Session 8: New Products, Product Design and the Law

We will look at some issues effecting new firms. We will start with the recent California legislation on employee status and then turn to a recent case on Section 230 of the Communications Decency Act. We will look at how the legal system is responding to new entry in transportation including a San Francisco response to entry in the scooter market and an update on how New York City is regulating Uber and other ride-hail services.
Assembly Bill No. 5

CHAPTER 296

An act to amend Section 3351 of, and to add Section 2750.3 to, the Labor Code, and to amend Sections 606.5 and 621 of the Unemployment Insurance Code, relating to employment, and making an appropriation therefor.

[Approved by Governor September 18, 2019. Filed with Secretary of State September 18, 2019.]

LEGISLATIVE COUNSEL'S DIGEST

AB 5, Gonzalez. Worker status: employees and independent contractors.
Existing law, as established in the case of Dynamex Operations West, Inc. v. Superior Court of Los Angeles (2018) 4 Cal.5th 903 (Dynamex), creates a presumption that a worker who performs services for a hirer is an employee for purposes of claims for wages and benefits arising under wage orders issued by the Industrial Welfare Commission. Existing law requires a 3-part test, commonly known as the “ABC” test, to establish that a worker is an independent contractor for those purposes.

Existing law, for purposes of unemployment insurance provisions, requires employers to make contributions with respect to unemployment insurance and disability insurance from the wages paid to their employees. Existing law defines “employee” for those purposes to include, among other individuals, any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

This bill would state the intent of the Legislature to codify the decision in the Dynamex case and clarify its application. The bill would provide that for purposes of the provisions of the Labor Code, the Unemployment Insurance Code, and the wage orders of the Industrial Welfare Commission, a person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that the person is free from the control and direction of the hiring entity in connection with the performance of the work, the person performs work that is outside the usual course of the hiring entity’s business, and the person is customarily engaged in an independently established trade, occupation, or business. The bill, notwithstanding this provision, would provide that any statutory exception from employment status or any extension of employer status or liability remains in effect, and that if a court rules that the 3-part test cannot be applied, then the determination of employee or independent contractor status shall be governed by the test adopted in S. G. Borello & Sons, Inc. v. Department of Industrial Relations (1989) 48 Cal.3d 341 (Borello). The bill would exempt specified occupations from the application of Dynamex, and would instead provide that these
occupations are governed by Borello. These exempt occupations would include, among others, licensed insurance agents, certain licensed health care professionals, registered securities broker-dealers or investment advisers, direct sales salespersons, real estate licensees, commercial fishermen, workers providing licensed barber or cosmetology services, and others performing work under a contract for professional services, with another business entity, or pursuant to a subcontract in the construction industry.

The bill would also require the Employment Development Department, on or before March 1, 2021, and each March 1 thereafter, to issue an annual report to the Legislature on the use of unemployment insurance in the commercial fishing industry. The bill would make the exemption for commercial fishermen applicable only until January 1, 2023, and the exemption for licensed manicurists applicable only until January 1, 2022. The bill would authorize an action for injunctive relief to prevent employee misclassification to be brought by the Attorney General and specified local prosecuting agencies.

This bill would also redefine the definition of “employee” described above, for purposes of unemployment insurance provisions, to include an individual providing labor or services for remuneration who has the status of an employee rather than an independent contractor, unless the hiring entity demonstrates that the individual meets all of specified conditions, including that the individual performs work that is outside the usual course of the hiring entity’s business. Because this bill would increase the categories of individuals eligible to receive benefits from, and thus would result in additional moneys being deposited into, the Unemployment Fund, a continuously appropriated fund, the bill would make an appropriation. The bill would state that addition of the provision to the Labor Code does not constitute a change in, but is declaratory of, existing law with regard to violations of the Labor Code relating to wage orders of the Industrial Welfare Commission. The bill would also state that specified Labor Code provisions of the bill apply retroactively to existing claims and actions to the maximum extent permitted by law while other provisions apply to work performed on or after January 1, 2020. The bill would additionally provide that the bill’s provisions do not permit an employer to reclassify an individual who was an employee on January 1, 2019, to an independent contractor due to the bill’s enactment.

Existing provisions of the Labor Code make it a crime for an employer to violate specified provisions of law with regard to an employee. The Unemployment Insurance Code also makes it a crime to violate specified provisions of law with regard to benefits and payments.

By expanding the definition of an employee for purposes of these provisions, the bill would expand the definition of a crime, thereby imposing a state-mandated local program.

The California Constitution requires the state to reimburse local agencies and school districts for certain costs mandated by the state. Statutory provisions establish procedures for making that reimbursement.
This bill would provide that no reimbursement is required by this act for a specified reason.

Appropriation: yes.

The people of the State of California do enact as follows:

SECTION 1. The Legislature finds and declares all of the following:
(a) On April 30, 2018, the California Supreme Court issued a unanimous decision in Dynamex Operations West, Inc. v. Superior Court of Los Angeles (2018) 4 Cal.5th 903 (Dynamex).
(b) In its decision, the Court cited the harm to misclassified workers who lose significant workplace protections, the unfairness to employers who must compete with companies that misclassify, and the loss to the state of needed revenue from companies that use misclassification to avoid obligations such as payment of payroll taxes, payment of premiums for workers’ compensation, Social Security, unemployment, and disability insurance.
(c) The misclassification of workers as independent contractors has been a significant factor in the erosion of the middle class and the rise in income inequality.
(d) It is the intent of the Legislature in enacting this act to include provisions that would codify the decision of the California Supreme Court in Dynamex and would clarify the decision’s application in state law.
(e) It is also the intent of the Legislature in enacting this act to ensure workers who are currently exploited by being misclassified as independent contractors instead of recognized as employees have the basic rights and protections they deserve under the law, including a minimum wage, workers’ compensation if they are injured on the job, unemployment insurance, paid sick leave, and paid family leave. By codifying the California Supreme Court’s landmark, unanimous Dynamex decision, this act restores these important protections to potentially several million workers who have been denied these basic workplace rights that all employees are entitled to under the law.
(f) The Dynamex decision interpreted one of the three alternative definitions of “employ,” the “suffer or permit” definition, from the wage orders of the Industrial Welfare Commission (IWC). Nothing in this act is intended to affect the application of alternative definitions from the IWC wage orders of the term “employ,” which were not addressed by the holding of Dynamex.
(g) Nothing in this act is intended to diminish the flexibility of employees to work part-time or intermittent schedules or to work for multiple employers.

SEC. 2. Section 2750.3 is added to the Labor Code, to read:
2750.3. (a) (1) For purposes of the provisions of this code and the Unemployment Insurance Code, and for the wage orders of the Industrial Welfare Commission, a person providing labor or services for remuneration
shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that all of the following conditions are satisfied:

(A) The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.

(B) The person performs work that is outside the usual course of the hiring entity’s business.

(C) The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

(2) Notwithstanding paragraph (1), any exceptions to the terms “employee,” “employer,” “employ,” or “independent contractor,” and any extensions of employer status or liability, that are expressly made by a provision of this code, the Unemployment Insurance Code, or in an applicable order of the Industrial Welfare Commission, including, but not limited to, the definition of “employee” in subdivision 2(E) of Wage Order No. 2, shall remain in effect for the purposes set forth therein.

(3) If a court of law rules that the three-part test in paragraph (1) cannot be applied to a particular context based on grounds other than an express exception to employment status as provided under paragraph (2), then the determination of employee or independent contractor status in that context shall instead be governed by the California Supreme Court’s decision in S. G. Borello & Sons, Inc. v. Department of Industrial Relations (1989) 48 Cal.3d 341 (Borello).

(b) Subdivision (a) and the holding in Dynamex Operations West, Inc. v. Superior Court of Los Angeles (2018) 4 Cal.5th 903 (Dynamex), do not apply to the following occupations as defined in the paragraphs below, and instead, the determination of employee or independent contractor status for individuals in those occupations shall be governed by Borello.

(1) A person or organization who is licensed by the Department of Insurance pursuant to Chapter 5 (commencing with Section 1621), Chapter 6 (commencing with Section 1760), or Chapter 8 (commencing with Section 1831) of Part 2 of Division 1 of the Insurance Code.

(2) A physician and surgeon, dentist, podiatrist, psychologist, or veterinarian licensed by the State of California pursuant to Division 2 (commencing with Section 500) of the Business and Professions Code, performing professional or medical services provided to or by a health care entity, including an entity organized as a sole proprietorship, partnership, or professional corporation as defined in Section 13401 of the Corporations Code. Nothing in this subdivision shall apply to the employment settings currently or potentially governed by collective bargaining agreements for the licensees identified in this paragraph.

(3) An individual who holds an active license from the State of California and is practicing one of the following recognized professions: lawyer, architect, engineer, private investigator, or accountant.

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A securities broker-dealer or investment adviser or their agents and representatives that are registered with the Securities and Exchange Commission or the Financial Industry Regulatory Authority or licensed by the State of California under Chapter 2 (commencing with Section 25210) or Chapter 3 (commencing with Section 25230) of Division 1 of Part 3 of Title 4 of the Corporations Code.

5 A direct sales salesperson as described in Section 650 of the Unemployment Insurance Code, so long as the conditions for exclusion from employment under that section are met.

6 A commercial fisherman working on an American vessel as defined in subparagraph (A) below.

(A) For the purposes of this paragraph:

(i) “American vessel” has the same meaning as defined in Section 125.5 of the Unemployment Insurance Code.

(ii) “Commercial fisherman” means a person who has a valid, unrevoked commercial fishing license issued pursuant to Article 3 (commencing with Section 7850) of Chapter 1 of Part 3 of Division 6 of the Fish and Game Code.

(iii) “Working on an American vessel” means the taking or the attempt to take fish, shellfish, or other fishery resources of the state by any means, and includes each individual aboard an American vessel operated for fishing purposes who participates directly or indirectly in the taking of these raw fishery products, including maintaining the vessel or equipment used aboard the vessel. However, “working on an American vessel” does not apply to anyone aboard a licensed commercial fishing vessel as a visitor or guest who does not directly or indirectly participate in the taking.

(B) For the purposes of this paragraph, a commercial fisherman working on an American vessel is eligible for unemployment insurance benefits if they meet the definition of “employment” in Section 609 of the Unemployment Insurance Code and are otherwise eligible for those benefits pursuant to the provisions of the Unemployment Insurance Code.

(C) On or before March 1, 2021, and each March 1 thereafter, the Employment Development Department shall issue an annual report to the Legislature on the use of unemployment insurance in the commercial fishing industry. This report shall include, but not be limited to, reporting the number of commercial fishermen who apply for unemployment insurance benefits, the number of commercial fishermen who have their claims disputed, the number of commercial fishermen who have their claims denied, and the number of commercial fishermen who receive unemployment insurance benefits. The report required by this subparagraph shall be submitted in compliance with Section 9795 of the Government Code.

(D) This paragraph shall become inoperative on January 1, 2023, unless extended by the Legislature.

(c) (1) Subdivision (a) and the holding in Dynamex do not apply to a contract for “professional services” as defined below, and instead the determination of whether the individual is an employee or independent
contractor shall be governed by Borello if the hiring entity demonstrates that all of the following factors are satisfied:

(A) The individual maintains a business location, which may include the individual’s residence, that is separate from the hiring entity. Nothing in this subdivision prohibits an individual from choosing to perform services at the location of the hiring entity.

(B) If work is performed more than six months after the effective date of this section, the individual has a business license, in addition to any required professional licenses or permits for the individual to practice in their profession.

(C) The individual has the ability to set or negotiate their own rates for the services performed.

(D) Outside of project completion dates and reasonable business hours, the individual has the ability to set the individual’s own hours.

(E) The individual is customarily engaged in the same type of work performed under contract with another hiring entity or holds themselves out to other potential customers as available to perform the same type of work.

(F) The individual customarily and regularly exercises discretion and independent judgment in the performance of the services.

(2) For purposes of this subdivision:

(A) An “individual” includes an individual providing services through a sole proprietorship or other business entity.

(B) “Professional services” means services that meet any of the following:

(i) Marketing, provided that the contracted work is original and creative in character and the result of which depends primarily on the invention, imagination, or talent of the employee or work that is an essential part of or necessarily incident to any of the contracted work.

(ii) Administrator of human resources, provided that the contracted work is predominantly intellectual and varied in character and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

(iii) Travel agent services provided by either of the following: (I) a person regulated by the Attorney General under Article 2.6 (commencing with Section 17550) of Chapter 1 of Part 3 of Division 7 of the Business and Professions Code, or (II) an individual who is a seller of travel within the meaning of subdivision (a) of Section 17550.1 of the Business and Professions Code and who is exempt from the registration under subdivision (g) of Section 17550.20 of the Business and Professions Code.

(iv) Graphic design.

(v) Grant writer.

(vi) Fine artist.

(vii) Services provided by an enrolled agent who is licensed by the United States Department of the Treasury to practice before the Internal Revenue Service pursuant to Part 10 of Subtitle A of Title 31 of the Code of Federal Regulations.

(viii) Payment processing agent through an independent sales organization.
(ix) Services provided by a still photographer or photojournalist who do not license content submissions to the putative employer more than 35 times per year. This clause is not applicable to an individual who works on motion pictures, which includes, but is not limited to, projects produced for theatrical, television, internet streaming for any device, commercial productions, broadcast news, music videos, and live shows, whether distributed live or recorded for later broadcast, regardless of the distribution platform. For purposes of this clause a “submission” is one or more items or forms of content produced by a still photographer or photojournalist that:
(I) pertains to a specific event or specific subject; (II) is provided for in a contract that defines the scope of the work; and (III) is accepted by and licensed to the publication or stock photography company and published or posted. Nothing in this section shall prevent a photographer or artist from displaying their work product for sale.

(x) Services provided by a freelance writer, editor, or newspaper cartoonist who does not provide content submissions to the putative employer more than 35 times per year. Items of content produced on a recurring basis related to a general topic shall be considered separate submissions for purposes of calculating the 35 times per year. For purposes of this clause, a “submission” is one or more items or forms of content by a freelance journalist that: (I) pertains to a specific event or topic; (II) is provided for in a contract that defines the scope of the work; (III) is accepted by the publication or company and published or posted for sale.

(xi) Services provided by a licensed esthetician, licensed electrologist, licensed manicurist, licensed barber, or licensed cosmetologist provided that the individual:
(I) Sets their own rates, processes their own payments, and is paid directly by clients.
(II) Sets their own hours of work and has sole discretion to decide the number of clients and which clients for whom they will provide services.
(III) Has their own book of business and schedules their own appointments.
(IV) Maintains their own business license for the services offered to clients.
(V) If the individual is performing services at the location of the hiring entity, then the individual issues a Form 1099 to the salon or business owner from which they rent their business space.
(VI) This subdivision shall become inoperative, with respect to licensed manicurists, on January 1, 2022.

(d) Subdivision (a) and the holding in Dynamex do not apply to the following, which are subject to the Business and Professions Code:
(1) A real estate licensee licensed by the State of California pursuant to Division 4 (commencing with Section 10000) of the Business and Professions Code, for whom the determination of employee or independent contractor status shall be governed by subdivision (b) of Section 10032 of the Business and Professions Code. If that section is not applicable, then this determination shall be governed as follows: (A) for purposes of
unemployment insurance by Section 650 of the Unemployment Insurance Code; (B) for purposes of workers compensation by Section 3200 et seq.; and (C) for all other purposes in the Labor Code by Borello. The statutorily imposed duties of a responsible broker under Section 10015.1 of the Business and Professions Code are not factors to be considered under the Borello test.

(2) A repossession agency licensed pursuant to Section 7500.2 of the Business and Professions Code, for whom the determination of employee or independent contractor status shall be governed by Section 7500.2 of the Business and Professions Code, if the repossession agency is free from the control and direction of the hiring person or entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.

(e) Subdivision (a) and the holding in Dynamex do not apply to a bona fide business-to-business contracting relationship, as defined below, under the following conditions:

(1) If a business entity formed as a sole proprietorship, partnership, limited liability company, limited liability partnership, or corporation (“business service provider”) contracts to provide services to another such business (“contracting business”), the determination of employee or independent contractor status of the business services provider shall be governed by Borello, if the contracting business demonstrates that all of the following criteria are satisfied:

(A) The business service provider is free from the control and direction of the contracting business entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
(B) The business service provider is providing services directly to the contracting business rather than to customers of the contracting business.
(C) The contract with the business service provider is in writing.
(D) If the work is performed in a jurisdiction that requires the business service provider to have a business license or business tax registration, the business service provider has the required business license or business tax registration.
(E) The business service provider maintains a business location that is separate from the business or work location of the contracting business.
(F) The business service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed.
(G) The business service provider actually contracts with other businesses to provide the same or similar services and maintains a clientele without restrictions from the hiring entity.
(H) The business service provider advertises and holds itself out to the public as available to provide the same or similar services.
(I) The business service provider provides its own tools, vehicles, and equipment to perform the services.
(J) The business service provider can negotiate its own rates.
(K) Consistent with the nature of the work, the business service provider can set its own hours and location of work.

(L) The business service provider is not performing the type of work for which a license from the Contractor’s State License Board is required, pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code.

(2) This subdivision does not apply to an individual worker, as opposed to a business entity, who performs labor or services for a contracting business.

(3) The determination of whether an individual working for a business service provider is an employee or independent contractor of the business service provider is governed by paragraph (1) of subdivision (a).

(4) This subdivision does not alter or supersede any existing rights under Section 2810.3.

(f) Subdivision (a) and the holding in Dynamex do not apply to the relationship between a contractor and an individual performing work pursuant to a subcontract in the construction industry, and instead the determination of whether the individual is an employee of the contractor shall be governed by Section 2750.5 and by Borello, if the contractor demonstrates that all the following criteria are satisfied:

1. The subcontract is in writing.
2. The subcontractor is licensed by the Contractors State License Board and the work is within the scope of that license.
3. If the subcontractor is domiciled in a jurisdiction that requires the subcontractor to have a business license or business tax registration, the subcontractor has the required business license or business tax registration.
4. The subcontractor maintains a business location that is separate from the business or work location of the contractor.
5. The subcontractor has the authority to hire and to fire other persons to provide or to assist in providing the services.
6. The subcontractor assumes financial responsibility for errors or omissions in labor or services as evidenced by insurance, legally authorized indemnity obligations, performance bonds, or warranties relating to the labor or services being provided.
7. The subcontractor is customarily engaged in an independently established business of the same nature as that involved in the work performed.
8. (A) Paragraph (2) shall not apply to a subcontractor providing construction trucking services for which a contractor’s license is not required by Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code, provided that all of the following criteria are satisfied:
   i. The subcontractor is a business entity formed as a sole proprietorship, partnership, limited liability company, limited liability partnership, or corporation.
   ii. For work performed after January 1, 2020, the subcontractor is registered with the Department of Industrial Relations as a public works
contractor pursuant to Section 1725.5, regardless of whether the subcontract involves public work.

(iii) The subcontractor utilizes its own employees to perform the construction trucking services, unless the subcontractor is a sole proprietor who operates their own truck to perform the entire subcontract and holds a valid motor carrier permit issued by the Department of Motor Vehicles.

(iv) The subcontractor negotiates and contracts with, and is compensated directly by, the licensed contractor.

(B) For work performed after January 1, 2020, any business entity that provides construction trucking services to a licensed contractor utilizing more than one truck shall be deemed the employer for all drivers of those trucks.

(C) For purposes of this paragraph, “construction trucking services” mean hauling and trucking services provided in the construction industry pursuant to a contract with a licensed contractor utilizing vehicles that require a commercial driver’s license to operate or have a gross vehicle weight rating of 26,001 or more pounds.

(D) This paragraph shall only apply to work performed before January 1, 2022.

(E) Nothing in this paragraph prohibits an individual who owns their truck from working as an employee of a trucking company and utilizing that truck in the scope of that employment. An individual employee providing their own truck for use by an employer trucking company shall be reimbursed by the trucking company for the reasonable expense incurred for the use of the employee owned truck.

(g) Subdivision (a) and the holding in Dynamex do not apply to the relationship between a referral agency and a service provider, as defined below, under the following conditions:

(1) If a business entity formed as a sole proprietor, partnership, limited liability company, limited liability partnership, or corporation (“service provider”) provides services to clients through a referral agency, the determination whether the service provider is an employee of the referral agency shall be governed by Borello, if the referral agency demonstrates that all of the following criteria are satisfied:

(A) The service provider is free from the control and direction of the referral agency in connection with the performance of the work for the client, both as a matter of contract and in fact.

(B) If the work for the client is performed in a jurisdiction that requires the service provider to have a business license or business tax registration, the service provider has the required business license or business tax registration.

(C) If the work for the client requires the service provider to hold a state contractor’s license pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code, the service provider has the required contractor’s license.

(D) The service provider delivers services to the client under service provider’s name, rather than under the name of the referral agency.
The service provider provides its own tools and supplies to perform the services.

The service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed for the client.

The service provider maintains a clientele without any restrictions from the referral agency and the service provider is free to seek work elsewhere, including through a competing agency.

The service provider sets its own hours and terms of work and is free to accept or reject clients and contracts.

The service provider sets its own rates for services performed, without deduction by the referral agency.

The service provider is not penalized in any form for rejecting clients or contracts. This subparagraph does not apply if the service provider accepts a client or contract and then fails to fulfill any of its contractual obligations.

For purposes of this subdivision, the following definitions apply:

(A) “Animal services” means services related to daytime and nighttime pet care including pet boarding under Section 122380 of the Health and Safety Code.

(B) “Client” means a person or business that engages a service contractor through a referral agency.

(C) “Referral agency” is a business that connects clients with service providers that provide graphic design, photography, tutoring, event planning, minor home repair, moving, home cleaning, errands, furniture assembly, animal services, dog walking, dog grooming, web design, picture hanging, pool cleaning, or yard cleanup.

(D) “Referral agency contract” is the agency’s contract with clients and service contractors governing the use of its intermediary services described in subparagraph (C).

(E) “Service provider” means a person or business who agrees to the referral agency’s contract and uses the referral agency to connect with clients.

(F) “Tutor” means a person who develops and teaches their own curriculum. A “tutor” does not include a person who teaches a curriculum created by a public school or who contracts with a public school through a referral company for purposes of teaching students of a public school.

This subdivision does not apply to an individual worker, as opposed to a business entity, who performs services for a client through a referral agency. The determination whether such an individual is an employee of a referral agency is governed by subdivision (a).

(h) Subdivision (a) and the holding in Dynamex do not apply to the relationship between a motor club holding a certificate of authority issued pursuant to Chapter 2 (commencing with Section 12160) of Part 5 of Division 2 of the Insurance Code and an individual performing services pursuant to a contract between the motor club and a third party to provide motor club services utilizing the employees and vehicles of the third party and, instead, the determination whether such an individual is an employee
of the motor club shall be governed by Borello, if the motor club
demonstrates that the third party is a separate and independent business
from the motor club.

(i) (1) The addition of subdivision (a) to this section of the Labor Code
by this act does not constitute a change in, but is declaratory of, existing
law with regard to wage orders of the Industrial Welfare Commission and
violations of the Labor Code relating to wage orders.

(2) Insofar as the application of subdivisions (b), (c), (d), (e), (f), (g),
and (h) of this section would relieve an employer from liability, those
subdivisions shall apply retroactively to existing claims and actions to the
maximum extent permitted by law.

(3) Except as provided in paragraphs (1) and (2) of this subdivision, the
provisions of this section of the Labor Code shall apply to work performed
on or after January 1, 2020.

(j) In addition to any other remedies available, an action for injunctive
relief to prevent the continued misclassification of employees as independent
contractors may be prosecuted against the putative employer in a court of
competent jurisdiction by the Attorney General or by a city attorney of a
city having a population in excess of 750,000, or by a city attorney in a city
and county or, with the consent of the district attorney, by a city prosecutor
in a city having a full-time city prosecutor in the name of the people of the
State of California upon their own complaint or upon the complaint of a
board, officer, person, corporation, or association.

SEC. 3. Section 3351 of the Labor Code, as amended by Section 33 of
Chapter 38 of the Statutes of 2019, is amended to read:

3351. “Employee” means every person in the service of an employer
under any appointment or contract of hire or apprenticeship, express or
implied, oral or written, whether lawfully or unlawfully employed, and
includes:

(a) Aliens and minors.
(b) All elected and appointed paid public officers.
(c) All officers and members of boards of directors of quasi-public or
private corporations while rendering actual service for the corporations for
pay. An officer or member of a board of directors may elect to be excluded
from coverage in accordance with paragraph (16), (18), or (19) of subdivision
(a) of Section 3352.
(d) Except as provided in paragraph (8) of subdivision (a) of Section
3352, any person employed by the owner or occupant of a residential
dwelling whose duties are incidental to the ownership, maintenance, or use
of the dwelling, including the care and supervision of children, or whose
duties are personal and not in the course of the trade, business, profession,
or occupation of the owner or occupant.
(e) All persons incarcerated in a state penal or correctional institution
while engaged in assigned work or employment as defined in paragraph (1)
of subdivision (a) of Section 10021 of Title 8 of the California Code of
Regulations, or engaged in work performed under contract.
(f) All working members of a partnership or limited liability company receiving wages irrespective of profits from the partnership or limited liability company. A general partner of a partnership or a managing member of a limited liability company may elect to be excluded from coverage in accordance with paragraph (17) of subdivision (a) of Section 3352.

(g) A person who holds the power to revoke a trust, with respect to shares of a private corporation held in trust or general partnership or limited liability company interests held in trust. To the extent that this person is deemed to be an employee described in subdivision (c) or (f), as applicable, the person may also elect to be excluded from coverage as described in subdivision (c) or (f), as applicable, if that person otherwise meets the criteria for exclusion, as described in Section 3352.

(h) A person committed to a state hospital facility under the State Department of State Hospitals, as defined in Section 4100 of the Welfare and Institutions Code, while engaged in and assigned work in a vocation rehabilitation program, including a sheltered workshop.

(i) Beginning on July 1, 2020, any individual who is an employee pursuant to Section 2750.3. This subdivision shall not apply retroactively.

SEC. 4. Section 606.5 of the Unemployment Insurance Code is amended to read:

606.5. (a) Whether an individual or entity is the employer of specific employees shall be determined pursuant to subdivision (b) of Section 621, except as provided in subdivisions (b) and (c).

(b) As used in this section, a “temporary services employer” and a “leasing employer” is an employing unit that contracts with clients or customers to supply workers to perform services for the client or customer and performs all of the following functions:

1. Negotiates with clients or customers for such matters as time, place, type of work, working conditions, quality, and price of the services.

2. Determines assignments or reassignments of workers, even though workers retain the right to refuse specific assignments.

3. Retains the authority to assign or reassign a worker to other clients or customers when a worker is determined unacceptable by a specific client or customer.

4. Assigns or reassigns the worker to perform services for a client or customer.

5. Sets the rate of pay of the worker, whether or not through negotiation.

6. Pays the worker from its own account or accounts.

7. Retains the right to hire and terminate workers.

(c) If an individual or entity contracts to supply an employee to perform services for a customer or client, and is a leasing employer or a temporary services employer, the individual or entity is the employer of the employee who performs the services. If an individual or entity contracts to supply an employee to perform services for a client or customer and is not a leasing employer or a temporary services employer, the client or customer is the employer of the employee who performs the services. An individual or entity that contracts to supply an employee to perform services for a customer...
or client and pays wages to the employee for the services, but is not a leasing employer or a temporary services employer, pays the wages as the agent of the employer.

(d) In circumstances which are in essence the loan of an employee from one employer to another employer wherein direction and control of the manner and means of performing the services changes to the employer to whom the employee is loaned, the loaning employer shall continue to be the employer of the employee if the loaning employer continues to pay remuneration to the employee, whether or not reimbursed by the other employer. If the employer to whom the employee is loaned pays remuneration to the employee for the services performed, that employer shall be considered the employer for the purposes of any remuneration paid to the employee by the employer, regardless of whether the loaning employer also pays remuneration to the employee.

SEC. 5. Section 621 of the Unemployment Insurance Code is amended to read:

621. “Employee” means all of the following:

(a) Any officer of a corporation.

(b) Any individual providing labor or services for remuneration has the status of an employee rather than an independent contractor unless the hiring entity demonstrates all of the following conditions:

1) The individual is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.

2) The individual performs work that is outside the usual course of the hiring entity’s business.

3) The individual is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

(c) (1) Any individual, other than an individual who is an employee under subdivision (a) or (b), who performs services for remuneration for any employing unit if the contract of service contemplates that substantially all of those services are to be performed personally by that individual either:

(A) As an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or drycleaning services, for their principal.

(B) As a traveling or city salesperson, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, their principal (except for sideline sales activities on behalf of some other person) of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations.

(C) As a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by that person that are required to be returned to that person or a designee thereof.
(2) An individual shall not be included in the term “employee” under the provisions of this subdivision if that individual has a substantial investment in facilities used in connection with the performance of those services, other than in facilities for transportation, or if the services are in the nature of a single transaction not part of a continuing relationship with the employing unit for whom the services are performed.

(d) Any individual who is an employee pursuant to Section 601.5 or 686.

(e) Any individual whose services are in subject employment pursuant to an election for coverage under any provision of Article 4 (commencing with Section 701) of this chapter.

(f) Any member of a limited liability company that is treated as a corporation for federal income tax purposes.

SEC. 6. No provision of this measure shall permit an employer to reclassify an individual who was an employee on January 1, 2019, to an independent contractor due to this measure’s enactment.

SEC. 7. No reimbursement is required by this act pursuant to Section 6 of Article XIII B of the California Constitution because the only costs that may be incurred by a local agency or school district will be incurred because this act creates a new crime or infraction, eliminates a crime or infraction, or changes the penalty for a crime or infraction, within the meaning of Section 17556 of the Government Code, or changes the definition of a crime within the meaning of Section 6 of Article XIII B of the California Constitution.
Homeaway.com v. City of Santa Monica

_ NGUYEN, Circuit Judge: Located on the coast of Southern California, the city of Santa Monica consists of only about eight square miles but serves 90,000 residents and as many as 500,000 visitors on weekends and holidays. Similar to other popular tourist destinations, Santa Monica is struggling to manage the disruptions brought about by the rise of short-term rentals facilitated by innovative startups such as Appellants HomeAway.com, Inc. and Airbnb Inc. (the “Platforms”). Websites like those operated by the Platforms are essentially online marketplaces that allow “guests” seeking accommodations and “hosts” offering accommodations to connect and enter into rental agreements with one another. As of February 2018, Airbnb had approximately 1,400 listings in Santa Monica, of which about 30 percent are in the “coastal zone” covered by the California Coastal Act, while HomeAway.com had approximately 300 live listings in Santa Monica, of which approximately 40 percent are in the coastal zone.

Santa Monica’s council reported that the proliferation of short-term rentals had negatively impacted the quality and character of its neighborhoods by “bringing commercial activity and removing residential housing stock from the market” at a time when California is already suffering from severe housing shortages. In response, the city passed an ordinance regulating the short-term vacation rental market by authorizing licensed “home-sharing” (rentals where residents remain on-site with guests) but prohibiting all other short-term rentals of 30 consecutive days or less.

The Platforms filed suit, alleging that the city ordinance is preempted by the Communications Decency Act and impermissibly infringes upon their First Amendment rights. The district court denied preliminary injunctive relief, and dismissed the Platforms’ complaints for failure to state a claim under the Communications Decency Act and the First Amendment. We affirm.

BACKGROUND

In May 2015, Santa Monica passed its initial ordinance regulating the short-term vacation rental market by authorizing licensed “home-sharing” (rentals where residents remain on-site with guests) but prohibiting all other forms of short-term rentals for 30 consecutive days or less. Santa Monica Ordinance 2484 (May 12, 2015), codified as amended, Santa Monica Mun. Code §§ 6.20.010-6.20.100. The ordinance reflected the city’s housing goals of “preserving its housing stock and preserving the quality and character of its existing single and multi-family residential neighborhoods.” Id. As originally enacted, the ordinance prohibited hosting platforms from acting to “undertake, maintain, authorize, aid, facilitate or advertise any Home-Sharing activity” that was not authorized by the city. Hosting platforms also were required to collect and remit taxes, and to regularly disclose listings and booking information to the city.

The Platforms each filed a complaint in the Central District of California challenging the initial ordinance, and the district court consolidated the cases for discovery and pretrial matters. On September 21, 2016, the parties stipulated to stay the case while the city considered amendments.

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1 The Platforms do not own, lease, or manage any of the properties listed on their websites, nor are they parties to the rental agreements. Instead, the content provided alongside the listings—such as description, price, and availability—are provided by the hosts. For their services, the Platforms collect a fee from each successful booking.
to the local ordinance. During the stay period, the district court for the Northern District of California denied a preliminary injunction requested by the plaintiffs in a separate case challenging a similar ordinance in San Francisco. See Airbnb Inc. v. City & County of San Francisco, 217 F. Supp. 3d 1066 (N.D. Cal. 2016). That case ended in a settlement in which the Platforms agreed to comply with an amended version of San Francisco’s ordinance that prohibited booking unlawful transactions but provided a safe harbor wherein any platform that complies with the responsibilities set out in the Ordinance will be presumed to be in compliance with the law.

In January 2017, Santa Monica likewise amended its own ordinance. The version challenged here, Ordinance 2535 (the “Ordinance”), retains its prohibitions on most types of short-term rentals, with the exception of licensed home-shares. In addition, the Ordinance imposes four obligations on hosting platforms directly: (1) collecting and remitting “Transient Occupancy Taxes,” (2) disclosing certain listing and booking information regularly, (3) refraining from completing any booking transaction for properties not licensed and listed on the City’s registry, and (4) refraining from collecting or receiving a fee for “facilitating or providing services ancillary to a vacation rental or unregistered home-share.” If a housing platform operates in compliance with these obligations, the Ordinance provides a safe harbor by presuming the platform to be in compliance with the law. Otherwise, violations are punishable by a fine of up to $500 and/or imprisonment for up to six months.

After the district court lifted the stay, the Platforms amended their complaint to challenge the revised ordinance and moved for a preliminary injunction. Santa Monica moved to dismiss the amended complaint. The court denied the Platforms’ motion for preliminary injunctive relief and subsequently granted Santa Monica’s motion to dismiss on the ground that the Platforms failed to state a claim under federal law, including the Communications Decency Act of 1996 and the First Amendment. The district court also declined to exercise supplemental jurisdiction over their remaining state-law claims. The Platforms timely appealed these decisions, and we consolidated the appeals. ***

DISCUSSION

I. Communications Decency Act

The Communications Decency Act of 1996 (“CDA” or the “Act”), 47 U.S.C. § 230, provides internet companies with immunity from certain claims in furtherance of its stated policy “to promote the continued development of the Internet and other interactive computer services.” Id. § 230(b)(1). Construing this immunity broadly, the Platforms argue that the Ordinance requires them to monitor and remove third-party content, and therefore violates the CDA by interfering with federal policy protecting internet companies from liability for posting third-party content. Santa Monica, on the other hand, argues that the Ordinance does not implicate the CDA because it imposes no obligation on the Platforms to monitor or edit any listings provided by hosts. Santa Monica contends that the Ordinance is simply an exercise of its right to enact regulations to preserve housing by curtailing “incentives for landlords to evade rent control laws, evict tenants, and convert residential units into de facto hotels.”

We begin our analysis with the text of the CDA. Section 230(c)(1) states that “[n]o provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider.” Id. § 230(c)(1). The CDA explicitly preempts inconsistent state laws: “Nothing in this section shall be construed to prevent any State from enforcing any State law that is consistent with this section. No cause of action may be
brought and no liability may be imposed under any State or local law that is inconsistent with this section.” Id. § 230(c)(3).

We have construed these provisions to extend immunity to “(1) a provider or user of an interactive computer service (2) whom a plaintiff seeks to treat, under a state law cause of action, as a publisher or speaker (3) of information provided by another information content provider.” Barnes v. Yahoo!, Inc., 570 F.3d 1096, 1100-01 (9th Cir. 2009). Only the second element is at issue here: whether the Ordinance treats the Platforms as a “publisher or speaker” in a manner that is barred by the CDA. Although the CDA does not define “publisher,” we have defined “publication” in this context to “involve[] reviewing, editing, and deciding whether to publish or to withdraw from publication third-party content.” Id. at 1102 (citing Fair Hous. Council v. Roommates.com, LLC, 521 F.3d 1157, 1170-71 (9th Cir. 2008) (en banc)).

The Platforms offer two different theories as to how the Ordinance in fact reaches “publication” activities. First, the Platforms claim that the Ordinance is expressly preempted by the CDA because, as they argue, it implicitly requires them “to monitor the content of a third-party listing and compare it against the City’s short-term rental registry before allowing any booking to proceed.” Relying on Doe v. Internet Brands, 824 F.3d 846, 851 (9th Cir. 2016), the Platforms take the view that CDA immunity follows whenever a legal duty “affects” how an internet company “monitors” a website.

However, the Platforms read Internet Brands too broadly. In that case, two individuals used the defendant’s website to message and lure the plaintiff to sham auditions where she was drugged and raped. Id. at 848. We held that, where the website provider was alleged to have known independently of the ongoing scheme beforehand, the CDA did not bar an action under state law for failure to warn. Id. at 854. We observed that a duty to warn would not “otherwise affect how [the defendant] publishes or monitors” user content. Id. at 851. Though the defendant did, in its business, act as a publisher of third-party content, the underlying legal duty at issue did not seek to hold the defendant liable as a “publisher or speaker” of third-party content. Id. at 853; see 47 U.S.C. § 230(c)(1). We therefore declined to extend CDA immunity to the defendant for the plaintiff’s failure-to-warn claim. Internet Brands, 824 F.3d at 854.

We do not read Internet Brands to suggest that CDA immunity attaches any time a legal duty might lead a company to respond with monitoring or other publication activities. It is not enough that third-party content is involved; Internet Brands rejected use of a “but-for” test that would provide immunity under the CDA solely because a cause of action would not otherwise have accrued but for the third-party content. Id. at 853. We look instead to what the duty at issue actually requires: specifically, whether the duty would necessarily require an internet company to monitor third-party content. See id. at 851, 853.

Here, the Ordinance does not require the Platforms to monitor third-party content and thus falls outside of the CDA’s immunity. The Ordinance prohibits processing transactions for unregistered properties. It does not require the Platforms to review the content provided by the hosts of listings on their websites. Rather, the only monitoring that appears necessary in order to comply with the Ordinance relates to incoming requests to complete a booking transaction—content that, while resulting from the third-party listings, is distinct, internal, and nonpublic. As in Internet Brands, it is not enough that the third-party listings are a “but-for” cause of such internal monitoring. See Barnes, 824 F.3d at 853. The text of the CDA is “clear that neither this subsection nor any other declares a general immunity from liability deriving from third-party content.” 570 F.3d at 1100. To provide broad immunity “every time a website uses data initially obtained from third parties would eviscerate [the CDA].” Barnes, 570 F.3d at 1100 (quoting Roommates.com, 521 F.3d at 1171 (9th Cir. 2008) (en banc)). That is not the result that Congress intended.
Nor could a duty to cross-reference bookings against Santa Monica’s property registry give rise to CDA immunity. While keeping track of the city’s registry is “monitoring” third-party content in the most basic sense, such conduct cannot be fairly classified as “publication” of third-party content. The Platforms have no editorial control over the registry whatsoever. As with tax regulations or criminal statutes, the Ordinance can fairly charge parties with keeping abreast of the law without running afoul of the CDA.

Second, the Platforms argue that the Ordinance “in operation and effect . . . forces [them] to remove third-party content.” Although it is clear that the Ordinance does not expressly mandate that they do so, the Platforms claim that “common sense explains” that they cannot “leave in place a website chock-full of un-bookable listings.” For purposes of our review, we accept at face value the Platforms’ assertion that they will choose to remove noncompliant third-party listings on their website as a consequence of the Ordinance. Nonetheless, their choice to remove listings is insufficient to implicate the CDA.

On its face, the Ordinance does not proscribe, mandate, or even discuss the content of the listings that the Platforms display on their websites. See Santa Monica Mun. Code §§ 6.20.010-6.20.100. It requires only that transactions involve licensed properties. We acknowledge that, as the Platforms explain in Airbnb’s complaint and in the briefing on appeal, removal of these listings would be the best option “from a business standpoint.” But, as in Internet Brands, the underlying duty “could have been satisfied without changes to content posted by the website’s users.” See 824 F.3d at 851. Even assuming that removing certain listings may be the Platforms’ most practical compliance option, allowing internet companies to claim CDA immunity under these circumstances would risk exempting them from most local regulations and would, as this court feared in Roommates.com, 521 F.3d at 1164, “create a lawless noman’s-land on the Internet.” We hold that the Ordinance is not “inconsistent” with the CDA, and is therefore not expressly preempted by its terms. See 47 U.S.C. § 230(e)(3).

Finally, the Platforms argue that, even if the Ordinance is not expressly preempted by the CDA, the Ordinance imposes “an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.” See Crosby v. Nat’l Foreign Trade Council, 530 U.S. 363, 372-73 (2000). Reading the CDA expansively, they argue that the Ordinance conflicts with the CDA’s goal “to preserve the vibrant and competitive free market that presently exists for the Internet . . . unfettered by Federal or State regulation.” See § 230(b)(2). We have consistently eschewed an expansive reading of the statute that would render unlawful conduct “magically . . . lawful when [conducted] online,” and therefore “giv[ing] online businesses an unfair advantage over their real-world counterparts.” See Roommates.com, 521 F.3d at 1164, 1164-65 n.15. For the same reasons, while we acknowledge the Platforms’ concerns about the difficulties of complying with numerous state and local regulations, the CDA does not provide internet companies with a one-size-fits-all body of law. Like their brick-and-mortar counterparts, internet companies must also comply with any number of local regulations concerning, for example, employment, tax, or zoning. Because the Ordinance would not pose an obstacle to Congress’s aim to

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3 The Platforms argued below that the district court must accept as true their allegation that they would “have to” monitor and screen listings. As a matter of law, the Ordinance does not require them to do so. Courts are “not bound to accept as true a legal conclusion couched as a factual allegation.” Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 555 (2007) (quoting Papasan v. Allain, 478 U.S. 265, 286 (1986)).
encourage self-monitoring of third-party content, we hold that obstacle preemption does not preclude Santa Monica from enforcing the Ordinance.

Fundamentally, the parties dispute how broadly to construe the CDA so as to continue serving the purposes Congress envisioned while allowing state and local governments breathing room to address the pressing issues faced by their communities. We have previously acknowledged that the CDA’s immunity reaches beyond the initial state court decision that sparked its enactment. See Fair Hous. Council v. Roommates.com, LLC, 521 F.3d 1157, 1163 (9th Cir. 2008) (en banc) (discussing Stratton Oakmont, Inc. v. Prodigy Servs. Co., which held an internet company liable for defamation when it removed some, but not all, harmful content from its public message boards, 1995 WL 323710 (N.Y. Sup. Ct. May 24, 1995) (unpublished)). As the Platforms correctly note, the Act’s policy statements broadly promote “the vibrant and competitive free market that presently exists for the Internet . . . unfettered by Federal or State regulation.” See 47 U.S.C. § 230(b)(2). “[A] law’s scope often differs from its genesis,” and we have repeatedly held the scope of immunity to reach beyond defamation cases. Barnes, 570 F.3d at 1101 (quoting Chicago Lawyers’ Comm. for Civil Rights Under Law, Inc. v. Craigslist, Inc., 519 F.3d 666, 671 (7th Cir. 2008), as amended (May 2, 2008)) (citing cases applying immunity for causes of action including discrimination, fraud, and negligence).

At the same time, our cases have hewn closely to the statutory language of the CDA and have limited the expansion of its immunity beyond the protection Congress envisioned. As we have observed, “the [relevant] section is titled ‘Protection for “good Samaritan” blocking and screening of offensive material.’” Roommates.com, 521 F.3d at 1163-64 (quoting 47 U.S.C. § 230(c)); see also Internet Brands, 824 F.3d at 852. Congress intended to “spare interactive computer services [the] grim choice” between voluntarily filtering content and being subject to liability on the one hand, and “ignoring all problematic posts altogether [to] escape liability.” Roommates.com, 521 F.3d at 1163-64. In contrast, the Platforms face no liability for the content of the bookings; rather, any liability arises only from unlicensed bookings. We do not discount the Platforms’ concerns about the administrative burdens of state and local regulations, but we nonetheless disagree that § 230(c)(1) of the CDA may be read as broadly as they advocate, or that we may ourselves expand its provisions beyond what Congress initially intended.

In sum, neither express preemption nor obstacle preemption apply to the Ordinance. We therefore affirm the district court’s dismissal for failure to state a claim under the CDA.

II. First Amendment

The Platforms also contend that the district court erred in dismissing their First Amendment claims. They argue that, even if the plain language of the Ordinance only reaches “conduct,” i.e., booking unlicensed properties, the law effectively imposes a “content-based financial burden” on commercial speech and is thus subject to First Amendment scrutiny. The district court concluded that the Ordinance “regulates conduct, not speech, and that the conduct banned . . . does not have such a ‘significant expressive element’ as to draw First Amendment protection.” We agree.

That the Ordinance regulates “conduct” is not alone dispositive. The Supreme Court has previously applied First Amendment scrutiny when “‘speech’ and ‘nonspeech’ elements are combined in the same course of conduct.” See United States v. O’Brien, 391 U.S.
But “restrictions on protected expression are distinct from restrictions on economic activity or, more generally, on nonexpressive conduct.” *Sorrell v. IMS Health Inc.*, **564 U.S. 552, 567** (2011). While the former is entitled to protection, “the First Amendment does not prevent restrictions directed at commerce or conduct from imposing incidental burdens on speech.” *Id.*

To determine whether the First Amendment applies, we must first ask the “threshold question [of] whether conduct with a ‘significant expressive element’ drew the legal remedy or the ordinance has the inevitable effect of ‘singling out those engaged in expressive activity.’” *Int'l Franchise Ass'n v. City of Seattle*, **803 F.3d 389, 408** (9th Cir. 2015) (quoting *Arcara v. Cloud Books, Inc.*, **478 U.S. 697, 706-07** (1986)). A court may consider the “inevitable effect of a statute on its face,” as well as a statute’s “stated purpose.” *Sorrell*, **564 U.S. at 565**. However, absent narrow circumstances, a court may not conduct an inquiry into legislative purpose or motive beyond what is stated within the statute itself. *See O'Brien, 391 U.S. at 383 n.30*. Because the conduct at issue—completing booking transactions for unlawful rentals—consists only of nonspeech, nonexpressive conduct, we hold that the Ordinance does not implicate the First Amendment.

First, the prohibitions here did not target conduct with “a significant expressive element.” *See Arcara, 478 U.S. at 706*. Our decision in *International Franchise Ass'n* is analogous. There, the plaintiff challenged a minimum wage ordinance that would have accelerated the raising of the minimum wage to $15 per hour for franchise owners and other large employers. **803 F.3d at 389**. In denying a preliminary injunction, the district court held that the plaintiffs were not likely to succeed on their First Amendment argument that the ordinance treated them differently based on their “speech and association” decisions to operate within a franchise relationship framework. *Id.* at 408-09. We agreed, concluding that the “business agreement or business dealings” were not conduct with a “significant expressive element.” *Id.* at 408. Instead, “Seattle’s minimum wage ordinance [was] plainly an economic regulation that [did] not target speech or expressive conduct.” *Id.*

Similarly, here, the Ordinance is plainly a housing and rental regulation. The “inevitable effect of the [Ordinance] on its face” is to regulate nonexpressive conduct—namely, booking transactions—not speech. *See Sorrell, 564 U.S. at 565*. As in *International Franchise Ass'n*, the “business agreement or business dealings” associated with processing a booking is not conduct with a “significant expressive element.” *See 803 F.3d at 408* (citation and quotation marks omitted). Contrary to the Platforms’ claim, the Ordinance does not “require” that they monitor or screen advertisements. It instead leaves them to decide how best to comply with the prohibition on booking unlawful transactions.

Nor can the Platforms rely on the Ordinance’s “stated purpose” to argue that it intends to regulate speech. The Ordinance itself makes clear that the City’s “central and significant goal . . . is preservation of its housing stock and preserving the quality and nature of residential neighborhoods.” As such, with respect to the Platforms, the only inevitable effect, and the stated purpose, of the Ordinance is to prohibit them from completing booking transactions for unlawful rentals.

As for the second prong of our inquiry, whether the Ordinance has the effect of “singling out those engaged in expressive activity,” *Arcara, 478 U.S. at 706-07*, we conclude that it does not. As the Platforms point out, websites like Craigslist “advertise the very same properties,” but do not process transactions. Unlike the Platforms, those websites would
not be subject to the Ordinance, underscoring that the Ordinance does not target websites that post listings, but rather companies that engage in unlawful booking transactions.

Moreover, the incidental impacts on speech cited by the Platforms raise minimal concerns. The Platforms argue that the Ordinance chills commercial speech, namely, advertisements for third-party rentals. But even accepting that the Platforms will need to engage in efforts to validate transactions before completing them, incidental burdens like these are not always sufficient to trigger First Amendment scrutiny. See Int'l Franchise Ass'n, 803 F.3d at 408 (“[S]ubjecting every incidental impact on speech to First Amendment scrutiny ‘would lead to the absurd result that any government action that had some conceivable speech inhibiting consequences . . . would require analysis under the First Amendment.’” (quoting Arcara, 478 U.S. at 708 (O'Connor, J., concurring))). Furthermore, to the extent that the speech chilled advertises unlawful rentals, “[a]ny First Amendment interest . . . is altogether absent when the commercial activity itself is illegal and the restriction on advertising is incidental to a valid limitation on economic activity.” See Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations, 413 U.S. 376, 389 (1973).

Finally, because the Ordinance does not implicate speech protected by the First Amendment, we similarly reject the Platforms’ argument that the Ordinance is unconstitutional without a scienter requirement. In most cases, there is no “closed definition” on when a criminal statute must contain a scienter requirement. See Morissette v. United States, 342 U.S. 246, 260 (1952). However, the Supreme Court has drawn a bright line in certain contexts, such as holding that the First Amendment requires statutes imposing criminal liability for obscenity or child pornography to contain a scienter requirement. See New York v. Ferber, 458 U.S. 747, 765 (1982). Such a requirement prevents “a severe limitation on the public’s access to constitutionally protected matter” as would result from inflexible laws criminalizing “bookshops and periodical stands.” Smith v. California, 361 U.S. 147, 153 (1959).

Here, even assuming that the Ordinance would lead the Platforms to voluntarily remove some advertisements for lawful rentals, there would not be a “severe limitation on the public’s access” to lawful advertisements, especially considering the existence of alternative channels like Craigslist. Id. Such an incidental burden is far from “a substantial restriction on the freedom of speech” that would necessitate a scienter requirement. Id. at 150. Otherwise, “[t]here is no specific constitutional inhibition against making the distributors of good[s] the strictest censors of their merchandise.” Id. at 152.

Because the district court properly dismissed the Platforms’ complaints for failure to state a claim, we dismiss as moot the appeals from the denial of preliminary injunctive relief.

AFFIRMED in part, DISMISSED in part.
Session 9: International Issues

We will look at three different takes on how the international law regime matters for U.S. firms. We will start with two recent press releases from the Court of Justice of the European Union. We then turn to the *Tianrui* case which raises issues about the circumstances under which the U.S. will block the importation of goods produced overseas. Finally, we will look at the Foreign Corrupt Practices Act (15 USC 78dd-1 to 15 USC 78dd-3) through the lens of a New York Times *story* on Walmart’s practices in Mexico.
The operator of a search engine is not required to carry out a de-referencing on all versions of its search engine

It is, however, required to carry out that de-referencing on the versions corresponding to all the Member States and to put in place measures discouraging internet users from gaining access, from one of the Member States, to the links in question which appear on versions of that search engine outside the EU

By an adjudication of 10 March 2016, the Commission nationale de l'informatique et des libertés (French Data Protection Authority, France) (‘the CNIL’) imposed a penalty of €100 000 on Google Inc. because of that company’s refusal, when granting a de-referencing request, to apply it to all its search engine’s domain name extensions.

Google Inc., having been given formal notice by the CNIL on 21 May 2015 to apply the de-referencing to all the extensions, had refused to do so and had confined itself to removing the links in question from only the results displayed following searches conducted from the domain names corresponding to the versions of its search engine in the Member States. Google Inc. requested the Conseil d’État (Council of State, France) to annul the adjudication of 10 March 2016. It considers that the right to de-referencing does not necessarily require that the links at issue are to be removed, without geographical limitation, from all its search engine’s domain names.

The Conseil d’État has referred several questions to the Court of Justice for a preliminary ruling seeking to ascertain whether the rules of EU law relating to the protection of personal data are to be interpreted as meaning that, where a search engine operator grants a request for de-referencing, that operator is required to carry out that de-referencing on all versions of its search engine or whether, on the contrary, it is required to do so only on the versions of that search engine corresponding to all the Member States or only on the version corresponding to the Member State of residence of the person benefiting from the de-referencing.

In today’s judgment, the Court begins by recalling that it has already held that the operator of a search engine is obliged to remove from the list of results displayed following a search made on the basis of a person’s name links to web pages, published by third parties and containing information relating to that person, also in a case where that name or information is not erased beforehand or simultaneously from those web pages, and even, as the case may be, when its publication in itself on those pages is lawful.

The Court points out, next, that Google Inc.’s establishment in French territory carries on activities, including commercial and advertising activities, which are inextricably linked to the processing of personal data carried out for the purposes of operating the search engine concerned and, second, that that search engine must, in view of, inter alia, the existence of gateways between its various national versions, be regarded as carrying out a single act of data processing in the context of the

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2 Case: C-131/12 Google Spain and Google see Press release 70/14.
activities of Google Inc.’s French establishment. Such a situation therefore falls within the scope of the EU legislation on the protection of personal data.

The Court emphasises that, in a globalised world, internet users’ access — including those outside the EU — to the referencing of a link referring to information regarding a person whose centre of interests is situated in the EU is likely to have immediate and substantial effects on that person within the EU itself, so that a global de-referencing would meet the objective of protection referred to in EU law in full. However, it states that numerous third States do not recognise the right to de-referencing or have a different approach to that right. The Court adds that the right to the protection of personal data is not an absolute right, but must be considered in relation to its function in society and be balanced against other fundamental rights, in accordance with the principle of proportionality. In addition, the balance between the right to privacy and the protection of personal data, on the one hand, and the freedom of information of internet users, on the other, is likely to vary significantly around the world.

However, it is not apparent from the legal texts that the EU legislature has struck such a balance as regards the scope of a de-referencing outside the EU, nor that it has chosen to confer a scope on the rights of individuals which would go beyond the territory of the Member States. Nor is it apparent from those texts that it would have intended to impose on an operator, such as Google, a de-referencing obligation which also concerns the national versions of its search engine that do not correspond to the Member States. What is more, EU law does not provide for cooperation instruments and mechanisms as regards the scope of a de-referencing outside the EU.

Thus, the Court concludes that, currently, there is no obligation under EU law, for a search engine operator who grants a request for de-referencing made by a data subject, as the case may be, following an injunction from a supervisory or judicial authority of a Member State, to carry out such a de-referencing on all the versions of its search engine.

However, EU law requires a search engine operator to carry out such a de-referencing on the versions of its search engine corresponding to all the Member States and to take sufficiently effective measures to ensure the effective protection of the data subject’s fundamental rights. Thus, such a de-referencing must, if necessary, be accompanied by measures which effectively prevent or, at the very least, seriously discourage an internet user conducting a search from one of the Member States on the basis of a data subject’s name from gaining access, via the list of results displayed following that search, through a version of that search engine ‘outside the EU, to the links which are the subject of the request for de-referencing. It will be for the national court to ascertain whether the measures put in place by Google Inc. meet those requirements.

Lastly, the Court points out that, while EU law does not currently require a de-referencing to be carried out on all versions of the search engine, it also does not prohibit such a practice. Accordingly, the authorities of the Member States remain competent to weigh up, in the light of national standards of protection of fundamental rights, a data subject’s right to privacy and the protection of personal data concerning him or her, on the one hand, and the right to freedom of information, on the other, and, after weighing those rights against each other, to order, where appropriate, the operator of that search engine to carry out a de-referencing concerning all versions of that search engine.

NOTE: A reference for a preliminary ruling allows the courts and tribunals of the Member States, in disputes which have been brought before them, to refer questions to the Court of Justice about the interpretation of European Union law or the validity of a European Union act. The Court of Justice does not decide the dispute itself. It is for the national court or tribunal to dispose of the case in accordance with the Court’s decision, which is similarly binding on other national courts or tribunals before which a similar issue is raised.

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The full text of the judgment is published on the CURIA website on the day of delivery.

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EU law does not preclude a host provider such as Facebook from being ordered to remove identical and, in certain circumstances, equivalent comments previously declared to be illegal

In addition EU law does not preclude such an injunction from producing effects worldwide, within the framework of the relevant international law which it is for Member States to take into account.

Mme Eva Glawischneg-Piesczek, who was a member of the Nationalrat (National Council, Austria), chair of the parliamentary party ‘die Grünen’ (The Greens) and federal spokesperson for that party, sued Facebook Ireland in the Austrian courts. She is seeking an order that Facebook Ireland remove a comment published by a user on that social network harmful to her reputation, and allegations which were identical and/or of an equivalent content.

The Facebook user in question had shared on that user’s personal page an article from the Austrian online news magazine oe24.at entitled ‘Greens: Minimum income for refugees should stay’. That had the effect of generating on that page a ‘thumbnail’ of the original site, containing the title and a brief summary of the article, and a photograph of Ms Glawischneg-Piesczek. That user also published, in connection with that article, a comment which the Austrian courts found to be harmful to the reputation of Ms Glawischneg-Piesczek, and which insulted and defamed her. This post could be accessed by any Facebook user.

Against that background, the Oberster Gerichtshof (Supreme Court, Austria) is asking the Court of Justice to interpret the Directive on electronic commerce.¹

Under that directive, a host provider such as Facebook is not liable for stored information if it has no knowledge of its illegal nature or if it acts expeditiously to remove or to disable access to that information as soon as it becomes aware of it. That exemption does not, however, prevent the host provider from being ordered to terminate or prevent an infringement, including by removing the illegal information or by disabling access to it. However, the directive prohibits any requirement for the host provider to monitor generally information which it stores or to seek actively facts or circumstances indicating illegal activity.

By today’s judgment, the Court of Justice answers the Oberster Gerichtshof that the Directive on electronic commerce, which seeks to strike a balance between the different interests at stake, does not preclude a court of a Member State from ordering a host provider:

- to remove information which it stores, the content of which is identical to the content of information which was previously declared to be unlawful, or to block access to that information, irrespective of who requested the storage of that information;

- to remove information which it stores, the content of which is equivalent to the content of information which was previously declared to be unlawful, or to block access to that information, provided that the monitoring of and search for the information concerned by such an injunction are limited to information conveying a message the content of which remains

essentially unchanged compared with the content which gave rise to the finding of illegality and containing the elements specified in the injunction, and provided that the differences in the wording of that equivalent content, compared with the wording characterising the information which was previously declared to be illegal, are not such as to require the host provider to carry out an independent assessment of that content (thus, the host provider may have recourse to automated search tools and technologies);

- to remove information covered by the injunction or to block access to that information worldwide within the framework of the relevant international law, and it is up to Member States to take that law into account.

**NOTE:** A reference for a preliminary ruling allows the courts and tribunals of the Member States, in disputes which have been brought before them, to refer questions to the Court of Justice about the interpretation of EU law or the validity of a European Union act. The Court of Justice does not decide the dispute itself. It is for the national court or tribunal to dispose of the case in accordance with the Court’s decision, which is similarly binding on other national courts or tribunals before which a similar issue is raised.

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Tianrui Group Company Ltd. v. International Trade Commission

661 F.3d 1322 (Fed. Cir. 2011)

BRYSON, Circuit Judge: This appeal arises from a determination by the International Trade Commission that the importation of certain cast steel railway wheels violated section 337 of the Tariff Act of 1930, 19 USC 1337. The Commission found that the wheels were manufactured using a process that was developed in the United States, protected under domestic trade secret law, and misappropriated abroad. We are asked to decide whether the Commission’s statutory authority over “[u]nfair methods of competition and unfair acts in the importation of articles . . . into the United States,” as provided by section 337(a)(1)(A), allows the Commission to look to conduct occurring in China in the course of a trade secret misappropriation investigation. We conclude that the Commission has authority to investigate and grant relief based in part on extraterritorial conduct insofar as it is necessary to protect domestic industries from injuries arising out of unfair competition in the domestic marketplace.

We are also asked to decide whether the Commission erred by finding that the imported wheels would injure a domestic industry when no domestic manufacturer is currently practicing the protected process. In light of the evidence before the Commission regarding the marketplace for cast steel railway wheels, we affirm the Commission’s determination that the wheel imports threaten to destroy or substantially injure an industry in the United States, in violation of section 337.

I

Amsted Industries Inc. is a domestic manufacturer of cast steel railway wheels. It owns two secret processes for manufacturing such wheels, the “ABC process” and the “Griffin process.” Amsted previously practiced the ABC process at its foundry in Calera, Alabama, but it no longer uses that process in the United States. Instead, Amsted uses the Griffin process at three of its domestic foundries. Amsted has licensed the ABC process to several firms with foundries in China.

TianRui Group Company Limited and TianRui Group Foundry Company Limited (collectively, “TianRui”) manufacture cast steel railway wheels in China. In 2005, TianRui sought to license Amsted’s wheel manufacturing technology, but the parties could not agree on the terms of a license. After the failed negotiations, TianRui hired nine employees away from one of Amsted’s Chinese licensees, Datong ABC Castings Company Limited. Some of those employees had been trained in the ABC process at the Calera plant in Alabama, and others had received training in that process at the Datong foundry in China.

Datong had previously notified those employees through a written employee code of conduct that information pertaining to the ABC process was proprietary and confidential. Each employee had been advised that they had a duty not to disclose confidential information. Eight of the nine employees had also signed confidentiality agreements before leaving Datong to begin working for TianRui. In the proceedings brought by Amsted before the International Trade Commission, Amsted alleged that the former Datong employees disclosed information and documents to TianRui that revealed the details of the ABC process and thereby misappropriated Amsted’s trade secrets.
TianRui partnered with Standard Car Truck Company, Inc., (“SCT”) to form the joint venture Barber TianRui Railway Supply, LLC. SCT and Barber have marketed TianRui wheels to United States customers and have imported TianRui wheels into the United States. Other than Amsted, SCT and Barber are the only companies selling or attempting to sell cast steel railway wheels in the United States.

B

Amsted filed a complaint with the Commission alleging a violation of section 337 based on TianRui’s misappropriation of trade secrets. Section 337(a)(1)(A) prohibits “[u]nfair methods of competition and unfair acts in the importation of articles . . . into the United States, . . . the threat or effect of which is . . . to destroy or substantially injure an industry in the United States.”

TianRui moved to terminate the proceedings on the ground that the alleged misappropriation occurred in China and that Congress did not intend for section 337 to be applied extraterritorially. An administrative law judge at the Commission denied that motion based on his view that section 337 focuses not on where the misappropriation occurs but rather on the nexus between the imported articles and the unfair methods of competition. The administrative law judge also rejected TianRui’s argument that Chinese courts would provide a better forum for Amsted’s complaint.

At the merits stage, the administrative law judge analyzed the alleged misappropriation under Illinois trade secret law. *** He applied Illinois law because Amsted, SCT, and Barber all have their principal place of business in Illinois. He noted, however, that “the Illinois law relating to trade secrets does not differ substantially from the law applied in previous Commission trade secret investigations,” and he then applied general principles of trade secret law, including the six factors defining a trade secret set forth in the comments to section 757 of the Restatement (First) of Torts.

Following a 10-day evidentiary hearing, the administrative law judge found that TianRui had misappropriated 128 trade secrets relating to the ABC process from Datong. That conclusion was based on evidence that included an admission by TianRui’s expert that TianRui’s foundry used the asserted trade secrets; his only contention was that the trade secrets were not actually secret. In addition, the administrative law judge compared TianRui’s manufacturing specifications with secret Datong documents outlining the ABC process and found them essentially identical. In fact, some of the TianRui specifications contained the same typographical errors that were found in the Datong documents. The administrative law judge also relied on similarities in foundry layout between the Datong and TianRui plants. The administrative law judge summarized the evidence as to the appropriation of the trade secrets by saying that “there is overwhelming direct and circumstantial evidence that TianRui obtained its manufacturing process for cast steel railway wheel[s] through the misappropriation of [Amsted’s] ABC Trade Secrets.”

Besides contesting the Commission’s authority to apply section 337 extraterritorially, TianRui contended that Amsted did not satisfy the domestic industry requirement of section 337 based on the fact that Amsted no longer practiced the ABC process in the United States. Because none of Amsted’s domestic operations used the ABC process, TianRui argued that there was no “domestic industry” that could be injured by the misappropriation of trade secrets relating to that process.
The administrative law judge rejected that argument, holding that it was not essential that the domestic industry use the proprietary process, as long as the misappropriation of that process caused injury to the complainant’s domestic industry. Applying that standard, the administrative law judge concluded that Amsted’s domestic industry would be substantially injured by the importation of TianRui wheels.

The Commission decided not to review the administrative law judge’s initial determination and issued a limited exclusion order. TianRui then appealed to this court.

II
The main issue in this case is whether section 337 authorizes the Commission to apply domestic trade secret law to conduct that occurs in part in a foreign country. Section 337 authorizes the Commission to exclude articles from entry into the United States when it has found “[u]nfair methods of competition [or] unfair acts in the importation of [those] articles.” 19 USC 1337(a)(1)(A). The Commission has long interpreted section 337 to apply to trade secret misappropriation. *** TianRui focuses on the fact that the disclosure of the trade secret information occurred in China. According to TianRui, section 337 cannot apply to extraterritorial conduct and therefore does not reach trade secret misappropriation that occurs outside the United States.

Amsted argues that the Commission did not apply section 337 extraterritorially, because trade secrets were misappropriated in the United States as a legal matter when railway wheels made by exploiting those trade secrets were imported into the United States and sold to customers or disclosed to the Association of American Railroads for certification purposes. ***

At the outset, we reject Amsted’s argument that Illinois trade secret law governs the section 337 inquiry in this case. The question of what law applies in a section 337 proceeding involving trade secrets is a matter of first impression for this court. We hold that a single federal standard, rather than the law of a particular state, should determine what constitutes a misappropriation of trade secrets sufficient to establish an “unfair method of competition” under section 337. ***

In any event, there is no dispute in this case pertaining to the substantive law of trade secrets. The administrative law judge’s findings establish that TianRui obtained access to Amsted’s confidential information through former Datong employees, who were subject to duties of confidentiality imposed by the Datong code of employee conduct, and that TianRui exploited that information in producing the subject goods. TianRui does not take issue with those findings, which are sufficient to establish the elements of trade secret misappropriation under either Illinois law or the generally understood law of trade secrets, as reflected in the Restatement, the Uniform Trade Secrets Act, and previous Commission decisions under section 337. Therefore, the choice of law issue, although it could be important in other cases, does not affect the outcome of this case.

In this case, TianRui argues that section 337 is inapplicable because Amsted’s confidential information was disclosed in China. The legal issue for us to decide is thus whether section 337 applies to imported goods produced through the exploitation of trade secrets in which the act of misappropriation occurs abroad. To answer that question, we must
review the principles that apply to federal statutes that create causes of action based in part on conduct that occurs overseas.

B

It is a “longstanding principle of American law ‘that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.’” EEOC v. Arabian Am. Oil Co., 499 U.S. 244, 248 (1991) (“Aramco”). That presumption expresses a canon of construction that is rooted in the “commonsense notion that Congress generally legislates with domestic concerns in mind.” Smith v. United States, 507 U.S. 197, 204 n.5 (1993). ***

The presumption against extraterritoriality does not govern this case, for three reasons. First, section 337 is expressly directed at unfair methods of competition and unfair acts “in the importation of articles” into the United States. *** The focus of section 337 is on an inherently international transaction—importation. In that respect, section 337 is analogous to immigration statutes that bar the admission of an alien who has engaged in particular conduct or who makes false statements in connection with his entry into this country. See, e.g., 8 USC 1101(f)(6), 1182(a). In such cases, the focus is not on punishing the conduct or the false statements, but on preventing the admission of the alien, so it is reasonable to assume that Congress was aware, and intended, that the statute would apply to conduct (or statements) that may have occurred abroad.

Second, in this case the Commission has not applied section 337 to sanction purely extraterritorial conduct; the foreign “unfair” activity at issue in this case is relevant only to the extent that it results in the importation of goods into this country causing domestic injury. In light of the statute’s focus on the act of importation and the resulting domestic injury, the Commission’s order does not purport to regulate purely foreign conduct. Because foreign conduct is used only to establish an element of a claim alleging a domestic injury and seeking a wholly domestic remedy, the presumption against extraterritorial application does not apply.

The dissent disregards the domestic elements of the cause of action under section 337 and characterizes this case as involving “conduct which entirely occurs in a foreign country.” That characterization accurately describes most of the events constituting the misappropriation, but the determination of misappropriation was merely a predicate to the charge that TianRui committed unfair acts in importing its wheels into the United States. In other words, the Commission’s interpretation of section 337 does not, as the dissent contends, give it the authority to “police Chinese business practices.” It only sets the conditions under which products may be imported into the United States.

Under the dissent’s construction of section 337, the importation of goods produced as a result of trade secret misappropriation would be immune from scrutiny if the act of misappropriation occurred overseas. That is, as long as the misappropriating party was careful to ensure that the actual act of conveying the trade secret occurred outside the United States, the Commission would be powerless to provide a remedy even if the trade secret were used to produce products that were subsequently imported into the United States to the detriment of the trade secret owner. We think it highly unlikely that Congress, which clearly intended to create a remedy for the importation of goods resulting from unfair methods of competition, would have intended to create such a conspicuous loophole for misappropriators.
Third, the legislative history of section 337 supports the Commission’s interpretation of the statute as permitting the Commission to consider conduct that occurs abroad. ***

C

TianRui argues that the Commission should not be allowed to apply domestic trade secret law to conduct occurring in China because doing so would cause improper interference with Chinese law. We disagree. In the first place, as we have noted, the Commission’s exercise of authority is limited to goods imported into this country, and thus the Commission has no authority to regulate conduct that is purely extraterritorial. The Commission does not purport to enforce principles of trade secret law in other countries generally, but only as that conduct affects the U.S. market. That is, the Commission’s investigations, findings, and remedies affect foreign conduct only insofar as that conduct relates to the importation of articles into the United States. The Commission’s activities have not hindered TianRui’s ability to sell its wheels in China or any other country.

Second, TianRui has failed to identify a conflict between the principles of misappropriation that the Commission applied and Chinese trade secret law. Indeed, in its forum non conveniens motion TianRui argued that Chinese trade secret law would provide a “more than adequate” remedy for any alleged misappropriation. In addition, China has acceded to the Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPS”), Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C. We cannot discern any relevant difference between the misappropriation requirements of TRIPS article 39 and the principles of trade secret law applied by the administrative law judge in this case. We therefore detect no conflict between the Commission’s actions and Chinese law that would counsel denying relief based on extraterritorial acts of trade secret misappropriation relating to the importation of goods affecting a domestic industry.

Finally, even apart from the acts of importation, the conduct at issue in this case is not the result of the imposition of legal duties created by American law on persons for whom there was no basis to impose such duties. The former Datong employees had a duty not to disclose Amsted’s trade secrets arising from express provisions in the Datong employee code and, in the case of most of the employees, from confidentiality agreements that they signed during their employment with Datong.7 Thus, the question in this case is whether the disclosure of protected information in breach of that duty is beyond the reach of section 337 simply because the breach itself took place outside the United States. To answer that question in the affirmative would invite evasion of section 337 and significantly undermine the effectiveness of the congressionally designed remedy.

D

Our conclusion that section 337 authorized the Commission’s actions in this case is not inconsistent with court decisions that have accorded a narrow construction to the extraterritorial application of U.S. patent law ***. By contrast, as we have noted, the statutory prohibition on “unfair methods of competition and unfair acts in the importation of articles . . . into the United States” naturally contemplates that the unfair methods of competition and unfair acts leading to the prohibited importation will include conduct that takes

7 TianRui does not argue that those duties were unenforceable for public policy reasons in any jurisdiction, and we do not presently address whether policy choices in a foreign jurisdiction can nullify a contractually imposed duty for the purposes of section 337.
place abroad. Because the statute applies to goods that are presented for importation, it would be a strained reading of the statute to bar the Commission from considering acts of trade secret misappropriation that occur abroad. In cases in which misappropriated trade secrets are used in the manufacture of the imported goods, the misappropriation will frequently occur overseas, where the imported goods are made. To bar the Commission from considering such acts because they occur outside the United States would thus be inconsistent with the congressional purpose of protecting domestic commerce from unfair methods of competition in importation such as trade secret misappropriation.

III

TianRui’s second ground for appeal focuses on the requirement of section 337 that the acts of unfair competition threaten “to destroy or substantially injure an industry in the United States.” 19 U.S.C. § 1337(a)(1)(A)(i). TianRui contends that in trade secret cases, the domestic industry must practice the misappropriated trade secret in order for the Commission to be authorized to grant relief. Because Amsted has no domestic operations practicing the misappropriated ABC process, TianRui argues that its imported wheels cannot be held to injure or threaten injury to any domestic industry within the meaning of section 337.

Section 337 contains different requirements for statutory intellectual property (such as patents, copyrights, and registered trademarks) than for other, nonstatutory unfair practices in importation (such as trade secret misappropriation). The provisions that apply to statutory intellectual property require that an industry relating to the protected articles exists or is in the process of being established. 19 USC 1337(a)(2). Such an industry will be deemed to exist if there is significant domestic investment or employment relating to the protected articles. Id. § 1337(a)(3). In contrast, the general provision relating to unfair practices is not satisfied by evidence showing only that a domestic industry exists; it requires that the unfair practices threaten to “destroy or substantially injure” a domestic industry. Id. § 1337(a)(1)(A). On the other hand, there is no express requirement in the general provision that the domestic industry relate to the intellectual property involved in the investigation. Notwithstanding that textual distinction, TianRui contends that investigations involving intellectual property under the unfair practices provision require the existence of a domestic industry that relates to the asserted intellectual property in the same manner that is required for statutory intellectual property. ***

In sum, we conclude that the Commission did not err in defining the domestic industry in this case. The parties submitted evidence indicating that the imported TianRui wheels could directly compete with wheels domestically produced by the trade secret owner. That type of competition, the Commission concluded, is sufficiently related to the investigation to constitute an injury to an “industry” within the meaning of section 337(a)(1)(A). We hold that the Commission’s conclusion in that regard is based on a proper construction of the statute and that its factual analysis of the effect of TianRui’s imports on the domestic industry is supported by substantial evidence.

AFFIRMED.

MOORE, Circuit Judge, dissenting: The majority in this case expands the reach of both 19 USC 1337 (§ 337) and trade secret law to punish TianRui Group Company Limited (TianRui) for its completely extraterritorial activities. As a court, however, we must act
within the confines set out by the text of the law. Here, there is no basis for the extraterritorial application of our laws to punish TianRui’s bad acts in China. As a result, I respectfully dissent.

The majority in this case holds that 19 USC 1337(a)(1)(A), which applies to “unfair acts in the importation of articles . . . into the United States,” allows the International Trade Commission (Commission) to bar imports because of acts of unfair competition occurring entirely in China. The majority states the issue: “The main issue in this case is whether § 337 authorizes the Commission to apply domestic trade secret law to conduct that occurs in part in a foreign country.” With all due respect, that is not the issue. The issue is whether § 337 authorizes the Commission to apply domestic trade secret laws to conduct which entirely occurs in a foreign country.

The facts of this case are not disputed. A Chinese company, Datong, had a license from a United States company, Amsted, to use in China a process which Amsted kept secret. TianRui, the Chinese company accused of violating § 337 in this case, hired several employees from its Chinese competitor, Datong. These employees disclosed the trade secrets to TianRui in China who used them in China to make railway wheels in China. The acts which arguably constitute misappropriation (theft of a trade secret) all occurred in China.

To be clear, I agree that trade secret misappropriation falls squarely within the terms of § 337: if TianRui carried out its acts of misappropriation in the United States—namely if TianRui came to the United States and stole Amsted’s trade secrets here—then § 337 could be used to bar import of any goods made with the stolen technology. But, as the majority concedes, these are not the facts of this case, and to the extent there was a misappropriation of any Amsted trade secret that misappropriation occurred abroad. In this case, none of the acts which constitute misappropriation occurred in the United States. While TianRui is certainly not a sympathetic litigant—it poached employees to obtain confidential information—none of the unfair acts occurred in the United States and, as such, there is no violation of United States law which amounts to an unfair trade practice under the statute.

United States trade secret law simply does not extend to acts occurring entirely in China. We have no right to police Chinese business practices. Under the majority’s rule today, if the United States government should decide that goods were being produced in a foreign country using what we consider to be unfair business practices, § 337 allows for their exclusion from the United States. The potential breadth of this holding is staggering. Suppose that goods were produced by workers who operate under conditions which would not meet with United States labor laws or workers who were not paid minimum wage or not paid at all—certainly United States industry would be hurt by the importation of goods which can be manufactured at a fraction of the cost abroad because of cheaper or forced labor. Would we consider these business practices unfair? Absent clear intent by Congress to apply the law in an extraterritorial manner, I simply do not believe that we have the right to determine what business practices, conducted entirely abroad, are unfair. According to the majority, its interpretation of § 337 does not give the Commission “the authority ‘to police Chinese business practices’, “[It] only sets the conditions under which products may be imported into the United States.” This holding could not be clearer—the Commission cannot police Chinese business practice unless the Chinese wish to import the goods into the United States. The act of importation opens the door to scrutiny of all business practices of the importer associated with the goods including those conducted
entirely within China. Section 337 simply does not authorize this level of scrutiny of entirely foreign acts.

I.

Section 337 provides that “[u]nfair methods of competition and unfair acts in the importation of articles . . . into the United States” which substantially injure a domestic industry are unlawful. 19 U.S.C. § 1337(a)(1)(A). The unfair act alleged to violate the statute is not the importation of the wheels into the United States. There is nothing inherently unfair about the wheels or the process by which they are imported in this case. Nor is the presence of the wheels in the United States somehow itself an unlawful act—a stark contrast to the illegal immigration cases relied on by the majority where the mere presence of the person in the United States is the unlawful act. The unfair act in this case is the alleged trade secret misappropriation. And both the majority and dissent agree that the conduct related to the misappropriation occurred entirely in China. Any “unfair act” in this case is wholly extraterritorial.

The question is thus whether § 337 contains a clear indication of congressional intent to extend its reach to wholly extraterritorial unfair acts. Analysis of § 337 must be carried out in view of the “longstanding principle of American law ‘that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.” EEOC v. Arabian Am. Oil Co., 499 U.S. 244, 248 (1991) (Aramco) (quoting Foley Bros., Inc. v. Filardo, 336 U.S. 281, 285 (1949)). “Unless there is the affirmative intention of Congress clearly expressed to give a statute extraterritorial effect, we must presume it is primarily concerned with domestic conditions.” Morrison v. Nat’l Austl. Bank Ltd., 130 S.Ct. 2869, 2877 (2010) (internal quotations omitted). When applying this principle, “we look to see whether ‘language in the [relevant Act] gives any indication of a congressional purpose to extend its coverage beyond places over which the United States has sovereignty or has some measure of legislative control.” Id. (alteration in original) (quoting Foley Bros., 336 U.S. at 285).

I see nothing in the plain language of the statute that indicates that Congress intended it to apply to unfair acts performed entirely abroad. The majority points to no statutory language that expresses the clear intent for it to apply to extraterritorial unfair acts. As a result, this is a simple case: without any indication of a congressional intent to extend § 337’s coverage beyond places over which the United States has sovereignty or has some measure of legislative control, we must limit the reach of the statute to unfair acts in the United States. When the statute is silent as to extraterritorial application, the law is clear: “it has none.” Indeed, based on this presumption the Supreme Court has rejected extraterritorial scope for a number of statutes with much stronger textual support than § 337.

The majority claims that importation “is an inherently international transaction,” and analogizes imports to illegal immigrants, false statements during entry into the United States, the failure to pay an excise tax, and the Economic Espionage Act. In each of those circumstances, however, the courts were confronted either with express statutory language indicating their extraterritorial application or the Court held their was no extraterritorial application of the statute at issue.

The proper focus to determine whether there is “an affirmative intention of Congress clearly expressed” is the language of the statute. Section 337 limits the unfair acts to “unfair acts in the importation of articles” into the United States. The majority reads this limitation(145.101.157.44)
out of the statute, and claims that Congress “clearly intended to create a remedy for the importation of goods resulting from unfair methods of competition.” Our predecessor court rejected essentially the same argument nearly eighty years ago, and held that § 337 could not be used to exclude from importation goods produced by a process patented in the United States but carried out abroad. *In re Amtorg Trading Corp.*, 75 F.2d 826, 834 (CCPA 1935). *** Section 337 was enacted to solve the problem faced by domestic industry when individuals outside the United States imported products which, upon release into the domestic stream of commerce, gave rise to a domestic cause of action. Section 337 provided a means to prevent the unfair act at its source, during the act of importation, thereby avoiding an impossible multiplicity of suits. ***

In sum, there is no indication in § 337 that Congress intended it to apply to wholly extraterritorial unfair acts. In light of the plain language of the statute, the legislative history, the selective Congressional action to grant extraterritorial effect to process patents, and the contrast to other extraterritorial statutes, I conclude § 337 does not reach the misappropriation and use of trade secrets in China, even if the product of the misappropriated process is ultimately imported into the United States.

II.

The problem underlying the majority’s analysis is that “[f]oreign conduct is generally the domain of foreign law.” *Microsoft Corp. v. AT&T Corp.*, 550 U.S. 437, 455 (2007) (internal quotations omitted). I sympathize with Amsted and, if the bad acts were carried out in the United States, would not hesitate to find for Amsted. My sympathy, however, is somewhat muted since Amsted had a readymade solution to its problem: obtain a process patent. The statute is clear that the extraterritorial acts in this case are subject to § 337 if the process is protected by a patent. In the alternative, Amsted could have also protected its intellectual property by keeping the various processes completely secret. Instead, Amsted chose to deny the public full knowledge of its innovation while simultaneously exploiting the trade secret by licensing it to a Chinese corporation for use in China.

By broadening the scope of trade secret misappropriation to the extraterritorial actions in this case, the majority gives additional incentive to inventors to keep their innovation secret. Of course, this also denies society the benefits of disclosure stemming from the patent system, which are anathema to trade secrets. Moreover, while Amsted (or more likely its Chinese licensee) will benefit from this decision, the burden of preserving Amsted’s trade secret now falls squarely on the American consumer who misses out on the opportunity for increased competition and concomitant lower prices offered by TianRui’s products.

I understand a restrictive approach to extraterritoriality is not immediately popular in this case. We must, however, work within the confines of the statute and the clear presumption against extraterritoriality. It is not our role to decide what the law should be but to apply it as we find it.
Session 10: Monitoring the Monitors

We will focus in this session on the role critical intermediaries in the functioning of our reporting systems for significant firms. The first set of materials focuses on the Enron case and the ultimate destruction of Arthur Andersen. The second set of materials looks at the issues that arose in connection with the sale of certain tax shelters by KPMG. Finally, the third reading is the September 9, 2015 memo from the U.S. Department of Justice on individual accountability for corporate wrongdoing.

§ 1512. Tampering with a witness, victim, or an informant

*** (b) Whoever knowingly uses intimidation or physical force, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to—

(1) influence, delay, or prevent the testimony of any person in an official proceeding;
(2) cause or induce any person to—
   (A) withhold testimony, or withhold a record, document, or other object, from an official proceeding;
   (B) alter, destroy, mutilate, or conceal an object with intent to impair the object’s integrity or availability for use in an official proceeding;
   (C) evade legal process summoning that person to appear as a witness, or to produce a record, document, or other object, in an official proceeding; or
   (D) be absent from an official proceeding to which such person has been summoned by legal process; or
(3) hinder, delay, or prevent the communication to a law enforcement officer or judge of the United States of information relating to the commission or possible commission of a Federal offense or a violation of conditions of probation, parole, or release pending judicial proceedings;

shall be fined under this title or imprisoned not more than ten years, or both.

*** (d) In a prosecution for an offense under this section, it is an affirmative defense, as to which the defendant has the burden of proof by a preponderance of the evidence, that the conduct consisted solely of lawful conduct and that the defendant’s sole intention was to encourage, induce, or cause the other person to testify truthfully.

(e) For the purposes of this section—

(1) an official proceeding need not be pending or about to be instituted at the time of the offense; and
(2) the testimony, or the record, document, or other object need not be admissible in evidence or free of a claim of privilege.
UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS

UNITED STATES OF AMERICA,

-against-

ARTHUR ANDERSEN, LLP,

Defendant.

THE GRAND JURY CHARGES:

I. ANDERSEN AND ENRON

1. ARTHUR ANDERSEN, LLP ("ANDERSEN"), is a partnership that performs, among other things, accounting and consulting services for clients that operate businesses throughout the United States and the world. ANDERSEN is one of the so-called "Big Five" accounting firms in the United States. ANDERSEN has its headquarters in Chicago, Illinois, and maintains offices throughout the world, including in Houston, Texas.

2. Enron Corp. ("Enron") was an Oregon corporation with its principal place of business in Houston, Texas. For most of 2001, Enron was considered the seventh largest corporation in the United States based on its reported revenues. In the previous ten years, Enron had evolved from a regional natural gas provider to, among
other things, a trader of natural gas, electricity and other commodities, with retail operations in energy and other products.

3. For the past 16 years, up until it filed for bankruptcy in December 2001, Enron retained ANDERSEN to be its auditor. Enron was one of ANDERSEN's largest clients worldwide, and became ANDERSEN's largest client in ANDERSEN's Gulf Coast region. ANDERSEN earned tens of millions of dollars from Enron in annual auditing and other fees.

4. ANDERSEN performed both internal and external auditing work for Enron mainly in Houston, Texas. ANDERSEN established within Enron's offices in Houston a work space for the ANDERSEN team that had primary responsibility for performing audit work for Enron. In addition to Houston, ANDERSEN personnel performed work for Enron in, among other locations, Chicago, Illinois, Portland, Oregon, and London, England.

II. THE ANTICIPATION OF LITIGATION AGAINST ENRON AND ANDERSEN

5. In the summer and fall of 2001, a series of significant developments led to ANDERSEN's foreseeing imminent civil litigation against, and government investigations of, Enron and ANDERSEN.

6. On or about October 16, 2001, Enron issued a press release announcing a $618 million net loss for the third quarter of 2001. That same day, but not as part of the press release, Enron announced to analysts that it would reduce shareholder equity by
approximately $1.2 billion. The market reacted immediately and the stock price of Enron shares plummeted.

7. The Securities and Exchange Commission ("SEC"), which investigates possible violations of the federal securities laws, opened an inquiry into Enron the very next day, requesting in writing information from Enron.

8. In addition to the negative financial information disclosed by Enron to the public and to analysts on October 16, 2001, ANDERSEN was aware by this time of additional significant facts unknown to the public.

- The approximately $1.2 billion reduction in shareholder equity disclosed to analysts on October 16, 2001, was necessitated by ANDERSEN and Enron having previously improperly categorized hundreds of millions of dollars as an increase, rather than a decrease, to Enron shareholder equity.

- The Enron October 16, 2001, press release characterized numerous charges against income for the third quarter as "non-recurring" even though ANDERSEN believed the company did not have a basis for concluding that the charges would in fact be non-recurring. Indeed, ANDERSEN advised Enron against using that term, and documented its objections internally in the event of litigation, but did
not report its objections or otherwise take steps to cure the public statement.

- ANDERSEN was put on direct notice of the allegations of Sherron Watkins, a current Enron employee and former ANDERSEN employee, regarding possible fraud and other improprieties at Enron, and in particular, Enron's use of off-balance-sheet "special purpose entities" that enabled the company to camouflage the true financial condition of the company. Watkins had reported her concerns to a partner at ANDERSEN, who thereafter disseminated them within ANDERSEN, including to the team working on the Enron audit. In addition, the team had received warnings about possible undisclosed side-agreements at Enron.

- The ANDERSEN team handling the Enron audit directly contravened the accounting methodology approved by ANDERSEN's own specialists working in its Professional Standards Group. In opposition to the views of its own experts, the ANDERSEN auditors had advised Enron in the spring of 2001 that it could use a favorable accounting method for its "special purpose entities."

- In 2000, an internal review conducted by senior management within ANDERSEN evaluated the ANDERSEN team assigned to audit Enron and rated the team as only a "2"
on a scale of one to five, with five being the highest rating.

- On or about October 9, 2001, correctly anticipating litigation and government investigations, ANDERSEN, which had an internal department of lawyers for routine legal matters, retained an experienced New York law firm to handle future Enron-related litigation.

III. THE WHOLESALE DESTRUCTION OF DOCUMENTS BY ANDERSEN

9. By Friday, October 19, 2001, Enron alerted the ANDERSEN audit team that the SEC had begun an inquiry regarding the Enron "special purpose entities" and the involvement of Enron's Chief Financial Officer. The next morning, an emergency conference call among high-level ANDERSEN management was convened to address the SEC inquiry. During the call, it was decided that documentation that could assist Enron in responding to the SEC was to be assembled by the ANDERSEN auditors.

10. After spending Monday, October 22, 2001 at Enron, ANDERSEN partners assigned to the Enron engagement team launched on October 23, 2001, a wholesale destruction of documents at ANDERSEN's offices in Houston, Texas. ANDERSEN personnel were called to urgent and mandatory meetings. Instead of being advised to preserve documentation so as to assist Enron and the SEC, ANDERSEN employees on the Enron engagement team were instructed by ANDERSEN partners and others to destroy immediately documentation
relating to Enron, and told to work overtime if necessary to accomplish the destruction. During the next few weeks, an unparalleled initiative was undertaken to shred physical documentation and delete computer files. Tons of paper relating to the Enron audit were promptly shredded as part of the orchestrated document destruction. The shredder at the ANDERSEN office at the Enron building was used virtually constantly and, to handle the overload, dozens of large trunks filled with Enron documents were sent to ANDERSEN’s main Houston office to be shredded. A systematic effort was also undertaken and carried out to purge the computer hard-drives and E-mail system of Enron-related files.

11. In addition to shredding and deleting documents in Houston, Texas, instructions were given to ANDERSEN personnel working on Enron audit matters in Portland, Oregon, Chicago, Illinois, and London, England, to make sure that Enron documents were destroyed there as well. Indeed, in London, a coordinated effort by ANDERSEN partners and others, similar to the initiative undertaken in Houston, was put into place to destroy Enron-related documents within days of notice of the SEC inquiry. Enron-related documents also were destroyed by ANDERSEN partners in Chicago.

12. On or about November 8, 2001, the SEC served ANDERSEN with the anticipated subpoena relating to its work for Enron. In response, members of the ANDERSEN team on the Enron audit were
alerted finally that there could be "no more shredding" because the firm had been "officially served" for documents.

THE CHARGE: OBSTRUCTION OF JUSTICE

13. On or about and between October 10, 2001, and November 9, 2001, within the Southern District of Texas and elsewhere, including Chicago, Illinois, Portland, Oregon, and London, England, ANDERSEN, through its partners and others, did knowingly, intentionally and corruptly persuade and attempt to persuade other persons, to wit: ANDERSEN employees, with intent to cause and induce such persons to (a) withhold records, documents and other objects from official proceedings, namely: regulatory and criminal proceedings and investigations, and (b) alter, destroy, mutilate
and conceal objects with intent to impair the objects' integrity and availability for use in such official proceedings.

(Title 18, United States Code, Sections 1512(b)(2) and 3551 et seg.)

A TRUE BILL

JOSHUA R. HOCHBERG
ACTING UNITED STATES ATTORNEY
SOUTHERN DISTRICT OF TEXAS

LESLIE R. CALDWELL
DIRECTOR, ENRON TASK FORCE

By: Samuel W. Buell
Andrew Weissmann
Special Attorneys
Department of Justice
United States v. Stein

541 F.3d 130 (2nd Cir. 2008)

DENNIS JACOBS, Chief Judge: The United States appeals from an order of the United States District Court for the Southern District of New York (Kaplan, J.), dismissing an indictment against thirteen former partners and employees of the accounting firm KPMG, LLP. Judge Kaplan found that, absent pressure from the government, KPMG would have paid defendants’ legal fees and expenses without regard to cost. Based on this and other findings of fact, Judge Kaplan ruled that the government deprived defendants of their right to counsel under the Sixth Amendment by causing KPMG to impose conditions on the advancement of legal fees to defendants, to cap the fees, and ultimately to end payment. See United States v. Stein, 435 F.Supp.2d 330, 367-73 (S.D.N.Y. 2006) (“Stein I”). Judge Kaplan also ruled that the government deprived defendants of their right to substantive due process under the Fifth Amendment.1

We hold that KPMG’s adoption and enforcement of a policy under which it conditioned, capped and ultimately ceased advancing legal fees to defendants followed as a direct consequence of the government’s overwhelming influence, and that KPMG’s conduct therefore amounted to state action. We further hold that the government thus unjustifiably interfered with defendants’ relationship with counsel and their ability to mount a defense, in violation of the Sixth Amendment, and that the government did not cure the violation. Because no other remedy will return defendants to the status quo ante, we affirm the dismissal of the indictment as to all thirteen defendants. In light of this disposition, we do not reach the district court’s Fifth Amendment ruling.

BACKGROUND

The Thompson Memorandum

In January 2003, then-United States Deputy Attorney General Larry D. Thompson promulgated a policy statement, Principles of Federal Prosecution of Business Organizations (the “Thompson Memorandum”), which articulated “principles” to govern the Department’s discretion in bringing prosecutions against business organizations. The Thompson Memorandum was closely based on a predecessor document issued in 1999 by then-U.S. Deputy Attorney General Eric Holder, Federal Prosecution of Corporations. Along with the familiar factors governing charging decisions, the Thompson Memorandum identifies nine additional considerations, including the company’s “timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents.” Mem. from Larry D. Thompson, Deputy Att’y Gen., U.S. Dep’t of Justice, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), at II. The Memorandum explains that prosecutors should inquire

1 In later decisions, Judge Kaplan ruled that defendants Richard Smith and Mark Watson’s proffer session statements were obtained in violation of their Fifth Amendment privilege against self-incrimination, and that their statements would be suppressed, see United States v. Stein, 440 F.Supp.2d 315 (S.D.N.Y. 2006) (“Stein II”); that the court had ancillary jurisdiction over Defendants-Appellees’ civil suit against KPMG for advancement of fees, see United States v. Stein, 452 F.Supp.2d 230 (S.D.N.Y. 2006) (“Stein III”), vacated, Stein v. KPMG, LLP, 486 F.3d 753 (2d Cir.2007); and that dismissal of the indictment is the appropriate remedy for those constitutional violations, see United States v. Stein, 495 F.Supp.2d 390 (S.D.N.Y. 2007) (“Stein IV”).
whether the corporation appears to be protecting its culpable employees and agents [and that] a corporation’s promise of support to culpable employees and agents, either through the advancing of attorneys fees, through retaining the employees without sanction for their misconduct, or through providing information to the employees about the government’s investigation pursuant to a joint defense agreement, may be considered by the prosecutor in weighing the extent and value of a corporation’s cooperation.

Id. at VI (emphasis added and footnote omitted). A footnote appended to the highlighted phrase explains that because certain states require companies to advance legal fees for their officers, “a corporation’s compliance with governing law should not be considered a failure to cooperate.” Id. at VI n. 4. In December 2006—after the events in this prosecution had transpired—the Department of Justice replaced the Thompson Memorandum with the McNulty Memorandum, under which prosecutors may consider a company’s fee advancement policy only where the circumstances indicate that it is “intended to impede a criminal investigation,” and even then only with the approval of the Deputy Attorney General. Mem. from Paul J. McNulty, Deputy Att’y Gen., U.S. Dep’t of Justice, Principles of Federal Prosecution of Business Organizations (Dec. 12, 2006), at VII n. 3.

Commencement of the Federal Investigation

After Senate subcommittee hearings in 2002 concerning KPMG’s possible involvement in creating and marketing fraudulent tax shelters, KPMG retained Robert S. Bennett of the law firm Skadden, Arps, Slate, Meagher & Flom LLP (“Skadden”) to formulate a “cooperative approach” for KPMG to use in dealing with federal authorities. Stein I, 435 F.Supp.2d at 339. Bennett’s strategy included “a decision to ‘clean house’—a determination to ask Jeffrey Stein, Richard Smith, and Jeffrey Eischeid, all senior KPMG partners who had testified before the Senate and all now [Defendants-Appellees] here—to leave their positions as deputy chair and chief operating officer of the firm, vice chair-tax services, and a partner in personal financial planning, respectively.” Smith was transferred and Eischeid was put on administrative leave. Stein resigned with arrangements for a three-year $100,000-per-month consultancy, and an agreement that KPMG would pay for Stein’s representation in any actions brought against Stein arising from his activities at the firm. KPMG negotiated a contract with Smith that included a similar clause; but that agreement was never executed.

In February 2004, KPMG officials learned that the firm and 20 to 30 of its top partners and employees were subjects of a grand jury investigation of fraudulent tax shelters. On February 18, 2004, KPMG’s CEO announced to all partners that the firm was aware of the United States Attorney’s Office’s (“USAO”) investigation and that “[a]ny present or former members of the firm asked to appear will be represented by competent counsel at the firm’s expense.” Stein IV, 495 F.Supp.2d at 407 (first alteration in original and internal quotation marks omitted).

The February 25, 2004 Meeting

In preparation for a meeting with Skadden on February 25, 2004, the prosecutors—including Assistant United States Attorneys (“AUSAs”) Shirah Neiman and Justin Weddle—decided to ask whether KPMG would advance legal fees to employees under investigation. Bennett started the meeting by announcing that KPMG had resolved to “clean house,” that KPMG “would cooperate fully with the government’s investigation,” and that its goal
was not to protect individual employees but rather to save the firm from being indicted. AUSA Weddle inquired about the firm’s plans for advancing fees and about any legal obligation to do so. Later on, AUSA Neiman added that the government would “take into account” the firm’s legal obligations to advance fees, but that “the Thompson Memorandum [w]as a point that had to be considered.” Bennett then advised that although KPMG was still investigating its legal obligations to advance fees, its “common practice” was to do so. However, Bennett explained, KPMG would not pay legal fees for any partner who refused to cooperate or “took the Fifth,” so long as KPMG had the legal authority to do so.

Later in the meeting, AUSA Weddle asked Bennett to ascertain KPMG’s legal obligations to advance attorneys’ fees. AUSA Neiman added that “misconduct” should not or cannot “be rewarded” under “federal guidelines.” One Skadden attorney’s notes attributed to AUSA Weddle the prediction that, if KPMG had discretion regarding fees, the government would “look at that under a microscope.”

Skadden then reported back to KPMG. In notes of the meeting, a KPMG executive wrote the words “[p]aying legal fees” and “[s]everance” next to “not a sign of cooperation.”

Communications Between the Prosecutors and KPMG
On March 2, 2004, Bennett told AUSA Weddle that although KPMG believed it had no legal obligation to advance fees, “it would be a big problem” for the firm not to do so given its partnership structure. AUSA Neiman added that “misconduct” should not or cannot “be rewarded” under “federal guidelines.” One Skadden attorney’s notes attributed to AUSA Weddle the prediction that, if KPMG had discretion regarding fees, the government would “look at that under a microscope.”

Skadden then reported back to KPMG. In notes of the meeting, a KPMG executive wrote the words “[p]aying legal fees” and “[s]everance” next to “not a sign of cooperation.”

Id. at 345-46. The government was copied on this correspondence.

On March 12, KPMG sent a memorandum to certain other employees who had not been identified as subjects, urging them to cooperate with the government, advising them that it might be advantageous for them to exercise their right to counsel, and advising that KPMG would cover employees’ “reasonable fees.”

The prosecutors expressed by letter their “disappoint[ment] with [the] tone” of this memorandum and its “one-sided presentation of potential issues,” and “demanded that
KPMG send out a supplemental memorandum in a form they proposed.” The government’s alternative language, premised on the “assum[ption] that KPMG truly is committed to fully cooperating with the Government’s investigation,” Letter of David N. Kelley, United States Attorney, Southern District of New York, March 17, 2004, advised employees that they could “meet with investigators without the assistance of counsel,” Stein I, 435 F.Supp.2d at 346 (emphasis omitted). KPMG complied, and circulated a memo advising that employees “may deal directly with government representatives without counsel.”

At a meeting in late March, Skadden asked the prosecutors to notify Skadden in the event any KPMG employee refused to cooperate. Over the following year, the prosecutors regularly informed Skadden whenever a KPMG employee refused to cooperate fully, such as by refusing to proffer or by proffering incompletely (in the government’s view). Skadden, in turn, informed the employees’ lawyers that fee advancement would cease unless the employees cooperated. The employees either knuckled under and submitted to interviews, or they were fired and KPMG ceased advancing their fees. For example, Watson and Smith attended proffer sessions after receiving KPMG’s March 11 letter announcing the Fees Policy, and after Skadden reiterated to them that fees would be terminated absent cooperation. They did so because (they said, and the district court found) they feared that KPMG would stop advancing attorneys fees, although Watson concedes he attended a first session voluntarily.3 As Bennett later assured AUSA Weddle: “Whenever your Office has notified us that individuals have not ... cooperat[ed], KPMG has promptly and without question encouraged them to cooperate and threatened to cease payment of their attorney fees and ... to take personnel action, including termination.” Letter of Robert Bennett to United States Attorney’s Office, November 2, 2004.

KPMG Avoids Indictment

In an early-March 2005 meeting, then-U.S. Attorney David Kelley told Skadden and top KPMG executives that a non-prosecution agreement was unlikely and that he had reservations about KPMG’s level of cooperation: “I’ve seen a lot better from big companies.” Bennett reminded Kelley how KPMG had capped and conditioned its advancement of legal fees. Kelley remained unconvinced.

KPMG moved up the Justice Department’s chain of command. At a June 13, 2005 meeting with U.S. Deputy Attorney General James Comey, Bennett stressed KPMG’s pressure on employees to cooperate by conditioning legal fees on cooperation; it was, he said, “precedent[ ]setting.” KPMG’s entreaties were ultimately successful: on August 29, 2005, the firm entered into a deferred prosecution agreement (the “DPA”) under which KPMG admitted extensive wrongdoing, paid a $456 million fine, and committed itself to cooperation in any future government investigation or prosecution.

Indictment of Individual Employees

On August 29, 2005—the same day KPMG executed the DPA—the government indicted six of the Defendants–Appellees (along with three other KPMG employees): Jeffrey Stein; Richard Smith; Jeffrey Eischeid; John Lanning, Vice Chairman of Tax Services; Philip Wiesner, a former tax partner; and Mark Watson, a tax partner. A superseding indictment

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3 As discussed above, in a decision that is the subject of the summary order filed today, the district court held that Defendants–Appellees Smith and Watson’s proffer statements were obtained in violation of their Fifth Amendment privilege against self-incrimination and that their statements would be suppressed.
filed on October 17, 2005 named ten additional employees, including seven of the Defendants-Appellees: Larry DeLap, a former tax partner in charge of professional practice; Steven Gremminger, a former partner and associate general counsel; former tax partners Gregg Ritchie, Randy Bickham and Carl Hasting; Carol G. Warley; and Richard Rosenthal, a former tax partner and Chief Financial Officer of KPMG. Pursuant to the Fees Policy, KPMG promptly stopped advancing legal fees to the indicted employees who were still receiving them.

Procedural History

On January 12, 2006, the thirteen defendants (among others) moved to dismiss the indictment based on the government’s interference with KPMG’s advancement of fees. In a submission to the district court, KPMG represented that

the Thompson memorandum in conjunction with the government’s statements relating to payment of legal fees affected KPMG’s determination(s) with respect to the advancement of legal fees and other defense costs to present or former partners and employees .... In fact, KPMG is prepared to state that the Thompson memorandum substantially influenced KPMG’s decisions with respect to legal fees....

Stein IV, 495 F.Supp.2d at 405 (internal quotation marks and emphasis omitted).

At a hearing on March 30, 2006, Judge Kaplan asked the government whether it was “prepared at this point to commit that [it] has no objection whatsoever to KPMG exercising its free and independent business judgment as to whether to advance defense costs to these defendants and that if it were to elect to do so the government would not in any way consider that in determining whether it had complied with the DPA?” The AUSA responded: “That’s always been the case, your Honor. That’s fine. We have no objection to that.... They can always exercise their business judgment. As you described it, your Honor, that’s always been the case. It’s the case today, your Honor.”

Judge Kaplan ordered discovery and held a three-day evidentiary hearing in May 2006 to ascertain whether the government had contributed to KPMG’s adoption of the Fees Policy. The court heard testimony from two prosecutors, one IRS agent, three Skadden attorneys, and one lawyer from KPMG’s Office of General Counsel, among others. Numerous documents produced in discovery by both sides were admitted into evidence.

Stein I

Judge Kaplan’s opinion and order of June 26, 2006 noted, as the parties had stipulated, that KPMG’s past practice was to advance legal fees for employees facing regulatory, civil and criminal investigations without condition or cap. See Stein I, 435 F.Supp.2d at 340. Starting from that baseline, Judge Kaplan made the following findings of fact. At the February 25, 2004 meeting, Bennett began by “test[ing] the waters to see whether KPMG could adhere to its practice of paying its employees’ legal expenses when litigation loomed [by asking] for [the] government’s view on the subject.” Id. at 341 (footnote omitted). It is not clear what AUSA Neiman intended to convey when she said that “misconduct” should not or cannot “be rewarded” under “federal guidelines”; but her statement “was understood by both KPMG and government representatives as a reminder that payment of legal

4 The superseding indictment filed on October 17, 2005 charged 19 defendants in 46 counts for conspiring to defraud the United States and the IRS, tax evasion and obstruction of the internal revenue laws (although not every individual was charged with every offense).
fees by KPMG, beyond any that it might legally be obligated to pay, could well count against KPMG in the government’s decision whether to indict the firm.” *Id.* at 344 (internal quotation marks omitted). “[W]hile the USAO did not say in so many words that it did not want KPMG to pay legal fees, no one at the meeting could have failed to draw that conclusion.” *Id.*

Based on those findings, Judge Kaplan arrived at the following ultimate findings of fact, all of which the government contests on appeal:

[1] “the Thompson Memorandum caused KPMG to consider departing from its long-standing policy of paying legal fees and expenses of its personnel in all cases and investigations even before it first met with the USAO” and induced KPMG to seek “an indication from the USAO that payment of fees in accordance with its settled practice would not be held against it”;

[2] the government made repeated references to the Thompson Memo in an effort to “reinforce[] the threat inherent in the Thompson Memorandum”;

[3] “the government conducted itself in a manner that evidenced a desire to minimize the involvement of defense attorneys”; and

[4] but for the Thompson Memorandum and the prosecutors’ conduct, KPMG would have paid defendants’ legal fees and expenses without consideration of cost. *Id.* at 352-53.

Against that background, Judge Kaplan ruled that a defendant has a fundamental right under the Fifth Amendment to fairness in the criminal process, including the ability to get and deploy in defense all “resources lawfully available to him or her, free of knowing or reckless government interference,” *id.* at 361, and that the government’s reasons for infringing that right in this case could not withstand strict scrutiny, *id.* at 362-65. Judge Kaplan also ruled that the same conduct deprived each defendant of the Sixth Amendment right “to choose the lawyer or lawyers he or she desires and to use one’s own funds to mount the defense that one wishes to present.” *Id.* at 366 (footnote omitted). He reasoned that “the government’s law enforcement interests in taking the specific actions in question [do not] sufficiently outweigh the interests of the KPMG Defendants in having the resources needed to defend as they think proper against these charges.” *Id.* at 368. “[T]he fact that advancement of legal fees occasionally might be part of an obstruction scheme or indicate a lack of full cooperation by a prospective defendant is insufficient to justify the government’s interference with the right of individual criminal defendants to obtain resources lawfully available to them in order to defend themselves....” *Id.* at 369.

Judge Kaplan rejected the government’s position that defendants have no right to spend “other people’s money” on high-priced defense counsel: “[T]he KPMG Defendants had at least an expectation that their expenses in defending any claims or charges brought against them by reason of their employment by KPMG would be paid by the firm,” and “any benefits that would have flowed from that expectation the legal fees at issue now were, in every material sense, their property, not that of a third party.” *Id.* at 367. He further determined that defendants need not show how their defense was impaired: the government’s interference with their Sixth Amendment “right to be represented as they choose, like a deprivation of the right to counsel of their choice, is complete irrespective of the quality of the representation they receive.” *Id.* at 369.
As to remedy, Judge Kaplan conceded that dismissal of the indictment would be inappropriate unless other avenues for obtaining fees from KPMG were first exhausted. To that end, Judge Kaplan invited defendants to file a civil suit against KPMG under the district court’s ancillary jurisdiction. The suit was commenced, and Judge Kaplan denied KPMG’s motion to dismiss. However, this Court ruled that the district court lacked ancillary jurisdiction over the action.

Stein IV

Judge Kaplan dismissed the indictment against the thirteen defendants on July 16, 2007. ***

III

Judge Kaplan found that “KPMG’s decision to cut off all payments of legal fees and expenses to anyone who was indicted and to limit and to condition such payments prior to indictment upon cooperation with the government was the direct consequence of the pressure applied by the Thompson Memorandum and the USAO.” Stein I, 435 F.Supp.2d at 353 (emphasis added); see also Stein II, 440 F.Supp.2d at 334 (relying on this finding to conclude that KPMG’s conduct was fairly attributable to the State for Fifth Amendment purposes). The government protests that KPMG’s adoption and enforcement of its Fees Policy was private action, outside the ambit of the Sixth Amendment. ***

KPMG’s adoption and enforcement of the Fees Policy amounted to “state action” because KPMG operated as a willful participant in joint activity with the government, and because the USAO significantly encouraged KPMG to withhold legal fees from defendants upon indictment. Flagg v. Yonkers Sav. & Loan Ass’n, 396 F.3d 178, 187 (2d Cir. 2005). The government brought home to KPMG that its survival depended on its role in a joint project with the government to advance government prosecutions. The government is therefore legally “responsible for the specific conduct of which the [criminal defendants] complain[].” Blum v. Yaretsky, 457 U.S. 991, 1004 (1982) (emphasis omitted).

The government argues that “KPMG’s decision to condition legal fee payments on cooperation, while undoubtedly influenced by the Thompson Memorandum, was not coerced or directed by the Government.” But that argument runs up against the district court’s factual finding (which we do not disturb) that the fees decision “was the direct consequence” of the Memorandum and the prosecutors’ conduct. Nevertheless, it remains a question of law whether the facts as found by the district court establish state action.

State action is established here as a matter of law because the government forced KPMG to adopt its constricted Fees Policy. The Thompson Memorandum itself—which prosecutors stated would be considered in deciding whether to indict KPMG—emphasizes that cooperation will be assessed in part based upon whether, in advancing counsel fees, “the corporation appears to be protecting its culpable employees and agents.” Since defense counsel’s objective in a criminal investigation will virtually always be to protect the client, KPMG’s risk was that fees for defense counsel would be advanced to someone the government considered culpable. So the only safe course was to allow the government to become (in effect) paymaster.

The prosecutors reinforced this message by inquiring into KPMG’s fees obligations, referring to the Thompson Memorandum as “a point that had to be considered,” and warning that “misconduct” should not or cannot “be rewarded” under “federal guidelines.”
The government had KPMG’s full attention. It is hardly surprising, then, that KPMG decided to condition payment of fees on employees’ cooperation with the government and to terminate fees upon indictment: only that policy would allow KPMG to continue advancing fees while minimizing the risk that prosecutors would view such advancement as obstructive.***

An adversarial relationship does not normally bespeak partnership. But KPMG faced ruin by indictment and reasonably believed it must do everything in its power to avoid it. The government’s threat of indictment was easily sufficient to convert its adversary into its agent. KPMG was not in a position to consider coolly the risk of indictment, weigh the potential significance of the other enumerated factors in the Thompson Memorandum, and decide for itself how to proceed.

We therefore conclude that KPMG’s adoption and enforcement of the Fees Policy (both before and upon defendants’ indictment) amounted to state action. The government may properly be held “responsible for the specific conduct of which the [criminal defendants] complain[,]” Blum, 457 U.S. at 1004 (emphasis omitted), i.e., the deprivation of their Sixth Amendment right to counsel, if the violation is established.

IV

The district court’s ruling on the Sixth Amendment was based on the following analysis (set out here in précis). The Sixth Amendment protects “an individual’s right to choose the lawyer or lawyers he or she desires,” Stein I, 435 F.Supp.2d at 366 (citing Wheat v. United States, 486 U.S. 153, 164 (1988)), and “to use one’s own funds to mount the defense that one wishes to present,” id. (citing Caplin & Drysdale, Chartered v. United States, 491 U.S. 617, 624 (1989)). The goal is to secure “a defendant’s right to spend his own money on a defense.” Id. at 367. Because defendants reasonably expected to receive legal fees from KPMG, the fees “were, in every material sense, their property.” Id. at 369. The government’s interest in retaining discretion to treat as obstruction a company’s advancement of legal fees “is insufficient to justify the government’s interference with the right of individual criminal defendants to obtain resources lawfully available to them in order to defend themselves.” Id. at 369. Defendants need not make a “particularized showing” of how their defense was impaired, id. at 372, because “[v]irtually everything the defendants do in this case may be influenced by the extent of the resources available to them,” such as selection of counsel and “what the KPMG Defendants can pay their lawyers to do,” id. at 371-72. Therefore, the Sixth Amendment violation “is complete irrespective of the quality of the representation they receive.” Id. at 369.10

10 In Stein IV, Judge Kaplan nevertheless expanded his findings as to Sixth Amendment harms suffered by particular defendants: defendants Gremminger, Hasting and Watson were deprived of their chosen counsel, “lawyers who had represented them as long as KPMG was paying the bills”; and defendant Ritchie was deprived of the services of Cadwalader Wickersham & Taft, “which was to have played an integral role in his defense.” 495 F.Supp.2d at 421. In addition:

All of the [present] KPMG Defendants ... say that KPMG’s refusal to pay their post-indictment legal fees has caused them to restrict the activities of their counsel, limited or precluded their attorneys’ review of the documents produced by the government in discovery, prevented them from interviewing witnesses, caused them to refrain from retaining expert witnesses, and/or left them without information technology assistance necessary for dealing with the mountains of electronic discovery. The government has not contested these assertions. The Court therefore has no reason to doubt, and hence finds, that all of them have been forced to limit their defenses in the respects claimed for economic reasons and
A
Most of the state action relevant here— the promulgation of the Thompson Memorandum, the prosecutors’ communications with KPMG regarding the advancement of fees, KPMG’s adoption of a Fees Policy with caps and conditions, and KPMG’s repeated threats to employees identified by prosecutors as being uncooperative— pre-dated the indictments of August and October 2005. (Of course, after the indictments were filed KPMG ceased advancing fees to all thirteen of the present defendants who were still receiving fees up to that point. As explained in Part III, this was also state action.) So we must determine how this pre-indictment conduct may bear on defendants’ Sixth Amendment claim. ***

Although defendants’ Sixth Amendment rights attached only upon indictment, the district court properly considered pre-indictment state action that affected defendants post-indictment. When the government acts prior to indictment so as to impair the suspect’s relationship with counsel post-indictment, the pre-indictment actions ripen into cognizable Sixth Amendment deprivations upon indictment. As Judge Ellis explained in United States v. Rosen, 487 F.Supp.2d 721 (E.D. Va. 2007), “it is entirely plausible that pernicious effects of the pre-indictment interference continued into the post-indictment period, effectively hobbling defendants’ Sixth Amendment rights to retain counsel of choice with funds to which they had a right... [I]f, as alleged, the government coerced [the employer] into halting fee advances on defendants’ behalf and the government did so for the purpose of undermining defendants’ relationship with counsel once the indictment issued, the government violated defendants’ right to expend their own resources towards counsel once the right attached.” Id. at 734.

Since the government forced KPMG to adopt the constricted Fees Policy—including the provision for terminating fee advancement upon indictment—and then compelled KPMG to enforce it, it was virtually certain that KPMG would terminate defendants’ fees upon indictment. We therefore reject the government’s argument that its actions (virtually all pre-indictment) are immune from scrutiny under the Sixth Amendment.
B
We now consider “what the [Sixth Amendment] right guarantees.” Rothgery, 128 S.Ct. at 2592 (Alito, J., concurring).

The Sixth Amendment ensures that “[i]n all criminal prosecutions, the accused shall enjoy the right ... to have the Assistance of Counsel for his defence.” U.S. Const. amend. VI. Thus “the Sixth Amendment guarantees the defendant the right to be represented by an otherwise qualified attorney whom that defendant can afford to hire, or who is willing to represent the defendant even though he is without funds.” Caplin & Drysdale, Chartered v. United States, 491 U.S. 617, 624-25 (1989). “[A]n element of this right is the right of a defendant who does not require appointed counsel to choose who will represent him.” United States v. Gonzalez-Lopez, 548 U.S. 140, 144 (2006).

that they would not have been so constrained if KPMG paid their expenses subject only to the usual sort of administrative requirements typically imposed by corporate law departments on outside counsel fees.

Id. at 418-19 (footnote omitted). Judge Kaplan explained that even though many defendants had net assets ranging from $1 million to $5 million, their resources were inadequate “to defend this case as they would have defended it absent the government’s actions.” Id. at 423.
The government must “honor” a defendant’s Sixth Amendment right to counsel:

This means more than simply that the State cannot prevent the accused from obtaining the assistance of counsel. The Sixth Amendment also imposes on the State an affirmative obligation to respect and preserve the accused’s choice to seek this assistance. At the very least, the prosecutor and police have an affirmative obligation not to act in a manner that circumvents and thereby dilutes the protection afforded by the right to counsel.

*Maine v. Moulton*, 474 U.S. 159, 170-71 (1985). This is intuitive: the right to counsel in an adversarial legal system would mean little if defense counsel could be controlled by the government or vetoed without good reason. ***

The government, relying on *Caplin & Drysdale, Chartered v. United States*, 491 U.S. 617 (1989), contends that a defendant has no Sixth Amendment right to a defense funded by someone else’s money. In that case, the Supreme Court ruled that a defendant’s Sixth Amendment right to retain counsel of choice was not violated when the funds he earmarked for defense were seized under a federal forfeiture statute, because title to the forfeitable assets had vested in the United States. *Id.* at 628.

The government focuses on the following passage from *Caplin & Drysdale*:

Whatever the full extent of the Sixth Amendment’s protection of one’s right to retain counsel of his choosing, that protection does not go beyond “the individual’s right to spend his own money to obtain the advice and assistance of ... counsel.” *Walters v. National Assn. of Radiation Survivors*, 473 U.S. 305, 370, 105 S.Ct. 3180, 87 L.Ed.2d 220 (1985) (Stevens, J., dissenting). A defendant has no Sixth Amendment right to spend another person’s money for services rendered by an attorney, even if those funds are the only way that that defendant will be able to retain the attorney of his choice. A robbery suspect, for example, has no Sixth Amendment right to use funds he has stolen from a bank to retain an attorney to defend him if he is apprehended. The money, though in his possession, is not rightfully his ....

*Caplin & Drysdale*, 491 U.S. at 626 (emphasis added and first omission in original). The holding of *Caplin & Drysdale* is narrow: the Sixth Amendment does not prevent the government from reclaiming its property from a defendant even though the defendant had planned to fund his legal defense with it. It is easy to distinguish the case of an employee who reasonably expects to receive attorneys’ fees as a benefit or perquisite of employment, whether or not the expectation arises from a legal entitlement. As has been found here as a matter of fact, these defendants *would* have received fees from KPMG but for the government’s interference. Although “there is no Sixth Amendment right for a defendant to obtain counsel using tainted funds, [a defendant] still possesses a qualified Sixth Amendment right to use *wholly legitimate funds* to hire the attorney of his choice.” *United States v. Farmer*, 274 F.3d 800, 804 (4th Cir. 2001) (emphasis added).

It is axiomatic that if defendants had already received fee advances from KPMG, the government could not (absent justification) deliberately interfere with the use of that money to fuel their defenses. And the government concedes that it could not prevent a lawyer from furnishing a defense gratis. Presumably, such a lawyer could pay another lawyer to represent the defendant subject, of course, to ethical rules governing third-party payments to counsel. And if the Sixth Amendment prohibits the government from inter-
fering with such arrangements, then surely it also prohibits the government from interfering with financial donations by others, such as family members and neighbors and employers. In a nutshell, the Sixth Amendment protects against unjustified governmental interference with the right to defend oneself using whatever assets one has or might reasonably and lawfully obtain.

The government points out that KPMG’s past fee practice was voluntary and subject to change, and that defendants therefore could have had no reasonable expectation of the ongoing advancement of fees. But this argument simply quarrels with Judge Kaplan’s finding that absent any state action, KPMG would have paid defendants’ legal fees and expenses without regard to cost. Defendants were not necessarily entitled to fee advancement as a matter of law, but the Sixth Amendment prohibits the government from impeding the supply of defense resources (even if voluntary or gratis), absent justification. Therefore, unless the government’s interference was justified, it violated the Sixth Amendment.

It is also urged that a company may pretend cooperation while “circling the wagons,” that payment of legal fees can advance such a strategy, and that the government has a legitimate interest in being able to assess cooperation using the payment of fees as one factor. Even if that can be a legitimate justification, it would not be in play here: prosecutors testified before the district court that they were never concerned that KPMG was “circling the wagons.” Moreover, it is unclear how the circling of wagons is much different from the legitimate melding of a joint defense.

The government conceded at oral argument that it is in the government’s interest that every defendant receive the best possible representation he or she can obtain. A company that advances legal fees to employees may stymie prosecutors by affording culpable employees with high-quality representation. But if it is in the government’s interest that every defendant receive the best possible representation, it cannot also be in the government’s interest to leave defendants naked to their enemies.

Judge Kaplan found that defendants Gremminger, Hasting, Ritchie and Watson were unable to retain the counsel of their choosing as a result of the termination of fee advancements upon indictment. The government does not contest this factual finding, and we will not disturb it. A defendant who is deprived of counsel of choice (without justification) need not show how his or her defense was impacted; such errors are structural and are not subject to harmless-error review. *** Therefore, the government deprived defendants Gremminger, Hasting, Ritchie and Watson of their Sixth Amendment right to counsel of choice.

The remaining defendants—Bickham, DeLap, Eischeid, Lanning, Rosenthal, Smith, Stein, Warley, and Wiesner—do not claim they were deprived of their chosen counsel. Rather, they assert that the government unjustifiably interfered with their relationship with counsel and their ability to defend themselves. In the district court, the government conceded that these defendants are also entitled to dismissal of the indictment, assuming the correctness of Stein I. We agree: these defendants can easily demonstrate interference in their relationships with counsel and impairment of their ability to mount a defense based on Judge Kaplan’s non-erroneous findings that the post-indictment termination of fees “caused them to restrict the activities of their counsel,” and thus to limit the scope of their pre-trial investigation and preparation. Defendants were indicted based on a fairly novel
theory of criminal liability; they faced substantial penalties; the relevant facts are scattered throughout over 22 million documents regarding the doings of scores of people; the subject matter is “extremely complex;” technical expertise is needed to figure out and explain what happened; and trial was expected to last between six and eight months. As Judge Kaplan found, these defendants “have been forced to limit their defenses ... for economic reasons and ... they would not have been so constrained if KPMG paid their expenses.” We therefore hold that these defendants were also deprived of their right to counsel under the Sixth Amendment.

For the foregoing reasons, we AFFIRM the judgment of the district court dismissing defendants’ indictment.
MEMORANDUM FOR THE ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION
THE ASSISTANT ATTORNEY GENERAL, CIVIL DIVISION
THE ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION
THE ASSISTANT ATTORNEY GENERAL, ENVIRONMENT AND
NATURAL RESOURCES DIVISION
THE ASSISTANT ATTORNEY GENERAL, NATIONAL
SECURITY DIVISION
THE ASSISTANT ATTORNEY GENERAL, TAX DIVISION
THE DIRECTOR, FEDERAL BUREAU OF INVESTIGATION
THE DIRECTOR, EXECUTIVE OFFICE FOR UNITED STATES
TRUSTEES
ALL UNITED STATES ATTORNEYS

FROM: Sally Quillian Yates
Deputy Attorney General

SUBJECT: Individual Accountability for Corporate Wrongdoing

Fighting corporate fraud and other misconduct is a top priority of the Department of Justice. Our nation’s economy depends on effective enforcement of the civil and criminal laws that protect our financial system and, by extension, all our citizens. These are principles that the Department lives and breathes—as evidenced by the many attorneys, agents, and support staff who have worked tirelessly on corporate investigations, particularly in the aftermath of the financial crisis.

One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing. Such accountability is important for several reasons: it deters future illegal activity, it incentivizes changes in corporate behavior, it ensures that the proper parties are held responsible for their actions, and it promotes the public’s confidence in our justice system.
There are, however, many substantial challenges unique to pursuing individuals for corporate misdeeds. In large corporations, where responsibility can be diffuse and decisions are made at various levels, it can be difficult to determine if someone possessed the knowledge and criminal intent necessary to establish their guilt beyond a reasonable doubt. This is particularly true when determining the culpability of high-level executives, who may be insulated from the day-to-day activity in which the misconduct occurs. As a result, investigators often must reconstruct what happened based on a painstaking review of corporate documents, which can number in the millions, and which may be difficult to collect due to legal restrictions.

These challenges make it all the more important that the Department fully leverage its resources to identify culpable individuals at all levels in corporate cases. To address these challenges, the Department convened a working group of senior attorneys from Department components and the United States Attorney community with significant experience in this area. The working group examined how the Department approaches corporate investigations, and identified areas in which it can amend its policies and practices in order to most effectively pursue the individuals responsible for corporate wrongs. This memo is a product of the working group’s discussions.

The measures described in this memo are steps that should be taken in any investigation of corporate misconduct. Some of these measures are new, while others reflect best practices that are already employed by many federal prosecutors. Fundamentally, this memo is designed to ensure that all attorneys across the Department are consistent in our best efforts to hold to account the individuals responsible for illegal corporate conduct.

The guidance in this memo will also apply to civil corporate matters. In addition to recovering assets, civil enforcement actions serve to redress misconduct and deter future wrongdoing. Thus, civil attorneys investigating corporate wrongdoing should maintain a focus on the responsible individuals, recognizing that holding them to account is an important part of protecting the public fisc in the long term.

The guidance in this memo reflects six key steps to strengthen our pursuit of individual corporate wrongdoing, some of which reflect policy shifts and each of which is described in greater detail below: (1) in order to qualify for any cooperation credit, corporations must provide to the Department all relevant facts relating to the individuals responsible for the misconduct; (2) criminal and civil corporate investigations should focus on individuals from the inception of the investigation; (3) criminal and civil attorneys handling corporate investigations should be in routine communication with one another; (4) absent extraordinary circumstances or approved departmental policy, the Department will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation; (5) Department attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases, and should
memorialize any declinations as to individuals in such cases; and (6) civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual’s ability to pay.¹

I have directed that certain criminal and civil provisions in the United States Attorney’s Manual, more specifically the Principles of Federal Prosecution of Business Organizations (USAM 9-28.000 et seq.) and the commercial litigation provisions in Title 4 (USAM 4-4.000 et seq.), be revised to reflect these changes. The guidance in this memo will apply to all future investigations of corporate wrongdoing. It will also apply to those matters pending as of the date of this memo, to the extent it is practicable to do so.

1. To be eligible for any cooperation credit, corporations must provide to the Department all relevant facts about the individuals involved in corporate misconduct.

In order for a company to receive any consideration for cooperation under the Principles of Federal Prosecution of Business Organizations, the company must completely disclose to the Department all relevant facts about individual misconduct. Companies cannot pick and choose what facts to disclose. That is, to be eligible for any credit for cooperation, the company must identify all individuals involved in or responsible for the misconduct at issue, regardless of their position, status or seniority, and provide to the Department all facts relating to that misconduct. If a company seeking cooperation credit declines to learn of such facts or to provide the Department with complete factual information about individual wrongdoers, its cooperation will not be considered a mitigating factor pursuant to USAM 9-28.700 et seq.² Once a company meets the threshold requirement of providing all relevant facts with respect to individuals, it will be eligible for consideration for cooperation credit. The extent of that cooperation credit will depend on all the various factors that have traditionally applied in making this assessment (e.g., the timeliness of the cooperation, the diligence, thoroughness, and speed of the internal investigation, the proactive nature of the cooperation, etc.).

This condition of cooperation applies equally to corporations seeking to cooperate in civil matters; a company under civil investigation must provide to the Department all relevant facts about individual misconduct in order to receive any consideration in the negotiation. For

¹ The measures laid out in this memo are intended solely to guide attorneys for the government in accordance with their statutory responsibilities and federal law. They are not intended to, do not, and may not be relied upon to create a right or benefit, substantive or procedural, enforceable at law by a party to litigation with the United States.

² Nor, if a company is prosecuted, will it support a cooperation-related reduction at sentencing. See U.S.S.G. USSG § 8C2.5(g), Application Note 13 (“A prime test of whether the organization has disclosed all pertinent information” necessary to receive a cooperation-related reduction in its offense level calculation “is whether the information is sufficient … to identify … the individual(s) responsible for the criminal conduct”).
example, the Department's position on "full cooperation" under the False Claims Act, 31 U.S.C. § 3729(a)(2), will be that, at a minimum, all relevant facts about responsible individuals must be provided.

The requirement that companies cooperate completely as to individuals, within the bounds of the law and legal privileges, see USAM 9-28.700 to 9-28.760, does not mean that Department attorneys should wait for the company to deliver the information about individual wrongdoers and then merely accept what companies provide. To the contrary, Department attorneys should be proactively investigating individuals at every step of the process – before, during, and after any corporate cooperation. Department attorneys should vigorously review any information provided by companies and compare it to the results of their own investigation, in order to best ensure that the information provided is indeed complete and does not seek to minimize the behavior or role of any individual or group of individuals.

Department attorneys should strive to obtain from the company as much information as possible about responsible individuals before resolving the corporate case. But there may be instances where the company's continued cooperation with respect to individuals will be necessary post-resolution. In these circumstances, the plea or settlement agreement should include a provision that requires the company to provide information about all culpable individuals and that is explicit enough so that a failure to provide the information results in specific consequences, such as stipulated penalties and/or a material breach.

2. Both criminal and civil corporate investigations should focus on individuals from the inception of the investigation.

Both criminal and civil attorneys should focus on individual wrongdoing from the very beginning of any investigation of corporate misconduct. By focusing on building cases against individual wrongdoers from the inception of an investigation, we accomplish multiple goals. First, we maximize our ability to ferret out the full extent of corporate misconduct. Because a corporation only acts through individuals, investigating the conduct of individuals is the most efficient and effective way to determine the facts and extent of any corporate misconduct. Second, by focusing our investigation on individuals, we can increase the likelihood that individuals with knowledge of the corporate misconduct will cooperate with the investigation and provide information against individuals higher up the corporate hierarchy. Third, by focusing on individuals from the very beginning of an investigation, we maximize the chances that the final resolution of an investigation uncovering the misconduct will include civil or criminal charges against not just the corporation but against culpable individuals as well.

3. Criminal and civil attorneys handling corporate investigations should be in routine communication with one another.

Early and regular communication between civil attorneys and criminal prosecutors handling corporate investigations can be crucial to our ability to effectively pursue individuals in
these matters. Consultation between the Department’s civil and criminal attorneys, together with agency attorneys, permits consideration of the full range of the government’s potential remedies (including incarceration, fines, penalties, damages, restitution to victims, asset seizure, civil and criminal forfeiture, and exclusion, suspension and debarment) and promotes the most thorough and appropriate resolution in every case. That is why the Department has long recognized the importance of parallel development of civil and criminal proceedings. See USAM 1-12.000.

Criminal attorneys handling corporate investigations should notify civil attorneys as early as permissible of conduct that might give rise to potential individual civil liability, even if criminal liability continues to be sought. Further, if there is a decision not to pursue a criminal action against an individual – due to questions of intent or burden of proof, for example – criminal attorneys should confer with their civil counterparts so that they may make an assessment under applicable civil statutes and consistent with this guidance. Likewise, if civil attorneys believe that an individual identified in the course of their corporate investigation should be subject to a criminal inquiry, that matter should promptly be referred to criminal prosecutors, regardless of the current status of the civil corporate investigation.

Department attorneys should be alert for circumstances where concurrent criminal and civil investigations of individual misconduct should be pursued. Coordination in this regard should happen early, even if it is not certain that a civil or criminal disposition will be the end result for the individuals or the company.

4. **Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals.**

There may be instances where the Department reaches a resolution with the company before resolving matters with responsible individuals. In these circumstances, Department attorneys should take care to preserve the ability to pursue these individuals. Because of the importance of holding responsible individuals to account, absent extraordinary circumstances or approved departmental policy such as the Antitrust Division’s Corporate Leniency Policy, Department lawyers should not agree to a corporate resolution that includes an agreement to dismiss charges against, or provide immunity for, individual officers or employees. The same principle holds true in civil corporate matters; absent extraordinary circumstances, the United States should not release claims related to the liability of individuals based on corporate settlement releases. Any such release of criminal or civil liability due to extraordinary circumstances must be personally approved in writing by the relevant Assistant Attorney General or United States Attorney.
5. Corporate cases should not be resolved without a clear plan to resolve related individual cases before the statute of limitations expires and declinations as to individuals in such cases must be memorialized.

If the investigation of individual misconduct has not concluded by the time authorization is sought to resolve the case against the corporation, the prosecution or corporate authorization memorandum should include a discussion of the potentially liable individuals, a description of the current status of the investigation regarding their conduct and the investigative work that remains to be done, and an investigative plan to bring the matter to resolution prior to the end of any statute of limitations period. If a decision is made at the conclusion of the investigation not to bring civil claims or criminal charges against the individuals who committed the misconduct, the reasons for that determination must be memorialized and approved by the United States Attorney or Assistant Attorney General whose office handled the investigation, or their designees.

Delays in the corporate investigation should not affect the Department’s ability to pursue potentially culpable individuals. While every effort should be made to resolve a corporate matter within the statutorily allotted time, and tolling agreements should be the rare exception, in situations where it is anticipated that a tolling agreement is nevertheless unavoidable and necessary, all efforts should be made either to resolve the matter against culpable individuals before the limitations period expires or to preserve the ability to charge individuals by tolling the limitations period by agreement or court order.

6. Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual’s ability to pay.

The Department’s civil enforcement efforts are designed not only to return government money to the public fisc, but also to hold the wrongdoers accountable and to deter future wrongdoing. These twin aims – of recovering as much money as possible, on the one hand, and of accountability for and deterrence of individual misconduct, on the other – are equally important. In certain circumstances, though, these dual goals can be in apparent tension with one another, for example, when it comes to the question of whether to pursue civil actions against individual corporate wrongdoers who may not have the necessary financial resources to pay a significant judgment.

Pursuit of civil actions against culpable individuals should not be governed solely by those individuals’ ability to pay. In other words, the fact that an individual may not have sufficient resources to satisfy a significant judgment should not control the decision on whether to bring suit. Rather, in deciding whether to file a civil action against an individual, Department attorneys should consider factors such as whether the person’s misconduct was serious, whether
it is actionable, whether the admissible evidence will probably be sufficient to obtain and sustain a judgment, and whether pursuing the action reflects an important federal interest. Just as our prosecutors do when making charging decisions, civil attorneys should make individualized assessments in deciding whether to bring a case, taking into account numerous factors, such as the individual’s misconduct and past history and the circumstances relating to the commission of the misconduct, the needs of the communities we serve, and federal resources and priorities.

Although in the short term certain cases against individuals may not provide as robust a monetary return on the Department’s investment, pursuing individual actions in civil corporate matters will result in significant long-term deterrence. Only by seeking to hold individuals accountable in view of all of the factors above can the Department ensure that it is doing everything in its power to minimize corporate fraud, and, over the course of time, minimize losses to the public fisc through fraud.

**Conclusion**

The Department makes these changes recognizing the challenges they may present. But we are making these changes because we believe they will maximize our ability to deter misconduct and to hold those who engage in it accountable.

In the months ahead, the Department will be working with components to turn these policies into everyday practice. On September 16, 2015, for example, the Department will be hosting a training conference in Washington, D.C., on this subject, and I look forward to further addressing the topic with some of you then.