DOLLARS AND DEMOCRACY:
A Blueprint for Campaign Finance Reform

HERMAN GOLDMAN MEMORIAL LECTURE
Should We End Life Support for Death Taxes?

21st Century Trademark Basics
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Of Note

IN JULY, OVER 200 WOMEN ATTENDED “WHAT IT’S (REALLY) LIKE TO Practice Law in NYC as a Woman,” held at the Association. The annual program, co-sponsored by the Committee on Women and the Law (Susan Kohlmann, Rosalyn Richter, co-Chair) and the Committee on Law Student Perspectives (Jennifer Mone, Chair), and held in conjunction with the New York Women’s Bar Association’s Committee to Advance Women in the Profession, featured a panel of women attorneys from diverse practice areas who addressed the problems women attorneys have faced in the past and continue to overcome.

※

ALSO IN JULY, FORMER NEW YORK STATE GOVERNOR MARIO COUMO addressed an enthusiastic group of summer associates and Association members at the Association. Governor Coumo discussed the legal profession and gave his advice to the summer associates as they start their professional lives. The event was co-sponsored by the New York Law Journal.

※

IN AUGUST, THE ASSOCIATION HOSTED A RECEPTION FOR THE OVER 60 participating students in the 2000 Thurgood Marshall Summer Law Internship Program. Association President Evan A. Davis made welcoming remarks, and Hon. Fern-Fisher Brandveen, Administrative Judge of the New York City Civil Court, addressed the students. The program provides paying summer jobs for New York City high school students—all of whom have shown an interest in the law—in a variety of legal environments such as law firms, corporate law departments and law schools. In addition to their employment experience, the interns were given a sense of the Columbia Law School environment and of Night Court, courtesy of the Legal Aid Society. The program is sponsored by the Committee on the Thurgood Marshall Summer Law Internship Program (Vaughan Buffalo, Chair).
THE FOLLOWING NEW COMMITTEE CHAIRS HAVE BEEN RECENTLY APPOINTED for terms beginning September 1, 2000:

Paul McDonnell (Criminal Justice Operations and Budget); Michael L. Schler (Herman Goldman Memorial Lectures); Sandra Weiksner (Mortimer H. Hess Memorial Lectures); Robert M. Kaufman (House); Joseph P. Burden (Housing Court); Alisa Levin (Lawyers in Transition); Lawrence M. Grosberg (Legal Education and Admission to the Bar); Darrell S. Gay (Minorities in the Profession); Erin E. Raccah (Sex and Law); Alfreida B. Kenny (Thurgood Marshall Summer Law Internship Program); and Penelope L. Christophorou (Uniform State Laws).
Recent Committee Reports

**Arbitration**
Recommend Supporting the Proposed Revised Uniform Arbitration Act (RUAA)

**Children and the Law/Family Court and Family Law**
Response to the Statement of the Committee on Representation of the Poor in the First Judicial Department

**Education and the Law**
Letter re: Comments to the Regulations for Qualified Zone Academy Bonds

**Election Law**
Letter re: A Bill in Relation to Presidential Primaries (S.7418)

**Family Court and Family Law**
Letter to the Governor re: Support of Bill which Provides for the Representation of Foster Care Children at Adoption Proceedings (S.7225)

**Federal Courts**
Letter to Judge Scirica, US Court of Appeals re: Subcommittee on Attorney Conduct Rules
Letter to Judge Rosenthal re: Comments on Changes to Federal Rule of Civil Procedure 23

**Futures Regulation**
Comments on Proposed Rule 4.27—Public Reporting by Operators of Certain Large Commodity Pools

**International Environmental Law**
Letter to The World Bank re: China-Western Poverty Reduction Project

**Land Use Planning and Zoning**
Letter to Senator Orrin Hatch re: Religious Land Use and Institutionalized Persons Act (S.2869)
RECENT COMMITTEE REPORTS

Pro Bono and Legal Services
Letter to NYS CLE Board re: Request for the Opportunity to Comment on Pro Bono Guidelines

Amicus Brief re: United States of America and Inspector General of the Legal Services Corporation v. Legal Services for New York City and Legal Aid Bureau, Inc.

Project Finance
Comments on UNCITRAL Guide to Privately Financed Infrastructure Projects

Real Property Law
Report on Property Conditions Disclosure Act (S.5039-A/A.1173-C)

Securities Regulation
Letter to the Securities and Exchange Commission re: File s7-31-99, Proposed Rules 10b5-1 and 10b5-2

Social Welfare Law
Amicus Brief: Legal Services Corporation and United States of America v. Velazquez

Copies of any of the above reports are available to members by calling (212) 382-6658, or by e-mail, at skumara@abcny.org.
Should We End Life Support for Death Taxes?

The Herman Goldman Memorial Lecture

Should we end life support for death taxes? This was the question posed at the Herman Goldman Memorial Lecture, held at the Association on the evening of May 22, 2000—its topicality, given the House of Representatives Ways and Means Committee's decision to repeal the Federal estate and gift tax, is obvious.

Taking the affirmative, and presenting the case for the repeal, was Edward McCaffery, Professor of Law, University of Southern California. Taking the negative, and presenting the case against repeal, was Charles Davenport, Professor of Law, Rutgers University. Judge James Halpern, United States Tax Court, presided (although he did not enter judgment); and Willard Taylor, Chair of the Herman Goldman Lecture Committee, introduced the speakers.

No transcript was made of the debate, but the speakers have set out below a summary of their arguments, and Judge Halpern has provided his comments. Attached at the end is a selective bibliography of the literature relating to the repeal of the Federal estate and gift tax.

AGAINST THE REPEAL—PROFESSOR CHARLES DAVENPORT

I explain here, as I did at the Herman Goldman Memorial Lecture, why our transfer taxes (here called the estate tax) should not be eliminated or radically reduced. The argument against it is wholly economic. The estate tax is said to suppress savings and encourage consumption because rational people would rather irrationally consume than leave a part of their wealth to the government. The empirical evidence on this proposition is nonexistent. It's pure theory, and it is balanced by an opposite economic theory. The estate tax might encourage just as much sav-
ing as it discourages because people want to amass an estate of some particular after-tax size.

Economics is not, of course, the only criteria for judging a tax. Most of my remarks go to these other matters, and I think that they make a compelling reason for not eliminating the estate tax. But first, I will deal with some arguments made against the estate tax. Then, I will discuss why I think that the estate tax can have only an insignificant effect on saving and the economy. After that, I will explain why I think the estate tax is important and discuss the very important purposes that it serves. I will also ask what justification there is for cutting the estate tax. Finally, I will show that the revenue effects of eliminating the estate tax are so unpalatable that they alone are strong support for continuing the tax.

I. SPECIAL ARGUMENTS AGAINST THE TAX

Beyond the arguments about the effect on saving and the economy, special arguments are made against the tax.

A. Closely Held Businesses

The estate tax is said to harm closely held businesses. Let's start by noting that most closely held businesses subject to the estate tax are not small. Some run into the billions of dollars. We are not talking about mom-and-pop grocery stores on the corner or even the stereotypical family farm. The evidence here is entirely anecdotal. In my view, shared by some knowledgeable practitioners, the need of businesses to replace management talent is probably greater than the need to fund estate taxes. If the latter is a problem, we have a host of provisions allowing closely held businesses to pay lower taxes and to defer payment of the tax over a long period of time, whether or not the estate is short of liquid funds.

We know almost nothing about what makes up closely held business. On estate tax returns, the total of all assets that might possibly be considered closely held business interests (and we know that some, if not many, are not) runs from 20 to 40 percent of all assets shown. Farm assets show up on less than 7 percent of the returns and make up under 0.5 percent of the assets. Although there are 90,000 returns filed in 1997, estates using the long-term payment of estate taxes available only to closely held businesses did not reach 1,000. If more than one heir existed, nontaxable estates had almost as much liquidity problem as taxable estates.

While there are reports of businesses being sold to pay estate taxes, there is no work validating this. Some anecdotal information suggests
the contrary. One business lawyer who for the last 10 years has practiced almost exclusively with several other lawyers who did mostly estate planning and administration told me that he had never been asked to sell off a business to pay estate taxes.

B. Compliance Costs
The cost of administration to the public and to the Internal Revenue Service is said to be some very large percentage of, or perhaps even equal to or more than, the tax. I have dealt with that myth in other places, and after making assumptions that probably were twice as generous as they should be, the cost was maybe 7-8 percent of the tax. The range of 2-4 percent of the tax is more likely.

II. WHY THE ESTATE TAX IS UNIMPORTANT ECONOMICALLY
Our last recession ended in 1992, and the concerted drive to repeal the estate tax began a year or two later. So, I will use data from that period. Let’s begin by looking at trends in the income and wealth in the last seven years.

A. Growth in Income
Income in America has grown significantly, but relatively the growth is all in the top one-fifth of the population. The share of AGI reported by persons having over $200,000 of AGI, making up 1.6 percent of the people filing returns, increased from 14.5 percent in 1993 to 21.6 percent in 1998. Those with 1998 AGI over $1,000,000 saw their share of AGI almost double from 4.9 percent of the total on 1993 returns to 9.3 percent on 1998 returns.

B. Growth in Wealth
In these same seven years, wealth growth in the United States was nothing short of phenomenal. Total wealth went from $22 trillion to about $37 trillion. After adjusting for inflation, the wealth growth was about $13 trillion. Put another way, over one-third of America’s total wealth accumulated since the beginning of time has come into existence in the last seven years.

This wealth has become more tightly concentrated. A little less than 40 percent of it is now held by the top one percent of households. This top one percent is the only group that saw an increase in its share of the wealth. Roughly, their wealth just about doubled in this seven years. This
happened despite the existence of our estate tax and an increase in the progressivity of the income tax in 1993.

C. Economic Aggregates

The aggregate economic numbers rolled up during the last seven years are boggling, really beyond comprehension. Our economy now pours out more than $9 trillion of goods and services (GDP) each year. For the seven-year period, GDP was $56 trillion. Our households saved (under the conventional definition of saving) $1.9 trillion in those years with the savings rate (again, conventionally defined) falling from nearly 7 percent to less than 2 percent of GDP. Yet, we invested over $9 trillion—some $5.5 trillion from depreciation allowances—over this period, and our wealth increased by almost $13 trillion (in 1992 dollars). We got much richer (some $13 trillion) than the amount of new savings we invested in productive capacity net of depreciation (only $3.5 trillion). An economy doing this well hardly needs to be further stimulated by a tax cut, particularly for the wealthy.

International goods and money flowed vigorously in and out of the United States. Total flows in and out were about $17.5 trillion. Of that, $12.5 trillion was goods, but over $5 trillion was financial—money or investment. In 1999, the United States held $1.2 trillion more dollars from overseas than the United States had sent overseas since 1992.

Let’s compare these aggregates to our transfer taxes. Over the same seven years, our transfer taxes brought $132 billion into the federal Treasury. Now over that same 7-year period what percentage were transfer taxes of?

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<thead>
<tr>
<th>Aggregate</th>
<th>Percentage</th>
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<tr>
<td>GDP</td>
<td>Less than 1/4 of 1%</td>
</tr>
<tr>
<td>Personal saving</td>
<td>Less than 7%</td>
</tr>
<tr>
<td>National saving</td>
<td>Less than 1.5%</td>
</tr>
<tr>
<td>Increase in wealth</td>
<td>Less than 1%</td>
</tr>
<tr>
<td>International financial flows</td>
<td>About 2.5%</td>
</tr>
<tr>
<td>Net international financial inflows into the U.S.</td>
<td>Less than 10%</td>
</tr>
</tbody>
</table>

As I look at these percentages, I wonder just what the estate tax has that could possibly damage the American economy. The forces that drive the economy are probably beyond our control—and perhaps, maybe our influence. The thought that an estate tax of the dimensions just outlined
could much affect the forces that roil our economy or the international flows through it just strikes me as bordering on frivolous. Do we really think otherwise? If we do, can its magical power be identified? Described? What is its Merlin-like power to face down GDP, international monetary flows, investment, and wealth, economic factors that simply dwarf it? Are we not being rather silly to think that it can? I cannot make an argument with a straight face that the estate tax is somehow going seriously to impede the economy and events as strong as those just described. But that it does is the main argument against the estate tax.

III. THE IMPORTANCE OF THE ESTATE TAX

By dismissing the economic argument against the estate tax, I do not mean to denigrate the importance of this debate. In fact, the dialogue is integral to the way we think about ourselves and our society. But the estate tax is unable either to fix the ills or damage the strength of our society in any meaningful way.

A. Virtues In General

Before turning to the major justification for the estate tax, let’s note some of its other virtues viewed from a societal perspective.

1. It is imposed on the wealth that is most able to pay. More than 80 percent is raised from the top one percent of the population, the very group that has enjoyed the most dazzling runup of wealth. This runup in wealth comes from any number of factors—new technology, economic philosophy, government action, hard work, and luck, among others.

2. The estate tax is frequently imposed on wealth (unrealized gains on property) that has never felt the hand of any tax collector. There’s a little controversy on how much of the wealth falls into this category. Most commentators think that it is at least one-half, but others argue that it is nearer three-quarters. As an aside, I note that the frequently mentioned substitute for the estate tax, the taxing of capital gains at death, presents many practical problems. If it were enacted with expected exceptions, it would not raise nearly the same revenue, and the distributional incidence would be very different from the estate tax.

3. The estate tax tends to equalize financial endowments.

4. The estate tax must certainly reduce the concentration of wealth. Rhetorically, I ask these questions:
a. Would wealth concentrations have been less had we had no estate tax?

b. Will the generation skipping transfer tax, which is now a planning factor for the new economy wealth, while it was not when the old economy wealth was planned in past decades, have some impact on concentrations?

c. Does the estate tax encourage charitable gifts? Do we think that charities do good things? Do they not dissipate concentration?

d. Does not the tax withdraw wealth, and thus concentration, from those having the most? If not, why are some people spending a lot of money to have the estate tax repealed? Don’t they think that it has some effect on concentration of wealth? Are they all wrong?

B. A Note on Flaws

Despite these virtues, the tax is quite flawed. Several things should be done. Rather than being torn out by the roots, its roots should be broadened and made shallower. That is, the base should be made greater, and the rates less. Let me emphasize there would be no 37 percent rate cliff in my ideal estate tax. Nor would there be multitudinous discounts and some other features of the current tax.

C. The Major Reason for Retaining the Tax

The foregoing reasons are only a preface to the main reason for retaining the estate tax. To eliminate it is kind of a reverse Robin Hood that I will explain. But first two observations must be made: One about the United States and one about the world.

1. Our government and our society are very stable—the envy of the world.

2. The international scene, in contrast, is, and has been, marked by both political and economic instability. One need only mention the Balkans, India, Pakistan, North Korea, and China on the political scene, and Asian Flu, George Soros, and Japanese stagnation on the economic to support this assertion.

Two thousand years ago there was a Pax Romana. Today we not only have Pax Americana but we also have Ekos Americana. The world may not
like it, certainly, even some Americans do not, but the world economy is at the mercy of, dominated by, the American economy. It is a rock of political stability and an economic safe haven. It is the resilient rubber ball that absorbs the blows to all the other economies of the world. Its economic doctrines are the major plans of the International Monetary Fund and the World Bank, on whom many countries are dependent.¹

I am sometimes forced to walk the streets of Newark, New Jersey. These ways are littered with the homeless. So, in moments of unrepressed guilt, I imagine to the best of my very limited and protected ability what it would be like to be with those I stumble across as I hurry between Penn Station and the law school. Would I much care what kind of government I had? Would it significantly affect the way that I live? Do I think that the homeless lived significantly less well in Imperial Russia? I then move up the income scale just a little from the homeless to those in poverty to those just over poverty to the low income² to the moderate income to the high income and finally to the truly wealthy. When I have maximized my imaginary wealth, I realize that as my imaginary wealth increased, so did my interest in continuing the kind of government and economic doctrine that now reigns—a limited, constitutional, republican (small r) democracy, with protection for political minorities, based on Darwinian capitalism. The greater my imaginary wealth, the greater the interest I had in a liberal (small l), stable society permitting earning and accumulation—not only permitting them but perhaps, making them the Holy Grail for which we all search and the altar at which we worship when we find them.

The tax we discuss this evening reaches only the very few at the top who have, compared to the average, immense wealth and income. They also have the most at stake—a government that protects them better abroad than in some places our local governments are able to do at home. They are the ones going abroad (either personally or through their investments) and they are reaping the greatest rewards from this government and the

¹ The world is indebted to us for providing this service, and ideally we should be able to tax those who have prospered because we have supplied this service. But we are unable to do so. We have no legal system that allows a direct tax on the rest of the world for the stability and philosophy we provide. So we have to raise our revenue at home. Where should we raise our revenue? More pointedly, for this evening, should we change the sources of our revenue? Is there something so skewed about our present distribution of the tax base that we should change it radically? I think not.

² I consider the transfers to these as ways of buying stability. Almost any affluent nation with any kind of a government would have to make transfers to this class.
world order established on our political and economic well-being and economic doctrines. This thought calls to mind the Mexican bail-out a few years back. It tanked the Mexican economy but saved American investors.

I then ask myself, “Why would we cut the taxes on this group? What possible justification is there for reducing their taxes?” They may not all be masters of the universe, but they are pretty comfortable in comparison to the wealthy in any other society in the world. Many more aspire to be here, estate taxes and all, than those among us who aspire to be in other places.

IV. ALTERNATIVES TO THE ESTATE TAX

While opponents of the estate tax commonly argue that the revenue raised is de minimis, this is a canard. The revenue is sufficiently large that its elimination would have to be offset by some equivalent fiscal action, and we now turn to them.

If we radically reduce or eliminate transfer taxes, what do we do to make up for them? There are only three choices:

1. We can use the surplus or we can borrow more.
2. We can cut spending.
3. We can raise taxes.

1. Using the surplus. The newspapers recently reported that the CBO estimates a larger budget surplus than forecast earlier. Similar reports circulate about the administration’s soon to be released re-estimates. These news stories also discussed the salivating committee chairs (in a conservative Republican Congress) waiting to spend this new surplus on prescription drugs, medical savings accounts, charter schools, and many other favorites including very narrowly defined tax cuts that are functionally the same as spending and that substitute for additional spending. More importantly, the change in the current budget numbers has not yet changed the long/Range projections. CBO seems to be pleading for the Congress to bring some spending, postponed to 2001, back in 2000 where it should have been but was put off so that the Congress should show a surplus in 2000. So, we do not know whether we will have a surplus next year or what its size will be. If a surplus develops, we will face whether using it some way other than cutting estate taxes is better economically, fiscally, and socially.

Perhaps, at least a part of the answer to that question turns on whether we need tax cuts in the face of a roaring economy and increasing interest
rates. National debt quadrupled in the lean decade of the 1980s, and a
good case can be made for using the surplus from our current fat years to
pay down the debt. Tax cuts may also be hard to justify where interest
remains a large part of annual federal expenditures. If we decide that tax
cuts can or should be made, the case for the particular cut is still to be
made. I do not know what case can be made for cutting the estate tax
outside the usual argument that it affects savings. We have dismissed that
argument, so there is no good argument to cut the estate tax as long as we
have the marriage penalty, alternative minimum tax anomalies, very high
marginal wage taxes on second earners, and impending Medicare insol-
vency. This list of alternatives can easily be expanded.

As for borrowing more if we should have an economic downturn,
after the last 30 or so years when the deficits were often truly magnificent,
this is not a politically plausible alternative although we just might fall
into it if the hoped-for surpluses fail to materialize to fund a tax cut.

2. Cutting spending. Whether or not we have a surplus, we can pay
for an estate tax cut by cutting spending programs. Here are some sugges-
tions of programs that alone or in aggregate are close to the amount of
the estate tax projected $414 billion over the current and next nine
years:

<table>
<thead>
<tr>
<th>Military retirement</th>
<th>$415 billion</th>
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<tr>
<td>Supplemental security income</td>
<td>$414 billion</td>
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</tbody>
</table>

<table>
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<tr>
<th>Aggregate of</th>
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<tbody>
<tr>
<td>family support</td>
<td>$270</td>
</tr>
<tr>
<td>child nutrition</td>
<td>$124</td>
</tr>
<tr>
<td>Total</td>
<td>$394</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Aggregate of</th>
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<tbody>
<tr>
<td>food stamps</td>
<td>$248</td>
</tr>
<tr>
<td>child nutrition</td>
<td>$124</td>
</tr>
<tr>
<td>Total</td>
<td>$372</td>
</tr>
</tbody>
</table>

| Aggregate of veterans' benefits and pensions | $319 |
| child nutrition | $124 |
| Total          | $443 |
None of these is a personal favorite. They are merely illustrative of the kinds of spending cuts that we could make if we decided to eliminate or reduce radically our transfer taxes. The other alternatives are using trust fund dollars (read social security) or raising other taxes. We won’t do the first, so let’s think about the second.

3. Raise taxes. Do we want to raise taxes to fund an estate tax cut? What tax do we increase? On whom? For what benefit? To push the tax burden downward? It is true that many near the bottom of the income scale pay little or no income tax and certainly no estate taxes. For many, their payroll taxes are partially reimbursed by the EITC. Perhaps, we can increase their burden a little since they pay so little now. Per capita it is not much (only about $100 a year—but growing). They may not even notice it.

If we can accomplish this downward push, we can leave our entire accumulations to our children. Is this a trade-off that we want this society to make? Will it make our children happy? Do we want to make our children happy at this cost? Will this make our children better off? Will this trade-off make our society better, economically or socially?

When we go home to our children chortling that we have secured their full inheritances for them, suppose a child asks, “At what cost?” We reply, “By raising other taxes on everybody, including ourselves, of course.” A curious child will say, “How much?” We rejoin, “Do you mean on us or on them?” “Both.” We can say, “Only $100 annually for every man, woman, and child in the country, including ourselves. We are an average family: Mommy, Daddy, Brother, and Sister. We will pay $400 a year more in other taxes for the rest of our lives. Of course, some of them—particularly those without good accountants—may not even notice the new tax. Let’s hope. “Excitedly, the child asks, (Daddy, Mommy,) how much did we save ourselves by eliminating those terrible estate taxes?” We must reply, “Remember, we are average. You and your (brother/sister) will get about $620,000 more because we’ve got rid of the estate tax. That’s about $310,000 for each of you.” Do we expect our child to smile, smirk, and say, “Hey, that’s a great trade-off. Any more places we can do that well?” What reply can we make but, “That’s enough for today. New goals are a longer story for another day. Tomorrow, perhaps, will bring a new horizon, another challenge to conquer. Go to bed and sleep well with what you have.”

These are the questions that were before us at the Herman Goldman Memorial Lecture. How we answer them will tell us a lot about ourselves and our society.
IN FAVOR OF THE REPEAL—PROFESSOR EDWARD J. McCAFFERY

I must confess to finding this occasion presented by the Herman Goldman Lecture a mixed blessing. I have been writing about—mainly against—the gift and estate tax for some years now, and doing so from a specifically liberal perspective. Yet I still feel that my argument, in both its broad strokes and some of its finer touches, is largely misunderstood. Neither side in the debate over the so-called death tax seems all that willing, interested, or even able to consider the best, most principled arguments on the other side. This is unfortunate. On a personal note, as my two daughters approach their teenage years, I am beginning to wonder if this isn’t simply the fate of the middle-aged man: to say one thing and have another heard.

Despite these frustrations, I welcome this opportunity to clarify anew my position on the estate tax before a distinguished audience. My argument proceeds in several steps, beginning with what I take to be the basic point that tax policy is a moral matter.

1. INTRODUCTION: THE MORALITY OF TAX

A title for my comments could well be, “Is There Really No Right Answer in Tax?” Some of you may recognize this as a reference to Ronald Dworkin’s work,4 which may cause those that do so to groan. Dworkin’s position is that the enterprise of law—by which he mainly means the judge-centered activities of common and constitutional law interpretation—is unavoidably moral. We may not know exactly what the “right” answer is—and we will rarely if ever be able to prove that we do—yet judges have no real choice in contested cases of law but to do the best that they can, supported by reasons that are necessarily moral. I believe that the same can be said—has to be said, in fact—about tax law and tax lawmakers. Tax is unavoidably moral.

I start here for two reasons. First, I believe that the case against the

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3. The bibliography to this series lists my principal works on point. Some of my frustration may be understood by considering the Colloquium on Wealth Transfer Taxation listed there, which was devoted to critiques of my lengthy academic work (largely The Uneasy Case for Wealth Transfer Taxation), and my response thereto; see Edward J. McCaffery, Being the Best We Can Be (A Reply to Critics), 51 Tax Law Review 615 (1996).

estate tax is primarily a moral case. It is not an economics-based case. This is important, for perhaps the largest aspect of the misunderstanding of my work is that it somehow turns on an undue solicitude for the capital stock. I shall return to this theme below. The quickest and most important take on the immorality of the estate tax is that it falls on the wrong people, that is, the wrong rich people: it falls on savers, not spenders. A liberal state should or at least reasonably could want its wealthiest citizens to continue to work and save. It should hesitate before encouraging them to spend. That’s a moral position.

The second reason to start on this meta-level is that the mere claim that tax is a moral subject has come under persistent if puzzling attack. Professor Davenport has written recently on just this point, in response to one of my shorter pieces. He writes that tax cannot and should not be moral; that the arguments for tax policy must be “economic.” Professor Davenport’s position sounds appealing to an age trained, with some good reason, to look askance at avowedly moral arguments. The position against morality is appealing, but it is also incoherent, for two very large reasons.

One, and most obviously, Professor Davenport’s position is itself a moral one. Leaving tax policy to “economics” or anything else—such as “neutral principles” or “definitions,” as of “income” or “consumption”—is itself a moral decision. Consider for a moment, as critics such as Professor Davenport do not, what morality might mean. Richard Posner gives us a critic’s eye’s view of morality in a book devoted to arguing against its use in legal analysis:

Morality is the set of duties to others...that are supposed to check our merely self-interested, emotional, or sentimental reactions to serious questions of human conduct. It is concerned with what we owe, rather than what we are owed....

Now what set of laws is more concerned with “what we owe” than tax? What greater constraint against “our merely self-interested” actions is there than tax? Tax tells us what material resources over which we have some claim we can keep, to do with more or less as we please, and what we have

5. See Charles Davenport, A Politics for Our Times, listed in the bibliography, which is a response to my short piece, Grave Robbers, also listed therein.
to give over to the common good—it is quite directly and literally concerned with what we owe others.

The American tax system collects some two trillion dollars a year; it is, as I have called it elsewhere, the largest instrument of coercive state control ever devised. How can its decisions—about the appropriate degree of progressivity, for example, or the appropriate accommodations for family size, urgent needs (such as medical or educational ones), savings, or charitable giving, not be “moral” ones? Progressive effective tax rates mean that the wealthy will owe more, on average, than the not wealthy; a charitable contribution deduction means that you can owe less than you otherwise would to the public at large by choosing to benefit certain select causes or activities; adjustments for family size mean that those with children owe less to the government, ceteris paribus, than those without. I happen largely to agree with these conclusions, but they certainly raise moral matters, none the less so because we are not used to discussing them in traditionally moral terms. If Professor Davenport means that we should turn all such questions over to the economists, to pursue some wealth or utility-maximizing course, this would surely be a moral decision, and also one strikingly in contrast with what we have done in a wide range of cases.

The trouble with the glib argument against a moral perspective on tax runs even deeper—or more particularly—than its general incoherence. It is also wildly under-determinative. If tax policy is not to be set by some process, however inchoate and articulate, of moral reasoning, we must do something else—leave it to “economics,” as Professor Davenport would have it. But what does “economics” mean? What does it tell us about gift and estate taxation? Economists are split on point, of course, but a pretty solid group of them—Joseph Stiglitz, Douglas Bernheim, Larry Summers, among others—have written pretty skeptically of the estate tax in their academic capacities. As I have pointed out in my general work, the economic theory of optimal taxation would lead to a very different tax system than we have today—one that would attempt to isolate our inelastic suppliers of labor, such as perhaps married men and recent immigrants, for higher levels of taxation. Is that what we should desire, as a way of escaping moral theory?

There is simply no way to avoid moral reasoning in tax. Delegating matters to the economists, even if this were a fully specified thing to do,
is a moral decision. But it is not a fully specified thing; under even the
most deferential of positions, the economists will need direction. A merely
cursory reading of Professor Davenport’s own case for the estate tax makes
abundantly clear that his, too, is a moral case.

One final point, on this general, admittedly somewhat abstract plain:
“Moral” does not mean “moralistic,” as Professor Davenport and others
seem to think. This confusion no doubt contributes to the bad image
that moral theory is getting of late. In none of my arguments against the
estate tax do I invoke the Bible, or any specific religious or other tradi-
tion, or any objective notion of truth writ large. John Rawls, in his recent
work, has charted out this territory quite well. Rawls argues that we must
use a kind of public reason in determining important elements of the
legal and institutional arrangements of society. Public reason avoids reliance
on any comprehensive ethical or religious conception of the good.
But public reason is undoubtedly moral; its morality is simply the public
political morality appropriate to a reasonably pluralist society. We do
ourselves a grave disservice, I believe, when we take the postmodern, poli-
tically correct times in which we live—that have rightfully, I feel, led to
a skepticism concerning the role of particular ethical and religious argu-
ments in our public life—to forbid all forms of moral theory, however
general, political, and pluralist, from seeing the light of day.

2. The Case Against the Estate Tax

Now that we have cleared the ground, so to speak, to talk about taxes
in unashamedly moral terms, I shall move more specifically against the
estate tax.

The estate tax is, quite simply, a bad tax. In practice and in theory.
And on its own intended ends.

Most arguments for repeal focus on the facts that the estate tax doesn’t
raise much revenue, in gross, and raises considerably less and may even
lose money, on net; that it encourages strange and uneconomic forms of
wealth ownership, such as the recent trend toward “dynastic trusts”; that
it falls, disproportionately and somewhat arbitrarily, on those unable or
unwilling to plan for it, such as those wealthy individuals surprised by an
early death; that it diverts resources, including the human capital of es-

8. Most importantly in John Rawls, Political Liberalism (New York: Columbia University
Press, 1993 and 1996 (paper)).

9. I press this argument in a different context in Edward J. McCaffery, The Tyranny of Money
estate planning practitioners, from higher and better uses; that it depletes the capital stock; and that it tends towards the breaking up of small, family-based, closely held businesses. The bibliography lists helpful sources on both sides of these various sub-issues. I think most of these arguments have some merit, and some of them carry considerable weight. But I want to locate the debate elsewhere, on ground that remains surprisingly unfamiliar.

Putting dollars and cents aside, as the balance of the evidence suggests we ought to do, defenders have tended to elevate the estate tax as an end unto itself. We must keep the estate tax, they reason, because it’s the best thing we have. Even if the tax fails to raise revenue or even if it costs us money, in the short or longer term, it still serves important political ends. But what are these ends? Why should we keep the estate tax notwithstanding its costs—what, exactly, is the tax doing that we should want done?

There are two appealing and generally liberal principles—equality of opportunity and equality of material wealth or resources—that the estate tax seems to promote. These two principles at least loosely correspond to ideals of justice within and between generations. Equal opportunity argues for starting life on “a level playing field,” equal wealth argues for living it out that way.

These are, I believe, perfectly legitimate ends for a reasonable liberal society to pursue, and I take it that my agreement with these ends qualifies me as a bona fide “liberal.” The problem is that the estate tax is terribly inadequate for promoting either one. The tax may well be counter-productive on its own terms: It may lead to greater inequalities, within and across generations, in what really matters. The mere existence of the tax, with all of its gaping holes and flaws, certainly seems to be blocking any deeper, better, more systematic thinking about achieving these ends. The estate tax is little better than a symbol of our commitment to greater equality and fairness. What we desperately need is more than symbolic help.

These are, I am aware, deep criticisms. To understand their full force, we must set the estate tax in the context of the broader federal tax system. Very few scholars have done this, and no politicians or journalists to my mind have even tried: We live in an age of incrementalism, of targeted solutions to structural problems. But pruning a tree doesn’t help if the forest is about to be overrun by rot. The best arguments for the estate tax are ones about lofty and abstract, if important, goals; it behooves the careful policy maker to consider if there are better means to such ends than the estate tax, or even if the estate tax is a means to these ends at all.
We have today a nominal income tax. It is not really an income tax. An "income" tax, as the Haig-Simons definition teaches us, is committed to taxing Consumption plus Savings: the two mutually exclusive and all-encompassing uses of the sources of income. Because of very large and systematic exemptions for savings and/or the yield to savings—pension plans and IRAs, cash value life insurance policies, the portfolios of the nonprofit sector and, most critically, the realization requirement, the so-called Achilles heel of the income tax—we don’t have an income tax at all. We have a hybrid income-consumption tax, one that is in fact far closer to a consumption tax because far less than half the yield to capital gets taxed currently.10

But we haven’t generally noticed this. As a result, scholars, politicians, journalists and others still talk of the income tax and about fixing it. At the same time, we lack one of the critical components of a pure, consistent cash-flow consumption tax: the inclusion of debt-financed consumption in the tax base.

This unprincipled combination makes possible a painfully, brutally, embarrassingly simple arbitrage. I begin my taxation class in law school by explaining how Bill Gates, or any other American who already has a sizeable store of wealth, need never pay any taxes again. Tax Planning 101, as I call it, is a simple, indeed trivial, matter. Reduced to its essence, it counsels the wealthy to:

- Buy,
- Borrow, and
- Die.

That’s it. One can take her wealth and buy appreciating assets—perhaps refining the trick by selling the losers and holding the winners—borrow against the appreciation, and die broke. Taken to its limit, this strategy generates no federal tax: no income, no payroll, no gift and estate taxes. Meanwhile, ordinary middle and upper-middle class wage earners are taxed on all sides, under the income and payroll tax systems, with no place to hide.

The estate tax is supposed to somehow correct all of this: to serve as a “backstop” to the income tax and/or to make up for our failure to get much progressivity from it. This is odd, and ought to be unsatisfying to

true adherents of progressivity. How can a back-ended wealth tax, falling at best once a generation (typically after the last spouse dies), compensate for the failure to get tax—sometimes any tax—on an annual basis? Professor Davenport throws up anecdotes and examples, most recently of Jeff Bezos, the Amazon.com magnate, for some kind of proof of the need for the estate tax.11 But what should really concern us who truly care about equality is the growing instance of thirty and forty year old billionaires, who have a half century or so to go before they will be subject to any meaningfully progressive tax, and who are left free to play Tax Planning 101 in the meantime. It’s the annual flow-based tax that is the problem here. The estate tax does not check Tax Planning 101 in the slightest.

It gets worse than that. Not only does the estate tax fail to get at the wealthy on an annual basis, it only ever gets at some of them. When it does, it falls on the wrong rich people. It hits savers, especially long-term intergenerational savers, and spares spenders. Jeff Bezos or any other staggeringly rich American no doubt has been told by his ever helpful tax advisors that the government will take more than half of his wealth when he dies unless he plans around this contingency. The easiest way to plan around the estate tax is to play Tax Planning 101: to spend it all while alive and die broke. Now we see that the estate tax, especially set in context of the flawed income-plus-estate tax regime, can easily lead to—encourage—inequalities in consumption, which is what ought to matter to the reasonable liberal state. Consumption measures lifestyles. Our current tax system encourages greater inequalities in lifestyles and less savings by the rich—both of which inducements will typically inure to the detriment of the less rich.

The problems of the flawed income-plus-estate tax run across generations as well. Large amounts of wealth can rather easily escape the gift and estate tax regime and flow down to second or later generations, all without the income tax asserting a claim.12 When and as wealth passes, the children and grandchildren—or their advisors, insurance companies, and so forth—can play Tax Planning 101 in full force. The tax system being so strenuously defended in the name of equal opportunity in fact allows and encourages entire generations to live off capital, tax-free.

Another way to get a handle on these ideas is to consider what is it that we should want the rich to do. I believe that a reasonable liberal society should want its rich to continue to work and save, even if this

11. Davenport, A Politics for our Times, supra, at note 52 and accompanying text.
means allowing them to pass on their wealth to others whom they love (and who will be taxed when and as they spend, as I discuss in the next section). It should be wary of its rich spending inordinate sums of money on themselves, on their own pleasures, whether this is buying up yachts to compete in the America’s Cup, piling up trophy houses, or running for elected office on their own considerable dimes. The estate tax is backwards—perverse—on these fronts; it spares the spenders, however decadent, and falls heavily on the savers, however thrifty and productive.

The estate tax is not a meaningful leveler of wealth or provider of equal opportunity. What progressivity we get under the estate tax comes very late—too late—in the day; it comes after a lifetime in which any wealthy person so inclined could have passed tremendous sums of wealth and opportunity onto his descendants. Worse, these heirs who have received inter vivos benefits will escape all taxation, with fairly trivial planning. When the progressivity comes, it comes in the wrong place.

A final note, to tie this and the prior section together: Mine is a moral argument. I am not arguing—not presenting macroeconomic models—that the estate tax, in any demonstrable way, actually leads to less work and savings among the rich. I am fairly confident that it does so, but this is not the structure of the argument. My argument is that by design the estate tax falls on the wrong rich people, and at the wrong time, and that this is unfair. Suppose, for example, for strange reasons, Congress decided to impose a tax on anyone who made any charitable contribution. The fact that charitably minded people continued to give anyway, and simply paid the tax, thereby reducing the relative burden of non-charitable givers, would not undermine the argument against the fairness of this absurd tax. So too with the estate tax. Wealthy savers are taxed; wealthy spenders are not. That’s unfair, whatever measurable consequences follow from it.

3. Better Ways

I have argued that tax must be a moral matter; that we must set the estate tax in the context of the broader tax system; that we must consider the ends of estate taxation; and, finally, that we must open up the possibility of better means to our chosen ends. So thinking, I believe that the estate tax becomes very unappealing indeed. But is there anything better? Without a sense of some suitable substitute, there might indeed be reasons to cling to the estate tax as the best of all possible worlds. But it turns out that a far better, far more systematic response to the ends favored by estate tax proponents is readily available.
As is typically the case in American life and politics, there is a large and important discussion that we are busily not having: What are we going to do with the unprecedented wealth we are generating? Professor Davenport, in his defense of the status quo, draws heavily on these facts. But the world we inhabit has grown up in the presence of the tax system, which is poorly set up to do anything at all about it. When people become billionaires by the time they are thirty, the estate tax, at a remove of fifty or sixty years, provides scant solace. One can do a lot with a billion dollars in half a century. Especially when, as is, one need never pay any federal tax, under Tax Planning 101, in the meantime.

A more systematic look at the American tax system, as I have sketched out above, reveals that its deepest problem is not its failure to better tax capital or savings, but its failure to tax debt whatsoever. This allows the arbitrage at the heart of Tax Planning 101: the ability to consume without tax.

Along with—as an integral part of—my writing against the estate tax, I have long been advocating a progressive consumption tax. This is quite an exciting thing. It changes the nature of the entire discussion of tax policy. It shuts down Tax Planning 101. It is a path towards true, not symbolic, progressivity. And it is also not all that radical a departure from the status quo, especially once we accept the fact that we are not taxing much savings as is. To get to a progressive consumption tax, we need only take three steps:

- Repeal limitations on the deductibility of savings, making for “unlimited savings accounts” (USAs);
- include debt as income (allowing a deduction for debt-financed savings under the first step); and
- repeal the gift and estate tax.

That’s it. With these three steps, we would have a consistent, cash flow consumption tax, one that would fall consistently on spending, not work or savings. We could also increase tax rates on the high end, as I have in fact argued in my longer work, but this is not needed. These three steps would shut down Tax Planning 101 and get all spending to bear some positive tax burden.

A few quick points. Although I am not a formal economic modeler, it is often said that rates will have to rise under such a cash flow consumption tax, because of the nontaxation of all savings, under step one. But step two is a base broadening move. We already don't tax most savings. Under a consistent cash flow consumption tax, we can also eliminate the need for a capital gains preference. All told, it is far from clear that we would have to raise rates at all under a consistent consumption tax, although I have argued that the possibility of raising rates at the high end—a possibility checked by supply side rhetoric and analysis under an income tax—is an appealing argument for change.

Two, under a consistent cash flow consumption tax, there is no need for the concept of “basis,” as savings will be systematically exempt from the tax. The plan can thus have a carry over basis for gifts and bequests—but that basis is zero. This will allow us to tax the heirs when and as they withdraw from their inherited savings accounts to spend. One of the points least understood about my argument is that a consistent cash flow consumption tax operates as a form of accessions or inheritance tax. It does a better job than the highly flawed status quo at getting at inequalities across generations—at getting at the spending of second and lower generations. (It also, again as I have explained in my longer work, gets at the yield to capital, to the extent such yield is used to finance high end consumption.)

Three, one of the more persistent arguments against a cash flow consumption tax is that it ignores the present power of capital; that by allowing and even encouraging large stores of capital to build up tax-free inside the USAs, the tax is somehow illiberal. It is hard to take this argument too seriously as a case for retaining the status quo; huge amounts of capital can and indeed already have built up, altogether unchecked by the tax system until and unless the estate tax comes along. (This by the way is true of many arguments against a consumption tax—that we will somehow have to define “savings” and “consumption,” or distinguish business expenses from consumption—all such matters come up under the income tax, which is largely a consumption tax even in theory (since savings rates are low) and even more so in practice.) Even so, a cash flow consumption tax gives us a better means for monitoring the problems of concentrated capital than we have now—the government in essence has a lien on the USAs, and can regulate them, however loosely. Critics have sometimes balked that this is a major departure from the status quo, but

14. See Being the Best We Can Be, supra.
in fact the government already loosely regulates the massive amounts of capital in pension plans, IRAs, insurance company and bank reserves, non-profit endowments, and so on. Businesses, too, are regulated by the taxing as well as other regulatory authorities. Indeed, the main “problem” of excessively concentrated capital may simply be the use of money to influence political processes, and this can be regulated simply by prohibiting the use of USA funds for lobbying or running for office.

4. Two Bad Misunderstandings

Before concluding, I wish to clarify two points about my own thoughts but, more importantly, about the structure of my arguments that are continually misunderstood, most recently by Professor Davenport.

One, my argument against the estate tax is not one about the total amount of savings, or about the importance of savings in general. I have been trying to make this point for so long with such little success that I shall underscore it: The form of the tax is neutral as to the aggregate level of the capital stock. If we were to have “too much” savings under a consistent cash flow consumption tax, the proper response is to lower the tax rates. We can have as much or as little savings under a consumption as under an income tax. The best arguments for a progressive consumption tax lie in its principled consistency and fundamental fairness.

To the extent my argument is about savings at all, it is about the identity of the savers, about who should be doing what with her money and why. A progressive consumption tax encourages and rewards the upper classes for their savings. The extra revenue generated by higher rates on high end consumption, the inclusion of debt-financed consumption within the tax base, and the repeal of a capital gains preference, can all be used to lower tax rates on lower and middle class consumption. This would reverse what I take to be a disturbing and counter-productive trend in American fiscal policy: the attempt to get the lower and middle classes to save, through a series of target and ad hoc savings programs. This policy is incoherent, given the nontaxation of debt (there is no reason why additional savings credits or deductions ought to lead to more savings) and the various inducements to the wealthy not to save. Wealthy citizens should be encouraged to save, and while there is no reason to penalize the vast masses of non-wealthy citizens when they do save, there is also something to be said for accepting the fact that most Americans live paycheck to paycheck and will simply not save whatever we do publicly to induce them to. Rather than adding complexity for little gain with savings proposals targeted to the middle classes, we should have gen-
eral savings provisions, hoping that those most able to do so will provide our private capital needs, and then shore up social security and similar systems to provide for the savings needs of others.

A second misunderstanding is that I favor relying uncritically on polls. I have never said or written this or anything close to it; I have specifically countered the misunderstanding in my academic work. Yet Professor Davenport and others keep bringing it up again. Once again, I think that polls are relevant, not decisive, perhaps especially in a field as complex as tax. But tax policy-makers should listen to the people, and talk to them—not at them, not down to them with scorn. The unpopularity of the so-called death tax runs deep and wide, as Republicans at least have figured out. At a minimum, this puts a responsibility on proponents of the tax to make their case to the people, articulating their goals in clear language and trying to educate the populace. More than that, I feel, it generates an obligation—dare I say a moral obligation?—to think through whether or not the popular opposition might just be right, and whether or not liberal ends can be served by other, more acceptable, means. This is what I have tried to do in my work with at least one collateral benefit: My attempt to take popular opinion seriously has made me feel close to the people. The fact that liberal supporters of the status quo seem to listen no better to me than to them makes me feel closer still.

CONCLUSION

I am aware that my arguments for repeal of the estate tax do not follow the usual course of such matters. I have spent a fair amount of time arguing here for the fundamental morality of tax policy, invoking John Rawls and Ronald Dworkin. Still not staying still, I have roamed far and wide across the tax system, pointing out the ways in which our porous income-plus-estate tax is not up to the pressing challenges of our time. I have chided defenders of the status quo on both fronts—certainly for not taking the time or making the effort to understand these more general arguments, but also for digging a hole in the sand, and clinging to the estate tax come hell or high water.

I do not apologize for my lack of convention. I see no other way to proceed.

Times have changed. Tax has not. We have in this country unprecedented levels of wealth, and wealth inequality, and we see people of

15. Id.
unprecedented youth sharing in lots of it. The American tax system was not established with this situation in mind. Certain self-proclaimed liberals, seeing the problems of society, would cling to the death tax, mainly out of inertia. I see things differently. I see the death tax as simply a poorly chosen means to legitimately desired ends, and clinging to it as misguided. If we are serious about the causes of progressivity, equality, and fairness, we need to fight for them. Seriously. Toy guns won’t help us win this war.

COMMENTS—JUDGE JAMES S. HALPERN

I. Introduction

Keep the estate tax; repeal the estate tax. Those are the positions advocated by Professors Davenport and McCaffery, respectively. My goals here are to clear some brush, identify the common issue on which they differ, describe their differences, and make a brief comment.

II. Non-Issues

The professors disagree as to the effect of the estate tax on closely held businesses, whether compliance costs approach, or even exceed, revenues, and the consequence the estate tax has on behavior. Neither, however, thinks that any, or all, of those items make or break the argument for the estate tax.16 In making their cases, neither thinks that the revenues produced by the estate tax are particularly significant, although Professor Davenport is justifiably concerned about how Congress would compensate for the revenue shortfall that repeal would bring.

I also believe that they would both sign on to Professor McCaffery's two liberal principles—equality of opportunity and equality of material wealth or resources (the two liberal principles)—and agree that achieving the two liberal principles is among the goals by which good tax policy should be judged.

III. Positions

Professor McCaffery's advocacy of “a consistent cash-flow consumption tax” (consumption tax) comes through loud and clear. His argument against the estate tax is derivative of his argument for a consumption tax:

“[A] consistent consumption tax operates as a form of accessions or inheritance tax.” Professor McCaffery argues that the two liberal principles would adequately be served by a consumption tax, perhaps with some tweaking,17 which would make the estate tax unnecessary.

Professor Davenport finds virtue in the fact that the estate tax is imposed “on the wealth that is most able to pay.” The wealthy, he believes, should have no cause to complain about the burden of the estate tax, since they undoubtedly benefit from the public goods and services purchased with the resulting revenue. I would be surprised if Professor Davenport would not favor a system of personal taxation based on annual levies against wealth. I assume that he favors an income tax and not a consumption tax, since the wealthy do not reduce their burden under the former by trading saving for consumption.18 Indeed, a principal virtue of the estate tax for Professor Davenport is that it backstops our imperfect income tax, which, with limited exceptions, does not include unrealized gains in gross income, and provides for a step-up in basis at death. Perhaps because he has taken our present, imperfect income tax system as a given, Professor Davenport does not address whether we should retain the estate tax if we were to “improve” our income tax to include unrealized gains in gross income, either annually or, at least, at death. It seems to me that, based on Professor Davenport’s justifications for the estate tax, he should be satisfied with a properly graduated income tax on an improved definition of income in lieu of our present combination of an imperfect income tax and the estate tax.

IV. Comments
I am not prepared to debate the merits of a consumption tax versus a Haig-Simons income tax. It is sufficient, I believe, to point out the nexus

17. To get a progressive consumption tax, Professor McCaffery would, among other things: “repeal limitations on the deductibility of savings, making for ‘unlimited savings accounts’ (USAs).” He recognizes the argument that “by allowing and even encouraging large stores of capital to build up tax-free inside USAs, the [consumption] tax is somehow illiberal.” He answers: “[A] cash flow consumption tax gives us a better means for monitoring the problems of concentrated capital than we have now—the government in essence has a lien on the USAs, and can regulate them, however, loosely.” As they say: The devil is in the details.

18. I am speaking here of ideals, i.e., an income tax levied on income as defined under the so-called Haig-Simons definition of that term: “[T]he algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” Henry C. Simons, Personal Income Taxation 50 (1938).
between that debate and the debate between Professors Davenport and McCaffery over the desirability of an estate tax. Both, I believe, are integrationists, sharing policy goals that can be achieved without the maintenance of a distinct estate tax. Since I do not believe that the ideal expressed by either is imminent, I invite the professors to tell us what partial solutions they advocate.
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Formal Opinion 2000-03

The Acceptance of Securities in a Client Company in Exchange for Legal Services to be Performed

Professional and Judicial Ethics

**TOPIC:** Acceptance of securities in a client in exchange for legal services to be performed; business transactions with clients; conflicts of interest; charging or collection of an excessive fee.

**DIGEST:** Attorney may, in certain circumstances, ethically accept securities in a client company in exchange for legal services to be performed; an attorney may have to meet the requirements of DR 5-104(A) if the client expects the lawyer to exercise independent professional judgment for the protection of the client; attorney should be mindful that, in some situations, there may be non-consentable conflicts of interest which preclude such an arrangement; in other situations, the attorney may be required to disclose potential conflicts of interest, advise client of right to seek independent counsel with respect to the fee arrangement and obtain written consent of client; attorney should evaluate, at the time the fee arrangement is agreed to, whether the acceptance of
securities as compensation for legal services to be rendered would constitute an excessive fee.

**CODE:** DR 2-106; DR 5-101; DR 5-104; DR 5-105; EC 2-20; EC 2-24; EC 5-3; EC 5-15

**QUESTION**
May an attorney accept securities in a corporate client for legal services to be rendered, and, if so, what ethical concerns are presented by an agreement by an attorney to accept securities in a client company instead of a cash fee?

**OPINION**
As high technology and internet companies have continued to spawn throughout the country from Silicon Valley, California to Silicon Alley, New York, the legal profession has been prompted to examine and adopt alternatives to the conventional hourly billing rate arrangement that has been traditionally applied to more mature companies. In response to the attitudes and concerns of the “new age” entrepreneurs who are often strapped for cash, normally risk-averse attorneys increasingly are accepting securities, including options or equity stakes, in startup companies, instead of their customary cash retainers and monthly payments for legal services.\(^1\) These relatively new and novel, business-driven fee arrangements, which provide the attorney with an additional interest in the business success of the client, raise important questions of professional and ethical concern to attorneys in private practice and have generated a new arena for critical review and analysis.\(^2\)

Among the ethical issues raised by a lawyer’s acceptance of securities in a corporate client in exchange for legal services to be rendered are those relating to the reasonableness of the fee charged to the client, the potential conflicts of interest with the client and the effect on the attorney’s

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independence and judgment. Given the increasing frequency with which lawyers are accepting securities and the widespread interest by members of the Bar in the ethical propriety of these arrangements, we take this opportunity to examine and address the ethical issues raised by acceptance of securities in exchange for legal services to be rendered.

In Part A, we examine the application of ethics rules governing an attorney’s business transactions with a client to arrangements between a lawyer and a client for fees to be paid in securities of a client company. In Part B, we analyze potential conflicts of interest that may arise as a result of accepting securities in exchange for legal services to be rendered. In Part C, we address the issues to be considered in determining whether a payment in the form of securities in the client company is “excessive.”

Before turning to these specific ethical concerns, for the sake of clarity, we state here our conclusion that there is no per se ethical prohibition on the acceptance of shares or other securities, including options, as compensation for legal services to be rendered. We hasten to add, however, our caution that such arrangements can present thorny ethical and other issues that must be resolved prior to entering into an arrangement in which a lawyer is to be compensated in client company securities.3

A. Entering into a Business Transaction with a Client

As a threshold matter, whenever an attorney is considering accepting securities in a client company as a fee for services to be rendered, DR 5-104(A) may be implicated. This rule outlines the parameters under which it is ethically permissible for an attorney to enter into a business transaction with her client. DR 5-104 provides:

(A) A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise professional judgment therein for the protection of the client, unless:

(1) The transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner that can be reasonably understood by the client;

3. It is beyond our scope, and, therefore, we do not address significant potential legal issues that may impact a lawyer’s determination to accept securities for legal services, including the possible heightened exposure to lawsuits and the impact on the lawyer’s insurance coverage for malpractice.
(2) The lawyer advises the client to seek the advice of independent counsel in the transaction; and

(3) The client consents in writing, after full disclosure, to the terms of the transaction and to the lawyer's inherent conflict of interest in the transaction.

On its face, DR 5-104(A) requires a two part inquiry. First, the attorney must determine if the transaction is one in which the attorney and her client have differing interests and in which the client expects the lawyer to exercise professional judgment on the client's behalf. If these questions are answered in the affirmative, then the attorney must demonstrate that the terms of the transaction are fair and reasonable to the client and have been transmitted to the client in clear written form, that the attorney has advised the client that the client may consult independent counsel and that the client has consented in writing after full disclosure.

In other jurisdictions, ethics committees considering arrangements in which an attorney accepts securities in a client instead of a cash fee consistently have concluded such transactions may withstand ethical scrutiny provided that the obligations to provide full disclosure, to advise the client of the client's right to obtain independent counsel and to obtain written consent of the client are satisfied. See, e.g., Utah 98-13 (1998) (finding that Model Rule 1.8, which is analogous to DR 5-104, “was intended to apply to any transaction with a client in which the lawyer acquires an ownership interest in the client”); Mississippi 230 (1995) (opining that the acceptance of stock in a corporation as a fee for incorporating the business does not create a conflict of interest per se” but that “the lawyer's acquisition of stock in the client amounts to the entering into a business transaction with the client”); Pennsylvania 89-158 (1989) (opining that attorney may accept securities in client as payment for corporate work and that such a fee arrangement constitutes a business transaction with the client within the purview of Pennsylvania's Rule 1.8). Accord Hazard & Hodes, The Law of Lawyering, § 1.8:202, p. 263, “Illustrative Case: Taking an Interest in a Client's Business in Lieu of a Fee” (finding that taking an interest in a client’s business instead of a cash fee implicates disclosure, consent and independent counsel requirements of ABA Model Rule 1.8(a)).

However, the text of N.Y. DR 5-104(A) differs from that of the rules

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4. See also Arizona 94-15 (1994) (finding that lawyer could ethically accept interest in client’s patent instead of cash fee, provided lawyer complied with requirements of Arizona Rule 1.8(a)).
under which these opinions were issued. Unlike these other rules, the New York rule interposes a threshold inquiry before requiring the lawyer to undertake the disclosure and other prescribed remedial measures. On its face, DR 5-104 applies only to business transactions where “the client expects the lawyer to exercise professional judgment therein for the protection of the client,” and absent a specific requirement imposed by disciplinary rule, requirements such as those imposed by DR 5-104(A) would not be mandated. See Beatie v. DeLong, 164 A.D.2d 104, 561 N.Y.S.2d 448, 451 (1st Dep’t 1990) (finding “[no] authority to support defendant’s contention that attorney . . . was obliged to advise [client] of the desirability of obtaining independent legal advice” before granting him an interest in the proceeds of the patent as payment for legal services to be rendered); see also N.Y. City 80-14.

Some commentators have concluded that DR 5-104(A)’s disclosure and consent requirements do not apply to fee arrangements entered into at the outset of the representation:

A prominent exception to DR 5-104(A) is that a fee agreement, at its inception, is not covered by the rule, even though a fee agreement is literally “a business transaction with a client.” If fee agreements were covered by the rule, then a lawyer would have to advise every client to obtain independent counsel before entering into a fee agreement. If the client retained independent counsel, that lawyer would also have to advise the client to obtain independent counsel before entering into a fee agreement—so on down the line. To avoid this absurd result, fee agreements are considered outside the scope of DR 5-104(A).

Simon’s Code of Prof’l Resp. Ann., DR 5-104(A), Commentary at 310 (West 2000). Professor Simon’s conclusion is consistent with a prior opinion of

5. Compare N.Y. DR 5-104(A) with Miss. RPC Rule 1.8 (1999); Pa. St. RPC Rule 1.8(a) (1999); Utah Code Jud. Admin. R. 1.8(a) (2000); D.C. Bar Appx. A, Rule 1.8 (2000). Under the analogous rule in Virginia, which is similar to New York’s rule in this respect, the ethics committee of the Virginia Bar concluded that “an attorney may, under DR 5-104(A), provide legal services to a corporation in consideration of the stock issued so long as he feels his independent professional judgment will not be affected by his status as a stockholder, the client consents after full disclosure by the lawyer of the potential conflicts of interest, and provided that the transaction is not unconscionable, unfair or inequitable when made.” Va. No. 1593 (1994).

6. However, it has been suggested that modifications to a fee agreement after the representation is under way are subject to the strictures of DR 5-104(A). Simon’s Code of Prof’l Resp.
this Committee. See N.Y. City 88-7 (1988) ("the mere establishment of a lawyer's fee . . . is not normally regarded as a 'business transaction' under DR 5-104(A") (citing Wolfram § 8.11.3, at 481-82). 7

In Opinion 88-7, we concluded that an attorney's acceptance of a mortgage interest in a client's home to secure payment of a fee constituted a "business transaction with a client" within the meaning of DR 5-104(A). In reaching this conclusion, we stated:

A mortgage and related agreements may well contain highly technical language raising important legal obligations readily ascertained by the lawyer but imperceptible to the untrained eye. People whose situation requires the assistance of counsel may be particularly vulnerable.

In certain circumstances, these concerns may also apply to the fee arrangements considered here. Principals in startup companies typically entering into "securities for fees" arrangements may be legally unsophisticated and may be relying on the attorney with respect to the transaction.

In our opinion, the application of DR 5-104(A) can, and should, be resolved by the text of the rule, which extends its mandates to all those situations in which the client expects the lawyer to exercise independent judgment for the protection of the client. Consistent with Opinion 88-7, we conclude that DR5-104(A) does not exclude from its ambit fee agreements between lawyers and clients. To be sure, garden variety fee arrangements generally can be expected to fall outside the scope of DR 5-104(A) because the client will rarely be relying on the lawyer to provide "independent advice" in connection with such an arrangement. As a result, the endless chain of independent lawyers envisioned by Professor Simon will not occur. In any event, there is nothing in the text of DR 5-104(A) that automatically precludes its application to all fee arrangements.

Ann., DR 5-104(A), Commentary at 310 ("material changes in fee arrangements made after the attorney-client relationship has begun generally do constitute business relationships between lawyers and clients and are governed by DR 5-104(A") (emphasis in original).

7. Although Professor Wolfram states that "courts have applied the code to all business transactions, including situations in which the lawyer does not contemporaneously perform legal work or in which the technical lawyer-client relationship has ended," Wolfram, Modern Legal Ethics, § 8.11.2 at 480, n.79 (West 1986), he writes elsewhere that strict scrutiny of lawyer-client business transactions "applies to all business dealings between lawyer and client after the relationship of lawyer and client has been established. It extends to fee contracts themselves if they have been entered into or modified after the representation begins." Wolfram, § 8.11.3 (emphasis added).
This same textual analysis also leads the Committee to the ineluctable conclusion that New York's DR 5-104(A) does not automatically impose any consent or disclosure requirements on all transactions in which an attorney accepts securities in a client company for legal services to be rendered, at least where such an agreement is reached at the outset of the representation. This is not to say that DR 5-104(A) will never apply to such a fee arrangement. Whether the rule applies in specific circumstances will necessarily turn on whether the lawyer is expected to provide independent advice in the specific transaction by which the securities for services exchange is made. If the lawyer is expected to play any role in advising the client, especially if a client lacks sophistication, the mandates of DR 5-104(A) must be followed. See N.Y. City 88-7. In performing this analysis, we note, however, that there is a crucial difference between bargaining with the client, a function that puts the lawyer squarely on the other side of the table, and providing advice to the client relating to a transaction, including a transaction involving fees, where the client expects to rely on the attorney's judgment.

Although DR 5-104(A) does not always apply, the Committee notes that the New York Court of Appeals has cautioned that transactions between attorneys and their clients are “not advisable.” Greene v. Greene, 56 N.Y.2d 86, 92, 436 N.E.2d 496, 499, 451 N.Y.S.2d 46 (1982); see also Mary C. Daly, “The Perils in Business Transactions with Clients,” The New York Professional Responsibility Report, at 2 (March 2000); Hazard & Hodes, The Law of Lawyering, § 1.8:200 at 262 (“there are no transactions that courts will scrutinize with more jealousy than dealings between an attorney and his clients”). Indeed, if the attorney-client relationship were to dissolve and litigation over the fee arrangement were to ensue, the terms of the agreement would be construed most favorably to the client. Schlanger v. Flaton, 218 A.D.2d 597, 631 N.Y.S.2d 293, 295 (2d Dep't 1995). Absent the attorney's ability to demonstrate “that the client was fully aware of the consequences and that there was no exploitation of the client's confidence in the attorney,” the client may be able to rescind the agreement. Greene, 56 N.Y.2d at 92. If the attorney makes complete disclosure, obtains client consent and informs the client that the client should seek independent advice with respect to the fee arrangement, even where such

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8. Concerns regarding the lawyer's liability arising out of a situation in which the client pays its fees in the form of its own securities are compounded by the fact that an attorney's malpractice insurance may not cover a dispute with a client relating to such a fee arrangement. See “Who Wants to Be a Millionaire?,” ABA Journal, February 2000, at 40.
measures are not required by DR 5-104, the lawyer may reduce the likelihood of such an adverse result. Thus, although it is not ethically mandated in all cases by DR 5-104(A), we believe that the more prudent course for an attorney exchanging legal services for securities in the client company would be to follow the disclosure and written consent requirements of the rule.

B. Conflicts of Interest

An attorney’s inquiry into her potential ethical obligations arising out of a transaction in which the attorney accepts securities for fees does not end with DR 5-104. Unique issues of potential conflicts of interest also may arise as a result of such arrangements.

At the outset of the representation, the acceptance of securities in a client corporation as part of the consideration for legal services to be rendered may implicate the standard of independent professional judgment that is embodied in DR 5-101(A):

A lawyer shall not accept or continue employment if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer’s own financial, business, property, or personal interests, unless a disinterested lawyer would believe that the representation of the client will not be adversely affected thereby and the client consents to the representation after full disclosure of the implications of the lawyer’s interest.

DR 5-101(A). 10

9. In order to assure that the disclosure requirements of DR 5-104(A) are met, the lawyer should disclose:

   (1) the nature of the transaction and each of its terms; (2) the nature and extent of the lawyer’s interest in the transaction; (3) the ways in which the lawyer’s participation in the transaction might affect the lawyer’s exercise of professional judgment in concurrent legal work for the client, if any; (4) the desirability of the client’s seeking independent legal advice if the client is not already independently represented; and (5) the nature of the respective risks and advantages to each of the parties to the transaction.

10. The analogous provision in the ABA Model Rules of Professional Conduct requires the client’s “consent after consultation” if the “representation of [the] client may be materially limited . . . by the lawyer’s own interest.” Model Rule 1.7(b). In addition, Model Rule 1.8(a) requires that the client be given a reasonable opportunity to seek independent counsel and that the client consent in writing if a lawyer “knowingly acquire[s] an ownership, possessory, security or other pecuniary interest adverse to a client.”
Under this rule, if the lawyer accepts securities from a client in exchange for legal services to be rendered, as a threshold matter, she must determine whether this ownership interest in the client would, or reasonably may, affect the exercise of her independent professional judgment on behalf of the client. If the answer is affirmative, the lawyer must then determine whether a “disinterested lawyer” would believe that the effect on the lawyer’s exercise of professional judgment will be adversely affected because the lawyer stands to be paid in securities of her client. If the effect is determined to be adverse, then the conflict is non-consentable and the representation on those terms must be declined. On the other hand, if a reasonable determination is made that the effect on the representation would not be adverse, then the arrangement can proceed if the client consents to the representation after the implications of the lawyer’s interest are fully disclosed.

The New York State Bar Association’s Committee on Professional Ethics has observed that “when there is no more than a fanciful, theoretical or de minimus risk that the lawyer’s judgment will be affected adversely by a potentially relevant set of interests, DR 5-101(A) imposes no restriction. . . . At the other extreme, DR5-101(A) has long been understood to foreclose the lawyer from undertaking a representation, even with the client’s consent after full disclosure, if there is a reasonable probability (viewed objectively) that the lawyer’s interests will affect adversely the advice to be given or the services to be rendered to the client.” N.Y. State 712 (1999) (citations omitted). See also NYSBA EC 5-2.

It is this Committee’s opinion that an arrangement by which a lawyer accepts securities in a client corporation as compensation for legal services to be rendered reasonably may affect the professional judgment of the lawyer on behalf of her client. By way of example, when a lawyer has agreed to accept securities in a client corporation as a fee for negotiating and documenting an equity investment, or for representing it in connection with an initial public offering, there is a risk that the lawyer’s judgment will be skewed in favor of the transaction to such an extent that the lawyer may fail to exercise independent professional judgment. It is possible that the lawyer’s interest in the securities may create economic pressure to “get the deal done,” which pressure in turn may impact the lawyer’s independent judgment on disclosure issues. In this respect, the risk is not significantly different than that presented when the lawyer’s cash fee depends (in whole or in part) on a business transaction’s success fully closing. In both cases, the lawyer is “invested” in the transaction. The contingent fee arrangement has long been accepted as ethical if the
fee is appropriate and reasonable and the client has been fully informed as to alternative billing arrangements. ABA 389 (1994). We see no ethical distinction between the transactional contingent fee and agreeing to take client securities instead of cash fees.11

Although such an arrangement may affect the lawyer’s independent professional judgment, it still can pass muster under the “disinterested lawyer” test of DR 5-101(A). DR 5-101(A) would preclude any arrangement if there exists a reasonable probability (viewed objectively) that the lawyer’s interests will affect adversely the advice to be given or the specific services to be rendered to the client. See N.Y. State 712 (1999). See also Utah 98-13 (1998) (if a lawyer agrees to accept stock in a client company in return for performing services for that company, a possible conflict does not preclude the representation; the critical questions are the likelihood that a conflict will arise and whether it will materially interfere with the lawyer’s professional judgment in considering alternatives or foreclosing courses of action). This Committee believes that, standing alone, acceptance by a lawyer of a “stake in the action,” is not sufficient to warrant the conclusion in every case that a lawyer’s exercise of professional judgment on behalf of his client will be adversely affected by accepting securities in her client’s company for legal services to be performed. See Mississippi 230 (1995) (there is no inherent conflict of interest in lawyer accepting stock for fees to incorporate a corporation and provide legal advice); Virginia 1593 (1994) (not per se improper for lawyer to be compensated in stock for his legal services).

The determination of whether a reasonable probability of such an adverse effect exists is factually driven and demands an analysis of the nature and relationship of the particular interest and the specific legal services to be rendered. Some salient factors to be considered may be the size of the investment in proportion to the holdings of other investors, the potential value of the investment in relation to the law firm’s earnings or assets, the possible impact on the lawyer of levels of risk involved, and whether the investment is active or passive. See Barrie, “Investing in Your Client’s Business,” Wash. State Bar News (Mar. 2000). The Committee can envision situations in which there exists a likelihood, when viewed objectively, that the lawyer’s interest in “getting the deal done” will adversely affect the lawyer’s independent professional judgment. The risk of

11. The Committee notes that ethical considerations have traditionally discouraged a “contingency” arrangement in situations where the client can afford to pay the fee in cash. NYSBA EC 2-20. See pp. 22 – 24 infra.
such an adverse effect would be especially high, for example, in the case of a potentially very large fee paid in client securities which represents both a significant portion of the law firm's revenues and a substantial stake in the client's business. In these circumstances, it is conceivable that the desire to obtain such a fee might diminish the willingness of the attorney, albeit unconsciously, to advise the client company to disclose negative information or increase the lawyer's willingness to issue a questionable legal opinion required to close the deal. In such situations, the conflict would be non-consentable and the fee arrangement ethically prohibited.

If, however, a determination is made under the “disinterested lawyer” test that the lawyer's representation of the client will not be adversely affected by an agreement to accept client securities as payment for legal services to be rendered, DR 5-101(A) allows the representation, but only if full disclosure is made to the client and the client's consent is obtained. Although not required under the Disciplinary Rule, the Committee recommends that the disclosure and consent be in writing for the same reasons we believe it is prudent under DR 5-104(A). See NYSBA EC 5-3.

Disclosure should include, among other things: (1) the risks inherent in representation by a lawyer with a financial, business, property, or personal interest in the company, including the possible effects upon the lawyer’s actions and recommendations to the client; (2) the possible conflicts that might arise between lawyer/shareholder and client or its management and the range of possible consequences stemming from them; and (3) any potential impact on the attorney/client privilege and confidentiality rules, particularly in communications between the client and the attorney in his role as investor rather than as counsel. See Barrie, “Investing in Your Client’s Business,” Wash. State Bar News (Mar. 2000).

12. This risk of compromising the lawyer’s independent judgment can be further exacerbated in situations where a lawyer’s compensation depends directly in whole or in part on the amount of fees generated for the firm and where the particular lawyer is also responsible for providing the legal services involved. In extreme cases, to minimize the possibility that the independent professional judgment of the lawyers working on behalf of the client would be compromised, a firm might consider taking measures such as prohibiting an attorney from working on matters of a client that she introduced to the firm and that is paying its fees in the form of its securities or at least placing some other partner in charge of the matters.

13. For guidance on disclosures to clients entering into a business transaction generally, see Wolfram, § 8.11.4., at 484-85.

14. Although it does not bear on the ethical propriety of accepting securities in a client for legal fees, it is noteworthy that if the securities are of significant value, they may foreclose the...
C. Excessive Fees

A lawyer must also consider whether accepting securities in a client as payment for legal services to be rendered constitutes the charging or collection of an excessive fee in violation of DR 2-106.

An agreement to accept securities in satisfaction of legal fees is not prohibited by DR 2-106(A). However, DR 2-106(A) prohibits a lawyer from agreeing to charge an excessive fee for his or her legal services as well as collecting such a fee. An arrangement by which an attorney is to be paid wholly or partly in securities must satisfy this requirement.

DR 2-106(B) provides a test for determining whether a fee is “excessive” by asking whether it would be the “definite and firm conviction” of “a lawyer of ordinary prudence” that “the fee is in excess of a reasonable fee.” This test (eliminated from comparable Rule 1.5(a) of the ABA’s Model Rules of Professional Conduct) is intended to be an objective one. The rule also provides eight “factors” to assist in determining whether a legal fee is excessive. Those eight factors are:

1. The time and labor required, the novelty and difficulty of the questions involved and the skill requisite to perform the legal service properly.
2. The likelihood, if apparent, or made known to the client, that the acceptance of the particular employment will preclude other employment by the lawyer.

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(3) The fee customarily charged in the locality for similar legal services.

(4) The amount involved and the results obtained.

(5) The time limitations imposed by the client or by the circumstances.

(6) The nature and length of the professional relationship with the client.

(7) The experience, reputation and ability of the lawyer or lawyers performing those services.

(8) Whether the fee is fixed or contingent.


The foregoing factors are not meant to be all-inclusive. Determination of what is excessive is a fact-specific exercise. See ABA, Annotated Model Rules of Professional Conduct, 4th ed., at 48 (discussing Model Rule 1.5(a) of the Model Code of Professional Responsibility which identifies the same eight factors as assisting in the determination of whether a fee is excessive).

A determination of whether a fee is excessive is not always easily made. In the case of an arrangement in which securities are received for legal services, the decision is more complex, and there are additional factors which should be considered, especially where the securities to be received are those of a “start up” business, or are part of or in connection with a public offering of the securities. Examples of additional such “factors” are:

... (1) The likelihood the transaction in question will or will not close and whether there are any contingent plans for payment of legal fees; (2) the estimated current and future value of the equity [i.e. securities] interest considering all the normal risks of a start-up business and any specific risks to the business or its assets; (3) the liquidity of the interest, including whether it is now or may in the future be publicly traded; (4) any restrictions on transfer of the interest, whether by agreement with the client ... or by law; (5) the percentage amount of the interest, and what, if any, degree of control it provides the lawyer over the business; and (6) what restrictions, if any, are placed
on the money used to pay for the equity interest—for example that it must be used to pay future legal bills.


Many of these factors, especially in the case of securities in a startup company, obviously cannot be determined with any degree of assurance, at least until the transaction or matter is completed. As such, a crucial question in determining whether a fee in the form of securities is “excessive” is the time at which the value is measured. An equity stake in a corporation that turns out to be successful might seem excessive in relation to the services rendered if the value is determined only after the success is achieved. But to make this evaluation at that end point—and with the wisdom of hindsight—would not value the fee that the client agreed to pay or the lawyer accepted, because it would eliminate the risk that the lawyer undertook that the venture would fail and the securities, i.e. the fee, would have little or no value. Accordingly, we conclude that a determination of whether a fee accepted in the form of securities is excessive requires a determination of value be made at the time the agreement is reached. To be sure, this test may allow attorneys to receive fees that turn out to be spectacular windfalls in relation to the compensation that would normally be received on a cash basis. But as long as the reward stems from the investment risk accepted, not from an excessive fee, the result will equate to a lawyer’s investing cash, not services, in the venture. We hasten to add that not all payments in the form of client securities will pass muster under this test. In cases where the risks are minimal and the amount of securities received by the lawyer is excessive in relation to the services to be rendered, the fee would not cease to be “excessive” merely because the venture was not a sure thing.

The importance of estimating the value of the arrangement whereby payment is made in the form of client securities instead of cash is not limited to issues of professional responsibility. In addition to being subject to professional discipline under DR 2-106(A) if a fee were found to be excessive, a lawyer might also face possible civil liability or a justified refusal on the part of the client to make payment of the agreed-upon fee. The problem is compounded by the rule that an attorney, as a fiduciary, bears the burden of proving that the transaction entered into with a client is reasonable and not the fruit of undue influence. See Mallen & Smith, Legal Malpractice, 3rd ed. 1989, Section 11.19.

A lawyer accepting payment in the form of client securities should seriously consider engaging an investment professional to advise as to the...
value of the securities so given. The attorney and client can then make their own advised decisions as to the reasonableness of the transaction.

In considering the lawyer's obligations under DR 2-106, attention must also be given to whether the taking of client securities as payment instead of a cash fee constitutes the making of a contingent fee arrangement. We have seen above that there is difficulty in estimating the value of the securities or the size of the fee until the success or failure of the matter or transaction has been established. There are obvious elements of contingency in such an arrangement. At least one committee on ethics of a sister state has concluded that a contingent fee is created where securities are given as an attorney's fee in payment for legal services furnished in a public offering. See Kansas Bar Association, Ethics Opinion 98-6 (September 25, 1998). The rationale for such a conclusion is that the failure of the offering will likely lead to no securities being given, or whatever is given being worthless.

Determination of whether a fee paid in whole or in part in securities should be characterized as a “contingent fee” is of importance in determining whether the lawyer is required by DR 2-106(D) to “provide the client with a written statement at the outset of the engagement stating the method by which the fee is to be determined” as well as a statement “at the conclusion of the contingent fee matter,” providing “the client with a written statement stating the outcome of the matter...” Although the foregoing disciplinary rule would seem to have been drafted with litigated actions in mind, there is no exception made in the provision for transactional matters.

Moreover, we note that New York State Bar Association Ethical Consideration 2-20, which is not a binding ethical rule but is aspirational in nature, states that a lawyer “generally should decline to accept employment on a contingent fee basis by one who is able to pay a reasonable fixed fee.” Thus, to the extent a “securities for fees” transaction includes a “contingent” element, such an arrangement is disfavored where the client could pay a reasonable cash fee. However, given the fact that many, if not most, of the clients seeking to exchange their securities for legal services to be performed are start-up companies that are strapped for cash, we view such arrangements to be consistent with EC 2-20. In addition, the Committee notes that Ethical Consideration 2-24 states that “even a person of means may be unable to pay a reasonable fee, which is large because of the complexity, novelty, or difficulty of the problem or similar factors.” As most of the matters in which client securities provide the currency for paying a lawyer's bill are complex corporate transactions,
even well-established commercial clients may not readily be in a position to be “able to” pay a cash fee for the legal services they require.

Finally, a lawyer who accepts securities in whole or in part as a substitute for cash fees is bound in the event of his or her premature discharge or withdrawal to receive no more in value than the work to the date of discharge or withdrawal justifies. To the extent the work has not been completed, it is clear that receipt of the entire fee contemplated to be charged at the outset would be excessive and must be credited or refunded to the client. N.Y. State 599 (1988). See In re Cooperman, 83 N.Y.2d 465, 633 N.E.2d 1069, 611 N.Y.S.2d 465 (1994). That principle is equally applicable to an arrangement whereby securities are given by the client in payment for legal services to be rendered.

July 2000

The Committee on Professional and Judicial Ethics

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Dollars and Democracy: A Blueprint for Campaign Finance Reform—Introduction and Summary

The Commission on Campaign Finance Reform

“Dollars and Democracy: A Blueprint for Campaign Finance Reform” is a book-length report recently issued by the Association’s Commission on Campaign Finance Reform. The Commission was formed in 1997, in the wake of the 1996 presidential and congressional elections. It was directed to examine all aspects of the current system and recommend appropriate changes.

The report describes the development of federal campaign financing laws and their implementation, and how campaigns have been financed in the context of this system. The report finds the current system to be broken and badly in need of reform. After its exhaustive work, the Commission reached a consensus as to a blueprint for campaign finance reform in America. This report reflects that consensus. The report’s recommendations reflect multiple and diverse goals and are interrelated. Not every member of the Commission subscribes to every recommendation. There were significant differences, as reflected in the separate statements in this report. Printed below are the Introduction and Summary of the report (chapter 1).

The full report, including the separate statements, may be found at the Association’s website (www.abcny.org) or may be obtained from the Executive Director’s office at the Association.

INTRODUCTION AND SUMMARY

A. The Collapse of the Watergate-Era Campaign Finance System

Our federal campaign finance system is in a state of disarray. In the
early 1970s Congress adopted legislation aimed at achieving full disclosure of the sources of campaign money; limits on the size of campaign contributions by wealthy individuals and organized interest groups; public funding, with spending limits, for presidential candidates; and effective enforcement through a new administrative agency, the Federal Election Commission (FEC). The Watergate-Era legislation known as the Federal Election Campaign Act (FECA)—also carried forward longstanding prohibitions on the use of corporation and union treasury funds in federal elections. These provisions of FECA were sustained by the Supreme Court in the leading case of Buckley v. Valeo, and in subsequent decisions.

Campaign finance activity in recent federal elections, however, has sharply departed from the framework adopted by Congress. A large and growing percentage of campaign funds is not subject to FECA's disclosure requirements. Wealthy individuals, organized interest groups, corporations, and unions easily, massively, and legally disregard FECA's dollar limitations and source restrictions on campaign funds. Publicly funded presidential candidates actively solicit and control the expenditure of millions of dollars of private contributions. The FEC has proven incapable of enforcing many of FECA's requirements, restrictions, and prohibitions.

The problems with the current campaign finance system, however, run deeper than evasions of the legal framework, as serious as those evasions are. The parts of the system that work as Congress intended have come to cause problems as well. The dollar limits on the size of contributions to candidates and parties are exactly the same as those enacted in 1974, even as campaign costs have skyrocketed and inflation has eaten away at the value of the statutory limits. (See figures 1-A and 1-B.) The spending limits that are part of the presidential public funding system are
adjusted for inflation but were initially set at such a low level that public funds are insufficient in light of the costs of contemporary campaigns. Many of the FEC’s problems were built into its structure by Congress.

Most importantly, the current statutory system does nothing to ensure that serious congressional candidates have the resources they need to mount effective campaigns. Nor does it attempt to level the electoral playing field by make it easier for challengers to compete fairly with incumbents. As a result, in many races, one candidate, typically the incumbent, has an enormous financial advantage over his or her opponents.

The current campaign finance system has significant negative effects on our democracy. The system produces many elections in which the incumbent runs without serious competition. A tiny number of very wealthy individuals, organizations, and interest groups have enormous influence over the financing of election campaigns and, ultimately, on the elections themselves. Large campaign donations, and candidates’ dependence on these donations for the funds necessary to fuel their campaigns, pro-
vide major donors with opportunities for special access to elected officials. The enormous burdens of fundraising on elected officials and candidates discourage many potentially serious candidates from participating in elections, have led many seasoned officeholders to decline to seek reelection, and cause candidates and public officials to devote a disproportionate amount of their time and effort to the campaign money chase. The burden of fundraising also operates as a barrier to participation by women and minority candidates. The widespread and highly publicized evasions of the campaign finance laws insult the integrity of our legal system and contribute to the public’s deep and growing cynicism about the campaign finance process, and about the very legitimacy of our democracy itself.

The problems with our current campaign system ought not to come as a surprise. The basic statutory framework was adopted more than a
quarter century ago. Tinkered with a few times in the 1970s, it is virtually unchanged over the last two decades. During that time, the political system has evolved, and new and expensive campaign technologies have developed. Candidates, contributors, and other participants in the political process have gained experience with the system, probed its weaknesses, found its loopholes, and exploited its shortcomings.

Campaign finance regulation needs to be a dynamic process that keeps pace with the changing nature of political campaigns. But our federal election laws remain frozen as they were written in the 1970s. Congress has frequently debated campaign finance regulation, and on occasion one house or the other has passed new measures. But the political process has been blocked. Despite growing public alarm and the mounting evidence of the inadequacies of the system under FECA, no significant federal campaign finance legislation has been adopted since 1979.

In addition to political gridlock on Capitol Hill, two significant factors further complicate the task of campaign finance reform. First, the Constitution, as interpreted by the Supreme Court, constrains the regulation of political campaigns. Campaign finance laws affect the communication of campaign messages and are, thus, subject to judicial review under the First Amendment. The Supreme Court has invalidated some campaign finance reforms and indicated that some campaign finance activities may not be regulated.

The limits imposed by the Supreme Court, however, should not be exaggerated. The Court has sustained the authority of Congress to limit contributions, to ban contributions by business corporations, to require the disclosure of campaign contributions and expenditures, to provide for public funding for candidates, and to make a candidate's acceptance of spending limits a condition for public funding. Indeed, the Court has held that many of these reforms—disclosure, limits on contributions, public funding—actually promote constitutional values. In the Court's most recent campaign finance case, decided in January of this year, several of the justices signaled their willingness to revisit campaign finance doctrine in light of the new campaign finance stratagems that have emerged in re-

cent years. The Supreme Court may have foreclosed certain regulatory options, but it has not prevented reform.

Second, campaign finance reform is difficult because of the inherent complexity of the problem. Campaign finance reform involves the consideration and reconciliation of multiple, diverse, and often conflicting goals. A well-functioning campaign finance system must protect freedom of speech, advance competitive elections, curtail special interest influence, and promote the equal political voice of all citizens, while minimizing the burdens of regulation on candidates, contributors, other participants in the process, and the FEC. Campaign finance reform requires respect for the open and dynamic character of the American political process, the evolving nature of campaigns, and the variety of circumstances and campaign styles across the country. Campaign finance reform must avoid burdening particular candidates or groups or providing advantages to their opponents. Reform must also take into account how candidates, contributors, and others will respond to particular efforts to regulate their behavior.

Campaign finance reform must be comprehensive. Limited approaches, targeting just one or another problem in the system, will have only a limited impact and are, in fact, likely simply to produce new forms of evasion and new loopholes. Only an integrated program of reforms can produce a strengthened democratic system. Yet given the range of conflicting values, the role of political interests, and the difficulties of designing reforms that can work in practice, comprehensive reform is by its very nature difficult to achieve.

B. The Role of the Commission on Campaign Finance Reform

The Association of the Bar of the City of New York believes that it can serve a constructive role in achieving comprehensive campaign finance reform. Formed in 1870 to combat corruption in the selection of judges, the Association has long played a leadership role in providing broad, in-depth, and nonpartisan analysis of major policy issues. The Association has always been particularly interested in questions of government integrity. It has produced landmark studies on conflicts of interest in the executive and legislative branches of the federal government, and on election-law reform in New York City and State.

The Commission on Campaign Finance Reform was created in February 1997, in response to the growing concerns within the membership of the Association about the large unregulated contributions, high levels of fundraising, and high costs of campaigns in the 1996 elections. The Commission is composed of a knowledgeable and diverse group of leaders of
the Bar. It consists of men and women, people of different ethnic and racial groups and diverse ideological backgrounds. It includes Republicans, Democrats, and independents. Many members currently hold or previously held elected or appointed office, or ran for elected office, at the federal, state, or local levels. Many have participated in the management and financing of campaigns. Our numbers include three past presidents of the Association (one of whom was also Secretary of State of the United States), a former Counsel to the President of the United States, a former New York State Attorney General, the General Counsel to the New York Civil Liberties Union, the Executive Director of the New York City Campaign Finance Board, academics, and practitioners without direct experience in campaigns who are knowledgeable in the ways of the world, and especially the operations of the legal system.

Over the past three years, the Commission has closely examined the operations of the federal campaign finance system, considered the principles that ought to govern campaign finance regulation, and carefully reviewed many pending reform proposals.\textsuperscript{5} The Commission has spoken with people active in the field, and in cooperation with the New York City Campaign Finance Board it sponsored a conference that drew participants from across the country to discuss state and local innovations and their implications for reform at the federal level.\textsuperscript{6}

The Commission has evaluated a broad range of reform options, including bills currently or recently before Congress; measures adopted or under consideration at the state and local level; and ideas put forward by numerous public policy and academic thinkers. We have extensively deliberated the strengths and weaknesses of a number of different ideas. Our recommendations draw from different, and conflicting, approaches to reform. Nevertheless, we believe that these proposals constitute a comprehensive package that, taken together, will protect free speech, promote competitive elections, curtail special-interest influence, reduce the burdens of fundraising, provide for a more open political process and more

\textsuperscript{5} This report is focused exclusively on the federal campaign finance system, with particular attention to the funding of congressional campaigns. It does not address state or local campaign finance regulation. The Association of the Bar has addressed state and local campaign finance practices in previous reports. See, e.g., Committee on Election Law, "Towards a Level Playing Field—A Pragmatic Approach to Public Campaign Financing." \textit{52 The Record} 660 (Oct. 1997).

\textsuperscript{6} The Conference was held at the Association of the Bar on Nov. 9, 1998. The conference was funded in part by grants from the New York Community Trust and the Joyce Foundation. The proceedings of the conference may be found at "From the Ground Up: Local Lessons for National Reform," \textit{27 Fordham Urban L. J.} 5-166 (1999).
representative governance, improve administration, and produce a campaign finance system that is both more consistent with the system adopted by Congress nearly three decades ago and more faithful to our democratic political ideas than the system that is in place today.

C. Summary of Recommendations

Our recommendations draw from three different approaches to campaign finance reform. First, we would relax some of the restrictions in existing law that, due to the passage of time and the effects of inflation, have become unduly burdensome and unnecessary to advance the goals of campaign finance regulation. Thus, we would raise the current limits on individual contributions to candidates and parties, and we recommend that all contribution limits be, henceforth, indexed for inflation. Second, we would repair weaknesses in the current regulatory framework by addressing two problems that have emerged since FECA's enactment—political party soft money and issue advocacy advertising—and we would strengthen the FEC so that it could be a more effective enforcement agency. Third, we would go forward to reduce the role of large, unequal private contributions in elections and governance, ameliorate the burdens of fundraising, and enhance candidate competitiveness by providing for a system of partial public funding for congressional elections.

These three approaches are reflected in five specific groups of recommendations:

(1) Public funding for congressional elections;
(2) Adjustment of existing contribution limits;
(3) Controls on soft money;
(4) Redefining electioneering speech to permit regulation of so-called issue advocacy advertising;
(5) Reforming the FEC.

(1) Public Funding

To promote voter equality and competitive elections, to ameliorate the burdens of fundraising, to facilitate political participation by new candidates, women, and minorities, to reduce the potentially corrupting effect of large contributions, and to increase the ability of candidates to get their messages to the voters, the Special Commission recommends that Congress add to the present system of public funding for presidential elections by enacting a system of public funding for elections to the House of Representatives and the Senate.
Candidates would become eligible for public funding by (i) raising a threshold amount of qualifying contributions, (ii) agreeing to limit the use of their personal or family funds in the election, and (iii) agreeing to limit their total campaign expenditures. Public funds would be provided on a matching-funds basis, with two dollars in public funds provided for every dollar in matchable private contributions of up to $250.

Public funding would be accompanied by a spending limit. The purpose of the spending limit is not primarily to limit or reduce the amount of money devoted to campaign activity. Election expenditures provide a valuable function in educating the public and mobilizing the electorate. Challengers, in particular, need to be free to spend enough money to offset the many advantages that incumbents enjoy. The purpose of spending limits is to eliminate the “arms race” mentality that causes candidates to embark on almost endless fundraising in order to be prepared for the possibility that they will be outspent by their opponents. Thus, the spending limit ought to be set high, so as not to interfere with the ability of candidates to mount competitive campaigns. But it needs to be firm to constrain the destructive effects of the current money chase. Consistent with the spending levels of competitive challengers in recent elections, we recommend that the limit in House elections be $1 million, indexed for inflation. The limit in Senate races will vary from state to state, reflecting differences in population and spending patterns. But as with the House, the limits are keyed to spending in competitive races and are not intended to reduce general levels of spending.

Candidates participating in the public-funding program need to be assured that by accepting a spending limit they have not denied themselves the ability to respond to a high-spending opponent who has opted not to participate in the public-funding program. Consequently, we recommend that the spending limit be raised when a publicly funded candidate’s opponent raises contributions that would enable him or her to spend over the limit, and that the limit be eliminated altogether when the opponent’s receipts are well above the limit.

In addition, we recommend that the public-funding program be financed out of the federal Treasury, not the income-tax checkoff currently used to provide the public funds for presidential campaigns. The checkoff does not provide enough funds to cover the costs of contemporary campaigns. Moreover, no other important public program depends on a checkoff. Public funding is too vital to the health of our democracy to depend on the ups and downs of the checkoff.
(2) Adjustment of Existing Contribution Limits

The Special Commission believes that contribution limits are necessary and appropriate to control the potential for undue influence by large donors and potential donors. But we believe that these limitations ought to be adjusted in light of changes in the cost of campaigns. As campaigns have become more expensive, the size of the maximum contribution an individual can make relative to the total funds the candidate must collect has grown smaller, thereby reducing the corruptive threat of contributions currently at the statutory ceiling. With the costs of campaigns rising but the size of the maximum contribution frozen at 1974 levels, the burdens of fundraising on candidates have grown. With individual contributions capped, candidates have become more dependent on intermediaries—such as PACs and bundlers—to help them raise the funds they need. So, too, the combination of 1974-level limits and 2000 campaign costs has provided both candidates and donors with a powerful incentive to engage in soft money financing. Thus, the current limits on private contributions have not so much limited the role of fat cats as they have enlarged the role of interest groups and contributed to the soft money evasion. Consequently, we recommend that FECA’s contribution restrictions be adjusted in light of changes in the costs of campaigns. The amount of money an individual can contribute to a candidate for federal office per election, thus, should be trebled from the 1974 level. This adjustment would be slightly less than the increase in the cost of living over that time. We also recommend that the current law, which provides for separate limits on contributions for primary and general elections, be changed. Realistically, candidates who make it to the general election are participating in one long campaign, not two, and moneys technically contributed for the primary election can be used for the general election. In practice, the current contribution limit is $2,000 per election cycle, not the $1,000 per election officially written into the statute book. FECA would be more consistent with campaign finance practices, and more honest with the public, if it set one overall limit for the entire election cycle. As a result, we recommend that an individual be permitted to contribute up to $6,000 per candidate per election cycle, and that the contribution level be readjusted every two years in light of changes in the cost of living.

With respect to individual contributions to PACs, and contributions by PACs to candidates and party committees, we recommend that the current limits be continued and then indexed for inflation following the enactment of comprehensive campaign finance reform legislation. We see no persuasive basis for the statute’s current posture of permitting larger
contributions to and by PACs than it permits individuals to give to candidates. By immediately raising the individual limit without raising the PAC limit, we would place individual and PAC donors on a more level playing field.

Consistent with trebling the limit on individual contributions to candidates, we would treble the limit on the aggregate contributions an individual can make for federal election purposes per calendar year, from the 1974 level of $25,000 to $75,000, with the limit again indexed for inflation in the future.

(3) Soft Money and the Political Parties

Soft money is money that, by definition, is not subject to the dollar limitations and source prohibitions of federal law. Soft money is outside of FECA’s regulation because it is technically used for purposes other than the support of federal candidates. But in practice, soft money has come to play an important role in federal elections. Soft money undermines the central goal of reducing the impact of special-interest influence on officeholders and the electoral process. Indeed, the very existence of soft money mocks campaign finance law.

We recommend that Congress ban the use of soft money in federal elections. We would prohibit federal officeholders and candidates for federal office from soliciting, receiving, directing, transferring, or spending any money that does not comply with the source and dollar limits applicable to federal campaign contributions. We also recommend that Congress prohibit the national committees, including the congressional campaign committees of the political parties, their officials, and their agents, from soliciting, receiving, directing, transferring, or spending any money that does not comply with the source and dollar limitations applicable to federal campaign contributions.

These proposals are not intended to reduce the role of the political parties in federal election campaigns. We recognize that parties are important participants in the financing of federal election campaigns. Party spending can have many benefits. Party money reflects a broader range of interests and concerns than money provided by PACs; party committees typically devote a greater share of their resources to competitive challengers and marginal incumbents than do other contributors; and parties give considerable attention to registering and mobilizing voters. But soft money permits unlimited participation by large donors, special interest groups, corporations, and unions. In so doing, soft money flouts the law and gives an excessive role to monetary influences within the parties.
Soft money must be prohibited to restore the integrity of federal election law.

The prohibition of soft money, however, ought to be accompanied by a loosening of the rules governing hard money contributions to and by the parties. The Commission recommends that Congress raise the limit on individual hard money donations to political parties. An individual donor could give to party committees in total any amount up to the proposed aggregate ceiling on individual contributions of $75,000 per calendar year. We would also raise the limits on donations by parties to candidates, and on party spending that is coordinated with candidates. We would allow candidates who participate in the proposed congressional public-funding system to receive party financial support up to the public-funding spending limit.

The Commission would also restore the integrity of the limitations on party spending in support of candidates by clarifying when a party expenditure ought to be considered independent and when it ought to be considered coordinated with a candidate. Once a party committee has made a direct contribution to, or a coordinated contribution with, a candidate, then all subsequent expenditures by that committee and by all committees of that party with respect to that candidate are to be treated as coordinated with the candidate and as subject to the limits on party support for candidates. In addition, once a party has nominated a candidate, all party expenditures supporting that candidate are to be treated as coordinated.

(4) Express Advocacy

FECA's rules and requirements apply only to campaign messages that constitute express advocacy of the election or defeat of federal candidates. The courts have generally defined express advocacy narrowly, by holding that only messages that contain literal words of electoral advocacy—such as “vote for,” “vote against,” “elect,” “defeat”—may be treated as express advocacy. Ads that praise or condemn clearly identified federal candidates but that carefully avoid using the magic words of express advocacy are labeled issue advocacy and are considered to be beyond the scope of regulation. Many so-called issue advocacy ads contain no discussion of issues at all. Most television viewers or radio listeners find these so-called issue ads indistinguishable from ads that contain the magic words of literal advocacy.

Electioneering ads that are deemed issue ads avoid federal reporting and disclosure requirements and may be funded by donations from cor-
porate and union treasuries. Parties may pay for issue ads with corporate and union donations, and with individual donations that exceed FECA’s limits. Party spending on issue ads is not subject to FECA’s limits on coordinated expenditures, even when the ads benefit a candidate who has accepted public funding and spending limits.

The Commission recommends that FECA be amended to provide that:

1. any advertisement that is coordinated with a candidate shall be treated as a contribution to that candidate even if the content of the advertisement avoids words of express advocacy;
2. any communication by a committee of a major political party that mentions by name or includes the likeness of a clearly identified federal candidate shall be treated as express advocacy subject to the expenditure limitations and reporting and disclosure requirements applicable to such advocacy; and
3. any communication that clearly identifies by name or likeness a candidate for federal office shall be presumed to be express advocacy if broadcast or published within the 30 days prior to a primary or general election; this presumption, however, may be rebutted by a showing that, based on the content and context of the speech, viewers, listeners, or readers are unlikely to treat the communication as election-related.

We recognize that these recommendations present important constitutional questions and that they depart from the current judicial definition of express advocacy. Nevertheless, for the reasons we lay out in the body of this Report, we believe that these proposals are constitutional and will withstand judicial scrutiny.

(5) Federal Election Commission

Effective enforcement is essential to any system of campaign finance law, but the current Federal Election Commission has failed to provide effective enforcement. Many of the problems with the FEC are built into its basic structure, including the even number of commissioners, the lack of a long-term chair, and the partisan appointments process, as well as congressionally imposed restrictions on the FEC’s investigatory and enforcement powers. As a result, the FEC is frequently incapable of taking effective action against the major parties or their candidates.

We recommend that the FEC be restructured, with an odd number of commissioners, a chair who is appointed to serve for at least two years,
and at least one member who is not affiliated with any major political party. We also recommend simplifying the FEC’s cumbersome multistep enforcement process, increasing its ability to detect violations by empowering it to conduct random audits, and providing for enforcement during the real time of a contested election by allowing the FEC to go to court and seek expedited relief in appropriate cases.

Finally, we urge Congress and the President to take seriously their responsibility for effective enforcement of the campaign finance laws by depoliticizing the appointments process and by providing the FEC with the additional resources necessary for it to discharge its many tasks.

We emphasize that all the elements of this comprehensive program are closely intertwined and interdependent. Raising contribution limits is desirable only if the other steps are taken to eliminate soft money, strengthen FECA, and provide public funding, thereby balancing the effects of larger private donations with more effective enforcement of the new limits and with public money that can dilute the impact of special-interest influence. Banning soft money and regulating issue advocacy assume both an increase in the hard dollar contributions and the provision of public funding as well as effective enforcement of the new rules to ensure that these restrictions do not make it more difficult for candidates to fund their campaigns and do not create incentives for the future development of campaign finance techniques that would evade these desirable regulations. Public funding assumes effective and enforceable controls on soft money and issue advocacy, lest the public-funding system be overwhelmed by large and unregulated donations from outside the system. Higher, but effective, restrictions on private contributions may be desirable to ensure that the proposed public-funding system is, as the Supreme Court has said the Constitution requires, truly a voluntary option for participating candidates.

We believe that our package of proposals, taken together, can produce a campaign finance system that is more open and competitive, provides voters with greater information, reduces the burdens of fundraising, reduces the undue influence of large donors on governance, better respects the norm of voter equality, and is more effectively enforced than the current system. (See table 1.)
### TABLE 1: SUMMARY OF RECOMMENDATIONS

#### PUBLIC FUNDING
Authorize voluntary, partial public funding in Congressional elections
- for primary and general elections
- for qualifying candidates
- $2:$1 match for each private donation up to $250 per individual donor
Qualifying by raising
- House—$25,000 (with only $250 per individual in-state donor counting)
- Senate—between $25,000 and $250,000, depending on state population (with only $250 per individual in-state donor counting)
Limit on candidate’s use of personal/family funds
Spending limit
- House—$1 million per election cycle, subject to cost of living adjustment
- Senate—in states with voting-age population (VAP) less than one million, limit of $1 million + $2.00 per voting-age person. In states with VAP greater than one million, limit of $1 million + $1.50 per voting-age person
Spending limit raised if participating candidate has high-spending non-participating opponent

#### CONTRIBUTION LIMITS
Limit on individual donation to candidate raised from $2000 per election cycle to $6000 per election cycle.
- and adjusted for future inflation
Limit on individual donations to party committees removed, subject only to limit on total donations by an individual
Limit on total donations by an individual to candidates, PACs, and parties raised from $25,000 per calendar year to $75,000 per calendar year
- and adjusted for future inflation
Limits on donations to and by PACs unchanged, but in the future to be adjusted for inflation

#### SOFT MONEY AND THE POLITICAL PARTIES
Federal officeholders and candidates forbidden from dealing with soft money
National party committees forbidden from dealing with soft money
State party committees forbidden from dealing with soft money for federal election activity
State party committees may use soft money for mixed federal-nonfederal activities subject to allocation,
- with approximately 60% of funds in hard money
Limits on party contribution/coordinated expenditures in support of candidates to be doubled
Party spending in support of a nominated candidate defined as a coordinated expenditure
All party spending in support of a candidate who has received a party contribution or benefited from a party coordinated expenditure is defined as coordinated

**ISSUE ADVOCACY/EXPRESS ADVOCACY**
All communications coordinated with a candidate are express advocacy
All communications by a political party that mention by name, or include the likeness of, a clearly identified federal candidate are express advocacy
Rebuttable presumption that all communications by any individual or organization that mention by name, or include the likeness of, a clearly identified federal candidate within 30 days of a federal election are express advocacy

**FEDERAL ELECTION COMMISSION**
Seventh commissioner to be appointed; must not be affiliated with a political party
Strong chair to be appointed for a two-year term
Civil enforcement process to be simplified
Random audit authority to be restored
Power to seek expedited relief authorized
Additional resources to keep pace with level of federal campaign activity

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**TABLE 1: SUMMARY OF RECOMMENDATIONS, continued**

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DOLLARS AND DEMOCRACY

The Commission on Campaign Finance Reform*

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* Many of the members listed below submitted separate statements regarding all, or aspects of, the report.

** The Commission dedicated its efforts to Cyrus Vance, whose health did not permit him to serve during the latter part of its endeavor. His life in public service has been a model of the legal profession at its very best.
21st Century
Trademark Basics

The Committee on
Trademarks and Unfair Competition

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I. TRADEMARK RIGHTS

A. What is a Trademark?

A trademark is a word or other kind of symbol that is used by a person or company to distinguish its goods or services and indicate their source. For example, Ford Motor Company uses the trademark MUSTANG to distinguish a line of cars.

1. What is capable of trademark registration?

Under the United States Trademark Act ("Lanham Act"), 15 U.S.C. Sec. 1051, et seq, a trademark may be “any word, name, symbol or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured or sold by others.” Although the Lanham Act’s definition of what is protectable as a trademark appears to be short and simple, the scope of its potential coverage extends as far as the creativity of marketing executives and is limited only by the decisions of judges and the U.S. Patent and Trademark Office.

The most common and straightforward protection extends to words. For example, PALMOLIVE is a famous trademark. Because the statute talks about a “combination” of any of the elements, a series of words turned into a slogan (e.g., SOFTENS HANDS WHILE YOU DO DISHES) can also be protected as a trademark. Of course, the slogan must function as a
trademark, which usually means that it must be on the goods themselves rather than just in advertising.

Even a single letter or a group of letters (or numbers) that do not make up a word can be protected as a trademark. For example, V-8 has been protected on vegetable juice and $ has been protected alone for Singer sewing machines. Phone numbers have been protected as trademarks—in one case, a retail mattress dealer with a 628-8736 phone number and the slogan “DIAL-A-MATTRESS and drop the last ‘S’ for savings” was able to obtain an injunction against the use of the slogan and telephone number 1-800-MATTRESS.

The key is that the words, letters, numbers or slogans should not be descriptive of the products or services but should serve as an identifier of the source of the products or services.

2. Can symbols or designs function as a trademark?

Symbols and designs are commonly used as trademarks. Some famous examples are the Nike “swoosh” and the Mercedes-Benz symbol. These symbols immediately convey the source of the goods to a consumer.

3. Can trade dress (that is, the design, appearance and/or shape of a product or its packaging) function as a trademark?

When the design and appearance of the product and packaging, with other elements that create the overall image, identify the source of the product, then this trade dress will be protected. To be considered trade dress, the combination of elements must be distinctive (either inherently or through acquired secondary meaning1) and cannot be functional. Examples of protected trade dress include the design of the Dodge VIPER, the combination of features on a jug of maple syrup and a toy bank that resembled a small flush toilet.

Similarly, distinctive elements that are used to identify the source of a service may be protected as trade dress: An example of service mark trade dress might be the distinctive décor of a restaurant chain.

4. Can colors function as a trademark?

For some time, it was unclear whether color alone could function as a trademark. In 1995, the Supreme Court settled the issue, holding that even a single color could be protected as a trademark as long as the color did not serve a utilitarian function. Qualitex Co. v. Jacobson Prods. Co., 514

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1. For a definition of secondary meaning, see the Answer to Questions I.A.9 and I.B. below.
U.S. 159 (1995). Usually, for a single color to serve as a trademark, a plaintiff will have to demonstrate secondary meaning, i.e., that the public associates the color with the source of the goods in question. An example is the pink color used on the Owens-Corning insulation.

5. Can one's name function as a trademark?
Generally, surnames and first names can be protected as trademarks only upon proof that they have acquired distinctiveness and secondary meaning through use. For instance, if the public has come to associate the name with goods or services that come from a particular source, then the name functions as a trademark and is entitled to protection. However, there is generally considered to be a qualified right of an individual to use her own name, even if that name has been trademarked by someone else. Courts may require disclaimers or other measures to prevent confusion on the part of the public in such situations.

6. Can non-visual marks such as sounds and smells function as a trademark?
There is little law on the protection of sounds, smells and other marks that are detected through non-visual senses. However, the Trademark Rules of Procedures allow marks that are “not used in printed or written form” to be registered, and the U.S. Patent and Trademark Office has on occasion permitted the registration of these “non-traditional” trademarks. Certificates of registration have been issued for sounds such as the roar of the Metro-Goldwyn-Mayer lion and the sound of the NBC “chimes.” In 1990, the Trademark Trial and Appeal Board ruled that a fragrance could serve as a trademark and permitted the registration of a scent in connection with sewing thread and embroidery yarn. The TTAB emphasized the evidence required to obtain such a registration is substantial, and that scents could not be registered as trademark for products such as cologne and perfume, where the scent is considered to be functional.

7. Are all trademarks equal in strength?
Not all trademarks are created equal. In the vast array of trademarks that consumers encounter in the marketplace, some marks are stronger than others. While some marks start out strong, others gain strength through time and effort. A strong mark is a mark that is distinctive in connection with the goods or services with which it is used, and, as a result will be readily recognized by consumers as a source indicator. The varying levels of distinctiveness are described below.
8. What is the difference between inherently distinctive and non-distinctive marks?

Inherently distinctive marks serve as source indicators the minute they are created. There are three types of inherently distinctive marks: arbitrary marks, fanciful marks and suggestive marks.

- Arbitrary marks are common words or symbols which are in common use but have no meaning in connection with the goods or services with which they are used. Some examples are, PENGUIN for books, and APPLE for computers.

- Fanciful marks are coined words or symbols that are created to serve as a trademark. Generally these words or symbols are readily recognized as source indicators because they have no other meaning. Some examples are, PROZAC for pharmaceutical preparations and CLOROX for bleach.

- Suggestive marks are trademarks which suggest a characteristic of the goods or services, but do not directly describe the goods or services. Some examples are MIRACLE GRO for plant fertilizers and SNACKWELLS for cookies.

Non-distinctive marks generally cannot be trademarked because they are either the generic names, and therefore not an indicator of the source of the goods or services, or they are so highly descriptive that consumers will never perceive them as indicating the source of the goods or services. For example, it is likely that the use of “WHITE” on white rice would never be perceived as a source indicator. Consumers would likely perceive this as a generic description that only describes the goods, not their source.

9. Can a mark “acquire distinctiveness”?

Some marks are not distinctive at their inception but grow to be distinctive over time. These words or symbols initially may not be recognized as trademarks for a variety of reasons. For example, the relevant wording may be descriptive of the goods on which it is used, or the name of the geographic origin of the goods. As a result, consumers would not immediately recognize the word or symbol as a source indicator.

Nevertheless, it is often possible for such designations to acquire distinctiveness and become source indicators, through efforts such as extensive use of the mark in commerce, or widespread advertising and promotion. Thus, while the wording EVEREADY at one time may have been perceived as a laudatory description of the readiness of batteries, this wording is now readily recognized by consumers as a trademark.
B. What is Secondary Meaning?

Things can become protectable trademarks in two ways: by being inherently distinctive or by becoming distinctive (see Questions I.A.8 and I.A.9, above). ‘Secondary meaning’ is another term used to indicate ‘acquired distinctiveness’ and means that the mark has come to indicate to consumers that goods or services bearing the mark come from or are sponsored or endorsed by one source. Thus, a phrase that has a ‘primary,’ natural meaning, e.g. ‘bird’s eye,’ comes to have a ‘secondary’ meaning—a brand of frozen food.

C. How Do You Prove Secondary Meaning?

To show that something has acquired secondary meaning, the following evidence is admissible:

- Age and history of the mark.
- Amount of effort and expenditure used to promote the mark as a name or symbol distinctive of the plaintiff’s goods or services.
- Conscious attempts by competitors to imitate the mark. Courts are divided over the evidentiary significance of conscious copying. Some circuits hold that evidence of conscious copying of a mark raises a presumption of secondary meaning, while other circuits hold that it is merely evidence of secondary meaning.
- Actual confusion.
- Consumer surveys.
- Registration. Because registered trademarks are presumed to be distinctive, owners of registered marks need not plead or prove secondary meaning, and may instead rely on a presumption of secondary meaning.

D. Can Others Still Use a Descriptive Mark to Indicate its Primary Significance (Fair Use)?

Related to the doctrine of secondary meaning in the doctrine of fair use. Even where a word or phrase has acquired secondary meaning, it can retain its original primary meaning in English, if any, e.g. high grade (Hygrade). Such marks can still be used freely when they are, indeed, used in their original sense and not in a misleading fashion. Such use is called “fair use.”

E. Are There Different Kinds of Marks?

While the word “trademark” is commonly used broadly to describe
all “marks” there are actually several different kinds of marks that are protected under the law: trademarks, service marks, certification marks and collective marks.

1. What is the difference between a trademark and a service mark?
   A trademark is used to distinguish or identify the source of goods. Service marks are like trademarks except that they apply to services rather than goods. The same word or symbol can be both a trademark and a service mark. For example, NICKELODEON is a service mark for television entertainment services, and it is also used as a trademark for products such as clothing and plush toys.

2. What is a certification mark?
   Certification marks are marks which certify, among other things, the quality or other characteristics of goods or services. One example of a certification mark is the Underwriter’s Laboratories UL logo.

3. What is a collective mark?
   A collective mark is used by members of a collective organization, such as a union, to indicate membership in the organization. For example, AAA is a collective mark for the American Automobile Association.

F. Trademark Rights at Federal, State, Common Law Levels
1. How are trademark rights acquired?
   In the United States, trademark rights are acquired through use of the mark on or in connection with the goods or services. While registration of the mark usually provides substantive and procedural benefits to the trademark owner, trademark rights are not created by the act of registration. In fact, while an application for federal trademark registration may be filed before use of the mark commences, a registration will not issue until the mark has been used in commerce.

2. Can trademark rights be enforced if the mark has not been registered?
   Yes. The ownership of a trademark registration is not a prerequisite for filing a trademark infringement action. If the trademark has been used in a way that has created a public association between the mark and the products or services, the owner of the trademark may possess enforceable common law trademark rights. What are the benefits of having a Federal registration?
There are two types of federal registrations in the United States: Principal Register registrations and registrations on the Supplemental Register. (See Questions II.B.2 and II.B.3 below). Both Principal and Supplemental Registrations confer upon the registrant valuable procedural and remedial benefits. Among these benefits are:

- The registration can be used as a basis for suit in federal courts.
- The owner may use the ® registration notice, which tends to discourage third party innocent infringement.
- The registration will be located by Trademark Examiners when conducting trademark searches and may therefore be cited as a bar against the registration of similar marks in later filed applications.
- The registration will also be located in clearance searches conducted by third parties and may therefore discourage adoption of a similar mark.
- The registration can be the basis for collecting treble damages for infringement of trademarks.

Marks that are registered on the Principal Register confer the following significant additional benefits:

- A Principal Register registration is prima facie evidence of the validity of the registration and of the registrant’s ownership thereof. In an infringement action the owner of a Supplemental Register registration would be required to prove ownership and validity of its claim.
- A Principal Register registration is constructive notice of the registrant’s claim of ownership. A Supplemental Register registration is not deemed to be constructive notice of such a claim.
- A Principal Register registration can become incontestable under Section 15 of the Lanham Act, 15 U.S.C. Sec. 1065 (which means it is not thereafter subject to cancellation on the grounds that it is descriptive, among other basis). A Supplemental Register registration can never become incontestable.

3. When should a state trademark registration be considered?

The filing of state trademark or service mark registration is a relatively simple and inexpensive matter. Moreover, a state trademark regis-
Registration can often be obtained even in the case of a relatively non-distinctive mark. Although state registrations give minimal protection, the comparative ease and availability they afford gives rise to a preference of overall efficiency and economy. In addition state trademark registrations are appropriate for marks that are only used within a given state, because use in interstate commerce is a prerequisite of federal registration. However, as a result of today’s Internet revolution, interstate commerce may be practically automatic for companies that advertise their goods and services on the Internet.

II. FILING AND REGISTRATION PROCESS

A. PRE-FILING CONCERNS

1. Is it necessary to perform a trademark availability search prior to filing a trademark application?

There is no requirement that a trademark availability search be performed before the adoption of a trademark or the filing of a trademark application. Notwithstanding the foregoing, performing a trademark availability search is a reasonable and prudent step prior to the adoption of a mark because it may reveal that use of the mark would infringe upon a third party’s rights. Similarly, performing a trademark availability search may reveal existing trademark registrations that are likely to constitute a bar to registration of the proposed mark.

2. How is a trademark availability search performed?

Trademark availability searches can be performed in various ways and in varying degrees of complexity and comprehensiveness.

3. What is a trademark search report and how do you evaluate it?

A simple or initial search may include a basic search of trademark directories, or the use of online trademark search systems that contain federal and state trademark registration information. This type of search may reveal quickly and inexpensively whether there is a directly conflicting trademark.

A more comprehensive search, usually conducted by an independent search firm, will attempt to locate marks that, while not identical to the proposed mark, may be considered confusingly similar to the proposed mark. For example, a comprehensive search will attempt to locate marks that are synonyms for the terms in the proposed mark, or alternate spellings of the mark. A comprehensive search will also attempt to locate marks in related fields.
For example, the proposed mark may be the name for a record label that might be blocked by the name of a band or a music publishing company using the same or a similar name. The use of the mark as name for a record label might not, however, be blocked by the use of the same name for an automobile parts distributor or a furniture manufacturer. See Question IV.B below on likelihood of confusion.

A comprehensive search would also include a wider variety of sources than the preliminary search described above. Trademark search firms maintain and have access to databases that may reveal unregistered marks that exist at common law. Such databases include periodicals, trade directories, company name registration databases and other sources.

B. Issues for Federal Registration/Prosecution
1. What is the procedure for obtaining a federal trademark registration?
   The United States Patent and Trademark Office ("PTO") issues federal trademark registrations after a detailed application process. Specific information on the trademark application process, including downloadable and electronic application forms, can be obtained from the PTO website. Additional information is available from the International Trademark Association and from numerous publications and treatises, some of which are referenced in Section VII below.

2. What is the Principal Register?
   The Principal Register is the primary register in the United States. Only marks that are distinctive, or have acquired distinctiveness may be registered on the Principal Register.

3. What is the Supplemental Register?
   The Supplemental Register is reserved for designations which are deemed to be capable of serving a trademark function, but which do not yet do so, such as descriptive marks and marks which are primarily merely surnames.

4. What are the statutory grounds for the rejection of a trademark application?
   Section 2 of the Lanham Act prohibits registration of a mark that:

   • Consists of or comprises immoral, deceptive or scandalous matter (Example: Dick Heads and design of male genitalia for restaurant services),

   For example, the proposed mark may be the name for a record label that might be blocked by the name of a band or a music publishing company using the same or a similar name. The use of the mark as name for a record label might not, however, be blocked by the use of the same name for an automobile parts distributor or a furniture manufacturer. See Question IV.B below on likelihood of confusion.

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C. POST-REGISTRATION

1. Do trademark registrations need to be renewed?

Yes. Trademark registrations that issued or were renewed on or after November 16, 1989 must be renewed every ten years. The renewal application is due on the tenth anniversary of registration. The initial renewal period for registrations that issued before November 16, 1989 is twenty years, with subsequent renewals due every ten years.

2. Are there any other filings that need to be made after registrations?

Yes. Pursuant to Section 8 of the Lanham Act, 15 U.S.C. Sec. 1058, the owner of a trademark registration is required to periodically submit a declaration attesting to and demonstrating that the mark is still in use in commerce. The Declaration of Use must initially be submitted between the fifth and sixth anniversaries of registration, and subsequently with or during the same registration year as each renewal.

3. What is a Declaration of Incontestability and when may it be filed?

A federal trademark registration can become incontestable if the mark...
has been used continuously for any consecutive five-year period after registration upon the filing of a Declaration of Incontestability. Accordingly, either simultaneously with the filing of the Declaration of Use, or at any subsequent point, the owner of the trademark registration may file such a declaration attesting to the continuous use of the mark.

III. USAGE

A. Proper Usage of Notice Symbols (™ v. Statutory notice ®)

1. When and how should a trademark owner use the ® symbol?

The ® symbol may only be used in connection with marks that are registered with the PTO and only when used in connection with the goods or services covered by the registration. The symbol should be displayed next to the word, logo, or drawing which is registered at least once in all advertising and promotional materials. In addition or as an alternative, the notation “Marca Registrada” or “Registered in the United States Patent Office” may also be used. Similarly, a legend may be used stating that the words or logo are “a registered trademark of...” or simply “® followed by the name of the corporate owner.” Failure to include some indication that the mark is registered may result in a denial of certain damage awards in an infringement action.

2. What are the ™ and SM symbols and how may they be used?

The ™ and SM symbols are symbols that a trademark owner may use to indicate that a term is considered a trademark (™) or service mark (SM) when the term has not been registered. Use of these symbols puts third parties on notice that trademark rights are being claimed. The symbols should be used in the same manner that an ® is used for registered marks.

B. Maintenance of Trademark Rights

1. In what ways can one lose the right to a trademark?

Unlike copyrights or patents which have a limited life, trademarks, at least theoretically, can exist indefinitely. However, under certain circumstances, trademarks can be “lost.” A trademark is “lost” when it ceases to identify the origin or quality of the goods or services on which it is used. The most common ways to lose a trademark are through (1) abandonment; (2) using the mark in a “generic” manner; (3) licensing the mark indiscriminately; and (4) failing to prosecute infringers.

Under the Lanham Act, a mark will be deemed abandoned when the trademark owner has discontinued use of the mark in connection with
the particular good or service and has no intent to resume use within the reasonably foreseeable future. In general, nonuse for three consecutive years creates a presumption of abandonment. A trivial or token interim use will not be sufficient to avoid a finding of abandonment. Even longer periods of nonuse will not create a presumption of abandonment under some circumstances. One is when the goodwill in the mark continues after the nonuse (i.e., where the public still associates the mark with the owner and its product or service). Another is when there is an explanation for the nonuse (i.e., the owner is in the process of re-positioning the product or its market). Finally, abandonment will also not be presumed if nonuse is caused by factors beyond the owner’s control (i.e., war, labor strike, import problems, or some natural catastrophe). If a mark truly has been abandoned through nonuse, a subsequent resumption of use will not revive it. In such a case, the trademark owner must start to build trademark rights anew.

2. What if a mark has not been used in a few years or has been used only minimally?
Because trademark rights are based on use, when a trademark owner discontinues its use of a mark, this can result in abandonment. However, the fact that use of the mark has stopped does not, by itself, mean that it has been abandoned.

In order for a mark to be abandoned, the owner must (1) intend not to resume use or (2) act in such a manner that its claims to resume use are not reasonable. Thus, while temporary cessation of use does not mean a mark has been abandoned, a trademark owner cannot “warehouse” a mark that it is truly not using merely by claiming that it intends to resume use.

3. What happens to a mark when the public adopts it as a generic name for a product or service?
Trademark rights can also be lost when the mark is used as the generic name for a product or service and thus ceases to serve its function of identifying the source (and quality) of the product or service. When a trademark owner itself uses the mark as a generic term or allows others to do so, rights are lost and it becomes available for use by all. While an occasional descriptive use will not cause a trademark to be lost, widespread generic use will. Examples of once-strong trademarks that have become generic through descriptive or generic use include “yo yo,” “cellophane,” “trampoline,” “escalator,” “thermos,” “aspirin” and even “raisin bran.”
To avoid this result, trademark owners should be careful to use the mark as a brand name rather than descriptively. A trademark can be lost if it becomes generic (i.e., when it is used to describe a product or service rather than to identify its source and quality). A trademark owner may avoid widespread generic use by: 1) using it as an adjective as opposed to a noun (i.e., “KLEENEX tissue” not “a kleenex”); 2) capitalizing the trademark or otherwise setting it apart from surrounding text; or 3) using it in conjunction with the term “brand” (i.e., “SCOTCH brand tape”). All of these measures will have the effect of preserving the trademark’s value as a “brand name” and will discourage its use as a generic term.

4. What is a trademark or service mark owner’s responsibility when licensing a mark for use by third parties?

While a trademark can be licensed to another by the owner, the owner must exercise control over the quality of the licensee’s goods. Therefore, in order for the owner to trademark its mark and keep ownership of it at the same time certain responsibilities in the arrangement are called for. Merely licensing the trademark to another without controlling the quality of the licensee’s goods will result to the loss of ownership over the trademark. Such a license is a license in gross and a naked license.

Quality control by the licensor can take various forms. The following are forms of general standard provisions that impose some responsibility on the owner to maintain quality control: (1) the owner shall have the right to control the quality of the licensee’s products; (2) written specific guidelines or standards must be followed by the licensee; (3) the owner shall have the right to inspect the licensee’s premises and production processes; (4) the licensee shall provide product samples to the licensor according to a specific schedule; and (5) the owner shall have the right to disapprove packaging and advertising by the licensee.

5. What are some of a trademark or service mark owner’s other responsibilities to preserve its rights in its mark?

The owner must take action against third party infringers of the mark. In short the owner must “police” his mark. Failure to prosecute infringers can substantially weaken the strength of the mark and thus the owner’s ability to stop future unauthorized use. Once infringement is discovered the owner should take prompt action against it. Many infringements can be addressed by sending cease and desist letters.
IV. CONFLICTS WITH THIRD PARTIES

A. Inter Partes Proceedings Before the Trademark Trial and Appeal Board

1. Can a member of the public or a competitor challenge a trademark application before a registration issues?

All trademark applications that have been approved for registration are published in a weekly Official Gazette. Any party that believes it will be injured by the issuance of a trademark registration may oppose that registration by filing a Notice of Opposition within the permitted time. Once a Notice of Opposition has been filed, the application file is transferred to the Trademark Trial and Appeal Board, a quasi-judicial administrative tribunal within the PTO, and proceedings are instituted. An opposition proceeding is similar to litigation in that discovery is permitted, testimony is recorded and briefs are submitted. Decisions of the Trademark Trial and Appeal Board may be appealed to the United States Court of Appeals for the Federal Circuit.

2. Can a member of the public or a competitor challenge a trademark registration after it has issued?

If at any time after a mark has been registered, a third party believes that the registration is statutorily invalid, that party may file a petition for cancellation of the registration. Cancellation proceedings are similar to oppositions and are also considered by the Trademark Trial and Appeal Board.

B. Infringement

1. When is use of a trademark an infringement?

The key issue in determining infringement is whether there is a likelihood of confusion caused by the alleged infringer’s use of the owner’s mark (or something similar).

The courts look at several factors in assessing likelihood of confusion. The factors are:

- The strength of the mark. Is the mark well-known? Has the owner devoted much time, money and effort to publicize the mark? How closely is it associated with the owner and its products and services?
- The degree of similarity between the mark and the thing alleged infringer is using—how close are they in appearance, meaning or sound?
The proximity of the parties' products—are they in the same product category? Do they use the same channels of distribution?

The likelihood that, if the parties' products do not directly compete, they will sometime in the future 'bridge the gap' that currently exists.

Actual confusion. Is there anecdotal evidence of confusion? Does the owner have a survey of consumers demonstrating confusion?

The intent of the defendants—did defendant know of plaintiff's mark? Did defendant deliberately copy plaintiff's mark?

The quality of the products—is defendant's product clearly inferior to plaintiff's?

The sophistication of the purchasers—are they discerning or careful enough that confusion is unlikely?

The court will balance these factors, and a trademark plaintiff need not prevail on each of them to succeed on its claim. For example, actual confusion is not required. Malicious intent is not required—a defendant who acts in complete good faith may still be prevented from using its own mark. Generally, and as one might expect, courts use common sense in balancing the relevant factors.

2. What is the difference between trademark infringement and unfair competition?

Unfair competition is the same as trademark infringement except without the requirement of the existence of an enforceable trademark. Seriously, unfair competition is the creation of a false impression as to the source, origin, sponsorship or endorsement of products or services without the use of a trademark. There is a federal version of unfair competition embodied in §43(a) of the Lanham Act, 15 U.S.C. Sec. 1125(a), which prohibits the use, with goods or services, of a false designation of origin or a false or misleading description or representation of fact. A claim of unfair competition may arise from the same facts as a claim for trademark infringement if a trademark is used in a way which creates a false designation of origin or a false or misleading description or representation of fact.

New York, like many states, has a body of legislation aimed at "deceptive business practices." Often, causes of action for unfair competition
under state common law are accompanied by such claims. See N.Y.B.C.L. Sec. 349 (which precedent has construed as being applicable to competitors, so long as there is an element of injury to the public at large). This "amorphous" cause of action may be used for claims sounding in false designation of origin, false advertising, etc. and has a six year statute of limitations compared with the three year period available for claims for common law unfair competition.

3. What is trademark dilution?
Trademark dilution is the use of a mark or trade name in a way that dilutes the distinctive quality of a famous mark. To establish a claim for dilution, the owner of a famous mark does not need to demonstrate that there is any competition between its goods or services and those offered under the offending mark, or that there is any likelihood of confusion. Traditionally, the courts have found two types of dilution to be actionable: dilution by blurring, and dilution by tarnishment.

a) What is dilution by blurring?
Dilution by blurring is the traditional injurious impact of dilution as envisioned by its original proponents and occurs when customers or prospective customers see the plaintiff’s mark used by other persons to identify different sources on many different goods and services. See J.T. McCarthy, McCarthy on Trademarks, §§ 24:68, 24:94. The unique and distinctive significance of the mark to identify and distinguish one source may be diluted and weakened, but no confusion as to source, sponsorship, affiliation, or connection has occurred. A hypothetical example of dilution by blurring would be the effect on the famous KODAK mark if it were used on pianos or ball gowns. While the average consumer would be unlikely to believe that Eastman-Kodak had begun to manufacture these items, KODAK would cease to become a unique identifier of Eastman-Kodak cameras and related products.

b) What is dilution by tarnishment?
Dilution by tarnishment can arise where the effect of the defendant’s unauthorized use is to degrade positive associations of the mark and thereby dilute the distinctive quality of the mark. Since a tarnishing use lessens the ability and capacity of a famous mark to identify a certain standing or reputation of type, quality, or wholesomeness of goods or services, the definition of dilution under the federal statute may be read to include tarnishment. In Hasbro, Inc. v. Internet Entertainment Group, Ltd., 40 U.S.P.Q.
2d 1479 (W.D. Wash. 1996), the court held that the mark “candyland.com,” which was used for an Internet web site showing sexually explicit pictures, diluted by tarnishment the famous mark CANDYLAND for a children’s board game.

c) What are the statutory defenses to a federal dilution claim?
Section 43(c) of the Lanham Act, 15 U.S.C. Sec. 1127(c)(4) defines three defenses to a claim of dilution under the federal statute: comparative advertising, non-commercial use, and news reporting and commentary. The comparative advertising defense is conditioned on the challenged use being “fair.” For example, use of a famous mark in a purely non-trademark, descriptive sense would be fair, while altering the famous mark in an advertisement so as to lead consumers to associate undesirable characteristics with the mark would be unfair.

The non-commercial use defense is intended to permit the use of a trademark in, for example, a negative product review in the media. See House Report 104-374 (Nov. 30, 1995).

4. What is counterfeiting?
A particularly egregious form of trademark infringement is called counterfeiting. See Lanham Act, Sec. 32(d), 15 U.S.C. Sec. 1116(d). Counterfeiting consists of the use of a substantially identical copy of a registered trademark on the same goods or services for which the original mark is registered. There are special remedies for counterfeiting including ex parte seizure orders, treble damages and statutory damages.

V. TRADEMARK AND THE INTERNET
A. Does Registering a Domain Name Automatically Trigger Trademark Protection of that Name Worldwide?
No. It is true that an internet site may be accessed through the domain name by internet users anywhere in the world. Courts in the United States have ruled that mere registration of a domain does not constitute use of the domain name as a trademark. The offering of goods or services through a website, however, usually does constitute interstate use for the purposes of U.S. trademark protection. Accordingly, if the domain name is distinctive, common law trademark rights will arise upon activation of the website. Domain names that consist merely of a descriptive or generic term for the goods or services offered on the website may be difficult to protect as trademark.
The foregoing is not necessarily true outside of the United States. Trademark rights are territorial, and the trademark laws of foreign countries vary widely. In fact, a number of countries will accord trademark protection only to a mark that has been registered in their country. Therefore, if the domain name owner seriously intends to effectively deter or prosecute infringers abroad, foreign trademark registrations may have to be sought.

B. May Registration of a Domain Name Subject the Domain Name Registrant to Liability for Trademark Infringement?

As stated above, in the United States, mere registration of a domain name does not constitute use of the domain name as a trademark. Accordingly, the courts have found that mere registration of a domain name, with no other act, does not constitute trademark infringement. Use of the domain name in connection with an active website, may however, trigger liability. In addition, registration of a domain name that consists of or contains a well-known trademark may constitute trademark infringement or dilution if the domain name registrant registered the domain name with the intent to sell it back to the trademark owner for a profit, or otherwise registered the domain name in bad faith.

Like any other user of a mark, a domain name registrant should consider having a thorough clearance of the domain name performed before embarking upon an extensive marketing campaign using the name or other activity that might subject the domain registrant to liability. Due to the international nature of the internet, the domain name registrant may be well advised to consider performing availability searches in foreign countries where the website is expected to be frequently accessed.

C. What is Cybersquatting?

Cybersquatting is a broad term used in the trademark and internet communities to describe the bad faith registration of domain names. Cybersquatting encompasses registration of domain names containing trademarks, either to sell back to the trademark owner or prevent the trademark owner from using the domain name. Cybersquatting has also been used to define certain types of wholesale domain name registration and warehousing.

1. Is there a law that regulates cybersquatting?

Congress recently enacted the Anti-Cybersquatting Consumer Protection Act which prohibits certain types of cybersquatting. The statute...
amended the Lanham Act to make it a type of trademark infringement if a domain name containing a distinctive or famous trademark is registered in bad faith.

2. What are some of the benefits conferred by this Act?
The Act provides certain benefits not previously available to trademark owners.

• Beyond the damages which are conventionally available in a trademark infringement action, the Act gives trademark owners the opportunity to elect to recover statutory damages between $1000 and $100,000 per domain name.

• When a trademark owner cannot obtain in personam jurisdiction over a domain name registrant, either because the person used an alias in registering the domain name or is outside the jurisdiction of the United States courts, the trademark owner may file a civil in rem action against the domain name. In these civil in rem actions, the relief is limited to transfer of the domain name to the trademark owner, cancellation or forfeiture.

D. Can Trademark Owners Complain to the Domain Name Registrar if they Believe a Domain Name was Improperly Registered?

According to the most recent regulatory framework, the Internet Corporation for Assigned Names and Numbers (“ICANN”) has established a uniform domain name dispute resolution policy that is applicable to all registrars of .com, .net and .org domain names. Currently, ICANN accredits domain name registrars. As a result, Network Solutions, Inc. (NSI) and other domain name registrars are required to adopt ICANN’s new policy, which became effective between December 1, 1999 and January 1, 2000.

1. Are there any differences between the new Domain Name Dispute Resolution Policy and prior such policies?
The drastic differences between the new policy and prior policies such as those issued by NSI are:

• no longer will domain name registrars place domain names on hold during a dispute;

• as well as federally registered trademarks, the new policy also recognizes state and common law trademarks;
under the new policy, domain names that are confusingly similar to a registered trademark can be challenged. The previous policy enacted by NSI only recognized identical trademarks.

VI. COMMON MISCONCEPTIONS

The following is a brief list of common misconceptions regarding trademarks:

**MISCONCEPTION:** Anyone can use a ® symbol.
**REALITY:** The ® symbol can be used only in connection with registered trademarks.

**MISCONCEPTION:** A ™ or SM symbol can be used only if a trademark application has been filed.
**REALITY:** There are no legal requirements governing the use of the ™ or SM symbols. Anyone claiming common law trademark rights may use these symbols.

**MISCONCEPTION:** A trademark owner can stop anyone from using the trademark for any goods or services.
**REALITY:** There can be more than one trademark consisting of the same term—i.e. FORD cars and FORD MODELS.

**MISCONCEPTION:** One has no rights in a trademark if it is not registered and if the mark is registered there are automatically rights.
**REALITY:** Trademark rights stem from use of the mark, not from registration. Accordingly, rights in a mark may exist at common law without a registration. Similarly, the ownership of a registration does not guarantee that there does not exist a prior, unregistered user whose rights may be superior to those of the registrant.

**MISCONCEPTION:** Ownership of a domain name confers trademark rights.
**REALITY:** Mere registration of a domain name confers no trademark rights. If the domain name is not being used as a trademark (e.g. there is an active, branded website associated with the domain name), then a subsequently filed trademark application may confer superior rights on the applicant.
MISCONCEPTION: Ownership of a corporate name registration with the Secretary of State confers trademark rights, or insulates the business from trademark infringement claims.

REALITY: The various Secretaries of State do not conduct comprehensive trademark searches prior to registering corporate names. The mere fact that a company has been registered under a given name confers no substantive trademark rights in that name.

VII. REFERENCES

Numerous resources are available to both attorneys and members of the general public regarding issues of trademark law, practice and procedure.

A. Government Resources and Information

1. www.uspto.gov—The United States Patent and Trademark Office website contains a wide variety of useful information relating to trademark law and prosecution, including a searchable database of United States trademark registrations, an extensive FAQ file, and downloadable and electronic application forms.

2. USPTO Basic Facts About Trademarks booklet—available in hard copy or on line at the USPTO website.

3. Title 17 of the USCA—contains the full text of the Lanham Act and all subsequent amendments.

4. Title 37 of the Code of Federal Regulations—contains the Rules of Practice before the USPTO.

5. The Trademark Manual of Examining Procedures—available on line at the USPTO website and in hard copy from several sources—is the manual used by Trademark Examiners at the USPTO in examining applications and post-registration materials.


B. International Trademark Association

1. www.inta.org—The International Trademark Association website contains basic trademark information and a catalogue of useful pamphlets, books and other publications.
C. Treatises
1. McCarthy, J. Thomas, McCarthy on Trademarks and Unfair Competition, 4th edition (West)
2. Gilson, Jerome, Trademark Protection and Practice (Matthew-Bender)

D. Trademark Search Firms
1. CCH Trademark Research Corporation—(800) 872-6275 and www.cch-trc.com
2. CorSearch—(800) 732-7241 and www.corsearch.com
3. Thomson & Thomson—(800) 692-8833 and www.thomson-thomson.com

The Committee on Trademarks and Unfair Competition

Mavis K. Fowler, Chair
Susan L. Crane, Secretary
The Twelfth Retreat of
the Council on Criminal Justice

Policing and the Community in the 21st Century: Searching for Common Ground

The Council on Criminal Justice

The Council on Criminal Justice hosted its Twelfth Retreat on April 1, 2000 at the House of the Association. The Retreat, entitled “Policing and the Community: Searching for Common Ground in the 21st Century,” gathered law enforcement leaders, attorneys, community leaders, academics, policy makers and members of the press to search for common ground on issues of race and policing in the aftermath of the Abner Louima, Amadou Diallo, and Patrick Dorismond tragedies.

The all-day conference included three sessions. The morning session consisted of a panel discussion led by NYU Law School Professor Burt Neuborne and focused on issues of race, drug enforcement, and community relations that were posed in a hypothetical scenario. United States Customs Commissioner, and former New York Police Commissioner, Raymond W. Kelly was the keynote luncheon speaker and advocated a return to community policing. The afternoon session consisted of presentations by Harvard Law School Professor Randall Kennedy on racial profiling, NYU Law School Professor Jerome Skolnick on police culture, and Dr. Joseph McNamara of the Hoover Institution on the war on drugs.1

THE MORNING SESSION

President’s Welcome and Introduction

Association President Michael Cooper welcomed the participants and stated that the conference may be the Association’s most important in a

1. This Report was written by Lauren C. Panora, the Secretary of the Council on Criminal Justice.
long time. He emphasized that because minorities and other citizens regard the New York City Police Department with hostility, fear, and even distrust, the subject of policing and the community presented the single, most complex set of issues now confronting New York City. These feelings, he said, are supported by irrefutable statistics that show that African-Americans and Latinos receive very different and far harsher treatment at the hands of the police than do whites. Although some may say or may think, but not be willing to say, that disparate treatment of communities is the inevitable price of reducing the incidence of violent crime, he refused to believe that is so.

Mr. Cooper observed since it was founded, the Association has been dedicated to the improvement of the administration of justice, and that police conduct is the front line of the administration of justice; therefore, it not only invites, but truly commands everyone’s attention. He hoped that by bringing together people who are thoughtful and committed to upholding the rule of law, they could lead, in the words of the title of the Retreat, the search for common ground, and that the suggestions and possibilities discussed will be the subject of discourse in the days to come.

The Panelists
Brooklyn Law School Professor William E. Hellerstein, Chairperson of the Council on Criminal Justice, introduced the members of the morning’s round table:

Richard Green, Chief Executive of the Crown Heights Youth Collective and Professor of History at Medgar Evers College;
Barry Kamins, a partner in the Brooklyn law firm of Flamhaft Levy Kamins Hirsh & Booth, and the author of New York Search and Seizure Law;
Eve Burton, Vice President and Deputy General Counsel of The New York Daily News;
Richard Condon, former New York Police Commissioner;
The Honorable C. Virginia Fields, Manhattan Borough President;
Zachary W. Carter, a partner in the firm of Dorsey & Whitney and former United States Attorney for the Eastern District of New York;
Richard Dienst, a partner in Dienst & Serrins with 30 years of experience representing federal and New York law enforcement officials;
Richard Emery, a civil rights litigator and a partner in the firm of Emery Cuti Brinckerhoff & Abady; and
Frank Wohl, a partner in the law firm of Lankler Siffert & Wohl and Chairman of the New York Civilian Complaint Review Board.

The Panel Discussion
Professor Neuborne opened the discussion by pointing out that New York City had experienced the fatal shooting by the police of at least four unarmed African-American men and that, as result, there is a crisis of confidence in the police force throughout the minority community and beyond and a deterioration of race relations generally in the city. On the other hand, he noted, there has been a dramatic decrease in crime, once thought impossible, especially in minority communities. Consequently, he observed, there is a collision between two absolutes: the absolute unacceptability of an aggressive police presence that turns the police into an occupying army that frightens and degrades the minority community, and the absolute unacceptability of relaxing efforts to reduce crime and return to an era of passive policing in which crime was rampant; the challenge, he said, is to achieve both a respectful police presence and a strong police presence that can deal effectively with crime.

Should aggressive police tactics be deployed to fight a war on drugs?
Before turning to the facts of the hypothetical, Professor Neuborne posed a general question about the propriety of aggressive street policing in order to disrupt the control of mid-level drug distribution on the streets.
Former Police Commissioner Richard Condon stated that allocation of police resources is a function of the events of the time. He explained that in the 1980s, a high proportion of murders were drug-related. Gang-related murders included police officers’ deaths. Therefore, resources were allocated for more police officers. So long as drugs are part of the City of New York, he would allocate resources to that problem and, if past results demonstrated that allocation of police resources for street level, buy-and-bust operations were effective, he would continue that strategy.
Professor Neuborne asked Professor Green whether aggressive street policing to tackle drug issues was appropriate at all. Professor Green observed that in 1979, cocaine was a $2 billion a year business in America; it is now a $200 billion a year industry. In 1979, cocaine was called a recreational drug. By 1985, the crack-cocaine industry came into focus, and lead society to declare war on drugs. As a result, young men who began
using cocaine while it was just a “recreational drug” became the focal point of the war and the consequence of our failure to go after cocaine as should have been done earlier. Law enforcement resources should be concentrated on the high-level importers of drugs instead of low-level street dealers; rather than baiting innocent young men on the streets by asking “where can you buy some drugs around here?” the police should be deployed at points of entry.

Professor Neuborne then asked Richard Dienst whether cops should be put on the street to perform buy-and-bust undercover operations that can lead to tragic shootings. Mr. Dienst replied that the single largest cause of crime in this city is the drug trade and those who fail to accept that have their heads in the sand. Even if interdiction at airports or other ports of entry is attempted, drugs are going to get into this city because we, as a society, have a demand for drugs and they will be distributed at street level because the profit margin is so extraordinarily high. Therefore, he stated, the police must prevent those street level sales. Otherwise, there will be gang wars and a parade of horribles that includes drug dealers shooting at one another, innocent children being shot, mothers afraid to buy a quart of milk for fear of getting mugged, and spouses who are afraid to go out, or to send the children out, for fear of getting shot in the street. He maintained that society must deal with two issues: (i) the misperception that the community has about the police and the police function and (ii) the misperception that the police have as far as the community is concerned. Nevertheless, cops must be out there, taking the drugs off the street, or drug proliferation will expand to such an extent that we will all be hiding behind locked doors.

Borough President Fields stated that drug enforcement is needed on both the high-level end and the street level. She agreed with Richard Green that as long as enforcement is limited to the street level, the source of the problem is not adequately addressed. Having observed many communities ravaged by drug sales and drug activities over the last 20–25 years, she believes that communities welcome new police initiatives. However, too often, various narcotic programs merely sweep the problem out of one neighborhood and into another. Although she appreciated having police officers in the community to remove narcotics from the street, it is the manner in which the work of the police is being carried out that has become the real problem. She stated that most of the drug enforcement units are not working with the precincts, nor are they working with community groups. They overlook the fact that many people in the community want to see their neighborhood cleaned up and that they, them-
selves, want to participate in the clean-up. In short, people want their community to be free from drugs, but they do not want people needlessly killed or frisked simply as a cost of that cleanup.

**Should street policing be centralized?**

Professor Neuborne then asked, if aggressive street policing is necessary and desired by the community, how should it be structured? Should it be centralized in One Police Plaza or should control lie in the precincts? He also asked whether it would help if aggressive street operations were balanced racially. Zachary Carter responded that greater racial balance was essential. He pointed out that by increasing interaction between white and non-whites, police officers can learn about those who are not from the same background as they and, therefore, those officers would be less likely to use race, class and national origin as a proxy for reasonable suspicion. Racial profiling, in his view, is merely a fancy label for the human phenomena of simplifying one's existence by stereotyping. He urged re-orientation of police officers so that when they see a young person on the street who is dressed the way most are and is engaged in conduct that most are, the police will be better able to distinguish between innocent and criminal conduct. To achieve this, he would seek ways in which the squad, in a non-confrontational setting, could connect to the precinct and to the community, such as residency requirements for police officers or some form of community service in which police officers could interact with local youths in a non-criminal setting, such as having officers referee nighttime basketball games. If the officers become familiar with these youths in this or similar ways, they will be more capable of recognizing innocent conduct.

Professor Neuborne then asked whether police officers, especially those in street-crime units, could be required to become more involved in the community. Barry Kamins called attention to an article in that morning's New York Times about a street crimes unit that was sent into the Rugby Road area of Brooklyn; the community welcomed the aggressive policing because it reduced the crime, but it also created tension because the officers who were sent in knew nothing about the people in that community. Mr. Kamins emphasized that special squads which are dispatched from a central location into remote communities that they know nothing about creates problems because each neighborhood in the city has its own cultural differences and its own uniqueness. Therefore, sensitivity training is needed and the Police Department must educate its officers about the areas they patrol.

Commissioner Condon reacted to Mr. Kamins' point by noting that,
in the aftermath of the Abner Louima incident, a large number of minority police officers were assigned to the 70th Precinct and that the officers were now suing the city because they feel that they are being assigned there because of their race. He explained that African-Americans and Hispanic police officers do not want to be assigned to dead-end precincts from which they cannot be promoted. In regard to residency requirements, Commissioner Condon stated that those already in existence require police officers to reside within the five boroughs or in certain of the surrounding counties. However, even those requirements, he argued, rested on a false assumption. For example, an officer living in Flatbush can be unfamiliar with the Parkchester section of the Bronx or one who lives in Cambria Heights may not know the first thing about Williamsburg. Instead of imposing residence requirements, greater police-community interaction is needed, as President Fields had earlier suggested.

Richard Dienst accepted that police profiling of individuals existed but argued that it was not necessarily racial profiling. He explained that when police go into a community, they are not seeking out innocent people and the community itself will tell the police who are the bad actors. For example, they will tell the police that on a particular street corner, the Bloods are selling crack and that the person doing the selling is wearing baggy pants and a floppy hat. He did not think it was unreasonable for police to conduct undercover operations with respect to such a person.

Richard Emery respond that although, in terms of profiling, the manner in which the police start their interaction with a person is important, of equal importance is the ability of the police to assess the true nature of the situation. They are now aware that they are in danger but they do not necessarily anticipate realistically the natural reaction of a person whom they confront. Far too often they misinterpret a suspect's reaction in an aggressive way and it is here where police training must concentrate its focus. He acknowledged that police officers who confront a suspect do not know whether he is armed but stated that the problem is that police do not distinguish between a false threat and a real one. He suggested that incidents such as the Diallo shooting result from police officers following a common pattern that sets itself up for a destructive result. Undoubtedly, police officers are on guard and aware that they are in danger when they interact with a suspect, but they fail to anticipate the natural reactions of the person stopped. Instead of interpreting those reactions innocently, police far too often interpret them in an aggressive and mistaken way. The police must be trained not to interpret every action of a
suspect as a defiance of authority to which their responses can range from a verbal assault, to a physical assault, to a deadly assault. Nor should it be overlooked that the interaction is often exacerbated by the issue of race. Mr. Kamins noted that a police officer can find a challenge in conduct as innocuous being asked for his badge number.

Richard Green stated that many serious incidents arise because gangs have proliferated in New York City. He maintained that young people must be provided with meaningful alternatives to gangs but that so far we, as a society, have failed in this regard; instead of giving children a choice, we have shut down their after-school activities. We cannot hold young people accountable if we do not give them a choice. He noted that the Boston Police Department has decided to allow Boston’s youth to “gang-bang” all they want, as long as they do not sell drugs or hurt each other. He suggested also working with parents to fill the needs that gangs such as the Bloods and the Crips supplant in the lives of children. President Fields stated that, as a member of the City Council, she voted to approve the “Safe Streets; Safe City Project.” The project had two components: “cops and teens.” It succeeded in increasing the number of police officers in order to address quality of life issues and criminal activities, but along the way, the project forgot about the teens.

Professor Neuborne asked Eve Burton to discuss the role of the press when reporting on police-citizen incidents of moment. She explained that the press must deal with the problem of how to play a story, pointing out that when a story highlights one side, the other side will always be critical. As an example, she told of a reporter who rode one evening with the Street Crimes Unit and then wrote positively about the conduct of the police in their handling of two arrests for weapons possession. Nonetheless, the Daily News received much community criticism claiming that the police behavior that evening was not representative. Ms. Burton contrasted that incident with the manner in which the News’ Abner Louima story was received. The Louima incident was either the case of the decade or simply another instance of a perpetrator being beaten by a cop. Although no one knew at the time the extent of Mr. Louima’s injuries, the News made it its cover story. Despite the administration’s efforts that night to downplay the incident, the News had made the right choice.

THE HYPOTHETICAL

Professor Neuborne moved the discussion to the hypothetical prob-
lem in which two white veteran police officers, as members of an anti-crime unit in upper Manhattan, are on patrol in plainclothes and in an unmarked car. The area is a significant distribution point for cocaine dealers, many of whom come up from Maryland and Virginia and are frequently armed. Two male African-American Maryland University students have arrived to visit the uncle of one and to deliver some wedding gifts. They park their car, which has Maryland license plates, and one of the men goes upstairs to deliver the gifts while the other remains standing alongside their car. The officers observe him glancing up and down the block and then see the other return to the car, carrying a backpack. A license check of the students’ car reveals nothing unusual but the officers decide to follow it. Noticing that the car has a broken tail light cover, the officers direct the driver to pull over. Both officers approach the car with their hands on their guns. One asks the driver for his license and registration; the other asks the passenger what is in the backpack. The passenger becomes upset and accuses the officer of stopping them because of their race. He then reaches for the backpack to show it to the officer. He removes a cellphone which the officer believes is a gun and yells “Drop it.” The other officer, also seeing a black object and hearing his partner yell “Drop it,” shoots the passenger, killing him. The community responds with outrage. The police close ranks. The politicians exploit the incident politically. The press turns the incident into a major front page story. Political activists rally around the parents of the dead student and the major networks seek the parents out for various news programs and talk shows.

Professor Neuborne first asked whether the tactics of the two officers were justifiable or whether they were merely the inevitable consequence of aggressive street policing. Barry Kamins stated that the surveillance was appropriate, but that the officers’ tactics were problematic. He argued that the officers could have defused the situation by approaching the two students when they were still on the street and asking them what they were about. Richard Emery disagreed, stating that the young men would have considered such intervention an affront because they would have believed that the police assumed because they were black, that they had done something wrong. Earlier intervention, in his view, would have led to an aggressive confrontation and a lack of cooperation. Mr. Kamins replied that it was their being stopped while in their car that escalated the situation. Frank Wohl pointed out the contradiction in both positions.

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2. The hypothetical problem, which was distributed in advance to the Retreat’s participants, is set forth as Appendix A to this report.
Had the police stopped the young men earlier, the intrusion would have been greater. Conversely, once the two men were in the car, the officers created the most dangerous possible situation. The irony lay in the fact that, by being more aggressive, perhaps improperly, the officers could have averted a very dangerous situation. Commissioner Condon was critical of the officers for failing to de-escalate the situation and stated that they should have identified themselves as police officers. Also, the officer should never have asked the passenger to reach into his backpack; in real life, a police officer would never allow a suspect to do that. President Fields commented that police officers rarely offer explanations for a stop but that if they did, de-escalation in these situations would occur.

Zachary Carter maintained that the stop was proper. He said it was unlikely that the police would have obtained any better information with a longer surveillance. He pointed out that the police face a dilemma when they stop people under circumstances in which they should be presuming them innocent, but where they also have concerns that those whom they stop are engaged in wrongdoing. However, he said that a mature, well-trained police officer, who is not preoccupied with his own authority, will not engage or stoop to the level of a 17-year old kid who is challenging his authority; good cops defuse situations like those presented in the hypothetical all the time. Richard Green added that police be trained to appreciate the perspective of a suspect who may be unfamiliar with the customs of a particular locale, pointing out that a young man from Maryland may not understand the situation in the same way as a New York City youth would.

Barry Kamins observed further that, under New York law, the officers’ stop of the car may have been illegal because, notwithstanding the broken tail light, the stop was pretextual. Although the Supreme Court, in Whren,\(^3\) has upheld pretextual stops, they may not be constitutional in New York. He pointed out that anti-crime officers are not in the habit of stopping cars for broken tail lights. Obviously, they stopped the car to find out what was in the bag. Consequently, both the stop and the question, “what’s in the bag?” could be unconstitutional under New York law.

b. Show of Force: the Drawing of Weapons

Turning from the officers’ stop of the car to the drawing of their guns, Professor Neuborne asked when it was appropriate for police to pull their guns. Commissioner Condon stated that there is no specific proto-

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The drawing of one's gun; if the police had stopped the two men because of a broken tail light, they would not need their guns. But, in truth, they stopped them because they thought they might be drug dealers, which suggested that they may be armed. Richard Emery stated that due to the inherent dangerousness of a vehicle stop, the police did act appropriately in having their hands on their guns. However, the problem was their failure to defuse the situation. He suggested that police officers can be trained to show respect in their confrontations with citizens as to convey a belief in a person's innocence, even though operationally they are proceeding on the assumption that the person may be guilty of something.

Frank Wohl expressed concern that by emphasizing police officer discretion, experience and judgment, we expected police officers to be superhuman. He stated that under New York law, the officers had no right to ask what was in the bag. For such an inquiry, they had to have a reasonable suspicion of criminal activity afoot; Maryland license plates and a backpack did not establish that. Difficulties arose because the police were making a theoretical traffic stop which, in their minds, was a felony stop. Therefore, the officers should have used their public address system and ordered the car's occupants to exit and place their hands on the car. Having already checked the car's license plates and found nothing wrong, they should have checked the driver's license to see if he was wanted; that not being the case, the officers should have told the students to have a nice day and sent them on their way.

Professor Green focused on the impact of encounters between police and innocent African-American youth, who are “put on the bricks” by police. He stated that such negative experiences discouraged those young people from pursuing a career on the police force. A new image of policing must be created, he said, so that minorities will want to become police officers and perforce bring about change in police culture.

Eve Burton observed that everyone's role has been made more difficult by the Police Commissioner and the Mayor's secretive, hard-line personality and policies. She expressed pessimism about the capacity for institutional readiness to accept new ideas or new programs: police officers feel pressure to meet quotas; kids think badly of cops because of the mayor's stance; the press suspects there is more to the story; and the police refuse to speak up. What we are left with at times is a family in mourning and the presumption of police misconduct. She believed it was possible for the Mayor and the Police Commissioner to change their current attitudes citing, as an example, a previous Mayor and Police Commissioner's constructive action to end police obstruction of press access to crime scenes.
Without similar types of commitment by the Mayor, she cautioned, any proposed solution will fail.

c. The Aftermath: Reactions

Professor Neuborne turned the panel’s attention to the responses of the police department, politicians, the community, and the media in the aftermath of the shooting in the hypothetical scenario. Commissioner Condon stated that the police need to protect the crime scene and find and interview witnesses. However, the police officers involved need not speak to investigators for 48 hours. Richard Dienst explained that the so-called “48 Hour Rule” was merely intended to afford an officer a reasonable period of time in which to communicate with counsel without being fired for insubordination. He argued that the interval was justified by what occurs in the immediate aftermath of a serious incident: the police department hierarchy takes an official position and the police unions circle the wagons in an attempt to protect the officer. Neither is the correct approach but the fact that frequently prosecutors have a political agenda creates a lack of trust and the department is not always cooperative. When there is greater trust, there will be more cooperation and coordination between the police and the prosecution. Commissioner Condon added that prosecutors often will ask the police commissioner not to question the officers involved because they do not want statements made by the officers that may contradict their testimony in the Grand Jury. He pointed to the inherent conflict between the prosecutor’s wishes and the responsibilities of the police commissioner. The commissioner, as chief administrative officer of the police department, has a right to know what happened and there are police commissioners, including himself, who do not abide the district attorney’s request not to question their officers; it is a commissioner’s responsibility to do just that.

Richard Dienst pointed out that the situation is complicated because an officer who is compelled to answer questions under a threat of job forfeiture receives testimonial or use immunity with respect to his statements and any leads developed therefrom. Richard Emery asserted that police officers use the 48 hour interval to concoct a cover story. Zachary Carter stated that the 48 hour rule should cover only officers who are targets of the investigation and may be subject to prosecution; the rule should not apply to officers who merely were witnesses to the event; people understand that officers who are target are entitled to the benefits of the Fifth Amendment.

Addressing community reaction, President Fields stated that the po-
lice commissioner should provide whatever public information can be made available and the Mayor should speak objectively about the incident and not put his own spin on the case. All that the Mayor need say, she suggested, is “that we’ve had this tragedy . . ., we are still waiting for the facts to evolve and as that happens, more information will come out.”

As to the responsibility of community activists, Richard Green stated that the most important thing was the dissemination of the right information, by the police commissioner and the mayor, as well as community leaders. Such efforts, in his opinion, would calm at least 75% of the community.

Eve Burton stated that the press also had the responsibility to present the facts as accurately as they develop but that without a lot of facts, it was difficult. As an example of responsible reporting, she cited the Daily News’ story in which allegations were made that Mayor Giuliani had violated the law with regard to the release of Patrick Dorismond’s sealed juvenile record, suggesting that the headline, “Dead Man’s Exception?” evidenced the story’s objectivity.

Richard Emery proposed the creation of a response team that would be available when tragic events occur. The team would be available to the Mayor but it would not be his team. The team would consist of five or six of the most important components of the problem, including the chief of the Patrolmen’s Benevolent Association and community activists who would be willing to participate. When a shooting occurred, the team would come together, and with civility, air their respective viewpoints at a joint press conference. In this fashion, the response team would provide an informative and constructive response for the public that would signify that everyone cares about the human tragedy that has transpired.

Commenting on community activism, Zachary Carter was critical of public officials who trivialized, as “street theater,” the public demonstrations by activists in the wake of the Amadou Diallo shooting. It was “street theater,” he said, in the same way the Boston Tea Party was “street theater.” When he, himself, was criticized by community activists for not obtaining guilty verdicts against all five police officers who were indicted in the Abner Louima case, even though Officers Volpe and Schwarz were convicted, the criticism was a useful reminder to him that public officials should not be too smug about their accomplishments. Activists are needed to dramatize an issue for attention by the general public and public officials. He added that a smart activist will not cross the line into rhetorical excess in a way that undermines his or her credibility but activists will be right to demand a thorough investigation. On the other hand, the Mayor

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**CRIMINAL JUSTICE**

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and police commissioner should never miss an opportunity to educate the public about the possibilities and limits of the criminal justice system in redressing particular problems.

d. Remedies

Professor Neuborne turned to the subject of remedies and asked Frank Wohl to comment on the Civilian Complaint Review Board's role. Mr. Wohl explained that, although the Board is an important part of the process, it would take a back seat in the situation described in the hypothetical because the first line of response is the criminal investigation. Only after that investigation is over, would the Board proceed, benefitting from the information developed in the investigation. In more typical situations, the Board investigates police conduct involving unlawful searches or other improper confrontations that do not result in arrests. In these instances, the Board may be the only forum in which the propriety of the police officer's conduct is reviewed. If the officer's conduct is found to be improper, that finding can result in departmental charges leading to dismissal or some lesser form of discipline.

Asked by Professor Neuborne to identify the most significant change he would make as to the Board's operations, Mr. Wohl replied that he would like to have much quicker access to police department information which would enable the Board to speed up its investigations. Asked whether the Board was sufficiently independent of the police department, Mr. Wohl stated that it was, pointing out that the Board has 13 members, all of whom are appointed by the mayor, but only three of whom are nominated by the police commissioner. He added that he did not want the Board to have the power to impose sanctions. Ultimate disciplinary authority, he believed, should reside with the police commissioner.

Richard Dienst complained about the numerous layers of review that already exist. He noted that, in addition to the Civilian Complaint Review Board, there are the investigations conducted by the Internal Affairs Division, the District Attorney, the United States Attorney, and the departmental trials. He stated that the Board, which is comprised of civilians who do not understand the nature and quality of police work, cannot conduct proper investigations; investigations of police officers should be conducted by police officers with integrity who know what they are doing. Zachary Carter disagreed, stating that the Board had the correct balance of civilians and police. However, he was dismayed that citizen complaints that the Board has substantiated and referred to the police department are not always acted upon by the department.
Asked by Professor Neuborne to comment on the remedial efficacy of the civil rights lawsuit, Richard Emery stated that such suits signified the bankruptcy of the system insofar as they demonstrate the system’s inability to address the problems that cause tragedies such as the Diallo case. He added that society often views such suits cynically—as little more than undertakings by opportunistic lawyers who reap financial benefits from them. Professor Neuborne suggested that rather than allow the city to indemnify police officers, the offending officer should have to pay a damage award, although it might be one that the jury pares down because of the officer’s more limited financial capacity. Richard Dienst disagreed and insisted that indemnification frequently does not occur when it should. In hundreds of his own cases defending police officers who were acting within the scope of their employment, the city refused to appear on behalf of the officers and it denied indemnification, claiming that the officer was on a frolic of his own.

Lastly, President Fields reminded that another important remedy, community policing, should not be overlooked. Community policing works, she asserted, because under it, police officers are assigned to beats which they walk regularly and are able to build relationships with the people in the community. Unfortunately, she stated, community policing has been discontinued. To her, its reinstatement would reduce greatly the tensions that currently exist between the community and the police.

THE LUNCHEON KEYNOTE SPEECH

Raymond W. Kelly, New York’s former Police Commissioner and currently Commissioner of the United States Customs Service, delivered the luncheon keynote speech. He stated that police and community relations would improve vastly if, in the aftermath of police shootings of innocent victims, police departments would do three things: (1) express sympathy to the family of the innocent victim, personally if possible; (2) undertake a thorough review of policy and practices to safeguard against similar occurrences that should include an assessment from an independent expert who is not afraid to tell police leaders exactly what went wrong and what reforms need to be made; and (3) tap into a reservoir of goodwill, if one exists, to prevent a tragic accident from igniting the kind of civic unrest that is described in the hypothetical scenario. The foundation for that reservoir of goodwill needs to be constructed in advance of any crisis and ranking police officials must establish and maintain open lines of communications with community leaders.
Commissioner Kelly recounted that a large reservoir of goodwill was under construction when he left the New York Police Department in 1994. It was called community policing. Regrettably, in his view, it was quickly abandoned for tough-sounding rhetoric and dubious stop and frisk tactics that sowed new seeds of community mistrust. He pointed out that there has been historic mistrust of predominantly white police forces deployed in predominantly black or other minority neighborhoods. Community policing was designed in part to get police officers closer to the people of the neighborhoods they patrol, regardless of race. It is premised on the belief that the police could be more effective in fighting crime in partnership with neighborhood residents. It recognizes that most residents of high-crime neighborhoods are law-abiding people who need the police more than most but who are frequently alienated by them. Under community policing, neighborhood leaders met regularly with precinct commanders. Together they mapped strategies for crime fighting and for addressing quality of life issues. They would return a month later to examine what police action worked and what did not. Community police officers won new respect by helping clean up prostitution, drug dealing, and even double-parking in neighborhoods that once were resigned to living with these conditions. Community policing also focused on returning the police officer to a beat where he or she might become a neighborhood fixture. And, as community confidence and trust in particular officers grew, the beat officer became a neighborhood resource and a conduit for information to combat serious crime.

Commissioner Kelly explained further that community policing provided more resources to the uniformed neighborhood police officer and thus reduced reliance on specialized units. Specialized units, he maintained, should be deployed sparingly and when so deployed, they should be highly supervised. He recalled that, at the end of Mayor Dinkins' administration, the resources to make community policing a reality had finally become available. Shortly thereafter, however, community policing was maligned as soft on crime and denounced for turning police officers into social workers. Although both criticisms were wrong, community policing was abandoned.

Commissioner Kelly disclaimed that community policing alone contributed to New York City's declining crime rate, which began in 1991. He observed that nationally, crime rates plummeted regardless of police policy or tactics and he listed causative factors such as the booming economy, the aging-out of the most criminally-prone offender group, and the decrease in the crack epidemic. He also took no issue with those who claimed...
that close monitoring of crime patterns, together with vigorous enforce-
ment of quality of life offenses, helped drive the crime rate down. He insisted,
however, that abandonment of community policing was not required.

Commissioner Kelly also detailed, apart from the abandonment of a
sensible policy strategy, how the elimination of community policing evis-
cerated the police department’s efforts at minority recruitment. He ob-
served that a very vigorous minority recruitment campaign had produced
a hiring list that contained the highest number of African-Americans and
Latinos ever; qualified military personnel were recruited at a time the U.S.
military was downsizing, mentoring programs were initiated, and study
groups were formed. As a result, minority applicants took and passed the
police department’s examination in record numbers. And, for the first
time in the department’s history, it had the wherewithal to offset the
historical racial imbalance in its ranks. Moreover, had the hiring list been
adopted, there would have been greater minority representation, not just
among police officers, but also in the department’s leadership ranks of
sergeants and lieutenants. Although Commissioner Safir, by launching a
recent recruitment drive, has tried to repair that damage, Commissioner
Kelly believed that the opportunity presented by the massive hiring cam-
paign five years ago was lost and that fallout would be visible for years to
come in the dearth of black and Hispanic representation in the department’s
ranks and leadership. Greater minority representation in all police ranks
is long overdue, he added, and would go a long way in breaking down
the walls of mistrust between the police and the African-American com-

In addition to community policing, Commissioner Kelly also described
several other policies which he had implemented but which were no longer
in effect in the NYPD. One concerned the use of semi-automatic pistols.
When they were introduced as an alternative service weapon to the six-
shot revolver, he limited their magazine capacity to 10 rounds. Not only
was the 17-round magazine marketed by the manufacturers unnecessary,
his department’s own research showed that police who use high capacity
semi-automatics tend to over-shoot. Another of his policies no longer in
effect is having a civilian head of the Internal Affairs Bureau. “When it
comes to internal investigations,” he said, “police departments need per-
spectives other than those provided by career uniform personnel.” On
the other hand, despite that Mayor Dinkins favored it, he recommended
against moving the Civilian Complaint Review Board out of the police
department. He believed that if it the Board was removed from under the
police department umbrella, it would lose “the muscle of police head-
quarters behind it,” and would have difficulty investigating effectively police officers. Commissioner Kelly also believed that the police department should no longer engage in questionable stop-and-frisk practices. Crime rates, however high, cannot justify illegal police conduct; that era in American policing is long over, he said, or at least it should be.

Despite these disagreements, Commissioner Kelly believed that the New York Police Department has a lot to be proud of and that it is “a remarkable organization.” He lauded its ability to “turn on a dime to respond to just about any emergency that rises,” and its leadership in the fields of hostage negotiations and the development of alternatives to deadly force, and he commented that police departments across the country and around the world have adopted the tactics of the NYPD’s Emergency Services Unit. There is no reason, he said in conclusion, “why the New York City Police Department could not be the leader in community relations as well.”

THE AFTERNOON SESSION

A. Professor Randall Kennedy: Racial Profiling as a Racial Tax

Harvard Law School Professor Randall Kennedy stated that it was imperative to define racial profiling because it is a complex subject, one that is prone to demagoguery and one that, when discussed, results in people usually talking past one another. Some define it as police surveillance or conduct that is triggered solely by a person’s race. The media often condemn racial profiling because they say it is wrong for the police to stop a person solely because of his or her race. Police chiefs also like to embrace that definition because they can publicly condemn police officers who pull someone over solely on the basis of race. And when political activists attack racial profiling, they also define it as action taken by the police solely on the basis of race. To make his point, Kennedy pointed to the New Jersey Turnpike episode, stating that in that instance, the state troopers who stopped people did not do so solely on a racial basis. Although race played a part, the officers also took into account the person’s age, car model, and whether the car had an out-of-state license. Thus, in his view, to assert that police action of this nature is based solely on race is a “red herring.” Although the police may do so occasionally, it is not where the heart of the problem lies.

For Professor Kennedy, “racial profiling occurs when police act ‘in part’ on the basis of race”—when race is one factor that police consider in determine whom to place under surveillance or take action against. Defined thusly, racial profiling is controversial because police officials justify
their actions as “good policing” based on “common sense.” To illustrate, he offered two examples. In the first, which takes place in the usual drug profile context, a young black man is traveling from Los Angeles to Kansas City, Missouri. Drug enforcement agents meet the plane and focus on him because he paid cash for his ticket, appeared nervous, did not check any bags, and traveled from a city notorious for drug exportation to one well known for importation. The agents defend their actions, pointing out that race was only one factor causing them to focus on this individual. In the second example, an officer sees a black man sitting in a car in front of a darkened house at 11 P.M. in a predominantly white neighborhood. He decides to ask the man why he is there. In both examples, not only do the police defend their actions as based on common sense, federal courts have upheld the constitutionality of their conduct because race was merely one factor taken into consideration. The problem with racial profiling as he defines it, is that police are allowed to give a non-racist rationale for their conduct even as they factor race in to justify their quantum of suspicion.

Professor Kennedy’s central thesis was that the police should not be allowed to factor race in at all in assessing whether a person is a legitimate suspect. To allow it is to impose a racial tax on all minorities, not just African-Americans. He, himself, is more vulnerable to police intrusion than others because of the “non-racist rationale” with which police justify their conduct. And in the Southwest, people of apparent Mexican ancestry also pay a racial tax because the United States Border Patrol maintains they are more likely to be engaged in the illegal trafficking of undocumented workers. Therefore, Professor Kennedy argued, society should not be allowed to “tax” people on a racially selective basis. He cautioned that people who must bear this racial tax resent it, with harmful consequences to society as a whole. As an illustration, he alluded to the acquittal of O.J. Simpson as an embodiment of minority resentment of the police and the justice system, and noted that minorities can manifest their resentment well beyond the jury room. Racial minorities, he pointed out, now hold positions of power and authority and attention to their sensibilities must be paid because they will act upon their resentment.

Acknowledging that one of the central tasks of the government is to protect its citizens, Professor Kennedy stated that there are better ways to fulfill that goal than imposing a racial tax on minorities. To deal with the illegal immigration problem, for example, he proposed that the government could hire more officers. And, if the government is concerned about drug-trafficking at airports, it could examine everyone’s luggage despite
the inconvenience to all passengers that it would cause. In fact, such a practice would, in his view, produce “some sober second thoughts about the war on drugs.” That reconsideration will not occur, he concluded, so long as a racial tax continues to be imposed on racial minorities.

B. Professor Jerome Skolnick: Specialized Units, Police Culture and the Blue Code of Silence

Professor Jerome Skolnick of NYU Law School expressed agreement with Commissioner Kelly’s preference for community policing. He pointed out that a cardinal principle of community policing is decentralization and that New York City is better able to decentralize than any other city because it has 75 precincts, each of which is about the size of most small police departments. On the other hand, when a police department’s main strategic focus is to operate through specialized units, there will be very little contact with the local citizenry, and the police are not going to know much about the people whom they are policing. One negative consequence flowing from the creation of specialized units, such as the NYPD’s Operation Condor and the Los Angeles Police Department’s CRASH units, is that such units manifest “the most questionable aspects of police culture, . . . [the] kind of culture [which] can create situations in which police are going to defend each other no matter what happens.”

To illustrate his point, Professor Skolnick described the case of a special drug unit in upper Manhattan that had been investigated by the Official Corruption Unit of the Manhattan District Attorney’s office: five officers, armed with a search warrant, had broken into a drug dealer’s apartment. When the dealer heard the officers at the door, he disposed of the drugs and when they entered, they found none. Frustrated, the officers beat the dealer and a buyer who was present; the buyer was beaten severely. The officers charged the buyer with resisting arrest but the extent of his injuries required that he be taken from the station house to the hospital. A suspicious emergency room doctor reported the matter to a friend in the District Attorney’s office and two of the officers were indicted for serious crimes. At their non-jury trial, they did not testify. The other officers claimed that they had not seen anything and the defendants were acquitted.

To Professor Skolnick, the trial reflected “a clash of moralities.” On one side were the police and a judge sympathetic to their plight. On the other side was the emergency room doctor and the prosecution. The most troubling aspect of the case occurred when, upon hearing the judge’s verdict of acquittal, the police officers who had packed the courtroom cheered.
and applauded their fellow officers. Such a reaction was a manifestation of “both the blue wall of silence and the code of police culture that pulls cops together even when they clearly had committed...assaultive crimes.” To counter this, he urged that high-ranking officers should send a message that “if you go over the line, we will [not] back you up.”

Professor Skolnick stated further that the real question for New Yorkers is whether under community policing, it is possible to reduce crime, and have a safe city. In his view, the answer is “yes.” He pointed out that over the past five years, a statistical program called Comsat has been implemented by the NYPD and that it has greatly improved the ability of the police to locate crime, affording police officers the flexibility to move around and eliminating the need for specialized units. When police are freed to walk beats, they will get to know the people in the community and not have to rely on racial profiling upon which, because of their unfamiliarity with people in the community, officers in special units must rely.

C. Dr. Joseph McNamara: Rethinking the War on Drugs

Dr. Joseph McNamara of the Hoover Institution argued that our current thinking about the war on drugs is responsible for much of what is wrong with policing today. He asserted that the shooting of Amadou Diallo was not a “tragic accident,” as Mayor Giuliani had claimed, but the result of a philosophy of policing that is the direct result of our misplaced approach to the drug problem. He noted that he had spent half his 35 years of policing in New York City as a patrol officer in Harlem and as a lieutenant in Fort Apache in the South Bronx, and that he came from a family of cops—father, brother, uncles and cousins—that had served some 150 years collectively in the city’s highest crime areas. “None of them,” he said, “would have shot Amadou Diallo.” That the jury acquitted the officers involved reflected the new morality in politics and policing. The jury felt the police officers had been too aggressive, had made a terrible mistake in judgment, but as individuals, they were not guilty of a crime; they were being aggressive as they had been trained. Years ago, if he or his relatives had shot Mr. Diallo, they would have been convicted, not only because they had violated the law, but also because they would have violated the values of the police department as they were then; a police officer did not use his gun unless someone else had a gun and it was absolutely necessary.

Dr. McNamara traced the beginning of this change to “a military mindset” in the philosophy of policing to 1972 when, for political purposes, President Nixon declared a war on drugs. He pointed out that, in
1972, the federal budget for the drug war was $101 million. It is now $17.8 billion. In 1972, the average monthly social security retirement check was $177. If Social Security benefits had increased at the same rate as spending for the war on drugs increased, the average monthly check today would be $30,444 a month. Overall, more than $40 billion a year is currently being spent on drug control, with states and local governments contributing more than half of that figure. Despite these vast expenditures, the federal government acknowledges that in the last decade, opium production has doubled and cocaine production is up by a third. In addition, drugs are cheaper, more plentiful and more powerful than ever. Ninety percent of the drugs enter this country undetected. Drug overdose deaths are up. Drug emergency room visits are up. Eighty-five percent of high school seniors say it is easier to obtain marijuana than beer. The AIDS epidemic is greatly increased by intravenous drug use, and there is enormous corruption, in Colombia and Mexico, and in our own government.

Dr. McNamara maintained that the war on drugs is also responsible for racial profiling and racial disparities in arrests because they are condoned by “drug war hawks.” “In the war on drugs,” he said, “everyone becomes a suspect because the police do not know who is doing drugs.” Consequently, the police search everyone in the open street markets of minority neighborhoods. Because these searches are confrontational, “it’s a real war against minority males,” and “the inevitable results are shootings.” Moreover, the shootings are not accidental, but the “deliberate result of the confrontational style of policing.” We have reached the points where cops on patrol are shooting people who are reaching for cell phones, wallets, and driver’s licenses. Police administrators now suggest that the public should be instructed on what to do when they are questioned or arrested. When he was a boy, Dr. McNamara recalled, his parents taught him and he, in turn, taught his children, that if you need help, you go to a police officer. Today, people of color teach their children to keep their hands out where the police can see them. Racial profiling that produces these conditions, he concluded, is not “appropriate in a society that would like to pretend that it’s a free and egalitarian society.”

Dr. McNamara next discussed the thesis of his forthcoming book, Gangster Cops: the Hidden Cost of America’s War on Drugs—that the police themselves have been corrupted by the war on drugs. He stated that, in the old scandals, cops were caught taking payoffs from gangsters but that in the drug war scandals, “the cops are the gangsters.” In thousands of cases in New York City, Los Angeles, Chicago, Philadelphia, Boston, Denver, and other cities and towns big and small, law enforcement officials
of all ranks have committed murders, armed robberies, kidnappings, and stolen and sold drugs—the same predatory crimes that they were sworn to prevent. Although "gangster cops" are not numerous, they have committed thousands of these predatory felonies and "they have done damage beyond our imagination." Exacerbating the problem is that these officers are covered by the code of silence "that is as natural to police work as it is to the legal profession and medical profession." Gangster cops, he bemoaned, are an unfortunate, but inevitable cost of America's war on drugs.

Dr. McNamara asked "how we got into this mess." For answers, he drew upon his Harvard Law School doctoral dissertation on the history of the criminalization of drugs in America. He pointed out that for the first 135 years of the Republic, the right to pursue life, liberty and happiness included the right to ingest any kind of chemicals we wanted—at least as far as national law was concerned. On December 17, 1914, that changed with Congressional passage of the Harrison Act. The Harrison Act was the product of successful lobbying by the Protestant missionary societies in China, the Women's Christian Temperance Union, the Anti-Saloon League and the Protestant Churches of America. It was passed with the most blatantly racist testimony that Congress had ever heard as evidenced by the legislative history which is replete with images of "black men going crazy raping white women," "white women lying next to Chimen in yellow opium dens," and of "marijuana driving people crazy as they murder everyone in sight." In addition, these "arguments" were supported "by the most ludicrous, non-scientific comments about the nature of the chemical structure of drugs." Although we laugh at those arguments today, these "simple, immoral stereotypes of drug usage created a century ago by these religious people are prevalent today." This history, he explained, is why we still talk about drugs as evil, as a "supernatural terror." and why we speak of "a crusade or holy war against drugs."

Dr. McNamara observed that, despite such questionable origins, drug laws not only exist today but they have been strengthened repeatedly by Congress and the states. He believes that politicians will only change these laws when the public begins to recognize that America's war on drugs is corrupt, and that the violence it produces stems not from drug use itself, but from the illegal commerce in drugs and the violence inherent in that commerce. Not only is our war on drugs ruining countries throughout the world as well as our own, it cannot succeed, he insisted, because of a much older and more powerful law—the law of supply and demand. Criminal prohibition of a cheaply produced product creates a black market "with a markup of about 17,000 percent." A markup of this dimension has cor-
ruptured officials throughout the world, including the police. Although drugs were a problem before they were criminalized, there did not exist a $500 billion international black market or an organized crime structure centered around drugs. All that we had was a drug problem.

D. Conclusion
Professor Hellerstein brought the Retreat to a conclusion by reviewing briefly the vast range of subjects that had been covered and the excellent ideas and suggestions for change that had been offered. He expressed the hope that the substance of the discussions and the recommendations made in the course of those discussions will contribute meaningfully in the future to the improvement of police-citizen encounters and to the broader relationship between the police and the community.

August 2000

The Council on Criminal Justice
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Lauren C. Panora, Secretary

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APPENDIX A

Hypothetical Scenario for the Morning Roundtable Discussion

Veteran Police Officers Adams and Barnes, who are white, are assigned to the anti-crime unit of an upper Manhattan precinct. The unit consists of 20 officers—16 white, 2 Latinos, and 2 African-Americans. Most of the precinct’s residents are newly-arrived Hispanic immigrants. Many work in the stores that dot the thriving commercial strips of the neighborhood. For a number of reasons, including its location near a major north-south highway, the precinct has become a significant distribution point for mid-level cocaine dealers.

As members of the anti-crime unit, Officers Adams and Barnes are primarily responsible for thwarting ongoing crimes. Given that the narcotics dealers who come to the neighborhood from out-of-state—Maryland and Virginia especially—generally carry weapons to protect their drugs and money, both officers have made numerous gun arrests during their six years in the precinct. Many of these arrests have been made after the officers discovered guns in the cars driven and bags carried by the out-of-state dealers.

During a Spring break, Cole and Dunn, two male African-American students from the University of Maryland, were visiting Dunn’s uncle who had married a woman living in the neighborhood. Before heading back to Maryland, they stopped at the uncle’s apartment in the early evening to drop off gifts Dunn had purchased for his uncle. Dunn ran up to drop off the gifts while Cole remained downstairs.

Officers Adams and Barnes, who were in plainclothes and in an unmarked car, spotted a car with Maryland plates parked in front of a building that had been the subject of narcotics search warrants. They also observed Cole, who was standing aside the car, smoking a cigarette and periodically glancing up and down the block. Officers Adams and Barnes drove past Cole and rounded the block. As they came back around, they saw Dunn, who was carrying a backpack over his shoulder, enter the car with the Maryland plates. The two men drove away, heading in the direction of the highway that leads out of the city. A check of the license plates revealed nothing unusual.

As the Maryland car headed toward the highway, it pulled up to a red stop light. The officers noticed that the glass cover of the car’s right side taillight was broken. The traffic light turned green and the officers sped up to catch the Maryland car before it entered the highway. They
activated their flashing light and signaled the car’s driver to pullover, which he did, and the officers pulled up directly behind the car.

Officers Adams and Barnes both got out of their car and approached the Maryland car. Adams went to the driver’s side and Barnes went to the passenger’s side. Concerned that the occupants might be armed, both officers had their hands on their guns as they approached. Adams asked Cole, the driver, for his license and registration. While Cole was removing those items from his wallet, Barnes asked Dunn what was inside the backpack that was between his legs. Dunn became upset and accused Barnes of stopping them solely because of their race. He also threatened to report the officer for violating his civil rights. The tone between Dunn and Barnes became more heated and Barnes threatened to arrest Dunn. Officer Adams, perceiving an increasingly dangerous situation given Dunn’s tone and his own belief that one or both men might be armed, drew his gun and pointed it at Cole. Dunn, frustrated by Officer Barnes’s continuing demand to see the inside of the backpack, stated, “Okay, I’ll show you what’s inside the damn bag.” Dunn reached into the backpack and removed the first item he touched, a small, black cellphone. Barnes, catching a glimpse of black metal, drew his gun and yelled out, “Drop it.” Officer Adams, also seeing black metal and hearing his partner shout, “Drop it,” fired his gun several times. One of the bullets passed through Dunn’s neck, killing him. Another hit Officer Barnes, wounding him slightly.

Once word of the incident spread, public reaction, especially in the city’s African-American communities, was extensive and intense. Various community leaders denounced the shooting as yet another example of racism in the NYPD. The Mayor and Police Commissioner held a joint news conference at which they stated that the police had acted in conformity with the law and that the shooting was a tragic accident. Dunn’s parents arrived within hours and were spirited away by community leaders, and appeared the next day at a news conference at which they too denounced the New York Police Department for its racism. Major network news programs and talk show hosts contacted the parents with requests for appearances, offering to host them at some of the city’s finest hotels. Numerous protest marches, in which demands for prosecution of the officers were made, were sponsored by various community and civil rights groups. Several of the demonstrations became unruly, resulting in injuries to several civilians and police officers. A grand jury was convened to investigate the shooting but decided not to indict the officers.
Letter to Securities and Exchange Commission
Regarding the Facilitation of Electronic Communications
Required Under the Securities Laws

The Committee on Securities Regulation

July 19, 2000

Re: Securities Act Release No. 33-7856
   Exchange Act Release No. 34-42728
   Investment Company Act Release No. IC-24426
   File S7-11-00

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Attn: Jonathan G. Katz, Secretary

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Securities Regulation (the “Committee”) of The Association of the Bar of the City of New York (the “Association”) in response to the Securities and Exchange Commission’s (the “Commission”) Release Nos. 33-7856, 34-42728, and IC-24426 (collectively, the “2000 Release”) and request for comments, dated
April 28, 2000, regarding the facilitation of electronic communications required under the securities laws. The Committee is composed of lawyers with diverse perspectives on securities issues, including members of law firms, counsel to investment advisers, investment companies and their independent directors, academics and members of the judiciary. A list of our Committee members is attached.

The Association believes that the Commission should adopt regulatory policies which recognize the substantial changes created by technology in the marketplace and promote the growth of such technology. Summarized below are three guiding principles the Association believes the Commission should consider in adopting such policies.

A. The Commission Should Provide a Flexible Regulatory Framework to Enable Market Participants to Fully Utilize Electronic Technology to Offer Securities Online

As the 2000 Release notes, investors have greatly benefited from the dramatically enhanced access to current information about issuers and markets generally as a result of electronic technology. These improvements have not occurred serendipitously, but rather because market participants have strong incentives to meet customer demands and preferences, and strive to provide low-cost, efficient and “value added” services to their customers, including both investors and issuers. Consequently, market participants constantly explore and invest in new technologies.

Both the rapid pace of technological change and the equally rapid developments in the securities markets make it essential that only a flexible regulatory framework can maximize the full benefits of electronic technology. Detailed regulatory requirements are unlikely to anticipate all issues that will arise in the future. Furthermore, a flexible approach to regulation will better address the differences among market participants in terms of their size and resources, their investor bases and their use of electronic media.

Similarly, adopting a rigid “one size fits all” or a “lowest common denominator” regulatory approach will undermine the benefits of new technology by reducing the ability and incentive of market participants to innovate or invest in new technologies and ultimately would disserve those investors who view and rely on electronic technology as an essential investing tool.

At the same time, the Association recognizes that specific guidance often may benefit the markets by providing greater regulatory certainty in a constantly evolving area. In the Association’s view, the Commission
can provide this more detailed guidance in a way that does not undercut the broader principles to allow market participants flexibility to implement electronic technology. For example, the Commission could adopt non-exclusive “safe harbors” that provide necessary guidance while preserving the flexibility of market participants to develop alternative approaches consistent with regulatory objectives but better suited to their particular needs.

In our view, all investors—including those without access to new technology—will benefit through the increasingly broad and rapid dissemination of useful information about securities markets and issuers. Overly broad limitations on the use of electronic technology would be inconsistent with the enhanced investor protection that this widespread dissemination will provide, and would also be likely to frustrate some of the Commission’s central statutory goals—efficiency, competition and capital formation—that are identified in the 2000 Release.1

B. The Commission Should Avoid Regulatory Policies That Discriminate Between “Online Only” Firms and Those Offering New Technologies Alongside Their Traditional Broker-Dealer Services

The Association believes that the use of electronic media by an issuer or market intermediary should be subject to the same regulatory policies whether or not that firm communicates with investors exclusively online. Regulatory treatment should not differ based solely on the methods (technological or otherwise) used by issuers or market intermediaries to communicate with investors.

C. The Commission Should Exercise its Exemptive Authority to Facilitate the Use of Electronic Media

Congress expressly granted broad exemptive authority to the Commission under NSMIA to promote the development of efficient, competitive markets. The Association urges the Commission to exercise this authority to modify existing regulations so that the needs of the electronic marketplace can be accommodated more effectively.

1. As Congress made clear in the National Securities Markets Improvement Act of 1996 ("NSMIA") that the Commission, in exercising its authority under those laws, also must consider the goals of efficiency, competition and capital formation. See, e.g., Section 2(b) of the Securities Act of 1933 (the “Securities Act”) (as amended by Section 106(a) of NSMIA) ("Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation").
The Association has sought to identify below several areas in which the Commission could beneficially exercise its exemptive authority to permit broader use of electronic media.

I. ONLINE OFFERINGS

The Association’s specific comments on online offerings can be summarized as follows:

• The increase in information about issuers, securities and markets generally that has resulted from the use of electronic media underscore the need to liberalize communications in the offering process. Specifically, the Commission should:
  • deregulate communications in the pre-filing period, the waiting period and the post-effective period;
  • at a minimum, expand the information permitted under Rule 134 to be disclosed, even if it does not completely liberalize communications as proposed; and
  • eliminate the prohibition against “general solicitation or general advertising,” at least in the case of online offerings where there is a reasonable basis for concluding that participants satisfy applicable offering restrictions.

• The Commission should allow market participants regulatory flexibility in developing efficient offering procedures as technology evolves.

• The Commission should eliminate the final prospectus delivery requirement.

Under current regulations, there are significant impediments to achieving the full benefits of electronic media in the context of online offerings. As the 2000 Release notes, issuers and broker-dealers have been using the Internet, e-mail and other electronic media to offer securities and provide related information to investors quickly and efficiently. However, the lack of clarity regarding, or the limitations on, the use of electronic media for certain types of communications has frustrated the ability of issuers and underwriters to satisfy investor demand for more information during offerings.

For example, issuers with effective shelf registration statements—many of whom tend to offer securities frequently—may be “in registration” and
therefore subject to publicity restrictions almost continuously. In addition, information about certain debt securities, especially asset-backed and mortgage-backed securities ("ABS"), are often best communicated outside the prospectus through quantitative presentations that do not lend themselves well to oral dissemination and for which electronic delivery would be particularly effective. The Association also notes that investors in the fixed income markets are predominantly institutions who use electronic media to obtain offering information.

The Association’s comments below address the use of electronic media first in connection with registered public offerings and then in connection with private placements. We believe the Commission can exercise its exemptive authority in both contexts in a manner that will meet investor protection concerns while creating more efficient, competitive capital markets.

1. Registered Public Offerings

The flow of information made possible by advances in information technology, increased investor demand for access to information, including during the offerings process, which is restricted under current regulations. Accordingly, to better meet the needs of investors and the markets, the Association recommends that the Commission adopt a framework that substantially deregulates communications during all offerings or, at a minimum, to expand the types of information permitted by Rule 134. The Association also urges the Commission to adopt a regulatory framework that provides greater flexibility for participants in online offerings.

The Commission should permit any communications throughout the offering process, at least in the case of offerings that qualify for use of a shelf registration statement. The Association notes that all material facts are required to be disclosed in an issuer's formal disclosure documents. Accordingly, issuers and underwriters should be free, subject to antifraud liability, to provide information to investors who generally seek more, not less, information. In addition, in the case of offerings that qualify for use of a shelf registration statement, any communications made while the issuer is “in registration” are unlikely to “condition” the market or


stimulate interest in a proposed offering in any material way. Moreover, shelf issuers are generally seasoned issuers, and thus existing investors would also benefit from an increase in information. Investor protection concerns would continue to be adequately addressed by existing antifraud requirements.

In the Association’s view, the benefits of any deregulation of communications during the offering process would be substantially undermined if such communications are required to be filed or become subject to Section 12(a)(2) liability. Filing would impose a substantial burden that, as a practical matter, would discourage communications, without any demonstrable benefit to investor protection. In addition, any imposition of Section 12(a)(2) liability also would likely chill communications by issuers and underwriters to investors, thereby reducing the amount of information available to investors.

As an alternative to the foregoing, the Association recommends that the information permitted by Rule 134 be expanded to allow the following information:

- Term sheets.
- Information regarding swaps or exchanges of securities that a broker-dealer may offer.
- Comparable market prices for similar securities.
- Road show calendars.
- Dealer commentary as to timing and book-building for an offering.
- Aggregated or other information regarding book-building that does not disclose specific customer orders.

Expanding the information permitted by Rule 134 to be disclosed after a registration statement is filed would allow market participants greater flexibility in developing procedures for online offerings and taking advantage of technological advances to provide information to investors more quickly and cost-effectively.

In addition, the Commission should clarify that materials providing information about a variety of offerings by different issuers should be
permitted under Rule 134 if the information about each offering comprises only permitted Rule 134 information.

Finally, as noted earlier, the Association believes that further guidance from the Commission in the area of online offerings should permit market participants flexibility in developing efficient offering procedures as technology evolves. Codifying specific procedures that were appropriate in one offering\(^5\) may not be appropriate for another. Furthermore, as the Release notes, developments in technology and market practice will quickly make overly-detailed regulatory prescriptions outdated.

In designing a flexible regulatory framework, the Association recommends that the Commission address the following issues with respect to online offerings:

(i) Hyperlinks. Hyperlinks from an online offering web site (such as to the issuer’s web site) should be freely permitted. Such hyperlinks simply facilitate an investor’s access to information.

(ii) E-mails. The use of e-mails to communicate with investors participating in an online offering should be viewed as oral, rather than written, communications (and therefore outside the definition of a “prospectus”). Many people use or prefer e-mail for communications that, in the absence of such technology, would occur orally over the telephone or in person. However, this applies only to the content of the actual e-mail which in theory replaces the oral telephonic or in-person communication. An attachment would still be considered a written communication.

(iii) Road Shows. Electronic road shows should be made available to institutional and retail investors, and continue to be viewed as oral communications. In addition, the requirement set out in existing Commission no-action guidance that a road show transmission not be conducted before a preliminary prospectus has been delivered to participants should be eliminated. Particularly in the case of investment grade debt offerings, often no preliminary prospectus is used, but rather simply an effective base prospectus and a final prospectus. Finally, the electronic road show not be required to be a live or recorded transmission of a road show that is or was actually presented live.\(^6\)

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The Commission should permit the requirement to deliver a final prospectus to be met under an access equals delivery model where it is readily available to the public (whether through EDGAR or on the Internet). This would allow a more streamlined offering process, in which market participants could post confirmations of sale and underwriter or dealer allocations on a web site. In addition, sales of securities could be made pursuant to an effective base prospectus, facilitating issuances of securities on a continuous basis under a shelf registration statement. As settlement cycles have become shorter and technology accelerates communications, underwriters have experienced growing difficulty in delivering prospectuses in accordance with current requirements. Under the federal securities laws, some delivery of a prospectus during the offering is required and elimination of a final prospectus may be achieved through delivery of the same information in another form at an earlier point in time. As a practical matter, the delivery of a final prospectus generally does not occur until after an investment decision is made, typically on the basis of other information that has been conveyed to the investor.\textsuperscript{7}

2. Private Offerings

The Association recommends that the Commission exercise its exemptive authority to eliminate the prohibition on general solicitations or general advertisements so long as a private offering clearly indicates the applicable restrictions on purchasers.

In the Association’s view, if an offering makes clear that the securities are only available to certain categories of investors—at least where information regarding the particular securities being offered is only made available after the person viewing the site has “clicked through” pages describing the applicable offering restrictions—should not constitute a general solicitation or general advertising. Investor protection objectives are satisfied by the requirement that, before selling any security to an investor, the issuer or underwriter have a reasonable basis for determining that the investor qualifies to participate in the private placement (e.g., if it is an “accredited investor” for an offering pursuant to Regulation D, or a “qualified institutional buyer” in a Rule 144A resale offering).

The Commission should, at a minimum, exempt from the prohibition against general solicitations or general advertisements online offerings where permissible offerees are limited to institutional investors.

The Commission should provide issuers and underwriters the flex-

\textsuperscript{7} Consistent with the Association’s position in Section V(A) of the Letter.
ibility to develop appropriate procedures for reaching a reasonable conclusion regarding an investor's ability to participate in an offering. With respect to institutional investors, “check-the-box” self-certification by an investor should be sufficient to establish its qualification. The Association notes that self-certification by QIBs is permissible under Rule 144A. As technology evolves, other satisfactory methods of determining an investor's qualifications may be developed and should be permissible.

At a minimum, the Commission should expand the information permitted by Rule 135 to be disclosed regarding a private placement, subject to the use of a prominent legend specifying who will be eligible to participate in the offering.

In addition, the timing of the determination of an investor's qualification should not be relevant, so long as it occurs prior to the sale of securities. In no instance, however, should the Commission impose a timing requirement on the process other than that the certification occur prior to sale of the security. Once a reasonable belief in investor accreditation is established, the investor should be permitted to participate in any offering (including pre-existing ones) currently available by the relevant entity. Imposing any restricted period during which the investor may not participate or prohibiting the investor from participating in offerings which were available prior to the investor completing the certification process serves no regulatory purpose and merely frustrates otherwise qualified investors.

Finally, we understand that the Commission has requested that its Division of Market Regulation considers whether the activities of a web site operator providing services like those described in the staff no action letters to Lamp Technologies would require the web site operator to register as a broker-dealer. While we agree that persons who effect transactions in securities should register as broker-dealer, those letters did not address broker-dealer registration issues and we see nothing in those letters to suggest that Lamp Technologies was effecting transactions in securities. (We note that the first Lamp Technologies letter refers to concerns of the Division of Market Regulation about broker-dealer registration and cites Venture Listing Services, Inc. (May 15, 1994) but the first Lamp Technologies letter does not indicate what those concerns were.) While we agree that the Lamp Technologies letters were limited to identifying accredited investors who could obtain information about hedge funds, the 2000 Release provides no reason for a distinction between hedge funds and other types of issuers for purpose of either Regulation D or the broker-dealer registration provision of the Exchange Act.

We believe that the discussion of the issue of broker-dealer registra-
LETTER TO SEC

tion in the Release has resulted in confusion on this issue and urge the Commission to take steps to clarify this issue.

II. ELECTRONIC DELIVERY

The Association’s comments below address the use of electronic delivery for delivery purposes of required communications under the securities laws. We are in general agreement with the Commission’s discussion in the 2000 Release of utilization of electronic communications to facilitate delivery.

1. Telephonic Consent

It is understood from the Commission’s 1995 Release that in order for there to be satisfactory electronic delivery, there must be “evidence of delivery.” One manner of acquiring sufficient evidence is by obtaining “an informed consent from an investor to receive information through a particular electronic medium.” As instructed in the SEC’s 1996 Release, an informed consent should be made by written or electronic means. Such language led to confusion as to whether such interpretation included consent via telephone. The Association believes the 2000 Release remedies this prior ambiguity by expressly including telephonic consent within the purview of the 1995 Release’s definition of “informed consent,” provided, however, a record of such consent is retained and the consent is obtained in a way that assures its validity.

2. Global Consent

Additionally, in the 2000 Release, the Commission suggests that broker-dealers, banks and other market intermediaries may obtain global consent to the electronic delivery of all documents of any issuer, as long as the consent given is informed. For example, a broker-dealer could obtain informed consent from a new client by issuing new account forms that include a separate electronic document delivery authorization section or by providing the investor with an altogether separate electronic delivery consent form. Informed consent would not be valid, however, if the opening of a brokerage account were conditioned upon the investor giving such consent to electronic delivery of documents. Additionally, in light of the broad scope of a global consent, investors should be made aware of their right to revoke consent at any time and to receive all documents in issue in paper format.

9 Intermediaries, however, may require investors to revoke on an “all or none” basis to cure any uncertainties on the part of intermediaries in terms of compliance with delivery responsibilities.
Furthermore, in order to prevent the use of electronic media that is incompatible with investor resources, an informed consent must specifically advise investors of the types of electronic media that will be used.

The Association believes that the Commission’s position on global consent is one that adopts a position more realistic and expansive from its previous position which required piecemeal consent of documents to be delivered via electronic format on an ongoing basis. The Commission’s position outlined in the 2000 Release is one which recognizes the advances in technology in the marketplace and will foster a more cohesive structure for delivery in the marketplace enhancing efficiency of the marketplace.

3. Access Equals Delivery

The 2000 Release also revisits the “access-equals-delivery” aspect of electronic media for delivery purposes. In the 1995 Release, the Commission stated that even though documents could be accessed via the Internet, issuers still needed to be prepared to follow up with hard copies at a customer’s request regardless of whether such customer had previously consented to electronic delivery. The Commission’s position was based upon the premise that although the Internet was gaining a hold in society it was not pervasive enough as to warrant utilization of an unmodified “access-equals-delivery” model. The Commission, while recognizing the rapid growth of the Internet since 1995, reaffirms this position in the 2000 Release based upon the Commission’s view that impediments still exist to such a model (i.e. download times, printer capabilities, etc.).

The Association generally agrees with the Commission’s position with respect to implementation of an “access-equals-delivery” model. The Association believes, however, that an “access-equals-delivery” model should be acceptable in the case of large institutional investors due to their sophistication and access to substantial resources. Further, such a system of delivery should be available to those individuals who consent to such a model of delivery. Implementation of such “elective” and/or “institutional” regulatory standards would maximize efficiency in the marketplace while minimizing the types of investor risk the Commission is directly concerned with in the area of implied consent, namely investor “approval” via inaction or indifference.

Additionally, more sweeping changes have been proposed in the area of implied consent. Commenters have argued that a fundamental change should be undertaken in the general scheme of electronic delivery. Such commenters have argued that implied consent should be acceptable in the case where an investor does not affirmatively object to electronic de-
delivery once notified of an issuer's or intermediary's intention to deliver documents in electronic format.

The Association agrees with the Commission's position with respect to implied consent. The Association believes that the burden of consent should not be a pro-active burden placed upon the investor but rather a burden carried by the issuer or intermediary who, in the majority of instances, possess greater sophistication, access to resources and knowledge required to effectively deliver the documents whereby such issuer and intermediary are deriving a benefit.

4. PDF Format

Another ambiguity from the 1995 Release was the Commission's position that, "the use of a particular medium should not be so burdensome that intended recipients cannot effectively access the information provided."\(^{10}\) This language led to uncertainty in the securities bar as to whether documents delivered in "portable document format" ("PDF") might be excluded as a proper medium for electronic delivery. In an effort to address such concern, the interpretative 2000 Release makes clear that market intermediaries may electronically deliver materials in PDF. In such a case, however, investors and security holders must be given information regarding downloading PDF and must be provided with necessary software and guidance shifting the burden from the investor to those delivering the information.

The Association believes that the Commission's position with respect to the utilization of PDF formatted documents for delivery purposes is one which recognizes the inherent technological improvements taking place in the market and fostering of such. PDF format has become one of the most widely-accepted formats for the downloading of information and files via Internet delivery and utilization of such in the securities industry can only promote efficiency in the marketplace. The Association also agrees with the Commission in its position that the burden to provide the software and technical support should be provided by those delivering the information to investors as there should not be a proactive burden on the investor to seek out the appropriate software and/or downloaded files when those delivering the information would have better knowledge and access to the software, formats and updates that work best with their respective systems.

5. “Envelope Theory”

In order to effectuate dissemination of information electronically in

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compliance with federal securities laws requiring simultaneous delivery of multiple documents, the 1995 Release noted that concurrent electronic delivery of documents was possible with the use of "virtual" envelopes. The 1995 Release set forth the view "that documents in close proximity on the same web site menu are considered delivered together" and "that documents hyperlinked to each other are considered delivered together as if they were in the same paper envelope." Thus, the "envelope theory" was born.

The theory, however, has caused some confusion among issuers and intermediaries in regard to proper web site content when an issuer is in registration and has introduced a level of metaphysics difficult to implement in practice. For example, some lawyers have questioned whether application of the envelope theory would cause everything on a particular web site to be included in a Section 10 prospectus posted on that site. The 2000 Release explains that only information that an issuer acts to make part of the Section 10 prospectus will actually become part of it. An embedded hyperlink, for instance, "within a Section 10 prospectus or any other document required to be filed or delivered under the federal securities laws causes the hyperlinked information to be a part of that document." 12

Another issue that has been raised is whether information, not within the Section 10 prospectus, but in close proximity to it, would be considered free writing. As the 2000 Release notes the actual location of the information is not important. Irrespective of whether a Section 10 prospectus is posted, the web site's content will be reviewed as a whole for improper free writing. "The close proximity of information on a web site to a Section 10 prospectus does not, by itself, make that information an "offer to sell," "offer for sale" or "offer" within the meaning of Section 2(a)(3) of the Securities Act." 13

In addition, the 2000 Release clarifies the duties of municipal securities underwriters under Exchange Act Rule 15c2-12 that requires the underwriter to send all potential customers the final official statement of a municipal securities issuer. A problem arises, however, when the issuer posts its official statement on a web site and also sets up hyperlinks to other sites, resulting in the uncertainty of municipal securities underwriters as to what comprises the final official statement to be sent to potential customers. To alleviate this problem, the 2000 Release states underwriters "may rely on a municipal securities issuer to identify the documents on the

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11. See id.
13. Id.
issuer's web site that comprise the preliminary, deemed final and final official statements.”14

The Association is in general agreement with the Commission with respect to its position on “Envelope Theory.” The Commission’s move to content-based review as opposed to proximity-based review is indicative of the Commission’s acceptance and adaptability of the evolving technology that is changing the marketplace wherein “proximity” is an obfuscated bearing point for substantive review of materials for compliance with the securities laws.

III. WEB SITE CONTENT

To meet investor demands for more information, separate cul-de-sac web pages should be permitted to allow seasoned issuers and broker-dealers to communicate with investors. Companies should be encouraged to communicate with investors, and we believe that a demarcated section of a seasoned issuer’s website, and only this section should be subject to any publicity restrictions when the company is in registration. Similarly, broker-dealers may wish to host chat rooms and other forums whereby investors have a mechanism to communicate with other customers of that broker-dealer, or the broker-dealer’s analysts or traders. Surely communications with investors can be encouraged through the Commission exercising its exemptive authority. At a minimum, such forums should be permitted under password access for customers of a broker-dealer.

* * *

As a general principle, the Association strongly favors an approach to the regulation of electronic media that facilitates the ability of issuers, market intermediaries and investors to fully take advantage of the changes wrought by information technology. For increasing numbers of investors and other market participants, the Internet and related computer technologies are no longer novelties but in fact essential tools of everyday life. As the 2000 Release notes, the Internet has had a significant impact on capital-raising techniques and on the capital markets generally, and the increased availability of information through the Internet has helped promote transparency, liquidity and efficiency in our capital markets. New developments in information technology may offer additional opportunities for further improvements.
The Association believes that the Commission should adopt regulatory policies that preserve and foster the benefits that electronic media has brought to the capital markets and to all investors. Accordingly, the Association urges the Commission to adopt policies that recognize the substantial changes that have already occurred in investors’ use of electronic technology and that will permit the use of new communications tools as they evolve or develop. In doing so, the Commission should pursue the following goals, as further described below: (i) giving market participants sufficient flexibility to utilize electronic technology to offer securities online, including ensuring that investors with access to electronic media can enjoy the full benefits of new technology, (ii) avoiding regulatory approaches that discriminate between purely online firms and those that offer electronic media in addition to their traditional broker-dealer services, and (iii) identifying areas where its exemptive authority can be used to remove regulatory impediments to the use of new technology in a way that will benefit investors.

Finally, we urge the Commission to work with regulators in other countries. Securities offerings are being done increasingly on a global basis, and investors seek investment opportunities without regard to borders. The use of electronic media, which is inherently global and transcends time zones and geographic boundaries, is an integral part of this development, and highlights the need for the Commission and other regulators to work closely together in developing the type of flexible regulatory framework market participants need. Otherwise, patchwork of regulation will continue and diminish the benefits of electronic media to investors and other market participants.

As a final note, the members of the Association would be pleased to meet with the staff of the Commission to discuss any aspect of this letter.

July 2000
LETTER TO SEC

The Committee on Securities Regulation

Stephen J. Schulte, Chair
André Weiss, Secretary

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Walter G. Ricciardi
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Faiza J. Saeed
Kathryn F. Schneider
Roslyn Tom
James Q. Walker
Lawrence J. Zweifach
# New Members

## As of August 2000

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<td>Mayra E. Bell</td>
<td>06/89</td>
<td>NYC Transit Authority Brooklyn NY</td>
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<td>NYC Comptroller's Office New York NY</td>
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<td>04/96</td>
<td>Martha Stewart Living, Omnimedia Inc. New York NY</td>
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<td>10/70</td>
<td>300 Park Ave New York NY</td>
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<td>Salans Hertzfeld Heilbronn Christy &amp; Viener New York NY</td>
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<td>Pesetsky &amp; Bookman New York NY</td>
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<td>D'Amato &amp; Lynch New York NY</td>
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A Selective Bibliography
Eyewitness Testimony
and Identification
by Ronald I. Mirvis

PERIODICALS

* Not in the Association's collection


Gibeaut, John. Confidence boost: study shows police conduct can convince eyewitnesses that they identified the right suspect. 83 ABA J. 26 (1997).


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*Shaw, John S., III and McClure, Kimberley A. Repeated postevent questioning can lead to elevated levels of eyewitness confidence. 20 Law & Hum. Behav. 629 (1996).


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