

Washington Journal of Law, Technology & Arts

University of Washington School of Law

VOL. 11

WINTER 2016

NO. 4

CONTENTS

Jail (E)Mail: Free Speech Implications of Granting Inmates Access to Electronic Messaging Services <i>Brennen J. Johnson</i>	285
End of the Parallel Between Patent Law's § 284 Willfulness and § 285 Exceptional Case Analysis <i>Don Zhe Nan Wang</i>	311
Undermining Bitcoin <i>Sam Hampton</i>	331
Much Ado About Transformativeness: The Seventh Circuit and Market-Centered Fair Use <i>Aaron B. Wicker</i>	355

Washington Journal of Law, Technology & Arts

University of Washington School of Law

VOL. 11

WINTER 2016

NO. 4

2015-2016 EDITORIAL BOARD

Editor-in-Chief

NAAZANEEN HODJAT

Associate Editor-in-Chief

ROBIN HAMMOND

Associate Editor-in-Chief

VIJAY KUMAR

Director of Outreach

BROOKS LINDSAY

Chief Submissions Editor

CHRISTIAN KAISER

Chief Managing Editor

JULIYA ZISKINA

Chief Articles Editor

JULIE LIU

Executive Submissions Editor

SAM HAMPTON

Executive Managing Editor

YAYI DING

Executive Articles Editor

MIRIAM SWEDLOW

Senior Submissions Editor

JOE DAVISON

Chief Online Editor

TALIA LOUCKS

Executive Online Editor

MICHAEL HUGGINS

Senior Managing Editors

CHIKE EZE

DENISE KIM

DON WANG

Senior Articles Editors

ANDREW FULLER

BRENNEN JOHNSON

CHERYL LEE

KELSEY O'NEAL

Faculty Advisor

ROBERT GOMULKIEWICZ

Web Design

KATHY KEITHLY

EDITORIAL STAFF

DANIELLE OLLERO

JEFF BESS

BETH ST. CLAIR

JASON LIU

CARLIE BACON

MACKENZIE OLSON

ALEXANDER BULLOCK

JESSY NATIONS

KIRAN JASSAL

GRADY HEPWORTH

SAMUEL DAHEIM

TYLER QUILLIN

GWEN WEI

EXTERNAL BOARD

JEN CHIANG

TRENT DYKES

ROBERT GOMULKIEWICZ

TIM LEE

SEAN O'CONNOR

BOB CUMBOW

JENNIFER FAN

CHRIS IGIELSKI

ASHLEY LONG

LONNIE ROSENWALD

JOHN WERESH

KAUSTUV DAS

PARAG GHEEWALA

JESSIE KENNEDY

GREGORY MCNEAL

CHRISTOPHER SWEENEY

JAIL (E)MAIL: FREE SPEECH IMPLICATIONS OF GRANTING
INMATES ACCESS TO ELECTRONIC MESSAGING SERVICES

*Brennen J. Johnson**

© Brennen J. Johnson

Cite as: 11 Wash. J.L. Tech. & Arts 285 (2016)
<http://digital.lib.washington.edu/dspace-law/handle/1773.1/1557>

ABSTRACT

The First Amendment protects not only our right to share ideas, but also to some extent, our right to choose the specific method by which we share them. Generally speaking, these protections apply to inmates' rights to communicate with those outside of prison. However, the protection of those rights must be balanced with the penological interests of prisons and jails. Electronic messaging has now become a standard form of communication within most American homes and businesses. Accordingly, the Federal Bureau of Prisons has implemented the TRULINCS program, a program which allows inmates to communicate with those outside of prison through electronic messaging. The Washington State Department of Corrections has installed JPay kiosks in state-operated facilities that allow inmates to send and receive electronic messages. However, most state prison systems and county jails currently do not offer inmates the option of receiving or sending electronic messages. The Supreme Court of the United States has indicated that prisoners have a constitutional right to send and receive mail, and some circuit courts have extended that right to telephone use. This Article examines the foundational aspects of free speech in prison settings and how the

* Brennen J. Johnson, University of Washington School of Law, Class of 2016. Special thanks to Theodore Myhre for his guidance and tutelage. The thoughts and views expressed in this Article solely reflect those of the Author.

evolution of communication might affect the breadth of an inmate's free speech rights. This Article argues that, in certain situations, the First Amendment should protect inmates' interests in sending and receiving emails.

TABLE OF CONTENTS

Introduction.....	288
I. Email and the Free Speech Framework.....	290
A. Applying the First Amendment to Email Communications.....	290
B. Applying the Appropriate Level of Scrutiny to Restrictions on Free Speech	292
II. The Free Speech Framework in a Prison Context	294
A. Guiding Principles Regarding Constitutional Rights of Prisoners	294
B. The Framework for Free Speech Challenges in Prison ..	295
C. What Happened to the Limited Power to Regulate Time, Place, or Manner?	297
III. Does Failure to Provide Email in Prison Implicate First Amendment Rights?	298
A. Comparing the Right to Telephone Use	299
B. A Lack of Direct Persuasive Precedent.....	300
C. Inmate Email Access in the Context of the Right to Select an Avenue of Speech.....	302
IV. The Positive Obligation Hurdle	302
V. Evaluating the Lack of Email Access in Prison Under Currently Existing Standards.....	304
A. Failure to Provide Email under the Turner Standard.....	304
1. Restricting Email Use Has No Rational Relation to a Legitimate and Neutral Governmental Objective.....	304
2. Alternative Avenues Exist to Exercise the Basic Right of Communicating, but May Not Offer Many of the Benefits that Might Lead an Inmate to Choose Email Over Postage.....	306
3. The Impact on Staff, Prisoners, and Prison Resources is Minimal, if Not Beneficial.....	306
4. The Easy and Obvious Alternative of Implementing an Email Service Indicates that Prison Practices are Overly Restrictive.....	307
B. Failure to Provide Email Access Under the Martinez or Thornburgh Standard.....	308
Conclusion	309
Practice Pointers.....	310

INTRODUCTION

Times have changed drastically since Tom Hanks and Meg Ryan sat anxiously at their computers awaiting that famously infectious chime, “*You’ve got mail.*” Email has since developed into an everyday staple of communication. On average, 182.9 billion emails are sent worldwide every day.¹ In 2013, the number of email accounts existing was approximately 3.9 billion.² That number is expected to rise to 4.9 billion by the end of 2017.³

Despite the prolific use of email in everyday communications, email has only recently started being used in prisons. It was not until 2006 that prisoners in eleven federal facilities gained access to a limited electronic messaging service through the Trust Fund Limited Inmate Communication System pilot program.⁴ By early 2009, the system was accessible in over thirty federal prisons⁵ and was renamed the Trust Fund Limited Inmate Computer System (“TRULINCS”)⁶. Today, the Federal Bureau of Prisons (“BOP”) can boast that all BOP operated facilities enjoy access to electronic messaging through TRULINCS.⁷

While electronic messaging remains unavailable to almost all prisoners in state and county custody, a small number of state prison systems have begun to provide electronic messaging

¹ Reno v. ACLU, 521 U.S. 844, 870 (1997).

² THE RADICATI GROUP, EMAIL STATISTICS REPORT 2013–2017 — EXECUTIVE SUMMARY 2 (Sara Radicati ed., 2013), <http://www.radicati.com/wp/wp-content/uploads/2013/04/Email-Statistics-Report-2013-2017-Executive-Summary.pdf>.

³ *Id.*

⁴ OFFICE OF THE INSPECTOR GENERAL, EVALUATION AND INSPECTIONS REPORT NO. I-2006-009, FEDERAL BUREAU OF PRISONS’ MONITORING OF MAIL FOR HIGH-RISK INMATES app. IV (2006).

⁵ Douglas Galbi, *Email for Prisoners Highly Successful*, PURPLE NOTES (Sept. 11, 2011), <http://purplemotes.net/2011/09/11/email-for-prisoners-highly-successful/>.

⁶ FEDERAL BUREAU OF PRISONS, U.S. DEP’T OF JUSTICE, PROGRAM STATEMENT NO. P5265.13, TRUST FUND LIMITED INMATE COMPUTER SYSTEM (TRULINCS) - ELECTRONIC MESSAGING (2009).

⁷ *TRULINCS Topics*, FEDERAL BUREAU OF PRISONS, <http://www.bop.gov/inmates/trulincs.jsp> (last visited Jan. 12, 2015).

systems to inmates. For instance, the Washington Department of Corrections (“WDOC”) has become the only prison system in the Ninth Circuit to provide incoming and outgoing email services to inmates by partnering with a service called “JPay” and installing commercial email kiosks in most WDOC operated facilities.⁸ Likewise, the Michigan State Department of Corrections has installed JPay kiosks in all of its facilities.⁹ Apart from Washington and Michigan, a total of five other state prison systems provide email access to inmates in at least some of their facilities—Virginia,¹⁰ Louisiana,¹¹ North Dakota,¹² Ohio,¹³ and Maryland.¹⁴ Some facilities in the Washington, Louisiana, North Dakota, and Virginia prisons systems have even implemented special tablets with limited functions to make email services more accessible to inmates.¹⁵

Whether in federal or state prison, email access comes to prisoners at a price. To send and receive messages through

⁸ *JPay Communication System (Email)*, WASH. STATE DEP’T OF CORR., <http://www.doc.wa.gov/family/jpay.asp> (last visited Jan. 12, 2015).

⁹ *Electronic Messages – Sending to Prisoners*, MICH. DEP’T OF CORRECTIONS, http://www.michigan.gov/corrections/0,4551,7-119-68854_68856_63694-201925--,00.html (last visited Jan. 12, 2015).

¹⁰ *Virginia Department of Corrections*, JPAY, <http://www.jpays.com/Agency-Details/Virginia-Department-of-Corrections.aspx> (last visited Jan. 12, 2015).

¹¹ *Louisiana Department of Corrections*, JPAY, <http://www.jpays.com/Agency-Details/Louisiana-Department-of-Corrections.aspx> (last visited Jan. 12, 2015).

¹² *North Dakota State Penitentiary*, JPAY, <http://www.jpays.com/Facility-Details/North-Dakota-Department-of-Corrections/North-Dakota-State-Penitentiary.aspx> (last visited Jan. 12, 2015).

¹³ *Ohio Department of Rehabilitation and Correction*, JPAY, <http://www.jpays.com/Agency-Details/Ohio-Department-of-Rehabilitation-and-Correction.aspx> (last visited Jan. 12, 2015).

¹⁴ *Maryland Correctional Institution – Women*, MD. DEP’T OF PUB. SAFETY & CORRECTIONAL SERVICES, <http://www.dpscs.state.md.us/locations/mciw.shtml> (last visited Jan. 12, 2015). It should be noted that Maryland is implementing electronic messaging on a trial basis, and only in one women’s correctional facility.

¹⁵ *Mini-tablet for Prisons Now Available in Louisiana, Virginia, Washington and N. Dakota!*, JPAY BLOG, <http://blog.jpays.com/mini-tablet-for-prisons-now-available-in-louisiana-and-virginia/> (last visited Jan. 12, 2015).

TRULINCS, JPay, or some other state implemented service, inmates and their loved ones must pay between seventeen and sixty cents per email.¹⁶ As the BOP states: “No taxpayer dollars are used for this service. Funding is provided entirely by the Inmate Trust Fund, which is maintained by profits from inmate purchases of commissary products, telephone services, and the fees inmates pay for using TRULINCS.”¹⁷

The First Amendment states that “Congress shall make no law . . . abridging the freedom of speech.”¹⁸ This prohibition applies equally to the several states that have incorporated this system through the Fourteenth Amendment’s Due Process Clause.¹⁹ In an era when technology has significantly increased the channels of communication available to the public, changing times have forced courts to evaluate the First Amendment guarantee of free speech in increasingly complex scenarios. This Article examines the intersection of free speech protections and access to electronic messaging in prison.

I. EMAIL AND THE FREE SPEECH FRAMEWORK

To understand how free speech protections interact with an inmate’s access to electronic messaging systems, it is necessary to recognize (1) how the First Amendment might interact with email communications and (2) what level of scrutiny applies to various restrictions on free speech rights.

A. Applying the First Amendment to Email Communications

Internet communications, such as emails, presumptively fall within the ambit of free speech protections.²⁰ In assessing an

¹⁶ Derek Gilna, *Prison Systems Increasingly Provide Email - For a Price*, PRISON LEGAL NEWS, Nov. 2015, at 35.

¹⁷ *TRULINCS Topics*, FEDERAL BUREAU OF PRISONS, <http://www.bop.gov/inmates/trulincs.jsp> (last visited Jan. 12, 2015).

¹⁸ U.S. CONST. amend. I.

¹⁹ U.S. CONST. amend. XIV, § 1; *see also* *Murdock v. Pennsylvania*, 319 U.S. 105, 108 (1943) (incorporating the First Amendment’s free speech clause into the Fourteenth Amendment’s due process clause).

²⁰ *See* *Clement v. Cal. Dep’t of Corr.*, 364 F.3d 1148, 1151 (9th Cir. 2004).

alleged violation of free speech, the initial consideration regarding any claim is whether a limitation implicates any free speech rights. These rights are not limited by form. Courts have found that Internet communications deserve the same protections as other more traditional forms of speech.²¹

Generally, communication enjoys a presumptive implication of First Amendment protection.²² As iterated by the Supreme Court, “[m]ost of what we say to one another lacks religious, political, scientific, educational, journalistic, historical, or artistic value (let alone serious value), but it is still sheltered from government regulation.”²³ As such, when government action limits the communicative use of words, free speech protections are implicated.

In the context of Internet communications, courts have determined that the First Amendment “protects material disseminated over the internet as well as by the means of communication devices used prior to the high-tech era.”²⁴ Accordingly, attempts to communicate over the Internet, which incorporate linguistic elements,²⁵ such as most emails, presumptively fall within the First Amendment’s scope; the presumption is rebuttable only if there is an established tradition of exclusion.²⁶

²¹ See *id.*; see also *Reno v. ACLU*, 521 U.S. 844, 868 (1997).

²² See Charles W. Rhodes, *The First Amendment Structure for Speakers and Speech*, 44 SETON HALL L. REV. 395, 404 (2014).

²³ *United States v. Stevens*, 559 U.S. 460, 479 (2010) (internal quotation marks omitted).

²⁴ *Clement*, 364 F.3d at 1151; see also *Reno*, 521 U.S. at 868.

²⁵ See Rhodes, *supra* note 22 (“The use of words or language to attempt to communicate any assertion, idea, perception, emotion, or thought—or any attempt to receive such words or language—is presumptively covered by the First Amendment.”).

²⁶ See Rhodes, *supra* note 22. See this article for a discussion of the types of exclusions that are common or may apply to free speech rights. Although many communications that are sent via the Internet could trigger such exclusions, they are irrelevant to the more general discussion of email *access* in a prison setting. Because such a discussion focuses on the initial ability to access email rather than the content of a particular inmate’s communications, there is no context here in which to address these exclusions.

B. Applying the Appropriate Level of Scrutiny to Restrictions on Free Speech

Once a government action has been shown to implicate free speech protections, the inquiry becomes whether the action imposes restrictions that are “content-neutral.” A regulation is content-neutral if its applicability to a given expression does not turn on the content of the speech.²⁷ Here, “[t]he government’s purpose is the controlling consideration. A regulation that serves purposes unrelated to the content of expression is deemed neutral”²⁸ In contrast, “[r]ules are generally considered content-based when the regulating party must examine the speech to determine if it is acceptable.”²⁹

If the action is not content-neutral, then the action will be examined under strict scrutiny, which means it violates the First Amendment unless shown to be “the least restrictive means of achieving a compelling state interest.”³⁰ However, if the action is content-neutral, then it is subject to intermediate scrutiny, which means that the court will determine if the action is “narrowly tailored to serve a significant governmental interest, and . . . leave[s] open ample alternative channels for communication of the information.”³¹ The application of intermediate scrutiny in the context of content-neutral governmental action is based on the premise that “the government may impose reasonable restrictions on the time, place, or manner of protected speech.”³²

Although the government may create reasonable time, place, or

²⁷ See *Clark v. Cmty. for Creative Non-Violence*, 468 U.S. 288, 293 (1984); *Ward v. Rock Against Racism*, 491 U.S. 781, 790–91 (1989).

²⁸ *Ward*, 491 U.S. at 791.

²⁹ *United Bhd. of Carpenters & Joiners of Am. Local 586 v. NLRB*, 540 F.3d 957, 964 (9th Cir. 2008); see also *Clark*, 468 U.S. at 293 (“[R]estrictions of this kind are valid provided that they are justified without reference to the content of the regulated speech, that they are narrowly tailored to serve a significant governmental interest, and that they leave open ample alternative channels for communication of the information.”).

³⁰ *McCullen v. Coakley*, 134 S. Ct. 2518, 2530 (2014).

³¹ *Clark*, 468 U.S. at 293.

³² *Ward*, 491 U.S. at 791.

manner restrictions in public forums,³³ the foreclosure of an entire avenue of speech should be subject to strict scrutiny. The Ninth Circuit has recognized that, in addition to the right to communicate the content of a message, “free speech protections extend to the ‘right to choose a particular means or avenue of speech . . . in lieu of other avenues.’”³⁴ Accordingly, the “[g]overnment may regulate the *manner* of speech in a content-neutral way but may not infringe on an individual’s right to select the *means* of speech.”³⁵ The total foreclosure of an avenue of speech, even while alternative avenues remain open, acts as the total abrogation of a protected constitutional right.

For example, in *Meyer v. Grant*,³⁶ the Supreme Court determined that a prohibition on paid petition circulators violated the First Amendment when it foreclosed the opportunity for the petitioner to communicate its message through the “most effective, fundamental, and perhaps economical avenue of political discourse, direct one-on-one communication.”³⁷ Specifically, the Court held that such actions by the government “involved a limitation on . . . expression subject to exacting scrutiny.”³⁸ Applying strict scrutiny, the Court concluded that the government action violated the First Amendment, even though multiple other avenues of expression remained open to the petitioner.³⁹ In reaching its conclusion, the Court determined that the First Amendment protects not only the right to communicate a message, “but also to select what [one] believe[s] to be the most effective means for so doing.”⁴⁰ This protection of the First Amendment may be applicable to the selection of email services to convey protected communications, especially when email has become such an efficient, fundamental, and economically advantageous avenue of discourse.

³³ *Clark*, 468 U.S. at 293.

³⁴ *United Bhd. of Carpenters*, 540 F.3d at 969 (quoting *Foti v. City of Menlo Park*, 146 F.3d 629, 641 (9th Cir. 1998)).

³⁵ *Foti*, 146 F.3d at 641–42.

³⁶ *Meyer v. Grant*, 486 U.S. 414 (1988).

³⁷ *Id.* at 424.

³⁸ *Id.* at 420.

³⁹ *Id.* at 424.

⁴⁰ *Id.*

II. THE FREE SPEECH FRAMEWORK IN A PRISON CONTEXT

Prisons and jails can be dangerous places, and some of the people inside can pose a serious threat to other prisoners and the outside world if their communications are not limited. Accordingly, to protect both the public and prisoners alike, free speech protections must be analyzed with greater caution in a prison context. Understanding how free speech protections might work in a prison setting requires examining: (1) the general principles behind the constitutional rights of prisoners, (2) the historical framework for free speech challenges in prison settings, and (3) the government's traditionally limited power to regulate time, place, or manner of free speech.

A. Guiding Principles Regarding Constitutional Rights of Prisoners

The analysis of the constitutional rights of prisoners is guided primarily by two often-conflicting principles: an inmate's retention of constitutional rights, and deference to prison authorities. When these two principles come into tension, courts must balance the "traditional policy of judicial restraint regarding prisoner complaints and the need to protect constitutional rights."⁴¹

Incarceration does not deprive inmates of their constitutional rights and protections. The Court in *Turner v. Safley* exemplifies this principle, stating that "[p]rison walls do not form a barrier separating prison inmates from the protections of the Constitution."⁴² This principle applies wherever a prisoner in government custody asserts constitutional protections.⁴³

However, in the context of prison administration, courts should

⁴¹ *Procunier v. Martinez*, 416 U.S. 396, 406 (1974), *abrogated by* *Thornburgh v. Abbott*, 490 U.S. 401 (1989).

⁴² *Turner v. Safley*, 482 U.S. 78, 84 (1987).

⁴³ *See, e.g.,* *Wolff v. McDonnell*, 418 U.S. 539, 556 (1974) (applying due process protections); *Johnson v. Avery*, 393 U.S. 483, 485–86 (1969) (protecting the right to petition the government); *Lee v. Washington*, 390 U.S. 333, 333 (1968) (applying Equal Protection Clause).

“accord deference to the appropriate prison authorities.”⁴⁴ Because the expertise, planning, and commitment of resources involved with running a prison fall “peculiarly within the province of the legislative and executive branches of government,” separation of power concerns support a policy of judicial restraint on questions that would affect these issues.⁴⁵

It is easy to see how deference to prison administrators might conflict with an inmate’s assertion of his or her retained constitutional protections. These principles are supposed to be “balanced” against the other when they conflict. However, the analysis in *Turner* suggests that the Court favors deference to prison authorities.

B. The Framework for Free Speech Challenges in Prison

Separate standards govern the evaluation of incoming and outgoing correspondence restrictions. The historical framework of free speech challenges in a prison context suggests that “heightened scrutiny” will be applied to restrictions on outgoing communications while a more deferential “reasonableness test” will be applied to limitations on incoming communications.

The Supreme Court’s first major articulation of a standard of review for prison regulations on free speech occurred in *Procunier v. Martinez*.⁴⁶ The Court required that such regulations “further an important or substantial governmental interest unrelated to the suppression of expression” and do not impinge on First Amendment protections more “than is necessary or essential to the protection of the particular governmental interest involved.”⁴⁷ Although this test largely mirrors the effective language of a heightened—or even strict—scrutiny standard, subsequent cases obscured this standard and it devolved into a vague test based on the “reasonableness” of prison regulations.⁴⁸

⁴⁴ *Turner*, 482 U.S. at 85.

⁴⁵ *Id.*

⁴⁶ *Procunier v. Martinez*, 416 U.S. 396 (1974).

⁴⁷ *Id.* at 413.

⁴⁸ See *Block v. Rutherford*, 468 U.S. 576, 586 (1984); *Bell v. Wolfish*, 441 U.S. 520, 550 (1979); *Jones v. N.C. Prisoners’ Labor Union, Inc.*, 433 U.S. 119,

Thirteen years after its decision in *Martinez*, the Court in *Turner* explicitly set forth a “reasonableness” standard for evaluating prison regulations that dealt with incoming correspondence.⁴⁹ There, the Court stated that prison regulations are “valid if [they are] reasonably related to legitimate penological interests.”⁵⁰ To evaluate the reasonableness of a regulation, the Court provided four factors to consider:

(1) [W]hether the regulation is rationally related to a legitimate and neutral governmental objective, (2) whether there are alternative avenues that remain open . . . to exercise the right, (3) the impact that accommodating the asserted right will have on other guards and prisoners, and on the allocation of prison resources; and (4) whether the existence of easy and obvious alternatives indicates that the regulation is an exaggerated response by prison officials.⁵¹

Two years later, in *Thornburgh v. Abbott*,⁵² after recognizing that the “implications of outgoing correspondence for prison security are of a categorically lesser magnitude than the implications of incoming materials,”⁵³ the Court clarified that the reasonableness standard applied subsequent to *Martinez*, and articulated in *Turner*, applied specifically to *incoming* correspondence. Pursuant to this conclusion, the Court explicitly overruled the standard of *Martinez* as it only applies to *incoming* correspondence. However, while the more deferential standard of *Turner* applies to incoming correspondence, it appears that the heightened scrutiny standard of *Martinez* remains in force for outgoing correspondence. Accordingly, it appears that separate standards govern the evaluation of incoming and outgoing correspondence restrictions: the *Martinez* heightened scrutiny test

131 (1977); *Pell v. Procunier*, 417 U.S. 817, 822 (1974).

⁴⁹ *Turner v. Safley*, 482 U.S. 78 (1987).

⁵⁰ *Id.* at 89.

⁵¹ *Prison Legal News v. Lehman*, 397 F.3d 692, 699 (9th Cir. 2005) (citing *Turner*, 482 U.S. at 89).

⁵² *Thornburgh v. Abbott*, 490 U.S. 401 (1989).

⁵³ *Id.* at 413.

for outgoing communications and the *Turner* reasonableness test for incoming communications.

Although “[l]awful incarceration brings about the necessary . . . limitation of many privileges and rights, a retraction justified by the considerations underlying our penal system,”⁵⁴ neither the *Martinez* nor the *Turner* standard turn on an individual’s status as an inmate. The only policy consideration supporting a lower standard of scrutiny for communications inside and outside of prisons is the deference that is due to the executive officers responsible for prison management. The evaluation of a prison regulation that implicates free speech rights is logically connected to the legitimate or substantial security concerns of running a prison, not a lessened value imputed to the constitutional rights of inmates. It is thus irrelevant whether the regulations implicate the free speech protections of inmates or of the free citizens who seek to communicate with them.

C. What Happened to the Limited Power to Regulate Time, Place, or Manner?

While the *Turner* standard attempts to balance conflicting policies by applying a “reasonableness” standard to prison regulations, it fails to account for the government’s limited power to regulate the time, place, or manner of free speech.⁵⁵

Many prison practices may designate limitations on speech such as the number of correspondences sent and received each day, the volume of single messages, or the manner of packaging written communications. These types of limitations would fall squarely within the power of the government to reasonably limit the time, place, or manner of speech. However, in establishing the *Turner* standard, the Court failed to account for government actions that go beyond the mere regulation of time, place, or manner. In doing so, it overlooked longstanding checks on the power to regulate

⁵⁴ *O’Lone v. Estate of Shabazz*, 482 U.S. 342, 348 (1987) (alteration in original) (quoting *Price v. Johnston*, 334 U.S. 266, 285 (1948)) (internal quotation marks omitted).

⁵⁵ See “Applying the Appropriate Level of Scrutiny to Restrictions on Free Speech,” *supra* at p. 7.

speech and instituted a standard that evaluates the reasonableness of abrogating a constitutional right by deferring to the executive authority of local prison administrators.

This viewpoint overlooks the risk of restrictions that go beyond the government's traditional power to regulate the time, place, and manner of speech and applies a "reasonableness" test to regulations that entirely abrogate certain First Amendment rights, such as the right of free citizens or inmates to select a particular means to communicate with one another. In any other context, such a significant abrogation of a constitutional right would be evaluated under the strict scrutiny standard. Nonetheless, modern courts reviewing a restriction that completely abrogates certain means of communication (such as written letters, phone calls, postcards, or emails) might evaluate such restrictions under the *Turner* reasonableness test when such sweeping regulations should be evaluated under a standard of strict, or at least heightened scrutiny. Otherwise, courts run the great risk that such regulations will unnecessarily violate constitutional rights. A standard of strict scrutiny is far more stringent than the *Turner* test, but it is not necessarily fatal to government regulations. Prisons would still be permitted to apply the least restrictive means available to achieve legitimate and compelling administrative interests.

III. DOES FAILURE TO PROVIDE EMAIL IN PRISON IMPLICATE FIRST AMENDMENT RIGHTS?

Although socially controversial, it is settled law that prison walls neither sever inmates from their constitutional rights nor "bar free citizens from exercising their own constitutional rights by reaching out to those on the inside."⁵⁶ As stated earlier, the threshold inquiry of any claim to free speech protections is whether or not the limitation at issue actually infringes on any free speech rights.

In the context of inmate email access, it is helpful to recognize:

⁵⁶ *Thornburgh*, 490 U.S. at 407 (citing *Turner*, 482 U.S. at 94–99; *Bell v. Wolfish*, 441 U.S. 520 (1979); *Jones v. N.C. Prisoners' Labor Union, Inc.*, 433 U.S. 119 (1977); *Pell v. Procunier*, 417 U.S. 817 (1974)) (internal quotation marks omitted).

(1) the cases that address access to other modern communication systems like telephones, (2) the lack of direct persuasive authority in the context of email, and (3) the fact that courts dealing with prisoner communications seem to have overlooked the right to choose a particular avenue of communication over another.

A. Comparing the Right to Telephone Use

There is a strong similarity between the uses of telephonic and of electronic messaging in the context of prisons. Both involve an inmate's access to a means of communication provided by modern technology and consequently implicate similar free speech considerations. But where email access for inmates is a novel issue, several circuit courts have directly addressed the assertion of telephone access as an inmate's constitutional right. Therefore, cases involving inmate assertions of a right to telephone use provide a helpful comparison for determining whether or not the assertion of a right to email access would implicate protected free speech rights. Currently, there is a pronounced circuit split on the issue of whether or not inmates possess a constitutional right to telephone access. This split illustrates that the success of asserting rights to email may depend on the jurisdiction in which the claim is brought.

The Ninth Circuit has held that "prisoners have a First Amendment right to telephone access," though this right remains "subject to reasonable limitations arising from the legitimate penological and administrative interests of the prison system."⁵⁷ Additionally, the Sixth Circuit has held that prisoners have a First Amendment right to limited telephone access,⁵⁸ while the Eighth Circuit has recognized that the First Amendment *may* include a right to prisoner telephone access.⁵⁹

Conversely, in *Arsberry v. Illinois*, the Seventh Circuit held that prisoners in Illinois have no First Amendment right to use the

⁵⁷ *Johnson v. State of Cal.*, 207 F.3d 650, 656 (9th Cir. 2000) (citing *Strandberg v. City of Helena*, 791 F.2d 744, 747 (9th Cir.1986)).

⁵⁸ *Washington v. Reno*, 35 F.3d 1093, 1100 (6th Cir. 1994).

⁵⁹ *Benzel v. Grammer*, 869 F.2d 1105, 1108 (8th Cir. 1989).

telephone.⁶⁰ Focusing solely on the general content of inmate communications, Judge Posner stated:

Although the telephone can be used to convey communications that are protected by the First Amendment, that is not its primary use and it is extremely rare for inmates and their callers to use the telephone for this purpose. Not to allow them access to a telephone might be questionable on other grounds, but to suppose that it would infringe the First Amendment would be doctrinaire in the extreme.⁶¹

Although only in dictum, the First Circuit has agreed with the court in *Arsberry*, stating that inmates have “no per se constitutional right to use a telephone.”⁶² However, the First Circuit has also affirmed at least one district court order that required jail officials to provide inmates with access to telephones.⁶³

While claims asserting a right to email access may succeed in jurisdictions like the Ninth Circuit, where access to telephone use is considered a constitutional right, they seem highly unlikely to succeed in jurisdictions like the First and Seventh Circuit.

B. A Lack of Direct Persuasive Precedent

The issue of whether inmates have a constitutional right to email access is a novel question. As of yet, it has only arisen in a few unpublished district court cases. These cases occurred in the Fourth Circuit,⁶⁴ the Sixth Circuit,⁶⁵ and the Tenth Circuit.⁶⁶ In

⁶⁰ *Arsberry v. Illinois*, 244 F.3d 558, 564–65 (7th Cir. 2001).

⁶¹ *Id.*

⁶² *United States v. Footman*, 215 F.3d 145, 155 (1st Cir. 2000).

⁶³ *Inmates of Suffolk Cnty. Jail v. Eisenstadt*, 360 F. Supp. 676 (D. Mass. 1973), *aff'd*, 494 F.2d 1196 (1st Cir. 1974).

⁶⁴ *Grayson v. Fed. Bureau of Prisons*, No. 5:11cv2, 2012 WL 380426, at *3 (N.D. W. Va. Feb. 6, 2012) (“[P]risoners have no First Amendment constitutional right to access email.”).

⁶⁵ *Bristow v. Amber*, No. 2:12-CV-412, 2012 WL 1963577, at *1 (S.D. Ohio May 31, 2012).

⁶⁶ *Rueb v. Zavaras*, No. 09–cv–02817, 2011 WL 839320, at *6 (D. Colo.

each instance the district court determined that “inmates have no established First Amendment right to access email.”⁶⁷

Although this narrow selection of cases rejects the notion that the First Amendment provides inmates with a right to email access, the reasoning behind each case suffers from a substantial deficit. In each case, the court based its decision on: (1) the lack of express authority establishing a constitutional right to email access, and (2) the precedent of one particular unpublished district court case from the Eighth Circuit, which stated that the government is not obligated to “provide telephones, videoconferencing, email, or any of the other marvelous forms of technology that allow instantaneous communication across geographical distances.”⁶⁸

First, as a novel issue, the lack of express authority establishing an inmate’s right to elect email access as an avenue of free speech does not suggest that such a right does not exist. Because inmates retain their constitutional rights during incarceration, limited only by the legitimate security concerns of the prison administration, precedent suggests that a complete limitation on the right to access a communicative avenue such as an email or phone service necessarily infringes upon the free speech interest of selecting the means of one’s communication.

The second basis for these decisions is troubling, especially where a district court within the Eighth Circuit relied upon the limitations of the First Amendment to impose positive obligations on a prison rather than the rights protected by the First Amendment.⁶⁹ Furthermore, if taken to mean that the First Amendment fails per se to protect inmate access to telephones, such a conclusion would directly contradict precedent from the Court of Appeals for the Eighth Circuit stating that limitations on telephone use may violate First Amendment protections.⁷⁰

Mar. 7, 2011).

⁶⁷ *Id.*

⁶⁸ *Holloway v. Magness*, No. 5:07CV00088 JLH-BD, 2011 WL 204891, at *7 (E.D. Ark. Jan. 21, 2011).

⁶⁹ *Id.*

⁷⁰ *See Benzel v. Grammer*, 869 F.2d 1105, 1108 (8th Cir. 1989).

C. Inmate Email Access in the Context of the Right to Select an Avenue of Speech

The conflicting guidance provided by cases dealing with phone or email use in prison focus narrowly on the right to send correspondence in and out of prison facilities. In doing so, they fail to account for the right to select a particular avenue or means of speech. It seems that a limitation that completely bars access to email systems would implicate First Amendment protections. Such a restriction would utterly eliminate an efficient, fundamental, and economically advantageous avenue of discourse. By eliminating the right to select email as a method of communication, prison officials do more than limit prisoners' right to send and receive correspondence—they entirely abrogate their right to choose the means of their speech.

IV. THE POSITIVE OBLIGATION HURDLE

In its traditional sense, the First Amendment acts as a security of negative obligations, prohibiting government *action* (as opposed to *inaction*) that violates certain protections. The failure of state prison systems to provide inmates with email access is not the same as a regulation barring access to email services that are already in place. Accordingly, it would be difficult to enforce a right to email access if prisons and jails state that they simply cannot provide the resources to facilitate this particular form of communication.

“[I]n those jurisdictions [such as the Ninth Circuit] where courts exercise constitutional review of state omissions and not only of state action, the guidelines for protecting social rights can be used to enforce the positive dimension of . . . freedom of expression.”⁷¹ Some district courts have applied this concept by ordering prison or jail officials to *provide* access to telephones in jurisdictions that have determined that inmates possess a First Amendment right to access them.⁷² Such orders imply that a

⁷¹ Ivar A. Hartmann, *A Right to Free Internet? On Internet Access and Social Rights*, 13 J. High Tech. L. 297, 370 (2013).

⁷² *Owens-El v. Robinson*, 442 F. Supp. 1368, 1386 (W.D. Pa. 1978) (citing

positive obligation can exist to provide communication services where inmates have a constitutional right to access. However, other courts have determined that affirmative obligations on prisons are limited to the protections guaranteed by the Eighth Amendment, and that the First Amendment cannot give rise to such duties.⁷³

Accordingly, while the failure of state prison systems to provide inmates with email access is not the same as a regulation barring access to communication methods that are already in place, administrators might still have a duty to install email services or unlock certain features of an existing service where they are affordable or already installed in a limited form. In prisons where services have not yet been implemented, the inquiry becomes whether courts may impose an affirmative duty on prison systems to provide inmates with access to methods of communication. In prisons where a service is already installed but the administrators implement some features while not implementing others—such as allowing money deposits or incoming messages but not outgoing messages⁷⁴—the question is whether such choices constitute “limiting” the features of those services.

Whether or not the First Amendment can create positive obligations on a prison is a complicated issue worthy of thorough examination. This Article will not endeavor to take up that immense discussion. Suffice it to say that this is a controversial subject that is not resolved. While some jurisdictions have acted in

Dillard v. Pitchess, 399 F. Supp. 1225 (C.D. Cal. 1975); Inmates of Suffolk Cnty. Jail v. Eisenstadt, 360 F. Supp. 676 (D. Mass. 1973), *aff'd*, 494 F.2d 1196 (1st Cir. 1974); Mitchell v. Untreiner, 421 F. Supp. 886 (N.D. Fla. 1976); O’Bryan v. Cnty. of Saginaw, Mich., 437 F. Supp. 582 (E.D. Mich. 1977)).

⁷³ *Holloway*, 2011 WL 204891, at *7.

⁷⁴ For instance, in 2014, Nevada State Prison System had implemented JPay email services, but only allowed incoming messages. The state has since stopped implementing JPay systems all together, but still allows incoming emails to be sent to the prison where they are printed by prison staff and then delivered in paper format. Nevada Prisons Inmate, Family & Friends Share Page, *Email from JPay*, FACEBOOK, <https://www.facebook.com/NevadaPrisons/posts/784982748258964> (last visited Jan. 23, 2015); *Inmate Email Information*, STATE OF NEV. DEP’T OF CORRECTIONS, http://doc.nv.gov/Inmates/Inmate_Email_Information/ (last visited Jan. 24, 2015).

a manner suggesting that they may impose a positive obligation on prisons to provide access to a particular means of communication, others will refuse to recognize a positive dimension of First Amendment protections.

V. EVALUATING THE LACK OF EMAIL ACCESS IN PRISON UNDER CURRENTLY EXISTING STANDARDS

The “reasonableness test” of the *Turner* standard seemingly rejects the need to apply strict scrutiny to sweeping limitations or regulations that abrogate entire avenues of free speech, such as email. Nonetheless, despite the potential pitfalls of such an extremely deferential standard, courts evaluating the free speech rights of inmates will analyze government limitations under the existing framework for free speech rights in prison. As such, courts faced with demands for email access in prisons will look to the standard outlined in *Turner* for incoming message services and that of *Martinez* for outgoing messages.

A. Failure to Provide Email Under the *Turner* Standard

Examining whether a regulation fails or passes the *Turner* standard requires assessing: (1) if the limitation is rationally related to a legitimate and neutral governmental objective; (2) if alternative avenues remain to exercise the asserted right; (3) the impact that accommodating the right will have on staff, prisoners, and prison resources; and (4) if easy and obvious alternatives indicate that prison practices are overly restrictive.⁷⁵

1. Restricting Email Use Has No Rational Relation to a Legitimate and Neutral Governmental Objective

The first *Turner* factor requires that a court determine (1) if the governmental objective behind the policy is legitimate and neutral, and (2) if a rational relationship exists between the asserted

⁷⁵ Prison Legal News v. Lehman, 397 F.3d 692, 699 (9th Cir. 2005) (citing *Turner*, 482 U.S. at 89).

objective and the policy regulation.⁷⁶ If a regulation lacks a rational relationship to a legitimate objective under this first factor, then it cannot be reasonably related to the motive behind judicial deference to prison administrators, and “a court need not reach the remaining three factors.”⁷⁷

The burden of showing a rational relationship lies with prison systems, and is initially satisfied by presenting an “intuitive, common-sense connection” between the objective and the regulation.⁷⁸ If challengers to prison practices show sufficient evidence refuting the connection, the prisons must additionally present enough evidence to show that the connection is not “so remote as to render the policy arbitrary or irrational.”⁷⁹

Email in prisons has the power to drastically reduce the potential of prisoners receiving contraband through postal mail. Furthermore, prison email systems like TRULINCS have been shown to be financially self-sustaining and even contributory to the funding of other traditional means of communication and prison maintenance. Although prison email could lead to an increase in incoming correspondence, electronic messages are more readily screened for dangerous or prohibited content. Any displacement of incoming postage will likely result in an overall increase of prison mail efficiency.

Perhaps more importantly on a social level, it has been recognized that such communication with family and friends “advances rather than retards the goal of rehabilitation.”⁸⁰ It seems unlikely that the failure to provide email access could be considered rationally related to a legitimate governmental interest. Although this factor is in itself not dispositive of the issue, it is of value to consider the remaining three *Turner* factors.

⁷⁶ *Thornburgh v. Abbott*, 490 U.S. 401, 414 (1989).

⁷⁷ *Prison Legal News*, 397 F.3d at 699; *see also* *Walker v. Sumner*, 917 F.2d 382, 385 (9th Cir. 1990).

⁷⁸ *Frost v. Symington*, 197 F.3d 348, 357 (9th Cir. 1999).

⁷⁹ *Turner*, 482 U.S. at 89–90.

⁸⁰ *Procunier v. Martinez*, 416 U.S. 396, 413 (1974).

2. Alternative Avenues Exist to Exercise the Basic Right of Communicating, But May Not Offer Many of the Benefits That Might Lead an Inmate to Choose Email Over Postage

In order for a prison or jail regulation that implicates free speech rights to be considered reasonable under the *Turner* standard, the inmate must retain some avenue of exercising his protected free speech. In evaluating this factor, “alternative means need not be ideal,”⁸¹ but instead “need only be available.”⁸² Nonetheless, “the right in question must be viewed sensibly and expansively.”⁸³

Analysis of this factor depends largely on how the asserted right is framed. If the right infringed by email limitations is viewed as narrowly as the right to send or receive written communications, it is obvious that alternative avenues remain available for sending written correspondence, such as letters and postcards. Nonetheless, the nature of handwritten postage differs greatly from that of electronic messaging. Email is cost-effective, allows for rapid response from those in correspondence with each other, is protected from physical decay, and is recallable from multiple locations due to its stored electronic form. It might be said that these characteristics of email so differ from those of paper correspondence that the loss of these enhanced features implicates some other subtle right couched in free speech protection—the most likely being the right to choose the means of communicating in a form that retains similar protections offered by email services. If the right infringed upon by email limitations is viewed expansively as the right to select a particular means or avenue of communication, it would appear that absolutely no alternative avenue for exercising that right remains.

3. The Impact on Staff, Prisoners, and Prison Resources is Minimal, if Not Beneficial

Assessing the appropriateness of a speech restriction under the

⁸¹ *Overton v. Bazzetta*, 539 U.S. 126, 135 (2003).

⁸² *Id.*

⁸³ *Mauro v. Arpaio*, 188 F.3d 1054, 1061 (9th Cir. 1999).

Turner standard also requires examining the impact that accommodating the right will have on staff, prisoners, and prison resources.⁸⁴ Because of the high likelihood that even the smallest changes will have some “ramification of the liberty of others or on the use of the prison’s resources,” this third factor weighs most heavily when “accommodation of an asserted right will have a significant ‘ripple effect’ on fellow inmates and staff.”⁸⁵ Also, “the policies followed at other well-run institutions [are] relevant to a determination of the need for a particular type of restriction.”⁸⁶

As stated in regards to the first *Turner* factor, the economic effects of email systems on prison resources are actually positive. It requires less manpower to monitor than physical mail, does not necessitate physical contact with mail, and can be reviewed by computer systems. Furthermore, such systems are self-financing. Looking to the policies of another well-run institution, the universal implementation of TRULINCS by the Federal Bureau of Prisons suggests that there is no need to arbitrarily restrict access to email communications.

4. The Easy and Obvious Alternative of Implementing an Email Service Indicates That Prison Practices are Overly Restrictive

Under the fourth *Turner* factor, courts consider whether easier and obvious alternatives exist for meeting the government’s interest in denying a privilege or implementing a regulation. If so, this would suggest that the prison practice might be overly restrictive. This factor should not be mistaken for a least restrictive alternative analysis. Under the *Turner* standard, prisons do not need to adopt the least restrictive alternative.⁸⁷ However, courts may consider “an alternative that fully accommodates the [asserted] rights at *de minimis* cost to valid penological interests” as evidence that the policy unreasonably infringes upon First

⁸⁴ *Prison Legal News v. Lehman*, 397 F.3d 692, 699 (9th Cir. 2005) (citing *Turner*, 482 U.S. at 89).

⁸⁵ *Turner*, 482 U.S. at 90.

⁸⁶ *Morrison v. Hall*, 261 F.3d 896, 905 (9th Cir. 2001).

⁸⁷ *See Turner*, 482 U.S. at 90–91.

Amendment rights.⁸⁸ Under the fourth *Turner* factor, the availability of easily implemented services like JPay, considered together with the success of the TRULINCS program, suggest that denying email access is unnecessarily restrictive.

The difficulty with this factor is determining what penological interests are actually advanced by restricting email communications. Fortunately, services like JPay have made installing email access in prisons a simple process. Perhaps, the theorized benefit to denying access to electronic communications is found in the simple reduction in the volume of communications that can enter and exit a prison. However, services like JPay can limit how many emails each inmate may send in a given time period. Additionally, any increase in the volume of communications might be offset by the added security benefits that accompany email services. Accordingly, the most reasonable alternative to prevent too high a volume of communications would be to limit the number of emails or letters allowed per day, but still provide access to email and postal services.

B. Failure to Provide Email Access Under the Martinez or Thornburgh Standard

If a prison practice does not satisfy the more deferential test of the *Turner* standard, it will logically fail the scrutinizing *Martinez* standard as well. Nonetheless, some prison systems offer incoming email services to inmates, but do not allow outgoing emails. For instance, in 2014, the Nevada State Prison System was using JPay email services, but only allowed those functions that provided inmates with *incoming* messages.⁸⁹ It should be noted that under the current framework for evaluating free speech rights in a prison context, prisons engaging in this practice should be subject to the more exacting scrutiny of *Martinez*. Once a prison implements email services such as JPay, and establishes that such services are available, limiting the service to incoming email should be permitted only if it furthers an important or substantial prison

⁸⁸ *Id.* at 91.

⁸⁹ *See supra* note 74.

interest and is no more restrictive than necessary to protect the particular interest involved.⁹⁰

CONCLUSION

Serious free speech concerns arise when prisons prevent inmates from accessing email services. This is true even under the currently accepted framework for assessing First Amendment claims of inmates, despite the extreme deference shown to prison administrators. Although actions eliminating an entire means of communication should be examined under a heightened level of scrutiny (prison setting or not), the more deferential *Turner* factors still suggest that preventing inmates from accessing email systems is unreasonable. Furthermore, the practice of implementing services such as JPay for incoming email services but not outgoing services should be evaluated under the even stricter standard of *Martinez*.

In jurisdictions such as the Ninth Circuit, where courts have imposed positive obligations on prisons in a First Amendment context, the right to access communication systems such as telephones suggests that free speech protections could likewise be evolving towards inmates' right to access email services.

⁹⁰ See *Procunier v. Martinez*, 416 U.S. 396, 413 (1974), *overruled on other grounds* by *Thornburgh v. Abbott*, 490 U.S. 401 (1989).

PRACTICE POINTERS

- Remember that separate standards typically apply to ingoing and outgoing prison correspondence.
- Keep in mind that the policy behind valid limitations on an inmate's constitutional rights is couched in the need to promote prison security, not a degradation or reduction to the constitutional rights of inmates.
- Although intermediate scrutiny typically applies to content-neutral regulations on free speech, strict scrutiny might still apply where the government completely restricts a *means* or avenue of communication rather than its time, place, or manner.

END OF THE PARALLEL BETWEEN PATENT LAW'S § 284
WILLFULNESS AND § 285 EXCEPTIONAL CASE ANALYSIS

Don Zhe Nan Wang^{*}
© Don Zhe Nan Wang

Cite as: 11 Wash. J.L. Tech. & Arts 311 (2016)
<http://digital.lib.washington.edu/dspace-law/handle/1773.1/1558>

ABSTRACT

Patent law's "willful infringement" analysis under 35 U.S.C. § 284 and the "exceptional case" analysis under 35 U.S.C. § 285 are largely considered parallel, and essentially identical. In 2014, the Supreme Court of the United States drastically changed the standards for the § 285 exceptional case analysis in its Octane Fitness, LLC v. ICON Health & Fitness, Inc. and Highmark Inc. v. Allcare Health Management System, Inc. decisions. This prompted two federal circuit judges to call for similar changes to the § 284 willful infringement analysis. On October 19, 2015, the Supreme Court granted certiorari to review whether such a change is warranted. This Article examines the legal and policy arguments on both sides and concludes that, while a drastic change of the substantive standard of the willful infringement analysis is unlikely, a change of the standard of review is possible. Consequently, the parallel between § 284 willfulness and § 285 exceptional case analysis will likely come to an end.

^{*} Don Zhe Nan Wang, University of Washington School of Law, Class of 2016. Thank you to Douglas Stewart, Adjunct Professor at University of Washington School of Law and Partner at Bracewell & Giuliani LLP, and Robert Gomulkiewicz, Foundation Professor of Law at University of Washington School of Law, for their generous support and thoughtful comments. I would also like to thank Miriam Swedlow and Alex Boguniewicz for their skillful editing.

TABLE OF CONTENTS

Introduction.....	313
I. The Historical Parallel Between § 284 Willfulness and § 285 Exceptional Case Analysis	315
A. Section 285 Exceptional Case Jurisprudence.....	315
B. Section 284 Willfulness Jurisprudence	317
II. The Interplay Between § 284 Willfulness and Pre- <i>Octane</i> § 285 Exceptional Case Analysis	319
III. The Arguments for Maintaining the Current § 284 Willful Infringement Jurisprudence	321
A. Section 284 Enhancement Focuses on Commercial Behavior While § 285 Focuses on Litigation Expenses.....	321
B. Section 284 Willfulness and Pre- <i>Octane</i> § 285 Exceptional Cases Developed Independently Through Case Law.....	323
C. The Parallel and Overlap Between § 284 and § 285 Jurisprudence are Overstated.....	324
IV. Policy Concerns Revealed in the Supreme Court's Recent Patent Cases Support the Current § 284 Analysis	325
A. The Supreme Court's Heightened Interest in Patent Law	325
B. Both <i>Octane Fitness</i> and <i>Highmark</i> Reflect The Court's Concerns Over Patent-Exceptionalism and Pro-Patent Bias.....	327
C. Maintaining the Current Substantive Standard of § 284, but Changing the Appellate Review Standard Comports with the Supreme Court's Concerns.....	328
Conclusion	329
Practice Pointers.....	330

INTRODUCTION

Section 284 of the U.S. Patent Act grants federal judges the discretion to enhance damages up to three times the amount found by a jury or assessed by a court in patent infringement actions.¹ The U.S. Court of Appeals for the Federal Circuit has established that “an award of enhanced damages [under § 284] requires a showing of willful infringement.”² Section 285 of the Patent Act allows a court to award attorney fees to the prevailing party “in exceptional cases.”³ The analyses used in these two areas of law have long been considered parallel and at times even identical.

In *Halo Electronics, Inc. v. Pulse Electronics, Inc.*, a panel of judges from the U.S. Court of Appeals for the Federal District upheld a decision denying enhanced damages based on the determination that the defendant’s infringement was not willful under 35 U.S.C. § 284.⁴ Significantly, two judges concurred and urged the full court to reconsider the current willfulness standard in light of the Supreme Court’s 2014 decisions in *Octane Fitness, LLC v. ICON Health & Fitness, Inc.* and *Highmark Inc. v. Allcare Health Management System, Inc.*⁵

The *Halo* concurrence argues that the *Octane Fitness* and *Highmark* decisions mandate a change of the current willfulness jurisprudence.⁶ In *Octane Fitness*, the Supreme Court overruled the Federal Circuit’s objective/subjective two-prong test for

¹ 35 U.S.C. § 284 (2012).

² *In re Seagate Tech., LLC*, 497 F.3d 1360, 1368 (Fed. Cir. 2007) (en banc).

³ 35 U.S.C. § 285 (1952).

⁴ *Halo Elecs., Inc. v. Pulse Elecs., Inc.*, 769 F.3d 1371, 1381–83 (Fed. Cir. 2014) (relying on the objective/subjective two-prong test set out in *In re Seagate Tech., LLC*, 497 F.3d 1360 (Fed. Cir. 2007), and *Bard Peripheral Vascular, Inc. v. W.L. Gore & Assocs., Inc.*, 682 F.3d 1003 (Fed. Cir. 2012)), *reh’g denied*, 780 F.3d 1357 (Fed. Cir. 2015), *cert. granted*, 136 S. Ct. 356 (2015).

⁵ *Halo Elecs.*, 769 F.3d at 1383–86 (citing *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749 (2014) and *Highmark Inc. v. Allcare Health Mgmt. Sys., Inc.*, 134 S. Ct. 1744 (2014)).

⁶ *Halo Elecs.*, 769 F.3d at 1384.

determining an “exceptional case” under 35 U.S.C. § 285.⁷ The concurrence points out that the § 284 willfulness analysis entails a two-prong test that closely mirrors the now-overruled objective/subjective test for a § 285 “exceptional case.” However, the circuit court denied the petition for an en banc hearing.⁸

On October 19, 2015, the Supreme Court granted certiorari to review whether the 2014 decisions on § 285 exceptional cases warrant a similar change to the § 284 willfulness analysis.⁹ The case has been consolidated with *Stryker Corp. v. Zimmer, Inc.* to further consider (1) whether it is appropriate to predicate an award of enhanced damages on a finding of willfulness, and (2) whether the Federal Circuit should apply the abuse of discretion standard instead of the current de novo standard when reviewing § 284 enhanced damages determinations.¹⁰

This Article examines the legal arguments and the underlying policy implications of the upcoming Supreme Court review, and concludes that the possibility of a drastic change to the substantive standard of § 284 willfulness is rather low. It is true that the histories of § 284 willfulness and § 285 exceptional case present similar and paralleled patterns of development, and that many Supreme Court criticisms of the Federal Circuit’s pre-*Octane* § 285 jurisprudence apply equally to the current § 284 framework. However, § 284 and § 285 are distinct areas of patent law, serving very different policy purposes, and therefore warrant different treatment. Most importantly, a drastic change of the current § 284 willfulness analysis will directly contradict the current initiative to counter the impact of so-called “patent trolls” on national patent enforcement trends. Consequently, although a change of the standard of review remains possible, a drastic change of the substantive standard of § 284 jurisprudence is unlikely.

⁷ *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749, 1757–58 (2014).

⁸ *Halo Elecs., Inc. v. Pulse Elecs., Inc.*, 780 F.3d 1357 (Fed. Cir. 2015) (per curiam) [hereinafter *Halo Rehearing Denial Order*].

⁹ *Halo Elecs., Inc. v. Pulse Elecs., Inc.*, 136 S. Ct. 356 (2015).

¹⁰ *Stryker Corp. v. Zimmer, Inc.*, 774 F.3d 1349 (Fed. Cir. 2014), *withdrawn and replaced by* *Stryker Corp. v. Zimmer, Inc.*, 782 F.3d 649 (Fed. Cir. 2015), *cert. granted*, 136 S. Ct. 356 (2015).

I. THE HISTORICAL PARALLEL BETWEEN § 284 WILLFULNESS AND § 285 EXCEPTIONAL CASE ANALYSIS

Arguments for changing the current § 284 willfulness analysis largely hinge on the historical parallel between the jurisprudence of § 284 willfulness and § 285 exceptional case analysis.¹¹ Thus, an examination of the evolving histories of both sets of cases is instructive for further analysis.

A. Section 285 Exceptional Case Jurisprudence

Section 285 of the U.S. Patent Act provides that, in the context of patent infringement actions, “[t]he court in exceptional cases may award reasonable attorney fees to the prevailing party.”¹² Before the creation of the U.S. Court of Appeals for the Federal Circuit, regional courts applied § 285 “in a discretionary manner, assessing various factors to determine whether a given case was sufficiently ‘exceptional’ to warrant a fee award.”¹³ For over two decades, the Federal Circuit followed this approach and instructed district courts to consider the “totality of the circumstances” when making an exceptional case determination.¹⁴

In 2005, the Federal Circuit radically changed course in *Brooks Furniture Manufacturing, Inc. v. Dutailier International, Inc.*,

¹¹ See *Halo Rehearing Denial Order*, 780 F.3d at 1361 (Judge O’Malley argues in his dissent that the two-prong test in §284 willful infringement jurisprudence is “analogous” to, and “has closely mirrored,” jurisprudence governing §285 exceptional cases).

¹² 35 U.S.C. § 285 (1952).

¹³ *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749, 1753–54 (2014) (citing *True Temper Corp. v. CF&I Steel Corp.*, 601 F.2d 495, 508–09 (10th Cir. 1979); *Kearney & Trecker Corp. v. Giddings & Lewis, Inc.*, 452 F.2d 579, 597 (7th Cir. 1971); *Siebring v. Hansen*, 346 F.2d 474, 480–81 (8th Cir. 1965)).

¹⁴ See, e.g., *Rohm & Haas Co. v. Crystal Chem. Co.*, 736 F.2d 688, 691 (Fed. Cir. 1984) (“Cases decided under § 285 have noted that the substitution of the phrase *in exceptional cases* has not done away with the discretionary feature.”) (emphasis added) (citations omitted) (internal quotation marks omitted).

applying a test that narrows the scope of analysis.¹⁵ Under *Brooks Furniture*, a case is “exceptional” under § 285 only “when there has been some material inappropriate conduct related to the matter in litigation, such as willful infringement, fraud or inequitable conduct in procuring the patent, misconduct during litigation, vexatious or unjustified litigation, conduct that violates Fed. R. Civ. P. 11, or like infractions.”¹⁶ Citing the Supreme Court’s decision in *Professional Real Estate Investors, Inc. v. Columbia Picture Industries, Inc.* (“PRE”), the Federal Circuit held that “[a]bsent misconduct in conduct of the litigation or in securing the patent, sanctions may be imposed against the patentee only if both (1) the litigation is brought in subjective bad faith, and (2) the litigation is objectively baseless.”¹⁷ Courts typically refer to this two-part inquiry as the objective/subjective test. Further, exceptional cases must be established by clear and convincing evidence.¹⁸

On April 29, 2014, the Supreme Court overruled the *Brooks Furniture* standard for § 285 exceptional cases in *Octane Fitness* and *Highmark*.¹⁹ In *Octane Fitness*, the Court criticized the objective/subjective test as “overly rigid” and “so demanding that it would appear to render § 285 largely superfluous.”²⁰ The Court noted that the Federal Circuit imported its narrow exception for sham litigation, despite the fact that it “finds no roots in the [statutory] text of § 285.”²¹ The Court went on to point out that the only constraint on a court’s discretion in assigning attorney fees

¹⁵ *Brooks Furniture Mfg., Inc. v. Dutailier Int’l, Inc.*, 393 F.3d 1378 (Fed. Cir. 2005), *abrogated by* *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749 (2014).

¹⁶ *Brooks Furniture*, 393 F.3d at 1381.

¹⁷ *Id.* (citing *Prof’l Real Estate Investors v. Columbia Picture Indus., Inc.*, 508 U.S. 49, 56, 60–61 (1993) (holding that, within the meaning of the “sham exception” to *Noerr* doctrine immunity from antitrust liability, a lawsuit must be objectively baseless)).

¹⁸ *Brooks Furniture*, 393 F.3d at 1382.

¹⁹ *Octane Fitness*, 134 S. Ct. 1749, 1749 (2014); *Highmark Inc. v. Allcare Health Mgmt. Sys., Inc.*, 134 S. Ct. 1744 (2014).

²⁰ *Octane Fitness*, 134 S. Ct. at 1756, 1758.

²¹ *Id.* at 1757.

under § 285 is that the case has to be “exceptional.”²² “[A]n ‘exceptional’ case is simply one that stands out from others with respect to the substantive strength of a party’s litigating position (considering both the governing law and the facts of the case) or unreasonable manner in which the case was litigated.”²³ As a result, “[d]istrict courts may determine whether a case is ‘exceptional’ in the case-by-case exercise of their discretion, considering the totality of the circumstances.”²⁴ The Court also held that the evidentiary burden of establishing an exceptional case requires only a preponderance of the evidence, rather than the more difficult clear and convincing standard.²⁵ In *Highmark*, the Court established that, on appeal, an abuse of discretion standard—rather than a *de novo* standard—should be applied when “reviewing all aspects of a district court’s § 285 determination.”²⁶

B. Section 284 Willfulness Jurisprudence

Section 284 of the Patent Act reads: “[T]he court may increase the damages up to three times the amount found or assessed.”²⁷ The current statutory language and its previous versions do not impose a specific standard for awarding enhanced damages, but early courts read a “willfulness” requirement into it.²⁸

Shortly after its establishment, the Federal Circuit adopted an affirmative duty of due care standard for determining willfulness in *Underwater Devices, Inc. v. Morrison-Knudsen Co.*²⁹ Specifically,

²² *Id.* at 1755–56.

²³ *Id.* at 1756.

²⁴ *Id.*

²⁵ *Id.* at 1758.

²⁶ *Highmark Inc. v. Allcare Health Mgmt. Sys., Inc.*, 134 S. Ct. 1744, 1749 (2014).

²⁷ 35 U.S.C. § 284 (2012).

²⁸ *See Seymour v. McCormick*, 57 U.S. 480, 488 (1853) (suggesting that a discretionary increase in damages under the 1836 Act should be reserved only for “the wanton and malicious pirate”); *Union Carbide Corp. v. Graver Tank & Mfg. Co.*, 282 F.2d 653, 663 (7th Cir. 1960) (holding that increased damages are for “conscious and wilful [*sic*] infringer”); *Aro Mfg. Co. v. Convertible Top Replacement Co.*, 377 U.S. 476, 508 (1964) (noting that increased damages are only available “in a case of willful or bad-faith infringement”).

²⁹ *Underwater Devices Inc. v. Morrison-Knudsen Co.*, 717 F.2d 1380,

the Federal Circuit explained that “[w]here . . . a potential infringer has actual notice of another’s patent rights, he has an affirmative duty to exercise due care to determine whether or not he is infringing.”³⁰ This includes “the duty to seek and obtain competent legal advice from counsel *before* the initiation of any possible infringing activities.”³¹ The court further announced that willful infringement would be based on the “totality of the circumstances presented.”³²

Underwater Devices and its progeny “set[] a lower threshold for willful infringement that is more akin to negligence.”³³ This development resulted in enhanced damages being regularly awarded in patent cases. In a study conducted from 1983 to 2000, willfulness was found in 67.7% of jury trials and in 52.6% of bench trials.³⁴ Furthermore, enhanced damages were imposed 95% of the time when a judge found willfulness, and 63% of the time when a jury found willfulness.³⁵ *Underwater Devices*’ progeny made it the subject of continuing criticism from academics and litigators.³⁶

In 2007, the Federal Circuit unanimously overruled the “affirmative duty of due care” standard in *In re Seagate Tech., LLC*.³⁷ In *Seagate*, the Federal Circuit referenced the Supreme Court’s *Safeco Ins. Co. of America v. Burr* decision, and developed

1389–90 (Fed. Cir. 1983). The Federal Circuit was established in 1982 through the Federal Courts Improvement Act, Pub. L. No. 97-164, 96 Stat. 50 (1982).

³⁰ *Underwater Devices*, 717 F.2d at 1389–90.

³¹ *Id.* at 1390 (emphasis added).

³² *Id.*

³³ *In re Seagate Tech., LLC*, 497 F.3d 1360, 1371 (Fed. Cir. 2007).

³⁴ Kimberly A. Moore, *Empirical Statistics on Willful Patent Infringement*, 14 FED. CIR. B.J. 227, 237 (2004–2005) [hereinafter *Willful Patent Infringement*].

³⁵ Kimberly A. Moore, *Judges, Juries, and Patent Cases—An Empirical Peek Inside the Black Box*, 99 MICH. L. REV. 365, 394 (2000) [hereinafter *Judges, Juries and Patent Cases*].

³⁶ See William F. Lee et al., *The Doctrine of Willful Patent Infringement After Knorr-Bremse: Practical Problems & Recommendations*, 7 SEDONA CONF. J. 169 (2006); Timothy R. Holbrook, *Possession in Patent Law*, 59 SMU L. REV. 123, 143 (2006) (noting that the current “willfulness doctrine . . . creates a huge barrier to the effective operation of the patent system’s disclosure function”).

³⁷ *In re Seagate Tech., LLC*, 497 F.3d 1360, 1371 (Fed. Cir. 2007).

a two-prong test for establishing willful infringement. This test requires (1) an objective inquiry into whether the defendant acted despite a high likelihood that his or her actions would infringe a valid patent, and (2) a subjective inquiry into whether the defendant knew or should have known that he or she was engaged in objective risk of infringing a valid patent.³⁸ *Seagate* also shifted the burden of proof for establishing willfulness back to the patentee and raised the evidentiary burden to “clear and convincing evidence.”³⁹ The Federal Circuit subsequently ruled that the objective prong of the test is a question of law, and thus is subject to de novo review.⁴⁰ These holdings remain controlling today.

II. THE INTERPLAY BETWEEN § 284 WILLFULNESS AND PRE-*OCTANE* § 285 EXCEPTIONAL CASE ANALYSIS

Seagate's two-prong test for willfulness is strikingly similar to the pre-*Octane* test for exceptional cases in terms of formality. Both tests require a showing that the accused's actions are likely to be deemed objectively wrongful,⁴¹ and a showing of subjective bad faith.⁴² Furthermore, the dissent in the *Halo Rehearing Denial Order* appeared to suggest that the § 284 willfulness standard and the pre-*Octane* § 285 exceptional case standard both rely on the Supreme Court's ruling in *PRE*, and therefore share common case law roots.⁴³

³⁸ *Seagate*, 497 F.3d at 1371 (citing *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 57–60 (2007) (holding that when a statute leaves the standard of willfulness undefined, the common law's objective recklessness standard should be applied)).

³⁹ *Id.*

⁴⁰ *Bard Peripheral Vascular, Inc. v. W.L. Gore & Assocs., Inc.*, 682 F.3d 1003, 1005 (Fed. Cir. 2012).

⁴¹ The *Seagate* willfulness analysis requires a patentee to show an objectively high likelihood that the infringer's actions constituted infringement. The pre-*Octane* exceptional case analysis requires the prevailing party to establish that the litigation is objectively baseless.

⁴² The pre-*Octane* exceptional case analysis requires a showing of “subjective bad faith,” while the *Seagate* willfulness analysis requires a showing that the infringer acted despite knowledge that his or her action was highly likely to be wrongful.

⁴³ *Halo Elecs., Inc. v. Pulse Elecs., Inc.*, 780 F.3d 1357, 1361–62 (Fed. Cir.

Closer examination suggests that the interplay between § 284 willfulness and pre-*Octane* § 285 exceptional case analysis goes beyond formalistic similarities and historical connections. In the seven years between *Seagate* and *Octane Fitness*, courts treated the two areas of law as inseparable, and even identical, in practice. Even the Federal Circuit has commented that the § 284 willfulness and the § 285 exceptional case standards are “parallel” or “identical” to each other.⁴⁴ In cases where the patentee prevailed under a § 285 exceptional case analysis, a finding of willful infringement alone can be sufficient to declare a case exceptional.⁴⁵ In other cases, the Federal Circuit makes no distinction between the two areas of law, citing cases from one area as precedents for the other.⁴⁶ Commentators were quick to

2015) (O’Malley, J., dissenting) (per curiam) (“Indeed, the structure for assessing willfulness set forth in *Bard* and our old § 285 *Brooks Furniture* test were both predicated on our interpretation of the Supreme Court’s decision *Professional Real Estate Investors, Inc. v. Columbia Pictures Indus., Inc.* (“*PRE*”), 508 U.S. 49 (1993), which we believed required a two-step objective/subjective inquiry before either enhanced damages or attorneys’ fees could be awarded.”).

⁴⁴ *Bard*, 682 F.3d at 1007 (“Our holding is consistent with similar holdings in other parallel areas of law. Our precedent regarding objectively baseless claims, which allow courts to award enhanced damages and attorneys’ fees under 35 U.S.C. § 285, and the Supreme Court’s precedent on ‘sham’ litigation are instructive.”); *iLOR, LLC v. Google, Inc.*, 631 F.3d 1372, 1377 (Fed. Cir. 2011) (“The objective baselessness standard for enhanced damages and attorneys’ fees against a non-prevailing plaintiff under *Brooks Furniture* is identical to the objective recklessness standard for enhanced damages and attorneys’ fees against an accused infringer for § 284 willful infringement actions under [*Seagate*].”).

⁴⁵ *See, e.g.*, *Golden Blount, Inc. v. Robert H. Peterson Co.*, 438 F.3d 1354, 1373–74 (Fed. Cir. 2006) (affirming award of attorneys’ fees after ruling district court did not err in finding that the infringement was willful and infringer did not challenge the fee award on any substantive bases other than the alleged error in the finding of willful infringement); *Golight, Inc. v. Wal-Mart Stores, Inc.*, 355 F.3d 1327, 1340 (Fed. Cir. 2004) (“Based on a finding of willful infringement, it is within the district court’s discretion whether to award attorney fees under § 285.”); *Avia Grp. Int’l, Inc. v. L.A. Gear Cal., Inc.*, 853 F.2d 1557, 1567 (Fed. Cir. 1988) (“[T]he willfulness of the infringement provided a sufficient basis for a section 285 attorney fee award to the prevailing patent owner.”).

⁴⁶ *See, e.g.*, *Highmark Inc. v. Allcare Health Mgmt. Sys., Inc.*, 701 F.3d

point out that the Federal Circuit “has practically equated a finding of willfulness with a finding that a case is exceptional.”⁴⁷

Due to the common and overlapping elements between the two areas of law, the Supreme Court’s criticisms of the Federal Circuit’s pre-*Octane* § 285 exceptional case analysis can arguably apply to the current § 284 willfulness analysis. First, similar to the pre-*Octane* § 285 jurisprudence, the Federal Circuit’s reading of the objective/subjective test and its inclusion of the word “willfulness” in § 284 jurisprudence did not have any “roots in the [statutory] text,” but rather was “imported” from Supreme Court case law.⁴⁸ Second, the objective/subjective test under § 284 is just as “overly rigid” as the now-overturned *Brooks Furniture* test.⁴⁹ Lastly, the de novo standard of review that applies in the objective prong of the *Seagate* willfulness test appears to be incompatible with the discretion allowed in a § 284 enhanced damages determination.

III. THE ARGUMENTS FOR MAINTAINING THE CURRENT § 284 WILLFUL INFRINGEMENT JURISPRUDENCE

At first glance, arguments for changing the current § 284 willfulness standard have some merit. However, several reasons support maintaining it.

A. Section 284 Enhancement Focuses on Commercial Behavior While § 285 Focuses on Litigation Expenses

Enhanced damages serve to penalize and deter unethical

1351 (Fed. Cir. 2012) (per curiam) (holding that objective prong of § 285 exceptional case should be reviewed de novo by citing *Bard Peripheral Vascular, Inc. v. W.L. Gore & Assocs., Inc.*, 682 F.3d 1003, 1005 (Fed. Cir. 2012) which held that the objective prong of § 284 willfulness analysis is subject to de novo review), *overruled by* 134 S. Ct. 1744 (2014).

⁴⁷ Debra Koker, *Fulfilling the “Due Care” Requirement After Knorr-Bremse*, 11 B.U. J. SCI. & TECH. L. 154, 157 (2005).

⁴⁸ *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749, 1752, 1757 (2014).

⁴⁹ *Id.* at 1756.

“commercial behavior.”⁵⁰ As the Federal Circuit explains, “[t]he rules of patent infringement are rules of business ethics, and require prudent commercial actions in accordance with law. . . . 35 U.S.C. § 284 provides [a] remedy to the patentee when these standards are not met, up to three times the amount of found or assessed damages.”⁵¹ Thus, an award of enhanced damages seeks to deter unacceptable business behavior, such as deliberately copying a patented invention without performing an analysis as to the legality of the copying. But lawful practices of competition, including studying a competitor’s patents and designing around these patents, are permissible.⁵² The focus is solely on the alleged infringer’s behavior in the marketplace—behavior during litigation is irrelevant.

By contrast, § 285’s fee-shifting targets improper litigation behavior, and thereby serves a different purpose from enhanced damages under § 284. The fees awarded under § 285 serve to reimburse a party for legal expenses incurred from participating in an exceptional case. For example, it can reimburse a party who is impacted by bad faith litigation tactics.⁵³ The fees awarded are not tied to the value of the technology or any party’s market behavior, but rather to the cost of the litigation itself.

Furthermore, courts have noted that § 284’s enhanced damages and § 285’s fee-shifting are different in nature. Cases suggest that by fulfilling their deterrent purpose, § 284’s treble damages are punitive.⁵⁴ By contrast, the fees awarded under § 285 are

⁵⁰ 4 ROBERT A. MATTHEWS, ANNOTATED PATENT DIGEST § 31:1 (2015).

⁵¹ *Vulcan Eng’g Co., v. Fata Aluminium, Inc.*, 278 F.3d 1366, 1378 (Fed. Cir. 2002); *see also* *Hoechst Celanese Corp. v. BP Chems. Ltd.*, 78 F.3d 1575, 1583 (Fed. Cir. 1996) (“The issue of ‘willful’ infringement measures the infringing behavior, in circumstances in which the infringer acted against an objective standard of reasonable commercial behavior in the same circumstances.”).

⁵² MATTHEWS, *supra* note 50, at § 31:1.

⁵³ 5 ROBERT A. MATTHEWS, ANNOTATED PATENT DIGEST § 33:1 (2015); *see also* *Mathis v. Spears*, 857 F.2d 749, 753 (Fed. Cir. 1988) (“The purpose of Section 285 is to reimburse a party injured when forced to undergo an ‘exceptional’ case.”).

⁵⁴ *See, e.g., Exxon Shipping Co. v. Baker*, 554 U.S. 471, 507 (2008) (listing Section 284 among punitive damages statutes); *Root v. Lake Shore & M.S. Ry. Co.*, 105 U.S. 189, 196 (1881) (“[T]he Patent Act of 1836 . . . leav[es] it to the

compensatory, not punitive, even when they are based on a finding of willful infringement.⁵⁵ The Supreme Court has held that “in our judicial system[,] compensatory and punitive damages, although usually awarded at the same time by the same decision maker, serve different purposes,” and thus should entail different standards.⁵⁶

B. Section 284 Willfulness and Pre-Octane § 285 Exceptional Cases Developed Independently Through Case Law

One argument for changing the current § 284 willfulness standard relies on the premise that “[the Federal Circuit’s] willfulness test, as described in *Seagate* and *Bard*, and [its] old § 285 test, under *Brooks Furniture*, were predicated on [the Court’s] interpretation of the Supreme Court’s decision in *Professional Real Estate Investors, Inc. v. Columbia Pictures Indus., Inc.* (“*PRE*”), 508 U.S. 49 (1993).”⁵⁷ Following this premise, the Federal Circuit should reconsider whether there is any justification for using the narrow *PRE* standard in analyzing § 284 willfulness, since its reliance on *PRE* in § 285 exceptional case analysis has been

discretion of the court to inflict punitive damages to the extent of trebling the verdict.”); *SRI Int’l, Inc. v. Advanced Tech. Labs., Inc.*, 127 F.3d 1462, 1468 (Fed. Cir. 1997) (“When willful infringement or bad faith has been found, the remedy of enhancement of damages not only serve its primary punitive/deterrent role, but in so doing it has the secondary benefit of quantifying the equities as between patentee and infringer.”); *Delta-X Corp. v. Baker Hughes Prod. Tools, Inc.*, 984 F.2d 410, 413 (Fed. Cir. 1993) (“Enhanced damages are punitive, not compensatory.”).

⁵⁵ *Knorr-Bremse Sys. Fuer Nutzfahrzeuge GmbH v. Dana Corp.*, 383 F.3d 1337, 1347 (Fed. Cir. 2004) (“The appellants also argue that the award of attorney fees is a matter of punitive damages, and is therefore improper. Precedent and statute do not support this position . . . and the court has confirmed that a finding of willful infringement may qualify a case as exceptional under § 285. That there were not actual damages does not render the award of attorney fees punitive.”).

⁵⁶ *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 416 (2003) (internal citation omitted).

⁵⁷ *Halo Elecs., Inc. v. Pulse Elecs., Inc.*, 769 F.3d 1371, 1384 (Fed. Cir. 2014) (O’Malley, J., concurring).

rejected.⁵⁸

However, a close reading of the respective histories of § 284 and § 285 reveals a different picture. In fact, the two areas of law were largely developed through independent and unrelated lines of authority. In *Seagate*, the Federal Circuit established the objective/subjective test without mentioning *PRE* at all.⁵⁹ Instead, the Federal Circuit looked to several Supreme Court decisions and essentially adopted the well-established meaning of “willfulness” from other civil contexts.⁶⁰ In *Bard*, the Federal Circuit in no way relied on *PRE*, but merely referenced the case, recognizing that the de novo standard of review of the *Seagate* test “is consistent with similar holdings in other parallel areas of law,” that is, the pre-*Octane* § 285 exceptional cases.⁶¹

C. The Parallel and Overlap Between § 284 and § 285 Jurisprudence are Overstated

Fee awards under § 285 may be granted to a prevailing party regardless of whether it is a prevailing patentee or a prevailing accused infringer.⁶² In contrast, § 284’s enhanced damages can only be applied to alleged infringers. The overlap between § 284 and § 285 jurisprudence only applies to situations where the award of attorneys’ fees is based on a finding of willful infringement.

On further examination, cases where attorneys’ fees were awarded after a finding of willfulness under § 285 illustrate how even the overlap between § 284 willfulness analysis and pre-*Octane* § 285 exceptional case analysis can be overstated. A finding of willful infringement under § 284 may be sufficient for

⁵⁸ *Id.* at 1384–85.

⁵⁹ *See In re Seagate Tech., LLC*, 497 F.3d 1360, 1370–71 (Fed. Cir. 2007).

⁶⁰ *Id.*

⁶¹ *Bard Peripheral Vascular, Inc. v. W.L. Gore & Assocs., Inc.*, 682 F.3d 1003, 1007 (Fed. Cir. 2012).

⁶² *See, e.g., Brasseler, U.S.A. I, L.P. v. Stryker Sales Corp.*, 267 F.3d 1370 (Fed. Cir. 2001) (affirming summary judgment where attorneys’ fees were awarded against a patentee); *Beckman Instrument, Inc. v. LKB Produkter AB*, 892 F.2d 1547 (Fed. Cir. 1989) (affirming award of attorney fees against the accused infringer).

awarding fees under § 285, but it does not mandate them.⁶³ Moreover, conduct that shows intentional infringement, but falls short of willful infringement under *Seagate*, may still support an award of attorneys' fees.⁶⁴

IV. POLICY CONCERNS REVEALED IN THE SUPREME COURT'S RECENT PATENT CASES SUPPORT THE CURRENT § 284 ANALYSIS

While the legal arguments for changing the § 284 willfulness analysis and the arguments against doing so appear to be equally strong, policy arguments tilt the scale in favor of maintaining § 284's current substantive standard with an adjustment of its standard of review.

A. The Supreme Court's Heightened Interest in Patent Law

The Supreme Court's interest in patent cases has been rising in recent years.⁶⁵ The Court's decisions reflect two predominant policy themes: (1) an interest in moving patent law back to the mainstream of general civil law, and (2) an increasingly skeptical attitude towards the Federal Circuit's pro-patent stance.

The Supreme Court's paradigmatic role is to harmonize the application of federal law across the country, particularly on jurisdictional or procedural questions. Recently the Supreme Court rejected patent-specific procedures as sanctioned by the Federal

⁶³ See, e.g., *Cybor Corp. v. FAS Techs., Inc.*, 138 F.3d 1448, 1460 (Fed. Cir. 1998) (en banc) (ruling that it was proper for the trial court not to declare the case exceptional despite the jury verdict of willful infringement); *Mentor H/S, Inc. v. Med. Device Alliance, Inc.*, 244 F.3d 1365, 1380 (Fed. Cir. 2001) (affirming the district court's decision not to award attorney fees even though the jury found willful infringement).

⁶⁴ See, e.g., *Kleen-Tex Indus. Inc. v. Mountville Mills, Inc.*, No. 3:03-CV-093-JTC, 2008 WL 2486363, at *18–19 (N.D. Ga. Mar. 28, 2008).

⁶⁵ James R. Barney & Jason W. Melvin, *The Supreme Court Shows Unprecedented Interest in IP Issues*, FINNEGAN (July 17, 2014), <http://www.finnegan.com/resources/articles/articlesdetail.aspx?news=4a125f5a-4d15-4f90-81fd-99e16212570c>. For example, the Supreme Court only took on one patent case in 1980, whereas the Court heard an unprecedented six patent cases 2013.

Circuit, bringing them back in line with mainstream jurisprudence in other civil contexts. In *eBay Inc. v. MercExchange, L.L.C.*, the Court made it clear that the availability of injunctive relief in patent cases should be no different from its availability in other areas of law.⁶⁶ In *MedImmune, Inc. v. Genentech, Inc.*, the Court relied on its broader declaratory judgment jurisprudence to reject the Federal Circuit's patent-specific standard.⁶⁷ In *Teva Pharmaceuticals USA, Inc. v. Sandoz, Inc.*, the Court sternly criticized the Federal Circuit's jurisprudence in claim constructions and stated that "we did not create an exception from the ordinary rule governing appellate review of factual matters."⁶⁸

Recent case law indicates that the Court is also acting to combat the Federal Circuit's alleged pro-patent bias. For example, in *Nautilus, Inc. v. Biosig Instruments, Inc.*, the Court gave powerful ammunition to companies seeking to invalidate patents by heightening the definiteness requirement under 35 U.S.C. § 112.⁶⁹ In *Limelight Networks, Inc. v. Akamai Technologies, Inc.*, the Court made induced infringement harder to prove by holding that there can be no induced infringement without an act of underlying direct infringement.⁷⁰ In *Alice Corp. v. CLS Bank International*, the Court substantially heightened the bar for § 101 patent eligibility in order to root out abstract patents.⁷¹ Scholars have long recognized that the Supreme Court's patent law jurisprudence swings like a pendulum between pro-patent and anti-patent stances.⁷² Many suspect that the recent shift from pro-patent to anti-patent was triggered by its concern over patent trolls.⁷³ The Court explicitly acknowledged this concern for the first time in its recent decision, *Commil USA, LLC v. Cisco Sys., Inc.*⁷⁴

⁶⁶ *eBay Inc. v. MercExchange, L.L.C.*, 547 U.S. 388, 391–93 (2006).

⁶⁷ *MedImmune, Inc. v. Genentech, Inc.*, 549 U.S. 118, 128–34 (2007).

⁶⁸ *Teva Pharm. USA, Inc. v. Sandoz, Inc.*, 135 S. Ct. 831, 838 (2015).

⁶⁹ *Nautilus, Inc. v. Biosig Instruments, Inc.*, 134 S. Ct. 2120 (2014).

⁷⁰ *Limelight Networks, Inc. v. Akamai Techs., Inc.*, 134 S. Ct. 2111 (2014).

⁷¹ *Alice Corp. v. CLS Bank Int'l*, 134 S. Ct. 2347 (2014).

⁷² DONALD S. CHISUM, CHISUM ON PATENTS § 5 (2015).

⁷³ Paul R. Gugliuzza, *Patent Litigation Reform: The Courts, Congress, and the Federal Rules of Civil Procedure*, 95 B.U. L. Rev. 279 (2015).

⁷⁴ *Commil USA, LLC v. Cisco Sys., Inc.*, 135 S. Ct. 1920, 1930 (2015) ("The Court is well aware that an 'industry has developed in which firms use

*B. Both Octane Fitness and Highmark Reflect the Court's
Concerns Over Patent-Exceptionalism and Pro-Patent Bias*

The Supreme Court's *Octane* and *Highmark* decisions on § 285 exceptional case analysis comport with the concerns for both patent exceptionalism and pro-patent bias. In *Octane Fitness*, the Supreme Court brought the evidentiary burden of proving the exceptional case standard back to a preponderance of the evidence—the “standard generally applicable in civil actions.”⁷⁵ Furthermore, in *Highmark*, the Supreme Court switched the standard of review for § 285's fee-shifting back to an abuse of discretion—the traditional standard for matters of discretion.⁷⁶ Once again, the Supreme Court knocked down one of the Federal Circuit's patent-specific rules bringing the jurisprudence back to mainstream civil law.

On the other hand, by abandoning the rigid *Brooks Furniture* test for finding an exceptional case, the Supreme Court gave companies incentives to incur the cost of litigating with the hope of winning back their fees and essentially signaled that lower courts should discourage aggressive suits brought by patent trolls.⁷⁷ Even before *Octane Fitness*, judges and scholars had long championed the idea of developing § 285's fee-awarding into an effective tool

patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees' . . . it is still necessary and proper to stress that district courts have the authority and responsibility to ensure frivolous cases are dissuaded.” (quoting *eBay Inc. v. MercExchange, L.L.C.*, 126 S. Ct. 1837, 1842 (2006)).

⁷⁵ *OctaneFitness, LLC v. ICON Health & Fitness, Inc.*, 134 S. Ct. 1749, 1758 (2014).

⁷⁶ *Highmark Inc. v. Allcare Health Mgmt. Sys., Inc.*, 134 S. Ct. 1744, 1748–49 (2014).

⁷⁷ Ryan Davis, *One Year On, Octane Causing More Hard-Fought Patent Cases*, LAW 360 (May 1, 2015 5:00 PM), <http://www.law360.com/articles/648905/one-year-on-octane-causing-more-hard-fought-patent-cases>. See also *Commil*, 135 S. Ct. at 1930–31 (2015) (“[D]istrict courts have the authority and responsibility to ensure frivolous cases [brought by trolls] are dissuaded . . . It is [also] within the district court's discretion to award attorney's fees to prevailing parties in ‘exceptional cases.’”).

to battle patent trolls.⁷⁸

C. Maintaining the Current Substantive Standard of § 284, But Changing the Appellate Review Standard Comports with the Supreme Court's Concerns

Drastically lowering the substantive standard of the enhanced damages of § 284 willfulness analysis—as proposed in the *Halo* concurrence—will directly contradict the Supreme Court's desire to rein in pro-patent bias and patent troll problems. Unlike § 285's double-edged fee-shifting, § 284's enhanced damages only apply to alleged infringers. Bringing down the barrier of establishing willfulness does nothing to deter aggressive suits and frivolous litigation brought by patent trolls. On the contrary, it provides patent trolls with more incentives to ramp up their activities.⁷⁹ Furthermore, abolishing the current two-prong test for establishing willfulness would pave the path for a patentee to establish an exceptional case under 35 U.S.C. § 285. Specifically, a patentee seeking attorneys' fees under § 285 will have a much easier time doing so by alleging that the infringement is willful as a result of a lowered standard. This change would roll back progress made by the Supreme Court in *Octane Fitness* and *Highmark* with respect to § 285 exceptional case jurisprudence—an unthinkable scenario

⁷⁸ Randall R. Rader, Colleen V. Chien & David Hricik, *Make Patent Trolls Pay in Court*, N.Y. TIMES (June 4, 2013), <http://www.nytimes.com/2013/06/05/opinion/make-patent-trolls-pay-in-court.html?>; Emily H. Chen, *Making Abusers Pay: Detering Patent Litigation by Shifting Attorneys' Fees*, 28 BERKELEY TECH. L.J. 351 (2013).

⁷⁹ Given that an accused infringer must be found liable before invoking enhanced fees under § 284, and the fact that the majority of patent cases settle without a determination of liability (whether by trial or motion), it is unlikely that a change of § 284 standard will lead to a dramatic increase in awards under § 284. However, such a change will materially alter the dynamics of the settlement negotiations, since it increases patentees' leverage. A lowered standard for § 284 encourages patentees to pursue enhanced damages more aggressively, or at least to threaten to do so. An alleged infringer would be forced to revise his settlement position in response, given that a more credible threat of § 284 would lead to an increase in both the potential damages award and the expected litigation cost in defending the case.

after the Court expressed its concerns in *Commil*.⁸⁰

However, switching the standard of review from de novo to abuse of discretion brings another patent-specific rule back in line with mainstream civil law jurisprudence. Such a switch would resolve the inherent tension between the de novo review standard and the clear and convincing evidentiary standard, as Justice Breyer pointed out in *Microsoft Corp. v. i4i Limited Partnership*.⁸¹ Furthermore, an abuse of discretion standard does not directly contradict the Supreme Court's concern over patent trolls, and leaves breathing room for Federal Circuit review.⁸²

CONCLUSION

The Supreme Court's upcoming review of the willful infringement standard under 35 U.S.C. § 284 for enhanced damages carries particular significance. Considering its policy implications on the patent troll problem, the Court is unlikely to lower the current willfulness standard substantially. However, a change of its standard of review from de novo to abuse of discretion remains possible. Consequently, this decision is likely to end the parallel between § 284 willfulness and § 285 exceptional case analysis.

⁸⁰ *Commil USA, LLC v. Cisco Sys., Inc.*, 135 S. Ct. 1920, 1930 (2015) (Kennedy, J., majority) (“The Court is well aware that an ‘industry has developed in which firms use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees.’” (quoting *eBay Inc. v. MercExchange, L.L.C.*, 126 S. Ct. 1837, 1842 (2006))); *see also id.* at 1932 (Scalia, J., dissenting) (“[I]t is by no means clear that the Court’s holding, which increases the *in terrorem* power of patent trolls, is preferable.”).

⁸¹ *Microsoft Corp. v. i4i Ltd. P’ship*, 131 S. Ct. 2238, 2253 (2011) (Breyer, J., concurring) (noting that the clear and convincing evidentiary standard only applies to question of fact whereas de novo standard applies to question of law).

⁸² *See Highmark Inc. v. Allcare Health Mgmt. Sys., Inc.*, 134 S. Ct. 1744, 1748 n.2 (2014) (“A district court would necessarily abuse its discretion if it based its ruling on an erroneous view of the law or on a clearly erroneous assessment of the evidence.”).

PRACTICE POINTERS

- Oral arguments were conducted on February 23, 2016, for the consolidated suit between *Halo Electronics, Inc. v. Pulse Electronics, Inc.* and *Stryker Corp. v. Zimmer, Inc.*⁸³ Notably, Justice Breyer and Justice Sotomayor seemed to recognize the necessity of maintaining the relatively high willfulness requirement currently in force, but also were receptive to minor adjustments to the substantive standard to give patentees “some leeway around the edges.”⁸⁴
- Pending the Supreme Court’s decision, the Federal Circuit will hold in abeyance any requests for en banc review regarding § 284 enhanced damages.⁸⁵
- Distinguish case law regarding 35 U.S.C. § 284 and 35 U.S.C. § 285 that has been overruled by *Octane Fitness* and *Highmark*, especially where cases in one area reference cases in the other as precedent or support.

⁸³ *Oral Argument Calendars: Session Beginning February 22, 2016*, SUPREME COURT OF THE UNITED STATES (Dec. 23, 2015), http://www.supremecourt.gov/oral_arguments/argument_calendars/MonthlyArgumentCalFebruary2016.pdf.

⁸⁴ Transcript of Oral Argument at 10–11, 15, 35–36, *Halo Elecs., Inc. v. Pulse Elecs., Inc.*, No. 14-1513 (Feb. 23, 2016).

⁸⁵ *Carnegie Mellon Univ. v. Marvell Tech. Grp.*, 805 F.3d 1382 (Fed. Cir. Oct. 19, 2015).

UNDERMINING BITCOIN

*Sam Hampton**

© Sam Hampton

Cite as: 11 Wash. J.L. Tech. & Arts 331 (2016)
<http://digital.lib.washington.edu/dspace-law/handle/1773.1/1559>

ABSTRACT

In March 2014, the IRS issued a notice detailing the tax treatment the agency would apply to virtual currencies such as Bitcoin. Although applauded by some as a step towards legal legitimacy for this new technology, the IRS's position severely undermines the transactional utility of virtual currencies. Using tax rules established for traditional property transactions frustrates one of virtual currencies' principal purposes: its use as a medium of exchange. Tax compliance requires calculation and payment of capital gains tax, which necessitates documentation of all acquisitions and dispositions of virtual currencies. This tax treatment will likely discourage the use of these currencies, or alternatively will encourage noncompliance by their users. Decentralized currencies like Bitcoin pose novel and difficult regulatory questions, but mechanically applying old rules will lead to an unsatisfactory outcome. The best solution is new legislation that specifically addresses the novel issues posed by virtual currencies, fosters the use of virtual currency in transactions, and still collects tax revenues from investors.

* Sam Hampton, University of Washington School of Law, Class of 2016. I would like to thank Professors Michael Hatfield and Robert Gomulkiewicz for their assistance in developing this Article and their thoughtful commentary. I would also like to thank Dean Falvy for his insightful feedback.

TABLE OF CONTENTS

Introduction.....	332
I. Introduction to Virtual Currencies.....	335
II. The Current Tax Regime for Virtual Currencies.....	338
A. Property Payments: The IRS Notice	338
B. Policy Rationale Underlying Barter and Property Payments	340
C. Logistical Problems with the Adopted Tax Regime	342
1. Record Keeping and Reporting	342
2. Accounting for Virtual Currency Transactions	344
3. Businesses that Accept Virtual Currencies	345
a. Inventory.....	346
b. Property Used in Trade or Business.....	347
III. Alternative Tax Regimes	348
A. United States Foreign Currency Tax Regime	348
B. Other Exemptions for Personal Transactions.....	349
C. Non-Regulation or Outright Illegality.....	351
Conclusion	353

INTRODUCTION

An investor who bought Bitcoins in early January 2012 would have paid around five dollars per unit of the virtual currency.¹ The same Bitcoins could have sold for prices ranging from \$800 to \$900 in late 2013.² In early 2016, even after a steep decline in value, the virtual currency is sold for amounts between \$350 and \$450.³ The savvy speculator could have made a great deal of money in this market, realizing returns over 100 times greater than the initial investment. Not surprisingly, the IRS has clarified how it would tax such a gain.

In March 2014, the IRS published its position on the tax

¹ *Bitcoin Price Index Chart*, COINDESK, <http://www.coindesk.com/price/> (last visited Mar. 2, 2016). This website is a web tool that allows users to search historical Bitcoin market prices.

² *Id.*

³ *Id.*

implications of virtual currencies like Bitcoins.⁴ The agency elected to treat virtual currency as property, and stated that established rules for property transactions would apply.⁵ This position has the practical effect of transforming each transaction in virtual currency into a taxable event with record keeping and reporting requirements for the taxpayer, no matter how small the gain.

Reactions to the IRS's position were mixed. Some commentators applauded the move as a step towards greater legal legitimacy for virtual currencies,⁶ while others worried about the practical compliance problems that the regime would impose on individual users.⁷ While the position was founded on well-established tax principles, the unsatisfactory results for those who regularly transact in virtual currencies speak to the need for new legislation addressing the issues unique to this new payment system.

Federal taxation of virtual currencies concerns three principal groups.⁸ First, there are those individuals and groups who "mine" it, i.e., create new virtual currency as income.⁹ Second, some users invest in virtual currency like stocks, bonds, or other securities.¹⁰

⁴ See Notice 2014-21, 2014-16 I.R.B. 938.

⁵ *Id.* (answer to Q-1 in Section 4).

⁶ See, e.g., Paul Caron, *Marian: Bitcoin and Notice 2014-21*, TAXPROF BLOG (Mar. 26, 2014), http://taxprof.typepad.com/taxprof_blog/2014/03/marian-bitcoin.html.

⁷ See, e.g., Victor Fleischer, *Taxes Won't Kill Bitcoin, but Tax Reporting Might*, N.Y. TIMES DEALBOOK, (Mar. 26, 2014 10:02 AM), <http://nyti.ms/1g0P5KU>; see also Erin M. Hawley & Joseph J. Colangelo, *Bitcoin Taxation: Recommendations to Improve the Understanding and Treatment of Virtual Currency*, 15 ENGAGE: J. FEDERALIST SOC'Y PRAC. GROUPS 4 (2014).

⁸ These conceptual groups are not mutually exclusive; rather, virtual currency enthusiasts probably engage in all three activities. However, it is helpful to strictly demarcate them when considering policy objectives.

⁹ See generally *Mining*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Mining> (last modified Dec. 8, 2015).

¹⁰ Many websites exist that allow for the trading of virtual currencies for real world currencies. See, e.g., CEX.IO, <https://cex.io/> (last visited Mar. 2, 2016).

Finally, there are those who transact in it as a unit of exchange.¹¹ The IRS notice adopts a sound policy position in its treatment of the first two groups, establishing rules analogous to existing provisions for income and gains on capital assets. However, those individuals hoping to use virtual currency to purchase goods and services will find that their interests are not given as much weight. The interests of these individuals are the focus of this Article.

The IRS's position is deficient for two main reasons. First, it establishes an onerous recording and reporting regime for transacting in virtual currencies without, in many cases, any substantial benefit. Second, it fails to clarify actual procedures for compliance both for individuals and businesses. Taken together, the IRS position does not give virtual currency users a realistic chance at compliance and legal legitimacy. Instead, it imposes unworkable standards and leaves the determination of tax liability in legal limbo. Potential new users are forced to choose among three bad options: attempting to comply with ambiguous and onerous tax provisions, disregarding the law, or not using virtual currencies at all.

The current state of the law is ill-equipped to address the new issues presented by virtual currencies. Sound policy regarding virtual currencies requires new statutory enactments with three principal considerations. First, small and routine transactions should be exempt from onerous reporting requirements. Second, sensible rules regarding basis and nature of gains and losses should be enacted and clarified. Finally, a coordinated scheme of regulations should attempt to protect consumers from theft and fraud, and mandate greater information reporting from both the users of virtual currencies and exchanges that facilitate consumer transactions.

This Article will explore tax regulations and their implications for virtual currency users. Part I briefly introduces virtual currencies and their current regulatory environment. Part II describes the regime established by the IRS notice, and outlines the rules' practical implications for individuals and businesses that use

¹¹ The Bitcoin.org website emphasizes the utility of the currency as an alternative payment system on its main page. See BITCOIN.ORG, <https://bitcoin.org/en/> (last visited Mar. 2, 2016).

and accept virtual currencies. Finally, Part III examines alternative tax treatment by looking to other domestic tax rules as well as foreign tax treatment of virtual currencies.

I. INTRODUCTION TO VIRTUAL CURRENCIES

Virtual currencies like Bitcoin operate as decentralized systems, which allow users to make secure transactions with one another without the need for a governmental or private intermediary.¹² The payments are denominated in virtual coins, or subdivisions thereof, and are carried out through virtual networks over the Internet.¹³ These transactions rely on encryption for security, hence the classification “crypto-currencies.”¹⁴ Satoshi Nakamoto first articulated the idea as a system for peer-to-peer payment in an article published online.¹⁵ Since Bitcoin’s introduction, other crypto-currencies have proliferated, using similar technological principles.¹⁶

¹² *Bitcoin*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Bitcoin> (last modified Jan. 29, 2016). This Article narrowly addresses convertible virtual currencies, as this is the express scope of the IRS notice. Notice 2014-21, 2014-16 I.R.B. 938 (Section 3). The term virtual currencies can be understood more expansively to include other virtual interests with real-world economic value. The GAO used a tripartite definition of virtual currencies: closed-flow, hybrid, and open-flow. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-13-516, VIRTUAL ECONOMIES AND CURRENCIES: ADDITIONAL IRS GUIDANCE COULD REDUCE TAX COMPLIANCE RISKS 4 (2013). Convertible virtual currencies are open-flow under this definition. Moreover, open-flow virtual currencies are not required to follow the decentralized, crypto-currency model of Bitcoin. A private actor could conceivably operate its own virtual currency system operating under different principles; this Article focuses on the decentralized model of Bitcoin.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Bitcoin*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Bitcoin> (last modified Jan. 29, 2016); Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN.ORG, <https://bitcoin.org/bitcoin.pdf> (last visited Feb. 20, 2016). Satoshi Nakamoto is a pseudonym; the real-world identity of the author or authors of this article is unknown, though there is much speculation. *See Who is Satoshi Nakamoto?*, COINDESK, <http://www.coindesk.com/information/who-is-satoshi-nakamoto/> (last updated Feb. 19, 2016).

¹⁶ *See, e.g., Comparison of cryptocurrencies*, BITCOIN WIKI, https://en.bitcoin.it/wiki/List_of_alternative_cryptocurrencies (last modified

While a full discussion of the technical features of virtual currencies is beyond the scope of this Article, understanding how virtual currency transactions work and a number of the key features of the network is integral to a proper legal analysis.¹⁷

Transactions are the heart of virtual currency systems.¹⁸ They consist of an input and an output, where the input is the output of a previous transaction.¹⁹ The transactions take place between Bitcoin addresses, which are somewhat like email addresses, though it is important to note that any individual user could control many addresses.²⁰ Each transaction sends a certain balance of virtual currency between the addresses.²¹ Any individual transaction can have multiple inputs and outputs.²² Each transaction conveys the private key, which allows virtual currency in addresses to be spent.²³

The system of exchange relies on a public ledger known as the “blockchain,” a record of all transactions in virtual currency.²⁴ The public ledger authenticates transactions between addresses without

Dec. 24, 2014). This website provides a list of the most popular virtual currencies outside of Bitcoin.

¹⁷ This discussion uses Bitcoin as an example, as many other cryptocurrencies are based on the same principles. However, it is conceivable that other decentralized virtual currencies could operate differently. For more detailed and technical descriptions of how these virtual currencies operate, see Nakamoto, *supra* note 15; *see also Developer Documentation*, BITCOIN.ORG, <https://bitcoin.org/en/developer-documentation>. For a more simplistic, but still detailed description of the system, see BITCOIN WIKI, https://en.bitcoin.it/wiki/Main_Page (last modified Jan. 1, 2016).

¹⁸ *See Transaction*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Transaction> (last modified May 28, 2015).

¹⁹ This chain extends back to the generation transaction, the result of mining; the system is somewhat analogous to a chain of title. *See id.*; *see also Mining*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Mining> (last modified Dec. 8, 2015).

²⁰ *Address*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Address> (last modified Jan. 29, 2015).

²¹ *See Mining*, *supra* note 19.

²² *Id.*

²³ *Id.*; *see also Private key*, BITCOIN WIKI, https://en.bitcoin.it/wiki/Private_key (last modified Feb. 10, 2015).

²⁴ *See Block chain*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Blockchain> (last modified Oct. 21, 2015).

the need for a third party to act as an intermediary.²⁵ The blockchain stores all the transactions of the various blocks and is searchable in terms of addresses and transactions.²⁶ This information is public, so transactions are not actually anonymous. That said, the names and personal information of parties are not automatically associated with identified individual users without further investigation, so the system is better characterized as pseudonymous.²⁷

Finally, wallets are the user interface by which casual users store virtual currencies.²⁸ A wallet stores the private keys for multiple addresses, and often keeps records of transactions made in virtual currency by the owner of the wallet.²⁹

The regulatory and legal environment concerning virtual currencies is newly emerging.³⁰ This Article is narrowly focused on the federal tax implications of the new currency. Other facets of virtual currencies that have been addressed include registration and regulation as money transmitters,³¹ use of virtual currencies in elections,³² and classification of virtual currency as a security.³³

²⁵ *Id.*

²⁶ *See, e.g.*, BITCOIN BLOCK EXPLORER, <https://blockexplorer.com> (last visited Mar. 2, 2016) (Feb. 20, 2016). This website is an example of such an online blockchain search engine.

²⁷ *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-516, VIRTUAL ECONOMIES AND CURRENCIES: ADDITIONAL IRS GUIDANCE COULD REDUCE TAX COMPLIANCE RISKS 6 (2013).

²⁸ *Wallet*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Wallet> (last modified Dec. 3, 2015).

²⁹ *Id.*

³⁰ *See, e.g.*, Nicholas Godlove, *Regulatory Overview of Virtual Currency*, 10 OKLA. J.L. & TECH. 71, 8–12 (2014) (providing an overview of regulatory developments).

³¹ *See FIN-2014-R012*, FINCEN (Oct. 27, 2014), http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R012.pdf; *see also FIN-2014-R011*, FINCEN (Oct. 27, 2014), http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R011.pdf.

³² *See AO 2014-2*, FEC, (May 8, 2014), *available at* <http://www.fec.gov/pages/fecrecord/2014/june/ao2014-02.shtml>.

³³ *SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013).

II. THE CURRENT TAX REGIME FOR VIRTUAL CURRENCIES

A. *Property Payments: The IRS Notice*

At its core, the IRS position elects to treat virtual currency as property, rather than apply any special treatment under existing law, such as foreign currency rules.³⁴ The subsequent answers in the IRS notice stems logically from this conceptualization of virtual currencies.³⁵ Treating virtual currency as property for the purposes of income rules and business reporting requirements simply extends current tax principles.³⁶ However, both logistical and theoretical problems arise when these rules are applied to virtual currency transactions.

The acquisition and disposition of property, including virtual currencies under the IRS position, have tax implications—namely, a gain includable in taxable income, or a potentially deductible loss.³⁷ Whether the amount realized exceeds the adjusted basis of the property determines whether there is a gain or loss upon disposition; these gains or losses are recognized unless there is an exception within the code.³⁸ The adjusted basis³⁹ of virtual

³⁴ Notice 2014-21, 2014-16 I.R.B. 938 (Apr. 16, 2014) (answer to Q-1). The IRS notice explicitly rejects the concept that virtual currencies are to be treated as foreign currency. *Id.* (answer to Q-2).

³⁵ For example, conceptualizing mining as income fits within the definition of gross income as “all income from whatever source derived” including “[g]ains derived from dealings in property.” 26 U.S.C. § 61(a) (2012) (1984). Similarly, information reporting requirements for payments in property over \$600 is a straightforward application of existing law. *See* 26 U.S.C. § 6041(a) (2012).

³⁶ *See generally* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶¶ 41–43 (3d ed. 1999) (discussing taxation of property transactions).

³⁷ *See* 26 U.S.C. § 61(a)(3) (2012); 26 U.S.C. § 165 (2012).

³⁸ 26 U.S.C. § 1001(a), (c) (2012).

³⁹ The IRC contains numerous interrelated basis rules. *See generally* 26 U.S.C. §§ 1011–1016 (2012). Adjusted basis is generally used to determine gain or loss; it is the basis as adjusted by the code. 26 U.S.C. § 1011(a) (2012). Basis is simply the cost of property. 26 U.S.C. § 1012 (2012). Numerous potential adjustments to basis are detailed in the code, but none are applicable in the case of virtual currency. *See generally* 26 U.S.C. § 1016 (2012). Therefore, in the case of virtual currencies, adjusted basis is in all cases simply the cost of the

currency is calculated upon acquisition as determined by the fair market value of the cash, goods, or services exchanged for the virtual currency.⁴⁰ A gain is realized upon the disposition of the virtual currency for goods, services, or cash when the fair market value of the goods or services received exceeds the adjusted basis; a loss is realized when the consideration received is below this basis.⁴¹

The IRS notice states that the character of the gain or loss depends on whether the virtual currency is a capital asset as held by the taxpayer.⁴² A typical individual user of virtual currencies would hold property as a capital asset, not qualifying for any special exception for ordinary gain or loss treatment.⁴³ However, a business holding virtual currencies may qualify for such exceptions.⁴⁴

Tax compliance therefore requires the recording of the following information for any transaction using virtual currencies: (1) an indication of what specific virtual currency units were used; (2) the basis for these units, calculated as the fair market value on the day of acquisition; and (3) the date and fair market value of the disposition transaction. Only with this information can gains and losses be accurately reported, as all taxable income must be under

currency upon acquisition.

⁴⁰ 26 U.S.C. § 1001(a) (2012). *See also* 26 C.F.R. 20.2031-1 (2010) (defining “fair market value” as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts”).

⁴¹ 26 U.S.C. § 1001(a) (2012).

⁴² Notice 2014-21, 2014-16 I.R.B. 938 (answer to Q-7 in Section 4).

⁴³ Capital assets are all assets held by a taxpayer unless they meet certain exceptions. 26 U.S.C. § 1221 (2012). These exceptions are all premised on the operation of a business. *Id.* Therefore, a taxpayer transacting in virtual currency in her personal capacity would hold the property as a capital asset. *See also* BITTKER & LOKKEN, *supra* note 36, at ¶ 47.1.

⁴⁴ Specifically, a business may meet the criteria of the exception for inventory, namely “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.” 26 U.S.C. § 1221 (2012). *See also* BITTKER & LOKKEN, *supra* note 36, at ¶ 47 (discussing the distinction between capital and non-capital assets).

the IRC.⁴⁵

The acquisition of this information may seem manageable, if inconvenient, on its face. However, the requirement that every transaction be reported acts as an enormous impediment to using virtual currencies for routine commercial transactions. It is especially problematic given that the notice expressly applies retroactively; taxpayers who have regularly transacted in these currencies will have to reassemble and report all their prior transactions.⁴⁶ Those who have been using virtual currencies for purchases are now in a state of tax uncertainty.

B. Policy Rationale Underlying Barter and Property Payments

Property payment rules as applied to virtual currencies are similar to tax rules as applied to barter transactions.⁴⁷ In addressing tax rules for virtual currencies, tax authorities in both Australia and Canada explicitly compare virtual currency transactions to barter transactions.⁴⁸ However, such reasoning by analogy does not adequately capture the practical and conceptual differences between traditional barter transactions and the emergence of a global, decentralized unit of exchange. Application of these provisions fails on policy grounds because barter and virtual currencies have several key differences.

The first difference is purposive: in developed economies, people participated in barter to make use of their skills and

⁴⁵ See 26 U.S.C. § 6001 (2012); see also 26 C.F.R. § 1.6001-1(a) (1990).

⁴⁶ Notice 2014-21, 2014-16 I.R.B. 938 (answer to Q-16 in Section 4).

⁴⁷ For a general discussion of taxation of barter, see MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 3.03 (2d ed. 2014). For IRS rulings on barter transactions, see Rev. Rul. 79-24, 1979-1 C.B. 60; see also Rev. Rul. 83-163, 1983-2 C.B. 26. For a scholarly take on the taxation of barter and the utility of the informal economy, see Sergio Pareja, *It Taxes a Village: The Problem with Routinely Taxing Barter Transactions*, 59 CATH. U. L. REV. 785 (2010).

⁴⁸ See *Tax treatment of crypto-currencies in Australia – specifically bitcoin*, AUSTRALIAN TAXATION OFFICE, <https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia---specifically-bitcoin/> (last modified Dec. 18, 2014); *What you should know about digital currency*, CANADA REVENUE AGENCY, <http://www.cra-arc.gc.ca/nwsrm/fctshts/2013/m11/fs131105-eng.html> (last modified Dec. 3, 2014).

property outside the ordinary economic system.⁴⁹ In effect, bartering is the exchange of goods or services within a community, without engagement with the monetary economy. Users of virtual currency cannot effectuate this purpose; traditional currency is necessarily exchanged for a stake in the system, either directly in the case of purchase of virtual currency on exchanges, or indirectly from the real expenses associated with mining, principally electricity.⁵⁰ Though users of virtual currencies are often looking for an alternative payment system, they cannot entirely avoid the monetary economy—dollars are put on the line somewhere along the line. The concern that barter is used in an attempt to understate income is not as concerning in the case of virtual currency.⁵¹

Second, both barter and other property transactions are comparatively inefficient systems that accommodate a clunky tax regime. The actual swapping of goods or services would presumably require direct contact, would not use a medium of exchange, and would therefore be relatively discrete and infrequent. The property transaction tax rules serve such a system adequately, though with less than ideal efficiency. Virtual currency transactions are much more similar to other modern electronic payments systems, and the property rules do not accommodate the frequency and ease with which virtual currency can be used. The apparent congressional intent in enacting the IRC's special foreign currency rules (discussed below) is to recognize the absurdity of

⁴⁹ This income tax evasion concern informed the IRS rulings on the subject. *See* Rev. Rul. 79-24, 1979-1 C.B. 60; *see also* Rev. Rul. 83-163, 1983-2 C.B. 26.

⁵⁰ Dedicating computer hardware to mining virtual currencies is not a costless proposition; whether mining will be profitable depends on electricity rates, the purchase of specialized computer hardware, cooperative efforts, and other factors. *See generally* *How to Calculate Mining Profitability*, COINDESK, <http://www.coindesk.com/information/mining-profitability/> (last visited Mar. 2, 2016).

⁵¹ Such concern evidently underlies the IRS rulings on barter of services and barter clubs, which clarify that such activities are includable in a taxpayer's gross income. *See* Rev. Rul. 79-24, 1979-1 C.B. 60; *see also* Rev. Rul. 83-16, 1983-1 C.B. 235. That said, failure to report gains on virtual currency has serious income tax evasion implications. Further, payments for goods and services in virtual currencies could act as the unit of exchange for people avoiding the monetary economy and evading income taxation.

tracking and reporting every small gain from foreign currency transactions.⁵² This is more closely analogous than the capital gain realized on the bartering of property.

Finally, barter has historically been a necessarily local affair. Direct barter takes place face-to-face. At its most sophisticated, collective bartering could be organized around a club, which would act as a central authority.⁵³ Such clubs use units to represent stake.⁵⁴ But even in those cases, the scope would be relatively local, whereas parties can currently conduct Bitcoin transactions across the globe with confidence and security. The market is much larger, and resembles something closer to a precious metal or a fiat currency than an interest in a local barter club. Again, though the IRS's position rejects this view, foreign currency seems a better analogy for the function of virtual currencies.

Analogizing virtual currency to a barter system only captures the legal rule to be imposed on the transaction. Actual practices in either sort of transaction differ substantially. These differences speak to the impetus for new rules, rather than transplants from a dissimilar regime.

C. Logistical Problems with the Adopted Tax Regime

1. Record Keeping and Reporting

Far and away the most undesirable consequences of the principles adopted in the IRS notice for individual users are the record keeping and reporting implications. Tax law requires that each transaction in virtual currency be reported, which in turn requires extensive record keeping to accurately state gains and losses.⁵⁵ This extra step is likely to discourage use or encourage non-compliance.

Information about what was exchanged in each transaction must be recorded; if one fails to do so during the exchange, reassembling all the necessary data would be cumbersome or even

⁵² See generally 26 U.S.C. §§ 985–988 (2012).

⁵³ Pareja, *supra* note 47, at 786.

⁵⁴ *Id.* at 787.

⁵⁵ See 26 U.S.C. § 6001 (2012); see also 26 C.F.R. § 1.6001-1(a) (1990).

impossible after the fact. This problem is particularly acute because the rules will be applied retroactively, as the IRS notice expressly states.⁵⁶ That said, wallet software typically keeps a comprehensive log of transactions for a user.⁵⁷ Operating under the assumption that virtual currency was exchanged at fair market value, reconstructing the records may be done with relative ease provided that users still have access to these digital records.⁵⁸

Second, each transaction would require individual reporting on tax returns.⁵⁹ While not a complicated problem in theory, the practical burden could mean the end of virtual currencies as a convenient unit of exchange. The effort of reporting each transaction is effectively a tax on the transaction—one more burdensome than even a significant sales tax, presuming that every purchase of coffee must be individually reported on an individual's annual tax return under this regime.⁶⁰

Finally, the information readily available to the IRS does not lend itself to enforcement at this time—a factor that may lead taxpayers to disregard the law.⁶¹ This is a particularly undesirable outcome, as the requirements of the IRC will lose their legitimacy

⁵⁶ Notice 2014-21, 2014-16 I.R.B. 938 (answer to Q-16 in Section 4 explains that there may be penalties for failure to comply prior to notice).

⁵⁷ See *Wallet*, BITCOIN WIKI, <https://en.bitcoin.it/wiki/Wallet> (last updated Dec. 3, 2015).

⁵⁸ This can be more problematic than it may sound. A common problem is losing access to one's virtual currency wallet, effectively cutting off anyone from using those coins again. See *Controlled supply*, BITCOIN WIKI, https://en.bitcoin.it/wiki/Controlled_supply (last updated Jan 15, 2016).

⁵⁹ Individuals file Form 1040, which includes a total for capital gains or losses on line 13. See Form 1040, Internal Revenue Service, (2015), <https://www.irs.gov/pub/irs-pdf/f1040.pdf>. Total gains or losses for capital transactions are reported on Schedule D of Form 1040 for individual taxpayers. See Schedule D (Form 1040), Internal Revenue Service, (2015), <https://www.irs.gov/pub/irs-pdf/f1040sd.pdf>.

⁶⁰ Schedule D includes totals capital gains or losses for various categories of capital gain transactions. See Schedule D (Form 1040), Internal Revenue Service, (2015), <https://www.irs.gov/pub/irs-pdf/f1040sd.pdf>. Individual transactions are to be listed on Form 8949—and, for those who use virtual currency regularly, will likely require many copies of this form. See Form 8949, Internal Revenue Service (2015) <https://www.irs.gov/pub/irs-pdf/f8949.pdf>.

⁶¹ That said, the digital records of virtual currency transactions would be available to the IRS under the IRC. See 26 U.S.C. § 7602 (2012).

by imposing onerous requirements while providing little to no benefit to the government. If other provisions of the tax code are to be taken seriously, then rules about documenting these transactions must be sensible and promote compliance.

Fortunately, new services may provide a solution. The first group of services, offered by companies like Libra, provide a technological solution to this technological problem.⁶² Taking advantage of the permanent record of transactions within the blockchain, the service reconstructs a user's virtual currency transactions, applies tax accounting rules, and even prepares tax documents for returns. A second option for businesses that do not want to engage with the tax issues presented by accepting virtual currencies is to outsource the work to a third party. This is the approach Overstock.com takes to accept virtual currency; Overstock uses a processor called Coinbase, which provides the company with cash receipts.⁶³ However, these services are not free. The IRS position should have sensible requirements that do not necessitate dedicated services and technology.

2. Accounting for Virtual Currency Transactions

The conceptualization of virtual currencies as property is easy in the abstract. The IRS notice goes no further than stating that virtual currency is property. But virtual currency is not a typical piece of property, and the notice offers little guidance for compliance. A unit of virtual currency is not a tangible thing—there is no bank holding virtual coins, notes, or instruments. Accounting for such an asset poses a challenge and strains existing principles.⁶⁴

The most conservative approach is tracking each individual unit of currency separately. This approach applies the IRS position quite literally: each balance of virtual currency is a discrete piece

⁶² See generally LIBRA, <http://libratab.com/> (last visited Mar. 2, 2016).

⁶³ See Al Moldof, *Accountability: Bitcoins, an All-Digital Currency and How it Affects Financial and Managerial Account: Part II* (May/June 2014), available at 2014 WL 2531958.

⁶⁴ *Id.* (arguing traditional financial accounting methods cannot be properly applied to virtual currencies).

of property, and exchanges should be treated under the established rules for property transactions. However, this method is extremely cumbersome to apply in practice because basis, value on acquisition, and disposition must be tracked for each individual currency balance, as described above.

A slightly more aggressive approach is to use an inventory accounting system.⁶⁵ Though it lacks specific statutory authorization, inventory accounting of virtual currency simplifies the process considerably.⁶⁶ Others have suggested such a method is appropriate.⁶⁷ Further, the tax preparation service Libra applies an inventory accounting method for their products.⁶⁸

The Internal Revenue Code is somewhat permissive when it comes to accounting methods, and allows an individual taxpayer to elect his or her accounting period and accounting method.⁶⁹

3. Businesses That Accept Virtual Currencies

The IRS notice states that the nature of the gain depends on the purpose for which the asset is held.⁷⁰ Gains from a capital asset are capital gains, whereas other sorts of assets qualify for ordinary gains and loss treatment.⁷¹ For consumers, virtual currency would almost certainly be held as a capital asset—exceptions are almost exclusively for businesses.⁷² Individual taxpayers benefit from a favorable rate for long-term capital gains on appreciated capital

⁶⁵ The Internal Revenue Code allows “first in, first out” and “last in, first out” inventory accounting systems. *See* 26 U.S.C. §§ 471, 472 (2012). It also authorizes the Secretary of Treasury to require inventory accounting where it most clearly reflects income. 26 U.S.C. § 471 (2012). However, the Secretary has not prescribed inventory accounting for virtual currencies.

⁶⁶ A full overview of accounting rules is beyond the scope of this Article. For more information, see BITTKER & LOKKEN, *supra* note 36, at ¶¶ 105–109.

⁶⁷ Timothy R. Koski, *Bitcoin—Tax Planning in the Uncertain World of Virtual Currency*, 93 PRACTICAL TAX STRATEGIES 255, 256 (2014).

⁶⁸ *Libra for Individuals*, LIBRA, <http://www.libratax.com/libra-for-individuals/> (last visited Mar. 2, 2016).

⁶⁹ *See* BITTKER & LOKKEN, *supra* note 36, at ¶ 105.1.3.

⁷⁰ Notice 2014-21, 2014-16 I.R.B. 938 (answer to Q-7 in Section 4).

⁷¹ *See* 26 U.S.C. § 1222 (2012).

⁷² *See generally* 26 U.S.C. § 1221 (2012).

assets.⁷³ However, there are also limitations on the deductibility of capital losses.⁷⁴ A business that wants to ensure that its losses are fully deductible would prefer ordinary gain and loss treatment.⁷⁵

The notice's language anticipates that some businesses and taxpayers may qualify for ordinary treatment of virtual currency gains and losses. However, the IRC and related case law are not particularly helpful in making this determination. Two possible avenues for ordinary character of losses are inventories and property used in a trade or business.

a. Inventory

Gains or losses on certain property are assessed as ordinary gains and losses, including "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."⁷⁶ It is not clear whether all businesses that transact in virtual currency would qualify under this definition. A business that holds virtual currency solely for the purpose of liquidating into U.S. dollars would likely qualify for ordinary gains and losses under current jurisprudence.⁷⁷

However, this legal determination would be considerably complicated if the business used virtual currency for purchases or payments to employees and vendors. The exemption anticipates a secondary purpose for the property in the use of the word "primarily," but where this line is drawn is not clear.⁷⁸ Further,

⁷³ See 26 U.S.C. § 1(h) (2012). However, there is no corresponding favorable rate for the taxation of corporations. See 26 U.S.C. § 11 (2012).

⁷⁴ Corporations can only take capital losses against capital gains. 26 U.S.C. § 1211(a) (2012). Individuals can take the lesser of capital losses against gains or \$3000. 26 U.S.C. § 1211(b) (2012). See generally 26 U.S.C. §§ 165(f), 1211, 1212 (2012).

⁷⁵ See 26 U.S.C. § 165 (2012).

⁷⁶ 26 U.S.C. § 1221 (2012).

⁷⁷ See BITTKER & LOKKEN, *supra* note 36, at ¶ 47.2 (discussing case law interpreting § 1221; where property is held solely for sale, even if not to customers, it is considered in compliance with the section).

⁷⁸ The Supreme Court validated dual purposes for inventories, with "primarily" meaning the purpose "of first important." See *Malat v. Riddell*, 383 U.S. 569, 572 (1966).

current case law addressing property such as securities or real estate is not likely to be factually analogous—a business is much more likely to make regular sales of virtual currency.⁷⁹ Moreover, a business that regularly uses virtual currency as a payment method for vendors and employees may not fall into the exception to capital asset treatment; there may no longer be a clear primary purpose of resale. Absent a new statutory enactment, businesses that desire ordinary treatments of gains and losses should not use virtual currency to make payments.

b. Property Used in Trade or Business or Section 1231 Property

To qualify for ordinary gains and losses, vendors who accept virtual currency could also attempt to characterize the held currency as property “used in trade or business.”⁸⁰ However, the property must be depreciable under the IRC in order to qualify.⁸¹ Virtual currencies do not experience wear and tear like physical property; in fact, the deflationary bias of most virtual currencies would result in an increase in their value over time.⁸²

The quasi-capital gain regime established by 26 U.S.C. § 1231 is not applicable either, as it relies on a similar definition.⁸³ Specifically, property must be depreciable under Section 167.⁸⁴ Again, virtual currencies are not a depreciable asset. Section 1231 treatment is highly favorable: capital character on gains and ordinary character of losses.⁸⁵ However, absent new enactments,

⁷⁹ For an excellent survey of the case law on this subject, see BITTKER & LOKKEN, *supra* note 36, at ¶ 47.2.

⁸⁰ 26 U.S.C. § 1221(a)(2) (2012).

⁸¹ *Id.*

⁸² The number of Bitcoins in circulation will reduce over time and eventually be fixed. See *Controlled supply*, BITCOIN WIKI https://en.bitcoin.it/wiki/Controlled_supply (last modified Jan. 15, 2016). Assuming increasing or fixed demand over time, this will lead to a deflationary bias, i.e. a single unit of Bitcoin will be worth more relative to real currencies.

⁸³ See 26 U.S.C. § 1231 (2012); see also BITTKER & LOKKEN, *supra* note 36, at ¶ 50.

⁸⁴ 26 U.S.C. § 1231(b)(1) (2012).

⁸⁵ See 26 U.S.C. § 1231 (2012); see also BITTKER & LOKKEN, *supra* note 36, at ¶ 50.

this treatment is not available for non-depreciable property like virtual currencies. Other exceptions to capital gains status are not applicable to the receipt of virtual currency for payments either.⁸⁶

III. ALTERNATIVE TAX REGIMES

A. *United States Foreign Currency Tax Regime*

Current foreign currency tax provisions would give preferable treatment to those who regularly transact in virtual currencies.⁸⁷ The policies underlying these enactments apply more logically to virtual currencies than rules for traditional barter. Two particular rules implemented in the IRC have favorable implications when applied to virtual currencies. This is not to say that the legal status as a currency is in itself important, only that that tax policy should be enacted with regard to the function of the asset in question.

The first advantage of foreign currency rules is non-recognition of gains for personal transactions where the realized gain is below a certain threshold—currently \$200.⁸⁸ While capital gains are paid by businesses and by individuals making foreign currency investments, an individual's dining out in Canada, for example, does not require reporting any *de minimis* gains or losses resulting from daily fluctuations in foreign exchange markets. This hybrid approach would allow for the taxation of significant gains for virtual currency held as an investment asset, while still allowing virtual currencies to be used as effective units of exchange without tax consequences.

The second advantage is a type of ordinary gain and loss treatment for certain businesses that deal in foreign currency,⁸⁹ as well as a series of complicated rules regarding foreign currency contracts.⁹⁰ Similar treatment for virtual currency would clarify the ordinary gain and loss question for businesses that accept virtual

⁸⁶ See 26 U.S.C. § 1221 (2012); see also BITTKER & LOKKEN, *supra* note 36, at ¶ 47.

⁸⁷ See generally 26 U.S.C. §§ 985–988 (2012).

⁸⁸ 26 U.S.C. § 988(e) (2012).

⁸⁹ 26 U.S.C. § 988(a)(1) (2012).

⁹⁰ See generally 26 U.S.C. §§ 985–988 (2012).

currencies. It would also give tax certainty to businesses that make payments in virtual currency, which may otherwise disqualify them under the current law.

However, the decentralized nature of virtual currency differs in principle from foreign currencies. While effective units of exchange, virtual currencies lack some features common to state-issued currencies, like price stability.⁹¹ Relatedly, currencies of foreign governments are relatively stable in exchange rates, or at least are intended to be. Moreover, foreign exchange is a prerequisite for purchases with economic actors from other countries, where virtual currency is in effect an alternative to official currencies. Whether, as a matter of policy, such legal legitimacy should be lent to a private monetary system is a question upon which reasonable minds can differ; the tax advantages to doing so for individuals are quite clear.

A House bill has been proposed that would give foreign currency tax treatment to virtual currencies.⁹² While certainly an improvement over the IRS notice as related to transactions, this treatment is the best among many imperfect alternative options. Specific legislation addressing the unique issues of virtual currencies is preferable.

B. Other Exemptions for Personal Transactions

An exemption from paying or reporting gains resulting from personal transactions in virtual currency would eliminate the problem of reporting requirements imposed by the property tax treatment. Australia has adopted such a rule, excluding such transactions from capital gains tax where the valuation of the virtual currency is less than \$10,000 AU.⁹³ It is not entirely clear,

⁹¹ Stephanie Lo & J. Christina Wang, *Bitcoin as Money?*, FED. RESERVE BANK OF BOSTON (Sept. 4, 2014), <https://www.bostonfed.org/economic/current-policy-perspectives/2014/cpp1404.htm> (arguing that while an effective medium of exchange, virtual currencies like Bitcoin are deficient as units of account and stores of value).

⁹² Virtual Currency Tax Reform Act, H.R. 4602, 113th Cong. (2014).

⁹³ *Tax treatment of crypto-currencies in Australia – specifically bitcoin*, AUSTRALIAN TAXATION OFFICE, <https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia---specifically-bitcoin/> (last modified

however, whether all transactions less than \$10,000 AU are exempt, or if there are gain implications where transactions together exceed this limit.⁹⁴

Such a rule is similar in effect to the foreign currency provisions of the IRC, except that it turns on the value of the disposed property, not the gain from the transaction. It essentially sets a spending limit in foreign currencies before there are tax considerations. However, both work towards a similar goal: exempting transactions from recording where the gain is minimal and burdensome to report.

There are a few more conceptual distinctions. Under the Australian model, virtual currency would still be understood as property, not elevated to the level of a currency. Furthermore, the thresholds for transactions could account for virtual currencies in particular, as opposed to simply adopting foreign currency standards. Perhaps small dispositions of virtual currency, e.g. under \$600, need not be reported, whereas larger transactions, regardless of gain or loss, are large enough to be of interest.⁹⁵

The Australian policy, however, may be over-inclusive. An exemption threshold as high as \$10,000 in value, or thousands of dollars in gains, would allow many who actually hold the virtual currency as an investment vehicle to characterize investment gains as personal transactions. Demonstrating the falsity of such an asserted categorization would be difficult and perhaps prohibitively expensive because of enforcement costs. The threshold could effectively become a standard exemption, and only users who transact above that level would be taxed. In contrast, the IRC's foreign currency treatment would be effective once the gains are considerable enough in the government's estimation to warrant recognition, i.e. over \$200.⁹⁶

Dec. 18, 2014).

⁹⁴ *TD 2014/26*, AUSTRALIAN TAXATION OFFICE 17–18 (Dec. 17, 2014), <http://law.ato.gov.au/atolaw/view.htm?locid=%27TXD/TD201426/NAT/ATO/ft18%27&PiT=99991231235958#ft18> (stating that transactions purposively constructed to avoid exceeding the limit may be considered together).

⁹⁵ This \$600 is the same dollar threshold as information reporting for certain transactions under the IRC. *See* 26 U.S.C. § 6041(a) (2012).

⁹⁶ 26 U.S.C. § 988(e) (2012).

The character of the transaction is of legal significance for many tax transactions, and in theory the exemption could be limited only to personal purchases or other narrowly defined transactions.⁹⁷ This shortcoming is equally true of the foreign currency tax treatment—the exemption is only for individuals making consumer purchases.⁹⁸ However, the records available from virtual currency transactions are not particularly conducive to this inquiry.⁹⁹ The public ledger only records one side of the transactions, and does not include the consideration received for the payment. For example, a public record would not reveal whether a user transferred \$100 worth of Bitcoins to buy a pair of jeans or swapped them for \$100 in cash.

C. *Non-Regulation or Outright Illegality*

While many countries have engaged with the emergence of virtual currency within the framework of their current regulatory system, others have taken a more extreme approach. Some countries, like Iceland, have adopted harsh regulatory responses to the emergence of virtual currencies, effectively rendering them illegal.¹⁰⁰ Other countries, like Belgium, have mostly abstained from any regulation.¹⁰¹ Advocates propose similarly extreme treatment within the United States, either in the form of severe regulatory scrutiny,¹⁰² or a much more laissez-faire regulatory

⁹⁷ For example, one of such significance of is that whether property is a capital asset depends on its use. *See* 26 U.S.C. § 1221 (2012). The foreign currency non-recognition rule is similarly only for consumer transactions. 26 U.S.C. § 988(e) (2012).

⁹⁸ 26 U.S.C. § 988(e) (2012).

⁹⁹ That said, the Secretary of the Treasury has broad powers to examine all relevant records material to determining tax liability. *See* 26 U.S.C. § 7602 (2012). An actual audit of a virtual currency user could demonstrate acquisition and disposition of virtual currency, and potentially upon what it was spent.

¹⁰⁰ *See World, MERKLE TREE*, <http://www.merkletree.io/> (last visited Feb. 2, 2016) (providing a map detailing virtual currency regulations across countries).

¹⁰¹ *Id. But see* Nermin Hajdarbegovic, *Belgian Regulators Issue Joint Bitcoin Warning*, COINDESK (Jan. 16, 2014), <http://www.coindesk.com/belgian-regulators-issue-joint-bitcoin-warning> (describing a governmental statement warning of virtual currency volatility).

¹⁰² Brian Fung, *Sen. Joe Manchin calls for a Bitcoin ban as regulators seek*

attitude.¹⁰³ Yet from tax and regulatory perspectives, neither approach is warranted or likely to be productive.

The deregulatory approach would amount to a major acquiescence. The markets for Bitcoin and other virtual currencies are active, volatile, and deeply traded—there are considerable gains being realized on a daily basis. There is no good reason for the users of virtual currencies to be exempt from ordinary tax treatment like other commodities and markets.¹⁰⁴ While the tax rules must be sensible given the unique issues presented by virtual currencies, new legislation should enact good policy, not simply turn a blind eye.

On the other end of the spectrum, proposals such as outlawing or severely restricting usage of virtual currencies usually have more to do with the potential for facilitating criminal acts than tax regulations.¹⁰⁵ Even so, many countries are concerned that virtual currencies are unreliable and risky investment vehicles for the unwary, and are worried about their potential use as tax shelters.¹⁰⁶

Ultimately, the prohibitory approach is unsatisfactory. Virtual currencies have enormous potential as units of exchange, particularly as alternatives to the current system of financial intermediaries and fees.¹⁰⁷ They do not pose a legitimate threat to the primacy of the dollar or any other official currencies.¹⁰⁸

'accelerated push', WASH. POST (Feb. 26, 2014), <http://www.washingtonpost.com/blogs/the-switch/wp/2014/02/26/sen-joe-manchin-calls-for-a-bitcoin-ban-as-regulators-look-for-an-accelerated-push/>.

¹⁰³ Pat Garofalo, *Don't Regulate Bitcoins ... Yet*, U.S. NEWS & WORLD REPORT (Mar. 5, 2014), <http://www.usnews.com/opinion/blogs/pat-garofalo/2014/03/04/dont-regulate-or-ban-bitcoins-yet>.

¹⁰⁴ Regardless of the label applied, be it currency or property, gains on the sale of virtual currency are clearly within the IRC's definition of gross income: "all income from whatever source derived." 26 U.S.C. § 61(a) (2012).

¹⁰⁵ See, e.g., Derek A. Dion, *I'll Gladly Trade You Two Bits on Tuesday for a Byte Today: Bitcoin, Regulating Fraud in the E-Conomy of Hacker-Cash*, 2013 U. ILL. J.L. TECH. & POL'Y 165 (2013) (detailing the potential for criminal facilitation with virtual currencies and arguing for strict regulation).

¹⁰⁶ See, e.g., Hajdarbegovic, *supra* note 101 (describing a governmental statement warning of virtual currency volatility).

¹⁰⁷ See Godlove, *supra* note 30, at 71.

¹⁰⁸ *Virtual Currency Schemes*, EUROPEAN CENTRAL BANK (Oct. 2012), <https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf>.

Further, the principles involved in the technology may be useful for financial institutions.¹⁰⁹ Discouraging use by complicated tax compliance is a curious approach, whereas a natural alternative would be regulation of the actual bad behavior. The idea that individuals who would use virtual currency for illicit goals would be discouraged by the current tax treatment is a dubious proposition.

Disengagement from the emergence of virtual currencies is a similarly poor policy. Instead, a sensible tax regime for virtual currencies should achieve the following: first, transactions should be facilitated by the law to the extent practicable; second, significant gains and losses should be recognized and taxed as such; and finally, regulation should protect consumers from theft, fraud, and other dangers as well as promote greater informational transparency.

CONCLUSION

Virtual currencies present novel legal issues. Preexisting tax rules do not establish an effective regime for encouraging compliance and reducing regulatory burdens on individuals and businesses, while still imposing taxes on significant gains.

There are two sides to every Bitcoin. On the one hand, it is an exceptionally effective unit of exchange: fungible, portable, and secure. It carries the relative anonymity of cash and does not require intermediaries. On the other hand, it has a broad and active market. Prices fluctuate greatly; investors are betting that the price is on the rise, and speculators try to game the ups and downs. Any sensible tax treatment must capture both facets of virtual currency. Accommodating one aspect to the exclusion of the other neglects an important consideration—either tax compliance or a useful technology.

Current tax rules artificially undercut the usefulness of virtual currencies as units of exchange. Record keeping and tax reporting

¹⁰⁹ See Adrian Blundell-Wignall, *The Bitcoin Question: Currency versus Trust-less Transfer Technology*, ORG. FOR ECON. COOPERATION & DEV. (June 16, 2014), http://www.oecd-ilibrary.org/finance-and-investment/the-bitcoin-question_5jz2pwjd9t20-en.

make transactions unattractive for those who wish to comply with tax law, and legally risky for those who do not. Yet the very utility that underpins the value of virtual currency is the expectation that another person ascribes value to it, and that it will be accepted in the future as payment for goods and services. Making these transactions difficult is a blow not just to the value of virtual currencies as units of exchange, but also to their very utility.

The most sensible policy to protect the utility of virtual currencies is the exemption of minor transactions from record keeping and reporting requirements, new enactment to clarify tax compliance procedures, and new regulations to foster consumer protection and address concerns of illegality.

PRACTICE POINTERS

- Individuals should retroactively amend tax returns for their past use of virtual currencies.
- Individuals should consider employing a service that will prepare returns to reflect their virtual currency gain or loss.
- Taxpayers should either track basis for each individual transaction, or, adopting a more aggressive stance, use an inventory accounting system to reflect their virtual currency gain or loss.
- Businesses should not make payments in virtual currencies if they want ordinary loss treatment for virtual currencies transactions.
- Businesses should consider using a third-party payment processing service to avoid the reporting requirements otherwise associated with accepting virtual currencies.

MUCH ADO ABOUT TRANSFORMATIVENESS: THE SEVENTH
CIRCUIT AND MARKET-CENTERED FAIR USE

*Aaron B. Wicker**

© Aaron B. Wicker

Cite as: 11 Wash. J.L. Tech. & Arts 355 (2016)
<http://digital.law.washington.edu/dspace-law/handle/1773.1/1578>

ABSTRACT

In Kienitz v. Sconnie Nation LLC, the U.S. Court of Appeals for the Seventh Circuit ultimately rejected the concept of transformative use having a central role within the doctrine of fair use. In doing so, the Seventh Circuit broke with judicial precedent, namely the Supreme Court's holding in Campbell v. Acuff-Rose Music, Inc., where the Court unanimously held that the inquiry for the first factor of fair use is whether, and to what extent, the work is transformative. The Seventh Circuit's 2014 decision raises questions about the scope of the holding in Campbell and about whether this holding extends to cases outside of the realm of parody.

This Article will examine the scope of Campbell and whether there can still be market-centered fair use post-Campbell. This Article will then consider the implications of a market-centered fair use analysis. Finally, this Article will conclude that courts should continue to utilize the transformative use inquiry for the purposes of fair use, that Congress need not intervene in fair use, and that there cannot be market-centered fair use post-Campbell.

* Aaron B. Wicker, American University Washington College of Law, Class of 2016. For their continued guidance and support during this process, I thank my family. For their valuable comments, I am grateful to Professor Victoria Phillips, Professor Peter Jaszi, and the editors of the Washington Journal of Law, Technology & Arts.

TABLE OF CONTENTS

Introduction.....	357
I. The Development of Transformative Fair Use.....	360
A. From Leval to <i>Campbell</i> : The Creation of the Transformative Use Paradigm.....	360
B. Application of <i>Campbell</i> by the Courts: The New Jurisprudence of Fair Use and the Development of a More Uniform Standard.....	363
C. <i>Cariou</i> : A Broadening of Transformative Use?	368
D. Pushing Back: The Seventh Circuit Rejects Transformative Use.....	369
II. Transformative Fair Use: An Issue?	372
A. Transformative Fair Use: A Second Circuit Analysis Would Likely Support a Finding of Fair Use Because Woratx’s Secondary Use Was Transformative	373
B. Market-Centered Fair Use: A Seventh Circuit Analysis Would Likely Hold Woratx Liable for Copyright Infringement Because the Works Are Substitute Goods.....	376
C. Assessing the <i>Kienitz</i> Decision: Should There Be Market-Centered Fair Use?	377
III. A Defense of Transformative Use: The Need For a Consistent Standard	380
Conclusion	382

INTRODUCTION

Fair use, a doctrine of copyright law in the United States, is an important instrument for the promotion of culture and innovation in our society. This doctrine is an affirmative defense against claims of copyright infringement that protects secondary creativity.¹ While fair use has been recognized in common law since the Statute of Anne of 1709,² it was not statutorily codified until the Copyright Act of 1976 (the “Copyright Act”).³ The statute sets out four non-exclusive factors to determine whether a fair use has been made:

(1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and (4) the effect of the use upon the potential market for or value of the copyrighted work.⁴

In the years immediately following the enactment of the Copyright Act, fair use was characterized by uncertainty.⁵ Fair use jurisprudence was wrought with the application of inconsistent principles and divided courts.⁶ In the 1980s, the Supreme Court endorsed the idea that commercial uses are presumptively unfair in back-to-back fair use opinions.⁷ In *Harper & Row Publishers v.*

¹ See Pierre N. Leval, *Toward A Fair Use Standard*, 103 HARV. L. REV. 1105, 1110 (1990) (stating that the fair use doctrine protects secondary creativity as a legitimate concern of copyright).

² See, e.g., *Gyles v. Wilcox*, (Ch. 1740) 26 Eng. Rep. 489 (recognizing that “fair abridgement” does not infringe an author’s rights).

³ 17 U.S.C. § 107 (1982).

⁴ *Id.*

⁵ See Leval, *supra* note 1, at 1106 (stating that judges did not share a consensus on the meaning of fair use).

⁶ See *id.* at 1106–07 (“Reversals and divided courts are commonplace.”).

⁷ See *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 451

Nation Enterprises, the Supreme Court proclaimed that the fourth factor is “undoubtedly the single most important element of fair use.”⁸ These judicial proclamations made it exceptionally unlikely that any use that was commercial in nature would qualify as fair use, and installed the inquiry into market harm as the dominant paradigm in any fair use analysis.⁹

Following a law review article by Pierre N. Leval¹⁰ and a Supreme Court decision in *Campbell v. Acuff-Rose Music, Inc.*,¹¹ however, a new strand of fair use jurisprudence arose in the early 1990s. In *Campbell*, the Supreme Court found that the inquiry for the first fair use factor focuses on whether, and to what extent, a work’s new use is transformative.¹² The Supreme Court further elaborated that “the more transformative the new work, the less will be the significance of other factors, like commercialism, that may weigh against a finding of fair use.”¹³ Importantly, the Supreme Court corrected the *Sony* dictum that commercial uses are presumptively unfair.¹⁴

Following *Campbell*, the circuit courts widely adopted the transformative use inquiry.¹⁵ In a recent opinion, *Kienitz v. Sconnie*

(1984) (“[E]very commercial use of copyrighted material is presumptively an unfair exploitation of the monopoly privilege that belongs to the owner of the copyright.”); *Harper & Row, Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 562 (1985) (citing *Sony*, 464 U.S. at 451).

⁸ *Harper & Row*, 471 U.S. at 562.

⁹ Neil Weinstock Netanel, *Making Sense of Fair Use*, 15 LEWIS & CLARK L. REV. 715, 722 (2011) (commenting that under the market-centered paradigm it was very unlikely that any use deemed “commercial” would qualify as fair use).

¹⁰ See Leval, *supra* note 1, at 1111 (noting that the question of justification should turn on whether and to what extent the use is transformative).

¹¹ *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569 (1994).

¹² *Id.* at 569.

¹³ *Id.*

¹⁴ See *id.* at 594 (“It was error for the Court of Appeals to conclude that the commercial nature of 2 Live Crew’s parody of ‘Oh, Pretty Woman’ rendered it presumptively unfair.”).

¹⁵ See *Blanch v. Koons*, 467 F.3d 244, 255 (2d Cir. 2006) (“We have applied *Campbell* in too many non-parody cases to require citation for the proposition that the broad principles of *Campbell* are not limited to cases involving parody.”).

Nation,¹⁶ however, the Seventh Circuit criticized the Second Circuit's use of transformativeness in its *Cariou v. Prince* decision,¹⁷ rejected the transformative use paradigm, and split from the majority in its treatment of fair use. In *Kienitz*, the Seventh Circuit suggested that the fourth factor was the most important of those enumerated in 17 U.S.C. § 107 and used a market-centered approach to fair use in its analysis.¹⁸ This contrasts with the typical analysis used by courts when utilizing the transformative use paradigm, which is driven by the first factor.¹⁹

This Article will address the scope of the holding in *Campbell v. Acuff-Rose Music, Inc.*, as well as the scope of transformative use. Furthermore, this Article will seek to provide a detailed description of the implications that transformative use has had and explain that the Seventh Circuit broke from an important legal precedent in its rejection of transformative use. Moreover, this Article seeks to explain the implications of taking the market-centered approach that the Seventh Circuit offered most recently in *Kienitz*. In light of the Seventh Circuit's recent holding, this Article will argue for transformative fair use and assert that there should no longer be market-centered fair use.

Part I of this Article examines the development of fair use, beginning with Pierre Leval's *Toward a Fair Use Standard* and its vast impact on fair use jurisprudence in the last two decades. It will then move on to the opinion in *Campbell* and how courts have applied its holding. More specifically, the section will look at the application of transformative use to appropriation art by the Second Circuit in *Cariou*. Following this, Part I will examine the Seventh Circuit's treatment of transformative use in *Kienitz*.

Part II begins by analyzing the two cases in question in order to determine what influenced each decision. The section demonstrates how the two standards can render different outcomes when applied

¹⁶ *Kienitz v. Scornie Nation LLC*, 766 F.3d 756 (7th Cir. 2014).

¹⁷ *Cariou v. Prince*, 714 F.3d 694 (2d Cir. 2013).

¹⁸ *Kienitz*, 766 F.3d at 758.

¹⁹ See Jason M. Nolan, *The Role of Transformative Use: Revisiting the Fourth Circuit's Fair Use Opinions* in *Bouchat v. Baltimore Ravens*, 16 VA. J.L. & TECH. 538, 555 (2011) (stating that transformativeness is dispositive of fair use).

to the same factual scenario. To demonstrate that the application of each case's inquiry has different results, this Article applies the different fair use standards to a hypothetical artist named Ronald Woratx.

Part III argues that there is still no need for congressional intervention in 17 U.S.C. § 107. This Article suggests that the *Campbell* decision offers a solution to fair use that best promotes the goals of copyright law, following two decades of more consistent outcomes and a more widely available defense. Part III also notes that the market-centered approach taken by the Seventh Circuit contradicts the goals of copyright law by narrowing the availability of the fair use defense and in turn stifles the promotion of both culture and innovation. It explains how the development of the transformative use paradigm has benefitted fair use immensely by creating a more uniform standard, which the Seventh Circuit should have followed. The section concludes that the transformative use paradigm is a beneficial interpretation of fair use and that it is a clear standard which reflects the original intent of both the fair use doctrine and copyright law.

I. THE DEVELOPMENT OF TRANSFORMATIVE FAIR USE

Part A provides an overview of the transformative use paradigm from an influential law review article to a critical Supreme Court decision. Part B examines the application of transformative use by courts after *Campbell* and the trends of fair use jurisprudence of the last two decades. Part C directly addresses the decision in *Cariou*. Finally, Part D examines the *Kienitz* decision and its criticism of *Cariou*, as well as the transformative use paradigm.

A. *From Leval to Campbell: The Creation of the Transformative Use Paradigm*

Pierre Leval's 1990 law review article, *Toward a Fair Use Standard*, has had a tremendous impact on modern fair use

jurisprudence.²⁰ Leval published the article following a period of inconsistency, divided courts, and reversals that marked the fair use jurisprudence of the 1980s.²¹ The article was where the term “transformative use” was first coined.²² In the article, Leval argues that courts should look to the intention of copyright law, maintaining that it serves a utilitarian purpose.²³ In particular, Leval suggests that courts should look toward the purpose of fair use, which is to ensure that copyright protection is not so expansive to stifle creativity.²⁴ Perhaps most importantly, Leval reasons that courts should look to “whether, and to what extent, the challenged use is transformative” in determining whether the first factor of 17 U.S.C. § 107 merits a finding of fair use.²⁵ Leval asserts that the soul of fair use is the first factor.²⁶ The article maintains that transformative use can take a multiplicity of forms and notably not just parody.²⁷

Leval goes on to argue that transformative use should trickle into a third factor analysis as well—specifically, that courts should look to the amount and substantiality of a use in order to determine whether there was in fact a transformative use.²⁸ Notably, the article discourages courts from relying too heavily on the fourth factor, which would severely cripple fair use.²⁹

In 1994, the Supreme Court issued an opinion in *Campbell* that

²⁰ See *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 579 (1994) (citing Pierre N. Leval, *Toward A Fair Use Standard*, 103 HARV. L. REV. 1105, 1110 (1990)).

²¹ See, e.g., *Universal City Studios, Inc. v. Sony Corp. of Am.*, 480 F. Supp. 429 (C.D. Cal. 1979), *rev'd*, 659 F.2d 963 (9th Cir. 1981), *rev'd*, 464 U.S. 417 (1984); see also *Harper & Row, Publishers, Inc. v. Nation Enters.*, 557 F. Supp. 1067 (S.D.N.Y. 1983), *modified*, 723 F.2d 195 (2d Cir. 1983), *rev'd*, 471 U.S. 539 (1985).

²² See Leval, *supra* note 1, at 1111 (“I believe the answer to the question of justification turns primarily on whether, and to what extent, the challenged use is transformative.”).

²³ *Id.* at 1118.

²⁴ *Id.* at 1109.

²⁵ *Id.* at 1111.

²⁶ *Id.* at 1116.

²⁷ See generally *id.*

²⁸ *Id.* at 1122–03.

²⁹ *Id.* at 1124–05.

echoed much of the philosophy Leval advocated in his article.³⁰ *Campbell* has since become arguably the most important Supreme Court fair use decision.³¹

Campbell addressed a parody of Roy Orbison's "Oh, Pretty Woman" by well-known rap artists 2 Live Crew.³² The *Campbell* Court found that a parody may be a fair use pursuant to § 107.³³ More importantly, however, the Court found that for the first factor:

[T]he enquiry focuses on whether the new work merely supersedes the objects of the original creation, or whether and to what extent it is "transformative," altering the original with new expression, meaning, or message. The more transformative the new work, the less will be the significance of other factors, like commercialism, that may weigh against a finding of fair use.³⁴

This seemed to follow the standard set out for transformative use in Leval's article.³⁵ This opinion sparked a wave of new fair use jurisprudence and brought life to transformative use as the dominant consideration in fair use analysis.³⁶

³⁰ *Campbell*, 510 U.S. at 579 (quoting Pierre N. Leval, *Toward A Fair Use Standard*, 103 HARV. L. REV. 1105, 1111 (1990)).

³¹ See, e.g., Pierre N. Leval, *Campbell v. Acuff-Rose: Justice Souter's Rescue of Fair Use*, 13 CARDOZO ARTS & ENT. L.J. 19, 19 (1994) (expressing joy that Justice Souter's opinion guided the fair use doctrine in the right direction).

³² *Campbell*, 510 U.S. at 571–72.

³³ *Id.* at 579–80.

³⁴ *Id.* at 569.

³⁵ See Barton Beebe, *An Empirical Study of U.S. Copyright Fair Use Opinions, 1978–2005*, 156 U. PA. L. REV. 549, 604 (2008) ("The *Campbell* court relied heavily on the concept of transformativeness and on Judge Leval's exposition of it in its first factor analysis of 2 Live Crew's parody.")

³⁶ *Id.*

B. Application of Campbell by the Courts: The New Jurisprudence of Fair Use and the Development of a More Uniform Standard

Following *Campbell*, circuit courts began to apply the transformative use paradigm.³⁷ Over time, the doctrine grew widespread. For example, in *Kelly v. Arriba Soft Corporation*, the Ninth Circuit considered whether thumbnails used by a search engine could be considered a fair use.³⁸ The court reasoned that the thumbnails did not supersede the original photographs' use and that they were transformative because they served a different purpose from the original photographs.³⁹ This opinion applied the transformative use inquiry to a case involving search engine thumbnails—a far cry from parody—and broadened the scope of *Campbell*.⁴⁰

Similarly, in *Bill Graham Archives v. Dorling Kindersley, Ltd.*, the Second Circuit considered whether a chronological assemblage of reduced-format posters in a biography of the Grateful Dead titled *Illustrated Trip* constituted a fair use.⁴¹ The court found that each poster differed from its original expressive purpose due to the bibliographic nature of the book, and accordingly was transformative.⁴² This case broadened *Campbell* by holding that even when a secondary user takes an entire work, the use can still be considered transformative, so long as the use does not supersede the original.⁴³

In recent years, transformative use has increasingly become a

³⁷ *Blanch v. Koons*, 467 F.3d 244, 255 (2d Cir. 2006) (“We have applied *Campbell* in too many non-parody cases to require citation for the proposition that the broad principles of *Campbell* are not limited to cases involving parody.”).

³⁸ *Kelly v. Arriba Soft Corp.*, 336 F.3d 811 (9th Cir. 2003).

³⁹ *Id.* at 819.

⁴⁰ *See generally id.* (applying transformative use to search engine thumbnails).

⁴¹ *Bill Graham Archives v. Dorling Kindersley Ltd.*, 448 F.3d 605 (2d Cir. 2006).

⁴² *Id.* at 609.

⁴³ *Id.*

more uniform standard amongst the circuit courts.⁴⁴ For example, the Second Circuit has cited Ninth Circuit decisions in recent opinions,⁴⁵ and consequently outcomes have become more predictable.⁴⁶ Circuit courts have interpreted *Campbell* broadly, and such opinions have not been limited to parody cases.⁴⁷ Cases such as *Kelly* and *Bill Graham* demonstrate that a use can be transformative if the secondary use serves some new purpose, even when the secondary user did not materially alter the original work.⁴⁸ *Kelly* and *Bill Graham* are cases about removing images from their original contexts, shrinking them, and using them in alternate contexts while still recognizing them as their original items. *Blanch v. Koons* is an artistic case about taking images from a copyrighted work, altering those images, and incorporating those altered images into a new whole.⁴⁹ *Blanch*, like *Kelly* and *Bill Graham*, supports the view that transformative use is fundamental to determining fair use. Further, *Blanch* reinforces that transformative use is primarily about new purposes.⁵⁰

In *Blanch*, the Second Circuit found that appropriation art

⁴⁴ See Matthew Sag, *Predicting Fair Use*, 73 OHIO ST. L.J. 47, 49, 51 (2012) (showing that findings of transformative use can be used to predict likely outcomes of fair use cases).

⁴⁵ See *Authors Guild, Inc. v. HathiTrust*, 755 F.3d 87, 95 (2d Cir. 2014); see also *Authors Guild v. Google, Inc.*, 804 F.3d 202, 217 (2d Cir. 2015).

⁴⁶ See Netanel, *supra* note 9, at 736.

⁴⁷ See, e.g., *Blanch v. Koons*, 467 F.3d 244, 255 (2d Cir. 2006) (“We have applied *Campbell* in too many non-parody cases to require citation for the proposition that the broad principles of *Campbell* are not limited to cases involving parody.”).

⁴⁸ See *Bill Graham Archives v. Dorling Kindersley Ltd.*, 448 F.3d 605 (2d Cir. 2006) (holding that using images of posters and tickets used in a book about the Grateful Dead was a fair use); see also *Kelly v. Arriba Soft Corp.*, 336 F.3d 811 (9th Cir. 2003) (holding that a search engine using thumbnail images was a fair use).

⁴⁹ See *Blanch*, 467 F.3d at 253 (noting that the defendant’s use of the copyrighted work involved “changes of its colors, the background against which it is portrayed, the medium, the size of the objects pictured, the objects’ details . . . as part of a massive painting commissioned for exhibition in a German art-gallery space”).

⁵⁰ See *id.* at 252 (“The sharply different objectives that Koons had in using, and Blanch had in creating, ‘Silk Sandals’ confirms the transformative nature of the use.”).

could serve a transformative purpose.⁵¹ An appropriation artist named Jeff Koons created a painting entitled “Niagara,” in which he appropriated a photograph taken by Andrea Blanch.⁵² Blanch’s photograph depicted a woman’s lower legs and feet in a pair of glittery Gucci sandals, decorated with bronze nail polish, which rested on a man’s lap.⁵³ Koons appropriated only the legs and feet from the photograph for his painting, excluding the background of the man’s lap.⁵⁴ Koons then changed the orientation of the feet from a 45-degree angle to a vertically inverted position.⁵⁵ Koons also added a heel to one of the feet and modified the coloring of the photograph.⁵⁶ The photograph was included in the painting along with three other pairs of feet and lower legs dangled over images of confections as well as a grassy field and the Niagara Falls in the background.⁵⁷

Relying on *Campbell*, the court applied a transformative use inquiry to the first statutory factor.⁵⁸ The court reasoned that Koon’s purposes in using Blanch’s photography were quite different from Blanch’s goals in creating it.⁵⁹ Blanch had created her photograph for publication in an American lifestyles magazine, while Koons used the image as part of a large-scale painting for a German museum.⁶⁰ Furthermore, Koons wanted “the viewer to think about his/her personal experience with these objects, products, and images and at the same time gain new insight into how these affect our lives.”⁶¹ Koons wanted to “show some sort of erotic sense [:] . . . to get . . . more of a sexuality to the photographs.”⁶²

The *Blanch* court did not believe that the mere fact that Koons’

⁵¹ See *id.* at 259 (holding that appropriation art can be transformative).

⁵² *Id.* at 247–48.

⁵³ *Id.* at 248.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.* at 251.

⁵⁹ *Id.* at 252.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

work was a painting and Blanch's work was a photograph was enough to support a finding of fair use, nor that Koons' work was in a museum and Blanch's was in a magazine to be sufficient.⁶³ In keeping with *Kelly* and *Bill Graham*, the court needed to find "new expression, meaning, or message" from the secondary use.⁶⁴ As such, the *Blanch* court pointed to *Ringgold v. Black Entertainment Television, Inc.* where a copy of a painting was used as decoration for a television program's set.⁶⁵ In particular, the court noted that the *Ringgold* court found that the secondary use served the same decorative purpose as the original and accordingly was not transformative.⁶⁶

Further, regarding the amount and substantiality of the selection used, the Second Circuit found that the amount that Koons took was "reasonable in relation to the purpose of the copying."⁶⁷ Koons only took the legs, feet, and sandals from the original photograph, and excluded the background.⁶⁸ More importantly, Koons excluded many of the creative decisions made by Blanch.⁶⁹

Recent empirical studies suggest that when a new work is found to be transformative, the statutory factors are essentially replaced by transformative use. While opinions do still incorporate by reference all of the considerations in the statute,⁷⁰ the inquiry

⁶³ *See id.* ("Koons does not argue that his use was transformative solely because Blanch's work is a photograph and his a painting, or because Blanch's photograph is in a fashion magazine and his painting is displayed in museums. He would have been ill advised to do otherwise.")

⁶⁴ *Id.* at 251 (quoting *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 579 (1994)).

⁶⁵ *Ringgold v. Black Entm't Television, Inc.*, 126 F.3d 70, 79 (2d Cir. 1997).

⁶⁶ *Blanch*, 467 F.3d at 252.

⁶⁷ *Id.* at 257.

⁶⁸ *Id.* at 258.

⁶⁹ *Id.*

⁷⁰ Michael J. Madison, *A Pattern-Oriented Approach to Fair Use*, 45 WM. & MARY L. REV. 1525, 1564 (2004) ("[T]he facial emptiness of the statutory language means that alone, it is almost entirely useless analytically, except to the extent that it structures the collection of evidence that a court might think relevant to its decision.")

has effectively been reduced to two prongs.⁷¹ In *A Pattern-Oriented Approach to Fair Use*, Michael Madison demonstrates that courts have recognized certain patterns of practice utilized by social and professional groups, such as the idea that journalism, education, and comparative advertising deserve fair use recognition.⁷² Madison's research reveals that courts have typically found uses to be fair when they find that a defendant is engaged in one of these patterns.⁷³ Similarly, in *Predicting Fair Use*, Mathew Sag establishes that findings of transformative use tend to precede findings of fair use.⁷⁴ Additionally, in *Making Sense of Fair Use*, Neil Netanel shows that transformative use has replaced inquiry into harm to an actual or potential market as the dominant paradigm in fair use doctrine.⁷⁵ Netanel demonstrates that courts almost always find uses to be fair when they find the use of a copyrighted work to be transformative. His conclusion shows that the fair use inquiry has narrowed to two prongs: whether a use has a transformative purpose, and whether amount of copyrighted material used was appropriate to that purpose.⁷⁶

To this end, modern courts typically disregard the fourth factor if the use is transformative.⁷⁷ The only market effects that are relevant in fair use analysis are those that result from consumer substitution. In *Authors Guild v. Google, Inc.*, an authoritative recent decision, the Second Circuit opined that:

⁷¹ See Netanel, *supra* note 9, at 768 (“If the use is for a transformative purpose, then the question is whether the defendant has copied more than a reasonable amount for that purpose.”).

⁷² Madison, *supra* note 70, at 1646–47.

⁷³ See *id.* at 1645–46.

⁷⁴ See Sag, *supra* note 44, at 49, 51.

⁷⁵ See Netanel, *supra* note 9, at 742.

⁷⁶ See *id.* at 743, 745–46.

⁷⁷ See *Bill Graham Archives v. Dorling Kindersley Ltd.*, 448 F.3d 605, 613 (2d Cir. 2006) (recognizing that copyright owners are not entitled to control the “transformative markets” for their works); see also *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 591 (1994) (“[W]hen, on the contrary, the second use is transformative, market substitution is at least less certain, and market harm may not be so readily inferred.”).

The more the appropriator is using the copied material for new, transformative purposes, the more it serves copyright's goal of enriching public knowledge and the less likely it is that the appropriation will serve as a substitute for the original or its plausible derivatives[.]⁷⁸

In other words, highly transformative uses have a lower risk for market harm because they are not serving the original work's intended market.

C. Cariou: *A Broadening of Transformative Use?*

In *Cariou v. Prince*, the Second Circuit held that a new work need not comment on the original in order to be transformative.⁷⁹ The court found that a new purpose and a different audience were sufficient for a finding of fair use.⁸⁰ In this case, the Second Circuit again considered whether a fair use defense could be applicable to appropriation art.⁸¹ Patrick Cariou, a professional photographer, brought a copyright infringement action against a well-recognized appropriation artist, Richard Prince, for his use of Cariou's copyrighted photographs of Rastafarians and Jamaican landscapes.⁸² Appropriation art by definition involves directly taking an object or another existing work of art and placing it into a new work of art.⁸³ In this case, Prince included Cariou's photographs into his new works of art. Prince had previously stated that in his work he "completely tr[ies] to change [another artist's work] into something that's completely different."⁸⁴

The Second Circuit found that Prince's use of Cariou's photographs was, in fact, transformative in twenty-five out of his

⁷⁸ Authors Guild v. Google, Inc., 804 F.3d 202, 214 (2d Cir. 2015).

⁷⁹ See *id.* at 706–07.

⁸⁰ See *id.* at 706, 709.

⁸¹ *Cariou v. Prince*, 714 F.3d 694, 706–07 (2d Cir. 2013).

⁸² *Id.* at 706, 709.

⁸³ *Id.* at 699.

⁸⁴ *Id.*

thirty paintings and constituted a fair use.⁸⁵ The court relied heavily on Leval's article and *Campbell* in its decision and gave great weight to the fact that the paintings were transformative when concluding that a fair use was made.⁸⁶

The court went on to hold that Prince's work could be transformative, notably without commenting on Cariou's photographs and in the absence of any defense from Prince suggesting that he intended to comment upon or criticize Cariou's work.⁸⁷ The court held that the photographs were transformative because Prince's work employed new aesthetics and had an entirely different audience than Cariou's work.⁸⁸ The court found that Prince's paintings had a new expression and a new communicative result. Accordingly, the first factor weighed in favor of Prince because his work was transformative.⁸⁹

The Second Circuit then cascaded transformativeness across the other three statutory factors.⁹⁰ For the fourth statutory factor of § 107, the court held that the inquiry is whether the new work completely usurps the market for the original, and that the more transformative the new work, the less likely it is that it does so.⁹¹ This broadened treatment of transformative use across statutory factors, as well as the court's rejection of the requirement of commentary, considerably extended the fair use doctrine previously employed in other circuits.

D. Pushing Back: The Seventh Circuit Rejects Transformative Use

Following *Cariou*, Harvard Law Review published an article criticizing the Second Circuit's analysis in the case and asserting that the definition of transformative use adopted by the Second Circuit was the broadest to date.⁹² This definition, the article

⁸⁵ *Id.* at 694.

⁸⁶ *Id.*

⁸⁷ *Id.* at 707.

⁸⁸ *Id.* at 708–09.

⁸⁹ *Id.* at 708.

⁹⁰ *Id.* at 708–09.

⁹¹ *Id.* at 709.

⁹² See Harv. L. Rev. Ass'n, *Copyright Law — Fair Use — Second Circuit Holds that Appropriation Artwork Need Not Comment on the Original to Be*

argues, is in tension with the definition of derivative works in 17 U.S.C. § 106 of the Copyright Act.⁹³ The article is primarily critical of the Second Circuit's holding that new work need not comment on the original in order to be transformative.⁹⁴ Additionally, it seems to suggest that there remains some uncertainty as to whether the holding in *Campbell* should be limited to the genre of parody.⁹⁵

In *Kienitz v. Sconnie Nation LLC*, the Seventh Circuit issued the first circuit-level critique of *Cariou* and, more broadly, of transformative use. In its opinion, the court cited some of the same concerns of the foregoing article.⁹⁶

The issue before the Seventh Circuit in *Kienitz* was whether a fair use was made where a copyrighted photograph of Paul Soglin, mayor of Madison, Wisconsin, was turned lime green, used to make t-shirts and tank tops along with the words, "Sorry for Partying," and sold by Sconnie Nation on clothing for a marginal profit.⁹⁷ The Seventh Circuit found that a fair use was made of Kienitz's photographs.⁹⁸ More interesting than the outcome, however, was the court's analysis. In the opinion, Judge Easterbrook held that transformative use was not a statutory factor and that it is better to adhere to the four factors listed in § 107.⁹⁹ Easterbrook then proceeded to emphasize that:

The Second Circuit has run with the suggestion and concluded that "transformative use" is enough to

Transformative. — *Cariou v. Prince*, 714 F.3d 694 (2d Cir. 2013), 127 HARV. L. REV. 1228, 1229 (2014).

⁹³ See *id.* at 1232 (stating that the Second Circuit's definition of transformative is in direct tension with the derivative work right); see also 17 U.S.C. § 106.

⁹⁴ *Id.* at 1228.

⁹⁵ See *id.* at 1232; cf. *Blanch v. Koons*, 467 F.3d 244, 255 (2d Cir. 2006) ("We have applied *Campbell* in too many non-parody cases to require citation for the proposition that the broad principles of *Campbell* are not limited to cases involving parody.").

⁹⁶ See *Kienitz v. Sconnie Nation LLC*, 766 F.3d 756 (7th Cir. 2014) (stating that transformative use is in tension with the derivative work right).

⁹⁷ *Id.* at 757.

⁹⁸ *Id.*

⁹⁹ *Id.* at 758.

bring a modified copy within the scope of § 107. See, e.g., *Cariou v. Prince*, 714 F.3d 694, 706 (2d Cir. 2013). *Cariou* applied this to an example of “appropriation art,” in which some of the supposed value comes from the very fact that the work was created by someone else.

We’re skeptical of *Cariou*’s approach, because asking exclusively whether something is “transformative” not only replaces the list in § 107 but also could override 17 U.S.C. § 106(2), which protects derivative works. To say that a new use transforms the work is precisely to say that it is derivative and thus, one might suppose, protected under § 106(2). *Cariou* and its predecessors in the Second Circuit do not explain how every “transformative use” can be “fair use” without extinguishing the author’s rights under § 106(2).¹⁰⁰

This last passage follows some of the concerns of the Harvard Law Review article, specifically with regard to § 106 derivative works and the holding that certain appropriation art is a fair use.¹⁰¹ Further, the Seventh Circuit maintained that the fourth factor, market effect, should be the most important in a fair use analysis.¹⁰² The opinion went on to look at fair use through an economic lens, relying on whether the allegedly infringing work was a complement to, or a substitute for, the original work.¹⁰³ Ignoring whether Scennie Nation’s work could be considered transformative, the *Kienitz* court held that, because a shirt or tank top is not a substitute for the original photograph, a fair use can be

¹⁰⁰ *Id.*

¹⁰¹ *See id.* (asserting that transformative use is in direct tension with the derivative work right); *see also* Harv. L. Rev. Ass’n, *supra* note 92.

¹⁰² *Kienitz*, 766 F.3d at 758 (“We think it best to stick with the statutory list, of which the most important usually is the fourth.”).

¹⁰³ *See id.* at 759 (“A t-shirt or tank top is no substitute for the original photograph.”).

made in such contexts.¹⁰⁴

Kienitz is significant in that it seemingly rejects the fair use jurisprudence developed after *Campbell*. While the opinion specifically criticizes *Cariou* and the Second Circuit, both the language and analysis are dismissive of transformative use as a whole. It thus hearkens back to pre-*Campbell* fair use decisions by placing most of the weight of the statutory analysis on the fourth factor.¹⁰⁵

II. TRANSFORMATIVE FAIR USE: AN ISSUE?

The Seventh Circuit's approach in *Kienitz* is problematic for a number of reasons. Not only does the opinion seemingly ignore the entirety of the fair use jurisprudence of the 1990s and 2000s, but it also diminishes the Supreme Court's holding in *Campbell*.¹⁰⁶ Instead, the opinion puts great weight on the fourth factor of § 107 analysis.¹⁰⁷

Placing such weight on the fourth factor does great harm to the availability of fair use.¹⁰⁸ In the words of Leval, “[b]y definition every fair use involves some loss of royalty revenue because the secondary user has not paid royalties.”¹⁰⁹ One of the greatest benefits of the new fair use jurisprudence has been that it has made the doctrine more widely available.¹¹⁰ A thriving fair use defense is

¹⁰⁴ *Id.*

¹⁰⁵ *See id.* at 758 (“We think it best to stick with the statutory list, of which the most important usually is the fourth.”).

¹⁰⁶ *See id.* (“The district court and the parties have debated whether the t-shirts are a ‘transformative use’ of the photo—and, if so, just how ‘transformative’ the use must be. That’s not one of the statutory factors, though the Supreme Court mentioned it in *Campbell*.”).

¹⁰⁷ *See id.* (holding that the fourth statutory factor is usually the most important).

¹⁰⁸ *See* Leval, *supra* note 1, at 1124–25 (“[I]f an insubstantial loss of revenue turned the fourth factor in favor of the copyright holder, this factor would never weigh in favor of the secondary user. And if we then gave serious deference to the proposition that it is ‘undoubtedly the single most important element of fair use,’ fair use would become defunct.”).

¹⁰⁹ *Id.* at 1124.

¹¹⁰ *See* Sag, *supra* note 44, at 79 (maintaining that focusing on the character of the use rather than the identity of the user makes the defense available to

paramount to accomplishing one of copyright law's foremost goals: the promotion of culture and innovation.¹¹¹

The following hypothetical exemplifies some of the differences between the circuit split and ideally will highlight some of the problems with the Seventh Circuit's approach to fair use in *Kienitz*: A professional photographer, Jessica Smith, takes several photographs of New Zealand landscapes and Māori people performing haka. The photographs are then published in a book entitled *Yes Haka*.

A recognized appropriation artist, Ronald Woratx, then incorporates the photographs into a sequence of paintings and collages. The original photographs are blown up in size, acrylic paint is added, the photographs are then superimposed along with photographs of various technologies not taken by Smith onto a piece of sheet metal. A major news network quotes Woratx in an interview: "I wanted to explore information-age propaganda and to get the viewer to think about their personal experience with it."

Gallery A is putting on a show. The owner contacts Smith about potentially incorporating some of her photographs from *Yes Haka* into the show. Gallery B is showing several of Woratx's works in another show, including his pieces that incorporate photographs by Smith. The owner of Gallery A learns of Woratx's pieces being shown at Gallery B and then attempts to contact Smith. Smith does not respond and the gallery owner concludes that Smith is collaborating with Woratx and is not interested in the exhibition at Gallery A. The owner of Gallery A then decides not to feature any of Smith's pieces from *Yes Haka* in the show.

A. Transformative Fair Use: A Second Circuit Analysis Would Likely Support a Finding of Fair Use Because Woratx's Secondary Use Was Transformative

Following the new and more unified jurisprudence of transformative fair use, a court would likely find that a fair use was

commercial actors and that the doctrine is more predictable than one might think).

¹¹¹ See Leval, *supra* note 1, at 1107 (maintaining that the observance of fair use is necessary to achieve the objectives of copyright law).

made of Smith's photographs. This school of jurisprudence has placed the first factor—whether the use was transformative in nature—at the center of the analysis.¹¹² Although first established in *Campbell*, two decades of case law have narrowed it to focus primarily on whether the purpose of the use was transformative in nature.¹¹³ Following this paradigm, courts would then look to the amount of the original work taken and whether it was appropriate to the purpose of the secondary use.¹¹⁴ *Cariou* took the first prong of this inquiry a step further, holding that a new work need not comment on the original in order to be transformative.¹¹⁵ This new fair use jurisprudence created a more uniform articulable standard by simplifying the analysis to the foregoing two prongs.¹¹⁶

Thus, a court would typically begin its transformative use analysis by examining the first factor: the purpose and character of the use.¹¹⁷ In *Campbell*, the Supreme Court found that the inquiry for the first factor is whether and to what extent the work is transformative.¹¹⁸ The circuits have interpreted this inquiry to focus on the extent to which the purpose is transformative.¹¹⁹

Professor R. Anthony Reese surveyed thirty-seven circuit court opinions, ranging from the decision in *Campbell* in 1994 to

¹¹² See Sag, *supra* note 44, at 55 (“According to *Campbell*, transformativeness not only occupies the core of the fair use doctrine but also reduces the importance of all other factors such that ‘the more transformative the new work, the less will be the significance of other factors, like commercialism, that may weigh against a finding of fair use.’”).

¹¹³ See R. Anthony Reese, *Transformativeness and the Derivative Work Right*, 31 COLUM. J.L. & ARTS 467 (2008) (“[I]n evaluating transformativeness the courts focus more on the purpose of a defendant’s use than on any alteration the defendant has made to the content of the plaintiff’s work.”).

¹¹⁴ See Netanel, *supra* note 9, at 745 (“Under the transformative use paradigm, factor three—the amount of the copyrighted work that the defendant has used—becomes a question not of whether the defendant took what is the most valuable part of the plaintiff’s work (as it was under the market-centered paradigm), but rather whether the defendant used more than what was reasonable in light of the expressive purpose driving the transformative use.”).

¹¹⁵ See *Cariou v. Prince*, 714 F.3d 694 (2d Cir. 2013).

¹¹⁶ See Sag, *supra* note 44.

¹¹⁷ Leval, *supra* note 1, at 1105.

¹¹⁸ *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 578–79 (1994).

¹¹⁹ See Nolan, *supra* note 19, at 554 (stating that courts have found purpose to be dispositive of transformativeness).

2007.¹²⁰ In thirty-one cases, transformativeness was expressly addressed in the first-factor analysis.¹²¹ Reese's study revealed that:

In all of those opinions, when the court found that the defendant had a transformative purpose for her use, the court found that the transformativeness inquiry weighed in favor of fair use, regardless of whether the court viewed the defendant as having transformed the actual content of the plaintiff's work in any way. Indeed, in all of the cases where transformativeness was found based on the defendant's transformative purpose, the opinion's ultimate conclusion was that the use was, or was likely to be, fair.¹²²

Following the above reasoning, the court would consider whether the purpose of Woratx's use of Smith's photographs was transformative. The application of this reasoning to the Woratx scenario would begin by looking at whether the secondary use serves a transformative purpose. The court would likely find such transformativeness because Woratx's secondary use serves a distinctly different purpose. Smith's photographs were created for a traditional book on the Māori people and their culture. Woratx sought to express an idea about the modern world by using Smith's photograph as part of a large-scale collage about information-age propaganda. This difference in the purposes of these works would likely weigh in favor of a finding that the use was transformative.

Next, the court would examine the amount of the original work taken and consider whether it was appropriate to the purpose of the secondary use.¹²³ In the Woratx scenario, the photographs taken by

¹²⁰ Reese, *supra* note 113, at 471.

¹²¹ *Id.* at 471.

¹²² *Id.* at 485.

¹²³ See Netanel, *supra* note 9, at 745 ("Under the transformative use paradigm, factor three—the amount of the copyrighted work that the defendant has used—becomes a question not of whether the defendant took what is the most valuable part of the plaintiff's work (as it was under the market-centered

Smith were part of a large-scale collage along with several other photographs and a sheet metal background. Accordingly, the amount taken is likely proportional to the amount needed to accomplish the purpose of the secondary use.¹²⁴

Based on this two-prong approach, the court would likely find that Woratx made a fair use of the photographs and, accordingly, Woratx would not be held liable for copyright infringement.

B. Market-Centered Fair Use: A Seventh Circuit Analysis Would Likely Hold Woratx Liable for Copyright Infringement Because the Works Are Substitute Goods

Applying the recent Seventh Circuit jurisprudence of fair use, however, the court would likely find Woratx liable for infringing Smith's photographs. The effect of this jurisprudence has been to place the fourth factor at the center of the analysis and to inquire whether the use constituted substitutional or complementary copying within the original's market.¹²⁵

The application of this analysis to the Woratx scenario would begin by looking at whether the secondary use was substitutional or complementary. The focal point of this analysis is whether the copying harms the market value of the original work. In the Woratx scenario, Woratx created a collage that was to be exhibited in art galleries. Smith took photographs that had potential to be displayed in an art gallery. In this scenario, in fact, when a gallery owner heard that Woratx's work was being displayed in a gallery she decided to no longer pursue an exhibit with Smith's photographs. According to the logic in *Kienitz*, this fact would weigh against a finding of fair use because Woratx's appropriation

paradigm), but rather whether the defendant used more than what was reasonable in light of the expressive purpose driving the transformative use.”).

¹²⁴ See *Blanch v. Koons*, 467 F.3d 244, 252 (2d Cir. 2006) (holding that because Koons only took the legs, feet, and sandals from the original photograph, excluding the background and excluded many of the creative decisions made by Blanch, the copying was reasonable in relation to the transformative use).

¹²⁵ See *Kienitz v. Sconnie Nation LLC*, 766 F.3d 756, 758 (7th Cir. 2014) (“We have asked whether the contested use is a complement to the protected work (allowed) rather than a substitute for it (prohibited).”).

of Smith's photographs harmed the market value of her photographs by costing her an opportunity at a museum exhibit by virtue of being a substitute for the photographs. Woratx's appropriation of Smith's photographs would thus be unlikely to constitute a fair use under the Seventh Circuit's approach to fair use.

C. Assessing the Kienitz Decision: Should There Be Market-Centered Fair Use?

Prior to *Campbell*, one of the mistakes of fair use precedent that Judge Leval lamented most was the inappropriate weight given to the market effect of a copyrighted work.¹²⁶ Leval accurately pointed out that all instances of fair use inherently involve certain market effects because, at a minimum, the author of the original work would be missing out on royalties.¹²⁷ Placing too much weight on this factor has the effect of stifling the availability of fair use, which in turn can have the effect of stifling secondary creativity.¹²⁸

The Seventh Circuit's fair use analysis in *Kienitz* hearkens back to a time when courts designated the fourth factor as central to a finding of fair use.¹²⁹ This approach is problematic for two reasons. First, it ignores a highly influential Supreme Court decision. *Campbell* overturned prior fair use precedent by decentering the fourth fair use factor and placing the first factor in the center of the inquiry. The opinion in *Kienitz* completely disregards this by stating that transformative use is "not one of the statutory factors, though the Supreme Court mentioned it in *Campbell v. Acuff-Rose Music, Inc.*"¹³⁰ *Campbell* did not simply mention transformative use, but rather installed it as the central

¹²⁶ See Leval, *supra* note 1, at 1125 (stating that if we treat the fourth factor as the single most important element of fair use, then fair use will become defunct).

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ See *Harper & Row Publishers v. Nation Enters.*, 471 U.S. 539, 566 (1985) ("[T]he last factor is undoubtedly the single most important element of fair use.").

¹³⁰ *Kienitz*, 766 F.3d at 758.

inquiry in cases involving fair use.¹³¹ The *Campbell* test has been central to fair use case law since it was decided.¹³² It has created a more uniform standard that, in turn, has increased the availability of fair use.¹³³ The Seventh Circuit should not have brushed this aside.

Second, and perhaps the most problematic aspect of *Kienitz*, is the Seventh Circuit's attempt to revive a market-driven approach to fair use.¹³⁴ This is precisely what Leval urged courts to avoid.¹³⁵ While the fourth factor is important, it should not eclipse the requirement of justification under the first factor.¹³⁶ Although a secondary use may not impair the market value of the original one, it does not necessarily follow that the secondary use is justified.¹³⁷ A party should still need to demonstrate that the purpose of the use was transformative and that the amount taken was proportional in relation to that purpose. Such reasoning is supported by the basic goal of copyright law, which is to stimulate progress in the arts for the benefit of the public. Fair use is meant to protect secondary creativity.¹³⁸ All intellectual creativity is in some sense derivative.¹³⁹ Authors and other artists do not simply start from scratch. Instead, they build on past ideas. Fair use recognizes this

¹³¹ See Beebe, *supra* note 35, at 605 (“[I]n those opinions in which transformativeness did play a role, it exerted nearly dispositive force not simply on the outcome of factor one but on the overall outcome of the fair use test.”).

¹³² See Netanel, *supra* note 9, at 736 (“During 2006–2010, 85.5% of district court opinions and 93.75%, or all but one, of appellate opinions considered whether the defendant’s use was transformative.”).

¹³³ See Sag, *supra* note 44 (stating that fair use outcomes are more predictable and consistent than commonly assumed); see also Beebe, *supra* note 35, at 566 (stating that unpredictability in fair use may cause defendants to settle).

¹³⁴ See *Kienitz*, 766 F.3d at 758 (maintaining that the fourth factor is usually the most important and that transformativeness is not a statutory factor).

¹³⁵ Leval, *supra* note 1, at 1125 (“[I]f we then gave serious deference to the proposition that it is ‘undoubtedly the single most important element of fair use,’ fair use would become defunct.”).

¹³⁶ *Id.* at 1124.

¹³⁷ See *id.* (“The fact that the secondary use does not harm the market for the original gives no assurance that the secondary use is justified.”).

¹³⁸ *Id.* at 1110.

¹³⁹ *Id.* at 1109.

process as an inherent and important aspect of innovation.¹⁴⁰

The *Campbell* test better aligns with this important aspect of innovation. An inquiry into whether the purpose of a use is transformative, rather than simply whether the market of the original is harmed, better ensures that the use is of the sort that fair use is designed to protect. While market effect should be considered in a finding of fair use, to place it as the central element of fair use would be a misstep by the courts.

There has been some concern, illustrated by the *Kienitz* court, that transformative use may potentially override 17 U.S.C. § 106(2), which protects derivative works.¹⁴¹ This concern, however, is misguided. Derivative works, by definition, involve transformation.¹⁴² The meaning of “transform” for the purposes of § 107, however, is distinctly different from the meaning of “transform” for the purposes § 106. In examining the relationship between transformative fair use and the derivative work right, a study by R. Anthony Reese found that courts:

[I]n evaluating fair use, generally disregard whether the defendant has created a derivative work. In assessing transformativeness, the courts generally emphasize the transformativeness of the defendant’s purpose in using the underlying work, rather than any transformation (or lack thereof) by the defendant of the content of the underlying work.¹⁴³

Reese concluded that U.S. appellate courts have so far “not applied fair use transformativeness in ways that significantly implicate the scope of the copyright owner’s derivative work right.”¹⁴⁴

Congress intended for fair use to be a doctrine with the ability

¹⁴⁰ *Id.*

¹⁴¹ *Kienitz v. Scornie Nation LLC*, 766 F.3d 756, 758 (7th Cir. 2014).

¹⁴² 17 U.S.C. § 101 (2006) (“A ‘derivative work’ is a work based upon one or more preexisting works, such as a translation, musical arrangement, dramatization . . . or any other form in which a work may be recast, transformed or adapted.”).

¹⁴³ Reese, *supra* note 113, at 484–85.

¹⁴⁴ *Id.* at 467.

to adapt and evolve.¹⁴⁵ The *Campbell* test has given the doctrine new life and brought it out of the darkness of the market-centered paradigm used throughout the 1980s. The Seventh Circuit's rejection of *Campbell* not only contradicts Supreme Court precedent, but also fails to consider congressional intent.

III. A DEFENSE OF TRANSFORMATIVE USE: THE NEED FOR A CONSISTENT STANDARD

In light of the foregoing analysis, courts should continue to follow a transformative use approach in fair use cases. At the heart of any discussion of fair use should be the goals of copyright law and the objectives that fair use seeks to accomplish. Copyright law aims to increase the progress of knowledge and creativity by providing a special reward—the monopoly of a copyright—to artists.¹⁴⁶ This individual reward, however, is given to serve a utilitarian purpose:¹⁴⁷ to benefit the public with “the Progress of Science and useful Arts.”¹⁴⁸ The fair use doctrine works synergistically with these goals based on the idea that “excessively broad protection would stifle, rather than advance, the objective.”¹⁴⁹ A thriving fair use right is vital to the progress of culture and intellectual creativity.

Since *Campbell*, the development of a more uniform standard has increased the availability of fair use dramatically.¹⁵⁰ This is

¹⁴⁵ See H.R. REP. 94-1476, at 66 (1976) (“[There is no disposition to freeze the doctrine in the statute, especially during a period of rapid technological change.”).

¹⁴⁶ Leval, *supra* note 1, at 1108.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* (quoting U.S. CONST. art. I, § 8, cl. 8).

¹⁴⁹ *Id.* at 1109.

¹⁵⁰ See Netanel, *supra* note 9, at 735 (“[U]nder the market-centered paradigm, fair use is available only when reasonable copyright holders would consent to the defendant’s use and others like it but are prevented from doing so due to the prohibitively high costs of negotiating for such a license.”); *see also id.* at 768 (stating that under the transformative use paradigm “if the use is transformative and the defendant has not copied excessively in light of the transformative purpose, the use will most likely be held to be a fair use even if the copyright holder might enter or already has entered a licensing market for similar uses, and indeed even if the copyright holder would have been willing in

beneficial. Fair use's present position provides the benefit of predictability for recognized fair uses, such as parody, and of flexibility when it comes to cases of first impression. This allows fair use to adapt to new technologies and the times.

The adoption of the Seventh Circuit's opinion in *Kienitz* by other district courts would be detrimental to the fair use doctrine. To maintain uniformity, the Seventh Circuit should uphold the standard set out by the Supreme Court in *Campbell*. At present, practitioners would have to prepare an entirely different argument for fair use in the Seventh Circuit than anywhere else in the United States.

Furthermore, the standard embraced by the Seventh Circuit in *Kienitz*, which places the fourth factor at the heart of the analysis, will too often cause a fair use plea to lose.¹⁵¹ Cases involving value-added uses, which are nevertheless public and commercial in nature, will always be present in the courts. If such cases were to lose out from an approach that focused on the fourth factor, the public would lose out on the benefit of such innovation. This contradicts what the fair use doctrine was intended to accomplish.¹⁵²

While some discrepancies will always exist regarding a fair use analysis,¹⁵³ rejecting a standard ubiquitous amongst the rest of the circuit courts is a different matter. The transformative fair use jurisprudence has served to empower the doctrine, resulting in more predictability, and is more closely aligned with the goals of copyright law. Fair use has evolved greatly over the last two decades and to revert to a pre-*Campbell* market-centered fair use analysis would be to regress back to a less consistent, weaker fair use defense. Accordingly, courts should disregard *Kienitz*'s larger implications and continue to use a transformative fair use

principle to license the use in question").

¹⁵¹ Leval, *supra* note 1, at 1125 (stating that if we treat the fourth factor as the single most important element of fair use, fair use will become defunct).

¹⁵² *Id.* at 1110 (maintaining that fair use is meant to protect secondary creativity as a legitimate concern of copyright).

¹⁵³ *Cambridge Univ. Press v. Patton*, 769 F.3d 1232, 1267 (11th Cir. 2014) (holding that a nonprofit educational use may weigh in favor of a finding of fair use under the first factor, even when nontransformative).

approach.

CONCLUSION

The decision in *Kienitz* would significantly impact the fair use landscape for secondary users of creative works if widely adopted. Congress intended fair use to promote secondary creativity and recognized it as a valid policy goal of copyright protection.¹⁵⁴ With multiple standards and less predictability, the result could stifle secondary creativity. Additionally, adoption of a market-centered fair use analysis would cause the public to lose out on the benefits of thriving fair use defense, including increased innovation and the progress of culture. Under the foregoing approach, value-added uses that are still public and commercial in nature would often lose.¹⁵⁵

There was a time, in the period following the Supreme Court decision in *Harper & Row*,¹⁵⁶ when the market-centered fair use inquiry dominated. This period, however, was marked by unpredictability and confusion over fair use—making it difficult to take advantage of the defense. Because there is a high cost of defending a claim of infringement in court and devastating liability if one incorrectly evaluates the outcome of a case, the ability to forecast outcomes to a certain extent is critical to a thriving fair use policy.¹⁵⁷

With the modern paradigm of transformative use, however, comes a doctrine that generates relatively predictable outcomes and is widely available. Accordingly, the circuits, including the Seventh Circuit, should follow the thriving transformative fair use jurisprudence that has been maintained since the Supreme Court decision in *Campbell*. There is no need for Congress to intervene

¹⁵⁴ See Leval, *supra* note 1, at 1110 (stating that the fair use doctrine protects secondary creativity as a legitimate concern of copyright).

¹⁵⁵ Leval, *supra* note 1, at 1125.

¹⁵⁶ See *Harper & Row Publishers v. Nation Enters.*, 471 U.S. 539, 566 (1985) (“[T]his last factor is undoubtedly the single most important element of fair use.”).

¹⁵⁷ Marjorie Heins & Tricia Beckles, *Will Fair Use Survive?*, BRENNAN CTR. FOR JUSTICE 4 (Jan. 4, 2005), <https://www.brennancenter.org/sites/default/files/publications/Will%20Fair%20Use%20Survive.pdf>.

in this circuit split; a strong fair use defense needs the ability to adapt to changing technology and times. Congress did not want to freeze fair use in 1976 by statute, but rather wanted the law to continue to adapt and evolve with the times.¹⁵⁸

The Supreme Court established the transformative use inquiry in *Campbell*, which the Seventh Circuit has seemingly ignored. It remains to be seen how other courts will react to *Kienitz*. However, it would be best practice for courts, including the Seventh Circuit, to follow a transformative use approach to cases involving fair use.

PRACTICE POINTERS

- The courts now focus on transformative use rather than inquiry into market harm when determining whether a use is fair.
- In determining whether a use is transformative, courts inquire primarily into whether a use has a new purpose, not whether there has been literal alteration of a copyrighted work.
- If it serves a new purpose, a use need not comment on an underlying work in order to be considered fair.

¹⁵⁸ See H.R. REP. 94-1476, 66 (1976) (“The bill endorses the purpose and general scope of the judicial doctrine of fair use, but there is no disposition to freeze the doctrine in the statute, especially during a period of rapid technological change. Beyond a very broad statutory explanation of what fair use is and some of the criteria applicable to it, the courts must be free to adapt the doctrine to particular situations on a case-by-case basis.”).

