE MACHINE-OR-TRANSFORMATION TEST ................................................. 179
   B. PROPOSED TESTS ......................................................................................................................... 180
       1. Preemption Test and Insignificant Limitation Test ......................................................... 181
       2. Equation Test ......................................................................................................................... 181
       3. Human Intervention Test ........................................................................................................ 182
       4. Data Comparison Test ............................................................................................................. 183
   C. APPLICATION OF THE PROPOSED TESTS TO PROCESS CLAIMS ........................................ 183
       1. The Prometheus Laboratories Decision .......... 183
       2. The Diehr Decision ................................................................................................................. 185
       3. The Flook Decision .................................................................................................................. 187

† Professor of Law & Co-Director, Intellectual Property Law Concentration; Suffolk University Law School, Boston, Massachusetts. B.S. (Engineering), 1976, Hofstra University; J.D., 1981, Western New England University School of Law; L.L.M., 1986, Temple University School of Law. Email: arodau@suffolk.edu; website: http://lawprofessor.org. Copyright © 2012, Andrew Beckerman-Rodau. Special thanks to Kip Bodi (Suffolk University Law School class of 2013) for research assistance.
ABSTRACT

The question of what type of inventions should be protectable under patent law is a controversial issue that has received significant attention. Recent Supreme Court decisions reject a bright-line test in favor of a more open-ended approach to determining patent eligibility. Unfortunately, this provides limited guidance to lower courts and consequently the issue remains unsettled. This article will examine the scope of patent-eligible subject matter defined by Patent Law section 101. It will look at judicial interpretation of the statute including exceptions judicially engrafted into the statute by the Supreme Court. Additionally, the competing policy concerns underlying the statute will be examined. It will be argued that this statute should be analyzed, interpreted, and applied consistently with the usual rules generally applied by courts. This requires understanding that underlying policies are often inconsistent or competing. Such policies must therefore be balanced in crafting an applicable rule. Any resulting rule will be imperfect because it will potentially be over- or under-inclusive. Additionally, it will have disproportionate effects on different industries. Nevertheless, the importance of a uniform and predictable rule outweighs these deficiencies. Rather than propose a single rule, several rules gleaned from Supreme Court decisions will be proposed in light of the fact that patents cover many different technologies and patent claims can be drafted in a multitude of ways. Violation of any of the proposed rules means the patent claim at issue is not patent-eligible subject matter.
I. INTRODUCTION

The question of what type of inventions should be protectable under patent law is a controversial issue that has received significant media attention.\(^1\) It has also been addressed in scholarly commentary.\(^2\) Moreover, it has been addressed by the U.S. Supreme Court\(^3\) and the Federal Circuit\(^4\) in numerous decisions. Despite this attention, the issue is still unsettled.\(^5\) Recent Supreme Court decisions suggest a desire by the Court to restrict the expansion of patentable subject


\(^4\) See, e.g., *In re Comiskey*, 554 F.3d 967, 969-70 (Fed. Cir. 2009) (holding that a method for resolving a dispute via arbitration standing alone was not patentable subject matter); *In re Nuijten*, 500 F.3d 1346, 1357 (Fed. Cir. 2007) (holding that electromagnetic signals are not patentable subject matter).

However, those decisions appear to reject a bright-line test in favor of a more open-ended philosophical approach. Unfortunately, this provides limited guidance to lower courts and consequently the issue continues to be unsettled. Moreover, it is unclear if all the judges on the U.S. Court of Appeals for the Federal Circuit, which hears virtually all appeals in patent disputes, fully agree with this restrictive trend.

Most inventions fit within the statutory requirements defining patent-eligible inventions. Often, assertions that an invention falls outside this requirement arise when new technology gains economic importance. The advent of software as an important freestanding industry generated significant litigation with regard to whether software should be eligible for patent protection. Research and development work in the biotech industry raised the question of whether patents should be granted for isolated genetic material and

---

6 See generally Mayo Collaborative Servs., 132 S. Ct. at 1301 (“The Court has repeatedly emphasized . . . a concern that patent law not inhibit further discovery by improperly tying up the future use of laws of nature.”).

7 In Bilski v. Kappos, 130 S. Ct. 3218, 3227 (2010), the Supreme Court rejected the Federal Circuit’s reliance on the machine or transformation test as the sole test to determine whether a process is patent eligible. The Court held that the test is merely a clue or investigative tool for determining patent eligibility of a process. Id. The Court then rejected the adoption of categorical rules for determining patent eligibility. Id. at 3229-30.

8 See generally Asher Hodes, Diagnosing Patentable Subject Matter, 26 BERKELEY TECH. L.J. 225, 228-29 (2011) (finding that many commentators have noted the limited guidance given to lower courts by the Supreme Court decision in Bilski v. Kappos).


11 See generally AMY LANDERS, UNDERSTANDING PATENT LAW § 23.01, at 298 (2d ed. 2012) (writing that what is patent-eligible subject matter tends to be an issue when new areas of technology produce patent claims that differ from precedent).


for living microorganisms created in a laboratory.\textsuperscript{14} The patentability of software-based business methods utilized in the financial services industry\textsuperscript{15} and in Internet commerce created controversy.\textsuperscript{16}

Patents have taken on increased economic importance today.\textsuperscript{17} Enterprises use patents defensively by amassing patent portfolios to protect a technology space for future technology development.\textsuperscript{18} Likewise, they are used offensively to protect existing market share.\textsuperscript{19}

\begin{itemize}
  \item \textsuperscript{14} See Diamond v. Chakrabarty, 447 U.S. 303 (1980) (holding in a 5-4 decision that a living, manmade microorganism is patentable subject matter).
  \item \textsuperscript{17} See generally Andrew J. Sherman, \textit{Fueling Rapid Growth Enterprises}, TECHAMERICA FOUNDATION, at 4 (July 2012), \url{http://www.techamericafoundation.org/content/wp-content/uploads/2012/07/Sherman-Fueling_Rapid_Growth_Enterprises.pdf} (“It is now estimated that 80 percent of the market value of the S&P 500 companies is due to intangible assets, compared to just 20 percent for physical and financial assets.”); Nick Timiraos, \textit{Business Battle Over Patent Laws}, WALL ST. J., June 9, 2007, at A7 (stating that about one third of the value of all U.S. stocks is currently comprised of intangible assets which includes intellectual property).
  \item \textsuperscript{18} See generally Stuart Graham & Ted Sichelman, \textit{Why Do Start-Ups Patent?}, 23 BERKELEY TECH. L.J. 1063, 1065-66 (2008) (patents can be used defensively to limit being subjected to infringement suits; they can also be used to create leverage in cross licensing negotiations with competitors).
  \item \textsuperscript{19} See, e.g., Owen Thomas, \textit{As It Gears Up For War With Samsung, Apple Adds To Its Patent Pile}, BUSINESS INSIDER (Nov. 15, 2012), \url{http://www.businessinsider.com/apple-rockstar-bidco-nortel-patents-2012-11} (last visited Nov. 16, 2012) (Apple buys 1,024 patents and patent applications to bolster its position against competitors in the mobile device market). Although many patents have little or no commercial value and hence create minimal market power
\end{itemize}
Non-practicing entities utilize patents to wring licensing revenue from technology producers. All of these activities are facilitated by broad patent claims that maximize the scope of patent protection. Hence, patents often include at least some claims that attempt to push the limits of what is protectable subject matter in order to maximize the potential economic value of the patent. It is these claims that tend to raise patent-eligible subject matter issues.

This article will examine the scope of patent-eligible subject matter defined by Patent Law section 101. It will look at both the legislative history and judicial interpretation of the statute, including exceptions or limitations judicially engrafted into the statute by the Supreme Court. Additionally, the competing policy concerns underlying the statute, which have been enunciated by the Court, will be examined. It will be argued that this statute should be analyzed, interpreted, and applied consistently with the usual rules generally applied by courts. This requires understanding that underlying policies are often inconsistent or competing. Such policies must therefore be balanced in crafting an applicable rule. Any resulting rule will be imperfect because it will potentially be over or under inclusive. Additionally, it will have disproportionate effects on different industries. Nevertheless, the importance of a uniform and predictable
rule outweighs these deficiencies. The article will conclude with a set of suggested rules gleaned from Supreme Court decisions that can be used to provide more predictable results with regard to determining if a patent claim covers patent-eligible subject matter.

II. THE CONTROLLING STATUTE—SECTION 101

Patent Law section 101 states that “[w]hoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title.”24 This statute can be dissected into several requirements. The first portion of the statute, which states, “[w]hoever invents or discovers,” arguably indicates that only an actual inventor can obtain a patent.25 The reference to “new” is a basic requirement of patent law typically referred to as the novelty requirement,26 which is dealt with in more detail by another section of the patent law.27 The word “useful” has been held to be the basis for the utility requirement, which mandates that an invention must have some use or utility to be eligible for patent protection.28 Finally, the statute lists several categories—“process, machine, manufacture, or composition of matter”—that an invention must fall within to be patent-eligible subject matter.29 Whether an invention falls within one of these statutory categories has been subject to substantial judicial review.30

24 Id.
25 This is traditionally referred to as the derivation requirement. See J. THOMAS McCARTHY, ROGER SCHECHTER & DAVID FRANKLYN, McCARTHY’S DESK ENCYCLOPEDIA OF INTELLECTUAL PROPERTY 151 (3d ed. 2004).
26 See id. at 406; BLACK’S LAW DICTIONARY 1092 (7th ed. 1999).
28 See McCarthy, supra note 25, at 650-53 (“To be patentable, an invention must have ‘utility’ in the sense that it can operate to perform some ‘useful’ function for society.”); see also JANICE MUELLER, PATENT LAW 235 (3d ed. 2009) (“[A] useful invention is one that possesses utility.”).
29 These categories are interchangeably referred to as defining “patentable subject matter,” “patent eligible subject matter” or “statutory subject matter.” See generally William T. Goglia, Annotation, Supreme Court’s Views as to What is Patentable Subject Matter Under Federal Law as “Process,” “Machine,” “Manufacture,” or “Composition of Matter”, 65 L. Ed. 2d 1197 (2012).
30 More specifically, very little controversy has existed over whether an invention is a machine, manufacture, or composition of matter. See ROBERT HARMON, PATENTS AND THE FEDERAL CIRCUIT § 2.2(a)(i), at 55 (7th ed. 2005). Most of the controversy has addressed the meaning of process. See id. See Generally Goglia, supra note 29, at 1201 (“Of the terms process, machine, manufacture, and composition of matter, the term "process" has been defined by the court more often than the others.”).
Interpreting the meaning of these statutory categories requires a multi-step process. 31 First, the language of the statute must be examined to determine its plain meaning. 32 This includes ascertaining if the statute provides specific definitions of relevant terms. 33 Second, in the absence of any definition, or if the meaning of the statute is unclear or ambiguous, the underlying purpose of the statute must be ascertained and utilized to understand the legislative intent of the statute. 34

Patent Law section 101 provides a definition of the term “process” which states that “[t]he term ‘process’ means process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material.” 35 This definition can be broken down into two parts. The first part tells us that the terms process, art and method are essentially interchangeable. The second part of the statute, which follows the word “includes,” merely lists several examples of acceptable processes. Arguably, this second part is merely illustrative and not limiting in light of the ordinary meaning of the term “includes” in a statute. 36 Therefore, a process can be viewed

31 See Conn. Nat’l Bank v. Germain, 503 U.S. 249, 253 (1992) (“[The] canons of construction are no more than rules of thumb that help courts determine the meaning of legislation, and in interpreting a statute a court should always turn first to one . . . .”).

32 See id. at 253-54 (“We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there.”). In Bilski v. Kappos, 130 S. Ct. 3218, 3226 (2010), the Supreme Court stated that a statute should be given its ordinary meaning in a case involving whether an invention was within the statutory categories under Patent Law section 101. Therefore, the wording of section 101 should be given its ordinary and common meaning, unless otherwise defined, and this may be based on a dictionary definition. Id.

33 See Bilski, 130 S. Ct. at 3226. (In a decision involving the meaning of “process” in section 101 the Court states, “[w]hen a statute includes an explicit definition, we must follow that definition” (quoting Burgess v. United States, 553 U.S. 124, 130, (2008))). See generally Perrin v. U.S., 444 U.S. 37, 42 (1979) (“A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning.”).

34 See United States v. Dickerson, 310 U.S. 554, 562 (1940) (“The meaning to be ascribed to an Act of Congress can only be derived from a considered weighing of every relevant aid to construction.”).

35 35 U.S.C. § 100(b) (2006). See Bilski, 130 S. Ct. at 3237 (Stevens, J., concurring) (“[T]he Patent Act does not on its face give much guidance about what constitutes a patentable process . . . [T]he definition is not especially helpful, given that it also uses the term “process” and is therefore somewhat circular.”).

36 See, e.g., 17 U.S.C. § 101 (2006) (definitional section of copyright law states that “[t]he terms ‘including’ and ‘such as’ are illustrative and not limitative”); see also BLACK’S LAW DICTIONARY 766 (7th ed. 1999) (definition of “include”).
as a method of accomplishing some result via a series of steps.\textsuperscript{37} Typically, a process claim in a patent recites a list of related actions in gerund form.\textsuperscript{38}

The patent law fails to contain any definitions of the other categories of patent-eligible subject matter. Therefore, these categories should be interpreted by using the ordinary or commonly understood meaning of the statutory language at issue.\textsuperscript{39} Absent a

\textsuperscript{37} See In re Durden, 763 F.2d 1406, 1410-11 (Fed. Cir. 1985) (“A process . . . is a manipulation according to an algorithm . . . [or] doing something to or with something according to a schema.”); see also In re Kollar, 286 F.3d 1326, 1332 (Fed. Cir. 2002) (“a process consists of a series of acts or steps . . . [that must] be carried out or performed”). Some early Supreme Court decisions indicated limits on what is a process. For example, in \textit{Cochrane v. Deener}, 94 U.S. 780, 788 (1876), the court stated:

A process is a mode of treatment of certain materials to produce a given result. It is an act, or a series of acts, performed upon the subject-matter to be transformed and reduced to a different state or thing. . . . The process requires that certain things should be done with certain substances, and in a certain order; but the tools to be used in doing this may be of secondary consequence.

Later Supreme Court decisions rejected limitations on what could be considered a patent-eligible process. See, e.g., \textit{Expanded Metal Co. v. Bradford}, 214 U.S. 366, 381-84 (1909) (processes not limited to chemical actions but can include purely mechanical processes). Finally, in \textit{Bilski v. Kappos}, 130 S. Ct. 3218, 3225-27 (2010), the Supreme Court rejected the conclusion of the Federal Circuit that a patent-eligible process must satisfy the so-called machine-or-transformation test which states that a claimed process is patent eligible “only if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing.” Additionally, the Court specifically held that its prior decision in \textit{Cochrane} did not limit the meaning of process, \textit{id.} at 3226.

\textsuperscript{38} For example, the following process claim is claim 5 in U.S. Patent No. 8,301,514 (issued Oct. 30, 2012):

A method of generating item recommendations, the method comprising: by a computer system comprising computer hardware: \textit{accessing} a transaction phrase index comprising a plurality of transaction phrases mapped to items purchased using the transaction phrases; \textit{identifying} a transaction phrase created by a target user; \textit{identifying} candidate recommendations from the transaction phrase index based at least partly on the identified target user transaction phrase, the candidate recommendations comprising one or more of the purchased items contained in the transaction phrase index; and \textit{selecting} one or more of the candidate recommendations to present to the target user as item recommendations.

\textsuperscript{39} See \textit{Bilski}, 130 S. Ct. at 3226 (“In patent law, as in all statutory construction, ‘[u]nless otherwise defined, ‘words will be interpreted as taking their ordinary, contemporary, common meaning.’” (quoting \textit{Diamond v. Diehr}, 450 U.S. 175, 182 (1981))).
A “machine” can be considered a tangible device or apparatus that uses mechanical or electrical energy to accomplish something.

A “manufacture” is typically a product that has been changed or transformed by a process. The Supreme Court, relying on the dictionary definition, has defined the term as “the production of articles for use from raw or prepared materials by giving to these materials new forms, qualities, properties, or combinations, whether by hand-labor or by machinery.” Some commentators have noted that a rough way to distinguish a machine from a manufacture is that a machine has moving parts, unlike a manufacture.

A “composition of matter” has also been defined by the Supreme Court consistent with its common meaning to apply to “all compositions of two or more substances and . . . all composite articles, whether they be the results of chemical union, or of mechanical mixture, or whether they be gases, fluids, powders or solids.” Although compositions of matter are typically chemical compounds, an overlap may exist with manufactures.

See Tilghman v. Proctor, 102 U.S. 707, 728 (1880) (“A machine is a thing. A process is an act, or a mode of acting. The one is visible to the eye, an object of perpetual observation.”); see also Burr v. Duryee, 68 U.S. 531, 570 (1863) (“A machine is a concrete thing, consisting of parts, or of certain devices and combination of devices.”). See generally Honolulu Oil Corp. v. Halliburton, 306 U.S. 550, 560 (1939) (“Machine includes apparatus”).


every mechanical device or combination of mechanical powers and devices to perform some function and produce a certain effect or result. But where the result or effect is produced by chemical action, by the operation or application of some element or power of nature, or of one substance to another, such modes, methods, or operations, are called processes.

Goglia, supra note 29, at § 6(a).


PAUL GOLDSTEIN & R. ANTHONY REESE, COPYRIGHT, PATENT, TRADEMARK AND RELATED STATE DOCTRINES 400 (6th ed. 2008); see also JANICE MUELLER, PATENT LAW 280 (3d ed. 2009).


Chakrabarty, 447 U.S. at 309 (1980) (determining that a genetically engineered microorganism was either a composition of matter or a manufacture continued . . .
The above definitions are quite broad, which is consistent with the legislative intent of the patent law.\footnote{Id. (“The Committee Reports accompanying the [ Patent] Act inform us that Congress intended statutory subject matter to ‘include anything under the sun that is made by man.’”)} In accordance with this intent, the Supreme Court has recognized that Congress intended a liberal view of patentable subject matter, and it has admonished courts to avoid reading limitations into the patent law.\footnote{Id. at 308.} Despite this warning, the Supreme Court has consistently read several exceptions into Patent Law section 101.\footnote{Id. at 309. } Statutory subject matter that is otherwise a process, machine, manufacture, or composition of matter is deemed non-patentable subject matter if it is a law of nature, physical phenomena, or abstract idea.\footnote{Chakrabarry, 447 U.S. at 309. } The Supreme Court acknowledged that the exclusion of laws of nature, natural phenomena and abstract ideas was not contained in the statutory language of section 101. Bilski v. Kappos, 130 S. Ct. 3218, 3225 (2010). Nevertheless, it has long been viewed that these exceptions are implicitly contained in section 101. Mayo Collaborative Servs. v. Prometheus Labs., Inc., 132 S. Ct. 1289, 1293 (2012).

III. PATENT LAW: UNDERLYING GOALS AND JUSTIFICATIONS

The basic goal of patent law is contained in the following section of the Constitution: “The Congress shall have power to . . . promote the progress of science and useful arts, by securing for limited times to . . . inventors the exclusive right to their . . . discoveries.”\footnote{U.S. CONST. art. I, § 8, cl. 8.} The plain meaning of this clause indicates that the purpose of enacting a law to protect inventor discoveries is to “promote the progress of science and useful arts.”\footnote{See Lab. Corp. of Am. Holdings v. Metabolite Labs., Inc., 548 U.S. 124, 126-27 (2006) (Breyer, J., dissenting) (noting that the phrase “promote the progress of science and useful arts” states the constitutional objective of patent law).} Courts have interpreted this to mean that the main

\footnote{Gottschalk, 409 U.S. at 67.}
\footnote{Parker, 437 U.S. at 589 (quoting Gottschalk, 409 U.S. at 67).}
\footnote{Id.}
\footnote{See Parker v. Flook, 437 U.S. 584 (1978); see also Gottschalk v. Benson, 409 U.S. 63, 67 (1972); Funk Bros. Seed Co. v. Kalo Inoculant Co., 333 U.S. 127, 130 (1948); O’Reilly v. Morse, 15 How. 62, 112-121 (1854); Le Roy v. Tatham, 14 How. 156, 175 (1853).}
underlying goal of patent law is to benefit the public rather than rewarding the inventor for his or her efforts.\textsuperscript{56} Granting exclusive rights to inventors in the form of patents is the method of incentivizing creative and innovative conduct, which ultimately benefits everyone by increasing the public storehouse of knowledge.\textsuperscript{57}

These exclusive rights, which are essentially property rights,\textsuperscript{58} may allow an inventor to operate in the marketplace in a privileged position.\textsuperscript{59} The inventor may be able to avoid direct competition with

\textsuperscript{56} In \textit{Quanta Computer, Inc. v. LG Elecs., Inc.}, 553 U.S. 617, 626 (2008), the court stated that the “primary purpose of our patent laws is not the creation of private fortunes for the owners of patents but is ‘to promote the progress of science and useful arts.’” This quoted language was reiterated approvingly in \textit{Bilski v. Kappos}, 130 S. Ct. 3218, 3252 n. 44 (2010) (Stevens, J., concurring). \textit{See also} Edward Rothstein, Connections; Swashbuckling Anarchists Try to Take the $ Out of Cyberspace, \textit{N.Y. TIMES}, June 10, 2000, at B1 (noting that courts have generally interpreted this constitutional clause to mean that the goal of patent law is to benefit the public rather than the inventor).

\textsuperscript{57} \textit{See generally} \textit{Bonito Boats v. Thunder Craft Boats}, 489 U.S. 141, 151 (1989) (“ultimate goal of the patent system is to bring new designs and technologies into the public domain through disclosure.”); \textit{see also} \textit{Seymour v. Osborne}, 78 U.S. 516, 533-34 (1871) (patents are granted to inventors to compensate them for their “labor, toil, and expense” which results in an invention beneficial to the public). In \textit{Kewanee v. Bicron}, 416 U.S. 470, 480 (1974), the Supreme Court said that, [t]he stated objective of the Constitution in granting the power to Congress to legislate in the area of intellectual property is to “promote the Progress of Science and useful Arts.” The patent laws promote this progress by offering a right of exclusion for a limited period as an incentive to inventors to risk the often enormous costs in terms of time, research, and development. The productive effort thereby fostered will have a positive effect on society through the introduction of new products and processes of manufacture into the economy, and the emanations by way of increased employment and better lives for our citizens. \textit{See also} \textit{Sears, Roebuck & Co. v. Stiffel Co.}, 376 U.S. 225, 229 (1964) (noting that patents are granted to encourage inventive activities). Arguably, if the patent law failed to produce a benefit for the public it could be determined to be unconstitutional and void. Nevertheless, the Supreme Court has indicated its willingness, at least in the context of copyright law, to defer to Congress with regard to whether copyright law benefits the public. \textit{See generally} \textit{Eldred v. Ashcroft}, 537 U.S. 186, 204-06 (2003). It is likely it would take a similar stance with regard to patent law because both patent and copyright laws are authorized by the same Constitutional provision. \textit{See U.S. CONST. art. I, § 8, cl. 8.}

\textsuperscript{58} 35 U.S.C. § 154(a)(1) (2006) (stating a patent grants “the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States, and, if the invention is a process, of the right to exclude others from using, offering for sale or selling throughout the United States, or importing into the United States, products made by that process. . .”).

\textsuperscript{59} \textit{Id.}
regard to the patented invention by being the exclusive producer of the invention.\(^{60}\) Alternatively, the inventor may allow others to make and use the invention in return for negotiated royalty payments.\(^ {61}\) Although this insulation from normal marketplace pressure is a necessary market interference, it is important that it does not unduly reduce investment in innovative and creative activities.\(^ {62}\) Therefore, the degree of interference must be adequate to incentivize the desired conduct without inhibiting others from engaging in innovative activities. Achieving this result is the balance that courts must accomplish in deciding which inventions are patent-eligible subject matter and which should be deemed ineligible.\(^ {63}\)

Although no reference to such a balance is expressly contained in the broad language of section 101, it is necessary for a court to interpret this section so that the statutory subject matter limitations are meaningful. Moreover, it can be argued that such a balance is mandated by the Constitution in order to achieve the goal of benefiting the public.\(^ {64}\) If the statutory categories are too broadly construed the potential exists for patent owners to have property rights in fundamental concepts that are too expansive to be the subject of property rights.\(^ {65}\) Such concepts are too valuable for anyone to own because such ownership could create economic barriers that would greatly inhibit others from engaging in creative endeavors that build

\(^{60}\) See generally JANICE MUELLER, PATENT LAW 8 (3d ed. 2009) (noting patent law is limited exception to free competition).

\(^{61}\) See AMY LANDERS, UNDERSTANDING PATENT LAW §1.06 16 (2d ed. 2012). It should be noted that “[t]he decision to grant or deny permanent injunctive relief is an act of equitable discretion by the district court, reviewable on appeal for abuse of discretion.” eBay Inc. v. MercExchange, L.L.C., 547 U.S. 388, 391 (2006). Therefore, patent infringement may result in the patent owner having exclusive rights in the market if the infringer is permanently enjoined from infringing or the patent owner may get damages for past infringement and payment of a royalty for future infringement. \(id.\) at 396 (“legal damages may well be sufficient to compensate for the infringement”).


\(^{63}\) Id. at 127 (noting courts must strike a balance between avoiding both overprotection and underprotection); See generally JANICE MUELLER, PATENT LAW 23-28 (3d ed. 2009) (providing cost/benefit analysis of patent law).

\(^{64}\) See U.S. CONST. art. I, § 8, cl. 8.

\(^{65}\) See generally Lab. Corp. of Am. Holdings, 548 U.S. at 126-28 (Breyer, J., dissenting) (2006) (noting that no one should own property rights in fundamental concepts such as laws of nature which are the basic tools of science).

\(^{66}\) See generally In re Chatfield, 545 F.2d 152, 157 (C.C.P.A. 1976) (“Some inventions, however meritorious, do not constitute patentable subject matter.”).
This would defeat the constitutional objective of promoting innovation. The exclusion of laws of nature, physical phenomena, and abstract ideas from patentable subject matter must be understood as an expression of this balance. Likewise, when courts have referred to mental processes, abstract principles, and fundamental truths as being exceptions to patentable subject matter, they are merely referring to the same balance. Often this balance is referred to by the oft-quoted black letter rule of law that ideas are not patentable but applications of ideas are patentable.

One way of thinking about these competing goals is to visualize a continuum as shown below in Fig. 1. At one end of the continuum is a potentially useful discovery. However, it is unknown how to implement or use the discovery such that it can produce a tangible and useful result. At the other end of the continuum is a fully developed and commercially viable device or method that uses the discovery to bring about a tangible and useful result.

---

68 See id. at 126-27.
69 See, e.g., Rubber-Tip Pencil Co. v. Howard, 87 U.S. 498, 507 (1874) (“An idea of itself is not patentable, but a new device by which it may be made practically useful is.”); see also GARY MYERS, PRINCIPLES OF INTELLECTUAL PROPERTY LAW ¶ 13.02 at 285 (2d ed. 2012) (“patentable subject matter does not include abstract ideas or theories, but only useful applications”). See generally Mackay Radio & Tel. Co. v. Radio Corp. of Am., 306 U.S. 86, 94 (1939) (“While a scientific truth, or the mathematical expression of it, is not patentable invention, a novel and useful structure created with the aid of knowledge of scientific truth may be.”).
70 See generally Brenner v. Manson, 383 U.S. 519 (1966) (disallowing a patent on a process, based on a lack of utility under section 101, even though the process worked because it produced a compound that had no known use at the time).
71 It should be noted that neither commercial viability nor actual construction of an invention is required to obtain a patent. See Joy v. Morgan, 295 F. 931, 935 (D.C. 1924). Filing a valid patent application that discloses enough information to enable a person of ordinary skill in the relevant art to make and use the invention is sufficient. Such disclosure is referred to as a constructive reduction to practice. See Eastman Kodak Co. v. E. I. DuPont de Nemours & Co., 298 F. Supp. 718, 725 (E.D. Tenn. 1969); see also Hybritech, Inc. v. Monoclonal Antibodies, Inc., 802 F.2d 1367, 1376 (Fed. Cir. 1986) (“constructive reduction to practice occurs when a patent application on the claimed invention is filed.”).
If undeveloped discoveries and abstract ideas were viewed as potentially patentable subject matter, it would arguably incentivize a certain amount of early stage research and development activity due to the significant potential economic value of such subject matter. It could be further argued that such incentivizing might be necessary to facilitate early stage research in capital-intensive areas of technology. If such early stage discoveries are ineligible for patent protection until they are developed into commercially viable products, that increases the economic risk and this may be a disincentive to devote resources to such activities.

Nevertheless, a counterargument is that allowing early stage discoveries and abstract ideas to be patent eligible may inhibit further research and development activities by others.

The Supreme Court has repeatedly indicated that early stage discoveries and abstract ideas should be viewed as “the basic tools of scientific and technological work” that should be free for everyone to utilize in order to prevent future innovation from being inhibited.
Hence, the Supreme Court has stated in multiple opinions that patent law must strike a balance between utilizing patents to incentivize innovation and avoiding granting patents that inhibit future innovation.77 The law’s goal is therefore to locate the optimum point on the continuum shown in Fig. 1, above, where the transition from unpatentable subject matter to patent-eligible subject matter is deemed to occur. The terms, “laws of nature,” “physical phenomena,” “abstract ideas,” “mental processes,” “abstract principles,” and “fundamental truths” have been used by the Supreme Court to identify subject matter deemed unpatentable.78 However, these terms can be viewed merely as conclusions that are applied to an invention after it has been deemed to fall outside the statutory categories in section 101.79 Although the Federal Circuit unsuccessfully attempted to adopt a specific controlling test—the machine-or-transformation test80—to determine patent eligibility of processes under section 101, the Supreme Court has taken a more flexible and open-ended approach. In contrast to the Federal Circuit, the Supreme Court has held that the machine-or-transformation test can be utilized, but it made clear that the test is not controlling81 and that other tests could also be used.82

77 See, e.g., Pfaff v. Wells Elecs., Inc., 525 U.S. 55, 63 (1998) (“[T]he patent system represents a carefully crafted bargain that encourages both the creation and the public disclosure of new and useful advances in technology, in return for an exclusive monopoly for a limited period of time. The balance between the interest in motivating innovation and enlightenment by rewarding invention with patent protection on the one hand, and the interest in avoiding monopolies that unnecessarily stifle competition on the other, has been a feature of the federal patent laws since their inception.”); see also Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141, 146 (1989) (“The Patent Clause itself reflects a balance between the need to encourage innovation and the avoidance of monopolies which stifle competition without any concomitant advance in the ‘Progress of Science and useful Arts.’”); Bilski, 130 S. Ct. at 3228 (“[T]he patent law faces a great challenge [today] in striking the balance between protecting inventors and not granting monopolies over procedures that others would discover by independent, creative application of general principles.”).

78 See, e.g., Lab. Corp. of Am. Holdings, 548 U.S. at 126 (Breyer, J., dissenting) (“The relevant principle of law ‘[e]xcludes from . . . patent protection . . . law of nature, natural phenomena, and abstract ideas.’”)

79 See Mark A. Lemley, Michael Risch, Ted Sichelman & R. Polk Wagner, Life after Bilski, 63 STAN. L. REV. 1315, 1317 (June 2011) (noting that the rule making abstract ideas unpatentable can be viewed as a rule against overclaiming by inventors).

80 In re Bilski, 545 F.3d 943, 954 (Fed. Cir. 2008) (stating that under the machine or transformation test “[a] claimed process is surely patent eligible under § 101 if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing.”).

81 Id. at 956 (stating that an invention was not a patent-eligible process under section 101, and “the machine-or-transformation test . . . is the governing test for continued . . .
Judge Linn adroitly summed up the state of the law with regard to patent-eligible subject matter in a recent Federal Circuit decision that addressed the meaning of abstract idea. Judge Linn stated:

The abstractness of the “abstract ideas” test to patent eligibility has become a serious problem, leading to great uncertainty and to the devaluing of inventions of practical utility and economic potential . . . . In Bilski, the Supreme Court offered some guidance by observing that “[a] principle, in the abstract, is a fundamental truth; an original cause; a motive; these cannot be patented, as no one can claim in either of them an exclusive right.” (citation omitted) This court has also attempted to define “abstract ideas,” explaining that “abstract ideas constitute disembodied concepts or truths which are not ‘useful’ from a practical standpoint standing alone, i.e., they are not ‘useful’ until reduced to some practical application.” (citation omitted) More recently, this court explained that the "disqualifying characteristic" of abstractness must exhibit itself "manifestly" "to override the broad statutory categories of patent eligible subject matter." (citation omitted) Notwithstanding these well-intentioned efforts and the great volume of pages in the Federal Reporters treating the abstract ideas exception, the dividing line between inventions that are directed to patent ineligible abstract ideas and those that are not remains elusive. "Put simply, the problem is that no one understands what makes an idea 'abstract.'" (citation omitted)\(^{83}\)

The theoretical backdrop for the question of what is and is not determining patent eligibility of a process under § 101.")}, *cert. granted*, 130 S. Ct. 3218, 3227, 3231 (2010) (upholding the conclusion of the Federal Circuit that the invention at issue was not statutory subject matter under section 101; however, noting, contrary to the Federal Circuit’s opinion, that the machine or transformation test could be utilized but that it was not the sole controlling test); *see Bilski*, 130 S. Ct. at 3235 (Stevens, J., concurring) (opining that although the machine-or-transformation test is not controlling it is still an effective test for evaluating the patent eligibility of most processes).

\(^{82}\) *See Bilski*, 130 S. Ct. at 3231 (“In disapproving an exclusive machine-or-transformation test, we by no means foreclose the Federal Circuit's development of other limiting criteria that further the purposes of the Patent Act and are not inconsistent with its text.”).

patent-eligible subject matter is both clear and logical in light of the balancing between competing policies enunciated by the Supreme Court. However, application of theory to specific factual scenarios is a challenge for lower courts in the absence of clear rules or tests. Nevertheless, courts will have to apply the legal theory on a case-by-case basis in an effort to produce the most equitable decision between competing parties. A consequence of this approach will be a lack of predictability, which is problematic.

IV. The Importance of Predictability

Patent law and law in general provide a framework of rules that facilitate an orderly society. This promotes marketplace conduct oriented to competitive activities for economic gain. This can only occur if the law demonstrates a high degree of predictability, which is necessary for economic decision making and future planning. Application of a variety of tests including the machine-or-transformation test, which are discussed below, to determine whether

---

84 See generally Miami Laundry Co. v. Fla. Dry Cleaning & Laundry Bd., 182 So. 759, 763-64 (Fla. 1938) (“Laws are nothing more than rules promulgated by government as a means to an ordered society.”); Baer v. Jarzombek, 153 Misc. 2d 351, 353 (Civ. Ct. City of N.Y. 1992) (Loft law enacted as an attempt to bring order to the confusing body of law for resolving landlord tenant disputes involving lofts). See generally Zunaira Zaki, Fiscal Cliff’ Worries Add to Jobless Woes, ABC NEWS CONSUMER REPORT (Dec. 3, 2012, 12:54pm) available at http://abcnews.go.com/blogs/business/2012/12/fiscal-cliff-worries-add-to-jobless-woes/ (noting effects of uncertainty on businesses caused by dispute between Congress and the President about how to modify the federal budget to avoid the so-called impending fiscal cliff); Hayden W. Gregory, Proving Infringement in Divided Performance Process Claims: Something’s Gotta Give, 5 LANDSLIDE vol. 2, at 1 (November/December 2012) (“The success and viability of any legal system is dependent upon its ability to provide stability and certainty while at the same time sufficient flexibility to adjust and adapt to changing conditions and needs.”).

85 See generally Ronald J. Colombo, Cooperation With Securities Fraud, 61 ALA. L. REV. 61, 117 (2009) (“Businessmen and businesswomen require clear and predictable laws in order to appropriately conduct themselves and their businesses.”); Christopher Guzelian, True and False Speech, 51 B.C. L. REV. 669, 672 (2010) (noting some commentators have asserted that it is important for law to be predictable so that consequences of one’s actions can be known in advance); Jill Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. CIN. L. REV. 1061, 1070 (2000) (“Commentators have observed that, with respect to business transactions, it is often more important that the applicable legal rules be settled than that they be settled correctly.”). See generally Bilski, 130 S. Ct. at 3231 (Stevens, J., concurring) (“In the area of patents, it is especially important that the law remain stable and clear.”).

86 In Bilski v. Kappos, 130 S. Ct. 3218, 3231 (2010), the Court seemed to be giving the Federal Circuit express permission to develop new tests to be used in...
a particular innovation is statutory subject matter under section 101 has the advantage of some degree of predictability. Certainly it will produce a more predictable result than the Supreme Court’s open-ended approach. In light of the many years that courts have struggled with this issue, the Court’s open-ended approach can arguably be viewed as a quest to find the perfect test. Unfortunately, it is an imperfect world, so a quest for the perfect test amounts to an attempt to attain the unattainable. In light of this, the machine-or-transformation test and the additional suggested tests discussed below, although imperfect, may represent the best possible approach for providing some degree of certainty or predictability.

Arguably, use of the machine-or-transformation test and the other tests suggested below may cause certain problems. First, the tests have the potential to draw somewhat arbitrary lines, which might result in some inventions that should be deemed patent-eligible subject matter being found to be outside the domain of statutory subject matter. Alternatively, some inventions that are not patent eligible may be found eligible. Second, it may have a disproportionate effect on some industries that rely more on patent protection than other industries. Finally, it may lead to unreasonable or unfair results under certain circumstances. None of these concerns are limited to statutory subject matter issues. These concerns arise in many areas of the law including under other provisions of the patent law.

For example, an invention that is deemed statutory subject matter must also be found to be new or novel to be patentable. One requirement of novelty is that no printed publications publicly available anywhere in the world disclose that a third party previously invented the same invention. Courts have applied a somewhat rigid conjunction with, or in lieu of, the machine-or-transformation test when it stated “[i]n disapproving an exclusive machine-or-transformation test, we by no means foreclose the Federal Circuit’s development of other limiting criteria that further the purposes of the Patent Act and are not inconsistent with its text.”

87 See generally In re Chatfield, 545 F.2d 152, 161 (C.C.P.A. 1976) (Rich, J., dissenting) (noting at a time when patent eligibility of software was unsettled that having settled law on this was an important socioeconomic issue of great magnitude).

88 For example, in Herbert Hovenkamp, Empire: Innovation and the Domain of Competition Policy, 60 ALA. L. REV. 103, 124-25 (2008), the author notes that the pharmaceutical industry favors strong patents; but the high tech industry, which is largely made up of software companies, favors weak patents. See generally Robert Mazzoleni & Richard Nelson, The Benefits and Costs of Strong Patent Protection, 27 RESEARCH POLICY 273, 281 (1998) (noting differing economic effect of patent law on different areas of technology).


90 Previously, Patent Law section 35 U.S.C. § 102(a) (2006) provided that an...
test, which can result in unfair results, at least from a reasonableness perspective. Typically, a public accessibility standard applies today.\textsuperscript{91} For example, under this test most documents that are properly indexed in a paper card catalogue at the library or in a modern computerized catalogue are considered prior art if they could be reasonably discovered by searching the paper or electronic catalogues. This applies despite the fact that it is unreasonable to expect an inventor to search every library catalogue for relevant printed publications. An obscure publication that few people are aware exists could potentially bar an inventor from obtaining a patent on an invention he or she spent substantial time, effort, and money developing. Likewise, such an obscure reference may never be discovered and a patent may be issued to a person who is not in fact the first inventor. Applying a reasonableness standard such that only printed publications that an inventor could reasonably be expected to find would produce a fairer result. However, such a reasonableness standard would produce uncertainty. One might explain rejection of such a standard as an effort to inject predictability into the process of determining novelty. Alternatively, this strict standard can be viewed as a balance between granting an inventor a patent on his or her innovation and the importance of preventing public domain subject matter from being removed from the public domain by issuance of a patent for a previously known invention.\textsuperscript{92} Strict judicial application of this rule suggests courts strongly favor protecting the public storehouse of knowledge from being diminished.

Novelty can also be negated by public use of an invention.\textsuperscript{93}

\textsuperscript{91}In re Hall, 781 F.2d 897, 898-99 (Fed. Cir. 1986); see also In re Klopfenstein, 380 F.3d 1345, 1347, 52 (Fed. Cir. 2004) (slide presentation of 14 slides which were printed and pasted onto poster boards, and made accessible to the public for several days was held to be a printed publication).

\textsuperscript{92}See AMY LANDERS, UNDERSTANDING PATENT LAW §14.02[B][2], at 188 (2d ed. 2012) (publicly accessible printed publications are in the public domain and therefore they cannot removed from the public domain and made private property via granting a patent).

\textsuperscript{93}Previously, under 35 U.S.C. § 102(b) (2006), an invention was not patentable if “the invention was . . . in public use . . . more than one year prior to the date of the application for patent in the United States . . . .” Effective March 16, 2013, recodified as 35 U.S.C. § 102(a)(1) (Supp. V 2012), an invention will not be
Courts have strictly interpreted public use such that it is triggered when an inventor reveals his invention to a single person who never discloses or tells anyone else about the invention.\footnote{94} Placing an invention on sale may also destroy novelty.\footnote{95} A single prior sale of an invention satisfies the on-sale bar.\footnote{96} Again, it can be argued that the above results strongly favor predictability even if the result may be viewed as unreasonable or unfair in some circumstances.

The goal of predictability, even if it trumps reasonableness or fairness in some situations, is not limited to patent law. Assume, for example, that Amy leaves her watch at a store that both fixes watches and sells used watches. Inadvertently, her watch is sold to Bob who entered the store looking to buy a used watch. At common law, Amy’s ownership rights would enable her to recover the watch from Bob.\footnote{97} However, under Article Two of the Uniform Commercial Code,\footnote{98} adopted by most states, Bob would typically become the owner of the watch,\footnote{99} and Amy’s only recourse would be a suit for damages against the store.\footnote{100} This result is unfair because it improperly deprives Amy of her property, and it places the burden of patentable if the invention was “in public use . . . before the effective filing date of the claimed invention . . . .” The previous 35 U.S.C. § 102(b) (2006) will continue to be applicable to applications filed prior to March 16, 2013, and applications filed on or after March 16, 2013 will be governed by § 102(a)(1) (Supp. V 2012).

\footnote{94} See Egbert v. Lippmann, 104 U.S. 333, 336 (1881); see also Watson v. Allen, 254 F.2d 342, 345 (D.C.C. 1958) (“[P]ublic use exists where the invention is used by, or exposed to, anyone other than the inventor or persons under an obligation of secrecy to the inventor.”).

\footnote{95} Previously, under 35 U.S.C. § 102(b) (2006), an invention was not patentable if “the invention was . . . on sale in this country, more than one year prior to the date of the application for patent in the United States . . . .” Effective March 16, 2013, recodified as 35 U.S.C. § 102(a)(1) (Supp. V 2012), an invention will not be patentable if the invention was “on sale . . . before the effective filing date of the claimed invention . . . .” The previous law will continue to be applicable to applications filed prior to March 16, 2013, and applications filed on or after March 16, 2013 will be governed by § 102(a)(1) (Supp. V 2012).

\footnote{96} Pfaff v. Wells Elecs., Inc., 525 U.S. 55, 67-68 (1998) (applying the on-sale bar to an invention subject to a commercial offer of sale when it was ready for patenting).

\footnote{97} See generally Beverage Prods. Corp. v. Robinson, 769 S.W.2d 424, 425 (Ark. Ct. App. 1989) (citing RALPH BOYER, SURVEY OF THE LAW OF PROPERTY 712-13 (3d ed. 1981)) (noting the common law rule that a seller cannot convey better title to a purchaser than that which he had).


\footnote{99} See U.C.C. § 2-403(2) (2003); see generally BOYER, supra note 97 (explaining how U.C.C. § 2-403 alters the common law by allowing a buyer, under certain circumstances, to acquire a better title than seller had to sell).

\footnote{100} See U.C.C. § 2-403(2) (2003).
bringing legal action for compensation on her. Nevertheless, this allows a shopper purchasing goods in good faith and in the ordinary course of business to assume the store has ownership of the goods it is selling. This eliminates placing the burden on shoppers to verify ownership of goods purchased in commonplace retail transactions, which would make such transactions cumbersome and consequently more costly. This bright-line or predictable rule codified in the Uniform Commercial Code favors societal interests over an individual’s property rights.

Recording statutes in many states likewise enable a non-owner to deprive a true owner of rights in real estate under certain circumstances. For example, in a jurisdiction that has a notice recording statute in effect, a bona fide purchaser of real estate from a non-owner of the real estate may have superior rights to the true owner if the true owner failed to record his or her ownership rights. This is true even though such recording is generally not required. A

101 See generally Deweldon, Ltd. v. McKean, 125 F.3d 24, 28 (1st Cir. 1997) (“It shifts the risk of resale to the one who leaves his property with the merchant.”).

102 See id. at 27 (explaining section 2-403(2) “is designed to enhance the reliability of commercial sales by merchants who deal in the kind of goods sold”). See also Patricia Youngblood Reyhan, A Chaotic Palette: Conflict of Laws in Litigation Between Original Owners and Good-Faith Purchasers of Stolen Art, 50 DUKE L.J. 955, 973-76 (2001).

103 See Johnson & Johnson Prods., Inc. v. Dal Int'l Trading Co., 798 F.2d 100, 104 (3rd Cir. 1986) (“The purpose of the good faith purchaser doctrine [codified in U.C.C. section 2-403] . . . is to promote commerce by reducing transaction costs; it allows people safely to engage in the purchase and sale of goods without conducting a costly investigation of the conduct and rights of all previous possessors in the chain of distribution.”).

104 See generally Boyer, supra note 97 (noting that U.C.C. section 2-403 represents “a valued judgment that security of transactions under [certain] circumstances . . . was more important than the protection of the innocent owner”).

105 See generally JESSE DUKEMINIER, JAMES E. KRIER, GREGORY S. ALEXANDER & MICHAEL H. SCHILL, PROPERTY 646-47 (7th ed. 2010) (explaining that at common law, the first-in-time buyer owns real estate even if he or she does not record the deed, but a subsequent bona fide purchaser may have superior rights to the buyer under an applicable recording statute).

106 “[T]he term ‘bona fide purchaser’ . . . is generally understood to mean ‘[o]ne who has purchased property for value without notice of any defects in the title of the seller.’” U.S. v. Watkins, 320 F.3d 1279, 1283 (11th Cir. 2003) (quoting In re Walter, 45 F.3d 1023, 1030 (6th Cir. 1995)). See generally WILLIAM B. STOEBUCK & DALE A. WHITMAN, THE LAW OF PROPERTY § 11.10, at 882-89 (3d ed. 2000) (discussing the different types of notice, which can include actual, constructive, or inquiry notice).

107 JOSEPH WILLIAM SINGER, PROPERTY § 11.4.5.2, at 538 (3d ed. 2010).

108 See id. § 11.4.5.1, at 538 (explaining that recording of deed is not required for property transfer to be valid in almost all states).
similar result occurs for a transfer of ownership rights in a patent in light of the recording statute contained in the patent law. Analogous to the rationale for section 2-403, discussed above, the bona fide purchaser rules for real estate and for patents insure the existence of vibrant markets by enabling buyers to have confidence they own the property purchased free of prior claims.

The concept of constructive notice also creates a predictable rule with regard to whether a person has knowledge of many publicly available documents such as land transfers, corporate records, liens, financing statements recorded pursuant to Uniform Commercial Code Article 9, federal trademark registrations, issued patents, and many other public records. Under this concept a person is held to have notice of all of these documents without regard to whether he or she actually has such notice. This may be unfair in some situations, but it promotes certainty and predictability by encouraging and enabling interested parties to rely on the validity of such documents, which facilitates transactions by reducing transactions costs.

The common law tort doctrine of vicarious liability shifts tort liability to an employer under certain circumstances. Generally, it

---

109 35 U.S.C. § 261 (2006) (“An assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage.”). See generally Filmtec Corp. v. Allied-Signal Inc., 939 F.2d 1568, 1573-74 (Fed. Cir. 1991) (noting that section 261 utilizes the same underlying concept as a state real property recording statute).


111 Schoedel v. State Bank of Newburg, 13 N.W.2d 534, 535 (Wis. 1944) (“[C]onstructive notice is in point of literal fact neither notice nor knowledge. For the promotion of sound policy or purpose, the legal rights and interests of parties are treated as though they had actual notice and knowledge.”).


114 35 U.S.C. § 287(a) (2006) (explaining that affixing the word “patent” or “pat” along with the patent number puts the public on notice of the patent).

115 See BLACK’S LAW DICTIONARY 1088 (7th ed. 1999).

116 See generally Schoedel v. State Bank of Newburg, 13 N.W.2d 534, 535 (Wis. 1944) (explaining that constructive notice is a legal fiction which ascribes notice to someone without regard to whether he or she has actual notice).

renders an employer liable for negligent conduct of an employee when the employee negligently injures a third party in the course of employment. This rule applies without regard to any culpability on the part of the employer. Likewise, banks are typically liable for forged checks and fraudulent use of credit cards by a third party via statute, without regard to whether the bank has any culpability. In each of these cases, the law makes a policy-based risk allocation between the bank and an innocent customer. Although such non-culpability-based risk allocation in the above examples is arguably unfair, it allows a business enterprise to plan accordingly for risk by setting aside funds or purchasing insurance. Such a predictable result is preferable to having an unknown, non-quantifiable monetary risk for which is it difficult to plan.

In contrast to promoting predictability, in some situations the law favors a reasonable result when insuring a fair or equitable outcome is more important than achieving predictability. Generally, this approach is heavily fact-based and applies on a case-by-case basis rather than broadly to a class of relationships or transactions, minimizing any potential externalities. For example, a valid and binding contract requires the existence of consideration. Nevertheless, under the doctrine of promissory estoppel, a contract lacking consideration may be enforced against a party who engaged in certain actions that lead another reasonable person to rely on such actions to his or her detriment. Similar estoppel doctrines exist in other areas of law


119 See Carter v. Reynolds, 815 A.2d 460, 463 (N.J. 2003) (“Although as a general rule of tort law, liability must be based on personal fault, the doctrine of respondeat superior recognizes a vicarious liability principle pursuant to which a master will be held liable in certain cases for the wrongful acts of his servants or employees.”).


121 See Lost or Stolen Credit, ATM, and Debit Cards, FED. TRADE COMM’N, http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre04.shtm (last visited Mar. 24, 2013) (“Your maximum liability under federal law for unauthorized use of your credit card is $50.”).


such as easement by estoppel, agency by estoppel, and corporation by estoppel.

In the context of patent infringement, some aspects of a literal infringement analysis are applied in a somewhat mechanical or predictable fashion. For example, a finding of literal infringement of a typical claim requires that every limitation contained in the claim must exist in the infringing device or method. Consider the following patent claim:

1. A sealed crustless sandwich, comprising:
   a first bread layer having a first perimeter surface coplanar to a contact surface;


An easement is a real property interest, which means it is subject to the statute of frauds and therefore requires a written document to be created. See Gerald Korgold, Private Land Use Arrangements: Easements, Real Covenants and Equitable Servitudes § 3.04(a), at 33 (2d ed. 2004). A license is a personal right that is freely revocable. Id. § 3.05(c), at 39. However, a licensee who improves the property by building a road and house on it, relying on the license to his or her detriment, may be able to assert an estoppel argument to bar the license from being revoked. The result is essentially the equivalent of an easement that arises from estoppel in lieu of a writing. See id. § 3.05, at 36-39; Holbrook v. Taylor, 532 S.W.2d 763 (Ky. 1976).

Agency by estoppel is an equitable theory under which someone who is not an agent can be held to be an agent of a person who holds out that individual as such, thereby inducing a third party’s reliance. Battle v. Seibels Bruce Ins. Co., 288 F.3d 596, 603 (4th Cir. 2002). See also Cram v. B.I.M., 200 A.2d 33 (Md. 1964) (holding that the creditor of corporation was estopped from asserting that the corporation did not exist when contract with corporation was signed, in light of the fact that the creditor erroneously dealt with the debtor as if it were a corporation at the time the contract was signed).

See also Craig Allen Nard, The Law of Patents 452 (2d ed. 2011). See also Larami Corp. v. Amron, No. CIV. A. 91-6145, 1993 WL 69581, at *3 (E.D. Pa. Mar. 11, 1993) (no infringement if any element of the claim is absent from the allegedly infringing invention) (citation omitted).
at least one filling of an edible food juxtaposed to said contact surface;
a second bread layer juxtaposed to said at least one filling opposite of said first bread layer, wherein said second bread layer includes a second perimeter surface similar to said first perimeter surface;
a crimped edge directly between said first perimeter surface and said second perimeter surface for sealing said at least one filling between said first bread layer and said second bread layer;
wherein a crust portion of said first bread layer and said second bread layer has been removed.\textsuperscript{130}

If every aspect of the above claim is copied except that the crust is not removed from the bread, the claim is not literally infringed because one limitation contained in the claim—removing the crust from the bread—was omitted.\textsuperscript{131}

The following claim describes a system for tracking clothing in a dry cleaning business. Assume every aspect of the claim is copied except that a laser printer is used in lieu of a dot matrix printer. Paragraph three of the claim specifically limits the system to using a dot matrix printer so using a laser printer avoids a finding of literal infringement.

1. The inventory control and reporting system, comprising:
   a data input device for manual operation by an attendant, the input device having switch means operable to encode information relating to sequential transactions, each of the transactions having articles associated therewith, said information including transaction identity and descriptions of each of said articles associated with the transactions;
   a data processor including memory operable to record said information and means to maintain an inventory total, said data processor having means to associate sequential transactions with unique sequential indicia and to generate at least one report of said total and said transactions, the unique sequential indicia and

\textsuperscript{130} U.S. Patent No. 6,004,596 (filed Dec. 08, 1997) (issued Dec. 21, 1999).
\textsuperscript{131} See London v. Carson Pirie Scott & Co., 946 F.2d 1534, 1539 (Fed. Cir. 1991) (“There can be no infringement as a matter of law if a claim limitation is totally missing from the accused device.”) (citation omitted). See also NARD, supra note 129, at 456.
the descriptions of articles in the sequential transactions being reconcilable against one another;

a dot matrix printer operable under control of the data processor to generate a written record of the indicia associated with sequential transactions, the written record including optically-detectable bar codes having a series of contrasting spaced bands, the bar codes being printed only in coincidence with each said transaction and at least part of the written record bearing a portion to be attached to said articles; and,

at least one optical scanner connected to the data processor and operable to detect said bar codes on all articles passing a predetermined station, whereby said system can detect and localize spurious additions to inventory as well as spurious deletions therefrom.\(^\text{132}\)

Nevertheless, the Supreme Court created an equitable doctrine called the doctrine of equivalents,\(^\text{133}\) which allows, under certain circumstances, a determination that an accused device is infringing even though it is literally not covered by a claim.\(^\text{134}\) This doctrine, which lacks any statutory support under the patent law\(^\text{135}\) and conflicts with the notice function of claims,\(^\text{136}\) has been justified by the Court in order to insure that patent claims are not interpreted so narrowly that a disincentive exists to file patents.\(^\text{137}\)

Such a consequence would be inimical to the public interest.

\(^\text{132}\) This claim was involved in an appeal in Markman v. Westview Instruments, Inc., 52 F.3d 967, 972 (Fed. Cir. 1995), aff’d, 517 U.S. 370 (1996).

\(^\text{133}\) See Mueller, supra note 28, at 351 (noting the “doctrine of equivalents is entirely judge-made law”).

\(^\text{134}\) See Warner-Jenkinson Co. v. Hilton Davis Chem. Co., 520 U.S. 17, 21 (1997) (“Under this doctrine [of equivalents], a product or process that does not literally infringe upon the express terms of a patent claim may nonetheless be found to infringe if there is ‘equivalence’ between the elements of the accused product or process and the claimed elements of the patented invention.”). See also Landers, supra note 11, § 29.08, at 385.

\(^\text{135}\) See Mueller, supra note 28, at 351 (stating “the doctrine of equivalents is entirely judge-made law”).

\(^\text{136}\) Warner-Jenkinson Co., 520 U.S. at 29 (noting conflict between notice function of claims and the doctrine of equivalents). See also Mueller, supra note 28, at 353 (noting tension between notice of equivalents and notice function of patent claims).

Under this doctrine, a court might find the above claim infringed if a laser printer was used in lieu of a dot matrix printer even if the laser printer was not invented until after the patent containing the above claim was granted.\footnote{Literal infringement is evaluated at the time a patent application was filed. Infringement under the doctrine of equivalents is determined at the time of infringement. Therefore, technology that exists at the time of infringement can be an equivalent element or limitation under the doctrine even if it did not exist at the time of filing. NARD, supra note 129, at 476-78.} The important question to address with regard to statutory subject matter under Patent Law section 101 is whether a predictable rule or an equitable rule should be applied.

\section*{V. Predictability and Statutory Subject Matter}

The importance of predictability in patent law jurisprudence is clear.\footnote{See generally Bilski v. Kappos, 130 S. Ct. 3218, 3231 (2010) (Stevens, J., concurring) (“In the area of patents, it is especially important that the law remain stable and clear.”).} Patents are typically commercial documents that affect the viability of business enterprises in diverse ways. This can include raising capital, prioritizing research, and developing budgets and general business planning.\footnote{See generally LANDERS, supra note 11, § 1.06, at 15-16 (2d ed. 2012) (discussing how patent owners use patents).} The flexible or open-ended approach adopted by the Supreme Court with regard to determining what is or is not statutory subject matter negatively impacts predictability. Both the Federal Circuit\footnote{In CLS Bank Int’l v. Alice Corp. Pty., 685 F.3d 1341, 1348-49 (Fed. Cir. 2012), vacated and reh’g en banc granted, CLS Bank Int’l v. Alice Corp. Pty. Ltd., No. 2011-1301, 2012 U.S. App. LEXIS 20906 (Fed. Cir. 2012), the court stated, “The abstractness of the ‘abstract ideas’ test to patent eligibility has become a serious problem, leading to great uncertainty and to the devaluing of inventions of practical utility and economic potential.”} and commentators have noted that lack of predictability produces uncertainty that is problematic.\footnote{Donald S. Chisum, Weeds and Seeds in the Supreme Court’s Business Method Patents Decision: New Directions for Regulating Patent Scope, 15 LEWIS & CLARK L. REV. 11, 14 (2011) (explaining that current statutory subject matter law can lead to arbitrary and unpredictable results, which can cause uncertainty that “does substantial harm to the effective operation of the patent system”); See Lemley, supra note 79, at 1316 (noting that “the problem is that no one understands what makes an idea ‘abstract,’ and hence ineligible for patent protection”).} Nevertheless, adoption of predictable or bright-line rules may create some unintended issues. Such rules may over- or under-include appropriate subject matter; they might produce unfair results in certain situations and they may have disparate effects on different industries. However, on balance, the benefits of predictability outweigh these
potential negative effects for a variety of reasons.

First, only a small number of patent disputes have historically involved statutory subject matter under section 101.\textsuperscript{143} It is typically not an issue with regard to product claims.\textsuperscript{144} Today, the issue seems to arise most commonly in a limited number of disputes involving method claims for medical diagnostic tests\textsuperscript{145} and for methods of doing business.\textsuperscript{146} And, even in cases where it does arise, the invention at issue will often be denied patent protection based on obviousness, lack of novelty, or failure to satisfy various disclosure requirements. In light of this, the Federal Circuit has stated:

District courts have great discretion to control the conduct of proceedings before them, including the order of presentation of issues and evidence and the sequence of events proscribed by the Federal Rules and leading up to judgment. See, e.g., Amado v. Microsoft Corp., 517 F.3d 1353, 1358 (Fed. Cir. 2008) ("District courts . . . are afforded broad discretion to control and manage their dockets, including the authority to decide the order in which they hear and decide issues pending before them."). Although § 101 has been characterized as a “threshold test,” (citation omitted) [by the Supreme Court], and certainly can be addressed before other matters touching the validity of patents, it need not

\textsuperscript{143} See generally NARD, supra note 129, at 476-78 (stating the statutory subject matter requirement has not historically been a major impediment to obtaining patent protection).

\textsuperscript{144} Nevertheless, in In re Nuijten, 500 F.3d 1346, 1348 (Fed. Cir. 2007), the court found a claim to an electronic signal, which was arguably a product claim, was not patent-eligible subject matter under section 101.


\textsuperscript{146} See, e.g., Bilski v. Kappos, 130 S. Ct. 3218, 3231 (2010) (discussing a method of hedging financial risk in the commodities market); CLS Bank Int’l, 685 F.3d at 1343 (discussing method and product claims for a trading platform that minimizes settlement risk when exchanging financial obligations); In re Comisky, 554 F.3d 967, 970 (Fed. Cir. 2009) (discussing method and product claims for an arbitration system).
always be addressed first, particularly when other sections might be discerned by the trial judge as having the promise to resolve a dispute more expeditiously or with more clarity and predictability. (citation omitted) Thus, consistent with its role as the master of its own docket, a district court properly acts within its discretion in deciding when to address the diverse statutory challenges to validity.\textsuperscript{147}

Therefore, in some disputes it may be advisable for a court to initially evaluate a patent or patent application under Patent Law sections 102,\textsuperscript{148} 103,\textsuperscript{149} and 112.\textsuperscript{150} Only if the invention passes muster under these sections should a statutory subject matter analysis be undertaken.\textsuperscript{151} This would minimize the instances of invoking section 101 because it would typically only be relevant in the limited number of cases where the discovery at issue is novel, nonobvious, and has utility\textsuperscript{152} in addition to satisfying the enablement,\textsuperscript{153} written description,\textsuperscript{154} and definiteness\textsuperscript{155} requirements.

This approach is not unique to patent law. It is commonplace for courts to avoid a difficult issue if a dispute can be resolved by resorting to an alternate issue.\textsuperscript{156} Such avoidance is often appropriate

\textsuperscript{147} CLS Bank Int'l, 685 F.3d at 1348. See generally Bilski, 130 S. Ct. at 3225 (explaining that to be patentable an invention must be patent eligible under section 101 in addition to satisfying Patent Law sections 102, 103 and 112).


\textsuperscript{151} Graham v. John Deere Co. of Kansas City, 383 U.S. 1, 14 (1966).


\textsuperscript{153} The enablement requirement, which is contained in 35 U.S.C. § 112(a), is satisfied if the patent discloses sufficient information so that a person of ordinary skill in the relevant technology can make and use the invention without having to engage in undue experimentation. See MagSil Corp. v. Hitachi Global Storage Techs., 687 F.3d 1377, 1380 (Fed. Cir. 2012).

\textsuperscript{154} The written description requirement, which is contained in 35 U.S.C. § 112(a), is satisfied if the patent discloses sufficient information to show that the inventor was in possession of the claimed invention at the time the patent application was initially filed. See Crown Packaging Tech., Inc. v. Ball Metal Bev. Container Corp., 635 F.3d 1373, 1380 (Fed. Cir. 2011).

\textsuperscript{155} Section 112 states that the patent shall include “one or more claims particularly pointing out and distinctly claiming the subject matter which the inventor or a joint inventor regards as the invention.” 35 U.S.C. § 112(b) (2006). This is commonly referred to as the definiteness requirement. See NovelPoint Learning LLC v. Leapfrog Enters., Inc., No. 6:10-cv-229 JDL, 2012 U.S. Dist. LEXIS 24701, at *6-7 (E.D. Tex. 2012). See also Noah Sys. Inc. v. Intuit Inc., 675 F.3d 1302, 1311 (Fed. Cir. 2012).

\textsuperscript{156} See, e.g., Monroe v. Rawlings, 49 N.W.2d 55, 55 (Mich. 1951) (resolving continued . . .
property dispute under an adverse possession theory so the court did not need to decide the validity of a tax deed); Van Sandt v. Royster, 83 P.2d 698, 703 (Kan. 1938) (stating it was unnecessary to address prescription issue because case resolved based on finding creation of an easement by implication). See generally Cummings v. Conglobal Indus., No. 07-CV-409-TCK-SAJ, 2008 U.S. Dist. LEXIS 81967, at *7-8 (N.D. Okla. 2008) (explaining that federal courts should avoid deciding constitutional law issues if alternate grounds exist to resolve the dispute).

157 Graver Tank & Mfg. Co. v. Linde Air Prods. Co., 339 U.S. 605, 607-09 (1950) (explaining that infringement can be asserted even if there is no literal infringement when the allegedly infringing device "performs substantially the same function [as the patented invention] in substantially the same way to obtain the same result"). See also Warner-Jenkinson Co. v. Hilton Davis Chem. Co., 520 U.S. 17, 21 (1997) (citing Graver Tank & Mfg. Co. and reaffirming the validity of the doctrine of equivalents).

158 See Graver Tank & Mfg. Co., 339 U.S. at 607 (noting that without the doctrine of equivalents, a copyist may be able to easily avoid literal infringement with a minor change and this would facilitate concealing an invention which is contrary to the one of the goals of the patent law which is public disclosure of patented inventions).

absent.  

This doctrine, which the Court characterized as equitable in nature, creates uncertainty because literally inventing around a claim will not insure avoidance of infringement. The doctrine essentially created a gray area which was bounded on one end by the literal claim limitations but potentially unbounded on the other end. Such uncertainty or lack of predictability, as noted earlier, is an undesirable aspect of a legal system. However, rather than abandon the judicial doctrine of equivalents, the Supreme Court and the Federal Circuit have slowly evolved specific rules that provide limits on the doctrine so that its scope is somewhat more predictable. The end result is a set of bright-line rules that provide some limits on how far beyond literal infringement a claim can be stretched under the doctrine of equivalents. Nevertheless, like any rule of law that balances competing interests or policies, a zone of uncertainty exists. This is unavoidable and should not be a basis for rejecting use of a bright-line rule to ascertain statutory subject matter under section 101.

Finally, the disparate effect of the patent law on different industries has long been an issue. Industries such as pharmaceuticals, which typically rely on one or two patents from internal research and

---

160 See, e.g., Graver Tank & Mfg. Co., 339 U.S. at 612 (finding infringement based on the doctrine of equivalents, despite finding no literal infringement). See generally LANDERS, supra note 11, § 29.01, at 372-73 (noting the balance between preserving an incentive to seek patents with the public notice function of a patent which underlies the patent system).


162 See id. at 730-31 (explaining that clear patent claim boundaries promote efficient investment in technology).

163 In Festo Corp., 535 U.S. at 733-38, the Court noted that the doctrine of prosecution history estoppel bars a patentee from using the doctrine of equivalents in an infringement action to recapture any part of the claim’s scope that was surrendered or abandoned during prosecution via amendment, in order to overcome objections to patentability. In Johnson & Johnson Assocs., Inc. v. R.E. Serv. Co., 285 F.3d 1046, 1054 (Fed. Cir. 2002) (en banc), the court stated that “when a patent drafter discloses but declines to claim subject matter . . . this action dedicates that unclaimed subject matter to the public” and it cannot be recaptured with the doctrine of equivalents. This is generally referred to as the public dedication rule. NARD, supra note 129, at 494. In Wilson Sporting Goods Co. v. David Geoffrey & Assocs., 904 F.2d 677, 684 (Fed. Cir. 1990), the court noted that the doctrine of equivalents could not be used to capture prior art. In Scimed Life Sys., Inc. v. Advanced Cardiovascular Sys., Inc., 242 F.3d 1337, 1345-46 (Fed. Cir. 2001), the court held that if the specification expressly or impliedly excludes something from a claim it cannot be recaptured by the doctrine of equivalents. This is referred to as the specific exclusion rule. NARD, supra note 129, at 502. Finally, the all limitations rule is applied so that each limitation in a claim must have a literal or equivalent element in the allegedly infringing device. Warner-Jenkinson Co. v. Hilton Davis Chem. Co., 520 U.S. 17, 29 (1997).
development activities to protect a drug, favor strong patents.\textsuperscript{164} In contrast, other industries, such as technology and software companies, which produce products that rely on a multitude of patents—many of which must be licensed from third parties—prefer a weaker patent system.\textsuperscript{165} This issue is not limited to patent law. Typically, any law of general application has the potential to cause this problem. The only potential solution is to enact specific subject-based legislation in lieu of laws of general application. This is unlikely to occur in patent law, whose basic concepts have remained largely unchanged for a long time.\textsuperscript{166} Additionally, it is doubtful that law would evolve quickly enough to keep pace with rapid changes in technology. Hence, this should likewise not be a reason to reject bright-line rules for determining what is or is not statutory subject matter because the various industries will likely develop marketplace adaptations.


\textsuperscript{165} See id. at 125 (noting that high tech industry, which is largely made up of software companies, favors weak patents).


\section*{VI. Proposed Tests in Addition to the Machine-or-Transformation Test}

In \textit{Bilski} the Supreme Court approved of the machine-or-transformation test, provided it was not used as the sole or controlling test to ascertain whether a process was patent-eligible subject matter.\footnote{Bilski v. Kappos, 130 S. Ct. 3218, 3227 (2010) ("This Court's precedents establish that the machine-or-transformation test is a useful and important clue, an investigative tool, for determining whether some claimed inventions are processes under § 101. The machine-or-transformation test is not the sole test for deciding whether an invention is a patent-eligible 'process.'").} In lieu of relying on this test the Court held that the claimed method of hedging was an abstract idea, which was not patent-eligible subject matter.\footnote{Id. at 3230.} Additionally, the Court noted that one of the claims at issue reduced the concept of hedging to a mathematical formula, which is not patent-eligible subject matter.\footnote{Id. at 3231.} The Court also stated that "[a]llowing petitioners to patent risk hedging would pre-empt use of this approach in all fields, and would effectively grant a monopoly over an abstract idea."\footnote{Id.} Arguably, the Court’s statements effectively create two tests in addition to the machine-or-transformation test: (a) mathematical formulas are not patent eligible (hereinafter the "equation test"), and (b) the preemption test.\footnote{See id. (holding that hedging is a mathematical formula that is not patent eligible, and that allowing patent protection would preempt the field and monopolize an abstract idea).} This raises two questions: (1) whether the machine-or-transformation test, the equation test, and the preemption test will produce predictable results,\footnote{See generally id. at 3227 (suggesting that use of the machine-or-transformation test could have a negative effect on technology such as software and diagnostic medical tests because it could make patentability of such inventions uncertain).} and (2) whether additional tests should be used in lieu of or
in addition to these tests. Arguably, the Bilski Court approves of the Federal Circuit developing additional tests.

A. Statement of the Machine-or-Transformation Test

Under the machine-or-transformation test, a process is statutory subject matter under Patent Law section 101 if either of the following applies: (1) the claim is tied to a particular machine; or (2) the claim transforms an article. Additionally, two limitations apply. First, “the use of a specific machine or transformation of an article must impose meaningful limits on the claim's scope to impart patent-eligibility” (hereinafter “preemption rule”). This is sometimes referred to as the preemption test. Second, “the involvement of the machine or transformation in the claimed process must not merely be insignificant extra-solution activity” (hereinafter “insignificant limitation rule”).

Legal rules cannot be properly applied in a vacuum. They can only be applied in light of the underlying reasons that justify the rule. The machine-or-transformation test represents an attempt to identify where on the innovation continuum, shown above in Fig. 1, the claimed invention falls. Additionally, the Supreme Court has expressly stated that mathematical formulas and the discovery of something that occurs in nature are not patent-eligible subject matter. However, use of a mathematical formula or a discovery that amounts to an application of that formula or discovery may be patentable because it is further along the invention continuum.

---

174 See id. at 3227-28 (suggesting that the inquiry as to a patentable process should not be confined to the machine-or-transformation test, but failing to specify whether such additional inquiries should replace or support the traditional test).
175 See id. at 3231 (“In disapproving an exclusive machine-or-transformation test, we by no means foreclose the Federal Circuit’s development of other limiting criteria that further the purposes of the Patent Act and are not inconsistent with its text.”).
177 Id.
178 Under this test, a process claim is not statutory subject matter if it essentially preempts use of a law of nature or an abstract idea in all contexts. See generally Mayo Collaborative Servs. v. Prometheus Labs., Inc., 132 S. Ct. 1289, 1294 (2012); Bilski v. Kappos, 130 S. Ct. 3218, 3231 (2010).
181 See Funk Bros. Seed Co. v. Kalo Inoculant Co., 333 U.S. 127, 130 (1948) (“He who discovers a hitherto unknown phenomenon of nature has no claim to a continued . . .
Hence, the machine-or-transformation test focuses on ascertaining if a machine is part of the process claim; or, in the absence of a machine, whether something is transformed.

The presence of either a machine or a transformation signals that the claimed process is potentially far enough along the invention continuum to be treated as patent-eligible subject matter. Nevertheless, the Court has recognized the practical reality that patent claims can be drafted so that they include extra verbiage to render them literally within the machine-or-transformation test even though the invention should not be treated as patent eligible.182 Therefore, the preemption rule, discussed above, tells a court to look beyond the actual claim language and ascertain whether, despite any limiting language in the claim, the claim in fact really preempts most or all meaningful uses of a mathematical formula, discovery of something that is naturally occurring, or any other non-patentable subject matter. If such preemption occurs, the claim can be treated as an attempt to claim something that is not patent eligible.183

The insignificant limitation rule, discussed above, recognizes that a claim can include various structural elements and/or transformative steps that may literally satisfy the machine-or-transformation test, but in reality do not provide any significant limitation on the claimed subject matter.

B. Proposed Tests

In addition to the machine-or-transformation test for process claims, the following alternative tests are proposed for both product and process claims. Multiple tests are necessary because no single test will produce predictable and consistent results in light of the different types of subject matter that can be patented and the variation in how patent claims are drafted.184 Although failure to satisfy the machine-monopoly of it which the law recognizes. If there is to be invention from such a discovery, it must come from the application of the law of nature to a new and useful end.”); Parker v. Flook, 437 U.S. 584, 591 (1978) (quoting the same language in Funk Bros.). See also Diamond v. Diehr, 450 U.S. 175, 188 (1981) (“Arrhenius’ equation is not patentable in isolation, but when a process for curing rubber is devised which incorporates in it a more efficient solution of the equation, that process is at the very least not barred at the threshold by § 101.”).

182 Mayo Collaborative Servs., 132 S. Ct. at 1300.

183 See Bilski, 130 S. Ct. at 3231 (concluding that a patent claim covering risk hedging was not patent-eligible subject matter, in part, because the claim would essentially preempt use of hedging generally).

184 See generally id. at 3227 (noting that machine-or-transformation test may be useful for tangible inventions that were typical for the industrial age, but it may not be useful for technological inventions in the current information age).
or-transformation test is not determinative,\footnote{\textit{Id.}} it is suggested that failure to satisfy one or more of the following proposed tests should render a claim unpatentable for failure to claim statutory subject matter under Patent Law section 101.

1. \textit{Preemption Test and Insignificant Limitation Test}

The preemption rule and the insignificant limitation rule, discussed above with regard to the machine-or-transformation test, can be applied independently. Additionally, \textit{Bilski} relied on the preemption rule, in part, in concluding that a claimed method of hedging was not patent-eligible subject matter.\footnote{\textit{See id. at 3231 (“[A]llowing petitioners to patent risk hedging would preempt use of this approach in all fields, and would effectively grant a monopoly over an abstract idea.”.”)}} Finally, these rules can be utilized with some or all of the following tests, where appropriate.

2. \textit{Equation Test}

The Supreme Court has clearly stated that equations such as $E=MC^2$, $F=MA$, or $I=V/R$ are not patent eligible.\footnote{Parker v. Flook, 437 U.S. 584, 585 (1978) (“[D]iscovery of a novel and useful mathematical formula may not be patented.”); see also Mayo Collaborative Servs. v. Prometheus Labs., Inc., 132 S. Ct. 1289, 1293 (2012); Diamond v. Chakrabarty, 447 U.S. 303, 309 (1980); $E=mc^2$, AM. INST. OF PHYSICS, http://www.aip.org/history/einstein/emc1.htm (last visited Mar. 24, 2013) (stating that $E=MC^2$ is Einstein’s famous equation that expresses the relationship between energy and mass); Newton’s Second Law, NASA, http://www.grc.nasa.gov/WWW/k-12/airplane/newton2.html (last visited Mar. 24, 2013) (stating $F=MA$ expresses Newton’s second law of motion which is that force equals mass times acceleration); Ohm’s Law, NDT RES. CTR., http://www.ndt-ed.org/EducationResources/HighSchool/Electricity/ohmslaw.htm (last visited Mar. 24, 2013) (stating $I=V/R$ is known as Ohm’s law and it expresses the relationship between current, voltage, and resistance in an electrical circuit).} Additionally, the \textit{Bilski} Court endorsed finding subject matter ineligible for patent protection if a claim merely covers a mathematical formula.\footnote{\textit{See Bilski}, 130 S. Ct. at 3231 (“[C]oncept of hedging . . . reduced to a mathematical formula in claim 4, is an unpatentable abstract idea . . . .”)}. Therefore, if a claim is merely a disguised attempt to cover a formula or equation, it should be determined that it is not patent-eligible subject matter. This test can be applied broadly by viewing an equation as any type of relationship that is expressed mathematically. If the claim includes, but is not limited to an equation, it is likely patent-eligible subject matter.\footnote{\textit{See Diamond v. Diehr, 450 U.S. 175, 187 (1981) (“[A] claim drawn to continued . . . “)}} The preemption rule, discussed
above, can be used to help ascertain if the claim at issue is only covering an equation. Under this rule, if the claim essentially preempts use of the equation or mathematical relationship in virtually all meaningful contexts, then it is not patent-eligible subject matter. Instead, it is really fundamental knowledge that is part of “the basic tools of scientific and technological work” that is part of the public domain and hence not patent eligible.\textsuperscript{190} Additionally, the insignificant limitation rule, discussed above, can also be used. Sometimes a claim contains numerous structural elements or other limitations that make the claim presumptively appear to be claiming more than solely an equation and therefore it is patent eligible. However, these limitations can be examined to determine if they in fact limit the claimed subject matter. The existence of meaningful limits indicates the claim is likely patent-eligible subject matter. Alternatively, the lack of any meaningful limits indicates the claim is directed to ineligible subject matter.

3. \textit{Human Intervention Test}

The discovery of a new plant species or a new mineral may be very valuable but they are not patent-eligible subject matter.\textsuperscript{191} Both of these things are examples of fundamental information or knowledge that are considered part of the public domain that anyone can freely use.\textsuperscript{192} Nevertheless, if the discovered item is altered or modified such that it is now in a state that is not naturally available and it has different properties than the naturally available item, it is typically considered patent-eligible subject matter by the U.S. Patent and Trademark Office\textsuperscript{193} and the Federal Circuit.\textsuperscript{194} An example would be an isolated portion of naturally occurring DNA that has been chemically manipulated to create isolated DNA that is different than subject matter otherwise statutory does not become nonstatutory simply because it uses a mathematical formula . . . .”).

\textsuperscript{190} \textit{See Mayo Collaborative Servs.}, 132 S. Ct. at 1292.
\textsuperscript{192} \textit{Id.; see also Funk Bros. Seed Co. v. Kalo Inoculant Co.}, 333 U.S. 127, 130 (1948).
\textsuperscript{194} Ass’n for Molecular Pathology v. USPTO, 689 F.3d 1303, 1328-29 (Fed. Cir. 2012), \textit{cert. granted sub nom. Ass’n for Molecular Pathology v. Myriad Genetics, Inc.}, 133 S. Ct. 694 (2012).
naturally occurring DNA. The human intervention that changes the naturally occurring thing to a new state has resulted in a novel thing, which is patent eligible. Nevertheless, the preemption test can be applied if the differences between the naturally occurring product and the new product are so insignificant that a patent on the novel product amounts to de facto property rights in the naturally occurring product.

4. Data Comparison Test

A claim that merely includes the act of comparing data should not render the claim unpatentable. However, if the claim solely covers the act of comparing data, it should not be patent-eligible subject matter. Typically, such a claim will control access to naturally occurring phenomena, natural relationships, or mental processes, all of which are outside the domain of patent law protection. As discussed above, both the preemption rule and the insignificant limitation rule can be used to facilitate determining the realistic scope of a claim directed at comparing data.

C. Application of the Proposed Tests to Process Claims

The following analysis looks at several Supreme Court and Court of Appeals for the Federal Circuit decisions that addressed the question of whether specific claims were based on patent-eligible subject matter. The machine-or-transformation test and the other proposed tests, discussed above, are applied to ascertain whether the results comport with the judicial decisions on review in each case.

1. The Prometheus Laboratories Decision

In Prometheus Laboratories, the Court considered the following method claim for optimizing administration of a drug to treat a disorder:

A method of optimizing therapeutic efficacy for treatment of an immune-mediated gastrointestinal disorder, comprising: “(a) administering a drug providing 6-thioguanine to a subject having said immune-mediated gastrointestinal disorder; and . . . (b) determining the level of 6-thioguanine in said subject

Id. at 1328; see generally NARD, supra note 129, at 169-70 (discussing how human intervention that isolates and purifies a portion of a naturally occurring gene can render that isolated gene patent-eligible subject matter).

See Chakrabarty, 447 U.S. at 309.
having said immune-mediated gastrointestinal disorder . . . wherein the level of 6-thioguanine less than about 230 pmol per 8x10^8 red blood cells indicates a need to increase the amount of said drug subsequently administered to said subject and . . . wherein the level of 6–thioguanine greater than about 400 pmol per 8x10^8 red blood cells indicates a need to decrease the amount of said drug subsequently administered to said subject.”

This claim, stripped to its bare essence, involves: administration of a specific drug to a patient with a certain disorder, measuring the resulting concentration of the drug in the patient, and then raising or lowering the amount administered in order to achieve a concentration within a specific range. The claim simply compares the measured data with a known range to determine if it is within the required range. Under the proposed data comparison test, this claim would not be considered patent-eligible subject matter because the only thing claimed is the data comparison.

The same result would occur under the proposed preemption test because this claim would essentially prevent anyone from adjusting the dose for the specific medicine in the claim based on the amount present in the person’s blood. The fact that the claim is limited to administering a specific drug for a specific medical disorder—immune-mediated gastrointestinal disorder—is not a sufficient limitation to overcome preemption. At most, this can be viewed as an insignificant limitation, and therefore the insignificant limitation test would also negate patent eligibility.

Likewise, this claim does not survive the machine-or-transformation test. The claim is not tied to a machine, nor is anything transformed via the claim. In contrast, the Federal Circuit found that the second prong of the test was satisfied because the human body, or the blood removed from a person, satisfied the transformation requirement. This analysis was properly rejected by the Supreme

---

198 See id. at 1294 (describing the claimed process).
199 See id. at 1298 (stating the claims at issue “simply tell doctors to gather data from which they may draw an inference in light of the correlations.”).
200 Id. at 1294-95 (The amount in a patient’s blood varies because different people metabolize the drug differently).
201 See id. at 1298.
202 Id. at 1296-97.
Such broad application of the test would render it ineffective because very little subject matter would be found unpatentable under such a broad application.

The conclusion, based on the proposed tests, that the above claim is not directed to patent-eligible subject matter disagrees with the Federal Circuit, although it is consistent with the Supreme Court’s conclusion.

2. The Diehr Decision

In *Prometheus Laboratories*, the Supreme Court, reasoning by analogy, reviewed two prior decisions that analyzed patent eligibility of process claims. In *Diehr*, the Court found that the claims at issue, which referred to the operation of a press as part of an industrial process, satisfied section 101. However, in *Flook*, the Court found that the claim at issue, which was related to a chemical process, was not patent-eligible subject matter.

One of the representative claims at issue in *Diehr* stated:

A method of operating a rubber-molding press for precision molded compounds with the aid of a digital computer, comprising: providing said computer with a data base for said press including at least, natural logarithm conversion data (ln), the activation energy constant (C) unique to each batch of said compound being molded, and a constant (x) dependent upon the geometry of the particular mold of the press, initiating an interval timer in said computer upon the closure of the press for monitoring the elapsed time of said closure, constantly determining the temperature (Z) of the mold at a location closely adjacent to the mold.

---

203 Id.
205 Mayo Collaborative Servs., 132 S. Ct. at 1289.
206 Id. at 1298-301.
cavity in the press during molding, constantly providing the computer with the temperature (Z), repetitively calculating in the computer, at frequent intervals during each cure, the Arrhenius equation for reaction time during the cure, which is ln v = CZ + x where v is the total required cure time, repetitively comparing in the computer at said frequent intervals during the cure each said calculation of the total required cure time calculated with the Arrhenius equation and said elapsed time, and opening the press automatically when a said comparison indicates equivalence. 209

The above claim involves use of a standard equation known as the Arrhenius equation. 210 However, it also includes using a computer to perform calculations as part of carrying out an industrial process to make molded rubber products with a press. 211 Under the equation test, the question is whether this claim is a disguised attempt to claim an equation. Application of the preemption rule indicates that the claim actually covers an industrial process for making molded rubber products, and it does not preempt virtually any uses of the equation. Consequently, in light of these tests, the claim is patent-eligible subject matter.

Applying the machine-or-transformation test produces the same result. The claimed process is tied to a machine—a rubber molding press—and therefore it is presumptively patent-eligible subject matter. As noted above, application of the preemption rule to this claim does not negate patent eligibility. The insignificant limitation rule also does not apply because the various limitations contained in the claim are necessary to carry out the claimed industrial process rather than being mere extraneous and unnecessary verbiage.

The other proposed tests are not applicable to this claim. Therefore, application of the proposed equation test, coupled with the preemption and insignificant limitation tests, agrees with the Supreme Court’s conclusion that the above claim is directed to patent-eligible subject matter.

209 Diehr, 450 U.S. at 180 n.5 (quoting from Respondents' application) (superfluous quotation marks omitted).
210 See generally Definition of arrhenius-equation, BRITANNICA ONLINE ENCYCLOPEDIA, http://www.britannica.com/EBchecked/topic/36095/Arrhenius-equation (last visited Mar. 6, 2013) (explaining that this equation is a “mathematical expression that describes the effect of temperature on the velocity of a chemical reaction”). See also Univ. of Cal., Davis, UC DAVIS CHEMWIKI, http://chemwiki.ucdavis.edu/Physical_Chemistry/Kinetics/Reaction_Rates/Temperature_Dependence_of_Reaction_Rates/Arrhenius_Equation (last visited Mar. 6, 2013) (containing a detailed discussion of the equation).
211 Diehr, 450 U.S. at 180, n.5.
subject matter.  

3. The Flook Decision

The claim at issue in Flook stated:

A method for updating the value of at least one alarm limit on at least one process variable involved in a process comprising the catalytic chemical conversion of hydrocarbons wherein said alarm limit has a current value of Bo + K wherein Bo is the current alarm base and K is a predetermined alarm offset which comprises:

(1) Determining the present value of said process variable, said present value being defined as PVL; (2) Determining a new alarm base B1, using the following equation: B1 = Bo(1.0 − F) + PVL(F) where F is a predetermined number greater than zero and less than 1.0; (3) Determining an updated alarm limit which is defined as B1 + K; and thereafter (4) Adjusting said alarm limit to said updated alarm limit value.  

The above claim in Flook is distinguishable from the claim at issue in Diehr. First, under the equation test, the claim in Flook appears to be an attempt to claim a mathematical relationship. In fact, the Flook Court noted that the equation in the claim was a novel mathematical formula discovered by the patent applicant. Although the claim preamble does indicate that it applies to the catalytic chemical conversion of hydrocarbons, no other part of the claim includes any specific structural components or limitations. Instead the claim merely includes a series of steps necessary to perform a calculation that is only, generally tied to the chemical conversion of hydrocarbons. The claim is not limited to a specific industrial process nor does it recite a specific product created by the process. It also does not recite which hydrocarbons are converted, what they are converted into or how the catalytic process is used. Finally, the Court noted:

---

212 Id. at 174.
213 Flook, 437 U.S. at 596-97 (quoting from Claim 1 of the patent) (superfluous quotation marks omitted).
214 Id. at 585.
215 Id. at 596-97.
216 See id.
217 See id.
218 See id.
The patent application does not purport to explain how to select the appropriate margin of safety, the weighting factor, or any of the other variables. Nor does it purport to contain any disclosure relating to the chemical processes at work, the monitoring of process variables, or the means of setting off an alarm or adjusting an alarm system. All that it provides is a formula for computing an updated alarm limit.\textsuperscript{219}

In light of the above holding in \textit{Flook}, under the preemption test, this claim would not be patent-eligible subject matter because it is an attempt to claim the use of a specific mathematical relationship in any process that involves converting hydrocarbons into another state via the use of any type of catalytic chemical conversion.

Under the first prong of the machine-or-transformation test, the claim is also not statutory subject matter because the process is not tied to a machine. However, under the second prong of the test it could be argued that hydrocarbons are transformed. Nevertheless, as noted above, the preemption rule, which is a limitation on the machine-or-transformation test, would render the claim non-statutory subject matter.

Therefore, application of the proposed equation test modified by the preemption test produces the same result as the Supreme Court’s conclusion;\textsuperscript{220} the above claim is not directed to patent-eligible subject matter.

\textbf{4. The Metabolite Decision}

In \textit{Metabolite Laboratories, Inc. v. Laboratory Corp. of American Holdings},\textsuperscript{221} the court considered the following claim for a diagnostic test for detecting a vitamin deficiency: “A method for detecting a deficiency of cobalamin or folate in warm-blooded animals comprising the steps of: assaying a body fluid for an elevated level of total homocysteine; and correlating an elevated level of total homocysteine in said body fluid with a deficiency of cobalamin or folate.”\textsuperscript{222} At the most basic level this method involves measuring a specific body fluid—homocysteine—which is a naturally occurring

\textsuperscript{219} \textit{Id.} at 586.
\textsuperscript{220} \textit{Id.} at 594.
\textsuperscript{222} \textit{Id.} at 1358-59.
amino acid found in blood.\textsuperscript{223} If the homocysteine level is elevated, it is known that the person has a deficiency of cobalamin or folate, which is commonly referred to as vitamin B-12.\textsuperscript{224} So in essence, a person’s homocysteine level is measured and is then compared to a normal level; if it is elevated, the person has a vitamin deficiency, and if it is not elevated, there is no vitamin deficiency.\textsuperscript{225}

This claim does not pass muster under the first prong of the machine-or-transformation test because no machine of any type is involved in the claim. Additionally, it fails under the second prong because nothing is transformed. The “assaying” step merely refers to analyzing the body fluid to determine the amount of homocysteine present,\textsuperscript{226} and the “correlating” step merely refers to comparing the measured homocysteine level with a normal level.

Additionally, this claim is not patent-eligible subject matter under the proposed data comparison test because the act of comparing data is the sole thing it claims. It would also fail the proposed preemption test because this claim prevents anyone from using the naturally occurring correlation that exists between homocysteine and vitamin B-12.

Ultimately, this claim was upheld as valid on other grounds because the issue of statutory subject matter was raised for the first time in the writ of certiorari filed with the Supreme Court.\textsuperscript{227} Although the writ was initially granted on the question of whether this claim was made patent ineligible by violating the prohibition on patenting “laws of nature, natural phenomena, and abstract ideas,”\textsuperscript{228} the Court subsequently dismissed the writ.\textsuperscript{229}

Based on the above analysis using the proposed data comparison test, the claim is not patent-eligible subject matter. Interestingly, at least three Supreme Court justices agreed with this conclusion in a non-binding dissenting opinion, which accompanied the dismissal of

\textsuperscript{225} Metabolite Labs., Inc., 370 F.3d at 1363-64 (holding that when interpreting this claim that the step of “correlating” meant “comparing the elevated [homocysteine] level with the normal homocysteine level.”).
\textsuperscript{228} Lab. Corp. of Am. Holdings v. Metabolite Labs., Inc., 543 U.S. 1185 (2005).
\textsuperscript{229} Lab. Corp. of Am. Holdings, 548 U.S. at 124.
5. The Biogen Idec Decision

Several recent Federal Circuit decisions seem to reach inconsistent results. In *Classen Immunotherapies, Inc. v. Biogen Idec*, the court reviewed the patent eligibility of the claims in three related patents. The district court originally found the claims to be non-statutory subject matter under section 101. But the Supreme Court vacated the decision and remanded it for reconsideration in light of its decision in *Bilski*. Following the remand, the Federal Circuit held that the following claim for evaluating the effectiveness of an immunization schedule was not statutory subject matter:

A method of determining whether an immunization schedule affects the incidence or severity of a chronic immune-mediated disorder in a treatment group of mammals, relative to a control group of mammals, which comprises immunizing mammals in the treatment group of mammals with one or more doses of one or more immunogens, according to said immunization schedule, and comparing the incidence, prevalence, frequency or severity of said chronic immune-mediated disorder or the level of a marker of such a disorder, in the treatment group, with that in the control group.

In contrast, the court held that the following claim related to immunization scheduling was statutory subject matter:

A method of immunizing a mammalian subject which comprises:

---

230 Id. at 134-38 (Justice Breyer, whose dissenting opinion was joined by Justices Stevens and Souter, makes it clear that he believes the claim at issue is not patent-eligible subject matter).
232 Id. at 1060.
234 Id.
235 Id.
236 *Classen Immunotherapies, Inc.,* 659 F.3d at 1065.
237 Id. at 1061 (quoting from Claim 1 of the ‘283 patent).
238 Id. at 1065.
(I) screening a plurality of immunization schedules, by
(a) identifying a first group of mammals and at least a second group of mammals, said mammals being of the same species, the first group of mammals having been immunized with one or more doses of one or more infectious disease-causing organism-associated immunogens according to a first screened immunization schedule, and the second group of mammals having been immunized with one or more doses of one or more infectious disease-causing organism-associated immunogens according to a second screened immunization schedule, each group of mammals having been immunized according to a different immunization schedule, and
(b) comparing the effectiveness of said first and second screened immunization schedules in protecting against or inducing a chronic immune-mediated disorder in said first and second groups, as a result of which one of said screened immunization schedules may be identified as a lower risk screened immunization schedule and the other of said screened schedules as a higher risk screened immunization schedule with regard to the risk of developing said chronic immune mediated disorder(s),

(II) immunizing said subject according to a subject immunization schedule, according to which at least one of said infectious disease-causing organism-associated immunogens of said lower risk schedule is administered in accordance with said lower risk screened immunization schedule, which administration is associated with a lower risk of development of said chronic immune-mediated disorder(s) than when said immunogen was administered according to said higher risk screened immunization schedule.

Contrary to the Federal Circuit, I would argue that both of the above claims merely cover a comparison of data that yields useful information for combating disease via immunization. Under the proposed data comparison test, both claims should be found deficient under section 101 because neither claim is directed to anything more than making data comparisons. Arguably, application of the machine-

239 Id. at 1060-61 (quoting from Claim 1 of the ‘739 patent).
or-transformation test would support finding neither claim to be patent-eligible subject matter since neither claim is tied to a machine, and neither involve a transformation of anything. 240

6. The PerkinElmer Decision

In PerkinElmer, Inc. v. Intema Ltd., 241 the Federal Circuit concluded that the following claim for determining the risk of giving birth to a child with Down’s syndrome was not patent-eligible subject matter: 242

A method of determining whether a pregnant woman is at an increased risk of having a fetus with Down’s syndrome, the method comprising the steps of: measuring the level of at least one screening marker from a first trimester of pregnancy by: (i) assaying a sample obtained from the pregnant woman at said first trimester of pregnancy for at least one first biochemical screening marker; and/or (ii) measuring at least one first ultrasound screening marker from an ultrasound scan taken at said first trimester of pregnancy; measuring the level of at least one second screening marker from a second trimester of pregnancy, the at least one second screening marker from the second trimester of pregnancy being different from the at least one first screening marker from the first trimester of pregnancy, by: (i) assaying a sample obtained from the pregnant woman at said second trimester of pregnancy for at least one second biochemical screening marker; and/or (ii) measuring at least one second ultrasound screening marker from an ultrasound scan taken at said second trimester of pregnancy; and determining the risk of Down’s syndrome by comparing the measured levels of both the at least one first screening marker from the first trimester of pregnancy and the at least one second screening marker from the second trimester of pregnancy with observed relative frequency distributions of marker levels in Down’s syndrome.

240 Classen Immunotherapies, Inc. v. Biogen Idec, 304 F. App’x. 866 (Fed. Cir. 2008), vacated, 130 S. Ct. 3541 (2010) (The Federal Circuit initially reached this conclusion prior to the case being vacated and remanded by the Supreme Court.).
242 Id. at *1-2.
pregnancies and in unaffected pregnancies.\footnote{U.S. Patent No. 6,573,103, claim 1 (filed Apr. 29, 1999) (issued June 3, 2003). See also id. at *2-3 (citing an abbreviated portion of the claim).}

The above claim solely involves obtaining certain biological data from a pregnant woman during her first and second trimesters of pregnancy, and then comparing that data to predict whether she is at an increased risk of giving birth to a baby with Down’s syndrome.\footnote{PerkinElmer, Inc., 2012 U.S. App. LEXIS 23845 at *2.} The court was correct in finding that this claim does not cover patent-eligible subject matter. The same result would be reached under the proposed data comparison test. Arguably, the machine-or-transformation test would also support the same conclusion because the claim does not involve any machine, or a transformation of anything.

7. The Association for Molecular Pathology Decision

In Association for Molecular Pathology v. U.S. P.T.O.,\footnote{Ass’n Molecular Pathology v. U.S. P.T.O., 689 F.3d 1303, 1309-10 (Fed. Cir. 2012), cert. granted sub nom., Ass’n Molecular Pathology v. Myriad Genetics, 133 S. Ct. 694 (2012).} the Federal Circuit held that the following claim for a method of screening for breast cancer did not cover patent-eligible subject matter: \footnote{See id. at 1333.}

A method for screening a tumor sample from a human subject for a somatic alteration in a BRCA1 gene in said tumor which comprises [ ] comparing a first sequence selected from the group consisting of a BRCA1 gene from said tumor sample, BRCA1 RNA from said tumor sample and BRCA1 cDNA made from mRNA from said tumor sample with a second sequence selected from the group consisting of BRCA1 gene from a nontumor sample of said subject, BRCA1 RNA from said nontumor sample and BRCA1 cDNA made from mRNA from said nontumor sample, wherein a difference in the sequence of the BRCA1 gene, BRCA1 RNA or BRCA1 cDNA from said tumor sample from the sequence of the BRCA1 gene, BRCA1 RNA or BRCA1 cDNA from said nontumor sample indicates a somatic alteration in the BRCA1 gene in said tumor sample.\footnote{Id. at 1310 (quoting from Claim 1 of the ‘999 patent).}
The court noted that this claim was merely related to comparing data to screen individuals for breast cancer.\textsuperscript{248} Therefore, the court concluded that because the claim amounted to no more than obtaining and comparing data, it was not patent eligible.\textsuperscript{249}

In contrast to the above result, the Federal Circuit held in the same decision that the following claim for screening cancer therapeutics was directed to patent-eligible subject matter:\textsuperscript{250}

A method for screening potential cancer therapeutics which comprises: growing a transformed eukaryotic host cell containing an altered BRCA1 gene causing cancer in the presence of a compound suspected of being a cancer therapeutic, growing said transformed eukaryotic host cell in the absence of said compound, determining the rate of growth of said host cell in the presence of said compound and the rate of growth of said host cell in the absence of said compound and comparing the growth rate of said host cells, wherein a slower rate of growth of said host cell in the presence of said compound is indicative of a cancer therapeutic.\textsuperscript{251}

A cursory examination of claims 1 and 20, quoted above respectively, indicates they both involve obtaining and comparing data to predict a result. However, the court finds a distinction between the two claims; it concludes that claim 1 only requires the comparison of data,\textsuperscript{252} but that claim 20 requires the creation of a transformed eukaryotic host cell, which is then used to obtain and compare the resulting data.\textsuperscript{253} This host cell is not a naturally occurring cell;\textsuperscript{254} it is essentially created in a laboratory via human intervention. Therefore, as the court notes, it is analogous to the Supreme Court’s decision in \textit{Diamond v. Chakrabarty},\textsuperscript{255} which held that an artificially created life-

\textsuperscript{248} Id. at 1334.
\textsuperscript{249} Id. at 1334-35.
\textsuperscript{250} Id. at 1337.
\textsuperscript{251} Id. at 1310 (quoting from Claim 20 of the ‘282 patent).
\textsuperscript{252} Id. at 1335.
\textsuperscript{253} Id. at 1336-37.
\textsuperscript{254} Id. at 1335-36.
\textsuperscript{255} Diamond v. Chakrabarty, 447 U.S. 303 (1980). See Ass’n Molecular Pathology, 689 F.3d at 1336 (“Claim 20 thus recites a screening method premised on the use of ‘transformed’ host cells. Those cells, like the patent-eligible cells in Chakrabarty, are not naturally occurring. Rather, they are derived by altering a cell to include a foreign gene, resulting in a man-made, transformed cell with enhanced function and utility.”).
form was statutory subject matter because it was not naturally occurring.\textsuperscript{256} Hence, claim 20 essentially requires creating a non-naturally occurring cell, which is then used to obtain data. That data is subsequently compared for screening potential cancer treatments. Consequently, claim 20 is directed to patent-eligible subject matter, but claim 1 is directed to non-statutory subject matter. Based on the factual assertions by the court, its conclusions appear to be correct.

Applying the proposed tests leads to the same conclusions as those reached in the Federal Circuit decision. Claim 1 would be held to be non-patentable subject matter under the data comparison test. In contrast, claim 20 would be patent eligible because it requires more than merely comparing data; it requires the creation of a non-naturally occurring host cell,\textsuperscript{257} and therefore, under the proposed human intervention test, it would be patent-eligible subject matter. If the machine-or-transformation test is applied, the result will arguably be consistent with this analysis. Claim 1 does not involve either a machine or a transformation of anything, but claim 20 arguably involves transforming a naturally occurring cell into a non-naturally occurring cell. Therefore, the machine-or-transformation test would negate claim 1 but uphold claim 20.

8. The Bilski Decision

In Bilski, the Supreme Court found that a business method claim\textsuperscript{258} for hedging\textsuperscript{259} was not patent-eligible subject matter.\textsuperscript{260} Both the

\textsuperscript{256} Chakrabarty, 447 U.S. at 309-10.

\textsuperscript{257} In contrast, although claim 1 in Ass’n for Molecular Pathology requires the creation of “BRAC1 cDNA made from mRNA” for both the tumor and the non-tumor samples, both cDNA and mRNA are naturally occurring, although they can also be artificially synthesized. A gene or other genetic material is not patent-eligible subject matter in its naturally occurring state. See Craig Nard, THE LAW OF PATENTS 169 (2d ed. 2011). But if such material is isolated and purified so that it exists in a form or state that does not occur in nature, it is potentially patent-eligible subject matter. Id. U.S. Patent and Trademark Office guidelines state that “an inventor’s discovery of a gene can be the basis for a patent on the genetic composition isolated from its natural state and processed through purifying steps that separate the gene from other molecules naturally associated with it.” Id.

\textsuperscript{258} Bilski v. Kappos, 130 S. Ct. 3218, 3228-29 (noting that the category of business method claims was not per se non-statutory subject matter under section 101).

\textsuperscript{259} See id. at 3223 (Hedging is a method of minimizing the risk of price changes.). See also Hedging, B Brittannica ONLINE ENCYCLOPEDIA, http://www.britannica.com/EBchecked/topic/259286/hedging (last visited Dec. 31, 2012).

\textsuperscript{260} Bilski, 130 S. Ct. at 3230 (“[A]ll members of the Court agree that the patent application at issue here falls outside of § 101 because it claims an abstract idea.”).
Patent and Trademark Office and the Federal Circuit had previously reached the same conclusion.\(^{261}\) One of the claims at issue stated:

A method for managing the consumption risk costs of a commodity sold by a commodity provider at a fixed price comprising the steps of:

(a) initiating a series of transactions between said commodity provider and consumers of said commodity wherein said consumers purchase said commodity at a fixed rate based upon historical averages, said fixed rate corresponding to a risk position of said consumer;
(b) identifying market participants for said commodity having a counter-risk position to said consumers; and
(c) initiating a series of transactions between said commodity provider and said market participants at a second fixed rate such that said series of market participant transactions balances the risk position of said series of consumer transactions.\(^{262}\)

The Supreme Court deemed the above claim to be an attempt to claim hedging.\(^{263}\) The Court then concluded that hedging was merely an abstract idea, and therefore not patent eligible.\(^{264}\) However, the Court did not provide a specific test or criteria for ascertaining whether a claim is, or is not, directed to an abstract idea. Arguably, the Court was using a test akin to the proposed equation test when it stated that the above claim, as a practical matter, reduced the concept of hedging to a mathematical formula, which is not patent-eligible subject matter.\(^{265}\) It also relied on the proposed preemption test when it concluded that the claim at issue would preempt the use of the abstract idea of hedging.\(^{266}\) Ultimately, the Court’s holding, as noted above, is consistent with the results of using the proposed tests.

Application of the machine-or-transformation test, although not determinative, also supports the Court’s conclusion because the claim does not include the use of any machine, nor does it transform anything. The claim only involves buying and selling commodities such that any risk of loss is hedged.

---

\(^{261}\) *Id.* at 3224.

\(^{262}\) *See In re* Bilski, 545 F.3d 943, 949 (Fed. Cir. 2008) (quoting Claim 1 of the ‘892 patent application).

\(^{263}\) *Bilski*, 130 S. Ct. at 3231.

\(^{264}\) *Id.* at 3230.

\(^{265}\) *See id.* at 3231.

\(^{266}\) *See id.*
9. The In re Comiskey Decision

The Federal Circuit, sitting en banc, found the following claim to cover a business method in the form of mandatory arbitration:

A method for mandatory arbitration resolution regarding one or more unilateral documents comprising the steps of: enrolling a person and one or more unilateral documents associated with the person in a mandatory arbitration system at a time prior to or as of the time of creation of or execution of the one or more unilateral documents; incorporating arbitration language, that is specific to the enrolled person, in the previously enrolled unilateral document wherein the arbitration language provides that any contested issue related to the unilateral document must be presented to the mandatory arbitration system, in which the person and the one or more unilateral documents are enrolled, for binding arbitration wherein the contested issue comprises one or more of a challenge to the documents, interpretation of the documents, interpretation or application of terms of the documents and execution of the documents or terms of the documents; requiring a complainant to submit a request for arbitration resolution to the mandatory arbitration system wherein the request is directed to the contested issue related to the unilateral document containing the arbitration language; conducting arbitration resolution for the contested issue related to the unilateral document in response to the request for arbitration resolution; providing support to the arbitration resolution; and determining an award or a decision for the contested issue related to the unilateral document in accordance with the incorporated arbitration language, wherein the award or the decision is final and binding with respect to the complainant.

The court’s conclusion that the above claim is not patent-eligible subject matter was based on finding that the claim merely covered a mental process for resolving a dispute via arbitration. Additionally, the court noted that the parties conceded that the claim would not

\[267\] In re Comiskey, 554 F.3d 967, 975-76 (Fed. Cir. 2009) (en banc).
\[268\] Id. at 970 n.1 (quoting from Claim 1 of the ‘742 patent application).
\[269\] Id. at 981.
survive the machine-or-transformation test.\textsuperscript{270}

10. The CLS Bank International Decision

In this case, the following business method claim was analyzed to determine if it was patent-eligible subject matter:

A method of exchanging obligations as between parties, each party holding a credit record and a debit record with an exchange institution, the credit records and debit records for exchange of predetermined obligations, the method comprising the steps of:
(a) creating a shadow credit record and a shadow debit record for each stakeholder party to be held independently by a supervisory institution from the exchange institutions;
(b) obtaining from each exchange institution a start-of-day balance for each shadow credit record and shadow debit record;
(c) for every transaction resulting in an exchange obligation, the supervisory institution adjusting each respective party's shadow credit record or shadow debit record, allowing only these [sic] transactions that do not result in the value of the shadow debit record being less than the value of the shadow credit record at any time, each said adjustment taking place in chronological order; and
(d) at the end-of-day, the supervisory institution instructing one of the exchange institutions to exchange credits or debits to the credit record and debit record of the respective parties in accordance with the adjustments of the said permitted transactions, the credits and debits being irrevocable, time invariant obligations placed on the exchange institutions.\textsuperscript{271}

The district court concluded that the above claim was not patent-

\textsuperscript{270} See id. (conceding the claims do not require a machine, they do not describe a manufacturing process, nor do they include a process that alters a composition of matter).

\textsuperscript{271} CLS Bank Int’l v. Alice Corp. Pty. Ltd., 685 F.3d 1341, 1343-44 (Fed. Cir. 2012) (quoting from Claim 33 of the ‘479 patent), vacated & reh’g en banc granted, 484 F. App’x 559 (Fed. Cir. 2012).
eligible subject matter.\textsuperscript{272} The Federal Circuit initially disagreed and determined that the claim was patent-eligible subject matter.\textsuperscript{273} The court’s reasoning was based on its finding that the above claim was directed to more than an abstract idea.\textsuperscript{274} The court held that it claimed a practical application of a business method, which required implementation on a computer.\textsuperscript{275} Additionally, the court noted that, because the claim would have to be implemented on a computer, it would likely satisfy the machine prong of the machine-or-transformation test.\textsuperscript{276} Subsequently, the Federal Circuit vacated this decision and agreed to rehear the case en banc.\textsuperscript{277}

Under the proposed preemption test, it can be argued that the above claim is not directed to patent-eligible subject matter. The claimed business method can be described as:

a computerized trading platform for exchanging obligations in which a trusted third party settles obligations between a first and second party so as to eliminate “settlement risk.” Settlement risk is the risk that only one party’s obligation will be paid, leaving the other party without its principal. The trusted third party eliminates this risk by either (a) exchanging both parties’ obligations or (b) exchanging neither obligation.\textsuperscript{278}

Any requirement that this method must be performed on a computer is not a realistic limitation because any modern financial transaction of this type would only be viable if it utilized a computer system. This limitation, therefore, is not relevant under the insignificant limitation test. Additionally, under the proposed preemption test, this claim would not be patent-eligible subject matter because it would preempt the basic idea of using a trusted third party to hold assets that will only be distributed under certain circumstances. This is a basic and commonly used idea which is analogous to the typical arrangement used in real estate transactions.\textsuperscript{279} Moreover, the

\begin{itemize}
\item \textsuperscript{272} \textit{id.} at 1345.
\item \textsuperscript{273} \textit{id.} at 1343.
\item \textsuperscript{274} \textit{see id.} at 1346-47 (holding that this claim was patent-eligible subject matter after stating that abstract ideas are not patent-eligible subject matter).
\item \textsuperscript{275} \textit{id.} at 1355.
\item \textsuperscript{276} \textit{id.}
\item \textsuperscript{277} \textit{CLS Bank Int’l v. Alice Corp. Pty. Ltd.,} 484 F. App’x 559 (Fed. Cir. 2012).
\item \textsuperscript{278} \textit{CLS Bank Int’l v. Alice Corp. Pty. Ltd.,} 685 F.3d 1341, 1343 (Fed. Cir. 2012).
\item \textsuperscript{279} \textsc{John Sprankling and Raymond Coletta}, \textsc{Property—A Contemporary Approach} 562 (2d ed. 2012) (In many states an escrow agent acts
\end{itemize}
claimed business method involves comparing various data to determine if an obligation should be honored by a financial institution. Arguably, this may cause the method to also be considered not patent-eligible subject matter under the proposed data comparison test.

D. Application of the Proposed Tests to Product Claims

1. The Association for Molecular Pathology Decision

In addition to the process claims discussed above, the Association for Molecular Pathology case also involved several “composition of matter” claims directed to isolated DNA molecules.\textsuperscript{280} The following is a representative claim which was held to be patent-eligible subject matter by the Federal Circuit:\textsuperscript{281} “An isolated DNA coding for a BRCA1 polypeptide, said polypeptide having the amino acid sequence set forth in SEQ ID NO:2.”\textsuperscript{282} The court concluded that this claim covered a patent eligible composition of matter and explained:

The [claimed] isolated DNA molecules before us are not found in nature. They are obtained in the laboratory and are man-made, the product of human ingenuity. While they are prepared from products of nature, so is every other composition of matter. All new chemical or biological molecules, whether made by synthesis or decomposition, are made from natural materials. For example, virtually every medicine utilized by today’s medical practitioners, and every manufactured plastic product, is either synthesized from natural materials (most often petroleum fractions) or derived from natural plant materials. But, as such, they are different from natural materials, even if they are ultimately derived from them. The same is true of isolated DNA molecules.\textsuperscript{283}

The court’s holding is consistent with the proposed human intervention test which is based on the Supreme Court decision in

\textsuperscript{280} Ass’n Molecular Pathology v. U.S.P.T.O., 689 F.3d 1303, 1309 (Fed. Cir. 2012) \textit{cert. granted sub nom.}, Ass’n Molecular Pathology v. Myriad Genetics, 133 S. Ct. 694 (2012).

\textsuperscript{281} \textit{Id.} at 1325.

\textsuperscript{282} \textit{Id.} at 1309 (quoting Claim 1 of the ‘282 patent).

\textsuperscript{283} \textit{Id.} at 1325.
Nevertheless, the proposed preemption test may negate patent eligibility. Under that test, if the above claim on an isolated DNA molecule would prevent anyone from utilizing that DNA in its natural state, then the claim is not statutory subject matter. The application of this test to the above claim turns on a factual question: is the claimed DNA so similar to the naturally occurring DNA that allowance of the claim essentially preempts others from utilizing the naturally occurring DNA? If the answer is yes, the claim should be held to be not patent-eligible subject matter. If the answer is no, the claim was correctly found to be patent-eligible subject matter by the Federal Circuit.

2. The State Street Bank Decision

This Federal Circuit decision,\(^{285}\) which categorically stated that business method patents were not per se invalid,\(^{286}\) actually involved a product claim, not a business method claim.\(^{287}\) The following claim was at issue:

A data processing system for managing a financial services configuration of a portfolio established as a partnership, each partner being one of a plurality of funds, comprising:

(a) computer processor means [a personal computer including a CPU] for processing data;
(b) storage means [a data disk] for storing data on a storage medium;
(c) first means [an arithmetic logic circuit configured to prepare the data disk to magnetically store selected data] for initializing the storage medium;
(d) second means [an arithmetic logic circuit configured to retrieve information from a specific file, calculate incremental increases or decreases based on specific input, allocate the results on a percentage basis, and store the output in a separate file] for processing

\(^{284}\) See, e.g., Douglas L. Rogers, Coding For Life—Should Any Entity Have The Exclusive Right To Use And Sell Isolated DNA?, 12 U. PITT. J. TECH. & POL’Y 1, 23-24 (2011) (inquiring whether or not “purification [is] the kind of human intervention into naturally occurring products that the Supreme Court in Chakrabarty contemplated as the dividing between patentable and unpatentable subject matter?”).


\(^{286}\) Id. at 1375.

\(^{287}\) Id. at 1371 (illustrating claim at issue directed to a machine).
data regarding assets in the portfolio and each of the funds from a previous day and data regarding increases or decreases in each of the funds, [sic, funds'] assets and for allocating the percentage share that each fund holds in the portfolio;
(e) third means [an arithmetic logic circuit configured to retrieve information from a specific file, calculate incremental increases and decreases based on specific input, allocate the results on a percentage basis and store the output in a separate file] for processing data regarding daily incremental income, expenses, and net realized gain or loss for the portfolio and for allocating such data among each fund;
(f) fourth means [an arithmetic logic circuit configured to retrieve information from a specific file, calculate incremental increases and decreases based on specific input, allocate the results on a percentage basis and store the output in a separate file] for processing data regarding daily net unrealized gain or loss for the portfolio and for allocating such data among each fund; and
(g) fifth means [an arithmetic logic circuit configured to retrieve information from specific files, calculate that information on an aggregate basis and store the output in a separate file] for processing data regarding aggregate year-end income, expenses, and capital gain or loss for the portfolio and each of the funds.\(^{288}\)

The above claim is for a machine, which makes rapid calculations with regard to a pool of mutual funds.\(^{289}\) Such rapid calculations are necessary\(^ {290}\) to obtain certain tax advantages and economies of scale with regard to a financial product.\(^ {291}\) A careful examination of the claim indicates it involves having a computer make a series of calculations, and then outputting the data to a computer file. The broad nature of the claim essentially covers an algorithm based on a variety of data sources. In essence, this claim is no more than an attempt to claim data calculations, which is akin to claiming an equation. Under the proposed equation test, this claim therefore does

\(^{288}\) Id. at 1371-72 (quoting Claim 1 of the ‘056 patent).

\(^{289}\) Id. at 1370.

\(^{290}\) Id. at 1371.

\(^{291}\) See id. at 1370 (providing a brief explanation of the financial product at issue).
not cover patent-eligible subject matter.

Although it could correctly be argued that this claim is specifically limited to performing the calculations on a computer system, such a limitation is inadequate to convert this claim into statutory subject matter. From a practical perspective, the necessary calculations in the claim can only be easily performed on a computer. Additionally, it is the speed with which a computer is able to carry out the claimed calculations that make the system viable. Hence, this claim could arguably also be considered patent ineligible subject matter under the proposed preemption test because it preempts all realistic use of the claimed calculations. Moreover, the claim limitations requiring use of a computer can also be viewed as insignificant limitations.

As a result, under the proposed tests, this claim would be directed to non-statutory subject matter, the opposite conclusion of the one reached by the Federal Circuit.

**VII. CONCLUSION**

The determination of what subject matter is potentially eligible for patent protection has long been, and continues to be, an unclear issue. Patent law specifically identifies four broad categories of subject matter—process, machine, manufacture, or composition of matter—that are patent eligible. Although very few things fall outside these categories, the Supreme Court has engrafted some exceptions and limitations onto these statutory categories. Patentable subject matter that is otherwise within these categories is deemed not to be patent eligible if it is a “law of nature,” a “physical phenomenon,” or an “abstract idea.” The precise meaning or scope of these limitations is difficult to enunciate despite numerous Supreme Court and lower court decisions, which have attempted to define these terms. Nevertheless, these limitations can be viewed merely as labels that are attached after a judicial balance has been made between competing or conflicting underlying concepts: providing patent protection to promote innovation, and denying patent protection when it disincentives innovative activities. Early stage research often produces discoveries such as previously unknown mathematical relationships, fundamental concepts, physical forces, biological data, or correlations. These discoveries are fundamental building blocks which are very valuable starting points for engaging in future research that will lead to new technological products and processes that have real world practical applications. Such discoveries are denied patent protection because they are potentially too valuable. Granting patent protection would ultimately impede future innovation based on these building blocks. Hence, fundamental building blocks are labeled as a
“law of nature,” a “physical phenomenon,” or an “abstract idea” to signify they are not patent-eligible subject matter. Once the level of innovation and development moves far enough downstream on the innovation continuum, the subject matter becomes patent eligible. Divining the precise point on the innovation continuum where the divide between patent-eligible and unpatentable subject matter occurs has eluded courts.

This article asserts that the commercial importance of patents in the modern marketplace strongly favors predictable determinations of what is, and what is not patent-eligible subject matter. This can only be accomplished via relatively bright-line rules which may be over- or under-inclusive, and which may have disparate and potentially inequitable impacts on different industries. Analogous to other areas of law, these potential problems are outweighed by the importance of having predictable results.

The variety of new technology, and the multitude of ways patent claims are drafted make it impossible to create a single rule for ascertaining whether something is patent-eligible subject matter. Therefore, this article proposes a number of different tests where failure to satisfy any one of the tests negates patent eligibility. These tests include the preemption test, which holds that a claim is not patent eligible if it essentially preempts all meaningful use of a law of nature, natural phenomena, or an abstract idea in substantially all contexts. The insignificant limitation test helps to recognize inclusion of limitations in claims that appear to limit claim scope, but in fact do not provide any significant practical limitation on claim scope, and therefore, the claim should be determined to cover unpatentable subject matter. The equation test disallows a claim that amounts to no more than a disguised attempt to claim a formula, equation, or mathematical relationship. The human intervention test provides that a fundamental discovery of something, such as a new plant species, a new mineral, a new compound, or a new biological material, is patent eligible if it is altered or modified so that it is in a non-naturally occurring state and has properties that are not exhibited in its naturally occurring form. Finally, the data comparison test negates patent eligibility if a claim merely covers the act of comparing data without more.
COMMENT: U.K.’S BINDING SAY-ON-PAY AND ITS SEMI-BINDING NATURE ON THE U.S.

Allison J. McCowan†

I. HISTORY OF EXECUTIVE COMPENSATION IN THE UNITED STATES

II. INTERNATIONAL APPROACHES TO EXECUTIVE COMPENSATION AND SAY-ON-PAY

A. UNITED KINGDOM

B. EUROPE

1. European Commission’s Non-Binding Vote

2. European Countries with Binding Votes

III. UNITED STATES’ TAKE ON EXECUTIVE COMPENSATION REFORM IN THE 21ST CENTURY

A. SAY-ON-PAY RULES UNDER THE TROUBLED ASSET RELIEF PROGRAM

B. SAY-ON-PAY RULES UNDER THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

C. PRACTICAL IMPLICATIONS OF SAY-ON-PAY UNDER DODD-FRANK

IV. MOVING FORWARD

A. UNITED KINGDOM

B. MANDATORY BINDING STOCKHOLDER VOTES IN THE UNITED STATES

V. CONCLUSION

† J.D. candidate (2013) Wake Forest University School of Law; B.A., Psychology (summa cum laude), Norwich University (2008). The Author would like to give a special thanks to her family and friends for their continuing love and support, as this would not be possible without them. Additionally, the Author would like to thank the editors and staff members of the Wake Forest Journal of Business and Intellectual Property for their many hours of hard work to prepare this Comment for publication.
INTRODUCTION

“One of the great, as-yet-unsolved problems in the country today is executive compensation and how it is determined.”


The growing concern surrounding executive compensation and the amount that executives get paid is rarely out of the media’s focus. In 2008, the collapse of major financial institutions run by extraordinarily well-paid executives brought intense focus and scrutiny on executive compensation. From the viewpoint of investors and the public, Chief Executive Officers (“CEOs”) pursued excessively risky strategies or investments that put corporations on thin ice, all the while they were paying themselves hefty paychecks. The prevailing view is that excessive compensation runs rampant, and boards of directors frequently award overly generous compensation packages to executives and officers with no regard for the interests of the corporation.

Executive compensation will never be the same for financial institutions following the financial crisis of 2008. Due to the crisis in the world’s financial markets, the world of executive compensation will not likely be the same for any publicly traded corporation. Many media outlets and governments around the world sought to blame the near collapse of the world’s financial institutions on the compensation policies and practices of financial institutions. In response to the financial crisis, restrictions and limitations on executive compensation became a central part of the legislation proposed and adopted. This Comment explores the history of executive compensation and argues that the current legislation is inadequate to prevent further abuse of the compensation system. While the United States took proactive and positive steps in drafting and passing the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), there are gaps in its enforcement and implementation that could render all of the hard work null and void. The practices of countries in Europe—the Netherlands and the United Kingdom—may seem extreme. However, their application presents a more systemic solution than that currently used in the United States, and their use as a regulatory device is valuable for achieving the intended goals of Dodd-Frank and executive compensation reform.

Part I examines the history of executive compensation in the United States including the call for reform. Part II presents United Kingdom and European legislation enacted to curtail obscene executive compensation, including the drafting history of the

regulations on both general and specific executive compensation reform. Part III presents situations from the United States that exemplify the problems and pitfalls in the executive compensation reform. Furthermore, Part III presents solutions that the United Kingdom has enacted to prevent the problems from happening again. Finally, this Comment concludes that the executive compensation reform enacted in the Netherlands and the United Kingdom is not an extreme solution, determines that the current reform in the United States is inadequate to address real world concerns, and demands a change in the present executive compensation climate.
I. HISTORY OF EXECUTIVE COMPENSATION IN THE UNITED STATES

While executive compensation may seem like a current hot topic, the attention surrounding it is not a new concept in the United States. An examination of the history of executive compensation in the United States in order to understand its problems. The executive compensation trends from the past can shed some light on possible solutions for the future.

Originally, in the 1800’s, the majority of business organizations were run by individuals who owned a large percentage of the organization and had a personal interest in how the organization was run. This type of proprietary management meant low executive pay and an extremely close connection between an organization and its leaders.

In the early 1900’s, around the time of the railroad boom, the United States began seeing great changes in the structure of business organizations. Small, family-run companies combined with each other to form new, giant industrial corporations. By 1904, over 1,800 small business organizations combined to form 157 large corporations. At this point, the senior and mid-level management positions, which were once held by owners of the organization, began to be held by executives with no interest or relationship to the business organization. Many scholars, academics, and analysts recognized this change in managerial positions and identified the disconnect between the separation of ownership and control of the corporation. In response to these theories, business leaders implemented bonus programs that paid senior and upper-level employees bonuses specifically linked to firm profits and success.

In the 1920’s, executive bonus plans flourished and were widely implemented in corporate structures. While every firm evaluated its bonus programs differently, most organizations used a formula that placed a percentage of earnings into a bonus pool to be distributed to

---

2 Harwell Wells, “No Man Can Be Worth $1,000,000 A Year”: The Fight Over Executive Compensation in 1930s America, 44 U. RICH. L. REV. 689, 695 (2010).

3 Id. at 695-96.

4 Id.

5 Id. at 696.


7 Wells, supra note 2, at 696-97.


9 Wells, supra note 2, at 697-99.

10 Id. at 700.
the top management. The primary reason for the implementation of executive bonus plans was the problem of the separation of ownership and control. However, there were other reasons for the new bonus scheme, such as persuading talented executives to work for the company, incentivizing executives to work for the firm instead of themselves, and curing the split between labor and capital. With these new bonus programs, executive compensation in the early 1900’s increased by dramatic numbers.

The development of executive compensation and bonus schemes did not mean the same development of executive compensation law. During this time, there was relatively no law dictating disclosure or executive compensation rates. However, in the early 1930’s, the Great Depression hit its peak and things began to change. Undoubtedly, the Great Depression was the most dominant factor in shaping public disclosures of executive compensation schemes. Through a series of government investigations and stockholder suits, executive compensation became a highly public issue. The disclosures made through various lawsuits and government investigations shocked the public and stockholders, encouraging them to take action.

With such strong public outrage, Congress realized that it must take action to curb the ever-growing executive compensation problem. Politicians with various motives for executive compensation reform found that the most popular and effective response turned on disclosure. The national push for greater disclosure and compensation reform found its way into the Securities Act of 1933 and the Securities Exchange Act of 1934. These two acts required corporations to disclose senior officers’ pay. Because of the 1933 and 1934 Acts, beginning in 1935, public corporations were required to disclose the compensation of officers making more than $20,000 per year, including bonus payments. These amounts were required

---

11 Id.
12 Id. at 701.
13 Id.
14 Id. at 702.
15 Id. at 709.
16 Id.
17 Id. at 737.

continued . . .
information on the public corporation’s annual Form 10-K.  

In light of the information that the government collected, multiple news sources used the information to create comprehensive lists of high-paid corporate executives. For example, The New York Times annually published lists of highly compensated executives compared to the pay figures of average workers in the executive’s industry. These figures only infuriated the public more. By the mid 1930’s, outcry over executive compensation was bubbling over. Shockingly, the public outcry and additional disclosure requirements did little to change the fundamental executive compensation practices.

World War II ushered in a new era of executive compensation, which was characterized by declines in executive compensation and slower growth of executive compensation plans. The war allowed corporations and executives to improve their negative images, and by the end of the war, any remnants of strong anti-corporation emotions had almost disappeared. While executive compensation faded from the forefront of major public issues, the composition of compensation began to change.

Following the end of World War II, compensation packages began including “fringe” benefits, such as health and life insurance, retirement plans, stock options, and other various benefits. These benefits, specifically stock options, got favorable tax treatment. They were used by firms as a tool to tie executives’ economic fates to the company’s. In the 1960’s the majority of publicly traded corporations offered stock options plans to their executives. Stock options plans supplemented executives’ traditional salaries; however, during this time corporations did not give their executives large stock option grants, instead corporations kept the lowered executive compensation plans.

(1934).

22 See Salaries Synthesized, TIME, July 20, 1936, at 65.
24 See Pay of Executives Found Moderate, N.Y. TIMES, July 6, 1936, at 23.
26 Id. at 12.
27 Id. at 13.
28 Id.
29 Id.
30 Id. at 14.
31 Id.
Once stock options became popular, they attracted a steady stream of commentary from courts and legal scholars. Courts imposed stricter guidelines on stock options than on other forms of executive compensation. Scholars and courts made strong attempts to understand and clarify executive compensation and the new stock option plans.

During this era, traditional theories of corporate governance depicted senior executives and the CEO as working under, and controlled by, the board of directors and the stockholders. These theories advanced the idea that executive compensation was completed during an arms-length transaction between the executives and the corporation’s board of directors. Although the traditional theory was widely accepted, it did not provide a complete answer to executive compensation and had wide, unexplained gaps. Critics of the traditional theory postulated that the reality of the traditional theory was actually true—the board of directors served at the pleasure of the CEO and other senior executives. These critics doubted any meaningful distance between the CEO and the board of directors. They believed that the CEO actually set his own salary with no regard to the board of directors. Proponents of this “new” theory thought that an executive could increase and control his own compensation by simply increasing sales instead of increasing overall profitability. Even with the academic chatter, executive compensation remained a minor issue, possibly due to its slow growth.

Around the mid 1970’s, executive compensation began growing at a faster rate. For example, in 1965, a CEO was paid approximately twenty-four times more than the average worker; however, by 1979, the figure rose to thirty-five times more. This trend still continues. In 1999, a CEO was making about 299 times more than the average worker’s pay. The average worker’s pay in the United States has become stagnant since the 1970’s, which only widens the gap between

32 Id.
33 Id. at 15.
34 Id.
35 Id. at 15-16.
36 Id. at 16.
37 Id.
38 Id.
39 Id.
40 Id.
41 Id.
42 Josh Bivens, CEOs Distance Themselves from the Average Worker, ECON. POLICY INST. (Nov. 9, 2011), http://www.epi.org/publication/ceo-ratio-average-worker/.
43 Id.
executive and average worker pay.\textsuperscript{44}

The executive compensation path from the 1970’s forward could be described like a roller coaster track, going up and down. In the 1970’s, executive compensation began growing at a quicker pace than the 1960’s and previously.\textsuperscript{45} In the 1980’s, the rising executive compensation gained new and powerful scrutiny.\textsuperscript{46} This new scrutiny focused on broad economic problems due to the discovery of widespread illegal corporate donations, corporate scandals, shortcomings in corporate governance, and newly formed doubts regarding the competency and integrity of CEOs and boards of directors.\textsuperscript{47} In sum, the attack on executive pay was viewed as a way to reform the corporate economy as a whole.\textsuperscript{48} Scrutiny as well as public criticisms increased during this time.\textsuperscript{49} Public hostility erupted when many CEO compensation packages surpassed the million-dollar-a-year threshold.\textsuperscript{50} Executive compensation tied to takeovers drew similar criticism.\textsuperscript{51} Following the media coverage of merger industries, the public was outraged that failing CEOs were not harmed due to the new “golden parachutes” that the corporation had enacted in the face of a merger or business combination.\textsuperscript{52} During the 1980’s, the amount of compensation grew and the composition of pay packages evolved away from an amount rewarded for corporation positive performance.\textsuperscript{53}

In 1992, to counteract public discontent with executive pay, Congress and the Securities and Exchange Commission (“SEC”) adopted new measures to refocus and rein in executive compensation.\textsuperscript{54} Congress used its power to change United States tax rules concerning compensation by preventing publicly traded corporations from deducting compensation over $1,000,000, unless the compensation was both “performance-based” and part of a plan approved by stockholders.\textsuperscript{55} The SEC created new disclosure requirements that mandated more detailed disclosure of policies used

\textsuperscript{45} Wells, supra note 25, at 17.
\textsuperscript{46} Id. at 18.
\textsuperscript{47} Id.
\textsuperscript{48} Id.
\textsuperscript{49} Id.
\textsuperscript{50} Id.
\textsuperscript{51} Id. at 19.
\textsuperscript{52} Id.
\textsuperscript{53} Id. at 20.
\textsuperscript{54} Id. at 21.
\textsuperscript{55} Id.
in setting compensation.\textsuperscript{56} The good intentions and practical implications behind the SEC’s and Congress’ actions could not curb executive compensation and did little to stall the overall growth of compensation.

At the start of the new century, in 2000, the Internet bubble burst, which led to a sharp decrease in CEO pay from 2001 to 2003.\textsuperscript{57} Following the bubble’s bursting, Enron and other major American corporations collapsed, which inspired public hope that executive compensation would once and for all be restrained.\textsuperscript{58} Unfortunately, executive compensation only continued to increase.

\section*{II. International Approaches to Executive Compensation and Say-on-Pay}

The United States was not unique in its executive compensation problems. As industries grew and companies became more complex, countries around the world developed problems with CEO and executive pay.

\subsection*{A. United Kingdom}

In 2002, the United Kingdom became the first country to pass mandatory, non-binding say-on-pay requirements.\textsuperscript{59} These executive compensation reforms were the first of their kind and set the tone for executive compensation reform.\textsuperscript{60} Although the United States does not have the exact market structure and size as the United Kingdom, the United States modeled its say-on-pay rules off the United Kingdom’s 2002 regulations.\textsuperscript{61} In order to fully understand the United Kingdom’s regulations it is imperative to take a comprehensive look at

\begin{itemize}
\item \textsuperscript{56} Id.
\item \textsuperscript{57} Id. at 25.
\item \textsuperscript{58} Id.
\item \textsuperscript{60} See Delman, \textit{supra} note 59, at 591.
\end{itemize}
the United Kingdom’s situation at the time surrounding the adoption of the regulations.

The United Kingdom experienced executive compensation outrage similar to that of the United States. In the 1980’s, during the rule of Margaret Thatcher, the United Kingdom privatized the majority of the country’s utilities, including water, electricity, and gas. Following the privatization of these utilities, the compensation of the senior officers skyrocketed for essentially doing the same job in the same way. The public outrage surrounding these new utility corporations and their seemingly overpaid senior officials lead to the beginning of government regulation of compensation.

In 1998, the London Stock Exchange adopted an industry-sponsored code referred to as the “Greenbury Code.” Without substantial change, the London Stock Exchange included a large part of the Greenbury Code in its Listing Rules as part of the Combined Code on Corporate Governance (“Combined Code”). The new Combined Code required public corporations to establish a remuneration committee of independent directors to evaluate and set executive compensation, and to disclose additional compensation information and policies through audited reports. The boards of public corporations were obligated to annually “consider” seeking stockholder approval for compensation decisions. Although the majority of public corporations complied with the Combined Code, executive compensation levels rose and only a small number of firms held stockholder votes on compensation schemes.

This legislation missed the mark on executive compensation reform. Therefore, in 2002, the United Kingdom amended the U.K. Companies Act and adopted a radical amendment, titled the Directors Remuneration Report Regulations (“DRR Regulations”). The DRR Regulations expanded disclosure of executive compensation above the then-current requirements of the London Stock Exchange and U.K.

---

63 Id.
64 Id. at 341-42.
66 Gordon, supra note 62, at 341-42.
67 Id. at 342.
68 Id.
69 Id.
70 DRR Regulation, supra note 59, at art. 1.
Companies Act.\textsuperscript{71} Most importantly, the new legislation required an advisory stockholder vote on the Director’s Remuneration Report (“DRR”), a company’s disclosure report of executive compensation.\textsuperscript{72}

Specifically, the 2002 DRR Regulations require that the DRR include specific disclosure of the types of compensation paid to the senior executives as well as a statement of the company’s overall compensation policy.\textsuperscript{73} The stockholder vote required under the DRR Regulations is a mandatory vote on the DRR by stockholders for every public company.\textsuperscript{74} This yearly mandatory vote requires the stockholders to “approve” executive pay; however the vote itself is not binding on the corporation.\textsuperscript{75} Essentially, the stockholders can vote “no” for a proposed executive compensation scheme and the board of directors can ignore the stockholder vote and adopt the compensation scheme, and the company would technically suffer no repercussions or adverse effects.\textsuperscript{76} Under the DRR Regulation, a board of directors can only be held liable or fined if it completely fails to satisfy the requirements mandated under the DRR, but not if it ignores the stockholder vote.\textsuperscript{77}

In addition to the advisory stockholder vote, the DRR Regulations require that each company submit a statement of the company’s overall compensation policy that includes an analysis of the company’s performance compared to its peers.\textsuperscript{78} Additionally, the statement must be signed by remuneration committee members and further independently audited by an outside source.\textsuperscript{79} The DRR Regulations radically improved the hopes of executive compensation reform on a global level.

\textbf{B. Europe}

The United Kingdom can be a helpful tool in understanding executive compensation reform due to the fact that it was the first country to enact a stringent compensation-targeted regulation. However, other countries in Europe were quick to follow the United Kingdom’s lead and these countries began adopting their own compensation reform. Some of these compensation reforms mirrored

\textsuperscript{71} Gordon, supra note 62, at 342.

\textsuperscript{72} DRR Regulation, supra note 59.

\textsuperscript{73} DRR Regulation, supra note 59, at art. 10, § 234B(2), (3).

\textsuperscript{74} DRR Regulation, supra note 59, at art. 7, § 241A(1), (6).

\textsuperscript{75} DRR Regulation, supra note 59, at art. 7, § 241A.

\textsuperscript{76} DRR Regulation, supra note 59, at art. 7, § 241A(6), (8).

\textsuperscript{77} DRR Regulation, supra note 59, at arts. 3, 7, §§ 234B, 241A(9), (10).

\textsuperscript{78} DRR Regulation, supra note 59, at art. 3, §§ 234B(2), (3).

\textsuperscript{79} DRR Regulation, supra note 59, at art. 3, § 234C.
the United Kingdom’s approach while others were much more drastic.

1. European Commission’s Non-Binding Vote

In 2004, only two years after the United Kingdom adopted the DRR Regulations, the European Commission (“EC”) recommended that all European Union countries submit their remuneration policy to the stockholders for an advisory vote. The EC’s recommendation allowed for stockholders to opt-in to a say-on-pay regime so long as a sufficient number of stockholders chose to opt-in. In other words, companies could decide to adopt the stockholder advisory vote only if stockholders holding a minimum of a quarter of the stocks requested it. In 2009, following a study conducted by the EC that showed that stockholders in the majority of member states had a say in determining the remuneration of the board of directors but not a vote on executive compensation, the EC issued sharply-worded recommendations aimed at improving stockholder oversight. This latest communication from the EC demonstrates its serious intent to forcefully direct member states to empower stockholders to have a stronger voice when it comes to executive compensation. Additionally, the forceful nature of the EC could mean that the EC is willing to accept diverging models of stockholder voting. Germany has followed in the EC’s footsteps and adopted a similar compensation regime.

2. European Countries with Binding Votes

The Scandinavian countries (Denmark, Sweden, and Norway) and the Netherlands have enacted very radical regulations that not only required a mandatory stockholder vote on executive compensation, but required that the mandatory vote be binding on the corporation. In 2003, the accounting scandal at Ahold, a large Dutch retailer, led to a revelation that the incoming CEO was guaranteed fixed

---

81 Id. at art. 4.2 (suggesting that the vote can be “held only if shareholders representing at least 25% of the total number of votes held by shareholders present or represented at the annual general meeting request it”).
83 Delman, supra note 59, at 594.
bonuses. A few high-profile cases of “pay-for-failure” only magnified the intense negative public response. In addition to the public outcry, Dutch trade unions, which form an integral part of the Dutch corporate model, pointed out that compensation for executives was growing roughly eight to ten times faster than wages for average workers. The public disdain, coupled with the trade union’s power, influenced the Dutch government to form the Corporate Governance Committee ("Tabaksblat Committee"). The Tabaksblat Committee crafted a code of best practices similar to the United Kingdom’s Greenbury Code. The Netherlands adopted the Tabaksblat Code in 2004 and made it mandatory for every corporation to comply with its corporate governance principals. Similar to the United Kingdom’s model, and in conformity with its overarching regulatory approach, the Netherlands had a “comply or explain” model for compliance with the Tabaksblat Code. The provisions of the Tabaksblat Code were applied unconditionally or required a persuading explanation for any departure of the code.

There are three key differences between the Netherlands approach and the DRR Regulations from the United Kingdom. First, in the Netherlands, the stockholder vote is only on the principles that will be used to devise the compensation package, but not on the amount and compensation package itself. Second, the stockholder vote in the Netherlands does not have to be annual. Under the Tabaksblat Code the stockholders only vote on policy when the corporation has changed its pay policy. Third, and possibly the most drastic departure of the United Kingdom rules, the stockholder vote is completely binding on the corporation. For example, if the stockholders vote down a new compensation policy, the former approved policy will stay in effect

84 Id. at 592.
85 Id.
86 Id.
88 Id.
90 TABAKSBLAT CODE, supra note 87, at Preamble 6.
91 Id.
92 Delman, supra note 59, at 593.
93 Id.
94 TABAKSBLAT CODE, supra note 87.
95 Delman, supra note 59, at 593.
until the stockholders approve a new one.

In response to their own corporate scandals, rising executive pay, and public anger, the Scandinavian countries soon enacted similar Dutch binding vote models instead of following the United Kingdom’s DRR Regulations model.96 All three countries require a mandatory, binding stockholder vote on prospective pay policies.97 However, Sweden and Norway mandate the stockholder vote to be annual, even when there is no change in compensation principles.98

III. UNITED STATES’ TAKE ON EXECUTIVE COMPENSATION REFORM IN THE 21ST CENTURY

A. Say-On-Pay Rules Under the Troubled Asset Relief Program

As discussed in Part I, public outrage raised concerns over excessive pay to executives employed at failing or failed companies. As a result, the federal government enacted several restrictions as a condition to receiving federal stimulus funds.99 In 2008 and 2009, Congress passed the Emergency Economic Stabilization Act (“EESA”) and the American Recovery and Reinvestment Act (“ARRA”) to combat the growing concern.100 These statutes imposed new obligations on boards of directors and compensation committees in an unprecedented area of compensation not previously regulated by federal law. In addition to the EESA and the ARRA, the federal government enacted the Interim Final Rules for Troubled Asset Relief Program (“TARP”) entities to become effective June 15, 2009.101 The TARP regulations implement and enforce the executive compensation provisions of the EESA and the ARRA.

The TARP statutes only apply to corporations that received governmental financial assistance under the TARP program and only if these corporations have outstanding federal debt.102 In these cases, any TARP funds recipient must permit a separate stockholder vote to

96 Id. at 594.
97 Id.
98 Id.
100 EESA Regulations, supra note 99; ARRA Regulations, supra note 99.
101 TARP Regulations, supra note 99.
approve the compensation of executives. The TARP stockholder vote is not binding on the corporation or its board of directors and cannot be construed to create or imply any additional fiduciary duties. The say-on-pay provision requires the corporation to adopt a plan that would give the corporation’s stockholders the ability to vote on executive compensation that it will employ in the future. These say-on-pay rules provide the foundation of contemporary executive compensation reform in the United States.

B. Say-On-Pay Rules Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was a massive overhaul of financial regulations in the United States following the financial crisis of 2008. President Barack Obama stated that the Dodd-Frank legislation is “the toughest financial reform since the ones we created in the aftermath of the Great Depression.” The Obama Administration believed that a federal law authorizing “say-on-pay” for all public corporations could “help restore investor trust by promoting increased shareholder participation and increasing accountability of board members and corporate management.”

Dodd-Frank, which passed on July 15, 2010, requires executive compensation packages to be submitted to stockholders for a mandatory, non-binding advisory vote at least once every three years. More specifically, Dodd-Frank contains a variety of provisions concerning the mechanisms for enacting the say-on-pay vote. First, regarding the timing of when the vote must occur, Dodd-Frank requires:

Not less frequently than once every 3 years, a proxy or

---

103 ARRA Regulations, supra note 99, at 519.
104 Id.
105 Id.
109 Id.
consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives . . . .

Additionally, in order to determine the frequency of the stockholder advisory vote to approve the executive compensation package, Dodd-Frank states:

Not less frequently than once every 6 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to determine whether votes on the resolutions required under paragraph (1) will occur every 1, 2, or 3 years.

Dodd-Frank not only requires disclosure of the proposed executive compensation scheme, it requires disclosure for “golden parachutes” agreements used to compensate executives in the face of terminated employment. A “golden parachute” is an agreement between a company and an executive specifying that the executive will receive specific, significant benefits in the event that the company is acquired, consolidated, or sold. Dodd-Frank requires that these golden parachute agreements be disclosed, specifically identifying any named executive and describing the aggregate total of parachute payments that may be paid to each executive. In addition to this disclosure, the company must provide a stockholder advisory vote to approve any parachute payment.

The stockholder vote on executive compensation and golden parachute agreements are non-binding on the directors. Specifically, Dodd-Frank requires that the votes may not be construed: (1) to overrule a decision by the board of directors or the company; (2)

---

111 Id. § 78n-1(a)(2).
112 Id. § 78n-1(b)(1).
115 See id. § 78n-1(a)(1), (b)(2).
116 See id. § 78n-1(c).
to create or imply changes to fiduciary duties; (2) to create or imply additional fiduciary duties; or (4) to limit stockholders’ ability to make executive compensation proposals in proxy materials.\footnote{See id. § 78n-1(c)(1)-(4).}

C. Practical Implications of Say-On-Pay Under Dodd-Frank

Under Dodd-Frank there are generally three different scenarios following a stockholder say-on-pay vote. The most positive scenario, for both the corporation and its stockholders, is that the stockholders would vote “yes” for the executive compensation package. Under this scenario, the board would enact the stockholder-approved compensation scheme and hopefully everyone would be happy. Another possible scenario would be for the stockholder to vote “no” for the proposed executive compensation plan. Under scenario two, the board of directors would consider the stockholder’s advisory vote and change the proposed compensation scheme to more reasonable compensation. The final scenario would be if the stockholders voted “no” and the board of directors ignored the vote and enacted the stockholder-rejected compensation scheme.

While stockholders are generally satisfied and content under the first two scenarios, the third scenario leaves stockholders and boards of directors in an oppositional position. Since its inception in 2010, the advisory say-on-pay rules have seen their fair share of time in the courtroom under the third scenario.

On March 15, 2011, stockholders brought a derivative suit in Georgia state court claiming that the board of directors of Beazer Homes breached its fiduciary duties to the stockholders by violating the corporation’s “pay-for-performance” policy when it increased the CEO’s and top officials’ executive pay despite massive corporate losses.\footnote{Complaint at 1, Teamsters Local 237 Additional Sec. Benefit Fund et al. v. McCarthy et al., No. 2011-CV-197841 (Ga. Super. Ct. Fulton Cnty. Mar. 15, 2011).} These substantial compensation increases came after the company lost a total of $34 million dollars in 2010 and stockholder returns were down by 17%.\footnote{Id. at 11.} Under the newly enacted Dodd-Frank regulations regarding say-on-pay, Beazer Homes conducted its first advisory stockholder vote to determine the upcoming compensation package for its executives.\footnote{Id.} Despite a unanimous recommendation from the board, almost 54% of stockholders voted against the proposed compensation scheme.\footnote{Id. at 11.} Despite the negative vote, Beazer
Homes’ board of directors still awarded the proposed executive pay to the senior executives and CEO.\textsuperscript{122}

The substance of the disgruntled stockholders’ claim is that the board’s decision to increase compensation in the face of a negative vote and corporate loses was “disloyal, unreasonable and not the product of a valid exercise of business judgment.”\textsuperscript{123} Moreover, the stockholders alleged that the executive compensation scheme offered was a clear violation of the company’s own “pay-for-performance” compensation policy.\textsuperscript{124} Overall, the Beazer Homes’ stockholders concluded that the executive compensation packages in question were not in the best interest of the corporation or the stockholders, and were in violation of the company’s stated policy.\textsuperscript{125}

In defense of its actions, Beazer Homes argued that although Dodd-Frank requires companies to conduct a say-on-pay vote regarding the company’s compensation for top executives, that advisory vote “shall not be binding” on the board and “may not be construed” to imply or create fiduciary duties owed by the company’s board.\textsuperscript{126} Beazer Homes asserted that the purpose of the say-on-pay provision is only to allow the stockholders to express their views on executive compensation without binding the hands of the board when the board is making compensation decisions.\textsuperscript{127}

On September 16, 2011, a Georgia Superior Court granted Beazer Homes’ motion to dismiss the stockholders’ derivative claim, reasoning that a stockholder “no” vote does not require the corporation to rescind or re-evaluate the compensation package.\textsuperscript{128} The court found that the stockholders did not demonstrate that the board acted in bad faith or without an honest belief that its decisions concerning the 2010 executive compensation were best for the corporation.\textsuperscript{129}

Just four days after the Georgia court dismissed the case in Beazer Homes, an Ohio federal court ruled in favor of allowing a similar stockholder derivative suit to continue.\textsuperscript{130} In \textit{NECA-IBEW Pension Fund v. Cox} (“Cincinnati Bell”), unhappy stockholders argued that

\begin{itemize}
\item \textsuperscript{122} \textit{Id.} at 1.
\item \textsuperscript{123} \textit{Id.}
\item \textsuperscript{124} \textit{Id.}
\item \textsuperscript{125} \textit{Id.}
\item \textsuperscript{127} \textit{Id.} at *11.
\item \textsuperscript{128} \textit{Id.} at *2.
\item \textsuperscript{129} \textit{Id.} at *19.
\end{itemize}
senior executives and the CEO were being handsomely rewarded in the face of poor company performance in the previous year. The Cincinnati Bell case features similar claims as the Beazer Homes case. The big difference between these two cases lies in the analysis of the judges. The Ohio federal court judge held that the business judgment rule was properly rebutted. The plaintiff demonstrated sufficient facts to rebut the rule by showing that the corporation ignored both written company policy and the express will of the stockholders in granting raises that were disproportionate to the company’s profits. The judge found that the plaintiff “pled specific facts to give reason to doubt that the directors could make unbiased, independent business judgments.” The board could not be depended upon to give a fair review of the charges considering that it already voted to approve the unpopular compensation plan, which was in violation of company policy and against the will of stockholders.

While the courts in Beazer Homes and Cincinnati Bell are technically correct in their statement of current law, the differences in the state court findings pose a major problem for stockholders and the legislators who enacted the say-on-pay provision of Dodd-Frank. By examining these two cases there is one large area of concern: in what circumstances will the advisory vote constructively bind the corporation?

IV. MOVING PAST ADVISORY SAY-ON-PAY

A. United Kingdom

The United Kingdom’s success under the 2002 regulations did not come easy; however, proponents of the say-on-pay regulations have claimed that the new disclosure requirements were a victory. GlaxoSmithKline experienced the first “no” vote under the new United Kingdom say-on-pay regulations. In May 2003, during the first year the DRR Regulation was in effect, the stockholders of GlaxoSmithKline rejected the CEO’s large golden parachute

\[\text{footnotes}\]

131 Id.
132 Id. at *3.
133 Id. at *3-4.
134 Id. at *4.
135 Id.
137 Id.
agreement by a vote of 50.72%. Following this rejection, GlaxoSmithKline met with stockholders and discussed a more appropriate and acceptable golden parachute agreement with the CEO.

The United Kingdom say-on-pay scheme stayed relatively quiet from 2003 until 2009, with the majority of the advisory stockholders voting in favor of the compensation plans and golden parachute agreements. The financial crisis of 2008 radically shook the atmosphere in the United Kingdom and ushered in a slew of upset stockholders. In 2009 and 2010, the number of stockholders who disagreed with their corporation’s executive compensation schemes rose dramatically. For instance, in 2009, 59% of the stockholders of Royal Dutch Shell (“Shell”) rejected the corporation’s compensation package for 2008 to protest the payment of bonuses in the face of the corporation’s failed performance goals. Shell’s bonus policy dictated that executives would not receive bonuses if Shell ranked fourth or lower in a group of its peers. In 2008, Shell was ranked fourth on the annual list; however, Shell’s remuneration committee decided to maintain its original compensation package. Some scholars argue that the increase of stockholder “no” votes is only a positive outcome of the say-on-pay regulations because it demonstrates the open communication lines between the board of directors and stockholders.

While some contend that the United Kingdom DRR Regulations proved successful, evidenced by both “yes” and “no” votes on executive compensation schemes, empirical evidence shows that executive pay has only increased since 2002 and the enactment of the DRR Regulation. Due to this perceived failure of the DRR

138 Id.
139 Id.
140 Id.
142 Id.
143 Delman, supra note 59, at 590 (referencing James Herron, Controversial Head of Shell Remuneration Committee to Retire, DOW JONES NEWswire, Sept. 11, 2009).
144 Herron, supra note 143.
145 Id.
146 Id.
Regulations, the United Kingdom government announced a package of new measures to address and reinvigorate the 2002 regulation.

On June 27, 2012, the government of the United Kingdom announced a new proposal setting out new standards for corporate DRR. The new changes included three key points. First, and most importantly, the proposed changes require that each company put its director remuneration policy (executive compensation package) to an annual binding stockholder vote. The only way for a company to avoid this yearly binding vote is to leave its policies unchanged each year; nevertheless, a company is then required to conduct a binding stockholder vote every three years. Second, the new regulation would require the “continuation of an annual advisory vote on how each company’s remuneration policy was implemented in the previous year,” including the amount of compensation that the company had previously paid to executives. Third, the proposed regulation would require a higher level of disclosure for executives and their termination packages.

Although the proposed legislation is being debated by Parliament, it is overwhelmingly expected to be enacted and applied to United Kingdom companies around October 2013.

The first proposed change, the forward-looking report, would inform a binding vote by stockholders on the executive compensation package and would be included in the annual report. The compensation scheme would require the affirmative vote of 50% to pass and the vote would be required to be conducted annually unless the corporations decide to leave their remuneration policy unchanged. If a corporation decides not to change its remuneration policy, the mandatory binding stockholder vote is only required to be conducted every three years. Any proposed change to the remuneration policy requires stockholder approval, even if the stockholders already voted once that year. In the event that the stockholders vote “no,” the corporation must keep using the last

---

149 Id.
150 Id.
151 Id.
152 Id.
153 Id.
154 Id.
155 Id.
156 Id.
157 Id.
compensation policy approved by stockholders until the stockholders approve a new plan.  

The second proposed change, the backwards-looking implementation report, gives an explanation to the stockholders of how the remuneration policy was implemented in the previous year. The report on the previous year’s policy is required to include specific details of actual payouts and awards made to senior executives and the CEO. The figures included in this annual report should reflect the actual remuneration earned as compared with the potential remuneration not yet earned by the end of the year. In compiling these reports, corporations are advised to be more proactive in their reporting techniques as well as in reporting whether directors and senior executives have met their annual performance goals.

The third proposed change specifically involves the disclosure of termination payments to directors. This proposal is a direct response to the perceived problem of “rewards for failure.” The proposal requires United Kingdom corporations to set out their approach to exit payments as part of the remuneration policy report—subject to the binding stockholder vote. The remuneration policy report should contain all necessary facts and elements that will be used when calculating exit payments for directors and senior executives. Once a director leaves and the corporation pays the director an exit payment, the proposed change would require the corporation to promptly publish a statement describing in detail the termination payments made.

B. Mandatory Binding Stockholder Votes in the United States

The United States would be keen to keep an eye on the binding say-on-pay in the United Kingdom. The regime proposed in the United Kingdom could have a significant impact on United States pay practices. These new regulations allow flexibility for directors, permit a stronger voice for stockholders, and impose a healthy divide of power and legal considerations for United States corporations.
Advisory stockholder voting has opened the window for advanced regulation and discussion. While corporations might not have liked the idea of an advisory stockholder vote on executive compensation, the majority of corporations listened to what the stockholders wanted and responded appropriately. Whether out of fear of market punishment or embarrassment of a “no” vote, in the cases where stockholders have voted “no,” boards have been quick to devise a more suitable compensation plan, accepted by all. However, as say-on-pay advisory votes become more commonplace, there is a risk that boards will treat those votes as non-events, even when stockholder dissent reaches higher levels. The recent cases highlight this phenomenon, and the instances of corporations disregarding negative votes have increased with the number of years that say-on-pay has been around.

The indifference of boards of directors can be curbed by adopting a mandatory binding stockholder vote on executive compensation. To start, requiring a mandatory binding stockholder vote on a corporation’s compensation package would place the power back in the corporate owner’s—the stockholders—hands. Historically, boards of directors were entrusted to manage the corporation’s assets and business; but unlike the contemporary view, boards do not have open-ended power. There are positive reasons for the allocation of power between boards and stockholders. The checks and balances that these two positions have on each other are worth noting. Additionally, because the stockholders are the “owners” of the corporation, they should be given rights at the expense of other corporate constituents. The stockholders would be more involved in the performance and risks of the company.

If mandating an advisory say-on-pay under Dodd-Frank seemed radical in 2010, mandating binding say-on-pay may seem out of the this world; but, stockholders have had a strong voice when it comes to executive compensation for a while. For example, in accordance with 2003 SEC stock exchange regulations, stockholders are required to approve any stock option plan.\textsuperscript{168} Essentially, under this rule, all equity-compensation plans or revisions to the terms of such plan are subject to stockholder approval.\textsuperscript{169}

\section*{V. Conclusion}

Under the current Dodd-Frank regulatory regime, executive compensation laws in the United States miss the mark of adequate


\textsuperscript{169} Id.
reform. If executive compensation reform is the accurate goal of these regulations, there must be some sort of checks and balances system in place to keep a lid on boards’ and senior executives’ decisions. The current regulations and debate surrounding executive compensation and say-on-pay in the United States have not paid enough attention to the additional options that are available. In particular, the new United Kingdom binding stockholder vote and the older Netherlands approach provide a good framework for constructing binding say-on-pay legislation. Although the United Kingdom’s 2012 regulations have not been put into force yet, the Netherlands has collected data demonstrating the positive effects of its binding say-on-pay legislation.

Without any credible source of liability or ouster, directors are unlikely to heed to an advisory non-binding vote seriously. As say-on-pay becomes more prevalent on a global scale and in the United States, the stockholder votes should be binding. Whatever form of say-on-pay the United States ends up taking in the future, it is clear that the current reform is not enough to bind pay-for-performance, which is the ultimate goal of executive compensation reform. To that end, other reforms should be closely studied and monitored in conjunction with the United States’ ideals and executive compensation goals.
YOU CAN’T FIRE ME! STATE COMMON LAW EXCEPTIONS TO EMPLOYMENT-AT-WILL

Kevin P. Harrison†

I. INTRODUCTION ................................................................. 231

II. A BRIEF HISTORY OF EMPLOYMENT-AT-WILL IN THE UNITED STATES ............................................. 231

III. ERODING EMPLOYMENT-AT-WILL: PRIMARY COMMON LAW EXCEPTIONS ........................................... 232
   A. THE PUBLIC POLICY EXCEPTION .................................. 233
   B. THE IMPLIED CONTRACT EXCEPTION .............................. 234
   C. THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING .............................................................. 235
   D. QUESTION OF DAMAGES .............................................. 236
   E. PREVALENCE OF THE EXCEPTIONS ................................. 238
   F. CURRENT TRENDS .......................................................... 239

IV. GENERAL APPROACHES TO CRAFTING EXCEPTION-CONSCIOUS POLICY .................................................. 240
   A. THE “ONE-SIZE-FITS-ALL” APPROACH ............................ 241
   B. THE “CUSTOM TAILORED” APPROACH ............................. 241
   C. THE MULTI-FACTOR APPROACH ...................................... 242

V. CRAFTING POLICY FOR SPECIFIC EXCEPTIONS........... 243
   A. THE PUBLIC POLICY EXCEPTION – DIFFICULT BY

† The Author is a J.D. Candidate (2013) at Wake Forest University School of Law and an alumnus of Miami University (2010), where he graduated with a B.S. in Business and a B.A. in Political Science. This article is the result of the encouragement and support of his family and friends. For that, the Author would like to express tremendous gratitude. The Author would like to give special thanks to Drs. Joshua Schwarz and David Walsh, whose exceptional teaching and scholarly work in this area inspired me to explore it, to the Honorable Judge Daniel Haughey, Dr. Daniel Herron, Gus Lazares and Katie Wallrabenstein, whose advice and friendship have always driven me to work harder and strive higher, and most of all to my parents, Mark and Patti, and my son Ryan, whose constant love and support is the fuel for all I do.
ABSTRACT
Since its inception approximately 135 years ago, the doctrine of employment-at-will offered near universal protection for employers who discharged non-union employees without an express contract containing provisions that specify employment for a definite duration and/or termination only for good cause. However, after spending close to sixty years enforcing the maxim that these “at-will” employees could have no recourse against their employer upon being discharged, the landscape changed.

In 1959, California became the first state to begin eroding the employment-at-will doctrine. Though the initial reaction around the country to this incursion was tepid at best, it ultimately marked the beginning of close judicial examination of the doctrine’s foundational rationales and implications. This examination eventually culminated in a revisionary revolution spanning from the mid-1970s to the early 1990s. What resulted was a reshaping of the employment-at-will doctrine, primarily based on three rationales for restricting employers’ ability to freely terminate the employment relationship.

Since the end of that revolution however, there has been very little change in the degree of recognition each theory has achieved. The basis of claims available against employers under each theory has also remained constant in each jurisdiction. What is surprising in the face of such constancy is that employers appear to be either unaware of the nuances of the three exceptions or gambling that they will not be hurt by them. With wrongful discharge claims sharply rising in these difficult economic times, this comment will explore the current state of the employment-at-will doctrine and provide guidance to employers about how to tweak traditional approaches to human resource practice in order to avoid running afoul of the three primary exceptions that impinge on their freedom to fire.
I. INTRODUCTION

Due in large part to the Great Recession and current sluggish economic growth, Americans are more focused now than at any time in recent memory on the world of work. Those who remain unemployed are necessarily focused on the availability of employment. But for those who have a job, the lurking question is whether that job (and the income and stability associated with it) is truly secure.

Underlying employees’ fears is the seemingly boundless power of most businesses to fire employees whenever and for whatever reasons they want. While they may not know this fear in their collective gut by name, it is not without strong legal merit. Since the late 1800’s, an employer’s power to terminate the employment relationship has been expansive for all but a few select classes of employees. For almost half that time, it was indeed almost limitless. In the modern business world, however, an employer’s power is not as vast as it seems, and certainly not as unfettered as it once was.

Unfortunately for many employers, their decision-makers may also be equally unaware of the limits on their power to terminate the employment relationship. Others may have the knowledge, but lack the desire to adapt their traditional policies and practices. Regardless of the reason(s), any employer that stays static or adopts an outdated approach to human resource management is making a dangerous legal and reputational gamble that could have significant consequences for both employer and employee. The purpose of this comment is to explore discharge as it applies to the majority of United States employees and guide employers through the proactive changes and reactive decisions that can be made to ensure that the dangers of state common law claims relating to discharge are avoided.

II. A BRIEF HISTORY OF EMPLOYMENT-AT-WILL IN THE UNITED STATES

In the United States, the doctrine of “employment-at-will” refers to the presumption that where no definite term is included in an employment contract, the relationship will be one of indefinite duration that can be terminated at any time by either the employer or the employee. Such relationships leave employers “free to discharge individuals ‘for good cause, or bad cause, or no cause at all.’”

The American version of the doctrine was born in 1877 in a treatise on “master-servant” relations by a New York attorney, Horace Gray Wood. According to Wood, the American rule was “inflexible that a general or indefinite hiring is prima facie a hiring at will.” Over time, Wood’s rule was gradually adopted throughout the United States. It continued to be enforced and went virtually unquestioned by American courts for the next eighty-two years.

In 1959, the California Court of Appeals’ decision in Petermann v. International Brotherhood of Teamsters was the first to carve out an exception to the doctrine of employment-at-will. The court based this departure from decades of precedent on public policy considerations. In Petermann, an employee was terminated after being instructed to commit perjury and subsequently testifying truthfully. In carving out the first exception, the court initially limited it to situations where an employee refused an order to violate a criminal statute, stating that:

To hold that one’s continued employment could be made contingent upon his commission of a felonious act at the instance of his employer . . . is patently contrary to the public welfare . . . [t]he public policy of this state requires that every impediment . . . to the above objective, must be struck down when encountered.

While it would take an additional fifteen years for another court to take up the torch, the Petermann decision would ultimately prove to be the marker of a forty-year long revolution across the United States eroding the employment-at-will doctrine, primarily through the adoption of three general common law exceptions.

### III. ERODING EMPLOYMENT-AT-WILL: PRIMARY COMMON LAW EXCEPTIONS

Though the Petermann decision was the first chink in the armor of employment-at-will, it was not without its limitations. Its narrow
coverage of only a refusal to perform criminal acts at the behest of an employer limited the applicability of the public policy considerations that served as its underpinnings on more general principles.\(^\text{10}\) What Petermann accomplished immediately, however, was to invite scrutiny toward the application of the employment-at-will doctrine in the context of employee discharges.\(^\text{11}\) Ultimately, this scrutiny led to the adoption of three primary common law exceptions to the doctrine: (1) the public policy exception, (2) the implied contract exception, and (3) the implied covenant of good faith and fair dealing.\(^\text{12}\)

A. The Public Policy Exception

The public policy exception, born in Petermann, was the first to take root in the United States.\(^\text{13}\) Though it was not adopted by another jurisdiction until fourteen years after Petermann, it proliferated widely throughout the United States, primarily in the 1980s.\(^\text{14}\)

While it exists in various forms depending on the jurisdiction, two cases decided in the doctrine’s formative years articulated the basic rationales for granting the public policy exception. In 1974, the New Hampshire Supreme Court became the first to consider the exception from a broader perspective in Monge v. Beebe Rubber Co.\(^\text{15}\)

In all employment contracts, whether at will or for a definite term, the employer’s interest in running his business as he sees fit must be balanced against the interest of the employee in maintaining his employment, and the public’s interest in maintaining a proper balance between the two. . . . [A] termination by the employer of a contract of employment at will which is motivated by bad faith or malice based on retaliation is not in the best interest of the economic system or the public good and constitutes a breach of the employment contract.\(^\text{16}\)

This view embodies one of the bases for establishing the public policy exception, namely the public interest in promoting economic

\(^{10}\) See Petermann, 344 P.2d at 27.

\(^{11}\) Id.


\(^{13}\) See Petermann, 344 P.2d at 27.


\(^{16}\) Id.
efficiency and stability in spite of the doctrine of employment-at-will when the circumstances of discharge are particularly egregious (“the economic perspective”). The *Monge* decision is also noteworthy for its failure to clearly adopt a particular exception. This was especially problematic due to its vague language and emphasis on fairness as opposed to the emphasis on public policy in *Petermann*. Eventually, any confusion was resolved by a subsequent New Hampshire decision clarifying that *Monge* represented New Hampshire’s recognition of a unique form of the public policy exception.

The other, more prevalent rationale came in a summative statement regarding the growth of the public policy exception and its development across the nation. In 1980, the California Supreme Court described the exception’s evolution as being founded in “a variety of factual settings in which a discharge clearly violated an express statutory objective or undermined a firmly established principle of public policy.” This is an expression of the other fundamental basis for the public policy exception – frustration of the goals and objectives of previously adopted policy (“the frustration perspective”), which was made even more explicit by the same court in 1992.

### B. The Implied Contract Exception

The implied contract exception was first recognized in 1980 in two jurisdictions which were, remarkably, over 1500 miles apart. First, in a single page decision, the New Mexico Supreme Court held that a public employer’s personnel guide provided the basis for an implied-in-fact contract to discharge only after following delineated procedures. Only four months later, the Michigan Supreme Court issued a thirty-six page opinion, holding that “employer statements of policy . . . can give rise to contractual rights in employees without evidence that the parties mutually agreed that the policy statements would create [such rights] . . . although . . . signed by neither party, [and able to be] unilaterally amended by the employer without notice.” Fortunately, though different rules still apply in different

---

17 See *id.* at 552.
18 See *Howard v. Dorr Woolen Co.*, 414 A.2d 1273, 1274 (N.H. 1980) (“We construe Monge to apply only to a situation where an employee is discharged because he performed an act that public policy encouraged, or refused to do that which public policy would condemn.”)
jurisdictions, the implied contract exception is easier to reduce to definition than the other two primary exceptions. At its core, jurisdictions that recognize this exception hold that factual circumstances surrounding employment, including oral and written representations made to employees or company policies or procedures disseminated or made known to employees can create a contract between employers and employees which modifies the at-will relationship.\footnote{See Crook, supra note 2, at 32.}

C. The Implied Covenant of Good Faith and Fair Dealing

The third primary common law “exception” to the doctrine of employment-at-will is the implied covenant of good faith and fair dealing.\footnote{For an advanced discussion of the implied covenant of good faith and fair dealing, see J. Wilson Parker, At-Will Employment and the Common Law: A Modest Proposal to De-Marginalize Employment Law, 81 IOWA L. REV. 347, 359-70 (1995).} Easily the least widely adopted of the three, it is premised on the idea that “neither party to a contract should be allowed to take actions that have the effect of denying the other party the benefits of the contractual relationship.”\footnote{Walsh, supra note 12, at 647.}

Despite only achieving adoption in a strong minority of jurisdictions, its existence traces back to two locations. First, in Fortune v. National Cash Register Co., the Massachusetts Supreme Judicial Court imputed the implied covenant of good faith and fair dealing, which other courts had found to be present in other types of contracts, to a particular employment contract.\footnote{Fortune v. Nat’l Cash Register Co., 364 N.E.2d 1251, 1255-56 (Mass. 1977).} While the court appeared to decline recognition of the exception based on the implied covenant of good faith and fair dealing,\footnote{See id. at 1257.} subsequent cases have construed Fortune to do just that, albeit in a narrow sense.\footnote{See, e.g., Chokel v. Genzyme Corp., 867 N.E.2d 325 (Mass. 2007); Ayash v. Dana-Farber Cancer Inst., 822 N.E.2d 667 (Mass. 2005).} The more popular source for the exception, however, arises out of the Restatement (Second) of Contracts. According to § 205, “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”\footnote{RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).}

Some jurisdictions have matched their law regarding employment contracts to this language, holding that the phrase “every contract”
includes “contracts” for employment-at-will. However, in declining to adopt the exception, some courts have considered such arrangements outside what the Restatement contemplates, because they are too likely to encourage excessive judicial intervention in discharges of at-will employees, or are subsumed by the public policy exception.

D. Question of Damages

One additional consideration for employers that is intimately related to the exceptions themselves is the exposure to different types of damages. Generally, the majority of courts have recognized that claims under the three exceptions described permit recovery either in contract or tort. For example, every jurisdiction that recognizes the implied contract exception at common law has found it sounds in contract (as the name implies). Additionally, all but one jurisdiction addressing the breach of the implied covenant of good faith and fair dealing exception at common law find that it sounds in contract. That jurisdiction is also the only deviant jurisdiction that heavily restricts its allowance for tort damages to very specific factual circumstances. Most jurisdictions also tend to recognize these exceptions by holding that they provide a basis for a generalized claim of either breach of contract or wrongful discharge.

The public policy exception, however, tends to be more of a mixed bag. Some jurisdictions have found that imposing tort damages would be too harsh to employers, and have accordingly restricted recovery to

---

35 Id.
36 Nevada is the only jurisdiction to not find this. See K-Mart Corp. v. Ponsock, 732 P.2d 1364, 1368 (Nev. 1987) (holding that the only basis for recovery based on a breach of good faith is in tort liability).
37 Id.
contractual remedies.\textsuperscript{39} Others recognize the exception as a basis for a generalized cause of action for wrongful discharge, typically sounding in tort,\textsuperscript{40} or find such discharges to be so egregious that tort damages are warranted (typically requiring malice or a similar standard).\textsuperscript{41}

Though these principles generally hold true, there are also outlier jurisdictions where the handling of lawsuits relating to these exceptions can be even more advantageous to employees. For example, some jurisdictions also permit employees to recover punitive damages, though usually only where malicious intent is found.\textsuperscript{42} Others extend the implied contract exception even where the facts do not establish a contract, but meet the elements required for promissory estoppel under state law.\textsuperscript{43}

A breakdown of the number of states recognizing each type of damages appears, by exception, in Table 3.1:

<table>
<thead>
<tr>
<th>TYPE OF DAMAGES</th>
<th>IMPLIED CONTRACT</th>
<th>GOOD FAITH &amp; FAIR DEALING</th>
<th>PUBLIC POLICY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract</td>
<td>38</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>Tort</td>
<td>0</td>
<td>1</td>
<td>33</td>
</tr>
<tr>
<td>Compensatory</td>
<td>0</td>
<td>1</td>
<td>32</td>
</tr>
<tr>
<td>Punitive</td>
<td>0</td>
<td>1</td>
<td>20</td>
</tr>
<tr>
<td>Unclear</td>
<td>0</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

Table 3.1

It should be noted that jurisdictions that recognize punitive damages obviously also recognize compensatory damages, so the sum of those sub-categories does not equal the number of jurisdictions recognizing tort damages.

Additionally, some states recognize both contract and tort-based claims, meaning that the sum of the “bold” categories does not equal

\textsuperscript{39} See Johnson v. Kreiser’s, Inc., 433 N.W.2d 225, 227 (S.D. 1988); Brockmeyer v. Dun & Bradstreet, 335 N.W.2d 834, 841 (Wis. 1983).

\textsuperscript{40} See Sheets v. Teddy’s Frosted Foods, 427 A.2d 385, 386-89 (Conn. 1980); Bowman v. State Bank of Keysville, 331 S.E.2d 797, 801 (Va. 1985) (holding that the public policy exception provided grounds for a cognizable tort claim for wrongful discharge).

\textsuperscript{41} See, e.g., Phipps v. Clark Oil & Ref. Corp., 408 N.W.2d 569, 572-73 (Minn. 1987); Hansen v. Harrah’s, 675 P.2d 394, 397 (Nev. 1984).

\textsuperscript{42} See, e.g., Hansen, 675 P.2d at 397; Shaw v. Titan Corp., 498 S.E.2d 696, 701 (Va. 1998).

the number of jurisdictions recognizing the exception.\textsuperscript{44} States that either: (1) did not explicitly recognize punitive damages or (2) recognized them pursuant to statute rather than one of the three exceptions, are excluded from the punitive damages count. Montana is entirely excluded because damages are assessed according to statute.\textsuperscript{45}

E. Prevalence of the Exceptions

Over time, a majority of states have come to recognize two out of the three primary common law exceptions discussed above. A summary of the number of states recognizing each exception is present in Table 3.2 below:

<table>
<thead>
<tr>
<th>STATUS</th>
<th>IMPLIED CONTRACT</th>
<th>GOOD FAITH &amp; FAIR DEALING</th>
<th>PUBLIC POLICY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognized</td>
<td>38</td>
<td>10</td>
<td>41</td>
</tr>
<tr>
<td>At Common Law</td>
<td>37</td>
<td>9</td>
<td>40</td>
</tr>
<tr>
<td>By Statute\textsuperscript{46}</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Not Recognized</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rejected</td>
<td>12</td>
<td>39</td>
<td>9</td>
</tr>
<tr>
<td>No Decision</td>
<td>0</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>Unclear</td>
<td>0</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

Table 3.2

For the purposes of this comment’s analysis, a state is considered to have recognized the exception if it has adopted the exception in any form. A state is considered to have not recognized the exception if it has: (1) explicitly rejected it, (2) considered the exception and failed to adopt it, or (3) issued a clarifying decision fully over-ruling a decision previously believed to have adopted the exception. A state’s stance is regarded as unclear where its language regarding the exception

\textsuperscript{44} See infra Appendix A– Jurisdictional Breakdown.


\textsuperscript{46} Id.
appears in dicta or where the court has ruled on a case where the issue was addressed, but failed to adopt, reject, or defer a decision explicitly.

F. Current Trends

As the numbers in Table 3.2 reveal, the number of jurisdictions recognizing each exception today is almost identical to what it was in the seminal 1996 study of the topic by Professors Walsh and Schwarz. Indeed, the only differences between the numbers in Table 3.2 and the 1996 study are that one less jurisdiction recognizes the public policy exception (with its status no longer unclear in any states) and one more jurisdiction has rejected the implied covenant of good faith and fair dealing in employment contracts.

This reality is troubling in a number of ways for employers. First, the statistics on the increase in employee lawsuits and related losses are troubling to say the least. According to a 2007 study on employment-related lawsuits and jury verdicts, wrongful termination claims in state courts increased 260 percent from 1986 to 2006. In addition to the sheer increase in the volume of claims, employers must be concerned about the cost of damages as well. Over the same time period, thirty-nine percent of cases resulted in compensatory damages. When cases settled in the most recent five year period covered by the study (2001-2006), settlement amounts skyrocketed by 138 percent.

While these statistics do not focus solely on litigation using one of the three exceptions outlined in this article, they still reveal an increasing amount of adversarial litigation initiated by former employees and increasing costs associated with such litigation. Even more discouraging is that none of these statistics take into account the substantial legal costs associated with resolving the cases.

Interestingly, however, the recognition of these three exceptions has not been entirely beneficial to employees. For example, a 2003 study revealed that state recognition of all three exceptions is inversely-related to employee wages, being correlated with decreased

---

47 See Walsh, supra note 12, Table 1 at 652.
48 Compare Walsh, supra note 12, Table 1 at 652 with supra Table 3.2.
50 Id.
51 Id.
wages of up to three percent.\textsuperscript{52} Numerous studies have also been conducted on the effect of the recognition of the exceptions on employment levels, a broad review of which leads to mixed conclusions. A 1992 study using aggregate data gathered from state employment statistics concluded that adopting such exceptions “reduced state employment levels by as much as 7 [percent].”\textsuperscript{53}

However, “[s]ubsequent analyses . . . using industry-level and household-level data . . . find either modest negative effects . . . or no effects of dismissal protections on employment levels.”\textsuperscript{54} A 2007 study using data from specific firms revealed that effects were marginally positive on employment levels when the implied covenant of good faith and fair dealing was read into employment contracts, but not statistically significant as to the other exceptions when considering both manufacturing and non-manufacturing employers.\textsuperscript{55} However, the study also concluded that the impact of introducing exceptions weighed more heavily on employers in the manufacturing sector, leading to workforce reductions in those industries.\textsuperscript{56} Perhaps more significantly though, the “effects were largest in the first three years following adoption and diminished thereafter,” indicating that the impact of the exceptions on employment levels may be largely behind us, barring their adoption by additional jurisdictions.\textsuperscript{57}

\textbf{IV. General Approaches to Crafting Exception-Conscious Policy}

Given the increase in wrongful termination claims that has taken place in recent years, it is imperative that employers be aware of the existence of these exceptions and their contours. However, mere knowledge is not enough. Employers must be proactive to ensure that their current policies and practices do not run afoul of these exceptions and to educate decision-makers about their implications. Because the exceptions vary based on the law of individual states, any approach must be tailored to the law of specific jurisdictions while accommodating business needs. This section will propose three conceptual approaches to insulating businesses from liability under the

\textsuperscript{52} Timothy M. Shaughnessy, \textit{How State Exceptions to Employment-at-Will Affect Wages}, 24:3 J. LAB. RES. 447.
\textsuperscript{54} Id.
\textsuperscript{55} Id. at F205-08.
\textsuperscript{56} Id. at F202.
\textsuperscript{57} Id. at F212.
exceptions. Then, with those ideas already in mind, the next section will focus on specific actions employers can take to avoid each exception individually.

A. The “One-Size-Fits-All” Approach

As the name implies, this approach is the least nuanced. It does not differentiate between employers of different sizes, in different industries, or with different geographic employment footprints (“GEFs”). However, its simplicity and restrictiveness make it effective. The first step is for the employer to identify its GEF by listing all states in which it currently has employees or foresees hiring employees in the next five years. This list effectively sets the jurisdictional boundaries of law that must be reviewed. Upon completion of the list, the employer should identify the most restrictive jurisdiction with regard to each exception and establish policies and practices that will allow it to comply with each standard. By doing so, the employer should be able to avoid liability under any interpretation of the three exceptions, provided decision-makers act in accord with the approach in terminating employees. It also allows the employer to maintain a uniform set of policies, practices, and procedures (“PPPs”) across its entire business. It should be emphasized that for employers with a GEF entirely within one state, this is the only justifiable approach.

B. The “Custom Tailored” Approach

While the foregoing approach is arguably the most effective, it is also the least flexible. Another approach is for employers to compartmentalize by jurisdiction. For example, if an employer has a twenty state GEF, it will have twenty different sets of PPPs (one for each state). This approach is arguably the most effective because it allows the employer to account for the nuances in the law of each jurisdiction and avoid burdening its operations with restrictions that may not apply in each state. There are two major drawbacks to this approach. First, it is much more resource intensive. For example, the employer must train its employees and decision-makers differently in each state, requiring different training materials and possibly additional personnel. Second, the employer gives up uniformity of PPPs across the company. This can cause related consequences such as decreasing the ease of transferring employees from one state to another.
C. The Multi-Factor Approach

A third approach is to use a multi-factor balancing model for establishing PPPs. It must be said at the outset that to do so is innately riskier than either of the previously-discussed approaches because it involves taking a calculated risk with respect to one or more of the three exceptions. However, the benefit is that it allows employers to utilize more flexible PPPs that best fit their business, while still maintaining company-wide uniformity.

Use of the multi-factor approach begins with an employer evaluating three factors: (1) GEF, (2) size (in terms of the number of employees), and (3) industry. These employer-centric factors will ultimately determine which of five risk levels the defendant falls in.

Analyzing the risk level begins with determining the employer’s GEF risk class. The key considerations here include: (1) whether the employer’s GEF extends to multiple geographic regions and (2) whether the employer’s GEF includes a high-risk state. For the purposes of this analysis, the high-risk states are: Arizona, California, Colorado, Louisiana, Massachusetts, Michigan, Montana, Nevada, and South Carolina. GEF risk classes based on these considerations are listed in Table 4.1 below:

<table>
<thead>
<tr>
<th>GEF CLASS</th>
<th>CHARACTERISTICS</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Multi-regional GEF – AND – GEF includes high risk state(s)</td>
</tr>
<tr>
<td>B</td>
<td>Multi-regional GEF – OR – GEF includes high risk state(s)</td>
</tr>
<tr>
<td>C</td>
<td>NEITHER</td>
</tr>
</tbody>
</table>

Table 4.1

The next factors, size and industry are considered in tandem. This is done because neither is alone dispositive in determining risk of employment-related litigation. For example, a small business that operates in a particularly thorny industry may have a similar risk class to a large business that operates in relatively “safe” industry. In assessing the relevance of industry in the tandem, the key considerations are: (1) whether the industry is “highly regulated”, (2) whether the industry is “particularly susceptible” to employee fraud, deceit, crime, or other misconduct, and (3) whether the employer is involved in manufacturing operations. For the purposes of determining Size-Industry (“S-I”) risk class, “highly regulated” industries include: finance, securities, insurance, medical, private utility providers, commodities, government contractors,
telecommunications, and construction. “Particularly susceptible” industries include: finance, securities, insurance, medical, and government contractors. S-I risk classes based on the foregoing are listed in Table 4.2 below:

<table>
<thead>
<tr>
<th>S-I CLASS</th>
<th>SIZE</th>
<th>INDUSTRY</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>ANY</td>
<td>Highly regulated – AND – particularly susceptible</td>
</tr>
<tr>
<td>B</td>
<td>100+</td>
<td>Highly regulated – OR – particularly susceptible; MFG.</td>
</tr>
<tr>
<td>C</td>
<td>100+</td>
<td>Highly regulated – OR – particularly susceptible; No MFG.</td>
</tr>
<tr>
<td>D</td>
<td>&lt; 100</td>
<td>Highly regulated – OR – particularly susceptible; MFG.</td>
</tr>
<tr>
<td>E</td>
<td>&lt; 100</td>
<td>Highly regulated – OR – particularly susceptible; No MFG.</td>
</tr>
</tbody>
</table>

Table 4.2

At this point, the employer should use Table 4.3 below to identify the overall risk level of the business.

<table>
<thead>
<tr>
<th>RISK LEVEL</th>
<th>GEF CLASS</th>
<th>S-I CLASS</th>
</tr>
</thead>
<tbody>
<tr>
<td>V</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>IV</td>
<td>B</td>
<td>A</td>
</tr>
<tr>
<td>III</td>
<td>B</td>
<td>B or C</td>
</tr>
<tr>
<td>II</td>
<td>C</td>
<td>D</td>
</tr>
<tr>
<td>I</td>
<td>C</td>
<td>E</td>
</tr>
</tbody>
</table>

Table 4.3

Finally, the employer should then balance their risk category against a fourth factor, the jurisdictional nuances of the exceptions, to identify the PPP strategy that best fits the employer’s needs and the demands of the jurisdiction, keeping in mind that higher risk levels should compel accommodation of greater business restrictions.

V. CRAFTING POLICY FOR SPECIFIC EXCEPTIONS

Of course, choosing a broad PPP development strategy like those described above is only part of the equation. Actually creating PPPs that will defeat the exceptions is another task entirely. This section will focus on the core challenges that each exception poses to employers and then propose solutions to those challenges.
A. The Public Policy Exception – Difficult by Definition

At first glance, beating the public policy exception might seem as simple as complying with state law. However, despite its widespread acceptance, a clear definition has proved remarkably elusive. Even one of the most oft-cited cases regarding the exception stated that “there is no precise definition of the term.”58 The broader definition that gained a significant degree of acceptance was provided in the same case:

In general, it can be said that public policy concerns what is right and just and what affects the citizens of the State collectively. It is to be found in the State’s constitution and statutes and, when they are silent, in its judicial decisions. Although there is no precise line of demarcation dividing matters that are the subject of public policies from matters purely personal . . . a matter must strike at the heart of a citizen’s social rights, duties, and responsibilities before the tort will be allowed.59

However, states with a more restrictive view define public policy much more narrowly, “refus[ing] to create a public policy exception . . . in the absence of a statute defining the public policy”60 or finding that a “narrow [public policy] exception covers only the discharge of an employee for the sole reason that the employee refused to perform an illegal act.”61 This definitional problem is the core challenge to employers and their decision-makers in drawing the line between an acceptable firing and one that will expose the employer to liability.

The easy answer is of course to never fire an employee under circumstances where doing so might be considered “in bad taste.” However, this ignores the classic employment law question – what is one to do when an employee who was already on thin ice (possibly already terminable) engages in potentially protected activity that causes them to violate the employer’s PPPs?

Fortunately, there are many proactive measures that can be taken. In the case of almost any termination, a consistent paper trail can prove to be an invaluable shield against an ultimate finding of liability. Whether the employee was a “good”, “bad”, or “average” employee

59 Id. at 878-79.
61 Sabine Pilot Serv., Inc. v. Hauck, 687 S.W.2d 733, 735 (Tex. 1985).
prior to termination, documentation can help demonstrate that an employer acted based on proper motives. Even if an employer is found to have violated public policy in discharging an employee, documentation can still be helpful because it can serve to convince the judge or jury that the discharge was less egregious and should thus result in a diminished damages award. For this reason, it is critical to train supervisors, managers, and executives to maintain proper documentation for an employee’s personnel file and establish a culture where keeping employee paperwork up-to-date is demanded rather than merely requested.

Another helpful tactic is to reward employees for performing actions which “public policy” might smile upon. Though some of these examples are already required in certain states, ideas include paid time off for jury duty and voting or bonuses for reporting potential workplace hazards that are followed up on and corrected or fraud that is identified and handled.

Attention should also be given to areas that are ripe for application of the public policy exception, such as workers’ compensation and whistleblowing. Some of the earliest post-Petermann adoptions of a form of the public policy exception arose out of workers’ compensation disputes. Additionally, the majority of states now have whistleblower protection laws and these laws have been cited as being protected from discharge under the public policy exception. This makes it imperative for businesses to be employee-friendly in these areas and to develop specific PPPs to address them. With respect to whistleblowing in particular, an effective program, which would include a telephone tip line that is staffed 24/7, never uses voicemail, and includes measures to protect anonymity (to the extent legally possible), is a win-win for employers. According to a 2002 study, twenty percent of American workers “possess personal knowledge of workplace fraud . . . and thirty-nine percent are more

---

62 See, e.g., ALASKA STAT. § 15.15.100 (2012) (requiring employers to provide paid time off when a voter does not have sufficient time to vote outside of work hours); ALA. CODE § 12-16-8 (2012) (requiring employers to pay full-time employees their normal compensation when on jury duty); 13 COLO. CODE REGS. § 71-126 (2011) (requiring employers to pay employees regular wages for the first three days of jury service).


64 Tim Burnett, Why Your Company Should Have a Whistleblowing Policy, SAM ADVANCED MGMT. J. 37, 38 (Autumn 1992).

65 Dave Slovin, Blowing the Whistle, INTERNAL AUDITOR, June 2006, at 45, 46-47.
likely to report fraud if they could remain anonymous.\textsuperscript{66} This leaves little excuse for employers not to incorporate such programs into their PPPs whenever feasible, especially given that doing so can simultaneously cut down on exposure to problems under the public policy exception.

### B. Communicating Your PPPs – An Implied Contract Weapon?

Up until now, this comment has spoken only of employers developing PPPs, not communicating them.\textsuperscript{67} That is because the thirty-eight states that now recognize the implied contract exception in some form do so most popularly when employers have communicated their PPPs to employees. This means communicating PPPs (formally or informally; orally or in writing) is risky business – so risky that if done incorrectly, it can completely destroy the protection given to employers by the employment-at-will doctrine. So should employers stop communicating PPPs at all? Absolutely not. But it is important to limit them in some respects and to go about communicating them in the right way.

Easily the most common scenario in which courts hold employers liable under the implied contract exception is where employers have communicated that termination will take place only “for good cause” (or similar language).\textsuperscript{68} However, others have gone even further, including permitting employees to recover based on their mere reliance on employer statements or assurances.\textsuperscript{69}

The reality is that most cases based on the implied contract exception arise out of handbooks, manuals, policy statements, and the like that are disseminated by employers. In these cases, the best solution can be accomplished in three simple steps. First, include in all such publications a clear and prominent disclaimer stating: (1) that the employee is an at-will employee, (2) that at-will employees can be terminated at any time, for any reason, at the discretion of either the employer or the employee, and (3) that nothing in the particular document should be construed to alter the employee’s at-will status. In the more typical case of a handbook or manual, this disclaimer should be placed, at minimum, on the very first page, on the very last page, and directly above the signature line of any acknowledgement.

\textsuperscript{66} Id. at 46.

\textsuperscript{67} See discussion supra Part IV.


Numerous jurisdictions have found such disclaimers to be effective in obliterating the implied contract exception’s applicability. However, it should be noted that this is not uniformly true. In Michigan, for example, “when a policy manual contains both assurances of job security and a disclaimer, it remains a question for the jury as to which governs.” Hiring personnel should also be directed to avoid giving anecdotal accounts along the lines of keeping a position “as long as you do your job,” as this type of phrase has been specifically found problematic before.

C. Keeping the Covenant – Good Faith and Fair Dealing

The least recognized exception is also fortunately one of the easiest for employers to handle. When addressing the implied covenant of good faith and fair dealing as applied to the employment context, almost all jurisdictions that recognize the exception have required a showing of “bad faith” before permitting recovery. This essentially means following the rules established for dealing with the public policy exception and making good hiring and promotion decisions so that individuals with authority over termination are not the kind who would act to deprive individuals of earned pay, benefits, or commissions or engage in other vengeful or abusive termination practices. Indeed, only one jurisdiction ever truly recognized the implied covenant of good faith and fair dealing as a significant restriction on employers. In Cleary v. American Airlines, the California Court of Appeals briefly held, under very specific facts, that the implied covenant along with employer promises and the employee’s history with the company could bar the employer from terminating him for anything other than good cause. However, after the decision was roundly criticized for its excessive breadth, it was quickly restricted by the California Supreme Court after only eight

76 Id. at 729.
years.77

VI. CONCLUSION

While the three exceptions discussed in this note operate to limit the extent of employers’ abilities to terminate as freely as they did in the employment-at-will heyday, the exceptions are not incredibly vast in scope or unnavigable if given due consideration. What is critical for employers to do to ensure they are not bit by the exceptions in court is to take the time to understand the applicability and contours of the exceptions in jurisdictions where they operate, assess the risk the exceptions pose to them, and develop and implement strategies targeted at avoiding liability by way of training and nuanced PPPs.

For employers and readers who wish to better understand these exceptions from the ground up, Appendix A to this comment contains a listing of jurisdictions (except Montana) including the exceptions they recognize, a case recognizing each exception, in the case of the implied covenant of good faith and fair dealing and public policy exceptions, whether the exception sounds in contract, tort, or both, and whether punitive damages are available (as described above).

77 See generally Foley v. Interactive Data Corp., 765 P.2d 373, 401 (Cal. 1988).
APPENDIX A – JURISDICTIONAL BREAKDOWN

Alabama
Implied Contract: **YES** – Hoffman-LaRoche, Inc. v. Campbell, 512 So.2d 725 (Ala. 1986)
Good Faith: **YES** – Hoffman-LaRoche, Inc. v. Campbell, 512 So.2d 725 (Ala. 1986) (unclear)
Public Policy: **NO**

Alaska
Public Policy: **NO** (Subsumed by good faith)

Arizona

Arkansas
Good Faith: **NO**
Public Policy: **NO**

California
<table>
<thead>
<tr>
<th>State</th>
<th>Implied Contract</th>
<th>Good Faith</th>
<th>Public Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Colorado</strong></td>
<td><strong>YES</strong></td>
<td><strong>NO</strong></td>
<td><strong>YES</strong></td>
</tr>
<tr>
<td></td>
<td>Cont’l Air Lines, Inc. v Keenan, 731 P.2d 708 (Colo. 1987)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Martin Marietta Corp. v. Lorenz, 823 P.2d 100 (Colo. 1992)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Connecticut</strong></td>
<td><strong>YES</strong></td>
<td><strong>NO</strong></td>
<td><strong>YES</strong></td>
</tr>
<tr>
<td><strong>Delaware</strong></td>
<td><strong>NO</strong></td>
<td><strong>YES</strong></td>
<td><strong>NO</strong></td>
</tr>
<tr>
<td><strong>Florida</strong></td>
<td><strong>NO</strong></td>
<td><strong>NO</strong></td>
<td><strong>NO</strong></td>
</tr>
<tr>
<td><strong>Georgia</strong></td>
<td><strong>NO</strong></td>
<td><strong>NO</strong></td>
<td><strong>NO</strong></td>
</tr>
<tr>
<td><strong>Hawaii</strong></td>
<td><strong>YES</strong></td>
<td><strong>NO</strong></td>
<td><strong>YES</strong></td>
</tr>
<tr>
<td><strong>Idaho</strong></td>
<td><strong>NO</strong></td>
<td><strong>YES</strong></td>
<td><strong>NO</strong></td>
</tr>
<tr>
<td></td>
<td>Jackson v. Minidoka Irrigation Dist., 563 P.2d 54 (Idaho 1977) (contract)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Illinois
Good Faith: **NO**

Indiana
Implied Contract: **NO**
Good Faith: **NO**

Iowa
Good Faith: **NO**
Public Policy: **YES** – Springer v. Weeks & Leo Co., 429 N.W.2d 558 (Iowa 1988) *(tort w/ punitives)*

Kansas
Good Faith: **NO**

Kentucky
Implied Contract: **NO**
Good Faith: **NO**
Public Policy: **YES** – Firestone Tire & Rubber Co., v. Meadows, 666 S.W.2d 730 (Ky. 1983) *(tort w/ punitives)*

Louisiana
Implied Contract: **YES** – Thebner v. Xerox Corp., 480 So. 2d 454 (La. App. 3d Cir. 1985)
Good Faith: **UNCLEAR**
Public Policy: **UNCLEAR**

Maine
Implied Contract: **NO**
Good Faith: **NO**
Public Policy: **NO**
<table>
<thead>
<tr>
<th>State</th>
<th>Implied Contract</th>
<th>Good Faith</th>
<th>Public Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Missouri</td>
<td>NO</td>
<td>NO</td>
<td>YES – Amaan v. City of Eureka, 615 S.W.2d 414 (Mo. App. en banc 1981) (tort w/ punitives)</td>
</tr>
<tr>
<td>State</td>
<td>Implied Contract</td>
<td>Good Faith</td>
<td>Public Policy</td>
</tr>
<tr>
<td>------------</td>
<td>------------------</td>
<td>------------</td>
<td>---------------</td>
</tr>
<tr>
<td>New York</td>
<td>NO</td>
<td>NO</td>
<td>NO</td>
</tr>
</tbody>
</table>
North Carolina
Implied Contract: NO
Good Faith: NO

North Dakota
Implied Contract: NO
Good Faith: NO
Public Policy: YES – Krein v. Marion Manor Nursing Home, 415 N.W.2d 793 (N.D. 1987) (tort w/ punitives)

Ohio
Good Faith: NO
Public Policy: NO

Oklahoma
Implied Contract: YES – Hinson v. Cameron, 742 P.2d 549 (Okla. 1987)
Good Faith: NO

Oregon
Implied Contract: NO
Good Faith: NO

Pennsylvania
Good Faith: NO

Rhode Island
Implied Contract: NO
Good Faith: NO
Public Policy: NO
### South Carolina
- **Implied Contract:** YES – Small v. Springs Indus., Inc., 357 S.E.2d 452 (S.C. 1987)
- **Public Policy:** YES – Ludwick v. This Minute of Carolina, Inc., 337 S.E.2d 213 (S.C. 1985) *(tort)*

### South Dakota
- **Good Faith:** NO
- **Public Policy:** YES – Johnson v. Kreiser’s, Inc., 433 N.W.2d 225 (S.D. 1988) *(contract)*

### Tennessee
- **Implied Contract:** YES – Hamby v. Genesco, Inc., 627 S.W.2d 373 (Tenn. App. 1982)
- **Good Faith:** NO
- **Public Policy:** YES – Clanton v. Cain-Sloan Co., 677 S.W.2d 441 (Tenn. 1984) *(tort w/ punitives)*

### Texas
- **Implied Contract:** NO
- **Good Faith:** NO
- **Public Policy:** YES – Sabine Pilot Serv., Inc. v. Hauck, 687 S.W.2d 733 (Tex. 1985) *(tort w/ punitives)*

### Utah
- **Implied Contract:** YES – Berube v. Fashion Ctr., Ltd., 771 P.2d 1033 (Utah 1989)
- **Good Faith:** NO
- **Public Policy:** YES – Retherford v. AT&T Commc’ns, 844 P.2d 949 (Utah 1992) *(tort w/ punitives)*

### Vermont
- **Implied Contract:** YES – Benoir v. Ethan Allen, Inc., 514 A.2d 716 (Vt. 1986)
- **Good Faith:** NO
- **Public Policy:** YES – Payne v. Rozendaal, 520 A.2d 586 (Vt. 1986) *(unclear)*
Virginia
Good Faith: NO

Washington
Good Faith: NO

West Virginia
Good Faith: NO

Wisconsin
Good Faith: NO

Wyoming
Good Faith: NO

END OF APPENDIX A
AMGEN AND PROVING MATERIALITY IN CLASS ACTION SECURITIES LITIGATION: HOW THE SEVENTH AND NINTH CIRCUIT’S APPROACH TO MATERIALITY OFFERS THE UNITED STATES SUPREME COURT THE CHANCE TO REINFORCE LEGAL MECHANISMS OF CORPORATE GOVERNANCE

Cory H. Howard†

I. INTRODUCTION ............................................................... 259

II. CURRENT STANDARDS FOR DETERMINING MATERIALITY ........................................ 261
   A. BASIC INC. V. LEVINSON ........................................... 262
   B. THE SECOND AND FIFTH CIRCUITS’ APPROACH .... 263
   C. THE THIRD CIRCUIT OR “INTERMEDIATE” APPROACH ........................................ 265
   D. THE SEVENTH AND NINTH CIRCUITS’ APPROACH .... 266

III. THE POTENTIAL EFFECTS OF THE COURT’S DECISION ON CORPORATE GOVERNANCE ............ 268
   A. THE ROLE OF SECURITIES LITIGATION IN CORPORATE GOVERNANCE ...................... 268
      1. Recent judicial and legislative history suggest a tendency to make securities litigation a readily available weapon for plaintiffs ........................................ 270
      2. Reduced access to securities litigation removes ................................................................. 270

† The author is a J.D. candidate at the Wake Forest School of Law (2014) and an alumnus of The George Washington University (2011), where he graduated magna cum laude with a B.A in International Affairs. This article is the result of the encouragement and support of his family and friends. For that the author would like to express tremendous gratitude. The author would like to give thanks to Professor Omari Simmons, whose exceptional teaching and scholarly work inspired him to explore corporate governance, to Chris Wimbush whose advice and friendship constantly forces him to work harder, and most of all to Sara and to his parents, Dewey and Tracy, whose constant love and support is and continues to be the driving force behind all of his endeavors. Any remaining mistakes are the author's alone.
the possibility of reform through settlements. .......... 273
3. Reducing plaintiff access to private securities
litigation would limit access to the discovery
process. .................................................................................................................. 275
B. HOW THE SEVENTH AND NINTH CIRCUIT’S
APPROACH WOULD ALLOW THE COURT TO
REINFORCE PRE-EXISTING CORPORATE
GOVERNANCE TOOLS.............................................................................. 276
IV. CONCLUSION ......................................................................................... 279
I. INTRODUCTION

By granting certiorari in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, the United States Supreme Court is positioning itself to resolve a split among several circuits over a crucial issue in securities litigation. Five circuits are currently split on whether it is proper to hear arguments about materiality during the class certification stage of class action securities litigation, with their standards falling into three distinct camps. Most securities litigation is brought as a class action suit and therefore plaintiffs must meet the burdens imposed by Rule 23 subsections (a) and (b) of the Federal Rules of Civil Procedure in order to obtain class certification. Class certification is not only an essential pre-trial step which must be completed in order to continue to trial, but can also highly affect the prospect of settlement. Although the requirements of Rule 23(a) are easily satisfied, plaintiffs must also prove that the class is maintainable under Rule 23(b)(1), (b)(2), or (b)(3). Plaintiffs in securities litigation most often seek certification under Rule 23(b)(3)—predominance—which requires that the questions of law and fact common to the

---


2 Compare In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 484 (2d Cir. 2008) (holding that courts are required to make a definitive assessment on Rule 23 requirements as a threshold matter, even if identical to issues on the merits (first camp)), and Unger v. Amedisys Inc., 401 F.3d 316, 325 (5th Cir. 2005) (holding that elements of fraud-on-the-market, such as market efficiency, cannot be treated differently from other preliminary certification issues (falling into the first camp with the Second Circuit)), with In re DVI, Inc. Sec. Litig., 639 F.3d 623, 638 (3d Cir. 2011) (holding that materiality need not be proven at the class certification stage (second camp)), and with Schleicher v. Wendt, 618 F.3d 679, 687 (7th Cir. 2010) (holding that plaintiffs need not establish materiality before a class can be certified (third camp)), and Conn. Ret. Plans, 660 F.3d at 1176-77 (9th Cir. 2011) (holding that plaintiffs do not need to prove materiality at the class certification stage (falling into the third camp with the Seventh Circuit)).

3 Michael J. Kaufman & John M. Wunderlich, The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions, 43 U.Mich. J.L. Reform 323, 324 (2010) (noting that securities litigation is normally in the form of class actions, and class certification turns on whether the plaintiffs can meet the requirements of Rule 23 subsections (a) and (b)); see also Fed. R. Civ. P. 23(a)-(b).

4 See Margaret Anne Caulfield, Class Action Certification in Private Securities Litigation: Endangered Species?, 14 Suffolk J. Trial & App. Advoc. 94, 108 (2009) (noting that class certification is an essential step to settlement, and once a class is certified defendants often move to settle to avoid large damage awards).

5 Kaufman & Wunderlich, supra note 3, at 324-25.

members of the class predominate over any questions affecting only individual members.\(^7\)

In order to meet the predominance requirement in securities litigation cases, plaintiffs often rely on the fraud-on-the-market presumption,\(^8\) a tool created by the Supreme Court in the seminal securities litigation case *Basic Inc. v. Levinson.*\(^9\) In certain types of securities litigation suits, plaintiffs must prove that they relied on the actions or statements of a corporate director. The fraud-on-the-market presumption acts as a substitute for individualized proof of reliance: instead of requiring each plaintiff in the class to show that they relied on a director’s actions (or lack thereof) in their decision making, the fraud-on-the-market permits a judicial presumption without individualized showings.\(^10\) However, some circuits—such as the Fifth and Second—require plaintiffs to prove materiality (an element of the presumption) at the class certification stage, while others—including the Ninth—consider it to be a merit of the case which should be relegated exclusively to the case-in-chief.\(^11\)

*Amgen* sets the stage for the Court to redefine the landscape of securities litigation by making securities litigation a readily available weapon for plaintiffs who seek to exert some influence on corporate managers. This case is especially important as the Court has, up until this point, issued decisions to facilitate class action suits\(^12\) and the

---

\(^7\) Fed. R. Civ. P. 23(b)(3).

\(^8\) See Scudder, *supra* note 6, at 441-42 (explaining the Supreme Court’s adoption of the fraud-on-the-market presumption allowed plaintiffs to satisfy the predominance requirement of Rule 23(b)(3) in securities class action suits).


\(^10\) Carol R. Goforth, *The Efficient Capital Market Hypothesis—An Inadequate Justification for the Fraud-on-the-Market Presumption,* 27 *Wake Forest L. Rev.* 895, 913 (1992) (noting that the fraud-on-the-market presumption serves as a substitute for each member of the class having to show individual reliance on a director’s actions or statements).

\(^11\) Compare Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 265 (5th Cir. 2007), *abrogated on other grounds by* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011) (holding that materiality must be proven in order to trigger the fraud-on-the-market presumption), and *In re* Salomon Analyst Metromedia Litig., 544 F.3d 474, 485-86 (2d Cir. 2008) (holding that since a successful rebuttal of materiality defeats the fraud-on-the-market presumption and would prevent certification, the court must permit defendants to present rebuttal arguments before making a certification decision), *with* Conn. Ret. Plans & Trust Funds v. Amgen Inc., 660 F.3d 1170, 1177 (9th Cir. 2011) (calling materiality a merit of the case and not permitting consideration of it until either trial or a summary judgment motion).

\(^12\) See *In re* DVI, Inc. Sec. Litig., 639 F.3d 623, 631 (3d Cir. 2011) (noting that the Supreme Court established the fraud-on-the-market rebuttable presumption in order to facilitate class action securities litigation).
imposition of additional legal burdens at the class certification stage could signal a pro-defense shift in the Court. More importantly, if the Court decides to adopt one of the more restrictive standards for plaintiffs, it could have a tremendous chilling effect on future class action securities suits. This could weaken the ability of shareholders to force directors and corporations to adopt corporate governance mechanisms, which would reduce agency costs. If there is an increased probability that plaintiff securities cases will be dismissed before or during the class certification stage, corporate directors and executives will feel less pressure to act in the shareholders’ best interests.

This note discusses the three different standards currently used to determine when issues of materiality in class action securities litigation may be heard by in various circuits. The note then explores how the goals of securities litigation (which now include corporate governance objectives\textsuperscript{13}) favor the adoption of a less strict approach to materiality during the class certification stage. Although there are a multitude of arguments for why a less strict approach to materiality is beneficial, this note will primarily focus on how a less strict approach enhances corporate governance objectives in light of the expanding role that securities litigation plays in corporate governance theory and practice. The note concludes with a brief discussion of how the approach of the Seventh and Ninth Circuits offers the Court these types of opportunities, focusing on how plaintiffs’ access to the courts increases the pressure that shareholders can exert on corporate executives through the discovery and settlement processes.

II. CURRENT STANDARDS FOR DETERMINING MATERIALITY

Before delving into the current split among the circuits and discussing when and whether materiality can be considered before the case-in-chief, this article quickly rehashes several important points from Basic Inc. v. Levinson, a seminal decision in securities litigation. Once this foundation is established, the note explores the current trends in the various circuits for determining when materiality may be considered. Currently, five circuits have issued opinions on this subject and these decisions fall into three categories:\textsuperscript{14} (1) the Second and Fifth Circuit Approach, hereinafter referred to as the “strict approach”, (2) the Third Circuit, also known as the “intermediate approach”, and (3) the Seventh and Ninth Circuits’ “no consideration”


approach. Although they are all vastly different takes on the issue of materiality, all three approaches stem from the Court’s holding in Basic.

A. Basic Inc. v. Levinson

In Basic, former shareholders of the company alleged that the corporation had violated § 10(b) of the Securities Exchange Act of 1934, specifically alleging that the board’s misstatements about a potential merger with Combustion Engineering, Inc. had artificially depressed the price of Basic’s shares prior to the merger. Plaintiffs then brought a class action securities lawsuit against the company to recoup the losses that they sustained after prematurely selling their stock, which was a direct result of the board’s misstatements about a pending merger with a more profitable company. Instead of requiring each plaintiff to prove individual reliance on the alleged misstatements, the Court in Basic adopted the fraud-on-the-market presumption, which did not require such individual showings of reliance.

Footnote 27 from Basic, which established the guidelines under which the fraud-on-the-market presumption may be claimed, also appears to be the main source upon which the Second and Fifth Circuits rely in their adoption of a strict requirement for proving materiality. It was in this footnote that the Basic Court established the five elements which a plaintiff must satisfy in order to trigger the

---

15 Basic Inc. v. Levinson, 485 U.S. 224, 228 (1988); see also Daniella Casseres, South Cherry Street, LLC v. Hennessee Group LLC: Investors’ Desperate Plea for Second Circuit Standards, 6 J. BUS. & TECH. L. 231, 235-36 (2011) (explaining that Rule 10b-5 of the Securities Exchange Act of 1934 implements § 10(b) of the act “which allows individuals to hold corporations liable for engaging in deceptive practices by giving the SEC the ability to civilly prosecute anyone who makes an untrue statement or who omits ‘to state a material fact . . . in connection with the purchase or sale of any security.’”).

16 Basic, 485 U.S. at 228-29 (plaintiffs alleging that the board’s denial of any potential merger activity led them to sell shares of the company that they would not have otherwise sold if they had known of a lucrative merger).

17 Id.

18 Id. at 247 (holding that an investor’s reliance on public material misrepresentations may be presumed for purposes of a Rule 10b-5 action); Michael J. Kaufman & John M. Wunderlich, Fraud Created the Market, 63 ALA. L. REV. 275, 297 (2012) (noting that in Basic, the Supreme Court adopted the fraud-on-the-market presumption of reliance for securities traded on efficient markets).

19 Conn. Ret. Plans & Trust Funds v. Amgen Inc., 660 F.3d 1170, 1176 (9th Cir. 2011) (noting that footnote 27 of the Basic opinion established the elements that a plaintiff must prove to invoke the fraud-on-the-market presumption, one of which being that “the misrepresentations were material.”).
fraud-on-the-market presumption. The second element, the requirement that the misrepresentation be material, continues to be the most litigious—not because courts struggle to determine when a misrepresentation is material, but because there is no uniformly set procedure as to when to hear the issue. Contention over this point caused a split among six of the circuits and resulted in varying guidelines for when it is appropriate to hear arguments related to the fraud-on-the-market presumption.

B. The Second and Fifth Circuits’ Approach

In deciding when to determine materiality, the Second and Fifth Circuits have traditionally adopted a strict approach, which requires plaintiffs to prove materiality in order to become certified as a class. Believing that each circuit is free to develop its own fraud-on-the-market rules, the Fifth Circuit has consistently “tighten[ed] the requirements for plaintiffs seeking a presumption of reliance.” In Unger v. Amedisys Inc., the court required that elements of the case, if pertinent to Rule 23(b) classification, must be tackled prior to class certification. In its decision, the Fifth Circuit held that plaintiffs must prove market efficiency in order to proceed with class certification, because “[w]ithout an initial demonstration of market efficiency, there is no assurance that the available material information

---

20 Basic, 485 U.S. at 248 n.27 (1988) (The five elements which a plaintiff must allege and prove are: “(1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.”).
21 In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 484 (2d Cir. 2008) (holding that the court is to make required a definitive assessment of the Rule 23 requirements as a threshold matter, even if it would be identical to an issue on the merits).
22 Abell v. Potomac Ins. Co., 858 F.2d 1104, 1120 (5th Cir. 1988) (noting that the Basic framework grants the circuits the ability to independently develop their own rules), abrogated on other grounds by sub nom. Fryar v. Abell, 109 S.Ct. 3236 (1989).
24 Unger v. Amedisys Inc., 401 F.3d 316, 325 (5th Cir. 2005) (holding that elements of the fraud on the market presumption, such as market efficiency, should not be treated differently than other issues normally handled at the class certification stage).
... supports a class-wide presumption of reliance."\textsuperscript{25} The adoption of the strict approach by the Fifth Circuit can be explained by the rationale that the court cannot simply presume facts bearing directly on class certification because the practical realities of class certification have serious financial implications through both increased litigation and settlement costs.\textsuperscript{26} Dicta from a rash of different decisions demonstrates that the Fifth Circuit’s approach to materiality for class certification\textsuperscript{27} is an attempt to protect defendants from extravagant costs imposed by frivolous lawsuits.\textsuperscript{28} In its attempt to protect corporate defendants, the Fifth Circuit extended its recognition of issues that can be considered for Rule 23(b) purposes to include issues usually considered to be merits of the case,\textsuperscript{29} while other circuits have balked at permitting such “sneak peeks.”

The Second Circuit adopted a strict approach to materiality as well, noting that Rule 23(b) requires that a definitive assessment as to the predominance requirement be made before the class can be certified.\textsuperscript{30} In In re Salomon, the court interpreted Basic to hold that a successful rebuttal of the fraud-on-the-market presumption would defeat certification, as the plaintiffs would then fail to meet the predominance requirement.\textsuperscript{31} Again, the court is concerned about preventing meritless litigation from proceeding past the class certification stage and needlessly increasing costs for defendants. Therefore, a potential class of plaintiffs who wish to rely on the fraud-on-the-market presumption instead of individualized showings of reliance by each plaintiff must successfully present elements of their claim to demonstrate the applicability of the presumption during the class certification stage.\textsuperscript{32}

\textsuperscript{25} Id. at 322.
\textsuperscript{26} Id. at 322-23 (noting that courts have often imposed rigorous preliminary standards to ensure that inappropriate class certification does not impose significant financial burdens on defendants).
\textsuperscript{27} Petition for Writ of Certiorari, supra note 14, at 9.
\textsuperscript{28} Unger v. Amedisys Inc., 401 F.3d 316, 322 (5th Cir. 2005).
\textsuperscript{29} Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 270 (5th Cir. 2007) (“The trial court erred in ruling that the class certification stage is not the proper time for defendants to rebut lead Plaintiffs’ fraud-on-the-market presumption.”), abrogated on other grounds by Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011).
\textsuperscript{30} In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 485 (2d Cir. 2008).
\textsuperscript{31} Id.
\textsuperscript{32} See Basic Inc., v. Levinson, 485 U.S. 224, 247 (1988) (noting that the fraud-on-the-market presumption acts as a substitute for individualized showings of reliance on misleading statements or omissions for plaintiffs in securities litigation).
C. The Third Circuit or “Intermediate” Approach

Similar to the Second and Fifth Circuit’s strict approach, the Third Circuit adopted the “intermediate approach” to the materiality requirement. Under this approach, plaintiffs are not required to demonstrate materiality during the class certification stage because the fraud-on-the-market presumption implies materiality. However, defendants may present evidence to rebut the materiality of the misrepresentation, along with any issues usually handled during the class certification stage. The Third Circuit clearly articulated its belief that materiality, like other Rule 23 elements, “falls within the ambit of issues that, if relevant, should be addressed by district courts at the class certification stage.” Therefore, in the Third Circuit, while a showing of materiality by plaintiffs is not required at the class certification stage, defendants are allowed to rebut a presumption of materiality at this point.

Like the Circuits that have adopted the strict approach, the Third Circuit has consistently declined to presume facts essential to a plaintiff’s case and instead has held that if a defendant has serious concerns about the materiality of the alleged misrepresentations, then the issue can be raised before the class is certified. In fact, in its In re DVI decision, the Third Circuit approvingly quoted language from the Second Circuit’s seminal In re Salomon decision and suggested that when the issue of materiality is brought up during class certification, “[e]ach element of a claim is examined through the prism of Rule 23(b)(3)” to ensure that each “element of [the legal claim] is

34 In re DVI, Inc. Sec. Litig., 639 F.3d 623, 638 (3d Cir. 2011) (noting that plaintiffs are not required to prove materiality at the class certification stage).
35 Petition for Writ of Certiorari, supra note 14, at 11; see also In re DVI, 639 F.3d at 638 (noting that defendants may present evidence to rebut materiality at the class certification stage).
36 In re DVI, 639 F.3d at 638.
37 Zlotnick v. TIE Comm’ns, 836 F.2d 818, 821-22 (3d Cir. 1988) (explaining that while materiality can be proven by the plaintiff, the court will not simply presume it).
38 In re DVI, 639 F.3d at 638-39 (quoting In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 485 (2d Cir. 2008)).
39 In re DVI, 639 F.3d at 630 (citing In re Hydrogen Peroxide Antitrust Litig., 552 F.3d 305, 311-12 (3d Cir. 2009)); see also Marcus v. BMW of N. Am., LLC, 687 F.3d 583, 600 (3d Cir. 2012) (“To assess predominance, a court at the certification stage must examine each element of a legal claim ‘through the prism’ of Rule 23(b)(3).”).
capable of proof at trial through evidence that is common to the class rather than individual to its members.” 40 Although it is deemed the intermediate approach, the mere fact that materiality can be questioned at the class certification stage and that the court is willing to scrutinize it heavily makes certification a potential stumbling block for plaintiffs, and thus is more similar to the “strict approach” than to the Seventh and Ninth Circuit’s “no consideration” approach.

D. The Seventh and Ninth Circuits’ Approach

The Seventh and Ninth Circuits have been hesitant to impose the burden of proving materiality on plaintiffs prior to class certification. Instead of requiring, or even permitting, materiality to be proven at the class certification stage, the Seventh and Ninth Circuits impose a complete bar on consideration of this issue by the courts until the defense’s case in chief. 41 The Seventh Circuit has expressly decreed that materiality, which is considered to be a merit of the plaintiff’s case, is independent of the issues affecting class certification and therefore, cannot be examined by the courts during the class certification stage. 42 This holding narrowed a previous Seventh

40 In re DVI, 639 F.3d at 630 (quoting In re Hydrogen Peroxide, 552 F.3d at 311-12 (“Instead, the task for plaintiffs at class certification is to demonstrate that the element of antitrust impact is capable of proof at trial through evidence that is common to the class rather than individual to its members.”)); see also Marcus, 687 F.3d at 600 (“A plaintiff must ‘demonstrate that the element of [the legal claim] is capable of proof at trial through evidence that is common to the class rather than individual to its members.’”).

41 Conn. Ret. Plans and Trust Funds v. Amgen Inc., 660 F.3d 1170, 1177 (9th Cir. 2011) (“because proof of materiality is not necessary to ensure that the question of reliance is common among all prospective class members’ securities fraud claims, we hold that plaintiffs need not prove materiality to avail themselves of the fraud-on-the-market presumption of reliance at the class certificate stage.” (emphasis in original)), cert. granted sub nom. Amgen Inc., v. Conn. Ret. Plans & Trust Funds, 132 S. Ct. 2742 (2012) (mem.); Schleicher v. Wendt, 618 F.3d 679, 685 (7th Cir. 2010) (rejecting the contention that “class certification is proper only when the class is sure to prevail on the merits” and explaining that “[i]t is possible to certify a class under Rule 23(b)(3) even though all statements turn out to have only trivial effects on stock prices,” in that situation “[c]ertification is appropriate, [even though] the class will lose on the merits.”); Timothy S. Bishop & Joshua D. Yount, US Supreme Court Grants Certiorari in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, MAYER BROWN LEGAL UPDATE (June 12, 2012), http://www.mayerbrown.com/us-supreme-court-grants-certiorari-in-emamgen-inc-v-connecticut-retirement-plans-and-trust-fundsem-06-12-2012/ (explaining that the Ninth Circuit has ruled that materiality is an element of the case and arguments for and against it should only be raised during trial or in a summary judgment motion).

42 Schleicher, 618 F.3d at 685 (noting that under the current version of Rule 23 class certification is largely independent of a case's merits).
Circuit decision, *Szabo v. Bridgeport Machines, Inc.*, in which the appellate court permitted the trial court to “peek” at the merits of the case if they could potentially affect Rule 23 considerations and would therefore be inappropriate to grant class certification.\(^{43}\) The court in *Schleicher* provides a substantial amount of dicta that finds that even if there was an issue with materiality, that a class could still be certified, which effectively, but not explicitly, abrogates the *Szabo* decision.\(^{44}\) This effectively precludes lower court judges from ever encountering a situation in which they would be justified in peeking at the merits of a case before certifying the class.

The Ninth Circuit’s decision in *Connecticut Retirement Plans and Trust Funds v. Amgen Inc.* explicitly rejected the strict and intermediate approaches adopted by the other circuits. The Ninth Circuit joined the Seventh Circuit in holding that materiality is a merit consideration and that arguments against it should be heard during the defendant’s case-in-chief.\(^{45}\) This decision continues the Ninth Circuit’s trend of not requiring plaintiffs to prove materiality in order to certify as a class.\(^{46}\) The Ninth Circuit believes that the other circuits which require or even permit materiality to be heard during the class certification stage fundamentally misinterpret footnote 27 in *Basic*.\(^{47}\) Additionally, the Ninth Circuit looks to post-*Basic* Supreme Court decisions, which require the plaintiffs to prove certain elements to establish the fraud-on-the-market presumption, but make no mention of materiality as a pre-requisite for class certification.\(^{48}\)

---

\(^{43}\) Szabo v. Bridgeport Mach., Inc., 249 F.3d 672, 675-76 (7th Cir. 2001) (holding that the courts cannot consider the merits of the case during class certification unless the merits directly implicate elements of Rule 23).

\(^{44}\) Schleicher, 618 F.3d at 685 (finding that a class may still be certified if the falsehoods were only trivial and that even if there have to be individual hearings to include plaintiffs in a class, there is still a likelihood of certification). By naming situations in which class certification could still be granted even though there were issues with the claim on the merits, the court attempts to effectively limit the situations in which a judge could rely on the *Szabo* decision to ‘peek’ at the merits of the case for certification purposes.

\(^{45}\) Conn. Ret. Plans, 660 F.3d at 1176-77 (holding that “a plaintiff need not prove materiality at the class certification stage . . . [and] materiality is a merits issue to be reached at trial or by summary judgment motion if the facts are uncontested”).

\(^{46}\) Id. at 1176-77 (citing Binder v. Gillespie, 184 F.3d 1059, 1064 (9th Cir. 1999), and Blackie v. Barrack, 524 F.2d 891, 900-01 & n. 17, 905-908 (9th Cir. 1975) (noting that neither of these previous class action securities litigation cases required plaintiffs to prove materiality in order to be certified as a class)).

\(^{47}\) Id. at 1176 (citing Schleicher, 618 F.3d at 687 (noting that the materiality requirement contained in footnote 27 of *Basic* is essential to establishing a fraud-on-the-market presumption, but not a pre-requisite to achieve class certification)).

\(^{48}\) See Erica P. John Fund, Inc. v. Halliburton Co., 131 S.Ct. 2179, 2185 (2011) (discussing the elements a plaintiff must prove to trigger the fraud-on-the-market continued . . .
III. THE POTENTIAL EFFECTS OF THE COURT’S DECISION ON CORPORATE GOVERNANCE

A. The Role of Securities Litigation in Corporate Governance

Of fundamental importance to this article is the interaction between securities litigation and its role in the legal community’s ongoing corporate governance efforts. Corporate governance is broadly characterized as the “process by which business decisions are made and the process by which the persons who will make those decisions are chosen.” It can be more narrowly seen, however, as a system to address the agency costs of businesses, that is, to minimize the strife between shareholders and non-ownership management. Although there are a variety of different legal and non-legal mechanisms that shareholders have in their struggle to continually monitor and control agency costs, one of the most significant, and controversial, is securities litigation. Securities litigation is increasingly seen as falling within the realm of corporate governance and no longer just a tool for investor protection. Therefore, any legal decision that purports to reduce shareholder access to class action litigation should be scrutinized heavily, not just because it could frustrate shareholder efforts to exert control over corporate managers, but because it could jeopardize corporate governance objectives aimed at reducing fraud.

presumption, but failing to mention materiality as a pre-requisite for Rule 23 certification).

49 David C. McBride, For Whom Does This Bell Toll?, 27 Del. Law. 28, 29-30 (2009).

50 Although there is currently substantial debate over whether or not corporate governance efforts should exclusively focus on the shareholder-manager relationship, for the purpose of this article corporate governance will be discussed as minimizing agency costs. For an extended discussion on the role of non-shareholder stakeholders, see generally John. C. Coffee, Jr., Unstable Coalitions: Corporate Governance As a Multi-Player Game, 78 Geo. L.J. 1495 (1990); Jonathan R. Macey, Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective, 84 Cornell L. Rev. 1266 (1999).

51 Fisch, supra note 13, at 335 (noting that scholars have begun to see the role of securities litigation as a corporate governance tool and not just a vehicle for investor protection).

52 See William S. Lerach, Partner, Milberg Weiss Bershad Hynes & Lerach, Achieving Corporate Governance Enhancements Through Litigation, Keynote Address Before the Council of Institutional Investors Spring Meeting (March 27, 2001), reprinted in 24 T. Jefferson L. Rev. 1, 8-9 (2001) (explaining that corporations that implement corporate governance reforms can create an environment where fraud is less likely, and that corporations with deficient mechanisms such as a lack of auditors and inadequate supervision by independent
There is serious contention about the role of securities litigation in corporate governance, with academics, practitioners and policy-makers divided and left arguing as to whether the potential benefits of securities litigation warrant the risk of systemic abuse. As a result, securities litigation is commonly seen by academics as either “dominated by greedy attorneys who use protracted litigation to extort large settlements from legitimate business[es]”\(^{53}\) or as a legitimate mechanism in the effort to force corporate compliance, especially as it pertains to disclosure requirements.\(^{54}\) Courts have also consistently recognized this power as both a positive force and a potential drain on resources.\(^{55}\) However, the potential that a meritorious suit has in discouraging corporate fraud\(^ {56}\) makes securities litigation a powerful tool for shareholders. The Supreme Court must seriously consider the effects that its decision in \textit{Amgen} will have on efforts to reduce corporate fraud by the use of securities litigation, as well as consider the important role that private securities litigation plays in the scheme of investor checks against corporate practices.\(^ {57}\) There are several different ways in which securities litigation serves as an important tool for shareholders to rein in corporate executives and check corporate fraud. These include reinforcing the Court’s—and thus the legal community’s—dedication to increasing the monitoring power of shareholders through securities suits, and increasing shareholder access to certain litigation tools such as discovery and settlement negotiations.


\(^{54}\) See Fisch, supra note 13, at 334-35.

\(^{55}\) Compare \textit{In re Cendant Corp. Litig.}, 264 F.3d 201, 227, 247 (3d Cir. 2001) (upholding the trial court judge’s decision to approve a settlement agreement between plaintiffs and Cendant Corp. that included provisions to institute corporate governance changes), with Perkins v. Daniel, No. 06-CV-01518(PGS), 2007 WL 4322596, at *2 (D.N.J. Dec. 6, 2007) (noting that the detrimental effects of shareholder derivative suits on director control and corporate governance have led courts to caution against unchecked shareholder litigation in an effort to stem frivolous and opportunistic suits).


\(^{57}\) See Fisch, supra note 13, at 335 (noting that scholars have begun to see securities litigation as a corporate governance tool and not just as a vehicle for investor protection).
1. Recent judicial and legislative history suggest a tendency to make securities litigation a readily available weapon for plaintiffs.

What is significant about the Amgen decision is not just its potential to unify (or further divide) the circuits on a highly litigious issue, but that it can serve as a manifestation of the Court’s willingness to extend judicial protection either to shareholders or corporate directors. Recently, the trend has been for both the Court and Congress to increase plaintiffs’ access to the judicial system, enabling them to use litigation as a tool to rein in rogue executives. Therefore, if the Court decides to signal a shift in its thinking by restricting plaintiffs’ access to the judicial system as a means of redress against corporate directors, it could simultaneously create a chilling effect on plaintiffs’ litigation and increase confidence in the boardrooms of corporations who would otherwise feel pressure from shareholders during their decision making process. Either of these events would severely temper the corporate governance movement and set back years of scholarship and legal reforms. Quite simply, plaintiffs and defendants have been down this road before, as the Private Securities Litigation Reform Act (PSLRA) restricted plaintiff access to the courts, and resulted in an astounding amount of corporate fraud. If the Court decides to retry limitations on plaintiff litigation it could signal an implicit acceptance of the corporate practices that brought down some of the largest corporations in the world in the late

58 See Nancy R. Mansfield et al., The Shocking Impact of Corporate Scandal on Directors’ and Officers’ Liability, 20 U. MIAMI BUS. L. REV. 211, 221, 231-32 (2012) (discussing the creation of personal liability for corporate directors and officers under the Sarbanes-Oxley Act and the increased trend in class actions); see also Cornerstone Research, Securities Class Action Filings: 2012 Mid-Year Assessment (2012), available at www.cornerstone.com/files/News/0ed759b3-91f6-425f-93a4-88a80129adb5/Presentation/NewsAttachment/bd1ee3f5-d23b-44c7-aeaf-91afad2ca7ea/Cornerstone_Research_Securities_Class_Action_Filings_2012_MYR.pdf (examining federal securities class action filings between January 1, 1996 and June 30, 2012).


1990s and early 2000s.

Two significant developments in securities litigation over the past thirty years demonstrate the Court’s and Congress’ willingness to make litigation an available weapon for plaintiffs: (1) the creation of the fraud-on-the-market presumption and (2) the passage of the Sarbanes-Oxley Act. The fraud-on-the-market presumption was specifically created by the Court to remove obstacles to litigation for plaintiffs. Indeed, “without the benefit of the fraud-on-the-market presumption of reliance, requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would prevent proceeding with a class action, since individual issues then would overwhelm the common ones.”

The Basic Court recognized that the adoption of the fraud-on-the-market presumption would make securities fraud cases more manageable and noted that “[c]ommentators generally have applauded the adoption of one variation or another of the fraud-on-the-market theory.”

However, after years of increased plaintiffs’ litigation following the Basic decision, Congress attempted to curb the rising volume of class action securities litigation through the passage of PSLRA, which imposed significant hurdles on plaintiffs, including an increased pleading standard. Although the Sarbanes-Oxley Act did not substantially relax the pleading standard that was set forth in the PSLRA, its passage marked a noticeable break from a period of pro-corporate legislation. In the post-PSLRA, pre-Sarbanes-Oxley years, plaintiffs saw an increase in the amount of class action cases that were dismissed, with 39.3% of cases ending with a dismissal, up from only

---

62 A.C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 VA. L. REV. 925, 948 (1999) (noting that the Court in Basic had recognized that the adoption of the fraud-on-the-market presumption would make cases more manageable, although it insisted that this was a procedural and not substantive change).
66 Id. at 504-05.
20.3% in the pre-PSLRA time period. These results were in line with the goal of the PSLRA, which was “to shift the advantage in private securities litigation from plaintiff to defendant” and therefore the reduction in plaintiff securities suits was considered a success. However, after the economic turmoil and string of corporate fraud scandals in the early 2000s, even the strongest supporters of the PSLRA admitted that the legislation “went too far.” In fact, the stunning amount of corporate fraud that surrounded the collapse of Enron and other large corporations led to congressional reconsideration of PSLRA.

As a result of the significant levels of fraud that came to dominate corporate America, Congress instituted a series of reforms to increase corporate governance. One such piece of legislation, the Sarbanes-Oxley Act, was designed to restore order to the “Wild West” corporate culture that prevailed in the early part of the twenty-first century. Sarbanes-Oxley, while incomplete and oftentimes ambiguous, did include a host of plaintiff-friendly provisions, such as one increasing the statute of limitations for private actions and one creating a requirement for the preservation of key financial audit documents. But the impact of Sarbanes-Oxley went beyond simply installing several notable, yet not truly fundamental, changes in favor of plaintiffs. Instead, its effects were more subtle, as it appeared to change the mindset of judges who seemed to become more open to class action securities litigation in the aftermath of the act’s passage.

---

67 Id. at 505.
69 Cummings, supra note 60, at 1017 (noting that the aftereffects of the PSLRA caused even the staunchest of Republicans and the most ardent corporate supporters to question the act’s efficacy).
72 Savett, supra note 65, at 505 (listing some of the plaintiff-friendly provisions that Sarbanes-Oxley included).
73 Id., (noting that dismissals of class action securities litigation fell sharply after SOA was passed, which could be the result of “judges . . . being more generous at the margin in evaluating the merits of cases on their desks, allowing a few more
Given this subtle but very important trend, if the Court decides to again reduce or limit plaintiff access to the courts, it would be a major break in recent judicial and legislative history. Such a step by the Court would signal to corporate managers and executives that the judiciary is no longer serious about corporate governance reforms and that the actions which caused the tumultuous and scandal filled times of the late 1990s and early 2000s are acceptable ways to conduct business in corporate America.

2. **Reduced access to securities litigation removes the possibility of reform through settlements.**

Securities litigation is often maligned by academics and politicians as nothing more than a simple way for attorneys to extract large settlements from companies without even requiring a meritorious case. Its detractors often point to the ever increasing settlement amounts that securities litigation generates, an amount that reached over $26.5 billion between the years of 2005 and 2006.\(^{74}\) Even more concerning is the idea that the merits of a class action suit do not have to be strong in order to warrant a settlement from a corporation.\(^{75}\) Given the apparent disjoint between the strength of a class action case’s merits and the settlement potential, it is important to respect the substantial economic effects that unrestrained class action suits can have on corporations. Academics and corporate executives should rightfully be concerned about the havoc that unchecked plaintiff litigation can wreck on corporations.

However, restricting plaintiffs’ access to litigation by imposing increasingly difficult burdens during the class certification stage is not an appropriate response to the settlement problems. In fact, “one important nonmonetary factor in securities litigation is the potential to obtain corporate governance reforms through [a] settlement.”\(^{76}\) While

---


a strictly economic analysis of class action securities settlements may show a problem with current litigation trends, a broader view actually shows a potential solution. In fact, high probability that a class action case will settle could be the avenue for reform of securities litigation. Instead of focusing on limiting the number of classes that can be certified (certification being an essential step in obtaining a settlement) settlements should be seen as a tool for imposing corporate governance changes with little monetary cost to corporations.

Additionally, the fact that plaintiffs’ securities cases result in settlement so often\(^\text{77}\) not only provides shareholders with an additional corporate governance tool, but presents academics with a platform for reforms which could curb abusive and frivolous plaintiff litigation. There is a recent trend, which started in 1995 with the rise of institutional investors as lead plaintiffs in securities litigation,\(^\text{78}\) for class action securities settlements to include provisions for corporate governance reforms.\(^\text{79}\) The institutional investors who extract these types of reform settlements have serious power (often bordering on indirect regulation\(^\text{80}\)) to change some of the fundamental ways in which a company operates to reduce agency costs and monitor corporate behavior.\(^\text{81}\) Class action settlements, therefore, can have tremendous power to increase the speed and breadth at which new corporate governance principles are integrated into the everyday operations of a company by allowing shareholders to have a more significant directory role. If reformed, settlements could give shareholders and institutional investors the power to monitor corporations and restrain negative executive behavior without the traditional monetary ramifications with which corporate law scholars are concerned.

However, these settlements still come at a high cost to corporations, as these reform provisions cannot constitute a stand-alone settlement unless they are substantial. Some courts will not allow settlement agreements which do not include monetary relief.

---

\(^\text{77}\) Garry, supra note 75, at 287 (noting that almost all plaintiff class action securities cases settle).

\(^\text{78}\) John Landry, Possible Limitations on Securing Corporate Governance Reforms Through Class Action Settlements, \textit{Wallstreetlawyer.com}, Mar. 2006, at 12 (noting that lead plaintiff requirement of the PSLRA has increasingly led to institutional investors taking on lead roles in class action securities litigation).

\(^\text{79}\) Id. (discussing the recent trend of institutional investors/lead plaintiffs requiring settlements to contain corporate governance reform provisions addressing issues from executive compensation to board makeup).

\(^\text{80}\) Id.

\(^\text{81}\) Id. (providing examples of reforms that lead plaintiffs have obtained in recent settlements).
unless shareholders gain (what the court views to be) a substantial benefit.\textsuperscript{82} Although this type of reform certainly has its drawbacks, most noticeably that it could lead to class action suits where the lead plaintiff/institutional investor is acting with a different motive than the rest of the class, it is certainly a problem preferable to the economic ramifications of frivolous plaintiff litigation. Therefore, it is settlement process reform, not restriction on the availability of litigation, which is the necessary and appropriate mechanism for ensuring that securities litigation is a properly used tool for corporate governance.

3. \textit{Reducing plaintiff access to private securities litigation would limit access to the discovery process.}

In addition to increasing the pressure on corporate executives and increasing the potential for non-monetary settlements, a more relaxed burden during the class certification stage ensures that plaintiffs have access to another important tool in the quest to detect corporate malfeasance: the discovery process. This is an important feature, as many other corporate governance tools, such as outside auditors, have failed to adequately uncover corporate fraud.\textsuperscript{83} The use of discovery to detect fraud has long been an important issue in securities litigation, as the courts have recognized the importance of discovery in uncovering corporate fraud,\textsuperscript{84} while at the same time realizing that the costs of discovery can result in unfair or meritless settlements.\textsuperscript{85} Increasing plaintiff access to discovery is an essential tool to uncovering and terminating corporate fraud, as plaintiffs may not have the ability to uncover information solely known to the parent company.

\textsuperscript{82} \textit{Id.} (citing Polar Int’l Brokerage Corp. v. Reeve, 187 F.R.D. 108, 117-18 (S.D.N.Y. 1999) (rejecting a settlement agreement because the non-monetary concessions did not provide a “substantial benefit” to shareholders)).

\textsuperscript{83} Gideon Mark, \textit{Accounting Fraud: Pleading Scienter of Auditors under the PSLRA}, 39 CONN. L. REV. 1097, 1148-49 (2007) (noting that external auditors only uncover 11.5\% of corporate fraud, with a higher percentage being discovered by accident).

\textsuperscript{84} Elliott J. Weiss, \textit{The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?}, 38 ARIZ. L. REV. 675, 704 (1996) (citing \textit{In re Time Warner Inc. Sec. Litig.}, 9 F.3d 259, 263 (2d Cir. 1993) (stating that the “interests in deterring fraud in the securities markets” can only protected by providing investors who believe they are victims of fraud with an opportunity to conduct discovery).

outside of the discovery process. Therefore, the ease of access to the discovery process must be a factor weighed considerably in the decision of when to consider materiality, and applying the strict materiality approach could stop plaintiff suits before the discovery process begins and hide otherwise detectable instances of corporate fraud.

B. How the Seventh and Ninth Circuit’s Approach Would Allow the Court to Reinforce Pre-existing Corporate Governance Tools

Given the scandals and failures that plagued corporations after the passage of the PSLRA, it is important to note that any judicial decision that attempts to reform class action litigation by reducing plaintiff access to the judiciary carries with it serious ramifications for the corporate governance movement. This is an important consideration to remember, as failure to ensure that corporations are sufficiently monitored by shareholders could lead to disastrous instances of fraud, similar to those which brought down Enron and Tyco. Therefore, when attempting to reconcile the various circuits’ stances on materiality and class certification, the Supreme Court must be aware of the ramifications. The Court’s decision will either continue recent literature and policy developments, which advocate for increased corporate monitoring, or it will strip plaintiffs of one of their most powerful tools for ensuring responsible corporate behavior and legal compliance.

By adopting the Seventh and Ninth Circuits’ approach and barring the evaluation of materiality at the class certification stage, the Court would open up lower courts for plaintiffs to file securities fraud actions. If the Court takes a more restrictive view on materiality by adopting the intermediate or strict standard, it risks losing meritorious suits to unnecessary hurdles. Plaintiffs’ attorneys face enormous up-front costs in securities litigation, from researching potential defendants, drafting the complaint, and responding to motions to dismiss, all before class certification and without immediate compensation. If plaintiffs’ attorneys are also forced to draft briefs

---

86 Choi, supra note 57, at 1473 (noting that discovery is an important tool in class action securities cases for plaintiffs to discover information only known to company insiders).

87 Petition for Writ of Certiorari, supra note 14, at 12 (noting that the Ninth Circuit’s decision to reject discussions of materiality at the class certification stage puts it in line with the Seventh Circuit).

88 Choi, supra note 57, at 1472-73 (listing the tasks that the plaintiffs’ attorneys must perform at the start of the trial and noting that these tasks impose high fixed continued . . .
and take part in an extended materiality hearing before the class can be certified, it is conceivable that plaintiffs’ firms would become increasingly hesitant to take a case, even though it may be meritorious. The courts have already seen that imposing burdens on plaintiffs who file securities class action suits reduces the number of suits that are filed, which has the possibility of eliminating the frivolous with the meritorious.\footnote{Id.\textsuperscript{(noting that the PSLRA could reduce the number of meritorious cases filed along with the frivolous); Stephen J. Choi and Robert B. Thompson, \textit{Securities Litigation and its Lawyers: Changes During the First Decade After the PSLRA}, 106 COLUM. L. REV. 1489, 1500 (2006) (referencing a 2005 Cornerstone study which reported that the PSLRA reduced litigation against Silicon Valley Companies in the Ninth Circuit, although the study did not differentiate between meritorious and frivolous litigation); Patrick Hall, \textit{The Plight of the Private Securities Litigation Reform Act in the Post-Enron Era: The Ninth Circuit’s Interpretation of Materiality in Employer-Teamster v. America West, 2004 BYU L. REV. 863, 889 (2004) (noting that even if the number of suits filed in the post-PSLRA era slightly increased, that is likely less than would have been filed given the huge increase in publically traded companies since 1995); David S. Escoffery, \textit{A Winning Approach to Loss Causation Under Rule 10B-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")}, 68 FORDHAM L. REV. 1781, 1815 n.313 (citing a Stanford study that after the passage of the PSLRA, the number of securities class action suits filed decreased in federal courts, although the number of state filings increased until additional Congressional action was taken in 1998) (2000). Although the Stanford study showed a temporary increase in state court filings, it still supports the proposition that when confronted with additional obstacles (such as the PSLRA’s increased pleading requirement), plaintiffs in securities class action cases will change their filing patterns. Since a 1998 reform effectively removed state court as an option for filing, another obstacle in the way of plaintiffs could lead to a decrease in the number of suits filed in toto.}}\footnote{Hall, supra note 89, at 888 (explaining that after the collapse of Enron, judges and lawmakers began to suspect that the PSLRA protected corporate fraud by making it difficult for innocent victims of fraud to file suit).} If the Court adopts a stricter standard than the Seventh and Ninth Circuits then it could close the courthouse to victims of fraud much like the PSLRA did with its increased pleading standard. This is a potentially disastrous consequence and many believe that the hurdles to plaintiff securities suits installed by the PSLRA contributed to the corporate scandals of the Enron-era.\footnote{Choi, supra note 57, at 1499 (giving examples of settlements under PSLRA-scheme).}

The “no consideration” approach is also the only way to ensure that corporations are constantly threatened with discovery, which incentivizes corporations to conduct business in such a manner that discovery would not unearth instances of fraud. Since a securities class action case always has the potential to unearth any corporate fraud present through the discovery process,\footnote{Choi, supra note 57, at 1499 (giving examples of settlements under PSLRA-scheme).} the Court should
consider the impact on corporate behavior if it adopts a standard that would effectively shield corporate defendants from the potentially embarrassing discovery process. By reducing the number of suits, even seemingly frivolous ones, at the class certification stage, the Court risks allowing corporations to roll the dice on illegal behavior, since uncovering fraud would be conditioned on an extremely strong shareholder case. The Seventh and Ninth Circuits’ approach, which permits materiality to be heard after certification and during trial, allows the two sides to begin the discovery process before materiality becomes an issue. This is essential to corporate governance objectives, as it allows plaintiffs, even those with weaker cases, to monitor corporations through the discovery process, which in turn incentives good corporate behavior.

Many commentators are quick to point out that permitting more suits to get to the discovery portion of a trial is exactly what litigation reforms should aim to prevent, as discovery is an extraordinarily expensive part of private securities litigation.\(^{92}\) However, these fears are misplaced as discovery abuse is misperceived to be widespread when in actuality it is not as common as scholars and lawmakers believe it to be.\(^{93}\) Additionally, leverage gained by discovery works as a two-way street where defendants can use voluminous discovery requests to force plaintiffs to either settle or even to dismiss cases, sometimes regardless of the underlying merits.\(^ {94}\) Although this has served as a justification for imposing barriers on plaintiffs in the past, plaintiffs’ attorneys generally struggle more with discovery than their corporate adversaries.\(^ {95}\) Therefore, restricting access to discovery for fear of burdening corporate defendants should not be the argument to carry the day, as the potential to uncover fraud through discovery and the absence of widespread discovery abuse make the “no consideration” approach a highly preferable alternative to other, more restrictive standards.

\(^{92}\) Alexander, supra note 75, at 537.


\(^{94}\) *Id.* at 242-43 (explaining that defendants, like plaintiffs, can use discovery to force the opposition to settle).

\(^{95}\) Kaufman & Wunderlich, *supra* note 3, at 370 (stating that in securities litigation it is often the plaintiffs who struggle with discovery, not the corporate defendants).
IV. Conclusion

Although the merits of shareholder litigation are a subject of intense debate, securities litigation can serve as a powerful tool in corporate governance to ensure that directors act in the best interests of the shareholders. Courts should therefore err on the side of caution and rely on other legal hurdles, such as motions for summary judgment, to weed out frivolous lawsuits. Increased class certification requirements should not be imposed to serve this purpose. If the Supreme Court follows the trends of the more restrictive courts by adopting either the strict or intermediate approach to the materiality requirement, it will risk creating a chilling effect on future class action suits.

If the Court adopts the strict approach towards proving materiality at the class certification stage, corporate executives may feel emboldened for several reasons. Recent legislative action has turned securities oversight from corporation-friendly to shareholder-accessible, and a change in direction could begin to shift momentum in the legal and academic worlds back toward protecting corporations (and thus their misdeeds) from monitoring by shareholders. Restricting plaintiff access to the judiciary would also threaten the settlement process which, as noted above, could be reformed to ensure that settlements are the primary vehicle of corporate governance reforms without a large economic impact on corporations. Adopting a strict approach to materiality also threatens to protect corporations from the discovery process, a litigation tool which is extraordinarily effective in unearthing corporate fraud.

The approach to materiality adopted by the Seventh and Ninth Circuits is therefore superior, as it empowers shareholders by strengthening a pre-existing weapon in their corporate governance arsenal. The not-so-distant PSLRA experience has demonstrated that restricting shareholder access to the judiciary not only removes their ability to monitor corporations, but in essence “deregulates” corporate behavior by removing the threat of a class action suit from the mind of corporate executives. Let Enron, Tyco, and the most recent economic collapse remind the Court that an unmonitored corporation quickly becomes a bold one, taking risks and committing fraud in a way that

has and will continue to pose a systemic threat to the American economy.