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STATUTORY MARKETING EXCLUSIVITY FOR THE FIRST FILER OF AN APPROVED GENERIC DRUG APPLICATION AND THE ORANGE BOOK

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ABSTRACT

The first drug manufacturer approved for a generic version of a branded drug has statutory exclusivity to market that generic drug for 180 days. The purpose of the exclusivity period is to make cheaper drugs available to the consumer. However, the Food and Drug Administration (FDA) has a policy requiring the generic drug manufacturer to sue the branded drug manufacturer to retain that market exclusivity when the branded drug patent holder has the patent(s) removed from the FDA's "Approved Drug Products with Therapeutic Equivalence Evaluations," also known as the Orange book. This paper discusses the effects of delisting a drug patent, and whether the FDA's policy is a valid one or contrary to the intent of statutory language.

THE MARKETING EXCLUSIVITY PERIOD

The marketing exclusivity period purpose is to make cheaper drugs available more quickly for the benefit of the consumer. Congress passed the Hatch-Waxman Amendments attempting to bring balance between the policy of inducing primary brand name pharmaceutical companies to invest sufficient capital necessary for new drug research and development and the, seemingly conflicting, policy of encouraging their competitors to market the cheaper generics as soon as possible (*Abbott Labs. v. Young*, 1990). An important part of the encouragement for drug manufacturers to bring generic drugs to the market faster, and run the risk of litigation in patent infringement, is to reward the first successful applicant the exclusive right to market the generic drug for 180 days (*Mylan Pharms. v. Shalala*, 2000).

The FDA had a previous policy of requiring a successful defense by the generic drug applicant in a suit by the NDA holder as a prerequisite for being granted the period of exclusivity. The court held that the FDA's interpretation was inconsistent with the statute and exceeded the authority necessary to carry out the intent of Congress (*Mova Pharms. Corp. v. Shalala*, 1998). Subsequently, a generic drug manufacturer was successful in a suit by the NDA holder, and the FDA refused to grant approval of the period of marketing exclusivity because, though it was the first ANDA applicant to successfully defend, it was not the first to file (*Mylan Pharms. v. Shalala*, 2000). The court held that the FDA policy was inconsistent with a literal interpretation of the Hatch-Waxman Amendments (*Mylan Pharms. v. Shalala*, 2000).

RANBAXY v. LEAVITT

Ranbaxy Laboratories Limited (Ranbaxy) and IVAX Pharmaceuticals, Inc. (IVAX) both filed ANDAs, November 2001 and December 2000 respectively, for the generic version of Zocor, a cholesterol reducing drug. The FDA gave tentative approval to Ranbaxy but not IVAX. Both Ranbaxy and IVAX gave Merck the required notice of their certification that their generic equivalent of Zocor would not infringe on Merck's patents or that Merck's patents were not valid or not enforceable. Merck didn't sue either one within the statutory required period, but requested that the FDA remove the patents from the Orange Book, which was granted by the FDA (Ranbaxy v. Leavitt, 2006a).

When Ranbaxy and IVAX learned of the delisting of the Merck patents, they both filed citizen petitions "requesting that the FDA confirm that it would not approve subsequent ANDAs until after the 180-day period and that the FDA relist the patents in the Orange Book" (Ranbaxy v. Leavitt, 2006a, p. 6). The petitions were denied for several reasons. Not only did the FDA decide not to relist the patents, but it decided to not allow any ANDA applicant to be eligible for the 180 day exclusivity period for those patents and that it would approve any and all ANDAs which were eligible thereafter. In separate suits, Ranbaxy and IVAX challenged the action of the FDA not relist the patents and its refusal to grant any marketing exclusivity for generics of Zocor (Ranbaxy v. Leavitt, 2006a).

The court consolidated all actions and all parties moved for summary judgment as a matter of law. The court reasoned that the language as to how a manufacturer of a generic drug might qualify for the period of marketing exclusivity was clear and unambiguous. Had the FDA not delisted Merck's patents, the plaintiffs would have been given a marketing exclusivity period upon approval of their ANDAs. The FDA, by its actions in delisting Merck's patents, restricted the rewarding of marketing exclusivity only to those ANDA holders who were sued by the NDA holder, thus contravening "the plain and undisputed intent of Congress" (Ranbaxy v. Leavitt, 2006a).

On appeal, the court held that the FDA's requirement that a successful generic challenge to a drug manufacturer be subject to litigation to acquire a marketing exclusivity period was contrary to the Hatch-Waxman Act. The manufacturer submitting an ANDA does not have to demonstrate the safety of the drug if it certifies that it is seeking approval for a drug which uses those patents which are listed in the Orange Book. Further, by allowing the delisting of the applicable patent(s), thus depriving the ANDA filer marketing exclusivity, the FDA reduced the certainty of receiving exclusivity and the incentive for a drug manufacturer to bring a generic drug to the market as intended by Congress. The FDA denial of a period of marketing exclusivity to Ranbaxy and Teva by delisting Merck's patents from the Orange Book was improper and the judgment of the district court was affirmed (Ranbaxy v. Leavitt, 2006b).

CONCLUSION

The FDA's policies under the Hatch-Waxman Amendments have been, generally, improper, inconsistent with the statutory language or not consistent with a literal interpretation of the language of the statute, particularly when the period of marketing exclusivity is involved. Congress intended to make sure that generic drugs reached the market as quickly as possible, to make cheaper versions

of previously brand name drugs available to the consumer in the shortest amount of time possible in the marketplace. To do this, the prospective generic drug manufacturer would have to apply before the brand name drug patents had expired, giving the FDA sufficient time to approve the application in time to have the generic drug on the market as soon as the patents for the brand name drug were no longer valid, either by challenge or expiration. Any pharmaceutical company willing to enter the generic market would also have to consider whether or not to engage in the costs of challenging existing drug patents or the risk of doing so in the uncertain economic workplace profit and loss.

Because the costs of producing a generic drug are significant, and the potential for recovery great if that generic is on the market without other generic competition for six months, the intent of Congress in its passing of the Hatch-Waxman Amendments is clear. The FDA, in its execution of the statutes, must either comply with the clear and unambiguous language that Congress intends, or make a reasonable interpretation of the statutes where Congress is unclear and ambiguous. Congress intended that the generic manufacturer be afforded every opportunity to hit the market running as soon as possible after all of the protections of the brand name drug have expired, to the benefit of the public, the consumer. Any actions by the FDA which frustrate the purpose and intention of Congress to expedite the production and marketing of generic drug is most likely going to be found improper.

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CAREGIVER RESPONSIBILITY DISCRIMINATION AND THE EQUAL EMPLOYMENT OPPORTUNITY COMMISSION (EEOC) GUIDELINES

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ABSTRACT

In May of 2007 in response to a perceived “potential for greater discrimination against working parents and others with caregiving responsibilities”, the United States Equal Employment Opportunity Commission (EEOC) issued new enforcement guidance addressing Unlawful Disparate Treatment of Workers with Caregiving Responsibilities (EEOC-A, 2007). On April 22, 2009, the EEOC issued additional guidance to employers, Employer Best Practices for Workers with Caregiving Responsibilities, offering “proactive measures that go beyond federal non-discrimination requirements” (EEOC B, 2009). These guidelines are designed to reduce employers’ exposure to litigation for “violations against caregivers, and to remove barriers to equal employment opportunity” (EEOC B, 2009). This paper examines the initial guidance provided by the EEOC with respect to individuals with caregiving responsibilities, the recent court cases involving the issue, and the best practices suggestions recently issued by the EEOC.

INTRODUCTION

In May of 2007 in response to a perceived “potential for greater discrimination against working parents and others with caregiving responsibilities”, the United States Equal Employment Opportunity Commission (EEOC) issued new enforcement guidance addressing Unlawful Disparate Treatment of Workers with Caregiving Responsibilities (EEOC-A, 2007). On April 22, 2009, the EEOC issued additional guidance to employers offering “proactive measures that go beyond federal non-discrimination requirements” designed to reduce employers’ exposure to litigation for “violations against caregivers, and to remove barriers to equal employment opportunity” (EEOC B, 2009).

What is unlawful disparate treatment of workers with caregiving responsibilities? While there are no federal statutes that prohibit discrimination based “solely” on parental or other caregiver status, unlawful disparate treatment arises when an employee with caregiving responsibilities is subjected to discrimination based on a protected characteristic under federal Equal Employment Opportunity (EEO) law (EEOC A, 2007). The enforcement guidance from the EEOC provides a number of examples of circumstances under which discrimination against caregivers may violate federal EEO law (See Exhibit 1).

Exhibit 1 Examples of Circumstances that may Violate Federal EEO Law

Treating male caregivers more favorably than female caregivers: Denying women with young children an employment opportunity that is available to men with young children.

Sex-based stereotyping of working women:

Reassigning a woman to less desirable projects based on the assumption that, as a new mother, she will be less committed to her job.

Reducing a female employee's workload after she assumes full-time care of her niece and nephew based on the assumption that, as a female caregiver, she will not want to work overtime.

Subjective decision making: Lowering subjective evaluations of a female employee's work performance after she becomes the primary caregiver of her grandchildren, despite the absence of an actual decline in work performance.

Assumptions about pregnant workers: Limiting a pregnant worker's job duties based on pregnancy-related stereotypes.

Discrimination against working fathers: Denying a male caregiver leave to care for an infant under circumstances where such leave would be granted to a female caregiver.

Discrimination against women of color: Reassigning a Latina worker to a lower-paying position after she becomes pregnant.

Stereotyping based on association with an individual with a disability: Refusing to hire a worker who is a single parent of a child with a disability based on the assumption that caregiving responsibilities will make the worker unreliable.

Hostile work environment affecting caregivers:

Subjecting a female worker to severe or pervasive harassment because she is a mother with young children.

Subjecting a female worker to severe or pervasive harassment because she is pregnant or has taken maternity leave.

Subjecting a worker to severe or pervasive harassment because his wife has a disability (EEOC A. 2007).

The EEOC has made it clear, that their guidance with respect to caregivers does not protect caregivers based on their caregiving status alone. In the past, that has meant that the unlawful disparate treatment must arise where a caregiver is discriminated in employment based on their sex or race. Action in this regard may also arise under the Americans with Disabilities Act (ADA) and under other federal statutes including the Family and Medical leave Act (FMLA) (EEOC A, 2007). While previous research would indicate that this has been primarily a problem for women in the workplace (See Still, 2006, Litigating the Maternal Wall: U.S. Lawsuits Charging Discrimination against Workers with Family Responsibilities) the EEOC guidelines cite numerous examples and case law involving discrimination against male caregivers.

The EEOC's perception for the potential for increased discrimination against those with caregiving responsibilities was the impetus for developing and issuing this guidance. This determination was based on a great deal of empirical evidence gathered by the Center for Work Life Law at the University Of California Hastings College Of Law, the National Alliance for Caregiving, and others. Their research resulted in important findings that have helped bring this issue to the attention of not only the EEOC but employers as well.

Discrimination claims brought by employees alleging discrimination involving their caregiving responsibilities have been increasing dramatically in recent years. Another report by the Hastings College of Law group “Litigating the Maternal Wall: U.S. Lawsuits Charging Discrimination against Workers with Family Responsibilities” reported a dramatic increase in the number of these cases. The report found that from 1996-2005 there were 481 court cases involving the issue compared to 97 cases in the prior ten year period – “an increase of nearly 400%” (Still, 2006). The study found that the cases were being filed by a wide range of individuals, across a wide range of industries and occupational types. A large number of high profile “award winning” companies were also involved in litigation over this issue (See Exhibit 2).

Exhibit 2 – Award-winning companies facing litigation

Abbott Laboratories
Aetna
AT&T
Baxter healthcare Corp.
Bell Atlantic
Bristol-Myers Squibb
Citibank
Ernst & Young
Exxon
General Motors
Hewlett-Packard
IBM
Massachusetts Mutual Life
McGraw-Hill Co.
Merck
Pfizer
Price Waterhouse Coopers
Sarah Lee Corp.
Sears
Smithkline Beecham
United Technologies
UPS
Wal-Mart

Source: Still, Mary C. (2006). Litigating the Maternal Wall: U.S Lawsuits Charging discrimination Against Workers with Family Responsibilities, page 12.

Many of these organizations had been identified as “Best Companies for Working Mothers” and good community citizens.

RECENT COURT CASES

The First and Ninth U.S. Circuit Courts of Appeal have issued recent decisions of note in regard to caregiver discrimination. In the First Circuit Court of Appeals case, the plaintiff had alleged that she was denied a promotion because of a sex based stereotype that women who are mothers, particularly of young children, neglect their jobs in favor of their presumed childcare responsibilities (*Chadwick v. Wellpoint, Inc.*, 2009). The court reversed the district court summary judgment ruling in favor of the employer and remanded the case for further proceedings.

In *Gerving v. OPBIZ, LLC* (doing business as Aladdin Resort and Casino) 2009, the Ninth Circuit Court of Appeals reversed a district court's grant of summary judgment on her claims of gender discrimination and retaliation under title VII of the 1964 Civil rights and Nevada state law. In the *Gerving v. OPBIZ, LLC* case Karen Gerving, a stepmother of three young children, was able to show that her supervisor, Jim Lauster, began to give her poor performance reviews after she became a stepmother. Gerving was also able to establish the Lauster told her that working mothers could not perform as well as men or women without children, that mothers should stay at home, and that she would have to choose between being a mother and a sales manager (*Gerving v. OPBIZ, LLC*, 2009).

EMPLOYER BEST PRACTICES

The rationale for the EEOC's advancement of Employer Best Practices for Workers with Caregiving Responsibilities guidelines is not just anchored to the rise in discrimination allegations. The EEOC cites numerous studies that show that employers that adopt flexible workplace policies that enable employees to achieve a satisfactory work-life balance also have been able to add to their customer base and their bottom line (*EEOC B*, 2009). The EEOC also cited additional studies that flexible workplace policies enhance employee productivity, reduce absenteeism, reduce costs, aid recruitment and retention, and provide employers with more alternatives when dealing with workforce reductions (*EEOC B*, 2009).

The EEOC suggestions of best practices for employers go beyond federal nondiscrimination requirements designed to remove barriers to equal employment opportunity and cover three areas: General suggestions regarding organizational policies and practices; suggestions regarding recruitment, hiring, and promotion; and suggestions as to terms, conditions, and privileges of employment.

While training of all managerial personnel is imperative, organizations should also make sure that they have strong EEO policies in place that clearly addresses the types of conduct that might constitute unlawful discrimination against caregivers. These policies must also be effectively communicated to all employees, providing examples of prohibited behavior, identify easy to access complaint procedures, and prohibit retaliation against individuals who report discrimination or harassment based on caregiving responsibilities or who provide information related to such complaints (*EEOC B*, 2009).

SUMMARY AND CONCLUSIONS

Given the well publicized demographic characteristics of today's work force, the rapid rise in litigation, and the EEOC's guidance in regard to caregiver discrimination, employers should allocate additional resources to deal with an issue that is not likely to go away any time soon. Employers should be taking "proactive steps to avoid allegations of discrimination against caregivers" (Proskauer Rose, LLP, 2009). Additionally, employers should be taking advantage of the rich body of knowledge that is available to promote flexible work environments and a healthy work-life balance for all their employees.

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FOOD SAFETY- FROM QUALITY TO QUANTITY

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ABSTRACT

Traditionally food safety had to do with minimizing the immediate risks arising from consuming a risky food. Usually it requires attention on how to prevent the distribution of food that is not fresh, how to avoid the existence of toxics and pest control materials in foods, and monitoring that the various industrial additives, which are added during production, do not exceed safety regulations. The traditional definition of food safety has to do with quality of the food: Food that may cause health damage in short run considered as risky, whereas food that may not cause damage is considered as safe.

This distinction between "good food" and "bad food" as based on the quality of the food is important in reducing the risk arising from eating something that is dangerous for us, but it ignores another kind of risk which is due to over-eating. The following paper expands the definition of food safety by distinguishing between the quality and the quantity of food consumed. Eating too much is dangerous. The risk of over-eating is not limited just to the risks of eating too much of a particular food, but also concerns the risk of eating too much in general. People today eat much more than in the past and use less energy. This leads to obesity and other health problems resulting in cardiovascular diseases such as coronary heart diseases, stroke and even death. From this description appears that, the criterion for distinguishing between unsafe - risky food to safe - non risky food, does not necessarily concerns quality, but depends on the quantity.

It is important to mention that the criterion for deciding whether a certain food is safe is relative- It is not possible to calculate and determine the amount of food which is considered absolutely safe, and it needs to be adjusted according to the amount of food a person consumes and the amount of physical activity that person does. Moreover the amount of food needed for a person spending much of his day exercising is higher than the amount needed for a person who does not exercise and spends her day in the office. The amount of food which is considered safe or risky for particular individual also depends on one's physical characteristics.

Although it is difficult to decide what amount of food is risky, it is possible to analyze the social and cultural process through which good food becomes dangerous. Understanding this process should lead to the creation of a new risk management ideology for food.

Keywords: Safe food, Risky food, Quality, Quantity, Risk Management

LEGISLATIVE ASSISTANCE FOR DISASTER LOSS VICTIMS

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ABSTRACT

When a severe natural disaster destroys an entire house through wind, fire and/or flood, often the records in the house are destroyed, too. In natural disaster areas, not even bank safety deposit boxes are safe. Normally, insurance records can be tentatively relied upon to assess the value of disaster losses, but not everyone is insured and flood victims are notoriously underinsured. The IRS recognized this for hurricane victims of Katrina, Rita and Wilma and passed a special safe-harbor provision establishing standard rates for the amount of a total loss of structure in the form of Revenue Procedure 2006-32. Subsequently, U.S. taxpayers have weathered several other major national disasters, including large-scale flooding in the Midwest and Hurricane Ike, which are not covered by this Revenue Procedure. Since many of the victims of these and future devastations are in a similar situation to Katrina victims, the authors of this paper argue that this Revenue Procedure should form the basis for a standard, geographically-adjustable structure allowance for all subsequent major catastrophes where record loss is likely and victims have inadequate third-party insurance records on which to rely. A structure which is similar to maximum Federal per diem rates detailed in IRS Publication 1542, detailing the established deductible amount for meals in different cities throughout the Continental United States. Another similar example would be the standard mileage rate for the business use of your vehicle. While the business purpose must be substantiated for these aforementioned expenses, no receipts are required in order for the taxpayer to eligible for the income tax deduction on their tax return.

PARITY RANKING OF AGGRIEVED SHAREHOLDER CLAIMS

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ABSTRACT

*Australian regulators are currently facing the question as to whether aggrieved shareholders should rank equally with creditors in cases of insolvency involving illegal or misleading conduct. This question sits at the crossroads of insolvency and securities law and raises difficult questions concerning the efficiency, certainty, transparency and fairness of the treatment of such claims in insolvency situations. In *Sons of Gwalia Ltd (admin apptd) v Margaretic* [2007] HCA 1, the High Court chose not to apply a rule said to be germane to insolvency cases involving fraudulent or misleading conduct inducing share purchase known as the rule in *Houldsworth's case*, which has prevented shareholders ranking on par with unsecured creditors in such circumstances for over a century. This paper considers the case for parity ranking of shareholders in cases of insolvency involving misleading and fraudulent behaviour in the context of modern developed markets.*

Keywords: Aggrieved shareholder claims, insolvency, Sons of Gwalia, Houldsworth

PARITY RANKING OF AGGRIEVED SHAREHOLDER CLAIMS

The question as to whether aggrieved shareholders should rank equally with creditors in cases of insolvency involving illegal or misleading conduct sits at the crossroads of both insolvency and securities law. Important questions arise at this juncture concerning the fairness, certainty, transparency and efficiency of the treatment of such claims when in competition with creditor claims. In *Sons of Gwalia Ltd (admin apptd) v Margaretic* (2007) 232 ALR 232; 60 ACSR 292; 25 ACLC 1; [2007] HCA 1 the High Court of Australia allowed shareholders to rank equally with unsecured creditors in insolvency cases involving illegal or misleading behaviour. This decision prevailed over traditional perceptions of a distinction between debt and equity, and the primacy historically accorded to creditors upon insolvency.

On 18 August 2004 Luka Margaretic bought 20,000 shares in Sons of Gwalia (SoG), a gold mining company based in Western Australia, on the Australian Securities Exchange (ASX). Just over a week and a half later on 29 August, directors of the company appointed administrators on the belief that the company was or was likely to become insolvent under s 436A(1). The company entered into a deed of company arrangement under Div 10 of Pt 5.3A of the *Corporations Act 2001* (Cth), under which administrators were to distribute SoG's remaining assets in the same order in which it would if it were being wound up.

It has since emerged that the company's Chief Financial Officer had been engaging in unauthorised gold hedging and foreign exchange trading activities from the mid 1990's. Spectacular losses were made and housed in off-balance sheet accounts to the point that 'directors considered

that the extent of the potential losses threatened the company's existence¹, yet no public announcements were made alerting the market to this information. Apparently, according to the administrator's report, SoG did not take an opportunity to close out commitments to its options contracts in August 1999 at a cost of \$74 million. Instead, with a rising gold price and more call than put options over its gold reserves, 'the company's treasury operations got out of control and the company appeared to have been riding a train with no brakes towards a cliff. The cliff took a long time to arrive – August 2004, when the company collapsed owing about \$1 billion'.²

Margaretic claimed that SoG was in breach of its Continuous Disclosure obligations as per s 674 of the *Corporations Act 2001* (Cth) as it did not inform the market of information which was likely to have a material effect on the price or value of its shares. The information concerned the company's inability to meet its gold delivery contracts due to insufficient gold reserves. Alternatively, he claimed that he was a victim of misleading and deceptive conduct on s 52, and that SoG contravened statutes regulating its existence (s 1041 of the Act and s 12DA of the ASIC Act), entitling him to compensation for the amount he lost as a result – the full purchase price of the shares of \$26,200, for it was agreed that upon the appointment of administrators the shares were and would continue to be worthless. With the decision of the High Court has come serious debate as to whether Australia should continue to rank shareholder claims in such circumstances alongside creditors, or subordinate them. With the decision of the High Court has come serious debate as to whether Australia should continue to rank shareholder claims in such circumstances alongside creditors, or subordinate them.

It has been stated by Bilski and Brown that in situations such as these 'the real conflict is not between shareholders and creditors, but between shareholders, and the impact of spreading loss diffusely throughout the wider market via the mechanism of higher interest rates'.³ Since this may be the case it is important to assess the arguments in support of treating shareholder and unsecured creditor claims in the same way.

As noted by Callinan J in his judgment in *Sons of Gwalia*, the major consideration in a market participant's mind when purchasing shares is most likely to be a desire to make as much money as possible.⁴ In doing so, investors will be aware that a condition for the possibility of profit is the chance of a loss, representing the risk involved in investing in equities markets. In developed markets with legislative and market based controls in place to prevent misleading and fraudulent behaviour by organisations constituting the market, it is fair to ask whether shareholders consent through their share purchase to bearing the risks involved in illegal securities issuance, fraudulent inducement, or failure to comply with the Continuous Disclosure regime.

The rules of the game for capital have been set by the legislature and the Australian Securities Exchange to promote a free, fair and efficient market, where reliable, timely information concerning the existing fortunes and future prospects of companies is released in order to allow interested parties to make informed decisions relating to their investments. Such information, to be of any use, must of necessity be true and fair to the company's knowledge. Within this frame, which has been constructed in order to promote investor confidence and interaction with the stock market, it is difficult to accept that shareholders should pay when these controls are flouted and loss is occasioned. According to Davis, '[g]iven the absence of any truly consensual arrangement among investors governing allocations of the fraud loss, distributing it evenly would seem the fairest solution, and a result consistent with the general bankruptcy dictates of parity'.⁵

It is indeed unclear, as Sarra notes, why in the context of greater availability of shareholder remedies for corporate misconduct that at the same time it is proposed that 'if the conduct is sufficiently egregious that satisfaction of claims makes the company insolvent, then the claims are completely subordinated to other interests in the firm'.⁶ Would it not be fair to assume that in the face of such developed markets and the controls currently in place that a company's very existence in the market is legitimate, that the risk of illegality or misrepresentation in security issuance is zero, and therefore, that shareholders should not be held accountable more than any other innocent party involved with the company which also relies on these mechanisms?

Comparisons have been made between insolvency involving illegality and those where insolvency is a result of unprofitable trading or bad business decisions, where a shareholder will have no recourse to lost monies. The risk of insolvency as a result of normal operations in the course of legitimate business is the flipside of making the profit that investors desire, meaning the company could prosper or it could fail. However, such occurrences (assuming no illegality) take place in the company's existence in the course of *legitimate* trade, not amidst smoke and mirrors in areas ordinary shareholders cannot access let alone question, in situations where falsified financial reports are constructed in ways which omit or hide essential information concerning the financial health of the company and its future existence, information which would otherwise be used by shareholders to make important decisions depending on their risk profile.

In cases involving fraud, illegality, or misleading and deceptive conduct, the necessary information which is supposed to oil the cogs turning the efficient market is obscured from view. While shareholders necessarily consent to the risk of failure in the ordinary course of business as a necessary possibility in the field of economic existence, they cannot be said in the frame of a developed market with controls geared to encourage considered investment and sustainable economic growth, goals which are anathema to misinformation, the deliberate withholding of information, illegality and fraudulent inducement, to assent to bearing the costs of such behaviour through their share acquisition.

The fact that modern share ownership is exponentially more diffuse, disinterested and detached from the realities of daily corporate action in the world, and that shareholders 'are a widely dispersed group that does not have the time, resources or capacity to monitor corporate officers'⁷ highlights the importance of the very mechanisms designed to ensure the integrity of the market such as the Continuous Disclosure requirements. While shareholders may be cognisant of the privileges of incorporation and limited liability, it cannot be said that they should bear the risk in cases where organisations have failed to keep the market properly informed of information which might affect the value of its shares. Rather, when a shareholder buys shares, they consent to the possible loss of their investment in the course of legitimate trading, all the while hoping that good management will bring home a gain, yet aware that a company can make bad business decisions as well as good ones, thus setting the risk profile which they are willing to commit themselves to. Herein there appears to be a certain level of trust placed in the market and its controls that the information released and on which the decision to invest and maintain that investment was made is a full, true and fair view of the company and its operations at that point in time. As such, shareholders are in no different position to creditors and the two classes should be treated alike in cases of insolvency involving fraudulent or misleading behaviour.

ENDNOTES

- 1 West Australian, quoting report by Sons of Gwalia Administrators, "Brothers of Gwalia face growling watchdog", August 22, 2005, available at: <http://www.theage.com.au/news/business/brothers-of-gwalia-face-growling-watchdog/2005/08/21/1124562751752.html>.
- 2 Alan Kohler, "Why did Gwalia fail? Ask the Lalor brothers" August 20, 2005, The Age available at: <http://www.theage.com.au/news/alan-kohler/why-did-gwalia-fail-ask-the-lalor-brothers/2005/08/19/1124435144575.html?oneclick=true>.
- 3 Bilski A and Brown P, "Sons of Gwalia versus shareholder subordination: Fairness versus efficiency" (2008) 26 Company and Securities Law Journal 93 at 100.
- 4 Sons of Gwalia Ltd v Margaretic [2007] HCA 1 at 208. Davis, K.B. "The Status of Defrauded Securityholders in Corporate Bankruptcy" (1983) 1(1) Duke Law Journal 1 at 62.
- 5 Davis, K.B. "The Status of Defrauded Securityholders in Corporate Bankruptcy" (1983) 1(1) Duke Law Journal 1 at 62.
- 6 Sarra J, "Risk allocation and efficient administration: System design and adherence to first principles in treatment of securities claims in insolvency proceedings", (2008) 22 Australian Journal of Corporate Law 105 at 121.
- 7 Sarra, above n 6 at 132.

THE RELIANCE INTEREST OF CREDITORS

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ABSTRACT

*At the crossroads of insolvency and securities law lies the question as to whether defrauded shareholders should rank equally with unsecured creditors in cases involving fraudulent or misleading behaviour. Important questions arise at this juncture concerning the efficiency, certainty, transparency and fairness of the treatment of such claims in insolvency situations. In *Sons of Gwalia Ltd (admin apptd) v Margaretic* [2007] HCA 1, the High Court chose not to apply a rule said to be germane to insolvency cases involving fraudulent or misleading conduct inducing share purchase known as the rule in *Houldsworth's case*. The "rule" said to have been developed in *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 had up until the High Court's decision been used to interpret legislative provisions concerning shareholder claims, resulting in problematic determinations in the context of modern developed markets. This paper considers the case for the subordination of aggrieved shareholder claims centering on the reliance interest of creditors.*

Keywords: Aggrieved shareholder claims, insolvency, Sons of Gwalia, Houldsworth

THE RELIANCE INTEREST OF CREDITORS

The question as to whether aggrieved shareholders should rank equally with creditors in cases of insolvency involving illegal or misleading conduct sits at the crossroads of both insolvency and securities law. Important questions arise at this juncture concerning the fairness, certainty, transparency and efficiency of the treatment of such claims when in competition with creditor claims. In *Sons of Gwalia Ltd (admin apptd) v Margaretic* (2007) 232 ALR 232; 60 ACSR 292; 25 ACLC 1; [2007] HCA 1 the High Court of Australia allowed shareholders to rank equally with unsecured creditors in insolvency cases involving illegal or misleading behaviour. This decision prevailed over traditional perceptions of a distinction between debt and equity, and the primacy historically accorded to creditors upon insolvency.

On 18 August 2004 Luka Margaretic bought 20,000 shares in Sons of Gwalia (SoG), a gold mining company based in Western Australia, on the Australian Securities Exchange (ASX). Just over a week and a half later on 29 August, directors of the company appointed administrators on the belief that the company was or was likely to become insolvent under s 436A(1). The company entered into a deed of company arrangement under Div 10 of Pt 5.3A of the *Corporations Act 2001* (Cth), under which administrators were to distribute SoG's remaining assets in the same order in which it would if it were being wound up.

It has since emerged that the company's Chief Financial Officer had been engaging in unauthorised gold hedging and foreign exchange trading activities from the mid 1990's. Spectacular losses were made and housed in off-balance sheet accounts to the point that 'directors considered

that the extent of the potential losses threatened the company's existence¹, yet no public announcements were made alerting the market to this information. Apparently, according to the administrator's report, SoG did not take an opportunity to close out commitments to its options contracts in August 1999 at a cost of \$74 million. Instead, with a rising gold price and more call than put options over its gold reserves, 'the company's treasury operations got out of control and the company appeared to have been riding a train with no brakes towards a cliff. The cliff took a long time to arrive – August 2004, when the company collapsed owing about \$1 billion'.²

Margaretic claimed that SoG was in breach of its Continuous Disclosure obligations as per s 674 of the *Corporations Act 2001* (Cth) as it did not inform the market of information which was likely to have a material effect on the price or value of its shares. The information concerned the company's inability to meet its gold delivery contracts due to insufficient gold reserves. Alternatively, he claimed that he was a victim of misleading and deceptive conduct on s 52, and that SoG contravened statutes regulating its existence (s 1041 of the Act and s 12DA of the ASIC Act), entitling him to compensation for the amount he lost as a result – the full purchase price of the shares of \$26,200, for it was agreed that upon the appointment of administrators the shares were and would continue to be worthless. With the decision of the High Court has come serious debate as to whether Australia should continue to rank shareholder claims in such circumstances alongside creditors, or subordinate them.

It has been argued that if shareholder claims are not subordinated, creditors will end up bearing more of the risk of illegal securities issuance than they *should*. On the basis that early in the history of corporations creditors referred to the amount of paid-up capital on a company's books in making a decision to lend, Slain and Kripke have argued that in the event of insolvency 'one interest should be weighted far more heavily than at present: the reliance interest of persons having the normal expectation that equity investment and junior debt will bear the first losses of the enterprise'.³ In appealing to historical notions of creditor priority, Slain and Kripke made the argument in 1973 that

in extending credit, [the creditor] has relied on the operation of the absolute priority rule in case of bankruptcy... in shifting his priority position, the courts impose upon him the burden of a risk he has never assumed and should not be made to assume – the possibility of a defective stock issue.⁴

In his judgment in *Sons of Gwalia* Callinan J maintained, in line with Slain and Kripke, that the fact shareholders have more rights and opportunities to exercise control, power and influence over a company than creditors evidenced the reality that creditors were innocent of the business and its decisions. The corollary was that creditors should not be made to bear risk which is supposedly assented to by shareholders who stand to gain unlimited upside from a company's success. Such reasoning ignores the fact that in circumstances where fraudulent and misleading behaviour has occurred that shareholders are just as innocent and powerless as creditors. If shareholders are deprived of the very information, which is required to be presented to them by the company by Australia's Continuous Disclosure regime, that could enable them to take appropriate action at shareholder meetings or vote with their feet and sell their shares away, their opportunities and power to exercise control over the company are illusory. Rights which may exist in theory are impossible

to action without relevant information, information which in such cases is being hidden or misrepresented.⁵

In the real world, creditors have more of an ability to check the financial health of corporations than ordinary shareholders: 'The modern business creditor has much broader sources of insight into the corporation's financial condition and a more refined appreciation for the particular financial characteristics that reflect an ability to repay debt'.⁶ Indeed, should creditors rank on par with shareholders in such cases, they may be more concerned to maintain accurate checks on the financial health of the company in question. This approach might also therefore leverage the ability of creditors to gain access to important information concerning the financial position of a company in order to ensure its compliance with the rules of the market. As noted by Davis,

[m]ost shareholders can obtain only the issuer's published financial reports and the output of securities analysts. Lenders, on the other hand, can commonly bargain for contractual rights to demand additional information from the borrower and to inspect its books, records, and facilities particularly if the financial condition of the borrower begins to deteriorate, the flow of financial information to lenders will typically go well beyond that available to the public or to most shareholders.⁷

Let us not forget that any interest charged by creditors involves a risk premium, meaning '[c]reditors cannot complain that insolvency as such has caused them loss because they have contracted to bear that risk, and have built compensation for bearing it into the cost of credit'.⁸ Evidently business risk is as much a reality for the creditor as it is for the shareholder. While it is only fair that creditors rank ahead of shareholders in their capacity as shareholders while a company remains solvent as the price of continuing operations, there is no point of differentiation between creditors and shareholders in insolvency cases where a company has engaged in fraudulent inducement and misinformation. In that situation, both creditors and shareholders find themselves in the same position.⁹

The application of the absolute priority rule to cases of insolvency involving fraudulent and misleading behaviour prevents otherwise legitimate claims being satisfied and is therefore a source of relative injustice *vis a vis* the broader frame of protection offered to market participants. As recognised by the majority of the High Court, the key issue in such cases is that information has not been provided as mandated, whether that means it was not disclosed in a timely or accurate manner, or that it was designed to mislead or fraudulently misrepresent the position of the organisation. Shareholders who had nothing to do with the dishonest actions of their company's managers and had not been afforded an opportunity to do anything about them are essentially in the same position as creditors, highlighting the injustice visited upon them by a total subordination approach.

ENDNOTES

1 West Australian, quoting report by Sons of Gwalia Administrators, "Brothers of Gwalia face growling watchdog", August 22, 2005 available at: <http://www.theage.com.au/news/business/brothers-of-gwalia-face-growling-watchdog/2005/08/21/1124562751752.html>.

2 Alan Kohler, "Why did Gwalia fail? Ask the Lalor brothers" August 20, 2005, The Age available at: <http://www.theage.com.au/news/alan-kohler/why-did-gwalia-fail-ask-the-lalor-brothers/2005/08/19/1124435144575.html?oneclick=true>.

3 Slain J and Kripke H, "The interface between securities regulation and bankruptcy – allocating the risk of illegal securities issuance between securityholders and the issuer's creditors" (1973) 48 New York University Law Review 261 at 263.

4 Slain and Kripke, above n 3 at 265.

5 Davis states that

[f]or most public shareholders and creditors alike the only meaningful opportunity for exercising choice of management lies in the so-called "Wall Street rule": the decision whether to invest in the issuer in the first place and whether to get out if the investment becomes unsatisfactory. Fraud taints this choice equally for equity and debt. It also ignores that fact that "public shareholders of a corporation usually have little voice in who the managers are or how they behave" and that "a large creditor is likely to have much more control, particularly as the corporation edges toward insolvency".

Davis, K.B. "The Status of Defrauded Securityholders in Corporate Bankruptcy" (1983) 1(1) Duke Law Journal 1 at 44.

6 Davis, above n 5 at 29.

7 Davis, above n 5 at 67.

8 Wishart D, "Models and Theories of Directors' Duties to Creditors" (1991) 14 New Zealand Universities Law Review 323 as quoted in Duffy MJ "After Sons of Gwalia – Some perspectives on the position of shareholders and creditors and the question of law reform" (2008) 22 Australian Journal of Corporate Law 161 at 176.

9 Indeed, it is possible to contrast the relatively privileged position of creditors and shareholders when comparing to those who may be absolutely innocent of the business and completely powerless in this sense such as involuntary creditors such as employees and arguably small trade creditors who cannot protect themselves either through diversification of share portfolios as shareholders can, or through the extra control over lending arrangements available to larger creditors. At least in the case of employees these interests are protected: See s 556 (1) (e-h) of the Corporations Act 2001 (Cth), which prioritises wages and superannuation contributions, injury compensation, leave and retrenchment payments.

CONSUMER CREDIT: THE NEXT SHOE TO DROP OR A BULLET DODGED?

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ABSTRACT

This research examines consumer credit outstanding and considers the benefits and risks to the various market participants in light of the financial crisis. The implications of recent regulatory changes regarding consumer credit are also considered. We conclude that there is a substantial risk to financial markets resulting from the amount of outstanding consumer credit in this economy. In addition to the widely recognized risk associated with consumer loans backed by real estate (home equity loans and lines of credit), credit card debt could experience significant defaults.

CORPORATE CHARACTERISTICS AND THE DISCLOSURE OF EARNINGS RESTATEMENTS

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ABSTRACT

While the accounting frauds have taken center stage in accounts of unethical behaviors of some managers, a more prevalent and equally disconcerting management activity results in accounting restatements. The unprecedented increase in restatements prompted Congress to commission the GAO to analyze these accounting irregularities. The Securities and Exchange Commission has also expressed concern over the rising number of accounting restatements and has noted that market participants would likely be interested in knowing the how the irregularity was found and initially disclosed. This study will investigate the differences in management and firm characteristics based on who disclosed an accounting irregularity resulting in an accounting restatement. In addition, we'll examine the type of irregularity reported. Revenue recognition issues tend to be the more serious violations, and we'll examine if management characteristics differ.

To test these differences, we used logistic regression model. The model is significant ($p=.03$) and the maximum rescaled R-squared is 14%. Firm size is significantly negative at the .04 level and CEO Age is significantly positive at the .01 level. Next, we examined if the irregularity was a revenue recognition issues, generally considered a more severe violations than some other issues. In this logistic regression, the return on assets is significant with companies with higher return on assets being more likely to have revenue recognition irregularities. In addition, being Chairman of the Board is a significant variable. Finally, CEO Tenure is marginally significant.

Therefore, this research confirms the ethics models in that smaller company's management is more likely to be the prompter of an earnings restatement. In addition, older CEOs are associated with being the prompter. In addition, if the CEO is also the Chairman of the Board, then the company is less likely to have a revenue recognition issue. The additional responsibility given to the CEO should improve governance and make that individual more accountable to the shareholders. In addition, the more entrenched the CEO is, the more likely the company was involved in revenue recognition irregularities.

THE FLSA AND NEW ISSUES CREATED BY A STRUGGLING ECONOMY

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Tommy Robertson, Sam Houston State University**

ABSTRACT

The Fair Labor Standards Act, which is referred to as the "wage and hour law," established the federal minimum wage and hour standards for covered employees. The FLSA requires that employers pay employees at least the hourly minimum wage, which is currently \$7.25 per hour, and overtime pay of one-and-one-half the rate of regular pay for hours worked in excess of 40 hours in a workweek. The FLSA contains recordkeeping provisions that require employers to keep detailed records of its' employees' daily and weekly hours worked.

A FAILURE OF CREDIT REGULATION: THE CASE OF NCAS OF DELAWARE

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ABSTRACT

The Truth in Lending Act of 1968 (TILA) was a landmark piece of legislation that was designed to inform consumers about the true cost of credit. Prior to the TILA, lenders used many different methods to calculate the stated interest rate on a loan. The TILA required all lenders to state an annual percentage rate (APR) that was calculated on a consistent basis. This allowed consumers to compare rates, and to assess the cost of borrowing.

*Over the years, however, banks and other lenders sought and obtained numerous exceptions that allowed them to charge fees that were not included or disclosed in the APR. This practice has become so egregious that in a recent case, *Pennsylvania Department of Banking v. NCAS of Delaware*, a lender was able to legally claim an APR of 5.98%, while the actual cost of the loan was 368%. This paper reviews the history of the TILA and uses the *NCAS of Delaware* case to show how the TILA's purpose has been undermined. The paper concludes with a recommendation for reform that would restore the TILA to its former role as an effective consumer protection statute.*

INTRODUCTION

On March 20, 2008, the Supreme Court of Pennsylvania decided the case of *Pennsylvania Department of Banking v. NCAS of Delaware*. This case illustrates the failure of the Truth in Lending Act of 1968 (TILA) to protect Americans from deceptive lending practices. The case involves a lender of "payday loans", short term loans in small amounts that often carry very high interest rates. The lender advertised an annual percentage rate (APR) of 5.98%. That was an accurate legal calculation of the loan's APR. However, in that case, the true cost of borrowing was approximately 368%.

This paper explores the failure of the TILA in the *NCAS of Delaware* case. It begins by reviewing the history of the TILA. Next, the paper uses the *NCAS of Delaware* case to illustrate how numerous exceptions to the TILA have so undermined the Act as to cause it to fail to perform its essential purpose. The paper concludes with a recommendation for reform that would restore the TILA to its former role as an effective consumer protection statute. This paper will help business students and managers better understand the role of predatory lending and consumer protection in our current credit environment.

HISTORY OF THE TRUTH IN LENDING ACT

The most important federal regulatory statute affecting the U.S. credit market is the Truth in Lending Act (TILA) of 1968. Prior to the TILA lenders used many different methods to calculate

the stated interest charge. Lender A might state an interest charge of 8 percent, while lender B stated an interest rate of 10 percent, but the actual cost of lender B's loan might be lower. This was true because different mathematical formulations yielded different results. In order to allow consumers to make an "apples to apples" comparison, the TILA created an "annual percentage rate" (APR) using a consistent formulation that lenders were required to use. The APR must be conspicuously displayed in the loan contract.

Another term that must be conspicuously displayed is the "finance charge". The finance charge is intended to reveal the total cost of the loan; that is, its interest charge plus fees. The finance charge is extremely important because it is used to calculate the APR. The APR is simply the finance charge calculated on an annual basis.

The centrality of the finance charge makes it imperative that this amount accurately reflect the true total cost of the loan. It must also be uniformly calculated by all lenders, in order to serve the basic purpose of the TILA to provide consumers with a simple method to compare loan costs. Unfortunately, the integrity of the finance charge, and therefore of the APR, has been undermined. This is a result of certain provisions in the TILA itself, and also because of action taken by the Federal Reserve Board.

First, the TILA itself provides for a limited number of exceptions: excluded charges that do not need to be disclosed or included in the stated finance charge. These include fees for property surveys, document preparation, appraisals, credit reports, notary fees, escrow fees, and insurance.

Second, the TILA gave the Federal Reserve Board authority to create additional exceptions, where "necessary or proper to effectuate the purposes of the Truth in Lending Act". The Federal Reserve Board issued Regulation Z, which created additional exceptions to the finance charge. Regulation Z added late fees, credit application fees, charges for exceeding a credit limit, and annual or periodic fees to participate in a credit plan for loans that did not have a fixed term.

A recent example of how these fees can distort the true cost of credit may be found in the case of *Pennsylvania Department of Banking v. NCAS of Delaware*. In that case a lender described a loan as having an APR of only 5.98 percent. However, this loan included a monthly participation fee of \$149.50. If the participation fee (excluded from the stated finance charge by Regulation Z) had been included in the APR, the APR would have been 368 percent. This case is discussed below.

The Federal Reserve Board created still more exceptions - charges that did not need to be included in the finance charge - through official staff responses to lender inquiries. Since 1981, these responses have been known as "Official Staff Commentary". These exceptions include credit report fees and participation fees even for fixed term loans like mortgages. These exceptions to the finance charge undermine the effectiveness of the APR. As Senator William Proxmire, one of the main proponents of the TILA, said in 1967:

A third principle is that the definition of the finance charge, upon which an annual percentage rate is calculated, needs to be comprehensive and uniform. It needs to be uniform to permit a meaningful comparison between alternative sources of credit ... The definition of the finance charge also needs to be comprehensive in order to convey the true cost of credit.

THE NCAS OF DELAWARE CASE

This case, which involved a payday loan, originated in the Commonwealth Court of Pennsylvania. The trial court's opinion was filed on July 31, 2007. It was written by Judge Bernard McGinley. The trial court's opinion did not follow a trial by jury or a bench trial; it consisted of a decision on pretrial motions made by both the plaintiff and the defendant. The plaintiff, a state regulatory agency, had moved for a summary judgment and an injunction ordering the defendant to cease and desist; the defendant moved for summary judgment. The trial court granted the plaintiff's motion and denied the defendant's motion. NCAS of Delaware, LLC, does business as Advance America Cash Advance Centers (AA). The court stated:

AA describes itself and its subsidiaries as "the country's leading provider of payday cash advance services." Payday cash advance is a form of consumer lending that involves offering consumers high-rate, short term loans secured by either a post-dated check or a debit authorization from a bank account, both of which are executed at the end of the loan term, which is usually for two weeks to coincide with the consumer's payday.

AA advertised payday loans of up to \$500 at an APR of 5.98%. This is a low rate that seems reasonable. However, AA also charged a "monthly participation fee" of \$149.50 per month. As noted above, this participation fee is not required to be included in calculating the APR. Nevertheless, Pennsylvania has a usury law, the Consumer Discount Company Act (CDCA). Section 3.A of that Act prohibits firms like AA from charging "interest, ...fees...charges or other consideration" which aggregate in more than 6% (in a case like this). Under Pennsylvania's usury law, the loan charge of approximately 368% was grossly in excess of the permitted rate of 6%.

AA denied liability. Its defense relied upon two arguments: first, that Delaware law, not Pennsylvania law applied to this loan transaction, and second, that even if Pennsylvania law applied, that AA's APR of 5.98% placed it in compliance with that state's usury law. This led to an extensive discussion of conflict of law rules. Both parties agreed that Section 187 of the Second Restatement of Conflicts of Laws governs this issue. Under Section 187 courts will apply the law of the state that the parties have chosen unless:

Application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of Sec. 188 [of the Second Restatement], would be the state of the applicable law in the absence of an effective choice of law by the parties.

The AA loan contracts included a provision that the contracts would be governed by the laws of the State of Delaware. Delaware has no usury law; AA's loan contracts were therefore in compliance with Delaware law. However, as noted above in the Restatement, if the parties have agreed to be governed by the laws of one state, but another state has a "fundamental policy" with a "greater interest" than the chosen state, then the agreement of the parties is overridden. The state with the fundamental policy interest is the state whose law will be applied to the transaction.

The trial court had no trouble finding that the fundamental public policy of Pennsylvania was to protect its citizens from usury, and so by application of the Restatement rule Pennsylvania law should apply. Moreover, the court noted that the plaintiff in this case was a state agency. That state

agency had not agreed to the choice of law provision in the AA loan contracts; borrowers had. The court reasoned that the state agency was not bound by that contractual provision. Therefore, for two reasons the trial court rejected the defendant's argument that Delaware law should apply to this case.

The defendant's next argument was that the APR of 5.98% was controlling, and placed AA in compliance with Pennsylvania law. An unlicensed lender such as AA may charge up to 6% "simple interest or its equivalent" according to the CDCA Sec. 3.A. However, the provision of the CDCA which calls for aggregation of fees, charges and interest persuaded the court that the equivalent rate was actually approximately 368%, not 5.98%. Having rejected both defense arguments, the trial court granted the plaintiff's summary judgment motion and it ordered AA to cease its violations of the CDCA.

THE CASE AT THE PENNSYLVANIA SUPREME COURT

Less than one year after this case was decided by the trial court, the Pennsylvania Supreme Court reviewed it. On March 20, 2008, in an opinion written by Justice Saylor, the Pennsylvania Supreme Court affirmed the trial court's decision. That court noted that in the earlier case of *Smith v. Steinkamp* that court had stated "A payday loan is a loan of short duration, typically two weeks, at an astronomical annual interest rate."

The Pennsylvania Supreme Court agreed that AA had violated the CDCA by charging an effective loan interest rate of approximately 368%, according to the aggregation provision of that statute. In addition, the court addressed the related charge by the Department of Banking that AA had also violated Pennsylvania's Loan Interest and Protection Act (LIPA). That law placed a maximum interest rate of 6% on the type of loans AA was making. The LIPA did not have an aggregation provision, and so the lower court had not granted summary judgment to the Department on that count. The Pennsylvania Supreme Court concluded that the \$149.50 monthly participation fee constituted "sham interest". The court stated that:

Appellant's characterization of the charges as a "participation fee" rather than interest is an example of the industry's latest scheme to avoid usury laws ... This Court has acknowledged that "usury is generally accompanied by subterfuge and circumvention of one kind or another to present the color of legality." *Richman v. Watkins*, 376 Pa. at 515, 103 A.2d at 691. We agree with the Department ... that Appellant's interpretation of the statute would undermine the usury laws' purpose: "to protect the citizenry of this Commonwealth from being exploited at the hands of unscrupulous individuals seeking to circumvent the law at the expense of unsuspecting borrowers who may have no other avenue to secure financial backing." *Smith v. Mitchell*, 420 Pa. Super. 137, 143, 616 A.2d 17, 20 (1992).

The Pennsylvania Supreme Court therefore concluded that AA had violated Pennsylvania's LIPA as well as its CDCA. One disappointment is that this decision did not address the fact that the Truth in Lending Act (TILA) permitted AA to exclude the monthly participation rate from its advertised APR. Consumers were probably misled into thinking that they were borrowing at a relatively low cost, when in fact the loan cost was, in the words of the *Steinkamp* decision cited above, "astronomical".

CONCLUSION

We have seen how the Truth in Lending Act (TILA) itself provides for a limited number of exceptions to charges and fees that are not included in the finance charge or in the annual percentage rate (APR). The Federal Reserve Board magnified the problem by issuing Regulation Z, which created additional exceptions. Regulation Z added late fees, credit application fees, charges for exceeding a credit limit, and annual or periodic fees to participate in a credit plan for loans that did not have a fixed term.

The Federal Reserve Board created still more exceptions - charges that did not need to be included in the finance charge or in the APR - through official staff responses to lender inquiries. As a result, we have cases like *Pennsylvania Department of Banking v. NCAS of Delaware*, in which the exclusion of a monthly participation fee resulted in a legally calculated APR of 5.98% even though the true cost of the loan was approximately 368%. The conclusion is inescapable that at this time the APR does not reflect the true cost of borrowing.

There is a simple and effective way to remedy this problem: require that all costs, fees and charges related to a loan be included in the finance charge and therefore in the APR. The Pennsylvania Supreme Court concluded that Advance America's monthly participation fee was "sham interest" and should be included in a proper calculation of loan interest or cost. Congress should follow this example, and revise the TILA to require that the finance charge and the APR include all fees, charges, and costs of any kind that are associated with a loan. As Senator William Proxmire pointed out, the APR "needs to be comprehensive in order to convey the true cost of credit". This was the intent of Congress when it enacted the TILA. By requiring the inclusion of all borrowing costs, the TILA would be restored to its role as an effective consumer protection statute.

THE DISPARITY BETWEEN DISPARATE TREATMENT AND DISPARATE IMPACT: AN ANALYSIS OF THE RICCI CASE

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ABSTRACT

The legal environment is a complicated and expensive component that all business should closely monitor, as changes can change the competitive landscape. In order to sustain a competitive advantage, employers must stay abreast of the numerous changes within the law that has the potential to affect their business. The need to monitor changes within the law is heightened when the business hires employees, as employment law issues have become the most litigated facet of law for small business owners. While the employee at-will doctrine still governs most employees, courts and legislatures have carved out numerous exceptions in order to afford additional safeguards to employees that they otherwise would not enjoy (Galberry, 2000). One of the more publicized examples involves employees seeking protections bestowed upon them through their employee handbook (Galberry, 2000). Courts consistently recognize that employee handbooks can create a reasonable expectation of rights as provided for within the handbook (Galberry, 2000). As a result, many attorneys are now advising their business clientele to adopt “employee instruction manuals” as opposed to employee handbooks in order to circumvent the negative precedence associated with the employee handbook.

A second, and more prevalent, exception to the employee at-will doctrine, and the focus of this article, is Title VII of the Civil Rights Act. The legislative intent associated with Title VII was to prevent discrimination based upon race, gender, religion, or national origin. The purview of Title VII prohibits employers from taking adverse actions against an employee within the employment realm, which includes the hiring, promoting, and termination function. While Title VII is the most comprehensive employee antidiscrimination protection, it has undergone a series of legislative and judicial revisions, expanding the scope of Title VII. One such revision, and the focus of this article, is legislative action prohibiting not only intentional discrimination, but also unintentional practices resulting in a disparate impact, for actions that resulted in discriminatory conduct (Griggs v. Duke Power Company, 1971).

Under the revision, employers must not only ensure their employment activities are facially neutral, but they must also be proactive in preventing and remedying any disparate treatment from facially neutral exams (Civil Rights Act, 1991)). Based upon the Act, employers are confronted with conflicting laws. First, they may not intentionally discriminate based upon race, gender, religion, or national origin (Civil Rights Act, 1961). Secondly, if they discover that their employment criteria results in a disparate impact on one class, the employer needs to remedy the discriminatory practice (Ricci, 2009). In order to correct the disparate impact, the issue often arises as to whether the

employer is permitted to revert back to disparate treatment, such as discarding the results from a promotional exam, in order to remedy disparate impact. Until the U.S. Supreme Court's holding in *Ricci* in 2009, courts were in disagreement, creating uncertainty and little guidance for employers.

In *Ricci v. DeStefano*, the U.S. Supreme Court was confronted with the inherent incongruity that arises when an employer is confronted with results indicative of disparate impact, and whether this warrants permitting the employer to disregard the results in order to avoid a lawsuit (2009). More specifically, the Court was required to address whether an employer may engage in the disparate treatment of the successful candidates in order to remedy the alleged disparate impact of another set of candidates.

In its holding, the U.S. Supreme Court held that an employer can engage in intentional discrimination, for the asserted purpose of avoiding or remedying an unintentional, disparate impact, if the employer has a strong basis in evidence to believe it will be subject to disparate-impact liability if it fails to take the race-conscious, discriminatory action (*Ricci*, 2009). In addition, the Court held that employers are entitled to incorporate affirmative efforts to ensure that all groups have a fair opportunity to apply for promotions and to participate in the process by which promotions will be made (*Ricci*, 2009). This permits employers to elect how to design that test or practice in order to provide an equitable opportunity for all individuals, regardless of their race. Once the test is adopted, however, and employers have made clear their selection criteria, they may not then invalidate the test results, thus upsetting an employee's legitimate expectation not to be judged on the basis of race, absent a strong basis in evidence to believe that they would be liable under the theory of disparate impact (*Ricci*, 2009). The Court held that to permit the employer to disregard the results without a strong basis in evidence of disparate impact would amount to the sort of racial preference that Congress has expressly disclaimed, and is antithetical to the notion of a workplace where individuals are guaranteed equal opportunity regardless of race (*Ricci*, 2009).

The *Ricci* case is a landmark case that has changed the way practitioners should view Title VII. The traditional method, which was used by both the District Court and Court of Appeals, focused primarily on remedying disparate impact as opposed to focusing on the disparate treatment of the successful candidates. Under the *Ricci* case, employers must still focus on the possibility of an unintended disparate impact, but may only invalidate results if there is a strong basis in evidence to support that claim. Moreover, the *Ricci* case specifically incorporates the process of creating and administering the exam to ascertain whether the results were biased, or based upon the candidate's qualifications. The holding also emphasizes the proactive measures during the implementation stage as opposed to corrective measures that occur after the employment criteria have been composed and adopted by the employer.

While the above case focused on race, it is important to evoke the holding extends to members of all protected classes. To illustrate, in *Lanning v. S.E. Pa. Transp. Auth.*, the employer required that all employees be able to pass a fitness test as a condition of employment (1999). More specifically, all perspective employees were required to be able to run 1.5 miles in under twelve minutes. Five women were unable to meet this condition, and subsequently sued, and prevailed, under the theory of disparate impact (*Lanning*, 1999). As a result, disparate impact can be applied to a wide variety of practices, such as ability and intelligence tests, education requirements, work history requirements, arrest records, credit history, and height, weight, and strength requirements” (*Sleiman*, 2004).

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