



# Chapman Law Review

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The Institute for Competitive Governance co-sponsored publication of the articles in this symposium edition and their presentation at the *Chapman Law Review's* symposium dedicated to special jurisdictions.



## Editor's Note

The *Chapman Law Review* is pleased to release the second issue of Volume 21 dedicated to our annual symposium. On January 26, 2018, the *Chapman Law Review* hosted a symposium titled "Special Jurisdictions Within and Outside of the United States." This event facilitated the discussion of special economic zones ("SEZs") and how they fit within conventional models of state authority. Panelists also discussed the form of SEZs within the United States and what SEZs may look like in the future. Despite the growing popularity of SEZs and their unusual features, they have largely escaped the attention of legal scholars.

The symposium portion of this issue opens with thought-provoking articles by experts in the field. Professor Bell begins the conversation with special international zones (a term he created), and specifically focuses on pre-asylum waiting areas, duty-free retail areas, international transit zones, international residency and work zones, and the public good they have the opportunity to hold in the future. Mr. Castle-Miller focuses on the Convention and Protocol Relating to the Status of Refugees and how refugee cities—a type of SEZ designed to facilitate migrant integration by allowing displaced people the opportunity to rebuild their lives and deliver benefits to the respective country—can assist countries to come into closer alignment with international law. Mr. Frazier explains opportunities for a New Hanseatic League of free zones and free cities in order to allow new frontiers to make way, such as seasteading on the oceans and entrepreneurial communities in space. Dr. Moberg discusses SEZs in the United States, including the reasons why they have had little impact on economic development and the implications they have for the future. Finally, Mr. Mulopulos concludes the symposium with a solution to the digital trade restrictions problem—digital trade zones. Mr. Mulopulos discusses what a theoretical framework of digital trade zones would look like and anticipates successes and problems posed by these zones.

The issue then concludes with three student comments. First, *Chapman Law Review's* current Senior Notes and Comments Editor Taylor Brown proposes alternative methods for physicians involved with firearm screening and counseling to

ensure accurate communication to patients. Next, current Production Editor Marissa Hamilton explains the California Supreme Court case *People v. Sanchez* and its application of the hearsay rule as it relates to the disclosure of expert basis testimony. Finally, current Articles Editor Steven Rimmer explores three different jurisdictional approaches to homeowner association lien priority in relation to other instruments, and discusses the best approach to fairly balance the competing policy interests.

The *Chapman Law Review* is grateful for the support of the members of the administration and faculty that made the symposium and the publication of this issue possible. We would like to thank Dean of Chapman University Dale E. Fowler School of Law, Matthew Parlow; our faculty advisor, Professor Celestine McConville; and our faculty advisory committee, Professors Deepa Badrinarayana, Michael Bayzler, John Hall, Janine Kim, and Associate Dean of Research and Faculty Development, Donald Kochan.

We would especially like to thank Professor Tom Bell for supporting the *Chapman Law Review* throughout the many stages of planning for the symposium—from his efforts in developing the topic and recruiting scholars, to his personal contribution to the discourse—and for his participation as a panelist and moderator. Additionally, I would like to recognize and thank Cindy Park, *Chapman Law Review*'s Senior Symposium Editor, for her hard work and enthusiasm in making this year's symposium a success.

Finally, I would like to express my sincere gratitude to all of the 2017–2018 *Chapman Law Review* editors. It was an honor to work beside such a talented, committed, and passionate group of individuals.

Lauren Fitzpatrick  
Editor-in-Chief

# Special International Zones in Practice and Theory

Tom W. Bell\*

## ABSTRACT

The French Republic had a problem. Foreign nationals had flown into the Roissy-Charles de Gaulle Airport near Paris and claimed the right to stay as refugees seeking asylum. Unwilling to have the supposed refugees imposed upon it, France resolved to process their claims without letting them into the country. How? By keeping them in the airport's international transit zone—the area between the exit doors of airplanes arriving from abroad and the far side of customs and immigration clearance. This split border allowed France to summarily process and (typically) deport the foreigners while keeping them outside the country's territory for asylum purposes. When detainees got seriously ill, France created so-called “floating international zones” to take them to a local hospital, a portion of which became a temporary international zone. These French innovations in border control inspired Hungarian *transit zones*, Australian *migration zones*, and similar partial territories across the planet. Few people beyond government attorneys and human rights workers have heard of that particular kind of special international zone, but most people know of the airport transit zone—an area where foreign travelers can catch connecting flights without going through local border controls and buy goods free of local customs, duties, or taxes. Research uncovers still other institutions that aspire to rise above merely local rules, including the United Nation's headquarters and CERN laboratories. Each of these species fits within a more general

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\* Professor, Chapman University Fowler School of Law. Copyright 2018 Tom W. Bell. For material aid, useful information, and worthy challenges, the author thanks: Nicolas Germaine, Marc Collins, Sherry Leysen, Matthew Flyntz, Michael Castle Miller, Kelly Ryan, Mark Frazier, Johann Thusbass, Sevan Chorluyan, Greg Knott, Joe Quirk, Mark Frazier, and Chapman University, Fowler School of Law. Disclosures and disclaimer: Although the author does or did provide consulting services for projects under the Honduran ZEDE system, to The Seasteading Institute (*pro bono*) in its effort to secure an MOU with French Polynesia for a Floating Island Project in that country, and to Blue Frontiers Pte. Ltd., for its SeaZone, this article does not represent the views of any principal, agent, or business associate of the author, who alone bears responsibility for its contents. “Author trans” herein refers to yours truly.

genus, the special international zone (“SIZ”): *An area that its host nation state places outside of its territory for the purpose of some local laws, leaving other such laws and applicable international obligations in force.* Special international zones already exist in great number and variety. They continue to spread, grow, and adapt. This article introduces SIZs as objects worthy of study on many counts, but most particularly because SIZs offer nation states a mechanism for selectively unbundling their territorial services in response to necessity, the constraints of international law, and promotion of the public good.

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## INTRODUCTION: NATION STATES BY DEGREES

In 1992, at the Roissy-Charles de Gaulle Airport outside Paris, the French Republic had a problem. Foreign nationals had flown into the airport and tried to stay as refugees seeking asylum. The government regarded the claims as bogus and the supposed refugees as mere economic migrants attempting to exploit a loophole in international law. Unwilling to have unwanted foreigners imposed upon it, France came up with a clever solution: It would process the supposed refugee's claims without letting them into the country.<sup>1</sup>

How did France work this bit of legal legerdemain? By keeping the foreigners within de Gaulle's *international transit zone*—the area between the exit doors of airplanes arriving from abroad and the far side of customs and immigration clearance, beyond which lies France proper.<sup>2</sup> Exploiting this bubble in its border allowed France to summarily process and deport most of the supposed refugees while keeping them outside of the national territory for purposes of claiming asylum.<sup>3</sup> *Voilà*.

As the days dragged on, the French built accommodations for the foreigners within the airport's international zone, forcing them to choose between staying within its confines or leaving the country entirely. That kept them safely outside of France's territory for immigration purposes. Eventually, though, the foreigners suffered medical conditions requiring hospital treatment. So the French designated certain vehicles as *floating international zones* and used them to transport the patients to a local hospital, relevant parts of which they also designated as *temporary international zones*.<sup>4</sup> This entire archipelago of fixed, floating, and temporary zones, specially created to allow foreign nationals to stay within the geographic borders of France but outside of its immigration or asylum territory, lawmakers called *zones d'attente pour personnes en instance* ("ZAPI" or "*zones d'attente*").<sup>5</sup>

This French innovation, turning international transit zones into extra-territorial pre-asylum processing areas, proved both popular and controversial. It rapidly spread to other countries, mutating in the process, giving rise to Hungarian *transit zones*,

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<sup>1</sup> See TUGBA BASARAN, SECURITY, LAW AND BORDERS: AT THE LIMITS OF LIBERTY 3 (2010).

<sup>2</sup> Code de l'entrée et du séjour des étrangers et du droit d'asile [Code of entry and stay of foreigners and of the right of asylum] art. L221-2 (Fr.) [hereinafter CESEDA art. L221-2].

<sup>3</sup> See BASARAN, *supra* note 1, at 50–64.

<sup>4</sup> See *id.* at 59.

<sup>5</sup> See JAMES C. HATHAWAY, THE RIGHTS OF REFUGEES UNDER INTERNATIONAL LAW 298 (2005); F. Julien-Lafferrière, *Le traitement des demandeurs d'Asile en Zone d'attente entre théorie et réalité*, 1238 HOMME & MIGRATIONS 32, 32–36 (2002).

Australian *migration zones* or *excised territory*, and similar devices in countries across the globe, under names such as *reception area*, *transit area*, or *detention area*.<sup>6</sup> Faced with similar problems at sea, the United States declared its territorial waters outside the reach of national and international laws applicable to asylum-seekers.<sup>7</sup> Some countries have even declared the decks of their ships extraterritorial zones, allowing them to rescue and return migrants without affording a venue for asylum claims.<sup>8</sup>

The advent of this new species of institution alarmed commentators, who criticized the supposedly extraterritorial zones as fictional, illegal, and illiberal.<sup>9</sup> Judicial authorities, in contrast, have gone no further than demanding respect for preexisting international obligations.<sup>10</sup> Thus, scrutinized and somewhat tempered, *zones d'attente* and similar special international zones have come to play an important role in regulating the global flow of asylum seekers, economic migrants, and others seeking to enter unwelcoming nation states.

Most people know of just one kind of international zone: the airport transit zone, where foreign travelers can buy goods free of customs, duties, or taxes and catch connecting flights without going through local border controls.<sup>11</sup> Students of international law may have heard of still more obscure examples of nation states willingly rolling back their effective borders, such as they have done for the United Nation's headquarters and CERN's laboratories.<sup>12</sup> In each of these and similar cases, such as the French *zones d'attente*, the same general pattern repeats: A nation state designates a portion of its geographic territory as outside the reach of some local laws, leaving local laws still in effect and preexisting international obligations unchanged.

Given their shared features, growing practical importance, and common theoretical challenges, these legal institutions need

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<sup>6</sup> Boldizsár Nagy, *Hungarian Asylum Law and Policy in 2015–2016: Securitization Instead of Loyal Cooperation*, 17 GERMAN L.J. 1033, 1048–49 (2016) (discussing migration zones); Tugba Basaran, *Legal Borders in Europe: The Waiting Zone, in A THREAT AGAINST EUROPE?: SECURITY, MIGRATION AND INTEGRATION* 63, 64 (J. Peter Burgess & Serge Gutwirth eds., 2011) (discussing other zones).

<sup>7</sup> *Immigration Consequences of Undocumented Aliens' Arrival in United States Territorial Waters*, 17 U.S. OP. O.L.C. 77, 79 (1993).

<sup>8</sup> Tugba Basaran, *Security, Law, Borders: Spaces of Exclusion*, 2 INT'L POL. SOC. 339, 343 (2008).

<sup>9</sup> See *infra* Section II(A).

<sup>10</sup> See, e.g., *Amuur v. France*, 1996-III Eur. Ct. H.R. 826 (holding that France could not unilaterally place part of its territory beyond the scope of Article 5, section 1 of the European Convention on Human Rights, pertaining to detention of protected persons).

<sup>11</sup> See *infra* Sections I(A), II(C).

<sup>12</sup> See *infra* Section I(E).



a shared name. The term “special economic zones” (“SEZs”) offers a model because SEZs also represent discrete areas where a host country applies unique, and usually less burdensome, financial and business regulations. Hence the term adopted for this article: Special International Zone (“SIZ”).

Summarizing the examples to follow, this article defines as an SIZ:

*An area that its host nation state places outside of its territory for the purpose of some local laws, leaving other such laws and applicable international obligations in force.*

Special international zones already exist in great number and variety. They continue to spread, grow, and adapt. What does the future hold for SIZs? Perhaps more of the same—but worse. A country could take France’s example too far, for instance, creating special border areas and floating personal temporary microzones that together have the practical effect of keeping entire regions and populations outside the country’s national territory in terms of legal rights and privileges, while putting them firmly inside the territory in terms of police powers.

Or SIZs might evolve in a more benign direction, creating refugee cities for homeless populations, “deep blue” zones for seasteads, or special international residency and work (“SIRW”) zones for digital nomads.<sup>13</sup> All these and other options become possible once the general concept of a SIZ—a designated area outside the reach of some local laws but still subject to international obligations—has been defined, illustrated, and explained. If that appeals, read on.

After this Introduction, Part I of the article surveys contemporary legal practices to discover SIZs regulating trade and travel across the globe through SEZs, international transit zones, duty-free retail areas, pre-asylum waiting areas, and other variations on the theme. Part II reviews the scant extant commentary on special international zones, especially criticisms of pre-asylum waiting areas, to develop a theory of special international zones under which they might redeem themselves as instruments of public policy. Part III applies that theory to describe some possible forms of future SIZs. The article concludes by explaining how special economic zones can promote the public good by providing a means for nation states, under the constraints of international law, to selectively unbundle their

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<sup>13</sup> See *infra* Part III.

services, by placing select territories outside the reach of some local laws by placing them within SIZs.

### I. SPECIAL INTERNATIONAL ZONES IN PRACTICE

This Part describes special international zones as observed in the field, so to speak, in the many places nation states have deliberately rolled back their powers, leaving a void filled by the governing influences of international trade, travel, and cultural exchange. The little-celebrated, but indisputably useful, international transit zone, described in Section I(A), fits squarely within the definition of a SIZ. Other examples fall at its edges. Section I(B) describes a class of zones—special economic zones—that do not so much import international law as simply let the default level for customs, duties, and taxes revert to their default level—zero—in the absence of a nation state. Section I(C)'s topic, the duty-free retail area, likewise serves the international community by setting certain parts of a nation state's territory beyond the reach of its powers.

Pre-asylum waiting areas, discussed in Section I(D), do the opposite; they leave some of a nation state's territory or guests within the reach of its power, but outside the comfort of its rights and privileges. In these areas, the chaos of international human migration smashes into the hard edges of state power. These, too, represent special international zones of a type—a distinctly dystopian one. Ending this survey of SIZs on a lighter note, Section I(E) offers a collection of other interesting species in the genus.

#### A. International Transit Zones

International transit zones ease the transition between a host state's territory and the places beyond, including the territories of other sovereigns and the ungoverned international commons of the sea and sky. The zone turns the border from a thin, solid line into a thick, complex, modulated buffer.<sup>14</sup> So far as passengers and their luggage are concerned, international transit zones typically extend from the point of departure from the craft arriving from abroad—the exit door of a foreign airplane, for instance—to the inside border of immigrations and customs control. They ease international transit by allowing passengers to touch down on the host's territory without passing through

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<sup>14</sup> See generally Jean-Baptiste Frétygny, *Air Travel Opens New Understanding of Borders: The Case of Paris Charles de Gaulle Airport*, ANNALES DE GEOGRAPHIE 1, 5 (2014), [http://www.academia.edu/12970808/Air\\_Travel\\_Opens\\_New\\_Understanding\\_of\\_Borders\\_The\\_Case\\_of\\_Paris\\_Charles\\_de\\_Gaulle\\_Airport](http://www.academia.edu/12970808/Air_Travel_Opens_New_Understanding_of_Borders_The_Case_of_Paris_Charles_de_Gaulle_Airport).

customs and immigration controls. Though it arises more as a gap between borders than as an entity unto itself, the international transit zones satisfies the definition of SIZ above: “An area that its host nation state places outside of its territory for the purpose of some local laws, leaving other such laws and applicable international obligations in force.”<sup>15</sup>

Like all SIZs, international transit zones come into being by the choice of the local sovereign, which withdraws the effective reach of otherwise applicable laws relating to customs, duties, and immigration. Still other local laws, such as those forbidding trafficking in forbidden drugs, remain in force. In almost all cases (because almost all countries have joined it), the *Convention on International Civil Aviation* (aka *Chicago Convention*) requires that an airport treat transiting craft as if in a customs and duty-free area.<sup>16</sup> In other cases, such as in implementing the special privileges shared by travelers among Schengen Area countries, airports in particular countries may configure their international transit zones to favor certain trips or travelers.<sup>17</sup>

In addition to serving the quotidian needs of typical travelers, international transit zones have won a storied place in diplomatic relations by serving as temporary (and sometimes not so temporary) holding pens for people caught between being arrested at home and becoming a political problem abroad.<sup>18</sup> Consider the case of Eric Snowden. Offered shelter of sorts by Russian authorities, who evidently sympathized with his crusade against elements of the United States government, he was allegedly housed in the international transit zone of Moscow’s Sheremetyevo International Airport; or perhaps, in a move akin to that used by France to justify scattering *zones d’attente* across its territory, in a more comfortable location nearby temporarily designated as extra-territorial by the Russians in pursuance of their campaign to irk the Americans.<sup>19</sup> But more on that ploy anon.<sup>20</sup>

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<sup>15</sup> See *supra* Introduction.

<sup>16</sup> Convention on International Civil Aviation art. 24, Dec. 7, 1944.

<sup>17</sup> Frétigny, *supra* note 14, at 13–15.

<sup>18</sup> Mehran Karimi Nasseri, an Iranian refugee, lived within the international transit area of Terminal 1 at Roissy-Charles de Gaulle Airport from 1988 to 2006. See Frétigny, *supra* note 14, at 21.

<sup>19</sup> Brian Palmer, *What’s Life Like in an Airport Transit Zone?*, SLATE (July 2, 2013), [http://www.slate.com/articles/news\\_and\\_politics/explainer/2013/07/edward\\_snowden\\_has\\_spent\\_a\\_week\\_in\\_a\\_transit\\_zone\\_at\\_moscow\\_s\\_airport\\_what.html](http://www.slate.com/articles/news_and_politics/explainer/2013/07/edward_snowden_has_spent_a_week_in_a_transit_zone_at_moscow_s_airport_what.html) [<http://perma.cc/CZ8G-QC9V>].

<sup>20</sup> See *infra* Section I(D).

## B. SEZs and Related Special Jurisdictions

The World Bank defines SEZs as “demarcated geographic areas contained within a country’s national boundaries where the rules of business are different from those that prevail in the national territory.”<sup>21</sup> Through SEZs, in other words, a host offers a haven from the status quo that prevails elsewhere in the national territory. As such, SEZs represent a kind of special international zone—one wherein the host country rolls back the scope of customs, duties, taxes, and other select impediments to commerce, leaving in their place nothing but lots of freedom on a thin layer of international law.

SEZs come in many types, including free trade zones, export processing zones, and wide-area hybrid export processing zone freeports.<sup>22</sup> They come in many sizes, too, ranging from a portion of a single factory to metropolitan areas housing millions.<sup>23</sup> Though not SEZs in the modern sense, areas governed by special rules have existed almost as long as government itself. SEZs proper have enjoyed special vigor in recent decades.<sup>24</sup>

To better understand how SEZs as a class qualify as a kind of special international zone, consider the Foreign Trade Zones (“FTZs”), which are popular in the United States.<sup>25</sup> FTZs lay within the country’s borders geographically speaking, but “are treated for purposes of the tariff laws and customs entry procedures as being outside the customs territory of the United States.”<sup>26</sup> The board charged with administering the zones thus considers them “outside the customs territory of the United States for the purposes of duty payment.”<sup>27</sup>

By design, being outside the customs and excise taxes area of the United States offers a considerable inducement to transshipment and import-export processing services. Other benefits follow from the extra-territorial status of FTZs, too. If a

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<sup>21</sup> Thomas Farole & Gokhan Akinci, *Introduction to SPECIAL ECONOMIC ZONES: PROGRESS, EMERGING CHALLENGES, AND FUTURE DIRECTIONS* 3 (Thomas Farole & Gokhan Akinci eds., 2011) (quoting Claude Baissac, *Brief History of SEZs and Overview of Policy Debates*, in *SPECIAL ECONOMIC ZONES IN AFRICA: COMPARING PERFORMANCE AND LEARNING FROM GLOBAL EXPERIENCE* 23 (Thomas Farole & Gokhan Akinci eds., 2011)).

<sup>22</sup> *Id.* at 2.

<sup>23</sup> *See id.*

<sup>24</sup> *See* TOM W. BELL, *YOUR NEXT GOVERNMENT?: FROM THE NATION STATE TO STATELESS NATIONS* 19–27 (2018).

<sup>25</sup> *See* Foreign-Trade Zones Act, 19 U.S.C. §§ 81a–81u (2016); Regulations of the Foreign-Trade Zones Board, 15 C.F.R. § 400 (2018). Section 81c(a) distinguishes between FTZs and the customs territory of the United States.

<sup>26</sup> *Scope*, 15 C.F.R. § 400.1(c) (2018).

<sup>27</sup> *Preface to FOREIGN-TRADE ZONES BOARD, 78TH ANNUAL REPORT OF THE FOREIGN-TRADE ZONES BOARD TO THE CONGRESS OF THE UNITED STATES* (2016).

processor in the zone works imported materials into goods destined for the United States proper, the processor can choose to have the requisite duties assessed on either the value of the materials as imported or the value of the finished goods that include them—a useful option for accounting reasons.<sup>28</sup> Merchandise brought into a zone for shipment abroad can be counted as exported immediately, before it physically leaves the United States, for purposes of federal excise taxes and drawbacks.<sup>29</sup> Also, consistent with the notion that in a federal system, no individual state can have a territory greater than the United States to which it belongs, personal property stored in the zone falls outside the scope of state and local *ad valorem* taxes.<sup>30</sup>

By withdrawing the reach of select federal and state laws back from the border of FTZs, the United States effectively cedes governance of such matters to international law, such as it is in these matters. And in the sorts of matters that concern FTZs—customs and taxes—international law mostly is *not*. As with the duty-free zones discussed next, in other words, FTZs represent special areas where international rather than local law has real effect.

### C. Duty-Free Retail Areas

A duty-free retail area functions as if it were outside the tax area of its host country for a select few people: passengers leaving for abroad. It allows them to purchase certain goods—typically, luxury ones such as liquor, cigarettes, or perfume—on condition that they immediately remove them from the host’s tax territory. The law of the United States, for instance, defines a duty-free retailer as “a person that sells, for use outside the customs territory, duty-free merchandise that is delivered from a bonded warehouse to an airport or other exit point for exportation by, or on behalf of, individuals departing from the customs territory.”<sup>31</sup>

Duty-free retail areas are thus defined not only by limits on a map, but also limits on behavior. Which transactions classify as “duty-free” depends not merely on where they happen, but also on the intent of the purchaser. More generally than that, with the advent of market-defined “Traveler Spaces” catering solely to the needs of ticket-bearing passengers passing through international transit zones and “duty-free prices” outside such zones designed to

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<sup>28</sup> William G. Kanellis, Comment, *Reining in the Foreign Trade Zones Board: Making Foreign Trade Zone Decisions Reflect the Legislative Intent of the Foreign Trade Zones Act of 1934*, 15 NW. J. INT’L L. & BUS. 606, 618 (1995).

<sup>29</sup> *Id.* at 618–19.

<sup>30</sup> See Foreign-Trade Zones Act, 19 U.S.C. § 810(e) (2016).

<sup>31</sup> 19 U.S.C. § 1555(b)(8)(D) (2016).

simulate the financial experience of shopping within them, duty-free retail areas have come to symbolize places freed from the usual, mundane social obligations.<sup>32</sup>

The ready availability of cut-priced alcohol, cigarettes, and luxury goods drives home the point: duty-free retail areas offer special zones beyond merely parochial local regulations. Duty-free zones belong in “an in-between space, global in dimension, whose strategies of appropriation are at odds with those of the nation states.”<sup>33</sup> Duty-free retail areas operate not so much as a space on a map, or even as a label for some people, but as an idealized special international zone, where nation states withdraw their impositions, and the bland nothing of the ungoverned commons allows as much trade in rich and intoxicating goods as the market will bear.

#### D. Pre-Asylum Waiting Areas

As related in the Introduction above, France created an innovative new kind of SIZ—*zones d’attente*—by placing areas within the geographic boundaries of the country outside of its territory for immigration and asylum purposes.<sup>34</sup> This new kind of SIZ began within Roissy-Charles de Gaulle Airport in 1992, but quickly multiplied across France, growing in size and number, and mutating into floating and temporary forms.<sup>35</sup> From France, pre-asylum waiting areas spread to other countries.<sup>36</sup> They now represent a routine matter of local law, used across the world, usually without much note, as one of several mechanisms that nation states use to manage the flow of refugees, economic migrants, and other wandering people.<sup>37</sup>

Why did the French create *zones d’attente*? Because, like other signatories to the *1951 Convention and Protocol Relating to the Status of Refugees* (“*Refugee Convention*”), it has promised to give refugees within its territory a variety of rights and privileges.<sup>38</sup> France has bound itself to allow guest refugees to practice their religion, receive identity papers, and travel freely throughout the country.<sup>39</sup> Most significantly, the convention forbids France, like other contracting parties, from expelling or

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<sup>32</sup> Fréteigny, *supra* note 14, at 22.

<sup>33</sup> *Id.* at 25.

<sup>34</sup> *See supra* Introduction.

<sup>35</sup> CESEDA art. L221-2.

<sup>36</sup> Basaran, *supra* note 6, at 64.

<sup>37</sup> *See* BASARAN, *supra* note 3, at 8.

<sup>38</sup> UN High Commissioner for Refugees, *Introduction to CONVENTION AND PROTOCOL RELATING TO THE STATUS OF REFUGEES 3* (2010) [hereinafter *REFUGEE CONVENTION*].

<sup>39</sup> *Id.* at 17, 28–29.

returning refugees to the country's borders if to do so would put his or her life or liberty at risk for certain reasons, such as on account of race, religion, or social group.<sup>40</sup> France doubts that the economic migrants showing up at Roissy-Charles de Gaulle and its other ports of entry qualify as "refugees" for purposes of the *Refugee Convention*, but if they can make it onto French territory, they can make a play for the status, thus winning at least temporary admittance (which by dint of flight often becomes *de facto* but illegal permanent admittance). France thus created the *zones d'attente* to, in effect, push back the border of its territory for purposes of those seeking asylum under the *Refugee Convention*.<sup>41</sup>

How did the French create the *zone d'attente*? The applicable provision of the civil code begins by giving the *zone* tightly defined boundaries, saying it "extends from embarkation and disembarkation points to where immigration checks are carried out."<sup>42</sup> From there, though, the lines quickly get broader and blurrier. The *zone* may also include, "in transit areas or near the railway station, port, or airport, or near the place of disembarkation, one or more places of accommodation providing the concerned foreigners with hotel-type services."<sup>43</sup>

The *zone d'attente* can thus grow within the boundaries of the existing international transit zone. The largest of France's immigration detention centers is located next to the runways of Roissy-Charles de Gaulle, for instance, ensuring that those housed in the *zone* receive frequent and unpleasant reminders of their tenuous status in the country.<sup>44</sup> Given that they arise by mere administrative fiat, a *zone d'attente* could also be added to the edges of an existing international zone, making up a larger complex of associated but distinct SIZs.<sup>45</sup> The French have done far more than that, though.

The civil code also stretches the *zone d'attente* to any place the unwanted alien must go for administrative procedures, such as to attend an off-site asylum hearing or "in case of medical necessity."<sup>46</sup> Through that provision, the French can justify their

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<sup>40</sup> *Id.* at 30.

<sup>41</sup> BASARAN, *supra* note 3, at 56–59.

<sup>42</sup> CESEDA art. L221-2.

<sup>43</sup> *Id.*

<sup>44</sup> Morgane Iserte, *Enquête en « zone d'attente réservée » de l'aéroport de Paris-Charles de Gaulle: vers une gestion sécuritaire des « flux migratoires »* [Investigation into "Waiting Area" of Paris-Charles de Gaulle], 71 CULTURES & CONFLICT 31, 33 (2008).

<sup>45</sup> CESEDA art. L221-2. The article's first line gives power to set the zone's boundaries to "the competent administrative authority."

<sup>46</sup> *Id.*

use of floating and temporary zones. The creativity of French lawyers does not end there, however. The code even provides for the creation of a retroactive temporary *zone d'attente* that runs from where and when any group of ten or more foreigners has arrived in France from outside a border crossing to where they are discovered, up to twenty-six days later.<sup>47</sup>

Commentators have not always treated the French *zones d'attente* with the highest regard, calling them fictional, illegal, and illiberal. This article reviews those critiques below.<sup>48</sup> Regardless of such theoretical musings, though, the *zones d'attente* did and do exist. Indeed, they have been booming.

Courts have shaped the operations of *zones d'attente*, as when the European Court of Human Rights held that France could not detain foreigners without counsel indefinitely.<sup>49</sup> This commentary and judicial guidance operates only at the edges, though. These sorts of pre-asylum waiting areas, because they help nation states regulate the flow of refugees, economic migrants, and other wandering people, will not go away any time soon. Whether called *migration zones*, *excised territories*, *reception areas*, *transit areas*, or *detention areas*, these SIZs will play a continuing and important role in international law.<sup>50</sup>

#### D. Other Special International Zones

This Section reviews some other special international zones. It offers only a small sample of what a more complete catalog might include: SIZs ranging from ancient sanctuaries to nascent block chain governments, with references to the many privileges traditionally associated with diplomatic personnel, friendly foreign military forces, and non-governmental organizations (“NGOs”).<sup>51</sup> The examples could include SIZs as well known as the United Nations’ headquarters,<sup>52</sup> or as obscure as Canada’s temporary surrender of sovereignty to aid the birth of a princess in exile.<sup>53</sup> The “other” SIZs reviewed here: CERN and the special administrative regions of Hong Kong and Macau.

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<sup>47</sup> *Id.* France is not alone in retroactively creating pre-asylum waiting areas. See BASARAN, *supra* note 3, at 91 (discussing Australian retrospective regulations).

<sup>48</sup> See *infra* Part II.

<sup>49</sup> *Amuur v. France*, 1996-III Eur. Ct. H.R. 826.

<sup>50</sup> Nagy, *supra* note 6, at 1048–49; Basaran, *supra* note 6, at 64.

<sup>51</sup> BASARAN, *supra* note 3, at 66.

<sup>52</sup> HANS KELSEN, THE LAW OF THE UNITED NATIONS: A CRITICAL ANALYSIS OF ITS FUNDAMENTAL PROBLEMS 350 (1950) (describing the origins and effects of UN’s “headquarters district”).

<sup>53</sup> *Netherlands’ Princess Margriet born in Ottawa*, RADIO CANADA (Jan. 23, 1992), <http://www.cbc.ca/player/play/1403696302> (recounting that in 1940, Canada temporarily withdrew sovereignty over an Ottawa hospital room in order to ensure that the birth of



## 1. CERN

The European Organization for Nuclear Research, better known as “CERN” from the acronym for its French name, the “Conseil Européen pour la Recherche Nucléaire,” offers a notable example of how an international zone can create a safe space for large scale investment, research, and development. CERN enjoys a special status in the laws of the member countries that together created and fund it. This status, set forth in the *Protocol on the Privileges and Immunities of the European Organization for Nuclear Research* (“*Protocol*”), exempts CERN’s property, officials, and the family of CERN officials from customs, duties, national taxes, and visa restrictions.<sup>54</sup> This has the practical effect of placing CERN properties, papers, and people in a sort of special international zone.

Territory under the reach of particular national laws seem to pull back where CERN touches down. The *Protocol* provides that CERN’s real property—its grounds, buildings, and other structures—“shall be inviolable” against the authority of any “agent of the public authorities,” who may enter only with “the express consent of the Director-General or his duly authorized representative.”<sup>55</sup> The organization, its property, its income, and its imports and exports escape national taxation, duties, or similar fees.<sup>56</sup> The *Protocol* thus defines CERN’s special international zone in both territorial and functional terms.

Although the *Protocol* reserves most of its benefits to CERN “officials,” it defines that term broadly enough to cover a wide range of employees, including “‘members of personnel’ as defined in the Staff Rules and Regulations of the Organization.”<sup>57</sup> These people must pay a sort of internal tax “for the benefit of the Organization,” but the salaries and emoluments they get from the Organization remain “exempt from national income tax” under the *Protocol*.<sup>58</sup> In practice, therefore, most CERN employment falls outside of any nation’s tax territory.

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the Netherlands’ Princess Margriet there to her family in exile would not take place under the cloud of a foreign flag, which might otherwise threaten her claim to royal succession).

<sup>54</sup> PROTOCOL ON THE PRIVILEGES AND IMMUNITIES OF THE EUROPEAN ORGANIZATION FOR NUCLEAR RESEARCH (Mar. 18, 2004), <http://cds.cern.ch/record/1035110/files/cer-002693576.pdf> [<http://perma.cc/RVV4-S7UU>].

<sup>55</sup> *Id.* at art. 3(1), (2).

<sup>56</sup> *Id.* at art. 6. Note, however, that this exemption does not extend to “the purchase or use of goods or services or the import of goods intended for the personal use” of those working for CERN. *Id.*

<sup>57</sup> *Id.* at art. 1(d).

<sup>58</sup> *Id.* at art. 10(2)(b)(i).

CERN employment and residency falls outside of any member country's legal territory, too. CERN officials enjoy "for themselves and the family members forming part of their household, the same exemption from immigration restrictions and aliens' registration formalities as are normally granted to officials of international organizations."<sup>59</sup> The *Protocol* renders Organization officials exempt "from all compulsory contributions to national social security schemes, on the understanding that such persons are provided with equivalent social protection" by CERN.<sup>60</sup>

The *Protocol* even puts CERN outside the justice systems of its member countries. As befits an international organization, the *Protocol* makes careful provision for the resolution of CERN's disputes in forums, such as in private arbitrations, that remain outside the control of any one country.<sup>61</sup> It could hardly be otherwise, given the high stakes at issue—CERN's cross-border Large Hadron Collider cost almost U.S. \$4.4 billion to build—and the many national interests affected.<sup>62</sup>

Taken together, these provisions have the practical effect of putting CERN property, papers, and personnel in a special international zone. As in a French *zone d'attente*, these exemptions apply only to certain activities and people. A CERN SIZ lies outside not all national boundaries, but only the boundaries of select customs, taxes, and visa laws. And like a French *zone d'attente*, the status of a CERN SIZ can attach to particular people, creating floating personal temporary microzones that follow covered individuals even outside of the zone.<sup>63</sup>

## 2. Special Administrative Regions of Hong Kong and Macau

Thanks to the history of European colonialism and the vagaries of fate, the People's Republic of China has adopted a policy of "one country, two systems" with regard to both Hong Kong and Macau, allowing each to exist within China's national territory as a Special Administrative Region ("SAR") with some,

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<sup>59</sup> *Id.* at art. 10(2)(c).

<sup>60</sup> *Id.* at art. 11.

<sup>61</sup> *Id.* at arts. 16–19.

<sup>62</sup> CERN, LARGE HADRON COLLIDER THE GUIDE 17 (2017), <http://cds.cern.ch/record/2255762/files/CERN-Brochure-2017-002-Eng.pdf> [<http://perma.cc/RZK8-HX99>] (listing total price of LHC of 4.332 billion Swiss francs).

<sup>63</sup> Appropriately enough, given its innovations with other sorts of SIZs, France had a central role in the creation of CERN; the Convention forming it was written in Paris and signed by France, *naturellement*. See *The European Organization for Nuclear Research is born*, CERN, <https://timeline.web.cern.ch/events/the-european-organization-for-nuclear-research-is-born> [<http://perma.cc/YL2W-6BQT>] (last visited Dec. 9, 2017).

but not all, attributes of sovereignty.<sup>64</sup> This policy, embodied in a Basic Law adopted to govern each region upon its handover from European powers to Chinese powers in the late 1990s, allows Hong Kong and Macau responsibility over each of their local customs,<sup>65</sup> taxes,<sup>66</sup> immigration,<sup>67</sup> labor,<sup>68</sup> and other areas of law traditionally the sole province of a national government. These SARs exist in a bubble of sorts—within the national Chinese territory but without the legal territory of Chinese customs, taxes, etc.

This special international zone is not, however, outside the reach of all Chinese laws. When the law concerns matters closer to the core of Chinese authority and pride, such as pertaining to the applicability of international agreements,<sup>69</sup> the supremacy of the national constitution,<sup>70</sup> or the adoption of flags and related symbols,<sup>71</sup> the SAR's autonomy ends. Here, the national and legal borders of China coincide, and the SARs exist in the same territory(ies) as other parts of China.

In a functional sense, the Hong Kong and Macau SARs fit the definition of special international zone set forth above. Both have been placed by China outside its territory for the purpose of some laws, leaving other Chinese laws and applicable international obligations in force. Granted, the peculiar circumstances surrounding the origins of those SARs makes them very special kinds of SIZs. The colonial powers that China convinced to peacefully abandon all claims to Hong Kong and Macau, England and Portugal, respectively, did so only under the promise that the newly formed SARs would enjoy considerable autonomy. Query, therefore, if China ever had full title to the powers hypothetically transferred. Did China withdraw its legal territory from Hong Kong and Macau? Or did China decline to fully expand to the SARs sovereign powers it enjoyed in adjoining territories? In either event, Hong Kong and Macau offer examples of a host country designating part of its territory as beyond the reach of select national laws and leaving room for

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<sup>64</sup> See THE BASIC LAW OF THE HONG KONG ADMINISTRATIVE REGION OF THE PEOPLE'S REPUBLIC OF CHINA art. 1, [http://www.basiclaw.gov.hk/en/basiclawtext/images/basiclaw\\_full\\_text\\_en.pdf](http://www.basiclaw.gov.hk/en/basiclawtext/images/basiclaw_full_text_en.pdf) [hereinafter HONG KONG BASIC LAW]; MACAU BASIC LAW pmbll., <http://www.umac.mo/basiclaw/english/pre.html>.

<sup>65</sup> HONG KONG BASIC LAW art. 116; MACAU BASIC LAW art. 112.

<sup>66</sup> HONG KONG BASIC LAW art. 106, 108; MACAU BASIC LAW art. 104, 106.

<sup>67</sup> HONG KONG BASIC LAW art. 154; MACAU BASIC LAW art. 139.

<sup>68</sup> HONG KONG BASIC LAW art. 147; MACAU BASIC LAW art. 115.

<sup>69</sup> HONG KONG BASIC LAW art. 153; MACAU BASIC LAW art. 138.

<sup>70</sup> HONG KONG BASIC LAW art. 11; MACAU BASIC LAW art. 11.

<sup>71</sup> HONG KONG BASIC LAW art. 10; MACAU BASIC LAW art. 10.

international principles—here, those of a more cosmopolitan and liberal world—to have effect.

## II. SPECIAL INTERNATIONAL ZONES IN THEORY

As documented above, special international zones have long operated, in many guises, all across the globe, without much incident. The SIZ has not, however, been subject to much consideration as a theoretical object itself. Has it perhaps been so ubiquitous as to escape notice?

Nation states have, after all, long relied on an intrinsic power to reshape their interior borders as each alone sees fit. As Tugba Basaran observes, “[t]he distinction between physical presence and legal presence is not a new invention used for migration controls only, but relies on historical precedents in different contexts.”<sup>72</sup> Citing ancient examples such as ancient sanctuaries from prosecution, the special privileges of ambassadors, military personnel deployed abroad, NGOs, and modern inventions such as special economic zones, Basaran concludes that “[t]he creation of outside spaces on the territory of the host state, placed under an international or foreign legal jurisdiction, and thus not part of domestic law, is an old technique.”<sup>73</sup>

In recent years, however, the advent of *zones d’attente* and similar pre-asylum waiting areas has raised concerns that nation states might be using SIZs not simply to reshape the scope of domestic law, but to evade the obligations of international law. This, in turn, has made the theoretical status of SIZs a pressing matter. Hence this Part. Section II(A) relates the predominant critiques of SIZs *qua* pre-asylum waiting areas: that they are legal fictions, illegal, or illiberal. Section II(B) offers a way to redeem SIZs in terms of theory, as refuges free from the constraining effects of some domestic laws on the one side and governed by principles of international liberty on the other. If built to those specifications, (which admittedly cannot always be said of pre-asylum waiting areas) SIZs fit nicely within the existing theoretical framework, both positive and normative, of international law.

### A. Zones as Fictional, Illegal, and/or Illiberal

Although for the most part SIZs quietly regulate the flow of international trade, travel, and cultural exchange without incident, *zones d’attente* and other pre-asylum waiting areas have

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<sup>72</sup> BASARAN, *supra* note 3, at 66.

<sup>73</sup> *Id.*

drawn withering criticism. James C. Hathaway calls pre-asylum areas “[a] particularly insidious mechanism”<sup>74</sup> and “a legal ruse”<sup>75</sup> used by France and other nation states to avoid their international obligations to refugees.<sup>76</sup> Other commentators call it “a fiction,”<sup>77</sup> “legal fiction,”<sup>78</sup> “arbitrary,”<sup>79</sup> or, perhaps most tellingly, as “places of illiberal practices.”<sup>80</sup> Such critiques speak too broadly, insofar as they condemn all SIZs, but justly target the growing practice of nation states rolling back the borders of local laws and protecting individual rights and privileges while leaving in place local police, security, and penal laws.

Why do commentators direct such ire at pre-asylum waiting areas? Because nation states arguably use them as a subterfuge to avoid fulfilling their obligations under the *Refugee Convention*.<sup>81</sup> That international agreement has proven very popular on paper; 146 countries have signed, including those now hosting various sorts of pre-asylum waiting zones.<sup>82</sup> In so doing, each promised to afford several rights to refugees who find themselves “in” or “within” the contracting state’s territory.<sup>83</sup> And while no country is legally required to admit refugees, Article 33 of the *Refugee Convention* says, “[n]o Contracting State shall expel or return (“refouler”) a refugee in any manner whatsoever to the frontiers of territories where his life or freedom would be threatened on account of his race, religion, nationality, membership of a particular social group or political opinion.”<sup>84</sup>

Commentators argue that member countries violate this principle of *non-refoulement* when they use pre-asylum waiting areas to “expel or return” refugees “to the frontiers of territories” where the enumerated threats await. Hathaway, for example, after dismissing the *zones d’attente* as “a legal ruse” and citing the seminal European Court of Human Rights case, *Amuur v.*

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74 HATHAWAY, *supra* note 5, at 298.

75 *Id.* at 321.

76 *Id.* at 298, 321.

77 Nagy, *supra* note 6, at 1048.

78 HUMAN RIGHTS WATCH, LOST IN TRANSIT: INSUFFICIENT PROTECTION FOR UNACCOMPANIED MINOR CHILDREN AT ROISSY CHARLES DE GAULLE AIRPORT 5 (2009); see also Lydia Gall, *Dispatches: Asylum Seekers Stuck Outside Transit Zones in Hungary*, HUMAN RIGHTS WATCH (Apr. 4, 2016, 12:00 AM), <https://www.hrw.org/news/2016/04/04/dispatches-asylum-seekers-stuck-outside-transit-zones-hungary>.

79 HUMAN RIGHTS WATCH, *supra* note 78, at 5.

80 Basaran, *supra* note 6, at 70.

81 See generally REFUGEE CONVENTION, *supra* note 38.

82 Protocol Relating to the Status of Refugees ch. 5, Oct. 4, 1967, 606 U.N.T.S. 267.

83 See REFUGEE CONVENTION, *supra* note 38, at 17 (guaranteeing religion); *id.* at 28 (art. 27 guaranteeing issuance of identity papers); *id.* at 29 (art. 31(1)–(2) guaranteeing “non-penalization for illegal entry or presence” and movements of refugees within country of refuge).

84 REFUGEE CONVENTION, *supra* note 38, at 30.

*France*, as authority, summarily concludes: “There is thus no international legal difference between opting not to consider the refugee status of persons present in ‘international zones’ or ‘excised territory’ and refusing to consider the refugee status of persons clearly acknowledged to be on the state’s territory.”<sup>85</sup> Human Rights Watch uses the same quick two-step citing *Amuur* and other cases in support of the claim that such zones represent nothing more than legal fictions used to hide violations of migrants’ rights.<sup>86</sup>

The *Amuur* court gave these critics an irresistibly good quote: “[d]espite its name, the international zone does not have extraterritorial status.”<sup>87</sup> In truth, however, like any holding, the effect of *Amuur*’s words can reach no farther than the underlying controversy allows. The dispute turned on application of Article 5, section 1 of the European Convention on Human Rights, a provision directed at preventing wrongful detention. Specifically, the court held that for France to hold the applicants in the *zone d’attente* for twenty days “under strict and constant police surveillance,” and without any “legal and social assistance,” wrongfully deprived the applicants of their liberty.<sup>88</sup>

The *Amuur* court thus did not speak so boldly as its oft-quoted words might suggest. Instead of ruling all extraterritorial zones legal nullities—an issue not before the court and quite beyond its power to decide—the court ruled only that France had operated its *zone d’attente* in violation of the European Convention on Human Rights.<sup>89</sup> That much should prove unremarkable.

The court did not—and indeed could not—forbid France from drawing its territorial borders in ways that impact only local law, or that leave its international obligations unimpeached. As proof of the opinion’s limited effect, France responded to *Amuur* and similar judicial corrections, not by abandoning its use of extra-territorial areas, but by amending and expanding the use of *zones d’attente*.<sup>90</sup>

Calling pre-asylum waiting zones “fictional” does not change their very real impact. Calling the operation of such zones “illegal” may or may not have an effect, as indicated by (sometimes)

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<sup>85</sup> HATHAWAY, *supra* note 5, at 321–22.

<sup>86</sup> HUMAN RIGHTS WATCH, *supra* note 78, at 9–10.

<sup>87</sup> *Amuur v. France*, 1996-III Eur. Ct. H.R. 826, 851.

<sup>88</sup> *Id.* at 848–49.

<sup>89</sup> *Id.*

<sup>90</sup> See *Gebremedhin v. France*, 2007-II Eur. Ct. H.R. 131, 174, 178 (holding that lack of a suspensive clause in appeals from denials of asylum violates the Refugees Convention).

successful litigation.<sup>91</sup> But what about calling pre-asylum waiting zones “illiberal” (in the sense of “liberty-violating” rather than of “leftist”)?

That is the concern voiced by Tugba Basaran, who argues that through such devices, “liberal states can deny to particular populations fundamental rights, which are the normative and legal foundation of liberal states, whilst continuing to control the very same space through policing powers.”<sup>92</sup> Contrary to commentators who view *zones d’attente* as fictional or *per se* illegal, Basaran sees them as alarmingly mundane tools of contemporary governance. “Border zones are legal constructions and law is an ordinary means by which the liberal state legitimizes illiberal practices.”<sup>93</sup>

On that view, at least in the guise of pre-asylum waiting zones, SIZs allow nation states to roll back human rights while leaving police powers in place. Indeed, in actual practice, most hosts not only leave police powers in place, but considerably augment them, surrounding the zones with fences and walls, placing them under close observation, and creating an overall experience, from the point of view of detainees and those tasked to guard them, not far removed from a prison.<sup>94</sup> The worst of these pre-asylum waiting areas has, by credible accounts, added not just detention, but punishment to the mix, offered in the form of *ad hoc* abuse dished out by overburdened border officials.<sup>95</sup> Sadly, but unsurprisingly, children have fared especially badly when foreign migration flows have run into modern machinery of border control.<sup>96</sup> It offers scant consolation to the detainees caught within such zones that they can exit back to the countries from which they fled.<sup>97</sup>

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<sup>91</sup> For an example of unsuccessful litigation against the operation of a pre-asylum waiting area, see *Mahdid and Haddar v. Austria*, 2005-XIII HRDC 289, 300, which held that a three-day wait in an international transit zone at Vienna International Airport, pending consideration of asylum claim, did not constitute unlawful deprivation of liberty.

<sup>92</sup> BASARAN, *supra* note 3, at 1.

<sup>93</sup> *Id.* at 7.

<sup>94</sup> HUMAN RIGHTS WATCH, *supra* note 78, at 16, 42; see also Clémence Richard & Nicolas Fischer, *A Legal Disgrace? The Retention of Deported Migrants in Contemporary France*, 47 SOC. SCI. INFO. 581, 594–95 (2008); see also Julien-Lafferrière, *supra* note 5.

<sup>95</sup> Sonia Wolf, *Illegal Immigrants Suffer Beatings, Humiliation at Paris Airport: Report*, AGENCE FRANCE PRESSE-ENGLISH 1 (Dec. 16, 2003).

<sup>96</sup> See Kim Willsher, *Boy of eight held at Paris airport for more than a week*, GUARDIAN (Mar. 30, 2016, 12:38 PM), <https://www.theguardian.com/world/2016/mar/30/boy-of-eight-held-at-paris-airport-for-more-than-a-week> [<http://perma.cc/QW5Y-RH94>]; *France: Unaccompanied Children Detained at Borders*, HUMAN RIGHTS WATCH (Apr. 8, 2014, 1:00 AM), <https://www.hrw.org/news/2014/04/08/france-unaccompanied-children-detained-borders> [<http://perma.cc/HFK9-V6JM>]; HUMAN RIGHTS WATCH, *supra* note 78.

<sup>97</sup> *Amuur v. France*, 1996-III Eur. Ct. H.R. 826, 849–50.

The fractured nature of pre-asylum waiting areas abets their use as instruments of illiberal government. They pop into existence and disappear again, even appearing retroactively, at the whim of mere administrators. They split like amoeba and wiggle away in the form of floating and temporary zones. At the farthest extreme, pre-asylum waiting areas become little more than labels reading “unwelcome foreigner” attached to entire populations in the form of myriad floating personal temporary micro-zones. Far from a legal fiction, that describes how *zones d’attente* function quite realistically.<sup>98</sup> It may, however, qualify as a legal absurdity.

It arguably mocks the meaning of “international” to call these kinds of zones “SIZs.” Rather than areas *between* nation states, pre-asylum waiting areas represent areas more fully national and statist than anywhere else on earth. In them, the softening graces of liberal government—its respect for human dignity and its adherence to the rules of law—draw back, leaving nothing but brute force.

On the charge of illiberality, then, the critics of *zones d’attente* and similar pre-asylum zones lay a telling blow. Done wrong, SIZs could allow nation states to violate their obligations to human rights, the international community, and their own citizens. How can theory set SIZs right? The next Section suggests keeping the “international” in SIZ by ensuring that they continue to promote free travel, trade, and cultural exchange.

#### B. Zones as Liberal International Refuges

The prior Section reviewed the theoretical critiques against *zones d’attente* and similar pre-asylum waiting areas and found one in particular especially telling: Such zones can serve as instruments through which supposedly liberal states enforce illiberal policies. This danger arises not only because nation states find it expedient to shrink the effective territory of the liberties and privileges they uphold while leaving the reach of their police powers undiminished, but also because international law has relatively little force to compel nation states to treat foreigners more respectfully in special international areas. Transit zones, SEZs, duty-free areas, and other SIZs typically serve those aims in practice, of course. As yet, though, theory has little to say about the matter. This Section begins filling that gap by justifying special international zones not simply as expressions of local power, but also as institutions that the

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<sup>98</sup> See BASARAN, *supra* note 3, at 54.



community of nations accepts and respects as instruments for promoting freedom of travel, trade, and cultural exchange.

It does not take much imagination to discern how SIZs could serve as refuges to those traditionally liberal values. All of the many types of SIZs reviewed above in Part I serve international trade, travel, and cultural exchange in various ways. Some do so obviously, as when international transit zones ease the passage of travelers through a country or when free ports encourage trade. Others do so indirectly, as when the Hong Kong and Macau SARs allow liberal values to subsist in a sea of nominal communism, or when, with the best of intentions but with mixed results, pre-asylum waiting areas attempt to impose a measure of order on the chaos of human migration.

These innate virtues of SIZs remain as yet underappreciated as theoretical ideals. It could hardly be otherwise, given that only in this article has the SIZ itself emerged as worthy of study. Now, having identified it in the wild, so to speak, and come to understand its ways, we can turn to directing SIZs toward human ends. That exercise might begin by curbing mutations, such as *zones d'attente* and other pre-asylum waiting areas that, if unchecked, might remove whole regions and people from the liberality of the nation state, but not coercive grip.

Again, it does not take much imagination to discern how to save SIZs from that fate. Activists, reporters, and scholars have brought the problem to the world's attention. *Amuur* and other judicial correctives on the scope of police powers imposed within *zones d'attente* show international law working exactly as it should, albeit at its usual glacial pace.<sup>99</sup> No theoretical discussion was needed to start that remedial process. Perhaps now it might contribute to the effort, however.

As SIZs continue to grow, spread, and adapt in practice, our theories about SIZs must keep pace. It ill serves our understanding to dismiss them as fictional or illegal. SIZs are no less real than any social institution and have become a commonplace tool of international law. Good theory should recognize the full potential, good and bad, of special international zones.

Illiberality is not built into the DNA of SIZs; quite the contrary. For the greatest part, during the long course of their history and throughout their many instantiations, SIZs have made international travel, trade, and cultural exchange more

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<sup>99</sup> See generally *Amuur v. France*, 22 Eur. Ct. H.R. 533 (1996); *Gebremedhin v. France*, 2007-II Eur. Ct. H.R. 131.

cheap, easy, and safe. In this capacity, they have served as powerful forces for peace, prosperity, and human freedom. Recognizing this theoretic ideal might make it easier to reform *zones d'attente* and similar pre-asylum waiting areas. It might also help when it comes to designing new SIZs—the topic of the next Part.

### III. SPECIAL INTERNATIONAL ZONES IN DEVELOPMENT

Having above described special international zones in practice and theory, this article now turns to questions of application. What might the next generation of SIZs bring? This Part offers four examples: refugee cities, deep blue zones, peer group country standards, and special international residency and work zones. The following Sections address each in turn, *seriatim*.

#### A. Refugee Cities

A select few policymakers and commentators have proposed creating zones designed to give displaced people a more appealing option than flinging themselves against the gates of unwelcoming countries. Alexander Betts and Paul Collier have called for the creation of special economic zones where refugees might find gainful employment relatively close to home, rather than in some far off European or North American country, without unduly disrupting the local labor markets of the host country.<sup>100</sup> Refugee Cities, a 501(c)(3) public charity, proposes to help host countries and NGOs implement a similar policy.<sup>101</sup>

Special refugee zones have already gotten a bit of traction in the real world. The EU has entered into a compact with Jordan under which productions from its SEZs will receive favored access to European markets on condition that Syrian refugees get to work alongside Jordanians (instead of, as is more typical of refugee populations, being barred from local labor markets).<sup>102</sup> That approach to aiding refugees has drawn criticism from human rights activists, however, and no other such projects appear in the offing.<sup>103</sup> Perhaps would-be host countries worry

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<sup>100</sup> See ALEXANDER BETTS AND PAUL COLLIER, REFUGEE: RETHINKING REFUGEE POLICY IN A CHANGING WORLD 171–73 (2017).

<sup>101</sup> REFUGEE CITIES, <https://refugeecities.org> [<http://perma.cc/AV7C-46WB>] (last visited Dec. 4, 2017).

<sup>102</sup> See European Union Press Release IP/16/588, Syrian Crisis: EU Ready to Step Up on Partnerships with Lebanon and Jordan (Oct. 17, 2016).

<sup>103</sup> See Heaven Crawley, *Why jobs in special economic zones won't solve the problems facing the world's refugees*, THE CONVERSATION (Apr. 6, 2017, 6:45 AM), <https://theconversation.com/why-jobs-in-special-economic-zones-wont-solve-the-problems-facing-the-worlds-refugees-75249> [<http://perma.cc/SQK3-J6XX>].

about setting out to offer aid to those in need but ending up with unwanted residents and citizens. A properly structured SIZ could help fix that problem.

Structuring a refugee camp as a special zone that lies outside the territory of its host country for purposes of many local laws, including for the purpose of establishing the privileges of residency or citizenship, would lower the risks of a host country taking in refugees and other wandering populations. That would make it easier for those suffering masses to find a place to rest. Absent binding international obligations to the contrary, a country should be able to create a SIZ outside of the host's legal territory for some purposes, such as for establishing rights to residency or citizenship, without causing much of a diplomatic stir. As noted above, such devices have become routine in many contexts and countries.<sup>104</sup>

Done right, and reported fairly, such a refugee SIZ program would likely win its host accolades. Who could complain if a country willing to let foreigners onto its territory as an act of humanitarian mercy, in response to an emergency situation, redrew its legal boundaries to withdraw the full panoply of its residents' and citizens' privileges and obligations from the foreign guests? All the many other countries unwilling to give shelter on better terms would, at any rate, have little grounds to criticize.

This outline of a legal framework for refugee SIZs leaves many questions unanswered. Foremost among them: Would it be right for a country hosting a refugee SIZ to deny those taking shelter within the zone from free access to and from other international zones, traffic, and travelers? The French *zones d'attente* seem headed in that direction, but remain a lot more like prisons than areas where local law has given way to international norms. Tugba Basaran reports a trend toward greater access, but notes that French *zones d'attente* remain subject to strict limits, under which a few NGOs can access certain parts of the zones, and certain parties therein, subject to the unfettered discretion of the Minister of the Interior.<sup>105</sup>

Another question worth asking: Conceding that a host country ought to have every right to deny a foreign sovereign the right to govern some or all of a refugee SIZ, can it rightly deny migrant people some form of self-government, if only that provided by an NGO, or church, or some other organization short of a competing sovereign nation? I should hope not, but should

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<sup>104</sup> See *supra* Part I.

<sup>105</sup> See Basaran, *supra* note 8, at 350.

also confess to a partial view of such matters, given professional interests in the field.<sup>106</sup> Refugee Cities seems to agree; it suggests that “a regional, supranational entity, such as the EU, or a collection of representatives from the host country and neighboring nations, could establish the regulatory authority” for the refugee cities it advocates.<sup>107</sup> It also calls for giving the residents of refugee cities various ways to get involved in self-government.<sup>108</sup>

Only time will tell what form refugee cities will take, and whether they will take form at all. Many other questions persist. The problems that inspire the idea of special international zones for refugees persist, too, though. Perhaps refugee cities, in some form, will help to abate them.

### B. Deep Blue Zone

French Polynesia has invited Blue Frontiers Pte. Ltd. to submit plans for developing a new kind of special economic zone in that country—a “SeaZone” encompassing both land and water areas.<sup>109</sup> The final legal structure of that special jurisdiction will depend on action by the National Assembly of French Polynesia. Even as a mere hypothetical, though, the SeaZone presents an interesting exercise for the application of the SIZ model. The seasteader’s unique situation—they seek little more from French Polynesia than a safe nursery where the first generation of their floating communities can grow and mature in anticipation of eventually moving to the high seas—calls for unique solutions.<sup>110</sup> It calls, for reasons set forth in more detail earlier and elsewhere, for a unique kind of special international zone: a “deep blue’ zone.”<sup>111</sup>

What is a deep blue zone? It takes its name from the prevailing color of the international waters of the planet, ocean areas shared by the vessels of all nations, under the exclusive control of none. The deep blue zone would recreate those areas in simulated form by offering close to shore many of the legal effects of staying far out at sea.

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<sup>106</sup> See BELL, *supra* note 24, at 219–33 (relating “stories of the sort ordinarily recounted over drinks” about the author’s consulting practice).

<sup>107</sup> *Governance, REFUGEE CITIES*, <https://refugeecities.org/about-the-project/our-response/governance/> [<http://perma.cc/4FUN-YDKA>] (last visited Dec. 4, 2017).

<sup>108</sup> *Id.*

<sup>109</sup> BLUE FRONTIERS, <https://www.blue-frontiers.com/> (last visited Dec. 8, 2017).

<sup>110</sup> See *generally* JOE QUIRK WITH PATRI FRIEDMAN, SEASTEADING: HOW FLOATING NATIONS WILL RESTORE THE ENVIRONMENT, ENRICH THE POOR, CURE THE SICK, AND LIBERATE HUMANITY FROM POLITICIANS (2017).

<sup>111</sup> See BELL, *supra* note 24, at 63.

A deep blue SIZ would allow select foreign vessels to anchor within the territorial or inland waters of its host nation on terms designed to simulate those that apply in international waters. This would change the rule ordinarily applicable in territorial waters, wherein foreign vessels can typically do no more than maintain innocent passage.<sup>112</sup> Because the host could fine-tune the zone's rules to disallow military vessels, resource extraction, and other international rights ill-suited for inland waters, the deep blue zone need not pose any unusual risks. At the same time, the arrangement would give seasteaders a protected harbor, both literally and legally speaking, in which they could try out the arrangements they aim to someday use in international waters.

If seasteaders make it out into the open ocean, for instance, as they so ardently claim to want, they will find themselves living in cities that, because they float in international waters, will enjoy ready access to the world's maritime trade. Vessels flying the flags of many sovereigns will visit and trade with seasteads. Furthermore, the seasteaders' vessels will themselves likely sport various flags, whether of nation states or, still more hypothetically, of seasteading polities.<sup>113</sup>

Because each flag brings with it much of the substantive law of the flag's issuer, rendering the vessel flying it national territory for some purposes,<sup>114</sup> seasteads offer the prospect of bringing many various polities together in close proximity under fluid conditions. Just as the borders of ecosystems, such as where a river meets the ocean, generate the greatest diversity and growth, this polycentric feature of seasteads offers the prospect of untold wonders—or chaos. Such complex systems do not always behave predictably. Through a deep blue SIZ, seasteaders might reduce the rough and tumble of international seas and laws to safe, controlled conditions.

### C. Peer Group Country Standards

Special economic zones, for the most part, aim to offer little more than areas free of customs, duties, and taxes, sometimes with the added benefit of one-window service for any government paperwork that persists. Zones competing on those fronts need not reference the laws of other countries. Relatively recently,

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<sup>112</sup> See UN Convention on the Law of the Sea, Dec. 10, 1982, 1833 U.N.T.S. 397 arts. 17–21.

<sup>113</sup> See BELL, *supra* note 24, at 63 (discussing flagging options, including self-flagging seasteads).

<sup>114</sup> See *id.* at 62.

however, zones have begun to compete not only on the price and convenience of governing services, but also on the applicable rules.<sup>115</sup> That opens the door for a zone that allows its guests to choose rule sets from any of a number of pre-approved countries, bringing international law to bear on what is ordinarily a purely local question.

Though somewhat by historical accident rather than by Chinese design, Hong Kong demonstrated long ago that importing the right foreign laws to a special jurisdiction can help it thrive. First as a Crown Colony and then, under a “Basic Law” that maintained the legal system’s fundamental features after its handover to China in 1997, Hong Kong has succeeded by offering Asia a common law legal system relatively friendly to private enterprise and high finance.<sup>116</sup> Eager to replicate that success, Dubai employed retired English judges, even fitting them out with robes and perukes, and wrote “the laws of England and Wales” into its legal system.<sup>117</sup> Honduras plans to take the process even further with its *zonas de empleo y desarrollo económico* (“zones of employment and economic development” or “ZEDEs”), which within broad limits will allow each zone to import common law or other rules from public or private sources of its own choosing.<sup>118</sup>

These trends suggest that a future special international zone might best satisfy the market demand for good rules not simply by offering another country’s laws within its bounds, as in Hong Kong or Dubai, nor even by offering a flag-free generic common law legal system, as Honduran ZEDEs might, but by offering a choice between any of the many rule sets that a variety of peer countries would apply to a particular area of regulation. The host would select the countries in its peer group on the basis of the quality of their regulations, market demand for them among zone clients, and their suitability given local conditions. A special zone set up in Central America might choose to put all OECD countries (thus including all members of EU and NAFTA) and its neighboring countries in its peer group, for example. With regard to some areas of regulation, guests could either stick with the regulatory scheme that applies by default in the zone (which

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<sup>115</sup> See BELL, *supra* note 24, at 187.

<sup>116</sup> See STEVE TSANG, A MODERN HISTORY OF HONG KONG 273–77 (2004).

<sup>117</sup> Law on the Application of Civil and Commercial Laws in the Dubai International Finance Center, DIFC Law No. 3 of 2004, art. 8(2)(e) (U.A.E.), [https://www.difc.ae/files/9214/5448/9184/Law\\_on\\_the\\_Application\\_of\\_Civil\\_and\\_Commercial\\_Laws\\_in\\_the\\_DIFC\\_DIFC\\_Law\\_No.\\_3\\_of\\_2004.pdf](https://www.difc.ae/files/9214/5448/9184/Law_on_the_Application_of_Civil_and_Commercial_Laws_in_the_DIFC_DIFC_Law_No._3_of_2004.pdf).

<sup>118</sup> Decreto No. 120-1203, Ley Organica de las Zonas de Empleo y Desarrollo Economico (ZEDE) [Organic Act for Zones for Employment and Economic Development (ZEDE)], LA GACETA, DIARIO OFICIAL DEL LA REPUBLICA DE HONDURAS (Sept. 6, 2013).

might itself come from outside the host country) or choose one from a peer country.

Under peer group standards, for example, if a company that manufactures and sells medical devices in the German market decides to expand its operations to the zone, it could choose to stick with the rules it has already mastered. The zone would not try to master those rules itself, but would instead require the company to certify that its practices in the zone, because they follow those established in its home country, comply with German law. This certification could be provided by the peer country itself under special arrangement or by some trusted third party. Upon offering its certification of compliance with peer group country standards, the company would be allowed to make and sell medical devices in the zone.

Though companies would probably often want to “bring to the zone” the same regulations they have already satisfied back home, thus saving the need to master another set of rules, a company setting up in the zone could choose the regulations of any peer country. It may turn out, after all, that all medical device companies in the zone, even those from other countries, will want work under German regulations.

In this way, a SIZ run on peer group standards could reveal which countries, among those trusted to have reasonably good rules, offer the sorts of regulations that protect the public while encouraging economic development. That in turn might encourage countries to compete for the coveted top spot in terms of trusted but efficient regulatory services. This is not just a matter of prestige, nor even of what revenue might be had from selling certification services to parties invoking a particular countries’ regulations within a zone that applies peer group country standards. The countries that take the lead in offering the world regulations that both protect the public while promoting profit will give its domestic industry a great advantage over foreign competitors, who instead of having already mastered the prevailing rules will have to either play catch up or suffer under the familiar but unpopular rules of their own home countries.

#### D. Special International Residency and Work Zones

Future SIZs could also take a form designed to attract digital nomads, voluntary exiles, and other parties eager to pay for enjoying lower barriers to international travel, trade, and cultural exchange. Enterprising host countries could serve that growing market by offering special international residency and work zones. This Section explains SIRW zones in greater detail.

In a SIRW zone, a nation state would roll back its customs and immigration border, legally speaking, and leave behind an area open to visitors, residents, and workers from abroad. Like French *zones d'attente*, these zones would begin as offshoots of a pre-existing international transit zone. The usual tourist and resident visa and work permit rules would not apply in a SIRW zone. Other rules might apply of course; that depends on the host government, the organization (probably private) that operates the zone, and the international market for places to live and work.

Most likely, the SIRW zone would offer comfortable housing and work environments for all its guests and expedited processing of residency visas and work permits for those seeking stronger links to the host country. To judge from current practices in international transit zones, private parties will likely manage SIRW zones under the host's oversight.<sup>119</sup> Instead of applying its customs and immigration rules to the zone, the host would assess a flat lease, *per capita*, or other fee. This would ensure that the zone pays its way, in terms of public finances, while being treated as a black box by the host country in terms of the taxation of (and thus interference with) the zone's internal operations.

Extant SIZs have come close to creating SIRW zones without quite fulfilling all the criteria. Norway's Svalbard Islands look like one at first glance. As its welcoming website says, "[e]veryone may, in principle, travel to Svalbard, and foreign citizens do not need a visa or a work or residence permit from Norwegian authorities in order to settle in Svalbard."<sup>120</sup> In contrast to the voluntary process through which host countries ordinarily create SIZs, however, Norway had to accept this limitation on its sovereignty somewhat by force. It never had the right to impose visa or work permit requirements in the islands, but rather had to foreswear imposing those limits on nationals of other parties to the Svalbard Treaty in order to win such control over the islands as it now claims.<sup>121</sup> It bears noting, however, that the Governor of Svalbard, evidently not pressed for space, has extended the invitation to *all* foreigners.<sup>122</sup>

Something akin to a SIRW zone also emerges from the details of the Hawksbill Creek, Grand Bahama (Deep Water Harbour and Industrial Area) Act, the legislative enactment of an agreement reached between the government and the private

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<sup>119</sup> See Frétigny, *supra* note 14, at 15–16; see also BASARAN, *supra* note 3, at 102–03.

<sup>120</sup> *Entry and Residence*, THE GOVERNOR OF SVALBARD, <https://www.sysselmannen.no/en/Visitors/Entry-and-residence/> [<http://perma.cc/W747-M99G>] (last updated Sept. 27, 2016).

<sup>121</sup> The Svalbard Treaty art. 3, Feb. 9, 1920.

<sup>122</sup> *Entry and Residence*, *supra* note 120.



developer of a free port.<sup>123</sup> The Act gave a new corporation, the Grand Bahama Port Authority, Ltd., sweeping powers to create and run the port, including responsibility for education and healthcare, and exemptions from all manner of customs, duties, taxes, and fees.<sup>124</sup> More to the point for present purposes, it also allowed the Port Authority (or its licensees) to bring to the Bahamas and employ a broadly defined class of skilled workers and their dependents, subject only to a government veto right against identified individuals.<sup>125</sup> This is not quite a SIRW zone, but neither is it far from one.

In its full flower, SIRW zones would offer something of a reflection of the pre-asylum waiting areas that France and other countries have created. Instead of trying to drive migrants away, a SIRW zone would try to convince them to come, stay, and work. Like pre-asylum waiting areas, though, SIRW zones would exist within a country's geographic borders but outside of its territory, legally speaking, for purposes of customs or immigration.

#### CONCLUSION: UNBUNDLING SOVEREIGNTY FOR THE PUBLIC GOOD

This article has introduced the special international zone—an area that its host nation state places outside of its territory for the purpose of some local laws, leaving other such laws and applicable international obligations in force—as a distinct genus of legal institution worthy of close study. As Part I documented, SIZs have a long history, already exist in great numbers across many types, and continue to grow and adapt. Their success should come as no surprise, given that SIZs prove so useful in helping smooth the barriers, gates, and gaps between nation states' various territories. The theoretical foundations of SIZs have hitherto remained rather undeveloped, however. Part II began correcting that deficiency by defending SIZs as irreplaceable tools for promoting the liberal ideals embodied in free trade, travel, and cultural exchange. Part III applied that theoretical approach to SIZs by describing special international zones that might, if brought to fruition, promote peace, prosperity, and human dignity.

Nation states usually follow the same business model as cable TV companies: bundle many various services into an indivisible whole. SIZs allow innovative nation states to offer

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<sup>123</sup> *The Hawksbill Creek Agreement*, GRAND BAH. PORT AUTH., <http://www.gbpa.com/index.php/about-us/the-agreement> [<http://perma.cc/9JME-JW2E>] (last visited Jan. 22, 2018). The author thanks Mark Frazier for bringing this arrangement to his attention.

<sup>124</sup> See generally *Hawksbill Creek, Grand Bahama (Deep Water Harbour and Industrial Area)* [*Hawksbill Creek Agreement*], CH.261 (June 20, 1955) (Bah.).

<sup>125</sup> *Id.* § 2(20).

something like service *à la carte*. Whereas in most of its territory, a government offers a single package of services—taxes, regulations, policing, etc.—in a SIZ it can offer a curated selection of these. In an international transit zone, for instance, most of the usual laws apply with the exception of certain ones relating to immigration and taxes. A SIRW zone might remove labor regulations from the mix, too. A deep blue zone would remove still other local restrictions, leaving international norms to fill the gap. This, the power of special international zones to regulate the territorial boundaries of nation states, stands to work widespread and lasting changes on the structure of international relations.

# The Law and Policy of Refugee Cities: Special Economic Zones for Migrants

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## INTRODUCTION

Migration is quickly becoming one of the most pressing issues of our time. Conflict, persecution, natural disasters, and economic inequality are driving people from their homes in record numbers.

Meanwhile, traditional responses to mass migration are becoming increasingly inadequate. Humanitarian assistance and border policing are ineffective and costly over the long term because they fail to address the root causes of migration.<sup>1</sup> Barriers to the labor market, both legal and socio-economic, prevent migrants from contributing to the economic development of the countries hosting them and force them into dependency.<sup>2</sup>

Recognizing this, some countries are exploring pragmatic pathways toward integrating migrants into economies. The special economic zone (“SEZ”) concept offers one potential path forward. SEZs are designated areas designed to promote development through a distinct policy and administrative framework. They can serve as vehicles for initiating beneficial policies when political obstacles stand in the way of nationwide reform.

Refugee cities would be a type of SEZ designed to facilitate migrant integration. They would be special-status jurisdictions in which displaced people—who would otherwise be barred from working—can be employed, start businesses, access finance, and rebuild their lives. Applying principles from SEZs, refugee cities could help countries benefit from migrants’ presence in a politically realistic manner. They could also deliver high-quality infrastructure, foreign direct investment, and improvements to the business environment.

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<sup>1</sup> See *infra* Section I(A).

<sup>2</sup> See *infra* Section I(B).

Refugee cities would also serve as a pathway for countries to come into closer alignment with international law. Under the Convention and Protocol Relating to the Status of Refugees (“Refugee Convention” and “1967 Protocol,” respectively), refugees are entitled to relatively strong rights regarding property, employment, and entrepreneurship.<sup>3</sup> However, most countries’ domestic legislation falls well short of these rights.

This article explores these gaps to show how refugee cities could fill them by creating designated areas in which refugee rights are respected and the policy benefits of migrant integration are achieved. Part I provides the background of the global migration situation. Part II discusses the evolution and role of SEZs. Part III explains the refugee-cities concept and its policy benefits. Part IV analyzes international and domestic law pertaining to refugees, including a special focus on Turkey.

## I. BACKGROUND OF GLOBAL FORCED DISPLACEMENT

Forced displacement is a growing major global concern. By the end of 2016, the United Nations High Commissioner for Refugees (“UNHCR”) reported 65.6 million people were forcibly displaced by persecution, conflict, violence, or human rights violations.<sup>4</sup> Included in that total are 22.5 million refugees,<sup>5</sup> 40.3 million internally displaced persons (“IDPs”),<sup>6</sup> and 2.8 million asylum seekers.<sup>7</sup> Moreover, 10.3 million people were forcibly displaced during 2016 alone, meaning that twenty people were forced to flee their homes every minute that year.<sup>8</sup>

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<sup>3</sup> *Protecting Refugees: questions and answers*, UNHCR (Feb. 1, 2002), <http://www.unhcr.org/afr/publications/brochures/3b779dfe2/protecting-refugees-questions-answers.html> [<http://perma.cc/XY46-Z396>].

<sup>4</sup> UNHCR, GLOBAL TRENDS: FORCED DISPLACEMENT IN 2016, at 2 (2016), <http://www.unhcr.org/5943e8a34.pdf> [<http://perma.cc/5CCH-HMCT>]. Actual numbers of displaced persons, including refugees, are probably much higher than the numbers provided in this section due to the number of people who would qualify as refugees, but are undocumented and thus not counted in official tallies. See Roger Zetter & Héloïse Ruandel, *Refugees’ Right to Work and Access to Labor Markets – An Assessment, Part I: Synthesis* 11 (KNOMAD Study 2016) (noting, for instance, that the Iranian government estimates 1.4 million to 2 million undocumented Afghans are within its borders, beyond the 979,400 documented refugees, and that there are an estimated 175,000 undocumented refugees in Venezuela, compared with only 5000 who are documented).

<sup>5</sup> UNHCR, *supra* note 4, at 2. “Refugees” generally includes people who have been forced to leave their country because of a well-founded fear of persecution and includes people who fall under the definition of refugee under international treaties, people granted complementary forms of protection and temporary protection, and people in “refugee-like situations.” *Id.* at 56.

<sup>6</sup> *Id.* at 2. “Internally displaced persons” are people who have been forced to leave their homes but have not left their country. *Id.* at 56.

<sup>7</sup> *Id.* at 2. “Asylum seekers” are those who have applied for international protection in a country, but whose refugee status is yet to be determined. *Id.* at 39.

<sup>8</sup> *Id.* at 2.

Developing countries hosted a growing majority of the world's refugees.<sup>9</sup> The top ten refugee hosting countries at the end of 2016 were:

- Turkey – 2.9 million
- Pakistan – 1.4 million
- Lebanon – 1 million
- Iran – 979,400
- Uganda – 940,800
- Ethiopia – 791,600
- Jordan – 685,200
- Germany – 669,500
- Democratic Republic of the Congo – 452,000
- Kenya – 451,100<sup>10</sup>

Lebanon hosted the highest number of refugees relative to its population, with one in every six people in the country being a refugee.<sup>11</sup> Jordan (one in eleven) and Turkey (one in twenty-eight) were the next two highest.<sup>12</sup>

Fifty-five percent of refugees came from three countries: Syria (5.5 million), Afghanistan (2.5 million), and South Sudan (1.4 million).<sup>13</sup> Syrians also made up the largest number of forcibly displaced persons (12 million, including 6.3 million IDPs).<sup>14</sup> Sixty-five percent of the Syrian population were forcibly displaced as of the end of 2016, a higher proportion than any other nationality.<sup>15</sup>

The year 2017 saw a major surge in Rohingya refugees fleeing ethnic cleansing campaigns in Myanmar. Between August 25th and September 30th of that year, over 600,000 Rohingya were driven out by reported human rights atrocities.<sup>16</sup> Bangladesh hosted approximately 800,000 Rohingya refugees as of October 4, 2017 in refugee camps and makeshift settlements that were

<sup>9</sup> *Id.* (observing that eighty-four percent of refugees under UNHCR's mandate (14.5 million out of 17.2 million) are hosted in developing countries and twenty-eight percent are in less developed countries (4.9 million)).

<sup>10</sup> *Id.* at 14–16.

<sup>11</sup> *Id.* at 3.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 6.

<sup>15</sup> *See id.*

<sup>16</sup> *Rohingya Refugee Crisis*, UN OFFICE FOR THE COORDINATION OF HUMANITARIAN AFFAIRS, <https://www.unocha.org/rohingya-refugee-crisis> [<http://perma.cc/WKG7-YKNT>] (last visited Nov. 27, 2017); *see also* Jeffrey Gettleman, *Rohingya Recount Atrocities: 'They Threw My Baby Into a Fire,'* N.Y. TIMES (Oct. 11, 2017), <https://www.nytimes.com/2017/10/11/world/asia/rohingya-myanmar-atrocities.html> (reporting stories of gang rape, murder, and home burnings from Rohingya survivors).

straining to provide basic services like water, healthcare, shelter, and sanitation.<sup>17</sup>

#### A. Responses to Refugees

The international response to refugee situations has evolved over the last several decades. After massive displacement caused by the Second World War, the newly created United Nations formed the UNHCR and adopted a treaty, the 1951 Refugee Convention, obligating member states to respect certain minimum standards of treatment of refugees. Since then, the UNHCR's main objective has been to ensure the international protection of refugees and to seek permanent solutions to their problems.<sup>18</sup>

Traditionally, the UNHCR's focus was on providing short-term humanitarian aid through emergency shelters, food, water, and medical care.<sup>19</sup> Over time, the UNHCR increasingly shifted to emphasize "durable solutions" for refugees.<sup>20</sup> The three durable solutions are: voluntary repatriation to the refugee's home country, resettlement to a third country, or integration into the host country.<sup>21</sup>

However, in recent years, the UNHCR has increasingly recognized that durable solutions are often only a remote possibility for refugees.<sup>22</sup> Conditions in their home country often do not improve for many years, making repatriation impossible in the near future. Only a small portion of the global refugee population are accepted for resettlement in third countries,<sup>23</sup> and few of the major refugee-hosting countries are willing to meaningfully integrate refugees into their societies.

As a result, most refugees remain displaced for many years, often in isolated refugee camps or informal settlements. As of the end of 2016, 11.6 million refugees (two-thirds of the total) were in "protracted refugee situations," generally lasting five years or more.<sup>24</sup> Of that number, 4.1 million people were in refugee situations lasting twenty years or more.<sup>25</sup>

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<sup>17</sup> *Rohingya Refugee Crisis*, *supra* note 16.

<sup>18</sup> OFFICE OF INTERNAL OVERSIGHT SERVICES, EVALUATION OF THE OFFICE OF THE UNITED NATIONS HIGH COMMISSIONER FOR REFUGEES 3 (2015).

<sup>19</sup> *Id.*

<sup>20</sup> *Id.* at 4.

<sup>21</sup> *Id.* at 5.

<sup>22</sup> UNHCR, *supra* note 4, at 24.

<sup>23</sup> In 2016, 189,300 refugees were resettled into thirty-seven countries. *Id.* at 3. The U.S. admitted the largest number at 96,900. *Id.*

<sup>24</sup> *Id.* at 22. "Protracted refugee situations" is defined as situations where 25,000 or more refugees from the same nationality have been in exile for five consecutive years or more in a given asylum country. *Id.*

<sup>25</sup> *Id.*

To address this reality, the UNHCR has been seeking to identify new approaches to refugee situations, including “complementary pathways,” which countries have implemented when durable solutions are not possible.<sup>26</sup> Examples of current complementary pathways include private sponsorship programs, labor schemes, family reunification programs, talent registers, and education programs.<sup>27</sup>

## B. Refugees’ Access to the Labor Market

The vast majority of refugees are prevented from working, both *de jure* and *de facto*.<sup>28</sup> In addition to legal restrictions, which are discussed in Part IV, refugees face restrictive policies and practices like forced encampment or bureaucratic and expensive processes for obtaining work permits.<sup>29</sup> They also face socio-economic barriers impacting the freedom to work and the ability to assimilate, such as xenophobia and discrimination, language difficulties, inadequate access to the courts, and lack of vocational training for refugees who need to develop new skills.<sup>30</sup> As a result, most refugees work in the informal sector and under relatively poor conditions where they have less of a positive impact on the economy than if they were allowed to work formally.<sup>31</sup>

These barriers exist despite evidence that allowing refugees, and other immigrants to work tends to bring significant net economic benefits to host countries. Over the medium-term to long-term, refugees tend to raise wages, create jobs, stimulate commerce, fill gaps in the labor market, and increase cross-border trade.<sup>32</sup> Refugees represent a major underutilized labor force that could make significant contributions to the economies hosting them if activated.<sup>33</sup> Additionally, work would enable them to develop skills and capital to facilitate their return to their home countries and would help advance the UN’s 2030 Sustainable Development Goals to end poverty and fight inequality.<sup>34</sup>

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<sup>26</sup> *Id.* at 24, 29.

<sup>27</sup> *Id.* at 29.

<sup>28</sup> ASYLUM ACCESS & THE REFUGEE WORK RIGHTS COALITION, GLOBAL REFUGEE WORK RIGHTS REPORT: TAKING THE MOVEMENT FROM THEORY TO PRACTICE 5 (2014) [hereinafter ASYLUM ACCESS].

<sup>29</sup> *Id.*; Zetter & Ruadel, *supra* note 4, at 14–19.

<sup>30</sup> ASYLUM ACCESS, *supra* note 28, at 5; Zetter & Ruadel, *supra* note 4, at 20.

<sup>31</sup> Zetter & Ruadel, *supra* note 4, at 26.

<sup>32</sup> See, e.g., *id.*; see also ASYLUM ACCESS, *supra* note 28, at 8; OECD, *Is migration good for the economy?* (May 2014), <https://www.oecd.org/migration/OECD%20Migration%20Policy%20Debates%20Numero%202.pdf> [<http://perma.cc/345C-LQAL>]; ALEXANDER BETTS ET AL., REFUGEE ECONOMIES: RETHINKING POPULAR ASSUMPTIONS (2014), <https://www.rsc.ox.ac.uk/files/files-1/refugee-economies-2014.pdf> [<http://perma.cc/E5EQ-UBVZ>].

<sup>33</sup> Zetter & Ruadel, *supra* note 4, at 4.

<sup>34</sup> *Id.*

## II. SPECIAL ECONOMIC ZONES HISTORY AND POLICY FUNCTIONS

An SEZ can be generally understood as a designated geographic area designed to promote economic development through a policy and administrative framework that is somehow different from the typical policy and administrative frameworks surrounding it.<sup>35</sup> The legal and regulatory regime is the most central aspect to an SEZ; their geographic, administrative, and infrastructural characteristics are also important, but less so.<sup>36</sup> The SEZ concept can include a wide variety of special-status jurisdictions going by different names from ancient to modern times, including free trade zones, export processing zones, freeports, and even semi-autonomous city-states.<sup>37</sup>

In recent years, new attention is being placed on the role of SEZs as vehicles for policy and structural transformation, such as by helping catalyze growth in new industry sectors or overcoming political roadblocks to beneficial legal reforms.<sup>38</sup> SEZs often also serve as industrial parks by providing facilities, infrastructure, and services designed to cater to certain types of businesses.<sup>39</sup> However, an increasing number are mixed-use or urban, in character.<sup>40</sup>

### A. History of Development

Modern SEZs emerged out of several historical precedents. The island of Delos functioned as a free zone during the Greek and Roman empires by serving as a place where goods could be stored and exchanged free of local prohibitions and taxes.<sup>41</sup> Medieval and Renaissance-era city-states, such as those in the Hanseatic

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<sup>35</sup> See Gokhan Akinci & James Crittle, *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* 2–6, 9–22 (World Bank Foreign Investment Advisory Service, Working Paper No. 45869, 2008) (referring to SEZs as “geographically delimited areas administered by a single body, offering certain incentives . . . to businesses [within it]” and noting how they enhance competitiveness through special policy, regulatory frameworks, and administration); see also Claude Baissac, *Brief History of SEZs and Overview of Policy Debates*, in SPECIAL ECONOMIC ZONES IN AFRICA: COMPARING PERFORMANCE AND LEARNING FROM GLOBAL EXPERIENCE 23 (Thomas Farole ed., 2011) (defining SEZs as areas where the “rules of business are different from those that prevail in the national territory,” generally with more liberal policies and more effective administration); Lotta Moberg, *The Political Economy of Special Economic Zones* (2015) (Ph.D. dissertation, George Mason University) (defining SEZs as “areas where a government allows for different rules to apply than the rest of the country”).

<sup>36</sup> Baissac, *supra* note 35, at 24–25 (2011) (observing how some SEZ programs—as in the case of “single-factory zone” programs—do not even have a designated geographic area; instead companies can acquire SEZ status while being located anywhere in the country).

<sup>37</sup> Akinci & Crittle, *supra* note 35, at 9–12.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> Baissac, *supra* note 35, at 31–32.



League, had almost complete autonomy from the ruling powers around them and provided spaces for free trade and commerce.<sup>42</sup> Colonial-era chartered territories and trading posts were independently administered by state-backed private companies.<sup>43</sup> Some of these trading posts emerged in the modern era as prosperous city-states and freeports, including Singapore, Hong Kong, and Macau.<sup>44</sup> These also could be characterized as a type of SEZ.<sup>45</sup>

In the early twentieth century, free-trade zones (“FTZs”), or “free zones,” existed near major international transit points, offering exemptions from tariffs for trade-related activities, including warehousing, packaging, sorting, exhibition, and sales.<sup>46</sup> In 1934, the United States adopted the Foreign Trade Zones Act,<sup>47</sup> which created these types of zones to mitigate the damaging impact of high tariffs under the protectionist trade policies prevailing just before and during the early Great Depression under laws like the Smoot-Hawley Tariff Act.<sup>48</sup> FTZs were deemed outside the customs territory of the country, which meant businesses could import foreign products and sell them in foreign markets duty free, and only pay customs duties if and when products were sold in the domestic market.<sup>49</sup>

FTZs evolved in the mid-twentieth century by opening up more to manufacturing industries, instead of remaining restricted to trade activities.<sup>50</sup> The starkest early example was the Shannon Free Zone (1959) which applied the FTZ model to a wide area located next to a major airport and offered ready-built industrial infrastructure and facilities, dedicated administrative support, and investment incentives.<sup>51</sup>

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<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> See Akinci & Crittle, *supra* note 35, at 14–16 (identifying Hong Kong, Macau, and Singapore as city-wide freeport SEZs).

<sup>46</sup> Baissac, *supra* note 35, at 32. Notably, however, the FTZ at the Port of Cadiz included substantial industrial production, even featuring one of the first Ford Motor Plants in Europe. *Id.*

<sup>47</sup> Foreign Trade Zones Act, 19 U.S.C.A. § 81a (1934).

<sup>48</sup> Tariff Act of 1930 (Smoot-Hawley Tariff Act), 46 Stat. 590; see also Baissac, *supra* note 35, at 32.

<sup>49</sup> Akinci & Crittle, *supra* note 35, at 9, 52; see also, e.g., WORLD CUSTOMS ORG., GLOSSARY OF INTERNATIONAL CUSTOMS TERMS 17 (2013) (defining “free zone” as “a part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs Territory”); 19 U.S.C.A. § 81c (2003) (describing the U.S. Customs territory as distinct from the FTZs).

<sup>50</sup> Baissac, *supra* note 35, at 32.

<sup>51</sup> *Id.* As another example of a growing openness of FTZs to manufacturing, in 1950, the United States amended the Foreign Trade Zones Act to allow for manufacturing activities. *Id.* However, this did not result in much manufacturing activity until an April 12, 1980 ruling from the U.S. Customs Service changed the formula for calculating the tariff

The Shannon Free Zone model was copied and spread throughout developing countries under the name “export processing zone” (“EPZ”) from the 1960s to the 1990s.<sup>52</sup> For developing countries, EPZs were tools for stimulating export-led industrial development, which boosted employment and labor productivity, diversified the economy, generated foreign exchange, attracted foreign direct investment, and facilitated technology transfer.<sup>53</sup> EPZs also had an important function as policy incubators—they served as pilots for trade liberalization in the midst of protectionist import-substitution regimes, which generally prevailed in developing countries at the time.<sup>54</sup> Over time, EPZ programs grew increasingly open to a wider range of business activities, to linkages with local businesses outside the EPZs, and to domestic sales, as opposed to an exclusive focus on exports.<sup>55</sup>

China took a monumental step in shaping the nature of SEZs in the early 1980s, when several local officials sought to boost economic growth in their jurisdictions by designating areas as free-market enclaves.<sup>56</sup> The idea was an outgrowth of the Open Door reforms, which began in the late 1970s as a controlled experiment of market-based reforms.<sup>57</sup> In 1980, the country designated four “special economic zones” (perhaps the first use of the term now used generically), which spanned large city-sized areas and granted a wide range of free market policies affecting finance, labor, foreign investment, and trade.<sup>58</sup> Many of these SEZs, especially Shenzhen, experienced explosive growth in investment, wages, population, and living standards.<sup>59</sup>

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applied to finished products sold from an FTZ to the domestic market so that domestic parts and labor were excluded from the value. *A Brief History of the U.S. Foreign-Trade Zones Program*, FOREIGN-TRADE ZONE RES. CTR., <http://www.foreign-trade-zone.com/history.htm> [<http://perma.cc/M8N8-SV89>] (last visited Dec. 3, 2017).

<sup>52</sup> Baissac, *supra* note 35, at 33.

<sup>53</sup> See generally THOMAS FAROLE & GOKHAN AKINCI, SPECIAL ECONOMIC ZONES: PROGRESS, EMERGING CHALLENGES, AND FUTURE DIRECTIONS (Thomas Farole & Gokhan Akinci eds., 2011) (evaluating the performance of SEZs in various countries).

<sup>54</sup> *Id.* (describing policy incubation as an important dynamic benefit of SEZs around the world).

<sup>55</sup> Baissac, *supra* note 35, at 28.

<sup>56</sup> Moberg, *supra* note 35, at 92–93.

<sup>57</sup> Douglas Zhihua Zeng, *How Do Special Economic Zones and Industrial Clusters Drive China's Rapid Development?*, in BUILDING ENGINES FOR GROWTH AND COMPETITIVENESS IN CHINA: EXPERIENCE WITH SPECIAL ECONOMIC ZONES AND INDUSTRIAL CLUSTERS 1, 8–9 (Douglas Zhihua Zeng ed., 2010) (noting how Chinese Premier Deng Xiaoping referred to the choice to only open certain segments of the economy to the market as “crossing the river by touching the stones”).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* As an example, Shenzhen’s GDP grew by fifty-eight percent per year between 1980 and 1984, and its GDP per capita grew from under \$100 at formation to over \$25,000 in 2016. *Shenzhen (Guangdong) City Information*, HKTDC RES. (Aug. 30, 2017), <http://china-trade-research.hktdc.com/business-news/article/Facts-and-Figures/Shenzhen-Guangdong-City-Information/ff/en/1/1X000000/1X09VT4H.htm> [<http://perma.cc/7BB3-KU5G>].

Beginning largely in the 1990s, zones in Latin America initiated another major shift in the nature of SEZs.<sup>60</sup> Whereas previous zones were primarily government-driven projects, SEZs began to increasingly rely on private-sector companies to finance, own, develop, and provide services to users.<sup>61</sup> This model has allowed the state to concentrate its resources on providing effective regulation, ideally through a dedicated SEZ regulatory authority that independently performs or coordinates many of the functions of government in a streamlined fashion.<sup>62</sup> In general, anecdotal evidence suggests that SEZs managed by private-sector companies or public-private partnerships have delivered higher quality services and facilities, better social and environmental outcomes, and higher financial returns at a lower cost than government-run SEZs.<sup>63</sup>

#### B. Function of SEZs

While SEZs can bring static benefits such as employment generation and foreign direct investment to an area, their greatest potential is in delivering dynamic benefits, especially long-term structural transformation, upgrades to domestic economy capacity, and changes to nationwide policy.<sup>64</sup> Examples of countries that have achieved these dynamic benefits in a very noticeable way include Mexico, Costa Rica, Dominican Republic, China, South Korea, Taiwan, and Mauritius.<sup>65</sup>

Many, if not most, SEZs have failed to achieve significant dynamic benefits; some may have even been counterproductive. For instance, rather than serving as catalysts of good policy, some SEZs may have acted as “pressure valves” that allow elites to avoid or delay nationwide reform by diverting social movements and isolating their impact to zones.<sup>66</sup> Many SEZs impose economic costs that exceed their benefits, primarily when SEZs rely heavily on the public sector for financing or operation or on massive tax

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It grew from a fishing village of 300,000 people to over fourteen million people today, many of them young people from rural areas in search of opportunities. See Da Wei David Wang, *Continuity and Change in the Urban Villages of Shenzhen*, 4 INT’L J. CHINA STUD. 233, 233–56 (2013). Many of the original fishing villagers became landowners in the city, profiting from the city’s success. *Id.* at 246.

<sup>60</sup> Baissac, *supra* note 35, at 37.

<sup>61</sup> *Id.* (noting how this shift was driven by the need to limit government spending and to regenerate stagnate free zone programs).

<sup>62</sup> Akinci & Crittle, *supra* note 35, at 5.

<sup>63</sup> *Id.* at 45–47.

<sup>64</sup> See *id.* at 32; see also THOMAS FAROLE, SPECIAL ECONOMIC ZONES IN AFRICA: COMPARING PERFORMANCE AND LEARNING FROM GLOBAL EXPERIENCE 3–16 (2011).

<sup>65</sup> See Thomas Farole & Gokhan Akinci, *Introduction*, in SPECIAL ECONOMIC ZONES: PROGRESS, EMERGING CHALLENGES, AND FUTURE DIRECTIONS, *supra* note 53, at 1, 8; Akinci & Crittle, *supra* note 35, at 26, 36.

<sup>66</sup> Akinci & Crittle, *supra* note 35, at 4, 34, 42.

breaks to attract investment.<sup>67</sup> Numerous reports have observed that many SEZs have not performed well at advancing beyond low-wage/low-skill jobs, stimulating local economic activity, or promoting labor and environmental performance.<sup>68</sup> SEZs have generally been successful at job creation and access to income for women, though there have been significant problems with pay equity, denying women access to attain higher paying positions, discriminatory working conditions, and sexual harassment.<sup>69</sup>

SEZs are becoming increasingly important vehicles for wide-ranging reforms.<sup>70</sup> Previously, their primary function was to reduce tariff barriers between countries.<sup>71</sup> Today, with overall effective tariff rates very low worldwide, their primary value is in easing other constraints in the investment climate through reducing unnecessary regulatory barriers, streamlining customs inspection and compliance procedures, facilitating human development (especially skills), easing access to investment approvals and business licenses, delivering reliable infrastructure, and improving access to work visas for foreign workers.<sup>72</sup> Generous tax incentives no longer offset disadvantages in these areas.<sup>73</sup>

### III. REFUGEE CITIES CONCEPT

The refugee cities concept is an evolution of the SEZ model. Whereas traditional zones have prioritized tax reductions, customs exemptions, business registration and licensing, and similar measures, refugee cities would prioritize migrant integration.<sup>74</sup> In refugee cities, migrants could legally work, operate their own businesses, access goods and services, have

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<sup>67</sup> *Id.* at 32–34, 39, 45–47.

<sup>68</sup> *See, e.g.*, Sheba Tejani, *The Gender Dimension of Special Economic Zones*, in SPECIAL ECONOMIC ZONES: PROGRESS, EMERGING CHALLENGES, AND FUTURE DIRECTIONS, *supra* note 53, at 247, 262–72; Int'l Labour Office, *Report of the InFocus Initiative on Export Processing Zones (EPZs): Latest Trends and Policy Developments in EPZs*, at 3–9, ILO Doc. GB.301/ESP/5 (March 2008); Int'l Labour Office, *Labour and Social Issues Relating to Export Processing Zones: Report for Discussion at the Tripartite Meeting of Export Processing Zones—Operating Countries*, at 47, ILO Doc. TMEPZ (1998). However, SEZs may perform better, in relative terms, than non-zone businesses and performance appears stronger in privately managed and geographically demarcated SEZs, as opposed to publicly operated zones and “single-factory” zones scattered throughout the country. Akinci & Crittle, *supra* note 35, at 17.

<sup>69</sup> *See* Tejani, *supra* note 68, at 269–70; *see also* Int'l Labour Office, *Report of the InFocus Initiative on Export Processing Zones (EPZs): Latest Trends and Policy Developments in EPZs*, *supra* note 68, at 4–7.

<sup>70</sup> Akinci & Crittle, *supra* note 35, at 6, 42–43.

<sup>71</sup> *See id.* at 13.

<sup>72</sup> *See id.* at 57–58.

<sup>73</sup> *See id.* at 49.

<sup>74</sup> *See* REFUGEE CITIES, REFUGEE CITIES: EXPANDING OPTIONS FOR DISPLACED PEOPLE THROUGH SPECIAL ECONOMIC ZONES 4 (Nov. 2016), <https://refugeecities.files.wordpress.com/2016/11/refugee-cities-concept-paper-november-2016.pdf> [<http://perma.cc/9ZKR-2AKU>].

property rights, and enjoy other rights and privileges ordinarily denied to them.<sup>75</sup> Ideally, refugee cities would also include aspects of well-performing SEZs, such as an effective and efficient regulatory system, private-sector investment, and trade facilitation.<sup>76</sup> However, they would also go beyond these elements, offering diverse, multi-use urban areas, support for entrepreneurs and small-sized and medium-sized enterprises, healthcare, trauma counseling, education, financial assistance, and other support in collaboration with international organizations and non-governmental organizations.<sup>77</sup>

## A. Benefits of Refugee Cities

### 1. Host Countries

For countries hosting large numbers of refugees, refugee cities convert a perceived problem into an economic growth opportunity.<sup>78</sup> Since these countries cannot keep migrants outside their borders for both practical and political reasons, they must decide how they will handle migrants.<sup>79</sup> If they house migrants in typical camps without economic opportunities, the migrants will tend to drain public resources and possibly become more prone to radicalization and violence.<sup>80</sup> The migrants will also tend to find ways to leave or avoid the camps and instead work in the informal sector “where they have less of a positive impact on the economy than if they were allowed to work legally.”<sup>81</sup> On the other hand, efforts to allow refugees to work anywhere in the country face overwhelming political resistance, especially due to the fear that they will take away employment opportunities from citizens.<sup>82</sup>

Refugee cities would help countries realize some of the potential benefits of refugees<sup>83</sup> by designating new spaces where

<sup>75</sup> See *id.* at 6–7.

<sup>76</sup> See *id.*

<sup>77</sup> See *id.* at 8.

<sup>78</sup> See *id.* at 6.

<sup>79</sup> See *id.*

<sup>80</sup> See generally Rebecca Horn, *Exploring the Impact of Displacement and Encampment on Domestic Violence in the Kakuma Refugee Camp*, 23 J. REFUGEE STUD. 356 (2010) (analyzing the connection between refugee camp residents’ structural conditions and domestic violence); see also BARBARA SUDE ET AL., LESSENING THE RISK OF REFUGEE RADICALIZATION 3 (2015), [https://www.rand.org/content/dam/rand/pubs/perspectives/PE100/PE166/RAND\\_PE166.pdf](https://www.rand.org/content/dam/rand/pubs/perspectives/PE100/PE166/RAND_PE166.pdf) [<http://perma.cc/9KWK-J6ZD>] (discussing the connection between refugee camp conditions and radicalization).

<sup>81</sup> REFUGEE CITIES, *supra* note 74, at 6; see also, e.g., BETTS ET AL., *supra* note 32, at 5.

<sup>82</sup> See Zetter & Ruaudel, *supra* note 4 (studying twenty countries hosting seventy percent of the world’s refugees and observing a general reluctance to ease restrictions on refugees’ ability to work).

<sup>83</sup> See BETTS ET AL., *supra* note 32, at 16–20 (covering the economic benefits of allowing refugees to enter the labor market).

refugees can work and start businesses, and where new foreign investment can be brought in, without competing for existing resources in existing spaces.<sup>84</sup> Host populations could also live and work in the new spaces and benefit from the opportunities and infrastructure developed there.<sup>85</sup>

Refugee cities are better tools for accomplishing the goals of refugee camps. Host countries often use refugee camps to cluster refugees to facilitate aid distribution, avoid competition for jobs, and more easily locate and, eventually, repatriate them.<sup>86</sup> Camps often do not accomplish this goal well, however, since refugees often avoid them because of the few economic opportunities there.<sup>87</sup> Refugee cities can reverse this trend by attracting migrants rather than repelling them.<sup>88</sup>

## 2. International Community and Aid Agencies

Refugee cities can also offer the international community a more cost-effective response to refugee crises than existing humanitarian methods. International organizations traditionally respond to mass migration with food aid, tents, water, basic security, and emergency medical care.<sup>89</sup> Refugee cities would offer these services, while also creating a platform for migrants to become self-supporting.<sup>90</sup> Private capital can be invested in real estate, businesses, and infrastructure and can generate returns from these productive assets.<sup>91</sup> Donor institutions can simply facilitate and abet this investment through technical support, investment guarantees, and monitoring and evaluation.<sup>92</sup>

For developed countries, such as in Europe, that are weary or fearful of migrants passing through refugee hosting countries and entering their territory, refugee cities could provide refugees with other attractive areas for settling.<sup>93</sup> Rather than attempting to find opportunities in an advanced economy, they can find opportunities in the countries hosting them.<sup>94</sup>

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<sup>84</sup> See REFUGEE CITIES, *supra* note 74, at 6–7.

<sup>85</sup> *Id.* at 4.

<sup>86</sup> See MILICA Z. BOOKMAN, AFTER INVOLUNTARY MIGRATION: THE POLITICAL ECONOMY OF REFUGEE ENCAMPMENTS 134–36 (2002).

<sup>87</sup> *Id.* at 98.

<sup>88</sup> See REFUGEE CITIES, *supra* note 74, at 6.

<sup>89</sup> See U.N. ECONOMIC & SOCIAL COUNCIL, EVALUATION OF THE OFFICE OF THE UNITED NATIONS HIGH COMMISSIONER FOR REFUGEES 4 (2015).

<sup>90</sup> See REFUGEE CITIES, *supra* note 74, at 3.

<sup>91</sup> See *id.* at 1, 4.

<sup>92</sup> See *id.* at 7.

<sup>93</sup> See *id.* at 6.

<sup>94</sup> See *id.* at 4.

### 3. Benefits for Businesses and Investors

Refugee cities can also open up new markets and underutilized talent pools for foreign and domestic investors.<sup>95</sup> Refugees and other migrants are perhaps often among the most motivated and enterprising workers,<sup>96</sup> and yet their abilities are normally withheld from the labor force.<sup>97</sup> Businesses in a refugee city could benefit from their abilities, as well as from other regulatory and business environment reforms introduced from the SEZ concept.<sup>98</sup>

### 4. Benefits for Refugees

Most importantly, refugee cities allow migrants themselves an often-rare opportunity to benefit themselves and their families through their own work.<sup>99</sup> They can earn income, experience the psychological benefits of meaningful work, and, perhaps, help rebuild their home countries from a better position than if they had lived in a refugee camp.<sup>100</sup>

## B. Progress

Significant strides are being made toward developing migrant-inclusive SEZs or refugee cities. Several projects I have consulted on are, as of the date of publication, underway in Africa (primarily the transit countries of Northern Africa) with support from European governments desiring to provide alternatives for migrants who are otherwise seeking refuge and opportunity within Europe.

Jordan has also made significant strides toward developing migrant-inclusive SEZs. In 2016, Jordan formed a trade agreement with the European Union that intends to attract EU-oriented investors to Jordan's SEZs in order to employ both Syrians and Jordanians.<sup>101</sup> The agreement grants manufacturers in eighteen of Jordan's industrial zones concessionary access to the European common market if at least fifteen percent of their

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<sup>95</sup> See *id.* at 7.

<sup>96</sup> See, e.g., *Personal Income of Migrants, Australia, 2009–10*, AUSTRALIAN BUREAU OF STATISTICS (June 9, 2017, 11:30 AM), <http://www.abs.gov.au/ausstats/abs@.nsf/mf/3418.0> [<http://perma.cc/3C8X-VW8U>] (analyzing economic activities of humanitarian migrants in Australia and observing above-average rates of income and entrepreneurship).

<sup>97</sup> See Zetter & Ruaudel, *supra* note 4, at 4.

<sup>98</sup> See REFUGEE CITIES, *supra* note 74, at 4.

<sup>99</sup> See *id.* at 8.

<sup>100</sup> See *id.*

<sup>101</sup> See European Commission Press Release IP/16/2570, EU-Jordan: Towards a Stronger Partnership (July 20, 2016), [http://europa.eu/rapid/press-release\\_IP-16-2570\\_en.htm](http://europa.eu/rapid/press-release_IP-16-2570_en.htm) [<http://perma.cc/V778-NCKP>].

employees are Syrian refugees.<sup>102</sup> The agreement covers fifty-two product groups and will last for ten years.<sup>103</sup>

Also, in 2016, the World Bank launched a \$300 million Program for Results Loan to improve Jordan's investment climate, attract investment, implement labor market reforms, and allow the Syrian labor force to further Jordan's economic growth.<sup>104</sup> There is a special focus on supporting trade facilitation, investment promotion, and Syrian entrepreneurship activities in existing SEZs.<sup>105</sup> Disbursements are linked to transparency requirements ensuring compliance with good labor practices.<sup>106</sup>

Jordan set a global target of bringing 200,000 Syrian refugees into the formal labor market and began issuing work permits free of charge to Syrians for a three-month period.<sup>107</sup> It also removed the requirement for holding a valid passport to obtain a work permit, a requirement that was impossible for many Syrians to fulfill.<sup>108</sup> Instead, Ministry of the Interior identification cards now serve as a substitute for a passport.<sup>109</sup>

The King Hussein Bin Talal Development Area ("KHBTDA"), one of Jordan's SEZs, has been identified as a strong option for allowing refugees access to the labor market.<sup>110</sup> KHBTDA is located nearby the Za'atari refugee camp in Mafraq, which houses roughly 80,000 Syrian refugees.<sup>111</sup>

#### IV. LAW APPLICABLE TO REFUGEES

The laws applicable to refugees depend on the countries in which they find themselves. International law pertaining to refugees is relatively well-developed; however, the strongest rights are conferred under treaties to which countries may or may not be a party. Even if they are parties, the countries may have

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<sup>102</sup> *Id.* (stating that after three years, the threshold will rise to twenty-five percent, and the agreement modifies the rules of origin applicable to qualifying products so that they are eligible for the same benefits applied to least-developed countries under the Everything but Arms Agreement).

<sup>103</sup> *Id.*

<sup>104</sup> See The World Bank Group, *Jordan – Economic Opportunities for Jordanians and Syrian Refugees Program-for-Results Project*, at 1–3, Report No. 108201-JO (Sept. 2, 2016), <http://documents.worldbank.org/curated/en/802781476219833115/pdf/Jordan-PforR-PAD-P159522-FINAL-DISCLOSURE-10052016.pdf> [<http://perma.cc/6GQ3-DJZ5>].

<sup>105</sup> *Id.* at 5.

<sup>106</sup> *Id.* at 82.

<sup>107</sup> *Id.* at 4.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> Bethan Staton, *Jordan Experiment Spurs Jobs for Refugees*, NEWS DEEPLY: REFUGEES DEEPLY (July 25, 2016), <https://www.newsdeedly.com/refugees/articles/2016/07/25/jordan-experiment-spurs-jobs-for-refugees> [<http://perma.cc/7M7D-GBWW>].

<sup>111</sup> *Id.*



made reservations regarding certain provisions, thereby limiting their applicability.

Domestic legislation varies greatly across countries. In most cases, it falls well short of international law, particularly in those countries hosting most of the world's refugees. Migrant-inclusive SEZs, or refugee cities, could help countries move significantly closer to alignment with the standards under international law in designated areas.

This Part analyzes both international law and domestic law. Regarding domestic law, it provides a general overview of countries hosting large refugee populations and then takes a more specific look at the law pertaining to refugees in Turkey—the largest host of refugees.

#### A. International Law

While certain standards are enshrined in customary international law and in general treaties regarding humanitarian law and human rights (such as the Geneva Conventions), the most specific and protective sources of international law pertaining to refugees is the Convention and Protocol Relating to the Status of Refugees.<sup>112</sup> States that are parties to the Refugee Convention are obligated to certain minimum standards of treatment toward refugees within their borders.<sup>113</sup> To qualify as a “refugee” entitled to protection under the Convention, a person must be outside the country of his or her nationality and unable to avail him-or-herself of the protection of that country<sup>114</sup> because of a well-founded fear of persecution “for reasons of race, religion, nationality, membership in a particular social group, or political opinion.”<sup>115</sup>

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<sup>112</sup> Convention Relating to the Status of Refugees, July 28, 1951, 189 U.N.T.S. 150, <http://hrlibrary.umn.edu/instreet/v1crs.htm> [<http://perma.cc/KV3T-5BBF>] [hereinafter 1951 Refugee Convention]; Protocol Relating to the Status of Refugees, Jan. 31, 1967, 606 U.N.T.S. 267, <http://hrlibrary.umn.edu/instreet/v2prsr.htm> [<http://perma.cc/8NXC-JDQG>]. When the 1951 Refugee Convention was adopted, it only applied to people displaced by events occurring before January 1, 1951 (i.e., because of World War II). 1951 Refugee Convention, art. 1(A)(2). Furthermore, states had the option of either applying it only to people displaced from events in Europe or from anywhere in the world. *Id.* art. 1(B)(1). However, the 1967 Protocol amended the 1951 Convention by removing the date restriction. Protocol Relating to the Status of Refugees, art. 1.

<sup>113</sup> See generally 1951 Refugee Convention, *supra* note 112 (providing wide-ranging obligations regarding the treatment of refugees).

<sup>114</sup> *Id.* art. 1(A)(2). Stateless persons are also protected. For them, “country of his [or her] nationality” is effectively replaced with country of his or her place of habitual residence. *Id.*

<sup>115</sup> *Id.* There are certain types of people explicitly excluded from protection under the Refugee Convention. This includes people who can now receive protection from the country of their nationality. *Id.* art 1(C)(5). It also includes people receiving assistance from agencies of the UN other than the UNHCR. *Id.* art 1(D). For example, Palestinian refugees who receive assistance from the United Nations Relief and Works Agency for Palestine Refugees in the Near East (“UNRWA”). UNHCR, *Revised Statement on Article 1D of the 1951 Convention* (Oct.

There are 145 states party to the Refugee Convention.<sup>116</sup> Among those members hosting the largest numbers of refugees as of the end of 2016 are Turkey (2.9 million),<sup>117</sup> Iran (979,400),<sup>118</sup> Uganda (940,800),<sup>119</sup> Ethiopia (791,600),<sup>120</sup> Germany (669,500),<sup>121</sup> Democratic Republic of Congo (452,000),<sup>122</sup> and Kenya (451,100).<sup>123</sup> Notable non-members of the 1967 Protocol with large refugee populations include: Pakistan (1.4 million),<sup>124</sup> Lebanon (1 million),<sup>125</sup> and Jordan (685,200).<sup>126</sup> Additionally, Bangladesh, which began hosting a sudden influx of Rohingya refugees in the last half of 2017, is not a party to the Refugee Convention.<sup>127</sup>

The Refugee Convention contains several provisions that are relevant to the refugee cities concept, including rights to property, work, residency and movement, and administrative facilities. These are discussed below.

### 1. Rights to Property

First, refugees have the right to property. Article 13 requires states to “accord to a refugee treatment as favourable as possible and, in any event, not less favourable than that accorded to aliens generally in the same circumstances,<sup>128</sup> as regards the acquisition of movable and immovable property and other rights pertaining thereto, and to leases and other contracts relating to movable and

2009), <http://www.unhcr.org/4add88379.pdf> [<http://perma.cc/Q7UV-3Q9Z>]. War criminals and others who have committed serious non-political crimes are also not protected. 1951 Refugee Convention, *supra* note 112, art. 1(F).

<sup>116</sup> 1951 Refugee Convention, *supra* note 112. There are 142 countries party to both the Refugee Convention and the 1967 Protocol. *Id.* The United States is a party to the 1967 Protocol only. *See* Protocol Relating to the Status of Refugees, *supra* note 112.

<sup>117</sup> Protocol Relating to the Status of Refugees, *supra* note 112; *see also* UNHCR, *supra* note 4, at 14.

<sup>118</sup> Protocol Relating to the Status of Refugees, *supra* note 112; *see also* UNHCR, *supra* note 4, at 15.

<sup>119</sup> Protocol Relating to the Status of Refugees, *supra* note 112; *see also* UNHCR, *supra* note 4, at 15.

<sup>120</sup> Protocol Relating to the Status of Refugees, *supra* note 112; *see also* UNHCR, *supra* note 4, at 15.

<sup>121</sup> Protocol Relating to the Status of Refugees, *supra* note 112; *see also* UNHCR, *supra* note 4, at 15.

<sup>122</sup> Protocol Relating to the Status of Refugees, *supra* note 112; *see also* UNHCR, *supra* note 4, at 16.

<sup>123</sup> Protocol Relating to the Status of Refugees, *supra* note 112; *see also* UNHCR, *supra* note 4, at 16.

<sup>124</sup> *See* Protocol Relating to the Status of Refugees, *supra* note 112 (not listing Pakistan as a state party); *see also* UNHCR, *supra* note 4, at 14.

<sup>125</sup> *See* Protocol Relating to the Status of Refugees, *supra* note 112 (not listing Lebanon as a state party); *see also* UNHCR, *supra* note 4, at 15.

<sup>126</sup> *See* Protocol Relating to the Status of Refugees, *supra* note 112 (not listing Jordan as a state party); *see also* UNHCR, *supra* note 4, at 15.

<sup>127</sup> *See* Protocol Relating to the Status of Refugees, *supra* note 112 (not listing Bangladesh as a state party).

<sup>128</sup> For the meaning of “in the same circumstances,” *see infra* note 135.

immovable property.”<sup>129</sup> Consequently, if a country generally allows aliens within its borders to purchase land, own shares of stock in a company, or lease real estate, it must also allow refugees this same right.<sup>130</sup>

Treatment “not less favourable than that accorded to aliens generally” does not include rights that are only given to aliens by legislative reciprocity,<sup>131</sup> nor treatment conferred because of special economic and customs agreements between nations.<sup>132</sup> Therefore, refugees can only enjoy those rights that are accorded to aliens in the absence of reciprocity requirements or special agreements.<sup>133</sup> However, many commentators consider the right to acquire movable and immovable property as now recognized by customary international law, which would make refugees entitled to the right even if the country’s laws condition the right upon reciprocity.<sup>134</sup>

## 2. Rights to Work

Secondly, refugees have the rights to work and to operate their own businesses. These rights are included in Articles 17, 18, 19, and 24 of the Refugee Convention.

Article 17 of the Refugee Convention covers wage-earning employment. It states in the first paragraph that “[t]he Contracting States shall accord to refugees lawfully staying in their territory the most favourable treatment accorded to nationals of a foreign country in the same circumstances,<sup>135</sup> as regards the right to engage in wage-earning employment.”<sup>136</sup> Commentators assert that “wage-earning employment” includes all kinds of employment that are not self-employment or a “liberal

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<sup>129</sup> 1951 Refugee Convention, *supra* note 112, art. 13.

<sup>130</sup> Atle Grahl-Madsen, Commentary on the Refugee Convention 1951: Articles 2-11, 13-37, art. 13 (Oct. 1997), [www.unhcr.org/3d4ab5fb9.pdf](http://www.unhcr.org/3d4ab5fb9.pdf) [<http://perma.cc/V7UW-9X7Y>]. This article includes the right to receive compensation in the case of expropriation, which is now enshrined in customary international law as well. *Id.*

<sup>131</sup> That is, rights conditioned on the alien’s home state conferring similar rights. *Id.*

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> “In the same circumstances” is understood as including any requirements (such as to length and conditions of residence) that aliens would have to fulfill to enjoy the right in question, except for those requirements that a refugee is incapable of fulfilling by virtue of being a refugee. 1951 Refugee Convention, *supra* note 112, art. 6. So, requirements such as education, examinations, membership in associations, length of residency, financial solvency, etc., that are generally imposed on aliens would need to be fulfilled by refugees as well. Grahl-Madsen, *supra* note 130, art. 6, cmt. 3. However, for requirements the refugee is incapable of fulfilling, such as, potentially, the inability to produce a certificate of nationality or to produce a certificate of graduation from a university in the home state, the state must provide other means of satisfying the requirements. *Id.*

<sup>136</sup> 1951 Refugee Convention, *supra* note 112, art. 17.

profession” (two categories treated in Articles 18 and 19, respectively), including work in factories, agriculture, offices, sales, domestic work, and virtually all other industrial or service sector occupations, including state employment.<sup>137</sup>

The standard of “most favourable treatment accorded to nationals of a foreign country” goes beyond the standard expressed for property rights (at least as favorable as treatment “accorded to aliens generally”).<sup>138</sup> It requires states to give refugees the same rights regarding employment as are given to any other aliens, even if they are given in the context of a special relationship with another state or under international agreements.<sup>139</sup> The purpose of this requirement, as expressed by the French delegate to the Convention, was to not deprive refugees of the support that could have only been obtained by the work of their home government, since refugees, by their very nature, are denied such support.<sup>140</sup>

On its face, this paragraph would appear to give refugees the same rights to receive work permits or visas as any other alien. Refugees would be subject to the most lenient requirements and standards for such permits or visas as are imposed on foreign nationals from other countries.<sup>141</sup> This would include work visas that are otherwise only issued on the basis of reciprocity.<sup>142</sup> Refugees would benefit regardless of whether their own government issues such visas or permits.<sup>143</sup>

The second paragraph of Article 17 goes further by requiring states to exempt refugees from “restrictive measures imposed on aliens or the employment of aliens for the protection of the national labour market” if they have completed three years’ residency in the country or if they have a spouse or children who are nationals of the country.<sup>144</sup>

This paragraph has its origin in earlier conventions pertaining to refugees in 1933 and 1938, in which similar paragraphs were drafted, despite the economic depression at the time—a period in which lawmakers became especially concerned with protecting nations’ jobs for their own nationals.<sup>145</sup> It was felt that such restrictions should not apply to refugees who had a

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<sup>137</sup> Grahl-Madsen, *supra* note 130, art. 17, cmt. 4.

<sup>138</sup> 1951 Refugee Convention, *supra* note 112, art. 17.

<sup>139</sup> Grahl-Madsen, *supra* note 130, art. 17, cmt. 3.

<sup>140</sup> UN Economic & Social Council, *Ad Hoc Committee on Statelessness and Related Problems, First Session: Summary Record of the Thirteenth Meeting*, REFworld (Feb. 6, 1950), <http://www.refworld.org/docid/40aa1cc34.html> [<http://perma.cc/4JNB-MXFK>].

<sup>141</sup> Grahl-Madsen, *supra* note 130, art. 17.

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> 1951 Refugee Convention, *supra* note 112, art. 17.

<sup>145</sup> Grahl-Madsen, *supra* note 130, art. 17, cmts. 1, 5.

special link to their country of refuge.<sup>146</sup> Based on his reading of the history of this paragraph, commentator Grahl-Madsen asserts that the requirement of three years' residency is to be interpreted as broadly as possible, even including individuals who have not had the status of refugees for the entire period of their residence, individuals whose presence has not been legal, and individuals who have spent short periods travelling or visiting other countries.<sup>147</sup>

The second paragraph only lifts restrictions that intend to prevent competition for domestic jobs.<sup>148</sup> Measures that restrict employment of foreign nationals for other purposes, such as national security, are not affected by this paragraph.<sup>149</sup>

The third paragraph of Article 17 requires states to "give sympathetic consideration" to giving refugees the same right to wage-earning employment as nationals, especially refugees who came to the country as part of labor recruitment programs or immigration schemes.<sup>150</sup> This provision obligates governments to undergo a good faith process in which they consider fully integrating refugees into the nation's labor market.<sup>151</sup> It does so with extra force if the country attracted the refugees under the promise of having the right to work.<sup>152</sup>

The effect of Article 17 is that states must place refugees on par with the most favorably treated foreign nationals when it comes to the right to employment—or better, if the refugees have lived in the country for three years or have a spouse or children who are nationals.<sup>153</sup> In this latter case, the refugees are not held back by restrictions imposed on the employment of foreign nationals for the purpose of preserving jobs for the country's own citizens.<sup>154</sup> States must also favorably consider fully assimilating refugees into their labor market, giving them national treatment.<sup>155</sup>

Article 18 extends similar, but slightly different, rights to self-employed refugees. It requires states to:

[A]ccord to a refugee lawfully in their territory treatment as favourable as possible and, in any event, not less favourable than that accorded to

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<sup>146</sup> League of Nations Doc. G.A. C.2/1933 (1933).

<sup>147</sup> Grahl-Madsen, *supra* note 130, art. 17, cmt. 7.

<sup>148</sup> *Id.* art. 17, cmt. 5.

<sup>149</sup> *Id.*

<sup>150</sup> 1951 Refugee Convention, *supra* note 112, art. 17(3).

<sup>151</sup> JAMES HATHAWAY, *THE RIGHTS OF REFUGEES UNDER INTERNATIONAL LAW* 763 (2005).

<sup>152</sup> Grahl-Madsen, *supra* note 130, art. 17, cmt. 12.

<sup>153</sup> *Id.* art. 17.

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

aliens generally in the same circumstances,<sup>156</sup> as regards the right to engage on his own account in agriculture, industry, handicrafts, and commerce and to establish commercial and industrial companies.<sup>157</sup>

The range of activities covered under this provision is the broadest possible.<sup>158</sup>

The term “lawfully in their territory” does not include the “staying” component that is in other articles using this phrase, such as was seen in Article 17.<sup>159</sup> This suggests that short-term visitors and persons merely travelling through the state are covered, provided they are refugees and their presence is legal.<sup>160</sup>

Additionally, the standard of treatment is potentially lower than the standard for wage-earning employment in Article 17. It is the same as was observed for the right to property: “[A]s favourable as possible . . . [but] not less favourable than that accorded to aliens generally in the same circumstances.”<sup>161</sup> Therefore, if the country generally allows aliens to be self-employed in the absence of reciprocity or special arrangements with other states, the country must grant the same rights to refugees.

Article 19 provides similar rights to refugees in “liberal professions.”<sup>162</sup> States must “accord to refugees lawfully staying in their territory who hold diplomas recognized by the competent authorities of that State, and who are desirous of practicing a liberal profession, treatment as favourable as possible and, in any event, not less favourable than that accorded to aliens generally in the same circumstances.”<sup>163</sup>

According to Grahl-Madsen, the term “diploma” is to be understood as “any degree, examination, admission, authorization, completion of course which is required for the exercise of a profession,” such as admission to the bar (for lawyers).<sup>164</sup> The term “liberal profession” is intended to include persons who act on their own in an occupation that requires certain qualifications, such as an advanced degree or license.<sup>165</sup> Lawyers, doctors, dentists, engineers, architects, and probably scientists would be included.<sup>166</sup>

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<sup>156</sup> For the meaning of “in the same circumstance,” see *supra* note 135.

<sup>157</sup> 1951 Refugee Convention, *supra* note 112, art. 18.

<sup>158</sup> Grahl-Madsen, *supra* note 130, art. 18, cmt. 4.

<sup>159</sup> *Id.* art. 18, cmt. 2.

<sup>160</sup> *Id.*

<sup>161</sup> Grahl-Madsen, *supra* note 130, art. 13(II).

<sup>162</sup> 1951 Refugee Convention, *supra* note 112, art. 19(1).

<sup>163</sup> *Id.*

<sup>164</sup> Grahl-Madsen, *supra* note 130, art. 19, cmt. 3.

<sup>165</sup> *Id.* art. 19, cmt. 4.

<sup>166</sup> *Id.*

Finally, Article 24 requires states to extend to refugees many of the same labor and social security protections as nationals. This includes covering them under any laws or regulations dealing with remuneration, work hours, overtime, holidays, child labor, apprenticeship and training, work-related injury, maternity, sickness, disability, and unemployment.<sup>167</sup>

### 3. Residency and Movement

Third, refugees have rights pertaining to residency and movement within the territory. Article 26 requires each state party to “accord to refugees lawfully in its territory the right to choose their place of residence and to move freely within its territory, subject to any regulations applicable to aliens generally in the same circumstances.”<sup>168</sup>

The right to choose a residence and to move about freely is distinct from the right to employment in Articles 17–19. To the extent that the country limits rights to employment to certain areas, that would not technically affect the right of refugees to move throughout the country or settle outside those areas, even though it might do so in practice.<sup>169</sup> Conversely, if the country requires aliens generally to only reside or travel in certain areas, this would also apply to refugees, even if they have the technical right to be employed anywhere in the country in accordance with Article 17.<sup>170</sup>

### 4. Administrative Facilities

Fourth, states are required to provide administrative assistance to refugees. Article 25 obligates states to arrange for administrative assistance to be provided to refugees when they would normally only be able to obtain that assistance from a foreign country.<sup>171</sup> This includes documents and certifications like birth, marriage, and death certificates, affidavits, and divorce judgements (or substitute instruments); it also includes broader forms of assistance, such as correspondence, investigations, and counselling.<sup>172</sup>

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<sup>167</sup> 1951 Refugee Convention, *supra* note 112, art. 24.

<sup>168</sup> *Id.* art. 26.

<sup>169</sup> Grahl-Madsen, *supra* note 130, art. 26, cmt. 5 (observing that “in so far as there are restrictions on the freedom to seek whatever employment one might desire, the right to choose one’s place of residence may be restricted in fact though not in law”).

<sup>170</sup> *Id.* art. 26, cmt. 6 (describing situations in which immigrants are only admitted on the condition that they remain in certain regions of the country and how such restrictions would apply to refugees as well).

<sup>171</sup> 1951 Refugee Convention, *supra* note 112, art. 25.

<sup>172</sup> Grahl-Madsen, *supra* note 130, art. 25, cmts. 1–2.

Relatedly, Articles 27 and 28 obligate states to allow access to identity papers<sup>173</sup> and travel documents,<sup>174</sup> respectively. Article 34 requires states to facilitate the assimilation of refugees, to expedite naturalization proceedings, and to reduce as far as possible the charges and costs of such proceedings.<sup>175</sup>

Refugee cities can be well-positioned to fulfill these requirements concerning administrative assistance by adopting mechanisms employed by SEZs, such as one-stop shops and special dedicated regulatory authorities. Such mechanisms can greatly streamline administrative approvals both onsite and online,<sup>176</sup> which would help overcome the procedural burdens and delays that currently face refugees.<sup>177</sup>

### 5. Additional and Blanket Rights

Other relevant protections in the Refugee Convention include the right of association,<sup>178</sup> free access to the courts,<sup>179</sup> housing,<sup>180</sup> education,<sup>181</sup> and welfare.<sup>182</sup> Several of the protections for refugees are considered so fundamental and reaffirmed in other international instruments that they are considered customary international law.<sup>183</sup> These include

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<sup>173</sup> 1951 Refugee Convention, *supra* note 112, art. 27 (giving the right to identity papers to any refugee “who does not possess a valid travel document”).

<sup>174</sup> *Id.* art. 28 (requiring states to issue refugees documents for the purpose of travelling outside their territory, subject to certain specified exemptions and restrictions).

<sup>175</sup> *Id.* art. 34.

<sup>176</sup> *See supra* notes 62–64 and accompanying text.

<sup>177</sup> *See infra* note 207–210 and accompanying text (discussing the bureaucratic hurdles, costs, and delays associated with refugee status determinations, work permit applications, and other procedures).

<sup>178</sup> 1951 Refugee Convention, *supra* note 112, art. 15 (granting lawful refugees the most favorable treatment accorded to nationals of a foreign country regarding non-political and non-profit-making associations and trade unions).

<sup>179</sup> *Id.* art. 16 (conferring free access to the courts of law to the same degree as nationals for refugees who are habitual residents (including legal assistance) and, for non-habitual residents, to the same degree as nationals of the country of habitual residence).

<sup>180</sup> *Id.* art. 21 (according to lawful refugees “treatment as favourable as possible and, in any event, not less favourable than that accorded to aliens generally in the same circumstances” as regards housing laws, regulations, or other public agency controls).

<sup>181</sup> *Id.* art. 22 (providing refugees the same treatment as nationals as regards elementary education and “treatment as favourable as possible and, in any event, not less favourable than that accorded to aliens generally in the same circumstances,” as regards non-elementary education).

<sup>182</sup> *Id.* art. 23 (securing for lawful refugees the same treatment as nationals as regards “public relief and assistance”).

<sup>183</sup> *See* UNHCR, *Introductory Note by the Office of the United Nations High Commissioner for Refugees, in CONVENTION & PROTOCOL RELATING TO THE STATUS OF REFUGEES 3* (2010), <http://www.unhcr.org/3b66c2aa10.pdf> [<http://perma.cc/9HW3-HDTZ>].



the principle of non-refoulement,<sup>184</sup> non-penalization,<sup>185</sup> and non-discrimination.<sup>186</sup>

Finally, the Refugee Convention contains a requirement for states to “accord to refugees the same treatment as is accorded to aliens generally,” unless other articles require more favorable treatment.<sup>187</sup> This blanket requirement covers all those benefits that aliens generally might enjoy that are not mentioned in the Refugee Convention.<sup>188</sup> The phrase “aliens generally” means that the requirement excludes benefits conferred under special arrangements with other countries or benefits granted on the basis of reciprocity.<sup>189</sup> This would naturally include all those rights provided under customary international law, such as the right to leave the territory of the state, protection from confiscation of property without compensation, and the right to not be expelled without cause.

Moreover, refugees enjoy any benefits to aliens that are conditioned on legislative reciprocity after three years’ residence.<sup>190</sup> This means that benefits that are only conferred upon foreign nationals if those individuals’ home states confer similar benefits on nationals of the other state, are available to refugees, notwithstanding the refugee’s home state’s policies.

#### B. Domestic Laws Pertaining to Refugees

Domestic law is typically far more restrictive toward refugees than the Refugee Convention. Even though many of the countries hosting large numbers of the world’s refugees are parties to the convention, few fully apply key rights, especially work rights. Common concerns supporting these restrictions are the fear that refugees will decrease the supply of jobs available to citizens, strain and distort an already weak labor market, reduce wages and working conditions, encourage refugees to claim citizenship, and pose security risks.<sup>191</sup>

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<sup>184</sup> 1951 Refugee Convention, *supra* note 112, art. 33. “Non-refoulement” is a prohibition on expelling or returning refugees against their will to any territories where they fear threats to life or freedom. UNHCR, *supra* note 183, at 3.

<sup>185</sup> 1951 Refugee Convention, *supra* note 112, art. 31.

<sup>186</sup> *Id.* art. 3.

<sup>187</sup> *Id.* art. 7(1).

<sup>188</sup> Grahl-Madsen, *supra* note 130, art. 7, cmt. 2.

<sup>189</sup> See *supra* note 32 and accompanying text. Grahl-Madsen, however, notes that reciprocity requirements may not apply at all if the benefits are ones that a country is prepared to grant to any alien and any number of aliens (as opposed to ones conferred on the basis of a particularly close relationship), since these are effectively a form of retaliation against the refugee’s home state, but transmitted through the refugee, who has no power to affect his home state’s policies. Grahl-Madsen, *supra* note 130, art. 7, cmt. 5.

<sup>190</sup> 1951 Refugee Convention, *supra* note 112, art. 7(2).

<sup>191</sup> Zetter & Ruauadel, *supra* note 4, at viii, xi.

Turkey is one example. The vast majority of forcibly displaced people within it do not meet the technical definition of “refugee” and thus do not have access to the rights granted by the Refugee Convention. Nevertheless, Turkey has made progress since the beginning of the Syrian refugee crisis at modifying its legal framework to extend more rights to refugees.<sup>192</sup> The refugee cities approach could help advance these efforts.

### 1. Overview of Domestic Law

The legal framework for refugees in many countries has weaknesses in terms of the ability to obtain formal status as refugees and, for those who do obtain refugee status, the protections conferred to them.<sup>193</sup> Inability to obtain formal status and protection as refugees leaves these individuals, such as Eritrean refugees in Sudan and Colombian refugees in Venezuela, vulnerable to roundups, detention, and refolement.<sup>194</sup> Refugees who are not granted formal status as refugees are sometimes given other classifications, such as temporary protection.<sup>195</sup>

Only seventy-five of the 145 states that are party to the Refugee Convention formally grant refugees the right to work.<sup>196</sup> Half of the states have declared full or partial reservations to the rights to work conferred in Articles 17–19, usually imposing similar restrictions as states not party to the Refugee Convention.<sup>197</sup> Only a few countries have refugee and labor legislation that specifically refers to a refugee’s right to work.<sup>198</sup> Others, such as Chad, Ecuador, and India, handle refugees under the same provisions applicable to foreigners generally.<sup>199</sup>

Many countries impose restrictions on the sectors refugees can work in. Prohibiting refugees from working in security and defense, as well as government employment generally, are fairly common.<sup>200</sup> Many countries go further, such as requiring that no qualified nationals be available to work in the particular sector.<sup>201</sup>

Other legal limitations supplement restrictions on the right to work, such as restrictions on owning property, mobility,

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<sup>192</sup> *See id.* at 15, 33.

<sup>193</sup> *Id.* at 11.

<sup>194</sup> *Id.* Also noting that failure to make refugee status determinations skews official counts of refugees because people who would otherwise receive refugee status are often left undocumented and thus uncounted. *Id.*

<sup>195</sup> *Id.* at 12.

<sup>196</sup> *Id.* at 4–5.

<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at 12 (noting the United States and Uganda as examples).

<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at 13.

<sup>201</sup> *Id.*

accessing credit, opening a business, opening a bank account, and entering into contracts.<sup>202</sup> Many countries restrict refugees from employment-related rights and benefits, such as social security, unemployment and disability insurance, and general labor rights, as in the case of stateless Palestinians in Jordan.<sup>203</sup>

There are exceptions. Uganda's 2006 Refugee Act provides a legal framework for refugees that is strongly oriented toward social and economic integration.<sup>204</sup> The Act aligns with the Refugee Convention and provides freedoms to work, operate businesses, access courts, receive an education, move and reside freely throughout the country, and own property.<sup>205</sup> The United States is similar.<sup>206</sup>

Beyond legal hurdles, countries' policies and practices often impose major constraints on employment.<sup>207</sup> There is significant confusion over where paperwork must be filed and whether obtaining refugee status is sufficient to work or whether an additional work permit is required.<sup>208</sup>

The processes for refugee status determinations, processing paperwork, and issuing permits and licenses are often slow, complex, costly, and burdensome.<sup>209</sup> In many countries, refugees must first obtain a job offer from an employer before they can obtain a work permit, as in Lebanon and Zambia.<sup>210</sup> Some countries are removing or simplifying these hurdles.<sup>211</sup> In 2016, for instance, Jordan provided a three-month period in which it would waive fees for twelve-month work permits for Syrian refugees, and Turkey permitted Syrian refugees to apply for work permits if they

<sup>202</sup> *Id.* at 13, 16. For example, Pakistan requires refugees to have a Pakistani partner in order to own real estate or a business. *Id.* at 13. Ecuador and Turkey limit access to financial institutions. *Id.* Bangladesh prohibits refugees from accessing credit, engaging in trade, and owning property. *Id.* Refugees in India and Sudan are prohibited from purchasing land. *Id.*

<sup>203</sup> *Id.*

<sup>204</sup> See UGANDA: THE REFUGEES ACT 2006 (May 24, 2006), <http://www.refworld.org/docid/4b7baba52.html> [<http://perma.cc/56G6-UYDF>].

<sup>205</sup> *Id.* § 29; Refugee Law Project, *Critique of the Refugees Act 3* (2006), [https://www.refugeelawproject.org/files/legal\\_resources/RefugeesActRLPCritique.pdf](https://www.refugeelawproject.org/files/legal_resources/RefugeesActRLPCritique.pdf) [<http://perma.cc/LJ4M-KZXX>]; see also WORLD BANK GROUP, AN ASSESSMENT OF UGANDA'S PROGRESSIVE APPROACH TO REFUGEE MANAGEMENT (2016) (describing and assessing the impact of the law and policy affecting refugees in Uganda).

<sup>206</sup> See Zetter & Ruaudel, *supra* note 4, at 12–13.

<sup>207</sup> See *id.* at 15.

<sup>208</sup> *Id.* at 12, 15 (observing that in the U.K. and U.S. a work permit is not necessary if a person has been determined to be a refugee, but noting how many countries are different).

<sup>209</sup> *Id.* at 15.

<sup>210</sup> *Id.*

<sup>211</sup> *Id.*

were in possession of temporary identity cards and resided in Turkey for six months.<sup>212</sup>

## 2. Turkey

Turkey currently hosts the world's largest refugee population at approximately 3.7 million as of 2017, and is a primary route for Syrians and Iraqis to reach Europe.<sup>213</sup> The EU has been providing substantial assistance to Turkey to stop illegal or informal entry of these migrants into Europe.<sup>214</sup>

Turkey is a party to the Refugee Convention, yet counterintuitively, few, if any, of its refugees are actually protected by the Convention.<sup>215</sup> This unusual situation arose from the fact that the primary impetus and focus of the Refugee Convention was the large number of displaced people in Europe after World War II.<sup>216</sup> Therefore, when the Refugee Convention was adopted, its member states had the option of limiting its scope to only people displaced by events in Europe or extending coverage to refugees from anywhere in the world.<sup>217</sup> Turkey was one of a few states that limited its scope to Europe, and expressly continued this limitation when it adopted the 1967 Protocol.<sup>218</sup> As a result, the only people technically under the protection of the Refugee Convention in Turkey are those who have fled European nations.<sup>219</sup> Nearly all of Turkey's refugee population is from non-European countries, especially Syria and Iraq.<sup>220</sup>

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<sup>212</sup> See *id.* at 15. But see Wendy Zeldin, *Turkey*, in *REFUGEE LAW AND POLICY IN SELECTED COUNTRIES* 256, 273 (The Law Library of Congress, Global Legal Research Center, Mar. 2016) (noting that, in practice, less than three percent of Syrian refugees have been issued work permits under this policy because they have been deemed "unqualified").

<sup>213</sup> European Commission, *European Civil Protection and Humanitarian Aid Operations: Turkey*, [http://ec.europa.eu/echo/files/aid/countries/factsheets/turkey\\_syrian\\_crisis\\_en.pdf](http://ec.europa.eu/echo/files/aid/countries/factsheets/turkey_syrian_crisis_en.pdf) [<http://perma.cc/RPN7-TZWA>] (last updated Jan. 10, 2018).

<sup>214</sup> *Id.*; see also, e.g., *EU-Turkey Joint Action Plan: Implementation Report* (Feb. 10, 2016), [https://ec.europa.eu/home-affairs/sites/homeaffairs/files/what-we-do/policies/european-agenda-migration/background-information/docs/managing\\_the\\_refugee\\_crisis\\_-\\_eu-turkey\\_join\\_action\\_plan\\_implementation\\_report\\_20160210\\_en.pdf](https://ec.europa.eu/home-affairs/sites/homeaffairs/files/what-we-do/policies/european-agenda-migration/background-information/docs/managing_the_refugee_crisis_-_eu-turkey_join_action_plan_implementation_report_20160210_en.pdf) [<http://perma.cc/56MS-XJQ3>] (pledging €3 million in assistance for measures aimed at curbing irregular migration); Council of the EU Press Release 144/16, EU-Turkey Statement (Mar. 18, 2016) (arranging that for every Syrian returned to Turkey from the Greek islands, one Syrian will be resettled from Turkey to the EU).

<sup>215</sup> Zeldin, *supra* note 212, at 256.

<sup>216</sup> UNHCR, *supra* note 183, at 2.

<sup>217</sup> See *id.* art. 1B(1) (providing states the option of interpreting the scope of Article 1 as applying only to persons displaced by events in Europe or in any nation).

<sup>218</sup> See UNHCR, *STATES PARTIES TO THE 1951 CONVENTION RELATING TO THE STATUS OF REFUGEES AND THE 1967 PROTOCOL* 5 (Apr. 2015) (observing that Turkey expressly maintained its declaration of geographic limitation).

<sup>219</sup> Zeldin, *supra* note 212, at 261.

<sup>220</sup> *Id.*

Nevertheless, Turkey has substantially adjusted its domestic legislation to protect refugees in recent years and collaborates with UNHCR.<sup>221</sup> The 2013 Law on Foreigners and International Protection (“LFIP”)<sup>222</sup> extended protections to categories of forcibly displaced people not meeting the strict Eurocentric definition of “refugee,” including “conditional refugees” and persons covered under “subsidiary protection” and “temporary protection.”<sup>223</sup> UNHCR works with the Ministry of the Interior to conduct status determinations and attempts to resettle refugees into third countries.<sup>224</sup> Generally speaking, the legal framework is geared to prevent integration of refugees and toward a temporary status, with eventual resettlement in a third country or repatriation as the goal.<sup>225</sup>

The LFIP created several classifications into which asylum seekers can fall. First it created the following classifications of persons entitled to “international protection status”:

- (1) Refugees, which are foreigners who, “as a result of events *occurring in European countries*,” cannot avail themselves of the protection of the country of their nationality or of former residence because of a well-founded fear of persecution for reasons of race, religion, nationality, membership of a particular social group, or political opinion.<sup>226</sup>
- (2) Conditional Refugees, which are foreigners who, “as a result of events occurring *outside European countries*,” cannot avail themselves the protection of the country of their nationality or of former residence because of a well-founded fear of persecution for reasons of race, religion, nationality, membership of a particular social group, or political opinion.<sup>227</sup>
- (3) Beneficiaries of “*subsidiary protection*,” which are foreigners who cannot qualify as a refugee or conditional refugee, but if returned to their country of origin or former residence would face the death penalty, torture, inhuman or degrading treatment, or serious threat of indiscriminate violence from armed conflict.<sup>228</sup>

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<sup>221</sup> *Id.*

<sup>222</sup> Law on Foreigners and International Protection (Law No. 6458) (Apr. 4, 2013) (Republic of Turkey) (unofficial English translation), [http://www.goc.gov.tr/files/files/eng\\_minikanun\\_5\\_son.pdf](http://www.goc.gov.tr/files/files/eng_minikanun_5_son.pdf) [<http://perma.cc/KY8Y-H3RW>] [hereinafter LFIP].

<sup>223</sup> *Id.* art. 61–63.

<sup>224</sup> Zeldin, *supra* note 212, at 261.

<sup>225</sup> As an example, refugees, conditional refugees, and beneficiaries of subsidiary protection and temporary protection are explicitly exempted from receiving long-term residence permits. LFIP, *supra* note 222, art. 42(2).

<sup>226</sup> *Id.* art. 61 (emphasis added).

<sup>227</sup> *Id.* art. 62 (emphasis added).

<sup>228</sup> *Id.* art. 63 (emphasis added).

Persons who apply for and receive international protection status must undergo lengthy procedures and are entitled to several rights specified in the LFIP.

However, given the realities of mass migration, particularly of Syrians, and the attendant difficulties of satisfying the procedural requirements of international protection applications for each one, the LFIP added an additional category—*Temporary Protection*.<sup>229</sup> Temporary protection status is more immediate than the categories of international protection and does not involve the same procedures and rights as the international protection categories.<sup>230</sup> Beneficiaries of temporary protection are those “foreigners who have been forced to leave their country, cannot return to the country that they have left, and have arrived at or crossed the borders of Turkey in a mass influx situation seeking immediate and temporary protection.”<sup>231</sup>

Syrians, who compose the vast majority of asylum seekers in Turkey, have been placed under temporary protection as a group, due to the large influx of them in recent years.<sup>232</sup> Non-Syrian asylum seekers are generally processed under one of the international protection categories by the UNHCR.<sup>233</sup>

The Temporary Protection status is further defined in the Temporary Protection Regulation.<sup>234</sup> Beneficiaries of temporary protection receive basic-needs assistance, including social services, translation services, IDs, travel documents, access to primary and secondary education, and the opportunity to receive work permits.<sup>235</sup>

People under temporary protection are typically required to live in designated reception and accommodation centers. These centers are managed by the Turkish Disaster and Emergency Management Authority and the Turkish Red Crescent, rather than by the UNHCR.<sup>236</sup> Camps reportedly have markets, reliable heating, religious services, communications infrastructure, psychosocial support, banking, and other services.<sup>237</sup> Residents are given three meals a day and electronic cards preloaded with funds for personal needs.<sup>238</sup> Residents are also covered under the

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<sup>229</sup> Zeldin, *supra* note 212, at 261–63.

<sup>230</sup> *Id.*

<sup>231</sup> LFIP, *supra* note 222, art. 91(1) (emphasis added).

<sup>232</sup> Zeldin, *supra* note 212, at 261–63.

<sup>233</sup> *Id.*

<sup>234</sup> Temporary Protection Regulation (Oct. 22, 2014) (unofficial English translation), <http://www.goc.gov.tr/files/files/tempmp.pdf> [<http://perma.cc/9V29-HQZ5>].

<sup>235</sup> *Id.* art. 26–32.

<sup>236</sup> Zeldin, *supra* note 212, at 270.

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*

country's social security and medical insurance programs.<sup>239</sup> Premium payments are at least partially covered by Turkey's Directorate General of Migration Management, though recipients are expected to contribute in full or in part in proportion to their financial means.<sup>240</sup>

Asylum seekers have limited access to the labor market. Persons who apply for international protection, as well as persons given conditional refugee status, may apply for a work permit six months after their international protection application was filed.<sup>241</sup> Persons who acquire refugee status or subsidiary protection status are automatically eligible to work, either in self-employment or regular employment, with their identity document substituting for a work permit.<sup>242</sup> However, such persons are subject to the general laws pertaining to foreign workers, which requires, among other things, for businesses to have at least five Turkish citizens as employees for every foreign worker.<sup>243</sup> Additionally, the LFIP states that refugees' and subsidiary protection beneficiaries' access to the labor market may be restricted concerning certain sectors, professions, lines of business or geographical areas for a period when necessary because of "the situation of the labor market," "developments in the working life," and employment-related "sectoral and economic conditions."<sup>244</sup> However, no such restrictions apply to refugees and subsidiary protection beneficiaries who have resided in Turkey for three years or have a spouse or children with Turkish citizenship.<sup>245</sup>

Persons under temporary protection may similarly apply for a work permit six months after being registered.<sup>246</sup> In addition to the general requirements regarding the issuance of work permits, temporary protection workers cannot make up more than ten percent of the Turkish citizens employed at a business, unless the employer can prove there is no qualified Turkish citizen in the province who can perform the job.<sup>247</sup> In practice, the government has deemed all but three percent of Syrian refugees as "unqualified" for work permits because they "do not have an identity card . . . [and their] professions are unknown."<sup>248</sup>

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<sup>239</sup> *Id.*

<sup>240</sup> *Id.*

<sup>241</sup> LFIP, *supra* note 222, art. 89(4).

<sup>242</sup> *Id.*

<sup>243</sup> *Id.*

<sup>244</sup> *Id.*

<sup>245</sup> *Id.* This exemption from labor market restrictions is analogous to Article 17(2) of the Refugee Convention, which would apply anyway to refugees. The LFIP extends the exemption to subsidiary protection beneficiaries. *Id.*

<sup>246</sup> Zeldin, *supra* note 212, at 272.

<sup>247</sup> *Id.* at 272–73.

<sup>248</sup> *Id.* at 273.

## CONCLUSION

Refugee cities provide a pathway for refugee integration and alignment with international norms in the face of political resistance to countrywide integration. They apply the most important feature of SEZs—their ability to overcome roadblocks to beneficial policy reforms—to address one of the most pressing global concerns and help countries benefit from, rather than be burdened by, migrants.

A refugee city would serve as a demonstration area where the benefits of extending international law pertaining to refugees would be tested. They would serve as a complementary pathway that helps achieve the UNHCR's objective of integrating refugees into host economies—one of its “durable solutions”—in a designated geographic area. They would also help realize the policy benefits of integrating migrants into the formal economy.

Within refugee cities, countries could extend rights to property that fulfill Article 13 of the Refugee Convention. Residents of a refugee city could have formal rights to land, such as a lease, and rights to movable property. At the same time, countries could address reluctance to make refugees permanent by setting time limits and expiration dates on leases, business licenses, or work permits. When the expiration date occurs, the country will have enabled refugees to return home on a much better footing than they would have been on otherwise.

Countries could also extend rights to work and self-employment that match Articles 17–19 of the Refugee Convention. This would mean refugees would have the most favourable treatment accorded to foreign nationals, with restrictions designed to protect the domestic labor market removed for those who have lived in the country for three years or have a spouse or children who are nationals. Alternatively, refugees could be placed on par with nationals, fulfilling the aspirations of Article 17, paragraph 3.

Refugee cities could streamline regulatory functions through dedicated regulatory authorities and one-stop shops to enable a more efficient processing of residents' status determinations and applications for work permits. These mechanisms would overcome the current backlog in countries like Turkey and others facing large refugee influxes. Refugee cities could also fulfill the blanket obligation to treat refugees with at least the same treatment as is accorded to aliens generally in Article 7 of the Refugee Convention.

For the developing countries currently hosting the overwhelming share of migrants, refugee cities would transcend the traditional refugee camp model. They would be spaces in which international legal norms align with both political realities and good policy and drive economic and social progress.



# **Emergence of a New Hanseatic League: How Special Economic Zones Will Reshape Global Governance**

*By Mark Frazier\**

## ABSTRACT

As trust dwindles in public institutions, special economic zones and free cities will have an opportunity to introduce billions of people to new systems of transparent and accountable governance. Thousands of actual experiments in “extrastatecraft”—areas benefiting from concentrated reform—are under way, creating alternatives to the surrounding rent-seeking practices of politicians, bureaucracies, and crony capitalists. Successful areas including Singapore, Dubai, and Chinese Special Economic Zones are being invited to partner in the development of new free zones in poor regions. Virtual realms also now enable such areas to massively expand access to new legal systems and asset-awakening partnerships. As mobile networks grow, zones of extrastatecraft and aligned online guilds of volunteers will be in a position to offer Blockchain-based land registries, smart contracts, eGovernance toolkits, and arbitration solutions to localities that have suffered from misrule and that have sites to commit for future free zone development. In parallel, leading city states and free zones can create virtual resources to help fill gaps for billions who have been shortchanged by public education and dysfunctional job markets. Free and open courseware, online work-study projects, and small human capital investments can help spread understanding of the culture and workings of free economies, and prepare millions of job-seekers for successful entry to rapidly growing global free

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markets for telework. Such initiatives can resolve one of the great challenges to international and national legal systems: providing a solution for the more than sixty million economic migrants, refugees, and stateless persons fleeing from breakdowns of their nation states. A new generation of World Cities—immigration-friendly areas of economic reform comparable in size to Hong Kong and Singapore—can be privately developed as havens for those who demonstrate skills and build reputations in online free markets. This article maps opportunities for a New Hanseatic League of free zones and free cities to fill voids left by dysfunctions in present systems of local, regional, and national governance. Such a network may be in a prime position to provide a legal framework for opening humanity's next great frontiers—including seasteading on the oceans and entrepreneurial communities in space—in ways compatible with current international treaties. It can introduce “nondominium” structures (aligned with Elinor Ostrom's contractual system for management of common pool resources) for humanity's common heritage frontiers, and sponsor “tokenized” commercial ventures that contractually vest all on the planet as beneficiaries of cryptocurrencies issued by entrepreneurial seasteading and spacefaring ventures.

#### INTRODUCTION

Today's systems of government are failing. Remote power centers and growing politicization of life in large nations have sparked growing movements for decentralization, autonomy, and/or independence. These movements seek to disperse concentrated political power, curb its capture by rent-seeking special interests, and reverse the plunge into untenable debt.

Opportunities are at hand for Special Economic Zones (“SEZs”) and startup societies to lead in spreading transparency and voluntary governance. As zones of “extrastatecraft,” they have become the world's most dynamic and open economies.<sup>1</sup> They have evolved as proving grounds for accountable, market-oriented alternatives in policies and institutional practice.

Yet such zones of innovation to date have fallen short in a key respect—they have done little to bring hope to billions caught in failing states or to deliver a systemic alternative to the sense of

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<sup>1</sup> Keller Easterling, *Zone: The Spatial Softwares of Extrastatecraft*, PLACES J. (June 2012), <https://placesjournal.org/article/zone-the-spatial-softwares-of-extrastatecraft/> [<http://perma.cc/26NT-K8FT>].

decline that pervades many national and multilateral institutions. A growing need exists for entrepreneurial areas of policy reform and technological innovation to link up and lay the groundwork to bring transparent rule of law and new kinds of economic opportunity within reach of all on the planet.

To explore how this scenario can practically unfold, it is useful to go back eight centuries to the early days of the Hanseatic League, a self-organizing network of free zones and free cities that endured for centuries and enabled much of Northern Europe to flourish. An updated version of the Hanseatic League open to participants across the globe can advance systemic changes in governance at all levels. In coming years, it could prepare tools for self-governance in voluntary communities and lay groundwork for new transcultural, immigration-friendly World Cities to cope with rising flows of migrants and refugees. And as entrepreneurs bring breakthrough technologies to market, a New Hanseatic League could offer a transnational framework for creating startup societies on the oceans and in space.

## I. THE HANSEATIC LEAGUE

### A. Origins and Growth of the Hanseatic League

Threats abounded in the Baltic and the North Sea during the twelfth century. Merchants attempting to travel on sea or land regularly came under threat from robbers, pirates, feudal lords, and tribal monarchs. Local rulers across Northern Europe often were bent on confiscating goods or exacting tributes. Merchants who tried to travel alone were fair game.<sup>2</sup>

In response, they began to organize convoys or troops—“Hanse” in Middle Low German—on trade routes across the region.<sup>3</sup> As losses to robbers and pirates fell, merchants grew more prosperous. Negotiated agreements with local rulers also conferred a measure of security for storage and movements of goods. One local lord in Northern Germany, Henry the Lion, exempted the merchants in Lübeck—a recently-established town with excellent access to the Baltic—from paying taxes throughout

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<sup>2</sup> I have relied on several works on the formation of the Hanseatic League for the background of this Part. See generally J.D. COLVIN, *THE GERMANS IN ENGLAND: 1066-1598* (1971); PHILIPPE DOLLINGER, *THE GERMAN HANSA* (1970); GEOFFREY PARKER, *SOVEREIGN CITY* (2004); T.H. LLOYD, *ENGLAND AND THE GERMAN HANSE* (1991); and HELEN ZIMMERN, *THE HANSA TOWNS* (2016).

<sup>3</sup> “Hansa” is the modern German term.

his realm.<sup>4</sup> Another boost came in 1181, when the Holy Roman Emperor, Barbarossa, designated the new town as a free and Imperial City.<sup>5</sup> This interim legal standing was reaffirmed by Emperor Frederick II in 1226, giving Lübeck an enduring shield to ward off the attentions of revenue-seeking nobles, and to effectively become a self-governing community.<sup>6</sup> Merchants of Lübeck used the municipality's status as a free city to negotiate trade agreements with the autonomous counterpart cities of Hamburg and Bremen, whose policies were also largely shaped by merchant guilds.<sup>7</sup> Their agreements to remove barriers to trade and to standardize weights and measures, including precious metal content in coinage, gave a boost to profits and helped spread Hanseatic trade across the Baltic and beyond.

In the largely Slavic-populated regions to the East, merchants from Hanseatic cities established new trade centers open to all guild members in good standing from their respective communities. These commercial outposts were often set up in the wake of conquests by Teutonic Knights determined to extend Christianity at swords' point. Yet for the larger areas surrounding the Baltic, as well as for those with ports on the North Sea, Hanseatic merchants spread a network of low-tax or tax-free trade zones through negotiated agreements with local authorities, rather than through military means. The appeal of trade relationships, and the negotiating skills and gifts of Hanseatic merchants, convinced many local rulers to designate areas for Hanseatic guild members to do business without imposing onerous taxes or arbitrary regulations. From the thirteenth to fifteenth centuries, the network of Hanseatic trade outposts grew to as many as 170 communities, ranging from Novgorod in Russia, to London in England, and Bruges in Belgium.

These zones enabled Hanseatic merchants to readily import grains, wax, fish, metal ores, and other raw materials from areas around the Baltic, and exchange them for textiles, apparel, and manufactured items produced in the Western European cities affiliated with the League.<sup>8</sup> Their success in long distance trade prompted new communities to join. It also inspired youths to enter into years of challenging apprenticeships to absorb Hanseatic skills and culture and earn their way into full-fledged membership

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<sup>4</sup> See ZIMMERN, *supra* note 2, at 318–19.

<sup>5</sup> See *id.* at 73.

<sup>6</sup> See *id.* at 73–74.

<sup>7</sup> See *id.* at 182.

<sup>8</sup> THE HANSE IN MEDIEVAL AND EARLY MODERN EUROPE 6 (Justyna Wubs-Mrozewicz & Stuart Jenks eds., 2013).

in the guilds of their respective cities. Once accepted, they were free to independently do business with other members and become co-owners of cargos and vessels.

Town-based merchant guilds were at the center of Hanseatic economic and social activity. Historian Justyna Wubs-Mrozewicz has summarized them as “non-hierarchical, bottom-up organizations of traders . . . [where] membership was voluntary, based on equality among all members and sealed by an oath.”<sup>9</sup> The basic rule for guild members was to “help each other in plight.”<sup>10</sup> Members strove to stay in good standing with their peers by exchanging useful information, keeping promises and fostering relationships based on honest trade, and using informal systems to resolve internal tensions and conflicts.

Hanseatic scholar Margrit Schulte Beerbühl has described the Hanseatic League as a:

[L]ate-medieval network of economically largely independent long-distance trade merchants which was based on trust, reputation and reciprocal relations. The informal cooperation among its members kept transactional, informational and organizational costs low, allowing the Hanse merchants to make good profits from the long-distance trade between the Baltic and the North Seas.<sup>11</sup>

Another German economic historian, Alexander Fink, has argued that the Hanse, overall, can be understood as a confluence of functionally overlapping and competing jurisdictions, whose fluidity enabled members to interact and adapt to circumstances faster than hierarchical political structures.<sup>12</sup>

Legal advances contributed to the growth of Hanseatic commerce. The town of Lübeck, whose governing council remained dominated by merchants, set new standards for procedural laws regarding trade, contracts, and dispute resolution. “Lübeck Law” grew to be widely admired and was adopted in whole or in part by other Hanseatic communities.<sup>13</sup> Over time, merchant customs as practiced in Lübeck and other Hanseatic cities came to be codified as elements within the branch of private international law known

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<sup>9</sup> *Id.* at 8.

<sup>10</sup> *Id.* at 9.

<sup>11</sup> Margrit Schulte Beerbühl, *Networks of the Hanseatic League*, EUROPEAN HIST. ONLINE (Jan. 13, 2012), <http://www.ieg-ego.eu/schultebeerbuehlm-2011-en> [<http://perma.cc/6UFH-AF66>].

<sup>12</sup> See generally Alexander Fink, *The Hanseatic League and the Concept of Functional Overlapping Competing Jurisdictions*, 65 KYKLOS 194 (2012).

<sup>13</sup> See ZIMMERN, *supra* note 2, at 151.

as *Lex Mercatoria*, or merchant law.<sup>14</sup> The impartiality of Lübeck's arbitration services also contributed to the city's enduring place as the de facto leader of the Hanseatic League.

To expand their markets, the Hanseatic League cities honed diplomatic skills over four centuries. Their tactics included making gifts and strategically timed loans to rulers in return for tax-free trading privileges.<sup>15</sup> Loans from Hanseatic merchants were vital to the success of various English monarchs. In 1317, King Edward II reaffirmed that Hanseatic merchants would be free of taxes, trade regulations, and travel restrictions applied to other foreign traders.<sup>16</sup> As historian T.H. Lloyd noted, "[n]ot only did Edward II confirm the grants of his predecessors and his own award of immunity from arrest but, for the first time, he conceded that neither he nor his heirs would place new impositions on the Hanse without its consent."<sup>17</sup> (English merchants, by contrast, had to pay certain taxes from which their Hanseatic competitors were exempt.) Trade monopolies negotiated by the League with many rulers in Scandinavia went even further by securing agreements that denied or severely limited their competitors' access to key markets. In Norway, Sweden, and other areas, local rulers acceded to the League's demand to ban or restrict other foreign merchants from doing business in highly profitable commodities.<sup>18</sup>

Boycotts were the League's means of choice for punishing countries and cities that moved to break agreements with Hanseatic merchants. When negotiated trade concessions came under threat or merchant cargos were confiscated without cause, the League called meetings of member cities to vote on imposing trade sanctions upon the offenders.<sup>19</sup> Throughout much of the League's history, such measures proved highly effective in reaffirming the trade privileges and securing restitution for damages.

Participation in boycotts was voluntary on the part of Hanseatic communities. No political authority existed in the League to force member cities to abide by the majority decision.

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<sup>14</sup> Klaus Peter Berger, *The Lex Mercatoria and the TransLex-Principles*, TRANS-LEX, [https://www.trans-lex.org/the-lex-mercatoria-and-the-translex-principles\\_ID8](https://www.trans-lex.org/the-lex-mercatoria-and-the-translex-principles_ID8) [<http://perma.cc/QC2T-V767>].

<sup>15</sup> See T.H. LLOYD, ENGLAND AND THE GERMAN HANSE, 1157–1611: A STUDY OF THEIR TRADE AND COMMERCIAL DIPLOMACY 319 (1991).

<sup>16</sup> *Id.* at 27–28.

<sup>17</sup> *Id.* at 27.

<sup>18</sup> See *id.* at 54.

<sup>19</sup> See *id.* at 40.

However, the majority could and often did punish communities that took action contrary to the League's decisions, through expulsion (or "unhansing").<sup>20</sup> In this case, merchants of the ostracized community lost access to the favorable commercial agreements and trade outposts negotiated by the League, to the benefit of the League's protective services, and to any right to do business with Hanseatic merchants in good standing. In cases where individual members of Hanseatic guilds abrogated an agreement, hearings would be held by guild appointed arbitrators, or by local courts in the Hanseatic cities. Any members who were found in breach of the local guild's code were expelled from the guild—and similarly unhansed across the League.<sup>21</sup>

These measures were sustained despite the exceptionally ambiguous legal and political character of the Hanseatic League. England's King Edward IV, under pressure from English merchants who chafed at the concessions given by his predecessors to the Hanseatic traders, imprisoned Hanseatic merchants and expropriated their goods in retaliation for the League's suspected collusion with Danish privateers to stop English attempts to trade in the Baltic.<sup>22</sup> As summarized by Professor Rainer Postel of Bundeswehr University, King Edward IV justified his action on the ground that the League was "a society, cooperative or corporation, originating from a joint agreement and alliance of several towns and villages, being able to form contracts and being liable as joint debtors for the offences of single members."<sup>23</sup> Lübeck sharply disagreed. In Postel's account, Lübeck maintained that the Hansa was neither a society nor a corporation on the grounds that it:

[O]wned no joint property, no joint till, no executive officials of their own; it was a tight alliance of many towns and communities to pursue their respective own trading interests securely and profitably. The Hansa was not ruled by merchants, every town having its own ruler. It also had no seal of its own, as sealing was done by the respective issuing town. The Hansa had no common council, but discussions were held by representatives of each town. There even was no obligation to take part in the Hansa meetings and there were no means of coercion to carry through their decisions. So, according to the Lübeck syndic [advocate], the Hansa could not be defined by Roman law and was not liable as a

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<sup>20</sup> ZIMMERN, *supra* note 2, at 29.

<sup>21</sup> *See id.* at 206.

<sup>22</sup> *See* Rainer Postel, Professor, Bundeswehr Universität, Address at Central Connecticut State University: The Hanseatic League and its Decline (Nov. 20, 1996).

<sup>23</sup> *Id.*

body. This was in fact correct and deliberately ambiguous; the Hansa was frequently urged to give a self-definition as well as the exact number of its members and deliberately left all this unclear.<sup>24</sup>

When Edward IV refused to free the Hanseatic merchants he had imprisoned and declined to restore their property, the League launched a boycott and assembled a powerful naval force in the Anglo-Hanseatic War.<sup>25</sup> The war ended in 1474 with a decisive victory by the League, which had crippled English commercial shipping. The Treaty of Utrecht confirmed restoration of the London Steelyard as a tax-free base for Hanseatic merchant guilds and brought about a virtual halt to English trade in the Baltic region.<sup>26</sup>

#### B. Reasons for the League's Demise

Although the Hanseatic League had done much to create policies for its member merchants to prosper, challenges worsened as the sixteenth and seventeenth centuries unfolded. Some of these were self-inflicted. Agreements among members of Hanseatic guilds—originally focused on setting standards for weights and measures, on the precious metal content of coinage, and on the quality of traded goods—mutated into complex requirements to restrict entry into the guilds, to fix prices, and limit supply of monopolized goods to drive up prices.<sup>27</sup> While such moves benefited incumbent merchants in the short term, they also discouraged, over time, the entry of new members into Hanseatic merchant guilds.

A larger reason for the erosion of the League was a rising resentment of one-sided tax and trade concessions. Hanseatic guilds were unwilling to open their membership to foreign merchants, or to allow open trade by foreign merchants with the League's member cities.<sup>28</sup> With the exception of Dinant, a small town with strong economic ties to Cologne, the League excluded all non-German speaking guilds from joining. Hanseatic insistence on exclusionary entry policies blocked merchants of non-German origins from access to a network of highly profitable tax-free trade concessions. The discrimination was also often backed by municipal ordinances in towns where Hanseatic merchants

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<sup>24</sup> *Id.*

<sup>25</sup> See M.M. POSTAN, *MEDIEVAL TRADE AND FINANCE* 101 (1978).

<sup>26</sup> See *id.*

<sup>27</sup> See Erik Lindberg, *Club Goods and Inefficient Institutions: Why Danzig and Lübeck Failed in the Early Modern Period*, 62 *ECON. HIST. REV.* 604, 612–13 (2009).

<sup>28</sup> See *id.*



dominated town councils.<sup>29</sup> As economic historian Erik Lindberg has written of two leading Hanseatic communities (Lübeck and Danzig):

The infamous ‘guest-rights’ legislation in the Hansa towns prohibited trade between non-Hanseatic merchants in the Hansa towns. Restrictions on the periods when foreigners were allowed to stay in the towns represented another cornerstone in the prohibitive legislation that characterized Hansa mercantile practices . . . . The long-term results for the two cities under scrutiny were stagnation and an increasingly marginal position in the European urban network.<sup>30</sup>

Foreign rivals in response stepped up their forays into the North Sea and the Baltic. Merchants from Holland and England, who long had been shut out of trading opportunities with cities in the Hanseatic trade network, grew especially bold as the Treaty of Utrecht fell into disregard. They did so by forging commercial links to communities that had left the League or were tenuously associated with it, by encouraging privateering and piracy against Hanseatic ships, and by deepening relationships with increasingly powerful monarchs across the region who had grown weary of Hanseatic trade monopolies.<sup>31</sup>

Holland dealt a further blow to the privileges of Hanseatic merchants. Instead of negotiating trade agreements that favored one foreign partner over another, Dutch cities began to experiment with introducing more open systems. Rulers of these cities, as described by Cambridge historian Sheilagh Ogilvie, discovered that wealth grew far faster by establishing generally welcoming environments for businesses, rather than setting rules that favored particular blocs of foreign merchants.<sup>32</sup> The rising Dutch cities of Amsterdam and Antwerp, in particular, became known for their embrace of open trade and immigration policies, as well as religious pluralism.<sup>33</sup> Their openness to free trade drew an influx of entrepreneurial talent, investors, and traders that eclipsed those of the leading Hanseatic cities, including Lübeck, Hamburg, and Bremen.<sup>34</sup>

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<sup>29</sup> *See id.* at 626.

<sup>30</sup> *Id.*

<sup>31</sup> OSCAR GELDERBLUM, *CITIES OF COMMERCE: THE INSTITUTIONAL FOUNDATIONS OF INTERNATIONAL TRADE IN THE LOW COUNTRIES, 1250–1650*, at 179 (2013); *see also generally* A COMPANION TO THE HANSEATIC LEAGUE (Donald J. Harreld ed., 2015).

<sup>32</sup> *See* SHEILAGH OGILVIE, *INSTITUTIONS AND EUROPEAN TRADE: MERCHANT GUILDS 1000–1800*, at 32, 211 (2011).

<sup>33</sup> *See id.* at 211, 399.

<sup>34</sup> *See id.* at 183, 211, 399.

As Dutch cities were confirming the value of open trade policies, English rulers again moved to overturn long-standing agreements that privileged merchants of the Hanseatic League. Queen Elizabeth of England, in 1598, ended all Hanseatic trade preferences and closed the Steelyard in London, where German merchants had owned and operated a tax-free zone for centuries.<sup>35</sup> Although the Steelyard site was returned several years later to Hanseatic guilds, merchants operating there henceforth no longer enjoyed special freedoms from taxation.<sup>36</sup> A further setback followed a few decades later with the signing of the Treaty of Westphalia in 1648.<sup>37</sup> The Treaty brought to an end the religious wars that had consumed much of Europe, affirmed the boundaries of newly powerful nation states, and enshrined their respective rights to control communities and economic activity within their borders.

The commercial ascendancy of free and highly autonomous Hanseatic cities was coming to a close. By the mid 1600s, only a small number of Hanseatic cities actively identified as members of the League. They held their last general meeting in 1687. Over the course of the following centuries, although they continued to identify as Hanseatic cities, the League's flagship communities of Lübeck, Bremen, and Hamburg were politically absorbed as states of Bismarck's Germany.<sup>38</sup>

Europe's newly sovereign nation states, meanwhile, were growing eager for overseas territorial and commercial gains. Merchant guilds of England—beginning with the Merchants Adventurers, which had originally been formed to counter Hanseatic League successes, and its successors, including the East India Company—established foreign trade outposts and consolidated colonies overseas.<sup>39</sup> Applying the free trade concepts advanced by Adam Smith, British trading companies and colonial administrators planted seeds in the 1800s for prosperous new freeports and tax-free trade zones in Singapore, Hong Kong, and Aden in the Middle East. These, like the Dutch open cities before them, became flourishing havens for commerce.

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<sup>35</sup> ZIMMERN, *supra* note 2, at 350–51.

<sup>36</sup> *Id.* at 353.

<sup>37</sup> *Id.* at 364.

<sup>38</sup> *See id.* at 375.

<sup>39</sup> *Id.* at 30.

## II. THE RESURGENCE OF CITY STATES AND STARTUP COMMUNITIES

Let us return to the present. Once-confident nation states are ailing. In many cases their bureaucracies have grown increasingly detached from their people even as programmatic aims and budgets have expanded. Corruption and brazen favor-giving have intensified distrust of politicians, national governments, and state-funded international organizations. Torrential innovation is leaving slow-moving organizations far behind in realizing potentials of new technologies. Overseas, exhausting assertions of force and aid by superpowers have failed to establish durable regimes in areas with failed and failing states. As people around the world gain wider access to information, they have been reaching their own conclusions regarding the efficacy of global, national, and local institutions.

Against this backdrop, cities are re-emerging as drivers of opportunities and hope. The late Benjamin Barber, author of *If Mayors Ruled the World*, has noted: “More than 50 % [sic] of the world’s population lives in cities. Cities produce more than 80 % [sic] of GDP. It is therefore inconceivable that national and international bodies discuss and decide on policy actions without cities and their mayors present at the table.”<sup>40</sup>

Parag Khanna, a senior research fellow at the National University of Singapore, has gone farther. In *Connectography*, Khanna writes:

In a world that increasingly appears ungovernable, cities—not states—the islands of governance on which the future world order will be built. Cities are humanity’s real building blocks because of their economic size, population density, political dominance, and innovative edge. They are real “facts on the ground,” almost immeasurably more meaningful to most people in the world than often invisible national borders. In this century, it will be the city—not the state—that becomes the nexus of economic and political power.<sup>41</sup>

Bruce Katz of the Brookings Institution concurs:

We’re entering a period where cities have new kinds of power. They have enormous chances to leverage their economic and financial advantages to augment their position and effect change . . . . Cities are not subordinate to nation-states, they are powerful networks of

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<sup>40</sup> *Mission Statement: Global Parliament of Mayors*, GLOBAL PARLIAMENT OF MAYORS (2017), <https://globalparliamentofmayors.org/mission-statement/> [<http://perma.cc/67ME-CP22>].

<sup>41</sup> Parag Khanna, *When cities rule the world*, MCKINSEY & CO. (Feb. 2011), <https://www.mckinsey.com/global-themes/urbanization/when-cities-rule-the-world> [<http://perma.cc/X9C5-2HUD>].

institutions and actors that co-produce the economy. Power in the 21st [sic] century belongs to the problem-solvers. National governments debate and mostly dither. Cities act, cities do.<sup>42</sup>

Katz concludes that “[p]ower increasingly comes from the cities up, not handed down from the nation-state.”<sup>43</sup>

#### A. SEZs and Autonomous Cities

As today’s nation states falter, autonomous city states and SEZs are moving to the forefront as proving grounds for policy innovation and institutional reform. As noted by Yale professor Keller Easterling, areas offering highly liberalized environments have soared in number in the postwar era from 600 in 1976 by the count of Walter Diamond,<sup>44</sup> to at least 3500.<sup>45</sup> Today, zones that offer concentrated relief from tax, regulatory, and trade barriers account for tens of millions of jobs and the majority of the export earnings in a number of developing countries. In spatial configuration, zones range from footprints as small as several floors of a single office building, to campus-style industrial and office parks of hundreds of acres, and up to free economic zones with cities or “regiopolis” areas that span from hundreds to thousands of square kilometers.

The dynamism of Hong Kong and Singapore, which occupy over 1100 square kilometers and 718 square kilometers respectively,<sup>46</sup> has inspired developers to zones of extrastatecraft in many settings. By establishing what are widely deemed to be among the world’s most transparent and free market economies, Asia’s most prominent freeports have moved from low-wage manufacturing to become among the most advanced, diversified, and prosperous cities in the world.<sup>47</sup> While their annual per capita income levels in 1965 were less than \$700 in terms of today’s dollars, they now stand at more than \$56,000 in Singapore and

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<sup>42</sup> Jamie Bartlett, *Return of the city-state*, AEON (Sept. 5, 2017), <https://aeon.co/essays/the-end-of-a-world-of-nation-states-may-be-upon-us> [<http://perma.cc/7WSZ-EPWJ>] (quoting Bruce Katz, Centennial Scholar at the Brookings Institution).

<sup>43</sup> *Id.*

<sup>44</sup> WALTER DIAMOND, *TAX-FREE TRADE ZONES OF THE WORLD* (Matthew Bender ed., 1976).

<sup>45</sup> Easterling, *supra* note 1.

<sup>46</sup> See *The World Factbook: Hong Kong*, CIA, <https://www.cia.gov/library/publications/the-world-factbook/geos/hk.html> (last updated Mar. 5, 2018); see also *The World Factbook: Singapore*, CIA, <https://www.cia.gov/library/publications/the-world-factbook/geos/sn.html> (last updated Feb. 22, 2018).

<sup>47</sup> Chuang Peck Ming, *Singapore Ranks 2nd in Ease of Doing Business*, BUS. TIMES (Oct. 27, 2016, 5:50 AM), <http://www.businesstimes.com.sg/government-economy/singapore-ranks-2nd-in-ease-of-doing-business> [<http://perma.cc/7268-YUZ6>].

over \$40,000 in Hong Kong.<sup>48</sup> Both freeports have substantially overtaken per capita incomes of their former colonial ruler, the United Kingdom.<sup>49</sup>

Singapore's economic success also has opened the door for it to embark on overseas joint ventures in free economic zone development. In the 1990s, Singapore prime minister Lee Kuan Yew announced a vision of creating up to a dozen "little Singapores" around the world, through real estate partnerships, to replicate the Singapore model.<sup>50</sup> Its subsequent joint ventures in China have included the development of a sixty-eight square kilometer Singapore-Suzhou Industrial Park and a similar joint venture for Guangzhou Knowledge City.<sup>51</sup> Singaporean private investors are also funding the development of a Health City in Gaobeidian, China, at a location which has just been designated as a SEZ.<sup>52</sup> Designation of Health City as a SEZ tripled property values overnight in the adjacent residential areas.<sup>53</sup> Singapore also has reached agreement with Jamaica to establish its first SEZ venture in the Caribbean.<sup>54</sup>

Hong Kong has had an even greater impact in spreading SEZs. Its economic progress in postwar decades stood in stark contrast to that of Mao's China. In the late 1970s, Deng Xioping, Mao's successor, moved to replicate Hong Kong's success by instituting business friendly reforms (including a business tax

<sup>48</sup> Gary Cheung, *Frenemy Cities*, S. CHINA MORNING POST, <http://www.scmp.com/news/hong-kong/economy/article/1847695/hong-kong-and-singapores-transformations-story-both-rivalry> [<http://perma.cc/7KK4-5N3T>] (last updated July 6, 2017, 11:13 PM).

<sup>49</sup> Singapore's and Hong Kong's lead over Britain holds both by measures of nominal GDP per capita and by measures of purchasing power parity adjusted GDP per capita. *Projected GDP Ranking (2016-2020)*, STATISTICS TIMES (Dec. 16, 2016), <http://statistics.times.com/economy/projected-world-gdp-ranking.php> [<http://perma.cc/NZ9Q-Z2JY>].

<sup>50</sup> See Mark Frazier, *What's next for the special economic zones*, CAYMAN FIN. REV. (July 12, 2013), <http://www.caymanfinancialreview.com/2013/07/12/whats-next-for-the-special-economic-zones/> [<http://perma.cc/GKD6-WDT7>]; see also Narendra Aggarwal, *Spore-China ties reach new heights*, BUS. TIMES (Nov. 6, 2015, 5:50 AM), <http://www.businesstimes.com.sg/hub/business-china-special/spore-china-ties-reach-new-heights> [<http://perma.cc/VCB4-L3L8>].

<sup>51</sup> See *id.*

<sup>52</sup> P.C. Lee, *JV Partners Say China's Latest SEZ Likely to Have 'Positive Impact' on Gaobeidian Project*, EDGE (Apr. 4, 2017, 6:54 PM), <https://www.theedgesingapore.com/article/jv-partners-say-china%E2%80%99s-latest-sez-likely-have-%E2%80%98positive-impact%E2%80%99-gaobeidian-project> [<http://perma.cc/72XC-8FUX>].

<sup>53</sup> Goola Warden, *How KSH Hit the Jackpot with China's Newest SEZ*, EDGE (Apr. 13 2017, 11:58 AM), <https://www.theedgesingapore.com/article/how-ksh-hit-jackpot-china%E2%80%99s-newest-sez> [<http://perma.cc/V53R-H42J>].

<sup>54</sup> Office of the Prime Minister, *GOJ Partners with Singapore to Develop Special Economic Zone*, JAM. INFO. SERV. (Jan. 26, 2017), <http://jis.gov.jm/goj-partners-singapore-develop-special-economic-zone/> [<http://perma.cc/RN57-94BK>].

rate of fifteen percent, about ten percent lower than that of Hong Kong) in four initial SEZ areas. The first of these was launched in 1979 in an area of 327 square kilometers along the Pearl River near Hong Kong.<sup>55</sup> Shenzhen, originally a fishing village with a population numbering less than 10,000, became the epicenter of a profound success. Today, this SEZ has a population of more than eleven million and has expanded in size to almost 2000 square kilometers.<sup>56</sup> Shenzhen's favorable policy conditions, location, and labor productivity have transformed it into the world's leading location for electronics manufacturing—the “Silicon Valley of hardware.”<sup>57</sup> As World Bank Chief Economist Paul Romer has noted, Hong Kong played a pivotal role in inspiring Beijing to designate scores of SEZs, free trade zones, and open cities—and from there to liberalize the Chinese economy as a whole.<sup>58</sup>

Having transformed China's own economy, SEZs also are now a strategic element in China's moves to make infrastructure investments on a global scale. The “Belt and Road Initiative” launched by China's paramount leader Xi Jinping in 2013,<sup>59</sup> including a projected \$4 to \$8 trillion in loans and direct investment from China, aims to fund construction of a world-class network of road and rail links throughout Asia and into Europe and the Middle East.<sup>60</sup> The plan also calls for a “maritime Silk Road” connecting with ports in Oceania, Africa and beyond.

As many as 100 new Chinese-backed SEZs are expected to stimulate commerce along these new corridors. In recent years, China has become a major investment partner in two Vietnamese SEZs, and a Chinese-funded SEZ employing 16,000 employees is also operating in Cambodia, on a trajectory to grow to 100,000

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<sup>55</sup> Ann Fenwick, *Evaluating China's Special Economic Zones*, 2 INT'L TAX & BUS. L. 376, 376 (1984).

<sup>56</sup> See Ben Bland, *Shenzhen, China, a Silicon Valley of Hardware*, FIN. TIMES (May 6, 2016), <https://www.ft.com/content/2c38ccb8-0ad8-11e6-b0f1-61f222853ff3>.

<sup>57</sup> *Comparative study on Special Economic Zones in Africa and China* 49 (United Nations Development Programme, Working Paper No. 06.2015, 2015), [https://issuu.com/undp-china/docs/undp-ch-comparative\\_study\\_on\\_sezs\\_i](https://issuu.com/undp-china/docs/undp-ch-comparative_study_on_sezs_i) [<http://perma.cc/5U47-644S>]; see also Bland, *supra* note 56.

<sup>58</sup> Paul Romer, Chief Economist and Senior Vice President of the World Bank, TEDGlobal Talk: Why the World Needs Charter Cities (July 2009).

<sup>59</sup> Jason Lee, *Belt and Road promotes growth of Cambodia's special economic zone*, BELT & ROAD PORTAL (Apr. 28, 2017), <https://eng.yidaiyilu.gov.cn/qwyw/rdxw/12004.htm> [<http://perma.cc/9R7K-L4GX>].

<sup>60</sup> David Ho, *Cost of funding 'Belt and Road Initiative' is daunting task*, S. CHINA MORNING POST (Sept. 27, 2017, 4:45 PM), <http://www.scmp.com/special-reports/business/topics/special-report-belt-and-road/article/2112978/cost-funding-belt-and> [<http://perma.cc/WA4L-LHE4>].

employees.<sup>61</sup> China is now negotiating to partner in similar SEZ projects to be launched in Myanmar<sup>62</sup> and Bangladesh, with the latter venture linked to construction of a \$700 million tunnel.<sup>63</sup> In Pakistan alone, China is planning partnerships to establish up to forty-six new SEZs.<sup>64</sup> A China-backed \$10 billion SEZ project oriented towards transshipment has been launched in Oman in the Middle East.<sup>65</sup> In Africa, Djibouti has opted to ally with China for development of ports and free zones.<sup>66</sup> China also has entered into SEZ development projects in six other African countries, most notably in Nigeria, Zambia, and Ethiopia<sup>67</sup>

Private sector Chinese land developers have also been seeking out opportunities in overseas SEZs. At the doorstep of Singapore, Malaysia's Iskandar SEZ hosts a new private community called Forest City.<sup>68</sup> China-based Country Garden Holdings has reached into an agreement with influential Malaysian counterparts to develop a \$100 billion startup community on four reclaimed islands totaling over thirteen square kilometers in Malaysia's Johor State.<sup>69</sup> To date, about 16,000 properties have been sold, primarily to Chinese citizens seeking to purchase overseas condominiums, single family homes in covenant-backed homeowners associations, and/or freehold land.<sup>70</sup> The ultimate aim is a private community

<sup>61</sup> Lee, *supra* note 59.

<sup>62</sup> *CITIC-led consortium wins bid for implementing SEZ in Myanmar*, CHINA DAILY (Dec. 31, 2015, 10:39 AM), [http://www.chinadaily.com.cn/business/2015-12/31/content\\_22882073.htm](http://www.chinadaily.com.cn/business/2015-12/31/content_22882073.htm) [<http://perma.cc/GG7W-JYX3>].

<sup>63</sup> Humayan Kabir, *Special Economic Zone (SEZ) for Chinese industries*, BUS. INTELLIGENCE BANGL., <http://bibd.info/special-economic-zone-sez-for-chinese-industries/> [<http://perma.cc/2ARY-ATWS>].

<sup>64</sup> Fawad Maqsood, *Government planning to establish 46 SEZs along CPEC route*, BUS. RECORDER (July 18, 2017), <http://www.brecorder.com/2017/07/18/359937/govt-planning-to-establish-46-sezs-along-cpec-route/>.

<sup>65</sup> Wade Shepard, *Why China Is Building A New City Out In the Desert of Oman*, FORBES (Sept. 8, 2017, 6:35 PM), <https://www.forbes.com/sites/wadeshepard/2017/09/08/why-china-is-building-a-new-city-out-in-the-desert-of-oman/#2d848bd26b2f>.

<sup>66</sup> Bashir Goth, *Africa's Singapore is Slowly Taking Shape*, GULF NEWS (July 22, 2017, 5:00 PM), <http://gulfnews.com/opinion/thinkers/africa-s-singapore-is-slowly-taking-shape-1.2062649> [<http://perma.cc/4QRT-P8GA>].

<sup>67</sup> *Comparative study on Special Economic Zones in Africa and China*, *supra* note 57.

<sup>68</sup> See Leanna Garfield, *Drone footage reveals what Malaysia's new \$100 billion 'dream paradise' city looks like*, BUS. INSIDER (May 10, 2017, 10:50 AM), <http://www.businessinsider.com/forest-city-malaysia-chinese-ghost-city-2017-5> [<http://perma.cc/Q27V-4ULJ>].

<sup>69</sup> Sarah Moser, *Forest city, Malaysia, and Chinese expansionism*, URB. GEOGRAPHY 1, 3 (2017).

<sup>70</sup> Aradhana Aravindan, *China Curbs Challenge \$100 billion Forest City's Malaysia Home Sales*, REUTERS (Aug. 4, 2017, 1:08 AM), <https://www.reuters.com/article/uk-forest-city-strategy/china-curbs-challenge-100-billion-forest-citys-malaysia-home-sales-idUKKB N1AK0QP> [<http://perma.cc/M6XS-D8MJ>].

with 700,000 residents and tourists.<sup>71</sup> Although recently-imposed Chinese foreign exchange restrictions have dampened purchases by their citizens of overseas real estate, Country Garden has responded by broadening its marketing effort to attract investors and homebuyers from around the world.

In the Middle East, Dubai has had an impact upon neighboring countries comparable to that of Hong Kong and Singapore. Given its relative lack of oil reserves, Dubai began during the 1980s to shift to a focus on SEZs, beginning with Jebel Ali Free Zone in 1985.<sup>72</sup> It since has designated two dozen specialized free zones that cater to a spectrum of industries.<sup>73</sup> Today, Dubai and other areas in the United Arab Emirates rank as the freest business environments in the region.<sup>74</sup> In addition to offering tax-free zones, Dubai levies no personal income taxes, and has instituted one of the world's most liberal visa policies for visitors, investors, and employer-sponsored workers.<sup>75</sup> Dubai also has established an "[a]lternative [j]udiciary" that enables financial services companies to operate under a parallel court system based on Common Law precedents of Great Britain, and is overseen by retired British judges.<sup>76</sup>

The city state's rapid rise to become one of the world's top tourism, logistics, and financial service centers has prompted neighboring countries to establish competing free economic zones, including Abu Dhabi, Sharjah, Qatar, and Ajman.<sup>77</sup> In the fall of 2017, Saudi Arabia's Crown Prince Mohammed Bin Salman committed the Kingdom to move to the front rank in SEZs, surpassing Dubai in many key respects.<sup>78</sup> He announced NEOM,

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<sup>71</sup> Pooja Thakur Mahrotri & En Han Choong, *\$100 Billion Chinese-Made City Near Singapore 'Scares the Hell Out of Everybody'*, BLOOMBERG NEWS (Nov. 21, 2016, 1:00 PM), <https://www.bloomberg.com/news/features/2016-11-21/100-billion-chinese-made-city-near-singapore-scares-the-hell-out-of-everybody> [<http://perma.cc/5J2S-US4R>].

<sup>72</sup> PKF ACCOUNTANTS & BUSINESS ADVISERS, *FREE ZONES IN THE UNITED ARAB EMIRATE 2* (2015), [http://pkfuae.com/pdf/FreeZones\\_in\\_UAE\\_2015.pdf](http://pkfuae.com/pdf/FreeZones_in_UAE_2015.pdf) [<http://perma.cc/Y6RU-J9RT>].

<sup>73</sup> *Id.*

<sup>74</sup> See Babu Das Augustine, *UAE leads Arab Region in World Bank's Ease of Doing Business Ranking*, GULF NEWS BANKING (Oct. 31, 2017, 19:17 PM), <http://gulfnews.com/business/sectors/banking/uae-leads-arab-region-in-world-bank-s-ease-of-doing-business-ranking-1.2116541> [<http://perma.cc/NP2R-ZA4E>].

<sup>75</sup> PKF ACCOUNTANTS & BUSINESS ADVISERS, *supra* note 72, at 20, 87, 91.

<sup>76</sup> Joe Worthington, *Dubai's Alternative Judiciary*, CARNEGIE MIDDLE EAST CTR. (May 24, 2017), <http://carnegie-mec.org/sada/70087> [<http://perma.cc/F3WJ-BYWL>].

<sup>77</sup> See *Free Zones and Economic Zones*, FUSION MIDDLE EAST (July 30, 2017), <https://www.fusion-me.com/free-zones-economic-zones/> [<http://perma.cc/T5H2-PYTC>].

<sup>78</sup> See Alaa Shahine et al., *Saudi Arabia Just Announced Plan to Build a Mega City That Will Cost \$500 Billion*, BLOOMBERG (Oct. 24, 2017, 2:35 AM), <https://www.bloomberg.com/news/articles/2017-10-24/saudi-arabia-to-build-new-mega-city-on-country-s-north-coast>.



a \$500 billion private SEZ to be located on a site of almost 26,000 square kilometers along the border with Jordan and Egypt.<sup>79</sup> The new zone aims to be the most advanced location in the world for automated manufacturing and alternative energy production. It will have its own economic laws, designed with private sector inputs, with the aim of becoming the world's most competitive venue for next generation manufacturing.

Dubai's breakaway economic success also has sparked invitations by African countries to extend its model for SEZ development. Dubai Ports World, over the past decade, has entered into agreements to upgrade transportation systems and assist in free zone development in Senegal, Egypt, Rwanda, Djibouti, and Mozambique.<sup>80</sup> The most recent project, launched in November of 2017 with Somaliland, gives Dubai a thirty-year concession to fund, develop, and operate a twelve square kilometer free zone at the Port of Berbera.<sup>81</sup>

Across Latin America and the Caribbean Basin, similar trends are at work. The Colón Free Trade Zone opened in 1948 with a tax and customs duty-free status. It since has grown to become a major warehousing and transshipment hub with annual imports and exports exceeding \$6.5 billion.<sup>82</sup> In 1969, Gulf + Western Corporation launched the Dominican Republic's first SEZ, using its (then-blocked) local currency holdings to fund site acquisition and development of an industrial park at La Romana, which grew rapidly to employ 15,000 workers.<sup>83</sup> The success of La Romana Free Zone set off a wave of entrepreneurially developed free zones throughout the country.<sup>84</sup> Today, the Dominican Republic is home to more than forty-seven privately developed and thirteen government owned industrial free zones specializing in apparel assembly, light manufacturing, and information services,

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<sup>79</sup> *Id.*

<sup>80</sup> See ASC Staff, *DP World Sharpens Focus on African Expansion*, ARABIAN SUPPLY CHAIN (Oct. 2, 2017, 10:21 AM), <https://www.logisticsmiddleeast.com/article-13544-dp-world-sharpens-focus-on-african-expansion> [<http://perma.cc/LTA9-4HWP>].

<sup>81</sup> Sarah Townsend, *DP World Says to Build Economic Free Zone in Somaliland*, NATIONAL (Nov. 6, 2017, 6:57 PM), <https://www.thenational.ae/business/dp-world-says-to-build-economic-free-zone-in-somaliland-1.673522> [<http://perma.cc/962A-PN5B>].

<sup>82</sup> See *Colon Free Zone*, GA. TECH PANAMA LOGISTICS INNOVATION & RES. CTR., <http://logistics.gatech.pa/en/assets/special-economic-zones/colon-free-zone/statistics> [<http://perma.cc/DUW9-6RN6>].

<sup>83</sup> WORLD BANK, SPECIAL ECONOMIC ZONES: PROGRESS, EMERGING CHALLENGES, AND FUTURE DIRECTIONS 162 (Thomas Farole & Gokhan Akinci eds., 2011).

<sup>84</sup> *Id.*

employing 140,000 workers and contributing more than \$5.5 billion annually in export earnings.<sup>85</sup>

Inspired by Panamanian and Dominican free zone successes, developers across Latin America have established 400 SEZs in twenty countries, generating 1.7 million jobs according to a 2016 survey by the Asociación de Zonas Francas de las Américas (“AZFA”).<sup>86</sup> Among Latin American SEZs, Zonamerica in Uruguay has won special recognition from AFZA for its achievements, which include de-monopolization of telecommunications, electricity, and other utilities in favor of free market alternatives.<sup>87</sup> Zonamerica has been invited by countries in Central America and North Africa to extend its model, and has recently invested in a SEZ in Colombia as well as established an operating foothold in China.<sup>88</sup>

North America-based developers have moved in to reap land value gains made possible in zones of extrastatecraft. Given that US foreign-trade zones and enterprise zones offer pallid customs duty and tax relief, relative to the levels found in overseas SEZs, the focus of the largest American SEZ developers has been on opportunities offshore.

Wallace Groves, a Florida-based developer, was the first to capitalize on the market. He negotiated in 1955 the Hawksbill Creek Agreement to privately develop approximately 500 square kilometers of marshy land in Grand Bahamas as a tax-free SEZ called Freeport.<sup>89</sup> In addition to privately funding and maintaining streets, building a water system, and constructing a container port and an international airport, Grand Bahamas Port Authority has facilitated formation of homeowners associations and condominium associations to self-provide a range of amenities. Foreigners were given rights to purchase and live in homes. Today, 26,000

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<sup>85</sup> JOSE DANIEL REYES, ET AL., SPECIAL ECONOMIC ZONES IN THE DOMINICAN REPUBLIC: POLICY CONSIDERATIONS FOR A MORE COMPETITIVE AND INCLUSIVE SECTOR 8–9, 12 (2017).

<sup>86</sup> *Start*, ASOCIACIÓN DE ZONAS FRANCA DE LAS AMÉRICAS (AZFA), <http://www.asociacionzonasfrancas.org/es> [<http://perma.cc/9RBH-XVKG>]. For further country statistics, see 3 REVISTA AZFA (Nov. 2017), [http://www.asociacionzonasfrancas.org/user/themes/azfa/documents/home/revista/ARTEFINALDIGITAL-Revista-AZFA-03-DISE%C3%91O-\(pgs1-34\)-FINAL-AjustePagDoble\(Dic1\).pdf](http://www.asociacionzonasfrancas.org/user/themes/azfa/documents/home/revista/ARTEFINALDIGITAL-Revista-AZFA-03-DISE%C3%91O-(pgs1-34)-FINAL-AjustePagDoble(Dic1).pdf) [<http://perma.cc/M7EP-P4E6>].

<sup>87</sup> See *Frequently Asked Questions*, ZONAMERICA, <http://web.zonamerica.com/#/faq> (last visited Mar. 12, 2018).

<sup>88</sup> See *Zonamerica Colombia*, ZONAMERICA, <http://web.zonamerica.com/#/zonamerica-colombia> [<http://perma.cc/RF88-YM4Q>]; *Zonamerica China*, ZONAMERICA, <http://web.zonamerica.com/#/zonamerica-china> [<http://perma.cc/N6C8-VQMC>].

<sup>89</sup> OXFORD BUS. GRP., THE REPORT: THE BAHAMAS 2009, at 77 (2009).

permanent residents live in Freeport,<sup>90</sup> and the SEZ attracts over a million visitors per year.

More recently, Gale International—a New York-based private developer—has become the main driver in an estimated \$40 billion Songdo SEZ in South Korea.<sup>91</sup> In 2006, Gale reached agreement to design and build an International Business District on more than 6000 hectares of reclaimed land in the Songdo SEZ. Songdo since has grown to a resident population of 30,000 and hosts a workforce of 33,000.<sup>92</sup> Gale’s flagship venture is being planned as a springboard to further global SEZs and startup community ventures. “We want to crack the code of urbanism, then replicate it,” says Stanley Gale, CEO of the privately-owned firm.<sup>93</sup> “We want to build at least twenty Songdos ourselves: the G20—Gale 20.”<sup>94</sup>

In Europe, the continent that gave birth to the Hanseatic League and founded the freeports of Singapore and Hong Kong, momentum has been shifting as well towards SEZs. Peter Hall—a world-known urban planner and former head of Britain’s socialist Fabian Society—proposed in 1977 a “Freeport Solution” inspired by the entrepreneurial energy he found in Asian cities, notably Singapore and Hong Kong.<sup>95</sup> He urged inner cities in the United Kingdom to adopt “an essay in Non-Plan . . . . In other words, we would aim to recreate the Hong Kong of the 1950s and 1960s inside inner Liverpool or inner Glasgow.”<sup>96</sup> Hall’s recommendations inspired the “enterprise zone” policy reforms central to Margaret Thatcher’s urban revitalization initiatives in the 1980s, notably including attraction of more than a billion dollars in private investment to London’s previously-dormant Docklands.<sup>97</sup> Over the past twenty years, the European Union (“EU”)—once adamantly opposed to geographically targeting tax and regulatory relief—has accepted SEZs as proving grounds for transparency and policy liberalization, most notably in formerly Communist countries

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<sup>90</sup> *Bahamas Population 2018*, WORLD POPULATION REV., <http://worldpopulationreview.com/countries/bahamas-population/> (last visited Mar. 27, 2018).

<sup>91</sup> *South Korea Conceptualizes the Ultimate Smart City*, NEWCITIES (Dec. 28, 2014), <https://newcities.org/cityquest-songdo-south-korea-conceptualized-ultimate-smart-sustainable-city/> [<http://perma.cc/3S5Y-85N7>].

<sup>92</sup> *New Songdo City*, KOHN PEDERSON FOX ASSOCS. PC, <https://www.kpf.com/projects/new-songdo-city> [<http://perma.cc/QXY8-DKMW>].

<sup>93</sup> *South Korea Conceptualizes the Ultimate Smart City*, *supra* note 91.

<sup>94</sup> *Id.*

<sup>95</sup> TIMOTHY P. R. WEAVER, *BLAZING THE NEOLIBERAL TRAIL: URBAN POLITICAL DEVELOPMENT IN THE UNITED STATES AND THE UNITED KINGDOM* 31 (2016).

<sup>96</sup> *Id.* at 84.

<sup>97</sup> *See id.* at 3, 8–9.

aspiring to EU accession.<sup>98</sup> A leading specialist in refugee and migrant flows, Kilian Kleinschmidt, also recently has drawn global attention for proposing the creation of free economic zones in economically lagging areas of Europe to engage large numbers of currently unemployed and underemployed immigrants from the Middle East and Africa.<sup>99</sup>

Why are zones of extrastatecraft expanding so rapidly in the global economy? Author Nassim Nicholas Taleb has coined the term “antifragile” to describe certain policies and actions that gain strength as surrounding conditions deteriorate.<sup>100</sup> This aptly describes an inherent quality of SEZs. As nation states slide towards dysfunction and corruption, rewards grow from creating trustworthy alternatives—areas whose governance is free of the surrounding woes. Hoover Institution Senior Fellow Alvin Rabushka has observed that the creation of free zones often becomes the only option available for failing, rent-seeking kleptocracies. “The last favor that a government can give—once its political favor-giving has paralyzed an economy—is to exempt areas from its own predations,” he has observed.<sup>101</sup> As political intrusions are lifted in designated locations, risk-taking investors and entrepreneurs flow in, and new wealth arises through unimpeded exchange. Land values soar to the degree that high taxes, red tape, and corruption are lifted—in short, land rents rise as political rents fall. As politicians discover they can create

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<sup>98</sup> See OECD, TRACKING SPECIAL ECONOMIC ZONES IN THE WESTERN BALKANS: OBJECTIVES, FEATURES AND KEY CHALLENGES 3, 22, 24 (2017), [http://www.oecd.org/south-east-europe/SEZ\\_WB\\_2017.pdf](http://www.oecd.org/south-east-europe/SEZ_WB_2017.pdf) [<http://perma.cc/YW5B-WdE3>]. It is worth noting that leading voices in the EU, early in the present, decade endorsed expanding the ability of localities to experiment with policy changes and coordinate directly together across national lines. Viviane Reding, VP of the European Commission, made this case in European Commission Press Release SPEECH/11/539, Opening Trade and Opportunities: From the Hanseatic League to European Contract Law (July 19, 2011). Regional movements for autonomy and movements to break away from the European movement have since revealed levels of grassroots disenchantment with EU’s central bureaucracies. In the aftermath of Brexit, some “Remainers” have proposed that the City of London—one of the world’s two leading financial hubs—exit from Brexit by separating from the U.K. and rejoining the EU as a newly-sovereign city state.

<sup>99</sup> See Renny Ramakers, *Immigrants Can Revive Shrinking Cities and Abandoned Areas*, DESIGN+DESIRES (Nov. 30, 2015), <http://socialcities.org/blog/immigrants-can-revive-abandoned-and-shrinking-areas/> [<http://perma.cc/MD3J-XR7H>].

<sup>100</sup> See NASSIM NICHOLAS TALEB, ANTIFRAGILE: THINGS THAT GAIN FROM DISORDER 3–6 (2012).

<sup>101</sup> Interview with Alvin Rabushka, David & Joan Traitel Senior Fellow, Hoover Institution, in Palo Alto, Cal. (Oct. 1976) (discussing free zone-generated funding for the Sabre Foundation Earthport Project).

windfall gains in areas they liberate, Rabushka has noted, “free zones become the way to pork-barrel freedom.”<sup>102</sup>

Economist Lotta Moberg has sounded a cautionary note. While zones in cases such as China have triggered wider reforms in their sponsoring countries, in other cases they have remained as firewalled enclaves, enabling predatory systems to keep their grip over much of the economy.<sup>103</sup> But she also points to the rise in populism as a force encouraging the further spread of SEZs.<sup>104</sup> “One feature of populism is nationalism, which leads to protectionism,” she has written. “And with increased protectionism, investors tend to demand more exemptions like those offered in SEZs.”<sup>105</sup>

Over the past four decades, the extraordinary growth in a number of SEZs has led to a rivalry among countries to stand out in the attractiveness of their policies and institutional environments.

Chinese SEZs, as previously noted, undercut Hong Kong’s tax rates at the time of their launch. The duration of tax holidays offered by export processing zones, as another example, ratcheted upwards from five to ten years to longer terms as many countries sought to outdo Taiwan, South Korea, and other early implementers of industrial park-style free zones.<sup>106</sup> Today, a prospering free zone technology park in Uruguay, Zonamerica, offers perpetual freedom from business taxes, customs duties, foreign exchange controls, and commercial governmental monopolies.<sup>107</sup> The competition to create more liberal tax and regulatory environments gives a further reason to anticipate continued growth of free cities and free zones.

As economists at the World Bank and elsewhere have argued, however, tax and regulatory competition aimed at attracting investors by no means assures success.<sup>108</sup> Investors take into account a host of location factors beyond the policy and institutional reforms formally offered by SEZs. Other key location factors include quality and costs of infrastructure and utilities,

<sup>102</sup> *Id.*

<sup>103</sup> See generally LOTTA MOBERG, *THE POLITICAL ECONOMY OF SPECIAL ECONOMIC ZONES: CONCENTRATING ECONOMIC DEVELOPMENT* (2017).

<sup>104</sup> See Lotta Moberg, *Is It Time That America Adopted Special Economic Zones?*, DAILY CALLER (Mar. 30, 2017, 2:02 PM), <http://dailycaller.com/2017/03/30/is-it-time-that-america-adopted-special-economic-zones/> [<http://perma.cc/F52C-844T>].

<sup>105</sup> Lotta Moberg, *Special Economic Zones: Opportunities and Pitfalls*, WILLIAM BLAIR (June 15, 2017), <https://blog.williamblairfunds.com/lottamoberg/special-economic-zones-opportunities-and-pitfalls/> [<http://perma.cc/NF22-7NFK>].

<sup>106</sup> See ARADHNA AGGARWAL, *SPECIAL ECONOMIC ZONES IN SOUTH ASIA* 8, 31 (2007).

<sup>107</sup> *Frequently Asked Questions*, *supra* note 87.

<sup>108</sup> See, e.g., JACQUES MORISSET & NED PIRNIA, *HOW TAX POLICY AND INCENTIVES AFFECT FOREIGN DIRECT INVESTMENT* 9 (2000); Alex Easson & Eric M. Zolt, *Tax Incentives*, WORLD BANK INSTITUTE 1, 8 (2002).

levels of labor skills and productivity, and the speed, efficiency, and responsiveness of administrative systems. Yet competition among zones is driving improvements in these areas as well. Private SEZ developers increasingly are shifting their focus to deliver unsurpassed solutions in all dimensions that concern investors. They are applying the higher rents accruing from exceptionally liberal business climates to privately fund improvements in essential infrastructure and amenities, skills training, and administrative systems. In consequence, the offerings of entrepreneurially developed zones often far surpass the quality of tax-funded infrastructure and services provided outside of the zones. Given the higher sensitivity of privately-run SEZs to market forces, in comparison with conventional municipalities and government-run zones, the competitive advantage of privately-funded zones of extrastatecraft will likely persist and even rise as exponentially improving technologies advance.

#### B. The Growth of Private Communities

As much as free zones and free cities today stand out globally as pioneers in tax and regulatory reform, private community associations have become proving grounds for market-based systems of governance. Their contractually-based systems of governance work to minimize “implicit taxes”—by filling the gap between what current political institutions ordinarily deliver, and what market-based governance can provide in higher quality and more efficient infrastructure, services, and amenities.

Private community developers in recent decades have found that buyers in many cases will pay a premium of as much as fifteen percent to reside in areas with contractual systems of self-governance.<sup>109</sup> In consequence, neighborhoods that include deed-based covenants to fund their infrastructure and services have grown spectacularly in numbers. A 1962 study by the Urban Land Institute found only 470 covenant-backed universal membership homeowners’ associations (“HOAs”) and condominium associations in the United States.<sup>110</sup> Today the number has risen by more than 500-fold. In 2016, the Community Associations Institute—a North America-based nonprofit supporting startup

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<sup>109</sup> URBAN LAND INST., *THE HOMES ASSOCIATION HANDBOOK* 14–15 (rev. prtgs. 1966, 1970).

<sup>110</sup> See Maurice C. Read, *Foreword*, in URBAN LAND INST., *THE HOMES ASSOCIATION HANDBOOK* (rev. prtgs. 1966, 1970); URBAN LAND INST., *supra* note 109, at vi.

societies around the world—tallied more than 340,000 such associations in the country,<sup>111</sup> a number over 600 times higher than the ULI’s count. More than twenty-six million US households today live in private community associations.<sup>112</sup> Neighborhoods with deed-based associations are normally highly resistant to decay, due to binding commitments on the part of all owners to keep buildings and grounds in good repair. These covenant-backed associations also commit their members to self-assess dues to meet the costs of shared infrastructure and amenities. They therefore overcome “free rider” problems that normally limit the private provision of public goods at local scale. By doing so, they boost property values in areas where municipal governments cannot be relied upon to deliver efficient services at acceptable quality.

Influential examples of private communities with deed-based covenants in the United States include Reston in Virginia (population 58,404),<sup>113</sup> Columbia in Maryland (population 99,615),<sup>114</sup> and the Disney-developed “new urbanism” community of Celebration in Florida (population 7427).<sup>115</sup> As noted by Tom W. Bell, the largest community based on a covenant-based contractual governance model appears to be Highland Ranch in Colorado, a community covering eighty-eight square kilometers with a population of 100,000 residents.<sup>116</sup> The association’s annual budget for infrastructure, services, and amenities exceeds \$22 million.<sup>117</sup>

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<sup>111</sup> *Community Associations in the United States*, COMMUNITY ASS’NS INST., <https://www.caionline.org/AboutCommunityAssociations/Pages/StatisticalInformation.aspx> [<http://perma.cc/M3SR-ZDBT>] (last visited Mar. 18, 2018).

<sup>112</sup> *Id.*

<sup>113</sup> *Quick Facts: Reston CDP, Virginia*, U.S. CENSUS BUREAU, <https://www.census.gov/quickfacts/fact/table/restoncdpvirginia/PST045216> [<http://perma.cc/RP7G-QQ6Q>] (last visited Mar. 18, 2018).

<sup>114</sup> *Quick Facts: Columbia CDP, Maryland*, U.S. CENSUS BUREAU, <https://www.census.gov/quickfacts/fact/table/columbiacdpmaryland/PST045216> [<http://perma.cc/BR8N-MR6R>].

<sup>115</sup> *Quick Facts: Celebration CDP, Florida*, U.S. CENSUS BUREAU, <https://www.census.gov/quickfacts/fact/table/celebrationcdpflorida/PST045216> [<http://perma.cc/UCR4-CKDD>] (last visited Mar. 18, 2018). See also SPENCER H. MACCALLUM, *THE ART OF COMMUNITY* (1970), which argues that the most competitive kinds of private communities will be based on a single landlord model, rather than a private association of homeowners. *Id.* at 66. MacCallum points to large resorts as an example of efficiency and sensitivity to individual users. See *id.* at 14. The question remains, however, as to how such a model would scale—there would likely need to be a contract-based federation of such owners to deal with common problems. In this case, it appears to be conceptually identical to the property owners association model, albeit at a higher level.

<sup>116</sup> TOM W. BELL, *YOUR NEXT GOVERNMENT?: FROM THE NATION STATE TO STATELESS NATIONS* 18 (2017).

<sup>117</sup> *Id.* For the data cited, see *Facts*, HIGHLANDS RANCH CMTY ASS’N, <https://hrcaonline.org/area-resources/highlands-ranch/facts> [<http://perma.cc/ZE68-J8BS>] last visited Mar. 13, 2018).

In recent years, Sandy Springs, Georgia—incorporated as a community with a current population of just over 100,000<sup>118</sup>—has also been noticed as a model of privatization. It has reduced the city management staff to a handful by outsourcing to private providers the responsibility for all city functions with the exception of police and fire/rescue operations. The annual cost savings to taxpayers—relative to comparable municipalities—is estimated at \$20 million.<sup>119</sup> Other notable startup communities are being developed by leading technology companies. With an aim to demonstrate efficiencies possible in convivial living environments, Google’s Sidewalk Labs has recently committed \$50 million to develop a waterfront “digital city” in a rundown area of Toronto.<sup>120</sup> Bill Gates has similarly purchased approximately eighty square kilometers in Arizona to build an innovative “City of Tomorrow” that “embraces cutting-edge technology, designed around high speed networks, data centers, new manufacturing technologies and distribution models, autonomous vehicles and autonomous logistics hubs.”<sup>121</sup>

Private communities are spreading as well in regions of developing countries that have been plagued by corruption, crime, and underperforming municipal services. In India, private developers over the past thirty years have turned the once sparsely populated area of Gurgaon into a thriving city of more than half a million.<sup>122</sup> The city features a privately-owned mass transit system along with extensive private security and fire protection services.<sup>123</sup> It now has the third highest per capita income in India,<sup>124</sup> and was recently ranked as the country’s best city to work in. Brazilian developer Alphaville Urbanismo has launched private gated communities based on homeowners associations in Sao Paulo, Rio de Janeiro, Curitiba, and close to twenty other cities. The developer also has expanded to Cacaais in

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<sup>118</sup> See *The Man Who Outsourced the Government: An Interview with Oliver Porter*, FOUND. ECON. EDUC. (May 28, 2013), <https://fee.org/articles/the-man-who-outsourced-the-government/> [<http://perma.cc/P3WU-9P8N>].

<sup>119</sup> *Id.*

<sup>120</sup> See Jane Wakefield, *‘Future City’ to be Built in Canada by Alphabet company*, BBC NEWS (Oct. 18, 2017), <http://www.bbc.com/news/technology-41665670> [<http://perma.cc/K2QZ-4FY3>].

<sup>121</sup> Conor Cawley, *Bill Gates Just Bought an \$80 Million Chunk of Land in Arizona*, TECH.CO (Nov. 8, 2017, 11:40 AM), <https://tech.co/bill-gates-80-million-land-arizona-2017-11> [<http://perma.cc/5Z2S-V5J6>].

<sup>122</sup> See Todd Krainin, *Gurgaon: India’s Private City*, REASON (Dec. 15, 2016), <http://reason.com/reasontv/2016/12/15/gurgaon-india-private-city> [<http://perma.cc/2669-3SXX>].

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*



Portugal.<sup>125</sup> Paranoazinho, a fifteen square kilometer new private community venture taking form near Brasilia, has the backing of libertarian developer Ricardo Birmann.<sup>126</sup>

Startup communities are improving conditions in low income neighborhoods as well as affluent areas. Thailand's Building Together initiative has worked with the informal sector to plan layouts for roads and lots, prior to "invasion" by squatters of idle public lands at the outskirts of Bangkok.<sup>127</sup> Squatter associations keep ownership of their newly created market areas and use the lease revenues paid by incoming merchants to defray the cost of infrastructure and basic services for community residents. In the Philippines, the Davao Development Foundation has worked in low and middle-income neighborhoods to help residents organize deed-based homeowners associations, to make neighborhoods safer and able to arrange for contractual provision of services.<sup>128</sup> In the United States, a similar approach has proven highly effective in reversing crime and blight in Waterman Place, St. Louis, doubling property values within a year of the residents' decision to turn from an informal group of neighbors into a durable, deed-based homeowners association.<sup>129</sup>

Housing cooperatives based on Community Land Trusts offer an innovative path to ensure affordable housing for low-income residents as property values rise. In Burlington, Vermont, the Champlain Housing Trust was formed in 1984 while Bernie Sanders was mayor.<sup>130</sup> It since has grown to become the largest community land trust in the country, managing 2200 apartments and more than 500 owner-occupied homes.<sup>131</sup> A notable innovation has been developed there. The Champlain Trust created a hybrid form of land trust that includes a commercial area where tenants pay market-priced rents, in parallel with residential areas where members of the Trust enjoy highly discounted long-term ground leases. The profits from the commercial areas enable the Trust to

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<sup>125</sup> ALPHAVILLE URBANISMO, <http://www.alphaville.com.br/> [<http://perma.cc/4LRZ-XVBN>] (last visited Nov. 26, 2017).

<sup>126</sup> Skype Interview with Ricardo Birmann [Brasilia] (Jan. 2016).

<sup>127</sup> See MARK FRAZIER & CECILIA SAGER, *COMMUNITY SELF HELP: A NEW STRATEGY* 12 (1985).

<sup>128</sup> See *id.* at 35.

<sup>129</sup> See Mark Frazier, *Seeding Grass Roots Recovery: New Catalysts for Community Associations*, in *RESIDENTIAL COMMUNITY ASSOCIATIONS: PRIVATE GOVERNMENTS IN THE INTERGOVERNMENTAL SYSTEM?* 63, 64 (1989).

<sup>130</sup> See *About Us*, CHAMPLAIN HOUSING TRUST, <http://www.getahome.org/about-us> [<http://perma.cc/99QS-NJWA>] (last visited Nov. 26, 2017).

<sup>131</sup> *Id.*

sustain affordable ground rents for low-income tenants and homeowners.<sup>132</sup> This hybrid approach—akin to that used by Bangkok’s Building Together projects—suggests a path for building future left-right coalitions. As residents become beneficiaries, via Community Land Trusts, of rising land values in commercial areas, they may become much more receptive to the introduction of SEZs and similar policy reforms that can rapidly lift land values in these areas. The more political rent-seeking is lifted, the higher will be the Trust’s distributions of commercial land lease revenues for shared benefit.

### III. INNOVATIONS IN GOVERNANCE

As fiscal and political strains intensify in nation states, reforms initiated by SEZs and startup communities can emerge as models for transforming governance. The following innovations point to opportunities for a phase change in governmental accountability and efficiency.

#### A. Incentivizing the Public Sector

Bureaucracies around the world tend towards inertia and stagnation whenever the quality of their performance has no impact on their internal rewards. Two of the world’s most successful free zones have found an answer to this problem. They motivate their public sectors through innovative fiscal measures:

##### 1. *Linking public sector pay to economic growth (via a national “Flexiwage” bonus)*

A key to Singapore’s success has been the introduction of systemic rewards in pay for all civil servants, proportional to the overall growth of the productive sector. The Flexiwage incentives, now known as National Bonuses, are indexed to GDP growth rates of the Singaporean economy.<sup>133</sup> This compensation innovation was introduced in the mid-1980s as a key part of Prime Minister Lee Kuan Yew’s effort to instill a higher level of professionalism and responsiveness in the culture of the civil service.<sup>134</sup> The reform has helped the public sector of Singapore become perhaps the most

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<sup>132</sup> See JOHN EMMEUS DAVIS & AMY DEMETROWITZ, PERMANENTLY AFFORDABLE HOMEOWNERSHIP 1 (2003).

<sup>133</sup> *Frequently Asked Questions: Bonus*, PUB. SERV. DIV., [http://www.ifaq.gov.sg/PSD/apps/fcd\\_faqmain.aspx?FAQ=34258](http://www.ifaq.gov.sg/PSD/apps/fcd_faqmain.aspx?FAQ=34258) [<http://perma.cc/G5KP-LHA6>] (last visited Mar. 18, 2018).

<sup>134</sup> See 1 SINGAPORE COUNTRY STUDY GUIDE: STRATEGIC INFORMATION AND DEVELOPMENTS 68 (2015).

transparent and efficient in the world. As a result of national bonuses based on the economy's performance, which has averaged more than six percent per annum since introduction of the policy,<sup>135</sup> compensation levels for Singaporean civil servants have risen to among the highest in the world. In contrast to their counterparts in most other countries, Singapore's civil servants have tended to consistently welcome, rather than resist, introduction of eGovernment and other solutions that help to remove bottlenecks for investors and entrepreneurs.

## *2. Capturing Land Value Gains*

Singapore and Hong Kong, as Asia's leading SEZs since the mid-1800s, also are world leaders in land value capture for shared benefit. More than ninety-nine percent of all land in Hong Kong, and more than eighty percent in Singapore, is now owned by government or parastatal bodies. Their governments offer long term leases to private developers who are competitively chosen through open auctions and tenders. Revenues from land value capture cover as much as a third of the public sector's annual operating budgets. As landlords seeking to maximize demand for their offerings, the governments of Singapore and Hong Kong are keen to ensure world-class conditions for investors and entrepreneurs, because investors bid more for leases when they have confidence in the quality and stability of the business climate.

### B. Using Technology to Cut Red Tape

SEZs also are innovators in eGovernment solutions that lift barriers to small and large firms alike. While bureaucracies in many nations cling to complex and opaque procedures for approving business startups, for importing/exporting goods, and for authorizing new investments, leading zones have introduced electronic systems that have radically simplified and sped up approval times to do business. Singapore's 4.5 million citizens and enterprises, for example, now can access 1600 eGovernment services at any time, providing rapid turnaround times for passport renewals, tax filings, and building construction.<sup>136</sup> The services—which can be accessed by cell phones as well as

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<sup>135</sup> *Singapore GDP Growth Rate*, TRADING ECON., <https://tradingeconomics.com/singapore/gdp-growth> [<http://perma.cc/GC28-8MPP>] (last visited Mar. 18, 2018).

<sup>136</sup> See Speech Dr. Lee Boon Yang, Minister of Information, Communications & the Arts, Singapore's e-Government Journey (Sept. 20, 2007).

computers—are being used more than 150 million times per year.<sup>137</sup> Dubai similarly offers an eGovernment services app to interact with twenty-two government bodies.<sup>138</sup> The app called DubaiNow offers a single portal for filling in forms, filing reports, or making payments.<sup>139</sup>

Dubai is intent on going much farther. It aims by 2020 to become the first government anywhere to fully embrace the Blockchain, the innovative encrypted public ledger that can create a public, tamper-proof, auditable, and distributed record keeping system for ensuring the transparency of all governmental transactions.<sup>140</sup> A new government body, Smart Dubai, has been formed with a mission to improve the efficiency of living and doing business in Dubai with Blockchain-based solutions. Backers of the initiative predict that its Blockchain strategy will save 25.1 million man-hours valued at \$1.5 billion annually.<sup>141</sup> The majority of the savings will come from a complete move away from paper-based systems in government to electronic document processing, which are to replace the current 100 million paper transactions a year.<sup>142</sup>

### C. Doing More Through Privatization

SEZs are setting global standards for comprehensive privatization. The 500 square kilometer tax-free concession of Freeport, Bahamas, which Florida developer Wallace Groves negotiated in 1955, became the first example of a large community featuring a privately-developed, owned, and operated international airport, port, highway and road network, water/sewerage system, and electrical grid.<sup>143</sup>

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<sup>137</sup> See Chew Hui Min, *Download These Mobile Apps for Government Services on the Go*, STRAITS TIMES (Jan. 26, 2015, 4:39 PM), <http://www.straitstimes.com/singapore/download-these-mobile-apps-for-government-services-on-the-go> [<http://perma.cc/KAN2-W54B>].

<sup>138</sup> Tan Wee Kwang, *6 Innovative Mobile Apps for Citizens*, EGOV INNOVATION (Aug. 2, 2016), <https://www.enterpriseinnovation.net/article/6-innovative-mobile-apps-citizens-1659286554> [<http://perma.cc/ZNN8-K73L>].

<sup>139</sup> *Id.*

<sup>140</sup> See Rebecca Campbell, *Dubai Set to Achieve Goal of Becoming First Blockchain Government by 2020*, CCN (July 24, 2017, 13:07), <https://www.ccn.com/dubai-set-achieve-goal-becoming-first-Blockchain-government-by-2020/> [<http://perma.cc/88V8-R3NQ>].

<sup>141</sup> Damian Radcliffe, *Could blockchain run a city state? Inside Dubai's blockchain-powered future*, ZD NET (Oct. 5, 2017, 10:24), <http://www.zdnet.com/article/could-Blockchain-run-a-city-state-inside-dubais-Blockchain-powered-future/> [<http://perma.cc/FH48-FEYD>].

<sup>142</sup> *Id.*

<sup>143</sup> See OXFORD BUS. GRP., *supra* note 89, at 77.

Other SEZ milestones in privatization exist in Zonamerica, created by a Uruguayan company following the passage in 1987 of a free zone law that states “state-owned monopolies do not apply within free zones.”<sup>144</sup> This sentence gave Zonamerica the right to bypass costly state telecommunications, electricity, and insurance monopolies, and to make private arrangements that gave its tenants access to services at competitive market prices. In addition, the Government allowed the Zonamerica developer to create and operate an electronically monitored Customs systems for the Zone, speeding movement of inbound and outbound goods. Given the scope of its freedoms from state monopolies, Zonamerica has become one of the most successful business centers in Latin America, presently employing more than 10,000 workers in logistics, software development, and a range of technology-intensive services and manufacturing operations.<sup>145</sup>

Privately developed startup communities—incorporating deed-based agreements that bind residential and commercial purchasers to join associations of property owners—have proven able to fund a full spectrum of local infrastructure and community services. Hundreds of thousands of homeowners associations, condominium associations, and housing cooperatives have been formed since the 1960s in the United States and around the world, taking on a number of responsibilities once left to local governments.<sup>146</sup>

#### D. Reducing Public Sector Debt

SEZs are also helping countries deal with unrepayable sovereign debts. Sri Lanka is a case in point. In late 2016, recognizing that its \$8 billion in debts to China were untenable, the government of Sri Lanka agreed to a Chinese proposal that erased \$1.1 billion of the amount due.<sup>147</sup> China accepted an in-kind

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<sup>144</sup> INSTITUTO NACIONAL DE LOGISTICA, *Regulatory Frameworks of Free Zones*, <http://www.inalog.org.uy/en/regulatory-framework-of-free-zones/> [<http://perma.cc/YZH4-8ULK>] (last visited Mar. 18, 2018).

<sup>145</sup> ZONAMERICA CAMPUS + PERFORMANCE, <http://web.zonamerica.com/#/conocer-zonamerica> (last visited Mar. 13, 2018).

<sup>146</sup> See *Community Associations in the United States*, COMMUNITY ASS'NS INST. (2016). Given that twenty-four million households in the United States now belong to deed-based associations, political pressures are growing to allow tax rebates or deductibility on tax returns for the portion of HOA fees that pay for what are normally local government responsibilities. New Jersey during the early 1990s became the first state to allow this, with passage of the “Kelly Bill.”

<sup>147</sup> See Roel Raymond, *SEZ Agreement with China Before Year-End*, DAILY NEWS (Nov. 21, 2016), <http://www.dailynews.lk/2016/11/21/local/99689> [<http://perma.cc/Q6G3-YC4A>].

payment in form of a concession to develop a fifteen square kilometer site as a SEZ. In follow up to the debt swap, China will make new direct investments in zone development and operate the zone in a self-funding way, collecting lease payments in hard currency.<sup>148</sup> Export-oriented companies locating in the new zone will contribute to Sri Lanka's foreign exchange and potentially generate hundreds of thousands of new jobs.<sup>149</sup> The Sri Lanka debt swap agreement creates a model that may become more widely applied with Chinese-owned SEZs in other countries, as and when host nations participating in China's global \$4 to \$8 trillion "Belt and Road" initiative find themselves unable to repay debts they have incurred.<sup>150</sup>

Costa Rica pioneered a "debt-for-free zone" swap in the 1980s, using it to fund a free-zone project near the capital of San José.<sup>151</sup> Private developers in that case purchased sovereign Costa Rican debt from third parties at a discount and reached an agreement with the Central Bank to erase the face value of the debt in exchange for a prime site and a concession to develop an industrial park-model SEZ. Today, the Sri Lankan and Costa Rican examples may prove useful precedents for investors seeking to convert unrepayable sovereign debt of countries such as Greece, Venezuela, and Zimbabwe into new SEZ concessions.<sup>152</sup>

#### E. Opening to Global Talent

SEZs also offer examples of innovative ways to engage global talent. As developed countries have been raising new barriers to immigration, Dubai, Singapore, and other city states and autonomous regions are welcoming unskilled skilled workers from all over the world. Approximately ninety percent of the workforce in Dubai and its sister Emirates are guest workers from other countries as a result of a liberal visa policy.<sup>153</sup> Although workers are exempt from paying income tax on their earnings, they or their employers must pay for a work permit and residency visa of approximately \$135 per year per person (additional household

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<sup>148</sup> *See id.*

<sup>149</sup> *See id.*

<sup>150</sup> Ho, *supra* note 60.

<sup>151</sup> Mark Frazier & Govindan Nair, *Stimulating Growth in Developing Countries*, 9 CATO POL'Y REP. 15 (1987).

<sup>152</sup> *See id.*

<sup>153</sup> *See* Froilan T. Malit Jr. & Ali Al Youha, *Labor Migration in the United Arab Emirates: Challenges and Responses*, MIGRATION POL'Y INST. (Sept. 18, 2013), <https://www.migrationpolicy.org/article/labor-migration-united-arab-emirates-challenges-and-responses> [<http://perma.cc/4PTR-5RFD>].

members pay about \$67 annually for residency).<sup>154</sup> Dubai and the Emirates earn approximately \$800 million annually from 7.8 million guest workers and their families.<sup>155</sup>

In Uruguay, Zonamerica is also benefiting from a liberal immigration policy. It is now home to more than 1000 software developers and ICT specialists from India, due to a policy that permits up to twenty-five percent of employees in the zone to be foreign nationals.<sup>156</sup> China has recently liberalized its visa policy as well to attract global talent to the Chengdu Free Trade Area and to Shanghai for three SEZ-style innovation zones.<sup>157</sup>

For more than a decade, Singapore has cast a global net to encourage immigration by entrepreneurs and highly skilled scientists, engineers, and academics. It now ranks number two (behind Switzerland) in Institute of Business Administration (“NSEAD”) ratings of locations attractive to global talent.<sup>158</sup> In mid-2017, Singapore took a further step towards gaining the top global ranking. It introduced an ‘EntrePass’ visa that widens the pool of overseas entrepreneurs eligible for immigration, expands the duration of the visa from one to two years, and waives the former \$37,000 minimum paid-in capital requirement for their startups in high technology fields.<sup>159</sup>

Although technically not a SEZ or startup community, the small “info state” of Estonia has introduced another innovation aimed at engaging global entrepreneurs and investors. Its e-Residency program, launched in December of 2014, makes available a government-issued digital identity to individuals anywhere in the world who pass a background check and pay a

<sup>154</sup> See *UAE New Visa Fees*, DUBAIOFW, <http://dubaiofw.com/uae-visa-fees> [<http://perma.cc/9DAJ-UW39>] (last visited Feb. 14, 2018).

<sup>155</sup> See Malit & Youha, *supra* note 153.

<sup>156</sup> See ZONAMERICA, <http://www.zonamerica.com> [<http://perma.cc/3ZfV-HLCK>]; see also Conversation via Skype with Orlando Dovat, Chairman, Zonamerica, in Montevideo, Uruguay (October 10, 2012).

<sup>157</sup> *Shanghai Introduces New Policies Aimed at Attracting Foreign Talent*, BAL GLOBAL (Dec. 19, 2016), <https://www.balglobal.com/bal-news/shanghai-introduces-new-policies-aimed-at-attracting-foreign-talent/> [<http://perma.cc/6YQP-DMKA>].

<sup>158</sup> David Roman, *Singapore is Asia's Best in Attracting Talent Amid Digital Push*, BLOOMBERG NEWS (Apr. 18, 2017, 11:11 PM), <https://www.bloomberg.com/news/articles/2017-04-18/singapore-is-asia-s-best-in-attracting-talent-amid-digital-push> [<http://perma.cc/6DD6-67V4>].

<sup>159</sup> See *Key facts for EntrePass*, MINISTRY OF MANPOWER, <http://www.mom.gov.sg/passes-and-permits/entrepass/key-facts> [<http://perma.cc/ETM2-6M26>] (last updated Aug. 3, 2017).

one-time fee of \$120.<sup>160</sup> Holders of e-Residency identities are allowed to virtually create and operate ventures in Estonia's highly transparent business climate and are not subject to national tax for whatever income they generate outside of Estonia.<sup>161</sup> To date, more than 4000 companies have been formed by 27,000 people who have responded to the program.<sup>162</sup>

Military and geopolitical strategist John Robb, a best-selling author, has speculated on how a city-state such as Singapore might use such a virtual system to become, almost overnight, a global superpower. In a 2013 symposium, he invited participants to consider a scenario in which Singapore decided that:

[W]e're going to expand our city state to 200 million of the best people in the world, and we're going to adopt them as citizens and stitch them together in a variety of unique and interesting ways. In that instance, you have a virtual city state that will become extremely powerful, and [that] can do much more than you can see with current physical political structures.<sup>163</sup>

#### F. Serving the Whole Person

As an alternative to distracting and harried lifestyles, a growing number of entrepreneurially-developed communities are offering amenities aimed at promoting personal wellbeing and civic engagement, as well as professional and business success. SEZs such as Zonamerica in Uruguay, and the America Free Zone in Costa Rica, offer campus-style parks that include green spaces, bikeways, arts and music events, recreation and fitness centers, learning venues, and residential areas.<sup>164</sup>

Startup communities, similarly, are evolving to encourage healthy lifestyles and engagement with neighbors. Celebration, a Disney-developed suburb of Orlando, incorporates elements of a "new urbanism" that encourages human scale development and

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<sup>160</sup> *Estonian eResidency is lowering business costs around the world*, MEDIUM (Dec. 16, 2016), <https://medium.com/e-residency-blog/estonian-e-residency-is-lowering-business-costs-around-the-world-d78d957a82fe> [<http://perma.cc/9NWL-WM8D>].

<sup>161</sup> *Id.*

<sup>162</sup> Chris Skinner, *e-Estonia, A Country Full of e-Everything*, CHRIS SKINNER'S BLOG (Jan. 16, 2018), <https://thefinanser.com/2018/01/e-stonia-country-full-e-verything.html/> [<http://perma.cc/T53T-2RPW>].

<sup>163</sup> Reinvent, *Reinvent Governance*, YOUTUBE (May 31, 2013), [https://www.youtube.com/watch?v=\\_fCCVt6Vfjc](https://www.youtube.com/watch?v=_fCCVt6Vfjc).

<sup>164</sup> ZONAMERICA CAMPUS + PERFORMANCE, *supra* note 145; Tom Rosenberger, *Costa Rica's Sustainable and Green America Free Zone*, COSTA RICA HOME BUILDER (June 26, 2017), <http://www.costaricahomebuilder.com/costa-ricas-sustainable-and-green-america-free-zone.html> [<http://perma.cc/K7UH-574A>].



interaction with neighbors.<sup>165</sup> Active adult communities with a variety of amenities for exercise and wellness, lifelong learning, and recreation are growing in North America for individuals and couples nearing retirement age.<sup>166</sup> Resort communities in many cases have moved to diversify the range of activities and amenities offered to guests of all ages, and some now also promote service learning and “voluntourism” offerings that go beyond pre-packaged entertainment.<sup>167</sup> The global growth of ecovillages and other intentional communities reflects a general trend where homebuyers are moving to areas that let residents interact with nature and with each other in more authentic ways.<sup>168</sup>

These trends may become increasingly relevant as accelerating technologies drive down the costs of goods and services, and as the trend towards automation of rote work creates opportunities for people to interact in more fulfilling ways. Entrepreneurial communities attuned to the needs of the “whole persons” who opt to reside or visit can point the way to new kinds of convivial living,<sup>169</sup> and become destinations of choice for tens or hundreds of millions of people around the world who may seek to exit from, or create alternatives within, failed and failing nation states.

#### G. Safeguarding the Environment

Exemplary SEZs funded by private investors have become committed to lowering carbon footprints and operating in sustainable ways. Costa Rica’s America Free Zone, launched in 1999, is at the forefront of environmentally sustainable office and industrial parks.<sup>170</sup> With more than 10,000 employees working primarily in call center and light industry for export markets, the campus-style Park is the first SEZ to earn overall Carbon Neutral certification from INTE.<sup>171</sup> Many of its buildings are LEED certified for Core & Shell, and the park has won Gold Certification from the US Green Building Council.<sup>172</sup> Its approximately 3000

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<sup>165</sup> See CELEBRATION, FLA., <http://www.celebration.fl.us> [<http://perma.cc/3F9P-NFBA>].

<sup>166</sup> See *id.*

<sup>167</sup> See *id.*

<sup>168</sup> See *Ecovillages?*, GLOBAL ECOVILLAGE NETWORK EUR., <https://gen-europe.org/about-us/ecovillages/index.htm> [<http://perma.cc/H9Y3-PF6V>] (last visited Jan. 28, 2018).

<sup>169</sup> Jordan Greenhall, *Politics Decentralized: A new paradigm of governance*, YOUTUBE (Feb. 4, 2017), <https://www.youtube.com/watch?v=r3OIG4OmzI>.

<sup>170</sup> See Rosenberger, *supra* note 164.

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

square meters of solar panels generate an average of 500 kilowatt hours of electricity per month.<sup>173</sup>

The \$40 billion Songdo SEZ in Korea is aiming higher.<sup>174</sup> Its developer is planning it to become the world's first completely LEED-certified city.<sup>175</sup> All major buildings have been designed to meet Korean standards, as well as international LEED certification requirements.<sup>176</sup> Its green design includes pneumatic tubes for waste disposal to avoid traditional garbage collection, windows with Low U value, water-cooled air conditioning, LED lighting, and solar energy.<sup>177</sup> These factors will reduce building energy consumption by almost one-third.<sup>178</sup> In addition to large reserves for parks and green areas, bike trails, and pedestrian paths, Songdo also features a network of charging stations for electrically powered vehicles.<sup>179</sup>

#### H. Sharing Upsides with Citizens

As concerns rise in developed nations over joblessness due to robotics and artificial intelligence, Universal Basic Income ("UBI") schemes are being discussed as a potential reform to soften the transition to economies that are based largely on automated production of goods and services. Three of the world's leading city-states—Singapore, Hong Kong, and Macau—are among the five economies in the world to date that have piloted UBI plans benefiting all residents.<sup>180</sup>

In Singapore, "Grow & Share" growth dividends were distributed from 2006–2011 to all adult Singaporeans out of the government's surplus.<sup>181</sup> The amount each resident received was

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<sup>173</sup> *Id.*

<sup>174</sup> *South Korea Conceptualizes the Ultimate Smart City*, *supra* note 91.

<sup>175</sup> Jack Eidt, *Songdo, South Korea: Utopian City of Big Data and Urban Sustainability*, WILDER UTOPIA (Oct. 1, 2013), <http://www.wilderutopia.com/sustainability/land/songdo-south-korea-utopian-city-of-big-data-and-urban-sustainability/> [<http://perma.cc/JY3M-DBHZ>].

<sup>176</sup> *South Korea Conceptualizes the Ultimate Smart City*, *supra* note 91.

<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> Goenchi Mati, *Five Countries already giving Basic Income*, GOENCHI MATI MOVEMENT (Feb. 9, 2016), <http://goenchimati.org/five-countries-already-giving-basic-income/> [<http://perma.cc/FV2B-X6X9>].

<sup>181</sup> See SGGOT Team Staff, *Growth Dividends 2011*, SGGOT: SINGAPORE TRAVEL & LIFESTYLE (Apr. 6, 2011), <http://sggo.com/growth-dividends-2011/> [<http://perma.cc/HSZ5-NA8T>]; see also Marissa Lee, *Memorable Singapore Budgets*, STRAIT TIMES (Feb. 8, 2015, 3:58 PM), <http://www.straitstimes.com/singapore/memorable-singapore-budgets> [<http://perma.cc/SKC9-A4C5>].

linked to their level of earnings and size of housing.<sup>182</sup> During the final year that the Government was running surpluses and funding the program, the dividends averaged \$700 per recipient.<sup>183</sup> Hong Kong also briefly tried a similar “Scheme 6000” in 2011.<sup>184</sup> It took the form of a tax rebate program distributing \$770 to all holders of a Hong Kong permanent identity card for the declared aim to “leave wealth with the people.”<sup>185</sup>

Macau, a prosperous former Portuguese free trade zone located near Hong Kong, has embarked on a more sustained UBI initiative, the “Wealth Partaking Scheme.”<sup>186</sup> Since 2008, Macau has distributed a UBI to all holders of a resident identity card issued by the Macau Special Administrative Region.<sup>187</sup> More than half a million non-permanent and permanent residents get the payments, with permanent residents now receiving about \$1200 annually, double what transient residents receive.<sup>188</sup>

### I. Experimenting with Polycentric Governance

Economists, legal scholars, and historians—including Vincent Ostrom, Tom W. Bell, Alexander Fink, Avner Greif, Bruno Frey, and James C. Bennett—have argued for decades that competition among and between jurisdictions and systems of law can lead to more efficient governance. Giving freedom of choice to individuals to choose among systems can be rewarding for providers of consistently transparent and accountable law.

SEZs in modern times have moved to make this promise a reality. By widening global options for entrepreneurs and investors, jurisdictions have had to compete to win the trust of people who formerly had far fewer high quality options for where to live and work.

Today, truly polycentric systems of law and governance are emerging in SEZs. These systems allow individuals to choose among legal systems without physically having to relocate. The

<sup>182</sup> See SGGOT Team Staff, *supra* note 181.

<sup>183</sup> *Id.*

<sup>184</sup> *Scheme \$6,000*, WIKIPEDIA, [https://en.wikipedia.org/wiki/Scheme\\_\\$6,000](https://en.wikipedia.org/wiki/Scheme_$6,000) [<http://perma.cc/4XZE-3BEU>] (last visited Jan. 28, 2018).

<sup>185</sup> *Id.*

<sup>186</sup> *Macau*, WIKIPEDIA, <https://en.wikipedia.org/wiki/Macau> [<http://perma.cc/2764-PVV8>].

<sup>187</sup> See Kate McFarland, *Macau: Over 543,000 receive unconditional cash grants under 2017 Wealth Partaking Scheme*, BIEN (Oct. 22, 2017), <http://basicincome.org/news/2017/10/macau-543000-receive-unconditional-cash-grants-2017-wealth-partaking-scheme/> [<http://perma.cc/9EZD-B9T4>].

<sup>188</sup> *Id.*

leading innovator in this regard is Dubai, which since 2004 has allowed firms operating under its Financial Services free zone regime to choose between resolving disputes under the law of the United Arab Emirates or under British Common Law.<sup>189</sup> Local courts now have no power to overrule decisions made by the retired British judges who run the Common Law courts in Dubai.<sup>190</sup> In part because of the confidence that this legal reform has engendered among leading global financial firms, Dubai has become a world-class financial center that directly employs more than 20,000 people.<sup>191</sup> The Dubai dual court system is now prompting Abu Dhabi and Sharjah to follow suit.

Another pioneer in approving polycentric governance is Honduras, which enacted a law in December of 2013 that brings freedom of choice in legal systems to a new level.<sup>192</sup> The ZEDE legislation not only recognizes English Common Law tradition as a baseline for dispute resolution, but also allows parties residing in any of the SEZs to use the legal system of any mutually agreed foreign government to resolve their dispute.<sup>193</sup> Although local and overseas private investors are waiting on official designation of ZEDE sites, global developers anticipate a sizable market response given the freedom to create a new, corruption-resistant legal regime.<sup>194</sup>

In coming years, innovations of the kinds highlighted above will likely accelerate the global growth of SEZs. A world of increasingly brittle nation states and international systems can hope for the fullest possible extension of these innovations, sooner rather than later. Exponential technologies, as described by Peter Diamandis and Jeremy Rifkin in their recent books, are set to sweep across the world in ways that undo much of the present economic and financial base underpinning the present power of national and international bodies.<sup>195</sup> Oxford University researchers have projected that robotics and artificial intelligence within several decades will put close to half of today's jobs in

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<sup>189</sup> Worthington, *supra* note 76.

<sup>190</sup> *Id.*

<sup>191</sup> Worthington, *supra* note 76.

<sup>192</sup> See Beth Gaglia, *Honduras: Reinventing the Enclave*, 48 NACLA REP. AMERICAS 353, 355 (2016).

<sup>193</sup> *See id.*

<sup>194</sup> *See id.* at 360.

<sup>195</sup> See JEREMY RIFKIN, *THE ZERO MARGINAL COST SOCIETY: THE RISE OF THE COLLABORATIVE COMMONS AND THE END OF CAPITALISM* 78 (2015); see also PETER H. DIAMANDIS & STEVEN KOTLER, *ABUNDANCE: THE FUTURE IS BETTER THAN YOU THINK* 31 (2012).

developed countries at risk.<sup>196</sup> In developing countries, the World Bank has predicted that the impact will be even greater, with as many as two-thirds of all industrial and agricultural jobs likely to be displaced by automation.<sup>197</sup> The rise of solar and other renewable energy technologies will have a further disruptive impact, collapsing revenues that now sustain fragile petrostates. This outcome will likely lead to job losses and contraction of entitlement programs, causing turmoil and further accelerating emigration. Polarizations and hatreds may flare as political demagogues cast blame upon others for deep technologically-driven internal and global dislocations.

Examples of trustworthy governance—and of new ways for people to share in the prosperity generated by free, technologically advanced areas—may be welcomed as traditional jobs grow scarce and nation states fail to meet public expectations. Successful SEZs and startup communities during this era of change can move to spread their innovations to economically troubled areas. Expanding relationships of trade, learning, and cultural exchange among SEZs can be key to their success. As Paragh Khanna observed:

[C]ities rather than states are becoming the islands of governance on which the future world order will be built. This new world is not—and will not be—one global village, so much as a network of different ones. . . . Alliances of these agile cities are already forming, reminiscent of that trading and military powerhouse of the late Middle Ages, the Hanseatic League along the Baltic Sea. Already, Hamburg and Dubai have forged a partnership to boost shipping links and life-sciences research, while Abu Dhabi and Singapore have developed into a new commercial axis. No one is waiting for permission from Washington to make deals.<sup>198</sup>

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<sup>196</sup> See Aviva Hope Rutkin, *Report Suggests Nearly Half of U.S. Jobs Are Vulnerable to Computerization*, MIT TECH. REV. (Sept. 12, 2013), <https://www.technologyreview.com/s/519241/report-suggests-nearly-half-of-us-jobs-are-vulnerable-to-computerization/> [<http://perma.cc/SHH9-GXF9>].

<sup>197</sup> *World Bank: Automation Could Wipe Out Two-Thirds of Jobs in Developing Countries*, VOICE OF AMERICA (Apr. 21, 2017, 1:00 PM), <https://www.voanews.com/a/world-bank-automation-could-wipe-out-two-thirds-of-jobs-in-developing-countries/3819640.html> [<http://perma.cc/K3JJ-6CEL>].

<sup>198</sup> See Paragh Khanna, *Beyond City Limits*, FOREIGN POL'Y (Aug. 6, 2010, 8:05 PM), <http://foreignpolicy.com/2010/08/06/beyond-city-limits/> [<http://perma.cc/LD8J-ZN9C>]. Khanna also notes that Japanese futurist Kenichi Ohmae foresaw the rise of an info-state era in *The Next Global Stage* (2005), including agglomerations of city-states resembling those of the Hanseatic era. He predicted these would become the world's next power centers. Khanna, *supra* note 41.

#### IV. POTENTIAL ALLIES FOR A PHASE CHANGE IN GLOBAL GOVERNANCE

Existing organizations that have specialized in free zones and contract-based communities are well positioned to help spread civil society and market-based governance alternatives. Potential global allies and partners for a global evolution in governing systems include:

##### A. World Economic Processing Zones Association ([www.wepza.org](http://www.wepza.org))

Over the past four decades, WEPZA has been an influential proponent of SEZs, bringing together best practices from zone operators, public officials, researchers, and consultants. WEPZA began as a UN-funded intergovernmental body focused principally on assisting public sector Export Processing Zones, but gained independence and broadened its charter during the 1980s to support knowledge sharing, conferences and workshops, and studies for a full range of SEZs.<sup>199</sup> Key research findings have been shared via the web, and through the *Flagstaff Journal of Special Economic Zones*.<sup>200</sup> In recent years, WEPZA has sought to become a collaboration network for zone practitioners, private consultants specializing in market analysis, legal reform, and engineering, multilateral development organizations, think tanks, university faculty members, and government officials.<sup>201</sup> It also aims to map opportunities for “bold and innovative uses and implementations of zones.”<sup>202</sup>

##### B. World Free & SEZs Federation ([www.femoza.org](http://www.femoza.org))

WFSEZF is a second nonprofit research and technical advisory group on SEZs that traces its origins to UN-supported initiatives for free zones. Formed in 1999, the Geneva-based organization has been supporting governments in identification and planning of free zone development and promotion opportunities.<sup>203</sup> It has assisted Iran, Kazakhstan, Serbia, and

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<sup>199</sup> *History*, WEPZA, <http://www.wepza.org/history/> [<http://perma.cc/A98L-TT8Z>] (last visited Mar. 13, 2018).

<sup>200</sup> *Id.*

<sup>201</sup> Jean-Paul Gauthier, *Mission*, WEPZA, <http://www.wepza.org/> [<http://perma.cc/44GL-KGL8>] (last visited Jan. 28, 2018).

<sup>202</sup> *Id.*

<sup>203</sup> *Meeting with the President of FEMOZA World Federation of Free and Special Economic Zones*, BELARUSIAN CHAMBER OF COM. & INDUSTRY (Jan. 24, 2015), <https://www.cci.by/en/content/meeting-president-femoza-world-federation-free-and-special-economic-zones> [<http://perma.cc/TE2U-CECZ>].

Belarus via workshops, guided tours, training, and legal consultancies.<sup>204</sup>

### C. The World Free Zones Organization (www.worldfzo.org)

WFZO is a Dubai-based non-governmental organization established in Geneva.<sup>205</sup> It was launched in 2014 by Sheikh Mohammed bin Rashid Al Maktoum, Vice President and Prime Minister of the United Arab Republics and ruler of Dubai, with participation from fourteen countries hosting SEZs.<sup>206</sup> WFZO has defined its mission as becoming the most international, multilateral organization for free zones of all kinds—“[p]roviding one, authoritative, collective voice to represent the interests of free zones around the world.”<sup>207</sup> As of 2015, its membership had grown to 155 members, including free zones and zone associations; specialists including lawyers, consultants, government agencies, chambers of commerce, academics, and private corporations; and multilateral organizations including UN bodies, the World Customs Organization, and the World Trade Organization.<sup>208</sup> Current priorities include creating and sharing best practices for free zone success, holding conferences and conducting workshops, and building databases on zone-related activities. WFZO aims to “ensure the sustainability and ongoing success of the free zone model.”<sup>209</sup>

### D. Die Hanse – City League of the Hanse (www.hanse.org/en)

In 1980, a movement was launched by former Hanseatic cities to rekindle long-dormant relationships for the purpose of fostering direct tourism, business, and cultural exchanges.<sup>210</sup> This has led to the formation of Die Hanse, which describes its aim as “reviving the ideas and spirit of the European city/municipality on the basis of the cross-border concept of the historic Hanseatic League.”<sup>211</sup> An annual assembly decides on which of member communities will

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<sup>204</sup> *FEMOZA & Other Organisations*, FEMOZA, <http://femoza.org/femoza-other-organisations> [<http://perma.cc/PST3-3CNC>] (last visited Jan. 28, 2018).

<sup>205</sup> *FAQ*, WORLD FREE ZONES ORG. (2017), <https://www.worldfzo.org/Pages/FAQ.aspx> [<http://perma.cc/4RS6-87ZQ>] (last visited Mar. 13, 2018).

<sup>206</sup> *About Us*, WORLD FREE ZONES ORG., <https://www.worldfzo.org/Pages/About-Us.aspx> [<http://perma.cc/4JJS-7MD8>] (last visited Mar. 13, 2018).

<sup>207</sup> *FAQ*, *supra* note 205.

<sup>208</sup> *Id.*

<sup>209</sup> *Id.*

<sup>210</sup> *Die Hanse today*, STADTEBUND: DIE HANSE, <http://www.hanse.org/en/hanse-today/active-network/> [<http://perma.cc/G9VA-7KHX>].

<sup>211</sup> *Id.*

host the “Hanseatic Days of Modern Times” international festival for the coming year. Public relations activities focus on publicizing historical and cultural aspects common to the Hanseatic towns and cities, and on engaging young people in ways that foster transnational understanding and relationships.<sup>212</sup> It is presently funded by the COSME program of the EU and by dues (approximately \$60 yearly) paid by the member cities.<sup>213</sup> Headquartered in Lübeck, Germany, its member cities range from Novgorod in Russia to Hull in England.<sup>214</sup>

E. Community Associations Institute (www.caionline.org)

The leading association advancing the interests of privately-developed residential communities is the Community Associations Institute (“CAI”). As a U.S.-based international organization with more than 35,000 members, CAI has sixty-three chapters worldwide, including Canada, the Middle East and South Africa.<sup>215</sup> The organization assists private developers, HOA and Condominium Association board members, community managers, legal advisors, and other professionals.<sup>216</sup> Its educational activities include conferences, workshops, seminars, training programs, and certifications.<sup>217</sup> CAI maintains a library and database on community association management and governance, and publishes books, manuals, magazines, and newsletters in addition to its website.<sup>218</sup> The organization also provides briefings and testifies about the impact of proposed policy changes that can positively or negatively affect the future of covenant-backed property owners’ associations. Through an affiliated foundation, CAI conducts research and acts as a global clearinghouse for information, innovations and best practices in private community association development, operations, and governance.<sup>219</sup>

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<sup>212</sup> *See id.*

<sup>213</sup> *Membership*, STADTEBUND: DIE HANSE, <http://www.hanse.org/en/hanse-today/active-network/membership/> [<http://perma.cc/G74K-WK6T>] (last visited Mar. 18, 2018).

<sup>214</sup> *Association – The Hanseatic League*, STADTEBUND: DIE HANSE, <http://www.hanse.org/en/hanseatic-cities/> [<http://perma.cc/5FQ7-NB4C>] (last visited Jan. 28, 2018).

<sup>215</sup> *About CAI*, COMMUNITY ASS’NS INST. (2017), <https://www.caionline.org/AboutCAI/Pages/default.aspx> [<http://perma.cc/3ZLX-BBZG>].

<sup>216</sup> *See id.*

<sup>217</sup> *Id.*

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*



## F. Other Promising Allies

Beyond these SEZ and private community-oriented organizations, other groups are working for increased decentralization and devolution of power to cities. Notable examples include the Global Parliament of Mayors, United Cities and Local Governments, and the World Association of Major Metropolises.<sup>220</sup> These organizations and others aligned with their goals may play a key part in the rebirth of a world of increasingly autonomous and sovereign cities, given their rising power in economic and demographic terms, and their political ability to counter centralizing tendencies in today's nation states.

## V. OPPORTUNITY FOR A RE-EMERGENT HANSEATIC LEAGUE

Although they have deep knowledge of and experience with past and present best practices, the above groups to date have offered few solutions on how SEZs and startup communities can adapt to a fast-approaching era of exponential change. Existing organizations of all kinds will be tested to the limit by coming changes in technology, financial markets, migrant and refugee flows, cultural conflicts, and security challenges. New solutions will be needed to navigate torrential changes ahead.

A New Hanseatic League can be at the forefront of innovating to meet these needs. It could arise through moves by online communities across the planet to explore self-funding solutions—grounded in zones of extrastatecraft—that can help societies transition through the upcoming disruptions.<sup>221</sup> With the help of volunteers forming virtual guilds to assist a range of technologically advanced free zone ventures, a New Hanseatic League can fill the vacuum created by the zero-sum power struggles of nation states by using digital tools to spread islands of opportunity in areas now ruled by corrupt regimes. These tools can introduce contractual forms of governance that can awaken assets in communities mired in poverty. They also can be extended to governance systems that can fully open oceans and space to human settlement and discovery.

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<sup>220</sup> Robert Muggah & Eugene Zapata Garesche, *How cities are rewiring international affairs*, DEVEX (Aug. 3, 2016), <https://www.devex.com/news/how-cities-are-rewiring-international-affairs-88517> [<http://perma.cc/7PZN-HTW6>].

<sup>221</sup> Vast pools of online talent could play a pivotal role in meeting these challenges. Wikipedia, Linux, Apache, and other open source and creative commons initiatives have engaged millions of volunteers in creation of free digital resources.

A global New Hanseatic League can engage those around the world who want to contribute towards these ends. It can offer associate member status to individuals who are ready to join (or create) online guilds that embrace what Explorers' Foundation founder Leif Smith describes as "freeorder" values and that can volunteer services to help existing and future SEZs and startup communities expand the frontiers of extrastatecraft.<sup>222</sup> Much as the original Hanseatic League drew strength upon the peer to peer relationships woven within and among its member guilds, a new Hanseatic League can work through social networks and specialized online communities to develop orientations and courses, provide work-study projects, and add value to grassroots projects freeing areas from political predation. This can create a powerful amplifier of extrastatecraft initiatives and force for their replication. Social networks, as observers such as Robert Muggah have noted, are now emerging as "Net States" approaching or overtaking nation states as a focus of the allegiances and daily engagement of billions of the world's people.<sup>223</sup>

Active communities of online volunteers can support a New Hanseatic League in bringing a range of opportunities to areas within failing and failed states. They can help plan and crowdfund "day one" benefits, such as microscholarships for online learning and eVouchers for telemedicine resources, for local residents who are interested in better governance and alternatives to predatory rule. These digital donations and related support services can flow especially to local allies who view New Hanseatic League-prepared orientations, who express interest in finding work in global freelancing markets, and/or who wish to launch entrepreneurial startups and self-help ventures. Volunteer guilds can expand virtual support for communities that identify possible sites for future SEZs, and chart paths for removing barriers to investment.

"In the twenty-first century, trust, reputation and reciprocal relations are again vital as people pursue projects and careers rather than just jobs," notes Jerry Edling, past editor of *Public Diplomacy* magazine.<sup>224</sup> "The port cities of the Hanseatic League

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<sup>222</sup> See Leif Smith, *freeorder – meaning and use*, LIBERTY (Apr. 30, 2014), <https://freeorder.liberty.me/freeorder-meaning-and-use-of-the-word/> [<http://perma.cc/G9KP-8DAT>].

<sup>223</sup> Robert Muggah, *Countries are so last century. Enter the 'net state,'* WORLD ECON. F. (Nov. 9, 2017), <https://www.weforum.org/agenda/2017/11/countries-nations-net-states-globalization-populism/> [<http://perma.cc/WW8J-VY23>].

<sup>224</sup> Jerry Edling, *The Future of Work*, AUGMENTED REALITY (May 9, 2017), <http://augmentedreality.blogspot.com/2017/05/the-future-of-work.html> [<http://perma.cc/KF5F-X3S9>]. Parag Khanna has expressed the view on many occasions that Hanseatic precedents are

may stand, to paraphrase former President Ronald Reagan, as shining cities on a hill for the present century.”<sup>225</sup> A New Hanseatic League backed by online guilds can spread digital seeds from which a new generation of free communities can emerge. These areas over time can break the grip of political rent-seekers on a worldwide basis, in rewarding ways for all who opt in.

#### A. Virtual Resources to Seed New SEZs and Startup Communities<sup>226</sup>

Three millennia ago, Phoenician merchants faced the challenge of building trust and trade across a war-torn Eastern Mediterranean. They came up with a solution that led to creation of the first sustained network of tax-free trade zones—an innovation that can help to spread hundreds or thousands of new zones of extrastatecraft in coming years.

Phoenician merchants discovered they could lead with a gift.<sup>227</sup> When exploring unknown areas, their vessels would anchor offshore from a new village and wait for nightfall, far away enough to avoid any risk.<sup>228</sup> In the darkness, they would dispatch a small boat to bring a sample of goods from their cargo. The merchants then would light a fire, leave gifts on the beach, and withdraw.<sup>229</sup> As daylight returned, the villagers’ response would become clear.<sup>230</sup> Often the gifts would vanish and the beach would remain empty, prompting the boat to sail onwards.<sup>231</sup> In other cases, the locals left gifts on the beach in return for the Phoenicians.<sup>232</sup> These villages were where the Phoenicians chose to land and begin trade relationships.<sup>233</sup> This trust-building strategy led to the creation of long distance trade with counterparts in the Levant, Spain, Tangier, and the British Isles. In some of the welcoming areas,

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increasingly salient, including in this 2012 interview: “I draw my inspiration from network prototypes like the Hanseatic League. Much can be learned from those medieval city alliances! Then as now, agile entities that respond[] in [a] network-based way to new technologies and commercial opportunities benefit the most.” Parag Khanna, *The Cities-State*, PARAG KHANNA (Apr. 2012), <https://www.paragkhanna.com/home/the-cities-state> [<http://perma.cc/KB7C-GHME>].

<sup>225</sup> *Id.*

<sup>226</sup> For a visual representation of what is detailed in this Section, see Appendix.

<sup>227</sup> Mark Frazier, *Leading With a Gift: Moving from Multicultural Tensions to an Era of World Cities 2–3* (Oct. 2016) (unpublished manuscript), [https://www.academia.edu/29722120/Leading\\_with\\_a\\_Gift\\_Moving\\_from\\_Multicultural\\_Tensions\\_to\\_an\\_Era\\_of\\_World\\_Cities](https://www.academia.edu/29722120/Leading_with_a_Gift_Moving_from_Multicultural_Tensions_to_an_Era_of_World_Cities).

<sup>228</sup> *Id.* at 2.

<sup>229</sup> *Id.* at 3.

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

<sup>232</sup> *Id.*

<sup>233</sup> *Id.*

Phoenicians also created tax-free trade outposts. These formed the western world's first enduring network of SEZs.

Offering "gifts on a beach" in digital form will enable a New Hanseatic League to plant seeds for potentially thousands of new zones of extrastatecraft. In the Internet age, digital donations can begin relationships with even remote communities that have been long mired in poverty and misrule, yet have promising sites for developing as future zones of extrastatecraft. Gift bundles can include free cell phone minutes, vouchers for Internet access, microsolarships for online courses, and offers of global volunteer support to help identify and launch crowdfundable local projects. As local allies explore these and other opportunities available through the virtual offerings of a New Hanseatic League, they can respond by uploading evidence of their interest in moving forward. The most promising local responses will be those that map scenarios for committing sites and reforms for new SEZs and startup communities to flourish. (As outlined later, such responses could unlock much higher levels of engagement and partnership opportunities with the League.)

Created with the help of new guilds of virtual volunteers, a new global Hanseatic League can offer digital donations and increasing layers of online support services for each of the following:

1. Anytime/Anywhere Learning

Education in many parts of the world falls far short of meeting needs. Public school teachers are frequently absent or go through the motions of teaching. Students tune out in class. Topics taught often are outmoded, ill preparing learners for coming market and technological change. Catalytic gifts from a New Hanseatic League can begin to change this. Microscholarships can be offered to cover the costs of accessing online skills and certifications, including new language and technical skills. In a not-far-off future, AI-assisted personal tutoring services and cell phone-based Augmented Reality and Virtual Reality experiences also can help learners more rapidly advance. These kinds of help can go to students and households whose members watch short clips on New Hanseatic League values and who pass a brief online quiz to confirm understanding of the near and long-term rewards of extrastatecraft. A key part of such introductions can be scenarios for awakening land values on idle sites via community land trusts formed as locally-owned SEZ development ventures. The League also can sponsor online contests with globally-recognized judges to help learners gain and spread skills valued in online markets.

Awards can recognize any person or group that records and uploads a proof of notable success—whether achieved through informal peer learning or League-provided online courses. Successes can include gaining or spreading skills in literacy, persuasive speaking and writing, keyboarding, graphic design, music, and/or storytelling.

## 2. Online Jobs and New Local Ventures

At present, hundreds of millions of jobseekers around the world remain unaware of immediate opportunities to find work in global freelance markets. Gifts offered by a New Hanseatic League can include online orientations on the range of such opportunities as well as starter bundles of credential-building experiences. These opportunities can be offered to individuals of all skill levels. For the less skilled, the League can arrange to send basic tasks such as entering data from scanned business cards, watching remote security cameras, creating custom ring tones, writing lyrics, sketching ideas for logos, and editing photos. Microprojects that require higher skills can include doing web searches, distilling information, creating short animations, or improving eLearning resources (including those provided by the League). New freelancers, by these means, can build a track record of experience crucial to their successful entry into burgeoning online markets such as Fiverr.com and Freelancer.com. High performers in these markets then may attract notice and direct investments into their new startup freelance ventures through organizations such as CodersTrust.com.<sup>234</sup>

In parallel with offering initial work-study “gigs” for jobseekers to build reputation visible in fast-growing online markets, a New Hanseatic League also can offer starter resources for individuals who prefer to launch actual ventures in their community. These can include how-to information and toolkits helping recipients identify self-help projects that can make their communities safer, healthier, and more attractive for business startups. Specific toolkits and volunteer services offered to local allies in poor areas could include help with launching entrepreneurial schools and peer learning circles, identifying sites for community land trusts, exploring markets for potential ecotourism and AirBnb ventures, and

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<sup>234</sup> *About*, CODERS TRUST, <https://www.coderstrust.com/about/> [<http://perma.cc/5B3F-XFFA>]. CodersTrust describes its vision: “We believe in a borderless world with equal opportunities for everyone. We believe student finance and the freelance market will make this happen.” *Id.*

creating web sites that highlight local opportunities for diaspora or other international investors.

### 3. Local Tech Initiatives

John Robb has summed up a formula for community success in the future: “[L]ocalize production. Virtualize everything else.”<sup>235</sup> Exponentially improving technologies are bringing this success formula within reach. A New Hanseatic League can prepare online courses, toolkits, and coaching to help communities understand and act upon the expanding range resources for local self-sufficiency. Aspects covered can include advances in affordable solar powered microgrids, smartphone and drone assisted farming, makerspaces, shelter, water purification, and waste treatment.<sup>236</sup> Digital tools and support services can help League-assisted counterparts in communities identify practical (and crowdfundable) options in the near term, as well as envision future opportunities to benefit from breakthrough technologies. By these steps, communities can better position themselves for self-sufficiency as technologies enable re-localizing of many kinds of production. This shift likely will have broader implications. As George Zarkadakis has noted, it is possible that “the automation of work will mean the demise of big corporations and the rise of digital, small-scale, distributed cottage industries. Over time, these collaborative networks might evolve into virtual city-states, and even replace physical nations as the units of political organisation and citizen loyalty.”<sup>237</sup>

### 4. Contract-based Governance

As failures of current political governance mount, a New Hanseatic League can offer digital resources that can enable civil society to create contract-based alternatives. These can be grounded on a simple pledge that could become a condition of membership in a global New Hanseatic League: “Do what you commit to do. Do not transgress against the person or property of others. Give in ways that help others become free.” Individuals who uploaded a further pledge to use arbitration could unlock

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<sup>235</sup> Michel Bauwens, *Localize Production. Virtualize everything else. A collection of citations on open design and manufacturing*, P2P FOUND. (June 3, 2010), <https://blog.p2pfoundation.net/localize-production-virtualize-everything-else-a-collection-of-citations-on-open-design-and-manufacturing/2010/06/03> [<http://perma.cc/T6K7-LWME>].

<sup>236</sup> See KEVIN A. CARSON, *THE HOMEBREW INDUSTRIAL REVOLUTION: A LOW-OVERHEAD MANIFESTO* 127 (2010).

<sup>237</sup> George Zarkadakis, *The economy is more a messy, fractal living thing than a machine*, AEON (Oct. 13, 2016), <https://aeon.co/ideas/the-economy-is-more-a-messy-fractal-living-thing-than-a-machine> [<http://perma.cc/S2HC-5YSF>].

further levels of digital support from the League, flowing as well to all of their friends and neighbors who make similar (Blockchain-recorded) commitments.

Among the additional digital donations can be apps for residents of poor areas to create private land registries, which could be especially helpful in awakening land values in places where government registries are prone to corruption. Residents could use cell phone cameras to take pictures of lot boundaries as well as short video statements by their neighbors regarding the uncontested property lines. These then can be uploaded through local internet centers to League-affiliated, Blockchain-based land registries for viewing by diaspora and other prospective investors. In cases where uploads to private land registries go unchallenged in an “open comments” period, and where public bodies agree to officially recognize the new (uncontested) neighborhood land registries, further digital resources would flow to all participants.<sup>238</sup>

A parallel offering by a New Hanseatic League could include apps and support services for neighborhoods seeking to form contract-based associations of property owners. Associations backed by Blockchain-recorded deed covenants would have a new means through which to privately undertake a wide range of functions. Based on their members’ decisions, these functions may include cleanup/fixup efforts, crime watches, and contracting with service providers to fill gaps left by underperforming municipalities. To make group decision-making easier in these private self-governance associations, the apps and toolkits also could support extended proxy voting systems (“liquid democracy”), as well as introduce “double democracy” innovations proposed by Tom W. Bell to protect the rights of non-property owners in the system.<sup>239</sup>

##### 5. Asset Uplift

Global “lead with a gift” offerings from a New Hanseatic League also could include innovative ways for all to share in the uplift in land values that occurs when political rent-seeking retreats. Hernando de Soto, a Peruvian economist and head of the

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<sup>238</sup> See Mark Frazier, *New Catalysts for Sustainability*, 36–54 (Oct. 15, 2005) (unpublished manuscript), [https://www.academia.edu/4397389/New\\_Catalysts\\_for\\_Sustainability\\_Sabre\\_Foundation](https://www.academia.edu/4397389/New_Catalysts_for_Sustainability_Sabre_Foundation) (exploring Asset-awakening impacts of digital donations for the Sabre Foundation with support from the late John C. Whitehead). The concept of digital donations as an opportunity for philanthropy originated with Sabre Foundation co-founder Josiah Lee Auspitz, an author and researcher on the philosophy of free institutions.

<sup>239</sup> Bell, *supra* note 116, at 158.

Institute for Liberty and Democracy, estimates that more than \$9 trillion in land values is now lost worldwide as a result of flawed governance systems.<sup>240</sup> The emergence of trustworthy land registries and creation of lasting property owners associations can be enormous catalysts in lifting land values.

Asset Uplift tools in the League's gift packages for poor communities could contain two key elements. The first would help local allies map contract-based ways for impoverished as well as affluent residents to share in the benefits created by upward moves in land values. It would provide guidance and support for creation of revenue-generating Community Land Trusts on now-idle public lands conveyed by local authorities. As neighborhoods become more attractive through the formation of private land registries and formation of homeowners associations, lease revenues would rise from lands held by the trust. These revenues could be directly shared with low-income residents who stayed active in crime watches, youth mentoring and tutoring, cleanup/fixup efforts, art and music festivals, or other actions benefiting neighborhood property values.

The second element in the Asset Uplift package would include tools for local residents to identify what barriers to investment and entrepreneurship most depress the value of their trust's land holdings. Working with global virtual guilds of the New Hanseatic League, the local residents could take stock of remediable barriers and identify practical policy measures that could bring about further gains for their shared land holdings. These reforms can become the foundation for future dialog between local residents and policymakers regarding ways to maximize lease revenues flowing from the Community Land Trusts. Lease revenues benefiting low-income residents could rise many times in value as policy reforms lifted barriers to investment and entrepreneurship in the trust-held areas. Variants of SEZs such as Endowment Zones and All-Share Zones have been proposed exactly for such purpose.<sup>241</sup>

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<sup>240</sup> See Chris Arsenault, *Property rights for world's poor could unlock trillions in 'dead capital': economist*, BUS. NEWS (July 31, 2016, 9:15 PM), <https://www.reuters.com/article/us-global-landrights-desoto/property-rights-for-worlds-poor-could-unlock-trillions-in-dead-capital-economist-idUSKCN10C1C1>.

<sup>241</sup> *Endowment Zones: Building resilient safety nets, environmental trusts, and public services*, RADICAL SOC. ENTREPRENEURS (Apr. 25, 2012), <http://www.radicalsocialentrepreneurs.org/2012/04/endowment-zones-using-commerce-to-build-safety-nets-and-public-services/> [<http://perma.cc/MK2R-JQ63>]; Mark Frazier, *Generating Assets in "All-Share" Demonstration Areas*, OPENWORLD INST. (2007), <http://www.openworldinstitute.org/demonstration-areas-open-world/> [<http://perma.cc/7G8W-BTM7>].



Virtual guilds working on Asset Uplift initiatives could fast-track fundraising support for especially attractive local projects. The guilds can help local allies plan and launch global crowdfunding campaigns for development of small projects on the initial land trust areas. By agreement with the land trust, a (small) share in the lease revenues from large expansion areas could be set aside to recognize help from League-affiliated volunteer guilds that made exceptional contributions to the local Asset Uplift initiatives. Revenues from such shares could help cover costs of ongoing support from the virtual guild in attracting investors and businesses to the trust-held locations.

#### 6. Financial Innovations

Another gift bundle offered by the New Hanseatic League, aimed at communities suffering from inflation or other monetary and financial disasters, could be a range of tools to bypass these failures. League support packages might include orientations on reasons for the explosive growth of cryptocurrencies, crowdfunding platforms, Blockchain-based systems for receiving and tracking overseas fund transfers, as well as new solutions for time-based bartering and creation of personally-issued currencies. The package also can include links to solution providers recommended by the League's various virtual guilds.

The League similarly could provide tools for creating local land-based currencies, in cases where Community Land Trusts or SEZs were ready to share ground lease revenues. As accelerating technologies make it possible to drive the costs of most goods and services toward free, land values will rise sharply in areas that best facilitate this process. Zones and startup communities offering plenitude to residents will find that their local land-based currencies will be in high demand, especially if holders can convert them into the rights to visit and/or live in the community for the lengths of stay indicated on the currency notes.

#### 7. Public Sector Resets

As nation states come under mounting internal strains, needs are growing for public officials to understand—and act upon—opportunities to evolve in more responsive and decentralized directions. Gift bundles offered by the New Hanseatic League could contain digital resources for public officials to explore and understand options that lead to rewarding transitions.

The Public Sector Reset package could include multimedia tours and Skype sessions with officials of areas that have successfully moved away from bureaucratic and corruption prone

systems towards more transparent systems, especially through the vehicle of SEZs. Innovations such as Singapore's Flexiwave for increasing public sector salaries (in step with economic growth rates),<sup>242</sup> and Hong Kong's postwar success in generating more than \$100 billion in revenue from leasing government-owned land,<sup>243</sup> can be among the innovations highlighted.

The League also could prepare a range of revenue-generating eGovernment solutions as part of the Public Sector Reset package. Turn-key eGovernment modules can draw upon global best practices, adaptable with the help of virtual guilds and in-country partners to local needs. Modules can be created for streamlined investment approvals, preparing build-operate-transfer deals with privately-funded infrastructure providers, open tendering of SEZ development concessions, auctioning of long-term leaseholds on publicly-owned sites, and introducing online systems for company registry, eResidencies and visas, and work permits.

The New Hanseatic League could globally promote ULEX as an interface for creating world-class SEZ enabling acts and implementing regulations. An open source initiative launched by Chapman University Fowler School of Law professor Tom W. Bell, ULEX makes it possible to integrate best practices from the statutes of a range of highly successful SEZ, as well as from established nation states, and apply them in small demonstration sites that can be designed to scale up to areas comparable to Singapore, Hong Kong, and Dubai in size.<sup>244</sup>

In almost all cases, the value of digital donations and support offered via a "lead with a gift" initiative would be keyed to evidence of local progress. Uploads by grassroots allies of videos to the Blockchain would confirm when pre-defined milestones had been reached. Each major milestone would unlock higher levels of support from a New Hanseatic League and its guilds of volunteers. These benefits would flow directly to neighborhood residents and to active self-help groups, in the form of microvouchers to access eLearning and eHealthcare, free cell phone minutes, and higher matching ratios in guild-assisted global crowdfunding campaigns to assist local projects. Smart contracts, also grounded in the

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<sup>242</sup> See PRIME MINISTER'S OFFICE, *supra* note 133.

<sup>243</sup> See Shirley Zhao, *Does Hong Kong's land sale system need a new lease of life?*, S. CHINA MORNING POST, <http://www.scmp.com/news/hong-kong/economy/article/2088556/does-hong-kongs-land-sale-system-need-new-lease-life> [<http://perma.cc/LT73-DVQ7>] (last updated Apr. 19, 2017).

<sup>244</sup> See Tom W. Bell, *Introducing ULEX: Towards Open Source Law for New Nations*, VOICE & EXIT (May 15, 2015), <https://www.voiceandexit.com/introducing-ulex-towards-open-source-law-for-new-nations/> [<http://perma.cc/R5Z6-H6KX>].

Blockchain, could be used to remove any question over whether enriched gift bundles would flow as local skills spread, land registries of undisputed properties were created, and deed-based neighborhood associations were formed.

The greatest gift bundles could be reserved for residents of areas where policymakers transferred idle public properties to community land trusts—and agreed to policy reforms that would rapidly boost their value. In this way, a New Hanseatic League and its virtual allies would spread seeds for initially small, but scalable, SEZs to emerge. Grants of expansion areas to community land trusts in many economically-lagging regions could be substantial, paving the way for phased development of SEZs that could come to rival Singapore, Hong Kong, Dubai, and Shenzhen in size. Revenues generated by holding tenders to attract private developers in each phase could be shared with residents, local self-help organizations, public sector bodies (including Flexi-wage-style bonuses for their personnel), and global virtual volunteers who had made contributions highly rated by the community.

SEZs created by this process would become full members of a New Hanseatic League, entering a community of virtually-frictionless hubs for innovation and wealth creation. As exponential technologies spread, all nodes in the New Hanseatic League network could become beneficiaries of a UBI—through radical reductions in the costs of now-scarce goods and services.<sup>245</sup> Peter Diamandis has referred to this trend as a manifestation of market-generated “technological socialism,” in which machines rather than governments provide a wide range of free education and health care resources wherever Internet connections exist.<sup>246</sup> With regard to education, any individual who joined directly as an associate or full member of a New Hanseatic League community in the near future could receive personalized learning—delivered through mutual learning networks, free courseware, and AI tutors—highly attuned to their individual interests and needs. Over time, agreements on “sojourner visas” akin to those proposed by futurist James C. Bennett in *The Anglosphere Challenge* could be reached that give residents in good standing the ability to visit or live in other areas that have joined the League’s network.<sup>247</sup>

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<sup>245</sup> See Peter Diamandis, *Demonetized Cost of Living*, DIAMANDIS TECH BLOG (July 18, 2016), <http://www.diamandis.com/blog/demonetized-cost-of-living> [<http://perma.cc/T78T-4ABX>].

<sup>246</sup> *Id.*

<sup>247</sup> JAMES C. BENNETT, *THE ANGLOSPHERE CHALLENGE: WHY THE ENGLISH-SPEAKING NATIONS WILL LEAD THE WAY IN THE TWENTY-FIRST CENTURY* 149–56 (2004).

This can lead to a rise in opportunities and living standards for residents of New Hanseatic League communities across the globe.

#### B. “Stretch Goals” for a New Hanseatic League

A New Hanseatic League also could advance human freedom, prosperity, and wellbeing in other ways. With the help of volunteers in virtual guilds working to free areas from political rent-seeking, the League can bring fundamentally new kinds of SEZs into being, adapting to the opportunities and challenges created by advanced technologies.

##### 1. Advanced Forms of SEZs and Startup Societies

Over the millennia, SEZs have evolved. They have gone from small tax-free areas for storage and transshipment of goods, to campus-sized areas for manufacturing and services operations, to large freeports and Shenzhen-style zones with diversified economies and millions of residents. A New Hanseatic League can help launch a new generation of SEZs and innovative startup communities. These can cater to the exponential technologies that increasingly will enable radical advances for humanity in self-governance and in opening new frontiers.<sup>248</sup>

The League could engage global volunteers and work with leading NGOs, private developers, and infrastructure providers in coming years to establish the following new kinds of contract-based SEZs and startup communities:

##### a. World Cities

As developed nations move to block entry by migrants and refugees, opportunities are growing to establish new Hong Kong or Singapore-scale areas that can welcome immigrants who possess language and technical skills and value cultural pluralism.<sup>249</sup> World Cities open to such pools of talent also could draw upon the best elements of existing SEZ statutes and

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<sup>248</sup> See Frazier, *supra* note 50.

<sup>249</sup> Mark Frazier, Creation of World Cities: An Opportunity for Economies in Transition 3 (Feb. 16, 1992) (unpublished manuscript), [https://www.academia.edu/28944734/Creation\\_of\\_World\\_Cities\\_An\\_Opportunity\\_for\\_Economies\\_in\\_Transition\\_1992\\_original\\_study\\_](https://www.academia.edu/28944734/Creation_of_World_Cities_An_Opportunity_for_Economies_in_Transition_1992_original_study_); see also Frazier, *supra* note 227. A point system for entry visas into World Cities could be developed, keyed to an applicant's demonstrated understanding of: (1) transcultural values of individualism, and (2) demonstrated success in spreading these values among family members and friends whom accepted immigrants also could directly sponsor for visas. Before moving, individuals could gain many extra points by earning high reputations—and revenue—in global freelance markets such as [www.Upwork.com](http://www.Upwork.com), [www.Fiverr.com](http://www.Fiverr.com), and [www.Guru.com](http://www.Guru.com).

regulations worldwide when creating their policy environments, so as to establish unsurpassed environments for investment and entrepreneurship.<sup>250</sup> Private developers may compete to win rights to develop World Cities of this kind without need for subsidy, given confidence in the economic reforms as well as in sites offered by the host country for lease on a long-term basis. Rent-sharing agreements and build-operate-transfer concessions signed by developers of World Cities can produce notable revenue and asset gains for the government and citizens of the countries. The market opportunity for creating multiple World Cities is enormous—a 2009 Gallup survey concluded that 700 million people on Earth would like to move permanently to other countries.<sup>251</sup> Virtual guilds interested in promoting examples of depoliticized communities and in alleviating hardships experienced by those fleeing wars and failed states could make potentially historic contributions by helping to launch and spread World Cities.

#### b. Seasteads

Global talent similarly can be tapped on a large scale for creating “Seasteads”—floating startup communities that operate with a high level of freedom—on the world’s oceans. Already, organizations such as the nonprofit, Seasteading Institute, and Blue Frontiers, its companion for-profit venture, have found a vibrant response from volunteers to initial Seasteading opportunities offered in the Pacific.<sup>252</sup> The success of an initial Seastead is likely to lead to generate waves of subsequent interest in sea-based communities. Many of these are likely to seek SEZ status or full-fledged autonomy and independence from political bodies. As described in *Seasteading*, a new book by Patri Friedman and Joe Quirk, Seasteads offer perhaps the most inspiring near-term prospects for volunteers from all countries to help create and spread globally visible examples of new forms of extrastatecraft.<sup>253</sup>

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<sup>250</sup> Bell, *supra* note 116, at 188.

<sup>251</sup> Nelli Esipova & Julie Ray, *700 Million Worldwide Desire to Migrate Permanently*, GALLUP NEWS (Nov. 2, 2009), <http://news.gallup.com/poll/124028/700-million-worldwide-desire-migrate-permanently.aspx> [<http://perma.cc/6G9H-AW2T>].

<sup>252</sup> *Floating City Project: A fresh start on a floating community by 2020*, SEASTEADING INST., <https://www.seasteading.org/floating-city-project/> [<http://perma.cc/ZU9R-ZCJW>].

<sup>253</sup> JOE QUIRK & PATRI FRIEDMAN, SEASTEADING: HOW FLOATING NATIONS WILL RESTORE THE ENVIRONMENT, ENRICH THE POOR, CURE THE SICK, AND LIBERATE HUMANITY FROM POLITICIANS 31 (2017).

### c. Earthports

Another opportunity to inspire New Hanseatic League volunteers is the prospect of creating large new SEZs that accelerate humanity's leap into space. Rapid plunges in launch costs are now making it possible for international space freeports, first proposed during the 1970s by the Sabre Foundation, to become economically as well as politically feasible.<sup>254</sup> Given the introduction of Hong Kong-class incentives at prime launch sites (ideally located near the equator for maximum launching efficiencies), and at nearby areas attractive to a range of investors, ground lease revenues could reach hundreds of millions of dollars annually. A portion of these revenues could be applied to prepare off-planet human settlements governed by contractual agreements rather than political bodies.

### d. Communities in Space

The prospect of mass movements of people into space is no longer a remote prospect. Elon Musk, the founder of SpaceX, has recently announced his intent to develop a city on Mars with one million residents before 2067.<sup>255</sup> He's planned the first manned Mars mission in 2023.<sup>256</sup> In view of this timeline, volunteer guilds assisting a New Hanseatic League could make valuable input regarding the potential for contractual governance systems to help new settlements on Mars minimize or avoid the kinds of recurring political dysfunctions that have scarred Earth.

These areas can be grounded in a philosophy of free institutions that respect a self-organizing "freeorder" contractual basis for civilizations. The next generation of SEZs and startup communities in a New Hanseatic League can be grounded in covenants to depoliticize relationships among sovereign individuals of all creeds, countries of origin, and biological lineages.

## 2. Uses of Common Heritage Resources

A New Hanseatic League can extend a revolution in governance in another way. It could lead in preparing extrastatecraft agreements for the development of resources in

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<sup>254</sup> Michael A.G. Michaud, REACHING FOR THE HIGH FRONTIER: THE AMERICAN PRO-SPACE MOVEMENT 1972-84, at 247-70 (1986).

<sup>255</sup> Sarah Knapton, *Elon Musk: We'll Create a City on Mars with a Million Inhabitants*, TELEGRAPH (June 21, 2017, 5:09 PM), <http://www.telegraph.co.uk/science/2017/06/21/elon-musk-create-city-mars-million-inhabitants/> [<http://perma.cc/MXD5-HZ5L>].

<sup>256</sup> *Id.*

Outer Space. International treaties recognize space as “common heritage” frontier whose resources are to be developed on a basis that benefits all humankind.<sup>257</sup> The Outer Space Treaty of 1967 forbids ownership claims by nations as well as corporations.<sup>258</sup>

The treaty has had a positive aspect. It creates room under international public law for depoliticized frameworks to globally share the commercial benefits of resources found on humanity’s ultimate frontier. In the five decades since the Outer Space Treaty was adopted, however, little headway has been made in opening space for the benefit of all of humanity. The 107 ratifying nation states have deadlocked over ways to commercially develop common pool resources of outer space in accord with the treaty provisions.

A New Hanseatic League may overcome the impasse by introducing new contractual systems for developing space resources for the benefit of all humanity. These can be grounded on the insights of Elinor Ostrom and Chris Cook, who have respectively mapped the potentials for non-governmental user associations and “nondominium” legal frameworks to encourage commercial development of common pool resources.<sup>259</sup> In both cases, agreements are created for stewardship, rather than for ownership of commercially-valued resources. (The nondominium legal vehicle would enable stewards to set transparent tenders for private investors to bid on commercial development opportunities, with escrowing of paid-in fees and royalties until all who wished to benefit from the common pool resource have come to unanimous agreement on how to use the funds.)<sup>260</sup> A New Hanseatic League could create covenants for communities to use such frameworks to escrow leasehold fees paid by developers, as a means of respecting the Treaty’s ban on land ownership claims.

The League could go a step further to ensure that every human being can share in commercial development of space

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<sup>257</sup> Valnora Leister, *Economic Governance and Space Law: Emerging Foundations for Development of “Common Pool Resources” in Outer Space*, 3 INDIAN J. INT’L ECON. L., 64, 66–67 (2010).

<sup>258</sup> Elizabeth Howell, *Who Owns the Moon? Space Law & Outer Space Treaties*, SPACE.COM (Oct. 27, 2017, 9:00 AM), <https://www.space.com/33440-space-law.html>.

<sup>259</sup> See Leister, *supra* note 257, at 64; *Nondominium: establishing consensus and collaboration for the Caspian nations*, UCL RESILIBLOG (Oct. 4, 2011), <http://blogs.ucl.ac.uk/resilience/2011/10/04/nondominium-establishing-consensus-and-collaboration-for-the-caspian-nations/> [<http://perma.cc/74LG-K2UQ>].

<sup>260</sup> Valnora Leister & Mark Frazier, *From Local to Global Commons: Applying Ostrom’s Key Principles for Sustainable Governance*, CONFERENCE ON EARTH SYSTEMS GOVERNANCE 18 (2012).

resources. Startup entrepreneurs who join New Hanseatic League could use the liberalized business climates established by member zones and startup communities to fund their ventures, by initiating global Initial Coin Offerings (“ICOs”) and equity crowdfunding campaigns. Ventures funded by this means could include a set-aside for a success-sharing innovation proposed by Trent McConaghy, who has suggested a way to broadly “tokenize” shares in enterprises conducting ICOs.<sup>261</sup> By contractual agreement with League and/or any of its supporting guilds, a small portion of the tokens issued by each spacefaring ICO could be escrowed for a future global “airdrop,” building on recent international precedents.<sup>262</sup> (In the New Hanseatic League covenants, each person on Earth would have a Blockchain-recorded birthright to a direct pro rata sliver of the tokens reserved for this success-sharing purpose by spacefaring ventures.) Over time, the value of such set-asides could rise significantly given the magnitude of the wealth waiting to be created on the new frontier. Escrowed funds for individuals would be released by New Hanseatic League smart contracts upon the first of the following conditions to occur: the value of the escrowed funds reach a League-set threshold level, or any nation state individually requests the League to release the escrowed funds directly to its citizens.

In the vacuums left by failures of nation states to act, Jurgen Brauer and Robert Haywood have identified ways for global civil society organizations to move forward as “non-state sovereign entrepreneurs” and “non-territorial sovereign organizations.”<sup>263</sup> Their paper, published by United Nations University in 2010, gave as examples the cases of ICANN, the nongovernmental body responsible for ground rules applying to all Internet domain registries, and the International Accounting Standards Board (“IASB”), a similar nonpolitical body which sets global standards for financial reporting. Brauer and Haywood conclude that “state-based global governance is unlikely to succeed” in creating effective, peaceful and just responses to looming challenges.<sup>264</sup> Another form of governance in their view holds far more hope—one

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<sup>261</sup> Trent McConaghy, *Tokenize the Enterprise . . . And Melt It Into the Community. Rinse, Repeat.*, BIGCHAIN DB (June 6, 2017), <https://blog.bigchaindb.com/tokenize-the-enterprise-23d51bafb536> [<http://perma.cc/4DJX-7BPJ>].

<sup>262</sup> See *Global Bitcoin Airdrop 2017 Will Take Place in Six Countries*, ALTCOINTODAY (July 29, 2017), <http://www.altcointoday.com/bitcoin-airdrop-2017/> [<http://perma.cc/F48J-NK4D>].

<sup>263</sup> Jurgen Brauer & Robert Haywood, *Non-state Sovereign Entrepreneurs and Non-territorial Sovereign Organizations* 9, 12 (UN Univ., Working Paper No. 2010/09), <https://www.unu.edu/sites/default/files/wp2010-09.pdf>.

<sup>264</sup> *Id.* at 9.



created by civil society and by business organizations that have transcended state boundaries. A New Hanseatic League can help fill the void created through nation state failures by following the precedents of ICANN and IASB to build a similar global sovereign non-state enterprise for contractual governance.

## VI. SHARING THE UPSIDES

Given adoption of favorable policies, zones of extrastatecraft have the potential to awaken trillions of dollars in now-dormant land values on Earth, as well as to open immense off-planet sources of wealth. The prospect of enabling such gains can help a New Hanseatic League reward governments and residents in sponsoring countries, incentivize guilds of virtual volunteers, tap talents of refugees and other at-risk populations, and create options for funding new global rounds of catalytic gifts to expand the number of success-sharing zones and startup communities affiliated with the League.

### A. Enriching Sponsoring Nations

Host countries assisted by the New Hanseatic League can reap substantial revenues and land value gains, proportional to the size and quality of sites conveyed and the strength of policy reform commitments. SEZs and startup communities operating on long-term land leases could become an especially rewarding opportunity. One way to enrich host countries would be through a Hong Kong-inspired system in which the host government retains ownership of all land and arranges global auctions and tenders to attract bids by risk-taking private investors that seek long-term (fifty-year) leases. Hong Kong has reaped more than \$100 billion over four decades in revenues from auctions and tenders given the exceptionally favorable tax and regulatory environment it has maintained for investors and entrepreneurs.<sup>265</sup> The upsides of this approach need not go to the government alone. Shares of the annual lease revenue generated on publicly-owned sites benefiting from SEZ status also could flow directly each year to residents, following the precedent of Macau's UBI "Wealth Partaking" system.

Other revenue-generating opportunities for host countries can arise through introduction of eResidencies and online company registry systems after the successful models of Estonia and of Delaware in the United States.<sup>266</sup> Substantial further earnings

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<sup>265</sup> See Zhao, *supra* note 243.

<sup>266</sup> See MEDIUM, *supra* note 160.

could be realized through introduction of Dubai-style online visa and work permits, as well as new “green lane” eGovernment services that offer fast-turnaround processing of forms and permits in return for a web-based user fee.

A further way for host countries to profit is through build-operate-transfer concessions. In these, private bidders seek rights within an economically liberalized area to develop airports, ports, road, electric, and/or water/sewer systems. The chosen concessionaire then can profitably recoup its investments through user fees over a pre-agreed period, normally in a twenty to fifty-year range. During this period, the concessionaires progressively transfer ownership of the infrastructure to local counterparts, who at the end of the agreed term hold full or almost-full ownership of the physical assets built by foreign risk-taking capital and ongoing income from user fees.

#### B. Rewarding Volunteers and their Guilds

A New Hanseatic League could offer rewards for individuals and guilds of their choosing that provide tools and services valued by communities and countries. Creators of open source eLearning resources, crowdfunding tools, policy reform packages, eGovernment apps, lease auction and tendering systems, and online support services could be rewarded with “Freedompoints,” a new League-issued reputation currency. Freedompoints could be earned by any volunteer earning overall high feedback ratings from participating communities, and/or by being credited by these communities for making valued specific contributions to achieving crowdfunding goals, policy reform targets or market-based successes for specific projects. Local allies in the same way might earn Freedompoints by uploading video clips confirming active contributions to neighborhood improvement efforts over a sustained period and/or launching community land trusts and securing policy reforms. All holders of Freedompoints might convert them into microvouchers or other digital resources of value to themselves, to their friends and families, and/or to others in their guilds. Recipients also would have options to donate Freedompoints to local or global good causes of their choosing aligned with New Hanseatic League values and pilots of extrastatecraft. In areas where local communities so agreed, Freedompoints might convert into shares for guilds in ground lease revenues generated by the land trusts and SEZs that their members had helped in early stages. The prospect of earning a share in the ground rents of future Hong Kongs and Singapores could be a powerful incentive for virtual guilds to effectively

volunteer. Visa costs also might be discounted by League-affiliated communities to ease future entry by volunteers and their families into the global network of League-affiliated SEZs and startup communities.

### C. Helping At-Risk Populations

At present, the challenge of dealing with sixty million migrants, refugees, displaced people, and stateless persons is overwhelming the capabilities of nation states and international organizations. A New Hanseatic League may be able to make urgently needed contributions. Virtual guilds of volunteers could directly assist refugees and others in gaining skills, absorbing transcultural values, entering online telework markets, and earning reputations through small work-study freelance gigs. High performing individuals then could be invited to join guild teams volunteering to help formative projects for SEZs and startup communities in impoverished or other troubled areas. These projects especially would aim to help seed and support immigration-friendly World Cities. Those who received positive feedback ratings for their volunteer work could earn Freedompoints for themselves and their families. Outstanding volunteers also could receive donations of frequent flier miles from their guilds, and/or employer-sponsored visas to locate in Dubai or other SEZs in the New Hanseatic League network that offer liberal entry for guild members in good standing.<sup>267</sup>

### D. Funding New Rounds of Catalytic Gifts

Before beginning volunteer efforts to help formative SEZs and startup communities, the League also might invite local counterparts to enter into pay-forward agreements, keyed to the future upsides generated. Such agreements might apply to expansion areas linked to small initial sites chosen for pilots of extrastatecraft. Such pay-forward provisions would be activated in cases where the local community asked the League to organize global tenders to attract private developers for the large-scale expansion areas. An agreed small portion of the upfront fees paid by the top bidder could help the New Hanseatic League seed more contractually-governed communities. (The rest would flow

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<sup>267</sup> For a fuller description of this Freedompoints-related opportunity, see Mark Frazier, *Seeds of Change Challenge Offers*, OPENWORLD (2014), <http://www.openworld.com/accessing-openworld-challenge> [<http://perma.cc/33VM-E7TS>]. Income earned from projects in online freelance markets (or from virtual volunteering through the League's virtual guilds to awaken land values for specific projects) would provide further resources for refugees and migrants in the course of resettling.

primarily to local stakeholders, plus any of the League's guilds that the local counterparts felt had made notable contributions.) The pay-forward funding would enable the League to extend further "lead with a gift" offers of digital donations and seed more voluntarily-governed areas.

A possible incentive might give added reason for local projects to support a global pay-forward fund. The League could track the flow of funds committed by each project for this wider purpose. As future revenues came into the New Hanseatic League, it could vest each of the contributing communities on a pro rata basis as beneficiaries. The revenue streams could be generated via performance-linked contracts, under which the League would hold global tenders to attract private investors to develop World Cities and other large new extrastatecraft ventures, both on and off the planet. As these new privately-funded communities contribute to the pay-forward agreements, they in turn would benefit from the creation of further areas of extrastatecraft.

## VII. A STRATEGY FOR LAUNCHING THE NEW HANSEATIC LEAGUE

The heart of the New Hanseatic League's strategy is to mobilize online talent and SEZs in partnerships that spread contractual systems of governance across the planet. Immutable agreements—such as those offered by the Blockchain and by Ethereum-based smart contracts—could ensure sharing of the resulting land value gains. Ultimately, the League's strategy can vest all people on Earth as shareholders in newly-created depoliticized areas. The following are steps to achieve this outcome.

### A. Startup Scenario

#### 1. Creating the Working Group

With support from highly regarded, technologically advanced SEZs—prospective Lübecks and Hamburgs for a globalized New Hanseatic League—a Working Group meets and refines the aims and values for the new venture. It designs a transparent, capture-proof, and politically nonaligned founding agreement to sustain peer-to-peer relationships among present and future zones of extrastatecraft.

Practical issues resolved by the Working Group include choosing a legal vehicle and domicile and inviting a global network of supporters to join as founding members of the League. They design incentive frameworks for virtual guilds and others to provide in-kind inputs to SEZs and startup communities. The Working Group also engages a global core management team to

approach aligned organizations and potential funders, begins a world-wide publicity campaign, and launches a crowdfunding drive to attract resources for the League.

## 2. Activating Partners

Open source communities form League-affiliated virtual guilds to prepare toolkits and provide online help for new SEZs and startup communities. Highly regarded NGOs and technology research and development ventures offer plans to pilot exponential technologies in learning, healthcare, power, transportation, and government.

## 3. Developing Orientations and Starter Toolkits

Virtual volunteers go to work on creating orientations that can help individuals see the scope of opportunities. They develop downloadable materials in multiple languages to build skills and credentials for students and jobseekers to successfully enter online freelancing markets. Similar packages are created for local groups in poor areas to create private land registries, strengthen neighborhood self-help abilities, and map paths for creating land trusts and scalable SEZs. Orientations for public officials on success-sharing zones also are completed.

## 4. Preparing Global Prizes and “Lead with a Gift” Challenge Offers

Global crowdfunding campaigns enable the League to announce contests for communities to win “Lead with a Gift” challenge offers of digital donations. These gift offers of microscholarships, vouchers for telemedicine services, and introductory telework gigs go to localities that agree to explore SEZ and startup community opportunities. An annual global prize also is funded to benefit communities that go the farthest in launching extrastatecraft initiatives.

## 5. Sparking Local Projects and Virtual Volunteering Initiatives

A test project offers catalytic donations to pilot communities in poor areas on each continent. These flow to residents once a target number has viewed New Hanseatic League orientations on tools and support services created by League-affiliated guilds of volunteers. Higher levels of donations and volunteer support are unlocked as and when local residents move ahead with any of the tools. Progress uploads from the pilot villages prompt release of further donations and online help, including guild support for

global crowdfunding drives to back their locally-chosen extrastatecraft pilots.

As videos from successful pilot projects are uploaded, the League raises new funds for its member guilds to expand challenge offers of digital donations. The League activates the first annual regional and global competitions to recognize and reward grassroots breakthroughs.

#### 6. Amplifying the Best Examples

Virtual volunteers and local allies prepare documentaries and short courses showing highlights and lessons learned from the best extrastatecraft projects. These become part of learning resources and toolkits for subsequent projects. Freedompoints are awarded to all co-creators of highly rated materials, as well as to volunteers who lend outstanding virtual or onsite help to exemplary local initiatives (based on local feedback ratings).

#### 7. Launching Large SEZs and Startup Communities

As local successes grow, the League mounts further global contests to support large-scale SEZ and startup community projects. Communities around the world are invited to commit vacant sites plus policy reforms to launch the next generation of Singapores and Hong Kongs. Contingent pledges of more than \$500 million are raised from crowdfunding campaigns, philanthropists, and others for a World City competition to create a SEZ with liberalized visa policies. Guest worker visas are granted to 100,000 refugees and economic migrants who have earned outstanding reputations for their projects in global freelance markets and passed tests confirming world-class language skills and an appreciation of transcultural values.

Within three years of operation, the first World City is prospering and the New Hanseatic League repeats the process. Private developers bid for concession rights to develop and operate the next World Cities under land rent-sharing and build-operate-transfer infrastructure agreements that directly benefit governments and citizens of the host countries.

#### 8. Opening New Frontiers for Voluntary Governance

The New Hanseatic League reaches agreements with entrepreneurial launch companies to work towards creating international space launch areas—Earthports—as tax-exempt freeports for opening humanity's next frontiers. Several of the sites offered by countries for the project include large land grants with SEZ incentives. Annual land lease revenues are shared

equally between the host government, citizens of the country, and civil society organizations working with entrepreneurs to create future off-planet communities.

A similar process unfolds with League assisted Seasteading initiatives. Virtual guilds of volunteers work with nonprofit and for-profit firms to establish land-based SEZs in tandem with Seasteading concessions. A pre-agreed share of the annual ground lease revenues produced by the land-based “Endowment Zones” goes to fund eLearning and eHealthcare vouchers for all residents of adjacent communities.

#### B. Issues to Resolve

Early in its activation, the New Hanseatic League can deal with a range of open questions. The following are initial ideas on how the League and the global guilds of virtual volunteers may choose to answer them.

##### *1. What could the League do for already established SEZs and contract-based communities?*

A key challenge for established zones and contractually-governed communities will be dealing with the demonetizing and job-destroying aspects of new technologies. Zones that rely on labor-intensive means of production will be vulnerable to disruption as automation advances and rapidly deflates the prices of goods and services in open markets. Rather than depend on yesterday’s models, such areas can use toolkits and volunteer services offered by the New Hanseatic League to press for policy reforms that accelerate introduction of exponential technologies. The League also could help established zones and communities in identifying expansion area opportunities for established developers by pressing governments to convey sites into “Endowment Zone” community land trusts and apply policy reforms to increase their value. Owners, residents, and workers in the original SEZs and contractual communities could become shareholders in the land value uplift from such expansion zones as new technologies drive goods and services towards free.

##### *2. How will the League help new extrastatecraft areas expand from small pilots?*

The League could provide model contracts that create dynamics for pilot areas to grow substantially over time. Initiators, investors, and providers of in-kind services in small startup zones could receive shares in the land value gains from each expansion area associated with the original project. Workers

and/or residents who came in during the first “quickstart” phase of SEZ development also might invest in shares of the lease revenues from development of later phases. Those who joined and helped during the second phase of development would reap rewards from a share in the lease earnings in third as well as subsequent expansion phases. In this way, “race conditions” could be established that incentivize all to contribute to pilot phase successes and to press thereafter for continuing expansion. Broad vesting of residents and workers in this way would create powerful economic and political pressures on policymakers to steadily enlarge zones of extrastatecraft.<sup>268</sup>

### *3. Can a New Hanseatic League contribute to easing refugee and migrant crises?*

Virtual volunteers could engage refugees and migrants in co-creating curricula aligned with New Hanseatic League values of pluralism, transculturalism, and respect for personally-chosen destinies.<sup>269</sup> Volunteers also could draw on refugee talent to prepare online platforms that help large numbers of students and jobseekers enter and find work in fast-growing global freelance markets such as [www.Fiverr.com](http://www.Fiverr.com) and [www.Freelancer.com](http://www.Freelancer.com). Migrants and refugees could further help the League’s guilds in preparing toolkits, business plans, asset-awakening policies, and model concession agreements for future Hong Kong and Singapore-scale World Cities. Augmented Reality and Virtual Reality walkthroughs could give prospective in-country allies and global crowdfunding supporters a preview of the opportunities. The League’s virtual guilds also could extend enriched online support for migrants and refugees who gain international language skills, accept a live and let live ethos, and earn positive feedback ratings in global telework markets. Through such means, the New Hanseatic League could bring near- and medium-term opportunities to those who have fled failing states and are searching for new safe havens, as well as to those who may wish to return home and apply extrastatecraft innovations.

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<sup>268</sup> Real Estate Investment Trust (“REIT”) the arms of a Community Land Trust could also offer reverse mortgages for private landowners. They would transfer their land to the trust but could retain lifetime ownership of their dwellings. In return for transferring land, they would receive upfront payment plus a pre-set share in earnings from ground leases in commercial areas of later zone expansions. The SEZ provisions would exempt upfront payments and later ground lease sharing from all tax burdens.

<sup>269</sup> Such learning resources can include virtual tours of leading free zones and contractual communities, examples of extrastatecraft found in global works of imaginative fiction, and introductions to seminal works on “freeorder” and on the philosophy of free institutions.



4. *How will nation states react to new areas of extrastatecraft?*

SEZs could help stagnating and fragile regimes. China went from a sclerotic state-dominated economy to the most dynamic economy in history following the introduction of economically liberalized zones as proving grounds for market-based reforms. A New Hanseatic League can help spread SEZs in brittle nations with now-stagnating or collapsing economies as a relatively safe path to more open and sustainable economic systems. The League also can offer appealing transitions for countries and communities where market forces remain suspect and where inflexible labor laws are entrenched. In such cases, the League and its guilds can propose models of SEZs based on social ownership of land, following Hong Kong and Singaporean precedents. Workers in zones where land is socially owned could receive direct shares in the lease auction revenues generated by rapidly appreciating areas of extrastatecraft. In return for such wealth-sharing, new labor code flexibility can be introduced in the zones as a means of boosting investor demand in the associated dividends from land rents to workers and their families. The New Hanseatic League would urge statist regimes of all kinds to move from their current (political) rent-seeking system to a more durable and lucrative alternative: land rent-seeking through (politically-designated) zones of extrastatecraft.

Rewards for countries that opt for pilots of extrastatecraft will rise to the degree that other nations do not allow them. States refusing to pilot deep reforms will divert global flows of investment and talent into more welcoming areas established by other societies. Ironically, on a personal basis, rulers who block zones of extrastatecraft in their own realms also are likely to favor the success of economically liberalized areas and tax havens in other jurisdictions, as a means of parking their wealth.<sup>270</sup>

5. *Will a New Hanseatic League be prone to capture by nation states?*

Great powers, as well as smaller nation states, throughout history have used SEZs as an instrument of expanding political

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<sup>270</sup> Bribery and corruption is a \$3.6 trillion annual industry according to 2016 United Nations' estimates. See *2017 Theme: United against corruption for development, peace and security*, UN (2017), <http://www.un.org/en/events/anticorruptionday> [<http://perma.cc/UGT5-9FXH>]. Given the scale of wealth stolen by politicians and their allies, it is unlikely that political regimes will let offshore havens be extinguished. As global investment advisor Harry Schulz noted in the 1976 international investment newsletter titled the *Harry Schultz Letter*, crooks need honest bankers to ensure the safety of their assets, as well as places to

and economic spheres of influence. There is a risk that similar dynamics may arise in coming decades.

In the United States, former House Speaker Newt Gingrich has advocated for bilateral treaties to establish a network of new “Free Cities” around the world to spread American values and economic opportunities.<sup>271</sup> The new Free Cities would be backed by United States security assurances.<sup>272</sup> China is currently pursuing bilateral agreements to finance and co-develop its own network of SEZs. Questions have been raised about whether scores of proposed new Chinese zones in Pakistan will be open to firms and workers from other countries. “There is no provision to protect Pakistani interests, with Pakistani businessmen barred from investing in the SEZs,” reports Gopalaswami Parahasrathy, India’s former High Commissioner to Pakistan.<sup>273</sup> “There are no assurances that the Chinese would utilize Pakistani labour in any meaningful manner.”<sup>274</sup> If the reports prove true, a number of Chinese-funded SEZs may be following the unfortunate model established by the original Hanseatic League’s network of tax-free zones, which excluded or restricted foreign merchants, workers, and investors.

A New Hanseatic League could take steps to avoid capture by existing SEZ-promoting nation states (and/or by state-backed private developers), and instead encourage global civil society support for inclusive zones and startup communities. It can do so by encouraging volunteer guilds to engage with any extrastatecraft projects of their choosing—and reciprocally, for communities to freely invite any League-affiliated volunteer guilds they would like to engage. The only stipulation would be that League-affiliated projects assisted by volunteers must be peaceful in nature and non-transgressive with regard to the persons and property of others. A Freedompoints reward system offered to virtual and onsite volunteers also would be used only for extrastatecraft projects that were inclusive in nature—specifically, privately developed zones and communities that did not discriminate

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which they and their families can comfortably retire or flee. Rulers of many nation states, and their cronies, can be expected to wield their power in nonpublic ways to protect safe havens.

<sup>271</sup> Newt Gingrich & Ken Hagerty, *Free Cities*, AM. ENTER. INST. (Aug. 19, 2010), <http://www.aei.org/publication/free-cities/> [<http://perma.cc/J4U4-DYMY>].

<sup>272</sup> *Id.*

<sup>273</sup> G. Parthasarathy, *Checked into Debt and Bankruptcy*, HINDU BUS. LINE (Mar. 22, 2017), <http://www.thehindubusinessline.com/opinion/columns/g-parthasarathy/checked-into-debt-and-bankruptcy/article9596452.ece> [<http://perma.cc/2RFR-F76H>].

<sup>274</sup> *Id.*

against individuals based on creed, national background, or biological heritage.

Under such a system, volunteers from SEZ-sponsoring nations would be welcome to participate in helping current and proposed zones of extrastatecraft. This help could include applying extrastatecraft innovations originating from any part of the world—including from Singapore, Uruguay, China, Europe, Israel, Dubai, the United States or any other nations—in global projects of each individual's or guild's choosing. Frameworks such as ULEX, an interface for remixing legal provisions from multiple sources, would enable grassroots allies embarking upon extrastatecraft initiatives to assemble innovations as they deemed best.

A framework of this kind would make it hard for any nation to capture the New Hanseatic League's network for helping SEZs and startup communities. Yet it is important to also note that the self-chosen paths taken by extrastatecraft projects and virtual guilds may gravitate towards certain models. A particular set of Chinese innovations, for example, might inspire global virtual volunteers and local project initiators active in South America (or vice versa). As an open and self-organizing system, there is no way to know at the outset which models will emerge to become the most widely adopted and influential. Therefore, great powers and nations of any size have an opportunity to "win" as this open system evolves. But they can do so only via the soft power of volunteers, the facilitation of private capital flows, and the appeal of their legal and institutional examples—rather than through attempts to capture and assert control over an inherently decentralized system.

*6. Could a global network of SEZs and startup communities prompt a populist reaction?*

Another risk to a New Hanseatic League may come in the form of public reaction to moves by the ultra-wealthy to create self-governing enclaves as nation states decline. Thomas Frey, a well-known futurist, has predicted that the world's wealthiest individuals and their families may turn to establishing, within the Westphalian legal framework, well-defended nation states with fully-privatized functions.<sup>275</sup> This scenario easily could come to pass with the advent of a deep global financial crisis. As the crisis hits, billionaires and others might cement deals with rulers of

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<sup>275</sup> Thomas Frey, *Owning Your Own Country*, FUTURIST SPEAKER BLOG (Nov. 26, 2008), <http://www.futuristspeaker.com/business-trends/owning-your-own-country/> [<http://perma.cc/EPN3-TBMQ>].

failing states to secure near or full sovereignty over a portion of existing national territories. To flourish financially, these areas of extrastatecraft in many cases could establish transparent legal systems and attract others seeking safe haven for their persons and their wealth.

Over the long term, such initiatives could have positive effects on global governance by promoting competition among polities—thereby increasing pressures on regimes to forego political rent-seeking in favor of land rent-funded systems of governance. Yet, in the short term, the effect likely would be to stoke popular anger towards the ultra-rich and their havens of extrastatecraft. Popular envy and resentment against them could spike as people in once-successful nation states experience wrenching fiscal strains, economic collapse, and widening unemployment. Demagogues could try to turn public hostility into support for mounting direct and indirect shakedown attempts against self-governing enclaves of the wealthy.

A New Hanseatic League and its virtual guilds might help such scenarios to boomerang. Via the Internet, the League could hollow out the support base of transgressive demagogues. They could do so by offering resources for communities to become more self-reliant as national leaders tried to consolidate power. They also could extend challenge offers to individuals and communities to explore early wins via extrastatecraft. The League's outreach especially could focus on finding local allies and exemplary sites for future Endowment Zones and on publicly challenging gatekeepers at all levels in a belligerent regime to end corrupt political rent-seeking practices in these areas. The offer to create areas of transparency could include offers of policies and tools and support systems to ensure rapid asset awakening in specific localities, with lease revenue shares flowing directly to struggling residents. Public opinion could pivot as the regime strove to explain refusals to accept such a challenge.

*7. What can a New Hanseatic League do about global environmental and other challenges?*

A Brazilian observer, Robert Muggah, has succinctly stated the overriding challenge facing nations today:

Global commitments are urgently required to reverse global warming, curb the threat of pre-emptive nuclear attack, prevent pandemics and superbugs, and respond to population dislocation and the protracted wars giving rise to it. As the global mood sours, grudging half measures are all that nation states seem prepared to muster. Not surprisingly, the international institutions created to address these challenges—chief

among them the United Nations Security Council—are paralysed to act. For their part, economically powerful cities are stepping up, but still lack the political power to take their place at the global decision-making table.<sup>276</sup>

A New Hanseatic League could make strides to fill this gap. A global network of contract-based communities can spread examples of innovations for radically reducing environmental impacts, such as Blue Frontiers Seasteading proposals in the Pacific, the America Free Zone in Costa Rica, and Songdo in Korea. Members of its virtual guilds can also help new areas of extrastatecraft pilot and spread exponential technologies for microfarming, relocalized manufacturing, solar microgrids, and virtual workspaces.

The League could help as well to bring Dominant Assurance Contracts to bear on what now appear to be intractable global problems. George Mason University economist Alex Tabarrok, a pioneer of early online crowdfunding solutions, has taken the concept of contingent pledges to a higher level. As he sees it, this level will be home to crowdfunding campaigns launched and sponsored by risk-taking entrepreneurs.<sup>277</sup> Enterprises with technologies to effectively and profitably tackle a global problem will post an offer to solve it once contingent funding pledges have reached a minimum target level. The corporate sponsor also posts a bond to guarantee that each person who pledges support in the crowdfunding campaign will receive a (small) direct payment if the campaign *fails* to reach the target needed to trigger actual release of the pledged and escrowed funds. This incentive gives everyone a direct financial incentive to join in pledging to support a solution that will benefit all. “In a dominant assurance contract if the group goal is not met then everyone who offered to contribute is given their money back *plus* a bonus,” Tabarrok writes.<sup>278</sup> “It turns out that it then becomes a *dominant* strategy to contribute and the public good is always provided!”<sup>279</sup>

In the case of climate change, members of the League might opt to put Dominant Assurance Contracts into action. A technical,

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<sup>276</sup> Muggah, *supra* note 223.

<sup>277</sup> See Alexander Tabarrok, *Assurance Contracts*, MARGINAL REVOLUTION (May 13, 2005, 7:10 AM), [http://marginalrevolution.com/marginalrevolution/2005/05/assurance\\_contr.html](http://marginalrevolution.com/marginalrevolution/2005/05/assurance_contr.html) [<http://perma.cc/5ZXJ-W929>].

<sup>278</sup> *Id.*

<sup>279</sup> *Id.* For a full-length introduction to the approach, see Alexander Tabarrok, *The Private Provision of Public Goods via Dominant Assurance Contracts*, 96 PUB. CHOICE 345 (1998), [https://mason.gmu.edu/~atabarro/Private Provision.pdf](https://mason.gmu.edu/~atabarro/Private%20Provision.pdf) [<http://perma.cc/LS4J-LQX2>].

cost-effective solution is within reach for global warming: private jets can be equipped to infuse the upper atmosphere with sulfate aerosols that could slow down or even reverse global warming. The aerosols would reflect back about one percent of the sunlight that now hits Earth. Effects would dissipate in a year as the sulfates broke down, requiring retreatments only for as long as needed for runaway warming to be abated.<sup>280</sup> This solution to climate change could be sparked by a bond posted by an Elon Musk or Richard Branson to incentivize crowdfunders across the planet to pledge contributions towards the funding threshold.

By linking global crowdfunding to the energies and capabilities of internationally-admired entrepreneurs, a New Hanseatic League could increase the ability of people around the world to resolve environmental, public health, and other challenges that long have been thought to be the responsibility of nation states and taxpayer-funded international organizations.

#### 8. *What about security challenges?*

Accelerating technologies also have transformed global security challenges. They are shifting the balance in favor of what author John Robb has called “open source insurgencies.”<sup>281</sup> Yuval Harari, an Israeli military historian, agrees. In a recent essay entitled “Why It’s No Longer Possible for Any Country to Win a War,” he observes:

In 2017, global elites don’t know what a successful war even looks like. They may have read about them in history books and seen fanciful recreations in Hollywood blockbusters, but they have good reason to suspect that this type of war has gone extinct . . . In the past, if you defeated your enemy on the battlefield, you could easily cash in by looting enemy cities, selling enemy civilians in the slave markets and occupying valuable wheat fields and gold mines. Yet in the twenty-first century, only puny profits could be made that way. Today, the main economic assets consist of technical and institutional knowledge — and you cannot conquer knowledge through war. . . . Cyber warfare makes things even worse for would-be imperialists. . . . [I]f the U.S. now attacks a country possessing even moderate cyber warfare capabilities,

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<sup>280</sup> See David Rotman, *A Cheap and Easy Plan to Stop Global Warming*, MIT TECH. REV. (Feb. 8, 2013), <https://www.technologyreview.com/s/511016/a-cheap-and-easy-plan-to-stop-global-warming/> [<http://perma.cc/8S3G-VUHK>].

<sup>281</sup> See David de Ugarte, *John Robb, from the open-source insurgency to the “Direct Economy,”* LASINDIAS BLOG (Nov. 14, 2013), <https://lasindias.blog/john-robb-from-the-open-source-insurgency-to-the-direct-economy/> [<http://perma.cc/E7QE-BXL8>].

malware and logic bombs could stop air traffic in Dallas, cause trains to collide in Philadelphia and bring down the electric grid in Michigan.<sup>282</sup>

In the twenty-first century, a network of city states and SEZs may become a source of innovative, soft power-based defense strategies. A New Hanseatic League could make nonlethal approaches a cornerstone of its mutual self-help strategy, rather than turning to military solutions. A sample of this strategy is brilliantly portrayed by science fiction author Bruce Sterling in short story called “Maneki Neko,” wherein unfortunate consequences cascade upon any person who uses or threatens violence—consequences that themselves never rise to the level of violence.<sup>283</sup> A New Hanseatic League, committed to a live-and-let-live ethos and capable of attracting world-class technical talent, could potentially respond in similar ways to a host of security risks.

Outward-reaching soft power initiatives might pay dividends as well. Virtual guilds aligned with the New Hanseatic League could quietly extend offers in radicalized areas to enable alternative paths. These might take the form of cryptocurrency-based microscholarships for people to build globally marketable skills, human capital investments to support their entry into online freelance markets, and the introduction of Blockchain based opportunities for the informal sector to bypass predatory rulers.

Over time, one of the most crucial contributions of a New Hanseatic League to world peace could come through the creation of a metasytem that enables a wide range of voluntary communities to flourish. At present, rampant politicization of life in many nations produces win-lose battles for power. By contrast, zones of extrastatecraft can encourage a variety of communities to emerge through nonpolitical means. Volunteers around the world can help their favorite kinds of actual communities succeed, without privileging some and subordinating others. Virtual guilds might be formed to assist a range of what have tended to be politically opposed types of communities, including: those based on open source models versus those based on intellectual property; those animated by communalist values versus those inspired by highly individualistic forms of capitalism; those building on Singapore-style incentivized public sectors versus those that are entrepreneurially-run for a full range of services; and those that

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<sup>282</sup> Yuval Noah Harari, *Why It's No Longer Possible for Any Country to Win a War*, TIME (June 23, 2017), <http://time.com/4826856/russia-trump-north-korea-china-war/> [<http://perma.cc/T95B-ZQ69>].

<sup>283</sup> See Bruce Sterling, *Maneki Neko*, LIGHTSPEED MAG. (Apr. 2011), <http://www.lightspeedmagazine.com/fiction/maneki-neko> [<http://perma.cc/5V3T-YSKX>].

are religiously cohesive versus those embracing heterogeneous faiths along with secular lifestyles. A New Hanseatic League could encourage within its network a full range of such peaceful soft power competitions, as long as all commit to transparency and to sharing experiences.

#### CONCLUSION

As nation states fall into dysfunctions, the world is entering what Michael Strong, a leading advocate of Special Economic Zones and Seasteading, has termed a “Cambrian explosion in government.”<sup>284</sup> Increasing decentralization and experimentation is generating legal, political, institutional innovations of value to all communities seeking better systems of governance.

SEZs and startup communities can go well beyond the innovations and levels of prosperity they have created to date. In coming years, they can be catalysts for peaceful and asset-awakening reforms in systems of governance across the planet. A New Hanseatic League of free zones and startup cities, backed by an army of virtual volunteers from all countries committed to a future of peaceful and inclusive innovation, can spread economic opportunities and spark transformations in governance on a global scale.

A New Hanseatic League could be a conduit for fast-growing online communities—what Robert Muggah has termed “Net States”—to help zones of extrastatecraft fill the huge gaps left by the increasingly dysfunctional responses of national governments and international organizations.<sup>285</sup> Virtual teams working with a new generation of free areas can bring about creative, self-funding, and scalable solutions to most, if not all, of the deepest challenges facing humanity.

Volunteers and funders who help grassroots pilots succeed will be seeding transcultural trust and respect even as exponential technologies help free people from misrule. In doing so, the world may move closer to what the Japanese-American philosopher Yasuhiko Genku Kimura has termed an “omnicentric” era for

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<sup>284</sup> See Michael Strong *Talk: Free Zones and the Cambrian Explosion in Government*, LET A THOUSAND NATIONS BLOOM (Nov. 12, 2009), <http://athousandnations.com/2009/11/12/michael-strong-talk-free-zones-and-the-cambrian-explosion-in-government/> [<http://perma.cc/C9CA-9LKT>].

<sup>285</sup> See Muggah, *supra* note 223.



human civilization, one based on a deep respect for the sovereignty of all individuals and their rights to consent-based governance.<sup>286</sup>

A New Hanseatic League can be a springboard for initiatives that have been held back by political rent-seeking. Today, new systems of trustworthy law can spread out far faster and more widely than did Lübeck Law eight centuries ago. Although methods of communication have transformed since then, the value of peer-to-peer relationships that sustained the original Hanseatic guilds and cities remains an enduring legacy. Depoliticized relationships of trust enabled the first League to thrive for centuries in an era also filled with hazards. Today, we have new tools to build more lasting trust networks among free peoples in a New Hanseatic League that offers onramps to all on our planet.

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<sup>286</sup> Yasuhiko Genku Kimura Interview / *What is the Omnicentric Mind*, YOUTUBE (Aug. 25, 2011), <https://www.youtube.com/watch?v=RdKLLeRdJsl>.

APPENDIX

# Extending the Global Reach of a New Hanseatic League

Virtual catalysts to connect people with online and actual free communities



# The Political Economy of Special Economic Zones: Lessons for the United States

Lotta Moberg\*

## INTRODUCTION

Imagine a policy change that could spur economic development without costing a dollar. A change that could increase employment in selected areas of a country through the growth of the industries of policy makers' choices. The change in question is the special economic zone ("SEZ"). This article explores the benefits and downsides of SEZs, and analyzes their economic and political impact on the United States. It argues that, though widely implemented in the country, SEZs have likely done more harm than good for the United States.

SEZs are areas where a government chooses to have different rules from the rest of the country. The zones are usually designed to attract investors in various industries with the aim to increase exports, employment, and production. SEZs are credited with promoting development in numerous countries, from the large-scale zones of China to the small industry parks scattered throughout Latin America and Asia.<sup>1</sup> In the past few decades, several African countries have introduced SEZ legislation, often with the hope of emulating the rapid industrialization of the Asian "Tigers."<sup>2</sup>

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<sup>1</sup> See, e.g., Hooshang Amirahmadi & Weiping Wu, *Export Processing Zones in Asia*, 35 ASIAN SURV. 828, 828–29 (1995); ANTOINE BASILE & DIMITRIOS A. GERMIDIS, INVESTING IN FREE EXPORT PROCESSING ZONES 11 (1984); Gokhan Akinci & James Crittle, *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* 32 (World Bank Foreign Investment Advisory Service, Working Paper No. 45869, 2008); ROBERT C. HAYWOOD, *Free Zones in the Modern World*, WEPZA 3 (2000); Thomas Farole & Gokhan Akinci, *Introduction to SPECIAL ECONOMIC ZONES: PROGRESS, EMERGING CHALLENGES, AND FUTURE DIRECTIONS* 4–5 (Thomas Farole & Gokhan Akinci eds., 2011); Jin Wang, *The Economic Impact of Special Economic Zones: Evidence from Chinese Municipalities*, 101 J. DEV. ECON. 133, 145–46 (2013). Most of these sources also note some of the problems with the SEZ model.

<sup>2</sup> THOMAS FAROLE, SPECIAL ECONOMIC ZONES IN AFRICA: COMPARING PERFORMANCE AND LEARNING FROM GLOBAL EXPERIENCE 166–67 (2011).

SEZs are not without their controversies, and as this article argues, the United States has largely failed to implement them in a way that promotes economic growth. The World Bank proposed in the early 1990s that SEZs are inferior to “economywide” reforms.<sup>3</sup> Some zones have failed to attract investors, despite generous incentives. Clearly, the policy does not always succeed. SEZ success, as discussed below, is also commonly misunderstood and can be defined in many different ways.

Most of the early SEZs, which focused on reshipping and warehousing, were found primarily at ports and airports, and served as spaces for tariff relief. The shipping and warehousing industries rely on importing and exporting goods. If the government imposes tariffs to protect its domestic industries, this clearly hurts the import-dependent industries. In this environment, SEZs can allow the shipping and warehousing industries to flourish. As long as they cannot buy their wares domestically, allowing them to import tariff-free causes no harm on the domestic producers that enjoy tariff protection.

SEZs have been around in their modern form at least since the 1950s. One of the first modern SEZs came about as the scope of the free zone at the Shannon Airport in Ireland was expanded. The airport had previously relied on air traffic in need of refueling airplanes on their way across the Atlantic.<sup>4</sup> The introduction of the jet engine made this business model obsolete.<sup>5</sup> The zone authority therefore decided to lure production to the zone as well, thus growing the town of Shannon and inducing air traffic for more reasons than mere transit.<sup>6</sup>

The Shannon zone represented an early version of the export processing zone, which is the form of SEZs that has prevailed ever since.<sup>7</sup> Export processing zones take the form of industrial parks, which means that they only contain production facilities, as opposed to also including residential areas.<sup>8</sup> They are generally small enough to fit within a few blocks. Governments often require that most or all zone investor production be exported—hence the label of the zone. Some SEZs are even smaller. So-called single factory zones<sup>9</sup> may host a single company and occupy one floor in an office building.

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<sup>3</sup> THE WORLD BANK, EXPORT PROCESSING ZONES 1 (1992).

<sup>4</sup> BRIAN CALLANAN, IRELAND'S SHANNON STORY: A CASE STUDY OF LOCAL AND REGIONAL DEVELOPMENT 47 (2000).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 50.

<sup>7</sup> THE WORLD BANK, *supra* note 3, at 25.

<sup>8</sup> *Id.* at 24.

<sup>9</sup> Akinici & Crittle, *supra* note 1, at 3.

The variation, size, and form of SEZs—from the multimillion-people zones of China to one-company schemes—implies that there is no one answer to the question of whether SEZs represent good policy. Depending on their size, regulations, and institutional context, they will function very differently and come with very different problems and benefits, as this article explores.

The United States introduced free zones in 1934 in response to the Smooth-Hawley tariffs.<sup>10</sup> This new-found protectionism threatened the U.S. warehousing and reshipping industry, and the zones isolated this segment of the American economy from much of this protectionism regime. Since then, SEZs have proliferated in the country and now amount to around 750, including smaller zones.<sup>11</sup>

Despite their ubiquity, the U.S. zones have had little impact on economic development in the country.<sup>12</sup> This paper applies a political economy analysis to SEZs and shows that the reason for their limited influence in the United States lies both in the nature of the zones themselves and in the institutional context in which they are introduced. It also suggests how to make American zones more successful, and explains what lessons can be drawn from SEZs of the past.

The next Part explains why a political economy analysis best assesses the costs and benefits of SEZs. Part II presents a framework for comparing SEZs to the status quo. Part III discusses whether SEZs are better than their political alternative. Part IV explores how SEZs can perform at their best. The paper concludes in Part V with a discussion of the implications for the SEZs in the United States.

## I. THE POLITICAL ECONOMY APPROACH TO SEZS

Most scholarly literature on SEZs applies a misleading perspective when assessing their success. Commonly stated goals of SEZs include increased exports, production, and employment in

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<sup>10</sup> Matthew Grant, *Why Special Economic Zones? Using Trade Policy to Discriminate Across Importers* 8–9 (Feb. 2018) (unpublished manuscript), [https://drive.google.com/file/d/0B\\_4Z5rmKH1P5VE0yV1QxZ0JaZTg/view](https://drive.google.com/file/d/0B_4Z5rmKH1P5VE0yV1QxZ0JaZTg/view).

<sup>11</sup> See Tom W. Bell, *Special Economic Zones in the United States: From Colonial Charters, to Foreign-Trade Zones, Toward USSEZs*, 64 *BUFF. L. REV.* 959, 969–70 (2016); Grant, *supra* note 10, at 7–8; Benjamin Chris Zissimos, *Summary of the 4th InsTED / 9th EESP-FGV Workshop*, INSTED INSTITUTIONS TRADE & ECONOMIC DEVELOPMENT (May 31, 2017), <http://blogs.exeter.ac.uk/insted/2017/05/31/summary-of-the-4th-insted-9th-eesp-fgv-workshop/> [<http://perma.cc/XN2A-9V8X>]; *How many zones exist now?*, U.S. FOREIGN-TRADE ZONES BOARD, <https://enforcement.trade.gov/ftzpage/info/zonestats.html> [<http://perma.cc/6UVD-PX7G>] (last visited Nov. 11, 2017).

<sup>12</sup> Susan Tiefenbrun, *U.S. Foreign Trade Zones, Tax-Free Trade Zones of the World, and Their Impact on the U.S. Economy*, 12 *J. INT'L BUS. & L.*, Spring 2013, at 214.

the area of the zone. Such outcomes are fairly easy to measure, but are unfortunately quite unhelpful in determining whether a zone policy is actually beneficial.<sup>13</sup>

Instead of looking only at outcomes, scholars should apply a cost-benefit analysis to SEZs and focus as much attention to the costs of the policy as to the benefits. To understand the impact of SEZs, one must take a political economy perspective that looks both at the incentives they promote and their most common unintended consequences. The political economy perspective reveals that the main costs of SEZs are political, rather than economic. The most severe costs are not easy (and often impossible) to measure with macroeconomic data. This perspective also reveals that the main benefits of SEZs are political too, rather than the economic outcomes for which the zones are commonly praised.

There have been attempts to perform cost-benefit analyses of SEZs, but these are limited in scope and rely on various quantitative approximations. Scholars have attempted to count company profits, wages, and the like in an SEZ. These benefits are then compared with the costs of the resources used in the zone, which must be based on prices and wage levels in the country at large. If, for instance, 100 zone workers earn \$10 per hour, while their wage elsewhere is \$5, the zone adds \$500 of benefits per hour in wages. If the return on a piece of capital, like a machine or natural resource, is \$1 per day in the zone and eighty cents outside the zone, the daily value created by the zone through capital use is twenty cents per piece of capital. Because of the complication of such estimates, this type of cost-benefit analysis can apply only to smaller zones with simple production and no residential property. Even then, the costs can only be approximated, and any dynamic benefits, such as technological transfers from foreign investors to domestic firms, must be excluded.<sup>14</sup>

A political economy analysis considers that policy makers cannot know the ultimate outcome of a policy. The analysis also accounts for the risk of a policy being abused by both businesses and policy makers. Any policy, SEZs included, look good on paper when any such political economy problems are assumed away. When policy makers always know the exact effect of the changes they introduce and govern with the best for society in mind, most

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<sup>13</sup> LOTTI MOBERG, *THE POLITICAL ECONOMY OF SPECIAL ECONOMIC ZONES: CONCENTRATING ECONOMIC DEVELOPMENT* 8 (2017).

<sup>14</sup> Peter G. Warr, *Export Processing Zones: The Economics of Enclave Manufacturing*, 4 *WORLD BANK RES. OBSERVER* 65, 77 (1989); Kankesu Jayanthakumaran, *Benefit-Cost Appraisals of Export Processing Zones: A Survey of the Literature*, 21 *DEV. POL'Y REV.* 51, 61-62 (2003).

policies are beneficial. Alas, the reality is that policy-makers inevitably have a poor understanding of the market conditions that they seek to affect. Just like businesses, they are also motivated by their own wellbeing. Under the wrong incentive structures therefore, they will take advantage of their positions to the detriment of society at large. Whether policy makers will act as if they are informed and selfless will depend on the institutional environment in which a policy is introduced.

Classical economic models generally assume away political-economy related frictions stemming either from the ignorance or distorted incentives of government officials. These models assume that policy makers aim to maximize social welfare, have perfect knowledge, and that the system is free of fraud or corruption. Alas, reality is famously fraught with such imperfections, an insight that a political economy analysis takes into account.

An assessment of SEZ success must also account for political economic benefits that standard macroeconomic studies generally overlook. Political influence can be for the better if it leads to beneficial policy changes. If these spread beyond the SEZ, they can catalyze beneficial change in the country as a whole.

SEZs should be deemed successful if they have long-term beneficial impacts on the broader host economy. Focusing only on one or a few macroeconomic variables as indicators of success is too narrow. Yet “beneficial” can have a different meaning, depending on the reference point. As such, SEZs may be seen as beneficial in three different ways:

1. Compared to the status quo:  
Would the country be better off without them, assuming all else stays the same in their absence?
2. Compared to their political alternative:  
Would the economy be in worse shape with the policies that would be introduced in the absence of SEZs?
3. Compared to their best possible outcome:  
Are the SEZs living up to their full potential?

The following three Parts discuss these levels of SEZ success in turn.

## II. COMPARING SEZs TO THE STATUS QUO

SEZs famously have many advantages. By attracting investors, they increase economic activity in the designated area

and provide employment for the local population.<sup>15</sup> They may also increase the demand for local products. When looking only at these benefits, SEZs seem like a winning proposition for any economy.

Unfortunately, SEZs can also come at great costs that, in a bad scenario, overshadow the benefits. While it is true that market-friendly SEZ policies generally increase economic activity in the country as a whole, the investments needed to make this happen may come at too high a price to make the policy worthwhile.

The most obvious cost of SEZs is government spending on zone infrastructure.<sup>16</sup> When planners envision an SEZ, its visible features usually come to mind most vividly. Governments commonly make sure that their visions are fulfilled by building the structures and offices that they expect investors to demand.<sup>17</sup> While that ambition is admirable, more spending on infrastructure means that the government must either spend less on other programs, raise taxes, or borrow money. In one way or another, the people of the country pay the bill for the zone project.

While infrastructure costs are easily measured, SEZs also come with several hidden costs that are harder to estimate. One is the loss of revenue that the government incurs from granting fiscal incentives to zone investors.<sup>18</sup> Domestic investors contribute more in taxes directly when located outside an SEZ. If they move from other parts of the country into the zones without increasing their production, the move constitutes a mere transfer of government revenue to company profits. Alas, this seems often to be the case for the U.S. zones. If domestic investors do expand and employ more people as they become SEZ investors, they can contribute to government revenue through income taxes, for instance. To account for the full impact on government finances, one must estimate how many more people domestic companies employ in the zone and what that implies in terms of increased income tax revenues.

The picture is equally as complicated for foreign SEZ investors. It is often assumed that they would not have chosen to come to the country in the absence of fiscal incentives.<sup>19</sup> If this is the case, no tax revenue is lost as it would not have been collected without a zone either. However, that will not always be true. If they would have invested in the country anyway, the government

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<sup>15</sup> *See id.* at 63.

<sup>16</sup> MOBERG, *supra* note 13, at 8.

<sup>17</sup> *Id.* at 9.

<sup>18</sup> *Id.*

<sup>19</sup> *See id.* at 2.



is foregoing revenues by offering them tax exemptions. Yet the government can always claim that the SEZ policy is the reason for any investments that enter the country, since nobody can ever prove the counterfactual.

Another hidden cost is the alternative cost of domestic resources employed in an SEZ.<sup>20</sup> Foreign investors may bring some of their employees and capital with them, but they generally take advantage of domestic resources too, which are removed from other parts of the economy. Domestic workers benefit as foreign companies compete for their loyalty by raising their wages, but this imposes costs, both on the domestic firms they leave, and on all firms that must meet higher wage requirements.<sup>21</sup> To claim that SEZs “create jobs” is therefore partially misleading. SEZs do benefit workers, but as long as not all of them were previously unemployed, SEZ investors hire people at the expense of domestic companies.

This logic applies similarly to production inputs and other forms of capital. As foreign investors bid up prices, they inevitably impose costs on other companies. In a functioning market economy, resources seldom lie idle. It is good for the producers of these production inputs that prices rise, but this is far from the full story.

The value of the alternative use of either labor or capital cannot be measured with any precision. Attempts have been made for simpler forms of SEZs, as was previously mentioned, but such analyses will always remain best guesses rather than proven costs.

Because several of these costs are difficult to measure, it is hard for a government to know whether the zones they are promoting actually benefit the economy. In their pursuit to increase growth and economic activity, they cannot ever be sure this is actually accomplished. Most analyses of SEZs presume that if a zone attracts investors and functions well, it has been a good project. However, knowing about the hidden costs of SEZs, a proper analysis must obviously be more complicated.

#### A. Policy Implications

A government initiating SEZs should consider how it can best lower its cost in relation to the benefit of any SEZ. Government spending on infrastructure may be necessary to attract investors to a zone, but will be profitable only in certain circumstances. For

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<sup>20</sup> *Id.* at 9.

<sup>21</sup> *Id.*

one, any SEZ must be placed in areas where investors want to go. Numerous SEZ projects have been poorly located, resulting in unused infrastructure and office space. Such “white elephants” present obvious examples of SEZ failure.<sup>22</sup>

In the less obvious case of failure, SEZs attract investors, but at a price not worth paying for the people of the country. Any location might be attractive to investors when endowed with enough government resources. By choosing a proper location, the government can minimize how much it has to “compensate” investors by paying them to come.<sup>23</sup>

Infrastructure investments must also be suitable for the kind of production that is located in the zone. In order not to waste resources, the government must choose carefully what kind of production they target with its incentives and regulations.

All of this may seem to impose an insurmountable burden on policy makers introducing SEZs. Yet, rather than requiring them to know the perfect location and policy framework for every zone, people in power are better off recognizing that they are not omniscient, and should therefore prudently set policies accordingly.

SEZs work by rearranging economic activity in a country, with the goal of increasing economic activity as a whole.<sup>24</sup> As such, there are inherent problems of assessing the cost of any changes in the current market structure. Companies in the country are located at particular spots for a reason. If they enter the SEZs, they are generally leaving a naturally optimal location for an inferior one, lured by fiscal incentives. It is also likely that international investors would not prefer the location of an SEZ, but are nevertheless incentivized to invest in the zone.

Governments may get around the problem of resource misallocation by allowing for a more market-driven process in finding an SEZ location. If a government relies on private parties for SEZ development, people with better understanding of market conditions seek out the most lucrative location to establish an SEZ.

The private zone model works as follows. The government announces the SEZ legislation, including the incentives offered and what kind of activities are permitted in the zones. Private developers must then buy or lease land and make all the necessary investments to establish the SEZs. A zone developer can then lease space to zone investors, who are willing to pay for the fiscal benefits, the infrastructure and services in the zone, and for the

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<sup>22</sup> *See id.* at 36.

<sup>23</sup> *See id.*

<sup>24</sup> *See id.* at 25.

proximity to peers and suppliers. The government need not be part of the location selection, but can still claim credit for the success of the policy.

In addition to zone location, it is also unlikely that the government will know what the best industries will be for its SEZs. The government may think that it is textile production if that has traditionally been a widely spread type of production in the country. In fact, the economy may be better off diversifying into other types of manufacturing, more sophisticated agriculture, or high-technology production.<sup>25</sup> The reverse is probably an even more common mistake. A government might believe that the economy should take unrealistic leaps into high-tech areas of production.<sup>26</sup> In fact, what a country is already producing likely reflects its inherent comparative advantage, implying that it should focus on those industries going forward. Targeting the wrong industry can be a costly mistake for the government.

Fortunately, private zone developers can also address the problem of finding the right kind of production. Private developers have both the incentive and expertise to assess what industries should fit for a particular location in a particular country. If potential investors are unknown, they can delay infrastructure investments until later, or work together with interested investors to provide the required business environment.<sup>27</sup> For private investors, the costs of poorly targeted infrastructure investments are more immediate. As a result, they are more prone to step carefully in finding a successful zone model.

Importantly, when private developers do make mistakes and fail to attract investors, it does not impose large costs on the country's tax payers. SEZs may thus fail by not attracting investors, but may still be neutral from a cost-benefit perspective to the host country. The reason governments are often reluctant to rely on private SEZs is that they cannot claim credit for introducing a job-creating policy if the zones fail to grow. When areas designated as SEZs are left idle, this constitutes political failure, even if the attempt to establish zones imposed costs only on private developers and not on the country's tax payers.

For this reason, a government may prefer that zone development be in the hands of a public authority. If so, it should consider decentralizing the process down to the local level. The United States has adopted this model to a large extent. American

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<sup>25</sup> *See id.* at 5–6.

<sup>26</sup> *See id.* at 38.

<sup>27</sup> *See id.* at 56.

zones are often developed by county or city governments or their subdivisions, such as port authorities.<sup>28</sup> This is a politically safe model, which is less likely than a centralized model to waste resources. Yet, even with decentralization, government-developed SEZs are prone to waste if the targeted locations or SEZ activities are suboptimal. However, in some cases, U.S. zones can be privately developed as well.<sup>29</sup> In these cases, the federal government stays out of involvement in zone development and leaves this up to the local entities.

Local politicians are more knowledgeable about the immediate business environment of any given area and are thus more likely to make informed decisions. They may also perceive and react to zone failure more rapidly and adjust policies accordingly. In addition, with fiscal decentralization, it becomes harder for local politicians to conceal the costs of an SEZ. While this means costs are more concentrated and can thus do more harm locally, it also makes it less likely for those costs to rise beyond proportion. As such, while decentralization does not ameliorate the problem with SEZ failure ultimately becoming a burden on tax payers, it is at least a second-best solution after zone privatization.

#### B. SEZs and Rent-Seeking

Besides policy makers not having sufficient information to create the perfect SEZ policy, they may also lack the will to do so. One inherent problem with SEZs is that they offer various kinds of opportunities for rent-seeking. It is the nature of a discriminatory policy that it offers people or businesses special treatments. This inevitably creates the incentive for private-sector actors to land on the right side of the policy.<sup>30</sup> Even more destructively, policy makers have the incentive to introduce policies that make it easier for businesses to engage in policy manipulation by offering the policy makers various gifts and favors.<sup>31</sup>

SEZs offer beneficial tax, tariff, and regulatory conditions for the businesses granted the privilege to enter.<sup>32</sup> As long as there is any kind of selection between investors, there is an opportunity for

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<sup>28</sup> See *Who Can Apply?*, U.S. FOREIGN-TRADE ZONES BOARD, <https://enforcement.trade.gov/ftzpage/info/applicant.html> [<http://perma.cc/N85T-BU8J>] (last visited Nov. 11, 2017).

<sup>29</sup> *Id.*

<sup>30</sup> JAMES M. BUCHANAN & ROGER D. CONGLETON, *POLITICS BY PRINCIPLE, NOT INTEREST: TOWARD NONDISCRIMINATORY DEMOCRACY* 3 (1998); Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 *AM. ECON. REV.* 291, 291–92 (1974).

<sup>31</sup> John Joseph Wallis, *The Concept of Systematic Corruption in American History*, in *CORRUPTION AND REFORM: LESSONS FROM AMERICA'S ECONOMIC HISTORY* 23, 50–51 (Edward L. Glaeser & Claudia Goldin eds., 2006).

<sup>32</sup> *Id.*

rent-seeking.<sup>33</sup> Businesses may bribe policy makers outright, lobby for the rules to change in their favor, or induce policy makers to make exceptions for them if they do not fulfill the criteria.<sup>34</sup>

Bribe-taking may not impose an obvious cost on the people of the country. After all, policy makers are benefiting at the expense of companies, and not directly at the expense of the people of the country. However, as businesses incur higher costs for entering the zones, they have less money for capital expenditures and for hiring people. As a result, they will produce, export, and benefit the country's workers to a lesser extent. Rent-seeking through SEZs thus transfers resources from workers and the government—which loses out on income tax revenues—to individual officials.

Even if the SEZ legislators try honestly to make the policy work, rent-seeking can occur in various levels of the government bureaucracy. The more agencies a business must pass to obtain their SEZ entrance, the larger is the risk of bureaucrats extracting rents along the way, thus diminishing the benefits of zone investing.<sup>35</sup>

Rent-seeking is more likely to occur in certain kinds of SEZs. In short, the smaller and simpler the zones, the easier it is to use them as vehicles for corruption.<sup>36</sup> The smallest kind of zone is the single-factory zone, which includes only one company.<sup>37</sup> Single-factory zones make it easy for government to select particular investors for fiscal benefits. Governments often motivate these schemes with the need of certain businesses to be located in particular spots, such as in the center of cities, where one cannot set up regular SEZs. While this is a sound argument, the problem with introducing single-factory zones is that they easily serve as ways to give favors to specific companies. If a policy maker wants his uncle to benefit, for example, he can designate the uncle's business as an SEZ, prompting the government to provide a source of extra profits.

It is understandable that such a scheme would often be confused with simple government favoritism and targeting of benefits of individual companies. In practice, there is little difference. There will also be no agglomerative effects with

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<sup>33</sup> See MOBERG, *supra* note 13, at 46.

<sup>34</sup> Krueger, *supra* note 30, at 292.

<sup>35</sup> See, e.g., WILLIAM EASTERLY, *THE ELUSIVE QUEST FOR GROWTH: ECONOMISTS' ADVENTURES AND MISADVENTURES IN THE TROPICS* 247 (2002) (arguing that low-level corruption creates a tragedy-of-the-commons problem as bureaucrats maximize their gains from implementing policies that benefit companies).

<sup>36</sup> See MOBERG, *supra* note 13, at 56–57.

<sup>37</sup> *Id.* at 6, 43.

single-factory zones, even though this is a common rationale for SEZs. Despite these drawbacks, single-factory zones are found in numerous countries with SEZ policies, the United States among them. It is certainly possible that rent-seeking in some cases drives their proliferation.

The more zone benefits that emanate from the government, the harder it will be for to rid an SEZ scheme of rent-seeking. The more opportunities for businesses to gain from lobbying and graft, the more resources will be wasted on such activities. The best a government can do in that case is to distance itself from the provision of favors, through infrastructure provisions and selection of SEZ investors. That is, it can allow for private zone development.

In addition to solving problems of finding the right location and zone production, private SEZs can also solve several problems related to rent-seeking. Private developers profit from the rents they charge investors. They have little incentive to extract additional rents illegally from private zone investors, as this diminishes the ability of those investors to pay rents the legal way. Private zone development thus means that there are fewer incentives for rent-seeking and less opportunity to trade rents for fiscal benefits.

Private developers can reap higher profits only by using their resources in more efficient ways. They can, for instance, find more cost-efficient forms of infrastructure, they can provide better services and charge higher rents, and plan for agglomerative effects that will help improve investor profits. All of these are ways to create value and thus increase the probability of a successful SEZ. By contrast, the government's main tool to attract investors is to increase fiscal incentives.<sup>38</sup> This does not necessarily imply a better way of organizing production more efficiently in a zone—which is the way private developers are incentivized to do.

The larger and more diversified the zones, the less likely rent-seeking will be a major problem. With zones the size of cities, where people work, live, and study, the government cannot possibly attract investors by providing all the buildings. It must rely on private planning and investment to make the zone function. The larger the zones, the more open they must be for people to enter and invest. This limits the government's ability to target benefits to certain sectors. Finally, larger zones make it harder to target specific companies. Because it will be difficult to benefit a specific company, fiscal incentives must be offered to

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<sup>38</sup> Tiefenbrun, *supra* note 12, at 12.

everyone in the zone, which is more expensive the larger the zone is. As a result, large zones are harder for governments to use as vehicles for rent-seeking, for which single-factory zones are so suitable.<sup>39</sup>

Decentralization may solve some of the problems with rent-seeking, albeit less effectively than private zone development.<sup>40</sup> At least in a democratic system, local policy makers are more incentivized to promote the economy through their policy-making. It is easier for the people to see the connection between their actions and social welfare. Come next election, policy makers risk losing their power if they fail to live up to expectations. Thus, when managing an SEZ scheme, they are less likely than central government officials to engage in graft at the expense of economic success of the program.

The incentive to avoid corruption does not, however, apply to less accountable officials. Bureaucrats dealing with SEZ applications, for instance, are seldom held accountable for poor economic performance and can therefore engage in graft (as long as they are not caught) without major repercussions.<sup>41</sup> Decentralization with checks and balances, therefore, is only a partial solution to the rent-seeking problem, and will alleviate the problem only in particular circumstances.

In conclusion, SEZs do introduce some efficiencies to the economy. But because of their discriminatory nature, they also present problems related to insufficient knowledge and distorted incentives. In the worst case, these problems render SEZs worse for an economy than the status quo. That is, even a country with high barriers to trade, taxes too high even to maximize government revenue, and a prohibitive business climate may be better off keeping such policies and shunning SEZs.

The main solution to these problems is private zone development. This zone model has been recognized as producing better results than public zones and is becoming increasingly popular as a result.<sup>42</sup> Yet policy makers are often reluctant to cede control over a program to the private sector. They may want to benefit a particular part of the country or take credit for introducing a particular industry in the country. As a result, government-developed zones remain common throughout the world. Any SEZ study should therefore account for the extent of

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<sup>39</sup> MOBERG, *supra* note 13, at 46.

<sup>40</sup> *See id.* at 42.

<sup>41</sup> *See id.* at 50.

<sup>42</sup> *See* FAROLE, *supra* note 2, at 37–39; Akinci & Crittle, *supra* note 1, at 4.

privately-driven investments in the zone. This may give a first clue about whether the scheme is even better than the status quo.

### C. Case Studies of Zone Failure

Throughout the history of SEZs, numerous programs have either failed to attract investors or been so infused by mismanagement, miscalculations, and inefficiencies that any benefits they generated failed to compensate for the costs. This Section explains how SEZ schemes can look successful, but nevertheless fail to benefit the country as a whole due to hidden costs. In some cases, failure is obvious as SEZs fail to take off despite government investments in infrastructure and facilities.

One vivid example of this is the Calabar zone in Nigeria. The location of the zone looked completely rational, primarily because of its proximity to the Calabar port.<sup>43</sup> The plan was to dredge the port so that it could serve ships that would export the manufactured goods of the Calabar SEZ.<sup>44</sup> However, for several years, the authorities tasked with the dredging failed to fulfill this mission. Goods were therefore shipped by truck to the port of Lagos at high costs. The Calabar zone is close to the Cameroonian border and not connected to any of Nigeria's highways. The government ran the zone and chose not to privatize it. Power supply to the zone was unreliable, which forced businesses to run generators for electricity.<sup>45</sup> It is no wonder that the number of investors was a small share of the capacity of the zone.<sup>46</sup> As a result, much of the SEZ infrastructure was left idle.<sup>47</sup>

Nigeria's SEZs have seen most investments in oil-related industries.<sup>48</sup> Most SEZ incentives have thus been given to oil extraction and production. Because oil is a lucrative and established industry in Nigeria, these SEZ incentives may not have done much to increase production and employment in the country.<sup>49</sup>

Another case of obvious failure is the SEZ of Bataan in the Philippines. The area was the site of a former U.S. military base, and the plan was to use the existing infrastructure to create a zone

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<sup>43</sup> FAROLE, *supra* note 2, at 204.

<sup>44</sup> *See id.*

<sup>45</sup> *Id.* at 219.

<sup>46</sup> *See id.* at 211–12.

<sup>47</sup> *Id.* at 187; Martin Norman, *Have 'Special Economic Zones' Entered the 21st Century Yet? A Tale of Two Cities*, WORLD BANK (Mar. 28, 2014), <http://blogs.worldbank.org/psd/have-special-economic-zones-entered-21st-century-yet-tale-two-cities> [<http://perma.cc/ULZ9-BRUA>].

<sup>48</sup> FAROLE, *supra* note 2, at 78.

<sup>49</sup> Ebehi Iyoha, *Nigerian Free Trade Zones: As Simple as SEZ*, STEARS BUS. (June 22, 2017), <https://www.stearnsng.com/article/nigerian-free-trade-zones-as-simple-as-sez> [<http://perma.cc/7GFK-H4D2>].



attractive to investors. The government invested hundreds of millions of dollars in the zone in the 1970s and 1980s.<sup>50</sup> The port was upgraded as the bridges and roads connecting the zone to highways and the like were inadequate.

Nevertheless, the business potential for the zone remained weak and investors stayed away. The zone was allegedly too remote. Thus, in this case, even substantial government spending in the zone did not make it grow. Sixteen years after its founding, the Bataan zone actually became a case of failure that made the international community question the zone model.<sup>51</sup> With time, the government spent even more money on the zone. It now hosts investors, so it is considered a success. However, this remains a case where the zone benefits for the economy can hardly live up to all the public investments made throughout the years.

Because of their obvious failures, SEZs such as Nigeria's Calabar zone and Bataan of the Philippines get the worse press. Yet they are likely not as costly for a country as zone schemes that look successful enough to continue without meaningful reforms, while relying on large investments from the government coupled with generous fiscal incentives. Thus, in contrast to the Calabar and Bataan SEZs, most unsuccessful SEZs in the world are likely not recognized as such. These are the zones that attract investors, but at a cost that cannot be justified on the basis of the benefit they bring to the country as a whole.

As mentioned previously, there have been attempts at cost-benefit analyses for functional SEZs. These get to the question of whether zones are actually better than the status quo and do not just take it for granted whenever a zone attracts investors. Warr lays out a framework for cost-benefit analysis of export processing zones.<sup>52</sup> Building on Warr's work, Jayanthakumaran assesses the net benefit of zones.<sup>53</sup> Their evaluations of specific SEZ schemes indicate that the zones in the Philippines were a net negative for the economy, while those in South Korea, Indonesia, Malaysia, Sri Lanka, and China were beneficial.<sup>54</sup>

India's SEZ present a prominent example of a scheme that was maintained despite its high costs. The rest of this chapter will therefore look closer at this case. India introduced its first zone in

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<sup>50</sup> See MOBERG, *supra* note 13, at 36.

<sup>51</sup> See Peter G. Warr, *Export Promotion via Industrial Enclaves: The Philippines' Bataan Export Processing Zone*, 23 J. DEV. STUD. 220, 238–39 (1987); MOBERG, *supra* note 13, at 36.

<sup>52</sup> Warr, *supra* note 14, at 77–81.

<sup>53</sup> Jayanthakumaran, *supra* note 14, at 53–56.

<sup>54</sup> *Id.* at 58.

1965, but it took another eight years to establish a second one.<sup>55</sup> In 2002, the country still had only seven SEZs.<sup>56</sup> To put this in the context of the country's development, India saw increased GDP growth in 1980, and even more so in the 1990s, after economically liberal reforms.<sup>57</sup> This was a turnaround period for India, which previously had seen the so-called "Hindu rate of growth" of only around 1.7% in real terms between 1950 and 1985.<sup>58</sup>

The SEZs seem to have played no part in this success. In 1984, around the time that the economy started to take off, India had only two SEZs.<sup>59</sup> The share of Indian exports stemming from the zones never exceeded four percent before 1996 and reached five percent only in 1998.<sup>60</sup> Also, while Indian growth relied primarily on services, the SEZs were more manufacturing oriented.<sup>61</sup>

Why, then, did the scheme show such poor results? Was it a matter of poor knowledge of government officials or distorted incentives? Alas, it seems, the answer is both. It is therefore worth taking a closer look at these issues, one at the time.

Much of the knowledge problem for Indian SEZs stemmed from the centralized nature of the scheme. The zones were government funded and thus came at a cost for the Indian taxpayers.<sup>62</sup> In addition, from the start of the program until 1994, only the central government could set up a zone, after which state governments, agencies, and private investors could take on SEZ projects.<sup>63</sup> SEZ policies were in the hands of a unit of the ministry of commerce. Furthermore, the task of approving investors

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<sup>55</sup> Aradhna Aggarwal, *Export Processing Zones in India: Analysis of the Export Performance* 4 (Indian Council for Res. on Int'l Econ. Relations, Working Paper No. 148, 2004), <http://icrier.org/pdf/wp148.pdf> [<http://perma.cc/AL53-9TUM>].

<sup>56</sup> *Id.* at 14.

<sup>57</sup> *Id.* at 12.

<sup>58</sup> *Penn World Table: The Database*, UNIV. OF GRONINGEN, <https://www.rug.nl/ggdc/productivity/pwt/> (last visited Oct. 29, 2017). This growth increased to 4.6% between 1985 and 2010. IMF data suggests that the growth 1985–2010 was 5.3%. See *World Economic Outlook Database*, International Monetary Fund, <http://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx> (last visited Nov. 3, 2017). For reference to "Hindu growth," see Dani Rodrik & Arvind Subramanian, *From "Hindu Growth" to Productivity Surge: The Mystery of the Indian Growth Transition 193–94* (International Monetary Fund, Working Paper, May 2004).

<sup>59</sup> Aggarwal, *supra* note 55, at 5.

<sup>60</sup> *Id.* at 5, 10, 13; *Penn World Table: The Database*, *supra* note 58. For discussion on the Penn World Table methodology, see Robert C. Feenstra, Robert Inklaar & Marcel P. Timmer, *The Next Generation of the Penn World Table*, 105 AM. ECON. REV. 3150, 3150 (2015).

<sup>61</sup> Ashok Kotwal, Bharat Ramaswami & Wilima Wadhwa, *Economic Liberalization and Indian Economic Growth: What's the Evidence?*, 49 J. ECON. LIT. 1152, 1168–69 (2011).

<sup>62</sup> Triyakshana Seshadri & Virgil Henry Storr, *Knowledge Problems Associated with Creating Export Zones*, 23 REV. AUSTRIAN ECON. 347, 351 (2010).

<sup>63</sup> Ram Krishna Ranjan, *Special Economic Zones: Are They Good for the Country?* 8 (Ctr. for Civil Soc'y, Working Paper No. 156, 2006).

seeking to enter the zones was given to an authority placed under this same ministry.<sup>64</sup>

In a country the size of India, centralized policy-making is bound to suffer from the limited knowledge of government officials about the conditions on the ground in various parts of the country. For the SEZs, one result of this flaw was the poor location of the initial SEZs in Kandla, a port city, and Falta, located by the Hooghly River, not far from Kolkata.<sup>65</sup> Both locations allegedly lacked not only an industrial culture, but also the necessary social and economic infrastructure.<sup>66</sup> The government later set up some zones in areas that already showed decent industrial performance, and these SEZs fared better.<sup>67</sup>

It certainly does not seem that the government had an insight about the potential of Kandla and Falta that private investors, which largely stayed away from these areas, were lacking. Falta, in particular, remained a small part of the SEZ scheme, providing only one percent of its exports by 2000.<sup>68</sup> Had the zones been privately developed, poor location choices would not have been such bad news. The companies invested in the zones would have lost money and been forced to relocate and start over. Alas, because much of the initial investments came from the central government, the poorly located zones inevitably imposed costs for the Indian economy as a whole.

In an attempt to improve the SEZ scheme, the Indian government introduced a new SEZ law that came into effect in 2005. Importantly, the law encourages privately developed zones.<sup>69</sup> Some of the authority of SEZ management is also transferred from the central government to the state government level.<sup>70</sup> The new law concentrates significant power in local-level development commissioners, who have both regulatory and administrative powers. This framework has been criticized as an “extreme

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<sup>64</sup> Aradhna Aggarwal, *Performance of Export Processing Zones: A Comparative Analysis of India, Sri Lanka and Bangladesh* 15–16 (Indian Council for Res. on Int'l Econ. Rel., Working Paper No. 155, 2005), <http://icrier.org/pdf/wp155.pdf> [<http://perma.cc/93LY-TEQF>].

<sup>65</sup> ASHOK KUNDRA, *THE PERFORMANCE OF INDIA'S EXPORT ZONES: A COMPARISON WITH THE CHINESE APPROACH* 66 (2000).

<sup>66</sup> *Id.*

<sup>67</sup> Seshadri & Storr, *supra* note 62, at 361.

<sup>68</sup> *Id.* at 353.

<sup>69</sup> AMITENDU PALIT & SUBHOMOY BHATTACHARJEE, *SPECIAL ECONOMIC ZONES IN INDIA: MYTHS AND REALITIES* 174 (2008).

<sup>70</sup> See Shankar Gopalakrishnan, *SEZs in India: An Economic Policy or a Political Intervention?*, in *SPECIAL ECONOMIC ZONES IN ASIAN MARKET ECONOMIES* 139, 143 (Connie Carter & Andrew Harding eds., 2011); PALIT & BHATTACHARJEE, *supra* note 69, at 174; Jona Aravind Dohrmann, *Special Economic Zones in India – An Introduction*, 106 *ASIEN* 60, 66 (2008); *Introduction*, *SPECIAL ECONOMIC ZONES IN INDIA*, <http://www.sezindia.nic.in/about-introduction.asp> [<http://perma.cc/5W5D-83BX>] (last visited Nov. 12, 2017).

centralization of government institutions.”<sup>71</sup> However, while such a concentration may be unwise, a more local authority is at least more likely to understand the local market conditions, and can better design SEZs commensurate to the development potential of any area. Still, the main authority accepting applications for approval to establish new SEZs remains a central-government function.<sup>72</sup> India has thus gone only some of the way to a decentralized system for its SEZs.

Indian land policy contributes to SEZ-related misallocation of resources. In an unregulated market, land owners could sell land to prospective SEZ developers if the latter are willing to pay more than the land is worth for the land owners, many of whom are farmers. This exchange would signal that the land had a higher potential value as an SEZ than for its current use. However, in India, land prices do not reflect supply and demand because they are set by the state government. This price must, by law, reflect the value of the current use of the land, and can thus not exceed the value of the land derived from farming.<sup>73</sup> Such a system discourages land transactions from ever taking place.

The government’s solution to the potential dearth of land transactions is eminent domain. By law, the government has the right to expropriate land “for any public purpose or for a company.”<sup>74</sup> The opportunity to seize land for SEZ use is further enhanced as zones are designated as public utility services, which per definition, are useful for social welfare.<sup>75</sup>

Fair or not, the system disguises the information that is embedded in market-derived prices. It thus makes it even harder for the government to determine the economic benefit of establishing an SEZ.

It is still unclear whether the new SEZ law sufficiently deals with the flaws of the previous system, but in the absence of change in the land laws, this is doubtful. The increasing number of private SEZ developers will need to turn to the state government to free up land for them, thus discouraging the investors to make the

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<sup>71</sup> Dohrmann, *supra* note 70, at 69; *see also* Gopalakrishnan, *supra* note 70, at 148.

<sup>72</sup> *Introduction*, *supra* note 70.

<sup>73</sup> Triyakshana Seshadri, *The Political Economy of Special Economic Zones in India* 79 (Spring Semester 2011) (unpublished Ph.D. dissertation, George Mason University), <https://search.proquest.com/docview/868552266?pq-origsite=gscholar>.

<sup>74</sup> SHRUTI RAJAGOPALAN & ALEXANDER TABARROK, *LESSONS FROM GURGAON, INDIA’S PRIVATE CITY 203* (2014), <https://mason.gmu.edu/~atabarro/Lessons%20from%20Gurgaon.pdf> [<http://perma.cc/M3CJ-ZCV5>].

<sup>75</sup> GOV’T OF INDIA MINISTRY OF COM. AND INDUSTRY, *SEZ RULES INCORPORATING AMENDMENTS UP TO JULY, 2010*, ch. 2 (2006), [http://sezindia.nic.in/upload/uploadfiles/files/14\\_SEZ\\_Rules\\_July\\_2010.pdf](http://sezindia.nic.in/upload/uploadfiles/files/14_SEZ_Rules_July_2010.pdf) [<http://perma.cc/WSU5-8NUJ>].

proper cost-benefit analysis. It is therefore worth looking into whether the new system is more likely to solve the incentive problems that plagued the SEZ policies of the past.

One prominent feature of the early SEZ scheme was the wide use of the single-factory model, which was introduced in 1981.<sup>76</sup> As previously discussed, such zones are potent tools for rent-seeking and lack the positive cluster-effects that are a prominent rationale for setting up SEZs. By the year 1998, 1210 single-factory zones were operational, and by 2009, as many as 2600.<sup>77</sup> As the selection process for companies designated as single-factory zones is not one based on competitive potential, it is not surprising that these companies seem not to live up to their export goals.<sup>78</sup>

Encouragingly, the new SEZ law aims to create larger zones, which should steer the country away from the single-factory model. However, an initial minimum zone size of 1000 hectares was soon compromised down to 500 hectares, with exemptions for agriculture and IT companies.<sup>79</sup> By 2008, only six percent of the zones were larger than 300 hectares, and forty percent were smaller than twenty hectares.<sup>80</sup> The government even chose to set a maximum SEZ size of 5000 hectares due to land disputes.<sup>81</sup> For perspective, the Chinese pioneering SEZ of Shenzhen covered 32,750 hectares in 1980, a year after its founding.<sup>82</sup>

While smaller zones are generally more prone to incentive problems, additional problems are introduced in India because of its land laws. With suppressed land prices combined with eminent domain, SEZ developers are incentivized to lobby officials to seize land on their behalf. Land will thus be found in the hands of those with the largest political influence, rather than those able to create the most value.

<sup>76</sup> *Export Oriented Unit Scheme*, EOU INDIA, [http://eouindia.gov.in/eou\\_scheme.htm](http://eouindia.gov.in/eou_scheme.htm) [<http://perma.cc/3KXL-9JGB>] (last visited Nov. 12, 2017).

<sup>77</sup> *Facts and Figures*, EOU INDIA, [http://eouindia.gov.in/fact\\_figure.htm](http://eouindia.gov.in/fact_figure.htm) [<http://perma.cc/56NB-H3TD>] (last visited Nov. 12, 2017).

<sup>78</sup> Niloptal Goswami & Pravakar Sahoo, *Why have export-oriented units in India failed to deliver?*, BRUEGEL (Oct. 22, 2016), <http://bruegel.org/2016/10/why-have-export-oriented-units-in-india-failed-to-deliver/> [<http://perma.cc/Z4BC-PAAR>].

<sup>79</sup> Dohrmann, *supra* note 70, at 66–67; Letter from Rajeev Arora, Joint Sec'y to the Gov't of India, to The Chief Sec'ys of States/UTs 1 (Sept. 13, 2013), <http://www.sezindia.nic.in/writereaddata/rules/Amendment%20rules.pdf> [<http://perma.cc/5GDU-VZMZ>].

<sup>80</sup> PARTHA MUKHOPADHYAY & KANHU CHARAN PRADHAN, *LOCATION OF SEZs AND POLICY BENEFITS WHAT DOES THE DATA SAY?* 70–71 (2009), [https://mpr.ub.uni-muenchen.de/24333/1/MPRA\\_paper\\_24333.pdf](https://mpr.ub.uni-muenchen.de/24333/1/MPRA_paper_24333.pdf) [<http://perma.cc/Q8P2-LNDA>].

<sup>81</sup> See Gopalakrishnan, *supra* note 70, at 144.

<sup>82</sup> April A. Herlevi, *What's so Special about Special Economic Zones? China's National and Provincial-Level Development Zones 14* (June 18, 2016) (unpublished research paper), <http://web.isanet.org/Web/Conferences/AP%20Hong%20Kong%202016/Archive/3a83092a-cbfa-4526-85d7-3ca39931b3b4.pdf> [<http://perma.cc/83F5-AM6Y>].

Another problem that has plagued India's SEZ scheme for many years is bureaucratic corruption.<sup>83</sup> Companies wanting to invest in a zone would previously have to pass through numerous authorities. This provided opportunities for rent-seeking as bureaucrats could demand unofficial payments for their services. A survey from 2004 found that sixty percent of responding SEZ companies claimed to have made "irregular payments"—payments not registered in the books—to the SEZ-related bureaucracies.<sup>84</sup>

The aim of the new scheme is to streamline the application and approval process with a so-called "single window" facility.<sup>85</sup> Yet it has taken time for such an institution to be set up. Admitting as much, the central government appealed in 2010 to state governments to set up their own single window facilities.<sup>86</sup> By 2015, a survey found that sixty-four percent of SEZ firms reported that no such facility existed in the state.<sup>87</sup> SEZ investors are thus still faced with several steps through the bureaucracy to obtain approval. The bureaucratic problems with SEZs have contributed to the de-notification of SEZs. While in 2013, India had 580 approved zones, there were only 405 in late 2016 and have since risen to 424 by July 2017.<sup>88</sup>

In conclusion, while the Indian SEZ scheme is moving in the right direction on some margins, it is yet to be seen whether this will be enough to improve it significantly. Insufficient decentralization and flawed land legislation will likely keep causing problems related to governments not having enough information to properly design an SEZ that would benefit the country as a whole. Those same land laws, combined with a burdensome SEZ bureaucracy and wide use of single-factory zones, create distorted incentives that further discredit the claim that the SEZs are meant to benefit the people.

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<sup>83</sup> See, e.g., S.R. Keshava, *The Effect of FDI on India and Chinese Economy: A Comparative Analysis* 18 (Feb. 2, 2008) (unpublished manuscript), <http://ssrn.com/abstract=1089964> [<http://perma.cc/U45U-V7PL>].

<sup>84</sup> Aggarwal, *supra* note 55, at 32.

<sup>85</sup> See Dohrmann, *supra* note 70, at 66; *Introduction*, *supra* note 70.

<sup>86</sup> BS Reporter, *Create single-window clearance for SEZs: Govt tells states*, BUS. STANDARD (Feb. 11, 2010, 11:06 AM), [http://www.business-standard.com/article/economy-policy/create-single-window-clearance-for-sezs-govt-tells-states-110021200075\\_1.html](http://www.business-standard.com/article/economy-policy/create-single-window-clearance-for-sezs-govt-tells-states-110021200075_1.html) [<http://perma.cc/5JNL-68RV>].

<sup>87</sup> PROGRESS HARMONY DEV. RES. BUREAU, *SEZs IN INDIA: CRISS-CROSS CONCERNS* 43 (2015).

<sup>88</sup> See *Set up a single-window clearance system for speedy approvals of special economic zones: ASSOCHAM Plea to Govt.*, THE ASSOCIATED CHAMBERS OF COM. & INDUSTRY OF INDIA (Nov. 30, 2015), <http://www.assochem.org/newsdetail.php?id=5357> [<http://perma.cc/JT4Z-FU2W>]; *Approved SEZs in India*, SPECIAL ECON. ZONES IN INDIA [<http://perma.cc/N5T7-S3QU>] (last visited Nov. 12, 2017).

More private zone development should enhance the scheme. During its decades of existence, the dominance of government investment in India's SEZs has imposed high costs that are ultimately borne by the Indian taxpayer. The conclusion must therefore be that India did not live up to the lowest bar of SEZ success, in that the scheme was not even better than the political status-quo.

### III. COMPARING SEZs TO THEIR POLITICAL ALTERNATIVE

Even if SEZs are better than the status quo, they might still not benefit a country if a superior set of policies could prevail in their absence. For example, policy makers might feel compelled to liberalize the economy and consider a cut in tariffs across the board. As they ponder their options, they might learn about SEZs and find them an attractive policy alternative. With SEZs, policy makers can look as though they are actively promoting trade and development for the country. A zone is a clearly-defined space where policy makers claim credit for the economic activity that they host. They can count the amount of foreign investors and employees in the zone and win praise for how much capital it attracted and how many jobs it created.<sup>89</sup> There will obviously be no mention of the public resources that the project consumed or how many investors simply moved within the country to enjoy the zone's fiscal benefits.

Besides the political point-scoring, SEZs have another feature that is even more attractive for protectionist-minded policy makers. SEZs allow for a dual trade system, in which the country as a whole can remain protectionist while opening up for imports only in limited spaces. Governments often protect certain sectors by limiting foreign competition.<sup>90</sup> In exchange for this favor, they can earn rents from the protected companies, in the form of political support, favors, or outright bribes.<sup>91</sup> Trade liberalization

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<sup>89</sup> See Chenggang Xu, *The Fundamental Institutions of China's Reforms and Development*, 49 J. ECON. LIT. 1076, 1093 (2011).

<sup>90</sup> Daron Acemoglu & James A. Robinson, *Economics Versus Politics: Pitfalls of Policy Advice*, 27 J. ECON. PERSP. 173, 189 (2013).

<sup>91</sup> See, e.g., Acemoglu & Robinson, *supra* note 90, at 186–87; Carlos F. Díaz Alejandro, *The Argentine Tariff, 1906–1940*, 19 OXFORD ECON. PAPERS 75, 95 (1967); Krueger, *supra* note 30, at 291–92; J.J. Pincus, *Pressure Groups and the Pattern of Tariffs*, 83 J. POL. ECON. 757, 757–58 (1975); Robert E. Baldwin, *The Political Economy of Protectionism*, in IMPORT COMPETITION AND RESPONSE 263, 278 (Jagdish N. Bhagwati ed., 1982); Robert E. Baldwin, *The Political Economy of Trade Policy*, 3 J. ECON. PERSP. 119, 125, 130 (1989); Arye L. Hillman, *Declining Industries and Political-Support Protectionist Motives*, 72 AM. ECON. REV. 1180, 1181, 1185 (1982); Giulio M. Gallarotti, *Toward a Business-Cycle Model of Tariffs*, 39 INT'L ORG. 155, 166–67 (1985); James H. Cassing & Arye L. Hillman, *Shifting Comparative Advantage and Senescent Industry Collapse*, 76 AM. ECON. REV. 516, 522 (1986); Barry Eichengreen, *The Political Economy of the Smoot-Hawley Tariff*, in

threatens such relationships. If interest groups no longer receive support from the government, they will be unwilling to offer anything in return.

While this suggests that policy makers should never consider trade liberalization, they may be forced to do so in the face of pressure from other interests. Potential investors in the country can complain about the lack of opportunity and widely declare that the country is losing jobs by keeping foreign investors away. Economists may write articles and speak out about how protectionism is impoverishing the country's people. Foreign trade representatives may pressure the country to open up.

Such demands present the dilemma for the protectionist government between yielding to the pressure and siding with its protected interest groups. SEZs offer a way out of the situation. As policy makers introduce zones, they can claim to pursue liberalization. Meanwhile, they are still protecting the interest groups from threatening imports by maintaining the protectionist regime elsewhere. Foreign investors will be happy to enter the zones, where they enjoy exemptions from tariffs and taxes, and economists and foreign government representatives may accept the partial liberalization as adequate, albeit not perfect.

In this way, SEZs can be a tool to avoid trade liberalization, and thus serve a very different function from that with which they are generally associated. They may improve on the status quo. Yet they may not benefit the economy when the status quo is not the relevant comparison. In the absence of SEZs, the policy makers would likely need to liberalize the economy more broadly in the face of pressure to do so. As a result, SEZs primarily benefit policy makers and protected industries at the expense of the rest of the society.

To understand whether SEZs are better than the status quo, one must consider the political context and understand the incentives of policy makers and the policy alternatives that they face. Any counterfactual scenario will remain a hypothesis. Nevertheless, this approach to assess SEZ benefits is superior to the naïve assumption that policies will remain the same in their absence. The very fact that a government introduces SEZs

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INTERNATIONAL POLITICAL ECONOMY: PERSPECTIVES ON GLOBAL POWER AND WEALTH 37, 37–38, 46 (Jeffrey A. Frieden & David A. Lake eds., 4th ed. 2000); Avinash Dixit & John Londregan, *Redistributive Politics and Economic Efficiency*, 89 AM. POL. SCI. REV. 856, 858 (1995); Dani Rodrik, *Political Economy of Trade Policy*, in 3 HANDBOOK OF INTERNATIONAL ECONOMICS 1457, 1468–69 (Gene M. Grossman & Kenneth Rogoff eds., 1995); Gene M. Grossman & Elhanan Helpman, *Electoral Competition and Special Interest Politics*, 63 REV. ECON. STUD. 265, 283–84 (1996); Jong-Wha Lee & Phillip Swagel, *Trade Barriers and Trade Flows Across Countries and Industries*, 79 REV. ECON. & STAT. 372, 372–73 (1997).



suggests that their incentives are not directly aligned with social welfare. The officials may have suddenly awoken to the benefits of economic openness. However, if the SEZs come in response to pressure to liberalize trade, they may be a mere tool to avoid any radical reforms.

#### A. The Case of the Dominican Republic

The Dominican Republic provides an example of SEZs introduced as a response to pressure to liberalize the economy broadly. The zones allow companies to import tariff-free and enjoy tax exemptions. Meanwhile, these SEZs remain small enough not to threaten the trade protection enjoyed by companies outside the SEZs' boundaries. As a result, while the zones promoted Dominican exports, they also helped preserve a system of protectionism which, in the absence of SEZs, might have been eroded.

In the 1960s, President Joaquín Balaguer inherited a country with a system of trade protectionism, government benefits to particular industries, and general government interventionism.<sup>92</sup> The United States occupied the country for a while and helped Balaguer reach his position of power, thus putting him in a position of loyalty towards the American government.<sup>93</sup>

Balaguer was no natural sympathizer of free markets and introduced new forms of trade protection in the country. On some margins, though, these barriers were made more flexible.<sup>94</sup> This, combined with higher prices of the crops the Dominicans exported, made the country wealthier, which increased the demand for imported goods.<sup>95</sup> Seeing that imports could threaten domestic businesses, Balaguer responded by establishing even more solid protectionism in the country.<sup>96</sup>

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<sup>92</sup> See FRANK MOYA PONS, *THE DOMINICAN REPUBLIC: A NATIONAL HISTORY* 371 (2010).

<sup>93</sup> *Id.* at 396, 398.

<sup>94</sup> See Frank Moya Pons, *Import-Substitution Industrialization Policies in the Dominican Republic, 1925–61*, 70 *HISPANIC AM. HIST. REV.* 539, 561 (1990); see also EMELIO BETANCES, *STATE AND SOCIETY IN THE DOMINICAN REPUBLIC* 120–21 (1995); Andrew Schrank, *Luring, Learning, and Lobbying: The Limits to Capital Mobility in the Dominican Republic*, 37 *STUD. COMP. INT'L DEV.* 89, 95–96 (2003).

<sup>95</sup> See *DOMINICAN REPUBLIC: A COUNTRY STUDY* (Richard A. Haggerty ed., 1989), <http://countrystudies.us/dominican-republic/> [<http://perma.cc/AKQ5-VB3M>].

<sup>96</sup> See JAN KNIPPERS BLACK, *THE DOMINICAN REPUBLIC: POLITICS AND DEVELOPMENT IN AN UNSOVEREIGN STATE* 44, 63 (1986); see also PONS, *supra* note 92, at 396–97; Fabio Rafael Fiallo, *Alternativas de Política Industrial en la República Dominicana* [*Industrial Policy Alternatives in the Dominican Republic*], *EL TRIMESTRE ECONÓMICO* [ETE] 159, 162 (1973); JONATHAN HARTLYN, *THE STRUGGLE FOR DEMOCRATIC POLITICS IN THE DOMINICAN REPUBLIC* 104–05 (1998); Andrew Schrank, *Foreign Investors, "Flying Geese," and the Limits to Export-Led Industrialization in the Dominican Republic*, 32 *THEORY & SOC'Y* 415, 422–24 (2003).

His policies soon met resistance from several corners. Importantly, the U.S. government pushed for trade liberalization in order to access the Dominican market.<sup>97</sup> To respond to these demands, while still protecting the important interest groups that represented domestically focused businesses opposed to foreign competition, Balaguer introduced SEZs in 1968. The new law offered companies two types of benefits: either trade protection or SEZ status that came with fiscal benefits. The law made the system of tariffs more systematic than previously, and offered attractive opportunities to monopolize the domestic market. The protectionist benefits were considered most attractive and were primarily seized by the politically connected elite in Santo Domingo. The SEZ benefits were considered less attractive and were claimed primarily by the less-connected manufacturers outside the capital.<sup>98</sup>

While this form of liberalization was not all the United States had hoped for, the American government accepted the new rules as a partial opening of the economy.<sup>99</sup> Balaguer thus succeeded in preserving and even strengthening the protectionist regime while pleasing the critics asking for more liberalization. In the absence of SEZs, the president might have had to pursue broader measures of liberalization.

The Dominican zones have been praised for diversifying the country's exports and for offering employment opportunities.<sup>100</sup> Yet, it has also been noted that the SEZs function as isolated enclaves that fail to transfer their sophistication and growth to the rest of the economy.<sup>101</sup> An understanding of the political purpose

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<sup>97</sup> See generally Ved P. Nanda, *The United States Action in the 1965 Dominican Crisis: Impact on World Order – Part II*, 44 DENV. L.J. 225 (1966); see also BETANCES, *supra* note 94, at 120–21; HARTLYN, *supra* note 96, at 105; Schrank, *supra* note 94, at 95; Schrank, *supra* note 96, at 423; PONS, *supra* note 92, at 402.

<sup>98</sup> See DOMINICAN REPUBLIC: A COUNTRY STUDY, *supra* note 95; BETANCES, *supra* note 94, at 121; Andrew Schrank, *Entrepreneurship, Export Diversification, and Economic Reform: The Birth of a Developmental Community in the Dominican Republic*, 38 COMP. POL. 43, 46–47 (2005); Andrew Schrank, *Peasants, Planters, and the Predatory State: Export Diversification in the Dominican Republic, 1970-2000*, 10 RES. RURAL SOC. & DEV. 353, 355 (2005); Schrank, *supra* note 94, at 97.

<sup>99</sup> See Schrank, *supra* note 94, at 95.

<sup>100</sup> See Larry Willmore, *Export Processing in the Caribbean: Lessons from Four Case Studies* 19 (Econ. Comm'n for Latin America and the Caribbean, Working Paper No. 42, 1996), <http://archivo.cepal.org/pdfs/1996/S9600501.pdf> [<http://perma.cc/JF9W-6ZWA>]; ADOZONA, IMPACTO ECONÓMICO Y SOCIAL DE LAS ZONAS FRANCAS: UNA VISIÓN DE 360 GRADOS [ECONOMIC AND SOCIAL IMPACT OF FREE ZONES: A 360 DEGREE VIEW] 19 (2012), <https://adozona.org/wp-content/uploads/2017/01/impacto-economico.pdf> [<http://perma.cc/SMM7-BXPF>]; THOMAS FAROLE, WORLD BANK, UNLOCKING CENTRAL AMERICA'S EXPORT POTENTIAL 4 (2012).

<sup>101</sup> See Raphael Kaplinsky, *Export Processing Zones in the Dominican Republic: Transforming Manufactures into Commodities*, 21 WORLD DEV. 1851, 1857 (1993); see also

of the zones explains this outcome. Because the SEZs were meant to divide the economy into the traditional protected sector and the internationally open and export-oriented sector, the latter was never supposed to integrate much with the country at large because that would have eroded the traditional system of trade protection.

The final verdict of the Dominican zones is ambiguous. They were better than the status quo of protectionism, but as tools to avoid reform, they were probably worse than the political alternative of broader economic liberalization.

#### IV. WHEN SEZS LIVE UP TO THEIR BEST POSSIBLE OUTCOME

So far, several flaws with SEZs have been discussed that are commonly overlooked in analyses of their success. When the political economy perspective is ignored, problems of resource misallocation, rent-seeking, and reform avoidance are overlooked. Yet ignorance of the political economy aspects of SEZs also leads to an under appreciation of what SEZs can accomplish when they are at their best. This Part will examine how SEZs can help solve the problem of rent-seeking.

One of the great problems in economic development is that destructive policies and institutions are commonly preserved because the ruling elite lacks the incentive to promote economic progress. Trade restrictions are but one example. Regulations can deter businesses from investing while doing little to protect consumers or preserve market stability. Tax systems can be too complex to comprehend, while offering too many loopholes to yield much government revenue. The list of seemingly irrational policies can be made long.

A simplistic analysis may deem such policies uninformed. Yet they often come about and remain in place due to highly rational calculations from individuals in government. Most interest groups can benefit from regulations that restrict the power of their competitors. They thus have an incentive to pressure the government to introduce seemingly irrational rules. Every burden on the business community is also an opportunity for people in government to demand favors in exchange for exemptions.

As a result, policy makers generally lack the incentive to simplify rules and make the system fairer and more transparent. This leads countries into destructive states of equilibria that

hamper their development, discourage investments, and confine people to poverty.<sup>102</sup>

This is precisely the context in which SEZs can function at their best. By changing the incentives for policy makers, they can set countries on a gradual path towards more growth-promoting policies.

In a system where the government prefers to preserve a protectionist status quo, any initiative for a change will not come from the top, but instead from interest groups that would benefit from liberalization. Just as some groups will pressure the government to introduce growth-suppressing policies, others will seek exemptions from them. A leather manufacturer, for instance, might lobby for tariffs on leather, while a clothes manufacturer would prefer exemptions from the same. One way to obtain more general exemptions is to introduce SEZs. In contrast to specific exemptions, SEZs can create a dynamic that spreads economic liberalization throughout the country.

This dynamic starts with initiatives from people close to the SEZs who will benefit from more openness. This may be business people seeking new opportunities or local policy makers hoping to expand the local government coffers through more economic activity. Assuming most people in power are against more openness, such reformers need to offer favors or bribes in exchange for an SEZ. The zone, while not perfect, is the best they can obtain in the face of strong resistance to change.

As the SEZ grows by attracting more investors, it starts having an impact on the economy at large. Some local monopolies wither as the SEZ inflicts more competition. Other opportunities for rent-seeking weaken as businesses move from other parts of the country to the SEZ with its inviting business environment. The country starts gaining the reputation of a more open economy.

All these factors change the calculation and optimal strategy of local policy makers. They can pursue two different strategies of

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<sup>102</sup> See, e.g., Daron Acemoglu & James Robinson, *Political Losers as a Barrier to Economic Development*, 90 AM. ECON. REV. 126, 126 (2000); Daron Acemoglu & James Robinson, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty* 243–44 (2012); Stephen Haber, *Introduction: The Political Economy of Crony Capitalism*, in *CRONY CAPITALISM AND ECONOMIC GROWTH IN LATIN AMERICA: THEORY AND EVIDENCE* xi, xii, xv–xvi (Stephen Haber ed., 2002); David C. Kang, *CRONY CAPITALISM: CORRUPTION AND DEVELOPMENT IN SOUTH KOREA AND THE PHILIPPINES* 187 (2002); Susan Rose-Ackerman, *Introduction and Overview to INTERNATIONAL HANDBOOK ON THE ECONOMICS OF CORRUPTION* xiv, xiv (Susan Rose-Ackerman ed., 2006); John V.C. Nye, *Why Do Elites Permit Reform?*, 1 ANN. PROC. WEALTH & WELL-BEING NATIONS 53, 55 (2008–2009); Fernanda Brolo, Tommaso Nannicini, Roberto Perotti & Guido Tabellini, *The Political Resource Curse*, 103 AM. ECON. REV. 1759, 1760 (2013).

enriching themselves: they can promote growth and benefit from higher tax revenue, or they can rent-seek by pursuing protectionism, giving monopoly rights to select companies. Thanks to their external effects, SEZs nudge this calculation towards more openness and reliance on tax revenue as opposed to rents from rent-seeking activities. As the first SEZ expands, more local leaders find they can benefit from more openness.

As long as most leaders are against liberalization, no local leader can possibly convince the government to pursue nationwide liberalization. That would threaten too many interest groups from which the government draws its support. Yet they can enjoy most of the fruits of openness by obtaining SEZs, which are less threatening to rent-seeking anti-reformers.

This process does not require a miscalculation of the impact of SEZs by any anti-reformist leader who accepts the zones in exchange for favors. The external effects come only after some time, perhaps several years. If the anti-reformers do not expect to be in power at that time, they are better off accepting the bribe today, at the expense of their successors who will lose out on rent-seeking opportunities.

The process requires a system of fiscal decentralization, though, which allows local leaders to benefit from local tax collection. If not, they would always be better off promoting rent-seeking at the expense of tax collection. With fiscal decentralization, local leaders face a trade-off between tax revenues and gains from rent-seeking, as they cannot promote one without diminishing the other.

The process is necessarily gradual and can take decades, depending on the size of the country. It may not seem like a great proposition for SEZs. Yet if the zones can change the equilibrium of rent-seeking in a country, they provide the solution to one of the main obstacles to economic development.

#### A. How SEZs Reformed China

China offers the most prominent example of a country that used SEZs to profoundly change the economic system of the country. As will be discussed, the SEZs worked to change the incentives of political leaders to promote reform in a context where broad liberalization would likely not have been possible otherwise.

In the 1970s, China was a closed economy in many ways. Rent-seeking by government officials was widespread and there was little indication that the leaders of the economy would want to disrupt the illiberal status quo. Yet the country provided a beneficial institutional setting for SEZ-driven reforms.

The most important feature was the country's decentralization, both on the political and fiscal front. After the death of Mao, the Communist party started focusing on economic development in the country, as opposed to class struggle.<sup>103</sup> The party leaders in Beijing pursued this through political decentralization and incentives to local leaders to produce economic growth. The central government had the power to award local leaders if they obtained their growth targets, and unseat them if not.<sup>104</sup> Yet policy-making was to a large extent left to the local levels of government. Fiscal decentralization meant that local leaders could benefit from higher tax revenues, and hence benefit in two ways from local growth.<sup>105</sup>

Fiscal decentralization thus presented these officials with a trade-off. They could promote protectionism and benefit from the rent-seeking opportunities that this would provide. The down side of this approach, however, was suppressed economic growth, which lowered their tax revenues. By promoting liberalization in their municipality or province, local leaders could amass more tax revenues, albeit at the expense of limiting their rent-seeking opportunities.<sup>106</sup>

The extent to which local leaders pursued growth at the expense of rent-seeking varied, as some areas were better exploited for rent-seeking and others for tax revenues. Areas close to trading spots, such as ports with more opportunities to benefit from trade and foreign investments, would offer more opportunities of real economic growth and tax revenues. However, China's closed system probably made this difficult in most cases. By contrast, areas close to Beijing would likely benefit more from central government largesse through rent-seeking schemes. Areas rich in extractive industries, like mining and other natural resources, would also incentivize officials to take the rent-seeking approach, by granting exploitation rights to friends and those offering favors in return.

The aggregate structure of China's economy at the time suggests that rent-seeking in many cases offered the most lucrative opportunities. In this context, a group of business people with connections to Hong Kong started lobbying for exemptions from protectionism, to make it easier for them to conduct business

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<sup>103</sup> See Xu, *supra* note 89, at 1090.

<sup>104</sup> See *id.* at 1093–94.

<sup>105</sup> See Shaomin Li, Shuhe Li & Weiyang Zhang, *The Road to Capitalism: Competition and Institutional Change in China*, 28 J. COMP. ECON. 269, 283–84 (2000).

<sup>106</sup> See *id.*

in the then-British colony.<sup>107</sup> They turned to Ye Fei, Minister of Transport, who ultimately granted them a special deregulated area from which they could conduct their business from Shekou in Guangdong Province, adjacent to Hong Kong.<sup>108</sup> The Shekou Industrial zone opened in 1979, as the first SEZ of China.<sup>109</sup>

Seeing the benefit of the zone, the governor of Guangdong province started to promote SEZs for China.<sup>110</sup> The first three zones officially labeled SEZs were thus located in Guangdong.<sup>111</sup> One of them is Shenzhen, which was only a small fishing village when it was designated an SEZ.<sup>112</sup> Its special status allowed it to grow into a megacity of over ten million people. With more SEZs being introduced, more local leaders lobbied for SEZs in their areas.<sup>113</sup>

The zones thus spread gradually throughout the country. 1984 was an important year in this development, as China's fifth SEZ was introduced in Hainan, together with fourteen other zones labeled "Coastal Cities."<sup>114</sup> In 1992, all provincial capitals were designated as SEZs, which meant that over half of all municipalities in China now hosted SEZs.<sup>115</sup>

It is important to understand the mechanism through which the SEZs proliferated. Some previous work on SEZs in China has described them as test-beds for policy-making. Government officials could see what worked in the SEZs and then implement those policies in the country at large.<sup>116</sup> This theory sells the SEZs short, as it suggests that they were not instrumental in liberalizing China. The leaders had allegedly already made up

<sup>107</sup> GEORGE T. CRANE, *THE POLITICAL ECONOMY OF CHINA'S SPECIAL ECONOMIC ZONES* 26 (1990).

<sup>108</sup> *Id.*

<sup>109</sup> Victor F.S. Sit, *Specials Economic Zones in China: A New Type of Export Processing Zone?*, 23 *THE DEVELOPING ECONOMIES* 69, 75 (1985); CRANE, *supra* note 107, at 26.

<sup>110</sup> See RONALD COASE & NING WANG, *HOW CHINA BECAME CAPITALIST* 61 (2012).

<sup>111</sup> *Id.*

<sup>112</sup> See *id.* at 59.

<sup>113</sup> See *id.* at 60–62; see also CRANE, *supra* note 107, at 26–27.

<sup>114</sup> CRANE, *supra* note 107, at 156; KAREN I. MCKENNEY, *THE INDUS. COLL. OF THE ARMED FORCES, AN ASSESSMENT OF CHINA'S SPECIAL ECONOMIC ZONES* 11 (1994).

<sup>115</sup> See Wang, *supra* note 1, at 136; Payton Alexander, *Laboratories for Capitalism: Testing the Limits of the Special Economic Zones of Mainland China* 11 (2014) (unpublished M.A. dissertation, University of Edinburgh).

<sup>116</sup> See Kwan-yiu Wong & David K.Y. Chu, *Export Processing Zones and Special Economic Zones as Locomotives of Export-led Economic Growth*, in *MODERNIZATION IN CHINA: THE CASE OF THE SHENZHEN SPECIAL ECONOMIC ZONE* 1, 6 (Kwan-yiu Wong & David K.Y. Chu eds., 1985); CRANE, *supra* note 107, at 96; Wei Ge, *Special Economic Zones and the Opening of the Chinese Economy: Some Lessons for Economic Liberalization*, 27 *WORLD DEV.* 1267, 1268, 1281 (1999); Jean-Pierre Cling & Gaëlle Letilly, *Export Processing Zones: A Threatened Instrument for Global Economy Insertion?* 7 (*Développement et Insertion Internationale*, Working Paper No. DT/2001/17, 2001), <http://ideas.repec.org/p/dia/wpaper/dt200117.html> [<http://perma.cc/S6TD-4XRL>]; Xu, *supra* note 89, at 1114–15.

their minds and were only looking for the right policies to promote growth. While the SEZs were tools in this pursuit, they would eventually have found the liberalizing reforms beneficial.

In this story, the SEZs were a top-down project, a notion that fits the common story about Deng Xiaoping making China an economic powerhouse through his convictions and strong leadership. In fact, Deng Xiaoping, like most leaders, did not support the SEZ policy until the mid-1980s, when they started to prove their worth.<sup>117</sup> SEZs can give policy makers an idea about the effect of certain policies, but as test-beds for reform, they cannot reconstruct a system built on rent-seeking into one of openness.

Another often-told story about SEZs is that they function as showcases for reform.<sup>118</sup> In the case of China, Communist Party leaders would have introduced the zones to show either other policy makers or the public that liberalization could create wealth. However, this too is a story about policy makers seeking ways to maximize the wellbeing of the citizenry. If this were indeed their goal, they would eventually understand what kind of reforms to introduce in this pursuit. As with SEZs as test-beds for reform, SEZs as showcases can benefit the country only at the margin by speeding up a process toward liberalization that is set to occur in any case.

The power of SEZs is instead that they can change the incentives of policy makers from relying on rent-seeking to promoting growth, and this is what seems to have happened in China. The new SEZs gave the country an image of newfound openness. China was, in practice, becoming capitalist.<sup>119</sup> Local leaders thus saw two main changes that affected their incentives. For one, it became possible to reap the rewards of economic growth through openness. Second, it became harder to rent-seek, as businesses within the country had the opportunity to move to SEZs with more open business environments. The trade-off between rent-seeking and taxation thus tilted in the favor of the latter for more local leaders. As they lobbied for and obtained their SEZs, they made rent-seeking a decreasingly attractive strategy for other local leaders.

Eventually, a majority of the ruling elite in China could benefit more from openness and liberalization than protectionism

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<sup>117</sup> See CRANE, *supra* note 107, at 156.

<sup>118</sup> See George T. Crane, 'Special Things in Special Ways': *National Economic Identity and China's Special Economic Zones*, 32 AUSTL. J. CHINESE AFF. 71, 76; see also COASE & WANG, *supra* note 110, at 160.

<sup>119</sup> See COASE & WANG, *supra* note 110, at 164–66.



and rent-seeking. At that point, China truly had relieved itself from its previous destructive status quo. By 2008, ninety-two percent of all Chinese municipalities hosted SEZs.<sup>120</sup> China still suffers from corrupt practices throughout their official institutions, but no more so than the United States did at a similar stage of development.<sup>121</sup>

In addition to opening up the country to the world, the SEZs in China have avoided many of the problems that plagued the Indian zones. For one, political decentralization meant that decisions about the zones were taken on the local level by people who were familiar with prevailing business conditions. As a result, fewer mistakes were made regarding zone location and nature of production. Also, Chinese policy makers had little reason to use the zones for rent-seeking. They owe their seats to the elites in Beijing, who reward them for high GDP growth and can demote them if they fail to reach the growth targets.<sup>122</sup> If granted an SEZ, they have the opportunity to secure their jobs and advance their careers by boosting economic growth. In many cases, the rewards that come from the top are larger than the rents they may extract by trading SEZ privileges. Similar to a democracy, China's system incentivizes local leaders to promote economic prosperity, as this rewards them politically.

China shows that SEZs can help profoundly change a country stuck in a rent-seeking disequilibrium. Still, it does not provide an example for how "governments" can use SEZs to promote growth. Had China's ruling elite wanted to reform the country, they could have done so much faster than through SEZs. The zones served instead as tools from the people at the bottom of the hierarchy to promote changes that initially were against the interest of the majority of rulers.

There may be no other policy that can promote such change so forcefully. For this to happen, though, conditions must be right, with sufficient decentralization and heterogeneity between municipalities, so that some can lead the SEZ reform while others follow. Alas, while it happened in China, it is unclear whether other countries will see a similar SEZ-led restructuring in the future.

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<sup>120</sup> Wang, *supra* note 1, at 136.

<sup>121</sup> See Carlos D. Ramirez, *Is Corruption in China "out of control"? A Comparison with the US in Historical Perspective*, 42 J. COMP. ECON. 76, 77–78 (2014).

<sup>122</sup> See Xu, *supra* note 89, at 1093, 1102.

## V. IMPLICATIONS FOR SEZs IN THE UNITED STATES

A thorough understanding of the political economy of SEZs allows for an analysis of the benefits and flaws of the SEZs of the United States. Labeled “foreign trade zones,” these were introduced in 1934 as a response to the Smoot-Hawley Tariff Act that came about as a reaction to the Great Depression.<sup>123</sup> Today, there are around 750 zones, which offer investors tariff and tax exemptions.<sup>124</sup>

These fiscal incentives allow zone companies to be more profitable by reducing the cost of doing business and encouraging regional commerce.<sup>125</sup> To the extent that taxes and tariffs discourage the productive use of resources, SEZs in the United States create wealth by offsetting them. However, the zones are not without their critics, who primarily seem to focus on the limited impact the zones have on the economy as a whole. Tiefenbrun, for instance, points out that exports from the zones are only 2.6% of the total<sup>126</sup> (this figure was closer to 2.7% by August 2017).<sup>127</sup> Therefore, she concludes that the zones have done little to promote U.S. exports.<sup>128</sup>

As was previously discussed, this is a flawed metric by which to judge SEZ success, as it tells us nothing about their net impact.<sup>129</sup> The U.S. zones may be small, but as long as their costs are smaller than their benefits, they still constitute a good policy for the country. However, as will be argued here, the United States relies far too much on small zones, and would be better off with larger, more diversified SEZs that include residential developments and offer investors more regulatory incentives.

There are some arguments for SEZ success in the United States. To start, the SEZs are largely decentralized. The federal government does not develop the zones, but leaves this to zone applicants. An applicant must be a “public or public-type corporation.”<sup>130</sup> Zone development is thus open to private development, although there is likely much governmental influence through public companies. Because these are local, they likely have an adequate understanding of the business climate in which the

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<sup>123</sup> Eichengreen, *supra* note 91, at 37.

<sup>124</sup> See *How many zones exist now?*, *supra* note 11.

<sup>125</sup> See Bell, *supra* note 11, at 974; see also Tiefenbrun, *supra* note 12, at 221.

<sup>126</sup> Tiefenbrun, *supra* note 12, at 214.

<sup>127</sup> See Press Release, U.S. Census Bureau & U.S. Bureau of Econ. Analysis, U.S. International Trade in Goods and Services (Oct. 5, 2017 8:30 AM), <https://www.census.gov/foreign-trade/Press-Release/2017pr/08/ft900.pdf> [<http://perma.cc/DN2C-ESZB>].

<sup>128</sup> *Id.*

<sup>129</sup> See MOBERG, *supra* note 13 and accompanying text.

<sup>130</sup> *Who can apply?*, *supra* note 28.

zones are introduced. Local policy makers should also be incentivized to pursue successful zones, as they must answer to the judgment of their voters of their economic policy-making.

Public companies, on the other hand, do not face such incentives, as their positions are more akin to bureaucrats who are not exposed to the democratic process. Thus, the decentralization of U.S. SEZs go only halfway in solving the knowledge and incentive problems associated with centralization. Moreover, if public companies fail in their SEZ project, they will sometimes do so at the expense of the local government and hence, its tax payers.

While the public involvement in SEZ development is a concern, the main problem with U.S. SEZs lies in the incentives they create for the actors involved. The country has unfortunately relied to a large extent on single-factory zones for the expansion of its zone scheme. SEZ developers can apply to expand their benefits to affiliated “subzones,” which are single companies that need not be located adjacent to the main zone. There are twice as many of such “subzones” than the 250 “general-purpose zones.”<sup>131</sup>

The subzones are predominantly focused on manufacturing, and thus are likely private in most cases.<sup>132</sup> The problem, though, is that such a scheme looks much like a program of targeted fiscal benefits for companies. In this respect, the United States looks much like India, with its numerous single-factory zones. This set-up contrasts sharply with China’s diverse SEZs with millions of residents. Single-factory zones incentivize companies to lobby for SEZ designation. They also prompt policy makers to make the scheme flexible enough that such lobbying is attractive. As a result, public resources are spent on a politically driven process of companies seeking benefits and officials responding to their demands.

Initially, only ports could become SEZs, which would at least have limited lobbying to that sector. In 1950, as manufacturing was allowed in the zones, the opportunities they provided became available to a much larger part of the U.S. economy.<sup>133</sup> With the introduction of single-factory zones in 1954, the field was ripe for widespread lobbying, as firms no longer had to relocate to obtain the benefits.<sup>134</sup> Although these zones must be affiliated with

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<sup>131</sup> *How many zones exist now?*, *supra* note 11; see also *Where can a Zone be Located?*, U.S. FOREIGN-TRADE ZONES BOARD, <https://enforcement.trade.gov/ftzpage/info/adjacency.html> [<http://perma.cc/7MQ7-SAEC>] (last visited Nov. 12, 2017).

<sup>132</sup> *Who can apply?*, *supra* note 28.

<sup>133</sup> Grant, *supra* note 11, at 8, 10.

<sup>134</sup> *Id.* at 10.

general-purpose zones, they can potentially be located anywhere.<sup>135</sup> Most SEZ-based manufacturing now takes place in subzones, while general-purpose zones engage primarily in distribution and wholesaling.<sup>136</sup>

Grant finds a significant lobbying activity surrounding the SEZs.<sup>137</sup> "Industry groups, individual producers, local and state governments, unions, congressmen and senators, and individual SEZ governing bodies all lobby."<sup>138</sup> The board that approves SEZ applications often cites the lobbyists' arguments for its decisions.<sup>139</sup> When a government offers fiscal benefits to single companies, such lobbying should be expected. The single-factory component of the SEZ scheme is therefore primarily a net waste of resources to the economy at large. Lower tariffs and taxes across the board for the county's manufacturers would clearly be more beneficial. Thus, the zones are hardly better than such a political alternative. Yet, even compared to the status quo, the fact that the system relies on lobbying suggests that the costs of the scheme outweigh its benefits.

The general-purpose zones, too, are hardly better than an alternative policy of lowering tariffs and taxes in a less discriminatory fashion. Still, these look more like traditional zones, and thanks to the decentralized system, they may well bring prosperity to the country. While ports also must lobby to become SEZs, the benefits brought about in applying the fiscal incentives over a larger area and for more companies can override the negatives. Whether the benefits of general-purpose zones outweigh the costs of the single-factory zones is nevertheless questionable.

For SEZs to benefit the United States, they must be made larger, more inclusive, and dominated by private developers. The smaller the zones, the larger the incentive problems become. Larger and more inclusive zones can also have dynamic effects that spread prosperity beyond the zone borders. Rather than small industrial parks, the United States should allow for larger areas with residential developments that can offer not only fiscal but also regulatory exemptions. Regulatory incentives not only cost less for the government to provide but also open up new opportunities for businesses, as opposed to merely lowering their expenses.

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<sup>135</sup> See *Where can a Zone be Located?*, *supra* note 131.

<sup>136</sup> Grant, *supra* note 11, at 10.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 12.

<sup>139</sup> *Id.* at 10.

The SEZ scheme in the United States came about as a response to heightened tariffs. In that light, there are three main roads that the United States can take. First, the government can reduce the fiscal burden from which companies seeking SEZ status are trying to alleviate themselves. A reversal of a mistake that caused the problem in the first place seems logical. Alas, although tariffs are not as high now as in the 1930s, recent administrations have not done much to lower them further. Second, the government can maintain the current SEZ system, which most likely will remain a burden for the economy. Third, the government can reform the SEZ scheme to make it more likely to succeed in enhancing welfare. Seeing that the program is unlikely to ever be abolished, the last option has the best chance of coming about.

#### CONCLUSION

There is reason to be optimistic about the future of SEZs. Decades of experience have shown which models promote prosperity and which come with too many burdensome costs. However, to understand what makes a successful SEZ, one needs a political economy perspective, which accounts for institutional contexts and recognizes the problems caused by limited knowledge and distorted incentives of the policy makers involved. Experience and logic show that an SEZ is a potent tool, which can do much good and much harm, depending on how it is used. With an increased appreciation of the political economy perspective of SEZs, more zone practitioners may promote the kinds of zone models that most likely promote welfare in any given institutional context.

The United States can also hope to learn from the rich experiences of the SEZs of the past. So far, the U.S. zones have hardly benefited the country, but that does not mean that they might not do so in the future. With large, privately developed zones, the United States can establish an SEZ policy that not only is better than the status quo, but also even better than its political alternative. In the best case, the U.S. zones may even promote countrywide reforms.



# Digital Trade Zones: Answering Impediments to International Trade in Information

*Sam Mulopulos\**

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## INTRODUCTION

In an age where information has become as significant as any natural resource, data remains fiercely constrained by protectionism. Whether out of genuine, yet misunderstood, concerns for privacy and cybersecurity or because of simple, unabashed protectionist instincts, countries around the world have pursued policies designed to impede cross-border data flows, localize data, and stifle digital trade. These digital trade barriers—such as, requiring data on citizens of a country to be stored in country rather than on overseas servers—increase costs, cut against competition (especially for small Internet-based businesses), and frustrate innovation.

As countries continue to erect digital trade barriers, the value of the global information flow diminishes. While a recent report by the U.S. International Trade Commission estimates that the Internet improves the productivity of digitally intense industries by 7.8% to 10.9%,<sup>1</sup> barriers from the European Union (“EU”) to China pose a direct challenge and potential impediment to that productivity. Data localization requirements and restrictions on cross-border data flows, perhaps more than any other digital trade barrier, impede the next generation of international trade facilitation—cloud computing. In recent years, cloud traffic has increased from 3.5 to 5.6 zettabytes<sup>2</sup> and will reach 10.4 zettabytes by 2019.<sup>3</sup> Cloud computing is particularly useful because it “provides portability” and “allows for more seamless upgrades and transitions to new or multiple devices, because content does not need to be laboriously copied from one device to another.”<sup>4</sup>

However, the success of cloud computing, and electronic commerce at large hinges on a global distribution of servers. Lack of servers and enormous distances between them can be the cause of lethargic delivery times, which undermines international trade.<sup>5</sup> Therefore, restrictions on digital trade frustrate the

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\* The views expressed herein belong solely to me. I would like to thank Patrick Holvey, Al Gidari, Bill Watson, and Carolyn Iodice for their advice and wisdom.

<sup>1</sup> Digital Trade in the U.S. and Global Economies, Part 2, Inv. No. 332-540, USITC Pub. 4485, at 65 (Aug. 2014) (Final).

<sup>2</sup> A zettabyte is one trillion gigabytes. See Thomas Barnett, Jr., *The Zettabyte Era Officially Begins (How Much is That?)*, CISCO BLOG (Sept. 9, 2016), <https://blogs.cisco.com/sp/the-zettabyte-era-officially-begins-how-much-is-that> [<http://perma.cc/X8YT-QFDE>].

<sup>3</sup> Markham C. Erickson & Sarah K. Leggin, *Exporting Internet Law Through International Trade Agreements: Recalibrating U.S. Trade Policy in the Digital Age*, 24 CATH. U. J.L. & TECH 317, 333 (2016).

<sup>4</sup> *Id.* at 334.

<sup>5</sup> See Steven R. Swanson, *Google Set Sail: Ocean-Based Server Farms and International Law*, 43 CONN. L. REV. 709, 715, 741 (2011).



distribution of the global network needed to make e-commerce and Internet-enabled international trade successful. Since it would be difficult for a state to block access to individual users, governments instead seek to control the flow of data higher up the chain, usually at the level of certain intermediaries like Internet Service Providers.<sup>6</sup> While reducing these barriers is a useful and necessary tool towards protecting free Internet-enabled commerce, it is also a traditional solution.

This article proposes an unconventional solution to the problem of digital trade restrictions: digital trade zones. Digital trade zones would be areas in which a country would forbear from jurisdiction over certain Internet and privacy laws in order to permit innovative arrangements between countries as a means of circumventing otherwise impeding digital trade restrictions. To date there has not been any discussion of creating special jurisdictions for the trade and treatment of data.<sup>7</sup>

This article lays a foundation for such a discussion. Part I highlights the key impediments to digital trade. Part II discusses the theoretical foundation of digital trade zones, analogizing this framework to both maritime law and Foreign Trade Zones (“FTZs”) in the United States, each a key ingredient needed to make digital trade zones function. Part III anticipates successes and problems posed by digital trade zones in practice by presenting some of the potential mechanics of digital trade zones in the United States. Specifically, it proposes two types of zones—experimental zones and waystation zones—addressing, respectively, the impediments created by restrictions on cross-border data flows and data localization. Part III also contains a discussion of the ways in which digital trade zones offer answers to some common intellectual property rights violations frequently encountered in the course of trade. The Conclusion summarizes the work and proposes next steps to further the discussion.

## I. IMPEDIMENTS TO DIGITAL TRADE

From galleons to gigabytes, international trade has come a long way.<sup>8</sup> Producers and consumers can be instantaneously connected, and the flow of information across the globe has facilitated a commercial revolution. While the world is more

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<sup>6</sup> See *id.* at 719.

<sup>7</sup> A single article does discuss treating the emerging internet ecosystem broadly as a single “digital free trade zone.” See Kristi L. Bergemann, *A Digital Free Trade Zone and Necessarily-Regulated Self-Governance for Electronic Commerce: The World Trade Organization, International Law, and Classical Liberalism in Cyberspace*, 20 JOHN MARSHALL J. COMPUTER & INFO. L. 595, 629 (2002).

<sup>8</sup> From pieces of eight to 8-bit also hits the tone I am going for.

connected than ever, barriers to digital trade are being erected at an alarming pace. Despite the myriad of challenges facing individuals and industry engaging in e-commerce, three of the most common digital trade restrictions are data localization, restrictions on cross-border data flows, and intellectual property rights infringement.<sup>9</sup>

#### A. Data Localization

Data localization refers to mandates that require companies to engage in digital trade-related activities inside of the particular country in order to do business in that country.<sup>10</sup> Sometimes called “data nationalism,” data localization is an extreme attempt by a government to restrict the flow of data from escaping beyond its control and its borders. Data localization can be contrasted with historical Internet border controls; while previous controls were mainly designed to keep information from entering a country, localization efforts build on this by preventing data from leaving.<sup>11</sup>

The most common localization efforts require that data storage facilities house data in the country or jurisdiction that originates the data.<sup>12</sup> For example, in 2015, Russia required that data collected by companies on Russian citizens be both processed and stored within Russia.<sup>13</sup> While there is still uncertainty about how the law will be implemented, the outlook for such localization requirements is not good. This is because Russia currently lacks the server capacity to shoulder the demand for data storage as required by the law.<sup>14</sup>

China also has localization restrictions aimed at cloud computing. Given its geographic agnosticism, cloud computing is frequently an unfortunate first casualty of data localization. In China, cloud computing is closed to foreign-invested companies and the country is presently seeking to limit foreign companies from offering cloud computing services if they are cross-border

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<sup>9</sup> OFFICE OF THE U.S. TRADE REPRESENTATIVE, NATIONAL TRADE ESTIMATE REPORT ON FOREIGN TRADE BARRIERS (2017) [hereinafter NATIONAL TRADE ESTIMATE REPORT] <https://ustr.gov/sites/default/files/files/reports/2017/NTE/2017%20NTE.pdf> [<http://perma.cc/YL6U-DT56>].

<sup>10</sup> Digital Trade in the U.S. and Global Economies, Part 1, Inv. No. 332-531, USITC Pub. 4415 (July 2013) (Final).

<sup>11</sup> Anupam Chander & Uyen P. Le, *Data Nationalism*, 64 EMORY L.J. 677, 679 (2015).

<sup>12</sup> See OFFICE OF THE U.S. TRADE REPRESENTATIVE, KEY BARRIERS TO DIGITAL TRADE (Mar. 2017), <https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2017/march/key-barriers-digital-trade> [<http://perma.cc/BWV4-VU7A>].

<sup>13</sup> NATIONAL TRADE ESTIMATE REPORT, *supra* note 9, at 382.

<sup>14</sup> *Id.*

services.<sup>15</sup> But localization is not limited to tyrannical regimes. Even Canada has caught the localization bug. British Columbia and Nova Scotia both have laws that require that personal information possessed by public institutions—such as schools, universities, or hospitals—must be stored and accessed only in Canada.<sup>16</sup>

Localization requirements such as these can be incredibly costly to service providers and consumers. Since, at its most extreme, localization could require a provider to construct physical data infrastructure in every jurisdiction where it does business, one can begin to imagine the expense that such requirements place on the private sector and the limitations they pose for global investment and business expansion. In Brazil, for example, a data center costs on average \$60.9 million.<sup>17</sup> Even in the United States, construction of a data center can exceed \$40 million.<sup>18</sup> In countries with more burdensome regulatory environments, construction costs could be even higher. For example, Chinese localization efforts could cost as much as 1.1% of the nation's gross domestic product.<sup>19</sup>

#### B. Cross-Border Data Flow Restrictions

Less extreme than data localization, restrictions on the flow of data across borders encompass a host of activities and regulations designed to impede information exchange. By limiting what types of data can be exported and how data flow restrictions can frustrate a broad range of e-commerce activities, banks may be unable to transfer data between international branches, and big data analysis may be limited by turning off the information spigot to companies that rely on cutting-edge marketing strategies.<sup>20</sup> Even individuals can be implicated by cross-border data flow restrictions. Consider that fifty-eight percent of eBay revenue comes from outside the United States and that Airbnb operates in more than 65,000 cities and 191 countries.<sup>21</sup> Consumers and companies in the United States are

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<sup>15</sup> *Id.* at 89.

<sup>16</sup> *Id.* at 72.

<sup>17</sup> Anupam Chander & Uyen P. Le, *Breaking the Web: Data Localization vs. the Global Internet* (Univ. of Cal. Davis Sch. of Law, Working Paper No. 378, 2014).

<sup>18</sup> *See id.*

<sup>19</sup> Matthias Bauer et al., *The Costs of Data Localisation: Friendly Fire on Economic Recovery*, EUROPEAN CTR. FOR INT'L POL. ECON. 2 (2014).

<sup>20</sup> *See* RACHEL G. FEFER, SHAYERAH ILIAS AKHTAR & WAYNE M. MORRISON, CONG. RES. SERV., R44565, DIGITAL TRADE AND U.S. TRADE POLICY 13 (2017).

<sup>21</sup> Craig Smith, *70 Amazing eBay Statistics and Facts*, DMR, <https://expandedramblings.com/index.php/eBay-stats/> [<http://perma.cc/6UME-GT3R>] (last updated Feb. 3, 2018); *About Us*, AIRBNB, <https://www.airbnb.com/about/about-us> [<http://perma.cc/7DHL-67JP>] (last visited Nov. 9, 2017).

connecting with international markets in a variety of innovative ways; they too can be entrepreneurially constrained by digital trade restrictions.

Restrictions on cross-border data flows are varied. Many are already familiar with China's Great Firewall, which blocks websites such as Twitter, Google, and Facebook.<sup>22</sup> In a recently issued policy, "On Cleaning up and Regulating Internet Access Services Market," China prohibits telecommunications carriers from permitting consumers access to virtual private network connections to contact data centers abroad.<sup>23</sup> The European Union is considering proposals on contract rules for digital content, such as streaming services and for goods sold online. Ostensibly designed to address "defective" content purchased online, it remains to be seen how this will limit the ability of U.S. providers to conduct digital business in Europe or lead to a bifurcation of service into separate geographic zones. These are just a handful of the numerous international limitations on data flows that threaten the free exchange of information throughout the world.

The numerousness of limits on cross-border data flows make the costliness of compliance with such efforts unsurprising. The Great Firewall blocks eleven of the top twenty-five global websites, and estimates place the total number of blocked sites at 3000.<sup>24</sup> This costs individuals and organizations countless dollars a year in lost business. Given the acceleration of cloud computing—twenty-two percent of OECD-based businesses<sup>25</sup> use cloud computing services—limiting the ability of the cloud to serve different populations easily is an expensive proposition.<sup>26</sup> Moreover, much of the value that comes from data is increasingly made by gleaning insights from data in real time.<sup>27</sup> Curtailing that real time analysis means placing an upper limit on a core part of data's intrinsic usefulness. Imagine a farmer relying on Internet-enabled equipment to plant crops more precisely. If that farmer is located in a country which limits his access to the cloud, the data he is simultaneously producing as he plants cannot be easily transformed from raw to useful information to make his activity more precise. Or consider the aircraft

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<sup>22</sup> NATIONAL TRADE ESTIMATE REPORT, *supra* note 9, at 90.

<sup>23</sup> *Id.* at 89.

<sup>24</sup> *Id.* at 90.

<sup>25</sup> OECD stands for Organization for Economic Cooperation and Development.

<sup>26</sup> *Expanding U.S. Digital Trade and Eliminating Barriers to Digital Exports: Hearing Before the Subcomm. on Trade of the H. Comm. on Ways and Means*, 114th Cong. 3 (2016) (statement of Robert D. Atkinson, President, Information Technology and Innovation Foundation) [hereinafter Atkinson Testimony].

<sup>27</sup> *Id.* at 2.

manufacturing industry. A Boeing 737 engine produces twenty terabytes of data per hour.<sup>28</sup> Boeing utilizes this enormous amount of data to enhance safety and reduce flight delays. Boeing's Airplane Health Management system is used by commercial airlines that operate Boeing aircraft in real time to assess and mitigate potential aircraft problems.<sup>29</sup> Given that crossing borders is core to an aircraft's purpose, the success of this entire endeavor is rooted in Boeing's ability to move enormous amounts of data around the globe quickly and effortlessly. It is estimated that the Internet of Things, such as Boeing's engines, other industrial machines, and consumer electronics, will yield \$11.1 trillion per year in economic impact.<sup>30</sup> Data flow limitations cut directly into that figure, threatening one of the largest potential additions to economic productivity in the coming years.

### C. Intellectual Property Rights Infringement

Internet-enabled trade has simultaneously created new markets for intellectual property rights ("IPR") and caused a great proliferation of IPR infringement. Frequently, Internet piracy is named as a key trade barrier, including foreign countries hosting websites that post pirated content or connect people to such stolen content.<sup>31</sup> According to the U.S. Trade Representative, who issues lists of countries that are serial IPR violators, the countries on the "priority watch list" span the globe, including Algeria, Argentina, Chile, China, India, Indonesia, Kuwait, Russia, Thailand, Ukraine, and Venezuela.<sup>32</sup>

Infringement of IPR can take many forms. Often times, foreign websites will host pirated or stolen content. For example, MP3VA.com is a site based in Russia and Ukraine that sells unauthorized U.S. audio recordings.<sup>33</sup> The site registers more than 860,000 visits per month, with most of the visits coming

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<sup>28</sup> See John B. Maggiore, *Remote Management of Real-Time Airplane Data*, BOEING (2007), [http://www.boeing.com/commercial/aeromagazine/articles/qtr\\_3\\_07/AERO\\_Q307\\_article4.pdf](http://www.boeing.com/commercial/aeromagazine/articles/qtr_3_07/AERO_Q307_article4.pdf) [<http://perma.cc/T9BS-GL4Z>]; Paul Mathai, *Big Data: Catalyzing Performance in Manufacturing*, WIPRO 3 (2011), <https://www.wipro.com/content/dam/nexus/en/industries/process%20and-industrial-manufacturing/latest-thinking/2606-Big%20Data%20-%20Copy.pdf> [<http://perma.cc/KXA4-M89Y>].

<sup>29</sup> Atkinson Testimony, *supra* note 27, at 6.

<sup>30</sup> *Id.* at 3.

<sup>31</sup> FEFER, AKHTAR & MORRISON, *supra* note 20, at 16.

<sup>32</sup> See OFFICE OF THE U.S. TRADE REPRESENTATIVE, 2017 SPECIAL 301 REPORT (2017) [hereinafter SPECIAL 301 REPORT] <https://ustr.gov/sites/default/files/301/2017%20Special%20301%20Report%20FINAL.PDF> [<http://perma.cc/LW35-7L6X>].

<sup>33</sup> *Id.*

from the United States.<sup>34</sup> A similar website is uploaded.net, which gives users access to different kinds of copyrighted content, such as movies, music, and books. Hosted in the Netherlands, uploaded.com uses a creative arrangement to make money whereby users receive greater compensation for the greater size of the file they pirate and load to the website.<sup>35</sup> Another website is taobao.com, an e-commerce platform that sells many counterfeit products. Taobao.com is one of the top websites in China.<sup>36</sup> Another example of IPR infringement is the theft of trade secrets. China is a repeat offender on this issue. While China has taken steps to address the theft of trade secrets, including amendments to the General Provisions of the Civil Law in March 2017 that extended civil intellectual property protection to trade secrets, there remains a long way to go.<sup>37</sup> This includes improving options for the use of preliminary injunctions and protections against frivolous trade secret litigation claims which can be used to gain advantage in unrelated disputes.<sup>38</sup>

Given the expansiveness of the Internet and the ease with which it facilitates IPR infringement, IPR infringement is exceptionally costly. Some estimate that Internet-enabled IPR infringement could be greater than the total volume of sales “through traditional channels such as street vendors and other physical markets.”<sup>39</sup> An OECD study places trade in fake goods at \$461 billion or 2.5% of global trade, and it has been noted that “the total magnitude of counterfeiting and piracy worldwide in all forms appears to be approaching, if not surpassing, the trillion dollar mark.”<sup>40</sup>

#### D. Motivations to Limit Digital Trade

The motivation to limit digital trade to prevent violations of IPR may appear the most straightforward—preventing the raw profiteering from the sale of stolen goods. However, when it comes to other barriers to digital trade, the motivations are somewhat more opaque. Data flow restrictions and associated

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<sup>34</sup> See OFFICE OF THE U.S. TRADE REPRESENTATIVE, 2016 OUT-OF-CYCLE REVIEW OF NOTORIOUS MARKETS 9 (Dec. 2016) [hereinafter Notorious Markets] <https://ustr.gov/sites/default/files/2016-Out-of-Cycle-Review-Notorious-Markets.pdf> [<http://perma.cc/LMT2-RZ6K>].

<sup>35</sup> *Id.* at 14.

<sup>36</sup> See *id.* at 12.

<sup>37</sup> See SPECIAL 301 REPORT, *supra* note 32, at 30.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 13.

<sup>40</sup> OFFICE OF THE INTELL. PROP. ENFORCEMENT COORDINATOR, U.S. JOINT STRATEGIC PLAN ON INTELLECTUAL PROPERTY ENFORCEMENT FY 2017–2019, at 20 (2016), <https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/IPEC/2016jointstrategicplan.pdf> [<http://perma.cc/U68K-6FUQ>].

localization requirements have been enacted for a myriad of reasons by various countries.

The most common rationales respond to fears that sharing data abroad will open such data up to surveillance by foreign governments. This public motivation stems from dual desires to protect the privacy of the country's own citizens and a protectionist motivation to stimulate domestic technology and Internet companies. In the wake of the Snowden revelations, countries, including India and the EU, have pursued various efforts to guard against U.S. surveillance.<sup>41</sup> Brazil, Russia, India, China, and South Africa (collectively known as the "BRICS countries") have also sought to create a series of global transmission cables intended to be "a network free of U.S. eavesdropping."<sup>42</sup> From a civil liberties perspective, some have commented that centralizing data within certain countries only makes it easier for domestic agencies and law enforcement to spy on their own citizens by concentrating citizens' data more closely.<sup>43</sup> The veracity of claims that localization and data flow restrictions are primarily rooted in concern over foreign surveillance belongs in a paper all its own, and it is worth noting that some have pushed back against this notion by arguing that surveillance concerns are a veneer for what is ultimately digital protectionism against mostly American companies.<sup>44</sup>

Regardless of motivations, these efforts have demonstrated protectionist effects. Governments may believe that by limiting foreign competition, which is often American competition given the United States' technological and commercial dominance, a domestic technology industry may flourish. However, governments around the world have worried about the impediments this logic poses to the information economy globally. The OECD has asked countries to abstain from "barriers to the location, access and use of cross-border data facilities and functions" in order to "ensure cost effectiveness and other efficiencies."<sup>45</sup> In a survey of domestic companies, the Swedish National Board of Trade concluded that "trade cannot happen without data being moved from one location to another."<sup>46</sup>

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<sup>41</sup> See Chander & Le, *supra* note 17, at 10, 28.

<sup>42</sup> *Id.* at 28.

<sup>43</sup> See *id.* at 30. Chander and Le refer to this as the "Honeypot" problem. *Id.*

<sup>44</sup> See Christopher Kuner, *Data Nationalism and its Discontents*, 64 EMORY L.J. ONLINE 2089, 2094–95 (2015).

<sup>45</sup> ORG. FOR ECON. COOPERATION AND DEV., OECD COUNCIL RECOMMENDATION ON PRINCIPLES FOR INTERNET POLICY MAKING 7 (Dec. 13, 2011), <http://www.oecd.org/sti/ieconomy/49258588.pdf> [<http://perma.cc/BA4E-LLDA>].

<sup>46</sup> The National Board of Trade, *No Transfer, No Trade – the Importance of Cross-Border Data Transfer for Companies Based in Sweden*, 1 KOMMERSKOLLEGIUM 23 (2014).

## II. DIGITAL TRADE ZONES IN THEORY

Digital trade zones possess two core theoretical tenets—freedom from data nationalism and existence as jurisdictions legally “outside” the territory of a country. Since digital trade zones do not presently exist, examination and understanding of these concepts is best done by analogy. The first tenet is demonstrated, in its purest form, on the high seas where nations are unable to exercise restrictions on the movement of Internet information. The second tenet is more real. FTZs in the United States offer a well-tested and successful framework to understand some of the basic mechanics of digital trade zones.

### A. The High Seas

At their core, digital trade zones (just like all special jurisdictions) are areas with unique rules. While these are manmade creations, the distinction of being an original special jurisdiction belongs to the open ocean. Since there are no established digital trade zones from which to highlight, this Section returns to the sea in order to share by analogy how digital trade zones might be arranged.

#### 1. The Precedent of Pirate Radio

In response to content restrictions imposed by the British Broadcasting Corporation, disc jockeys and music promoters started what was known as pirate radio and began to pipe rock n’ roll music into Great Britain from vessels stationed in international waters.<sup>47</sup> These vessels, and some old naval forts located outside British territorial waters that were used for broadcasting, were usually anchored to the seafloor and supplied by tenders from the mainland.<sup>48</sup> In 1966, the most popular pirate broadcasters, Radio Caroline and Radio London, boasted an audience of over eight million listeners.<sup>49</sup> And Britain was not alone; the Netherlands had its share of pirate stations as well.<sup>50</sup>

At the time the pirate broadcasters were operating, controlling law was the 1958 Geneva Convention on the High

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<sup>47</sup> See Kimberley Peters, *Taking More-Than-Human Geographies to Sea: Ocean Natures and Offshore Radio Piracy*, in WATER WORLDS: HUMAN GEOGRAPHIES OF THE OCEAN 177, 178–80 (Jon Anderson & Kimberley Peters eds., 2014).

<sup>48</sup> See *id.* at 182–83.

<sup>49</sup> Horace B. Robertson, Jr., *The Suppression of Pirate Radio Broadcasting: A Test Case of the International System for Control of Activities Outside National Territory*, 45 LAW & CONTEMP. PROBS. 71, 75 (1982).

<sup>50</sup> See *id.* at 76.



Seas.<sup>51</sup> This agreement did not approve or prohibit an explicit right to broadcast from the high seas.<sup>52</sup> In fact, the Convention only lists four core nautical freedoms: navigation, fishing, laying of pipelines and cables, and flight.<sup>53</sup> Some argue that so long as broadcasting or any other activity did not interfere with any of these four freedoms, it would be permissible under the Convention.<sup>54</sup>

Despite the apparent security offered under the Geneva Convention, pirate broadcasters were still targets of British and European authorities. To circumvent these authorities, the pirate broadcasters were known to fly a flag of convenience. These flags belonged to states that lacked the ability or will to hold pirate broadcasters accountable for their transmissions.<sup>55</sup> Coastal countries, like Great Britain, could not exercise authority over pirate broadcasters flying flags of convenience because only the flag state possesses sole jurisdiction over its vessels.<sup>56</sup> Early on, pirate radio learned the vital lesson that finding flags of convenience was necessary to avoid collapsing into the jurisdiction of the country which the pirates were attempting to avoid. Similarly, an embryonic digital trade zone—embodied in an oceangoing data center—would need to find a suitable flag of convenience to be able to exist apart from the onerous trade restrictions it seeks to evade.

In an effort to punish pirate broadcasters, the 1965 European Agreement for the Prevention of Broadcasts Transmitted from Stations Outside National Territories (“European Pirate Radio Agreement”) required “that signatory flag states punish pirate broadcasters found on their own ships.”<sup>57</sup> The European Pirate Radio Agreement did not establish a new form of jurisdiction, however. Instead, it aimed to strengthen enforcement by targeting “acts of collaboration,” such as the provision or maintenance of the vessels, the provision of supplies to the broadcasters, and the provision of advertising to fund the pirate stations.<sup>58</sup> Even though the vessels and transmitters were themselves beyond reach of

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<sup>51</sup> *Id.* at 79.

<sup>52</sup> *See id.*

<sup>53</sup> *See* Convention on the High Seas art. 2, Apr. 29, 1958, 13 U.S.T. 2312, 450 U.N.T.S. 82 [hereinafter Convention on the High Seas].

<sup>54</sup> *See* Robertson, *supra* note 49, at 79.

<sup>55</sup> *See* Robert C. F. Rueland, Note, *Interference with Non-National Ships on the High Seas: Peacetime Exceptions to the Exclusivity Rule of Flag-State Jurisdiction*, 22 VAND. J. TRANSNAT'L L. 1161, 1225 (1989).

<sup>56</sup> *See* Swanson, *supra* note 5, at 739.

<sup>57</sup> *Id.*

<sup>58</sup> Robertson, *supra* note 49, at 95.

European governments, the network of logistical, financial, and human support for pirate radio was not.

Pirate radio was effectively extinguished in the United Nations Convention on the Law of the Sea (“UNCLOS”). Article 109 gives states, even those who are not the flag states of a broadcasting vessel, power to arrest “any person or ship engaged in unauthorized broadcasting and seize the broadcasting apparatus.”<sup>59</sup>

Pirate radio represents an inchoate, primitive digital trade zone. Seeking to circumvent impediments to the flow of transmitted information, individuals took to the seas. In international waters, these pirate broadcasters were able to successfully carve out space and challenge state-owned radio corporations, much in the same way digital trade zones seek to challenge the protectionist impulses of data localization and cross-border data flow restrictions, but this time with state approval.

## 2. The Legal Status of Oceanic Data Centers

Pirate radio offers an instructive case study about the potential, as well as the limits, of using the ocean as a means of bypassing territorial laws limiting the flow of information. However, to understand the theory that gives purpose to digital trade zones, the pirate radio analogy must be improved by considering the effect of putting servers on the seas. Can territorial restrictions on the flow of information be circumvented by placing the data on a vessel in the ocean?

For a time, Google pursued barge-based server farms that would deliver computing power throughout the world. In 2009, Google was granted a patent for a “water-based data center.”<sup>60</sup> Using the ocean to power and cool a data center could potentially mean operating the facility much more cheaply at sea than on land. While there are doubts about the technological feasibility of such server ships, it may nonetheless be possible for a data center to maintain a degree of independence from national Internet restrictions by remaining at sea.<sup>61</sup>

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<sup>59</sup> United Nations Convention on the Law of the Sea, Dec. 10, 1982, 1833 U.N.T.S. 397 [hereinafter UNCLOS]. At present, the United States has signed but not ratified UNCLOS and treats parts of the agreement as customary international law.

<sup>60</sup> U.S. Patent No. 7,525,207 (filed Feb. 26, 2007) (issued Apr. 28, 2009).

<sup>61</sup> See Tim Worstall, *Google's Offshore Data Centres Won't Be Out of the NSA's Reach, Nor the US Government's*, FORBES (Oct. 27, 2013, 9:25 AM), <https://www.forbes.com/sites/timworstall/2013/10/27/googles-offshore-data-centres-wont-be-out-of-the-nas-reach-nor-the-us-governments/#3e87c3787536> [<http://perma.cc/6GGG-25VH>].

Such was the case when the Swedish website, Pirate Bay, attempted to purchase an old British naval fort located outside the country's territorial waters in order to avoid law enforcement attempts to shut down the website.<sup>62</sup> While this attempted acquisition was for nefarious purposes, it underscores the interest in, and potential of, efforts to find places where digital restrictions do not apply. The fort, known as Sealand, had been previously used as a pirate radio base and claims a modicum of sovereignty.<sup>63</sup> Referred to as "a near-perfect embodiment of a data haven," Sealand has already tested its independence in cyberspace by hosting HavenCo, a provider of online gambling services.<sup>64</sup>

Building upon the lessons learned by pirate broadcasters and Sealander alike, floating data centers would have to adhere to two important requirements at minimum. These vessels would have to remain on the high seas and would need to fly the flag of some nation.

UNCLOS applies several degrees of territoriality to the ocean.<sup>65</sup> Of these several degrees, only the final—the high seas—offers sufficient freedom from the prescriptive and enforcement jurisdiction of national governments to be of use in the intellectual development of digital trade zones. The high seas begin where a country's exclusive economic zone ends; 200 miles from the shore.<sup>66</sup> On the high seas, a state that is not the flag state of the vessel in question can exercise jurisdiction over a ship in international waters only in very limited circumstances such as if the ship is engaged in piracy or poses a specific threat to national security.<sup>67</sup> One would hope that operating a cloud computing service at an offshore data center would not fall into

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<sup>62</sup> See Jan Libbenga, *The Pirate Bay plans to buy Sealand*, THE REGISTER (Jan. 12, 2007, 2:44 PM), [https://www.theregister.co.uk/2007/01/12/pirate\\_bay\\_buys\\_island/](https://www.theregister.co.uk/2007/01/12/pirate_bay_buys_island/) [<http://perma.cc/LHZ8-W3DY>].

<sup>63</sup> See Kevin Fayle, *Sealand Ho! Music Pirates, Data Havens, and the Future of International Copyright Law*, 28 HASTINGS INT'L & COMP. L. REV. 247, 261 (2005). Since it lacks the permanent population and capacity to pursue diplomatic relations, Sealand is unable to fully achieve sovereign recognition. *Id.* However, Sealand has been acknowledged to have a degree of sovereignty. *Id.* An English court found that Great Britain did not have jurisdiction over Sealand, and in 1978, the residents of Sealand lost the fort to German and Dutch nationals before they were able to recapture the fort in an air assault. *Id.* The Dutch and German invaders were then held as prisoners of war. *Id.*; see also Andrew H. E. Lyon, *The Principality of Sealand, and Its Case for Sovereign Recognition*, 29 EMORY INT'L L. REV. 637, 642–43 (2015).

<sup>64</sup> Fayle, *supra* note 63, at 262.

<sup>65</sup> The UN Convention on the Law of the Sea specifies these zones as internal waters, territorial seas, contiguous zones, exclusive economic zones, the continental shelf, and the high seas. Swanson, *supra* note 5, at 727–38.

<sup>66</sup> UNCLOS, *supra* note 59, at 40.

<sup>67</sup> See *id.* at 53–54.

these categories, though countries such as China, which have highly restrictive Internet regimes, may argue otherwise.

While the high seas offer a forum free from territorial data protectionism, a floating data center would also need, just like the pirate radio broadcasters of yore, to identify with a flag state in order to be protected against unwanted boarding and seizure. International law is explicit that a ship not flying the flag of a country is considered to be operating beyond the law.<sup>68</sup> The flag state, to the contrary, enjoys exclusive jurisdiction over the vessel flying its flag, thus “[h]aving a nationality actually protects the ship from other states’ jurisdiction and lets the flag state exercise diplomatic protection over the vessel.”<sup>69</sup>

Therefore, the operator of an oceangoing data center would want to select a flag state under which to operate the vessel. Options are not just limited to the United States or a company’s nation of incorporation, but also a host of nations offering their flags for sale. Countries offering flags of convenience include Panama, Liberia, the Bahamas, and Bermuda.<sup>70</sup> Organizations usually select flags of convenience because of the light-regulatory touch and low taxes found in these nations.<sup>71</sup> However, in order to access markets with greater Internet regulatory schemes, especially when it comes to privacy, the operators of a floating data center may wish to choose a country that mimics the data protection regime of the jurisdiction within which they hope to conduct business. As such, operators of floating data centers may wish to affiliate with EU member states or Canada.

### 3. Applicability to Digital Trade Zones

The hypothetical treatment of data on the high seas offers two instructive lessons for digital trade zones. First, in order to be successful, a digital trade zone should attempt to mimic the legal conditions found on the high seas as much as possible. The digital trade zone should be a space free from territorial regulation on the flow of data; the digital trade zone should serve as a neutral zone separate and apart from domestic data restrictions. Just as it is for other special jurisdictions, extraterritoriality is important, and given the difficulty of operating data centers out in the ocean, replicating those legal conditions on land is core to the digital trade zones project. Second, digital trade zones still must be located somewhere in

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<sup>68</sup> See Sean Hickman, *Flagging Options for Seasteading Projects*, THE SEASTEADING INSTITUTE 3 (Mar. 2012).

<sup>69</sup> Swanson, *supra* note 5, at 735–36.

<sup>70</sup> Hickman, *supra* note 68, at 8.

<sup>71</sup> *Id.* at 3.

order to benefit from a broader rule of law. This is similar to how a floating data center would need to select a flag state to avoid the predations attendant to being a stateless vessel on the high seas. Just as some flag states are more convenient for different operations, the United States likely offers the best conditions for digital trade zones, as it possesses a history of well-regarded privacy protection, a vibrant Internet industry, a strong rule of law, and a history of operating special jurisdictions. The advantages conferred on the first mover in this field would also be substantial, and policy makers may wish to work towards capturing these benefits.

## B. U.S. Foreign Trade Zones

While the high seas offer an analogous way to think about the legal status of digital trade zones, FTZs in the United States offer direct insight into the mechanics of their digital trade counterparts. Created by the U.S. Congress in 1934, FTZs permit the occupants of the zone to defer customs duties and excise taxes on goods brought into the zone.<sup>72</sup> FTZs have proven to be successful special jurisdictions in the United States and as such offer a template from which to model their digital cousins.

### 1. The Purpose of Foreign Trade Zones

The purpose of FTZs is to prove an incentive for siting certain manufacturing functions within the United States. FTZs promote “importation for the purpose of conditioning or combining foreign goods with domestic products prior to exporting the finished products to foreign markets, rather than retaining them for domestic consumption.”<sup>73</sup> At present, most activity in FTZs is manufacturing. Since their creation, the number of FTZs has proliferated. Before 1970, there were only ten cities with zones.<sup>74</sup> Today, there are over 200 approved zones.<sup>75</sup> Domestic inputs into zones account for fifty-eight percent of inputs while forty-two percent of inputs come from foreign sources.<sup>76</sup>

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<sup>72</sup> 19 U.S.C. § 81c(a) (2012).

<sup>73</sup> Barbara M. Sheppard, *Foreign Trade Zones – International Business Incentives*, 7 GA. J. INT'L. & COMP. L. 669, 670 (1977).

<sup>74</sup> See John J. DaPonte, Jr., *The Foreign Trade Zones Act: Keeping Up with the Changing Times*, BUS. AM., Dec. 1997, at 22.

<sup>75</sup> See *US Foreign Trade Zones*, EXPORT.GOV (Oct. 20, 2016), <https://www.export.gov/article?id=US-Foreign-Trade-Zones> [<http://perma.cc/MR9K-8G4Z>].

<sup>76</sup> MARY JANE BOLLE & BROCK R. WILLIAMS, CONG. RES. SERV., R42686, U.S. FOREIGN-TRADE ZONES: BACKGROUND AND ISSUES FOR CONGRESS 7 (2013).

## 2. The Structure of Foreign Trade Zones

The most unique factor of FTZs is that they exist outside of U.S. customs territory.<sup>77</sup> This allows FTZs to offer duty deferral on goods entering the zones. Customs duties are only paid when the imported goods are actually transported into U.S. customs territory.<sup>78</sup> In this way, FTZs represent more of a “procedure” than an actual physical demarcated place.<sup>79</sup> While all the zones are exempt from the same customs procedures, the zones are hardly homogenous, ranging from large, sprawling facilities to single warehouses.<sup>80</sup>

Applications for FTZs are reviewed by the Foreign Trade Zones Board. Located within the U.S. Department of Commerce, the Board is made up of the Secretary of Commerce and the Secretary of the Treasury.<sup>81</sup> The Board has an Executive Secretary to lead the daily operations.<sup>82</sup> The Board examines and, where appropriate, approves applications for new FTZ designations and then grants the designation to local governments or non-profit corporations, which then create and maintain the zone as a public utility.<sup>83</sup> Customs and Border Protection oversees all activities and collects all revenues from FTZs.<sup>84</sup>

## 3. Foreign Trade Zones Meet Digital Trade Zones

FTZs offer an established model for digital trade zones. Proposed digital trade zones in the United States would be established via federal legislation, and organizations would petition a Digital Trade Zones Board—perhaps also including the Secretary of Commerce and the Secretary of the Treasury as leaders—for inclusion in the program. Digital trade zones would be areas where instead of deferring duty collection, the United States would forbear from various Internet and privacy-related jurisdictions providing participating organizations the ability to self-regulate in ways that would satisfy the requirements of international data markets. Thus, digital trade zones would, similar to their foreign trade progenitors, be procedures rather than standard physical locations. Digital trade zones could be permitted to take a variety of forms and sizes; from the

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<sup>77</sup> See Tom W. Bell, *Special Economic Zones in the United States: From Colonial Charters, to Foreign-Trade Zones, Toward USSEZs*, 64 *BUFF. L. REV.* 959, 982 (2016).

<sup>78</sup> BOLLE & WILLIAMS, *supra* note 76, at 11.

<sup>79</sup> DaPonte, *supra* note 74, at 206.

<sup>80</sup> Sheppard, *supra* note 73, at 670.

<sup>81</sup> BOLLE & WILLIAMS, *supra* note 76, at 13.

<sup>82</sup> See NAT'L ASS'N OF FOREIGN TRADE ZONES, *THE U.S. FOREIGN TRADE ZONES PROGRAM – PROMOTING TRADE, JOB CREATION & ECONOMIC DEVELOPMENT* 5 (2013).

<sup>83</sup> *Id.*

<sup>84</sup> See *id.*

largest of data centers to the most unusual of Internet communication arrangements.

### III. DIGITAL TRADE ZONES IN PRACTICE

While there may be other applications of digital trade zones, and their enacting legislation should anticipate and encourage alternative uses, this article contemplates two practical uses. These two applications consider digital trade zones as experiments and digital trade zones as waystations. Both types of zones would adhere to the general procedures and structures in Part II. By permitting a country, in this analysis the United States, to forbear from jurisdiction over a defined area for the purposes of establishing law governing the Internet or other data uses unique to the zone, both experimental and transitory zones would be able to bypass restrictions on cross-border data flows and data localization requirements.

#### A. Digital Trade Zones as Experiments

Digital trade zones could also be used to detour around restrictions on cross-border data flows. This could be done by creating zones where companies could participate in different experimental arrangements designed to safeguard consumer privacy and work towards developing more beneficial arrangements for the transfer of data across borders.

Digital trade zones as experimental areas are perhaps most applicable to the relationship between the United States and the EU. In 2012, U.S. digital exports to the EU were worth \$140.6 billion, representing seventy-two percent of all services exports to the EU.<sup>85</sup> Total U.S.–EU trade in goods and services totaled \$1 trillion, and U.S. foreign direct investment in the EU amounted to \$2.4 trillion—fifty-six percent of total U.S. direct investment worldwide.<sup>86</sup> There are several ways in which the flow of data across the Atlantic creates such exceptional value. For instance, many businesses in Europe sell products to and engage customers in the United States, European firms receive investment advice from U.S. consultancies, and companies share data internally from their international subsidiaries.<sup>87</sup> This is similar to how Boeing tracks engine operating data throughout

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<sup>85</sup> Joshua P. Meltzer, *The Importance of the Internet and Transatlantic Data Flows for U.S. and EU Trade and Investment* 12 (Brookings Inst. Glob. Econ. & Dev., Working Paper No. 79, 2014).

<sup>86</sup> See MARTIN A. WEISS & KRISTIN ARCHICK, CONG. RES. SERV., R44257, U.S.-EU DATA PRIVACY: FROM SAFE HARBOR TO PRIVACY SHIELD 4 (2016).

<sup>87</sup> See Meltzer, *supra* note 85, at 8.

the world and shares it through its company and with commercial airlines.

### 1. Attempts to Preserve U.S.–EU Cross-Border Data Flows

Despite the incredible amount of data driven commerce between the United States and the EU, the EU's exceptionally rigorous data privacy requirements has been a thorn in the side of U.S.–EU trade relations when it comes to cross-border data flows. In October 1995, the EU adopted the Data Protection Directive (“DPD”) to create a unified, comprehensive framework for data protection.<sup>88</sup> The DPD mandates that data on EU citizens can only leave the EU (and DPD's protections) if the destination jurisdiction has a sufficient data protection regime.<sup>89</sup> The EU assesses how adequate foreign data protections are by reviewing the circumstances governing the transfer of data.<sup>90</sup>

This initially posed problems for the United States, which lacks the same kind of comprehensive data protection law. Consumer privacy protection laws in the United States are “industry specific and vary by sector, with different laws governing the collection and disclosure of financial data, health-related data, student information, and motor vehicle records.”<sup>91</sup> Some commentators have noted that, while less comprehensive on the whole, the alleged patchwork protections found in the United States form a much more nimble and flexible response to consumer privacy than the European approach, a view shared by the Department of Commerce, which maintains that “[t]he sum of the parts of U.S. privacy protection is equal to or greater than the single whole of Europe.”<sup>92</sup>

Despite these reassurances, and in order to maintain transatlantic data flows, the U.S. and the EU agreed to the Safe Harbor Agreement in 2000.<sup>93</sup> The Safe Harbor Agreement was the result of negotiations between both sides in order to find an

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<sup>88</sup> Directive 95/46/EC, of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of such Data, 1995 O.J. (L 281) 31 [hereinafter Directive 95/46/EC].

<sup>89</sup> WEISS & ARCHICK, *supra* note 86, at 2.

<sup>90</sup> *Id.* The EU also focuses on “the nature of the data, the purpose and direction of the proposed processing operations, the countries of origin, and the final destination of the data, and that country’s laws, rules, and security measures.” *Id.*; see also Directive 95/46/EC, *supra* note 88, at arts. 25–26.

<sup>91</sup> WEISS & ARCHICK, *supra* note 86, at 3.

<sup>92</sup> Natasha Singer, *Data Protection Laws, an Ocean Apart*, N.Y. TIMES (Feb. 2, 2013), <http://www.nytimes.com/2013/02/03/technology/consumer-data-protection-laws-an-ocean-apart.html>.

<sup>93</sup> See U.S. DEP’T OF COM., U.S.-EU SAFE HARBOR FRAMEWORK; A GUIDE TO SELF-CERTIFICATION 3 (2009).



arrangement that satisfied the “adequate level of protection” for data mandated by the DPD.<sup>94</sup> At its peak, about 4500 U.S. companies participated in the framework established by the Safe Harbor Agreement. Participation was open to any U.S. organization that was regulated by the Federal Trade Commission and, separately, airlines, even though they are regulated by the Department of Transportation. This restriction did limit the Safe Harbor Agreement to these regulated industries and notably, it did not include U.S. financial or telecommunications companies.<sup>95</sup>

The serenity found under the Safe Harbor Agreement was dashed when in October 2015, the European Court of Justice struck down Safe Harbor Agreement as insufficient under the DPD.<sup>96</sup> First, the court found that a European Commission finding that a foreign country—the United States—had sufficient privacy protections does not supersede and reduce the powers of EU authorities to assess data privacy protections.<sup>97</sup> The European Court of Justice also determined that because the European Commission did not investigate “the domestic laws or international commitment of a third country prior to making a determination on the adequacy of their data privacy protection,” the Commission decision adopting the Safe Harbor Agreement was invalid.<sup>98</sup>

The bombshell decision was followed by the U.S. and the EU scrambling to find a new mechanism to protect privacy and then facilitate transatlantic movement of data as quickly as possible. In February 2016, the U.S. and the EU announced a replacement to the Safe Harbor Agreement: the Privacy Shield Framework.<sup>99</sup> The Privacy Shield Framework is meant to be a more robust version of the Safe Harbor Agreement. The Privacy Shield Framework is characterized by several changes, including stronger enforcement measures administered by the Department of Commerce and the Federal Trade Commission, improved redress for citizens who believe their data has been compromised, and greater commitments by participating U.S. companies, such as more detailed notice obligations, prescriptive access rights,

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<sup>94</sup> WEISS & ARCHICK, *supra* note 86, at 5.

<sup>95</sup> *Id.* at 6.

<sup>96</sup> See Scott J. Shackelford, *Seeking a Safe Harbor in a Widening Sea: Unpacking the EJC's Schrems Decision and What it Means for Transatlantic Relations*, SETON HALL J. DIPL. & INT'L REL. (forthcoming) (manuscript at 2–3).

<sup>97</sup> See Mira Burri & Rahel Schar, *The Reform of the EU Data Protection Framework: Outlining Key Changes and Assessing Their Fitness for a Data-Driven Economy*, 6 J. INFO. POL'Y 479, 486 (2016).

<sup>98</sup> WEISS & ARCHICK, *supra* note 86, at 7.

<sup>99</sup> *Id.* at 9.

and data retention limits.<sup>100</sup> Currently, 2500 organizations participate in the Privacy Shield Framework.<sup>101</sup>

In October 2017, the European Commission released a report announcing that the Privacy Shield Framework continues to provide sufficient protection under EU law.<sup>102</sup> However, this positive development should not obfuscate concerns that the Privacy Shield Framework, like the Safe Harbor Agreement before it, will be eternal. Even at its inception, the EU recognized “shortcomings” with the framework,<sup>103</sup> and with the DPD’s forthcoming replacement by the General Data Privacy Directive (“GDPD”) in 2018, questions may once again arise about the survival of data flow arrangements between the U.S. and the EU.<sup>104</sup> The GDPR has a somewhat more expansive scope than the DPD—particularly when it comes to territoriality, data-subject rights, and personal data processing, to name a few—which may mean the currently accepted Privacy Shield Framework protections will be suddenly out of date when the GDPR comes into force next year.<sup>105</sup> And even without this worry, litigation relating to another tool available for U.S. business compliance with the DPD—standard contractual clauses—has been unceasing since the invalidation of the Safe Harbor Agreement. Given that this litigation, centered on the acceptability and protective adequacy of the standard contractual clauses will continue regardless of the GDPR issue, the Privacy Shield Framework will continue to face active threats and challenges for the foreseeable future.<sup>106</sup>

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<sup>100</sup> The Judicial Redress Act, 5 U.S.C. § 552a (2015), which was signed into law by President Obama in February 2016, improved transatlantic trust regarding data flows. Broadly, the Act aims to include citizens of foreign countries or organizations (like the EU), which the United States has an agreement with to promote privacy protections. Similar to the promise offered by digital trade zones, passage of the Judicial Redress Act was hailed as a turning point in U.S.–EU data relations. See WEISS & ARCHICK, *supra* note 86, at 10, 13.

<sup>101</sup> See Press Release, U.S. Dep’t of Com., U.S. Secretary of Commerce Wilbur Ross Welcomes Release of European Commission Report on EU-U.S. Privacy Shield (Oct. 18, 2017), <https://www.commerce.gov/news/press-releases/2017/10/us-secretary-commerce-wilbur-ross-welcomes-release-european-commissions> [<http://perma.cc/Z7NZ-PLFB>].

<sup>102</sup> *Report from the Commission to the European Parliament and the Council on the First Annual Review of the Functioning of the EU–U.S. Privacy Shield*, at 2, COM (2017), 611 final (Oct. 18, 2017).

<sup>103</sup> WEISS & ARCHICK, *supra* note 86, at 11.

<sup>104</sup> W. Gregory Voss, *European Union Data Privacy Law Reform: General Data Protection Regulation, Privacy Shield, and the Right to Delisting*, 72 BUS. LAW. 221, 222 (2017).

<sup>105</sup> *Id.* at 222, 225.

<sup>106</sup> See Catherine Muyl, *EU Updates on Schrems II and the Privacy Shield*, SECURITY, PRIVACY AND THE LAW (Oct. 2, 2017), <http://www.securityprivacyandthelaw.com/2017/10/eu-updates-on-schrems-ii-and-the-privacy-shield/> [<http://perma.cc/LCU6-BC4L>]. There is also litigation in France challenging the Privacy Shield Framework. See Les Exégètes

## 2. Digital Trade Zones as Experiments

The tense history, and continued fragility, of U.S.–EU data privacy agreements offers an opportunity for proposed digital trade zones to shine. While digital trade zones could be viewed as experimental zones in a variety of ways, this article focuses on one prominent way in which digital trade zones could be valuable areas of trade innovation. Currently, any data privacy arrangement between the U.S. and the EU has to be negotiated in great detail and would apply to the entirety of both jurisdictions. The stakes are also exceptionally high; a single agreement must be, at least at the time of its adoption, near perfect, or face invalidation.<sup>107</sup> And even where an agreement is successful at fending off legal challenges, these challenges still undermine the agreement's stability until resolution, potentially forestalling quick adoption of the framework.

Digital trade zones could be designed to permit organizations to experiment with different data privacy arrangements. The United States could forbear from standard privacy laws in specified zones. The governing principle in the zones would be a hybrid privacy regime: U.S. law contextualized by EU requirements. This would allow several places to experiment with data privacy arrangements. There are three benefits to using digital trade zones to experiment with privacy arrangements in order to circumvent impediments to the international flow of data. One way this might function would be if parties, such as the U.S. and EU, negotiated a variety of data privacy arrangements and then specified specific zones in which the arrangements would apply. Much like FTZs, these digital trade zones would be limited to the geographic area around single companies or server complexes. Interested organizations would be able to apply to the Department of Commerce to be the guinea pigs for different privacy arrangements. For participating companies, the benefits would be clear: access to European markets that would otherwise be beyond reach. Just as companies apply to participate in the FTZ program because it gives them more efficient and less costly access to difficult to source inputs, companies handling big data would be motivated to participate in a digital trade zone by the inverse: access to difficult to reach overseas markets.

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Amateurs, *Privacy Shield*, LES EXÉGÈTES AMATEURS (2016), <https://exegetes.eu.org/dossiers/privacysshield/index.html> [<http://perma.cc/W324-QP7H>].

<sup>107</sup> See Graham Greenleaf, *International Data Privacy Agreements after the GDPR* and Schrems, 139 PRIVACY L. & BUS. INT'L REP. 6, 8 (noting that a less than perfect Privacy Shield Framework invites litigation designed to destroy the agreement).

There are three benefits to using digital trade zones to experiment with privacy arrangements in order to circumvent impediments to the international flow of data.

First, experimental digital trade zones would reduce the currently high stakes of every data protection agreement negotiation. Since the Safe Harbor Agreement and the Privacy Shield Framework apply to the entire United States, companies do not have a choice of participating in some other arrangement. This means that the stakes are exceptionally high during a negotiation over a new arrangement or when considering updating an arrangement. If there were numerous arrangements in place, any of which could be applied for and to specific local jurisdictions, the stakes would be lower for each individual agreement. The U.S. and the EU might be more willing to experiment with different types of arrangements, perhaps even limiting the initial number of organizations which could participate during pilot programs, and would be more likely to approach agreements in an iterative process, adopting lessons learned from test agreements and adjusting to developments in U.S. and EU privacy law.

Relatedly, these zones could act as fail safes in the event certain regimes were invalidated. With lower stakes and more experimental agreements spread over different jurisdictions, the numerousness of digital trade zones would guarantee that if a single arrangement was invalidated by a U.S. or EU court, other agreements would still be in place. Indeed, if digital trade zones are permitted to “stack” agreements, conforming to the most stringent aspects of every agreement, even where one of the jurisdiction’s agreements is invalidated, the jurisdiction is still able to function under other agreements. Consider the creative commons license system. Just as licensors are able to select different types of licenses that give them the desired level of attribution, commercial reuse, and derivativeness, organizations operating in a digital trade zone would be able to select the data privacy and legal arrangements that best suit their organization and the market access it hopes to achieve.<sup>108</sup> Modularity means longevity for transatlantic data agreements. The dispersed nature of the zones’ agreement frameworks would no longer necessitate hurried negotiation for global replacements where a prior regime is withdrawn. Even without an agreement stack, there would already be other types of model agreements in place

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<sup>108</sup> See *About the Licenses*, CREATIVE COMMONS, <https://creativecommons.org/licenses/> [<http://perma.cc/87JF-EMJP>] (last visited Nov. 10, 2017).

that the parties could draw upon to replace a failed or invalidated experimental arrangement.

Third, digital trade zones would inject market forces into a currently bulky, and non-market process. By marketizing data privacy arrangements, digital trade zones would be more responsive to consumers while giving greater choice to policy makers. Right now, consumers can only choose to do U.S.–EU business with companies complying with the Privacy Shield Framework. Consumers are not able to choose amongst companies that might protect their privacy even better under an experimental arrangement, and companies are not efficiently incentivized to offer greater or lesser, but more targeted, protections. Given the privacy concerns that form the basis of many people’s desire to remain offline or minimize their online presence, this consumer choice is critical.<sup>109</sup> Businesses will also be interested in such a proposal because it offers a chance to improve their reputations vis a vis consumers’ privacy desires, likely in a certification-style manner.<sup>110</sup> In this way digital trade zones can help organizations seeking to operate in Europe, while also giving consumers a voice in what types of data privacy arrangements they prefer.

## B. Digital Trade Zones as Waystations

While data localization policies are difficult to surmount because the policies are designed to prohibit the international movement of data entirely, digital trade zones can still offer an answer to data localization problems when used as waystations. These types of digital trade zones would exist to hold data in transition and would be aimed at addressing localization initiatives, such as those found in Canada.

### 1. Data Localization in Canada

As mentioned previously, the Canadian provinces of British Columbia and Nova Scotia both have serious localization requirements for public data. Both provinces require that personal information held by a public organization, such as a university, hospital, school, or public department, be held in Canada.<sup>111</sup> Moreover, these public entities are prohibited from using U.S.–based services if there is the chance the data

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<sup>109</sup> See Gregory Shaffer, *Globalization and Social Protection: The Impact of EU and International Rules in the Ratcheting Up of U.S. Data Privacy Standards*, 25 YALE J. INT’L L. 1, 37 (2000).

<sup>110</sup> See *id.* at 35–36.

<sup>111</sup> NATIONAL TRADE ESTIMATE REPORT, *supra* note 9, at 72.

covered by the laws could be “stored in or accessed from the United States.”<sup>112</sup>

British Columbia’s localization requirement comes from the Freedom of Information and Protection of Privacy Act (“FIPPA”), an act governing the protection of public information.<sup>113</sup> Section 30.1 of FIPPA mandates that “a public body must ensure that personal information in its custody or under its control is stored only in Canada and accessed only in Canada.”<sup>114</sup> There are three exceptions: (1) if the individual consents to their information being stored in or accessed from another jurisdiction; (2) if the data is stored in or accessed from another jurisdiction “for the purpose of disclosure allowed under this Act”; and (3) if the information was disclosed in order to make a payment or resolve an issue surrounding a payment to “the government of British Columbia or a public body.”<sup>115</sup> “Under FIPPA, a ‘record’ includes books, documents, maps, drawings, photographs, letters, vouchers, papers and any other thing on which information is recorded or stored by graphic, electronic, mechanical or other means.”<sup>116</sup>

In Nova Scotia, the Personal Information International Disclosure Protection Act (“PIIDPA”) forms the core of the province’s localization requirement, since PIIDPA focuses on the unauthorized disclosure of information specifically beyond Canada and makes it illegal for information to be stored in, or accessed from, jurisdictions outside of Canada. There are exceptions, instances of which are detailed in a report issued by the government of Nova Scotia.<sup>117</sup> For example, energy officials in Nova Scotia permitted twenty-four staffers to use their government email while traveling abroad to places like the United States, Norway, and China.<sup>118</sup> The explanation provided for this exemption from PIIDPA is innocuous and standard: “staff may be required to monitor their email and voicemail for business continuity purposes.”<sup>119</sup> Almost all the other entries in

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<sup>112</sup> *Id.*

<sup>113</sup> OFFICE OF THE INFO. & PRIVACY COMMISSIONER FOR B.C., GUIDE TO ACCESS AND PRIVACY PROTECTION UNDER FIPPA 3 (Oct. 2015) [hereinafter FIPPA GUIDE].

<sup>114</sup> Freedom of Information and Protection of Privacy Act, 165 R.S.B.C. § 30.1 (1996).

<sup>115</sup> 165 R.S.B.C. §§ 30.1, 33.1(1).

<sup>116</sup> FIPPA GUIDE, *supra* note 113, at 7.

<sup>117</sup> See Ian Wallace, *Privacy: what laws apply in Atlantic Canada?*, STEWART MCKELVEY, [http://www.smss.com/abcnewsletter/AEC/2014\\_Summer/A1.html](http://www.smss.com/abcnewsletter/AEC/2014_Summer/A1.html) [<http://perma.cc/ML8K-MGG8>] (last visited Nov. 9, 2017).

<sup>118</sup> N.S. DEPT OF JUSTICE, PERSONAL INFORMATION INTERNATIONAL DISCLOSURE PROTECTION ACT: 2014 ANNUAL REPORT 12 (July 2015).

<sup>119</sup> *Id.*

the report detail similar situations of staff bringing laptops and phones outside of Canada on official or personal trips.<sup>120</sup>

## 2. Digital Trade Zones as Waystations

In this conception of digital trade zones, waystations are locations where data is transitory. Information will flow through the zone but not be accessed there. Data may be stored there as long as necessary until it is repatriated back to the jurisdiction with the localization requirement. The waystation model would work by creating space where organizations would be permitted to add additional privacy and cybersecurity protections to meet the protection thresholds necessary to handle the data coming out of a localized jurisdiction. However, the waystation would not be physically located in that jurisdiction and may even be situated in a foreign country.

In the case of Canada, the United States could create digital trade zones that exist as spaces outside of U.S. jurisdiction for the purposes of privacy laws, similar to how FTZs exist “outside” the U.S. for the purposes of duty collection on initial imports. In these zones, organizations would be able to build and operate servers to handle public data from British Columbia or Nova Scotia. Since the zones would be outside the jurisdiction of the United States for the purposes of privacy law, the zones would be able to be sealed from intrusion by host jurisdiction surveillance agencies. Title II of the Electronic Communications Privacy Act, also known as the Stored Communications Act (“SCA”), would not apply. Law enforcement would not be able to use a warrant issued under the SCA to access data stored outside the United States.<sup>121</sup> The individual whose data is being stored remains inviolate because the organization storing the individual’s information is merely a “caretaker.”<sup>122</sup> The right to the data remains with the individual, in this case in Canada, and the server itself remains in the digital trade zone thus technically outside the borders of the United States. With ensured privacy protection from the United States, organizations operating in the zone would still need to certify to the relevant province that they had met the necessary privacy and cyber protection to handle the province’s public data. Furthermore, the data would not be able to be accessed in these zones. It would simply be stored there

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<sup>120</sup> See generally *id.*

<sup>121</sup> *In re Matter of Warrant to Search a Certain Email Account Controlled and Maintained by Microsoft Corp. v. United States*, 829 F.3d 197, 201 (2d. Cir. 2016).

<sup>122</sup> Andrew J. Pecoraro, *Drawing Lines in the Cloud: Implications of Extraterritorial Limits to the Stored Communications Act*, 51 CREIGHTON L. REV. 75, 95 (2017).

until the data was requested back in Canada, at which point it would be transmitted back to the originating province.

The benefit of the waystation model is that it may be easier, more cost-effective, and less burdensome to construct, maintain, and operate a collection of servers in jurisdictions that are not subject to the localization requirement. In the U.S.–Canada example, it may be easier to build and operate servers in the United States, or another country, than it is in Nova Scotia.

For example, in Toronto it costs \$1580 per square meter to build a high-tech factory, the closest type of structure to a data center mentioned in a recent report on comparative construction costs.<sup>123</sup> Presumably it may be even more expensive to do such construction in places outside of Canada's largest city, such as Nova Scotia. While all U.S. cities in the report were listed as having higher construction costs than Toronto, numerous other cities did have lower costs, potentially making them ripe candidates for using digital trade zones as waystations. Some notable cities where construction costs are lower than Toronto include Seoul, Singapore, and Brisbane.<sup>124</sup> However, data centers are different from generic high-tech factories, and so these general numbers might not encompass the exact cost of construction for such a specialized facility. In the United States, it costs on average \$43 million to build a data center.<sup>125</sup> Costs are even higher in Brazil (\$60.9 million) and Chile (\$51.2 million).<sup>126</sup> Directly comparable data was not available for Canada. However, data center construction costs in Brazil and Chile were higher than the United States, even though construction of high-tech factories in both of those countries were considerably cheaper than such construction in the United States.<sup>127</sup> This suggests that there is something intrinsic about the construction of *data centers* that makes such construction cheaper in the United States than abroad. To the extent that such construction is cheaper in the United States rather than British Columbia or Nova Scotia, digital trade zones can serve as a way to promote the domestic construction industry, while also

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<sup>123</sup> TURNER & TOWNSEND, INTERNATIONAL CONSTRUCTION MARKET SURVEY 2016, at 26 (2016) (comparing construction costs on numerous global cities—Toronto was the only Canadian city included and U.S. cities covered by the report were New York City, Houston, San Francisco, and Seattle).

<sup>124</sup> See *id.* at 13.

<sup>125</sup> Chander & Le, *supra* note 17, at 36.

<sup>126</sup> *Id.*

<sup>127</sup> See TURNER & TOWNSEND, *supra* note 123, at 24, 28, 78. Construction costs for a high-tech factory was \$1300 in Brazil and \$3500 in Chile. *Id.* at 24, 28. Comparatively, according to the report, the city with the lowest cost of construction of a high-tech factory was Houston at \$4272. *Id.* at 78.



bringing U.S. organizations in closer proximity to Canadian information markets.

Construction is not the only driving cost of data centers. Data centers are exceptionally energy intensive,<sup>128</sup> with energy costs accounting for three-quarters of a data center's cost of operation.<sup>129</sup> In Canada, data centers use approximately one percent of the entirety of the country's energy consumption.<sup>130</sup> And, since Canada actually has more expensive electricity than the United States, small businesses pay, on average, eight percent more and industrial businesses pay thirty percent more per kilowatt hour than their southern neighbors.<sup>131</sup> Cheap electricity in the United States may be a reason why businesses would want to site their data centers in the United States rather than in Canada. While Canada has 164 data centers, the costs of operating those centers can be reduced by siting those centers in the U.S., or by contracting with U.S.-based centers to handle provincial public information.<sup>132</sup> Waystation digital trade zones would help enable this cross-border data storing to be realized.

### C. Digital Trade Zones and Intellectual Property Rights

The practical proposals of digital trade zones as experiments and waystations only addresses two of the three main types of digital trade barriers. Digital trade zones could also help advance national interests in protecting intellectual property. While the potential for digital trade zones to seriously mitigate intellectual property rights infringement is reserved for future works, it is worthwhile to mention one particular way that digital trade zones guard against intellectual property rights infringement, even only examining the simple applications presented in the present work.

The Trade Related Intellectual Property ("TRIPS") Agreement, which was created along with the World Trade Organization ("WTO") at the Uruguay Round, requires participating states to establish minimum intellectual property rights standards.<sup>133</sup> However, some view the TRIPS Agreement

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<sup>128</sup> Swanson, *supra* note 5, at 715.

<sup>129</sup> Chander & Le, *supra* note 17, at 37.

<sup>130</sup> *Data Centres*, NAT. RESOURCES CAN., <https://www.nrcan.gc.ca/energy/products/categories/data-centres/13741> [<http://perma.cc/4HZKLFQA>] (last modified Jan. 19, 2018).

<sup>131</sup> See Gerry Angevine & Kenneth P. Green, *Paying More for Power: Electricity Costs in the US and Canada*, FRASER INST. iii (May 2014), <https://www.fraserinstitute.org/sites/default/files/paying-more-for-power-rev.pdf> [<http://perma.cc/M59X-8EJ4>].

<sup>132</sup> *Colocation Canada*, DATA CTR. MAP, <http://www.datacentermap.com/canada/> [<http://perma.cc/22JL-RGUS>] (last visited Nov. 7, 2017).

<sup>133</sup> See Rachel Brewster, *The Surprising Benefits to Developing Countries of Linking International Trade and Intellectual Property*, 12 CHI. J. INT'L L. 1, 2 (2011).

minimum standards as insufficient. For example, the TRIPS Agreement requires that countries make available “enforcement procedures” against intellectual property rights violations.<sup>134</sup> This language stops short of any “affirmative obligation to stop acts of infringement.”<sup>135</sup> This suggests that digital trade zones may be able to fill gaps in the TRIPS Agreement by denying violators an opportunity to purloin intellectual property.

One example from a country mentioned in this article is Canada. Canada remains on the U.S. Trade Representative’s Special 301 Watch List for a variety of reasons.<sup>136</sup> Canada does not give customs officials authority to “detain, seize, and destroy pirated and counterfeit goods.”<sup>137</sup> Presumably, this limitation could be extended to goods in digital form, although there remains a debate about the proper classification of e-products under the WTO.<sup>138</sup> As digitally neutral territory that retain (or even improve upon) the intellectual property rights regimes of their host country, digital trade zones offer safe havens for digital content to be stored without fear of piracy. While the data may be subject to piracy if it moves across borders and outside the digital trade zone, digital trade zones can offer intellectual property protection for the data they hold.

#### CONCLUSION

In a world with non-tariff restrictions on trade, there is a truism that speaks to those who desire to negotiate around these restrictions: to play the game, participants must give something up. That is, to engage in commerce across borders, participants—whether they be countries or organizations—must be prepared to find some compromise. In the context of digital trade zones this thinking also holds true. Countries seeking to expand their digital markets might forbear from some jurisdiction over their territory, internet laws, and surveillance authority in order to promote the creation of digital trade zones and the proliferation of e-commerce by domestic organizations. Countries seeking to protect their domestic technology sectors should also be

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<sup>134</sup> Agreement Trade-Related Aspects of Intellectual Property Rights art. 41, Apr. 15, 1994, 1869 U.N.T.S 299.

<sup>135</sup> Brewster, *supra* note 133, at 22.

<sup>136</sup> Special 301 Report, *supra* note 32, at 62.

<sup>137</sup> *Id.*

<sup>138</sup> See Sam Fleuter, *The Role of Digital Products under the WTO: A New Framework for GATT and GATS Classification*, 17 CHI. J. INT’L L. 153, 158–59 (2016). For the domestic version of the debate over the classification of digital goods, see *ClearCorrect Operating, LLC v. International Trade Commission*, 810 F.3d 1283, 1289–99 (Fed. Cir. 2015), finding that the International Trade Commission lacks authority to exclude patent infringing digital goods under Section 337 of the Tariff Act of 1930. See also Sapna Kumar, *Regulating Digital Trade*, 67 FLA. L. REV. 1909, 1924–25 (2015).

prepared to give up some of the artificial advantage created by protectionist policies. Privacy remains protected at the level required by the home jurisdiction and data-based commerce flows more easily in a trusted environment in the host jurisdiction.

This article has provided some initial thoughts to start a conversation on digital trade zones; many additional inquiries on this topic and opportunities for exploration yet exist. A further investigation of the ways in which digital trade zones could protect intellectual property rights, especially as data flows through jurisdictions that do not contain digital trade zones, is vital. It would also be worthwhile to consider what digital trade zones might look like in other, non-common law countries. This article proposed a particular conception of digital trade zones based off of international maritime law blended with the procedures of FTZs in the United States. Given the expansiveness of special jurisdictions throughout the world, what other types of special jurisdictions could serve as models to improve the usefulness of digital trade zones or tailor them to even more specific applications of situations? And is there a different base framework better suited to the general foundation of the digital trade zone?

While digital trade zones may never be deployed in the real world, the underlying principles which would motivate their consideration and adoption is worth noting. The forbearance of jurisdiction that would be required to occur in digital trade zones represents an inherently pro-commerce approach. Where governments can be persuaded to forbear from protectionist policies generally, and limit other impeding regulations in certain narrow cases or jurisdictions, private industry, organizations, and entrepreneurs can leverage this freedom to create value for the communities in which they are based.



# The Gun Debate Extends to the Doctor's Office: Developing a Standard of Care for Firearm Screening and Counseling

*Taylor B. Brown\**

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### INTRODUCTION

For at least two decades, many medical organizations have openly supported stricter gun regulations, with some even stressing a complete ban on firearms.<sup>1</sup> More recently, at least eight professional health organizations (“Professional Health Organizations”) and the American Bar Association (“ABA”) have resolutely recognized firearm-related injuries and deaths as a major public health problem.<sup>2</sup> As such, these organizations have adopted official policy positions, which include the practice of physicians screening and counseling patients on firearms.<sup>3</sup> Many doctors routinely ask their patients about potential dangers to their health, including drugs, swimming pools, household chemicals, and firearms.<sup>4</sup> Additionally, some doctors educate certain patients on the risks of firearms in the home and firearm safety.<sup>5</sup>

In 2011, in reaction to patients’ complaints about firearm screening and counseling by doctors in Florida, Florida became the first state to pass a law curtailing physicians’ ability to inquire about whether patients own firearms and to counsel

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<sup>1</sup> See, e.g., En Banc Brief of Amici Curiae Second Amendment Foundation & Citizens Committee for the Right to Keep & Bear Arms Supporting Appellants & Reversal at 21, *Wollschlaeger v. Governor of Fla.*, 649 Fed. App’x 647 (11th Cir. 2016) (No. 12-14009), 2016 WL 1642979, at \*21 [hereinafter Second Amendment Foundation Amicus Brief].

<sup>2</sup> Steven E. Weinberger et al., *Firearm-Related Injury and Death in the United States: A Call to Action From 8 Health Professional Organizations and the American Bar Association*, 162 ANNALS INTERNAL MED. 513, 513 (2015).

<sup>3</sup> *Id.* at 513–14.

<sup>4</sup> See Brief Amicus Curiae of American Medical Ass’n et al. Submitted in Support of Plaintiffs/Appellees at the Rehearing En Banc & Urging Affirmance at 3, *Wollschlaeger v. Governor of Florida*, 649 Fed. App’x 647 (11th Cir. 2016) (No. 12–14009), 2016 WL 3011481, at \*3 [hereinafter American Medical Ass’n Amicus Brief].

<sup>5</sup> See *id.* at 3–4.

patients on firearm safety.<sup>6</sup> Less than a month after Florida passed the Florida's Firearm Owners' Privacy Act ("FOPA"),<sup>7</sup> physicians and physician interest groups challenged the law in court as violating the First Amendment.<sup>8</sup> On February 16, 2017, after five years of litigation, the United States Court of Appeals for the Eleventh Circuit struck down major parts of the law as unconstitutional.<sup>9</sup> In its en banc ruling, the Circuit found that FOPA's provisions were content-based restrictions on speech, and thus strict scrutiny should apply.<sup>10</sup> The Circuit decided, however, it need not determine whether the provisions would withstand strict scrutiny, because three out of four of the provisions did not survive heightened scrutiny.<sup>11</sup> Applying heightened scrutiny, the Circuit held most provisions were unconstitutional because they did not advance a substantial government interest and were not narrowly drawn to achieve that interest.<sup>12</sup>

*Wollschlaeger* was a landmark ruling for health organizations, firearm interest groups, and many state legislatures. The Eleventh Circuit's decision essentially solidified a doctor's right to screen and counsel patients on firearms. Consequently, this precedent may lead to more aggressive policies and practices by physicians and healthcare providers regarding firearms.<sup>13</sup> States may even create laws to encourage this practice based on the policy recommendations of many health organizations.<sup>14</sup> On the other hand, some state legislatures may look for a way to

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<sup>6</sup> *Wollschlaeger v. Farmer*, 880 F. Supp. 2d 1251, 1255, 1258–59 (S.D. Fla. 2012), *rev'd in part, vacated in part sub nom.*, *Wollschlaeger v. Governor of Florida*, 760 F.3d 1195 (11th Cir. 2014), *opinion vacated and superseded on reh'g*, 797 F.3d 859 (11th Cir. 2015), *opinion vacated and superseded on reh'g*, 814 F.3d 1159 (11th Cir. 2015), *reh'g en banc granted, opinion vacated*, 649 Fed. App'x 647 (11th Cir. 2016), *on reh'g en banc*, 848 F.3d 1293 (11th Cir. 2017) [hereinafter *Wollschlaeger I*].

<sup>7</sup> FLA. STAT. § 790.338 (2011).

<sup>8</sup> *Wollschlaeger I*, 880 F. Supp. 2d at 1251.

<sup>9</sup> See *Wollschlaeger v. Governor, Fla.*, 848 F.3d 1293, 1299 (11th Cir. 2017) [hereinafter *Wollschlaeger 2017*].

<sup>10</sup> *Id.* at 1307.

<sup>11</sup> *Id.* at 1311 (finding the three provisions that could not survive the heightened scrutiny standard are the "record-keeping" provision, the "inquiry" restriction provision, and the "anti-harassment" provision); see also *infra* note 23 and accompanying text.

<sup>12</sup> *Wollschlaeger 2017*, 848 F.3d at 1311–12.

<sup>13</sup> See Bethany L. Strong et al., *The American College of Preventive Medicine Policy Recommendations on Reducing and Preventing Firearm-Related Injuries and Deaths*, 51 AM. J. PREVENTIVE MED. 1084, 1084–86 (2016); see also M. Denise Dowd et al., *Firearm-Related Injuries Affecting the Pediatric Population*, 130 PEDIATRICS 1416, 1421 (2012).

<sup>14</sup> See Wendy E. Parmet et al., *Wollschlaeger v. Governor of Florida—The First Amendment, Physician Speech, and Firearm Safety*, 374 NEW ENG. J. MED. 2304, 2306 (2016); see also Garen J. Wintemute, *Yes, You Can: Physicians, Patients, and Firearms*, 165 ANNALS OF INTERNAL MED. 205, 206–07 (2016).

constitutionally restrict physicians from asking questions and educating patients on firearms.<sup>15</sup>

Even if there is no immediate reaction by state legislatures to the Eleventh Circuit's ruling, doctors are arguably restrained in implementing this practice in other ways. Because many physicians have no formal firearm safety training or education, patients may be legitimately concerned about doctors' qualifications for providing firearm-related health advice.<sup>16</sup> This dynamic creates a potential for inadequate or harmful medical advice, which in turn calls into question the physician standard of care for firearm screening and counseling.<sup>17</sup>

As a relatively innovative practice, at least for some healthcare providers, firearm screening and counseling does not have well established standards beyond the general policy recommending physician intervention to prevent firearm-related injuries and deaths in patients.<sup>18</sup> This Note attempts to answer the following question: in light of the Eleventh Circuit's ruling that states cannot prohibit physicians from screening and counseling patients on firearms, how should physicians, the professional health community, and state legislatures proceed? Although the ruling struck down major parts of FOPA, the arguments for and against the law and the practice of firearm screening and counseling are still relevant to shaping the legislation and standards that should apply to the practice.

This Note proceeds in four parts. Part I briefly explains the background of FOPA, its litigation, and how the Eleventh Circuit addressed the main arguments for and against FOPA. Part II delves into the argument that storing firearms in the home is a threat to the health of household members. Relatedly, Part II shows why the professional health community considers firearm-related deaths and injuries to be a major public health problem. This part also presents data showing that out of all

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<sup>15</sup> See, e.g., Marla Spector Bowman, *Docs. v. Glocks: Speech, Guns, Discrimination, and Privacy—Is Anyone Winning?*, 67 FLA. L. REV. 1455, 1469–70 (2015).

<sup>16</sup> *Id.*; see, e.g., Paul J. D. Roszko, et al., *Clinician Attitudes, Screening Practices, and Interventions to Reduce Firearm-Related Injury*, 38 EPIDEMIOLOGIC REV. 87, 104–06 (2016) (emphasizing the inconsistent education and training of physicians on firearm safety and the need for additional training to improve intervention by physicians).

<sup>17</sup> See En Banc Brief of Amicus Curiae Unified Sportsmen of Florida, Inc., Supporting Appellants & Reversal at 13–16, *Wollschlaeger v. Governor of Fla.*, 649 Fed. App'x 647 (11th Cir. 2016) (No. 12-14009), 2016 WL 1642980, at \*13–16 [hereinafter *Unified Sportsmen Amicus Brief*].

<sup>18</sup> See Weinberger et al., *supra* note 2, at 513–16 (discussing physician gag laws and intervention and treatment of mental and substance use disorders, but not laying out specific standards for doing so); see also Roszko et al., *supra* note 16.



firearm related deaths, a high percentage takes place in the home, and that suicide or homicide by firearm is a leading cause of death for all ages. Finally, Part II includes data on firearm safety and shows the correlation between firearm access regulations and reduction in firearm-related deaths and injuries.

Part III delves into the strongest arguments for why physicians should not be encouraged, or even allowed, to screen and counsel patients on firearms. Proponents of FOPA fear that through the practice, doctors are promoting a political agenda posing as medical advice and that doctors may not be qualified to render advice on firearms to patients.<sup>19</sup> For both contextual and argumentative purposes, Part III presents statistics on non-firearm-related dangers and leading causes of fatal and nonfatal unintentional injuries. Additionally, Part III discusses one legitimate motivation behind firearm ownership, namely self-defense, and the possible consequences of diminishing this purpose.

Part IV concludes that physicians, the professional health community, and state legislatures should take measures to reduce the risk of physicians using firearm screening and counseling as a way to promote a political agenda and of unqualified physicians giving advice on firearm safety. While this Note does not cover concerns of harassment and discrimination by physicians based on a patient's firearm ownership status, it explores the dynamics of firearm screening and counseling, the standard of care, and medical malpractice. Part IV proposes that the professional health community should establish strict standards of expert knowledge regarding firearms, and in turn, physicians should accurately communicate that knowledge to patients. Finally, Part IV calls for more extensive research on who should be questioned and advised on firearms, and explores the best practices for firearm screening and counseling.

### I. FOPA AND ITS DOWNFALL

In 2011, Florida passed a law, known as FOPA, which created Florida Statute section 790.338, entitled "Medical privacy concerning firearms."<sup>20</sup> FOPA's legislative record includes several anecdotes involving complaints where doctors threatened to end the physician-patient relationship or to refuse treatment to patients based on the patient's answers to the doctor's questions

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<sup>19</sup> See *infra* Sections III(B) and III(D).

<sup>20</sup> Wollschlaeger I, 880 F. Supp. 2d 1251, 1255 (S.D. Fla. 2012).

about the patient's firearm ownership.<sup>21</sup> The Florida Legislature identified these anecdotes as a primary influence leading to the enactment of FOPA.<sup>22</sup> The statute includes the following four provisions concerning the conduct of licensed health care practitioners or facilities:

- a) The "record-keeping provision" prohibits practitioners from recording any information regarding a patient's firearm ownership in the patient's medical record, if the practitioner knows the information is not relevant to the patient's medical care or safety, or the safety of others.
- b) The "inquiry restriction provision" prohibits practitioners from inquiring about a patient's firearm ownership status, unless the practitioner in good faith believes the information is relevant to the patient's medical care or safety, or the safety of others.
- c) The "antidiscrimination provision" prohibits practitioners from discriminating against a patient based solely on firearm ownership.
- d) The "anti-harassment provision" prohibits practitioners from unnecessarily harassing a patient about firearm ownership.<sup>23</sup>

The Florida legislature originally passed FOPA to protect the Second Amendment and privacy rights of patients, and to regulate the doctor-patient relationship.<sup>24</sup> Less than a month after FOPA's enactment, physicians and physician interest groups challenged the law in the District Court for the Southern District of Florida, alleging FOPA violated the First and Fourteenth Amendments of the U.S. Constitution.<sup>25</sup> In 2012, the district court applied strict scrutiny and found FOPA's provisions were unconstitutional as violating free speech.<sup>26</sup>

The case made its way to the United States Court of Appeals for the Eleventh Circuit, where a three-judge panel upheld the law in three different opinions, each vacating the one before it on

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<sup>21</sup> See *Wollschlaeger* 2017, 848 F.3d 1293, 1302 (11th Cir. 2017) ("A state representative said that his daughter's pediatrician inquired if he owned a firearm, and then asked him to remove the firearm from the home. An email described how a mother 'was separated from her children while medical personnel . . . interrogated' them about firearm ownership and put information about such ownership in their medical records. One doctor refused to treat a child because he wanted to know if there were firearms in the home.") (internal citations omitted).

<sup>22</sup> *Id.*

<sup>23</sup> *Wollschlaeger I*, 880 F. Supp. 2d at 1255; FLA. STAT. § 790.338 (2011).

<sup>24</sup> See *Wollschlaeger I*, 880 F. Supp. 2d at 1256.

<sup>25</sup> *Id.* at 1259.

<sup>26</sup> *Id.* at 1261–62, 1267.

different grounds.<sup>27</sup> Upon the plaintiffs' motion, the Court of Appeals agreed to rehear the case en banc to determine the propriety of applying strict scrutiny to this case and whether the State "has a sufficiently compelling interest, such that the Act can withstand strict scrutiny."<sup>28</sup> On February 16, 2017, eight months after oral arguments, the Circuit issued its opinion that struck down the record-keeping, inquiry, and anti-harassment provisions of FOPA as violating the First Amendment, but upheld the anti-discrimination provision.<sup>29</sup>

The Eleventh Circuit held that FOPA's provisions were content-based restrictions of speech by medical providers on firearm ownership, and "[c]ontent-based restrictions on speech normally trigger strict scrutiny."<sup>30</sup> However, the Circuit declined to decide whether strict scrutiny should apply, because the record-keeping, inquiry, and anti-harassment provisions could not survive the less stringent standard of heightened scrutiny.<sup>31</sup> Under heightened scrutiny, state officials must show, at minimum, that the provisions directly advance a substantial government interest and are narrowly drawn to achieve that interest.<sup>32</sup>

Substantial scholarly attention focuses on the constitutional issues of FOPA and its litigation.<sup>33</sup> An in-depth analysis of those issues is beyond the scope of this Note. The arguments for and against FOPA, however, are relevant to the public and social policy debate surrounding firearm screening and counseling by physicians, including its relation to medical malpractice. As such, this Note will next lay out Florida's arguments in defense of FOPA and how the Eleventh Circuit addressed them.

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<sup>27</sup> See *Wollschlaeger v. Governor of Fla.*, 760 F.3d 1195 (11th Cir. 2014) [hereinafter *Wollschlaeger II*]; see also *Wollschlaeger v. Governor of Fla.*, 797 F.3d 859 (11th Cir. 2015) [hereinafter *Wollschlaeger III*]; *Wollschlaeger v. Governor of Fla.*, 814 F.3d 1159 (11th Cir. 2015) [hereinafter *Wollschlaeger IV*].

<sup>28</sup> Maryanne Tomazic, *Docs v. Glocks: Restricting Doctor's Professional Speech in the Name of Firearm Owner Privacy*—*Wollschlaeger v. Governor of Florida*, 41 AM. J.L. & MED. 680, 682 (2015).

<sup>29</sup> *Wollschlaeger 2017*, 848 F.3d 1293, 1311, 1314–15 (11th Cir. 2017).

<sup>30</sup> *Id.* at 1307–08.

<sup>31</sup> *Id.* at 1311.

<sup>32</sup> *Id.* at 1311–12.

<sup>33</sup> See generally, e.g., Michelle Foody, Comment, *Docs Versus Glocks: N.R.A. Takes Aim at Florida Physicians' Freedom of Speech: Leaving Patients' Health, Safety, and Welfare at Risk*, 2013 CARDOZO L. REV. DE NOVO 228 (2013); Tomazic, *supra* note 28; Harrison Blythe, *Physician-Patient Speech: An Analysis of the State of Patients' First Amendment Rights to Receive Accurate Medical Advice*, 65 CASE W. RES. L. REV. 795 (2015).

### A. Protecting the Second Amendment

According to Florida, FOPA is necessary to protect “the Second Amendment right of Floridians to own and bear firearms” from “private encumbrances.”<sup>34</sup> Further, Florida argued “that doctors and medical professionals should not ask about, nor express views hostile to, firearm ownership.”<sup>35</sup> The Eleventh Circuit rejected this argument, saying that even if there were any “actual conflict between the First Amendment rights of doctors and medical professionals and the Second Amendment rights of patients,” it would not be significant enough to justify FOPA’s record-keeping, inquiry, and anti-harassment provisions.<sup>36</sup> First, there was no evidence that firearm screening and counseling of patients had infringed on patients’ Second Amendment rights, beyond the six anecdotes included in FOPA’s legislative record.<sup>37</sup> Further, heightened scrutiny does not allow Florida to “burden the speech of others in order to tilt public debate in a preferred direction,”<sup>38</sup> especially given the necessity of open and honest dialogue between doctors and patients about firearms and firearm safety.<sup>39</sup> The court conveyed that the “profound importance of the Second Amendment does not give the government license to violate the right to free speech under the First Amendment.”<sup>40</sup>

### B. Protecting Patient Privacy

The second interest Florida asserted in defense of FOPA was the need to protect a patient’s privacy from the public eye.<sup>41</sup> Although the Eleventh Circuit conceded that “individual privacy is a substantial government interest,” it rejected this argument as a valid defense of FOPA’s record-keeping, inquiry, and anti-harassment provisions.<sup>42</sup> The crux of the Circuit’s finding on this issue was based on an unchallenged provision of FOPA, section 790.338(4), which allows patients to refuse to answer doctors’ questions about guns.<sup>43</sup> Because Florida failed to give any reasons why this provision does not sufficiently protect patient privacy, this interest failed to satisfy heightened scrutiny.<sup>44</sup>

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<sup>34</sup> *Wollschlaeger 2017*, 848 F.3d at 1312 (internal marks omitted).

<sup>35</sup> *Id.* at 1313–14.

<sup>36</sup> *Id.* at 1313.

<sup>37</sup> *Id.* at 1312.

<sup>38</sup> *Id.* at 1314 (quoting *Sorrell v. IMS Health Inc.*, 564 U.S. 552, 578–79 (2011)).

<sup>39</sup> *Id.* at 1313.

<sup>40</sup> *Id.* at 1327 (Pryor, J., concurring).

<sup>41</sup> *Id.* at 1314.

<sup>42</sup> *Id.*

<sup>43</sup> *See id.*

<sup>44</sup> *See id.*

Florida also argued FOPA protects “the privacy of patients’ firearm ownership from the chilling effect of disclosure and record-keeping.”<sup>45</sup> According to the Eleventh Circuit, Florida’s current limits on disclosure of a patient’s medical information provides sufficient protection, and “there [was] no evidence that doctors or medical professionals [had] been improperly disclosing patients’ information about firearm ownership.”<sup>46</sup> Moreover, the Circuit explained it could not base its decision under heightened scrutiny on hypothetical dangers, such as hacking, theft, or some other intrusion of electronically stored information.<sup>47</sup> Consequently, Florida’s interest in protecting the privacy of patients could not carry FOPA’s record-keeping, inquiry, and anti-harassment provisions under heightened scrutiny.<sup>48</sup>

### C. Protecting Patients from Discrimination or Harassment

The Eleventh Circuit held that, besides FOPA’s anti-discrimination provision, the challenged provisions were not narrowly tailored to further Florida’s interest in “ensuring access to health care without discrimination or harassment.”<sup>49</sup> The Circuit noted that Florida law still allows a doctor to terminate his or her relationship with a patient as long as “the patient has reasonable notice and can secure the services of another health care provider.”<sup>50</sup> It also rejected Florida’s argument that the power imbalance between doctors and their patients was enough to warrant protection of a “vulnerable listener” from offensive speech, because “where adults are concerned the Supreme Court has never used [this] rationale to uphold speaker-focused and content-based restrictions on speech.”<sup>51</sup> Again, Florida law gives patients the right to refuse to answer offensive questions, and there was no evidence to show that offended patients were “psychologically unable to choose another medical provider.”<sup>52</sup>

### D. Protecting the Public by Regulating the Medical Profession

As its final defense of FOPA, Florida asserted its interest in regulating “the medical profession in order to protect the public.”<sup>53</sup> Although the Eleventh Circuit agreed Florida has a general interest in regulating the medical profession, that

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<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *See id.*

<sup>48</sup> *See id.* at 1319.

<sup>49</sup> *Id.* at 1314.

<sup>50</sup> *Id.* at 1315.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 1316.

interest does not justify FOPA's record-keeping, inquiry, and anti-harassment provisions, "[g]iven that the applicable standard of care encourages doctors to ask questions about firearms" and the provisions were not narrowly tailored to address such interest.<sup>54</sup> The Circuit additionally stated:

There is no claim, much less any evidence, that routine questions to patients about the ownership of firearms are medically inappropriate, ethically problematic, or practically ineffective. Nor is there any contention (or, again, any evidence) that blanket questioning on the topic of firearm ownership is leading to bad, unsound, or dangerous medical advice.<sup>55</sup>

Because there was no evidence to show firearm screening and counseling was negatively affecting the doctor-patient relationship or medical treatment for patients, this interest could not withstand heightened scrutiny.<sup>56</sup>

In sum, FOPA's record-keeping, inquiry, and anti-harassment provisions could not pass heightened scrutiny for determining constitutionality, and thus would certainly fail strict scrutiny, which is normally applied to content-based restrictions.<sup>57</sup> Many of Florida's arguments in support of FOPA failed due to insufficient evidence to support Florida's contentions. For example, Florida presented no evidence that questions and counseling about firearms amounted to ineffective or dangerous medical advice.<sup>58</sup> However, that is not to say that these complaints should be forgotten or ignored by state legislatures and the professional health community because these concerns have the potential to become real detriments to adequate medical care. This idea will be explored further in Parts III and IV. Part II will lay out the professional health community's argument that guns are not only a danger to members of a household, but also a public health problem. This perception is what led to the policy encouraging doctors to ask questions about firearms, or what the Eleventh Circuit called "the applicable standard of care."<sup>59</sup>

## II. FIREARMS AS ADVERSE HEALTH RISKS

Joined by the ABA, the Professional Health Organizations collectively declared a policy to address firearm-related deaths and injuries based on their conclusion that the effects of firearm-related deaths and injuries pose a serious public health

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<sup>54</sup> *Id.* at 1317.

<sup>55</sup> *Id.* at 1316.

<sup>56</sup> *See id.*

<sup>57</sup> *See id.* at 1311.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* at 1317; *see also* Weinberger et al., *supra* note 2, at 514.

problem.<sup>60</sup> To deal with this problem, these organizations recommend doctors do the following: counsel their patients about gun safety, intervene when patients may be at risk for initiating or becoming victim to gun violence, and document conversations and information regarding a patient's gun ownership status in the patient's medical record.<sup>61</sup>

Rather than reiterating the data relied upon by the Professional Health Organizations in support of their conclusion and polices, Part II will use data from the National Violent Death Reporting System ("NVDRS")<sup>62</sup> and the Centers for Disease Control and Prevention's ("CDC") Web-Based Injury Statistics Query and Reporting System ("WISQARS"),<sup>63</sup> supplemented by studies from various literature on firearm safety and storage practices.

This Part will begin by attempting to rectify the varying claims coming from both sides of the gun debate on how significant firearm-related deaths are compared to other leading causes of death due to injury. For example, in their call to action, the ABA and Professional Health Organizations identify firearms as being the "second-leading cause of death due to injury after motor vehicle crashes for adults and adolescents."<sup>64</sup> One well-known anti-gun organization, Everytown for Gun Safety Support Fund ("Everytown"), suggests that federal data "substantially undercount[s]" the number of unintentional shootings in children.<sup>65</sup> According to Everytown, "[f]rom December 2012 to December 2013, at least 100 children were killed in unintentional shootings."<sup>66</sup> On the other side of the debate, the National Shooting Sports Foundation found that "[f]irearms are involved in less than 1.4 percent of unintentional fatalities among

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<sup>60</sup> Weinberger et al., *supra* note 2, at 513.

<sup>61</sup> *Id.* at 514; see En Banc Brief of Amicus Curiae the America Prof'l Soc'y on the Abuse of Children in Support of Plaintiffs-Appellees & Affirmance at 10, *Wollschlaeger v. Governor of Florida*, 649 Fed. App'x 647 (Fla. 2016) (No. 12-14009), 2016 WL 3011483, at \*3 [hereinafter *America Prof'l Soc'y on the Abuse of Children Amicus Brief*].

<sup>62</sup> NVDRS uses information from death certificates, medical examiner or coroner records, law enforcement records, and crime laboratory records from seventeen participating states to compile data on violent death, including the circumstances surrounding these deaths. Mary D. Fan, *Disarming the Dangerous: Preventing Extraordinary and Ordinary Violence*, 90 IND. L.J. 150, 163 (2015).

<sup>63</sup> WISQARS is an online database that provides fatal and nonfatal injury, violent death, and cost of injury data from a variety of sources, including NVDRS, the National Vital Statistics System, and CDC's National Center for Health Statistics. See *Welcome to WISQARS*, CTRS. FOR DISEASE CONTROL & PREVENTION (Jan. 12, 2017), <https://www.cdc.gov/injury/wisqars/index.html> [<http://perma.cc/FX3D-YQG2>].

<sup>64</sup> Weinberger et al., *supra* note 59, at 513.

<sup>65</sup> *Innocents Lost: A Year of Unintentional Child Gun Deaths*, EVERYTOWN FOR GUN SAFETY SUPPORT FUND 3 (June 2014), <http://everytownresearch.org/documents/2015/04/innocents-lost.pdf> [<http://perma.cc/3DMP-ZG2M>].

<sup>66</sup> *Id.*

children 14 years of age and under and are among the least likely causes of unintentional fatality.”<sup>67</sup>

#### A. Leading Causes of Death Due to Injury

According to the CDC data on the leading causes of death due to injury in 2015 for all ages, suicide by firearm was the fourth leading cause of death due to injury, making up 10.2% (22,018 deaths of the 216,694 total injury deaths).<sup>68</sup> Homicide by firearm was the fifth leading cause at 6% (12,979 deaths).<sup>69</sup> The number one leading cause was unintentional poisoning at 21.9% (47,478 deaths), followed by motor vehicle traffic at 16.7% (36,161 deaths).<sup>70</sup> Homicide by cut/pierce made up 0.7% (1622 deaths) as the fifteenth leading cause of death due to injury.<sup>71</sup>

For ages 10 to 44, the number of firearm-related deaths due to injury was slightly more significant than for all age groups.<sup>72</sup> There were 86,235 total injury deaths. Homicide by firearm was the third leading cause at 12.1% with 10,454 deaths, and suicide by firearm was the fourth leading cause at 10.1% with 8670 deaths.<sup>73</sup> Again, unintentional poisoning was the number one leading cause at 29.9% with 25,767 deaths, and motor vehicle traffic was the second leading cause at 21.1% with 18,212 deaths for this age group.<sup>74</sup> The data from the state of Florida on the leading causes of death due to injury virtually mirrors the national data.<sup>75</sup>

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<sup>67</sup> *Firearms-Related Injury Statistics*, NAT'L SHOOTING SPORTS FOUND. 1 (2013), [http://www.projectchildsafe.org/sites/default/files/2014\\_InjuryIIR\\_2015.pdf](http://www.projectchildsafe.org/sites/default/files/2014_InjuryIIR_2015.pdf).

<sup>68</sup> *Leading Causes of Death Reports, 1981 – 2016*, CTRS. FOR DISEASE CONTROL & PREVENTION, <https://webappa.cdc.gov/sasweb/ncipc/leadcause.html> (last updated Feb. 19, 2017) (To generate the statistics for leading causes of death due to injury, select “2015” to “2015” for “Year(s) of Report”; select “Top 20” for “Number of Causes”; select “All Injuries” for “Categories of Causes”; leave all other report options unchanged; then follow “Submit Request.” To view the statistics for all ages, follow the link for “All Ages” in the last column of the generated table.).

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* (To generate the statistics for leading causes of death due to injury for ages 10 to 44, select “2015” to “2015” for “Year(s) of Report”; select “Top 20” for “Number of Causes”; select “All Injuries” for “Categories of Causes”; select “Custom Age Range” for “Age Group Formatting” and input “10” to “44”; leave all other report options unchanged; then follow “Submit Request.” To view the statistics for ages 10 to 44, follow the link for “10–44” at the top of the generated table.).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* Out of 15,225 total injury deaths for all age groups in Florida, suicide by firearm was the fourth leading cause (11% or 1630 deaths). *Id.* Homicide by firearm was the fifth leading cause (6% or 880 deaths). *Id.* Unintentional poisoning was the number one leading cause (19.3% or 2938 deaths), followed by motor vehicle traffic (19% or 2896 deaths). *Id.*



Based on these numbers, the ABA and the Professional Health Organizations' claim that firearms were the "second-leading cause of death due to injury after motor vehicle crashes for adults and adolescents" needs clarifying. If the number of firearm-related suicides and homicides are combined into one category of firearm-related deaths by injury, they would amount to 34,997 deaths, which still falls below the number of both poisoning and motor vehicle traffic deaths. However, for ages 10 to 44, the combined firearm-related deaths by injury would amount to 19,124 deaths, surpassing motor vehicle traffic as the second leading cause. It is unclear what the ABA and the Professional Health Organizations meant by "adults and adolescents" and whether it was their intention to combine firearm-related suicides and homicides into one category.

With that being said, multiple injury-causing mechanisms or forces consistently lead to more deaths per year than firearm-related deaths due to injury. For example, unintentional poisoning and motor vehicle traffic-related injuries are deadlier than firearms for all age groups. Despite this fact, we must recognize while injuries and deaths from poisoning and motor vehicle crashes pose a greater risk overall than firearm-related deaths due to injury, motor vehicle and poisoning deaths cannot be alleviated in the same way injuries and deaths from firearms can be alleviated. First, nine out of ten American households have access to a motor vehicle, while less than a third contain a gun.<sup>76</sup> Second, poisoning deaths—the leading cause of injury death in the United States—primarily involve both pharmaceutical and illicit drugs and occur when a person accidentally takes or gives too much of a substance.<sup>77</sup> While there are certainly ways to prevent and reduce motor vehicle crashes and drug overdoses, motor vehicles and prescription drugs are essential in homes. Guns, while constitutionally protected, are arguably not necessary in a household and are certainly not ubiquitous to households.

#### B. Violent Firearm Deaths in the Home

The percentage of violent firearm-related deaths that take place in the home, as reported in the NVDRS, is particularly

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<sup>76</sup> *Gun Deaths Compared to Motor Vehicle Deaths*, VIOLENCE POL'Y CTR., <http://www.vpc.org/regulating-the-gun-industry/gun-deaths-compared-to-motor-vehicle-deaths/> [<http://perma.cc/HAC3-UUTD>] (last visited Dec. 27, 2017).

<sup>77</sup> See *NCHS Data on Drug-poisoning Deaths*, NAT'L CNTR. FOR HEALTH STATISTICS (Aug. 24, 2017), [https://www.cdc.gov/nchs/data/factsheets/factsheet\\_drug\\_poisoning.pdf](https://www.cdc.gov/nchs/data/factsheets/factsheet_drug_poisoning.pdf) [<http://perma.cc/L7FD-JPGF>]; see also *Poisoning*, CTRS. FOR DISEASE CONTROL & PREVENTION (Nov. 24, 2015), <https://www.cdc.gov/homeandrecreationalafety/poisoning/index.html> [<http://perma.cc/6N3P-AHTR>].

relevant to the discussion on firearm screening and counseling of patients by physicians. The NVDRS defines a violent death “as a death resulting either from the unintentional use of physical force or power against oneself, another person, or a group or community.”<sup>78</sup> Manners of violent death include suicide, homicide, unintentional firearm, undetermined intent, and legal intervention.<sup>79</sup> An unintentional firearm death is a death from a gunshot where “the shooting was not directed intentionally at the decedent” or “the person causing the injury did not intend to discharge the firearm.”<sup>80</sup>

According to the NVDRS, out of 4486 total homicides in 2013, 67% (3021 deaths) were firearm-related homicides.<sup>81</sup> Out of all firearm-related homicides, 48% (1443 deaths) took place in the home.<sup>82</sup> The percentage of unintentional violent-firearm related deaths that take place in the home is also significant. Out of 125 total unintentional violent firearm deaths in 2013, 70% (87 deaths) took place in the home.<sup>83</sup> There are certainly many

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<sup>78</sup> Sharyn E. Parks et al., *Surveillance for Violent Deaths — National Violent Death Reporting System, 16 States, 2010*, CTRS. FOR DISEASE CONTROL & PREVENTION 3 (Jan. 17, 2014), <https://www.cdc.gov/mmwr/pdf/ss/ss6301.pdf> [<http://perma.cc/Q932-4JQX>].

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 3–4.

<sup>81</sup> *National Violent Death Reporting System (NVDRS)*, CTRS. FOR DISEASE CONTROL & PREVENTION (Jan. 24, 2017), <https://wisqars.cdc.gov:8443/nvdrs/nvdrsDisplay.jsp> (To generate the statistics for total number of homicides, select “Homicide” for “What was the intent or manner of the injury based on the abstractor-assigned manner of death?”; select “2013” as “Year(s) of Report”; leave all other report options unchanged; then follow “Submit Request.” To generate the statistics for total number of firearm related-related homicides, select “Homicide” for “What was the intent or manner of the injury based on the abstractor-assigned manner of death?”; select “Firearm” as “What was the cause or mechanism of the injury based on the abstractor-assigned manner of death?”; select “2013” as “Year(s) of Report”; leave all other report options unchanged; then follow “Submit Request.” The percentage of firearm-related homicides was calculated by dividing 3021 (total firearm-related homicides) by 4486 (total deaths).).

<sup>82</sup> *Id.* (To generate the statistics for total number of firearm-related homicides that took place in the home, select “Violent Death Counts and Percentages by KNOWN CIRCUMSTANCES of DEATH, Place of Injury . . .” as the “Victims of Violence” report type (the first report input option); select “Homicide” for “What was the intent or manner of the injury based on the abstractor-assigned manner of death?”; select “Firearm” as “What was the cause or mechanism of the injury based on the abstractor-assigned manner of death?”; select “2013” as “Year(s) of Report”; leave all other report options unchanged; then follow “Submit Request.” The percentage of firearm-related homicides that took place in the home was calculated by dividing 1443 (total firearm-related homicides that took place in the house, apartment, including driveway, porch, and yard) by 3021 (total firearm-related homicides).).

<sup>83</sup> *Id.* (To generate the statistics for total number of unintentional violent-firearm related deaths that took place in the home, select “Violent Death Counts and Percentages by KNOWN CIRCUMSTANCES of DEATH, Place of Injury . . .” as the “Victims of Violence” report type (the first report input option); select “Unintentional firearm” for “What was the intent or manner of the injury based on the abstractor-assigned manner of death?”; select “Firearm” as “What was the cause or mechanism of the injury based on the abstractor-assigned manner of death?”; select “2013” as “Year(s) of Report”; leave all other report options unchanged; then follow “Submit Request.” The percentage of unintentional

explanations for why almost half of all firearm-related homicides and more than half of unintentional violent firearm deaths take place in the home, but that analysis is beyond the scope of this Note.<sup>84</sup> Whatever the reasons may be, these rates have led medical organizations to believe that the best way to prevent gun violence is by removing guns from the home.<sup>85</sup>

Based on this data, the ABA and the Professional Health Organizations' recommendation for physicians to ask patients about firearms and counsel patients on firearm safety is not unreasonable. Because most violent firearm-related deaths occur in the home, it is logical to highlight the firearm-related health problem by targeting those firearm-related deaths and injuries that occur in the home. After all, doctors talk to patients about many other potential household health risks as part of the practice of preventive medicine.<sup>86</sup> Furthermore, there are statistics suggesting that the presence of firearms in the home increases the likelihood of firearm-related deaths or injuries,<sup>87</sup> and safe storage practices have shown to be effective at reducing these incidents.<sup>88</sup>

### C. Prevalence and Effect of Firearm Safety and Storage Measures

The American College of Preventive Medicine is one health organization that has encouraged counseling of patients on firearm safety, as well as stricter laws regulating child access to firearms.<sup>89</sup> Child Access Protection ("CAP") laws, which hold the adult gun owner criminally responsible if a minor uses a gun that has been stored insecurely, are one such form of regulation.<sup>90</sup> CAP laws are relevant to the discussion of firearm screening and

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violent-firearm related deaths that took place in the home was calculated by dividing 87 (total unintentional firearm deaths that took place in the house, apartment, including driveway, porch, and yard) by 125 (total unintentional firearm deaths).

<sup>84</sup> For further discussion on this point, see America Professional Society on the Abuse of Children Amicus Brief, *supra* note 61, at 6–10, *Wollschlaeger v. Governor of Fla.*, 649 Fed. App'x 647 (Fla. 2016) (No. 12-14009), 2016 WL 3011483, at \*3. See generally Arthur L. Kellermann et al., *Gun Ownership as a Risk Factor for Homicide in the Home*, 329 NEW ENG. J. MED. 1084 (1993); Eric J. Crossen et al., *Preventing Gun Injuries in Children*, 36 PEDIATRICS REV. 43 (2015).

<sup>85</sup> See Dowd et al., *supra* note 13, at 1416 ("The absence of guns from children's homes and communities is the most reliable and effective measure to prevent firearm-related injuries and children and adolescents.").

<sup>86</sup> See America Professional Society on the Abuse of Children Amicus Brief, *supra* note 61, at 3.

<sup>87</sup> See, e.g., Dowd et al., *supra* note 13, at 1419 ("Research in several US urban areas indicates that a gun stored in the home is associated with a three-fold increase in the risk of homicide and a fivefold increase in the risk of suicide.").

<sup>88</sup> See *infra* notes 95, 104 and accompanying text.

<sup>89</sup> See Strong et al., *supra* note 13, at 1086.

<sup>90</sup> *Id.*

counseling of patients due to the overlapping goals of CAP laws and firearm screening and counseling. The purpose of CAP laws is to make guns inaccessible to children while still providing accessibility to adults.<sup>91</sup> Similarly, the public health community's policy promoting firearm screening and counseling is aimed at maximizing firearm safety regulations, while staying consistent with the Second Amendment.<sup>92</sup> Therefore, members of the public health community and legislatures concerned with doctors talking to patients about firearms should consider the effect CAP laws may have on reducing nonfatal firearm-related injuries.

Twenty-eight states have child access prevention laws as of 2014.<sup>93</sup> These laws range from statutes imposing criminal liability when a child gains access to a firearm as a result of negligent firearm storage (strictest CAP regulation) to laws preventing people from providing firearms to minors (least strict CAP regulation).<sup>94</sup> A recently published study, based on annual hospital discharge data from 1998 to 2003, suggests CAP laws are associated with a decrease in nonfatal gun injuries.<sup>95</sup> The study found that the existence of any type of CAP law is associated with a total average annual 26% reduction in self-inflicted gun injuries among youth.<sup>96</sup> For the strictest type of CAP regulation, negligent storage laws, the average annual reduction was 30%.<sup>97</sup> For non-self-inflicted injuries—encompassing assaults, unintentional injuries, and injuries of undetermined intent—CAP laws are associated with a 5% reduction.<sup>98</sup>

Why do CAP laws matter to the discussion of FOPA and the general practice of firearm screening and counseling by doctors? Doctors who ask patients about firearm ownership are arguably effectuating the purpose of CAP laws and other access protection regulations.<sup>99</sup> Take a Florida CAP law, for example. Florida's Title XLVI section 790.174(1) provides that a person who

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<sup>91</sup> See Jeffrey DeSimone et al., *Child Access Prevention Laws and Nonfatal Injuries*, 80 S. ECON. J. 5, 6 (2013).

<sup>92</sup> Weinberger et al., *supra* note 2, at 514.

<sup>93</sup> *States with Firearm Laws Designed to Protect Children*, THE HENRY J. KAISER FAMILY FOUND., <http://kff.org/other/state-indicator/firearms-and-children-legislation/?currentTimeframe=0&sortModel=%7B%22colId%22:%22Location%22,%22sort%22:%22asc%22%D> [<http://perma.cc/2KN3-RDUV>] (last visited Dec. 21, 2017).

<sup>94</sup> *Summary of State Child Access Prevention Laws*, WASHINGTON STATE LEGISLATURE (Dec. 2012), <http://leg.wa.gov/Senate/Committees/LAW/Documents/SummaryOfStateChildAccessPreventionLaws.pdf> [<http://perma.cc/R9B9-MJ96>]. State definitions of minor vary from children under age fourteen to those under age eighteen. *Id.*

<sup>95</sup> DeSimone et al., *supra* note 91, at 5, 22.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> See Bowman, *supra* note 15, at 1459.

reasonably knows a minor may gain access to a firearm “shall keep the firearm in a securely locked box or container or in a location which a reasonable person would believe to be secure.”<sup>100</sup> This statute is based on access by a minor to a negligently stored firearm, which is the strongest type of CAP law.<sup>101</sup> While state legislatures are in a better position to regulate firearms, doctors still play an important role in promoting safe storage practices.

The number of households that store unlocked and/or unloaded guns in the house lends further support for why preventive measures and CAP laws are needed. A 2002 study estimated that 248,430 children and youths in Florida were being raised in a household with at least one loaded gun.<sup>102</sup> Approximately half of those households contained a firearm that was both unlocked and loaded.<sup>103</sup> There are reliable studies to show that keeping a gun locked and unloaded have significant protective effects with regard to risk of both unintentional injury and suicide for children and teenagers.<sup>104</sup> Therefore, primary care physicians should, at the very least, ask whether patients keep firearms in the home and provide them reliable safety advice accordingly.

### III. THE DANGERS OF DOCTORS DISCUSSING FIREARMS WITH PATIENTS

This Part lays out the strongest arguments for FOPA and against the practice of firearm screening and counseling, including those made in support of FOPA in its litigation. It will first attempt to put firearm related injuries and deaths into perspective by introducing data on fatal and nonfatal unintentional injuries. Next, it will discuss the argument that doctors use this practice to promote their politics and that most doctors are not qualified to give advice on firearms. Lastly, this Part evaluates the self-defense motivation behind keeping a

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<sup>100</sup> FLA. STAT. § 790.174(1) (2017).

<sup>101</sup> *Summary of State Child Access Prevention Laws*, WASH. STATE LEGISLATURE 3 (Dec. 2012), <http://leg.wa.gov/Senate/Committees/LAW/Documents/SummaryOfStateChildAccessPreventionLaws.pdf> [<http://perma.cc/R9B9-MJ96>].

<sup>102</sup> Catherine A. Okoro et al., *Prevalence of Household Firearms and Firearm-Storage Practices in the 50 States and the District of Columbia: Findings From the Behavioral Risk Factor Surveillance System, 2002*, 116 PEDIATRICS 370, 373 (2005). This study was compiled from the 2002 cross-sectional Behavioral Risk Factor Surveillance System survey of 240,735 adults from randomly selected households with telephones in the fifty states and the District of Columbia. *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> See Dowd et al., *supra* note 13, at 1420 (“A multisite study found that keeping a gun locked and keeping a gun unloaded have protective effects of 73% and 70% respectively, with regard to risk for both unintentional injury and suicide for children and teenagers.”).

firearm in the home and presents statistics on the incidence of gun use for self-defense. All of these arguments tie into the overarching idea behind FOPA that firearms are not an appropriate conversation topic in the doctor's office.

#### A. Firearms and Unintentional Injuries

Perhaps surprisingly, the briefs in support of FOPA and the State of Florida do not appear to challenge the conclusion that firearms pose a public health problem, but they do argue that firearm screening and counseling is not as crucial to protecting the public health as the Professional Health Organizations portray it to be.<sup>105</sup> Although not mentioned in the briefs, a possible factor contributing to this belief is the WISQARS data on the leading causes of both fatal and nonfatal unintentional injuries.

For all ages, unintentional injury was the fourth leading cause of death in the United States in 2015, accounting for 5.4% of all deaths.<sup>106</sup> Out of the 146,571 total unintentional injury deaths, firearm-related injury was only the sixteenth leading cause at 489 deaths (0.3% of fatal unintentional injuries).<sup>107</sup> Poisoning-related injury was the number one leading cause at 32.4% (47,478 injuries), followed by motor vehicle traffic at 24.7% (36,161 injuries).<sup>108</sup> Unintentional drowning-related deaths caused 3602 deaths, which is over seven times more deaths than unintentional firearm-related injuries.<sup>109</sup> Falls, suffocation, drowning, fire/burn, and machinery all caused more unintentional injury deaths than firearms.<sup>110</sup>

For ages 10 to 44, unintentional injury was the number one leading cause of death.<sup>111</sup> Out of the 50,890 total unintentional injury deaths for this age group, firearm-related injury was the thirteenth leading cause at 274 deaths (0.5% of fatal unintentional injuries).<sup>112</sup> Again, poisoning-related and motor vehicle traffic injuries were the first and second leading causes of unintentional injury deaths.<sup>113</sup> For this age group, unintentional drowning-related injuries caused approximately five times more

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<sup>105</sup> See, e.g., Unified Sportsmen Amicus Brief, *supra* note 17.

<sup>106</sup> Nat'l Ctr. for Injury Prevention & Control, *Leading Causes of Death Reports, 1981–2016*, CTRS. FOR DISEASE CONTROL & PREVENTION (June 24, 2015), <https://webappa.cdc.gov/sasweb/ncipc/leadcause.html> [<http://perma.cc/DH57-8XG6>].

<sup>107</sup> *Id.* (choose “Unintentional Injuries Only” for “Categories of Causes”).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.* (choose 10–44 as the “Custom Age Range” and choose “Unintentional Injuries Only” for “Categories of Causes”).

<sup>113</sup> *Id.*

deaths than firearms. Falls, suffocation, drowning, and fire/burn all caused more fatal unintentional injuries than firearms.<sup>114</sup>

Based on this data, firearms are not a top-ten leading cause of fatal unintentional injuries, nor are they a top-ten leading cause of nonfatal unintentional injuries.<sup>115</sup> Nonfatal unintentional injury data includes “injuries and poisonings described as unintended or ‘accidental,’ regardless of whether the injury was inflicted by . . . another person.”<sup>116</sup> WISQARS compiles nonfatal injury data from hospital emergency departments.<sup>117</sup> In 2015, there were 29,608,581 nonfatal unintentional injuries, with firearm-gunshots causing only 0.1%, (17,311 injuries) making firearm-gunshots the twentieth leading cause of nonfatal unintentional injury.<sup>118</sup> Other causes, such as falls, cut/pierce, poisoning, bite/sting, fire/burn, machinery, and suffocation, all preceded unintentional firearm gunshot injuries on the list.<sup>119</sup>

Does the data on unintentional injuries suggest that firearm related deaths and injuries are not, in fact, a public health problem? Not necessarily. Remember that both suicide and homicide by firearm were in the top-five leading causes of death due to injury.<sup>120</sup> Furthermore, homicide by firearm accounts for over 60% of all violent deaths.<sup>121</sup> Even though firearms only account for 0.5% of unintentional injury deaths for ages 10 to 44, that is still 274 children and adults who lost their lives to the unintentional use of a firearm by or against them.<sup>122</sup> Firearm-related injuries may appear insignificant compared to other causes of fatal and nonfatal unintentional injuries, but that does not mean the professional health community is wrong in focusing its policies on preventing firearm violence.

While poisonings and motor vehicle accidents are obviously a public health concern, we cannot completely eradicate these forces due to the ubiquity of medicines, toxic products, and motor vehicles. Among the CDC's “Key Prevention Tips” for preventing

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<sup>114</sup> *Id.*

<sup>115</sup> *See id.*; *infra* note 118; *see also* *Definitions for WISQARS Nonfatal*, CTRS. FOR DISEASE CONTROL & PREVENTION (Mar. 21, 2007), <https://www.cdc.gov/ncipc/wisqars/nonfatal/definitions.htm> [<http://perma.cc/A39M-2HFG>] (defining a nonfatal unintentional injury as “bodily harm resulting from severe exposure to an external force or substance” not inflicted by deliberate means).

<sup>116</sup> *Definitions for WISQARS Nonfatal*, *supra* note 115.

<sup>117</sup> *Id.*

<sup>118</sup> *20 Leading Causes of Nonfatal Unintentional Injuries, United States*, CTRS. FOR DISEASE CONTROL & PREVENTION (Feb. 19, 2017) [<http://perma.cc/2WGGK-3G85>].

<sup>119</sup> *Id.*

<sup>120</sup> *See supra* notes 68–75 and accompanying text.

<sup>121</sup> *See supra* note 81 and accompanying text.

<sup>122</sup> *See supra* notes 111–114 and accompanying text.

poisonings in the home are to “[s]afely dispose of unused, unneeded, or expired prescription drugs and over the counter drugs, vitamins, and supplements,” and “[k]eep medicines and toxic products, such [as] cleaning solutions and detergent pods, in their original packaging where children can’t see or get them.”<sup>123</sup> With regard to motor vehicle safety, the CDC recommends health professionals “[e]ncourage patients to make wearing a seat belt a habit”<sup>124</sup> and parents “[i]ninstall and use car seats and booster seats according to the seat’s owner’s manual or get help installing them from a certified Child Passenger Safety Technician.”<sup>125</sup>

These tips embrace the reality that potentially poisonous products and motor vehicles, while dangerous, are necessary to most households and families. That is why doctors often ask patients with children whether they have toxic chemicals in the home and whether they implement seatbelts and/or car seats, and counsel them on safe storage and use of these products. On the other hand, firearms are not ubiquitous to most homes and, according to some health organizations, are not necessary either.<sup>126</sup> It does not make sense that doctors should continue to counsel parents on the safety benefits of using car seats and securing chemicals, while simultaneously remaining silent on firearm safety.

However, as will be discussed in the rest of this Note, firearms are a complicated issue, and thus the standard for firearm screening and counseling must submit to special considerations. Firearms are constitutionally protected and have strong political connotations. There are also many legitimate motivations behind owning firearms, such as self-defense. Additionally, many physicians lack knowledge of or training on firearm safety, which opens the door to liability for harmful medical advice.

## B. Hidden Political Agendas

Despite the Supreme Court’s ruling in *District of Columbia v. Heller* (where the Court struck down a statute banning handgun possession in the home)<sup>127</sup> and the more recent case of *McDonald v. City of Chicago* (where the Court struck down

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<sup>123</sup> *Poisoning Prevention*, CTRS. FOR DISEASE CONTROL & PREVENTION (Apr. 28, 2016), <https://www.cdc.gov/safechild/poisoning/index.html> [<http://perma.cc/5RVF-8EHU>].

<sup>124</sup> *Adult Seat Belt Use*, CTRS. FOR DISEASE CONTROL & PREVENTION (Jan. 4, 2011), <https://www.cdc.gov/vitalsigns/seatbeltuse/index.html> [<http://perma.cc/FN3k-Q9HX>].

<sup>125</sup> *Child Passenger Safety*, CTRS. FOR DISEASE CONTROL & PREVENTION (Sept. 18, 2017), <https://www.cdc.gov/features/passengersafety/index.html> [<http://perma.cc/5H2V-BX7M>].

<sup>126</sup> See Dowd et al., *supra* note 13, at 1416.

<sup>127</sup> *District of Columbia v. Heller*, 554 U.S. 570, 635 (2008).



comprehensive local and statewide firearm bans),<sup>128</sup> certain medical organizations advocate for the strongest possible legislative and regulatory approaches to prevent firearm injuries and deaths.<sup>129</sup> For this reason, supporters of FOPA believe the policies of these organizations demonstrate “an institutional motivation in unrestrained political advocacy for gun control, up to and including firearm bans.”<sup>130</sup> For example, the American Academy of Pediatrics (“AAP”) openly advocates for the removal of guns from homes and communities as “the most reliable and effective measure to prevent firearm-related injuries in children and adolescents.”<sup>131</sup>

In fact, each amicus curiae brief supporting the State of Florida in *Wollschlaeger* contains a similar argument regarding the political motivations behind physicians questioning and advising patients on firearms.<sup>132</sup> The Unified Sportsmen of Florida underscored the importance of protecting patients and regulating the medical profession because “[p]atients see physicians for medical advice and treatment, not to be harangued about politics[.]”<sup>133</sup> Supporters of FOPA contend FOPA actually protects the public health by “(1) strengthen[ing] the integrity of the doctor-patient relationship by taking politics out of the examination room and (2) stym[ying] politicized efforts to deter people who wish to own arms for public-safety reasons.”<sup>134</sup>

While the “politicization of medical care” is theoretically concerning,<sup>135</sup> this should not be a basis for prohibiting firearm screening and counseling for several reasons. First, these briefs present little to no data to bolster their argument that physicians who engage in firearm screening and counseling “desire to push an anti-gun message” and “are clearly placing their own interests above their patients.”<sup>136</sup> According to the Eleventh Circuit, “the Florida Legislature, in enacting FOPA, relied on six anecdotes and nothing more. There was no other evidence, empirical or otherwise, presented to or cited by the Florida Legislature.”<sup>137</sup> Florida may have been preemptively attempting to prevent the

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<sup>128</sup> *McDonald v. City of Chicago*, 561 U.S. 742, 780 (2010).

<sup>129</sup> *See Dowd et al.*, *supra* note 13, at 1416, 1421.

<sup>130</sup> Second Amendment Foundation Amicus Brief, *supra* note 1, at 21.

<sup>131</sup> Dowd et al., *supra* note 13, at 1416.

<sup>132</sup> *See id.* at 1421; *see also* Unified Sportsmen Amicus Brief, *supra* note 17, at 20–22; En Banc Brief of Amicus Curiae Nat'l Rifle Ass'n of America, Inc. in Support of Appellants and Reversal at 21, *Wollschlaeger v. Governor of Fla.*, 649 Fed. App'x 647 (11th Cir. 2016) (No. 12–14009), 2016 WL 1642981, at \*11–12 [hereinafter Nat'l Rifle Ass'n Amicus Brief].

<sup>133</sup> Unified Sportsmen Amicus Brief, *supra* note 17, at 22.

<sup>134</sup> Nat'l Rifle Ass'n Amicus Brief, *supra* note 132.

<sup>135</sup> Unified Sportsmen Amicus Brief, *supra* note 17, at 6.

<sup>136</sup> Second Amendment Foundation Amicus Brief, *supra* note 1, at 24, 25.

<sup>137</sup> *Wollschlaeger* 2017, 848 F.3d 1293, 1312 (11th Cir. 2017).

politicization of medical care by enacting FOPA, but in reality, Florida effectively “pick[ed] ideological winners and losers” without any meaningful facts to support its conclusions.<sup>138</sup> Thus, Florida clearly overstepped its boundaries.

Another reason political-agenda prevention is not a valid basis for prohibiting physicians from questioning and advising patients on firearms is that patients can refuse to answer these questions or they can find a new doctor.<sup>139</sup> The topic is not so sensitive as to require a statutory ban, especially when a doctor may terminate his or her relationship with a patient in most circumstances.<sup>140</sup> Given these conditions, restricting the “potentially unpopular speech” on firearms is far less necessary than Florida and FOPA’s supporters allege.<sup>141</sup>

However, one argument in support of FOPA deserves further consideration and ultimately forms the basis of the overall proposal of this Note. Namely, there is a legitimate concern that a physician’s advice on firearms “is given with complete disregard for personal or family decisions about home defense, matters that physicians are dangerously unqualified to advise on.”<sup>142</sup> To effectively evaluate this proposition, it is important to understand the patterns of gun ownership and usage for self-defense purposes, which this Note will discuss next.

### C. Second Amendment and Self-Defense

In 2008, the Supreme Court in *District of Columbia v. Heller* solidified an individual’s Second Amendment right to keep a handgun in the home for self-defense.<sup>143</sup> A pre-*Heller* study determined that approximately one-third of America’s privately held firearms were handguns.<sup>144</sup> About three-fourths of handgun owners reported owning a handgun for self-protection purposes.<sup>145</sup> While a clear majority of handgun owners say their primary motivation for having a gun is self-protection, the actual incidence of gun use for self-defense against crime is unclear.<sup>146</sup> One very commonly cited report on the use of guns in self-defense asserts there are 2.2 to 2.5 million episodes of defensive gun

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<sup>138</sup> *Id.* at 1328 (Pryor, J., concurring).

<sup>139</sup> *See supra* note 43 and accompanying text.

<sup>140</sup> *See supra* note 50 and accompanying text.

<sup>141</sup> *Wollschlaeger 2017*, 848 F.3d at 1328 (Pryor, J., concurring).

<sup>142</sup> Second Amendment Foundation Amicus Brief, *supra* note 1, at 23.

<sup>143</sup> *District of Columbia v. Heller*, 554 U.S. 570, 628–29 (2008).

<sup>144</sup> Philip J. Cook et al., *Gun Control After Heller: Threats and Sideshows From a Social Welfare Perspective*, 56 UCLA L. REV. 1041, 1046 (2009).

<sup>145</sup> *Id.* at 1046 n.21.

<sup>146</sup> Philip J. Cook & Jens Ludwig, *Aiming for Evidence-Based Gun Policy*, 25 J. POL’Y ANALYSIS & MGMT. 691, 702 (2006).

use per year.<sup>147</sup> Briefs in both *Heller* and *Wollschlaeger* cite these results.<sup>148</sup>

However, these estimates differ significantly from estimates of the National Crime Victimization Survey (“NCVS”), a “large government-sponsored in-person survey that is generally considered the most reliable source of information on predatory crime[.]”<sup>149</sup> Based on the NCVS data from 2007 to 2011, there were 235,700 incidents of a victim using a firearm to threaten or attack an offender.<sup>150</sup> Based on this estimate, victims used firearms in about 1% of all nonfatal violent victimizations in the five-year period.<sup>151</sup> This is compared to 44% of nonfatal violent crimes where the victim offered no resistance, 26% where the victim used non-confrontational tactics (e.g., yelling, running, or arguing), 22% where the victim attacked or threatened without a weapon, and 1% where the victim used another type of weapon.<sup>152</sup> The 235,700 estimate means that an average of 47,140 incidents of defensive gun use occurred each year from 2007 to 2011, which is about four or five orders of magnitude smaller than Kleck and Gertz’s figure.

Before considering the significance of the NCVS data, it is important to understand why the various estimates for episodes of defensive gun use are grossly inconsistent. Kleck and Gertz have challenged the NCVS data as underestimating the true count of defensive gun use.<sup>153</sup> Kleck and Gertz based their study on one-time telephone surveys, while NCVS involves in-person interviews.<sup>154</sup> The Kleck and Gertz telephone method likely includes many false positives due to the use of open-ended questions, which allow “telescoping, confusion, a desire to impress the interviewer, and other causes.”<sup>155</sup> The NCVS data

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<sup>147</sup> Gary Kleck & Marc Gertz, *Armed Resistance to Crime: The Prevalence and Nature of Self-Defense with a Gun*, 86 J. CRIM. L. & CRIMINOLOGY 150, 164 (1995).

<sup>148</sup> Unified Sportsmen Amicus Brief, *supra* note 17, at 21; Brief for the Nat’l Rifle Ass’n and the NRA Civil Rights Defense Fund as Amici Curiae in Support of Respondent at 32, *District of Columbia v. Heller*, 554 U.S. 570, 635 (2008) (No. 07-290), 2008 WL354081, at \*32.

<sup>149</sup> Cook & Ludwig, *supra* note 146.

<sup>150</sup> Michael Planty & Jennifer L. Truman, *Firearm Violence, 1993–2011*, U.S. DEPT OF JUSTICE 12 (2013), <https://www.bjs.gov/content/pub/pdf/fv9311.pdf> [<http://perma.cc/H7HG-2FAN>]. The estimates of nonfatal violent victimizations in the NCVS data are based on “information on nonfatal crimes against persons age 12 or older reported and not reported to the police from a nationally representative sample of U.S. households.” *Id.* at 2.

<sup>151</sup> *Id.* at 12.

<sup>152</sup> *Id.*

<sup>153</sup> See PHILIP J. COOK & JENS LUDWIG, *GUNS IN AMERICA: RESULTS OF A COMPREHENSIVE NATIONAL SURVEY ON FIREARMS OWNERSHIP AND USE* 73 (1996).

<sup>154</sup> See Philip J. Cook, *The Great American Gun War: Notes from Four Decades in the Trenches*, 42 CRIME & JUST. 19, 42 (2013).

<sup>155</sup> *Id.*; COOK & LUDWIG, *supra* note 153, at 85–86.

attempts to deal with the potential for false-positives by only asking respondents about defensive gun use if they first say they were the victim of a crime.<sup>156</sup> This means some NCVS respondents “fail to report a defensive gun use,” because they are never asked about it, leading to some false-negatives in the NCVS figure.<sup>157</sup>

Philip J. Cook and Jens Ludwig undertook to resolve the discrepancies in the numbers by organizing a comparable telephone survey to the one used by Kleck and Gertz in terms of instrument, sampling procedure, and interviewing method.<sup>158</sup> Cook and Ludwig’s study suggests there are about 1.5 million defensive gun users per year.<sup>159</sup> If we accept the 1.5 million figure, we would be “led to conclude that . . . guns are used far more often to defend against crime than to perpetrate crime.”<sup>160</sup> However, “if we reject these estimates in favor of those based on NCVS data, the reverse is true.”<sup>161</sup> Cook and Ludwig ultimately concluded their 1.5 million figure, and Kleck and Gertz’s 2.5 million figure, include a significant amount of false-positives and that the “NCVS is closer to a truly representative sample of U.S. adults than are telephone surveys.”<sup>162</sup> What this means is that while the NCVS data might be lower than the true number of defensive gun uses per year, “[t]he 2.5 million figure [that] has been picked up by the press and now appears regularly in newspaper articles, letters to editorials, and even in Congressional Research Services briefs for public policymakers” is greatly exaggerated.<sup>163</sup>

#### D. Risks of a Doctor’s Advice on Firearm Removal

With the self-defense data as background, this Section briefly presents the argument that if a patient follows a physician’s advice on firearms, the advice “could lead to adverse personal consequences” for patients.<sup>164</sup> In its amicus curiae brief in *Wollschlaeger*, the Unified Sportsmen of Florida posits that the practice of firearm screening and counseling is usually devoid of informed consent.<sup>165</sup> The brief argues that informed consent requires a physician “to render objective advice about the

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<sup>156</sup> COOK & LUDWIG, *supra* note 153, at 86.

<sup>157</sup> Cook, *supra* note 154, at 42.

<sup>158</sup> See COOK & LUDWIG, *supra* note 153, at 61.

<sup>159</sup> See *id.* at 62.

<sup>160</sup> *Id.* at 68.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.* at 73.

<sup>163</sup> *Id.* at 57, 70.

<sup>164</sup> Unified Sportsmen Amicus Brief, *supra* note 17, at 17.

<sup>165</sup> *Id.* at 13–15.

alternatives in order to obtain an informed consent.”<sup>166</sup> It poses the questions:

Of the physicians who pursue an anti-Second Amendment agenda under the pretension of rendering medical advice, how many advise patients that not having a firearm in the home could render the patient defenseless in the event of a burglary, home invasion, or attempted rape? And how many obtain a written consent with objective warnings to patients to undergo the “treatment” of removing firearms from their homes and becoming defenseless?<sup>167</sup>

Thus, informed consent will not exist where doctors merely discuss one viewpoint on firearms and reject another. According to this amicus curiae, physicians must evaluate the claim that a gun “would be an effective protection against violent intrusion or deadly force in the home” and must relay this information to a patient in order for the patient to “weigh[ ] the risks and benefits of gun ownership.”<sup>168</sup>

Consider a situation where a physician advises a patient to remove a gun from her household, but omits any information about the use of guns for self-protection. If that patient follows her doctor’s advice, gives up her gun, and subsequently becomes the victim of robbery or rape in her home without her gun for protection, she may have a claim against her doctor for medical negligence. She could argue that “but for the physician’s advice, she would have been armed at the time of the attack, and her being armed would have prevented the injury.”<sup>169</sup> The validity of this claim would depend on proximate cause and the foreseeability of the attack on the patient, but it is possible that a court would find that “the physician’s negligent counseling created a foreseeable risk that the patient would be the victim of a crime by impairing her ability to defend herself.”<sup>170</sup>

The potential harm to patients and the expansion of liability for physicians are very legitimate concerns. As such, the professional health community must soon develop a standard of care for firearm screening and counseling if they are to continue to encourage the practice in their official policies and recommendations. Next, Part IV discusses generally how a standard of care is developed, the current standard of care for firearm screening and counseling, and possible ways to improve this practice.

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<sup>166</sup> *Id.* at 14–15.

<sup>167</sup> *Id.* at 15.

<sup>168</sup> *Id.* at 21–22.

<sup>169</sup> *Id.* at 21.

<sup>170</sup> *Id.*

#### IV. REDUCING NEGATIVE EFFECTS OF FIREARM SCREENING AND COUNSELING BY DEVELOPING AN APPROPRIATE STANDARD OF CARE

Before the Eleventh Circuit struck down FOPA, opponents of the law and Florida judges were concerned about doctors “self-censoring themselves out of fear of disciplinary actions”<sup>171</sup> (e.g., suspension or permanent revocation of medical licenses, restriction of practices, fines of up to \$10,000, and refunds of fees billed<sup>172</sup>). Indeed, physicians and physician interest groups presented evidence that “[a]gainst their professional judgement, [practitioners] are no longer asking patients questions related to firearm ownership, no longer using questionnaires with such questions, and/or no longer maintaining written records of consultations with patients about firearms.”<sup>173</sup> Under FOPA, doctors could only engage in firearm screening and counseling and recording information on firearms in the patient’s medical record if such acts were “necessary” or “relevant” to the patient’s medical care.<sup>174</sup> Consequently, doctors were second-guessing whether they could legally question and advise patients on firearms, with some ultimately deciding to avoid the topic altogether, out of fear of disciplinary consequences for violating FOPA’s provisions.<sup>175</sup>

Now that FOPA is no longer in effect, doctors need not fear liability for breaching its provisions. The hypothetical malpractice lawsuit presented above, however, demonstrates there is still a likelihood of expanded liability for doctors who question and advise patients on owning and storing firearms.<sup>176</sup> Whether such lawsuits would be successful may not matter, because the mere possibility of medical malpractice liability prevents doctors from engaging in the practice in the first place.<sup>177</sup> This expanded liability stems from at least two causes: lack of informed consent from patients<sup>178</sup> and lack of

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171 *E.g.*, *Wollschlaeger v. Farmer*, 814 F. Supp. 2d 1367, 1383 (S.D. Fla. 2011).

172 FLA. STAT. § 456.072(2)(b)–(d), (f), (i)–(j) (2016).

173 *Wollschlaeger* 2017, 848 F.3d 1293, 1304 (11th Cir. 2014).

174 *Id.* at 1319 (Marcus, J., concurring).

175 *See* American Medical Ass’n Amicus Brief, *supra* note 4, at 8–9.

176 *See supra* Section III(D).

177 *See supra* notes 171–175 and accompanying text.

178 *See supra* notes 164–170 and accompanying text; *see also* Rodney A. Smolla, *Professional Speech and the First Amendment*, 119 W. VA. L. REV. 67, 106 (2016) (“Doctors, for example, are required by tort law to obtain a patient’s informed consent before performing a medical procedure, out of solicitude for preserving the dignity and autonomy of patients.”); RICHARD A. EPSTEIN, *TORTS* § 6.3 (1999) (indicating that in every state, violation of a patient’s right to informed consent is actionable in tort).

training of healthcare providers on firearm intervention.<sup>179</sup> Thus, for professional health organizations to see their policies through, there must be an accepted standard of medical practice for firearm screening and counseling. Otherwise, physicians, lawyers, and judges “may genuinely not know the degree of malpractice liability risk that is associated with adopting [this relatively] new clinical” practice.<sup>180</sup>

This Part proceeds by explaining medical malpractice liability in general and the development of a particular standard of care. Next, it discusses the current standard of care for firearm screening and counseling and suggests ways to improve it.

#### A. Medical Malpractice and Developing a Standard of Care

Medical malpractice liability allows individuals harmed by a healthcare provider's negligence to bring suit against the provider to recover damages. Generally, a claim for medical malpractice requires the plaintiff to establish the following: (1) the defendant owed a duty of care to the plaintiff; (2) that duty was breached by the defendant; (3) the plaintiff was harmed and suffered damages; and (4) the plaintiff's harm was caused by the defendant's actions.<sup>181</sup> In essence, a healthcare provider can be held liable if the care that he or she provides deviates from the standard of care of a reasonable physician as dictated by the profession.<sup>182</sup> The medical practitioner's duty is specific to the specialty involved and is based on a national standard of care, rather than a specific standard for the particular locality.<sup>183</sup>

In a medical malpractice suit, “courts require only that physicians and surgeons exercise in diagnosis and treatment that reasonable degree of skill, knowledge, and care ordinarily possessed and exercised by members of the medical profession under similar circumstances.”<sup>184</sup> To determine whether a

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<sup>179</sup> See, e.g., Second Amendment Amicus Brief, *supra* note 1, at 23 (“The advice is given with complete disregard for personal or family decisions about home defense, matters that physicians are dangerously unqualified to advise on.”); Bowman, *supra* note 15, at 1459 (“At the same time, many patients may certainly wonder what qualifies a medical doctor as an appropriate person to give advice on firearm safety.”); see also *infra* Section IV(C).

<sup>180</sup> Michael D. Greenberg, *Medical Malpractice and New Devices: Defining an Elusive Standard of Care*, 19 HEALTH MATRIX 423, 425 (2009).

<sup>181</sup> W. PAGE KEETON ET AL., PROSSER AND KEETON ON TORTS 164–65 (5th ed. 1984).

<sup>182</sup> Greenberg, *supra* note 180, at 423.

<sup>183</sup> Telephone Interview with Dr. Richard Redding, Vice Chancellor for Graduate Education, Chapman Univ. (Apr. 13, 2017). Dr. Redding specializes in forensic issues in criminal law and juvenile justice and the use of social science research in law and public policy, among other areas. Dr. Richard Redding, CHAP. UNIV., <https://www.chapman.edu/our-faculty/richard-redding> [<http://perma.cc/8GF2-6Z9F>] (last visited Apr. 26, 2017).

<sup>184</sup> Mann v. Cracchiola, 694 P.2d 1134, 1143 (Cal. 1985).

healthcare provider failed to adhere to accepted standards within the profession, courts will rely on expert opinion testimony, unless the medical procedure or treatment is a matter of common knowledge.<sup>185</sup> Thus, experts will testify about what a doctor should have done in the circumstances based on their education, their medical experience, and results of scientific or medical research.<sup>186</sup> As these basics of medical malpractice law demonstrate, the medical profession itself develops certain standards of practice for medical treatment, such as how a surgery should be performed and what kinds of tests should be run for patients showing certain symptoms.<sup>187</sup>

The data presented above in Parts II and III is conflicting and inconclusive in many respects, such as the significance of firearm-related injuries and the frequency of self-defense uses of guns. However, the Professional Health Organizations have come to the conclusion that clinician intervention to reduce firearm-related deaths and injuries is necessary to the public health. Therefore, it would appear that in a medical malpractice lawsuit involving a doctor's advice on firearms, expert testimony would favor the physician's intervention, yet it is unclear what standards would apply beyond this basic starting point.

#### B. Current Standard of Care for Firearm Screening and Counseling

In 2015, the ABA and the Professional Health Organizations released a "Call to Action" with recommendations and policies for "a public health approach to firearm-related violence and prevention of firearm injuries and deaths."<sup>188</sup> In addition to opposing laws that "forbid physicians to discuss a patient's gun ownership," the Call to Action recommended the following:

When appropriate, physicians can intervene with patients who are at risk for injuring themselves or others due to firearm access. To do so, physicians must be allowed to speak freely to their patients in a nonjudgmental manner about firearms, provide patients with factual information about firearms relevant to their health and the health of those around them, fully answer their patients' questions, and advise them on the course of behaviors that promote health and safety without fear of liability or penalty. Physicians must also be able to document these conversations in the medical record as they are

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<sup>185</sup> See *Kelley v. Trunk*, 78 Cal. Rptr. 2d 122, 124 (App. 1998); *Curtis v. Santa Clara Valley Med. Ctr.*, 2 Cal. Rptr. 3d 73, 76–77 (Ct. App. 2003).

<sup>186</sup> Telephone Interview with Dr. Richard Redding, *supra* note 183.

<sup>187</sup> *Id.*

<sup>188</sup> Weinberger et al., *supra* note 2, at 513.



able and required to do with discussion of other behaviors that can affect health.<sup>189</sup>

In turn, specific medical organizations released their own policies to mirror this recommendation.<sup>190</sup>

Based on these broad recommendations, the Eleventh Circuit concluded “that the applicable standard of care encourages doctors to ask questions about firearms (and other potential safety hazards).”<sup>191</sup> To the contrary, the Unified Sportsmen of Florida posited that it is merely a “charade” to say that firearm screening and counseling by physicians is “an accepted standard of medical practice among members of the medical profession with similar training and experience.”<sup>192</sup> They argued “such viewpoints are not part of medical training and experience and there is no such accepted standards of medical practice.”<sup>193</sup> These conflicting conclusions demonstrate that the standard of care for this practice is ill-defined, which may lead to adverse consequences for patients, healthcare providers, and the public health.

### C. Education and Training on Firearms and Intervention

Since many physicians are not knowledgeable when it comes to firearms, there is a legitimate concern over physicians' qualifications for giving advice on firearm safety. This potential lack of training and expertise on firearms could result in inadequate or harmful medical advice, which in turn could lead to adverse consequences for patients who heed such advice. While medical malpractice suits provide a way to redress injuries caused by a healthcare provider's negligence, an appropriate standard of care, including consistent training of physicians on firearm safety and intervention, could prevent many injuries from ever occurring.

A 2016 report (“Interventions Report”) “systematically identif[ied] and summarize[d] existing literature on clinical

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<sup>189</sup> *Id.* at 514.

<sup>190</sup> *See, e.g.,* Dowd et al., *supra* note 13, at 1421 (“Pediatricians and other child health care professionals are urged to counsel parents about the dangers of allowing children and adolescents to have access to guns inside and outside the home. The AAP recommends that pediatricians incorporate questions about the presence and availability of firearms into their patient history taking and urge parents who possess guns to prevent access to these guns by children.”); Strong et al., *supra* note 13, at 1086 (“ACPM supports . . . Physicians' ability to speak openly to their patients about firearms, fully answering questions, and advising them on the course of behaviors that promote health and safety.”).

<sup>191</sup> *Wollschlaeger* 2017, 848 F.3d 1293, 1317 (11th Cir. 2017).

<sup>192</sup> Unified Sportsmen Amicus Brief, *supra* note 17, at 14 (internal quotations omitted).

<sup>193</sup> *Id.*

firearm injury prevention screening and interventions” and assessed each study based on its methodological quality and bias.<sup>194</sup> The Interventions Report found fifty-three studies examining clinician attitudes/practice patterns, prior training, experience, and expectations correlated with clinicians’ regularity of firearm screening.<sup>195</sup> Most of these assessed the frequency of clinicians asking parents about firearm ownership and recommending safe storage or firearm removal.<sup>196</sup>

The studies showed that clinicians who lacked formal training or who felt that patients were unlikely to follow their advice were unlikely to screen and counsel on firearm safety.<sup>197</sup> In turn, clinicians who believed that screening and counseling made a difference in injury prevention, who had prior training, and who had high self-efficacy reported higher screening and counseling rates.<sup>198</sup> Further, the Interventions Report found that pediatric, psychiatric, and family medicine residencies, as well as program directors for preventive medicine, psychiatric nursing, and physician assistant training programs, reported infrequently offering firearm injury prevention or safety training to their residents and students.<sup>199</sup> One cross-sectional study of high methodological quality found only 16% of family practitioners sometimes or usually counsel patients regarding firearm safety, with over 75% reporting they lacked formal training.<sup>200</sup>

These studies indicate that there are inconsistent attitudes among physicians toward screening and counseling to increase firearm safety. Furthermore, there is a disparity between the attitudes and the actual practice, which is likely caused by “the lack of screening and intervention guidelines, as well as the absence of clinician education about why and how to reduce high-risk patients’ firearm injury rates.”<sup>201</sup> The results of the Interventions Report suggest the existing standard of care for firearm screening and counseling, if there is such a standard at all, is severely deficient. Healthcare providers cannot be expected to provide consistent and effective treatment to prevent firearm-related deaths and injuries when there is insufficient clinician awareness and training regarding firearm injury prevention. Therefore, the professional health community—and

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<sup>194</sup> Roszko et al., *supra* note 16, at 87–88.

<sup>195</sup> *Id.* at 87.

<sup>196</sup> *Id.* at 103.

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

<sup>200</sup> *Id.* (referring to Sherry A. Everett et al., *Family Practice Physicians’ Firearm Safety Counseling Beliefs and Behaviors*, 22 J. COMMUNITY HEALTH 313, 320–21 (1997)).

<sup>201</sup> Roszko et al., *supra* note 16, at 105.

state legislatures, if necessary—must improve clinician training on firearm safety counseling. Such training should include the identification of who should be screened for firearms and the execution of effective injury prevention practices.<sup>202</sup>

#### D. Affirmative Duty to Advise and Counsel or Something Else

Other crucial considerations in developing an appropriate standard of care for firearm intervention by physicians is determining when intervention is necessary and the extent of the intervention that is required. The Professional Health Organizations' recommendation applies to "patients who are at risk for injuring themselves or others due to firearm access," but this provides little guidance for physicians on recognizing persons at risk.<sup>203</sup> Further, there is insufficient literature identifying "who should be screened for firearms and in what health-care setting such screening should occur."<sup>204</sup>

Although the medical profession itself typically develops the standard of care for a particular practice or procedure, states often enact statutes that define the boundaries of a standard of care. In the last decade, over a dozen states have introduced legislation that would either completely bar doctors from asking patients about firearm ownership (known as "gag laws") or would somehow regulate the discussion between a doctor and patient on firearms.<sup>205</sup> Other than FOPA, only three laws have passed; none of them are true gag laws, as they only limit the collection of gun ownership information by medical professionals or agencies.<sup>206</sup> Therefore, the existing statutes regulating the doctor-patient relationship with respect to firearms do not fill the void in the current standard of care regarding when and in what setting firearm screening and counseling is appropriate.

Some states have certain statutes or judicially-created laws imposing an affirmative duty on individuals to prevent harm to

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<sup>202</sup> For a discussion of possible interventions, see *id.* at 105–06, and Ali Rowhani-Rahbar et al., *Firearm-Related Hospitalization and Risk for Subsequent Violent Injury, Death, or Crime Perpetration*, 162 ANNALS OF INTERNAL MED. 492 (2015).

<sup>203</sup> Weinberger et al., *supra* note 2, at 514.

<sup>204</sup> Roszko et al., *supra* note 16, at 105.

<sup>205</sup> *Doctor Gag Order Laws*, EVERYTOWN FOR GUN SAFETY SUPPORT FUND (July 7, 2015), <https://everytownresearch.org/wp-content/uploads/2015/07/0715DoctorGagOrderLaws.pdf> [<http://perma.cc/5344-J2FJ>].

<sup>206</sup> Wintemute, *supra* note 14, at 205–06 ("Montana prohibits requiring patients to provide firearm information as a condition of receiving health care. Missouri prohibits requiring that health professionals collect or record firearm information, but with an exception 'if such inquiry or documentation is necessitated or medically indicated by the health care professional's judgment'. Minnesota prohibits collection of firearm information by its state health commissioner and MNsure, the agency administering its health insurance exchange.") (footnotes omitted).

another. These laws may provide some guidance on developing when a physician's duty to advise and counsel a patient on firearms and record information about firearms in the patient's medical record applies. For example, under Florida Statute section 456.059, "a psychiatrist may 'disclose patient communications to the extent necessary to warn any potential victim or to communicate the threat to a law enforcement agency' after a 'patient has made an actual threat to physically harm an identifiable victim' and the psychiatrist has made a clinical judgment that the patient is capable of committing the threatened action."<sup>207</sup>

Similar to Florida's statute, a California Supreme Court ruling provides:

When a therapist determines, or pursuant to the standards of his profession should determine, that his patient presents a serious danger of violence to another, he incurs an obligation to use reasonable care to protect the intended victim against such danger. The discharge of this duty may require the therapist to take one or more of various steps, depending upon the nature of the case. Thus it may call for him to warn the intended victim or others likely to apprise the victim of the danger, to notify the police, or take whatever other steps are reasonably necessary under the circumstances.<sup>208</sup>

This duty of a psychotherapist "to use reasonable care to protect the intended victim of a patient who presents a serious danger of violence" has come to be known as the *Tarasoff* duty, a violation of which can give rise to a negligence claim against the psychotherapist.<sup>209</sup> However, not all jurisdictions that follow *Tarasoff* have extended the affirmative duty to warn to primary care doctors.<sup>210</sup>

The above examples raise the question of whether an affirmative *Tarasoff*-like duty should apply to all healthcare providers in all situations where a patient appears to be a danger to himself or others. This is an important question, considering that many primary care doctors are unaware of the *Tarasoff* duty.<sup>211</sup> Even more expansive would be the duty for physicians to question and counsel *all* patients on firearm safety, regardless of whether something triggers the physician to believe that such intervention is necessary to the patient's health or the health of others. One factor to support this expansive duty is that patients

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<sup>207</sup> See Bowman, *supra* note 15, at 1478–79.

<sup>208</sup> *Tarasoff v. Regents of Univ. of Cal.*, 551 P.2d 334, 340 (Cal. 1976).

<sup>209</sup> MIGUEL A. MENDEZ, EVIDENCE: THE CALIFORNIA CODE AND THE FEDERAL RULES 910 (5th ed. 2012).

<sup>210</sup> See Damor Muir Walcott et al., *Current Analysis of the Tarasoff Duty: an Evolution towards the Limitation of the Duty to Protect*, 19 BEHAV. SCI. L. 325, 336 (2001).

<sup>211</sup> See Telephone Interview with Dr. Richard Redding, *supra* note 183.

are protected by the right to refuse to answer their physician's questions. On the other hand, the breadth of this obligation may be unrealistic, given that doctors do not engage in the same methods of preventive care for all patients.<sup>212</sup>

One possible alternative to the universal duty to verbally question and counsel patients on firearms is the dissemination of pamphlets or brochures on firearm safety to patients.<sup>213</sup> The pamphlets could provide information and resources on firearm safety and invite patients to discuss these issues further with their doctor. This alternative could make it less likely that patients will perceive their doctors as promoting an anti-Second Amendment political agenda.<sup>214</sup> Furthermore, a healthcare provider can provide this information without the usual hesitation that may come with advising patients on an area that is unfamiliar to the healthcare provider. The downside to this option is that patients may not actually read the information in the pamphlets and it would be difficult to tailor the intervention to different populations.<sup>215</sup> There is also a chance that advocates of the Second Amendment will be just as offended, if not more, by such literature. Thus, disseminating pamphlets or brochures may protect physicians from liability, but it realistically does little for the public health and may not reduce the likelihood of offending some patients.

Another possible alternative would be for the professional health community to explicitly define specific conditions that would trigger a doctor's duty to intervene to prevent firearm-related injuries.<sup>216</sup> These conditions should include: when a patient has directly or indirectly expressed suicidal or homicidal thoughts; when a patient exhibits other personal risk factors for violence (i.e., history of violence perpetration, history of violence victimization, substance abuse, mental disorders, etc.); and when a patient is part of a particular demographic that is known to be at increased risk for firearm violence (i.e., middle-aged white men, young African American men, etc.).<sup>217</sup> The limitations to this option relate to the lack of high-quality studies and conclusive evidence on who is at risk and best practices for

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<sup>212</sup> *See id.*

<sup>213</sup> Interview with Kimberly D. Snow, Shareholder, LaFollette, Johnson, DeHaas, Fesler & Ames (Apr. 20, 2017). Ms. Snow specializes in civil litigation defense, primarily representing physicians and hospitals in medical malpractice claims. *Attorneys List*, LAFOLLETTE JOHNSON (2016), <http://www.ljdfa.com/attorneys.php?attorney=snow> [<http://perma.cc/QY9L-UMMZ>].

<sup>214</sup> *See* Interview with Kimberly D. Snow, *supra* note 213.

<sup>215</sup> *Id.*; *see also* Roszko et al., *supra* note 16, at 106.

<sup>216</sup> *See* Wintemute et al., *supra* note 14, at 210.

<sup>217</sup> *See id.*

firearm safety screening and counseling.<sup>218</sup> Consequently, this lack of consensus causes physicians to hesitate to intervene at all.

Thus, the most persistent barrier to rounding out the standard of care for firearm screening and counseling is a lack of consistent guidance and reliable evidence on determining exactly when and in what setting the duty to screen and counsel on firearms should apply. The proposals in this Section should serve as a starting point for the professional health community in developing an appropriate standard of care; but first and foremost, there is a need for a stricter focus on studying effective injury prevention practices and identifying who is at risk.

#### CONCLUSION

In light of the Eleventh Circuit's recent ruling that states cannot prohibit physicians from screening and counseling patients on firearms, the professional health community must develop an applicable standard of care for this practice to safeguard patients against unadvised counseling. The standard of care should be evidence-based, focusing on data about the following: firearm-related deaths and injuries; firearm safety and storage practices and their effects; defensive uses of firearms; and qualifications and training of healthcare providers on firearms. Further, although FOIPA is no longer in effect, the arguments for and against the law and the practice of firearm screening and counseling can provide guidance to the professional health community in developing the standard.

The data presented in Part I showed that firearm-related injuries are a leading cause of death for all age groups. Additionally, firearm-related homicides account for 67% of all violent deaths, a large majority of which take place in the home. Even though the data presented in Part II showed that firearm-related injuries are not a top-ten leading cause of fatal and nonfatal unintentional injuries, the data presented in Parts I and II, taken as a whole, supports the conclusion that firearm violence is a public health problem. Although a public health approach to prevention of firearm injuries and deaths is advisable, the standard applicable to this sort of preventive treatment must take into account the legitimate use of guns for self-defense and the risks of doctors advising patients without having adequate education or training on firearm safety and counseling.

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<sup>218</sup> *Id.* at 106; *see also* Roszko et al., *supra* note 16, at 106.

As it currently stands, the standard of care for firearm screening and counseling is ill-defined, and most healthcare providers lack the minimum training necessary to effectively identify at risk patients and implement intervention practices. This causes reluctance in health care providers to engage in the practice because they fear malpractice liability as well as overstepping into an unfamiliar area of practice. At this juncture, the crucial next step for the professional health community is to implement more uniform and formal training on firearm screening and counseling and research on clinical interventions to prevent firearm-related injuries, focusing on best practices and recognition of persons at risk.





# The End of Smuggling Hearsay: How *People v. Sanchez* Redefined the Scope of Expert Basis Testimony in California and Beyond

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## INTRODUCTION

It is a well-settled principal that expert witnesses may give testimony in the form of an opinion, relying all or in part on sources that are hearsay.<sup>1</sup> An expert may explain to the jury on direct examination the matters upon which the expert relied in forming that opinion, even if those matters would ordinarily be inadmissible.<sup>2</sup> But when that matter is otherwise inadmissible hearsay, how much substantive detail may the expert relate to the fact-finder,<sup>3</sup> and, further, how may the fact-finder consider such evidence in evaluating the expert's opinion?<sup>4</sup>

The California Supreme Court recently weighed in on these questions in *People v. Sanchez* and clarified the proper application of the hearsay rule as it relates to the scope of expert testimony.<sup>5</sup> The *Sanchez* court issued a strict bright-line test, putting an end to the prior paradigm in California:

When any expert relates to the jury case-specific out-of-court statements, and treats the contents of those statements as true and accurate to support the expert's opinion, the statements are hearsay. It cannot logically be maintained that the statements are not being admitted for their truth.<sup>6</sup>

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\* J.D., Chapman University Dale E. Fowler School of Law, May 2018. Thank you to Supervising Deputy Attorney General Scott Taryle and Deputy Attorney General Nicholas Webster for bringing the *Sanchez* case and its importance to my attention, Professor Scott Howe for his guidance and kind words of encouragement in writing this Comment, and the Editors of the *Chapman Law Review* for their hard work throughout the editing and publication process.

<sup>1</sup> CAL. EVID. CODE § 801 (West 2017).

<sup>2</sup> See CAL. EVID. CODE § 802 (West 2017); see also *People v. Sanchez*, 374 P.3d 320, 329 (Cal. 2016).

<sup>3</sup> Can the expert relate all substantive details or just the general kind and source?

<sup>4</sup> Can the evidence be considered as substantive evidence or only for the limited purpose of evaluating the expert's opinion?

<sup>5</sup> See *Sanchez*, 374 P.3d at 324.

<sup>6</sup> *Id.* at 334.

California courts have long paid lip service to the rule that experts may not “under the guise of reasons [for their opinions] bring before the jury incompetent hearsay evidence.”<sup>7</sup> However, prior to *Sanchez*, California courts allowed experts to testify to hearsay statements as the basis for their opinions on the grounds that such statements were being offered for a non-hearsay purpose, and mitigated any potential hearsay problems with the use of a two-pronged test.<sup>8</sup> California’s two-pronged test was an attempt to balance the “jury’s need for information sufficient to evaluate [the] expert opinion” with the “accused’s interest in avoiding substantive use of unreliable hearsay.”<sup>9</sup>

Under this two-pronged test, the courts would “cure” hearsay problems by issuing a limiting instruction that matters admitted through an expert go only to the basis of the expert’s opinion and should not be considered for its truth.<sup>10</sup> Thus, so as long as a limiting instruction was provided to the jury, the expert could testify to the hearsay details forming the basis of the expert’s opinion.<sup>11</sup> In situations where the court found a limiting instruction not be enough to “cure” hearsay problems, the court could elect to exclude, under California Evidence Code section 352, any hearsay with a potential for prejudice from the misuse of the hearsay statements outweighed the probative value of assisting the jury in evaluating the expert’s opinion.<sup>12</sup>

Under California Evidence law, expert testimony concerning general background information, even if technically derived from hearsay, has generally not been subject to exclusion on hearsay grounds because experts assist the jury in understanding subjects that are sufficiently beyond common experience.<sup>13</sup> By contrast, experts have traditionally, at least under common law, been precluded from relating case-specific facts to the jury, since the expert lacked independent knowledge of the facts.<sup>14</sup> However, under the pre-*Sanchez* two-pronged test paradigm, there was no longer a need to distinguish between an expert’s testimony concerning background information and case-specific facts because the admissibility inquiry instead turned on whether the

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<sup>7</sup> *People v. Coleman*, 695 P.2d 189, 203 (Cal. 1985); *see also* *People v. Linton*, 302 P.3d 927, 969 (Cal. 2013); *People v. Nicolaus*, 817 P.2d 893, 910 (Cal. 1991); *N. Am. Capacity Ins. Co. v. Claremont Liab. Ins. Co.*, 99 Cal. Rptr. 3d 225, 244 (Ct. App. 2009).

<sup>8</sup> *See, e.g.*, *People v. Montiel*, 855 P.2d 1277, 1299 (Cal. 1993); *People v. Gardeley*, 927 P.2d 713, 721–22 (Cal. 1996).

<sup>9</sup> *Montiel*, 855 P.2d at 1299.

<sup>10</sup> *Id.*; *see also Sanchez*, 374 P.3d at 329.

<sup>11</sup> *Montiel*, 855 P.2d at 1299; *see also Sanchez*, 374 P.3d at 329.

<sup>12</sup> *Montiel*, 855 P.2d at 1299; *see also Sanchez*, 374 P.3d at 329.

<sup>13</sup> *See* CAL. EVID. CODE § 801 (West 2017); *Sanchez*, 374 P.3d at 327.

<sup>14</sup> *Sanchez*, 374 P.3d at 327–28.

jury could follow the court's limiting instruction regarding the nature of the case-specific out-of-court statements.<sup>15</sup> The use of a limiting instruction was sanctioned because it instructed the jury that the hearsay contents could only be considered for the sole purpose of evaluating the expert's credibility, and not for the truth of the matter asserted (i.e., not as independent substantive proof of fact).<sup>16</sup> However, such limiting instruction may "never [be] tied to particular evidence, and the jury's attention [may] never [be] drawn to specific hearsay information disclosed by expert witnesses which should only be considered as a basis for evaluating their opinions."<sup>17</sup>

What resulted was that the pre-*Sanchez* paradigm effectively amounted to a hearsay exception, even though no such hearsay exception existed.<sup>18</sup> The blurring of this line between general background knowledge and case-specific facts has, arguably, opened the door to abuse; namely, expert witnesses being used as conduits to transmit inadmissible hearsay that does not otherwise fall under a statutory exception as assertions of fact to the jury.<sup>19</sup> With such a liberal approach to admissibility, there is a risk that damaging inadmissible evidence, which would be unable to make its way to the jury through the proper channels, could be smuggled to the jury through the expert; or worse, parties may offer expert testimony simply to place such damaging evidence before the fact-finder disguised as expert basis testimony.<sup>20</sup> The *Sanchez* rule curbs this potential for abuse with its bright-line rule prohibiting an expert from relating all case-specific hearsay statements forming the basis of the expert's opinion, unless such hearsay statements fall under an applicable hearsay exception or are properly admitted independent of the expert's testimony.<sup>21</sup>

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<sup>15</sup> *Id.*

<sup>16</sup> See *Montiel*, 855 P.2d at 1299 (stating "matters admitted through an expert go only to the basis of [the expert's] opinion and should not be considered for their truth").

<sup>17</sup> *Id.* at 1299–1300.

<sup>18</sup> Cf. DAVID H. KAYE ET AL., *THE NEW WIGMORE: A TREATISE ON EVIDENCE – EXPERT EVIDENCE* 190 (2d ed. 2010).

<sup>19</sup> See Patrick Mark Mahoney, *Houses Built on Sand: Police Expert Testimony in California Gang Prosecutions; Did Gardeley Go Too Far?*, 31 HASTINGS CONST. L.Q. 385, 386–87 (2004) (arguing the *Gardeley* court erred in permitting the expert to relate otherwise inadmissible hearsay evidence as the basis of the expert's opinion, and the California Supreme Court missed a critical opportunity to emphasize a restrictive view of expert testimony and the importance of judicial gatekeeping); see also *People v. Zavala*, No. H036028, 2013 WL 5720149, at \*58 (Cal. Ct. App. Oct. 22, 2013) (Rushing, J., dissenting) (stating that "rote application of the not-for-truth rationale to police gang experts has opened the gates to a veritable flood of incriminating hearsay").

<sup>20</sup> See KAYE ET AL., *supra* note 18, at 170–71.

<sup>21</sup> See *People v. Sanchez*, 374 P.3d 320, 333–34 (Cal. 2016).

While the *Sanchez* hearsay ruling does not change the basic understanding of the definition of hearsay, it does restore the restrictive common law approach in dealing with the scope of expert basis testimony, which has substantial implications for California trial practice both in criminal and civil contexts. California courts may no longer overrule a hearsay objection on the grounds that the hearsay is being considered solely for explaining the basis of the expert's opinion, and experts may no longer be asked to assume case-specific facts and opine on the significance of such case-specific facts, if such facts have not been, or will not be, independently admitted into evidence. Since the paradigm of allowing a limiting instruction to justify the admittance of expert basis testimony is no longer tenable under *Sanchez*, trial counsel will be forced to shift their focus to ensuring they have established a proper evidentiary basis for admission of case-specific facts forming the basis of expert opinion testimony. This may include calling more witnesses to properly authenticate and introduce evidence that trial counsel wishes the expert relate to the jury. But if that's not possible, trial counsel may be unable to present such evidence all together.

This Comment explores the various trial contexts the *Sanchez* hearsay rule will likely affect. Part I discusses the facts of *Sanchez* and summarizes the California Supreme Court's lengthy hearsay discussion and ruling. Part II explores both the criminal and civil implications of the *Sanchez* ruling in California trial practice. Part II also surveys various states that do not follow a restrictive approach to the scope of expert basis testimony, and exposes the problems surrounding such a liberal approach, thereby urging states to adopt and follow a *Sanchez*-like rule. Lastly, Part III examines the differences between California's *Sanchez* approach and the Federal Rules of Evidence related to the scope of expert basis testimony. Part III also surveys the variances in interpretation and application of Federal Rule of Evidence 703, namely, the ongoing controversy as to how much, if any, substantive hearsay detail an expert may relate to the fact-finder as opinion basis testimony in both federal courts and legal scholarship. Finally, this Comment also argues that other state courts, as well as federal courts, should follow California's restrictive *Sanchez* approach to hearsay as it relates to the scope of expert basis testimony. *Sanchez* was a criminal case and therefore also addressed Confrontation Clause concerns;<sup>22</sup> however, this Comment focuses solely on the implications of the hearsay ruling.

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<sup>22</sup> See *infra* notes 38, 39, 76, 80 and accompanying text.

I. THE CALIFORNIA SUPREME COURT DECISION:  
*PEOPLE V. SANCHEZ*

In the June 30, 2016 case, *People v. Sanchez*, the California Supreme Court considered the application of the hearsay rule as it relates to case-specific out-of-court statements offered as the basis of an expert's opinion.<sup>23</sup> The *Sanchez* court took the opportunity to "revisit and revamp" the proper application of California Evidence Code sections 801 and 802, specifically the application of the hearsay rule as it relates to the scope of expert testimony.<sup>24</sup> The court issued a bright-line test in an attempt to restore the common law distinction between general background information and case-specific facts: "When any expert relates to the jury case-specific out-of-court statements, and treats the contents of those statements as true and accurate to support the expert's opinion, the statements are hearsay."<sup>25</sup>

A. Facts and Procedural History

On October 16, 2011, the defendant, Marcos Arturo Sanchez, was charged with various criminal felonies coupled with gang enhancements, including active participation in and commission of a felony for the benefit of the Delhi gang.<sup>26</sup> At trial, David Stow, a police detective, testified for the prosecution as a gang expert.<sup>27</sup> The expert testified generally about gang culture, in particular, the Delhi gang's culture and pattern of criminal activity.<sup>28</sup> The expert's testimony then turned to the defendant specifically, regarding the details of defendant's STEP notice,<sup>29</sup> FI card,<sup>30</sup>

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<sup>23</sup> *Sanchez*, 374 P.3d at 324.

<sup>24</sup> John T. Brazier & Katherine Frank, *Hearsay, the Experts Say!*, L.A. DAILY J. (Nov. 21, 2016), <http://www.cgdrblaw.com/wp-content/uploads/2016/12/Hearsay-The-Experts-Say.pdf>; see also *Sanchez*, 374 P.3d at 324.

<sup>25</sup> *Sanchez*, 374 P.3d at 328, 334.

<sup>26</sup> *Id.* at 324.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 325.

<sup>29</sup> STEP notices, or the California Street Terrorism Enforcement and Prevention Act, are issued by police officers to individuals associating with known gang members. *Id.* at 324 n.3. The purpose of STEP notices is two-fold; they provide, as well as gather, information. *Id.* at 324. The STEP notices provide notice to the recipient that they are associating with a known gang, the gang engages in criminal activity, and, if the recipient commits certain crimes with gang members, the recipient may face enhanced penalties for the crimes. *Id.* The STEP notices also gather information (such as the date and time the notice was given) and identify information (such as descriptions of tattoos, identification of the recipient's associates, and any statements made at the time of the interaction). *Id.* at 324–25.

<sup>30</sup> FI cards, or field identification cards, are small reports prepared by police officers that record the police officer's contact with the individual. *Id.* at 325. FI cards record the date and time of the contact; personal information about the individual, associates, nicknames; and any statements made at the time of the interaction. *Id.*

previous police contacts, and prior police contacts while in the company of known Delhi gang members.<sup>31</sup>

On direct examination, the prosecutor asked the expert a lengthy hypothetical in which the expert was asked to assume the out-of-court statements from the STEP notice, FI card, and previous police contacts.<sup>32</sup> Based on these assumed out-of-court facts, the expert opined the defendant's conduct indicated that he was a member of the Delhi gang and committed the crime for the benefit the Delhi gang.<sup>33</sup>

On cross-examination, the expert admitted that he had never met defendant, was not present when defendant was given the STEP notice, and was not present during any of defendant's other police contacts.<sup>34</sup> Further, the expert stated that his knowledge of defendant's prior police contacts while in the company of known Delhi gang members were derived solely from police reports and FI cards prepared by other officers.<sup>35</sup>

The jury convicted defendant on all charges, including the gang enhancement charges.<sup>36</sup> The Court of Appeal reversed defendant's conviction for active gang participation, but otherwise

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<sup>31</sup> *Id.* at 325. The expert testified the defendant had received a STEP notice earlier in 2011, in which "the defendant indicate[d] to the police officer . . . that the defendant for four years had kicked it with the guys from Delhi," and that the defendant "got busted with two guys from Delhi." *Id.* The prosecutor questioned the expert about four other contacts that defendant had with police officers between 2007 and 2009. *Id.* The expert's testimony relayed detailed statements from police documents, including: (1) that on August 11, 2007, defendant's cousin, a known Delhi member, was shot while defendant stood next to him and that defendant grew up in the Delhi neighborhood; (2) that on December 30, 2007, defendant was with a documented Delhi member when that member was shot from a passing car by a rival gang member; (3) that on December 4, 2009, an officer contacted defendant in the company of a documented Delhi member and completed an FI card; and (4) that on December 9, 2009, defendant was arrested in a garage with two known Delhi members where police officers found a surveillance camera, Ziploc baggies, narcotics, and a firearm. *Id.* at 325.

<sup>32</sup> The hypothetical question was:

(1) a Delhi gang member, 'who's indicated to the police he kicks it with Delhi and has been contacted in a residence where narcotics and a firearm have been found in the past,' is contacted by police in Delhi territory on October 16, 2011; (2) that gang member 'grabbed something, and then grabs his waistband' as he runs up the stairs into an apartment; and (3) he runs into the bathroom and police later find a loaded firearm and drugs on a tar outside the bathroom window.

*Id.*

<sup>33</sup> The expert reasoned that the defendant was "willing to risk incarceration by possessing a firearm and narcotics for sale in the Delhi's turf," and that the defendant's conduct "created fear in the community redounding to Delhi's benefit." *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 326.

affirmed the criminal and other gang enhancement convictions.<sup>37</sup> The California Supreme Court granted review to clarify the proper application of California Evidence Code sections 801 and 802 regarding the scope of expert witnesses concerning case-specific hearsay content in explaining the opinion basis.<sup>38</sup>

## B. California Supreme Court Analysis and Holding

The defendant contended the expert's testimony detailing descriptions of defendant's past contacts with police officers was offered for its truth and, therefore, constituted hearsay.<sup>39</sup> The Attorney General claimed the statements made by the expert were not admitted for their truth, but rather to aid the jury in evaluating the expert's testimony, and therefore not hearsay.<sup>40</sup>

The California Supreme Court provided an in-depth discussion on hearsay, from its historical common law development to its modern status as it relates to expert basis testimony.<sup>41</sup> California Evidence Code section 1200 defines hearsay as "evidence of a statement that was made other than by a witness while testifying at the hearing and that is offered to prove the truth of the matter stated," and provides that hearsay is inadmissible unless it falls under an exception.<sup>42</sup> The Court noted that, as a matter of practicality, the hearsay rule has traditionally not barred an expert from testifying about general background knowledge in the expert's field of expertise, even if that expert's general knowledge comes from inadmissible hearsay evidence.<sup>43</sup> This is because "the common law recognized that experts frequently acquired their knowledge from hearsay," and "to reject . . . some facts to which [the expert] testifies are known to [them] only upon the authority of others would be to

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<sup>37</sup> *Id.* The reversal was based on precedent that established the substantive offense of active gang participation required the defendant commit an underlying felony with at least one other gang member. *Id.* at 326 n.5.

<sup>38</sup> *Id.* at 324. The court also granted review to consider the degree to which the *Crawford* rule, concerning the Confrontation Clause, limits an expert witness from relating case-specific hearsay content as the basis for the expert's opinion when the basis involves testimonial hearsay. *Id.*

<sup>39</sup> *Id.* at 326. The defendant further argued that admission of the expert's testimony violated the Confrontation Clause because the statements were testimonial hearsay. *Id.*

<sup>40</sup> *Id.* The Attorney General further contended that even if the expert's statements were admitted for their truth, the expert's statements were not testimonial and thus not in violation of the Confrontation Clause. *Id.*

<sup>41</sup> See generally *id.* at 326–30.

<sup>42</sup> *Id.* at 326. The Senate Committee comments to California Evidence Code section 1200 provide that a statement "offered for some purpose other than to prove the fact stated therein is not hearsay," and thus usually admissible. *Id.*

<sup>43</sup> *Id.* at 327.

ignore the accepted methods of professional work and to insist on impossible standards.”<sup>44</sup>

However, the court continued, “an expert has traditionally been precluded from relating *case-specific* facts about which the expert has no independent knowledge.”<sup>45</sup> Generally, parties establish the facts on which their case relies by calling witnesses who have personal knowledge of the case-specific facts.<sup>46</sup> Then, a party calls an expert witness to testify as to generalized background information to help the fact-finder understand the significance of the case-specific facts and to provide an opinion on what the case-specific facts might mean.<sup>47</sup>

The use of hypothetical questions also honors the common law distinction between general background information and case-specific facts because under “this technique, other witnesses suppl[y] admissible evidence of the facts, the attorney ask[s] the expert witness to hypothetically assume the truth of those facts, and the expert testifie[s] to an opinion based on the assumed facts.”<sup>48</sup> The common law strictly followed the rule that “[i]f no competent evidence of a case-specific fact has been, or will be, admitted, the expert cannot be asked to assume it.”<sup>49</sup>

The *Sanchez* court acknowledged that the modern treatment of an expert’s testimony as to general background information and case-specific hearsay has become “blurred.”<sup>50</sup> Recognizing the common law justifications<sup>51</sup> for exceptions to the general rule barring disclosure of and reliance on otherwise inadmissible case-specific hearsay—mainly practicality and judicial economy—the Legislature generalized these justifications in the enactment of

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<sup>44</sup> Ian Volek, Note, *Federal Rule of Evidence 703: The Back Door and the Confrontation Clause, Ten Years Later*, 80 *FORDHAM L. REV.* 959, 965 (2011) (quoting 1 JOHN HENRY WIGMORE, *A TREATISE ON THE ANGLO-AMERICAN SYSTEM OF EVIDENCE IN TRIALS AT COMMON LAW* § 665 (2d ed. 1923)); see also *Sanchez*, 374 P.3d at 327.

<sup>45</sup> *Id.* The court defines case-specific facts as “those relating to the particular events and participants alleged to have been involved in the case being tried.” *Sanchez*, 374 P.3d at 327.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 328 (quoting Edward J. Imwinkelried, *The Gordian Knot of the Treatment of Secondhand Facts Under Federal Rule of Evidence 703 Governing the Admissibility of Expert Opinions: Another Conflict Between Logic and Law*, 3 *U. DEN. CRIM. L. REV.* 1, 5 (2013)).

<sup>49</sup> *Id.* at 328.

<sup>50</sup> *Id.*

<sup>51</sup> These justifications included: (1) “the routine use of the same kinds of hearsay by experts in their conduct outside the court;” (2) “the experts’ experience, which included experience in evaluating the trustworthiness of such hearsay sources;” and (3) “the desire to avoid needlessly complicating the process of proof.” *Id.* at 329 (quoting *KAYE ET AL.*, *supra* note 18, at 155).



the California Evidence Code in 1965.<sup>52</sup> Under California Evidence Code sections 801(b)<sup>53</sup> and 802,<sup>54</sup> “reliability of the evidence is a key inquiry in whether expert testimony may be admitted.”<sup>55</sup> The rationale in allowing an expert to rely on information that is of a type generally relied upon by experts in that field is that it “assures the reliability and trustworthiness of the information used by experts in forming their opinions.”<sup>56</sup> Therefore, to explain his or her basis to a fact-finder, “an expert is entitled to explain to the jury the ‘matter’ upon which he [or she] relied, even if that matter would ordinarily be inadmissible.”<sup>57</sup>

Naturally, courts have grappled with how much substantive case-specific hearsay an expert may provide to the jury and how the jury may consider this evidence.<sup>58</sup> The California Supreme Court has long held that “an expert may not ‘under the guise of reasons [for an opinion] bring before the jury incompetent hearsay evidence.’”<sup>59</sup> In an attempt to resolve this problem, California has followed “a two-pronged approach to balancing ‘an expert’s need to consider extrajudicial matters, and a jury’s need for information sufficient to evaluate an expert opinion’ so as not to ‘conflict with an accused’s interest in avoiding substantive use of unreliable hearsay.’”<sup>60</sup>

The first prong involved the use of a limiting instruction to “cure” hearsay problems, whereby the judge instructed the jury that matters admitted through an expert should go only to the basis of the expert’s opinion and should not be considered for its truth.<sup>61</sup> The second prong was applicable in instances where a limiting instruction may not be enough to “cure” the hearsay

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<sup>52</sup> *Id.*

<sup>53</sup> California Evidence Code section 801(b) provides that an expert witness may render an opinion “[b]ased on matter (including his special knowledge, skill, experience, training, and education) perceived by or personally known to the witness or made known to him at or before the hearing, whether or not admissible, that is of a type that reasonably may be relied upon by an expert in forming an opinion upon the subject to which his testimony relates, unless an expert is precluded by law from using such matter as a basis for his opinion.” CAL. EVID. CODE § 801(b) (West 2016); *see also Sanchez*, 374 P.3d at 329.

<sup>54</sup> California Evidence Code section 802 states that an expert “may state on direct examination the reasons for his opinion and the matter (including, in the case of an expert, his special knowledge, skill, experience, training, and education) upon which it is based, unless he is precluded by law in using such reasons or matter as a basis for his opinion.” CAL. EVID. CODE § 802 (West 2016); *see also Sanchez*, 374 P.3d at 329.

<sup>55</sup> *Sanchez*, 374 P.3d at 329.

<sup>56</sup> *Id.* (quoting CAL. EVID. CODE § 801 (West 2016) (Law Revision Commission Cmt.)).

<sup>57</sup> *See Sanchez*, 374 P.3d at 329.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* (quoting *People v. Coleman*, 695 P.2d 189, 203 (1985)).

<sup>60</sup> *Sanchez*, 374 P.3d at 329 (quoting *People v. Montiel*, 855 P.2d 1277, 1299 (1993)).

<sup>61</sup> *Sanchez*, 374 P.3d at 329.

problems.<sup>62</sup> In this situation, the court would apply California Evidence Code section 352, the balancing test that allows the court to exclude from an expert's testimony any hearsay whose irrelevance, unreliability, or potential for prejudice outweighs the probative value of the expert's testimony.<sup>63</sup>

The court stated that, "under this paradigm, there was no longer a need to carefully distinguish between an expert's testimony regarding background information and case-specific facts" because "[t]he inquiry instead turned on whether the jury could properly follow the court's limiting instruction in light of the nature and amount of the out-of-court statements admitted."<sup>64</sup> The court "conclude[d] this paradigm is no longer tenable because an expert's testimony regarding the basis for an opinion *must* be considered for its truth by the jury."<sup>65</sup>

The *Sanchez* court acknowledged that other courts have avoided hearsay issues entirely by finding that statements related by experts are not hearsay because they are not admitted for their truth, but rather "go only to the basis of [the expert's] opinion."<sup>66</sup> However, the *Sanchez* court disagreed with this "not-for-truth" rationale, calling it a logical fallacy.<sup>67</sup> The court reasoned that "[w]hen an expert relies on hearsay to provide case-specific facts, considers the statements as true, and relates them to the jury as a reliable basis for the expert's opinion, it cannot logically be asserted that the hearsay content is not offered for its truth."<sup>68</sup> This is because "the validity of [the expert's] opinion ultimately turn[s] on the truth of . . . [the hearsay] statement . . . if the hearsay that the expert relies on and treats as true is not true," then "an important basis for the opinion is lacking."<sup>69</sup>

Further criticizing the "not-for-truth" rationale, the court noted that when an expert witness is not testifying in the form of a proper hypothetical question and evidence of the case-specific facts the expert is testifying to has not, and will not, be properly

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<sup>62</sup> *Id.*

<sup>63</sup> *See id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* at 329–30. While the court concluded the old paradigm is no longer tenable, the rationale the court provides suggests the old paradigm *was never tenable* to begin with. Thus, it is interesting to note that essentially nothing about the actual rule has changed, other than the courts implementation and opinion on how it should be applied and policed in practice.

<sup>66</sup> *Id.* at 330 (quoting *People v. Montiel*, 855 P.2d 1277, 1299 (1993)).

<sup>67</sup> *Sanchez*, 374 P.3d at 332.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* (citing *Williams v. Illinois*, 132 S. Ct. 2221, 2258 (2012) (Thomas, J., concurring)) (emphasis removed).

admitted independent of the expert's testimony, "there is no denying that such facts are being considered by the expert, and offered to the jury, as true."<sup>70</sup> In this case, the jury was instructed that they "must decide whether information on which the expert relied was true and accurate,"<sup>71</sup> while at the same time instructed that "the gang expert's testimony concerning 'the statements by the defendant, police reports, F.I. cards, STEP notices, and speaking to other officers or gang members'" should not be considered for their truth.<sup>72</sup>

The court opined that "[j]urors cannot logically follow these conflicting instructions" because the jury "cannot decide whether the information relied on by the expert 'was true and accurate' without [first] considering whether the specific evidence identified by the instruction, and upon which the expert based his opinion, was also true."<sup>73</sup> To admit the case-specific basis testimony as nonhearsay, presented solely to aid the jury in evaluating the expert's testimony, would be "to ignore the reality that jury evaluation of the expert requires a direct assessment of the truth of the expert's basis."<sup>74</sup>

The California Supreme Court's ruling<sup>75</sup> restores the traditional common law distinction between an expert witness's testimony regarding general background information and case-specific facts: "When any expert relates to the jury case-specific out-of-court statements, and treats the content of those statements as true and accurate to support the expert's opinion, the statements are hearsay. It cannot logically be maintained that the statements are not being admitted for their truth."<sup>76</sup>

The court expressly disapproved of its prior decisions that held: (1) an expert's basis testimony is not offered for its truth; (2) a limiting instruction coupled with the court balancing the prejudicial effect versus probative value sufficiently addresses hearsay issues; and (3) an expert may testify to

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<sup>70</sup> *Sanchez*, 374 P.3d at 333.

<sup>71</sup> *Id.* (quoting Judicial Counsel of California Criminal Jury Instruction § 332 (Oct. 2017)).

<sup>72</sup> *Sanchez*, 374 P.3d at 333 (quoting jury instructions used at trial).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* (quoting KAYE ET AL., *supra* note 18, at 179–80).

<sup>75</sup> The California Supreme Court made clear the ruling in *Sanchez* does not change the basic understanding of the definition of hearsay. See *Sanchez*, 374 P.3d at 326.

<sup>76</sup> *Id.* at 334. The court's rule also went on to state that in the context of criminal cases, "[i]f the case is one in which a prosecution expert seeks to relate testimonial hearsay, there is a Confrontation Clause violation unless (1) there is a showing of unavailability and (2) the defendant had a prior opportunity for cross-examination, or forfeited that right by wrongdoing." *Id.* at 334–35.

case-specific out-of-court statements when no applicable hearsay exception applies.<sup>77</sup>

The court summarized what an expert can do and what an expert cannot do in light of its ruling in *Sanchez*. An expert witness can “still *rely* on hearsay in forming an opinion” and can tell the jury “in general terms” that he or she did so by “relat[ing] generally the kind and source of the ‘matter’ upon which his [or her] opinion rests.”<sup>78</sup> What an expert cannot do, the court explained, is relate case-specific facts asserted in hearsay basis statements as true, unless those case-specific facts are proven independently by competent evidence or are covered by an applicable hearsay exception.<sup>79</sup>

The California Supreme Court concluded the admission of the gang expert’s hearsay testimony relating the case-specific statements concerning the defendant’s gang affiliations were not harmless beyond a reasonable doubt.<sup>80</sup> Accordingly, the court reversed the findings on the defendant’s criminal street gang enhancements.<sup>81</sup>

## II. APPLICATION OF *SANCHEZ* BEYOND THE SCOPE OF THE CRIMINAL GANG CONTEXT

While *Sanchez* dealt with criminal gang enhancements, and thus addressed Confrontation Clause concerns, the court’s ruling on the proper application of the hearsay rule as it relates to case-specific out-of-court statements offered as expert basis testimony applies equally to other criminal, as well as civil, contexts.<sup>82</sup> Section A discusses the extension of the *Sanchez* rule to other criminal contexts in California, including drug possession cases and Mentally Disordered Offenders (“MDO”) and Sexually Violent Predator (“SVP”) proceedings. Section A also looks at how other states apply the hearsay rule to case-specific out-of-court statements offered as expert basis testimony in these criminal

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<sup>77</sup> *See id.* at 334 n.13.

<sup>78</sup> *Id.* at 334.

<sup>79</sup> *Id.* For example, the court stated the length of a skid mark measured at an accident scene is a case-specific fact, while how skid marks are left on the pavement and the fact that the speed of the vehicle can be estimated based on the skid mark is general background information. *Id.* at 328. A witness who measured the skid mark at the accident scene could establish this case-specific fact. *Id.* The proper subject of an expert’s opinion in this situation could include that the car that left the skid mark had been traveling at about eighty miles an hour when the brakes were applied. *Id.*

<sup>80</sup> *Id.* at 344. The court further held the police reports and STEP notice the expert relied upon in describing the basis of his opinion recited testimonial hearsay, and thus violated the Confrontation Clause. *See id.* at 340–44. The court held the FI card may be testimonial, but did not rule definitively on the issue. *See id.* at 342–44.

<sup>81</sup> *Id.* at 344.

<sup>82</sup> *See infra* Sections II(A) and II(B).

contexts. Section B explores how the *Sanchez* rule will likely affect civil cases in California, including product and strict liability, negligence, medical malpractice, personal injury, and valuation cases. Section B also discusses how other states apply the hearsay rule to case-specific out-of-court statements offered as expert basis testimony in these civil contexts. This Part also urges other states to adopt a *Sanchez*-like rule in determining the admissibility and scope of expert basis testimony.

#### A. Other Criminal Contexts

California courts have applied the *Sanchez* rule in criminal cases outside of the gang enhancement context, namely in drug possession cases and MDO and SVP proceedings.<sup>83</sup> Other states, however, have not applied a restrictive *Sanchez*-like approach to the scope of expert basis testimony relating inadmissible hearsay in these criminal contexts, but should adopt a *Sanchez*-like rule.<sup>84</sup>

##### 1. Drug Possession

In a criminal context, the *Sanchez* ruling will have a sizeable impact on drug possession cases. In a case decided shortly after *Sanchez*, *People v. Stamps*,<sup>85</sup> a California Appellate Court extrapolated the hearsay rule in *Sanchez* and applied it to a criminal drug possession case. In *Stamps*, the defendant, who was convicted of multiple drug possession offenses, argued on appeal the trial court improperly admitted the case-specific hearsay testimony of a criminalist expert witness.<sup>86</sup> At trial, the expert testified that her identification of the drugs in pill form was based solely on a visual comparison of the shape, color, and markings of the seized pills to those on a website called “Ident-A-Drug.”<sup>87</sup> The defendant argued the expert should not have been allowed to testify as to the case-specific contents of the Ident-A-Drug website because the expert’s testimony was inadmissible hearsay the jury considered for its truth and used as direct evidence of the charged offenses.<sup>88</sup>

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<sup>83</sup> See *infra* Sections II(A)(1) and II(A)(2).

<sup>84</sup> See *infra* Sections II(A)(1) and II(A)(2).

<sup>85</sup> 207 Cal. Rptr. 3d 828 (Ct. App. 2016).

<sup>86</sup> *Id.* at 829.

<sup>87</sup> *Id.* at 830–31. The Ident-A-Drug website allows a user to enter the color, shape, markings, class, brand, or other descriptions on a pill in order to identify what substance the pill is likely to contain. See Therapeutic Research Center, IDENT-A-DRUG REFERENCE (Oct. 21, 2017, 7:56 PM), <http://identadrug.therapeuticresearch.com/home> [<http://perma.cc/GR5Q-P5AN>].

<sup>88</sup> *Stamps*, 207 Cal. Rptr. 3d at 830.

The court discussed *Sanchez* in depth and held that “[i]t is [the] non-*Crawford* aspect of *Sanchez* that comes into play [in this case].”<sup>89</sup> The court stated, “[a]fter *Sanchez*, reliability is no longer the sole touchstone of admissibility where expert testimony to hearsay is at issue” and, as such, “[i]ncorporated within the *Sanchez* rule is . . . a new litmus test . . . [that] depends on whether the matter the prosecution seeks to elicit is ‘case-specific hearsay’ or . . . part of the [expert’s] ‘general background information.’”<sup>90</sup>

Applying *Sanchez*, the court reversed the defendant’s conviction of possession of the drugs in pill form.<sup>91</sup> The contents of the Ident-A-Drug website could not be independently admissible because the statements were hearsay,<sup>92</sup> and the prosecution failed to offer any hearsay exception that would render the website statements admissible.<sup>93</sup> Further, the court concluded the Ident-A-Drug hearsay statements were “admitted as proof of the very gravamen of the crime with which [the defendant] was charged,” and clearly were case-specific facts, rendering the expert’s basis testimony inadmissible under *Sanchez*.<sup>94</sup>

The factual circumstances in *Stamps* are by no means a one-time occurrence. In the 2014 California case, *People v. Logan*, the court was faced with a set of facts nearly identical to those in *Stamps*.<sup>95</sup> In *Logan*, however, the California Appellate Court reached the opposite conclusion on the admissibility of the

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<sup>89</sup> *Id.* at 833 n.5 (stating “[t]he *Crawford* line of cases has no direct application here because the challenged hearsay was not testimonial”).

<sup>90</sup> *Id.* at 833–34.

<sup>91</sup> *Id.* at 836. In determining its reversal, the court also went through a harmless error analysis. The court determined the expert’s Ident-A-Drug website testimony was the only evidence that the pills indeed contained the drugs charged, and therefore could not be dismissed as “carrying little weight with the jury or being duplicative of other evidence.” *Id.* at 835. As an aside, the court affirmed the possession conviction of the drugs in crystalline form because the prosecution proved the chemical composition of the crystalline drugs through the expert witness, who performed a detailed chemical analysis on the crystalline drugs, and thus there was no *Sanchez* violation with respect to this evidence. *Id.* at 830.

<sup>92</sup> *Id.* at 834 n.6 (stating that, based on the expert’s testimony, the Ident-A-Drug website “provided photographs of the pills, together with sufficient text to communicate that the photograph depicted a specified pharmaceutical,” thus “this combined content . . . constitute[d] an out-of-court ‘statement’ of a ‘person’ (the person who entered the information on the Web site) so as to bring it within the definition of hearsay” under California evidence law).

<sup>93</sup> *Id.* at 834–35.

<sup>94</sup> *Id.* at 835.

<sup>95</sup> *People v. Logan*, No. A137403, 2014 WL 971444, at \*1 (Cal. Ct. App. Mar. 13, 2014). In *Logan*, the defendant, like in *Stamps*, was charged with possession of drugs in both crystalline and pill form, and the expert ran a chemical analysis only on the drugs in crystalline form. *Id.* As for identifying the drugs in pill form, the expert visually identified the pills by entering the color, shape, and markings of the pills on the Ident-A-Drug website. *Id.*

expert's testimony regarding the Ident-A-Drug hearsay contents.<sup>96</sup> Instead, the court's Ident-A-Drug testimony analysis focused on reliability of the website's contents as being the "preliminary fact[or]" of admissibility.<sup>97</sup> The *Logan* court opined the Ident-A-Drug hearsay statements were admissible because the website constituted a material that was "of the type reasonably relied upon by experts in [the expert's] field," and any challenge as to whether the expert's identification of the pills was faulty went "to the weight of [the expert's] testimony, not its admissibility."<sup>98</sup>

If *Logan*, or a factually similar case, was presented to a California court post-*Sanchez*, the *Sanchez* (and *Stamps*) rulings indicate the prosecutor would not be able to get the website contents before the jury unless the prosecutor called another witness to properly authenticate and admit the evidence, or it fell within an applicable hearsay exception. However, proper independent admission in most cases is unlikely given the anonymity of many Internet sources and courts' general skepticism towards the reliability of Internet sources.<sup>99</sup>

Other states, such as Arizona, Louisiana, Texas, Ohio, and Washington, have been generally consistent in allowing experts to testify to case-specific hearsay contents in the context of drug identification cases.<sup>100</sup> In criminal drug possession cases, states

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<sup>96</sup> *Id.* at \*4–5.

<sup>97</sup> *Id.* at \*3. The court determined that even though the expert did not know the particular details about the Ident-A-Drug website (e.g., the website author, who maintained the website, how often it was updated), it did not mean that the website contents were "speculative, conjectural, or lacking a reasonable basis." *Id.* at \*4.

<sup>98</sup> *Id.* It should be noted the court determined that the admissions hearsay exception would, in this particular case, render the expert's testimony regarding the Ident-A-Drug website contents admissible even if the court determined the trial court erred in allowing the testimony. *Id.* (stating the defendant himself admitted to the same evidence offered by the expert). However, what is significant is that the court found that disclosing the otherwise inadmissible hearsay basis was allowed, regardless of whether such evidence was properly independently supplied or whether an applicable hearsay exception was present. *Id.*

<sup>99</sup> See *People v. Stamps*, 207 Cal. Rptr. 3d 828, 834–35 (Ct. App. 2016) (stating that courts continue to view the Internet "warily and wearily" as a catalyst for "rumor, innuendo, and misinformation" because "[t]he Internet 'provides no way of verifying the authenticity' of its contents"). The court went on to state, websites are unreliable because "[a]nyone can put anything on the Internet," websites are not "monitored for accuracy and nothing contained therein is under oath," and "hackers can adulterate the content." *Id.*

<sup>100</sup> See, e.g., *Pineda v. State*, No. 13-13-00574-CR, 2015 WL 5311237, at \*4–5 (Tex. Ct. App. Sept. 10, 2015) (where the expert testified as to the chemical composition and weight of the seized pills based solely on a visual comparison on "Drugs.com"); *State v. Murphy*, 28 So.3d 496, 499 (La. Ct. App. 2009) (where the expert testified as to the identification of the seized pills solely by a visual examination and comparison of the pills' characteristics with a website called "Just Drug Identification"); *State v. Garnett*, No. 12CA0099-M, 2013 WL 6021467, at \*2 (Ohio Ct. App. Nov. 12, 2013) (where the expert testified as to the identification of the seized pills based solely on her use of the Ident-A-Drug database, instead of testing the milligram composition of the pills); *State v. Sandoval*, No. 1CA-

should follow the restrictive *Sanchez* (and *Stamps*) approach to determine the admissibility of expert basis testimony when case-specific hearsay is at issue.<sup>101</sup> Even putting aside issues related to unreliability of anonymous Internet sources, the admission of this kind of case-specific hearsay presents problems. As the *Stamps* court recognized, no special expertise is required to enter the characteristics of a pill onto a website and interpret the results provided by the website; so in instances such as this, the expert's testimony "[does] not reveal any special expertise . . . beyond ordinary visual acuity . . . so as to make it an integral part of some larger opinion."<sup>102</sup> By presenting hearsay evidence solely through the expert, the court is "allow[ing] [the expert] to place case-specific non-expert opinion before the jury, with the near certainty that the jury [will] rely on the underlying hearsay as direct proof of the chemical composition of the pills."<sup>103</sup> In this type of factual circumstance, the expert is the only source of the identification evidence presented to the jury; the expert unavoidably becomes a "mere conduit" for the hearsay contents.<sup>104</sup> Absent the expert testimony proffering the case-specific hearsay to the jury, these convictions likely would not stand.<sup>105</sup> Therefore, other states

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CR14-0242, 2015 WL 1035236, at \*6 (Ariz. Ct. App. Mar. 10, 2015) (where the expert testified as to the identification of the seized pills based solely on the use of a website that law enforcement used to gather information about drugs and by a conversation with a non-testifying pharmacist at Walgreens); *State v. Carter*, 981 So.2d 734, 744 (La. Ct. App. 2008) (where the expert testified as to the identification of the seized pills based solely on a visual inspection and comparison of the pill's characteristics with a book); *State v. White*, No. 24174-2-III, 2006 WL 1778096, at \*3-4 (Wash. Ct. App. June 29, 2006) (where the expert testified as to the identification of a seized pill capsule based solely on a conversation, in which the expert described the pill's characteristics and logo, with a non-testifying poison control center employee).

<sup>101</sup> Note, I am not proposing that a chemical analysis must be conducted in order for there to be a conviction. Many states, including California, have explicitly held that a defendant may be convicted of drug possession without a chemical analysis of the drugs. *See, e.g.*, *People v. Camp*, 163 Cal. Rptr. 510, 512 (Ct. App. 1980) (stating the court does not know of any case precedent that holds a chemical analysis of a substance is required for a possession conviction); *People v. Sonleitner*, 228 Cal. Rptr. 96, 99 (Ct. App. 1986) (holding that the fact the prosecution did not conduct a chemical analysis on the substance did not warrant a reversal of defendant's conviction because "the nature of a substance, like any other fact in a criminal case, may be proved by circumstantial evidence"); *White*, 2006 WL 1778096, at \*3 ("A chemical analysis of a suspected controlled substance is not essential to a conviction in a criminal trial proceeding . . ."); *Carter*, 981 So.2d at 745 ("An expert may identify a controlled substance without chemical analysis.") (quoting *Sterling v. State*, 791 S.W.2d 274, 277 (Tex. Crim. App. 1990)).

<sup>102</sup> *Stamps*, 207 Cal. Rptr. 3d at 831 n.2.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> *See id.* at 998 ("We conclude it is reasonably probable the jury would have acquitted [the defendant] of the charges based on pill possession in the absence of the Ident-A-Drug testimony."). For other state courts which have concluded similarly, *see, e.g.*, *People v. Hard*, 342 P.3d 572, 579 (Colo. App. 2014), which found the admission of the expert's testimony regarding visual identification of the pills via "Drugs.com" was not



should follow California's *Sanchez* hearsay rule in drug possession cases to uphold the intent of the rule against hearsay and curb convictions resulting largely based on inadmissible, unsubstantiated, and unreliable hearsay.<sup>106</sup>

## 2. Mentally Disordered Offenders and Sexually Violent Predator Proceedings

Another criminal context<sup>107</sup> the *Sanchez* ruling will have a large impact on is MDO<sup>108</sup> and SVP<sup>109</sup> proceedings. In MDO and SVP cases, defendants convicted of serious crimes meeting statutory requirements face civil commitment, and prosecution experts are called to opine on defendants' mental status and

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harmless because the expert's "testimony . . . was the only evidence presented at trial to identify some of the pills" and thus the court could not "say with fair assurance that the erroneous admission of [the expert's] testimony did not substantially influence the verdicts in this case."

<sup>106</sup> Many legal scholars agree the reason for the rule against hearsay is that hearsay is untested by cross-examination, and that prohibiting hearsay assists the fact-finder in ascertaining an accurate picture of the truth. See Christopher B. Mueller, *Post-Modern Hearsay Reform: The Importance of Complexity*, 76 MINN. L. REV. 367, 381–82 (1992); Michael L. Seigel, *Rationalizing Hearsay: A Proposal for a Best Evidence Hearsay Rule*, 72 B.U. L. REV. 893, 898 (1992).

<sup>107</sup> While Mentally Disordered Offenders ("MDO") and Sexually Violent Predators ("SVP") proceedings are technically civil proceedings (because they determine whether a defendant is to be civilly committed), I am discussing them in the criminal context section because the proceedings are criminal in nature, since the MDO and SVP defendants are afforded many of the same procedural protections afforded to criminal defendants (e.g., the right to court-appointed counsel and experts, the right to a unanimous jury verdict, the right to testify in one's defense, and the right to have the prosecution prove the SVP or MDO status beyond a reasonable doubt), and the adjudication of MDO or SVP status is related to the defendant's criminal convictions. See *Moore v. Super. Ct.*, 237 P.3d 530, 538 (Cal. 2010). While this Comment focuses only on the hearsay implications of *Sanchez*, not the Confrontation Clause issues, it is still important to note that because MDO and SVP proceedings are considered civil proceedings, there is no right to confrontation under the state and federal Confrontation Clause in MDO and SVP trials, only a right under the due process clause measured by the standard applicable to civil proceedings is due to an MDO or SVP defendant. See *People v. Nelson*, 147 Cal. Rptr. 3d 183, 194 (Ct. App. 2012) (citing *People v. Otto*, 26 P.3d 1061, 1069 (Cal. 2001)).

<sup>108</sup> The MDO Act, enacted in 1985 (codified in CAL. PENAL CODE §§ 2960–81 (2017) and regulated in CAL. PENAL CODE §§ 2570–80 (West 2017)) "requires that offenders who have been convicted of violent crimes related to their mental disorders, and who continue to pose a danger to society, receive mental health treatment during and after the termination of their parole until their mental disorder can be kept in remission." *In re Qawi*, 81 P.3d 224, 227 (Cal. 2004) (finding the purpose of the MDO Act is to treat the MDO, while also protecting the general public from the danger posed by the MDO).

<sup>109</sup> The SVP Act (codified in CAL. WELF. & INST. CODE §§ 6600–09 (West 2017)) "targets a select group of convicted sex offenders whose mental disorders predispose them to commit sexually violent acts if released following punishment for their crimes" and "confines and treats such persons until their dangerous disorders recede and they no longer pose a societal threat." *Moore*, 237 P.3d at 536–37 (finding the SVP Act applies only to the "most dangerous offenders" who have been convicted of an enumerated sexually violent offense against two or more victims, and who has a diagnosed mental disorder that poses a danger to society of reoffending).

likelihood of reoffending if released.<sup>110</sup> Often times, the experts are not the defendants' treating doctors, and thus the experts' testimonies rely entirely on the hearsay statements of treatment personnel and law enforcement.<sup>111</sup> California Appellate Courts have applied the *Sanchez* rule to both MDO<sup>112</sup> and SVP cases.

In the post-*Sanchez* California Appellate Court case *People v. Burroughs*, the defendant appealed a jury verdict adjudicating him an SVP, arguing the court violated the *Sanchez* rule by allowing the prosecution's experts to testify to a large amount of case-specific hearsay.<sup>113</sup> The case-specific hearsay facts the defendant challenged included details about the defendant's uncharged sex offenses and details about the defendant's behavior while in state custody, which were gleaned from documents, such as police reports, probation reports, and hospital records.<sup>114</sup>

The court, applying *Sanchez*, determined that much of the case-specific facts testified to by the experts were hearsay and not independently admitted at trial, nor did they fall within a hearsay exception.<sup>115</sup> The details of the reports, testified to by the experts, were the only sources in the record that included the details about defendant's uncharged offenses.<sup>116</sup> Moreover, the experts' testimony regarding the defendant's uncharged offenses was described in "lurid detail" and was "exceedingly inflammatory."<sup>117</sup>

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<sup>110</sup> See, e.g., Deirdre M. Smith, *Dangerous Diagnoses, Risky Assumption, and the Failed Experiment of "Sexually Violent Predator" Commitment*, 67 OKLA. L. REV. 619, 623 (2015) (stating that "trial courts permit prosecution experts to offer diagnoses and predictions of risk" to support the experts' opinions on whether to civilly commit defendants).

<sup>111</sup> *Id.* at 696–97 ("[E]xperts testif[y] as to their diagnostic opinions of [defendant] and their assessments of . . . volitional impairment solely on the basis of information compiled and furnished to them by government attorneys without ever having examined the [defendant]. . . . Government experts, in such cases, typically review criminal investigation reports and alleged victims' statements (including information that would be inadmissible in a criminal proceeding) and utilize these accounts of conduct to identify 'symptoms.'").

<sup>112</sup> See, e.g., *People v. Belin*, No. E064815, 2017 WL 944210, at \*10–11 (Cal. Ct. App. Mar. 10, 2017). The court applied the *Sanchez* rule in a MDO case, but found a reversal was not warranted because the expert was the defendant's treating psychiatrist, and consequently much of the expert's basis testimony was based on the expert's own personal knowledge. *Id.* The small amount of case-specific hearsay facts testified to by the expert was inconsequential because defendant confirmed such facts during the defendant's own testimony. *Id.*

<sup>113</sup> *People v. Burroughs*, 6 Cal. Rptr. 3d 656, 660, 677 (Ct. App. 2016).

<sup>114</sup> *Id.* at 677, 680. The trial court allowed extensive testimony on these subjects on the ground that the content formed the basis of the experts' opinions, and gave a limiting instruction that the jury consider the content for that limited purpose only. *Id.* at 678.

<sup>115</sup> *Id.* at 684.

<sup>116</sup> *Id.* at 682.

<sup>117</sup> The expert's hearsay testimony described in detail numerous sex offenses that defendant was not charged with or convicted of, including the repeated sodomy of a young boy and the use of a knife to penetrate a woman. *Id.* at 684. The expert's hearsay

Thus, the court found the “improperly admitted hearsay permeated the entirety of [the defendant’s] trial and strengthened crucial aspects of the [prosecution’s] case.”<sup>118</sup> Because the admission of the experts’ case-specific hearsay testimony violated the *Sanchez* rule, and the court determined the admission was not harmless error, the court reversed defendant’s SVP commitment.<sup>119</sup>

Pre-*Sanchez*, California courts in MDO and SVP proceedings have disagreed on the admissibility of expert basis testimony that is hearsay. Interestingly, regardless of the courts’ determination on this hearsay issue, the case-specific testimony still found its way to the jury one way or another. Courts that determined the testimony was admissible did so based on the “not-for-truth” rationale, i.e., the testimony is not hearsay because it is not coming in for the truth, but rather to evaluate the expert’s credibility.<sup>120</sup> On the contrary, courts that determined the testimony was hearsay nevertheless admitted the testimony, so long as it was followed by a limiting instruction to the jury.<sup>121</sup> Neither of these outcomes are tenable post-*Sanchez*.<sup>122</sup>

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testimony also provided that defendant was a gang member and described bizarre and “lethal” behavior that defendant allegedly engaged in while in custody. *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* (holding there was a reasonable probability the jury would not have committed defendant as a SVP but for the hearsay evidence).

<sup>120</sup> *See, e.g.*, *People v. Welch*, No. H035567, 2012 WL 1107925, at \*7 (Cal. Ct. App. Apr. 3, 2012) (allowing the expert in a SVP trial to testify as to the “hearsay” statements because the court determined the statements were not hearsay, as they were “not offered for the truth of the matters asserted but instead for the *nonhearsay* purpose of explaining the bases for the expert’s opinions”).

<sup>121</sup> *See, e.g.*, *People v. Dean*, 94 Cal. Rptr. 3d 478, 486–90 (Ct. App. 2009) (allowing expert basis testimony in SVP trial disclosing details of defendant’s hospital and institutional records because such testimony was coupled with multiple limiting instructions to the jury to consider the testimony only for the limited purpose of assessing the expert’s credibility).

<sup>122</sup> *See supra* note 77 and accompanying text. While outside the scope of this Comment, it is interesting to note that it remains unclear whether the *Sanchez* rule will affect MDO and SVP trials (or any trials for that matter) when the proceeding is a bench trial, rather than a jury trial. The analysis in *Sanchez*, in criticizing the “not-for-truth” rationale, focuses heavily on the issue that juries cannot logically follow the conflicting instructions given to them (i.e., the jury must decide whether the information relied on by the expert was true and accurate, while, at the same time, not considering the evidence for its truth). *See supra* Section I(B). However, California courts have contemplated the idea that courts (judges) are able to correctly reconcile the conflicting ideas, and consider the expert’s hearsay testimony solely for the purpose of assessing the expert’s credibility. For example, in *People v. Martin*, 127 26 Cal. Rptr. 3d 174, 179–80 (Ct. App. 2005), a MDO bench trial, the court allowed expert testimony reciting hearsay statements from probation reports that were not independently admissible. The court stated that, because this proceeding was tried before the court and not a jury, “[w]e must assume . . . the court . . . considered the testimony . . . solely for the proper purpose of assessing the experts’ credibility, and not as independent proof of the facts contained therein.” *Id.* at 180. Based on this logic, one could argue the *Sanchez* rule does not apply to bench trials.

Other states that have MDO and SVP proceedings or similar proceedings, such as Illinois, Pennsylvania, South Carolina, Texas, and Washington, have somewhat consistently allowed experts to testify to the details of the hearsay contents forming the basis of the expert's opinion.<sup>123</sup> The impact of the *Sanchez* ruling is likely to be highly pertinent in MDO and SVP cases because, in many instances, expert opinion is the only evidence supporting commitment presented by the prosecution.<sup>124</sup> MDO and SVP trials generally make liberal use of hearsay evidence embedded in expert testimony, and thus allow extrinsic hearsay evidence to be introduced to the fact-finder.<sup>125</sup> The evidence is also often highly prejudicial because the prosecution experts, who are proffering opinions on the ultimate issue (i.e., whether the individual is dangerous and at risk of reoffending), relate hearsay details gleaned from, inter alia, institutional records, criminal reports, and conversations with treatment professionals that are graphic in nature.<sup>126</sup> Allowing experts to relate inflammatory

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<sup>123</sup> See, e.g., *People v. Swanson*, 780 N.E.2d 342, 350 (Ill. App. Ct. 2002) (stating expert testimony recounting details from reports in an SVP trial are admissible because “[a]lthough reports made by others are not substantively admissible, an expert is nonetheless allowed to reveal the contents of the materials upon which the expert has reasonably relied to explain the basis of his or her opinion”); *Commonwealth v. Miller*, No. 702-WDA-2016, 2017 WL 908315, at \*3 (Pa. Super. Ct. 2017) (allowing the expert to testify as to hearsay details on the grounds that the hearsay content was not being offered for its truth, but rather to show what information the expert relied upon in forming her opinion); *In re Manigo*, 697 S.E.2d 629, 633–34 (S.C. Ct. App. 2010) (holding the expert in a SVP trial could testify as to the details of the expert's conversation with the defendant's non-testifying treatment provider, even though it was hearsay, because the testimony went to the basis of the expert's opinion); *In re Commitment of Stuteville*, 463 S.W.3d 543, 554–56 (Tex. Ct. App. 2015) (allowing the expert to testify as to the hearsay details of defendant's past uncharged offenses from inadmissible reports to explain the basis of the expert's opinion because a limiting instruction was given to the jury); *In re Detention of Leck*, 334 P.3d 1109, 1119–20 (Wash. Ct. App. 2014) (allowing the expert to relate hearsay details from a report because the report contents were used as part of the basis of the expert's opinion and a limiting instruction was given to the jury).

<sup>124</sup> See Heather E. Cucolo & Michael L. Perlin, “*Far from the Turbulent Space*”: *Considering the Adequacy of Counsel in the Representation of Individuals Accused of Being Sexually Violent Predators*, 18 U. PA. J.L. & SOC. CHANGE 125, 142 (2015); see also *People v. Ward*, 83 Cal. Rptr. 2d 828, 832 (Ct. App. 1999) (“In civil commitment cases, where the trier of fact is required by statute to determine whether a person is . . . likely to be dangerous, expert prediction may be the only evidence available.”).

<sup>125</sup> See Eric S. Janus, *Closing Pandora's Box: Sexual Predators and the Politics of Sexual Abuse*, 34 SETON HALL L. REV. 1233, 1234 (2004); John L. Schwab, *Due Process and “The Worst of the Worst”: Mental Competence in Sexually Violent Predator Civil Commitment Proceedings*, 112 COLUM. L. REV. 912, 914 (2012).

<sup>126</sup> See, e.g., *People v. Burroughs*, 211 Cal. Rptr. 3d 656, 684 (Ct. App. 2016) (where the expert's basis testimony disclosed details of defendant's uncharged offenses, “in lurid detail” including “the repeated sodomy of a young boy and the use of a knife to penetrate a woman”); *In re Commitment of Stuteville*, 463 S.W.3d at 547–48 (where the expert's basis testimony disclosed victim statements from uncharged offenses, including those from defendant's own teenage daughter, who stated “her father had masturbated in front of her, and made her sit naked while he fondled her breasts and genitals”); see also Smith, *supra* note 110, at 696–700 (stating that victim statements in criminal reports and

hearsay details concerning, for example, a defendant's uncharged sex offenses or lewd behavior while in custody, tempts the fact-finder to commit the defendant just to punish past wrongdoings.<sup>127</sup> Significantly, MDO and SVP civil commitment trials implicate liberty interests; the trials are not limited by double jeopardy and ex post facto protections, meaning liberal admission of hearsay contents have serious consequences for defendants.<sup>128</sup> To ensure the liberty interests of defendants are protected, other states should follow a restrictive *Sanchez*-like approach to policing the scope of expert basis testimony in MDO and SVP proceedings.

### B. Civil Contexts

The *Sanchez* hearsay ruling is equally applicable in civil contexts.<sup>129</sup> In *Sanchez*, the court noted that it intended to “clarify the proper application of Evidence Code sections 801 and 802, relating to the scope of expert testimony.”<sup>130</sup> California Evidence Code sections 801 and 802 govern the admission of expert testimony in both criminal and civil cases.<sup>131</sup> Nothing in the *Sanchez* opinion indicates the court intended to limit its ruling regarding expert basis testimony to criminal cases only.<sup>132</sup>

In regards to California civil cases, the *Sanchez* ruling likely will not have as extensive of an impact as it expectedly will in criminal cases. This is because California courts have already

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reports of uncharged crimes are often used by experts). Also, experts often do not examine the defendant themselves because the defendant may refuse to be examined. *Id.* at 696.

<sup>127</sup> See *Burroughs*, 211 Cal. Rptr. 3d at 684 (stating the evidence testified to by the expert was “exceedingly inflammatory” because it “depicted [defendant] as someone with an irrepressible propensity to commit sexual offenses, and invited the jury to punish him for past offenses”).

<sup>128</sup> MDO offenders are committed for one-year periods and thereafter can be released unless the prosecution petitions for recommitment and, each time, proves beyond a reasonable doubt the offender should be recommitted for another year. See *Lopez v. Super. Ct.*, 239 P.3d 1228, 1233 (Cal. 2010). SVP offenders are committed for an indefinite period of time, with annual examinations to determine whether the SVP status qualifications continue to be met (subject to continued/recommitment hearings). See CAL. WELF. & INST. CODE §§ 6604, 6604.1, 6605 (West 2017); see also *People v. McKee*, 223 P.3d 566, 570–72 (Cal. 2010). “In particular, individuals designated as SVPs are rarely released ‘and placement within SVP programs typically amounts to a [life] sentence.’” Schwab, *supra* note 125, at 914 (quoting Corey R. Yung, *The Emerging Criminal War on Sex Offenders*, 45 HARV. C.R.-C.L. L. REV. 435, 448 (2010)).

<sup>129</sup> The *Sanchez* ruling related to the Confrontation Clause will not apply in civil contexts because it is based on the state and federal right to confrontation, which only applies to criminal defendants and has not been extended to civil cases. See *People v. Otto*, 26 P.3d 1061, 1070 (Cal. 2001).

<sup>130</sup> *People v. Sanchez*, 374 P.3d 320, 324 (Cal. 2016).

<sup>131</sup> See CAL. EVID. CODE § 300 (West 2017) (“[T]his code applies in every action before the Supreme Court or a court of appeal or superior court . . .”).

<sup>132</sup> See *Burroughs*, 211 Cal. Rptr. 3d at 678 n.6.

been following a *Sanchez*-like rule in many civil contexts<sup>133</sup> based on the holding in *Continental Airlines, Inc. v. McDonnell Douglas Corp.*<sup>134</sup> In *Continental Airlines*, the expert, an aircraft repair estimator, was to testify about the costs of repair for an airplane that had been severely damaged in a landing accident.<sup>135</sup> The expert did not prepare the cost-analysis report he relied upon in forming his opinion, but rather two of his employees actually gathered and compiled the specific information into the report.<sup>136</sup> The court did not allow the expert to testify as to the specific contents of the employees' report.<sup>137</sup>

The *Continental Airlines* court recognized the distinction between allowing "an expert [to] state on direct examination the matters on which he relied in forming his opinion," while at the same time, not allowing an expert to "testify as to the details of such matters if they [were] otherwise inadmissible."<sup>138</sup> The court relied on the rationale that an expert "may not under the guise of reasons bring before the jury incompetent hearsay evidence."<sup>139</sup> Further, the court stated that an expert "may not relate an out-of-court opinion by another expert as independent proof of fact."<sup>140</sup>

While the court in *Continental Airlines* did not touch on the distinction between general background information and case-specific facts, the hearsay analysis is effectively the same as in *Sanchez*.<sup>141</sup> California courts have followed the rule recognized by *Continental Airlines* in a number of civil contexts, including

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<sup>133</sup> While beyond the scope of this Comment, it is interesting that a more restrictive approach to the scope of expert basis testimony has been applied in California civil cases than in criminal cases pre-*Sanchez*. It is curious that criminal defendants have been receiving less protection than civil parties, especially considering the differing consequences in criminal versus civil cases, namely liberty interests versus mere pecuniary interests.

<sup>134</sup> *Cont'l Airlines, Inc. v. McDonnell Douglas Corp.*, 264 Cal. Rptr. 779 (Ct. App. 1989). *Continental Airlines* was a civil suit that alleged negligence, strict liability, deceit, breach of warranty, and breach of contract based on an airplane crash involving an aircraft that was sold from McDonnell Douglas to Continental Airlines. *Id.* at 782-83.

<sup>135</sup> *See id.* at 792.

<sup>136</sup> *See id.* The expert stated that he had seen the report, but did not verify the data and numbers or "review them hard" because "[t]hey looked like they were in the ballpark." *Id.*

<sup>137</sup> *Id.* at 794.

<sup>138</sup> *Id.* at 793 (quoting *Grimshaw v. Ford Motor Co.*, 174 Cal. Rptr. 348, 369 (Ct. App. 1981)).

<sup>139</sup> *Cont'l Airlines*, 264 Cal. Rptr. at 793.

<sup>140</sup> *Id.* at 794 (quoting *Mosesian v. Pennwalt Corp.*, 236 Cal. Rptr. 778, 782 (Ct. App. 1987)) ("It is proper to solicit the fact that another expert was consulted to show the foundation of the testifying expert's opinion, but not to reveal the content of the hearsay opinion.").

<sup>141</sup> *See Brazier & Frank, supra* note 24.

product liability, strict liability, and negligence cases.<sup>142</sup> However, the *Sanchez* rule may have a noticeable impact on two civil contexts in California: (1) certain medical professional expert testimony in medical malpractice, and (2) personal injury cases, and cases involving valuation of property or services.

Generally, California courts have not allowed physician experts to testify to the hearsay statements of other non-testifying physicians in medical malpractice and personal injury cases.<sup>143</sup> But, California courts have allowed a physician expert to testify as to the out-of-court opinions of other non-testifying physicians if certain “limited admissibility”<sup>144</sup> requirements are met.<sup>145</sup> Application of the limited admissibility doctrine has been held to be appropriate “in situations where the out-of-court doctors’ opinion is truly ‘on a parity with a patient’s history . . . given to [the patient’s] physician’ and is ‘a part of the information’ used by the physician in ‘diagnosis and treatment.’”<sup>146</sup>

Legal scholars have theorized that application of the limited admissibility doctrine to physician basis testimony is warranted because the testifying doctor relied on the opinions of the other doctors in their medical treatment of the patient, and thus the law should not prevent the physician from doing the same at

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<sup>142</sup> See, e.g., *Cantu v. Hermansen*, No. B257534, 2015 WL 5008279, at \*4 (Cal. Ct. App. Aug. 24, 2015) (finding the trial court erred in permitting the expert to testify concerning the content of medical records when the medical records were not properly admitted independently); *Korsak v. Atlas Hotels, Inc.*, 3 Cal. Rptr. 2d 833, 834 (Ct. App. 1992) (holding the expert could not testify regarding the details of hearsay statements from an informal survey the expert conducted about hotel maintenance practices); *Mosesian v. Pennwalt Corp.*, 236 Cal. Rptr. 778, 782 (Ct. App. 1987) (“The opinions of the six outside experts were unquestionably hearsay opinions. Experts may rely upon hearsay in forming opinions. They may not relate an out-of-court opinion by another expert as independent proof of fact.”).

<sup>143</sup> See, e.g., *Whitfield v. Roth*, 519 P.2d 588, 603 (Cal. 1974) (finding the expert doctors could not testify as to the out-of-court statements of other non-testifying doctors to show the basis of the experts’ opinions because the statements of the non-testifying doctors were hearsay); *Jamison v. Lindsay*, 166 Cal. Rptr. 443, 449 (Ct. App. 2007) (finding the court properly precluded the expert from testifying to the hearsay statements of a non-testifying doctor, stating “[o]pinions of out-of-court experts are not admissible to show the basis of a testifying expert’s opinion if the witness did not use the opinions of the out-of-court [doctor] in the course of treatment or diagnosis of the plaintiff”); *Williams v. Rizvi*, No. F038590, 2003 WL 165017, at \*6 (Cal. Ct. App. Jan. 24, 2003) (holding that it was proper to preclude the expert physician from testifying as to the hearsay contents of the excluded portions of an operative report).

<sup>144</sup> When referring to the doctrine of limited admissibility, I am referring to the doctrine as it was applied to physician basis testimony in *Kelley v. Bailey*, 11 Cal. Rptr. 448, 454–55 (Ct. App. 1961), not the general application of the doctrine of limited admissibility as stated in CAL. EVID. CODE § 355 (West 2017).

<sup>145</sup> It should be noted that this limited admissibility applies only to expert witnesses testifying as treating doctors, not to doctors who are consulted solely to render expert opinions. See *Trannguyen v. Laska*, No. B172741, 2004 WL 2498279, at \*8–9 (Cal. Ct. App. Nov. 8, 2004).

<sup>146</sup> *Whitfield*, 519 P.2d at 603 n.26 (quoting *Kelley*, 11 Cal. Rptr. at 455).

trial.<sup>147</sup> However, the logic behind the *Sanchez* rule would seem to render evidence that falls within the doctrine of limited admissibility inadmissible in the post-*Sanchez* world. This is because the expert medical professional's testimony is relating case-specific hearsay from a different (non-testifying) medical professional.<sup>148</sup> Further, relating the non-testifying doctor's opinion, which is identical to the expert's opinion, naturally bolsters and fortifies the opinion of the testifying expert.<sup>149</sup>

When the doctrine of limited admissibility is applied, a limiting instruction is given instructing the jury to consider the evidence for the "narrow and limited purpose" of disclosing the "information upon which the physician based his diagnosis and treatment [on]," and "not as independent proof of the facts."<sup>150</sup> While the *Sanchez* court did not address medical expert basis testimony detailing case-specific statements of a non-testifying physician, the *Sanchez* rule likely now dictates exclusion of such testimony, since admission of case-specific out-of-court statements coupled with a limiting instruction mirrors the exact paradigm the *Sanchez* court rendered untenable.

In regards to expert basis testimony concerning valuation of property and services, California courts have somewhat consistently allowed property valuation experts to testify to the details upon which the expert's opinion is based, even if such details are hearsay.<sup>151</sup> Often, a valuation expert's testimony will

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<sup>147</sup> See Volek, *supra* note 44, at 966–67.

<sup>148</sup> The court's rationale for allowing the evidence in this limited capacity is because the evidence "stands on a parity with a patient's history of an accident and ensuing injuries given to his physician. It is admissible not as independent proof of the facts but as a part of the information upon which the physician based his diagnosis and treatment, if any." *Springer v. Reimers*, 84 Cal. Rptr. 486, 494 (Ct. App. 1970) (allowing an expert to testify to the contents of hearsay statements from a non-testifying doctor's report based on the limited admissibility doctrine rationale).

<sup>149</sup> *Cf. Whitfield*, 519 P.2d at 604 (stating the testimony of the testifying doctors "as to the views of the 54 [non-testifying] doctors they respectively consulted was actually offered to establish the opinion of such latter doctors"); *Williams v. Rizvi*, No. F038590, 2003 WL 165017, at \*6 (Cal. Ct. App. Jan. 24, 2003) ("[T]he only purpose in plaintiff's expert testifying to the excluded portions of [the non-testifying doctor's] operative report would be to bolster the opinion of plaintiff's expert.").

<sup>150</sup> *Kelley*, 11 Cal. Rptr. at 455.

<sup>151</sup> *See, e.g., Appel v. Burman*, 206 Cal. Rptr. 259, 263–64 (Ct. App. 1984) (allowing an architect expert to testify as to the details of a cost estimate report performed by a non-testifying cost estimator); *McElligott v. Freeland*, 33 P.2d 430, 436–37 (Cal. Ct. App. 1934) (allowing an accounting expert to testify as to the details of the hearsay information he based his property valuation on); *see also Burow v. JTL Dev. Corp., Inc.*, 2d Civil No. B227256, 2012 WL 34384, at \*3–4 (Cal. Ct. App. Jan. 9, 2012) (allowing the expert to testify as to the details of data and laboratory tests conducted by a non-testifying engineer in opining on a measurement of future soil consolidation); *Blakenbaker v. Ingram*, No. E033930, 2005 WL 40033, at \*2–3 (Cal. Ct. App. Jan. 10, 2005) (finding an accident reconstructionist expert's testimony relating the measurements of crush damage to a car



be derived from predominantly inadmissible hearsay sources.<sup>152</sup> Therefore, in order to inform the fact-finder of the information relied upon to assist in weighing the expert's credibility, California courts have held that an expert "should, so far as is practicable, detail the facts upon which his conclusion or judgment is based even though the facts upon which he relies would be incompetent to affect value in the particular case."<sup>153</sup> The California courts' rationale in finding the hearsay facts are reliable is that the valuation expert evaluates the hearsay and "gives the sanction of his general experience."<sup>154</sup>

In *Sanchez*, the court pointed out that under the common law, property valuation experts were one of the exceptions to the general rule barring disclosure of otherwise inadmissible case-specific hearsay.<sup>155</sup> The justification for this exception was threefold: (1) the hearsay was of routine use by the expert in their conduct outside the courtroom; (2) the expert had experience in evaluating the hearsay sources' trustworthiness; and (3) the court did not want to needlessly complicate the process of proof.<sup>156</sup> The legislature's codification of the California Evidence Code generalized this common law exception with courts employing reliability as the key inquiry as to whether expert basis testimony may be admitted.<sup>157</sup>

However, under *Sanchez*, a more cut-and-dry rule has emerged; reliability is no longer the key determination as to whether disclosure of the case-specific facts will be permitted.<sup>158</sup> *Sanchez* dictates that "[i]f it is a case-specific fact and the witness has no personal knowledge of it, if no hearsay exception applies, and if the expert treats the fact as true, the expert simply may not testify about it."<sup>159</sup> *Sanchez* made no indication that it intended to leave the traditional common law exceptions in place,

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taken by a non-testifying individual to opine on the speed of a vehicle admissible to show the basis of the expert's opinion).

<sup>152</sup> See *McElligott*, 33 P.2d at 436. In property valuation cases, the basis of the expert's opinion may be based on inquires made of others, commercial circulars, correspondence, newspapers, market quotations or reports, price lists, current prices, comparable sales, relevant sales known to the expert, and other secondary sources. See 31 CAL. JUR. 3D EVID. § 712 (2017); see also *People v. Sanchez*, 374 P.3d 320, 328 (Cal. 2016).

<sup>153</sup> *Appel*, 206 Cal. Rptr. at 264 (quoting *McElligott*, 33 P.2d at 436).

<sup>154</sup> *Appel*, 206 Cal. Rptr. at 264 (citing *McElligott*, 33 P.2d at 437).

<sup>155</sup> *Sanchez*, 374 P.3d at 328. The court stated the other common law exception was physicians who relied on patients' hearsay to form diagnoses. *Id.* at 329.

<sup>156</sup> *Id.* at 329 (quoting KAYE ET AL., *supra* note 18, at 155).

<sup>157</sup> *Sanchez*, 374 P.3d at 329.

<sup>158</sup> *Id.*; see also *Stamps*, 207 Cal. Rptr. at 834 (Ct. App. 2016) ("After *Sanchez*, reliability is no longer the sole touchstone of admissibility where expert testimony to hearsay is at issue. Admissibility—at least where 'case-specific hearsay' is concerned—is now more cut-and-dried.")

<sup>159</sup> *Stamps*, 207 Cal. Rptr. 3d at 834.

and thus its holding suggests that the practice of allowing basis disclosure, in its entirety, is no longer tenable because the “expert’s testimony regarding the basis for an opinion *must* be considered for its truth by the jury.”<sup>160</sup>

Accordingly, it appears the *Sanchez* rule encompasses the disclosure of case-specific facts forming the basis of a valuation expert’s opinion. The expert’s valuation price of the property or services is inarguably case-specific, since it is often the ultimate issue in a case and is the principal matter the expert was called to give an opinion on.<sup>161</sup>

Of course, the *Sanchez* rule does not alter the established rule that valuation experts may rely on hearsay sources that would otherwise be inadmissible, provided that it is of a type reasonably relied upon by experts in the given field.<sup>162</sup> However, *Sanchez* arguably dictates that valuation experts can now do no more than generally state what they relied upon in forming the basis of their opinions; meaning the experts cannot disclose the case-specific details of such hearsay information—which could include, for example, reports or price lists prepared by others, conversations with others, and newspaper advertisements—unless such information falls under a hearsay exception or has been properly admitted independent of the experts’ opinions.<sup>163</sup> Therefore, post-*Sanchez*, a valuation expert will likely no longer be able to disclose case-specific hearsay contents forming the basis of their opinion. This holds true even if the hearsay is of a type reasonably relied upon by experts in the given field or because it is a general practice in the industry to use content prepared by others without complying with the requirements *Sanchez* mandates.<sup>164</sup>

While California has generally followed a *Sanchez*-like rule in many civil contexts, other states have liberally allowed experts

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<sup>160</sup> *Sanchez*, 374 P.3d at 330.

<sup>161</sup> See *McElligott v. Freeland*, 33 P.2d 430, 437 (Cal. Ct. App. 1934) (“[T]he testimony of the witness wherein he related [hearsay statements from an informal survey he conducted] . . . was given in response to a question which was preliminary to the matter upon which he was called to give his opinion.”).

<sup>162</sup> See *Sanchez*, 374 P.3d at 334 (“Any expert may still *rely* on hearsay in forming an opinion, and may tell the jury in *general terms* that he did so . . . [by] relat[ing] generally the kind and source of the ‘matter’ upon which his opinion rests.”); see also *Appel v. Burman*, 206 Cal. Rptr. 259, 264 (Ct. App. 1984) (“It has long been held in this state that an expert opinion on the valuation of property or services may be based in whole or in part on hearsay publications.”).

<sup>163</sup> See *Sanchez*, 374 P.3d at 334 (“There is a distinction to be made between allowing an expert to describe the type or source of the matter relied upon as opposed to presenting, as fact, case-specific hearsay that does not otherwise fall under a statutory period.”).

<sup>164</sup> Cf. *Appel*, 206 Cal. Rptr. at 264 (finding expert’s disclosure of hearsay information admissible because the expert “testified that it is the general practice in his industry to use a cost estimator to perform the actual mathematical computation of an estimate”).

in civil cases to testify to case-specific hearsay facts forming the basis of an experts' opinion.<sup>165</sup> Some states' evidence codes, such as Pennsylvania, Rhode Island, and Texas, statutorily allow for disclosure of an experts' basis, even if such testimony is otherwise inadmissible hearsay.<sup>166</sup> Other states, whose state evidence codes are similar to that of Federal Rule of Evidence 703, allow for the disclosure of an experts' basis, even if such testimony is otherwise admissible hearsay, subject to a balancing of the prejudicial effect versus probative value of the basis testimony.<sup>167</sup>

For example, states such as Arkansas, Arizona, Illinois, Georgia, Ohio, Texas, and Washington, have allowed experts to testify to case-specific hearsay statements in civil contexts, including personal injury, negligence, medical malpractice, and products liability cases.<sup>168</sup> Further, states such as Arkansas,

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<sup>165</sup> For a comparison of states that permit an expert to testify to hearsay matters forming the basis of the expert's opinion to states that do not allow the expert to testify to the hearsay forming the expert's basis, see 89 A.L.R. 4TH 456, § 3–4 (2011) (originally published in 1991).

<sup>166</sup> See PA. STAT. AND CONST. STAT. ANN. § 705 (West 2017) ("If an expert states an opinion the expert must state the facts or data on which the opinion is based."); R.I. GEN. LAWS ANN. § 703 (West 2017) ("If of a type reasonably and customarily relied upon by experts in the particular field in forming opinions upon the subject, the underlying facts or data shall be admissible without testimony from the primary source."); TEX. EVID. CODE ANN. § 705(d) (West 2017) ("If the court allows the [expert] to disclose [the underlying] facts or data the court must . . . restrict the evidence to its proper scope and instruct the jury accordingly.").

<sup>167</sup> Compare FED. R. EVID. 703 ("[I]f the facts or data would otherwise be inadmissible, the proponent of the opinion may disclose them to the jury only if their probative value in helping the jury evaluate the opinion substantially outweighs their prejudicial effect."), with e.g., ARIZ. REV. STAT. ANN. § 703 (West 2017) (same as Federal Rule 703), and Ga. Code Ann. § 24-7-703 (West 2017) ("[F]acts or data that are otherwise inadmissible shall not be disclosed to the jury by the [expert] . . . unless . . . their probative value in assisting the jury to evaluate the expert's opinion substantially outweighs their prejudicial effect.").

<sup>168</sup> See, e.g., *Lawhon v. Ayres Corp.*, 992 S.W.2d 162, 166 (Ark. Ct. App. 1999) ("[A]n expert must be allowed to disclose to the trier of fact the factual basis for his opinion because the opinion would otherwise be left unsupported, and the trier of fact would be left with little if any means of evaluating its correctness."); *Nunez v. Prof'l Transit Mgmt. of Tucson, Inc.*, No. 2 CA-CV 2010-0201, 2011 WL 1998433, at \*3 (Ariz. Ct. App. May, 18 2011) (allowing the expert to testify to the hearsay statements of a non-testifying individual's unsworn written declaration, which was not otherwise admissible); *Ziekert v. Cox*, 538 N.E.2d 751, 757 (Ill. App. Ct. 1989) (holding that "not only may experts consider medical records commonly relied upon by members of the medical profession in forming their opinions, but that they may testify as to the contents of those records as well" because the contents are admitted "not to prove the truth of the matter asserted therein, but for the limited purpose of the explaining the expert's testimony") (quoting *Roebuck v. State*, 586 S.E.2d 651, 655 (Ga. 2003)); *Thomas v. Metro. Atl. Rapid Transit Auth.*, 684 S.E.2d 83, 87–88 (Ga. Ct. App. 2009) (allowing the expert to testify as to hearsay and inadmissible attachments based on the rationale that "[a]n expert may base his opinion on hearsay and may be allowed to testify as to the basis for his findings" because any hearsay issue "presents a jury question as to the weight [that] should be assigned [to] the opinion"); *Fry v. King*, 950 N.E.2d 229, 231–38 (Ohio Ct. App. 2011) (allowing the expert to testify as to facts and data prepared by others because the expert verified the facts and

Arizona, Georgia, Mississippi, Pennsylvania, and Washington, have allowed experts to testify to case-specific hearsay statements in valuation and appraisal contexts.<sup>169</sup>

Generally, these states have allowed experts to disclose case-specific hearsay basis testimony based on four different rationales: (1) the testimony is not hearsay because it is not coming in for the truth, but rather the limited purpose of showing the basis forming the expert's opinion;<sup>170</sup> (2) the testimony is hearsay, but needs to be disclosed to the jury in order for the jury to assign weight to the expert's opinion;<sup>171</sup> (3) the testimony is hearsay, but the expert's experience in evaluating the hearsay material renders the information reliable, and thus any inaccuracies go to the weight of the expert's credibility;<sup>172</sup> and (4) the testimony is hearsay, but a limiting instruction and balancing test cures any potential hearsay problems.<sup>173</sup>

The holding in *Sanchez* rejects each of these admittance rationales. Experts are used extremely often in civil cases, almost

data by use of Google Earth based on the reasoning that any inaccuracies go to the weight of the testimony, and not the admissibility); *Stam v. Mack*, 984 S.W.2d 747, 750 (Tex. Ct. App. 1999) (allowing a physician expert to testify as to the details of a non-testifying physician's opinion because the state evidence rules "allow a testifying expert to relate on direct examination the reasonably reliable facts and data on which he relied in forming his opinion" subject to a limiting instruction and balancing test); *Allen v. Asbestos Corp.*, 157 P.3d 406, 413 (Wash. Ct. App. 2007) (allowing the expert to testify as to otherwise inadmissible hearsay facts because "[t]he otherwise inadmissible facts or data underlying an expert's opinion [are] admissible for the limited purpose of explaining the basis of an expert's opinion, but [are] not substantive evidence").

<sup>169</sup> See, e.g., *Ark. State Highway Comm'n v. Schell*, 683 S.W.2d 618, 621 (Ark. Ct. App. 1985) (stating that "an expert must be allowed to disclose to the trier of fact the basis for his opinion, as otherwise the opinion is left unsupported in midair with little if any means for evaluating its correctness"); *Town of Gilbert v. Freeman*, No. 1A-CV09-0660, 2010 WL 5018514, at \*5 (Ariz. Ct. App. 2010) (allowing the expert to testify to hearsay details based on the rationale that the disclosure of hearsay facts or data not admitted in evidence go to the credibility of the expert's opinion, not the truth of the matter asserted); *King v. Browning*, 268 S.E.2d 653, 655 (Ga. 1980) (allowing a surveyor expert to testify to hearsay facts because "[a]n expert may base his opinion on hearsay and may be allowed to testify as to the basis for his findings"); *Williamson v. Harvey Smith, Inc.*, 542 S.E.2d 151, 155 (Ga. Ct. App. 2000) (allowing the expert to testify to the details of a report prepared by another inspector); *Martin v. Miss. Transp. Comm'n*, 953 So.2d 1163, 1167 (Miss. Ct. App. 2007) (quoting *Bishop v. Miss. Trans. Comm'n*, 734 So.2d 218, 221 (Miss. Ct. App. 1999)) (allowing a valuation expert to testify to details of another non-testifying expert because "a witness is not a mere conduit, if the 'expertise of the testifying witness is such as to permit that witness's adoption of the statements of a similar expert'"); *Barrack v. Kolea*, 651 A.2d 149, 155-56 (Pa. Super. Ct. 1994) (allowing the expert to testify as to the details of cost figures prepared by his non-testifying subcontractors); *Deep Water Brewing, LLC v. Fairway Res. Ltd.*, 215 P.3d 990, 1014 (Wash. Ct. App. 2009) (allowing the appraiser expert to testify as to the details of past appraisal reports prepared by non-testifying experts).

<sup>170</sup> See, e.g., *Ziekert*, 538 N.E.2d at 757; *Town of Gilbert*, 2010 WL 5018514, at \*5.

<sup>171</sup> See, e.g., *Lawhon*, 992 S.W.2d at 166; *Thomas*, 684 S.E.2d at 88.

<sup>172</sup> See, e.g., *Martin*, 953 So.2d at 1167; *Deep Water Brewing*, 215 P.3d at 1014; *Fry*, 950 N.E.2d at 236.

<sup>173</sup> See, e.g., *Stam*, 984 S.W.2d at 750.

universally when it comes to quantifying value and damages, and are often a necessary and critical part of litigation because expert testimony can help the fact-finder understand complex facts and issues.<sup>174</sup> Because experts offer testimony that is often central to the question of liability in a case,<sup>175</sup> the need for jurors to have all the information forming the basis of an expert's opinion becomes obvious; jurors need to assess the expert's credibility when deciding the outcome of a case.

However, *Sanchez* exposes the issues that arise if experts are permitted to relate otherwise inadmissible basis testimony to the fact-finder: When experts treat hearsay statements as true and accurate in forming the basis of their opinion, jurors must accept the hearsay statements as true if they believe the expert is credible, and thus the statements are inescapably being admitted for their truth.<sup>176</sup> The *Sanchez* court realized that merely telling the jury that the expert relied on additional information in general terms, as opposed to reciting the details, might do less to bolster the credibility and weight of the expert's opinion.<sup>177</sup> However, this point confirms the case-specific hearsay, if admitted, is in fact being considered for its truth. If admittance bolsters the expert's opinion, "[t]he expert is essentially telling the jury: 'You should accept my opinion because it is reliable in light of these *facts* on which I rely.'"<sup>178</sup> Because it cannot logically be maintained that the case-specific hearsay statements are not being admitted for their truth, and it is dangerously likely the fact-finder is considering such hearsay statements for their truth<sup>179</sup>, other states should follow the *Sanchez* rule.<sup>180</sup>

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<sup>174</sup> See Greg Eastman, Vandy M. Howell & Maria Salgado, *A Primer on When to Use Expert Witnesses and How to Find Them*, BLOOMBERG NEWS (Jan. 7, 2013), [https://www.bna.com/a-primer-on-when-to-use-expert-witnesses-and-how-to-find-them/\[http://perma.cc/R45D-UUDX\]](https://www.bna.com/a-primer-on-when-to-use-expert-witnesses-and-how-to-find-them/[http://perma.cc/R45D-UUDX]).

<sup>175</sup> See *id.*

<sup>176</sup> See *People v. Sanchez*, 374 P.3d 320, 334 (Cal. Ct. App. 2016).

<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> New York, for example, already follows a *Sanchez*-like rule based on the reasoning in the 2005 case *People v. Goldstein*, 843 N.E.2d 727, 729–33 (N.Y. 2005), which disallowed a psychiatrist expert from testifying to the details of interviews with third parties forming the basis of the expert's opinion regarding the defendant's sanity. The New York court reasoned:

We do not see how the jury could use the statements of the interviewees to evaluate [the expert's] opinion without accepting as a premise either that the statements were true or that they were false. Since the prosecution's goal was to buttress [the expert's] opinion, the prosecution obviously wanted and expected the jury to take the statements as true.

*Id.* at 732.

### III. *SANCHEZ* AND FEDERAL RULE OF EVIDENCE 703

California's restrictive *Sanchez* method in policing the scope of expert basis testimony differs from the current federal method. Federal Rule of Evidence 703 currently states:

An expert may base an opinion on facts or data in the case that the expert has been made aware of or personally observed. If experts in the particular field would reasonably rely on those kinds of facts or data in forming an opinion on the subject, they need not be admissible for the opinion to be admitted. *But if the facts or data would otherwise be inadmissible, the proponent of the opinion may disclose them to the jury only if their probative value in helping the jury evaluate the opinion substantially outweighs their prejudicial effect.*<sup>181</sup>

Thus, the current federal rule, while taking an approach that favors exclusion, allows experts to relate case-specific hearsay for the purpose of assisting the jury in evaluating the expert's opinion if the hearsay content's probative value in assisting the jury in weighing the expert's opinion substantially outweighs the risk of prejudice resulting from the jury's potential misuse of the information.<sup>182</sup> If the court determines the hearsay contents can be admitted, Rule 703 requires a limiting instruction, upon request, instructing the jury not to use the information as substantive evidence.<sup>183</sup>

In 2012, the U.S. Supreme Court grappled with the same hearsay issue that was presented in *Sanchez*—the admissibility of expert basis testimony disclosing inadmissible hearsay—albeit in a federal Confrontation Clause context in *Williams v. Illinois*.<sup>184</sup> *Williams* was a criminal rape prosecution in which the identity of the offender was a central issue.<sup>185</sup> DNA evidence was collected from the victim and sent to an outside laboratory for analysis.<sup>186</sup> Independent of the rape case, the defendant's DNA was in the state's police database.<sup>187</sup> The prosecution called an expert who testified that she compared the DNA sample from the outside laboratory to the known DNA sample of the defendant, concluding the two DNA samples matched.<sup>188</sup> The issue presented to the Court was whether the details of the outside laboratory's DNA analysis report, forming the basis of the

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<sup>181</sup> FED. R. EVID. 703 (emphasis added).

<sup>182</sup> *Id.* (advisory committee's note to the 2000 Amendment).

<sup>183</sup> *See id.*

<sup>184</sup> *See Williams v. Illinois*, 567 U.S. 50, 56 (2012).

<sup>185</sup> *Id.*

<sup>186</sup> *Id.* at 59.

<sup>187</sup> *Id.*

<sup>188</sup> *Id.* at 60.

expert's opinion, were inadmissible hearsay.<sup>189</sup> A four-member plurality opined the expert's testimony regarding the contents of the outside laboratory's DNA report was non-hearsay, and thus admissible, since it was admitted to help the fact-finder assess the expert's testimony, and not for its truth.<sup>190</sup> However, five justices (a four-member dissent and a one-member concurrence writing separately) specifically rejected the plurality's "not-for-truth" rationale.<sup>191</sup> Justice Thomas's concurrence stated that the expert's testimony did not merely reveal the opinion basis because the validity of the expert's opinion "ultimately turned on the truth of [the hearsay] statements."<sup>192</sup> Similarly, the dissent stated, in order "to determinate the validity of the [expert's] conclusion, the factfinder must assess the truth of the out-of-court statement on which it relies," which contributed to the dissent's consensus that the "not-for-truth" rationale is "very weak, factually implausible, nonsense, and a sheer fiction."<sup>193</sup> It is the analysis of these five justices in *Williams* that directly influenced the *Sanchez* court's ruling.<sup>194</sup>

Despite the strong opinions of a majority of justices in the *Williams* case regarding the flaws of the "not-for-truth" rationale,

<sup>189</sup> And, further, the Court was presented with the question of whether the admission of the expert's testimony violated the Federal Confrontation Clause. *Id.* at 57.

<sup>190</sup> The plurality further held this type of expert testimony does not violate the Federal Confrontation Clause because the Sixth Amendment right to confrontation has no application to out-of-court statements that are not offered to prove the truth of the matter asserted. *Id.* A five-justice majority (the four-member plurality and Justice Thomas) opined that the independent laboratory report was not testimonial and thus mooted the Rule 703 issue. *Id.* at 85–86, 97 (Thomas, J., concurring).

<sup>191</sup> See generally *id.* at 103–40 (referring to Justice Thomas's concurrence and Justice Kagan's dissent, with whom Justice Scalia, Justice Ginsburg, and Justice Sotomayor joined).

<sup>192</sup> *Id.* at 108 (Thomas, J., concurring) (stating the "not-for-truth" rational "overlook[ed] that the value of [the expert's] testimony depended on the truth of those very assumptions").

<sup>193</sup> *Id.* at 125–28 (Kagan, J., dissenting) (quoting KAYE ET AL., *supra* note 18, § 4.10.1 (2d ed. 2011)). The dissent went on to illustrate the flaw in the "not-for-truth" rationale:

The Confrontation Clause prevented the State from introducing that report into evidence except by calling to the stand the person who prepared it. So the State tried another route—introducing the substance of the report as part and parcel of an expert witness's conclusion. In effect, [the expert] testified . . . "I concluded that Williams was the rapist because [the outside laboratory], an accredited and trustworthy laboratory, says that the rapist has a particular DNA profile and, look, Williams has an identical one. . . ." Nothing in [the expert's] testimony indicates that she was making an assumption or considering a hypothesis. To the contrary, [the expert] affirmed, without qualification, that the Cellmark report showed a "male DNA profile found in semen from the vaginal swabs of [the victim]."

*Id.* at 111–30.

<sup>194</sup> See *People v. Sanchez*, 374 P.3d 320, 330–33 (Cal. 2016) (discussing the opinions of the five justices in *Williams* who expressly rejected the "not-for-truth" rationale, stating "[w]e find persuasive the reasoning of a majority of justices in *Williams*").

some federal courts have allowed experts to relate otherwise inadmissible hearsay evidence to the fact-finder on the grounds the evidence is being admitted solely to assist the fact-finder in evaluating the expert's opinion.<sup>195</sup> On the other hand, some federal courts have not permitted experts to testify to case-specific hearsay evidence on the grounds the hearsay contents are more prejudicial than probative under Rule 703.<sup>196</sup> Legal scholars have also diverged on whether experts in federal courts should be able to testify to case-specific facts from otherwise inadmissible hearsay sources.<sup>197</sup> Thus, there has been

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<sup>195</sup> See, e.g., *U.S. v. NCR Corp.*, 960 F. Supp. 2d 793, 834–36 (E.D. Wis. 2013) (allowing the expert to testify regarding the details of a report prepared by others because it is customary for experts in this field to rely on and adopt such reports in forming their opinion, even though the expert is unfamiliar with the details of how such a report is made); *In re Moyer*, 421 B.R. 587, 596–97 (Bankr. S.D. Ga. 2007) (allowing the expert to testify to the hearsay details of a report, stating that “[w]hile, normally the Report itself would be inadmissible under Federal Rule of Evidence 703 as hearsay, the Court finds it admissible to explain the basis of [the expert’s] opinion, not as substantive evidence”); *Geyer v. NCL (Bahamas) Ltd.*, 203 F. Supp. 3d 1212, 1216–18 (S.D. Fla. 2016) (allowing a physician expert, who did not examine the plaintiff, to testify to hearsay details of medical records and reports prepared by non-testifying physicians); *Westfield Ins. Co. v. Harris*, 134 F.3d 608, 611–13 (4th Cir. 1998) (allowing Fire Marshall expert to testify to the hearsay details of reports made by the insurance company investigator and discussions with the expert’s subordinates); *U.S. v. Wolling*, 223 Fed. Appx. 610, 612 (9th Cir. 2007) (allowing a defense expert to describe the hearsay contents of medical reports that were excluded from being admitted into evidence under the Rule 703 balancing test); *In re Amey*, 40 A.3d 902, 914–15 (D.C. 2012) (allowing psychiatrist to testify to the hearsay contents forming the basis of the expert’s opinion, including reports and notes prepared by other doctors because a limiting instruction was given to the jury).

<sup>196</sup> See, e.g., *McDevitt v. Guenther*, 522 F. Supp. 2d 1272, 1294 (D. Haw. 2007) (holding that, while it is permissible for the expert to base his opinion on otherwise inadmissible hearsay, “the facts on which [the expert] bases his opinion are also the facts in dispute before the factfinder in this case” and “[f]or this reason, the probative value of any inadmissible facts would be outweighed by . . . the prejudicial effect of having an expert recite inadmissible facts as though they are established”); *Loeffel Steel Prods., Inc. v. Delta Brands, Inc.*, 387 F. Supp. 2d 794, 808 (N.D. Ill. 2005) (“Rule 703 was . . . not intended to abolish the hearsay rule and to allow a witness, under the guise of giving expert testimony, to in effect become the mouthpiece of the witnesses on whose statements or opinions the expert purports to base his opinion.”); *Mike’s Train House, Inc. v. Lionel, LLC*, 472 F.3d 398, 409 (6th Cir. 2006) (holding that it was error to allow an expert to testify as to the hearsay details of another non-testifying expert’s conclusions and the degree to which the expert’s and the non-testifying expert’s conclusions overlapped); *U.S. v. Mejia*, 545 F.3d 179, 197–99 (2d Cir. 2008) (holding that it was error to allow the expert to recite hearsay statements from otherwise inadmissible interviews).

<sup>197</sup> Compare *KAYE ET AL.*, *supra* note 18, at 179–80 (“To admit basis testimony for the nonhearsay purpose of jury evaluation of the experts is therefore to ignore the reality that jury evaluation of the expert requires a direct assessment of the truth of the expert’s basis. Having invited the jury to make such an assessment, is it either fair or practical then to ask the jury to turn around and ignore it?”), Ronald L. Carlson, *Experts as Hearsay Conduits: Confrontation Abuses in Opinion Testimony*, 76 MINN. L. REV. 481, 493 (1992) (arguing that a restrictive approach to policing the bases of modern expert testimony should be implemented to bar “[d]etailed renditions[s] of unauthenticated hearsay” and to curb Rule 703 abuses), Daniel D. Blinka, *Ethical Firewalls, Limited Admissibility, and Rule 703*, 76 FORDHAM L. REV. 1229, 1257–58 (2007) (stating that it seems unlikely the amended Rule 703 has resulted in fewer rulings permitting disclosure for the limited purpose of better understanding the expert’s reasoning because, in certain



much controversy over Rule 703 as it relates to the disclosure of expert basis testimony.

The *Sanchez* rule excluding all expert basis testimony that relates case-specific hearsay takes a far more restrictive approach than the federal rule in that it completely rejects the “not-for-truth” rationale, disallows the use of a limiting instruction, and eliminates the use of the balancing test in determining admissibility. It is unclear whether the ruling in *Sanchez* will influence the ongoing federal debate. The 2000 Amendment to Rule 703 favoring inadmissibility seems to suggest the Federal courts are at least somewhat concerned with the potential for jurors to improperly consider expert testimony.<sup>198</sup> The Advisory Committee’s note makes clear the amendment to Rule 703 was intended to emphasize the “underlying information [forming the basis of the expert’s opinion] is not admissible simply because the opinion or inference is admitted.”<sup>199</sup> Moreover, it appears the dominant view expressed in legal literature seems to reject the “not-for-truth” rationale, just as the *Sanchez* court did.<sup>200</sup> Thus, perhaps it is just a matter of time before federal courts adopt a *Sanchez*-like bright-line approach when it comes the disclosure of hearsay evidence forming the basis of an expert’s opinion.

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situations, the jury’s need for the basis evidence would likely substantially outweigh the prejudicial effect of the hearsay in light of the court’s limiting instructions), Mark I. Bernstein, *Jury Evaluation of Expert Testimony Under the Federal Rules*, 7 DREXEL L. REV. 239, 286 (2015) (“The procedures adopted by the Federal Rules of Evidence on expert testimony violate a fundamental logical concept . . . when the factual basis is revealed by the expert . . . was to be ‘cured’ by the logically inconsistent, totally ineffectual, judicial instruction to restrict use of the factual basis evidence only to ‘evaluate the expert’s opinion’ and not for the truth of any of the facts relied upon.”), and Volek, *supra* note 147, at 996–97 (stating that “[t]he limiting instruction contemplated by Rule 703 is problematic” because “the jury must somehow use the inadmissible basis evidence to evaluate the expert’s opinion, without considering whether or not the inadmissible basis evidence is true”), with Paul R. Rice, *Inadmissible Evidence as a Basis for Expert Opinion Testimony: A Response to Professor Carlson*, 40 VAND. L. REV. 583, 584 (1987) (arguing that “the introduction of the inadmissible facts or data upon which experts rely no more violates the hearsay rule’s spirit than do the volumes of evidence that regularly are introduced through the numerous hearsay rule exceptions”), and Alexander J. Toney, *The Credibility-Based Evaluative Purpose: Why Rule 703 Disclosures Don’t Offend the Confrontation Clause*, 67 RUTGERS U. L. REV. 953, 1000 (2015) (“Rule 703 is no sinister device for admitting evidence when no other provision allows it . . . . [T]he Rule’s purpose, to offer jurors indicia for assessing the credibility—and, by proxy, the correctness—of expert testimony, is a real purpose, and one that serves the interests of justice.”).

<sup>198</sup> FED. R. EVID. 703 advisory committee’s note to the 2000 Amendment (“The amendment provides a presumption against disclosure to the jury of information used as the basis of an expert’s opinion and is not admissible for any substantive purpose, when that information is offered by the proponent of the expert.”).

<sup>199</sup> *Id.*

<sup>200</sup> See Toney, *supra* note 197, at 984–85 (citing to treatises, law review articles, and Professor Richard Friedman’s amicus brief to the U.S. Supreme Court in *Williams v. Illinois* to support the inference that the view that juries must consider basis evidence for its truth is the dominant view in the federal realm).

## CONCLUSION

Prior to *People v. Sanchez*, California courts have long tolerated experts disclosing to the jury case-specific out-of-court statements forming the basis of the expert's opinion under the guise that the statements were being offered for the sole purpose of explaining the expert's opinion basis, and that, in most instances, a limiting instruction could cure any hearsay problems.<sup>201</sup> *Sanchez* struck down this paradigm, holding the expert's testimony regarding the basis for the opinion must be considered for its truth by the jury and the jury's evaluation of an expert's opinion requires a direct assessment of the truth of the basis forming the expert's opinion.<sup>202</sup> Post-*Sanchez*, an expert may no longer relate to the jury case-specific out-of-court statements when, to support the expert's opinion, the expert treats the content of the statements as true and accurate.<sup>203</sup> Such statements are hearsay and to be admissible, must fall within a firmly rooted hearsay exception or be properly admitted independent of the expert's testimony.<sup>204</sup>

What does this mean for California trial practice? Trial counsel now must devote greater attention to establishing a proper evidentiary basis for any case-specific out-of-court statements they intend their expert to assume, disclose, and opine on. California courts will have to act as stricter gatekeepers in policing the disclosure of expert basis testimony, and will likely face much stricter appellate review in such matters.<sup>205</sup> If trial counsel cannot independently admit the case-specific facts, or the case-specific facts do not fall under an applicable hearsay exception, an expert will likely only be able to communicate in general, admittedly vague, terms the basis for their opinion, and hope the jury will trust and believe the expert.<sup>206</sup> In upcoming cases, it is likely there will be much litigation over what constitutes a case-specific fact.<sup>207</sup> Moreover, courts will likely also

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<sup>201</sup> See *supra* note 8 and accompanying text.

<sup>202</sup> See *People v. Sanchez*, 374 P.3d 320, 333 (Cal. 2016).

<sup>203</sup> *Id.* at 334.

<sup>204</sup> *Id.* at 333 ("Like any other hearsay evidence [the out-of-court statements] must be admitted through an applicable hearsay exception. Alternatively, the evidence can be admitted through an appropriate witness and the expert may assume its truth in a properly worded hypothetical question.").

<sup>205</sup> Of course, any *Sanchez* challenge must survive a harmless error analysis.

<sup>206</sup> See, e.g., *People v. Atkins*, No. B278735, 2017 WL 3587418, at \*8 (Cal. Ct. App. Aug. 21, 2017) (finding no *Sanchez* violation because the expert merely recited in general terms the basis for his opinion was conversations with other gang detectives, and offered no specific details concerning those communications).

<sup>207</sup> For example, in order to obtain a gang enhancement conviction, one element the prosecution must prove is that members of the gang have engaged in a pattern of criminal gang activity by committing two or more "predicate offenses" (which are statutorily

grapple with determining what basis testimony qualifies as revealing the general “kind and source of the matter” upon which the expert relied,<sup>208</sup> without disclosing too much information so as to violate the *Sanchez* rule.

The *Sanchez* hearsay rule implications extend and apply equally in both criminal and civil contexts in California.<sup>209</sup> While some states, such as New York, already follow a restrictive *Sanchez*-like approach when it comes to the scope of expert basis testimony, many other states have rather consistently allowed liberal disclosure of expert basis testimony, opening the flood-gates to experts smuggling otherwise inadmissible hearsay evidence to the jury.<sup>210</sup> In regards to federal courts, while Rule 703 presumes inadmissibility but allows admissibility in certain circumstances, there has been great tension concerning how much, if any, substantive hearsay detail an expert may relate to the fact-finder as opinion basis testimony.<sup>211</sup> Perhaps California’s return to the restrictive approach to policing the scope of expert basis testimony will encourage other states, as well as federal courts, to become stricter gatekeepers, thereby curbing the practice of using experts to smuggle otherwise inadmissible hearsay contents before the ears of the fact-finder.

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enumerated offenses). *See Sanchez*, 374 P.3d at 342–43. It is unclear from the ruling in *Sanchez* whether predicate offenses constitute general background information about the gang in question or case-specific facts. Can the prosecution elicit details of these predicate offenses when such information is not based on the expert’s personal knowledge and not admitted independent of the expert? If the predicate offense testimony is considered to be general background information about the gang, if the predicate offense happens to involve the specific defendant in the case, does this fact shift the testimony from general background information to case-specific facts? *Compare e.g.*, *People v. Vasquez*, No. C069228, 2017 WL 3699636, at \*8 (Cal. Ct. App. Aug. 28, 2017) (holding testimony detailing predicate offenses were “more akin to general background information concerning the gang” as the predicate convictions did not involve the defendant), *and* *People v. Chavez*, No. C074316, 2016 WL 5940068, at \*9 (Cal. Ct. App. Oct. 13, 2016) (finding testimony regarding predicate offenses did not involve the defendant or events involved in the case, and thus were not case-specific, but rather general background information concerning the gang), *with* *People v. Lara*, 215 Cal. Rptr. 3d 91, 126–27 (Ct. App. 2017) (determining the gang expert’s testimony regarding the predicate offenses, which involved the defendant, were case-specific facts), *and* *People v. Carrillo*, No. F070459, 2017 WL 2463468, at \*23 (Cal. Ct. App. June 7, 2017) (holding testimony detailing predicate offenses involving defendant were case-specific facts, not general background information).

<sup>208</sup> *Id.* at 685–86 (“Any expert may still rely on hearsay in forming an opinion, and may tell the jury in *general terms* that he did so . . . [by] relat[ing] generally the kind and source of the ‘matter’ upon which his opinion rests.”).

<sup>209</sup> *See supra* Sections II(A) and II(B).

<sup>210</sup> *See supra* Sections II(A) and II(B).

<sup>211</sup> *See supra* Part III.



# Whose Lien is it Anyway? A Comparative Analysis of Approaches to Homeowner Association Lien Priority

*Steven L. Rimmer\**

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## INTRODUCTION

No one likes to play against a stacked deck, yet both homeowners' associations ("HOAs") and banks tend to make the complaint that this is exactly what is happening post-foreclosure crisis. HOAs complain that when a bank forecloses, the foreclosure wipes away any chance at recovery against unpaid assessments. Banks claim that the priority-adjustment remedy to that problem deals their chances of recovery a bad hand from the bottom of the deck despite having what they thought was an ace up their sleeve: priority of time. How a jurisdiction sets lien priority between an HOA and lender largely determines who will have the winning hand. Where to set that line is an exceedingly difficult problem for which jurisdictions are struggling to find a practical solution. This Comment seeks to explore this balancing act in detail.

Assume a homeowner's residence is located within a neighborhood with an HOA,<sup>1</sup> and was purchased through a first deed of trust with a lender. The homeowner falls on hard times and is unable to pay either the monthly assessments required by the HOA or payments on their loan to the lender. Both the HOA and the lender initiate separate non-judicial foreclosure proceedings relatively close in time, but the lender's sale is postponed for an unrelated reason. In the meantime, the HOA holds their foreclosure sale and the home is bought by a subsequent purchaser for much less than market value. Having knowledge of the deed of trust, the subsequent purchaser brings a quiet title action, alleging the lender's first deed of trust was extinguished by the HOA's foreclosure on its lien.

This is the situation that confronted the Nevada Supreme Court in the 2014 case, *SFR Investments Pool 1, LLC v. U.S. Bank*.<sup>2</sup> In a decision that "set off bank alarms," the court held that according to the state's lien priority statute, after the non-judicial foreclosure sale for \$6000, the HOA lien, valued at \$4542, took priority over *and extinguished* the lender's \$800,000 first deed of trust.<sup>3</sup>

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<sup>1</sup> This note groups together all common interest communities ("CICs"), which include both planned housing communities with homeowners' associations ("HOAs") and condominium communities. While there are differences in general law between these two types of communities, there are no major general differences with respect to lien priority. Therefore, HOAs, condominium associations, and CICs will be used interchangeably throughout this Comment.

<sup>2</sup> See *SFR Investments Pool 1, LLC v. U.S. Bank*, 334 P.3d 408, 409–10 (Nev. 2014).

<sup>3</sup> Mark Gardberg, *HOAs vs. Banks vs. Homeowners: Nevada Shifts Ground on Superiority HOA Liens*, NEV. LAW., June 2016, at 13, 14; see also Katie McConnell, *The Super Priority of Homeowners' Associations*, NEV. LAW., June 2016, at 22, 23; *HOA Foreclosures Leave Banks Empty-Handed*, REALTOR MAG. (Oct. 15, 2014),

Although some may find such an outcome shocking, a contrary conclusion would also have negative consequences. The inability to collect dues (if not aided by such statutory priority adjustments) can be crippling to the ability of an HOA to operate, sometimes causing it to pass on these costs to other association members.<sup>4</sup> Such a limitation on an association's ability to collect is particularly perceptible during a slump in the real estate market.

Consider just one example from Kings Lake Townhomes in Gibsonton, Florida.<sup>5</sup> During the financial recession following the 2008 foreclosure crisis, sixty percent of the 242 condominium owners of this community association were delinquent in paying their \$194 monthly assessments.<sup>6</sup> The Kings Lake neighborhood association had over \$150,000 in delinquent dues and did not have enough funding in its reserve to even replace a broken security gate when needed.<sup>7</sup> In order to fix the gate, the association had to levy an additional assessment on its member homeowners of \$230 each for three months.<sup>8</sup>

By both raising fees for paying members and foreclosing on non-paying member's homes, the association at Kings Lake was able to prevent itself from becoming insolvent.<sup>9</sup> In response to outcry from members footing the bill of the higher fees, the association began to aggressively pursue foreclosures on its delinquent members.<sup>10</sup> The association's option to foreclose was aided by Florida's statutory priority allowing an association to collect a year's worth of dues upon foreclosure by a lender.<sup>11</sup> Counsel for the Kings Lake Association noted foreclosure is typically a more effective method of collecting assessments

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<http://realtormag.realtor.org/daily-news/2014/10/16/hoa-foreclosures-leave-banks-empty-handed> [<http://perma.cc/E3EA-DBJX>]; Davis S. Vaughn, *Lien Back: Why Homeowner Association Super-Priority Lien Statutes Should Be Repealed* (2017), <https://ssrn.com/abstract=2903577> [<http://perma.cc/7RP4-VDEB>].

<sup>4</sup> Jeff Collins, *O.C. homeowners associations in a cash crunch*, ORANGE COUNTY REGISTER (Sept. 29, 2008, 6:00 PM), <https://www.oregister.com/2008/09/28/oc-homeowners-associations-in-cash-crunch/> [<http://perma.cc/CW87-EH53>] (“A Placentia complex with at least 33 homes in foreclosure or default ended up raising monthly fees and levying a \$1,000 special assessment.”).

<sup>5</sup> Shannon Behnken, *Foreclosing Isn't Just For Lenders These Days*, TAMPA BAY TIMES, <http://www.tbo.com/business/business/2008/dec/28/bz-foreclosing-isnt-just-for-lenders-these-days-ar-111034/> [<http://perma.cc/5Q9L-8B9J>] (last updated May 22, 2013, 3:10 PM).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* According to the report, the association board will be raising fees an additional \$31 to a total of \$225 per month in hopes it will be enough, but will be “keeping the association's foreclosure attorney on speed dial.” *Id.*

<sup>11</sup> *Id.*

against delinquent members than other methods, such as pursuing a money judgment against the debtor.<sup>12</sup>

Nevertheless, this remedy's potency and power is dependent on the laws governing lien priority in the home state of the foreclosing community association. In some jurisdictions, a lender's lien has priority over an association's lien.<sup>13</sup> In such a jurisdiction, a lender's foreclosure on the property first for less than the amount of its lien will leave no residual for the association to pursue.<sup>14</sup> Similarly, a foreclosing association will have difficulty finding a buyer under such law because a purchaser would take the property with a large mortgage lien still attached.<sup>15</sup> Under these circumstances, the HOA's most reliable option for recovery of the delinquency is rendered impotent and inadequate.<sup>16</sup> HOAs responded to these circumstances by joining and supporting interest groups, such as the Community Associations Institute ("CAI"), which lobbied in support of increased association lien priority under state law.<sup>17</sup>

These contrasting vignettes set the scene for the conflict: choosing which lien should have priority, the lien held by the association or the lien held by the lender. These tales of competing claims also raise a larger question of who should bear the cost of unpaid homeowner association dues when the delinquent owner is not a practical option. In response to pressure from both HOAs and lenders, states have attempted to find an acceptable solution to balance the competing interests and manage the conflict. These solutions have arguably sometimes fallen short in both fairness and practicality—metrics critical to this Comment's evaluation of the lien priority debate.

Nevada's controversial statute and its judicial interpretation are the result of a nation-wide trend cultivated by the lobbying efforts of HOA interest groups to increase the priority of association liens in response to the financial crisis of 2008.<sup>18</sup> That

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<sup>12</sup> *Id.*

<sup>13</sup> *See infra* Part I.

<sup>14</sup> *See infra id.*

<sup>15</sup> *See infra id.*

<sup>16</sup> *See infra id.*

<sup>17</sup> *See State Advocacy*, CMTY. ASS'NS. INST., <https://www.caionline.org/Advocacy/StateAdvocacy/Pages/default.aspx> [<http://perma.cc/8DZZ-KRG6>] (last visited Apr. 17, 2017). State governments are urged to consider and give favorable treatment to one or more of the uniform acts, such as the Uniform Common Interest Ownership Act ("UCIOA"), which contains favorable provisions for community association lien priority. *Id.*

<sup>18</sup> *See* Robert Aalberts, *Super Liens Help Fix Homeowners Associations But Will They Survive Politically?*, 44 REAL EST. L.J. 327, 327–29 (2015); *see also* Casey Perkins, Note, *Privatopia in Distress: The Impact of the Foreclosures Crisis on Homeowners' Associations*, 10 NEV. L.J. 561, 566–68, 580–81 (2010) (summarizing the recession caused by the 2008 foreclosure crisis).



trend is now being met with pushback from lenders across the United States.<sup>19</sup> Experts claim that while common interest communities (“CICs”) have formidable allies in state legislatures, lending institutions and real estate brokers have just as much or more influence to counter this shift in transactional power.<sup>20</sup> In Nevada, home of the *SFR Investments* decision and the epicenter of the debate, lenders and real estate brokers with “considerable resources and political experience” are currently building pressure for change.<sup>21</sup>

The law is far from uniform on how each state approaches the issue of HOA lien priority (in terms of both statute and case law), and states take different approaches when addressing the issue of what priority an HOA lien should take in relation to other instruments.<sup>22</sup> For ease of analysis, this Comment has grouped the many variations in state law into three distinct categories based on the priority given to an association’s assessment lien. These three categories include: the first-in-time approach, the super lien priority approach, and the purchaser liability approach.

This Comment examines how three different jurisdictions, each representing one of the approaches mentioned above, address the issue. It then discusses which approach, or combination thereof, most adequately and fairly balances the competing policy interests. In this evaluation, this Comment focuses its analysis on which methodology (1) better assists an HOA in collecting delinquent assessments without treating the lender’s interest unfairly, and (2) most adequately balances the competing public policy concerns. To better understand the different approaches each jurisdiction takes and frame the issue presented, we will first need an understanding of the general law that governs lien priority and the basic history of the development of super lien priority statutes. The next Part discusses that background and history.

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<sup>19</sup> See Aalberts, *supra* note 18, at 327–29.

<sup>20</sup> *Id.* (“But now super lien laws are under attack by more powerful forces than even homeowners associations might be able to withstand—lenders and real estate brokers.”).

<sup>21</sup> *Id.* However, HOA proponents dismiss this reaction as mere bluster since it would be impractical for lenders to stop doing business in all jurisdictions with super-lien priority statutes. *Id.*

<sup>22</sup> See Christian J. Bromley, *Encouraging Cooperation: Harmonizing the Battle of Association and Mortgage Lien Priority in America’s Common Interest Communities*, 43 REAL EST. L.J. 255, 257–59, 276–85 (2014). Recovery by an association is dependent on lien priority law in the state which has jurisdiction over the property. *Id.* A survey of these jurisdictions has revealed “inconsistent approaches to determining an association’s priority, or lack thereof, against the liens of any mortgages.” *Id.*

## I. BACKGROUND

To understand the issue of which approach most fairly balances competing policy interests, one must understand the basic mechanics of lien priority law. In order to provide a framework for analysis, this Part provides a brief overview of the general law governing HOA lien priority.

Covenants, which are created when an HOA is formed by recording a declaration of the community association's conditions, covenants, and restrictions ("CC&Rs"), often require homeowners to join an association and pay dues.<sup>23</sup> The governing documents of the association must provide for the collection of regular and special assessments from members to pay for community services and amenities, such as maintenance of common areas and facilities.<sup>24</sup> The members' obligation to pay assessments begins with the first conveyance of the subdivision, and this obligation is transferred to all subsequent purchasers of the property.<sup>25</sup>

Assessments accrued while a member owns the property are personal liabilities, which as a default rule, remain a personal liability to a debtor even after the property is transferred to another, whether voluntarily or involuntarily.<sup>26</sup> However, a member is not liable for dues that accrue either before or after their ownership of the HOA property.<sup>27</sup> Consequently, a purchaser at a foreclosure sale is usually not liable for a previous member's delinquent dues, while that previous member remains personally responsible for the debt to the HOA.<sup>28</sup>

The power an association has to impose assessments on its members can lead to the ability of the HOA to create a lien on the property that runs with the land.<sup>29</sup> Priority between an HOA lien and a lender's mortgage or deed of trust is usually determined by first-in-time principles unless modified by statute or agreement.<sup>30</sup> Generally, the HOA lien is perfected when the owner defaults on paying dues, and in some states like California, the recordation

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<sup>23</sup> RICHARD R. POWELL, *POWELL ON REAL PROPERTY* § 54.08 (Matthew Bender ed., 1995).

<sup>24</sup> *Id.* at 145–47.

<sup>25</sup> Tara C. Narayanan & Ella K. Gower, *Common Interest Developments*, in 8 MILLER & STARR CALIFORNIA REAL ESTATE § 28:93 (4th ed. 2017).

<sup>26</sup> *Id.* § 28:97.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> WAYNE S. HYATT, *CONDOMINIUM AND HOMEOWNER ASSOCIATION PRACTICE* 117–19 (3d ed. 2000).

<sup>30</sup> Karl E. Geier, *Recording and Priorities*, in 4 MILLER & STARR CALIFORNIA REAL ESTATE § 10.1 (4th ed. 2017).

of the delinquent assessment.<sup>31</sup> Since the lien is usually not perfected until the assessment becomes delinquent, a properly recorded first mortgage or deed of trust will normally be first in time in relation to an HOA lien as it generally occurs at the purchase of the property.<sup>32</sup>

Chief Justice John Marshall in *Rankin v. Scott* described the temporal priority relationship of liens under the first-in-time principle in the following terms:

The principle is believed to be universal, that a prior lien gives a prior claim, which is entitled to prior satisfaction, out of the subject it binds, unless the lien be intrinsically defective, or be displaced by some act of the party holding it, which shall postpone him in a Court of law or equity to a subsequent claimant.<sup>33</sup>

Thus, the principle of first-in-time is universally recognized by every United States jurisdiction as a guiding principle for determining lien seniority that acts as a default rule absent modification by agreement or statute.

As a general rule, a purchaser at a foreclosure sale takes title to property free of all liens that are junior to the lien under which the property is sold.<sup>34</sup> However, a purchaser usually takes title subject to any liens that have seniority over the lien under which the property is sold.<sup>35</sup> Priority establishing seniority of liens is often modified by state statute.<sup>36</sup> In reference to the first-in-time principle discussed in *Rankin* above, the Supreme Court noted the default nature of the principle by explaining, “[t]his principle is widely accepted and applied, *in the absence of legislation to the contrary*.”<sup>37</sup> This modification by statute and judicial interpretation of such statute is what has precipitated the super lien priority statute controversy that Nevada faces today.

A brief explanation of the developmental history of super lien statutes will help to better explain the nature of this controversy. This Part proceeds with such a summary explanation by starting with an analysis of an example of a common law first-in-time regime and moving forward in time to the creation of HOA true super lien priority regimes in certain jurisdictions.

<sup>31</sup> See NARAYANAN & GOWER, *supra* note 25, § 28:97; see also POWELL, *supra* note 23, § 37.41.

<sup>32</sup> POWELL, *supra* note 23, § 37.41.

<sup>33</sup> *Rankin v. Scott*, 25 U.S. 177, 179 (1827).

<sup>34</sup> Geier, *supra* note 30, § 10:1.

<sup>35</sup> *Id.*

<sup>36</sup> See R. Wilson Fryermuth & Dale A. Whitman, *Can Associations Have Priority Over Fannie or Freddie?*, 29 PROB. & PROP., July/August 2015, at 27, 27–28.

<sup>37</sup> *U.S. v. City of New Britain, Conn.*, 347 U.S. 81, 85 (1954) (emphasis added).

Currently, the laws of twenty-two states alter the general first-in-time rule of priority by giving HOA liens a “super priority” status.<sup>38</sup> This priority status gives association liens superior priority to first mortgages and deeds of trust in some form or another, accomplishing those goals through differing mechanisms between jurisdictions.<sup>39</sup> The degree of priority varies substantially, with some states adopting different generations of model and uniform laws (such as the Uniform Common Interest Ownership Act (“UCIOA”)) promulgated by organizations like the Uniform Law Commission.<sup>40</sup>

The law of community association lien priority has developed and diverged from the nearly universal common law principle of first-in-time through the adoption or rejection of different uniform laws by state legislatures. Over the past fifty years, state laws on CICs have developed from legislative incorporation of one of several (model or uniform) so-called “foundational” statutes that can be said to include: the 1958 Puerto Rican Horizontal Property Act or Horizontal Property Regime Act (“HPRA”), the 1962 Federal Housing Administration’s (“FHA”) Model Statute for the Creation of Apartment Ownership, the 1980 Uniform Condominium Act (“UCA”), and both the 1982 UCIOA and 1982 Uniform Planned Community Act (“UPCA”).<sup>41</sup>

Of the twenty-two states that have adopted super lien priority statutes, eight have adopted versions of the UCIOA,<sup>42</sup> five the UCA,<sup>43</sup> two the HPRA,<sup>44</sup> and seven have “stand-alone” statutes,<sup>45</sup> giving some type of priority to association liens.<sup>45</sup> One

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<sup>38</sup> Hugh Lewis, *National Matrix of Association “Super-priority” Lien Legislation*, UNIF. LAW COMM’N 1 (Oct. 14, 2016, 4:36 PM), <http://www.uniformlaws.org/shared/docs/jeburpa/CAlienprioritymatrix2013.pdf> [<http://perma.cc/7R3B-SP43>].

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 1–3.

<sup>41</sup> *Id.*; *Acts*, UNIF. LAW COMM’N, <http://www.uniformlaws.org/Acts.aspx> [<http://perma.cc/X9YH-UQ82>] (last visited April 4, 2017). While a detailed analysis of the logistical workings of these uniform statutes is beyond the scope of this Comment, it is sufficient to understand that the states’ incorporation of all or part of these varied foundational schemes is largely the basis for the wide variety of approaches taken by different jurisdictions in regard to association lien priority. For a detailed discussion of the history and the mechanics of these statutory schemes, see Andrea J. Boyack & William E. Foster, *Muddying the Waterfall: How Ambiguous Liability Statutes Distort Creditor Priority in Condominium Foreclosures*, 67 ARK. L. REV. 225, 244–45 (2014).

<sup>42</sup> Lewis, *supra* note 38, at 2. States that have adopted versions of the UCIOA with HOA lien priority include: Alaska, Colorado, Connecticut, Delaware, Minnesota, Nevada, Vermont, and West Virginia. *Id.*

<sup>43</sup> *Id.* UCA states with HOA lien priority include: Alabama, Pennsylvania, Rhode Island, Tennessee, and Washington. Other states adopting portions of the UCA without the priority provision are omitted from this list. *Id.*

<sup>44</sup> *Id.* at 2 n.3. HPRA states with HOA lien priority include: Hawaii and Massachusetts. *Id.*

<sup>45</sup> *Id.* “Stand-alone” jurisdictions with HOA lien priority include: District of Columbia, Florida, Illinois, Maryland, New Hampshire, New Jersey, and Oregon. *Id.*

state has also adopted the UPCA that similarly includes a super lien priority statute.<sup>46</sup> Certain states that adopted an increased HOA lien priority under these uniform laws came to question the priority's sufficiency during the foreclosure crisis of 2008.<sup>47</sup>

During the foreclosure crisis, homeowners were defaulting on both their HOA assessments and mortgages.<sup>48</sup> This “snowball effect” began when the housing market dropped and subprime loans ballooned causing homeowners, many of whom were speculating, to walk away from their underwater homes that were worth a fraction of what was owed on the mortgages.<sup>49</sup> When these homeowners stopped paying their mortgages, many also stopped paying their assessment dues causing the associations' reserve funds to run dry.<sup>50</sup> The unmitigated volume of owners delinquent in paying their assessments—that in some cases were ten times higher than before the recession—was causing associations to become insolvent and incapable of providing the services they were obligated to perform.<sup>51</sup> In response, HOAs in many states were able to successfully lobby their state legislatures and courts through association interest groups to increase their liens' priority.<sup>52</sup>

One such HOA lobbying organization, CAI, seeks to influence state legislatures and courts to increase priority of HOA liens “equal to the amount of the assessments that are due over the term of the lien of a mortgage or first deed of trust.”<sup>53</sup> The CAI and other similar organizations were able to convince legislators and courts to increase association lien priority above what was afforded under previous common law and statute,

<sup>46</sup> *Id.* In addition to the UCA, Pennsylvania is the only state thus far to adopt the UPCA that also provides for increased HOA lien priority. *Id.*

<sup>47</sup> See Aalberts, *supra* note 18, at 327–28.

<sup>48</sup> Kylee Gloeckner, Note, *Nevada's Foreclosure Epidemic: Homeowner Associations' Super-Priority Liens Not So "Super" for Some*, 15 NEV. L.J. 326, 326–27 (2014).

<sup>49</sup> Dennis Wagner, *Skipped dues crunch home associations*, USA TODAY (May 26, 2008, 3:00 PM), [http://www.usatoday.com/money/2008-05-26-condo-fees\\_N.htm](http://www.usatoday.com/money/2008-05-26-condo-fees_N.htm) [<http://perma.cc/C3RL-BUY6>].

<sup>50</sup> *Id.*

<sup>51</sup> See Andrea J. Boyack, *Community Collateral Damage: A Question of Priorities*, 43 LOY. U. CHI. L.J. 53, 58–61 (2011) (stating that on a national level at the time the article was written, mortgage delinquency rates were between ten percent and thirteen percent; and explaining that “this precipitous rise in mortgage delinquency corresponds with an even steeper increase in association assessment delinquency ‘which will continue until solvent owners replace delinquent owners’”).

<sup>52</sup> See Aalberts, *supra* note 18, at 327 (“[T]he managers of the CIC's, are often able to harness significant political allies during times of need. This occurred during the depths of the Great Recession of 2007-2010 when HOA's successfully lobbied state legislatures in 22 states and the District of Columbia to pass super lien laws.”).

<sup>53</sup> See *Lien Priority for Community Association Assessments*, COMMUNITY ASS'NS INST., <https://www.caionline.org/Advocacy/PublicPolicies/Pages/Lien-Priority-for-Community-Association-Assessments.aspx> [<http://perma.cc/WRE8-YCVN>] (last visited Mar. 1, 2018).

including subordinating the senior liens of other lienholders such as lenders.<sup>54</sup> As the real estate market gradually recovered, lenders in states that adopted super priority statutes began to respond by putting pressure on state legislatures and courts to rebalance lien priority.<sup>55</sup> In a typical association response to this lender pressure, CAI has called upon its “State Legislative Action Committees” to combat the lender attacks on association’s increased lien priorities.<sup>56</sup>

This battle has generated a pro-HOA legislative position and a pro-lender legislative position, each seeking to advance particular interests rather than accomplishing a true balance of the competing interests. This Comment seeks to evaluate existing models to craft a framework from which a blueprint for a better balanced approach might be created.

To facilitate analysis of the issue, this Comment has categorized the various statutory schemes into three basic approaches in regards to HOA lien priority.<sup>57</sup> First, most states still follow a first-in-time approach and have not adopted super lien statutes.<sup>58</sup> Second, there are states that have adopted super lien statutes where an HOA foreclosure extinguishes a lien made junior by the super priority status.<sup>59</sup> Finally, some states have adopted super lien statutes, but first mortgages and deeds of trust are not extinguished.<sup>60</sup> The next Part takes each in turn, analyzing one jurisdiction representing each approach.

## II. THE THREE APPROACHES TO HOA LIEN PRIORITY

This Comment’s comparative analysis will begin by examining how different jurisdictions have attempted to strike a balance between community association and lender interests.

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<sup>54</sup> See Aalberts, *supra* note 18, at 327–29 (“In response to these factors, some states’ lawmakers sought to help HOA’s by passing super lien laws.”).

<sup>55</sup> *Id.* at 328–29.

<sup>56</sup> See *State Advocacy*, *supra* note 17.

<sup>57</sup> See Lewis *supra* note 38, at 1–2. The legislatures of twenty-two states have adopted lien priority statutes that give priority to community association liens making these liens superior to other liens, including mortgages, to some degree. The remainder of the states, which are still the majority, follow a first-in-time approach to determine association lien priority. Florida has adopted a novel approach that deserves further study, and so will be included in the analysis of this Comment. *Id.*

<sup>58</sup> See Boyack & Foster, *supra* note 41, at 244–45. Boyack and Foster explain that most states provide that “a first-mortgage lien on a unit is completely superior in priority to association liens.” *Id.*

<sup>59</sup> See *SFR Investments Pool 1, LLC v. U.S. Bank*, 334 P.3d 408, 419 (Nev. 2014).

<sup>60</sup> See Christian J. Bromley, *Supremacy and Superiority: The Constitution’s Effect on State Lien Priority Statutes*, 44 REAL EST. L.J. 442, 453–55 (2016). Unlike the Nevada regime, the Florida HOA priority does not threaten the mortgagee’s lien with extinguishment and instead “the priority functions as a liability on purchasers, not as a lien competing with mortgages.” *Id.*

California will be examined first as a prototypical first-in-time jurisdiction. Next, Nevada's super lien statute will be analyzed as a representation of a jurisdiction where HOA foreclosure extinguishes a first deed of trust. Finally, this Comment will examine Florida's regime shifting liability for delinquent dues to purchasers as an alternative to both the first-in-time and super lien priority approaches.

#### A. First-in-Time Approach to HOA Lien Priority

The original type of regime governing lien priority—first-in-time—will act as our control for evaluating shifts in lien priority. Only after understanding this common law priority system will one understand how and why super lien statutes have shifted the balance in favor of HOAs. Under the common law, the priority of liens was determined by a “first in time, first in right principle.”<sup>61</sup> Today, all United States jurisdictions still follow this rule as a general default, but application of the principle is often modified by a state's recording statute and sometimes a specific law granting priority to certain types of interests.<sup>62</sup> While recording can affect the priority of a mortgage or HOA lien, this Comment focuses on when the general principle of first-in-time, assuming proper recording, is still further modified by statute.<sup>63</sup>

Under a first-in-time regime, a first mortgage or deed of trust usually remains superior to an HOA lien.<sup>64</sup> The reason a first deed of trust is commonly senior to an association's lien is that such instruments are generally prioritized in the order in which they are perfected.<sup>65</sup> Since mortgage loans are usually executed prior to an HOA delinquency being assessed, a mortgage lien in a first-in-time jurisdiction will normally be prior, and thus superior, to an association lien.<sup>66</sup> This temporal principle governs unless there is a statutory exception.<sup>67</sup>

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<sup>61</sup> See JOSEPH WILLIAM SINGER, INTRODUCTION TO PROPERTY 516 (Aspen Law & Business 2001); see also ROBERT G. NATELSON, LAW OF PROPERTY OWNERS ASSOCIATIONS 234–38 (1989).

<sup>62</sup> SINGER, *supra* note 61, at 516–20 (“Recording acts focus on protecting buyers who record first and/or purchase without notice of prior recorded claims. The major types of recording acts are: (1) race, (2) notice, and (3) race-notice. About half the states have notice statutes, and about half the states have race-notice statutes.”).

<sup>63</sup> Geier, *supra* note 30, § 10:1 (“Priority may depend upon which instrument was created executed or recorded first, or it may be affected by other factors, such as . . . specific legal priority accorded to particular interests by law[.]”) This Comment focuses on specific legal priority accorded to the particular interest of an HOA lien in relation to a first deed of trust.

<sup>64</sup> NATELSON, *supra* note 61, at 239.

<sup>65</sup> See Boyack, *supra* note 51, at 93; see also Geier, *supra* note 30, § 10:1.

<sup>66</sup> Geier, *supra* note 30, § 10:1.

<sup>67</sup> *Id.*

Such exceptions are provided for under state law and usually consist of notice under a recording act, agreement of the parties, “the doctrine of equitable subrogation, or specific legal priority accorded to particular interests by law, such as tax liens or other governmental lien interests.”<sup>68</sup> HOA super lien priority statutes fall within the last category. However, unless state law provides a shift in priority, the general principal of first-in-time continues to govern.<sup>69</sup> First-in-time jurisdictions do not have statutes that specifically modify association lien priority, and therefore do not create an HOA exception to the general rule.<sup>70</sup> Most of the jurisdictions in the United States use this type of unmodified first-in-time approach in regards to HOA lien priority.<sup>71</sup>

In most cases, the first-in-time principle is applied in two different ways. Some first-in-time states, including California, have a notice requirement that provides an association must file a notice of delinquency on assessment dues before an HOA lien is perfected.<sup>72</sup> Other states hold that lien perfection relates back to the time the community is formed.<sup>73</sup> The relating back of a lien to community formation would normally make it prior in time to a first mortgage or deed of trust.<sup>74</sup>

However, the superior priority of a first mortgage or deed of trust is usually expressly stated in a relating back jurisdiction’s statute.<sup>75</sup> When a statute does not give direction on the issue, courts in relating back jurisdictions have uniformly held first mortgages and deeds of trusts to be superior to HOA liens in order to support the opportunity for borrowers to obtain credit.<sup>76</sup>

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<sup>68</sup> Geier, *supra* note 30, § 10:1; *see also* Boyack, *supra* note 51, at 93.

<sup>69</sup> Boyack, *supra* note 51, at 94 (“In the absence of a statutory directive to the contrary, assessment liens follow the general first-in-time priority rule, and because mortgage loans are typically funded prior to assessment delinquencies, such first mortgage liens are senior to assessment liens.”).

<sup>70</sup> *Id.*

<sup>71</sup> *See* Boyack & Foster, *supra* note 41, at 244–45; *see also* NATELSON, *supra* note 61, at 239.

<sup>72</sup> *See* Boyack & Foster, *supra* note 41, at 245 (“Some states require an association to file a notice of delinquent assessment—which occurs after one perfects the first-mortgage lien—as a prerequisite step to perfecting an association lien.”) (footnote omitted).

<sup>73</sup> *See* Boyack & Foster, *supra* note 41, at 245 n.120. For example, Colorado’s law grants “granting priority over an association lien to ‘[a] security interest on the unit which has priority over all other security interests on the unit and which was recorded before the date on which the assessment sought to be enforced became delinquent.’” *Id.* (quoting COLO. REV. STAT. ANN. § 38-33.3-316 (West 2014)).

<sup>74</sup> Boyack & Foster, *supra* note 41, at 245. Boyack notes that in these jurisdictions “an association’s lien perfects at the time of the CIC’s formation; thus, recording the CIC declaration is the act of perfection.” *Id.*

<sup>75</sup> *Id.* (“Such states’ statutes specifically provide that first-mortgage liens on individual units in a common-interest community take priority over the association lien, even though the association lien relates back to the date of the CIC declaration.”).

<sup>76</sup> *Id.* (“[I]n the few states where statutes are less clear or do not address this point at all, courts have uniformly acknowledged the superior priority of first



Although there are two types of first-in-time approaches, the remainder of this Comment will use California as an exemplar sufficient to understand the larger first-in-time grouping of states for comparative purposes with those that deviate from a first-in-time standard.

California's statute follows the first-in-time principle stating that an association's lien "shall be prior to all other liens recorded subsequent to the notice of delinquent assessment[.]"<sup>77</sup> Such association liens may be secured and foreclosed upon if the assessments are not paid, but only after giving the required period of notice and subsequent recordation of the delinquent assessment.<sup>78</sup> Once the assessment has been recorded, the lien is imposed on the property and has priority from and after that date as against other interests in the property, such as a deed of trust.<sup>79</sup> Even when the association's recorded declaration provides for a present lien relating back to the beginning of the community, the lien is only imposed upon the recordation of the delinquent assessment.<sup>80</sup>

Under California law, the first-in-time principle puts associations at a disadvantage in their ability to collect delinquent member dues. Upon foreclosure of the lien by the association, deeds of trust that were recorded prior to the recording of the delinquent assessment "remain unaffected with their priority intact."<sup>81</sup> Conversely, when a first deed of trust is foreclosed on, it extinguishes all other junior liens which will usually include the association's assessment lien.<sup>82</sup> The buyer of the property at a mortgage foreclosure sale is not personally liable for any delinquent dues owed to the association by the homeowner.<sup>83</sup> Instead, the former homeowner remains personally liable for his unpaid assessments, but this debt is unsecured.<sup>84</sup> This structure creates problems regarding an association's ability to collect, because often a foreclosure sale on the first mortgage will leave no residual to satisfy the association's lien which is extinguished by the sale.<sup>85</sup>

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mortgagees—consistent with the desire to promote the availability of mortgage capital.") (footnote omitted).

<sup>77</sup> CAL. CIV. CODE § 5680 (West 2014).

<sup>78</sup> CAL. CIV. CODE § 5675 (West 2014).

<sup>79</sup> Narayanan & Gower, *supra* note 25, § 28:97.

<sup>80</sup> Thaler v. Household Fin. Corp., 95 Cal. Rptr. 2d 779, 783–85 (Ct. App. 2000).

<sup>81</sup> Narayanan & Gower, *supra* note 25, § 28:96.

<sup>82</sup> *Id.* § 10:1.

<sup>83</sup> CAL. CIV. CODE § 1466 (West 2017).

<sup>84</sup> *Id.*

<sup>85</sup> HYATT, *supra* note 29, at 121.

The dilemma an association faces in a first-in-time regime is illustrated by the result in *Thaler v. Household Finance Corp.* Thaler was a purchaser of a condo at a foreclosure sale pursuant to an HOA lien.<sup>86</sup> A second deed of trust had been recorded prior to the association's lien under which the property was foreclosed.<sup>87</sup> Thaler claimed that his interest was not subject to the second deed of trust even when the association lien was recorded after the deed of trust because the condominium's declaration of CC&Rs provided for a "present lien" (at formation of the community) with a power of sale to secure assessments.<sup>88</sup> While the CC&Rs provided the association lien would be subordinate to a first mortgage or deed of trust, they were silent on the HOA lien's priority in relation to other instruments, including a second deed of trust.<sup>89</sup>

The court in *Thaler* held that, despite the CC&Rs, the second mortgage had priority over the assessment lien which was recorded after the mortgage when the homeowner defaulted on monthly assessments.<sup>90</sup> The court reasoned that though the CC&Rs purported to create a present lien for the collection of assessments, the clear language of the relevant statute provided for a "first in time, first in right" lien priority system.<sup>91</sup> The assessment lien was not perfected until the delinquent assessment was recorded.<sup>92</sup> Therefore, because the second deed of trust was recorded prior to the delinquent assessment, it took priority over the assessment lien.<sup>93</sup> As a matter of law, Thaler bought the property at the association's foreclosure sale subject to the second deed of trust.<sup>94</sup>

As demonstrated in *Thaler*, a mortgage often takes priority over an association lien under California law because the association lien is not perfected until a member defaults on association dues and the delinquent assessment is recorded. Because a mortgage lien is typically placed on a property at the

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<sup>86</sup> *Thaler v. Household Finance Corp.*, 95 Cal. Rptr. 2d 779, 780–81 (Ct. App. 2000).

<sup>87</sup> *Id.*

<sup>88</sup> *Id.* ("Thaler seems to argue that, as a result, the lien for the enforcement of the Homeowners' assessment either sprang from the lien created by the CC & R's (rather than the Assessment Lien), or the Assessment Lien related back to (and derived priority from) the CC & R's. Thaler thus claims that [the second mortgagee] took its interest subject to, and therefore subordinate to, the lien by which Thaler ultimately purchased the property.") *Id.*

<sup>89</sup> *Id.* at 781–82.

<sup>90</sup> *Id.* at 780–81.

<sup>91</sup> *Id.* at 783 ("Such lien shall be prior to all other liens recorded subsequent to the recordation of said notice of assessment.") (emphasis removed).

<sup>92</sup> *Id.* at 783–85.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* at 784–85.

time of purchase, this will usually be before that purchaser stops paying their HOA dues. This puts associations at a temporal disadvantage in relation to first mortgages that translates into a disadvantage in priority due to the first-in-time principle.

In order to illustrate how the rules of a first-in-time regime determine the possible outcomes for each party, this Part will use two hypothetical situations. The first hypothetical will show what happens when a lender forecloses on the first mortgage lien or deed of trust. The second will reverse the situation with the association initiating foreclosure. We will return to these hypotheticals in Sections II(B) and II(C) to illustrate how each regime shapes the rational decisions of the parties and the logical outcome of those decisions.

Assume the property in question is located in an HOA neighborhood and was purchased just prior to the 2008 recession through a first deed of trust with the lender in the amount of \$885,000. During the recession, the homeowner becomes unemployed and is unable to keep up with both the mortgage payments and association assessments. The homeowner owes \$4500 in association dues. The balance on the mortgage is \$800,000, but the fair market value of the property has plummeted to \$400,000. The homeowner makes a decision to walk away from the underwater property and pay neither the mortgage nor the association assessments.

In our first scenario, the lender chooses to institute foreclosure proceedings before the association. The lender's first deed of trust has seniority over the association lien since the HOA lien is not perfected until the delinquency is recorded. This makes the first deed of trust prior in time and superior to the association lien. The lender is unable to find a buyer to pay more than market value, and the price at the foreclosure sale is \$400,000. The lender's senior lien is satisfied from the proceeds first, and there is nothing left for the association whose junior lien is extinguished during the sale.

Assume for the second hypothetical that instead of promptly initiating foreclosure, the lender delays initiation in order to see if the market makes a recovery and to avoid paying HOA dues if it decides to purchase the property. During this period of delay, no one is paying association dues on the property. The association waits for the lender to act for months, but finally decides they can wait no more. The association initiates foreclosure before the lender. Because the lender's lien is senior to the association's, the buyer at the foreclosure sale must take title subject to the lender's \$800,000 mortgage lien on the property. This makes it extremely difficult to find a buyer when

the market value of the property is worth half of the mortgage lien on the property. Unable to find a buyer, the association is forced to internalize the debt and passes the cost along to its remaining members with higher dues and special assessments.

Between an association and a lender, the first-in-time approach appears to heavily favor the lender's interests. As long as the loan is made prior to a homeowner ceasing to pay association assessments, a lender's lien will usually be senior to an HOA lien.<sup>95</sup> This seniority provides a lender with security in its interest. When a lender forecloses, its lien will be satisfied by the proceeds first, and the association will only be paid if there is a surplus. Furthermore, the lender need not fear that an HOA foreclosure will extinguish its interest because a lender's senior lien will survive an association's foreclosure.<sup>96</sup>

In contrast, the first-in-time approach puts community associations at a significant disadvantage. When a homeowner is in substantial debt for delinquent assessments, foreclosure is the more secure of the methods of recovery for an HOA.<sup>97</sup> However, since both associations and lender-mortgagees hold liens on specific properties, these two groups are inherently in competition with one another when the sale proceeds cannot satisfy payment on both obligations.<sup>98</sup> Under the California first-in-time approach, a lender's first deed of trust will almost always have priority over an association's lien because the statute bases the priority assessment of the HOA's lien off of the time the delinquent assessment is recorded.<sup>99</sup>

A California-type regime will continue to have the same kinds of problems identified during the Great Recession that motivated adoption of HOA super lien priority statutes. Associations under these first-in-time statutes will continue to struggle to collect deficient assessments during dips in the real estate market when association liens are extinguished by lender foreclosure with few viable alternative remedies for collection available.<sup>100</sup> The issue of collection is compounded when lenders

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<sup>95</sup> CAL. CIV. CODE § 5680 (West 2014).

<sup>96</sup> *Thaler*, 95 Cal. Rptr. 2d at 780–81. While a lender may not need to fear extinguishment of their lien under these circumstances, they do have a concern that association foreclosure will affect the market value of the property. This may have an adverse effect on their ability to maximize their return upon a foreclosure sale on the mortgage lien. See Courtney Newsom, Note, *No Free Ride: An Equitable Remedy to Protect Homeowners' Associations from Delayed Foreclosures*, 46 LOY. L.A. L. REV. 361, 363–64 (2012).

<sup>97</sup> See Bromley, *supra* note 22, at 257.

<sup>98</sup> *Id.*

<sup>99</sup> CAL. CIV. CODE § 5680 (West 2014).

<sup>100</sup> See Bromley, *supra* note 22, at 258; see also Boyack, *supra* note 51, at 78.

become reluctant to expedite foreclosure for financial reasons.<sup>101</sup> Without foreclosure sales being completed, new owners who could pay dues and provide income to the association are not taking title to the zombie property.<sup>102</sup>

Lenders operating inside the rules of a first-in-time jurisdiction have little motivation to expedite foreclosure proceedings<sup>103</sup> because lenders' liens have almost guaranteed priority under this approach.<sup>104</sup> A lender's senior interest is not substantially threatened—such as when the interest could be extinguished—by HOA foreclosure, so a lender is not under sufficient pressure from the association to quickly foreclose on a property.<sup>105</sup> Furthermore, a lender has little internal incentive to foreclose quickly in a declining real estate market. Under such conditions, the market value of the property is likely to be much less than the value of the mortgage loan.<sup>106</sup> To maximize the return on their lien, lenders often prefer to wait and see if the market makes a recovery before foreclosing on a property.<sup>107</sup> In addition, if the lender plans to be the purchaser at the foreclosure sale, taking title to the property would lead to the lender having to pay regular HOA assessments.<sup>108</sup> Most lenders would prefer to avoid this additional cost if they are able, and a

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<sup>101</sup> Newsom, *supra* note 96, at 367. Newsom explains that “[b]anks are able to take a free ride—and cause additional hardship for homeowners in an HOA—because of the combination of laws governing California HOAs and lien prioritization.” *Id.* The “free ride” she refers to is the ability of a lender to delay foreclosure in hopes the housing market will recover, allow maximization of the return on their lien during foreclosure, and avoid paying the additional cost of association dues.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at 361 (“[A] bank will often delay foreclosure, sometimes months or even years, when the property is part of a homeowner’s association since the association must continue to insure and maintain the property regardless of whether the bank or the homeowner makes any contribution to the association.”).

<sup>104</sup> *Id.* at 373–78. Newsom explains that in California, a lien is not perfected until recorded after meeting the notice requirements of the statute. This will almost always make an association lien subsequent and junior to a first mortgage since the first mortgage is perfected at the purchase of the property. *Id.*

<sup>105</sup> *Id.* at 378 (“Without laws to the contrary, the lender is free to take advantage of the HOA because there is no incentive for the bank to foreclose or pay its fair share of HOA expenses.”) (footnote omitted).

<sup>106</sup> Joint Editorial Board for Uniform Real Property Acts, *Distribution of JEB Report on Common Interest Assessment Lien Priority*, UNIFORM LAW COMMISSION (Aug. 22, 2013), [http://www.uniformlaws.org/shared/docs/jeburpa/2013aug22\\_JEBURPA\\_UCIOA%20Lien%20Priority\\_Request%20for%20Comments.pdf](http://www.uniformlaws.org/shared/docs/jeburpa/2013aug22_JEBURPA_UCIOA%20Lien%20Priority_Request%20for%20Comments.pdf) [<http://perma.cc/M3LB-5FB5>] [hereinafter *JEB Report*].

<sup>107</sup> See Newsom, *supra* note 96, at 377 (“Delaying foreclosures allows lenders to control the number of homes on the market and potentially prevent continued drops in value marketwide, keep the loan on the performing side of the balance sheet, and avoid ownership costs.”) (footnotes omitted).

<sup>108</sup> *Id.*

first-in-time regime offers lenders such an opportunity by allowing them to simply forestall foreclosure on their lien.<sup>109</sup>

During economic recessions, ineffective collection methods and lack of paying members lead to HOAs not being able to fulfill their core functions of neighborhood maintenance.<sup>110</sup> The lack of neighborhood care and upkeep then contributes to the continued drop in the market value of member properties.<sup>111</sup> If HOAs are unable to collect dues by foreclosure or other means of collection, they are often forced to increase their dues to other members in order to continue operating.<sup>112</sup> As noted in the Miller and Starr treatise, “[t]here is a strong public policy in favor of the levying and enforcement of assessments in a common interest development as an economic necessity for the proper functioning of the development.”<sup>113</sup> This public policy interest is so strong that the California legislature granted regular assessments of housing associations an exemption from the claims of creditors to the extent necessary for the association to perform its obligation to provide essential services.<sup>114</sup>

However, as illustrated by the above discussion, the California legislature seems to have overlooked the obstacles associations must contend with when collecting assessments if their liens must compete with other senior liens such as a first deed of trust. Exemption from creditor claims for assessments is not a significant advantage when the association cannot collect sufficient assessments.

The difficulties associations face in the collection of assessments under the constraints of a first-in-time regime are the catalyst of UCIOA-type super lien priority statutes, which endeavor to resolve the problem. The next Section will discuss Nevada’s attempt to address this issue by its super lien priority statute and judicial interpretation that an HOA lien has true priority over a first mortgage.

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<sup>109</sup> *Id.*

<sup>110</sup> *JEB Report*, *supra* note 106. The report explains that during delays in foreclosure, “neither the defaulting unit owners nor the first mortgagee typically pay the assessments on the unit” because under a first-in-time regime, “the mortgagee does not become legally liable to pay assessments on the unit unless and until the mortgagee acquires title to the unit via a foreclosure sale or deed in lieu of foreclosure.” *Id.* at 2.

<sup>111</sup> *See Collins*, *supra* note 4.

<sup>112</sup> Newsom, *supra* note 96, at 361. An HOA in a first-in-time jurisdiction often has little recourse other than to increase dues of paying members because “[t]he bank is able to shed its financial obligation at the expense of the property’s innocent neighbors.” *Id.*

<sup>113</sup> Narayanan & Gower, *supra* note 25, § 28:93 (footnote omitted).

<sup>114</sup> *Id.* (“Regular assessments imposed on or collected from unit owners are exempt from execution by the association’s judgment creditors to the extent necessary for the association to perform its obligations under the governing documents as required by law.”).

## B. True Priority Super Lien Priority Statutes

In order to address the issues encountered by HOAs in collecting delinquent dues in a first-in-time jurisdiction, a minority of states, including Nevada, have taken the position that an HOA foreclosure on its lien extinguishes the interests of “all other liens and encumbrances,” including a first mortgage or deed of trust.<sup>115</sup> As previously mentioned, the laws of twenty-two states alter the general first-in-time rule of priority by giving HOA liens a “super priority” status.<sup>116</sup> The specific priority differs by state, with legislatures having adopted different generations of uniform codes and model statutes.<sup>117</sup> While several jurisdictions have held that a first deed of trust may be extinguished under its super lien priority statute,<sup>118</sup> this Comment uses only Nevada’s statute and case law as its focal point of discussion and as an example to understand generally the direction chosen by states that fit into the super lien category.<sup>119</sup>

To understand the nature of the issues, it is helpful to begin with a brief summary of the history of Nevada’s super lien statute. Super lien priority statutes arose in response to the issue of HOA inability to collect delinquent assessments under a traditional first-in-time type regime.<sup>120</sup> The Uniform Law Commission promulgated uniform model community association

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<sup>115</sup> NEV. REV. STAT. § 116.3116(2) (West 2015).

<sup>116</sup> See Lewis, *supra* note 38, at 1 (“The laws of twenty-two (22) jurisdictions contain provisions that afford a so-called ‘super-priority’ to the liens available to condominium associations and/or community associations, making such liens superior to the liens of mortgage loans and other types of liens, to some varying extent.”).

<sup>117</sup> See Boyack & Foster, *supra* note 41, at 244–45. Boyack and Foster explain that “[t]hese acts vary widely in how they address buyers’ liability and association-lien priority” and “[t]he statutory divide among states is traceable largely to the historical development of their condominium regimes.” *Id.* at 246. This historical development is mainly from “four foundational condominium-ownership statutes: (a) the Puerto Rican Horizontal Property Act; (b) the Federal Housing Administration’s (FHA) Model Statute for the Creation of Apartment Ownership; (c) the Uniform Condominium Act (UCA); and (d) the Uniform Common Interest Ownership Act (UCIOA).” *Id.* at 246–47.

<sup>118</sup> See *Chase Plaza Condo. Ass’n, Inc. v. JPMorgan Chase Bank*, 98 A.3d 166, 178 (D.C. 2014); see also *Summerhill Village Homeowners Ass’n v. Roughley*, 289 P.3d 645, 646 (Wash. Ct. App. 2012).

<sup>119</sup> *HOA Foreclosures Leave Banks Empty Handed*, *supra* note 3. Nevada’s statute and case law are both at the forefront of the debate and may have “implications nationwide.” *Id.*

<sup>120</sup> Vaughn, *supra* note 3, at 10. Vaughn explains:

In response to an increase in HOAs, and a desire to help HOAs collect debt more efficiently, the Uniform Law Commission (“ULC”) developed the Uniform Condominium Act (“UCA”) . . . . Under the UCA, HOAs were granted some measure of lien priority against mortgages. . . . Subsequent acts, the Uniform Common Interest Ownership Act (“UCIOA”) and the Uniform Planned Community Act (“UPCA”), were passed in 1982 and all contained language granting HOAs super-priority status.

*Id.*

statutes such as the UCA, the UCIOA, and the UPCA, all of which included an HOA lien priority (for six months of delinquent assessments) over a first mortgage or deed of trust.<sup>121</sup> The original comments to the UCIOA stated the purpose of the HOA super lien priority as follows:

[T]he six months' priority for the assessment lien strikes an equitable balance between the need to enforce collection of unpaid assessments and the obvious necessity for protecting the priority of the security interests of lenders. As a practical matter, secured lenders will most likely pay the six months' assessments demanded by the association rather than having the association foreclose on the unit.<sup>122</sup>

The comments underscore the Uniform Law Commission's intent that the burden of paying for a delinquent homeowner's assessment be shifted to the lender who has substantially more assets, and therefore, may bear the burden more easily than an HOA.<sup>123</sup> However, most courts have interpreted the original language of UCIOA section 3-116 to suggest that an HOA lien should not have a true lien priority (which would extinguish a first mortgage), but rather a "limited priority lien" affording only a payment priority.<sup>124</sup> Such a scheme provides the priority position of the HOA lien is split with six months of unpaid assessments taking priority over a first mortgage, and the remaining assessment deficit staying subordinate to the first mortgage.<sup>125</sup> This "six-month capped 'super priority' portion" of an HOA lien is not accorded true priority in the original UCIOA because this portion cannot be foreclosed on by the association as senior to a first mortgage or deed of trust.<sup>126</sup> Instead, such a limited priority lien offers priority in payment upon foreclosure by the lender.<sup>127</sup>

In 1991, the Nevada state legislature adopted a modified version of the UCIOA.<sup>128</sup> The Nevada Uniform Common Interest

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<sup>121</sup> *See id.*

<sup>122</sup> UNIFORM COMMON INTEREST OWNERSHIP ACT § 3-116 cmt. 2 (2008) (amended 2014) (note that this language has since been removed) [hereinafter UCIOA § 3-116].

<sup>123</sup> *See Vaughn, supra* note 3, at 10–11. ("The Comments essentially suggests [sic] that because mortgage lenders have more money than HOAs, they should be responsible for the delinquent dues that stem from a common debtor.")

<sup>124</sup> *See Boyack, supra* note 51, at 98–99. Boyack explains the position of most states with super lien priority statutes is "[t]he six-month capped 'super priority' portion of the association lien does not have a true priority status under UCIOA since this six-month assessment lien cannot be foreclosed as senior to a mortgage lien." *Id.*

<sup>125</sup> *Id.* at 99 n.216.

<sup>126</sup> *Id.* at 99.

<sup>127</sup> *Id.* ("Rather, it either creates a *payment* priority for some portion of unpaid assessments, which would take the first position in the foreclosure repayment 'waterfall,' or grants *durability* to some portion of unpaid assessments, allowing the security for such debt to survive foreclosure.") (footnotes omitted).

<sup>128</sup> Gloeckner, *supra* note 48, at 329.



Ownership Act was enacted as NRS Chapter 116, and it included an HOA super lien priority statute.<sup>129</sup> In Nevada, NRS section 116.3116 governs HOA liens and is substantially similar to section 3-116 of the UCIOA.<sup>130</sup> The relevant parts of NRS section 116.3116 state the following:

A lien under this section is prior to all other liens and encumbrances on a unit except: . . . (b) A first security interest on the unit recorded before the date on which the assessment sought to be enforced became delinquent or, in a cooperative, the first security interest encumbering only the unit's owner's interest and perfected before the date on which the assessment sought to be enforced became delinquent, except that a lien under this section is prior to a security interest described in this paragraph to the extent set forth in subsection 3.<sup>131</sup>

This section of the statute provides that an association lien is superior to all other liens on a property with the exception of a first mortgage or deed of trust recorded prior to the recordation of the delinquent assessment. The priority provided to the HOA lien up to this point in the statute is the same as in a common law first-in-time jurisdiction. However, the following section alters the priority of the association lien:

A lien under this section is prior to all security interests described in paragraph (b) of subsection 2 to the extent of: (a) Any charges incurred by the association on a unit pursuant to NRS 116.310312; (b) The unpaid amount of assessments, not to exceed an amount equal to assessments for common expenses based on the periodic budget adopted by the association pursuant to NRS 116.3115 which would have become due in the absence of acceleration during the 9 months immediately preceding the date on which the notice of default and election to sell is recorded.<sup>132</sup>

According to the plain language of the statute, as drafted by the Nevada legislature, this section provides that nine months of the HOA lien's assessments will take priority over a first mortgage or deed of trust.<sup>133</sup> In the event of a foreclosure sale by the lender, the amount for nine month's assessments will be considered senior to a first deed of trust, and the association may collect this amount from the proceeds of the sale before the lender receives their portion.<sup>134</sup> However, there remained an

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<sup>129</sup> *Id.* ("The section of the statute relevant to the HOA foreclosure issue is NRS 116.3116, which is almost identical to section 3-116 of the UCIOA; this section governs liens against units for assessments.").

<sup>130</sup> *Id.*

<sup>131</sup> NEV. REV. STAT. ANN. § 116.3116(2) (West 2015).

<sup>132</sup> *Id.* § 116.3116(3).

<sup>133</sup> Gloeckner, *supra* note 48, at 330 ("Thus, a portion of the HOA's lien—limited to nine months of unpaid assessments preceding the lien—is given priority over the bank's first mortgage, creating a 'super-priority' status.").

<sup>134</sup> *Id.* ("In this case, the HOA's lien is considered 'senior' to the bank's first deed of

ambiguity in the statute regarding whether an HOA's foreclosure on its lien automatically extinguishes all prior liens on the property made junior by this super priority status.<sup>135</sup> In 2014, the Nevada Supreme Court resolved this ambiguity.<sup>136</sup>

In *SFR Investments*, the Nevada Supreme Court interpreted the NRS section 116.3116 priority to be a true lien priority, rather than just a limited payment priority as previously discussed.<sup>137</sup> Relying on the statute's plain language that an association lien is "prior to all other liens and encumbrances," the court held that an association lien held absolute priority to a first mortgage or deed of trust recorded before the delinquent assessment.<sup>138</sup> The court reasoned that the statute splits an association's lien into a "superpriority piece" of nine months of assessments senior to a first deed of trust and a "subpriority piece" remaining subordinate to the first deed of trust.<sup>139</sup> The court interpreted the language of the statute to mean that the HOA super priority piece was prior to, and therefore senior to, first security interests.<sup>140</sup>

The court used the comments to UCIOA section 3-116 to interpret the statute's ambiguity.<sup>141</sup> The comments stated "lenders will most likely pay the . . . assessments demanded by the association rather than having the association [foreclose] on the unit."<sup>142</sup> The court reasoned that if the super priority piece only established payment priority, this reference to the lender paying off the super priority piece to avoid foreclosure "would make no sense."<sup>143</sup> The court's interpretation in *SFR Investments* means that with both the statutory priority of an HOA lien being higher than a first mortgage and an association's ability to invoke non-judicial foreclosure, an HOA lien can completely extinguish a mortgage or first deed of trust on the foreclosed property.<sup>144</sup>

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trust, which is often referred to as a 'junior' security interest, even though the HOA lien was asserted subsequently in time.").

<sup>135</sup> *Id.* at 332 ("The ambiguity pertains to whether a foreclosure sale, properly conducted pursuant to NRS Chapter 116, automatically extinguishes all prior encumbrances on the property, thereby allowing a bona fide purchaser at an HOA foreclosure sale to obtain the property free and clear of all prior encumbrances.").

<sup>136</sup> *See SFR Invs. Pool 1, LLC v. U.S. Bank*, 334 P.3d 408 (Nev. 2014).

<sup>137</sup> *See Bromley*, *supra* note 60, at 453; *see also SFR Invs.*, 334 P.3d at 409.

<sup>138</sup> *SFR Invs.*, 334 P.3d at 409 (quoting NEV. REV. STAT. § 116.3116(2) (West 2015)).

<sup>139</sup> *Id.* at 411.

<sup>140</sup> *Id.* at 412.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.* at 413 (quoting UNIFORM COMMON INTEREST OWNERSHIP ACT § 3-116 cmt. 1 (1982); UNIFORM COMMON INTEREST OWNERSHIP ACT § 3-116 cmt. 2 (1994); UCIOA § 3-116 cmt. 2 (emphasis omitted)).

<sup>143</sup> *Id.*

<sup>144</sup> *See Bromley*, *supra* note 60, at 453; *see also SFR Invs.*, 334 P.3d at 409.

To illustrate how a Nevada type regime works in contrast to a first-in-time jurisdiction, let us return to the hypothetical found in Section II(A) and apply the Nevada rules to the situation. Recall that the property in question is located in an HOA neighborhood and was purchased just before the Great Recession through a first deed of trust for \$885,000. The homeowner is unable to keep up with both the mortgage payments and association assessments, which accrue to \$4500. The balance on the mortgage is \$800,000, but the fair market value of the property has plummeted to \$400,000. The homeowner makes a decision to walk away from the underwater property and pay neither the mortgage nor the association assessments.

Assume for our first scenario that the lender initiates foreclosure first. The association's super priority amount for nine months of assessments is afforded super priority status under the statute. Assume that assessments for nine months in the community equal \$1800, which is the super priority amount under the statute. The lender sells the property for \$400,000, and the senior super priority amount of \$1800 must be paid before the first mortgage is satisfied. The HOA receives \$1800 from the proceeds while the lender gets \$398,200 from the foreclosure sale.

For the second scenario, assume that the lender decides not to foreclose in hopes of market recovery and to avoid paying HOA dues if it decides to purchase the property. During this period of delay, no one is paying association dues on the property. However, unlike in a first-in-time jurisdiction, the association has an ace up their sleeve under a Nevada type regime. The association can initiate foreclosure under their lien and the super priority amount of the lien is made senior to the first mortgage by statute. Because this portion is senior and given true lien priority, a foreclosure upon this senior portion of the lien will extinguish the first mortgage. As required by statute, the association provides notice to the lender of the impending foreclosure. The lender is allowed to pay off the \$1800 super priority amount and save its interest on the property from extinguishment. But if the lender does not pay this amount before the association forecloses, the lender's lien for \$800,000 will be extinguished. Furthermore, because the amount of the assessments is only \$4500 and the \$800,000 mortgage is extinguished, it is very likely that the association will find a buyer. Since the association can only satisfy \$4500 worth of dues, it is likely the association would sell the property for an amount around \$5000. It would then send a check for the surplus of the proceeds to the lender for \$500.

Essentially, the court took what was supposed to be a limited payment priority under the UCIOA and instead held that it was a true lien priority capable of extinguishing other junior interests in the property.<sup>145</sup> Under the original UCIOA as adopted by Nevada, the association's lien was given limited protection during a lender's foreclosure sale by allowing the HOA to collect six months' worth of assessments from the proceeds before the lender could satisfy its own lien. But the limited priority given to association liens upon lender foreclosure did not solve the problem of lender delay in initiating foreclosure found in first-in-time jurisdictions. Lender delay continued to be a problem because the lender did not have adequate motivation to foreclose. A lender's lien retained true priority over an HOA lien and certainly was not in danger of being extinguished.

The Nevada Supreme Court tackled this issue with the nuclear solution of giving the super priority piece of the association lien true priority over other liens made junior by the statutory priority.<sup>146</sup> Because the super priority piece of nine months of assessments held true priority over a first mortgage, an association can now foreclose on the super priority piece and extinguish a first mortgage. Under such a scheme, lenders must act to either initiate foreclosure or pay off the association lien if they wish to preserve their substantial interest in the property.

The result of this interpretation of Nevada's super lien priority statute is that it essentially takes away the lender's advantage afforded in a first-in-time jurisdiction and gives it to the HOA.<sup>147</sup> Under the Nevada-style regime, associations are almost guaranteed to be able to collect their unpaid dues.<sup>148</sup> This can be done either: (1) from the proceeds of a foreclosure action by the lender since the HOA lien is senior to a mortgagee's, (2) direct foreclosure by the HOA on its lien because it has priority, or (3) a buyout of the association lien by the lender who is forced to pay the assessment to avoid extinguishment of the mortgage lien by an HOA initiated foreclosure.

While this scheme essentially solves association problems found in a first-in-time jurisdiction, the result appears to be significantly unfair to the lender whose substantial interest in

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<sup>145</sup> *SFR Invs.*, 334 P.3d at 409.

<sup>146</sup> *Id.*

<sup>147</sup> See Bromley, *supra* note 60, at 453.

<sup>148</sup> See Aalberts, *supra* note 18, at 328 ("With super liens an association can actually collect even if the property's value is greatly underwater to the amount owed on the mortgage; this is in contrast to states without super lien laws where the lack of equity makes it generally impossible to collect.").

the property can be extinguished.<sup>149</sup> The result is unfair because a lender's security interest on a property will generally be for an amount far greater than a few months of delinquent assessments.<sup>150</sup> The ability of an HOA to wipe out a security interest on a million dollar loan for a few thousand dollars worth of dues is disproportionate and does not give the impression of being fair and equitable.<sup>151</sup> This interpretation is arguably not in accordance with the equity originally intended by the UCIOA drafters, and grants far too much of the balance of power to associations.<sup>152</sup>

Despite the perceived failings at achieving a true balance, super lien priority statutes do not appear to be in danger of disappearing in the near future absent lenders' successful lobbying of state legislatures. In 2014, the Uniform Law Commission updated the UCIOA to reflect the recent court holdings granting the super priority lien true priority status.<sup>153</sup> In fact, against prior judicial interpretation of UCIOA section 3-116 holding that the section merely provides a payment priority, the Commissioners state that the original UCIOA intended a true lien priority capable of extinguishing junior interests.<sup>154</sup> However, the UCIOA comments to section 3-116 also state that the equitable balance between associations and lenders contemplated by the uniform code was premised on the assumptions that lenders would foreclose quickly, and a sufficient return existed on the foreclosure sale to satisfy both liens.<sup>155</sup> The comments go on to explain that this situation did not exist during the foreclosure crisis, and the language of the statute created an interpretive dispute as to

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<sup>149</sup> *Lenders' Mortgage Liens at Risk of Being Extinguished by Condo and Homeowners' Association "Super-Priority" Liens*, GOODWIN PROCTOR LLP (Sept. 27, 2014), <https://www.goodwinlaw.com/publications/2014/09/lenders-mortgage-liens-at-risk-of-being-extinguish> [hereinafter *Goodwin Mortgage Liens*].

<sup>150</sup> *HOA Foreclosures Leave Banks Empty Handed*, *supra* note 3.

<sup>151</sup> See Gardberg, *supra* note 3, at 13.

<sup>152</sup> Bromley, *supra* note 60, at 453 ("This result lacks any of the equitable balance intended by the UCIOA drafters and alternately affords the association exactly what the UCIOA and the Nevada statute intended to avoid: absolute priority status of a mortgagee at the expense of unpaid associations.").

<sup>153</sup> UCIOA § 3-116 cmt. 2 ("First, subsection (a) affirms the result in *Summerhill Village Homeowners Ass'n v. Roughley*, . . . and makes clear that the association's lien has true priority over the lien of an otherwise first mortgage lender to the extent of the amount specified in subsection (c). Thus, if the association conducts a foreclosure sale of its association lien and the otherwise first mortgagee does not act to redeem its interest by satisfying the association's limited priority lien, the mortgagee's lien would be extinguished.").

<sup>154</sup> *Id.* ("As originally promulgated in 1982, subsection (c) provided that the association's lien did have priority to the extent of six months of unpaid common expense assessments, based on the association's periodic budget.").

<sup>155</sup> *Id.*

whether the super priority lien should be a true lien priority or a payment priority.<sup>156</sup>

The Uniform Law Commission resolved this ambiguity in the UCIOA by changing the language of section 3-116(b)(3) to include: “[a]ny priority accorded to the association’s lien under this section is a priority in right and not merely a priority to payment from the proceeds of the sale of the unit by a competing lienholder or encumbrancer.”<sup>157</sup> With this amendment to the UCIOA, it is now clear that the Uniform Law Commission intends that the priority provided to an association lien under section 3-116 is intended to be a true priority. What is left to be seen is whether the remaining states that adopted section 3-116 will agree with the Commissioners’ intent and adopt true lien priority for their super priority statutes.

Though Nevada and the Uniform Law Commission have essentially solved the problems encountered by associations in first-in-time jurisdictions, serious issues remain with true priority super lien priority statutes. While a first-in-time jurisdiction gives lenders a significant advantage, super lien priority statutes holding foreclosure on an HOA lien extinguishes a first deed of trust shift the balance completely to community associations.

Both approaches result in significant disadvantages to whichever party is not favored under the law. Each approach grants priority to parties on opposite ends of the association-lender spectrum. Either may be considered a valid approach if it is determined that either the lender or the association should hold priority in a competitive zero-sum game. However, it may be more fair to the parties involved to aspire to achieve a more balanced lien priority scheme. The next Section will examine an approach that falls somewhere in between these two polar extremes.

### C. The Purchaser Liability Approach

Some jurisdictions have sought to craft a solution to the perceived imbalances created in the groups described in Sections II(A) and II(B) above. While the first-in-time approach greatly favors the lender, super lien priority jurisdictions with true lien priority provisions shift the advantage to associations. Florida takes an approach somewhere between the two. This Section begins with an overview of the Florida scheme and the context in

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<sup>156</sup> *Id.* at 189–90.

<sup>157</sup> UCIOA § 3-116.

which it developed, followed by an analysis of the legal structure set forth in Florida's approach to balancing competing lien interests.

Florida was one of the states hit hardest during the Great Recession, which began with the foreclosure crisis in 2008.<sup>158</sup> By March 2010, sixty percent of Florida CICs were reporting that at least half of their units or parcels were two months or more behind in paying their assessments.<sup>159</sup> Homeowners that did pay their dues were paying for the upkeep of sometimes dozens of empty homes in the process of foreclosure in their neighborhoods.<sup>160</sup> One community association attorney likened the situation to "getting stuck with the bar tab of a roomful of people you have never met."<sup>161</sup> As a result, CICs had to increase assessments and were sometimes unable to provide the maintenance and services they were obligated to perform, which further depreciated the neighborhood's property values.<sup>162</sup> Florida required an innovative solution to its foreclosure problem.

Under Florida common law, the general rule governing lien priority is unsurprisingly "first in time is first in right," absent statutory regulation otherwise.<sup>163</sup> Florida's recording statute makes it a notice jurisdiction, and the holder of a lien must record in order to preserve his lien's priority against subsequent purchasers, creditors, and other lien holders.<sup>164</sup> Under Florida's statute, both condominium and homeowners association liens are

<sup>158</sup> See Daniel Goldmintz, Note, *Lien Priorities: The Defects of Limiting the "Super Priority" for Common Interest Communities*, 33 CARDOZO L. REV. 267, 282–83 (2011).

<sup>159</sup> Rachael Lee Coleman, *Desperate condo, homeowner associations thrown a lifeline*, MIAMI HERALD (Mar. 7, 2010), [https://www.miamiforeclosurelawyerblog.com/files/2015/07/Desperate-condo-homeowner-associations-thrown-a-lifeline-03\\_07\\_2010-MiamiHerald.com\\_.pdf](https://www.miamiforeclosurelawyerblog.com/files/2015/07/Desperate-condo-homeowner-associations-thrown-a-lifeline-03_07_2010-MiamiHerald.com_.pdf) [<http://perma.cc/H8WN-VN8M>].

<sup>160</sup> Rich McKay, *Empty Homes Mean Others Pick Up Tab*, ORLANDO SENTINEL (Jan. 24, 2010), [http://articles.orlandosentinel.com/2010-01-24/news/1001230144\\_1\\_dues-town-homes-housing-market](http://articles.orlandosentinel.com/2010-01-24/news/1001230144_1_dues-town-homes-housing-market) [<http://perma.cc/ED8L-KHRT>].

<sup>161</sup> *Id.*

<sup>162</sup> Boyack, *supra* note 51, at 78. Boyack provides the following example:

Parkview Point Condominium in Miami Beach suffered a large enough loss of assessment revenue that it was unable to pay water bills for the building, and the unit owners nearly had their water cut off before solvent owners were able to raise funds to pay the arrearage. The lobby ceiling repairs, however, were stopped mid-repair, leaving wiring and ducts exposed.

*Id.*

<sup>163</sup> 34 FLA. JUR. 2D § 34 (2017). In other words, "the general rule is thus that liens shall take precedence in the order of their creation unless the one prior in time is extrinsically defective or is destroyed by some act of the holder." *Id.*

<sup>164</sup> THOMAS E. BAYNES, JR., FLORIDA MORTGAGES § 9-1 (2016).

effective from, and relate back to the recording of the original declaration establishing the CIC.<sup>165</sup>

In accordance with Florida's recording statute, the original declaration of the community is said to provide notice to other potential interest holders so long as the declaration provides that the CIC lien will have a higher priority than other liens.<sup>166</sup> However, the Florida statutory scheme makes an exception for first mortgages, which are given an expressly prescribed priority higher than an association lien.<sup>167</sup> Therefore, in relation to a first mortgage, the association lien becomes effective once the claim of lien is recorded in the county public records.<sup>168</sup> Because only junior liens are extinguished in a foreclosure action, this means that a foreclosure action by a CIC, on its lien, will usually not extinguish a first mortgage since a first mortgage will normally be senior to a CIC lien.<sup>169</sup>

In 1992, Florida altered association lien priority by its partial adoption of the UCIOA super lien priority statute which grants association liens a six-month limited payment priority.<sup>170</sup> However, the priority granted under this statute does not work in the traditional sense prescribed by the UCIOA which required an association lien to compete with other liens, including a first mortgage.<sup>171</sup> Instead, the Florida statute allows an association's lien to bypass direct competition with a first mortgage because the foreclosure sale purchaser is held jointly and severally liable with the former homeowner for unpaid association assessments.<sup>172</sup> At an HOA foreclosure sale, a purchaser is often the lender because a lender will usually prefer to purchase the property itself rather than dealing with an unknown third party. But regardless of whether the purchaser is the lender or a third party, the association recovers directly from that purchaser

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<sup>165</sup> See THE FLA. BAR, FLORIDA REAL PROPERTY LITIGATION § 5.40 (8th ed. 2016); Homeowner's Association Act, FLA. STAT. § 720.3085 (2017); Condominium Act, FLA. STAT. § 718.116 (2017).

<sup>166</sup> THE FLA. BAR, *supra* note 165, § 5.272; *see also* Coral Lakes Cmty. Ass'n, Inc. v. Busey Bank, 30 So. 3d 579, 584–85 (Fla. Dist. Ct. App. 2010).

<sup>167</sup> THE FLA. BAR, *supra* note 165, § 5.628; FLA. STAT. § 720.3085; FLA. STAT. § 718.116.

<sup>168</sup> FLA. STAT. § 720.3085; FLA. STAT. § 718.116.

<sup>169</sup> POWELL, *supra* note 23, § 37.41.

<sup>170</sup> *See* Bromley, *supra* note 22, at 284–85; *see also* 1992 Fla. Laws. ch. 92-49, at 444.

<sup>171</sup> UCIOA § 3-116 cmt. 2.

<sup>172</sup> *See* Boyack & Foster, *supra* note 41, at 258–59. Boyack and Foster note that Florida's approach is unique because it “impos[es] joint and several liability on any foreclosure purchaser for past-due assessments of the previous owner but limit[s] such liability in the case of a first-priority lender to the amount of the CIC super-priority lien.” *Id.*



rather than collecting their super priority against the foreclosing mortgagee's sale proceeds.<sup>173</sup>

Both Florida and some other states have taken a purchaser liability approach, but only Florida applies it to a holder of a first mortgage's purchase of the property at an association's foreclosure sale.<sup>174</sup> However, the Florida statute still limits a lender-purchaser's liability.<sup>175</sup> While the lender is liable for the previous owner's past due assessments upon purchase at the foreclosure sale, the Florida statute imposes a statutory cap on the lender's liability.<sup>176</sup> This statutory cap is restricted to the amount of the CIC's super priority lien.<sup>177</sup> Originally, the maximum under the Florida super priority lien statute was six months of delinquent assessments prior to the foreclosure purchase.<sup>178</sup>

During the housing crisis beginning in 2008, foreclosure timelines became longer as more and more property foreclosures inundated the judiciary.<sup>179</sup> These timelines were especially a problem in states such as Florida that required judicial foreclosure, since judicial foreclosure typically involves longer wait times due to required judicial oversight of the foreclosure process.<sup>180</sup> In 2010, the Florida legislature passed an amendment to their super lien priority statute increasing associations' super priority from the six months of delinquent assessments to twelve months or one percent of the amount of the foreclosing mortgage.<sup>181</sup> Therefore, the lender-purchaser's super lien liability is now currently restricted to the lesser of either (1) twelve months of delinquent assessments proceeding the purchase, or (2) one percent of the original mortgage debt on the property.<sup>182</sup>

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<sup>173</sup> Bromley, *supra* note 60, at 454–55 (“Florida’s limited priority is provided through the statutory liability of a foreclosure sale purchaser. The statute allows a mortgagee to foreclose its interest and imposes liability for the priority amount on that mortgagee as a foreclosure sale purchaser.”).

<sup>174</sup> Boyack & Foster, *supra* note 41, at 257–59 (“Florida is the only state that imposes assessment liability on a lender who acquires title at a foreclosure sale, although it caps the amount of liability imposed on such lender.”).

<sup>175</sup> *Id.* at 255.

<sup>176</sup> *Id.* at 258–59.

<sup>177</sup> *Id.*

<sup>178</sup> THE FL. BAR, *supra* note 165, § 5.628.

<sup>179</sup> Boyack, *supra* note 51, at 107–08. Boyack notes, “[t]he lengthy foreclosure timeline is caused in part by the sheer magnitude of the increase in foreclosure volume over the past few years—in 2010, there were more foreclosures commenced each month than were typically commenced in an entire year prior to 2005.” *Id.*

<sup>180</sup> Bromley, *supra* note 60, at 454. Bromley argues that “[t]he challenges of the foreclosure crisis, especially with protracted timeframes in judicial foreclosure states like Florida, necessitate increased priority rights for associations.” *Id.*

<sup>181</sup> Fla. S. 1196, Gen. Assemb., Reg. Sess. (Fla. 2010).

<sup>182</sup> FLA. STAT. ANN. § 720.3085 (West 2017); FLA. STAT. ANN. § 718.116 (West 2017).

Let us revisit the earlier hypos of Sections II(A) and II(B) to apply the Florida regime to those facts. Again, assume the property in question is located in an HOA neighborhood and was purchased just prior to the 2008 recession through a deed of trust for \$885,000. The homeowner is unable to keep up with both the mortgage payments and association assessments, owing \$4500 on the latter. The balance on the mortgage is \$800,000 while the fair market value of the property is \$400,000. The homeowner makes a decision to walk away from the underwater property and pay neither the mortgage nor the association assessments.

In our first scenario the lender forecloses on their mortgage lien. Under the Florida approach, the lender's lien is not in competition with the association's lien. Instead, the Florida statute shifts responsibility for the delinquent assessments to the purchaser at the foreclosure sale.<sup>183</sup> Whether this is the lender or a third party, the purchaser must pay the cost of the assessments. If the lender decides to purchase the property, then as a purchaser, the lender would be required to pay up to twelve months of the assessments or one percent of the overall mortgage value. In this case let us assume that regular assessments are \$200 a month. Twelve months of assessments would be \$2400 while one percent of the mortgage would be \$8000. The lender would be responsible for the lesser of these amounts and would have to pay \$2400 included in the purchase price. If the purchaser is a third party, then they would have to pay the entire amount of \$4500 in delinquent dues included in the purchase price of the property. This is because the statute only limits the liability of lender-purchasers, not when a purchaser is a third party.

For the second scenario, assume that the lender delays foreclosure in hopes the market recovers or to avoid paying HOA assessments in the event the lender decides to purchase the property. During this period of delay, no one is paying association assessments on the property. The lender is under some pressure during this period to institute foreclosure because they know the priority amount is building up to twelve months' assessments. But assume they wait the full year period and there is no longer additional motivation for the lender to initiate foreclosure. The HOA waits as long as it can and then initiates foreclosure itself. A lender will often have motivation to purchase the property in this situation to avoid having to deal with a third-party purchaser with whom it is not familiar.

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<sup>183</sup> See FLA. STAT. ANN. § 720.3085 (West 2017); FLA. STAT. ANN. § 718.116 (West 2017).

Regardless of whether the lender or a third party purchases the property, the cost of the delinquent assessments will be included in the purchase price: \$2400 for the lender, or the entire \$4500 for a third-party purchaser.

The Florida approach differs significantly from the previously discussed approaches in two distinct ways: (1) the 2010 amendment doubled the priority amount from six months under the UCIOA to twelve months or one percent of the mortgage under the Florida statute, and (2) the super priority of the lien bypasses competition with the first mortgage and instead acts as a statutory liability on the purchaser.<sup>184</sup> Some Florida lawyers have interpreted the plain language of the statute to mean that a non-lender foreclosure purchaser would be liable for the entire amount of delinquent assessments, though this has not yet been decided by a court.<sup>185</sup> This regime is very similar in effect to the limited priority of an HOA lien offered under the UCIOA, but differs by virtually guaranteeing the eventual recovery of delinquent assessments via the liability imposed on the purchaser by the statute.<sup>186</sup>

Some have criticized this approach on the basis that, while it increases the overall delinquent assessment amount an association may recover, it does not solve the underlying problem that remains in both first-in-time jurisdictions and super lien priority statutes that act only as a payment priority.<sup>187</sup> The underlying problem manifests because lenders have no incentive to expedite foreclosure on their lien once assessments have accrued to the maximum allowable super priority level.<sup>188</sup> As discussed in first-in-time jurisdictions, a

<sup>184</sup> Bromley, *supra* note 60, at 454 (explaining that the lien priority of the Florida statute “functions as a liability on purchasers, not as a lien competing with mortgages”).

<sup>185</sup> See Boyack, *supra* note 51, at 109. Boyack notes that “[a]ccording to some Florida lawyers, the new law permits unlimited recovery of unpaid assessments from third-party buyers at mortgage foreclosure (unlimited durability of the association lien) and caps recovery only from lenders.” *Id.* at 109 n.281.

<sup>186</sup> See FLA. STAT. ANN. § 720.3085; see also FLA. STAT. ANN. § 718.116. Boyack explains that “[t]he six-month capped ‘super-priority’ portion of the association lien does not have true priority status under UCIOA since this six-month assessment lien cannot be foreclosed as senior to a mortgage lien. Rather, it creates a payment priority for some portion of unpaid assessments.” Boyack, *supra* note 51, at 99 (emphasis removed).

<sup>187</sup> See Boyack, *supra* note 51, at 108.

<sup>188</sup> *Id.* Boyack explained the underlying problem of first-in-time jurisdictions in the following text:

Although . . . these enhanced lien priority measures increased ultimate recovery by an association, they failed to solve the underlying problem that still plagues the six-month capped priority laws: once the designated period has elapsed (be it six or nine or twelve months), lenders have no further incentive to contribute to property upkeep or to expeditiously foreclose so that someone new can take title.

*Id.*

lender has little incentive to foreclose on an underwater property in a stagnant market when doing so would require it to pay HOA assessments.<sup>189</sup>

Under the Florida-type alternative, the lender has some incentive to move forward with foreclosure during the twelve-month period while assessments are building up to the statutory cap.<sup>190</sup> However, once this period is over, the lender may continue to delay foreclosure and is still not obligated to pay the assessments since it has not yet taken title.<sup>191</sup> Therefore, the Florida approach somewhat addresses the problem of lender delay in foreclosure by the increase in the statutory cap of assessments for which a lender-purchaser can be held responsible. However, the increased statutory cap does not have the force of extinguishment of the lender's lien that unreservedly forces lender compliance under the Nevada regime.

Others have praised this Florida-style approach as greatly expanding an association's potential recovery of delinquent assessments.<sup>192</sup> Bromley, for example, has posited: "This extension contemplates what the UCIOA drafters could not have foreseen decades prior."<sup>193</sup> Bromley believed that this expansion of the statutory cap under the super priority statute would effectively counter the financial difficulties of HOAs caused by the expanded foreclosure timelines in judicial foreclosure states such as Florida.<sup>194</sup> Furthermore, he noted that the procedure of imposing statutory liability on the purchaser (often the mortgagee) at the foreclosure sale would probably prevent the inequitable results found in decisions like *SFR Investments*.<sup>195</sup> Notably, these assessments of up to twelve months' payments or one percent of the original mortgage debts are generally more generous than the recovery available even in states such as Nevada.<sup>196</sup> Under Nevada law, though the regime grants absolute

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<sup>189</sup> See *supra* Section II(A).

<sup>190</sup> A lender has increased incentive to foreclose during this period simply because the amount they can be liable for as a purchaser is increasing during the twelve-month period. The more quickly they foreclose on the property, the less of the super priority amount they will owe upon purchase of the property.

<sup>191</sup> See *supra* Section II(A).

<sup>192</sup> Bromley, *supra* note 60, at 453–54 (arguing that "Florida separates condominium and homeowners' association liens into separate statutes that greatly expand an association's potential recovery") (footnote omitted).

<sup>193</sup> *Id.* at 454 (explaining that what UCIOA drafters could not have foreseen decades prior were "[t]he challenges of the foreclosure crisis, especially with protracted timeframes in judicial foreclosure states like Florida, necessitate increased priority rights for associations.").

<sup>194</sup> See *id.*

<sup>195</sup> See *id.* at 453–54.

<sup>196</sup> FLA. STAT. ANN. § 720.3085; FLA. STAT. ANN. § 718.116.

priority to an HOA lien, the statutory super priority cap is set at nine months' worth of delinquent assessments.<sup>197</sup>

At first glance, the Florida statutes appear to better balance the interests of the HOAs and lenders. In effect, the Florida regime is “effectively identical to limited priority over a mortgagee,” but also ensures the CIC will recover delinquent assessments through the imposition of liability for these unpaid fees on the purchaser of the property.<sup>198</sup> While providing for the highest recovery for an HOA of any state discussed in this Comment, the method of collection of these dues is unlikely to reproduce the risk of unfairness to lenders imposed by a true priority regime with a super lien priority statute.<sup>199</sup> Despite these attractive characteristics, further analysis of the positive and negative aspects of each approach in regards to their ability to fairly balance competing policy interests is still required before fully evaluating which system works best. Part III broadens the comparative assessment to consider overall fairness and furtherance of other policy objectives across the alternatives.

### III. A COMPARISON OF THE APPROACHES IN RELATION TO FAIRNESS AND POLICY<sup>200</sup>

The preceding Section of this Comment have provided an analysis of the mechanics and consequences to the parties of each jurisdiction's lien priority approach. The following Sections will discuss how each jurisdiction balances issues of fairness and achieves desired policy results. This Part will begin with a discussion of each jurisdiction's effectiveness at achieving fairness and equity for the relevant parties. It will then proceed to examine each type of approach in relation to the policy concerns regarding (1) the disproportionate value of the liens, (2) the value of encouraging HOAs as a means of private governance, (3) the availability of credit to buyers in association communities, and (4) the party in the best position to internalize the externality of delinquent dues.

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<sup>197</sup> NEV. REV. STAT. ANN. § 116.3116.

<sup>198</sup> Bromley, *supra* note 60, at 454.

<sup>199</sup> *Id.*

<sup>200</sup> While this Comment recognizes the ongoing constitutional challenges to super lien priority statutes, this Comment will instead focus on other infirmities of these statutes in terms of fairness and public policy. *See generally* Bourne Valley Court Tr. v. Wells Fargo Bank, 832 F.3d 1154 (9th Cir. 2016); Saticoy Bay LLC v. Wells Fargo Home Mortg., 388 P.3d 970, 971 (Nev. 2017).

### A. Fairness and Equity to the Parties

An attempt to determine a superior approach to HOA lien priority rightly begins with a discussion of fairness and equity. One of the paramount concerns of property law is that an individual's reasonable expectations of his or her interests in property will be respected and protected.<sup>201</sup> Therefore, it is important that the law be settled and predictable in order to offer owners and potential owners of property greater certainty in their property rights.<sup>202</sup> With greater certainty comes greater confidence in investment.<sup>203</sup> This confidence drives our economy, which in turn, distributes the benefits of increased wealth to our society as a whole.<sup>204</sup> This principle was summarized in the seminal case, *State v. Shack*, in which the court recognized that “[p]roperty rights serve human values. They are recognized to that end, and are limited by it.”<sup>205</sup> Both fairness and equity are uniquely human values, and any attempted determination of a system of property rights must include a discussion of these principles.

For reasons discussed previously in Part II, lenders do not have sufficient motivation in a bad housing market to expedite foreclosure proceedings. One reason for this is the lender's hope of maximization on the return on their mortgage lien by waiting to see if the market improves. Another reason is the avoidance of the responsibility of paying HOA dues should the lender purchase the property. Regardless of the reasons for delay, this deliberate and calculated inaction is crippling to associations who have to reduce services they are obligated to provide or increase assessments on paying members.<sup>206</sup> With paying members fitting the bill, lenders receive the benefit of the value of their collateral being preserved without having to pay for this advantage.<sup>207</sup>

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<sup>201</sup> See Donald J. Kochan, *Dealing with Dirty Deeds: Matching Nemo dat Preferences with Property Law Pragmatism*, 64 U. KAN. L. REV., Nov. 2015, at 1, 5–7.

<sup>202</sup> *Id.* at 29–35 (explaining the importance of recording acts as one area of property law that provides “confidence in the transfer of property in a very real way because buyers and sellers have greater predictability in the enforcement of their conveyances”).

<sup>203</sup> See Donald J. Kochan, *Certainty of Title: Perspectives after the Mortgage Foreclosure Crisis on the Essential Role of Effective Recording Systems*, 66 ARK. L. REV. 267, 298–311 (2013).

<sup>204</sup> *Id.* at 310 (“Delineation of ownership facilitates exchange. Contracting would be impossible if parties were unable to trade rights. Likewise, property ownership must be protected from aggression in order for a civil society to flourish. At a minimum, therefore, government must have the power to protect these institutions of property and free exchange.”).

<sup>205</sup> *State v. Shack*, 277 A.2d 369, 372 (N.J. 1971).

<sup>206</sup> See Newsom, *supra* note 96, at 361. Newsom explains that while a “bank is able to shed its financial obligation at the expense [of] the property's innocent neighbors,” an “association must continue to insure and maintain the property regardless of whether the bank or homeowner makes any contribution to the association.” *Id.*

<sup>207</sup> *Id.*

Thus, the lenders were being unjustly enriched by not acting expeditiously in initiating foreclosure proceedings.<sup>208</sup> They were receiving the benefit of preservation of their collateral's value through the dues paid by other members of the community.<sup>209</sup> The payment of these additional costs by the remaining members kept up the property values of the abandoned homes by maintaining attractive characteristics such as exterior upkeep and lawn care despite the lack of a steward-owner to perform these routine tasks. The dues also contributed towards the upkeep of common areas in the neighborhood that increased the abandoned properties' values.

HOA payment for these absconded member shares presented an inherently unfair situation to both community associations and to their remaining members who had to shoulder the cost. Lenders were receiving the value from the preservation of their mortgaged property without a requirement to contribute towards that upkeep. Both the inability of HOAs to remain financially solvent and unjust enrichment of lenders led to the Nevada Supreme Court decision affording true priority to their state's UCIOA-type super lien priority statute.

In contrast to the above examples, super lien priority statutes have resolved many of the problems facing community associations in first-in-time jurisdictions and limited priority UCIOA jurisdictions.<sup>210</sup> Goldmintz argued in favor of a Nevada-type regime that eliminates the limited priority of the UCIOA in lieu of true priority for association liens.<sup>211</sup> His student comment advocated that "giving associations a full priority over all mortgages will insure that associations recover all back-maintenance fees and will put their budgets back on track."<sup>212</sup> He also notes that the burden will be placed "squarely onto lenders," and argues this is equitable because "lenders are better situated to protect against the risks of default, are better

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<sup>208</sup> *Id.*

<sup>209</sup> *Id.* at 363 ("The banks get a premium price for each home because the homes are located in a well-maintained development with a well-run HOA, even though the banks did not pay a dime toward the expenses of the HOA.")

<sup>210</sup> CMTY. ASS'N INST., MORTGAGE BANKERS VS. LOCAL COMMUNITIES: PROTECTING HOMEOWNERS AND AMERICA'S NEIGHBORHOODS (2014), [https://www.caionline.org/Advocacy/StateAdvocacy/PriorityIssues/PriorityLien/Documents/2014\\_NV\\_Response.pdf](https://www.caionline.org/Advocacy/StateAdvocacy/PriorityIssues/PriorityLien/Documents/2014_NV_Response.pdf) [<http://perma.cc/FN7F-VSC8>] (noting that after the *SFR Investments* decision in Nevada, mortgage lenders are moving more quickly to effectuate foreclosures and pay community associations).

<sup>211</sup> Goldmintz, *supra* note 158, at 289–90. Goldmintz proposed that "[t]he limited super-priority should be abolished and associations should be given full priority over mortgagees in order to reverse the downward fiscal spiral of associations and the lenders that finance them." *Id.* (footnote omitted).

<sup>212</sup> *Id.* at 289.

able to bear the burden, and have the tools and sophistication to maximize the value of the sale at foreclosure proceedings.”<sup>213</sup>

However, the fix to HOA issues through such a system does so in an arguably unfair manner at the expense of the lender, whose interest may be extinguished without adequate justification. Lenders and their supporters have stated that “[t]hese initiatives run contrary to the very heart and nature of secured lending.”<sup>214</sup> A Nevada-style regime effectively coerces a lender to pay association dues by using the threat of extinguishing his interest (sometimes worth hundreds of thousands of dollars) for the act of omission of not instituting its own foreclosure proceedings in a timely manner.<sup>215</sup>

However, proponents of super lien priority statutes have argued that because notice to the lender is required to be given of an HOA foreclosure, the lender has adequate time and opportunity to ensure the security of its interest.<sup>216</sup> In October of 2015, in response to constitutional challenges relating to adequate notice, the Nevada Legislature amended its statute to ensure a lender with an interest in a property being foreclosed on by an HOA would receive adequate notice to protect its interest.<sup>217</sup> NRS section 116.31163 provides that:

The association or other person conducting the sale shall also mail, within 10 days after the notice of default and election to sell is recorded, a copy of the notice by certified mail to: . . . Each holder of a recorded security interest encumbering the unit’s owner’s interest which was recorded before the recordation of the notice of default, at the address of the holder that is provided pursuant to NRS 657.110 on the Internet website maintained by the Division of Financial Institutions of the Department of Business and Industry.<sup>218</sup>

This statute requires that notice be delivered to a holder of a recorded security interest that was recorded prior to the HOA

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<sup>213</sup> *Id.*

<sup>214</sup> Aušra Gaigalaite, *Priority of Condominium Associations’ Assessment Liens vis-à-vis Mortgages: Navigating in the Super-Priority Lien Jurisdictions*, 40 SEATTLE U. L. REV. 841, 866 (quoting AM. BANKERS ASS’N ET AL., STATEMENT OF PRINCIPLES ON HOA SUPER PRIORITY LIENS 1 (2015)).

<sup>215</sup> See *supra* Section III(B).

<sup>216</sup> Gloeckner, *supra* note 48, at 343–44. Gloeckner explains the notice argument for true lien priority:

For example, proponents of HOAs have argued that because NRS Chapter 116 requires multiple notices be provided to lenders, there is sufficient time to secure their interest. A lender does not lose its interest until the property is sold at an HOA foreclosure sale; therefore, lenders have ample time to cure delinquent assessments on the home.

*Id.* at 343 (footnotes omitted).

<sup>217</sup> See Gardberg, *supra* note 3, at 17.

<sup>218</sup> NEV. REV. STAT. ANN. § 116.31163 (West 2015).



assessment under which an association forecloses. Because first mortgage or deed of trust holders fall squarely within the category of parties who must be afforded notice, extinguishment of the lender's interest is arguably equitable if they fail to act to protect their interest by paying the assessment. However, the argument that a lender has adequate notice to pay off an association lien and save its interest in the property ignores the basic principle that the lender is not responsible for the assessment debt in the first place.

It is important to remember that the original homeowner who defaulted on payments is the party who is ultimately responsible for the assessment debt. The most equitable solution would be for the debtor to pay his own debts. However, often times this is not a practical solution because the debtor may not have the necessary funds to pay their debt. While placing the burden on another party that has the resources to pay is obviously more practical, it brings up issues of fairness and equity that cannot be ignored.

One of the strongest fairness arguments for a Nevada-type regime is that it is fair for a lender to shoulder the responsibility of HOA dues because the lender acts wrongfully by delaying foreclosure proceedings and is thereby unjustly enriched.<sup>219</sup> However, in order for a party to fairly be held accountable for a wrongful omission or inaction, they must fail to perform a legal duty the party is obligated to perform. *Black's Law Dictionary* defines a duty as "[a] legal obligation that is owed or due to another and that needs to be satisfied; that which one is bound to do, and for which somebody else has a corresponding right."<sup>220</sup>

A lender is in privity with a homeowner mortgagor who has been granted a mortgage loan to purchase property located within a neighborhood governed by an HOA. An association is in privity with such a homeowner through the covenants attached to the purchased property. However, a lender and association have no direct connection with each other through these relationships with the homeowner. Until a lender takes title to the property by foreclosure sale or deed in lieu of foreclosure, a

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<sup>219</sup> See Goldmintz, *supra* note 158, at 289. Goldmintz states that a full priority scheme "incentivizes . . . the quick execution of foreclosure proceedings, since, the longer the bank waits, the more money they'll have to pay to associations. This, in turn, is therefore more equitable, more efficient, and more beneficial to all the parties involved." *Id.* (footnote omitted). See also Newsom, *supra* note 96, at 363 (arguing that banks are unjustly enriched by receiving the benefit of the higher value of a property in a well-run HOA by delaying foreclosure, and therefore, their obligation to pay assessments).

<sup>220</sup> *Duty*, BLACK'S LAW DICTIONARY (10th ed. 2014).

lender has no legal duty to pay association assessments.<sup>221</sup> Therefore, a lender has no legal duty to pay an HOA when the homeowner mortgagor defaults on association assessments, just as the HOA has no legal duty to pay the homeowner's mortgage when he or she defaults on mortgage payments.

Even if it is determined that it is equitable for a lender to pay the mortgagor's delinquent assessments, extinguishment and threat of extinguishment of the lender's mortgage lien does not correspond proportionally to the wrong the lender committed. As to the wrong the lender commits, there is a good argument that the lender is unjustly enriched by not paying dues the non-defaulting HOA members must pay.<sup>222</sup> *Black's Law Dictionary* defines unjust enrichment as "[a] benefit obtained from another, not intended as a gift and not legally justifiable, for which the beneficiary must make restitution or recompense."<sup>223</sup> As previously discussed in this Part, a lender obtains the benefit of protection the value of his interest in the property without having to pay for that benefit.

However, the normal remedy for unjust enrichment is restitution which does not involve extinguishment of a lien far more valuable than the benefit conferred.<sup>224</sup> The remedy of restitution definition provides that "the measure of recovery is usually based not on the plaintiff's loss, but on the defendant's gain."<sup>225</sup> The unjust benefit conferred to lenders was protection of their interests' value through the payment of assessments by other association members. Restitution of this benefit would mean that the lender would have to disgorge the benefit conferred: the payment of the assessments.

A Nevada-style regime does require payment of assessments by the unjustly enriched lender and is in accordance with the principle of restitution. However, it does so by giving a power of extinguishment of the lender's lien to the HOA through its ability to foreclose on the property. Because a lender's lien will usually be much more substantial than the relatively minor benefit of protection of the mortgaged property's value, even inadvertent extinguishment would produce an extremely harsh and unjust result.

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<sup>221</sup> *JEB Report*, *supra* note 106.

<sup>222</sup> See Newsom, *supra* note 96, at 361, 363–64 ("[A] bank that purposely delays foreclosure on a property located in a homeowner's association is unjustly enriched by the association when the bank knows the homeowner has also defaulted on its homeowner's association dues.").

<sup>223</sup> See *Unjust Enrichment*, BLACK'S LAW DICTIONARY (10th ed. 2014).

<sup>224</sup> *Id.*

<sup>225</sup> *Restitution*, BLACK'S LAW DICTIONARY (10th ed. 2014).

The Florida approach of joint and several liability for the purchaser and seller likely strikes a fairer balance between these divergent extremes of first-in-time jurisdictions and true priority super lien priority statutes. As previously discussed, both first-in-time and true priority super lien priority statutes completely place the cost of delinquent dues either on the association or lender respectively. Under the Florida method, the burden of paying delinquent HOA dues shifts to the purchaser.<sup>226</sup>

After the homeowner who originally defaulted on the debt, the purchaser is arguably the party upon which it is most fair to impose this cost. The negative externalities of delinquent assessments must be borne by a party other than the original debtor if the debtor cannot be made to pay. Pursuit of a judgment against that debtor may be impractical because they are insolvent or judgment proof. If the association internalizes the cost of the debt, the cost is distributed to its other members.<sup>227</sup> This is an unjust result because the other members are not responsible for the debts of the defaulting members, and those other members are likely under similar financial burdens which caused the non-paying members' defaults.<sup>228</sup> As previously discussed, while a lender may be better able to bear the cost, forcing him or her to pay for an externality he or she did not cause also produces an unjust result.

In contrast to the association and lender, a purchaser of the property has the ability to either accept the added liability of paying the delinquent dues, or to walk away from the foreclosure sale. In addition, the association lien is taken out of competition with the first mortgage because the assessment amount is statutorily required to be paid by the foreclosure purchaser.<sup>229</sup> Rather than having a zero sum game between the association and lender, liability for the externality is simply placed upon the shoulders of the one party who can make the choice to accept it.<sup>230</sup> The added factor of choice arguably makes the Florida approach the most fair and equitable of the different

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<sup>226</sup> See FLA. STAT. ANN. § 720.3085 (West 2017); see also FLA. STAT. ANN. § 718.116 (West 2017).

<sup>227</sup> Christine Haughney, *Collateral Foreclosure Damage for Condo Owners*, N.Y. TIMES (May 15, 2008), <http://www.nytimes.com/2008/05/15/business/15condo.html>.

<sup>228</sup> See CMTY ASS'N LEADERSHIP LOBBY, COMMUNITY ASSOCIATIONS FACE A PERFECT STORM: FORECLOSURES, BUDGET SHORTFALLS, AND STATE MANDATES (Dec. 1, 2009).

<sup>229</sup> Bromley, *supra* note 60, at 454–55.

<sup>230</sup> Under a first-in-time regime, a first mortgage or deed of trust will usually take priority and extinguish an association lien upon the lender's foreclosure. On the other hand, a true priority super lien priority statute completely shifts this advantage to the HOA lien that will extinguish a first mortgage if foreclosed upon by the association. This situation presents a zero sum game where it is all or nothing for either side. See *supra* Sections II(A) and II(B).

lien priority schemes discussed. The next Sections examine whether it remains in that favored position after considering other policy concerns.

#### B. The Disproportionate Value of the Liens

One of the most compelling policy arguments against the Nevada super lien statute and its interpretation by the Nevada Supreme Court relates to the differential value between competing lien interests. The value of an association lien compared to a first mortgage is usually extremely disproportionate. An association lien will typically only be for a few thousand dollars of delinquent dues,<sup>231</sup> whereas a first mortgage will usually be an amount closer to the entire value of the home at the time it was bought.<sup>232</sup> To allow an HOA foreclosure on a lien worth a few thousand dollars to extinguish a million dollar mortgage does not appear to be fair and just. Consider the following examples of the inequities that can result in some true super lien priority jurisdictions.

In *SFR Investments*, U.S. Bank approved a mortgage loan for \$885,000 in 2007, just before the housing bubble imploded the following year.<sup>233</sup> During the recession, the homeowner fell behind on payments and then quit paying altogether because the value of the home was underwater.<sup>234</sup> In addition to their mortgage, the homeowners also owed about \$4500 in association dues.<sup>235</sup> The HOA began a non-judicial foreclosure proceeding without notice to the bank and sold the home at an auction for \$6000 to SFR, a speculation company that was taking advantage of the legal/economic situation.<sup>236</sup> SFR initiated a quiet title action, and the court held U.S. Bank's security interest on the remaining \$800,000 of the loan was extinguished.<sup>237</sup> The

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<sup>231</sup> Melissa Waite, *The HOA Foreclosure and Priority: Who is in First?*, CLARK COUNTY B. ASS'N COMMUNIQUÉ, Nov. 2013, at 26, 26–28. Waite describes HOA foreclosure sales in Nevada at the time of this article as being “very low in relation to the fair market value of the property being sold” with the typical sales price being between \$3000 and \$12,000. *Id.*

<sup>232</sup> Timm Herdt, *Foreclosure crisis not driven by luxury home purchases*, VENTURA COUNTY STAR (Aug. 17, 2010), <http://archive.vcstar.com/business/foreclosure-crisis-not-driven-by-luxury-home-purchases-ep-367899884-348388001.html?page=1> [<http://perma.cc/L2EW-4FTA>] (stating an analysis by the nonprofit Center for Responsible Lending showed that the average value at the time of loan origination was \$396,351).

<sup>233</sup> *SFR Investments Pool 1, LLC v. U.S. Bank*, 334 P.3d 408, 409 (Nev. 2014).

<sup>234</sup> *Id.*

<sup>235</sup> *Id.* at 418.

<sup>236</sup> *Id.* at 409. Note that under subsequent Nevada laws, notice would be required. The Nevada Legislature addressed the issue of notice by requiring adequate notice to other interest holders in a property that is the subject of an HOA foreclosure. *See supra* Section III(A).

<sup>237</sup> *Id.* at 418–19.

loan became unsecured and eventually resulted in losses to the bank.<sup>238</sup>

In *Chase Plaza Condominium Association, Inc. v. JPMorgan Chase Bank*, the original buyer of a condo bought the property with a loan from JPMorgan Chase Bank for \$280,000.<sup>239</sup> The owner fell behind on payments for the loan, and also owed payments to their condominium association amounting to \$9415.<sup>240</sup> The association foreclosed without notifying the bank and sold the condo for \$10,000.<sup>241</sup> The bank was alerted to the sale when the association sent a check to the bank for the surplus of \$478.<sup>242</sup> The court upheld this action as valid because the Washington D.C. super lien priority statute gave the CIC lien priority over the mortgage, and the foreclosure by the HOA extinguished the bank's interest in the condo.<sup>243</sup>

In *Saticoy Bay*, the original purchaser took out a mortgage loan for \$81,370 from Wells Fargo Bank.<sup>244</sup> The homeowner fell behind on their association dues, and the HOA foreclosed on their lien.<sup>245</sup> The property was sold for only \$6900 to another speculation LLC intending to cash in on the situation.<sup>246</sup> The Court upheld the Nevada super lien priority statute as constitutional, holding, inter alia, that the HOA's exercise of its new statutory rights did not constitute state action for purposes of the Due Process Clause and the Takings Clause.<sup>247</sup>

As these cases demonstrate, because an HOA can only collect the small amount it is owed on its lien from the profits of its foreclosure sale, it has little incentive to sell the home at a price which exceeds the amount they are owed.<sup>248</sup> One Nevada attorney stated that a typical sales price at an association foreclosure in Nevada during 2013 was between \$3000 and

<sup>238</sup> Vaughn, *supra* note 3, at 4.

<sup>239</sup> *Chase Plaza Condo. Ass'n, Inc. v. JPMorgan Chase Bank*, 98 A.3d 166, 168 (D.C. Cir. 2014).

<sup>240</sup> *Id.*

<sup>241</sup> *Id.* The court hinted that the failure of the lien priority statute to require notice be sent to other lienholders may be facially unconstitutional, but was unable to reach the issue because JPMorgan did not raise it as an issue. See *Goodwin Mortgage Liens*, *supra* note 149.

<sup>242</sup> *Chase Plaza Condo. Ass'n*, 98 A.3d at 168–69.

<sup>243</sup> *Id.* at 178.

<sup>244</sup> *Saticoy Bay LLC v. Wells Fargo Home Mortg.*, 388 P.3d 970, 971 (Nev. 2017).

<sup>245</sup> *Id.*

<sup>246</sup> *Id.*

<sup>247</sup> *Id.* at 975.

<sup>248</sup> See 6A PATRICK J. ROHAN, REAL ESTATE TRANSACTIONS: HOME OWNER ASSOCIATIONS AND PLANNED UNIT DEVELOPMENTS – LAW AND PRACTICE § 9.15 (Matthew Bender ed., 2013) (“The purpose of foreclosure of an association's lien is to have the property applied to the payment of the outstanding assessment liability.”).

\$12,000.<sup>249</sup> This amount is not even close to what would usually be required to satisfy a first mortgage, which can often run in the hundreds of thousands, if not millions, of dollars. Savvy real estate investment companies have taken advantage of the situation and often make a profit of twenty to fifty times the amount in which they paid at the HOA foreclosure.<sup>250</sup> It is obvious that equity to the lender demands this wrinkle in the law be addressed, and addressed quickly.

One route for challenging an association's foreclosure sale that has been met with limited success is a claim the UCIOA incorporates a duty of good faith on the part of HOAs conducting foreclosure sales to expend efforts to get the fair market price for the property.<sup>251</sup> The UCIOA states: "Every contract or duty governed by this [act] imposes an obligation of good faith in its performance or enforcement."<sup>252</sup> The Vermont Supreme Court recently held that enforcement of an HOA lien via foreclosure must be executed in good faith as defined by section 1-113 of the UCIOA, which requires a standard of commercial reasonableness.<sup>253</sup> In doing so, the court set aside a foreclosure sale of a parcel just over \$33,500 when that parcel had a fair market value of at least \$70,000.<sup>254</sup> The court reasoned that the sale was not commercially reasonable, so the sale must be void under the good faith standard of the UCIOA.<sup>255</sup>

This application of the law by the Vermont Supreme Court demonstrates a possible solution to prevent this unjust result under Nevada-type lien priority regimes.<sup>256</sup> It is possible that had the good faith issue been raised in *SFR Investments, Chase Plaza*, and *Saticoy Bay*, these courts could have found that the associations failed to meet the good faith standard because the sales prices were for just a fraction of the likely fair market

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<sup>249</sup> See Waite, *supra* note 231, at 26.

<sup>250</sup> See Robin E. Perkins, *Can an HOA "Super-Priority" Lien Extinguish a Lender's Deed?*, A.B.A. SEC. LITIG. (Mar. 18, 2014), <https://www.americanbar.org/groups/litigation/committees/corporate-counsel/articles/2014/winter2014-can-an-hoa-super-priority-lien-extinguish-a-lenders-deed.html> [<http://perma.cc/KP6J-SV4R>]. Perkins states a home costing anywhere from \$200,000 to \$500,000 would be sold at an HOA foreclosure sale for an amount between \$3000 and \$10,000 because "properties are auctioned for little more than the amount of the HOA lien." *Id.*

<sup>251</sup> See Gaigalaité, *supra* note 214, at 868.

<sup>252</sup> UCIOA § 1-113.

<sup>253</sup> *Will v. Mill Condo. Owners' Ass'n*, 848 A.2d 336, 341 (Vt. 2004).

<sup>254</sup> *Id.* at 342-43.

<sup>255</sup> *Id.*

<sup>256</sup> Although beyond the scope of this Comment, which focuses on three approaches to HOA lien priority as they currently exist, incorporation of the duty of good faith into the UCIOA may be a possible solution to the inequitable result to lenders of homes being sold by HOAs at foreclosure for a fraction of their value. It will be interesting to see if this proposition is adopted by the true super lien priority states in the near future.

values of the properties. Such sales of properties would probably not fall within the definition of commercial reasonableness required by the UCIOA good faith standard. Therefore, the good faith standard may have played an important role in these cases because the UCIOA was incorporated by the lien priority statutes of both the District of Columbia and Nevada.

While super lien priority statutes have solved many of the problems that associations have encountered in first-in-time jurisdictions, the cost of this benefit should not be a disaster to lenders and a windfall to third-party purchasers taking advantage of the situation. When an association's small value lien is able to extinguish a large first mortgage, there is possibly a commercially unreasonable transaction if the HOA forecloses and sells the property. The other possible end result is the lender is coerced into paying another's bill to prevent such a transaction. It is difficult to invent an argument where either of these results could be considered fair to the lender. Nonetheless, any proposed solution must balance fairness to the lender with the ability of an association to collect dues and remain financially solvent, a goal that we have seen is not easy to reach. The next Section focuses again on some of the special values of HOAs implicated by the competing liens.

### C. The Value of HOAs as an Efficient Means of Private Governance

Another major policy consideration related to lien priority lies in preserving the financial security of CICs so that they may serve to reduce the burdens on local governments. Many argue that typically, HOA's are a more efficient and better vehicle for neighborhood maintenance, upkeep, and community relations than public government.<sup>257</sup> HOA's are usually run by members of the community who are closely attached to the situation in their neighborhood and have a personal stake in the betterment of their community.<sup>258</sup> In contrast, elected officials in public government may be detached from specific needs and requirements of a particular neighborhood.<sup>259</sup> Allowing semi-autonomous governance of a community by private associations reduces the responsibilities of municipal government and places

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<sup>257</sup> See Bromley, *supra* note 22, at 261–65.

<sup>258</sup> See HYATT, *supra* note 29, at 21 (“An association of the property owners in the community (the ‘community association’) manages the common property with funds obtained by levying assessments against the property.”).

<sup>259</sup> See Bromley, *supra* note 22, at 262–63.

them in the hands of the community members themselves.<sup>260</sup> This often equates to a well maintained community with corresponding higher property values.<sup>261</sup>

Beginning in the 1960s, CICs developed from an experiment in suburban housing into one of the most common forms of residential neighborhoods in America today.<sup>262</sup> In 1970, there were about 10,000 CICs with an estimated 2.1 million residents living in approximately 700,000 housing units.<sup>263</sup> By 2015, the number had exponentially increased to an estimated 338,000 communities with sixty-eight million residents living in 26.2 million housing units, and twenty-one percent of the total United States population living in CICs.<sup>264</sup> CIC housing was estimated, in aggregate, to be valued at \$5.287 trillion in 2015.<sup>265</sup>

The Foundation for Community Association Research attributes this rapid growth of community association to four factors: (1) the value of collective management at the neighborhood level, (2) the privatization of public functions reducing financial pressure on local municipalities, (3) the expansion of affordable homeownership with condominiums as lower cost entry housing, and (4) the minimization of social costs and fostering of market efficiencies by reducing government oversight of routine community maintenance.<sup>266</sup> In fact, local governments often require new subdivisions to form HOAs as a condition of land use approval as a “load shedding” function of services and tasks which are usually carried out by local government.<sup>267</sup>

The ability of an HOA to collect the dues necessary to maintain the community through a secure mechanism afforded by law is essential to encouraging the continued growth of HOAs.<sup>268</sup> If associations are underfunded because members are not paying their dues, both lower property values and higher

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<sup>260</sup> See FOUND. FOR COMMUNITY ASS'N RES., STATISTICAL REVIEW FOR U.S. HOMEOWNERS ASSOCIATIONS, CONDOMINIUM COMMUNITIES AND HOUSING COOPERATIVES (2012).

<sup>261</sup> Daniel S. Scheller, *Neighborhood Governments and their Role in Property Values*, URBAN AFFAIRS REV. 1, 24–25 (2010).

<sup>262</sup> See Bromley, *supra* note 22, at 261–62.

<sup>263</sup> COMMUNITY ASS'N INST., NATIONAL AND STATE STATISTICAL REVIEW FOR 2015: COMMUNITY ASSOCIATION DATA (2015).

<sup>264</sup> *Id.*

<sup>265</sup> *Id.*

<sup>266</sup> FOUND. FOR COMMUNITY ASS'N RES., *supra* note 260.

<sup>267</sup> Bromley, *supra* note 22, at 262.

<sup>268</sup> *Id.* at 264–65. Bromley notes there is an “inherent interdependency” between associations and their members. *Id.* at 264. “The association provides vital necessities to the community that will be dramatically affected, should some or all be eliminated if the association is unable to sufficiently fund them. The association is simultaneously dependent on the property owners’ payment of dues in order to maintain these necessities.” *Id.*



dues for members who are continuing to pay assessments result.<sup>269</sup> The impact on association services, in turn, can actually have a negative effect on the economy on a large scale by the corresponding decline in property values.<sup>270</sup> Therefore, it is in the interest of public policy to both encourage the growth of HOAs and ensure they have the means to fund themselves.

While encouragement of community associations remains a high public policy goal, such support should not undermine issues of fairness under the law and other public policy goals. These issues are at the center of the controversy over the Nevada statutes.<sup>271</sup> Although these regimes have largely solved first-in-time HOA lien priority issues, they have also lead to negative fairness and policy consequences. In contrast, the original difficulties of HOA collection on delinquent dues remain in the first-in-time and limited priority UCIOA jurisdictions.<sup>272</sup> A more balanced approach is required to address the issue of protecting HOA solvency because negative policy consequences result from the application of both super lien priority statutes and traditional first-in-time regimes.

A better solution may be one similar to the more balanced Florida approach. Unlike the preferential treatment to either lender or association afforded under the other approaches through lien priority, this method passes the cost of the unpaid assessments to the purchaser of the property by statute.<sup>273</sup> The purchaser is free to make the decision to either assume or reject the debt imposed by the statute on the purchase price because they may decide whether or not to purchase the property. While some may argue that this approach would damage HOAs by chilling possible sales due to the additional cost, this will usually only amount to a few thousand dollars on top of the purchase

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<sup>269</sup> Haughney, *supra* note 227. Even “[b]argain hunters say they are reluctant to buy” when “they might have to pay unexpected fees as distressed neighbors default on their mortgages or just stop paying the association fees that cover everything from taxes to pool maintenance to air-conditioning repair.” *Id.*

<sup>270</sup> See Goldmintz, *supra* note 158, at 286–87. Goldmintz argues that “when associations buckle under the pressure of multiple, simultaneous delinquencies, property values suffer. This hinders the mortgagee’s ability to maximize its recovery at a foreclosure sale.” *Id.* at 286. Therefore, “the lender’s pecuniary interests are intimately wrapped up in the long-term viability and short term liquidity of associations. As lenders work to undermine the extension of super-liens beyond the current six-months, they work contrary to their own financial interests.” *Id.*

<sup>271</sup> See Aalberts, *supra* note 18, at 327–29.

<sup>272</sup> See *supra* Section II(A).

<sup>273</sup> See FLA. STAT. ANN. § 720.3085 (West 2014); see also FLA. STAT. ANN. § 718.116 (West 2014).

price.<sup>274</sup> Because a buyer is probably already getting a reduced price in a foreclosure sale, it is likely that this small amount in relation to overall cost will not have a large effect on finding buyers at foreclosure sales.

The Florida statute also addresses the first-in-time jurisdiction problem of lenders delaying foreclosure proceedings. As discussed previously, one of the major problems of a first-in-time jurisdiction is that a lender's superior priority allows them to delay foreclosure to wait for market recovery and avoid paying the additional cost of association assessments. Lender foreclosure delay places a large burden on associations and their remaining members because it causes the property to remain without a custodian and no one paying dues.

Both the Florida HOA and condo association lien priority statutes allow for up to twelve months of assessments or one percent of the mortgage in regards to a purchase by the lender.<sup>275</sup> This is double the amount which is provided for under the UCIOA and currently greater than any super priority lien statute jurisdiction allows.<sup>276</sup> This provides incentive to a lender who will be motivated to expedite foreclosure proceedings because the assessments it is liable for upon purchase will be accruing for twice the period provided for by most states with super lien priority statutes.

However, the large Florida super priority amount does not address the issue of lender foreclosure delay in two situations: (1) when the lender is not considering purchase of the property if the HOA forecloses, and (2) when the lender has already waited twelve months to foreclose and the super priority amount it would have to pay upon purchase is already capped. One possible solution to the second issue is for Florida to adopt a provision similar to the 2014 UCIOA section 3-316(c)(1) amendment allowing for rolling liens.<sup>277</sup> The rolling lien authorized under the UCIOA allows for a six month super priority amount for each budget year for the HOA.<sup>278</sup> Therefore, an HOA is entitled to the super priority amount available under the statute for each budgeted year.

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<sup>274</sup> Waite, *supra* note 231, at 26–28. Waite states that a typical sales price of a Nevada home in an HOA foreclosure sale would be in between \$3000 and \$12,000, which is “slightly more than the amount owed to the HOA.” *Id.* at 26.

<sup>275</sup> FLA. STAT. ANN. § 720.3085 (West 2014); FLA. STAT. ANN. § 718.116 (West 2014).

<sup>276</sup> See Lewis *supra* note 38, at 1. The UCIOA offers six months of assessments for its super priority amount. Nevada statute provides for up to nine months of assessments which is the second largest amount provided for by any state. *Id.*

<sup>277</sup> UCIOA § 3-116(c)(1).

<sup>278</sup> *Id.*

While not a perfect solution, the Florida regime balances the interests of both parties by providing a better mechanism for collection of association dues without threatening or otherwise jeopardizing the lender's substantial interest in the property. As will be shown in the next Section, security in a lender's interest in a property may have more importance than solely on the question of what is equitable and fair.

#### D. Lender Willingness and Buyer Opportunity to Obtain Financing

Lenders have been watching carefully (and with anxiety and unease) the decisions affording true priority to HOA liens. There is inherent risk in implementing unrestricted HOA super lien priority statutes because it may have a chilling effect on the housing market.<sup>279</sup> Lenders will be taking on a great amount of additional risk by lending to borrowers purchasing in HOA communities.<sup>280</sup> When their liens can be subordinated by statute and extinguished if they fail to pay a homeowner's delinquent assessment, they will be reluctant to take on this substantial risk.<sup>281</sup>

Proponents of HOA super lien priority statutes have argued that this risk can be almost completely mitigated by adequate notice to the lender of the association's intent to foreclose.<sup>282</sup>

In 2015, the Nevada Legislature amended its super lien priority statute to require the HOA to send foreclosure notices to any lienholders who have a recorded interest in the property.<sup>283</sup>

<sup>279</sup> Deborah Goonan, *Is the HOA priority lien necessary and beneficial?*, INDEP. AMERICAN COMMUNITIES (June 9, 2016), <https://independentamericancommunities.com/2016/06/09/is-the-hoa-priority-lien-necessary-and-beneficial/> [<http://perma.cc/FKB3-ZDZT>] (“Essentially, wiping out the first mortgage lien ultimately forces other borrowers to pay more for a mortgage, makes it more difficult to obtain a mortgage, and makes homeownership more elusive.”).

<sup>280</sup> Kenneth R. Harney, *Homeowner association liens pose perils for condo buyers*, L.A. TIMES (May 17, 2015, 5:00 AM), <http://www.latimes.com/business/la-fi-harney-20150513-story.html> [<http://perma.cc/J9K4-KG6N>] (“For example, if the amount of back assessments owed is \$6,000 but the first mortgage on the property is in the hundreds of thousands of dollars, the house might be sold at foreclosure to a bargain-hunting buyer for the assessment amount plus fees, leaving the lender with huge losses.”).

<sup>281</sup> *Realtor Magazine* noted the lending industry has warned that “[h]ome buyers may soon face more stringent underwriting standards and even higher interest rates when applying for a mortgage to purchase a home that falls within a homeowner association.” *Buyers Face Barriers in HOA Neighborhoods*, REALTOR MAG. (May 17, 2015), <http://realtormag.realtor.org/daily-news/2015/05/18/buyers-face-barriers-in-hoa-neighborhoods> [<http://perma.cc/KM7G-7ZF8>].

<sup>282</sup> See *SFR Investments Pool 1, LLC v. U.S. Bank*, 334 P.3d 408, 414, 418 (Nev. 2014) (“[A]s a junior lienholder, U.S. Bank could have paid off the SHHOA lien to avert loss of its security.”).

<sup>283</sup> Gardberg, *supra* note 3, at 17 (“The lienholder then has a specific period of time—until five days before the foreclosure sale—to pay off the superpriority lien. Upon

However, it is not yet clear if this notice process will reduce the risk of inadvertent extinguishment of lender interests. Large lending institutions have mortgages on a large amount of properties, and verifying which properties are located in some sort of community association is not as easy as one would assume.<sup>284</sup> Lenders continue to deal with the uncertainty of inadvertent extinguishment because the reliability of the notice regime to correct information deficiencies has yet to be fully tested.

This higher risk in super lien priority statute jurisdictions, whether real or merely perceived, could trigger both higher rates on financing and an overall reluctance of creditors to extend credit to certain buyers.<sup>285</sup> The Mortgage Bankers Association reports that currently:

Over 1,000 Nevada cases continue to be litigated to determine whether clear title existed for property purchasers at HOA foreclosure sales, and subsequently whether proper notice was given by HOAs to first lien mortgagees before these sales were executed. If the courts determine notice was proper and clear title exists, these mortgagees could lose hundreds of millions of dollars from this change in interpretation.<sup>286</sup>

This additional risk and possible loss of a substantial amount of lender investment has a high probability of affecting availability and interest rates on credit. Though it has not yet played out, lending industry representatives have already indicated that “[w]here any HOA super lien authority exists, lenders may be forced to price risk through higher interest rates, mitigate it through larger downpayment [sic] requirements, or exit risky jurisdictions altogether. Property owners may even be unable to sell or refinance their homes.”<sup>287</sup> This effect, in turn, could lead to certain buyers being effectively shut out of the market.

While lenders will most likely not make good on their threat to exit super lien priority statute jurisdictions since almost half of the United States has some form of these statutes, other effects such as higher interest rates and limited availability of

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doing so, the HOA may still foreclose (on the portion of its lien, if any, not having superpriority status), but the lender’s lien will not be extinguished.”)

<sup>284</sup> Goonan, *supra* note 279 (“According to Equifax . . . private industry has taken the lead in creating a national database of HOAs,” but the “database is missing a minimum of 125,000 HOAs, based upon CAI’s estimated total of 350,000 HOAs.”)

<sup>285</sup> Harney, *supra* note 280. In a statement before the Nevada Legislature, general counsel for the Federal Housing Finance Agency, Alfred Pollard, stated that if lenders’ rights can be extinguished by community associations, purchasers “may face challenges in securing a loan to buy a unit or refinance.” *Id.*

<sup>286</sup> *Homeowners and Condominium Associations Should Not Be Granted “Super Lien” Priority*, MORTGAGE BANKERS ASS’N, <https://www.mba.org/issues/residential-issues/hoa-super-lien-priority> [<http://perma.cc/48LC-8MX4>] (last visited March 19, 2018).

<sup>287</sup> *Id.*

credit to certain borrowers are very real possible consequences.<sup>288</sup> Proponents of super lien priority statutes argue that lenders are in the best position to absorb the externality of delinquent assessments by directly assuming those debts when the original debtor cannot be compelled to pay.<sup>289</sup> However, it is likely that these costs will ultimately be passed on to consumers causing further negative economic consequences.

#### E. Which Party is in the Best Position to Internalize the Cost?

One of the major questions in determining which of the three discussed approaches is better, both in fairness and policy, is money. Who should bear the cost of the delinquent HOA dues when the original debtor walks away from the property and refuses to pay both the mortgage and association assessments? There appear to be four different options of those whom could potentially bear the cost: (1) the original homeowner, (2) the association, (3) the lender, or (4) the purchaser at the foreclosure sale.

One student comment suggests that the optimal method would be for the HOA to seek a money judgment against the original homeowner who is in default.<sup>290</sup> While this approach seems to be the most equitable because it would force the person who incurred the debt to internalize their own costs, it does not have a realistic likelihood of resulting in successful collection. A person who is underwater and walking away from their home, including the debt associated with it, likely does not have enough assets to make legal action against them worthwhile.<sup>291</sup> This type of judgment is also difficult to enforce both because it is against an individual rather than a business, and the personal debt against the individual is unsecured.<sup>292</sup> A court order could provide for garnishment of wages, but pursuing a judicial remedy against the owner costs the association money and time.<sup>293</sup>

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<sup>288</sup> See Lewis, *supra* note 38, at 1. Lewis notes that twenty-two states currently have super lien priority statutes. *Id.* It will be interesting to see if loan statistics confirm the lender threat of higher interest rates and less availability of credit.

<sup>289</sup> Vaughn, *supra* note 3, at 11.

<sup>290</sup> *Id.* at 28–30.

<sup>291</sup> JAMES J. BROWN, JUDGMENT ENFORCEMENT § 2.11 (3d ed. 2017) (“The client may decide that the hourly fees have reached the limit of economically achieving the judgment enforcement objectives. There is a point in postjudgment litigation when the client rightfully cuts his losses, sits on the judgment, and waits for other enforcement opportunities to come along.”).

<sup>292</sup> ALAN M. AHART, *Lawyer’s Role in Debt Collection Process*, in ENFORCING JUDGMENTS AND DEBTS (2017). Judge Ahart explains that enforcing unsecured judgments on consumer claims are difficult to collect because of liberal exemptions under the law, difficulty in locating the debtor, insufficient assets and income, and a consumer is more likely than a business to file a Chapter 7 bankruptcy petition. *Id.*

<sup>293</sup> BROWN, *supra* note 291, § 2.11 (“Counsel engaged in enforcing judgments must consider the size of the judgment and collection prospects vis-à-vis a reasonable budget for

The problems associated with HOAs collecting money judgments against debtors are compounded when there are multiple owners within the community who have walked away from their debt. In such situations legal costs for pursuing and collecting the individual judgments will be multiplied since they must be pursued against multiple debtors. Because the debt is secured by lien, foreclosing on the property is a safer and more cost efficient option for an association to collect the deficiency when an owner is likely not to have sufficient personal assets to pay a judgment.<sup>294</sup>

Making the HOA bear the cost of the delinquent assessments is another option. The first-in-time approach gives priority to the lender's mortgage when it is first-in-time.<sup>295</sup> In the foreclosure context, the HOA cannot recoup the cost of the delinquent dues unless: (1) there is a surplus from the lender's foreclosure, or (2) the HOA forecloses and is able to sell the property for an amount in excess of the lender's mortgage.<sup>296</sup> Either are highly unlikely in a recession, and the law should be prepared for the worst of situations.<sup>297</sup> Therefore, in a first-in-time jurisdiction, the burden remains with the association, which will have to internalize the cost by passing it on to its members through higher regular and special assessments.<sup>298</sup> These new costs may prove too expensive for other innocent association members. Therefore, these costs may cause additional harm by forcing even more homeowners to default on assessment dues and walk away from their underwater properties.<sup>299</sup>

Another option would be to make the mortgagee lender bear the cost of delinquent assessments. The Nevada super lien priority approach shifts the cost to the lender who must "buy out" the HOA lien or have its own interest extinguished.<sup>300</sup> There is a good argument that this is an efficient and secure approach for associations to recoup their costs because the lender has a

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accomplishing postjudgment objectives, whether his fees are paid on an hourly or percentage basis.").

<sup>294</sup> Roger Chase, *HOA Collection Options: Lien Foreclosures vs. Money Judgments*, CONDO ASS'N (May 25, 2009, 9:56 AM), <http://www.condoassociation.com/blog/tabid/19257/bid/8954/HOA-Collection-Options-Lien-Foreclosures-vs-Money-Judgments.aspx> [<http://perma.cc/QX34-53WF>]. Chase explains that "[m]any attorneys specializing in homeowner association law recommend the lien foreclosure route because it is less expensive and typically more successful than a money judgment." *Id.*

<sup>295</sup> See *supra* Section II(A).

<sup>296</sup> Boyack, *supra* note 51, at 95.

<sup>297</sup> See Bromley, *supra* note 22, at 258; Boyack, *supra* note 51, at 78.

<sup>298</sup> See Collins, *supra* note 4.

<sup>299</sup> See CMTY. ASS'N LEADERSHIP LOBBY, *supra* note 228. One HOA board member recognizes the issue that raising assessments can drive other members into foreclosure. *Id.*

<sup>300</sup> See *SFR Investments Pool 1, LLC v. U.S. Bank*, 334 P.3d 408, 409–10 (Nev. 2014).

substantial motivation to pay this relatively small amount to protect its interest.<sup>301</sup> Proponents of the method state it is also fair, provided the lender has notice and the opportunity to protect its interest.<sup>302</sup> Institutional lenders typically have much greater resources than HOAs, and can internalize the external cost of paying their borrowers' delinquent dues much easier than a community association.<sup>303</sup> But as previously mentioned, this policy forces the lender to pay the debt of another when the lender has not committed any kind of wrongful act.<sup>304</sup>

Instead, the law could be structured so that the purchaser at the foreclosure sale bears the cost of the delinquent assessments. The Florida approach shifts the cost from the HOA to the purchaser by a statutory mechanism.<sup>305</sup> This method is likely superior to a money judgment on the original debtor, the HOA internalizing the debt, or cost shifting to the lender, because shifting the cost to the purchaser is both fair and financially practical.

Presumably, the purchaser has the resources to pay this relatively small additional cost, either through their own funds or through financing, since they are making an offer on the property. Therefore, this approach is more financially realistic than collecting the delinquent assessment directly from the original debtor. Also, the association's lien is taken out of competition with the lender's lien by the statutory imposition on the purchaser.<sup>306</sup> This bypassing of lien priority provides the HOA with a better chance of recouping its costs than in a first-in-time regime where its lien will usually be junior to a first mortgage.<sup>307</sup> Lastly, a lender's first mortgage or deed of trust survives extinguishment by an HOA foreclosure.<sup>308</sup> Therefore, this approach does not have the unjust result of forcing the lender to pay to maintain their interest, nor the negative economic consequences to borrowers of that approach.

#### CONCLUSION

This Comment has analyzed three different jurisdictions with respect to HOA lien priority and whether the interest of a first mortgage or deed of trust may be extinguished under each.

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<sup>301</sup> See UNIF. COMMON INT. OWNERSHIP ACT § 3-116.

<sup>302</sup> See *SFR Investments*, 334 P.3d at 409–10.

<sup>303</sup> Vaughn, *supra* note 3, at 11.

<sup>304</sup> See *supra* Section II(B).

<sup>305</sup> FLA. STAT. ANN. § 720.3085 (West 2014); FLA. STAT. ANN. § 718.116 (West 2014).

<sup>306</sup> FLA. STAT. ANN. § 718.116 (West 2014).

<sup>307</sup> See *supra* Section II(C).

<sup>308</sup> FLA. STAT. ANN. § 720.3085 (West 2014); FLA. STAT. ANN. § 718.116 (West 2014).

Traditional first-in-time jurisdictions favor a lender's interest to the detriment of HOAs. Under a first-in-time regime, a lender's first mortgage usually takes priority over an association's lien, and therefore, is not extinguished by an HOA's foreclosure on the property in question. While this falls in line with the lender's interest, this means that an HOA's junior interest will usually be extinguished by a foreclosure sale by the lender because such a sale will not usually generate enough profits to satisfy both liens, especially in a troubled economy.

A similar situation arises if the HOA tries to foreclose on its lien because the first mortgage still has priority. This leaves associations with the less reliable option of seeking a money judgment against delinquent homeowners. Furthermore, lenders have no incentive to expedite foreclosure proceedings in such a jurisdiction, and may intentionally postpone initiating foreclosure in order to avoid paying HOA assessments.

Nevada's super lien priority statute and case law flips the balance of power completely in the HOA's favor. Under this regime, an association lien's super priority portion is afforded true priority. This allows an association to foreclose on the super priority portion and extinguish a first mortgage or deed of trust as a junior lien. This puts lenders at an HOA's mercy, and requires them to pay off the super lien portion of the HOA lien, or suffer the consequences of lien extinguishment.

Proponents of this approach argue that this has solved the financial problems for associations inherent in first-in-time type regimes, because it encourages the lender to expedite foreclosure proceedings and almost guarantees an association's ability to collect delinquent dues. However, it does so by arguably violating principles of fairness while generating negative policy consequences that could adversely affect borrowers' access to credit.

While not a perfect solution, the purchaser liability approach taken by Florida is a more balanced method, improving the chances of collection for an HOA while avoiding the drastic measure of extinguishment of a first mortgage. This regime is more equitable to both lenders and associations because it bypasses priority competition between the liens and instead attaches liability to the purchaser of the property at the foreclosure sale. Of the parties involved, only the purchaser has both the financial assets to accept the burden of the delinquent assessments and the freedom of choice to accept it.

This regime also addresses the problem of lender recalcitrance to institute foreclosure by doubling the super priority amount currently provided for under the UCIOA. When



such an increase occurs, a lender has more motivation to foreclose since the super priority is capped at the greater amount of twelve months or one percent of the mortgage debt.

However, the Florida approach to lender delay of foreclosure does not address when a lender is not considering buying the property if the HOA forecloses, or when the super priority period is already maxed out. One possible solution to lender delay of foreclosure under these circumstances is partial adoption of the 2014 UCIOA amendment providing for rolling liens. Under this amendment, an association is entitled to the super priority amount for each budget year for the association. Adoption of such an amendment would mean the statutory cap would continue to accrue, and a lender purchaser would be motivated to initiate foreclosure because its liability for assessments would continue to grow. However, this solution still does not address the situation of when a lender has decided it will not purchase the property in question.

Given the negative consequences discussed in affording lien priority to either the association or the lender by Nevada-type regimes and first-in-time jurisdictions respectively, states should give the search for a balanced approach to lien priority greater future consideration as they attempt to find an optimal solution to the HOA lien priority issue. Only by bringing transparency to the existence of the stacked deck can we determine how to make the system work for all involved. Only then, by finding the right balance, can we achieve the objectives of real estate law to provide an equitable and predictable system of lien priority.



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