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## THE JOURNAL OF INTERNATIONAL BUSINESS &amp; LAW

**PREFACE**

This is the eighth issue of the *Journal of International Business and Law* (JIBL), a joint effort by the students of the Law School and the Zarb School of Business of Hofstra University. This issue is the output of an enthusiastic group of student editors and staff who devoted considerable amount time and energy in publishing yet another issue of JIBL.

JIBL continues to serve as a vehicle to disseminate the research findings of students, faculty and alumni in the areas of international business, international trade, transactional law, and other related interdisciplinary fields. By definition, globalization implies interdisciplinary activities and there is no better way to foster this than to have students from the discipline of Business and Law collaborate on a journal that seeks out articles in both the fields.

A major accomplishment of the Journal and its staff this year was hosting two half-day symposiums that attracted many outside scholars. The first symposium held in October, titled "U.S. Foreign Policy and its Effect on the Domestic Economy" focused on international diplomatic relations and how in a global economy these relations impact the U.S. economy. The second symposium was held in March and it focused on the current financial meltdown and its effect on the nonprofit organizations and on bankruptcy filings. The symposium was well attended and our students and faculty were able to listen to some interesting analysis of the current state of the U.S. economy.

This issue contains eight articles covering a wide range of topics from cultural identity to U.S foreign relations and its impact on the U.S. economy. Four of the notes/articles were written by students of the Zarb School of Business and the Law School. The issue also includes articles by our alumni and practitioners in the field of international business. Reflecting the broad scope of the Journal, the eighth issue features an eclectic collection of articles that cover such topics as International Financial Reporting Standards (IFRS), economic crisis and its impact on BRIC group of countries, and planning for pension benefits in the 21<sup>st</sup> century.

For future issues, JIBL welcomes manuscripts on various international topics including the legal aspects of international business, corporate social responsibility, effects of outsourcing, global warming and its impact on businesses, emerging economies and their impact on international trade, exchange rate fluctuations and their impact on financial markets, and the cross-

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border legal and business issues that global companies need to address.

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- Be original
- Have not previously been published or accepted for publication elsewhere

We hope you find the journal useful. We encourage and seek your active participation and patronage in this endeavor.

James P. Neelankavil Ph.D.,  
Professor of Marketing and International Business  
Faculty Advisor  
March 2009

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## AT THE INTERSECTION OF GLOBAL ECONOMICS AND POLITICS

*Dennis Keegan\**

### INTRODUCTION

The United States and the world are at the most painful intersection of economics and politics. The United States is in its first major recession since 1992 and the world is in its first coordinated world recession since World War II.<sup>1</sup> The non-capitalistic governments, that used to gloat over the down cycles of capitalism, have become trade dependent neo-capitalists who now must share those same cycles. The world cannot decouple from the United States because it is the world's largest economy, representing 25% of all world production and demand.<sup>2</sup> Based on an IMF report, the United States ranked number one in representing 25.3% of world production, Japan was second at 8.1%, and Germany and China came in third and fourth respectively, each representing only about 6% of world Gross Domestic Production (hereinafter "GDP").<sup>3</sup> These three countries, even combined, do not add up to the GDP of the United States. Thus, it is evident that the global recovery cannot even start if the

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\* On October 15, 2008, Hofstra University hosted the third and final televised Presidential Debate between Senators John McCain and Barack Obama. In the week leading up to it, The Journal of International Business and Law organized a symposium on U.S. Foreign Policy and Its Effect on the Domestic Economy featuring Dean Thomas Cooley (NYU Stern School of Business), Amb. Karl F. Inderfurth (George Washington University), W. Michael Reisman (Yale Law School), Lea Brilmayer (Yale Law School) and Dennis Keegan (Chairman and Chief Investment Officer of the Auspex Group). This article stems from Mr. Keegan's comments at the fall symposium. Mr. Keegan served for fifteen years with Salomon Brothers, Inc., in New York and London. During his career with Salomon Brothers, he headed up the U.S. proprietary trading, European fixed income arbitrage, and foreign exchange divisions. He was the chairman of Salomon's risk management committee, co-head of global fixed income, and co-chief executive of European operations. Mr. Keegan earned a bachelor's degree in economics at UCLA, and an MBA from the UCLA Anderson School of Management, where he currently serves on the Board of Visitors.

<sup>1</sup> To be noted, although 2001-2 was a recession, it was the mildest recession recorded despite the stock market crash and the attacks of September 11, 2001.

<sup>2</sup> INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK: FINANCIAL STRESS, DOWNTURNS, AND RECOVERIES (2008), <http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf> [hereinafter WORLD ECONOMIC OUTLOOK].

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

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United States recovery is not underway.

However, in order for the United States economy to recover, politicians must lead governments in taking bold pro growth steps and avoiding the knee jerk protectionist policies which can transform a recession into a depression. Protectionism, currency devaluation and trade barriers are political expedients to be avoided because they do not create effective growth. For example, in the 1930s, the Smoot Hawley Tariffs and other economic policies in many countries damaged trade relations and interfered with the necessary adjustments in wages.<sup>4</sup> The economic consequences of these political decisions turned that recession into the Great Depression.<sup>5</sup> Furthermore, low inflation rates limit the effectiveness of purely monetary policy. As this article will demonstrate, the United States is leading the world with aggressive pro growth counter cyclical fiscal and monetary policies.

In addition to trade, the world is connected by its integrated financial system. The United States government under the Bush Administration and the United States Federal Reserve Bank (hereinafter "the Fed") under Bernanke were quick to realize the implications to the financial system as the subprime mortgage crisis led to the falling housing prices.<sup>6</sup> The mortgage foreclosures caused a collapse of bank balance sheets thereby inciting chaos in the world financial system. With the financial system disrupted, trade and investment could not be financed. Such a severe drop in trade inevitably, of course, stopped economic growth. By destroying bank balance sheets, which prevented banks from lending, the real estate collapse fed a broad scale credit crisis that choked off all sources of consumer demand. The Fed started dropping official interest rates by September of 2007 and the Federal Government moved into counter cyclical fiscal stimulus early in 2008.<sup>7</sup> Many other countries did not appreciate the threat of the collapsing asset prices and the nascent recession. Through the first half of 2008, there were more nations actually tightening policy measures to control inflation than there were countries easing policy to aid growth.<sup>8</sup> Canada and the United Kingdom followed the United States with

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<sup>4</sup> See RICHARD K. VEDDER, ET. AL., *OUT OF WORK: UNEMPLOYMENT AND GOVERNMENT IN TWENTIETH-CENTURY AMERICA* 112-127 (1997).

<sup>5</sup> *Id.* at 209-225. See also PETER TEMIN, *LESSONS FROM THE GREAT DEPRESSION* 41-88 (MIT Press, 1991).

<sup>6</sup> Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Address at the Federal Reserve Bank of Kansas City's Economic Symposium: Housing, Housing Finance, and Monetary Policy (Aug. 31, 2007), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm>.

<sup>7</sup> Associated Press, *Bush Signs Stimulus Package into Law*, MSNBC.COM, Feb. 13, 2008, <http://www.msnbc.msn.com/id/23143814>.

<sup>8</sup> IMF Survey online, *IMF Urges Action to Strengthen Global Financial System*, IMF SURVEY

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the policy of lowering rates in December 2007.<sup>9</sup> The European Central Bank, China, Australia, Japan and most developing economies did not adopt pro growth policies such as dropping interest rates until the middle of 2008.<sup>10</sup> The common wisdom among those countries still tightening policy was that the world had decoupled from United States' business cycles and those countries' monetary and economic authorities were focused on inflation caused by booming commodity prices. The Fed was early in realizing that inflation was not the problem. As recession spread globally, the United States acted to aggressively pursue new and creative policies to dampen the cycle, ease market conditions and support bank lending. The United States beyond its domestic activities took the unusual step to create facilities to allow more dollars to be available globally by making swap facilities available to foreign central banks. This directly provided dollars to the international market, enabling foreign banks to maintain dollar liquidity and not be forced to sell dollar based assets in distress.<sup>11</sup>

The best solution for all nations is not protectionism, but rather an aggressive countercyclical pro-growth policy in each country. The United States has led the way aggressively and creatively, but these national policies are limited and work with long, uncertain time lags. The United States is also in a fiscal position with respect to the level of debt to GDP that may give it more room to maneuver than many other developed countries. The United States has net debt to GDP of 48% (at the end of 2007) compared to Germany at 57%, Japan at 94%, and France at 55%.<sup>12</sup> The United Kingdom and Canada are in strong positions to react with pro-growth policies because they have a net debt to GDP ratios of less than 40%.<sup>13</sup> As with the United States, monetary policy will also be extremely constrained in most countries as 25 years of successful

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MAGAZINE, Mar. 12, 2008, <http://www.imf.org/external/pubs/ft/survey/so/2008/new031208a.htm>. See also Patrick Roy, *International Economic Update*, FEDERAL RESERVE BANK OF DALLAS, Mar. 20, 2009, <http://www.dallasfed.org/institute/update/2009/int0902.cfm>; Butterfield Private Bank, *Money Market And Currency Report*, June 25, 2008, [http://www.butterfieldprivatebanklondon.co.uk/wedfax/2008/MMC\\_080625.pdf](http://www.butterfieldprivatebanklondon.co.uk/wedfax/2008/MMC_080625.pdf).

<sup>9</sup> See Press Release, Bank Of England, Bank of England Reduces Bank Rate by .25 Percentage Points to 5.25% (Feb. 7, 2008), available at <http://www.bankofengland.co.uk/publications/news/2008/004.htm>. See also Press Release, Bank of Canada, Bank of Canada Lowers Overnight Rate Target By 1/4 Percentage Point To 4 Per Cent (Jan. 22, 2008), available at [http://www.bankofcanada.ca/en/fixe-dates/2008/rate\\_220108.html](http://www.bankofcanada.ca/en/fixe-dates/2008/rate_220108.html).

<sup>10</sup> Press Release, Bd. of Governors of the Fed. Reserve Sys. (Dec. 11, 2007), available at <http://www.federalreserve.gov/newsevents/press/monetary/20071211a.htm>.

<sup>11</sup> Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 18, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20080918a.htm>.

<sup>12</sup> WORLD ECONOMIC OUTLOOK, *supra* note 2.

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

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inflation fighting for the developed world has brought inflation and long term inflation expectations down to low single digits. Despite the 2007-2008 fear of commodity driven inflation, core inflation measures in the United States and most developed nations' economies never moved far into the danger zone (over 2.5%).<sup>14</sup> The current recession and rapid drop in headline inflation will quickly bring the potential for deflation, such as negative inflation rates, into the economic and policy framework. A level of zero inflation makes it difficult for monetary policy alone to drive growth. In deflationary conditions, the government cannot stimulate demand through the traditional method of bringing policy interest rates below the inflation rates to induce borrowing and therefore accelerate consumption. The limitations on monetary policy, the inability to take official rates below zero, make it important that pro-growth fiscal deficits and pro trade national policies are pursued in the United States and across the world. These two limitations, the zero rate policy bound for interest rates and the stretched levels of debt to GDP in many nations, account for why the Fed and other Central Banks have taken new creative policy alternatives trying to provide a greater quantity of money and liquidity to the economy even if they can't take the price of borrowing below zero.

## I. TODAY'S RECESSION IN CONTEXT

As demonstrated in the table below, despite the hyperbole in the media, the current recession is severe but is still only a recession. The most remarkable difference between this recession and previous recessions is the change in the unemployment rate. Although the expected peak unemployment rate of 8.8% is below the 9.7% rate the United States experienced in 1982 and 1983,<sup>15</sup> the absolute change in the level of unemployment from recent annual lows of 4.6% to 8.8% is nearly twice the increase experienced in the previous three recessions.<sup>16</sup> In the previous recessions the unemployment rate had increased by only 2-2.5% from its low point.<sup>17</sup> In this recession the unemployment rate has already risen 3% and is expected to peak at more than 4% above its low point for the cycle.<sup>18</sup> As with previous recessions, the

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

<sup>15</sup> Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, U.S. DEPT. OF LABOR, Apr. 19, 2009, available at [http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data\\_tool=latest\\_numbers&series\\_id=LNS14000000](http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000).

<sup>16</sup> *Id.*

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

<sup>18</sup> Tessa Moran, *US FED: Fed Worsens Protections For 2009 GDP, Inflation, Unemployment*, FORBES.COM, Feb. 18, 2009, <http://www.forbes.com/feeds/afx/2009/02/18/afx6067181.html>.

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unemployment rate will continue higher even after the economy starts to grow.<sup>19</sup> This is because unemployment does not decrease until the growth rate in the economy exceeds the long term potential growth rate which, for the United States economy, is generally assumed to be around 3% of GDP per year.<sup>20</sup> In other words, the unemployment rate will continue to rise until U.S. GDP growth exceeds 3% on an annual basis. An estimated length of over 18 months also makes this the longest recession since the 1970s and accentuates the impact of the high unemployment rate. The stress on unemployment will continue to elicit strong government response as it percolates through the political system.

	<b>January 80 to July 81 and July 81 to Nov 82 Back to back Recessions</b>	<b>July 90 to March 91</b>	<b>March 01 to November 01</b>	<b><i>Estimated December 07 to June 08</i></b>
<b>Pre recession low in unemployment rate-year Peak Unemployment rate-year year over year low in GDP- end of period year over year rebound in GDP- end of period Peak Annual federal budget deficit for the Recession Peak Net Federal Debt as a percent of GDP</b>	7.20% - 1980	5.20% - 1989	4.10%-2000	4.60% - 2006
	9.70% - 1982/3	7.50% - 1992	6.00%-2003	8.80% - 2009
	-2.70% - Sept 1982	-1.00% - Mar. 1991	0.20%- Dec. 2001	-2.80% - <i>June 2009*</i>
	8.50% - Mar. 1984	4.1% - Dec. 1992	4.10% - June 2004	?
	5.60%	5.90%	4.80%	11.9%*
	33%	56%	43%	60%*

\* BASED on CBO Baseline Estimate

<sup>19</sup> BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO CONGRESS 37-41 (2009), [http://www.federalreserve.gov/monetarypolicy/files/20090224\\_mprfullreport.pdf](http://www.federalreserve.gov/monetarypolicy/files/20090224_mprfullreport.pdf).

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

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Yet, as is evidenced by the above chart,<sup>21</sup> this is clearly not a depression because the parameters of economic weakness remain in the range of recessions. In the Great Depression, as opposed to a recession, the GDP was falling in excess of 15% per year and unemployment peaked over 30%.<sup>22</sup> The 2009 net federal budget deficit figure in the chart presumes that the majority of the Treasury's remaining \$350 billion Troubled Asset Relief Plan ( hereinafter "TARP" ) continues to be equity investments, therefore increasing the reported deficit, as opposed to debt purchases which would be netted out with no impact on the net total deficit.<sup>23</sup> The table assumes a federal budget deficit of 11.9% which implies a \$1.7 trillion shortfall in 2009.<sup>24</sup> That means an increase of over 8% in the expected federal budget deficit compared to 2008.<sup>25</sup> In the 1982-3 recession and 1991-2 the fiscal impetus, the increase in deficit was only 0.8%.<sup>26</sup> The 2001 increase in fiscal stimulus, the year over year increase in deficit, was 3.5%.<sup>27</sup> Since the major stimulus in 2001 was a permanent tax cut, the impetus of expanding budget shortfalls impacted 2001 and kept deficits high over several years.<sup>28</sup> The current increase in federal deficit spending is important. Clearly, if the government increases spending by 4% of GDP and the rest of the economy was flat over the year, GDP would be up 4%. Yet, in reality, there are other drags and many portions of the economy will record negative growth in 2009, resulting in overall GDP growth of less than 4% despite the government's aggressive spending.

Thus, the key to creating employment and reversing the negative momentum in the economy is to increase demand. The government spending employs people and creates demand. While current increases in demand are just offsetting loss of demand in other sectors because the vast majority of the

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<sup>21</sup> WORLD ECONOMIC OUTLOOK, *supra* note 2.

<sup>22</sup> Christopher Chantrell, *Time Series Chart of US Government Spending*, [http://www.usgovernmentspending.com/downchart\\_gs.php?year=1930\\_1940&view=1&expand=&units=b&fy=fy09&chart=F0-total&stack=1&size=m&title=&state=US](http://www.usgovernmentspending.com/downchart_gs.php?year=1930_1940&view=1&expand=&units=b&fy=fy09&chart=F0-total&stack=1&size=m&title=&state=US) (last visited Apr. 19, 2009). See also S. Mintz, *The Great Depression and the New Deal*, DIGITAL HISTORY, <http://www.digitalhistory.uh.edu/historyonline/us34.cfm> (last visited Apr. 18, 2009).

<sup>23</sup> See CONGR. BUDGET OFFICE, A PRELIMINARY ANALYSIS OF PRESIDENT'S BUDGET AND AN UPDATE OF CBO'S BUDGET AND ECONOMIC OUTLOOK 1-18 (2009), <http://www.cbo.gov/ftpdocs/100xx/doc10014/03-20-PresidentBudget.pdf>.

<sup>24</sup> *Id.* at 2 tbl.1.1.

<sup>25</sup> *Id.* at 11 fig.1.1.

<sup>26</sup> See OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 2008 (2008), <http://www.whitehouse.gov/omb/budget/fy2008/pdf/hist.pdf>.

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

<sup>28</sup> *Id.* at 21 tbl.1.1.

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economy is reducing demand for goods and services.

## II. WHAT ARE THE DRAGS ON THE ECONOMY?

The fundamental drags on the United States economy are rooted in the loss of wealth to the American consumer as a result of the drop in the housing market and the stock market. The International Strategy and Investment Group (ISI), which is headed by Ed Hyman, estimates consumer net worth will have dropped by 15% in 2008 compared to low single digit declines recorded in recessions since the 1970s.<sup>29</sup> The drop in wealth reduces consumer willingness to spend money. The Case Schiller 10 City Home Price Index in October 2008 indicated a 19% drop in home prices over the last year.<sup>30</sup> According to the United States Census Bureau, the United States home ownership rate exceeded 67% in 2006, indicating that the drop in home prices impacted a larger percentage of the population more directly than the stock market.<sup>31</sup> This drop takes home prices back to their 2004 levels.<sup>32</sup> Four years of price appreciation was lost. As for the stock market, as represented by the Standard and Poor 500 Stock Index (hereinafter “the S&P Index”), it was 45% below the S&P Index 2007 high price and the all time high as of November 2008.<sup>33</sup> The drop in the S&P Index is similar to the drop in 2001-2 and is larger than the stock market drop in the prior two recessions.<sup>34</sup> Many studies demonstrate that the “wealth effect” impacts consumer demand.<sup>35</sup> The drop in consumption experienced by the economy as a result of the drop in consumers’ wealth varies greatly in different studies, but it does seem to relate to how permanent the consumer

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<sup>29</sup> See Rex Nutting, *Household net worth plunges 18% in 2008*, MARKETWATCH, Mar. 12, 2009, <http://www.marketwatch.com/news/story/household-net-worth-plunges-18/story.aspx?guid=%7b8BBD33C0-EB35-47BB-9CE1-D7AC35EE2734%7d&siteid=yahoomy&print=true&dist=printMidSection>; Catherine Clifford, *Household net worth sinks \$11.2 trillion*, CNNMONEY.COM, Mar. 12, 2009, [http://money.cnn.com/2009/03/12/news/economy/flow\\_funds/](http://money.cnn.com/2009/03/12/news/economy/flow_funds/).

<sup>30</sup> STANDARDS & POOR’S, CONSUMER HOME PRICE HISTORY (2008), [http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice\\_History\\_022445.xls](http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_History_022445.xls).

<sup>31</sup> Press Release, U.S. Census Bureau News, Census Bureau Reports on Residential Vacancies and Homeownership (Feb. 3, 2009), *available at* <http://www.census.gov/hhes/www/housing/hvs/qtr408/files/q408press.pdf>.

<sup>32</sup> STANDARDS & POOR’S, *supra* note 29.

<sup>33</sup> See e.g. StockCharts.com, S&P 500 Index (1960 – Present Weekly), <http://stockcharts.com/charts/historical/spx1960.html>.

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

<sup>35</sup> See ERIC BELSKY & JOEL PRAKKEN, HARVARD UNIV. JOINT CTR. FOR HOUS. STUDIES, *Housing Wealth Effects: Housing’s impact on Wealth Accumulation, Wealth Distribution and Consumer Spending* (2004), <http://www.jchs.harvard.edu/publications/finance/w04-13.pdf>.

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believes the loss in wealth will be. To remedy the situation, there needs to be aggressive action by governments and central banks to have this loss be perceived as temporary.

Central bank monetary policies are only effective if they lower the real cost of money and therefore increase the consumers' and corporations' propensity to spend. When consumers start to spend and buy goods, corporations will then start to rebuild inventories and hire more employees. Currently, the demand for goods has been crushed by the financial crisis as corporations' experienced evaporating demand because buyers were unable to find loans to finance new purchases for consumption or investment. The major bottleneck preventing government policy initiatives from accelerating demand has been the broken banking system. More than a year of falling official interest rates, from a high of 5% to an effective rate of near zero and a significant United States fiscal stimulus of 1.5% of GDP in 2008 has failed to ignite demand because the lower rates have not been passed on to the end consumer.<sup>36</sup> The failure of demand to re-accelerate has forced companies to position themselves for lower demand and lower growth, resulting in an increase in unemployment, which thus extends and deepens the recession. Despite the aggressive action by central banks to lower official rates, the market interest rates have remained high. Those market interest rates keep the real cost of borrowing and cost of money for corporations and consumers very high, particularly compared to the collapsing inflation rates. High market interest rates that are at historically extreme wide spreads over official government rates reflect the unwillingness or inability of banks to supply credit. The result severely dampens the transmission of government stimulus to final demand.

As demonstrated in the chart below,<sup>37</sup> enormous capital was lost by financial institutions due to the collapse of housing prices and the related mortgage losses as well as other overly aggressive bank lending decisions in the early part of this decade. It is important to note that all that lost capital has been replaced by public and private equity investment. Some of the capital has come from traditional market sources, but a lot has come from government institutions. The majority of United States Treasury's first tranche of \$350 billion TARP funds, committed as of December 2008, went to replace equity

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<sup>36</sup> Press Release, U.S. Dep't of the Treasury, The Consumer and Business Lending Initiative: A Note on Efforts to Address Securitization Markets and Increase Lending (Mar. 3, 2009), available at [http://www.treas.gov/press/releases/reports/talf\\_white\\_paper.pdf](http://www.treas.gov/press/releases/reports/talf_white_paper.pdf); Rebecca Wilder, *Credit Remains Tight; Corporate Spreads are Elevated*, RGE MONITOR, Mar. 10, 2009, [http://www.rgemonitor.com/us-monitor/255921/credit\\_remains\\_tight\\_corporate\\_spreads\\_are\\_elevated](http://www.rgemonitor.com/us-monitor/255921/credit_remains_tight_corporate_spreads_are_elevated).

<sup>37</sup> Bloomberg, WDCI (Dec. 2008).

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lost by banks and other financial companies.<sup>38</sup> Other countries are acting to replace bank capital with France and Germany, each committing between 40 and 80 billion Euros and the United Kingdom starting a 50 billion sterling plan to recapitalize banks.<sup>39</sup>

Losses and Write downs	Loss through 12/08 \$Bns	Capital Raised though 12/08 \$Bns
TOTAL Worldwide Financial Co.s	1005.8	926
US Financial Companies	678	552
Worldwide Banks	745	797
Wachovia	96.5	11
CITI	67	114
Merrill Lynch	56	30
Washington Mutual	46	12

Yet, banks are still attempting to remedy their losses and expected future losses. The Fed Board Senior Loan Officer Opinion Survey through the end of 2008 continued to show banks still tightening credit availability and plan to reduce their balance sheets with respect to their current levels of capital.<sup>40</sup> Historical experience leads the banks to expect that until the recession ends and US GDP growth turns positive, there will be accelerating losses on credit cards and corporate loans as the recession proceeds through a normal cycle.<sup>41</sup> Thus,

<sup>38</sup> Maya Jackson Randall, *US Treasury: \$134.5 Billion Left In TARP; Expects Cos To Repay 25 Billion*, DOW JONES NEWSWIRES, Mar. 28, 2009, available at

[http://news.morningstar.com/newsnet/ViewNews.aspx?article=/DJ/200903282009DOWJONESDJONLINE000448\\_univ.xml](http://news.morningstar.com/newsnet/ViewNews.aspx?article=/DJ/200903282009DOWJONESDJONLINE000448_univ.xml); Reggie Middleton, *Amid the Rally, I Look at the Doo Doo 32 and Their Receipt of the TARP*, SAFE HAVEN, Jan. 6, 2009, <http://www.safehaven.com/article-12240.htm>.

<sup>39</sup> Jennifer Yousfi, *U.K. Unveils Its Own Banking Bailout Package*, Money Morning, Oct. 9, 2008, <http://www.moneymorning.com/2008/10/09/british-banking-bailout/>; ORRICK, HERRINGTON & SUTCLIFFE LLP, ORRICK CLIENT ALERT: U.K. GOVERNMENT TAKES NEW STEPS TO SUPPORT U.K. FINANCIAL SYSTEM (2009), <http://www.orrick.com/fileupload/1603.pdf>; Press Release, European Central Bank, Adjustment of Risk Control Measures for Newly Issued Asset-Backed Securities and for Uncovered Bank Bonds (Jan. 20, 2009), available at <http://www.ecb.int/press/pr/date/2009/html/pr090120.en.html>.

<sup>40</sup> See BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE JANUARY 2009 SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES (2009), available at <http://www.federalreserve.gov/boarddocs/SnloanSurvey/200902/fullreport.pdf>.

<sup>41</sup> William C. Dudley, President and Chief Executive Officer, Fed. Reserve Bank of N.Y., Remarks at the Council on Foreign Relations Corporate Conference 2009, Financial Market Turmoil: The Federal Reserve and the Challenges Ahead, available at <http://www.newyorkfed.org/newsevents/speeches/2009/dud090306.html>.

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the banks are attempting to build equity capital reserves to prepare for future expected losses. The government policy initiatives are not transmitted to higher demand and consumption because credit is not effectively available to those who would still desire to build businesses or add to consumption. The added liquidity provided by the Fed and the equity provided by the TARP have only shored up the bank balance sheets and prevented a more accelerated collapse in credit. The financial system has used the policy initiatives so far, merely to reduce the speed of credit being withdrawn from the system.

### III. CREATIVE POLICY RESPONSE

The Fed has been creative and aggressive in responding to the banking crisis. The strong policy response is not surprising since Bernanke's academic research specialized in the causes and impacts of the Great Depression, including how it could have been avoided.<sup>42</sup> The Fed has increased its non-United States Treasury assets from effectively none at the beginning of 2007 to \$1.9 Trillion in the last few months of 2008. The Fed did this in order to provide the desperately needed financial support to banks' balance sheets and the market for securitized home mortgages and thereby stop the spiraling collapse of credit availability and the concomitant drop in asset prices. The Fed has responded to the dysfunction in credit markets by creating numerous programs to offset the current credit collapse that is aggravating the economic situation. Among the many programs the Fed has created, several are of a fixed targeted size and some are unlimited in potential size, meaning the value of assets purchased can be determined by the needs of the financial systems.<sup>43</sup> If the "unlimited" programs the Fed has created stay at their current levels on the balance sheet and the Fed becomes fully committed under its other programs, the Fed balance sheet will expand to at least \$3.8 trillion. This implies that only about half of the Fed's balance sheet expansion has taken place and future purchases will probably be even more effective, on the margin, in narrowing credit spreads. The Fed appears committed to replacing dysfunctional commercial bank balance sheets with a federal balance sheet.<sup>44</sup>

The Fed has created a proliferation of new programs to support asset prices and to replace or support bank balance sheets and lower market interest rates. In addition to traditional 28 day repurchase agreements, the Fed has

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<sup>42</sup> See BEN S. BERNANKE, *ESSAYS ON THE GREAT DEPRESSION* (2004).

<sup>43</sup> Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Statistical Release (Mar. 26, 2009), available at <http://www.federalreserve.gov/releases/h41/Current/h41.pdf>.

<sup>44</sup> Lawrence H. Meyer and Brian P. Sack, *Monetary Policy Insights; Policy Focus*, MACROECONOMIC ADVISERS, Dec. 16, 2008.

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created Term Auction Facility (TAF and Forward TAF) and Term Securities Lending Facility (TSLF and related TOP) to support bank balance sheets and reduce the cost of money for banks.<sup>45</sup> These term lending arrangements as of January 2008 made up \$766 billion of the Fed balance sheet and have an announced capacity of \$1.25 trillion.<sup>46</sup> As mentioned previously, the Fed has additional operational new programs that will be available on an unlimited, as needed basis.<sup>47</sup> These unlimited programs, including the central bank FX swaps, Asset Backed CP Facility (ALMF), commercial paper funding facility and purchases of agency discount notes, were not in existence a year ago, but in early 2008 represented \$920 billion on the Fed balance sheet.<sup>48</sup> All these programs are available on an open-ended basis and are designed to lower market interest rates in addition to funds available to banks at the traditional discount window (known by the acronym PDCF).<sup>49</sup>

Beyond these programs, the Fed has also been involved in rescuing financial companies to prevent disruption of the flow of money in the banking system.<sup>50</sup> In addition to the \$4 billion which the Fed has already tied up in credits to AIG and Bear Stearns, if necessary, it has committed to lend an additional \$300 billion to these said institutions and to Citicorp.<sup>51</sup> Moreover, the \$300 billion guaranty to Citicorp allows Citi to carry those assets at a 20% risk ratio, effectively saving Citi \$20 billion in capital requirements.<sup>52</sup> The Fed has also committed an additional \$800 billion to be invested in 2009 through its

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<sup>45</sup> BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS 47 app. (2009), [http://www.federalreserve.gov/monetarypolicy/files/20090224\\_mprfullreport.pdf](http://www.federalreserve.gov/monetarypolicy/files/20090224_mprfullreport.pdf) [hereinafter MONETARY POLICY REPORT].

<sup>46</sup> See BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE'S BALANCE SHEET, *in* CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, <http://www.federalreserve.gov/monetarypolicy/bst.htm> (last visited Apr. 2, 2009) [hereinafter BALANCE SHEET].

<sup>47</sup> Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the National Press Club Luncheon (Feb. 18, 2009), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20090218a.htm>

<sup>48</sup> BALANCE SHEET, *supra* note 44.

<sup>49</sup> BD. OF GOVERNORS OF THE FED. RESERVE SYS., LENDING TO PRIMARY DEALERS, *in* CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, [http://www.federalreserve.gov/monetarypolicy/bst\\_supportspecific.htm](http://www.federalreserve.gov/monetarypolicy/bst_supportspecific.htm) (last visited Apr. 19, 2009).

<sup>50</sup> Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the Stamp Lecture: The Crisis and the Policy Response (Jan. 13, 2009), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm> [hereinafter Bernanke, Speech at the Stamp Lecture].

<sup>51</sup> BD. OF GOVERNORS OF THE FED. RESERVE SYS., SUPPORT FOR SPECIFIC INSTITUTIONS, *in* CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, *supra* note 47.

<sup>52</sup> *Id.*

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new Term Asset-Backed Securities Loan Facility (TALF) and in purchases of agency debt and mortgage backed securities.<sup>53</sup> These latter moves are designed to lower the spread of mortgages and other loans over treasuries, in order to lower the cost of money to the end user: corporations and consumers. The Fed balance sheet that has already expanded from \$800 billion to \$2.1 trillion seems clearly on its way to \$3.8 trillion and beyond, as the United States central bank tries to return normal pricing and credit extension to the United States financial markets.<sup>54</sup>

Like the Fed, the United States Treasury is clearly on the way to aggressively intervene in the financial system. By January 2009, \$350 billion of its \$700 billion TARP facility has been committed to date and the majority of that, about \$250 billion, has been spent on equity investments in banks.<sup>55</sup> Bank equity is important because every \$8 billion of equity supports \$100 billion of fully risk weighted assets or \$400 billion of lower risk weighted assets such as mortgages.<sup>56</sup> It is likely that the majority of the remaining \$350 billion dispersed by the Treasury will also go to bank equity.<sup>57</sup> Even if the TARP package is not increased beyond the original \$700, it is important to understand that only 50% of the planned spending has taken place as of the end of 2008.<sup>58</sup> The Treasury also has a program guaranteeing \$3 trillion in money market funds in order to keep the commercial paper market open.<sup>59</sup>

Equally as important, the United States Treasury has stepped in and put Freddie Mac (hereinafter "FRE") and Fannie Mae (hereinafter "FNMA") into government conservatorship.<sup>60</sup> These two institutions are the conduits for more than 60% of all mortgages in the United States. If FNMA and FRE are not able to function, then the United States mortgage market would effectively close. As of January 2008, FNMA and FRE had reported \$110 billion in losses

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<sup>53</sup> Bernanke, Speech at the Stamp Lecture, *supra* note 48.

<sup>54</sup> *Id.*

<sup>55</sup> Middleton, *supra* note 36.

<sup>56</sup> William J. McDonough, President, Fed. Reserve Bank of N.Y., Risk-Based Capital Standards: Amendments to Regulations H and Y for Consistency with Other Regulatory Agencies, Circular No. 11144 (Mar. 25, 1999), *available at* [http://www.newyorkfed.org/banking/circulars\\_archive/11144.html](http://www.newyorkfed.org/banking/circulars_archive/11144.html).

<sup>57</sup> Press Release, U.S. Dep't of the Treasury et al., Joint Statement by the Treasury, FDIC, OCC, OTS and the Federal Reserve (Feb. 23, 2009), *available at* <http://www.treas.gov/press/releases/tg38.htm>.

<sup>58</sup> Middleton, *supra* note 36.

<sup>59</sup> Press Release, U.S. Dep't of the Treasury, Treasury Announces Extension of Temporary Guarantee Program for Money Market Funds (Mar. 31, 2009), *available at* <http://www.treas.gov/press/releases/tg76.htm>.

<sup>60</sup> Statement from Tim Geitner, U.S. Sec'y of the Treasury, on Treasury's Commitment to Fannie Mae and Freddie Mac (Feb. 18, 2009), *available at* <http://www.treas.gov/press/releases/tg32.htm>.

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and are only continuing to operate solely due to the Treasury intervention.<sup>61</sup> The Treasury, by providing a de facto debt guaranty, is enabling the mortgage market to continue to fund new home purchases. The ability to fund new home purchases is a critical step to eliminate the overhang of unsold and foreclosed properties that are depressing home prices.

Additionally, the FDIC (Federal Deposit Insurance Corporation) is also involved by guaranteeing bank debt. The FDIC has approved a program to provide a Federal guarantee for up to \$1.4 trillion in bank debt so that market disruptions do not create a liquidity crisis for banks.<sup>62</sup>

The originality, depth and breadth of these bold moves are unprecedented. Multi-faceted new government responses and policy tools not used since the Great Depression are, in fact, beginning to turn the economy around. The Fed asset purchases directly impact the market rate, lowering the interest rate on a wide array of assets. The TARP is working by giving banks enough equity to limit the shrinkage of balance sheets and increasing the confidence that the banking system is safe and will continue to function. The FNMA and FRE intervention are maintaining access to capital in the mortgage markets. The FDIC lowers the cost of money for banks so that the cost of loans can reflect more closely reflect official interest rates. In aggregate, liquidity is entering the system, providing the potential for increases in demand and growth in GDP.

## IV. SIGNS OF ECONOMIC THAW

Basic monetary numbers indicate the Fed has provided plenty of fuel for a recovery. The monetary base is up 102% year over year and M2, a broader indicator of readily available cash and bank deposits, is up over 17% on an annual rate.<sup>63</sup> Every time money supply has grown this fast, it has been a coincident indicator of economic recovery.<sup>64</sup> The extremely low return (0%) on holding these cash balances will soon push decision makers toward new

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<sup>61</sup> Kerry E. Grace & Lauren Pollock, *Freddie Mac Posts Wider Q4 Loss on Bad Loans*, DOW JONES NEWSWIREs, Mar. 11, 2009, available at <http://www.smartmoney.com/breaking-news/on/?story=ON-20090311-000994-1704>.

<sup>62</sup> Press Release, Fed. Deposit Ins. Corp., *FDIC Announces Plan to Free Up Bank Liquidity: Creates New Program to Guarantee Bank Debt and Fully Insure Non-Interest Bearing Deposit Transaction Accounts* (Oct. 14, 2008), available at <http://www.fdic.gov/news/news/press/2008/pr08100.html>.

<sup>63</sup> See Daniel L. Thornton, *Is There Less Agreement About Inflation?*, in FED. RESERVE BANK OF ST. LOUIS MONETARY TRENDS 1 (2009), <http://research.stlouisfed.org/publications/mt/20090101/mtpub.pdf>.

<sup>64</sup> *Id.* at 6.

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investment and spending.

The spreads between various market rates and government rates, although still very high, in January 2009 were starting to come down.<sup>65</sup> These high spreads were being brought down as fear and uncertainty dissipated and nominal yields on short maturity treasury securities remain near zero. The spread between 3 month treasury bills and 3 month Eurodollar was still wide at 150 basis points at the end of 2008, but that spread had peaked near 600 basis points after the Lehman Brothers collapse.<sup>66</sup> The CDX North American Investment Grade 5 year index at the end of 2008 was trading at a spread of 200 basis points, down from an October high of 280 basis points, but still high compared to historical spreads of 50-75 basis points.<sup>67</sup> The A2 commercial paper rate that had been as high as 6% in October was down to 1.25% by January 2009.<sup>68</sup> These spreads narrowing are an indicator that the government's money is starting to work its way into the economic system and return the price of credit to more normal spreads.

Conventional prime mortgage rates in January 2009 are below 5%, after being well over 6% just two months prior.<sup>69</sup> The decline in house prices combined with the lower mortgage rates and relative stable median household incomes means that the housing affordability index is over 140.<sup>70</sup> This level of affordability has not been seen since the early 1990s and is usually a harbinger of a resurgent housing market.<sup>71</sup> Another reflection of that relationship is that the monthly interest payment for a median priced existing house is now less than 17% of after tax income, the lowest percent of median household income

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<sup>65</sup> Scott Lanman & Vivien Lou Chen, *Bernanke Says Fed Aims to Ease Credit-Market Strains (Update3)*, BLOOMBERG, Mar. 20, 2009,

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aAWzQMDmmdhk&refer=home>.

<sup>66</sup> Kim-Mai Cutler, *Money-Market Rates Climb on Lehman Bankruptcy; Bill Yields Fall*, BLOOMBERG, Sept. 15, 2008,

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aUUeQpyhIwmA>.

<sup>67</sup> Prieur du Plessis, *Credit Crisis Watch (December 8, 2008)*, THE BIG PICTURE, Dec. 8, 2008, <http://www.ritholtz.com/blog/2008/12/credit-crisis-watch-december-8-2008/>.

<sup>68</sup> Bernanke, *Speech at the Stamp Lecture*, *supra* note 48.

<sup>69</sup> *Primary Mortgage Market Survey, Contract Rate On 30-Year, Fixed-Rate Conventional Home Mortgage Commitments*, [http://www.federalreserve.gov/releases/h15/data/Monthly/H15\\_MORTG\\_NA.txt](http://www.federalreserve.gov/releases/h15/data/Monthly/H15_MORTG_NA.txt) (last visited Apr. 19, 2009).

<sup>70</sup> NAT'L ASS'N OF REALTORS, *HOUSING AFFORDABILITY INDEX (2008)*, [http://www.realtor.org/wps/wcm/connect/77f28a804c7c3587a76aa72e4ec772bd/research\\_\\_REL0811A.pdf.pdf?MOD=AJPERES&CACHEID=77f28a804c7c3587a76aa72e4ec772bd](http://www.realtor.org/wps/wcm/connect/77f28a804c7c3587a76aa72e4ec772bd/research__REL0811A.pdf.pdf?MOD=AJPERES&CACHEID=77f28a804c7c3587a76aa72e4ec772bd).

<sup>71</sup> MKM Partners, *Home Sales May Have Already Bottomed*, BARRONS.COM, Apr. 1, 2009, <http://online.barrons.com/article/SB123852012752974373.html>.

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since the 1970s.<sup>72</sup> The University of Michigan's "Good Time to Buy a House" survey is at 72%, which is its strongest level since 2005.<sup>73</sup> These lower absolute interest rates on mortgages are benefiting affordability of housing, but in January 2009 mortgage rates were still more than 100 basis points wider than normal over treasury securities.<sup>74</sup> Given a normal spread over treasuries, mortgage rates would be 100 basis points lower, and monthly cost of buying a home would be 20% lower with interest rates on mortgages at 4% instead of 5%.<sup>75</sup> Stability in the housing markets will ease the pressure on bank balance sheets and reassure consumers who were shocked to see their major financial asset, their home, in decline. A more confident consumer is the key element in turning around the United States' economy.

Corporations are facing a lower cost of money, as referenced above by the A2 commercial paper rates, which in turn reduce the required rate of return on investment encouraging companies to expand.<sup>76</sup> Simultaneously, consumers are seeing lower mortgage rates combined with lower house prices, which increases the number of people who could afford to buy a home or makes trading up to a new home more attractive.<sup>77</sup> These are examples of a better functioning market increasing demand. Increasing demand eventually leads to more production and more employment.

## CONCLUSION

America sneezes and the world gets a cold. The whole world is now focused on the cure. Successful growth strategies in the United States are

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<sup>72</sup> Nat'l Ass'n of Home Builders, *Housing Affordability Surges at Year-End 2008*, NAHB/WELLS FARGO HOUSING OPPORTUNITY INDEX (HOI), Feb. 19, 2009, [http://www.nahb.org/news\\_details.aspx?sectionID=135&newsID=8665](http://www.nahb.org/news_details.aspx?sectionID=135&newsID=8665); *How Much Further Will Housing Fall?*, SEEKING ALPHA, Sept. 2, 2008, <http://seekingalpha.com/article/93550-how-much-further-will-housing-fall>.

<sup>73</sup> Jeffrey Kleintop, *Healing in Housing*, in LPL FINANCIAL RESEARCH, WEEKLY MARKET COMMENTARY (2009), <http://www.thesapientsolution.com/research/20090105WMC%20-%20Healing%20in%20Housing%20-%20thesapientsolution.pdf>.

<sup>74</sup> Paul Krugman, *Mortgage rates are still too high*, N.Y. TIMES, Dec. 26, 2008, <http://krugman.blogs.nytimes.com/2008/12/26/mortgage-rates-are-still-too-high/?page=3>.

<sup>75</sup> Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Statement before the Committee on Financial Services (Feb. 10, 2009), *available at* [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/bernanke021009.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/bernanke021009.pdf).

<sup>76</sup> Press Release, Fed. Reserve Bd., Commercial Paper Rates and Outstandings (Apr. 16, 2009), *available at* <http://www.federalreserve.gov/releases/cp/>.

<sup>77</sup> Julie Haviv, *U.S. mortgage applications jump; rates at record low*, BOSTON.COM, Mar. 25, 2009, [http://www.boston.com/news/nation/articles/2009/03/25/us\\_mortgage\\_applications\\_jump\\_rates\\_at\\_record\\_low/](http://www.boston.com/news/nation/articles/2009/03/25/us_mortgage_applications_jump_rates_at_record_low/).

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critical to global growth. The United States is 25 % of the world GDP and its economy is at least three times the size of the number two economy.<sup>78</sup> Although the year 2009 will probably be remembered as the start of the Obama Boom, the structure and actions that reversed the economy had already taken place under the Bush administration and the Bernanke Federal Reserve Bank. Aggressive United States policy implementation is creating the preconditions for growth. Housing has become affordable. Bank balance sheets are being supported by government policy. Aggressive fiscal stimulus, reflected in Obama's first budget, will impact the economy by approximately 4% of GDP in 2009.<sup>79</sup> The Fed has been clear that their goal is to stimulate growth. Money supply, credit spreads and coordinated global policies all indicate that growth should be reignited. The European Central Bank, China, Canada, the United Kingdom and every developed country is pursuing pro growth monetary and fiscal policies. This broad and consistent set of policies will insure positive GDP growth by the end of 2009.

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<sup>78</sup> WORLD ECONOMIC OUTLOOK, *supra* note 2.

<sup>79</sup> CONG. BUDGET OFFICE, *supra* note 22.

## ECONOMIC CRISIS AND THE BRIC COUNTRIES

*Dr. Walter Molano\**

### INTRODUCTION

The world as a whole is currently facing an economic downturn that some feel would drag the U.S. and the rest of the world into a deep economic depression. The affected countries are undergoing a credit crisis that has now resulted in an economic crisis of gigantic proportions. The mess caused by fast-and-loose mortgage lending in the U.S. has now blown into a perilous global crisis of confidence that has revealed both the scale and the limitations of globalization. Linked together in an increasingly tattered web of loans, banks around the world have dragged one another down. At the root of the troubles are the toxic assets, that is, the highly leveraged securities mainly linked to U.S. mortgages that banks around the world still have on their books.

The financial crisis engulfing both the developed and developing countries is raising the specter of market panic and even social unrest. The list of countries under threat is growing by the day, and now includes such emerging market stalwarts as Brazil, China, Russia, South Africa, and Turkey. They have become collaterally damaged in a crisis that began in the American subprime market. Analysts in all corners of the world simply missed the boat when it came to the current crisis. No one was able to tell the extent, timing, and breadth of the collapse.

It was expected that the self correcting powers of the free markets would somehow manage to steady the economies and avert a catastrophe. But, this did not happen; the problem was too vast and too complex for the market forces to correct something that is beyond correction. The self-correcting market forces had failed to anticipate the self-destructive power of wanton mortgage lending.

The fast growing economies of the world depend on money from Western banks to build factories, buy machinery and export goods to the United States and Europe. When those banks stop lending and the money dries up, as it has in recent months, investor confidence vanishes and the countries suddenly find themselves in crisis.

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The break-down of the credit markets has triggered fear and uncertainty across financial markets the world over. The crisis has triggered a profound liquidity crunch not just among vehicles supporting mortgage debt, but across a wide array of asset classes. Mortgage lenders are not lending at fair and logical rates even to prime borrowers.

In normal times, problems in the economy cause problems in the financial markets because hard-pressed consumers and businesses have trouble repaying their loans. But this time, the problems in the financial markets are slowing the economy. If the economy continues to spiral down, that could cause a second dip in the financial system.

The global economy is undergoing a gut wrenching deleveraging process. The desire by policymakers and central bankers to destroy savings through the debasement of money is manifesting itself into a massive destruction of capital. Given the dearth of liquidity, even defensive strategies can be hyperactive trading strategies. Following is a brief exposition of the economic crisis as it relates to Brazil, China, India, and Russia (BRIC countries) that were until recently models of economic growth and stability.

### I. THE BRIC COUNTRIES

Brazil, China, India, and Russia (BRIC) were collectively one of the strongest economies of the world, with growth rates that were higher than the well established industrial countries of Europe, Japan, and the U.S. For example, between 2002 and 2008, China's economy grew on an average of 10 percent per year. Similarly, India's economy grew by an average of 8 percent per year. But, the recent economic crisis that is fanning the world has also affected these high flying four economies with potential to derail their phenomenal resurgence in the world economic order.

#### A. Brazil

Brazil, part of the high flying BRIC economies had a robust five year average growth of 4.6 percent, a substantial flow of foreign capital of 328 billion and a surplus in its current account balance (Table 1). The globalization and its resulting decoupling of the economies were supposed to protect countries in regions that did not create or participate in the economic downturn and, hence, continue their drive for economic sustainability. But, Brazil's economic data released in February confirmed that decoupling was just another myth. Indeed, the Brazilian economy hit the proverbial BRIC wall, with industrial production plunging 14.5 percent. This was in addition to dropping 6.4 percent in November. Manufacturing and white goods were the hardest hit,

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as banks curtailed credit facilities.

Brazil, despite having modernized its economy with trade liberalization and high capital flows, has plunged into an economic crisis that might be difficult for it to extricate itself from<sup>1</sup> (<http://www.twinside.org>, 2009). Even though the Brazilian economy is considered to be a relatively closed economy, the downturn in global demand has had a devastating effect on industrial output, and this is rippling throughout the rest of the economy.

For the first time in more than seven years, Brazil has posted a trade deficit. Exports plunged 29 percent in January, posting a shortfall of \$518 million. In contrast, Brazil at the end of 2008 reported a \$2.3 billion trade surplus. Exports to the U.S. have dropped by 36 percent and embarkations to the European Union fell 27.4 percent. If the current trend continues, Brazil is expected to report a current account deficit of \$32.9 billion by the end of 2009 and will probably face similar shortfalls until the economic crisis facing the world is lifted.

Brazil and its citizens are expected to face difficult times as companies trim their expansion programs. In addition, the pre-salt offshore oil fields do not look so promising now with crude oil prices hovering below the \$40 barrel mark. There is a general foreboding among business executives that the global downturn will be long and hard. The economic crisis that is being felt in Brazil is cutting a broad swath across all socio-economic classes. There is a dearth of trade finance in Brazil, which is having a devastating effect on small producers. For example, the fruit industry, concentrated in the northeastern region of the country, has seen a decline in exports by more than a third as small exporters cannot get the credit to ship their produce. This slowdown in fruit production and exports has forced many of these farmers and small businesses to furlough 20,000 workers in one of the poorest regions of the country.

To compound the problem facing Brazilian policymakers, there is a looming stock of consumer debt. Because of the growing economy and consumer spending, consumer credit was on a tear for the last five years, expanding at an annual rate of 20% per year. Therefore, it is not surprising to see non-performing loans rise as the economy decelerates. Brazilian banks and financial institutions have also practiced their version of subprime lending in the form of automobile loans that are risky at best. The banks have given very generous terms to people who were not qualified to take such large obligations, sometimes for terms that go beyond the useful life of the automobile. In hard times, people tend to default on loans, and banks hold vast non-performing portfolios.

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<sup>1</sup> Michael Bailey & Heinz Stecher, *The Brazilian economic crisis* (Mar. 4, 2009), available at <http://www.twinside.org.sg/title/brazil-cn.htm>.

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Brazil with its closed economy was expected to weather the international storm, but is now facing the grim realities of globalization. The forecast for the Brazilian economy for the near future is a contraction in almost all sectors of the economy. Unless the policymakers act aggressively by tightening budgets and bailing out some of the financial institutions, the prospect for Brazil is dim. Critical public works projects to modernize the economy are being delayed, further compounding the crisis<sup>2</sup> (Kraul, 2008). The effects of European and U.S. governments stabilization initiatives are not going to trickle down to Brazil until these economies themselves come out of a tailspin that many economists predict will take years to materialize.

**Table 1**  
**Selective Economic Data for Brazil (2002-2008)**

Variables	2002	2003	2004	2005	2006	2007	2008 Estimate
Exports (% of GDP)	14	15	16	15	15	13	10
External debt (000,000 current US\$)	230	234	219	187	194	229.4	236.6
FDI Net flows (000,000 of current US\$)	100.9	132.8	161.3	195.6	236.2	328.5	345.6
GDP Growth rate (%)	3	1	6	3	4	5	5.2
Imports (% of GDP)	13	12	12	12	12	11	9
Inflation (%)	16	14	8	8	4	4	5.8

Source:<http://devdata.worldbank.org/data-query> , March, 2009

<http://cia.gov/library/publications/the-world-factbook/geos/html>,  
March, 2009

<http://unctad.org/templates/startpage.asp/> , March, 2009

### B. China

Among the BRIC group of countries, China had the most vibrant economy with a GDP growth rate averaging over 10 percent, a large trade

<sup>2</sup> Chris Kraul, *Economic Crisis Hits as Brazil Builds*, Los Angeles Times, Oct. 27, 2008, at C1.

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balance with the rest of the world, and FDI flows averaging \$250 billion for the past five years (Table 2). Additionally, China had about \$2 trillion in foreign exchange reserves. But, the economic crisis that is engulfing the world has also affected this once powerful economic behemoth. The belief that China would lead us out of the morass has proven false. Indeed, the Asian economies have turned out to be the least resilient. Their open structures have been immediately impacted by the contraction in U.S. demand and the collapse of trade finance. Their export-led growth models withered a drop from 37 percent of GDP in 2007 to an estimated rate of 19 percent in 2008 (See table 2), posting dramatic declines in economic activity. For example, China's electricity demand dropped 9.3 percent in December and imports plunged more than 20 percent, suggesting contraction in total output.

China's economy is growing at its slowest pace in five years, from an average growth rate of over 10 percent for the previous decade to under 10 percent for the year 2008. China's industrial production growth for September slowed to 11.4 percent, the lowest in several years<sup>3</sup> (Schearf, 2008). The quarterly economic growth was the weakest since 2003, when China was hit by the SARS outbreak. Many of Chinese leaders and some leading economists agree that the global financial crisis is largely to blame for the current downturn.

It was not surprising for many of the leading economists that China faltered in spite of its stellar economic performance over the past decade. Given the high level of dependence on exports, China's economy could not escape the impact of the global slowdown. After 30 years of fast growth, China's investment-driven and export-oriented development model, with exports accounting for close to 40 percent of GDP, had become increasingly difficult to sustain<sup>4</sup> (Chen, 2008). For example, China's auto export declined by 22.18 percent in August alone and has continued to decline since<sup>5</sup> (Xu, 2008)

The current situation has also cast a doubt on China's long-term economic growth, as it is so closely tied to the rest of the world. Policy makers and government leaders are trying to bail out many sectors and build infrastructure by infusing capital into the system. This alone is not expected to propel the economy on the way to recovery. The massive lay offs in the manufacturing sector, coupled with a weak financial structure, are definitely going to create economic chaos for the Chinese economy during foreseeable

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<sup>3</sup> Daniel Schearf, *Global Financial Crisis Drops China's Economic Growth to Slowest Pace in Five Years*, Voice of America News, Oct. 20, 2008, at 1.

<sup>4</sup> Zhiwa Chen, *Economic Crisis Could Push Reform in China* (Mar. 4, 2009), available at <http://yaleglobal.yale.edu/display.article?id>.

<sup>5</sup> Shenglan Xu, *Financial Crisis Hits China's Auto Exports*, China Daily, Oct.15, 2008, at 1.

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future. It is believed that the current crisis might be an impetus for Chinese leaders to introduce some badly needed reforms into the Chinese economy. These reforms include promoting land-use rights, subsidizing education, and development of a mechanism to distribute wealth much more widely and evenly.

**Table 2**  
**Selective Economic Data for China (2002-2008)**

Variables	2002	2003	2004	2005	2006	2007	2008 Estimate
Exports (% of GDP)	25	30	34	37	40	37	19
External debt (000,000 current US\$)	186.1	208.0	247.0	281.0	322.0	373.6	420.8
FDI Net flows (000,000 of current US\$)	216.5	228.4	245.5	292.1	292.6	327.1	-
GDP Growth rate (%)	9	10	10	10	12	12	9.8
Imports (% of GDP)	23	27	31	32	32		15
Inflation (%)	1	3	7	9	10	16	6

Source: <http://devdata.worldbank.org/data-query> , March, 2009

<http://cia.gov/library/publications/the-world-factbook/geos/html> ,  
March, 2009

<http://unctad.org/templates/startpage.asp/> , March, 2009

### C. India

India, with its thriving middle class and consumption driven economy, was considered a model economy that has had phenomenal economic success with its technology and software related exports. Through liberalization initiatives and opening of the country for foreign investors, India had gained considerable economic stability that was unthinkable just two decades ago. By encouraging FDI flows and holding inflation under 6 percent, India's annual average GDP growth rate was just under 10 percent (Table 3).

India's economy grew at its slowest pace in nearly six years in the third and fourth quarters of 2008 as the Asian giant started to feel the full brunt

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of the deepening global downturn<sup>6</sup> (“India’s Economy Suffers Sharp Slowdown”, 2009). The economy grew by 5.3 percent, down from 8.9 percent a year earlier. Even with this slowdown, the mood in the country and among its leaders is a sense of resiliency. While most of the world grapples with a crippling financial crisis and a recession, optimism reigns in much of India as its economy continues to grow albeit at lower rate<sup>7</sup> (Timmons, 2009).

Compared to the rest of the world, India’s economy remains robust and its chances of weathering the current crisis are high. Thanks to its rigid banking policies, the slow grinding bureaucratic process and its protectionist policies, India seems to be insulated from the global recession and economic crisis faced by many countries of the world. The conservative approach taken by regulators and policy makers, at its banking and financial institutions has safeguarded the financial sectors from the upheavals of mortgage backed securities and other instruments of high risk and volatility. Moreover, the state dominated financial system is virtually unconnected to foreign markets.

India’s exports to the rest of the world are relatively low. Being largely a domestic economy with exports including software at around 17% of GDP, India is relatively insulated from foreign economic turmoil<sup>8</sup> (Malkani, 2008). Whereas, China and Russia, two large countries like India boast of exports as a percentage of GDP in the range of 30 to 40 percent, India’s exports are under 20 percent of its GDP (Table 3). In addition, other economic indicators have remained relatively stable – inflation is under 8 percent and growth for the year is estimated to be above 7 percent. India’s banks are much stronger in capitalization than many European and U.S. banks. For example, the market capitalization of State Bank of India recently surpassed that of Citigroup.

In spite of India’s relative stability, there are some troubling signs for the country. The government deficit as a percentage of GDP will probably double to 11.4 percent, and Standard & Poor’s revised the outlook for Indian long-term sovereign debt from stable to negative. It is also possible that the country would receive lower remittances from abroad as the economies of some of the Middle East countries cool. Remittances by Indian’s working in the Middle East not only add to the country’s foreign reserves but also provide consumption expenditures for many families that depended on these remittances.

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<sup>6</sup> *India’s Economy Suffers Sharp Slowdown*, Times of India, Feb. 27, 2009, pp1-3.

<sup>7</sup> Heather Timmons, *India Maintains Its Sense of Optimism and Growth*, The New York Times, Mar. 2, 2009, at B1-B4.

<sup>8</sup> Rohibi Malkani, *Will Financial Crisis Derail India’s Economy?*, The Economic Times, Sept. 23, 2008, pp1-3.

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Overall, the prognosis for India is good. With the stability in its financial sector, demand for its technology outsourcing services, high savings rates, and foreign investor's confidence in its economy, India is expected to turnaround much faster than many other countries. According to Palaniappan Chidambaram, India's Finance Minister, India will not face an economic meltdown as the fundamentals of the Indian economic system are sound<sup>9</sup> (Chidambaram, 2008). India's economy is expected to grow in the range of 5 to 7 percent for this coming year.

**Table 3**  
**Selective Economic Data for India (2002-2008)**

Variables	2002	2003	2004	2005	2006	2007	2008Estimate
Exports (% of GDP)	14	15	18	20	22	21	11
External debt (Current US\$)	105	112	124	123	153	201.4	163.8
FDI Net flows (000,000 of current US\$)	25.4	31.2	38.2	44.6	52.4	76.3	142.9
GDP Growth rate (%)	4	8	8	9	10	9	7.3
Imports (% of GDP)	15	16	20	23	25	24	9
Inflation (%)	4	4	6	4	6	4	7.8

Source:<http://devdata.worldbank.org/data-query> , March, 2009

<http://cia.gov/library/publications/the-world-factbook/geos/html> ,  
March, 2009

<http://unctad.org/templates/startpage.asp/> , March, 2009

<sup>9</sup> P. Chidambaram, *India's Economy is Capable to Weather Financial Crisis*, The Economic Times, Oct. 9, 2008, at P1.

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### D. Russia

For the last five years, Russia was one of the shining stars of the emerging markets, with huge current account surpluses, massive capital flows, and towering international reserves (Table 4). Its geographic location astride the Eurasian land mass left it well-prepared to cater to the fastest growing markets on the planet. With its vast natural resources, well-educated workforce and treasure-trove of financial resources Russia became the envy of the world.

The Russian markets held up well, initially withstanding the credit crunch that was savaging much of Europe and North America. But, the wheels began coming off the Russian behemoth during the third quarter of last year, and, now it finds itself in a mess similar to the one it faced in 1998. A problem faced by Russia is its reliance on commodities to drive its economy. Despite Moscow's attempt to move the economy up the value-added chain, it is still based on commodities. Energy and metals remain the dominant sectors of the economy. Therefore, the collapse in commodity prices was a devastating blow for Russia.

Furthermore, Russia is still mired in its central planning mode of the past. The state plays a domineering role. Its leadership converted many of the previously privatized companies back into the arms of the state. As a result, the state became the main driver of economic activity. In short, Russia became a mixed economy with most of the largest and powerful companies owned by the state, and the small and medium-sized companies owned by the private sector. This resulted in a change in the national incentive structure, where the brightest and ambitious graduates of prestigious universities headed to state owned enterprises leaving a lack of talent for the small and medium-sized companies. In addition, corruption has been on the rise further eroding the confidence of the people in the government and its bureaucrats. The result of the shift in private sector, loss of talent pool and corruption is the creation of an inefficient system that was hit hard when commodity prices declined.

All the above confluence of forces has left Russia with very few options to tackle the current economic crisis. In addition, there is some infighting going on among the Russia's inner circle of policy makers whose incentives and benefits are being drastically cut back and, hence, their mind is not on the country's problems but, on their own<sup>10</sup> (Scott, 2009). In trying to stem the economic crisis, Moscow tried various initiatives to provide rescue and assistance programs which then reduced the incentive for the private sector to make the painful adjustments needed to confront the global liquidity crisis. The

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<sup>10</sup> Michael Scott, *Fewer Economic Spoils Prompt Fight among the Elite*, The Guardian, Mar. 4, 2009, at p1.

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problem is, as we now know, that all liquidity crises mutate into solvency crises if left unattended. The government is also trying to stabilize the ruble so as not be affected by the speculators who see an opportunity to gain from exchange rate fluctuations<sup>11</sup> (O'Brien, 2009).

In light of the current crisis, Russia has been one of the biggest disappointments considering its enviable economic position just a few years ago. Having taken comfort in its massive reserves and huge current account surpluses, no one imagined the rot that lurked below the surface. Unless Russia's leaders use the current crisis as an opportunity to shift more of its activities into the private sector, the checks and balances needed to keep some of its instinctive behavior handed down over its long history of socialistic leanings, the country is probably going to be economically handcuffed for the foreseeable future.

**Table 4**  
**Selective Economic Data for Russia (2002-2008)**

Variables	2002	2003	2004	2005	2006	2007	2008 Estimate
Exports (% of GDP)	35	35	34	35	34	30	21.4
External debt (Current US\$)	147.3	175.6	196.7	229.0	251.0	356.5	527.1
FDI Net flows (000,000 of current US\$)	70.8	96.7	122.3	180.3	271.6	324.1	491.2
GDP Growth rate (%)	5	7	7	6	7	8	6
Imports (% of GDP)	24	24	22	21	21	22	14
Inflation (%)	6	14	20	19	16	14	13.9

Source: <http://devdata.worldbank.org/data-query> , March, 2009

<http://cia.gov/library/publications/the-world-factbook/geos/html> ,  
March, 2009

<http://unctad.org/templates/startpage.asp/> , March, 2009

<sup>11</sup> Emma O'Brien, *Russia to Keep Ruble with Tight Band Survey Shows* (Mar. 4, 2009), available at <http://Blomberg.com>.

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### CONCLUSION

Brazil, China, India and Russia had achieved extraordinary economic success through a well-planned economic program that was built on trade liberalization, FDI flows, and domestic consumption. With a large population base these countries were able to provide huge markets for both domestic and foreign producers. It was expected that these four countries would continue their economic growth patterns and be less vulnerable to the economic cycles that often peril smaller countries. Then came the economic meltdown. The economic crisis now engulfing the world has also affected these four countries with a probable exception of India which seems to have the potential to weather this storm.

The forecast for the BRIC countries is a slow economic recovery that will place extra burden on its populations and cause severe contraction of the economies. It is apparent that without strong policies and a generous stimulus package, the countries of Brazil, China, India and Russia will see their economies flounder in the short-term. China and Russia seem to have enough reserves to implement stimulus packages that might help to elevate the problem. But, for Brazil and India, with ballooning fiscal deficit, the governments of these two countries cannot introduce any impact driving stimulus packages and may have to rely on interest rate cuts to jumpstart the economy.

The economic recovery of the four BRIC countries is also to some extent dependent on the recovery of the U.S. and other western European countries that provide the export opportunities for these countries. The global financial crisis, and subsequent economic slowdown, will continue to have a negative effect on export growth for these countries. In the case of the U.S, its recovery is very much tied to the success of the current economic stimulus package and the way in which the rewards of the package are distributed. There is a growing trend towards capital protectionism which if it does materialize would allocate capital resources to domestic operations that in turn will force an inefficient allocation of capital at a time of extreme scarcity. The global economy needs to work through the cycle, thus permitting inventories and capacity to deplete below demand, and sowing the seeds for an eventual recovery.

**SARBANES-OXLEY WRIT LARGE:  
SARBANES-OXLEY AND THE  
FOREIGN COMMERCE CLAUSE**

*Karl T. Muth\**

“The Congress shall have power . . . To regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes[.]”<sup>1</sup>

“The Courts of no country execute the penal laws of another[.]”<sup>2</sup>

INTRODUCTION

It is easy to imagine the brilliant young CEO of Startup Corporation in the country of Hypothistan. He runs a successful technology startup that recently went public on the NYSE. He has never visited the United States, was educated at Hypothetical University, and has no contacts at all with the United States aside from his company being listed on the NYSE. Still, when an accounting irregularity is discovered at Startup Corporation that the Securities Exchange Commission (SEC) deems to be financial fraud rather than acceptable earnings management, the young CEO – who has been personally signing the financials for Startup Corporation as required by Sarbanes-Oxley<sup>3</sup> (and, with that, has been taking on personal civil and criminal liability in the United States) – may well be summoned into court in the United States and even sent to an American prison.

The possibility of jail time is very real for any executive whose stock trades on an American exchange. The CEO and the CFO of Worldcom, Bernie

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\* © Karl T. Muth 2008. M.B.A. Candidate, The University of Chicago Booth School of Business; J.D., The John Marshall Law School, Chicago, Illinois. I am grateful to Professor Randal C. Picker of The University of Chicago Law School for allowing me to explore the initial idea for this Article on his blog. Thanks also to Professor Arnold Rochvarg for piquing my interest in wide-reaching implications of the Foreign Commerce Clause during my time at Universiteit Nederlandse Ant. This Article would not have been possible without the help of my dear friend Angela Ewald. Elizabeth M. Schutte contributed thoughtful comments on earlier drafts.

<sup>1</sup> U.S. CONST. art. I § 8, cls. 1, 3.

<sup>2</sup> *The Antelope*, 23 U.S. 66, 123 (1825).

<sup>3</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.); *see, e.g.*, 18 U.S.C. § 1350 (Supp. V 2005) (as to conscious misrepresentations).

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Ebbers and Scott Sullivan were sentenced to twenty-five<sup>4</sup> and five years,<sup>5</sup> respectively. Dennis Kozlowski, former CEO of Tyco, was sentenced to twenty-five years.<sup>6</sup> Jeff Skilling, formerly of Enron, has already served several years of his twenty-four-years-and-four-months sentence.<sup>7</sup> These convictions by the American court system encourage foreign executives to delist their companies from American stock exchanges, in part to avoid the mere possibility of gigantic civil and criminal penalties under United States securities laws, including Sarbanes-Oxley.<sup>8</sup>

The criminal penalties available for financial fraud under Sarbanes-Oxley, combined with Congress's authority to criminalize extraterritorial conduct, leads to a scenario where many of the world's non-American executives are subject to prosecution in American courts simply because their company's stock is traded on an American exchange.

## I. THE POWER OF THE FOREIGN COMMERCE CLAUSE

It is unclear, historically, whether the Framers expected the Foreign Commerce Clause to have criminal jurisdictional implications.<sup>9</sup> Until the late Nineteenth Century, the Foreign Commerce Clause was seen to grant general regulatory powers.<sup>10</sup> What is without a doubt, however, is that the Foreign

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<sup>4</sup> United States v. Ebbers, 458 F.3d 110, 129 (2d Cir. 2006).

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

<sup>6</sup> See Fed. Ins. Co. v. Tyco Int'l Ltd., 422 F. Supp. 2d 357, 361 (S.D.N.Y. 2006).

<sup>7</sup> See Malcolm Gladwell, *Open Secrets: Enron, Intelligence, and the Perils of Too Much Information*, NEW YORKER, Jan. 8, 2007; Joshua v. Adams, 231 Fed. App'x. 592, 594 n.1 (9th Cir. 2007).

<sup>8</sup> Press Release, Canon Inc., *Canon Inc. to Delist Shares from the Frankfurt Stock Exchange* (Jan. 29, 2007), available at <http://www.canon.com/ir/release/2007/ir2007jan29e.pdf>. Strategic delisting likely already occurs, but is difficult to detect. At the January 29, 2007 board meeting of the Canon Board of Directors, the Directors voted to, rather suddenly, delist Canon from the Frankfurt Stock Exchange. Canon insists the lone motive for delisting was low volume in European trading rather than requirements to comply with European accounting standards and disclosure rules. It would be nearly impossible for an outside investor to discern whether this event was a delisting motivated by regulatory measures or trading volumes. *Id.*

<sup>9</sup> See Kenneth M. Casebeer, *The Power to Regulate "Commerce with Foreign Nations" in a Global Economy and the Future of American Democracy: An Essay*, 56 U. MIAMI L. REV. 25, 34 (2001); see also Daniel Bolia, Comment, *Policing Americans Abroad: The PROTECT Act, the Case Against Michael Lewis Clark, and the Use of the Foreign Commerce Clause in an Increasingly Flat World*, 48 S. TEX. L. REV. 797 (2007).

<sup>10</sup> See Peter Markowitz, *Straddling the Civil-Criminal Divide: A Bifurcated Approach to Understanding the Nature of Immigration Removal Proceedings*, 43 HARV. C.R.-C.L. L. REV. 289, 351 n.46 (2008) ("the federal power over immigration [w]as derived principally from the Foreign Commerce Clause").

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Commerce Clause now empowers two separate streams of congressional commands: commercial regulation and criminal statutes.

The domestic commerce power grew in breadth during the Twentieth Century, with the Court in *Lopez* drawing a rare boundary line.<sup>11</sup> Today, Congress has sweeping power to regulate, tax, or criminalize nearly anything tangentially related to channels of interstate commerce, the instrumentalities of interstate commerce, or activities that substantially affect interstate commerce.<sup>12</sup> Congress also enjoys broad power to restrict, with criminal statutes, the behavior of individuals and corporate persons abroad.

For example, courts upheld in *Clark* and *Bredimus* the validity of a law under which individuals can be prosecuted for traveling abroad for the purpose of “sex tourism”<sup>13</sup> involving minors.<sup>14</sup> The *Clark* case is unusual because the defendant’s ties to the United States were unrelated to the underlying criminal act: Clark was a United States citizen residing in Cambodia who only visited the United States once per year.<sup>15</sup> While there is a presumption that Congress intends its laws to only have effect in the United States,<sup>16</sup> this presumption was overcome in *Clark* by explicit congressional intent that the statute apply extraterritorially.<sup>17</sup> In other words, where Congress explicitly intends to criminalize something globally, it likely can.

On some level, every act by a U.S. citizen abroad takes place subsequent to an international flight or some form of “travel[ ] in foreign commerce.” This cannot mean that every act with a bare economic component that occurs downstream from that travel is subject to regulation by the United States under its Foreign Commerce power, or the Commerce Clause will have

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<sup>11</sup> See *United States v. Lopez*, 514 U.S. 549 (1995) (Court invalidated 18 U.S.C. § 922(q), Gun Free School Zones Act, placing limits on exercise of Commerce Clause power for first time since World War II).

<sup>12</sup> *Gonzales v. Raich*, 545 U.S. 1, 16-17 (2005).

<sup>13</sup> “Sex tourism” as used here refers to the act or series of acts prohibited by 18 U.S.C. § 2423 and its subsections taken in aggregate. For the legislative history regarding the use of this term in the context of this legislation, see generally H.R. REP. NO. 108-66, at 51 (2003) (Conf. Rep.), as reprinted in 2003 U.S.C.C.A.N. 683, 686.

<sup>14</sup> *United States v. Clark*, 435 F.3d 1100 (9th Cir. 2006) (Congress did not exceed authority in passing commercial sex act with minor law, 18 U.S.C. § 2423(c)); *United States v. Bredimus*, 352 F.3d 200, 207-08 (5th Cir. 2003) (conviction affirmed under 18 U.S.C. § 2423(b)).

<sup>15</sup> *Clark*, 435 F.3d at 1103.

<sup>16</sup> See *Small v. United States*, 544 U.S. 385, 388-89 (2005).

<sup>17</sup> *Clark*, 435 F.3d at 1106.

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been converted into a general grant of police power.<sup>18</sup>

The Court noted in *Morrison* that in the context of American federalism, “[t]he concern . . . that Congress might use the Commerce Clause to completely obliterate the Constitution’s distinction between national and local authority seems well founded,” but did not mention respect for local authority abroad.<sup>19</sup> For decades, scholars have wrestled with the question of whether – and to what extent – Congress should pass extraterritorial laws with criminal penalties that affect citizens (and non-citizens) abroad.

Regardless of one’s views on the subject, Congress has already created the legal framework within which to do so.<sup>20</sup> In *Georgescu*, a Romanian national aboard a Scandinavian Airlines flight allegedly sexually assaulted a female national of Norway.<sup>21</sup> The court found that the “Special Aircraft Jurisdiction” of the United States allowed the prosecution of a foreign national by the United States, despite the crime of sexual assault not having occurred in the United States.<sup>22</sup> It is unsettled whether this claim of jurisdiction is contrary to the Tokyo Convention.<sup>23</sup> Nevertheless, the United States has a twenty-five year history<sup>24</sup> of pushing the boundaries of its ability to prosecute foreign nationals located overseas for violating United States law.<sup>25</sup> Recently,

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<sup>18</sup> *Id.* at 1120 (Ferguson, J., dissenting) (internal citation omitted).

<sup>19</sup> *United States v. Morrison*, 529 U.S. 598, 615 (2000); *see also* *Japan Line, Ltd. v. County of L.A.*, 441 U.S. 434 n.13 (1979) (Federalism and state sovereignty concerns do not restrict Congress’s power over foreign commerce).

<sup>20</sup> *See, e.g.*, 18 U.S.C.S. § 2241(c) (2009); 49 U.S.C. § 1472(k)(1) (Supp. V 1987) (current version at 49 U.S.C.S. § 46506 (2009)).

<sup>21</sup> *United States v. Georgescu*, 723 F. Supp. 912 (E.D.N.Y. 1989).

<sup>22</sup> *Id.* at 913.

<sup>23</sup> Article 3 of the Tokyo Convention seems to allow a broad exercise of jurisdiction on airplanes. *See* Convention on Offences and Certain Other Acts Committed on Board Aircraft art. 3, Sept. 4, 1963, 20 U.S.T. 2941, 2944 [hereinafter Tokyo Convention]. However, Article 4 of the Convention specifically limits authority in cases that involve authorities trying to “interfere with an aircraft in flight . . . to exercise . . . criminal jurisdiction.” *Id.* at art. 4.

<sup>24</sup> *See, e.g.*, *Chua Han Mow v. United States*, 730 F.2d 1308 (9th Cir. 1984) (Malaysian defendant located in Malaysia successfully prosecuted under drug charges stemming from violations of 21 U.S.C. §§ 846, 963 and 21 U.S.C. § 959 while residing in Malaysia in the 1970s); *United States v. Roberts*, 1 F. Supp 2d 601 (E.D. La. 1998) (Defendant had sex with a minor roughly sixty miles off the coast of Mexico in international waters, while living aboard a ship registered in Liberia which flew a Liberian flag and was successfully prosecuted for violating 18 U.S.C. §§ 2243(a), 2244(a) where primary link to United States was victim’s citizenship).

<sup>25</sup> An explicit example of an “overseas” provision appears in the Hostage Taking Act, 18 U.S.C. § 1203(a) (1996):

[W]hoever, whether *inside or outside* the United States, seizes or detains and threatens to kill, to injure, or to continue to detain another person in order to

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jurisdictional restraints at common law have been largely disregarded; for instance, the United States contravened the common law rule that domestic courts should not enforce foreign tax law in *Pasquantino*.<sup>26</sup>

**Applicability to Sarbanes-Oxley**

“[C]riminal statutes which are, as a class, not logically dependent on their locality for the government’s jurisdiction” will not be read with a presumption against extraterritorial application.<sup>27</sup> Securities laws with penal implications, by virtue of today’s global markets, are almost certainly not limited by the presumption against extraterritorial application: “[C]ongress is presumed to intend extraterritorial application of criminal statutes where the nature of the crime does not depend on the locality of the defendants’ acts and where restricting the statute to United States territory would severely diminish the statute’s effectiveness.”<sup>28</sup> Sarbanes-Oxley affects any CEO or CFO, regardless of geography, who signs a financial statement in his or her executive capacity.<sup>29</sup> This is true without the United States’ having signed any treaty or having engaged in any bilateral agreement.<sup>30</sup>

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compel a third person or a governmental organization to do or abstain from doing any act . . . shall be punished by imprisonment for any term of years or for life . . . . (emphasis added).

<sup>26</sup> See *Pasquantino v. United States*, 544 U.S. 349, 352 (2005).

<sup>27</sup> *United States v. Bowman*, 260 U.S. 94, 98 (1922).

<sup>28</sup> See *United States v. Yousef*, 327 F.3d 56, 87 (2d Cir. 2003).

<sup>29</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 § 302(a), 116 Stat. 745, 777. See also Irina Shirinyan, *The Perspective of U.S. Securities Disclosure and the Process of Globalization*, 2 DEPAUL BUS. & COM. L.J. 515, 555 (2004). Oddly, other provisions of Sarbanes-Oxley have been hobbled with substantial geographical limitations. For instance, the whistleblower protection provision of the Act provides no appreciable protection for whistleblowers in foreign offices, even if the company involved is an American company traded on an American exchange. See *Carnero v. Boston Scientific Corp.*, 433 F.3d 1 (1st Cir. 2005) (Boudin, C.J., on behalf of unanimous panel) (Argentine whistleblower employee unshielded by Act; extraterritorial effects question presented case of first impression in First Circuit). Yet, though the whistleblower him- or herself receives no protection from the Act, the overseas executive upon whom the whistle is blown is subject to the entire range of criminal penalties and prosecutorial procedures described in the Act. This type of asymmetry is highly unusual and problematic from a policy perspective.

<sup>30</sup> The mechanism for this is the requirement, under Sarbanes-Oxley, is essentially one of privity rather than treaty: that the CEOs and CFOs of the companies in question sign a statement guaranteeing the legitimacy of the financial information conveyed to the United States government. This also guarantees that proper internal controls are in place and have been examined by the CEO and CFO within ninety days of the reporting date. Sarbanes-Oxley Act of 2002 § 302(a)(4). This includes that all significant deficiencies or material weaknesses in the company’s internal controls have been identified and that the audit committee is aware of such deficiencies and weaknesses. See

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## II. GLOBAL PROSECUTION

There seems little doubt at this moment in American jurisprudence that Congress may attach extraterritorial effect to criminal statutes, so long as this does not offend the Due Process Clause of the Fifth Amendment.<sup>31</sup> The Ker-Frisbie Doctrine<sup>32</sup> allows the abduction of foreign executives for purpose of delivering them to the United States for prosecution, even where the abduction itself is illegal.<sup>33</sup> Under the Doctrine, the warrantless seizure of people and chattel needed for such a prosecution is likely allowable.<sup>34</sup> As the Supreme Court wrote in *Frisbie*, “the power of a court to try a person for crime is not impaired by the fact that he had been brought within the court’s jurisdiction by reason of a ‘forcible abduction.’”<sup>35</sup> The Ker-Frisbie Doctrine is presumptively

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*id.* § 302(a)(5); Brian Kim, *Sarbanes-Oxley Act*, 40 HARV. J. ON LEGIS. 235, 247-48 (2003). This set of documents is personally attested-to by the company’s executives and, hence, has high evidentiary utility in later prosecutions.

<sup>31</sup> See *United States v. Larsen*, 952 F.2d 1099, 1100 (9th Cir. 1991).

<sup>32</sup> *Ker v. Illinois*, 119 U.S. 436 (1886); *Frisbie v. Collins*, 342 U.S. 519 (1952).

<sup>33</sup> In the context of this Article, I use “abduction” and “kidnapping” interchangeably where both describe the taking of a living person by force from one jurisdiction to another where the removal of the person from the first jurisdiction is neither in accordance with the laws of that jurisdiction, nor supported by bilateral accord or treaty. See, e.g., *United States v. Alvarez-Machain*, 504 U.S. 655 (district court not required to affirmatively divest jurisdiction upon learning defendant was forcibly kidnapped and brought to United States for trial); accord *United States v. Cordero*, 668 F.2d 32 (1st Cir. 1981); *United States v. Reed*, 639 F.2d 896 (2d Cir. 1981) (holding same in case involving securities fraud); *Virgin Islands v. Ortiz*, 427 F.2d 1043 (3d Cir. 1970); *United States v. Toro*, 840 F.2d 1221 (5th Cir. 1988); *United States v. Valot*, 625 F.2d 308 (9th Cir. 1980) (holding same as to defendant kidnapped by DEA agents in Thailand); *United States v. Rosenthal*, 793 F.2d 1214 (11th Cir. 1986), modified, 801 F.2d 378 (11th Cir. 1986) (holding same as to defendant accused of operating large-scale drug smuggling operation). The district courts that have had occasion to examine the issue in the context of extreme fact patterns in recent years have held in accord. See *United States v. Noriega*, 746 F. Supp. 1506 (S.D. Fla. 1990) (same as to military invasion by United States armed forces used to seize defendant); accord *Matta-Ballesteros ex rel. Stolar v. Henman*, 697 F. Supp. 1040 (S.D. Ill. 1988) (same as to defendant kidnapped from his home in Honduras); *United States v. Wilson*, 565 F. Supp. 1416 (S.D.N.Y. 1983) (same as to defendant abducted from Libya in absence of extradition treaty with Libya, though possibly weakened in light of Second Circuit’s decision in *Reed*).

<sup>34</sup> See *United States v. Verdugo-Urquidez*, 494 U.S. 259 (1990) (holding no Fourth Amendment protection applies to search and seizure by United States of property owned by non-resident alien in foreign country). Or allowable in any case where the sovereignty of another nation is not violated, according to some scholars. L. OPPENHEIM, INTERNATIONAL LAW: A TREATISE § 295 (H. Lauterpacht ed., 8th ed., 1955).

<sup>35</sup> *Frisbie*, 342 U.S. 519. But see A. Abramovsky & S. J. Eagle, *U.S. Policy in Apprehending Alleged Offenders Abroad: Extradition, Abduction, or Irregular Rendition?*, 57 OR. L. REV. 51, 71 (1977) (noting that one country’s abduction of person on land of another may constitute de facto violation of international law principles).

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applicable to Sarbanes-Oxley defendants in view of the *Tarkoff* case.<sup>36</sup> In *Tarkoff*, there was no violent crime and arguably no American victim. Rather, Mr. Tarkoff engaged in money laundering by implementing two questionable monetary transactions outside the United States involving bank accounts in Willemstad, Curaçao and Tel Aviv, Israel.<sup>37</sup> The only tie between the Israeli bank account and the United States was that “the Israeli bank [was] a financial institution which, by communicating with parties in the United States and providing banking services to United States citizens, was a financial institution that was engaged in, or the activities of which affected, foreign commerce in any way or degree.”<sup>38</sup> Despite both transactions having occurred outside the United States, Mr. Tarkoff’s conviction for conspiring to violate, and in fact violating 18 U.S.C. § 1956(a)(1)(B)(i), was affirmed by the Eleventh Circuit.<sup>39</sup>

Even prior to Sarbanes-Oxley, wholly extraterritorial prosecutions of foreign corporations were considered and carried out.<sup>40</sup> In *Nippon Paper*, the Sherman Act was used to prosecute a Japanese corporation in a case of price-fixing in the fax machine paper market.<sup>41</sup> *Nippon Paper*’s conduct, whether criminal or not, took place “entirely in[side] Japan.”<sup>42</sup> Despite there being no question as to *Nippon Paper*’s nationality or the extrajurisdictional geography of its acts, the First Circuit reversed the district court’s decision that applying the Sherman Act to a foreign corporation’s activities in its home country was improper.<sup>43</sup>

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<sup>36</sup> *United States v. Tarkoff*, 242 F.3d 991 (11th Cir. 2001).

<sup>37</sup> *Id.* at 992. Tarkoff was convicted of conspiring to commit money laundering under 18 U.S.C. § 1956(h) and two counts of money laundering in violation of 18 U.S.C. § 1956(a)(1)(B)(i). *Id.*

<sup>38</sup> *Id.* at 995. This argument that the destination for funds (or something else) could have been the United States appears in a variety of cases on the periphery of jurisdictional analysis. *See, e.g.*, *United States v. Ricardo*, 619 F.2d 1124 (5th Cir. 1980) (only link between ship in international waters and United States was presence of nautical charts that would, in theory, allow ship to navigate to the United States). It is worth noting that under the “nautical ability” theory, any ship with a laptop and a GPS receiver is within the ambit of American jurisdiction. Or, by extension, anyone with a vague idea of where the United States is located, a wristwatch, a sextant, a compass, and basic maritime navigational know-how.

<sup>39</sup> *Tarkoff*, 242 F.3d 991.

<sup>40</sup> The most common justification for this under international law has been the objective territorial principle. Put simply, a given nation may exercise jurisdiction, for purpose of enforcing its criminal laws, over conduct that occurs outside the nation’s borders where that conduct has or the actor intends it to have a substantial effect within the nation’s borders. *See United States v. Yousef*, 327 F.3d 56, 91 (2d Cir. 2003) (citing *In re Marc Rich & Co.*, 707 F.2d 663, 666 (2d Cir. 1983)).

<sup>41</sup> *United States v. Nippon Paper Indus.*, 109 F.3d 1 (1st Cir. 1997).

<sup>42</sup> *Id.* at 2.

<sup>43</sup> This is a controversial holding and essentially holds in accord with *United States v. Aluminum Co. of Am.*, 148 F.2d 416 (2d Cir. 1945) but contradicts *Am. Banana Co. v. United Fruit Co.*, 213 U.S. 347 (1909), which may still be good law as to the proposition that a business occurrence

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Wholly or partly state-controlled large corporations pose a particularly difficult question. While prosecution of the CEO or CFO of such a company may be proper under the Foreign Commerce Clause and Sarbanes-Oxley, it is likely not proper to the extent that the executives in question are also “foreign officials.”<sup>44</sup> Where two executives are accused of similar wrongdoing, the “foreign official” exception may well create a different outcome for one versus the other.

III. NULLUM CRIMEN SINE LEGE<sup>45</sup>

This leads to a difficult situation for foreign executives. Suppose a Chinese CEO or CFO, who is not a “foreign official”, is minding his own business (literally and figuratively) and ensures that his company’s accounting complies with Chinese GAAP.<sup>46</sup> The executive has never left China and his company’s only link to the United States is that a small percentage of its total outstanding shares are traded on the NASDAQ.<sup>47</sup> Chinese GAAP (and the Chinese version of IFRS)<sup>48</sup> does not include a section on related-party transactions akin to the section in United States GAAP.<sup>49</sup> As a result, there may

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overseas that has no substantial effect on the United States cannot be subjected to the scrutiny of American courts on the basis of potential Sherman Act violations.

<sup>44</sup> “Foreign officials” are defined in a variety of ways, but a representative piece of legislation is the Foreign Corrupt Practices Act of 1977, which exempts foreign officials from prosecution. Foreign Corrupt Services Act, 15 U.S.C. § 78dd-1(f)(1)(A) (2009). For the most recent and relevant interpretation of the statute by an appellate court see *United States v. Castle*, 925 F.2d 831 (5th Cir. 1991).

<sup>45</sup> “Nullum crimen sine lege, nulla poena sine lege,” the Latin translates, “No crime without law, no punishment without law.” In other words, the scope of criminalized conduct must be formally established and the actor-defendant must have been on notice of the crime and its penalties prior to the state’s undertaking a criminal prosecution. See Marc Ancel & Louis B. Schwartz, *The Collection of European Penal Codes and the Study of Comparative Law*, 106 U. PA. L. REV. 329, 345-46 (1958).

<sup>46</sup> The GAAP acronym (pronounced “gap”) stands for Generally Accepted Accounting Principles, which vary from country to country. See FASB: Financial Accounting Standards Board, <http://fasb.org/> (last visited Mar. 8, 2009).

<sup>47</sup> This link is sufficient to require the CEO to sign any United States tax returns for the company under Title X of The Sarbanes – Oxley Act of 2002, Pub. L. No. 107-205 (2002). Such a company is also bound to comply with Section 13 of the Securities Exchange Act of 1934 as to reporting. Pub. L. No. 110-455 § 13, 15 U.S.C. § 78m (2008). Additionally, the company is bound by Section 401 of The Sarbanes-Oxley Act of 2002 as to disclosures. Pub. L. No. 107-204 § 401, 116 Stat 745 (2002).

<sup>48</sup> INTERNATIONAL FINANCIAL REPORTING STANDARDS (Int’l Accounting Standards Bd. 2008).

<sup>49</sup> The two sections are not comparable because Chinese GAAP exempts state-owned enterprises (SOEs) from the reporting requirements for related-party transactions. As many of the largest

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be scenarios where this Chinese businessperson, adhering to Chinese GAAP or the Chinese version of IFRS, is still exposed to criminal liability under Sarbanes-Oxley despite following all of the applicable laws of his own country. In light of the Ker-Frisbie Doctrine, if such an executive were to be abducted by American law enforcement and “found” in the United States, he or she could be prosecuted in American courts, and ultimately sent to an American prison.<sup>50</sup>

Such an executive is caught in a regrettable legal paradox. If he or she follows Chinese law and Chinese accounting rules, to the extent that they conflict with American law and the expectations of American investors, he or she will enjoy the protection of domestic law, but the specter of jeopardy before American courts will persist. Similarly, if he or she follows American law and American accounting rules, local officials and investors will be dissatisfied, perplexed, and litigious. Further, it should not be required that the hypothetical Chinese executive be on constructive notice of the minutiae of American securities law at all times.

Without legislative provisions that are manageable for executives, understood by stakeholders, and limited to a reasonable scope, foreign executives will be unwitting victims of the American legal system. It is unreasonable to expect all foreign executives to abide by two separate, occasionally conflicting, sets of laws. It is unjust to expect the same group of individuals to submit to the jurisdiction of alien courts and foreigners’ arbitrary rules where their livelihood and freedom will no doubt be threatened. The number of CEOs and CFOs of major, publicly-traded enterprises is finite. Hence, there persists a small, yet unmanageable, risk that Sarbanes-Oxley will be transformed into a bill of attainder<sup>51</sup> wielded against the least popular and most vulnerable among them. Whether such a prosecution – and the resulting feather in the cap of an ambitious Assistant U.S. Attorney – is worth causing an international incident is a question that deserves a policy analysis all its own.

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ventures in China are SOEs, a substantial portion of the Chinese economy need not report related-party transactions under Chinese GAAP. These discontinuities force Chinese companies to choose between domestic GAAP and American financial reporting standards. See Erica Fung, *Regulatory Competition in International Capital Markets: Evidence from China in 2004-2005*, 3 N.Y.U. J. L. & BUS. 243, 272 (“In some cases, it is nearly impossible to reconcile U.S. GAAP and Chinese GAAP; consequently, the Chinese company will decide to drop the U.S. component.”).

<sup>50</sup> See *United States v. Oscar-Torres*, 507 F.3d 224, 228 (4th Cir. 2007) (The Supreme Court “simply references ‘ the long-standing rule, known as the *Ker-Frisbie* doctrine, that illegal police activity affects only the admissibility of evidence; it does not affect the jurisdiction of the trial court[.]’”) (citing *United States v. Olivares-Rangel*, 458 F.3d 1104, 1110 (2006)).

<sup>51</sup> U.S. CONST. art. I, § 9, cl. 3 (“No Bill of Attainder or ex post facto Law shall be passed.”).

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## A. Outcomes

“The Constitution is the source of Congress’ authority to criminalize conduct, whether here or abroad, and of the Executive’s authority to investigate and prosecute such conduct. But the same Constitution also prescribes limits on our Government’s authority to investigate, prosecute, and punish criminal conduct, whether foreign or domestic.”<sup>52</sup> There must be reasonable limits on the investigation, prosecution, and punishment of crimes that occur wholly outside the United States. No one argues that international criminal conspiracies should not be prosecuted by the United States where a substantial step or affirmative act is undertaken in the United States.<sup>53</sup>

The abduction and prosecution of foreign executives is politically and procedurally dangerous. Many scholars have wondered: “Will America become a rogue nation, abducting fugitives at will? Even if we accept Executive Branch assurances that abduction will be confined to extreme cases, there could be many such seizures.”<sup>54</sup> Indeed, abduction may increasingly be viewed by the United States as an alternative to traditional, ratified extradition arrangements in the case of foreign executives. This is, in part, because the international law principle of dual criminality<sup>55</sup> might allow extradition for other financial crimes, but is inapplicable to Sarbanes-Oxley. As of 2008, Sarbanes-Oxley is the farthest-reaching legislation of its kind worldwide, and contains more criminal penalties than regulations in other countries.<sup>56</sup> In the absence of roughly

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<sup>52</sup> United States v. Verdugo-Urquidez, 494 U.S. 259, 281 (1990) (Brennan, J., dissenting).

<sup>53</sup> See, e.g., United States v. Saccoccia, 58 F.3d 754 (1st Cir. 1995) (international money-laundering scheme to legitimize proceeds of Cali drug cartel activity subject to United States prosecutorial power due to co-conspirator’s activities in Rhode Island, New York, and California).

<sup>54</sup> J. A. Bush, *How Did We Get Here? Foreign Abduction After Alvarez-Machain*, 45 STAN. L. REV. 939, 969 (1993).

<sup>55</sup> “The principle of dual criminality dictates that, as a general rule, an extraditable offense must be a serious crime (rather than a mere peccadillo) punishable under the criminal laws of both the surrendering and the requesting state. ...The principle of dual criminality does not demand that the laws of the surrendering and requesting states be carbon copies of one another. Thus, dual criminality will not be defeated by differences in the instrumentalities or in the stated purposes of the two nations’ laws. By the same token, the counterpart crimes need not have identical elements. Instead, dual criminality is deemed to be satisfied when the two countries’ laws are substantially analogous.” *Saccoccia*, 58 F.3d at 766.

<sup>56</sup> Most countries rely heavily upon investors’ private lawsuits as the primary means of enforcement of securities laws; this approach can be seen in the American 10b-5 framework. See John C. Coffee & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 291 (1981) (“[D]irect shareholder actions under [R]ule 10b-5 or [R]ule 14a-9 may be adequate to enforce the statute’s policies.”). Though Sarbanes-Oxley’s critics often call its criminal penalties “draconian” or “tragic,” many claim regulation without “teeth” will not deter corporate crime. See David Mills & Robert Weisberg, *Corrupting*

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congruent legislation in other countries, the United States would be forced to act alone, relying solely on the largely-theoretical<sup>57</sup> extraterritorial applicability of Sarbanes-Oxley and the apparent propriety of defendant abduction under the expansive Ker-Frisbie Doctrine.<sup>58</sup>

The government has other powers that serve to bolster a case brought against foreign nationals. For instance, to deny a government motion to depose material witnesses overseas is likely an abuse of discretion by a trial court.<sup>59</sup> However, to compel a person to testify, to allow a deposition, or to encourage a foreigner to be present at a trial differ drastically from the abduction of foreign executives.<sup>60</sup> Centuries of jurisprudence suggest that the taking of person or property from a foreign land is not something to be done lightly.<sup>61</sup> In the current environment, where international tension often eclipses international cooperation, the abduction of foreign firms' executives is a particularly perilous enterprise. Nevertheless, the Ker-Frisbie Doctrine makes such abductions expedient, temptingly so.

Actions in the wake of the markets turmoil of 2008 suggest that the United States government may be compelled – politically, if not legally – to seize and prosecute foreign executives as part of routine market regulation.<sup>62</sup> It

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*The Harm Requirement in White Collar Crime*, 60 STAN. L. REV. 1371, 1442 (2008); see also Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 18-47 (2002). This concept of using criminal, rather than civil, remedies to deal with large-scale corporate fraud is very recent and almost uniquely American. See Exec. Order No. 13,271, 67 Fed. Reg. 46,091 (July 9, 2002) (issued by President Bush, creating Corporate Fraud Task Force which went on to establish guidelines for criminal prosecutions involving business organizations).

<sup>57</sup> See *Prosecutor v. Delalić, Mucić, Delić & Landzō*, Case No. IT-96-21-T, Judgment, ¶ 412 (Nov. 16, 1998) (“It has always been the practice of courts not to fill omissions in legislation when this can be said to have been deliberate. It would seem, however, that where the omission was accidental, it is usual to supply the missing words to give the legislation the meaning intended.”).

<sup>58</sup> Even military invasion of a foreign sovereign state to seize a prospective defendant was found to be proper as the Ker-Frisbie Doctrine expanded, rather than contracted, during the Twentieth Century. See *United States v. Noriega*, 117 F.3d 1206, 1214 (11th Cir. 1997) (“a defendant cannot defeat personal jurisdiction by asserting the illegality of the procurement of his presence”) (*Kravitch, P.*) (citing *United States v. Darby*, 744 F.2d 1508, 1530 (11th Cir. 1984)).

<sup>59</sup> See *United States v. Drogoul*, 1 F.3d 1546 (11th Cir. 1993) (ruling that trial court abused its discretion in denying government motion to depose Italian witnesses in wire fraud case).

<sup>60</sup> See generally F.A. Mann, *Reflections on the Prosecution of Persons Abducted in Breach of International Law*, in *INTERNATIONAL LAW AT A TIME OF PERPLEXITY* 407 (Yoram Dinstein & Mala Tabory eds., 1989).

<sup>61</sup> See *The Apollon*, 22 U.S. 362 (1824).

<sup>62</sup> Abductions under Ker-Frisbie are generally permissible. However, such abductions are improper insofar as they violate express provisions of a self-executing treaty. See Stefan A. Riesenfeld, *The Doctrine of Self-Executing Treaties and U.S. v. Postal: Win at Any Price?*, 74 AM. J. INT'L L. 892,

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was less than a month after Lehman Brothers failed that its CEO, Richard Fuld, was called to testify before Congress.<sup>63</sup> Had Lehman Brothers been a foreign firm with an uncooperative set of executives, would the Ker-Frisbie Doctrine's policy of abduction have been applied to foreign executives? What foreign and domestic policy problems would such an approach present?

### B. Policy Concerns

Prior to the enactment of the Eighteenth Amendment,<sup>64</sup> the general policy of the United States had been to only exercise its authority as to criminal statutes within the United States and within four leagues of its coastlines.<sup>65</sup> The United States had the authority to exercise its powers beyond this four-league nautical penumbra,<sup>66</sup> but chose a policy of restraint.<sup>67</sup> Congress broadened the policy incrementally by passing the Tariff Act of 1922,<sup>68</sup> which sanctioned the use of this authority to perform searches beyond this three-mile periphery and, in some cases, to seize the vessels involved in trafficking operations.<sup>69</sup>

Examining the shift in policy from the ratification of the Eighteenth Amendment in 1919 to the Tariff Act in 1922 is informative, as this expansion occurred after the Ker-Frisbie Doctrine had been contemplated and established.

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893-94 (1980) (ruling that abductions under Ker-Frisbie are generally permissible and only improper insofar as they violate express provisions of a self-executing treaty). *But see* United States v. Toscanino, 500 F.2d 267 (2d Cir. 1974); United States *ex rel.* Lujan v. Gengler, 510 F.2d 62 (2d Cir. 1975), *cert. denied*, 421 U.S. 1001 (1975). The only other check on the exercise of this power is a relatively obscure exception to the Ker-Frisbie Doctrine, known as the Toscanino Exception. Essentially, the Toscanino Exception requires a court to affirmatively divest itself of jurisdiction where the abducted defendant brought before it arrived under circumstances that shock the conscience and violate basic notions of due process. However, given the outrage among investors, scholars, jurists, and legislators aimed at executives in the financial turmoil of 2008, it seems unlikely to this author that the Toscanino Exception would realistically provide ample procedural protection for an executive abducted for purpose of prosecution under Sarbanes-Oxley and the Ker-Frisbie Doctrine.

<sup>63</sup> See Christian Plumb & Dan Wilchins, *Lehman CEO Fuld's Hubris Contributed to Meltdown*, REUTERS, Sept. 14, 2008, <http://www.reuters.com/article/reutersEdge/idUSN1341059120080914>; Andrew Clark & Elana Schor, *Your Company is Bankrupt, You Keep \$480M. Is that fair?*, GUARDIAN, Oct. 7, 2008, <http://www.guardian.co.uk/business/2008/oct/07/lehmanbrothers.banking>.

<sup>64</sup> U.S. CONST. amend. XVIII §§ 1-3 (repealed 1933), effective January 16, 1920.

<sup>65</sup> *Cook v. United States*, 288 U.S. 102, 112-13 (1933). Four leagues is equivalent to approximately 14 miles (22 kilometers).

<sup>66</sup> The Act of August 4, 1790, 1 Stat. 145, 164 (1790) seems to, in theory, allow searches of all inbound vessels, for instance. However, the execution of these searches was a rare practice.

<sup>67</sup> *Cook*, 288 U.S. at 112-14.

<sup>68</sup> See Tariff Act of 1922, 42 STAT. L. 858, 935-975.

<sup>69</sup> *Id.* § 581, 42 STAT. L. 979.

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Despite this, no one in Congress seems to have advocated its use to kidnap and prosecute individuals involved in the violation of temperance provisions.<sup>70</sup> The Supreme Court contemporaneously noted in *Cook* the importance of a “‘definite fixing of the zone’”, wherein the United States would enforce its criminal laws and seize foreigners’ property despite the fact that the United States was able to search and seize beyond its territorial waters.<sup>71</sup>

The argument that the United States should vastly expand the principles and application of United States criminal law extraterritorially has been very successful, particularly during the last half-century.<sup>72</sup> This may be due, in part, to the “wars” taking place during that period, whether termed a War on Communism,<sup>73</sup> War on Drugs,<sup>74</sup> War on Crime,<sup>75</sup> or War on Terror.<sup>76</sup>

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<sup>70</sup> The policy appears to have been to treat any invasion of another sovereign’s ships, places, and people as a serious matter of international policy concern. See Hon. Charles E. Hughes, U.S. Sec’y of State, Recent Questions and Negotiations, Address Before Council of Foreign Relations (Jan. 23, 1924), in 18 AM. J. INT’L. L. 229 (1924).

<sup>71</sup> *Cook*, 288 U.S. at 118.

<sup>72</sup> During the same time period, many leading scholars have raised concerns that incrementally less judicial review will inevitably lead to a decrease in the degree to which individuals in the broader society can exercise and enjoy their civil rights. See, e.g., Erwin Chemerinsky, *In Defense of Judicial Review: A Reply to Professor Kramer*, 92 CAL. L. REV. 1013 (2004); see also Cornelia T. L. Pillard, *The Unfulfilled Promise of the Constitution in Executive Hands*, 103 MICH. L. REV. 676 (2005). Post hoc review of the decision to forcibly abduct, in a foreign land, an executive of a multi-billion-dollar corporation simply may not be sufficient in view of the damage already done to the integrity of international relations, foreign markets, and the reputation of the United States legal system as a fair arbiter of alleged securities law violations.

<sup>73</sup> Several cases take, essentially at face value, the idea that a “war” against communism was occurring at some point in the mid-Twentieth Century. See, e.g., *Petition of Elken*, 161 F. Supp. 823, 824 (1958); *McBride v. Roland*, 248 F. Supp. 459, 469 (1965) (suggesting United States “was at war against communism” generally, and that military engagement in Korea was part of that broader war).

<sup>74</sup> For information on sentences imposed upon enemies during the height of the War on Drugs, see generally William W. Wilkins, Jr., Phyllis J. Newton, & John R. Steer, *Competing Sentencing Policies in a “War on Drugs” Era*, 28 WAKE FOREST L. REV. 305 (1993). President Nixon declared a “[W]ar on [D]rugs” in 1969. *Gonzales v. Raich*, 545 U.S. 1, 10 (2005). The resulting legislation was called the Comprehensive Drug Abuse Prevention and Control Act of 1970 and now resides at 84 Stat. 1236.

<sup>75</sup> See *Florida v. Meyers*, 466 U.S. 380, 385 (1984) (discussing “the never-ending war against crime”); *Harris v. United States*, 331 U.S. 145, 157 (1947) (dissenting opinion) (contemplating whether Bill of Rights is a “nuisance” or “serious impediment” in war against crime); *On Lee v. United States*, 343 U.S. 747, 758 (1952) (Frankfurter, F., dissenting) (noting that “[l]oose talk about [the] war against crime too easily infuses the administration of justice with the psychology and morals of war.”).

<sup>76</sup> See Richard H. Fallon & Daniel J. Meltzer, *Habeas Corpus Jurisdiction, Substantive Rights, and the War on Terror*, 120 HARV. L. REV. 2029 (2007); *Hamdi v. Rumsfeld*, 542 U.S. 507 (2004); *al-Marri v. Pucciarelli*, 534 F.3d 213 (2008) (discussing “global war on terror” and what that might

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However, expanding criminal jurisdiction under Sarbanes-Oxley raises policy concerns distinguishable from those seen, for instance, in fighting terrorism. The rise in the enforcement of United States law internationally occurred in a period during which United States financial markets were forced to share the stage with other major players. Today, few would argue a company's decision to list its stock on the NYSE or NASDAQ, rather than the London Stock Exchange or the Hang Seng, is clear-cut or simple. Young venture capitalists around the world and storied Wall Street firms alike have both demonstrated that it is not substantially more difficult to raise capital abroad than in New York.<sup>77</sup>

With the move toward an international marketplace where foreign exchanges are legitimate peers of the NYSE and the NASDAQ, questions of international law and policy arise.<sup>78</sup> Regulatory concerns already discourage many foreign companies from listing their stocks on American exchanges.<sup>79</sup> The political momentum in the United States appears to be oriented toward more, rather than fewer, regulatory measures. To add the threat of American authorities prosecuting foreign executives under Sarbanes-Oxley is likely to make the American environment particularly unattractive.

## CONCLUSION

Congress must set reasonable limits on the degree to which the United States enforces its laws extraterritorially and must keep American markets attractive and competitive. In order to achieve these goals, Congress should pass, relative to Sarbanes-Oxley, a law similar to Section 6(a), which was meant to clarify the reach of United States antitrust law overseas.<sup>80</sup>

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entail); *Wilson v. Libby*, 535 F.3d 697, 712 (2008) (suggesting that interrogating foreign nationals is central to "duties [of] military officers charged with winning the war on terror").

<sup>77</sup> Ioannis Kokkoris & Rodrigo Olivares-Caminal, *Lessons from the Recent Stock Exchange Merger Activity*, 4 J. COMPETITION L. & ECON. 837 (2008).

<sup>78</sup> See SOFIA RAMOS, INT'L CTR. FOR FIN. ASSET MGMT. & ENG'G, COMPETITION BETWEEN STOCK EXCHANGES: A SURVEY 6 (2003), <http://www.swissfinanceinstitute.ch/tp77.pdf>.

<sup>79</sup> See Irina Shirinyan, *The Perspective of U.S. Securities Disclosure and the Process of Globalization*, 2 DEPAUL BUS. & COM. L.J. 515, 555-56 (2004).

<sup>80</sup> 15 U.S.C.A. § 6(a) (2007). See H.R. CONF. REP. No. 97-924, at 2431 (1982) (Conf. Rep.); *McGlinchy v. Shell Chemical Co.*, 845 F.2d 802, 814 n.8 (9th Cir. 1988) (explaining tripartite test for determining extraterritorial reach of antitrust laws (citing *Timberlane Lumber Co. v. Bank of Am.*, 549 F.2d 597, 613, 615 (9th Cir. 1976))).

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The proposed section would read:

No provision of Title VIII, Title IX, or Title XI of The Sarbanes-Oxley Act of 2002 shall create extraterritorial criminal liability outside the states, properties, and territories of the United States unless—

(1) the alleged conduct has a direct, substantial, and reasonably foreseeable effect—

(A) upon a corporation headquartered in or with substantial operations in the United States; or

(B) upon the viability or efficiency of a major equities market located in the United States; and

(2) such effect gives rise to a claim related to the provisions of Sections 802, 807, or 902 of The Sarbanes-Oxley Act of 2002; and

(3) a defendant person undertook to complete the criminal act while in the United States or upon its properties or within its territories.

“Fundamental human rights, the rights of minorities, and the rights of those unpopular in society should not depend on the wishes of the majority.”<sup>81</sup> The internal political pressures for criminal answerability in the United States that gave rise to the Sarbanes-Oxley Act of 2002 also fostered the metastasis of the Ker-Frisbie Doctrine. While accountability for criminal acts should not be prevented by accidents of geography, little guidance is provided to government agents and prosecutors by rules and doctrines that permit many behaviors but, in practice, prohibit none. The restraints outlined here serve to confine the solution put forward by the Act to the source of the problem it intended to resolve and return the nation to the concrete limits of its borders, rather than the uncertain boundaries of its markets.

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<sup>81</sup> Erwin Chemerinsky, *In Defense of Judicial Review: A Reply to Professor Kramer*, 92 CAL. L. REV. 1013, 1025 (2004).

## 21ST CENTURY PENSIONS: THE RISK, THE HEDGE AND THE DUTY TO CONSIDER

*Martin Rosenburgh\* & Andrew C. Spieler\*\*†*

### INTRODUCTION

Among the most significant of the damages to result from the recent market turmoil may be those suffered by U.S. pension plans and their participants. In a period of little more than a year, defined benefit (“DB”) plans have been taken from fully-to-over-funded status to historically large deficit levels.<sup>1</sup> Furthermore, many of these underfunded plans are sponsored by companies facing drastic deterioration in financial health (and in some cases potential bankruptcy); and the Pension Benefit Guaranty Corporation (“PBGC”), the agency responsible for insuring DB plans, is itself experiencing significant and rising deficits.<sup>2</sup> The result may likely be a rising uncertainty as to the status and future of benefits for a large number of pension plan participants.<sup>3</sup>

Perhaps what is most troubling about this development is that it occurred “under the watch” of one of the world’s most robust legal and

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<sup>1</sup> In a recent report by Mercer, “funded status” (defined as the ratio of assets to liabilities) for the S&P 1500 companies declined from 104% in 2007 YE to 75% in 2008 YE. The pension funding deficit for the same group is estimated to be \$409 billion as of 2008 YE. In addition, U.S. pension related expenses are estimated to increase from approximately \$10 billion in 2008 to \$70 billion in 2009. Published by Mercer on January 7, 2009, reported by Pension & Benefits Daily on January 8, 2009.

<sup>2</sup> The PBGC is currently experiencing \$11.2 Billion deficit. See “PBGC Premium Boost - Outgoing PBGC chief Millard pushes to strengthen agency’s financial footing”, Pension & Investments, January 20, 2009.

<sup>3</sup> See Note 1.

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regulatory frameworks, designed to protect against this very harm – that of the Employee Retirement Income Security Act of 1974 (“ERISA”).<sup>4</sup> With ERISA provisions governing virtually every aspect of pension plan entitlement and operation, and administrative and enforcement responsibility shared by three U.S. agencies (i.e., the U.S. Department of Labor (“DOL”), the U.S. Treasury and the PBGC), three questions immediately come to mind: i) how is such significant DB plan risk exposure (and consequential large losses) permissible under ERISA? (in short- how could this sort of thing happen?), ii) are there safeguards available which could have been (or could be in the future) implemented?, and iii) if so, is someone responsible for failing to take them?

The answers to these questions are found in a review of the applicable law governing the investment of pension plan assets, as well as in consideration of industry practices and available investment solutions. In summary, we find the following:

1. Notwithstanding the fact that plan investment decision-makers are “fiduciaries” under ERISA, subject to a number of stringent standards regarding conduct and decision-making (e.g., the statutory duty of the “Prudent Man Standard of Care”), plan fiduciaries have been afforded a great deal of freedom under ERISA in their choices regarding plan investment strategy.
2. Pension solutions experts offer safeguards against the forms of defined benefit plan-related risk experienced during the past year, in hedging-based investment strategies called “Liability Driven Investing” (“LDI”).
3. Although applicable law is sparse and uncertain, it does appear plausible for ERISA fiduciary liability to arise in connection with a failure to adopt such safeguards,

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<sup>4</sup> As amended. “. . . that owing to the inadequacy of current minimum standards, the soundness and stability of plans with respect to adequate funds to pay promised benefits may be endangered; that owing to the termination of plans before requisite funds have been accumulated, employees and their beneficiaries have been deprived of anticipated benefits; and that it is therefore desirable in the interests of employees and their beneficiaries, for the protection of the revenue of the United States, and to provide for the free flow of commerce, that minimum standards be provided assuring the equitable character of such plans and their financial soundness.” 29 U.S.C. § 1001(a), ERISA § 2(a) Congressional findings and declaration of policy.

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particularly where the decision-making process involved in choice or monitoring of investment strategy is found to be inadequate.

### I. HOW IS SUCH SIGNIFICANT DB PLAN RISK EXPOSURE, AND CONSEQUENTIAL LARGE LOSSES, PERMISSIBLE UNDER ERISA? (I.E, HOW COULD THIS SORT OF THING HAPPEN?)

For the groundwork of understanding of what is, and is not, permissible with respect to plan investment decision-making, one must begin with a review of the ERISA statute itself and interpretive DOL regulations, ending with remedies available under ERISA and common law.

#### A. ERISA Section 404(a) “Prudent Man Standard of Care”

ERISA sets forth a “Prudent Man Standard of Care” governing all fiduciary behavior, including investment decisions.<sup>5</sup> Fiduciaries are required to act

“with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”<sup>6</sup>

Viewed generally by courts as adoption of the “prudent person” standard from the common law of trusts, these and the other provisions of ERISA §404 are interpreted under a significant and growing body of federal common law of ERISA.<sup>7</sup>

In addition, a fiduciary is required to “discharge his duties with respect to a plan solely in the interest” of the plan participants, for the “exclusive purpose” of providing benefits and “defraying reasonable expenses” of plan administration.<sup>8</sup> Investment decision-making is also subject to a diversification

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<sup>5</sup> ERISA § 404(a).

<sup>6</sup> ERISA § 404(a)(1)(B).

<sup>7</sup> See *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983). See also *Varity v. Howe*, 516 U.S. 489(1996).

<sup>8</sup> ERISA § 404(a)(1)(A). Sometimes referred to as the “exclusive benefit” rule, this has been viewed as incorporating a trust law “duty of loyalty”.

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requirement “so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so”,<sup>9</sup> and must also be made “in accordance with the documents and instruments governing the plan.”<sup>10</sup>

DOL Regulation 2550.404a-1, referred to by courts as the “prudence rule”,<sup>11</sup> provides guidance for what is deemed a “prudent” discharge of duties under ERISA Section 404(a) with respect to an “investment” or “investment course of action”.<sup>12</sup> Such requirements are deemed satisfied

“if the fiduciary. . . has given *appropriate consideration* to those facts and circumstances that, given the scope of such fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan’s investment portfolio with respect to which the fiduciary has investment duties; and . . . has acted accordingly” (*emphasis added*).<sup>13</sup>

The regulation defines “appropriate consideration” as including (but not limited to) the following two components:

A. A determination by the fiduciary that the particular investment course of action is reasonably designed, as part of the portfolio. . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and

B. Consideration of the following factors as they relate to such portion of the portfolio:

i. The composition of the portfolio with regard to diversification;

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<sup>9</sup> ERISA § 404(a)(1)(C).

<sup>10</sup> ERISA § 404(a)(1)(D).

<sup>11</sup> *California Ironworkers v. Loomis Sayles & Co.*, 259 F.3d 1036, 1043 (9<sup>th</sup> Cir. 2001).

<sup>12</sup> DOL Reg. 2550.404a-1. The DOL is the U.S. agency authorized to enforce ERISA fiduciary requirements.

<sup>13</sup> DOL Reg. 2550.404a-1.

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- ii. The liquidity and current rates of return of the portfolio relative to the anticipated cash flow requirements of the plan, and
- iii. The projected return of the portfolio relative to the funding objectives of the plan.<sup>14</sup>

By directing an investment (or investment course of action) be “reasonably designed as part of the portfolio”, this guidance has been viewed by courts as the adoption by the DOL of the Modern Portfolio Theory.<sup>15</sup> Accordingly, risk and return characteristics of investment choices are held to be properly considered in light of their operation *within the portfolio as a whole*, taking into account the additional appropriate factors (e.g., diversification, liquidity and current returns relative to anticipated cash flow requirements, and projected returns relative to plan funding objectives).<sup>16</sup>

These statutory and regulatory provisions form the basis for judicial review of plan investment decision-making. It is noteworthy that the regulatory “safe harbor” outlined above is based on an “appropriate consideration” of qualitative and quantitative factors deemed relevant and generally in accordance with Modern Portfolio Theory.<sup>17</sup> This emphasis on the investment *process* is also reflected in case law, which holds generally that review of an investment or course of action for prudence purposes is focused on the procedure employed, not on the outcome yielded.<sup>18</sup> Courts have stated the rule as follows:

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<sup>14</sup> DOL Reg. 2550.404a-1. The regulation’s preamble indicates that this guidance is not intended to provide an exclusive manner of compliance with prudence requirements: “It should also be noted that the Department does not view compliance with the provisions of the regulation as necessarily constituting the exclusive method for satisfying the requirements of the “prudence” rule. Rather, the regulation is in the nature of a “safe harbor” provision; it is the opinion of the Department that fiduciaries who comply with the provisions of the regulation will have satisfied the requirements of the “prudence” rule, but no opinion is expressed in the regulation as to the status of activities undertaken or performed that do not so comply.”

<sup>15</sup> DiFelice v. U.S. Airways, 497 F.3d 410, 423 (4th Cir. Va. 2007).

<sup>16</sup> DOL Reg. 2550.404a-1 Preamble (An investment “should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk.) Courts have drawn a distinction between this review of an investment’s risk, to be determined within the context of the whole portfolio, and the requirement that each and every investment or course of action be “prudent” on an individual basis. (“That is, a fiduciary must initially determine, and continue to monitor, the prudence of each investment option available to plan participants.”) DiFelice v. U.S. Airways, 497 F.3d 410, 423.

<sup>17</sup> DOL Reg. 2550.404a-1.

<sup>18</sup> See Brock v. Robbins, 830 F.2d 640, 648 (7th Cir. 1987) (a failure to follow reasonable procedures is imprudent even if the fiduciaries reached a reasonable decision). See also Anderson v. Mortell, 722 F. Supp. 462, 470 (N.D. Ill. 1989) (the duty of fiduciary is to conduct a prudent, independent investigation, not to achieve “the highest possible price” in sale of a plan asset).

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When deciding whether a plan fiduciary has acted prudently, a “[c]ourt must inquire whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.” (internal quotation marks omitted). In other words, a court must ask whether the fiduciary engaged in a reasoned decision-making process, consistent with that of a “prudent man acting in like capacity,”<sup>19</sup>

Notwithstanding the stringent level of care and consideration dictated under the forgoing ERISA prudence requirements,<sup>20</sup> plan fiduciaries have been afforded a great deal of freedom under ERISA in their choices regarding plan investment technique and strategy. In the Preamble to the foregoing regulation, the DOL indicates an intent to avoid limitation of “the investments, classes of investment, or investment techniques that might be permissible under the ‘prudence’ rule. No such list could be complete; moreover, the Department does not intend to create or suggest a ‘legal list’ of investments for plan fiduciaries.”<sup>21</sup>

Ironically, the clearest indication of regulatory intent on the freedom to choose strategy comes from a DOL Advisory Opinion regarding the permissibility of use of the “Liability Driven Investing” pension portfolio management strategy:

Within the framework of ERISA’s prudence, exclusive purpose and diversification requirements, the Department believes that plan fiduciaries have broad discretion in defining investment strategies appropriate to their plans. In this regard, the Department does not believe that there is anything in the statute or the regulations that would limit a plan fiduciary’s ability to take into account the risks associated with benefit liabilities or how those risks relate to the

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<sup>19</sup> ERISA § 404(a)(1)(B). *DiFelice v. U.S. Airways*, 497 F.3d at 421, citing *Flanigan v. GE*, 242 F.3d 78, 86 (2d Cir. 2001).

<sup>20</sup> See *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982) (the court emphasizes the high degree of care required under ERISA’s prudence standard, noting that ERISA fiduciary duties are “the highest known to the law”). See also *Donovan v. Mazzola*, 716 F.2d at 1231.

<sup>21</sup> DOL Reg. 2550.404a-1 Explanatory Preamble.

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portfolio management in designing an investment strategy.<sup>22</sup>

There is, however, one noteworthy piece of DOL guidance weighing in on the use of a particular type of investment – a 1996 DOL Information Letter regarding the use of derivatives.<sup>23</sup> In the letter, guidance is provided with respect to additional factors which should be considered in a decision to use derivatives (or in implementing and/or maintaining a derivatives-based strategy). Among the factors to consider are “..sufficient information to allow an independent analysis of the credit risk and market risk being undertaken by the plan..”, to be determined by an “appropriate methodology used to evaluate market risk.” Toward this end, the letter notes that “stress simulations are particularly important because assumptions which may be valid for normal markets may not be valid in abnormal markets, resulting in significant losses.” In addition, the letter instructs:

As part of its evaluation of the investment, a fiduciary must analyze the operational risks being undertaken in making the investment. Among other things, the fiduciary should determine whether it possesses the requisite expertise, knowledge, and information to understand and analyze the nature of the risks and potential returns involved in a particular derivative investment. In particular, the fiduciary must determine whether the plan has adequate information and risk management systems in place given the nature, size and complexity of the plan’s derivatives activity, and whether the plan fiduciary has personnel who are competent to manage these systems.<sup>24</sup>

While there is no indication in this guidance that derivatives are deemed more “risky” or inherently less prudent than other investment types,<sup>25</sup> it does suggest that derivatives usage would require a specific form of expertise that may not be present at all plans, and that a layer of due diligence would likely be required above and beyond that with respect to other investments.

Accordingly, without providing any significant guidance regarding the selection of portfolio investment strategies (other than with respect to the use of derivatives or the LDI portfolio approach), there is an inference from the

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<sup>22</sup> DOL Advisory Opinion 2006-08A.

<sup>23</sup> DOL Information Letter to Honorable Eugene A. Ludwig, dated March 21, 1996.

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

<sup>25</sup> The letter states that “investments in derivatives are subject to the fiduciary responsibility rules in the same manner as are any other plan investments.” *Id.*

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foregoing regulatory guidance that the “tried and true” or traditional approaches to portfolio management may provide a “less burdensome” or “safer” means of satisfying ERISA prudence requirements.

**B. ERISA Civil Enforcement of Fiduciary Breaches**

ERISA Section 409 “Liability for breach of fiduciary duty” provides that, with respect to breaches of fiduciary duty, fiduciaries are personally liable “to make good to such plan any losses to the plan resulting from each such breach.”<sup>26</sup> ERISA Section 502 “Civil enforcement” provides empowerment to bring civil actions to enforce rights under ERISA.<sup>27</sup> With respect to enforcement of liability for fiduciary breaches (under ERISA Section 409), actions may be brought by “the Secretary, or by a participant, beneficiary or fiduciary. . . .”<sup>28</sup>

Accordingly participants, in addition to the DOL, are among parties who may bring civil actions to enforce breaches of fiduciary duty and recoup losses to the plan.<sup>29</sup> In this manner, ERISA Section 502(a)(2) arguably enhances the enforcement power under ERISA by “deputizing” as enforcers of fiduciary liability the large constituency of U.S. plan participants. Historically, however, a significant limitation on such actions by participants, seeking to recover losses with respect to DB plans, has been found in “Article III Constitutional Standing”. Under the doctrine of Article III Constitutional Standing, a plaintiff must have “suffered an injury in fact”.<sup>30</sup> Such “injury” has been held by some courts as lacking where, notwithstanding the losses suffered to a DB plan, the plan remained adequately funded to pay “all accrued or accumulated benefits”.<sup>31</sup>

In large part for these reasons, the responsibility for enforcing rights with respect to DB plan investment decision-making has been left largely to the DOL. However, as indicated above, the DOL has traditionally refrained from prohibiting (or requiring) specific types of investment strategy, and would

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<sup>26</sup> ERISA § 409.

<sup>27</sup> ERISA § 502.

<sup>28</sup> ERISA § 502(a)(2).

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

<sup>30</sup> Harley v. Minnesota Mining and Manufacturing Co., 284 F.3d 901, 906.

<sup>31</sup> Harley v. Minnesota Mining and Manufacturing Co., 284 F.3d at 907. *See also* Hughes Aircraft v. Jacobson, 525 U.S. 432, 440 (“Given the employer’s obligation to make up any shortfall, no plan member has a claim to any particular asset that composes a part of the plan’s general asset pool”). However, the rule governing Constitutional Standing is far from settled, with inconsistent positions taken among different Circuits. *See* Amicus Brief of the Secretary of Labor, Harley v. Minnesota Mining and Manufacturing Co., 284 F.3d 901.

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therefore not likely bring an action where the investment course of action arising in an alleged breach of duty was the adherence to a “tried and true” or traditional portfolio allocation approach (unless there was some other visible failure in the investment decision-making process). Accordingly, significant DB plan risk exposure (and consequential large losses) continues to remain permissible, and quite likely, under ERISA.

Recent events, however, may have altered the landscape of enforcement and litigation. As mentioned above, plan funding levels have deteriorated significantly over the past twelve to eighteen months.<sup>32</sup> Accordingly, there is likely to be a growing universe of DB plan participants for whom receipt of benefits is uncertain, and who would therefore satisfy any applicable review of Constitutional Standing.<sup>33</sup>

### II. ARE THERE SAFEGUARDS WHICH COULD HAVE BEEN TAKEN?

The most significant form of risk that arises in connection with DB plan funding and investment is a function of the deviation or “mismatching” that can occur between plan assets and liabilities.<sup>34</sup> Traditional pension investment performance measurement (or “benchmark” development) has been primarily “asset based” (i.e., based on performance of comparable assets in the market, often represented by indices). However, due to market fluctuations, both plan assets and liabilities can experience significant volatility, and not necessarily in the same direction. This difference is often referred to as “tracking error to liabilities” or “surplus volatility”.<sup>35</sup> This volatility is largely driven by changes in interest rates, which in turn cause changes in the present value of plan liabilities and asset values of plan-held fixed income investments (and often occur in connection with volatility in other asset types as well, such as equities).

Safeguards against this risk are available in the plan investment industry, in strategy primarily known as Liability Driven Investing (“LDI”).<sup>36</sup> The LDI strategy has two essential components: i) build a benchmark based on timing and amount of plan liabilities, not on the targeted return of assets, and ii)

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<sup>32</sup> See Note 1.

<sup>33</sup> See Notes 30-31.

<sup>34</sup> See Rene Martel, FSA, CFA, “LDI: Not One Magic Bullet” (Viewpoints, PIMCO Oct. 2008).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* (“With better understanding and knowledge, there is now a broader recognition that LDI is not a product. Instead, more and more people accept LDI as a process or framework to assess the risk position of defined benefit plans relative to their liabilities in order to identify the investment strategy that is best suited to the sponsor’s objectives.”).

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construct a fixed income portfolio designed to “track” the benchmark.<sup>37</sup> In order to obtain maximum risk reduction benefits, derivatives such as interest rate swaps may also be used (but are not necessary). Furthermore, in order to generate sufficiently high returns, a remaining portion of the portfolio would be allocated to riskier assets such as equities (but this portion is much smaller than the traditional allocation).

Adoption of such a strategy can result in significant reduction in risk associated with a DB plan’s funded status.<sup>38</sup> This is largely due to the fact that investments are structured to provide returns and income that match the timing and amounts of the plan’s liabilities, so that the plan is essentially “hedged”.<sup>39</sup>

For those plans considering the use of interest rate derivatives in connection with such a strategy, there are likely to be additional considerations (some of which are outlined in the DOL Information Letter regarding the use of derivatives, discussed above).<sup>40</sup> For instance, derivative positions can result in interim cash flow requirements to the portfolio, which fluctuate in accordance with interest rate changes. Such impacts could (and should) be modeled under different interest rate scenarios.<sup>41</sup> In addition, plan fiduciaries may not possess the expertise with which to understand how these investments operate and would impact the plan, and therefore may require outside advice.<sup>42</sup>

Accordingly, safeguards to DB plan underfunding do exist in the form of hedging-based strategies such as LDI. Although the strategy can be implemented through the use of derivatives, such usage is not required and may be limited in accordance with the needs, expertise and risk tolerances of the plan.

The following hypothetical should provide a better understanding as to

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<sup>37</sup> See “Liability-Driven Investing: PIMCO’s Innovative Approach to Custom Solutions”, PIMCO Product Focus, May 2007.

<sup>38</sup> Funded status represents the economic position of the pension plan: fair value of the assets – present value of the anticipated pension obligations (using several managerial and actuarial assumptions).

<sup>39</sup> One can think of a plan’s liabilities as similar to bond investment but in reverse: various payment requirements are expected into the future at different times. Accordingly, LDI develops fixed income investment solutions which provide income to match these expected liabilities.

<sup>40</sup> DOL Information Letter to Honorable Eugene A. Ludwig, dated March 21, 1996.

<sup>41</sup> As discussed in the Letter, such modeling, or “stress testing”, would likely be considered a necessary part of a prudent investment process. *Id.*

<sup>42</sup> See Susan Mangiero, Ph.d, AIFA, AVA, CFA, FRM, and Society of Actuaries Joint Pension Risk Research Project, “Pension Risk Management: Derivatives, Fiduciary Duty and Process” (October 2008) (In response to the question “What reasons account for your decision not to use derivative instruments to manage the risk of your defined benefit plan(s)?”, “Lack of Fiduciary Understanding”, “Perception of Excess Risk” and “[DB] Plan Risk Not Considered Significant” were the most frequent responses.).

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how a plan might be faced with the type of investment decision-making described in this article. It also may serve to highlight several of the issues raised under ERISA, which will be explored further below.

### **Part I. The Proposal**

You sit on the investment committee for your company's multi-billion dollar defined benefit pension plan. It is Spring 2007 and the plan is "fully funded" (pursuant to ERISA funding requirements) and in excellent financial health. With a portfolio allocation of 65% equities, the plan's strong investment performance can be attributed in large part to that of the S&P 500, which has earned double-digit annualized returns for the previous five years. Notwithstanding the success of your current portfolio performance, the committee is being presented with a portfolio allocation strategy called "Liability Driven Investing" which would represent a radical change.

In a presentation to the committee, the new investment advisor candidates argue that the plan funding level is exposed to a series of substantial risks. First, the plan is exposed to significant asset-based volatility associated with the plan's equities and other "risky" assets. Another primary risk arises from the volatility in interest rates, which causes the present value of the plans liabilities to fluctuate. It is explained that these could be greatly reduced, if not largely eliminated, through the use of a "hedging" strategy:

-First, a new performance benchmark for the plan would be created, based not on investment indices (such as the S&P 500 or the Lehman Aggregate Bond indices) but on the plan's liabilities. This would be accomplished by constructing a model of the timing and amount of the plan's forecasted future benefit payments.

-The investment advisor would create a portfolio of fixed income investments, with incoming interest and cash flows designed to "match" the (anticipated) outgoing benefit payments of the plan. Portfolio performance

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would be measured against the new liability-based benchmark.

-A portion of the plan assets would remain in equities and other asset classes intended to yield higher/excess returns, but this percentage would be far less than the plan's traditional allocation. The end result would be a portfolio with overall lower returns than the current plan, although likely exhibiting less volatility as measured against the plan's liabilities.

### **Part II. The Decision**

After reviewing the proposal, there were aspects that appealed to you and the committee, but it was ultimately rejected (at least for the time being). One of the primary concerns raised was that the strategy seemed too "complex", and the committee was uncertain that they possessed the expertise necessary to approve, and then adequately monitor, the strategy implementation. There was also discussion of the potential use of "interest rate swaps" in the fixed income portion of the portfolio. Although it was advised that derivative usage would not be necessary in order to implement the strategy, it was ultimately recommended; and there were a number of the committee members who were uncomfortable with derivatives generally (again, largely due to a lack of committee expertise and understanding of the risks involved).

There was one other concern that weighed on you. In order to implement this strategy, you would be required, pursuant to financial accounting standards, to make a significant downward adjustment to your expected return assumption for the plan's investments. (The lower expected return would result from shifting asset allocation away from the historically higher performing equities asset class toward fixed income). This would have an immediate negative impact on company reported earnings, an outcome with which you were certain would please no one in upper management.

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Spring, 2009

It is two years later, Spring 2009 and, after an unexpected credit crunch and subsequent market downturn, your company's defined benefit plan is now seriously underfunded. Not only has your plan portfolio lost in excess of 50% of its value from two years ago, but plan liabilities, calculated on a present value basis, have actually risen (in part due to current interest rates being at historically low levels). There is now significant uncertainty that the plan (or the company) has the ability to pay promised pension benefits when due (and there is informal discussion about termination of the plan). You are asking yourself now whether the committee was too hasty when it rejected the "Liability Driven Investing" approach two years ago. Of course, hindsight is always 20/20 and your plan has fared no worse than a large number of other U.S. pension plans. Notwithstanding, you call your attorney and ask: as pension plan "fiduciaries" under ERISA, could the investment committee members be liable for failing to adequately consider a hedging strategy before rejecting it?

## III. IF SO, IS SOMEONE RESPONSIBLE FOR FAILING TO TAKE THEM?

As discussed above, fiduciary duties with respect to plan investments are grounded in a prudent investment *process*,<sup>43</sup> with an emphasis placed on an "appropriate consideration"<sup>44</sup> and a "reasoned decision-making process"<sup>45</sup> given to investments and investment courses of action involved.<sup>46</sup> The question presented by this article is whether fiduciary liability could arise in connection with a failure to provide such adequate process *in considering*: i) existing pension portfolio-related risk exposure and/or ii) employing a strategy to reduce such risks (i.e., through a portfolio management strategy such as LDI). Such a

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<sup>43</sup> See Notes 17-19.

<sup>44</sup> Reg. 2550.404a-1.

<sup>45</sup> *DiFelice v. U.S. Airways*, 497 F.3d at 421.

<sup>46</sup> It should be noted that although Reg. 2550.404a-1 is provided as a "safe harbor" or non-exclusive means of satisfying prudence requirements, courts have looked to its provisions for guidance in determining whether investment actions were "prudent". See *California Ironworkers v. Loomis Sayles & Co.*, 259 F.3d at 1044.

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failure could arguably arise in one of two decision-making contexts. First, as described in the hypothetical above, it could be alleged that plan fiduciaries rejected without an adequate process the proposal of such a strategy that was presented for consideration. Second, a claim could arise that fiduciaries failed to “appropriately consider” significant risk exposure in their existing traditional portfolio, and subsequently failed to pursue, or look into, LDI strategy solutions as a means of reducing that risk. In order to review the validity of potential claims, there are several issues to consider

Typically, investment-related breaches are found to arise in connection with the entering into, or adoption of, discrete investments or investment courses of action.<sup>47</sup> However, the question presented here is more likely to arise from some degree of *failure to act* (i.e., by *failing* to change existing portfolio allocations and/or *failing* to engage in a hedging strategy). Accordingly, in review of such claim, a court may look for authority supporting liability for what may be argued is a failure to act.<sup>48</sup>

In addition, as discussed above, ERISA neither restricts nor obligates fiduciaries in the types of investments or strategies which they may adopt.<sup>49</sup> A breach is not likely to arise from the failure to act itself (e.g., the *choice* not to adopt a hedging strategy). Instead, liability would likely be limited to instances where such investment inaction was found to be the result of a failure in the consideration and decision-making process (e.g., with respect to portfolio risk and available hedging strategies).<sup>50</sup> Applicable law indicates several principals which are likely to bear upon such a review.

First, ERISA prudence requirements broadly cover all aspects of the plan investment process, extending far beyond initial decisions to enter into investments. Under the “prudence rule” DOL Reg. 2550.404a-1 (discussed

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<sup>47</sup> See, for instance, *Donovan v. Mazzola*, 716 F.2d at 1232 (The issue before the court was “whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.”).

<sup>48</sup> It is also possible for a claim to be made that the earlier-constructed traditional portfolio allocation is itself the investment course of action with respect to which a failure to give appropriate consideration. This is unlikely to succeed, however, as courts would review the decision-making in light of the information available at the time of the investment, when the availability of LDI and other hedging strategies was likely much less prevalent in the industry. See Note 19 above. See also *Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915, 917-18 (8th Cir. 1994) (“[T]he prudent person standard is not concerned with results; rather it is a test of how the fiduciary acted viewed from the perspective of the time of the challenged decision rather than from the vantage point of hindsight.” (internal quotation marks omitted)).

<sup>49</sup> See Notes 22-24 above.

<sup>50</sup> E.g., by giving “appropriate consideration” to the applicable investment or investment course of action and available information, pursuant to Reg. 2550.404a-1.

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above), the “appropriate consideration” requirement applies to both “investment[s]” and “investment course[s] of action”; and an “investment course of action” is defined as “any series or program of investments or actions related to a fiduciary’s performance of his investment duties”.<sup>51</sup> Although the scope of this definition has not been reviewed by courts, it is reasonable to expect that the term “investment course of action” could be held to include a portfolio management strategy, including the manner of benchmarking overall plan investment performance.<sup>52</sup> Furthermore, courts have recognized an ongoing “duty to monitor” investments, notwithstanding delegation of management authority to third parties.<sup>53</sup>

Second, applicable law generally holds that prudent investment process is reviewed from the standpoint of experts and in light of available industry standards. Courts hold that the ERISA prudent person standard is applied from the perspective of “a prudent fiduciary with experience dealing with a similar enterprise”.<sup>54</sup> Where fiduciaries lack expertise in a specific area being considered, they have been held to have an affirmative duty to seek out such expertise.<sup>55</sup> In addition, in review of whether a fiduciary’s methods employed and information reviewed satisfy ERISA prudence requirements, courts have looked at prevailing industry methods and standards.<sup>56</sup> This essentially means that although standards for ERISA prudence requirements may be reviewed by

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<sup>51</sup> Reg. 2550.404a-1(c)(2).

<sup>52</sup> Support for such interpretation may be found in the regulation itself, requiring for consideration, “i. The composition of the portfolio with regard to diversification, ii. The liquidity and current rates of return of the portfolio relative to the anticipated cash flow requirements of the plan, and iii. The projected return of the portfolio relative to the funding objectives of the plan”, which are generally critical components in the development of a portfolio strategy and in LDI strategies in particular. See Notes 34-38.

<sup>53</sup> Liss v. Smith, 991 F. Supp. 278 (Defendants failed to monitor the fund’s solvency and adjust levels. Defendants failed to utilize due care in selecting and monitoring the fund’s service providers and in reviewing the performance of trustees.). See also Harley v. Minnesota Mining & Manufacturing Company, 42 F. Supp. 2d 898 (D. Minn. 1999) (The court held that the trustees’ delegation of responsibility to an investment advisor did not relieve the trustees of their fiduciary obligation to monitor investments.).

<sup>54</sup> U.S. v. Mason Tenders District Council of Greater New York, 909 F. Supp. 882, 886, citing Marshall v. Snyder, 1 Empl. Ben. Cases (BNA) 1878, 1886 (E.D.N.Y. 1979).

<sup>55</sup> Katsaros v. Cody, 568 F. Supp. 360, 367 (E.D.N.Y. 1983), affirmed in relevant part, 744 F.2d 270, citing Donovan v. Bierwirth, 680 F.2d 263, 272-73).

<sup>56</sup> Analyzing “appropriate consideration” under DOL Reg. 2550.404a-1, Ironworkers v. Loomis Sayles & Co., 259 F.3d at 1044 (“the district court found more persuasive Loomis’ evidence that the Bloomberg system was the tool prevalently used in the industry and that only a few portfolio managers were using OAS analysis, and it made factual findings to that effect.”). See also DiFelice v. U.S. Airways, 436 F. Supp. 2d (E.D.V.A., 2006) (“In the present context, this means that U.S. Airways was required to act pursuant to the standards of the investment industry . . .”).

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attorneys and in the courtroom, they are ultimately determined by the investment industry and its experts.

Furthermore, the common law of trusts provides some precedent for fiduciary liability in connection with a failure to adopt hedging strategies.<sup>57</sup> It is not uncommon in analysis of ERISA claims, for courts to look to trust law for guidance (to the extent not inconsistent with ERISA).<sup>58</sup>

Based upon the foregoing, to the extent that a court found that prevailing industry standards included knowledge of pension portfolio-related risks, such as interest rate risk or portfolio tracking error, and risk-hedging solutions such as LDI, it is plausible that a court could find that any wholesale rejection of these concepts could constitute an imprudent investment decision (i.e., via a failure to give “appropriate consideration”). Furthermore, as indicated above, it is unlikely that a lack of expertise would provide defense against such a claim.

Finally, it is worth mentioning that, in addition to the prudence requirements discussed above, the ERISA investment decision-making processes is also subject to the ERISA “Exclusive Benefit” rule. Stated above, ERISA requires that a fiduciary “discharge his duties with respect to a plan solely in the interest” of the plan participants, for the “exclusive purpose” of providing benefits and “defraying reasonable expenses” of plan administration.<sup>59</sup> Accordingly, in their consideration of DB investment strategies, fiduciaries are not permitted to take into account factors other than those involved in provision of benefits under the plan. Such impermissible factors might include the impact of certain investment strategies on the financial statement reporting of the plan sponsor. An example of this concern was described in the previous Hypothetical, where a reduction in the plan’s allocation to equities would result in lower reported earnings (due to changes in plan asset expected return assumptions).<sup>60</sup> To the extent such influences were

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<sup>57</sup> See Randall H. Borkus, A TRUST FIDUCIARY’S DUTY TO IMPLEMENT CAPITAL PRESERVATION STRATEGIES USING FINANCIAL DERIVATIVE TECHNIQUES, 36 Real Prop. Prob. & Tr. J. 127, Spring, 2001, analyzing Brane v. Roth, 590 N.E.2d 587 (Ind. Ct. App. 1992) (“The court entered specific findings and conclusions determining that the directors breached their duties by retaining a manager inexperienced in hedging; failing to maintain reasonable supervision over him; and failing to attain knowledge of the basic fundamentals of hedging to be able to direct the hedging activities and supervise the manager properly.”).

<sup>58</sup> See California Ironworkers v. Loomis Sayles & Co., 259 F.3d at 1047, citing Harris Trust and Savings Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 250 (2000) (“The common law of trusts is incorporated into analysis of ERISA claims unless inconsistent with the statute’s language, structure or purpose.”).

<sup>59</sup> ERISA §404(a)(1)(A).

<sup>60</sup> This factor could in certain instances bear significant weight, as reported earnings may be impacted significantly from changes in the expected return assumptions regarding plan investments.

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found present in an investment decision-making process, fiduciary liability may be more likely to arise.

### CONCLUSION

DB plans serve the important function of enabling employers to assume risk in connection with employee retirement income. This past year has demonstrated that, notwithstanding this “assumption of risk”, there is still enormous risk exposure present within our defined benefit pension plan system, and the resulting volatility will most certainly impact retiree benefits. An underlying question presented in this article is whether this exposure is necessary.

To the extent that viable solutions in the reduction of DB plan risk exist and are readily available within the investment industry, plan fiduciaries may wish to consider them carefully and thoroughly. As to whether and in what contexts fiduciaries could be held liable for failing to do so, this issue remains uncertain. However, as discussed above, “consideration” lies at the heart of prudence under ERISA. Applicable case law makes clear that such process must be informed by relevant expertise and knowledge of industry practices (and not be influenced by factors other than those involved in the provision of plan benefits). As the risks inherent in DB plan funding continue to be realized, and as the pension investment industry continues to develop the solutions to those risks, it is not unreasonable to expect that their appropriate consideration will become viewed as required components of the prudent investment process.

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*See generally* FAS 158. *See also* David Zion, CFA, CPA, *The Magic of Pension Accounting*, Part III. *See also* Susan Mangiero, Ph.d, AIFA, AVA, CFA, FRM, and Society of Actuaries Joint Pension Risk Research Project, “Pension Risk Management: Derivatives, Fiduciary Duty and Process” (In response to the question “What defined benefit plan risk areas concern you?”, “Accounting Impact” was the number one risk concern among DB plan sponsors.).

## GLOBALIZATION AND DEVELOPMENTS IN THE APPORTIONMENT OF JURISDICTION BETWEEN ARBITRATORS AND COURTS CONCERNING INTERNATIONAL COMMERCIAL ARBITRATION

*Pedro J. Martinez-Fraga\* & Rafael Domingo Oslé\*\**

“Man can only be understood by dealing with all the provinces of his activity simultaneously and comparatively, and avoiding the mistake of trying to elucidate some problem, say, or his politics or his religion or his art, solely in terms of particular sides of his being, in the belief that, this done, there is no more to be said.”<sup>1</sup>

### INTRODUCTION: GLOBALIZATION, THE STATE, AND INTERNATIONAL DISPUTE RESOLUTION

The juridic theme of the twenty-first century is defined by the fissure between the homogeneous nature of economic globalization and the current state of a fragmented international law that is limited in its efficacy and application by its very genesis in such concepts as *nationalism* and *national sovereignty*. While humanity as a whole has suffered and agonized as a result of such shared crises as international terrorism, transnational security needs,

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<sup>1</sup> OSWALD SPENGLER, *MAN AND TECHNICS: A CONTRIBUTION TO A PHILOSOPHY OF LIFE* (1931).

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global poverty, environmental threats that threaten the very survival of mankind as we now know it and that likely shall lead to the displacement of hundreds of millions of persons, poverty, regional genocide, political corruption, unworkable judiciaries, sexual exploitation, the vertical and horizontal proliferation of nuclear weapons and similar armaments of mass destruction, and unprecedented shortages in food and vital resources, these common “problems” have assumed a protagonistic role within the prevailing rubric of economic globalization. It is not a pessimistic statement, but rather a commitment to phenomenological integrity to conclude that these crises define and redefine the very unique moment in which we now live. In turn, economic globalization has spawned a virtual borderless world with respect to the placement of manufacturing manpower, research and development, and the novel paradigm pursuant to which cross-border commerce is effectuated in cyberspace, i.e. everywhere and nowhere in particular. In this same vein, advances in communications technology have contributed to never before experienced speed in transnational, national, regional, and local information flow.

At one point seemingly omnipotent in its capacity to absorb territorial and global challenges, the rudimentary precepts set by the founders of the modern contemporary state, Jean Bodin, in *Les six livres de la République* (1576), and, to some extent, Thomas Hobbes in *The Leviathan* (1651) and John Locke in *The Second Treaties of Government* (1690), the *state* has proven to be not only inadequate, but harmful to the requisite reforms for purposes of addressing global problems common to the citizens of all nations. Indeed, the jurisprudence endemic to principles of sovereignty, nationalism, and statehood in the sense of the modern state first enunciated in the sixteenth century and transformed by the French revolution, has demonstrated a progressive inability to address global problems using rules applicable to the relationships between sovereign states. In turn this anomaly has rendered it increasingly more taxing, and in some instances impossible, to distinguish between public and private spheres, identifying the normative foundation for jurisprudence and positive law, and a virtual want of any predictive value that would be consonant with the most reasonable and fundamental expectations forming part of any legal framework.

Irrespective of the formation and transformation of the modern state into paragons that may resemble the European Union, we need not explore the uncharted waters of the future to glean that globalization, in all of its manifestations, shall require the modern state to change. This transformation shall entail a systematic yielding of sovereignty. Here, the European Union does indeed present a helpful paradigm. In tracing the contours of this benchmark, it is rather poignant that perhaps the most critical badge or indicia

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of sovereignty is the element that first must evolve and transform itself: the judiciary. Put simply, globalization, and economic globalization in particular, cannot reach its perfect workings so long as a parallel “judicial globalization” is not established. The need for transnational courts of civil procedure with jurisdiction over private disputes arising in cross-border contexts certainly cannot address the perils that humanity now faces, but they appear to be the logical response to economic globalization. Recourse to multiple foreign jurisdictions (here “foreign” refers to non-citizens of jurisdictions where judicial procedures are to be had) is not viable. Venture capitalists, captains of industry, practitioners, and academics are all of a single voice in underscoring the need for a judicial methodology concerning the equitable administration of justice that is emblematic of a confluence of legal cultures so as to further the precepts of party-autonomy, predictability, transparency, and uniformity. It is precisely at this critical historical and judicial juncture that international commercial arbitration serves its most universal purpose that far transcends the resolution of private individual disputes.

International commercial arbitration is but a temporizing measure, perhaps unbeknownst to its vast constituency in the world of commerce, law, and academia, that is serving as a historical temporal bridge until such time as transnational courts of civil procedure vested with authority to adjudicate private disputes arising from cross-border controversy, or the courts of “superstates” , such as perhaps the European Court of Justice with respect to the European Union are capable of exercising jurisdiction over such conflicts. Indeed, here international commercial arbitration, whether in the context of free trade agreements or ICSID, shall serve as the fertile petri dish for the right proportions of different legal systems that ultimately shall create a confluence of legal cultures capable of satisfying the well reasoned expectations of parties to an arbitral proceeding. Moreover, the transfer of dispute resolution from the public to the private arena also constitutes a gradual exercise in the ceding of sovereignty pursuant to the reallocation of dispute resolution together with a new role for the judiciary as subservient to arbitrations. This new space for judicial activism, which admittedly is confining in nature, represents a first step in the demise of traditional paradigms of sovereignty, the modern state, and nationhood.

Here we shall attempt to focus on a very narrow, almost microscopic, doctrinal development illustrative of this transformation that certainly may be used, to some extent, as a guidepost that may lead those interested in tracing virtually imperceptible changes that are constant and so persistent in essence so as to be otherwise oblivious to the ordinary observer as in the case of Darwin’s initial and unalloyed proposition. Indeed, first a fleeting glance at *party-autonomy* shall be exercised. Second, analysis of caselaw, in particular *Prima*

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*Paint Corp. v. Flood and Conklin Mfg.*, will be undertaken. Third, the normative foundation for the Federal Arbitration Act will be explored so as to fathom the depths of the precepts actually providing for arbitration to serve its dispute resolution aspirations in a federal system. Finally, the trilogy of authority comprised by *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, *Southland Corp. v. Keating*, and *Buckeye Check Cashing v. Cardegna*, shall be studied in considerable detail so as to understand the doctrinal movement or development that came in to being with the rigorous majesty of the common law throughout a twenty-three year timeframe. It will be argued that in leading to greater jurisdictional scope for arbitral proceedings, the finest interest of commerce at international levels and those of economic globalization shall be served.

I. A RETURN TO PARTY-AUTONOMY AS A NEW FORM OF NON-STATE  
SOVEREIGNTY, THE ARBITRATION CLAUSE

A. A Review of *Prima Paint Corp. v. Flood and Conklin Mfg. (1967)*

The doctrinal development of arbitration in the United States in large measure constitutes the rediscovery and renaissance of the venerable principle of *party-autonomy*.<sup>2</sup> This precept, in turn, certainly cannot be conceptually severed from the juridic dignity accorded to contractual agreements. It followed from the four historical propositions that deemed arbitration to be a second tier dispute resolution methodology<sup>3</sup> that an arbitration clause was neither (i) a “free standing” contract separate and distinct from the underlying agreement embodying it, nor (ii) an agreement enjoying equal dignity with commercial contracts of whatsoever ilk.

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<sup>2</sup> For purposes of this analysis, it is assumed that the “demise” of judicial intervention in arbitral proceedings is tantamount to *party-autonomy* in conformance with basic premises upon which the adversarial system rests. In fact, in tracing the borders of this development, it becomes clear that “intervention” itself is transformed into “assistance” and “cooperation” such that, instead of assuming a protagonist’s role in arbitration proceedings, courts shall undertake the more modest subordinated tasks of supporting arbitration proceedings with enforcement of arbitral awards.

<sup>3</sup> These badges of prejudice have been identified as: (i) the contention that arbitration ousts jurisdiction of otherwise courts having competent jurisdiction over parties and subject matter, (ii) the proposition that arbitration is ill-suited as a dispute resolution methodology for certain classes of federally enacted statutory causes of action aimed at protecting specific classes of prospective victims, (iii) the assertion that arbitration must be conducted under the auspices of courts, and (iv) the perception that arbitration lack the requisite training and skill set to adjudicate justice equitably with respect to complex and specialized subject matters.

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The doctrinal development of arbitration in the United States in large measure has sought to place arbitration at the same level as judicial proceedings. This effort, however, has been undertaken parallel to the transformation of arbitration agreements from the status of a second genre of a “binding”<sup>4</sup> contract to one equal in all respects to enforceable commercial contracts. This transformation required sustained analysis of four rudimentary questions.

First, as a matter of substantive federal arbitration law, is an arbitration provision severable from the remaining contract? Second, is a challenge to a contract containing an arbitration clause to be adjudicated by a judge or an arbitrator? Third, is there a federal substantive law created by the FAA? Fourth, is such a law applicable in state as well as federal courts? These four inquiries found final resolution on February 21, 2006,<sup>5</sup> but only after first having been identified, albeit embryonically, on June 12, 1967.<sup>6</sup>

The answers to these questions will in turn resolve the issue of “whether a court or an arbitrator should consider the claim that a contract containing an arbitration provision is void for illegality.”<sup>7</sup> Precisely, inquiries of this ilk highlight the virtually imperceptible cessation of sovereignty in minute but material transformation capable of finding a conceptual framework able to accommodate faster, and encourage permutations of this ilk. Unbeknownst to court, jurists, and practitioner at the time, this “evaluation” is an endemic part of a process conducive to a reconfiguration, if not altogether the evisceration, of the “modern state.” It is only after resolving this final issue that the answers to these four questions shall find their perfect working. Moreover, in addition to systematically addressing these four questions, the precept of *party-autonomy* implicitly, if not explicitly, had to play an important

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<sup>4</sup> The many exceptions to which arbitration agreements were submitted by judicial fiat by dint of the four propositions identified in the immediately preceding footnote alone, rendered it a euphemism to use the word “binding” in an arbitral context as it is used when discussing commercial contracts or judicial decrees. Because of the historical legacies of prejudice that nourished judicial skepticism for and rejection of arbitration as an alternative dispute resolution methodology, irrespective of any finding of wrongdoing or illicit activity attendant to an arbitration agreement, a court may simply render the arbitration clause unenforceable as a matter of “policy”, without more. This status identifies a quite unique space that provided judges with virtually unbridled discretion in adjudicating the propriety of an arbitration clause. Mere recourse to any of the four referenced propositions generated by historical prejudice and ignorance would have sufficed for voiding an otherwise perfectly enforceable arbitration contract.

<sup>5</sup> On this date the Supreme Court issued its landmark opinion in *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440 (2006).

<sup>6</sup> On this date the Supreme Court issued its opinion in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967).

<sup>7</sup> *Buckeye Check Cashing*, 546 U.S. at 442.

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role if the doctrinal development is to be internally consistent as well as harmonious with the common law framework predicated on an individualistic adversarial party paradigm. In this same vein, *party-autonomy* would be best integrated into any analysis, in party, by minimizing or redefining the role of judicial intervention in arbitral proceedings.

With respect to this last proposition, it has been assumed that without some degree of judicial cooperation or assistance, in contrast to “intervention”, arbitration proceedings simply would not be viable, *i.e.* could not exist. Accordingly, any doctrinal development of meaningful consequence to the elevation of arbitration to the same level as judicial proceedings and, consequently, or the rediscovery and reintroduction of the principle or *party-autonomy* as to the law and jurisprudence governing, configuring, and defining arbitration, would be conceptually necessary. Revisiting *Prima Paint* is an indispensable predicate to any analysis seeking to identify the doctrinal development that engrafts upon arbitration clauses – arbitration contracts – the same status as commercial contracts as a matter of law.

**B. Who Decides the Validity of a Contract Having an Arbitration Clause:  
Judge Or Arbitrator?**

The exact issue before the Court in *Prima Paint* was “whether the federal court[s] or an arbitrator is to resolve a claim of ‘fraud in the inducement,’ under a contract governed by the United States Arbitration Act of 1925, where there is no evidence that the contracting parties intended to withhold that issue from arbitration.”<sup>8</sup> The facts giving rise to this query are eloquent enough. Plaintiff, Prima Paint Co., filed an action in federal district court premised on a purchase agreement and a consulting agreement arising from its acquisition of defendant’s business and retention of defendant’s chairman in an advisory capacity. The complaint alleged, among other things, that defendant had “fraudulently represented that it was solvent and able to perform its contractual obligations, whereas it was in fact insolvent and intended to file a petition under Chapter XI of the Bankruptcy Act, 52 Stat. 905, 11 U.S.C. § 701 et seq., shortly after execution of the consulting agreement.”<sup>9</sup>

Simultaneously with the filing of its complaint, Prima Paint Co. moved the Court for issuance of an order enjoining defendant from proceeding with arbitration.<sup>10</sup> Defendant cross-moved to stay the district court action pending conclusion of all arbitral labor under the theory “that the issue presented –

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<sup>8</sup> *Prima Paint*, 388 U.S. at 396.

<sup>9</sup> *Id.* at 398.

<sup>10</sup> *Id.* at 399.

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whether there was fraud in the inducement of the consulting agreement – was a question for the arbitrators and not for the District Court.”<sup>11</sup> Defendant’s motion to stay the legal proceeding pending arbitration was granted, and the Court held “that a charge of fraud in the inducement of a contract containing an arbitration clause as broad as this one<sup>12</sup> was a question for the arbitrators and not for the court.”<sup>13</sup> An appeal ensued to the Second Circuit, which dismissed Prima Paint’s petition, holding that:

the contract in question evidenced a transaction involving interstate commerce; that under the controlling *Robert Lawrence Co.* decision a claim of fraud in the inducement of the contract generally – as opposed to the arbitration clause itself – is for the arbitrators and not for the courts; and that this rule – one of “national substantive law” – governs even in the face of a contrary state rule.<sup>14</sup>

The Supreme Court affirmed the Second Circuit’s ruling.<sup>15</sup>

At the outset of a three-prong analysis, the Supreme Court held that the consulting agreement between plaintiff, Prima Paint, Co., and defendant squarely fell within the realm of contracts specified in Sections 1 and 2 of the FAA and, therefore, provided a legal foundation for invoking the stay provision of Section 3.<sup>16</sup> The Court further underscored that plaintiff had “acquired a

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

<sup>12</sup> The clause at issue read: “Any controversy or claim arising out of or relating to this Agreement, or the breach thereof, shall be settled by arbitration in the City of New York, in accordance with the rules then obtaining of the American Arbitration Association...” *Id.* at 398.

<sup>13</sup> *Id.* at 399. The district court found analytical support for this proposition in *Robert Lawrence Co. v. Devonshire Fabric, Inc.*, 271 F.2d 402 (2d Cir. 1959), *cert. granted*, 362 U.S. 909, *appeal dismissed*, 364 U.S. 801 (1960).

<sup>14</sup> *Id.* at 399-400.

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

<sup>16</sup> *Id.* at 401. 9 U.S.C. §§ 1-3 (1976) reads:

§ 1. “Maritime transactions” and “commerce” defined; exceptions to operation of title

“Maritime transactions”, as herein defined, means charter parties, bills of lading of water carriers, agreements relating to wharfage, supplies furnished vessels or repairs to vessels, collisions, or any other matters in foreign commerce which, if the subject of controversy, would be embraced within admiralty jurisdiction; “commerce”, as herein defined, means commerce among the several States or with foreign nations, or in any Territory of the United States or in the District of Columbia, or between any such Territory and another, or between any Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation,

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New Jersey paint business serving at least 175 wholesale clients in a number of States, and secured F & C's [defendant's] assistance in arranging the transfer of manufacturing and selling operations from New Jersey to Maryland."<sup>17</sup> Thus, it concluded that "[t]here could not be a clearer case of a contract evidencing a transaction in interstate commerce."<sup>18</sup>

Second, the Court resolved a split of authority among the circuits on the narrow and specific questions of whether a claim of fraud in the inducement of a contract containing an arbitration clause is to be adjudicated by a federal court or referred to arbitration.<sup>19</sup>

Even though the Supreme Court observed and stressed that, pursuant to

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but nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.

§ 2. Validity, irrevocability, and enforcement of agreements to arbitrate

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

§ 3. Stay of proceedings where issue therein referable to arbitration

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

<sup>17</sup> *Prima Paint*, 388 U.S. at 401.

<sup>18</sup> *Id.*

<sup>19</sup> On this issue the Second Circuit Court of Appeals holds that pursuant to federal law arbitration clauses are "separable" from the contract of which they form a part and, consequently, absent a claim that the fraud at issue was specifically directed to the arbitration clause itself, a broad arbitration clause shall be found to encompass arbitration of the averment that the contract itself was induced by fraud. *See, e.g.,* *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 410 (2d Cir. 1959); *In Re Kinosita & Co.*, 287 F.2d 951, 953 (2d Cir. 1961). In stark contrast, the First Circuit Court of Appeals had repeatedly held that the issue of "severability" must be governed by state law. The argument thus says that where a state deems such a clause as inseparable from the corpus of the contract, a claim for fraud in the inducement *must* be adjudicated by court of competent jurisdiction. *See, e.g.,* *Lummus Co. v. Commonwealth Oil Ref. Co.*, 280 F.2d 915, 924 (1st Cir.), *cert. denied*, 364 U.S. 911 (1960). Accordingly the issue of arbitration in federal court, or, stated otherwise, the standing of an arbitration agreement with respect to any other enforceable contract, remained less than clear.

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a plain language analysis, the FAA's statutory language does not expressly and necessarily provide federal courts with authority to adjudicate fraud in the inducement claims, Section 4 plainly does not relate to or contemplate scenarios where a stay of a federal proceeding is petitioned in deference to an arbitral proceeding.<sup>20</sup> The Court, however, enunciated that it would be

inconceivable that Congress intended the rule to differ depending upon which party to the arbitration agreement first invokes the assistance of a federal court. We hold, therefore, that in passing upon a § 3 application for a stay while the parties arbitrate, a federal court may consider only issues

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<sup>20</sup> 9 U.S.C. § 4 (1976). The statute reads:

§ 4. Failure to arbitrate under agreement; petition to United States Court Having

Jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination.

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. Five days' notice in writing of such application shall be served upon the party in default. Service thereof shall be made in the manner provided by the Federal Rules of Civil Procedure. The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. The hearing and proceedings, under such agreement, shall be within the district in which the petition for an order directing such arbitration is filed. If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, or if the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such an issue is raised, the party alleged to be in default may, except in cases of admiralty, on or before the return day of the notice of application, demand a jury trial of such issue, and upon such demand the court shall make an order referring the issue or issues to a jury in the manner provided by the Federal Rules of Civil Procedure, or may specially call a jury for that purpose. If the jury finds that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury find that an agreement for arbitration was made in writing and that there is a default in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof.

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relating to the making and performance of the agreement to arbitrate. In so concluding, we not only honor the plain meaning of the statute but also the unmistakably clear congressional purpose that the arbitration procedure, when selected by the parties to a contract, be speedy and not subject to delay and obstruction in the courts.<sup>21</sup>

The fourth and final tenet upon which the decision rests relates to the question of whether a federal court's issuance of a stay in deference of an arbitral proceeding, notwithstanding a contrary state rule, is constitutional. This inquiry was answered in the affirmative.<sup>22</sup> After reviewing the mandate in venerable chestnuts such as *Erie R. Co. v. Tompkins*,<sup>23</sup> and *Guaranty Trust Co. v. York*,<sup>24</sup> the Court predicated its affirmance of the rule's constitutionality on a thoughtful and eloquent exegesis of the legislative intent and jurisprudence construing the Act.<sup>25</sup>

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<sup>21</sup> *Prima Paint*, 388 U.S. at 404. 9 U.S.C. § 4 (1976), in pertinent part, reads:

The court shall hear the parties, and upon being satisfied that the making of the argument for arbitration for the failure to comply therewith is not an issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. If the making of the arbitration agreement or the failure, neglect or refusal to perform the same be an issue, the court shall proceed summarily to the trial thereof.

<sup>22</sup> *Prima Paint*, 388 U.S. at 405.

<sup>23</sup> *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938).

<sup>24</sup> *Guaranty Trust Co. v. York*, 326 U.S. 99 (1945).

<sup>25</sup> This jurisprudential analysis compels citation in its entirety:

It is true that the Arbitration Act was passed 13 years before this Court's decision in *Erie R. Co. v. Thomkins*, *supra*, brought to an end the regime of *Swift v. Tyson*, 16 Pet. 1 (1842), and that at the time of enactment Congress had reason to believe that it still had power to create federal rules to govern questions of "general law" arising in simple diversity cases -- at least, absent any state statute to the contrary. If Congress relied at all on this "oft challenged" power, see *Erie R. Co.*, 304 U.S. at 69, it was only supplementary to the admiralty and commerce powers, which formed the principle bases of the legislation. Indeed, Congressman Graham, the bill's sponsor in the House, told his colleagues that it "only affects contracts relating to interstate subjects and contracts in admiralty." 65 Cong. Rec. 1931 (1924). The Senate Report on this legislation similarly indicated that the bill "[relates] to maritime transactions and to contracts in interstate and foreign commerce." S. Rep. No. 536, 68th Cong., 1st Sess., 3 (1924).

Non-congressional sponsors of the legislation agreed. As Mr. Charles L. Bernheimer, chairman of the Arbitration Committee of the New York Chamber of Commerce, told the Senate subcommittee, the proposed legislation "follows the lines of the New York arbitration law, applying it to

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## II. THE COMMERCE CLAUSE AS THE NORMATIVE BASIS FOR THE FEDERAL ARBITRATION ACT

**A. *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.* (1983):  
Defining a Concept as a Predicate to the Normative Elevations of  
International Commercial Arbitration**

While *Prima Paint* stands, in part, for the unquestioned proposition that the Federal Arbitration Act finds its genesis and normative foundation in the Commerce Clause, the opinion only suggests that the substantive rules of the FAA are to apply in state as well as in federal proceedings. Consequently, despite implicitly asserting the extraordinary proposition that the Federal Arbitration Act gives rise to a *corpus* of federal substantive law applicable in state and federal fora, this doctrinal development did not attain “explicit status” until 1983, pursuant to the Supreme Court’s command in *Moses H. Cone Memorial Hospital v. Mercury Construction Corporation*.<sup>26</sup>

The procedural configuration in *Moses H. Cone* is now eminently predicable. The district court stayed the proceeding pending resolution of a concurrent state court case pursuant to an order to compel arbitration, which

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the fields wherein there is Federal jurisdiction. These fields are in admiralty and in foreign and interstate commerce.” Hearing on S. 4213 and S. 4214, before the Subcommittee of the Senate Committee on the Judiciary, 67th Cong., 4th Sess., 2 (1923). In the joint House and Senate hearings, Mr. Bernheimer answered “Yes; entirely,” to the statement of the chairman, Senator Sterling, that “What you have in mind is that this proposed legislation relates to contracts arising in interstate commerce.” Joint Hearings on S. 1005 and H. R. 646 before the Subcommittees of the Committees on the Judiciary, 68th Cong., 1st Sess., 7 (1924). Mr. Julius Henry Cohen, draftsman for the American Bar Association of the proposed bill, said the sponsor’s goals were: “First... to get a State statute, and then to get a Federal law to cover interstate and foreign commerce and admiralty, and, third, to get a treaty with foreign countries.” Joint Hearings, *supra*, at 16 (emphasis added). See also Joint Hearings, *supra*, at 27-28 (statement of Mr. Alexander Rose). Mr. Cohen did submit a brief to the Subcommittee urging a jurisdictional base broader than the commerce and admiralty powers, Joint Hearings, *supra*, at 37-38, but there is no indication in the statute or in the legislative history that this invitation to go beyond those powers was accepted, and his own testimony took a much narrower track.

*Prima Paint*, 388 U.S. at 405 n.13.

<sup>26</sup> *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-26 (1983).

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initiated the entire proceeding.<sup>27</sup> The Supreme Court held that the lower court indeed had abused its discretion because there were no indicia of exceptional circumstances warranting issuance of a stay.<sup>28</sup> In furtherance of its ruling, the Court observed that “the presence of federal-law issues” pursuant to the Federal Arbitration Act was “a major consideration weighing against surrender [of federal jurisdiction].”<sup>29</sup> Consequently, it construed the underlying issue of arbitrability as an inquiry of substantive federal law, “federal law in the terms of the Arbitration Act governs that issue in either state or federal court.”<sup>30</sup>

Both *Prima Paint* and *Moses H. Cone* illustrate a material doctrinal development that is often undermined, if not altogether ignored, by the broader issue concerning the elevation of arbitration to a state of equal status with judicial proceedings and the issue of arbitrability within federal purview. This predicate and essential transformation of arbitration agreements entails their theoretical development such that they may enjoy equal hierarchy with other forms of binding and enforceable contractual arrangements in the pantheon of U.S. jurisprudence. Hence, *Moses H. Cone*, decided sixteen years after *Prima Paint*, renders explicit what was contained only implicitly in the Court’s earlier mandate, *i.e.* irrespective of state law considerations, a federal court is empowered to issue a stay in favor of having matters adjudicated pursuant to arbitration and not in the context of court proceedings because the Federal Arbitration Act governs the question of arbitrability in either state or federal fora.

To be sure, while the legislative history is far from being opaque, it is also less than clear on the issue of rendering arbitration agreements enforceable beyond just the federal arena. The House Report may be suggestive of more universal objectives: “[t]he purpose of this bill is to make valid and enforceable agreements for arbitration contained in contracts involving interstate commerce or within the jurisdiction or admiralty, or which may be the subject of litigation in the Federal courts.”<sup>31</sup>

The Supreme Court itself has recognized that “[t]his broader purpose can also be inferred from the reality that Congress would be less likely to address a problem whose impact was confined to federal courts than a problem of large significance in the field of commerce.”<sup>32</sup> The Arbitration Act sought to “overcome the rule of equity, that equity will not specifically enforce any

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<sup>27</sup> *Id.* at 7.

<sup>28</sup> *Id.* at 19.

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

<sup>30</sup> *Id.* at 24.

<sup>31</sup> H.R. REP. No. 68-96, at 1 (1924).

<sup>32</sup> *Southland Corporation v. Keating*, 465 U.S. 1, 13 (1984).

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arbitration agreement.”<sup>33</sup> It is demonstrable that by 1984, it was finally meaningfully identified in the jurisprudence that part of the FAA’s goal was to ensure parties to an arbitration agreement touching upon interstate commerce that neither federal courts, state courts, nor legislatures would frustrate their expectations.<sup>34</sup> In addition, it was also rendered plain that Congress had been struggling with three rudimentary and, therefore, obstinate problems in fostering the development of arbitration. First, the prejudicial historical legacy of English courts requiring that arbitration proceedings be conducted under the auspices of courts, and that arbitration generally, as a conceptual matter, was somehow against public policy because it “ousted” jurisdiction from courts that otherwise enjoyed competent jurisdiction, weighed heavily on the national collective judicial consciousness. Historical baggage, like old habits, apparently is proverbially hard to abandon.

Second, nationally grown prejudices directed at arbitral proceedings were no less pernicious. The unchallenged precepts that arbitration was ill-suited for the administration of justice arising from certain statutorily created rights as well as the view that arbitrators (together with the arbitral process itself) lacked competence to process complex commercial disputes of a domestic or international nature, certainly hampered legislative efforts to accord arbitration its rightful place as an alternative dispute resolution methodology.<sup>35</sup>

Third, Congress had to identify and confront the problem arising from state arbitration statutes that fail to mandate enforcement of arbitral agreements. The result of these three sectors of influence was a restricted and restrictive reading of the Act that necessarily would limit the Act’s scope to arbitrations only sought to be enforced in federal tribunals. Such a reading “would frustrate Congressional intent.”<sup>36</sup>

While *Prima Paint* does resolve the inquiry as to whether a federal court or an arbitrator is to adjudicate a claim of fraud in the inducement directed at a contract governed by the FAA absent evidence that the contracting parties intended to segregate that issue from arbitration, it leaves open the question of whether the FAA preempts state legislation that directly and explicitly conflicts

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<sup>33</sup> *Id.* (citing *Hearing on S.4214 Before a Subcomm. of the Senate Comm. on the Judiciary*, 67th Cong. (1923) (remarks of Sen. Walsh). The Court went on to cite the House Report attendant to the bill that stated: “[t]he need for the law arises from... the jealousy of the English courts for their own jurisdiction.... This jealousy survived for so lon[g] a period that the principle became firmly embedded in the English common law and was adopted with it by the American courts. The courts have felt that the precedent was too strongly fixed to be overturned without legislative enactment.” *Id.* (citing H.R. REP. No. 96, at 1-2 (1924)).

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

<sup>35</sup> See *Prima Paint*, 388 U.S. at 412-16.

<sup>36</sup> *Southland Corp.*, 465 U.S. at 15-16.

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with FAA strictures by directing parties to the statutory causes of action in state court.<sup>37</sup> The resolution of this federal preemption issue is an essential condition precedent to the juridic elevation of arbitration agreements to the same level as that enjoyed by commercial contracts. In addition, the resolution of this issue in favor of federal preemption highlights and underscores anew the critical role of the precepts of *party-autonomy*, even though this principle is not explicitly referenced in *any* of the Supreme Court authority that ultimately answer the four questions<sup>38</sup> addressed by the *Prima Paint*, *Southland*, and *Buckeye*, trilogy. It is asserted that the *de facto* consequence of this tripartite development constitutes an extraordinary juridic evolution that, when analyzed through the prism of globalization generally, and economic globalization in particular, is compounded and multiplied as it represents a meaningful contribution to the redefining of the classical paradigm of the judiciary and, therefore, of traditional statehood sovereignty.

**B. *Southland Corporation v. Keating* (1984)**

The FAA's preemption over state legislation rendered it judicially impossible for parties to an arbitration agreement to arbitrate state statutory claims where the statute at issue prescribes judicial resolution to disputes based on the specific statutory rubric. This concern was addressed by the Supreme Court in *Southland Corporation v. Keating*.<sup>39</sup>

There, the Supreme Court observed that it has "probable jurisdiction to consider (a) whether the California Franchise Investment Law, which invalidates certain arbitration agreements covered by the Federal Arbitration Act, violates the Supremacy Clause and (b) whether arbitration under the Federal Act is impaired when a class action structure is imposed on the process by the state courts."<sup>40</sup> The case reached the Court following a ruling from the California Supreme Court, by a vote of 4-2, which reversed a holding that claims asserted under the Franchise Investment Law are indeed arbitrable. The California Supreme Court construed the Franchise Investment Law as requiring "judicial consideration of claims brought under the statute and concluded that

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<sup>37</sup> See *Prima Paint*, 388 U.S. at 410-11

<sup>38</sup> The four questions are the following: (i) as a matter of substantive federal arbitration law, is an arbitration provision severable from the remaining contract? (ii) is a challenged to a contract containing an arbitration clause to be adjudicated by a judge or an arbitrator? (iii) is there a federal substantive law created by the FAA? (iv) is such a law applicable in state as well as federal courts?

<sup>39</sup> *Southland Corp.*, 465 U.S. at 1.

<sup>40</sup> *Id.* at 4.

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the California statute did not contravene the Federal Act.”<sup>41</sup> The Supreme Court held that Section 31512 of the California Franchise Investment Law violates the Supremacy Clause.<sup>42</sup> Moreover, it also held that “[t]he judgment of the California Supreme Court denying enforcement of the arbitration agreement is reversed”.<sup>43</sup> The reversal was predicated on four fundamental propositions.

First, it was observed that the California Court’s judgment had the plain effect of nullifying a valid and enforceable contract requiring arbitration.<sup>44</sup> Therefore, the ruling explicitly conflicts with the FAA by allowing “parties to an arbitrable dispute [to move] out of court and into arbitration as quickly and easily as possible.”<sup>45</sup> In this regard, it was emphasized that “[c]ontracts to arbitrate are not to be avoided by allowing one party to ignore the contract and resort to the courts.”<sup>46</sup> The court further added that “[s]uch a course could lead to prolonged litigation, one of the very risks the parties, by contracting for arbitration, sought to eliminate.”<sup>47</sup> Significantly, analytical support for this rationale is plainly grounded on the precept of *party-autonomy*. The parties’ will in electing to resolve disputes pursuant to an arbitral proceeding as clearly embodied in an arbitration clause negotiated at arm’s-length is highlighted with particularity in the Court’s analysis. In fact, direct reference is made to the *Bremen v. Zapata* analysis where, as discussed, the Court observed “that [a] contract fixing a particular forum for resolution of all disputes” was made in an arm’s-length negotiation by experienced and sophisticated businessmen, and absent some compelling and countervailing reason it should be honored by the parties and enforced by the Courts.”<sup>48</sup> The emphasis on party initiative and the deemphasized role of courts in an arbitral context marks an analytical turning point.

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<sup>41</sup> *Id.* at 2.

<sup>42</sup> *Id.* at 16.

<sup>43</sup> *Id.* at 17.

<sup>44</sup> *Id.* at 7.

<sup>45</sup> *Id.* (citing *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983)).

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

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* (citing *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 14 (1972)). Here the Supreme Court also stressed that in *Zapata* it deemed an arbitration clause to be a special kind of forum selection clause. While this proposition is plagued with conceptual difficulties that distort the nature of both arbitration and judicial proceedings, those issues do not detract from the Court’s explicit, although not articulated, return to *party-autonomy* as a conceptual fulcrum to be used in according arbitration the same hierarchy as judicial proceedings and arbitration contracts the same judicial integrity as commercial contracts. It is also important to note that by 1984, one year before its seminal decision in *Mitsubishi*, the Court no longer finds it necessary to engage in a protracted recitation of the four badges of prejudice that nourished judicial contempt for arbitration, even though it does refer to the “old common law hostility toward arbitration”. *Id.* at 13.

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Second, the California Supreme Court's construction of the Franchise Investment Law<sup>49</sup> placed that legislation in direct and explicit conflict with Section 2 of the Federal Arbitration Act. Thus, the Court found that the Franchise Investment Law "violate[d] the supremacy clause."<sup>50</sup> After asserting that in enacting Section 2 of the FAA Congress was instituting a national policy favoring arbitration and divesting states from legislatively requiring dispute resolution pursuant to judicial proceeding,<sup>51</sup> the Court discerned only two

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<sup>49</sup> The California Franchise Investment Law states: "Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void." Cal. Corp. Code § 31512 (West 1977).

<sup>50</sup> *Southland Corp.*, 465 U.S. at 1.

<sup>51</sup> This proposition has elicited as much controversy as Justice Burger's majority opinion holding that the FAA was intended to apply to state court proceedings as well as federal cases. *See id.* at 10-16. Justice Thomas and O'Connor have vigorously criticized the opinion and perhaps it is precise to state that most scholars agree that the FAA's legislative history does not contain any explicit language supporting this proposition. In fact, some scholars argue that "[t]he structure of the [FAA] reveals an unquestionably integrated, unitary statute, consisting of core provisions and provisions supplementing them." IAN R. MACNEIL, *AMERICA ARBITRATION LAW: REFORMATION, NATURALIZATION, INTERNALIZATION* 105-06 (1992). Professor MacNeil also asserts that the FAA was designated to apply only to federal courts, i.e. one jurisdiction, based upon his own exegesis drawn from the historical fact that the FAA was patterned after the New York arbitration law. *See id.* In a very thoughtful article by Christopher R. Drahozal, entitled *In Defense of Southland: Reexamining the Legislative History of the Federal Arbitration Act*, Mr. Drahozal disagrees with Professor MacNeil's conclusion that "[a]ny reading of the [FAA] leading to substantive and procedural parts with differing applicability creates a monstrosity found nowhere else in the world of American arbitration." MACNEIL, *supra*, at 107. Mr. Drahozal argues that:

As the above description of the FAA demonstrates, the language of the Act supports construing section 2 to apply more broadly than the rest of the Act. Section 2 alone by its terms applies to maritime transactions and transactions in interstate commerce, which could cover proceedings both in federal and state court. The rest of the Act creates procedures applicable only in federal court. I do not suggest that the language of the Act requires this interpretation, but it certainly is a plausible one.

Moreover, the fact that the FAA is based on New York arbitration law--which does not bind courts other than New York courts--does not show that the FAA likewise applies only in a single jurisdiction. MacNeil disregards a key distinction between the New York arbitration law and the FAA: the drafters of the FAA inserted the phrase, "maritime transactions and contracts evidencing a transaction involving commerce", into section 2. Obviously, no such jurisdictional nexus was present in the original New York law. Plainly, the drafters of the FAA knew that they were drafting a statute for a federal system, in which federal law is supreme over state law. Their use of the New York model does not demonstrate that section 2 is limited to a single jurisdiction, i.e., federal court. Finally, it is not surprising that there is no similar statute elsewhere in American arbitration law, since the FAA was designed to be enacted by the national government in a federal system, while

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limitations governing the enforceability of arbitration pursuant to the Federal Arbitration Act. First, the provisions of the FAA “must be part of the written maritime contract or a contract ‘evidencing a transaction involving commerce.’”<sup>52</sup> Second, such a clause only may be revoked upon “grounds as exist at law or in equity for the revocation of any contract.”<sup>53</sup> Obviously, neither limitation proscribes applicability to state courts, so the argument says.

Third, borrowing from its *Prima Paint* opinion entered seventeen years earlier, the Court observed that its prior construction of the FAA’s legislative history led it to conclude that the statute “is based upon and confined to the incontestable federal foundations of ‘control over interstate commerce and over admiralty.’”<sup>54</sup> Thus, the Court amplifies its reasoning by observing that Congressional commerce clause authority has a long-standing juridic history of having been deemed plenary.<sup>55</sup> After establishing, at least to its satisfaction, this minor premise, the majority concludes that because the Arbitration Act “was an exercise of the Commerce Clause power clearly implied that the substantive rules of the Act were to apply in state as well as federal courts.”<sup>56</sup>

Thus, at this juncture, in reversing the California Supreme Court’s ruling, the Court has construed the FAA (i) as having substantive *and* procedural provisions,<sup>57</sup> (ii) where the substantive provisions apply to *both* federal and state courts, and (iii) as encompassing only two limitations on the enforceability provisions: (a) the provision must be part of a written maritime contract or a contract concerning a transaction that touches and concerns commerce, (b) the clause would be susceptible to revocation based on extant legal principles or equitable principles applicable to all contracts.<sup>58</sup>

The opinion candidly acknowledges that “[a]lthough the legislative

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other arbitration laws are enacted by the states.

Christopher R. Drahozal, *In Defense of Southland: Reexamining the Legislative History of the Federal Arbitration Act*, 78 NOTRE DAME L. REV. 101, 124-25 (2002).

<sup>52</sup> *Southland Corp.*, 465 U.S. at 11.

<sup>53</sup> *Id.* at 10.

<sup>54</sup> *Prima Paint Corp. v. Flood & Conklin Mfg. Corp.*, 388 U.S. 395, 405 (1967) (quoting H.R. REP. No. 96, at 1 (1924).

<sup>55</sup> *Southland Corp.*, 465 U.S. at 11-12 (citing *Gibbons v. Ogden*, 22 U.S. 1, 196 (1824) (Marshall, C.J.)).

<sup>56</sup> *Id.*

<sup>57</sup> Based on this analysis, federal courts, for example, on the issue of punitive damages, hold that an arbitral tribunal’s award granting punitive damages preempts state law or policy otherwise proscribing such awards. *See e.g.*, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995); *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989) (holding that arbitration award entered pursuant to AAA rules allowing for punitive damages was proper); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1062 (9th Cir. 1991) (same).

<sup>58</sup> *See generally Prima Paint Corp. v. Flood & Conklin Mfg., Co.*, 388 U.S. 395 (1967).

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history is not without ambiguities, there are strong indications that Congress had in mind something more than making arbitration agreements enforceable only in the federal courts.”<sup>59</sup> The House Report plainly suggests the more comprehensive objectives:

The purpose of this bill is to make valid and enforceable agreements for arbitration contained in *contracts involving interstate commerce* or within the jurisdiction or admiralty, *or* which may be the subject of litigation in the Federal courts.<sup>60</sup>

Critical to the majority opinion is the ability to broaden the Act’s scope and purpose, which it derives from the proposition “that Congress would be less likely to address a problem whose impact was confined to federal courts than a problem of large significance in the field of commerce.”<sup>61</sup> Thus, the Court added that “[t]he Arbitration Act sought to ‘overcome the rule of equity, that equity will not specifically enforce any arbitration agreement.’”<sup>62</sup> The struggle to find a predicate on which to ground Congressional intent justifying a broader scope and purpose for application of the Act is certainly a debility that pervades the opinion and that has spawned the referenced criticism.<sup>63</sup> Indeed, perhaps too much ink has been spilled on this issue. Although academically intriguing, it hardly warrants a probing or cunning analysis aspiring to questioning the need for the amplified construction. To be sure, while the majority is not persuasive in its analysis, it is devastatingly so in its conclusion.<sup>64</sup> Put simply, the “broader

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<sup>59</sup> *Southland Corp.*, 465 U.S. at 12.

<sup>60</sup> *Southland Corp.*, 465 U.S. at 12 (citing H.R. REP. No. 68-96 (1924)).

<sup>61</sup> *Id.* at 13.

<sup>62</sup> *Id.* (citing Hearing on S. 4214 Before Subcomm. Of the Senate Comm. on the Judiciary, 67th Cong., 4th Sess. 6 (1923) [hereinafter “Senate Hearing”]; H.R. REP. No. 96-68, at 1-2 (1924)) (“[T]he need for the law arises from...the jealousy of the English courts for their own jurisdiction . . . [t]his jealousy survived for so lon[g] a period that the principle became firmly embedded in the English common law and was adopted with it by the American courts. The courts have felt that the precedent was too strongly fixed to be overturned without legislative enactment . . .”).

<sup>63</sup> *See id.* at 10-16.

<sup>64</sup> This opinion is well articulated by Mr. Drahozal. He eloquently states:

I agree that the Chief Justice's opinion failed persuasively to make the case that the FAA applies in state court. But the Chief Justice nonetheless reached the correct conclusion: “[a]lthough the legislative history is not without ambiguities, there are strong indications that Congress had in mind something more than making arbitration agreements enforceable only in the federal courts.” [FN376] A reexamination of the FAA's legislative history reveals that while the “primary purpose” of the FAA was to make arbitration

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purpose” of the Act that the majority gleans from the legislative history and statutory constructions that lead to greater coherence and uniformity in both analysis and application, merits serious consideration.

Fifth, Justice O’Connor’s quite viable contention that Congress understood the FAA “as a procedural statute, applicable only in federal courts”,<sup>65</sup> is frontally addressed by referencing the opinion’s ever present war horse, contracts “involving commerce,” as an express limitation to be read together with the limitation that would arise had Congress called on the Commerce Clause to evidence the Act’s state court application but then find itself limited only to transactions involving interstate commerce.<sup>66</sup>

The Court reasoned that the anomaly in Justice O’Connor’s construction of the Act, causing claims brought pursuant to the California Franchise Investment Law in state court to be non-arbitrable, cannot be reconciled with the proposition that if such a claim were brought in a federal district court with subject matter premised on diversity jurisdiction, “the arbitration clause would have been enforceable.”<sup>67</sup>

Perhaps most persuasive is the proposition that it would be odd, if not altogether ill-conceived, to ascribe to Congress “the intent, in drawing on the comprehensive powers of the Commerce Clause, to create a *right* to enforce an arbitration contract and yet make the right dependent for its enforcement on the particular forum in which it is asserted.”<sup>68</sup> This argument is bolstered, particularly when considering the Act’s presumably broader scope, by the perplexing statistics establishing that the overwhelming number of civil

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agreements enforceable in federal court, a secondary purpose was to make arbitration agreements enforceable in state court. A contemporaneous commentator, overlooked by the critics, sums it up well: “[t]he act is broad enough to apply to actions commenced in state courts as well as to those instituted in federal courts, and it was so intended by those who drafted it.” While ambiguities in the legislative history remain, this interpretation of the legislative history results in fewer ambiguities than the prevailing interpretation.

Drahozal, *supra*, at 169-70 (citation omitted). Even though it far from clarifies any ambiguity in the legislative history, there is merit in the Court’s observation that Congress faced two problems: “the old common law hostility toward arbitration, and the failure of state arbitration statutes to mandate enforcement of arbitration agreements.” *Southland Corp.*, 465 U.S. at 14.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 14-15.

<sup>67</sup> *Id.* at 15. The Court found the arbitration clause to encompass claims under the California Franchise Investment Law. *Id.* The clause, in pertinent part, reads: “Any controversy or claim arising out of or relating to this Agreement or the breach hereof,” appears broad and general enough to include the statutory cause of action.

<sup>68</sup> *Id.* (emphasis added).

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litigation cases filed in the United States rest in state courts. Here, the Court, naturally limited to the date on which the opinion issued in 1984, identified rather astonishing statistics. Only two percent (2%) of all civil litigation in the United States is filed in federal courts.<sup>69</sup> Two hundred and six thousand (206,000) filings were recorded during a twelve month window ending on June 30, 1982, excluding bankruptcy cases, in federal courts.<sup>70</sup>

The most salient single proposition in *Southland* is the assertion that in fashioning substantive provisions forming part of the FAA, these provisions are applicable both to state and federal courts, and, therefore, wrest from state legislatures the ability to undermine or otherwise circumvent the Federal Arbitration Act.<sup>71</sup> While even today the debates arising from the Act's legislative history remain as relevant as ever, and, similarly, as never ending rich material for scholastic analyses, the conclusion is powerful and compelling. It is a tortured reading of the FAA to limit its application only to the realm of federal jurisdiction. Such a construction surely would carve out from the Act its effectiveness, particularly in light of the staggering state court filings when compared to federal court proceedings initiated during a comparable time frame. It would also, as the Court to some extent articulated or tried to articulate, condition a right on the forum on which it is filed. Lastly, the hypothetical that the majority opinion crafted concerning a federal court sitting in diversity where the parties have executed an arbitration agreement that constitutes the subject matter of the federal court filing is certainly illustrative and represents an aberration to the precepts that Justice O'Connor proposed.<sup>72</sup>

*Prima Paint* and *Southland* answer the four questions previously posed. First, as a matter of substantive federal arbitration law, an arbitration provision is severable from the remaining contract. Second, a challenge to a contract containing an arbitration clause, at first instance, is to be adjudicated by an arbitrator so long as the challenge is not directed at the arbitration clause itself. Third, the FAA does create a substantive federal law having a normative basis in the Commerce Clause. Fourth, the substantive law provisions of the FAA are applicable to both state and federal fora.

Incident to this time frame was virtually a vertical increase in international commercial arbitration.<sup>73</sup> Thus, the stage was poised for the Court

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<sup>69</sup> *Id.* at 15, n.8 (citing Administrative Office of the United States Court, Annual Report of the Director 3 (1982)).

<sup>70</sup> *Id.*

<sup>71</sup> *Southland Corp.*, 465 U.S. at 11.

<sup>72</sup> *Id.* at 15-16.

<sup>73</sup> Catherine A. Rogers, *Emerging Dilemmas in International Economic Arbitration: The Vocation of the International Arbitrator*, 20 AM. U. INT'L L. REV. 957, 965 (2005).

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to sharpen and amplify the doctrinal development that it had initiated with *Prima Paint* and continued in *Southland*. An important permutation of the issues addressed in those two cases is “whether a court or an arbitrator should consider the claim that a contract containing an arbitration provision is void for illegality.”<sup>74</sup> The Court’s analysis and opinion highlight a conceptual refinement of the issues first addressed in *Prima Paint* and redefines the role of judicial intervention in arbitral proceedings as well as the meaningful return to *party-autonomy* as a guiding principle in common law jurisprudence as well as the law of arbitration. It is precisely this return to party-autonomy, to the private sphere of the individual and not the state, that should be understood as the very embryonic development leading to the transformation of the role of the judiciary in international affairs and, ultimately, to a radical change in the traditional meaning and rise of the principle of national sovereignty.

**C. Relinquishing Sovereignty in Favor of Arbitration:  
*Buckeye Check Cashing, Inc. v. Cardegna* (2006)**

*Buckeye* is a procedural rosary of reversals. Here respondent filed a putative class action in Florida state court averring that petitioner “charged usurious interest rates and that the Agreement violated various Florida lending and consumer-protection laws, rendering it criminal on its face.”<sup>75</sup> The trial court denied petitioner’s subsequent motion to stay or dismiss the state court proceeding in favor of arbitration.<sup>76</sup> In denying petitioner’s motion, the court held that a judicial tribunal, rather than an arbitration panel, as a matter of law should adjudicate the specific and narrow issue of whether the contract is illegal and void *ab initio*.<sup>77</sup>

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<sup>74</sup> *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 442 (2006).

<sup>75</sup> *Id.* at 443.

<sup>76</sup> *Id.* The contract at issue contained an arbitration clause providing that:

2. *Arbitration Provisions.* Any plain, dispute, or controversy...arising from or relating to this Agreement...or the validity, enforceability, or scope of this Arbitration Provision or the entire Agreement (collectively “Claim”), shall be resolved, upon the election of you or us or said third-parties, by binding arbitration.... This arbitration Agreement is made pursuant to a transaction involving interstate commerce, and shall be governed by the Federal Arbitration Act (“F.A.A.”), 9 U.S.C. Sections 1-16. The arbitrator shall apply applicable substantive law constraint [*sic*] with the FAA and applicable statu[t]es of limitations and shall honor claims of privilege recognized by law. . . .

*Id.* at 442-43.

<sup>77</sup> *Id.* at 443.

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Florida's Fourth District Court of Appeal reversed the trial court ruling on the theory that respondents failed to challenge the arbitration provision itself at the trial court level and instead elected to aver that the contract in its entirety was void, the agreement to arbitrate was enforceable, and the issue concerning the contract's legal viability should be determined by an arbitrator.<sup>78</sup>

On appeal the Florida Supreme Court, which reversed the Fourth District Court of Appeal, embraced the premise that enforcement of an arbitral agreement in a contract challenged as unlawful "could breathe life into a contract that not only violates state law, but also is criminal in nature, by use of an arbitration provision."<sup>79</sup>

The two reversals (the Fourth District Court of Appeals revising the trial court, and the Florida Supreme Court reversing the Fourth District Court of Appeal) were followed by the Supreme Court's reversal of the Florida Supreme Court on the narrow question of "whether a court or an arbitrator should consider the claim that a contract containing an arbitration provision is void for illegality."<sup>80</sup>

Providing an arbitration agreement, *i.e.*, an arbitration clause, with the *same* juridic hierarchy as a commercial contract is a predicate for discerning between two different challenges requiring disparate analyses and attendant conclusions. First, the Court adjudicated a challenge to the validity of the arbitration clause or the agreement to arbitrate, as was the case in *Southland*.<sup>81</sup> The second challenge concerns testing the legality of the underlying contract memorializing the commercial transaction at issue that also contains an arbitration clause. Here, the argument says, the entire agreement would be rendered unenforceable because it could have been fraudulently induced, the agreement may be illegal because it seeks to realize an objective that is against public policy, or the very illegality of one of the contract's clauses may render the whole contract invalid.<sup>82</sup> Upon review of the complaint, the Court

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<sup>78</sup> *Id.*

<sup>79</sup> *Cardegna v. Buckeye Check Cashing*, 894 So.2d 860, 862 (Fla. 2005) (quoting *Party Yards v. Templeton*, 751 So.2d 121, 123-24 (Fla. Dist. Ct. App. 2000)).

<sup>80</sup> *Buckeye*, 546 U.S. at 442.

<sup>81</sup> The Supreme Court characterized the issue in *Southland Corp.* as "challenging the agreement to arbitrate as void under California law insofar as it purported to cover claims brought under the state Franchise Investment Law." *Id.* at 444.

<sup>82</sup> *Id.* The opinion emphasizes that because

[t]he issue of the contract's validity is different from the issue whether any agreement between the alleged obligor and obligee was ever concluded. Our opinion today addresses only the former, and does not speak to the issue decided in the cases cited by respondents (and by the Florida Supreme Court), which hold that it is for courts to decide whether the alleged obligor ever

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underscored that it is the second, *i.e.*, a challenge to the contract as a whole and not specifically to the arbitration clause, that brings before it the issue concerning whether court or arbitrator should adjudicate the validity of the contract.<sup>83</sup>

Four critical premises were analyzed in highlighting the primacy of the arbitral process, the precept of *party-autonomy*, and the new role of judicial intervention in arbitral proceedings. First, the Florida Supreme Court had placed considerable weight on the distinction arising between “void” and “voidable” contracts. Indeed, it asserted that “Florida public policy and contract law,” permit “no severable, or salvageable, parts of a contract found illegal and void under Florida Law.”<sup>84</sup> The Court rejected this proposition based upon its understanding of *Prima Paint*. Specifically, the Supreme Court observed how “[t]hat case rejected application of state severability rules to the arbitration agreement *without discussing* whether the challenge at issue would have rendered the contract void or voidable.”<sup>85</sup> In addition, further analytic support was drawn from *Southland* where the Court deliberately and explicitly rejected *not* to consider whether the legal and factual averments in the underlying complaint rendered the contract at issue either void or voidable.<sup>86</sup> Instead, it disavowed the assertion that the enforceability of an arbitration agreement is contingent upon a state legislature’s determination of the applicable forum for enforcement of a state law statutory cause of action.<sup>87</sup> Likewise, the Court held that it “cannot accept the Florida Supreme Court’s conclusion that enforceability of the arbitration agreement should turn on ‘Florida public policy and contract law.’”<sup>88</sup>

Second, the FAA’s “substantive” command in Section 2 was emphasized in the context of the Court’s prior ruling in *Prima Paint*. Not surprisingly, respondents had argued that *Prima Paint*’s stricture was predicated only on Sections 3 and 4 of the FAA’s “procedural” provisions.<sup>89</sup> Respondents further asserted that both these sections exclusively applied to the Federal Court, while Section 2 is the only provision that the Supreme Court had applied

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signed the contract.

*Id.* at 444 n.1.

<sup>83</sup> *See id.*

<sup>84</sup> *Cardegna*, 894 So.2d at 864.

<sup>85</sup> *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 446 (2006) (citing *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388, U.S. 395, 400-404 (1967)).

<sup>86</sup> *Id.* at 447-48.

<sup>87</sup> *Id.* at 446.

<sup>88</sup> *Id.* (citing *Cardegna*, 894 So.2d at 864).

<sup>89</sup> *Id.* at 447.

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to state courts.<sup>90</sup> This contention was rejected in what is, in effect, a scholarly critique of the Court's own analysis in *Prima Paint*. Specifically, the Supreme Court observed that while "§ 4, in particular, had much to do with *Prima Paint*'s understanding of the rule of severability", the Court explained that the severability doctrine has its genesis in Section 2 of the FAA.<sup>91</sup> Therefore, "[r]espondents' reading of *Prima Paint* as establishing nothing more than a federal-court rule of procedure also runs contrary to *Southland*'s application of that case."<sup>92</sup> Not to place epicycles upon epicycles in a Ptolemaic effort 'to save the appearance,' *Southland*'s own application of Section 2 is "for [its] holding on Congress' broad power to fashion substantive rules under the Commerce Clause."<sup>93</sup>

Consequently, the Court in *Buckeye* held that the Severability Doctrine is applicable to the case at bar. Its applicability follows from an inquiry finding that the 1967 ruling in *Prima Paint* addressing Sections 3 and 4 of the FAA. This developed the *Severability Doctrine* from the 1953 single sentence ruling in *Wilko*, which is applicable to state court proceedings and found to be such in *Southland* in 1984 because of the Doctrine's foundation on Section 2 of the FAA, which in turn rests on judicial acknowledgement of Congress' broad powers to craft substantive rules pursuant to the Commerce Clause. The normative sequence is the following:

(1) *Prima Paint* in deciding whether a federal court or arbitrator is to adjudicate fraud in the inducement and misrepresentation claims of the underlying contract containing the arbitration clause, crafts the Severability Doctrine, but only in the context of interpreting Sections 3 and 4 of the FAA;

(2) *Southland* applies Section 2 of the FAA to a state court proceeding concerning the prosecution of state legislation (the California Franchise Investment Law) based upon its reading of *Prima Paint* as resting on Congressional authority to fashion substantive rules pursuant to the Commerce Clause;

(3) The Supreme Court in *Southland* concludes that that Section 2 of the FAA is the substantive provision based upon the Commerce Clause upon which *Prima Paint*'s analysis of Section 3 and 4 of the FAA can only ultimately be predicated;

(4) Thus, the Supreme Court in *Buckeye* finds a normative basis in

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<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.* at 447.

<sup>93</sup> *Id.* (citing *Southland Corp. v. Keating*, 465 U.S. 1, 11 (1984)). In connection to this, the Court stressed that in *Southland* it had "refused to 'believe Congress intended to limit the Arbitration Act to disputes subject only to federal-court jurisdiction.'" *Id.* (citing *Southland*, 465 U.S. at 15).

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rejecting the Florida Supreme Court's public policy contention that enforceability of the contract should rest on Florida public policy and contract law.

Third, respondents advanced the remarkably circular pronouncement that, because the underlying contract containing the arbitration agreement was void *ab initio* under Florida Law, and Section 2 of the FAA only applies to contracts that are "valid, irrevocable and enforceable", there is no conceivable contract or agreement to which Section 2 can possibly apply.<sup>94</sup> The Supreme Court analyzed this issue by scrutinizing Section 2 of the FAA so as to glean a broader understanding of the word "contract" within the meaning of Section 2.<sup>95</sup>

Finally, even though under the *Prima Paint* rubric a court and not an arbitrator may enforce an arbitration clause that an arbitrator later finds to be void, as respondents suggest, "it is equally true that respondents' approach permits a court to deny effect to an arbitration provision in a contract that the court later finds to be perfectly enforceable."<sup>96</sup> This apparent anomaly is reconciled by the *Prima Paint* doctrine, providing for separate enforcement of the underlying contract and the arbitration agreement, *i.e.* the Severability Doctrine.

In addition to refining the doctrinal framework established in *Prima Paint* and *Southland, Buckeye* serves as a guide to interpreting both *Prima Paint* and *Southland* together as part of a doctrinal and conceptual development seeking to emphasize:

- (i) the FAA's federal preemption so as to render conceptually possible the proposition;
- (ii) the FAA has substantive provisions;

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<sup>94</sup> *Id.* at 447.

<sup>95</sup> The Court stated:

We do not read "contract" so narrowly. The word appears four times in § 2. Its last appearance is in the final clause, which allows a challenge to an arbitration provision "upon such grounds as exist at law or in equity for the revocation of any *contract*." (Emphasis added.) There can be no doubt that "contract" as used this last time must include contracts that later prove to be void. Otherwise, the grounds for revocation would be limited to those that rendered a contract voidable-which would mean (implausibly) that an arbitration agreement could be challenged as voidable but not as void.

*Id.* at 448.

<sup>96</sup> *Id.* at 448-49.

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- (iii) these substantive provisions apply both to federal and state fora;
- (iv) Section 2 is the basis for the FAA's substantive directives; and
- (v) the substantive command contained in Section 2, which pervades Sections 3 and 4, is ultimately grounded on Congress' broad powers to craft substantive rules based upon the Commerce Clause.<sup>97</sup>

Certainly, as Justice Thomas' rather abbreviated dissent seeks to emphasize, concerns have not been dispelled or otherwise allayed with respect to the very fundamental issue of whether the FAA applies to state courts.<sup>98</sup> The Act's legislative history is ambiguous and extremely difficult to construe in any definitive manner. As already referenced, the analysis in *Prima Paint* is far from overwhelmingly compelling. *Prima Paint*, *Southland*, and *Buckeye* do constitute an important trilogy that enriches the doctrinal development of arbitration in the United States and, therefore, in the world. All three cases, decided during a thirty-nine year time frame, seek to place arbitration contracts at the same juridic level as commercial contracts. The trilogy also bolsters arbitration's juridic integrity and standing by redefining the relationship between arbitration and judicial proceedings.

## CONCLUSION

These judicial efforts are susceptible to meaningful and material critique with respect to technical matters of statutory construction. *Tour de force* arguments do bring to mind the proliferation of epicycles identified in Ptolemy's *Almagest* so as to reconcile recurring discrepancies that challenged a rubric that sought to "save appearances" where the underlying premise was predicated on the proposition that the sun revolved around the earth. Irrespective of the intellectual and conceptual debilities that rendered possible the Severability Doctrine, judicial tenets rendering Section 2 of the FAA's application to state courts, the importance of the principle of *party-autonomy*, and the doctrine of limited judicial intervention in arbitral proceeding, were

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<sup>97</sup> See generally *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 442 (2006).

<sup>98</sup> *Id.* at 449 (Thomas, J., dissenting).

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significantly advanced. These developments simultaneously enhanced arbitration's standing while diminishing even further the last vestiges of historical prejudice that fueled judicial contempt and skepticism for arbitration.

Hegel's aphorism here finds a quite suitable home; "the owl of Minerva flies at dusk."<sup>99</sup> Indeed, perhaps it is certain that wisdom is attained with the passage of time and the passing of events, and only then is a comprehensive attainment of knowledge at all possible. If so, *today* it would appear to be quite a myopic reading to construct and interpret the redefined role of the judiciary, the primacy of arbitration agreements, in part based upon the new normative standing ascribed to international contracts, and the protagonistic role of the precept of *party-autonomy* as just mere refinements of the jurisdictional workings of both domestic and international arbitral proceedings. Instead, as "children of our times" we are witnessing the development of a judicial framework that slowly but steadily is diminishing the state's role in the equitable administration of justice. It follows that any such transformation also cannot be severed from a significant modification of the most rudimentary elements of classical sovereignty and statehood: the judiciary. This transformation could not have been predicted with any greater apodictic certainty than our musings concerning its final development in time. Yet there is rigorous predictive value in the proposition that economic globalization, and globalization generally, has affected, and will continue to affect, the configuration of traditional notions of sovereignty, the State, nationhood, nationalism, and international law. These particular details characterizing the subject material transformations are as challenging to predict as the predictive value that we can now engraft unto the movement of tropisms themselves: absolutely none. How international law will change or give way to a global law no person can detail. We live in interesting times. But then again, so too said Homer.

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<sup>99</sup> G.W.F. HEGEL, THE PHILOSOPHY OF RIGHT (1820).

## **DELIGHT AND DISASTER RELIEF THROUGH THE USE OF MULTIMEDIA**

*Dr. Laura Lally\* & Mohammad Ahad\*\**

### INTRODUCTION: DELIGHT AND DISASTER RELIEF

Information technology can play a large role in disasters. First, IT frequently exhibits the characteristics of disaster prone systems. IT is frequently complex, tightly coupled and poorly controlled (Lally, 2002) which makes it prone to accidents in the normal state of its operation. Furthermore, the rapid pace of change in the field of IT makes the control of these systems an even greater challenge. However, Lally (2003) argued that IT can also play a role in disaster prevention, mitigation of damages, and the enhancement of learning to prevent future disasters. As a final stage in disaster survival, Lally (2008) introduced the concept of *Post Crisis Renewal* and applied it to survivors of Hurricane Katrina.

Individuals, organizations, and societies that have survived life changing crises face the challenging task of rebuilding their lives and cultures. In Lally's case study of Hurricane Katrina, she argued that IT- based technologies can help this difficult process (Lally, 2008, p.14)

Rebuilding a sense of community is an important task in the face of a devastating loss and keeping in touch with fellow survivors and loved ones an important part of recovery for the individuals involved. In the case of New Orleans, half the population has been relocated, creating a culture in a state of Diaspora. Concerts and food festivals throughout the world can help keep the city's unique culture alive, as well as making others aware of it. Internet sites keep individuals in touch with family and friends, and can educate others about the city's history, art and architecture.

Most citizens of the U.S. "Know what it means to miss New Orleans,"

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(Armstrong, 1932) even if they have never been there. Since Katrina, films, concerts, and cookbooks have celebrated the unique qualities of New Orleans culture. Celebrities such as Spike Lee, Wynton Marsalis, and Brad Pitt have played active roles in relief and rebuilding projects. Web sites have also played a large role in the rebuilding process:

One example of this was during Hurricane Katrina, when software consultant Katrina Blankenship permitted her website to be converted to an online forum about the hurricane including pointers to other websites and a message board to help locate missing people. The site received over 12 million hits and is still active as a Katrina memorial site and a source for hurricane preparedness information (Lally, 2008, p.12).

Individuals who are able to survive and flourish again after disasters tend to be those who can remember happy times in the past and look forward to happier times ahead. Sigmund Freud wrote in "Mourning and Melancholia," that "a critical difference between ordinary grief and acute depression is that mourners can successfully anticipate a life where there will once again be joy and meaning," (Banks and Coutu, 2008, p. 114).

Unlike the case of New Orleans, most U.S. citizens are not highly aware of the culture of Afghanistan. Newspaper headlines like "Afghanistan the Beautiful" are meant to be a joke (Newsday, March 24, 2008, p. A10). Newspaper images focus on war and destruction, rather than on the beauty of the culture that is struggling to revive itself. This paper will argue that *Positive Affect Technology*—Lally's (2008)—technology designed to delight individuals—can help raise awareness of the beauties of Afghanistan's unique culture, and that resulting awareness will make Americans more willing to support post war relief efforts.

The authors considered this a major challenge, since the words "Afghanistan" and "Delight" do not usually appear in the same sentence in today's media. We developed two multimedia presentations on the beauties of Afghan culture and conducted a survey to determine if the presentations impacted support for cultural rebuilding. Our results were strongly positive indicating that individuals exposed to the delights of another culture would be more like to support relief efforts. The results could have major significance for how other developing countries and the aid organizations that help them, make use of IT and delight to further their fund raising goals. A second goal of the research would be to develop educational materials, specifically for Hofstra's entry level business computing class, to encourage students to develop presentations and Web Sites to raise awareness of other cultures.

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## DELIGHT AND DISASTER RELIEF THROUGH USE OF MULTIMEDIA

### **A. Rumi and Rosewater: Discovering the Beauties of Afghan Culture**

Since 1979, Afghanistan has been under siege, first by the Russians and then by the Taliban, leaving a severely damaged infrastructure, health care, and education system. Intervention by the United State, England, and Australia, focuses primarily on military aid, motivated by the desire to avenge 9/11 and drive the Taliban followers of Osama Bin Laden out of the country. In 1979, U.S. lead forces, aided by local Mujahedeen militias, succeeded in driving out Russian invaders. But as Charlie Wilson noted, "Americans won the war and lost the peace," (Crile, 2004, p. 172) leaving behind a devastated country where the average age of the population was fourteen. Current chairman of the Joint chiefs of Staff Michael Mullen warned the U.S. congress that, "We can't kill our way to victory," and that the U.S. needs to "improve its nation building abilities," (CNN, 2008) to secure a lasting peace in Afghanistan.

Afghanistan was on both the silk road and the spice road and as a result is a heterogeneous blend of a number of cultures that have left behind a wide range of beautiful cultural artifacts. A museum show of these artifacts is currently in the Smithsonian in Washington D.C. The show highlights from the National Museum of Kabul which was destroyed by the Taliban. The show includes a trove of items from a storehouse in Bagram that was at the center of the silk trade, featuring a range of treasures from Afghan, Chinese, Greek, Indian and Roman origin. Also included in the show is the "Bactrian Hoard," from Tillya Tepe a tomb containing more gold jewelry and artifacts than King Tutankhamen. The tomb was discovered in 1978, just before the invasion of the Russians by a Russian scientist, and its contents buried in a safe until just last year. Afghanistan also has a rich literary tradition, and celebrates its great poets such as Rumi and Jani. Elaborate tombs of great poets adorn the landscape of Afghanistan and Turkey. A new English translator, Coleman Barks, has created a new surge of interest in Rumi's work in the English speaking world (Barks, 1995). Afghanistan, like New Orleans, has beautiful music and fascinating cuisine with exotic seasonings, such as rosewater (Saber, 2007). Entrepreneurial initiatives are underway, such as the one by Jalalabad farmer Shafiq Azizi to grow roses for perfume and rosewater, instead of using the land to grow opium poppies (Watson, 2008).

### **B. Experimental Design of the Study**

Students entering both sections of Dr. Lally's IT 14 class in the Fall of 2008 were given a survey asking them to list up to ten things they know about New Orleans and ten thing they know about Afghanistan. Students recalled an average of 7.2 things about New Orleans. Although all students mentioned

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Katrina first, most also students recalled positive joyful things like Jazz, Cajun cooking, the Saints and Mardi Gras as well.

In comparison, students recalled an average of 4.7 things about Afghanistan all almost entirely negative such as terrorism, women's rights violations, and the opium trade. A number of recollections were wrong including "Oil rich" (one response described Afghanistan as both "Poverty Stricken" and "Oil Rich") and in the Middle East. These responses could be explained by student's exposure to the news media. A search on the term Afghanistan on news media sites resulted in overwhelmingly negative facts and events. To counter this negative view, we developed two multimedia presentations on Afghanistan to raise student's awareness of the culture and tested to see if the presentation would impact their support for rebuilding Afghanistan's infrastructure and culture.

The multimedia presentations, Afghan Odysseys I and II, focused on:

I) Treasures from the Kabul museum which encompassed art work from the many cultures that have lived in and crossed Afghanistan during its years as a trade route, including the Bactrian Horde a collection of gold jewelry and sculpture large than the one found in King Tutankhamen's tomb, Roman and Greek style sculpture, jewelry and elaborately decorated cookware, Buddhas from the Bamian Valley, as well as traditional music and quotations from classical Afghan poets such as Rumi and Jani.

II) The people and places of Afghanistan including the stunning landscape of the Bamian Valley, the sport of Buzkashi, carpet bazaars and caravans of Afghanistan that one could have seen on a tour of the country prior to 1979, featuring the music of the lively Afghan national dance. The presentations are currently in Powerpoint and will be developed into a Web site. Versions of the presentations without the music are attached in Appendices A and B.

The experiment utilized the classic control group design:

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Our research propositions were:

## DELIGHT AND DISASTER RELIEF THROUGH USE OF MULTIMEDIA

*Research Proposition #1: Individuals who view “Afghan Odyssey’s I and II” will recall more things, and more favorable things about Afghanistan, than those who do not.*

*Research Proposition #2: Individuals who view “Afghan Odyssey’s and II” will be in favor of greater degrees of post war support for Afghanistan, than those who do not.*

*Research Proposition #3: The more positive things individuals remember about a culture, the more likely they will be in favor of post war support.*

Immediately after completing the preliminary survey, the students in the test group were shown the Afghan Odyssey presentations. Two weeks later, the students were again asked to recall ten things they knew about Afghanistan. During that time the news media covered stories of corruption in the Afghan government, and further incursions of the Taliban into the country, which now were listed in student’s recollections. Students who had seen the presentations now recalled 7.6 things about Afghanistan in comparison with the control group (3.9), providing support for Research Proposition #1.

Students who had been shown the presentations, now also recalled beautiful landscapes, Buddhas, Rumi, Buskashi, hand woven carpets, bazaars, music and other positive things about the culture. Both the groups of students were then asked to respond on a Likert scale (1 to 7), the degree to which they agreed that the U.S. should help rebuild Afghanistan’s infrastructure and culture. Students who had been show the presentation averaged 6.2 on infrastructure rebuilding and 5.7 on cultural rebuilding, in contrast to the control group who scored 4.7 on infrastructure rebuilding and 4.2 on cultural rebuilding. This statistically significant result supported Research Hypothesis #2. There was a strong positive correlation between the number of positive things students could recall and willingness to support infrastructure rebuilding (.81) and cultural renewal (.77), in the group who had been shown the presentations supporting Research Hypotheses #3. The control group still recalled almost nothing positive.

### **C. Extending the Study and Developing Educational Materials**

This study can be applied across a wide range of cultures about which there is limited global understanding. Often cultures that have been besieged by war and poverty are represented overwhelmingly with negative terms and depressing images, perhaps with the hope of generating sympathy for fund raising causes. News media further reinforce these negative images which may

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endure over time. Many Americans over 40 still associate Vietnam with smelling like “napalm in the morning” as described in the movie “Apocalypse Now,” despite the current beauty of the landscape and many cultural treasures. American’s over 40 were frequently ordered to eat their vegetables as children because “people are starving in India.” Again, despite beautiful landscapes, cultural treasures and a much richer culinary tradition than American has of making vegetables taste delicious, India has also been typecast in terms of poverty and conflict.

This bombardment with negativity, however, can induce burnout even in generous, caring individuals as all disaster areas begin to look and sound alike and appear to continue emerging no matter how much effort is made.. Using multimedia to induce delight may provide a fresh new way to gather attention, involvement, and financial commitment to cultural appreciation and renewal in a global environment.

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## THE INTERNATIONAL ACCOUNTING DEBATE: OPTIONS IN STANDARDIZATION

*Keith Bader\**

### INTRODUCTION

In the next few years, the accounting industry in the United States will experience numerous changes in generally accepted practices. The traditional wisdom of following U.S. Generally Accepted Accounting Principles (GAAP) is now being questioned; both financial statement users and preparers are calling for a standardized, more widely-accepted approach to financial reporting in order to “reduce diversity and harmonize accounting standards and practices internationally.”<sup>1</sup> The increased use of such standards, collectively known as International Financial Reporting Standards (IFRS), by companies based in countries around the world is evidence of this phenomenon.

Additional evidence suggesting a trend towards establishing one set of reporting standards exists in the “Roadmap to Convergence,” developed by the Securities and Exchange Commission (SEC). Under this initiative, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working together to “bring about a common set of accounting standards that will enhance the quality, comparability and consistency of global financial reporting, enabling the world’s capital markets to operate more effectively.”<sup>2</sup> Their proposed date for reaching full adoption of one set of reporting standards is the year 2014.<sup>3</sup> Further evidence of this trend can be found in the U.S. SEC’s relaxing of the

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<sup>1</sup> Doupnik, Timothy and Hector Perera, *International Accounting*. (New York: McGraw-Hill Irwin, 2007), p75.

<sup>2</sup> Taub, Stephen, “FASB, IASB Issue Convergence ‘Roadmap’,” *CFO.com*, 2/27/2006.

<sup>3</sup> Moberg, Liza McAndrew, “Speech by SEC Staff: Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments,” 12/8/2008. Source: [www.sec.gov/news/speech/2008](http://www.sec.gov/news/speech/2008).

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reconciliation requirement between U.S. GAAP and IFRS in 2007. The removal of this requirement, which applied to all non-U.S. companies reporting under IFRS, “allow[ed] foreign private issuers to file their financial statements without reconciliation to U.S. GAAP.”<sup>4</sup> These significant events indicate a shift toward one set of reporting standards. Because of initiatives such as the “Roadmap to Convergence,” an understanding of the different alternatives available toward achieving a single set of high quality reporting standards is crucial.

The proliferation of cross-border entities and the globalization process as a whole have both played critical roles in encouraging this standardization process. However, in moving toward one set of reporting standards, the United States has three options. First, the U.S could pursue convergence of standards, whereby elements of both U.S. GAAP and IFRS are brought together. The second alternative is wholesale adoption of IFRS, which would require the U.S. to abandon its traditional GAAP standards and fully espouse IFRS. Finally, there is the option of keeping U.S. GAAP intact. Choosing which option to follow is a matter of great controversy. In the following sections, arguments for and against each alternative will be presented. However, before delving further into such an analysis, an examination of the history of this controversy is prudent.

### I. HISTORY & ORGANIZATIONAL STRUCTURE / FRAMEWORK

The concept of establishing one set of global accounting standards is not new, as it dates back over forty years. “[T]he need for high quality ‘global GAAP’ was officially recognized in 1966, when professional accounting bodies first began working towards a set of globalized accounting standards.”<sup>5</sup> Since then, as a byproduct of globalization, “world capital markets have become increasingly tied to one another, and so ‘integrated and interdependent’ that ‘the stability of one market affects others.’”<sup>6</sup> Efforts to advance the process of globally standardizing accounting standards accelerated dramatically in the late 1990s when “a heightened recognition of the benefits of having ‘one set of high-quality globally recognized financial reporting standards’” was achieved.<sup>7</sup>

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<sup>4</sup> Weiss, Paul, “SEC Proposes to Eliminate Reconciliation Requirement for IFRS Financial Statements,” [www.businesswire.com](http://www.businesswire.com), 7/19/2007.

<sup>5</sup> Irvine, Helen J. and Natalie Lucas, “The Rationale and Impact of the Adoption of International Financial Reporting Standards: The Case of the United Arab Emirates.” *Faculty of Commerce – Papers, University of Wollongong*, (2006), p2.

<sup>6</sup> *Ibid.*

<sup>7</sup> *Ibid.*

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The call for such global accounting standards was answered in 2001, when the IASB was formed as a result of the restructuring of its predecessor, the International Accounting Standards Committee (IASC), in accordance with the expectations of the International Organization of Securities Commissions (IOSCO).

The IASB is an independent, industry-driven standard-setting board, appointed and overseen by a geographically and professionally diverse group of Trustees of the IASC Foundation.<sup>8</sup> The twenty-two Trustees of the IASC Foundation are responsible for governance, oversight and funding.<sup>9</sup> The IASC Foundation appoints members of the IASB, the International Financial Reporting Interpretations Committee (IFRIC), and the Standards Advisory Council (SAC).<sup>10</sup> The SAC is a forum for the IASB to consult with a wide range of representatives from user groups, preparers, financial analysts, academics, auditors, regulators, and professional accounting bodies that are affected by the IASB's pronouncements.<sup>11</sup> Trustees are appointed for a renewable term of three years and must be chosen in the following way: six must be selected from the Asia/Oceania region, six from Europe, six from North America, and four from any other region.<sup>12</sup> Also, each is expected to have an understanding of international issues relevant to the development of global accounting standards.<sup>13</sup>

The IASB works with national accounting standard-setters to achieve convergence in accounting standards worldwide. Their mission is "to develop, in the public interest, a single set of high quality, understandable and international financial reporting standards (IFRSs) for general purpose financial statements."<sup>14</sup> The IASB's strategy is "to identify the best standard and build a body of accounting standards that constitute the highest common denominator of financial reporting."<sup>15</sup> By using an open process, the IASB develops principles-based international financial reporting standards (IFRSs) that focus on establishing general principles derived from the IASB Framework.<sup>16</sup>

Since its formation, the IASB has worked extensively with the FASB towards achieving their joint goal of convergence. Among other things,

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<sup>8</sup> <http://www.iasb.org>.

<sup>9</sup> *Ibid.*

<sup>10</sup> *Ibid.*

<sup>11</sup> *Ibid.*

<sup>12</sup> *Ibid.*

<sup>13</sup> *Ibid.*

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.*

<sup>16</sup> *Ibid.*

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convergence is a logical and necessary goal because it will help improve the comparability and understandability of financial statements of companies based in countries around the world. Additionally, convergence will result in higher-quality standards which will facilitate investor decisions. A further discussion follows in section II.

The early efforts of the IASB and the FASB led to the famous Norwalk Agreement (also known as the Memorandum of Understanding). This agreement was the result of a meeting held at the FASB's offices in Norwalk, Connecticut in September of 2002. At this meeting, the two groups "pledged to use their best efforts to (1) make their existing financial reporting standards fully compatible as soon as is practicable and (2) to coordinate their work program to ensure that once achieved, compatibility is maintained."<sup>17</sup> It is important to note that "compatible does not mean [word-for-word] identical [standards]"; rather, it "means the two sets of standards do not contain conflicts."<sup>18</sup> In 2006, and again in 2008, the IASB and the FASB reaffirmed their commitment to work closely toward achieving convergence.

But what exactly is convergence? From an historical perspective, the concept of convergence originated from "a program of harmonization of national GAAPs," which the IASC began in 1973.<sup>19</sup> Harmonization meant:

- [D]eveloping IASC standards that could serve as a model on which national standard setters could base their own standards[;]
- [N]arrowing but not necessarily eliminating the range of acceptable methods of accounting for particular types of transactions[;]
- [D]eveloping standards that set out broad principles but did not include the degree of detail that would almost surely put them in conflict with most of the existing standards[; and]
- [W]riting standards that were more descriptive of acceptable practices than prescriptive.<sup>20</sup>

This concept of harmonization evolved into one of convergence in 2001 when the IASC was restructured, resulting in the formation of the IASB.<sup>21</sup>

Convergence became the new goal and it called for a higher quality set of global accounting standards.<sup>22</sup> Under the purview of 'achieving

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<sup>17</sup> Douppnik, Timothy and Hector Perera, International Accounting. (New York: McGraw-Hill Irwin 2007), p101.

<sup>18</sup> Pacter, Paul, "What Exactly Is Convergence?" International Journal of Accounting, Auditing, and Performance Evaluation, 2, Nos. 1/2 (2005).

<sup>19</sup> *Ibid.*

<sup>20</sup> *Ibid.*

<sup>21</sup> *Ibid.*

<sup>22</sup> *Ibid.*

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convergence,' the organization sought "to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements, and other financial reporting to help participants in the world's capital markets and other users make economic decisions [,] and to promote the use and rigorous application of those standard [,] to bring about convergence of national accounting standards and International Accounting Standards to high quality solutions."<sup>23</sup> Although many efforts toward convergence have been made, some U.S. commentators, such as PCAOB member Charles Niemeier, have not embraced the idea of commingling the U.S.'s rules-based standards with more lax, principles-based standards.<sup>24</sup> Other opponents of convergence believe that "the world needs to adopt a single set of high-quality global accounting and financial reporting standards . . . [and] . . . that IFRS should serve as that set of standards."<sup>25</sup> Therefore, although some might favor a convergence effort, combining the standards of both U.S. GAAP and IFRS, others would prefer retaining the traditional U.S. model. However, there are some who also believe wholesale adoption of IFRS is the best alternative.

## II. POSSIBLE OPTIONS IN STANDARDIZATION

### A. Convergence

There are distinct advantages and disadvantages in the pursuit of an effort of convergence. In the broadest sense, the advantages of convergence include:

- Improved comparability of financial statements
- Reduced investor risk through facilitating diversification
- Desired standardization in the most reasonable way
- Increased reliability of financial statements
- Decreased complexity of standards, thereby making them easier to understand while simultaneously providing an adequate level of guidance

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<sup>23</sup> *Ibid.*

<sup>24</sup> Kranacher, Mary-Jo, "An Interview with Charles D. Niemeier, Public Company Accounting Oversight Board Member; At the Frontlines in the Battle for Investor Protection," *CPA Journal*, 78 (2008), pp16-22.

<sup>25</sup> Heffes, Ellen M., "Global Accounting Firm CEOs on Challenges Transitioning from GAAP to IFRS, and More," *Financial Executive*, 1 (2008).

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One argument, posed by many proponents of accounting convergence is that “comparability of financial statements worldwide is necessary for the globalization of capital markets.”<sup>26</sup> Further, comparable financial statements would facilitate the evaluation of potential investments in foreign securities. This will enable investors to “take advantage of the risk reduction possible through international diversification.”<sup>27</sup> Additionally, some believe that convergence would “help raise the quality level of accounting practices internationally, thereby increasing the credibility of financial information.”<sup>28</sup> Lastly, some propose that “a sensible way to achieve a single set of global accounting standards in a reasonable time span is to work towards convergence of IFRSs and US GAAP, in turn causing a ‘trickle down effect’ in those countries that continue to maintain their national GAAPs. And this is the approach the IASB has adopted.”<sup>29</sup> These are the standard arguments in favor of a general harmonization of accounting standards.

More specific to convergence, some argue that such an effort should be pursued because by converging the two sets of standards (i.e. U.S. GAAP and IFRS), the new set of uniform, global standards will not be “as overwhelming as[, say,] US GAAP, while at the same time, providing a reasonable level of guidance [for financial statement users].”<sup>30</sup> Additional support for pursuing an effort of convergence came in 2002 with the passage of the Sarbanes-Oxley Act. “Section 108 of the Act permits the SEC to recognize [sic] standards established by a private-sector accounting standard-setter (i.e. FASB) provided that the standard-setter considers ‘the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors.’”<sup>31</sup> This significant piece of legislation “provided some impetus and support for the Norwalk agreement,” which called for a convergence of standards.<sup>32</sup>

However, there are some potential drawbacks, or challenges, in attempting to converge two sets of inherently disparate standards. These challenges include:

- High magnitude of differences in reporting standards between countries

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<sup>26</sup> Douppnik Timothy and Hector Perera, *International Accounting* (New York: McGraw-Hill Irwin 2007), p76.

<sup>27</sup> *Ibid.*

<sup>28</sup> *Ibid.*

<sup>29</sup> Pacter Paul, “What Exactly Is Convergence?” *International Journal of Accounting, Auditing, and Performance Evaluation*, 2, Nos. 1/2 (2005).

<sup>30</sup> *Ibid.*

<sup>31</sup> *Ibid.*

<sup>32</sup> *Ibid.*

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- High cost of convergence
- Doubt over the need for convergence
- Strong belief by some that differences in reporting standards are necessary, as delineated in the concept of the “Global Dilemma” discussed below.
- Convergence will be fruitless without strong, competent enforcement

By some estimates, “the greatest obstacles to [convergence] are the magnitude of the differences that exist between countries and the fact that the cost of eliminating those differences would be enormous.”<sup>33</sup> Overcoming such differences will be very difficult and, by some measures burdensome. Additionally, “not only is [convergence] difficult to achieve, but also the need for such standards is not universally accepted.”<sup>34</sup> These are two central challenges that must be faced when pursuing an effort of convergence.

Another challenge of pursuing convergence, in light of the globalization process, is the idea of a “global dilemma,” first posited by Professor Frederick Choi. The “global dilemma” refers to another potent argument against convergence, which says that “because of different environmental influences, differences in accounting [standards] across countries might be appropriate [and even] necessary.”<sup>35</sup> Such differences could result from countries being at “different stages of economic development, or countries relying on different sources for financing.”<sup>36</sup> Because some differences between reporting standards may be necessary, the idea of combining all accounting standards into one global set has not been accepted by all.

Additionally, not everyone is convinced of the need for a single set of standards. According to some, “full harmonization of international accounting standards is probably neither practical nor truly valuable. . . it is not clear whether significant benefits would be derived in fact.”<sup>37</sup> Further, these critics of convergence argue that “a well-developed global capital market exists already [and] it has evolved without uniform accounting standards.”<sup>38</sup> Lastly, some are concerned that convergence “will not work without enforcement.”<sup>39</sup>

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<sup>33</sup> Douppnik, Timothy and Hector Perera. International Accounting. New York: McGraw-Hill Irwin (2007), p76.

<sup>34</sup> *Ibid.*

<sup>35</sup> Choi, Frederick D. “A Cluster Approach to Harmonization,” Management Accounting ,(1981), p29.

<sup>36</sup> *Ibid.*

<sup>37</sup> Goeltz, Richard K. “International Accounting Harmonization: The Impossible (and Unnecessary?) Dream,” Accounting Horizons, (1991), pp85-86.

<sup>38</sup> *Ibid.*

<sup>39</sup> Pacter, Paul. “What Exactly Is Convergence?” International Journal of Accounting, Auditing,

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They argue that “in an international environment with national capital markets in various stages of development and maturity, enforcement of [these] standards [will] be more challenging than in the U.S. environment.”<sup>40</sup> As a result, because convergence will not work without strong enforcement, and such enforcement will be untenable at best, convergence of standards may not be the best alternative to pursue.

### B. Wholesale Adoption of IFRS

As an alternative to converging U.S. GAAP standards with IFRS, some believe wholesale adoption of IFRS is the best course of action. Proponents of wholesale adoption of IFRS cite many reasons for this. The two most significant arguments are:

- All member nations of the European Union (EU) have fully adopted IFRS
- Wholesale adoption benefits both developed and developing countries alike

This first significant argument in favor of wholesale adoption of IFRS has become a very dominant one in recent years because “[i]n the European Union (EU), for listed companies, convergence has simply been bypassed in favor [sic] of [wholesale] adoption of IFRSs.”<sup>41</sup> “In June 2002, the Council of the EU approved an Accounting Regulation requiring all European companies listed on a stock exchange in the EU to follow IASB standards in their consolidated financial statements starting in 2005.”<sup>42</sup> Since then, the twenty-five member states of the EU and three members of the European Economic Area have all switched to IFRSs as the basis of their financial reporting; this means that 9,000 of the largest companies in these twenty-eight countries now report under IFRS.<sup>43</sup> Because the U.S. has relations with many of these countries, this is a potent argument in favor of wholesale adoption of IFRS. These twenty-eight countries are listed in Table 1 below.<sup>44</sup>

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and Performance Evaluation, 2, Nos. 1/2 (2005).

<sup>40</sup> *Ibid.*

<sup>41</sup> *Id.* at 75.

<sup>42</sup> *Ibid.*

<sup>43</sup> *Ibid.*

<sup>44</sup> *Ibid.*

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**Table 1: 28 Countries which have fully adopted IFRS as of 2005**

Austria	Belgium	Cyprus	Czech Republic	Denmark
Estonia	Finland	France	Germany	Greece
Hungary	Iceland	Ireland	Italy	Latvia
Liechtenstein	Lithuania	Luxembourg	Malta	Norway
Poland	Portugal	Slovakia	Slovenia	Spain
Sweden	The Netherlands	UK		

Currently there are over one hundred countries around the world that have fully adopted IFRS. Additionally, some countries continue in their efforts to pursue wholesale adoption. Figure 1 below, adapted from the IASB website, is a pictorial representation of those countries as of 2008.<sup>45</sup>

**Figure 1: Prevalence of wholesale adoption of IFRS in countries around the world**

A second argument in favor of wholesale adoption says that, for developing nations, “[t]he prospect of greater mobility of capital at a decreased cost, more efficient allocation of resources, improved quality of financial

<sup>45</sup> www.iasb.org.

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reporting, a decline in earnings management, and [an] avoidance of the necessity of having to develop their own accounting standards, against a backdrop of the accountability demands of the World Bank and IMF [the International Monetary Fund], are all compelling incentives for the adoption of IFRS by countries wishing to participate in global capital markets.”<sup>46</sup> Additionally, wholesale adoption of IFRS benefits the developed countries, because “[t]he adoption of IFRS will save multinational corporations the expense of preparing more than one set of accounts for different national jurisdictions.”<sup>47</sup> Other benefits of wholesale adoption include “[the enhancement] of the professional status of accounting bodies” and “[the opportunity for] the big international accounting firms [to] benefit in their efforts to expand the global market for their services.”<sup>48</sup>

Of course, as with convergence, there are some drawbacks to pursuing an effort of wholesale adoption of IFRS. First, “there are still significant difficulties for all countries in handing over power to an international body, particularly when global GAAP includes such differences in measurement and terminology.”<sup>49</sup> This argument refers to the challenges of translating each country’s local GAAP into a clear and concise reporting model that is well understood in different languages and contexts. Another related challenge faced by countries that already opted for wholesale adoption is “the taking of a foreign concept and translating it into another language where there is no exact equivalent terminology or regulatory infrastructure.”<sup>50</sup> This statement again attests to the fact that, due to such structural differences, some of the challenges faced in wholesale adoption of IFRS in light of the globalization process will prove to be difficult, if not insurmountable.

Some critics of wholesale adoption believe that “in many developing and emerging countries, the accounting profession is not developed to the point where it can regulate accounting and financial reporting effectively as it must do in the implementation of IFRS.”<sup>51</sup> Further, in the United States, certain of the rules in U.S. GAAP are tied to tax law and as a result, abandoning U.S. GAAP altogether will prove to be problematic. The same is true in other nations, where “the regulatory infrastructure [of these countries] may not

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<sup>46</sup> Irvine, Helen J. and Natalie Lucas. “The Rationale and Impact of the Adoption of International Financial Reporting Standards: The Case of the United Arab Emirates.” *Faculty of Commerce – Papers, University of Wollongong*, (2006), p2.

<sup>47</sup> *Id.*

<sup>48</sup> *Ibid.*

<sup>49</sup> *Ibid.*

<sup>50</sup> *Ibid.*

<sup>51</sup> *Ibid.*

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provide the sound financial reporting base or corporate governance structures implicit in the adoption of IFRS, which may [in turn] necessitate coordination of legislative requirements to overcome inconsistencies between IFRS and national laws.”<sup>52</sup>

Additional arguments against wholesale adoption of IFRS are more subjective in nature. For example, some believe that “IFRS-compliant annual reports are too complex and that users [have] to be financially literate to understand them.”<sup>53</sup> Others contend that a complete overhaul of accounting standards would be very costly, as the process would require “professional expertise, education and training, legal backing, substantial equity financing in the form of both multinational corporations and local companies, and the possibility of adopting IFRS with amendments to suit [each country’s] own specific culture and legislative infrastructure.”<sup>54</sup> Such costs would not be outweighed by the benefits. In a recent study conducted by researchers at the Institute of Chartered Accountants of Scotland, it was discovered that, for financial statement users in the UK and Ireland, “financial statements produced under IFRS had not changed any of their investment decisions and they did not consider them to be any more decision-useful than UK/Irish GAAP financial statements.”<sup>55</sup> In consideration of these arguments, wholesale adoption of IFRS may not be the best course of action either.

## CONCLUSION

Although there are many arguments for and against convergence of U.S. GAAP and IFRS, and wholesale adoption of IFRS, the decision as to which course of action to take is a difficult one and has been the topic of much controversy in the accounting industry. Proponents of convergence argue that it is the better alternative to wholesale adoption of IFRS because it would aid in comparability of financial statements and facilitate investor decisions, thereby reducing risk. Additionally, convergence “would reduce financial reporting costs for companies that seek to list their shares on foreign stock exchanges” and such cross-listing of securities “would allow companies to gain access to

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<sup>52</sup> *Ibid.*

<sup>53</sup> Dunne, Theresa, et. al. “The Implementation of IFRS in the UK, Italy, and Ireland: Executive Summary,” *The Institute of Chartered Accountants of Scotland*, 2008.

<sup>54</sup> Irvine, Helen J. and Natalie Lucas. “The Rationale and Impact of the Adoption of International Financial Reporting Standards: The Case of the United Arab Emirates.” *Faculty of Commerce – Papers, University of Wollongong*, 2006, p2.

<sup>55</sup> Dunne, Theresa, et. al. “The Implementation of IFRS in the UK, Italy, and Ireland: Executive Summary,” *The Institute of Chartered Accountants of Scotland*, 2008.

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less expensive capital in other countries and would make it easier for foreign investors to acquire the company's stock."<sup>56</sup> Opponents of convergence cite that it is difficult to achieve and that it will not work without enforcement.

Those in favor of wholesale adoption of IFRS claim that it will improve developing nations' access to capital and it will save multinational corporations the added expense of creating more than one set of financials. Opponents of wholesale adoption are largely not convinced of its utility to financial statement users and also point out that one set of global accounting standards may not be practical due to certain inconsistencies between IFRS and each country's local laws. Nonetheless, these opponents still acknowledge that there are clear benefits to the wholesale adoption of one set of reporting standards for both developed and developing countries around the world.

Presently, IFRS is widely accepted among countries outside of the U.S. Additionally, the SEC has already established a timetable for the wholesale adoption of IFRS. As a result, in consideration of these two factors, the arguments for and against each alternative, and the challenges identified in light of the globalization process, it seems reasonable to conclude that the accounting profession will embrace wholesale adoption of IFRS over the coming years.

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<sup>56</sup> Douppnik, Timothy and Hector Perera. International Accounting. (New York: McGraw-Hill Irwin 2007), p76.

**THE CISG AFTER MEDELLIN V. TEXAS:  
DO U.S. BUSINESSES HAVE IT?  
DO THEY WANT IT?**

*Mark Cantora\**

INTRODUCTION

The Convention on the International Sale of Goods (the “CISG”) is a multilateral uniform sales treaty adopted at a diplomatic conference in Vienna in 1980.<sup>1</sup> The objectives of the CISG, as outlined in its preamble, are to “remove legal barriers to international trade and promote the development of international trade.”<sup>2</sup> In practice, the CISG is a set of default rules developed for the purpose of maximizing and streamlining efficient international trade.<sup>3</sup> The Convention is commonly understood to have entered into force for all the states a party to it, on January 1, 1988.<sup>4</sup>

Two assumptions about the CISG have prevailed since it supposedly came into force in the United States.<sup>5</sup> The first assumption concerns the very

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\* J.D. Candidate, 2010, Hofstra University School of Law. I would like to thank the entire staff of the Journal of International Business and Law for their assistance in preparing this article for publication. Special thanks to my advisor, Professor Norman Silber, and my Notes and Comments editor, Conor McDonald, for helping guide my work through its many stages. I would like to thank Christopher Richins and Vanessa Tiradentes, for all of his invaluable assistance, without which, this note would never have been prepared for publication. I would also like to express my sincerest gratitude to my parents, James and Elizabeth Cantora, for supporting me in all my endeavors. Finally, I would like to dedicate this note to Tamar Katz—we both know that all my accomplishments are only possible because of you.

<sup>1</sup> United Nations Convention on Contracts for the International Sale of Goods, Final Act (Apr. 10, 1980), U.N. Doc. A/CONF.97/18, Annex I (1980), *reprinted in* S. Treaty Doc. No. 98-9, 98<sup>th</sup> Cong., 1<sup>st</sup> Sess., *and in* 19 Int'l Legal Materials, 668 (1980), *also available at* <http://www.uncitral.org/pdf/english/texts/sales/cisg/CISG.pdf> [hereinafter “CISG”].

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

<sup>3</sup> *See generally Id.*; Nicholas G. Karambelas, *International Sale of Goods: An International Law as Domestic Law*, WASHINGTON LAWYER, Apr. 2009, at 27 (noting that the CISG is a set of “uniform and coherent” default rules).

<sup>4</sup> CISG, *supra* note 1.

<sup>5</sup> United Nations Commission on International Trade Law: Status-1980: United Nations Convention on Contracts for the International Sale of Goods, *available at*

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meaning of the phrase “came into force in the United States.” Since 1988, the U.S. courts that have not ignored the CISG altogether have assumed that the CISG is self-executing, and have therefore assumed that the CISG has come into force in the U.S. without the need for any congressional action.<sup>6</sup> The second prevailing assumption is that the CISG is efficient and beneficial for U.S. businesses engaged in the international sale of goods.<sup>7</sup> Most treatises and commentators have either assumed the CISG’s benefits by explicitly stating so or by ignoring the question of the CISG’s usefulness altogether.<sup>8</sup>

On March 25, 2008, the Supreme Court majority in *Medellin v. Texas* arguably asserted a new standard for determining the self-executing status of all international treaties to which the U.S. is a signatory.<sup>9</sup> This new standard has thrown into doubt the self-executing status of the CISG.<sup>10</sup> This note will argue that because of the ruling in *Medellin v. Texas*, the two prevailing assumptions about the CISG must be reexamined.<sup>11</sup> Both the status of the CISG and the benefits accruing from the CISG’s implementation will be examined for the purpose of answering two simple questions: (1) Is the CISG a self-executing treaty in force in the U.S. and (2) Do U.S. businesses want it to be?

Before the analysis begins, however, the scope of this article must be explicitly defined. First, this article is not a general analysis of the history of the Supreme Court’s interpretation of self-executing and non-self-executing treaties. This topic has been covered extensively in many books, treatises, and articles by eminent jurists and commentators, and any analysis of that history in this article would be superfluous and unnecessary.<sup>12</sup> It suffices to say that the opinions of both the majority and the dissent in *Medellin* approach the

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[http://www.uncitral.org/uncitral/en/uncitral\\_texts/sale\\_goods/1980CISG\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html).

<sup>6</sup> See Claire R. Kelly, *The International Sale of Goods: The Back and Forth of the CISG and International Law*, A.L.I.-A.B.A. Continuing Legal Education—The U.C.C. and Beyond: Current Developments in Commercial Law, SN086 ALI-ABA 47 (2008).

<sup>7</sup> See Gilles Cuniberti, *Is the CISG Benefitting Anybody?*, 39 VAND. J. TRANSNAT’L L. 1511 (2006).

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

<sup>9</sup> *Medellin v. Texas*, 128 S. Ct. 1346, 1356 (2008).

<sup>10</sup> *Id.* at 1361.

<sup>11</sup> See generally Posting of Jeremy Telman to Contracts Law Prof Blog: *Medellin and Contracts Revisited II*, [http://lawprofessors.typepad.com/contractsprof\\_blog/2008/04/medellin-and--1.html](http://lawprofessors.typepad.com/contractsprof_blog/2008/04/medellin-and--1.html) (Apr. 8, 2008).

<sup>12</sup> See, e.g., 3 JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES, 696-97 (1833), available at [http://www.constitution.org/js/js\\_000.htm](http://www.constitution.org/js/js_000.htm); Carlos Manuel Vasquez, *The Four Doctrines of Self Executing Treaties*, 89 AM. J. INT’L L. 695 (1995); Martin S. Flaherty, *History Right?: Historical Scholarship, Original Understanding, and Treaties as “Supreme Law of the Land”*, 99 COLUM. L. REV. 2095 (1999); John Yoo, *Treaties and Public Lawmaking: A Textual and Structural Defense of Non-Self-Execution*, 99 COLUM. L. REV. 2218 (1999).

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interpretations of a treaty's self-executing status from the two major, yet divergent, historical theories of treaty interpretation, and in the end, the *Medellin* majority's theory is now the new dominant theory in force.

Second, this article is not an analysis of the efficiency of the CISG when the parties include a "choice of governing law" provision in their contracts. Every analysis in this article assumes that the parties have not included any provisions in their contract providing for a specific governing law. In a hypothetical world where the parties do not include a contractual provision for a specific governing law, and where the CISG is not in force in the United States, the default rules of the Uniform Commercial Code (the "U.C.C.") would be applied. Therefore, this article compares the efficiency of the CISG's default rules against the U.C.C. default rules that would be applied if the CISG was not in force.

Finally, this article concludes that (a) pursuant to the *Medellin* decision, the CISG is a self-executing treaty and is in force as such in the United States today, and (b) even when compared to the U.C.C. default rules hypothetically applicable to international sales of goods in the absence of the CISG, the CISG is economically efficient and beneficial for U.S. businesses.

### I. MEDELLIN AND SELF-EXECUTION

Because the CISG has been assumed to be self-executing by nearly all U.S. courts and commentators,<sup>13</sup> any ruling on the definition and understanding of "self-executing" has the potential to have an enormous impact on the CISG. Therefore, the *Medellin* analysis of "self-execution" must be studied in order to reveal whether or not the CISG ever was, or is now, self-executing.

At first glance, the *Medellin* majority's opinion seems to never clearly state that a treaty requires an actual statement within the treaty, explicitly declaring the treaty to be "self-executing."<sup>14</sup> However, ambiguity is inserted into the analysis by the dissent's misreading of the majority's statement that a treaty must "convey an intention" to be self-executing.<sup>15</sup> In coming to the conclusion that a treaty must convey an intention to be self-executing, the majority cites *Igartua-De La Rosa v. United States*.<sup>16</sup> However, the court in *Igartua* is presumably the first court to make the leap from the original understanding of the Supreme Court that the language itself must "act directly

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<sup>13</sup> See Kelly, *supra* note 6.

<sup>14</sup> *Medellin v. Texas*, 128 S. Ct. 1346, 1356 (2008) (holding that in order to be self-executing a treaty need only convey an intention to be so).

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

<sup>16</sup> *Id.*

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on the subject [of the treaty],”<sup>17</sup> to the understanding that a treaty must “convey an intention” to be self-executing.<sup>18</sup> This seems to show that the dissent’s theory that the Court’s opinion requires explicit language in the text acting directly on the subject<sup>19</sup> *could* be logically and interpretively correct.

The interpretation of this major part of the majority’s opinion turns completely on the understanding of the word “convey.” Since in this context the word “convey” is not a legal term of art, the plain meaning of the word can be derived from its standard definition.<sup>20</sup> Merriam-Webster defines “convey” as meaning “to impart or communicate by statement, suggestion, gesture, or appearance.”<sup>21</sup> Therefore a “conveyed” intention need not be explicit in a text in order to be present; to be a conveyed intention, that intention may be implied.<sup>22</sup>

Of course, the *Medellin* majority’s standard is the new precedent to be followed by all future courts. However, the majority’s and dissent’s divergent opinions on the proper interpretation of the majority’s standard is a source of ambiguity and, when applied in the future, could lead to completely opposite outcomes. Therefore, these two questions must be analyzed in order to properly understand the implications the *Medellin* majority’s standard will have on the CISG: Does the CISG language convey an intention that the treaty is self-executing (a) pursuant to the majority’s own characterization of its standard, and (b) pursuant to the dissent’s understanding of the majority’s standard?

#### **A. Is the CISG Self-Executing under the Majority’s Own Interpretation of Its Standard?**

The CISG is self-executing under the majority’s own interpretation of its expressed standard. After emphatically stating that the treaty language itself is of the utmost importance in interpreting the nature of a treaty,<sup>23</sup> the majority goes on to state that neither its cases nor its standard requires a “talismanic”

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<sup>17</sup> Foster v. Nielson, 27 U.S. 253, 314-15 (1829).

<sup>18</sup> Igartua-De La Rosa v. U.S., 417 F.3d 145, 150 (1st Cir. 2005) (improperly citing Foster v. Nielson for the contention that in order for a treaty to be self-executing, it must convey an intention to be so).

<sup>19</sup> See *Medellin*, 128 S. Ct. at 1380 (“[T]oday’s majority looks for language about ‘self-execution’ in the treaty itself, and . . . it erects ‘clear statement’ presumptions . . .”).

<sup>20</sup> No law dictionaries include a definition for the word “convey” as it is used in this context.

<sup>21</sup> <http://www.merriam-webster.com/dictionary/convey>.

<sup>22</sup> “Imply” being a synonym for “Suggest.” See <http://www.merriam-webster.com/dictionary/suggesting>.

<sup>23</sup> *Medellin*, 128 S. Ct. at 1356-57.

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word in the text in order for a treaty to be found to be self-executing.<sup>24</sup> The majority's explanation of its own standard (and its refutation of the dissent's interpretation of its standard) shows that the language of the treaty must convey an intent to be self-executing, but that it must not necessarily do so explicitly.<sup>25</sup> The majority's opinion, when understood on its own terms (as even the dissent points out),<sup>26</sup> considers numerous treaties to be self-executing even when they lack specific and explicit language on the matter of self-execution.<sup>27</sup> In the words of the majority, "[W]e have held treaties to be self-executing when the textual provisions *indicate* that the President and Senate *intended* for the agreement to have domestic effect."<sup>28</sup> The majority also states that it will look secondarily to the negotiation and drafting history of the treaty, and to the post-ratification understanding of the treaty.<sup>29</sup>

Therefore, in order to determine if the CISG is self-executing, the analysis must start with an examination of the text of the CISG in order to determine whether it contains provisions indicating its drafters intended for the agreement to have immediate domestic effect and to be self-executing.

There are only two specific sections in the CISG which could be understood to speak to the issue of the CISG's self-executing status: the preamble and article 99(2).

*The Preamble*

The preamble of the CISG broadly states the purposes, objectives, and goals of the treaty.<sup>30</sup> However, attempting to find language in the preamble of the CISG that would be dispositive to proving that the CISG is self-executing is problematic because the preamble does not contain the oft-used phrases that tend to prove either self-execution or non-self-execution, such as "the states may" or "the states shall" or "the states will undertake to."<sup>31</sup> The preamble merely states that "the States Parties to this Convention . . . Have Agreed as follows."<sup>32</sup> This statement is ambiguous and can be interpreted to mean that the

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<sup>24</sup> *Id.* at 1366.

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

<sup>26</sup> *Id.* at 1381 ("Indeed, the majority does not point to a single ratified United States treaty that contains the kind of 'clea[r]' or 'plai[n]' textual indication for which the majority searches.").

<sup>27</sup> *Id.* at 1363, 1368.

<sup>28</sup> *Id.* at 1364 (emphasis added).

<sup>29</sup> *Id.* at 1357.

<sup>30</sup> CISG, *supra* note 1.

<sup>31</sup> *See id.* at 1358-59 (discussing interpretations of "must" and "shall," and "undertake" in a larger discussion of Article 94 of the UN Charter).

<sup>32</sup> CISG, *supra* note 1.

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states agree to execute the convention and make it part of their domestic law, or, conversely, that the states agree that upon ratification the convention is immediately in force as law. Unfortunately, the preamble does not provide any interpretive guidance because it does not contain any language that the treaty conveys, either explicitly or implicitly, an intention to be self-executing.

*Article 99(2)*

Article 99(2) addresses when and how the CISG comes into force for each state. It reads:

When a State ratifies, accepts, approves or accedes to this Convention after the deposit of the tenth instrument of ratification, acceptance, approval or accession, this Convention, with the exception of the Part excluded, enters into force in respect of that State, subject to the provisions of paragraph (6) of this article, on the first day of the month following the expiration of twelve months after the date of the deposit of its instrument of ratification, acceptance, approval or accession.<sup>33</sup>

Article 99(2) could be read to assert that after the deposit of the instrument of ratification, acceptance, approval, or accession, the CISG will “come into force.” If construed this way, it would necessarily follow that the CISG was meant to be self-executing for each state where the CISG was ratified, accepted, approved, or accessed, after the tenth state ratifies the convention.<sup>34</sup>

However, Article 99(2) must be read in light of the relevant passage in Article 7 of the CISG. Article 7 states that “[i]n the Interpretation of this Convention, regard is to be had to its international character.”<sup>35</sup> Reading Article 99(2) within the context of Article 7 could be interpreted to implicitly mean that the drafters of the CISG understood that, because the CISG is a multilateral international treaty, all signatory states have multiple and varying ways of bringing a treaty into force as domestic law within their own legal system.<sup>36</sup>

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

<sup>34</sup> Posting of Antonin I. Pribetic, [http://lawprofessors.typepad.com/contractsprof\\_blog/2008/04/medellin-and--1.html](http://lawprofessors.typepad.com/contractsprof_blog/2008/04/medellin-and--1.html) (April 9, 2008, 12:42:54 EST).

<sup>35</sup> CISG, *supra* note 1, art. 99.

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

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The listing of the four options—ratification, acceptance, approval, accession—could be meant to imply that the convention comes into force with respect to that state *only* after the treaty is also approved in that state’s own unique way.<sup>37</sup> However, the very ambiguity of this section, and the equal possibility that the section could be construed either way, proves that the section does not meet the Court’s requirement that a treaty provision either explicitly or implicitly convey an intention to be self-executing.

The clear ambiguities within the only two sections that could possibly speak to the issue of self-execution means that, pursuant to the majority’s opinion, recourse must be had to the “secondary” interpretive tools: the drafting history and the post-ratification understandings of the treaty.<sup>38</sup>

Recourse to the drafting history can be quickly discarded as an interpretive tool. A thorough search of the drafting history reveals no interpretive guidance for determining whether or not the CISG is self-executing.<sup>39</sup> Therefore, according to the majority’s opinion, the only tool left to determine whether the CISG is self-executing is the U.S. government’s post-ratification understanding of the CISG.<sup>40</sup>

It seems significant that in the “Message from the President of the United States to the Senate about the United Nations Convention on Contracts for the International Sale of Goods,” the President stated that, “[t]he Convention is subject to ratification by signatory States (Article 91(2)), but is self-executing

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<sup>37</sup> For example, no one would make the argument that the CISG cannot come into force within a state if that state signs the CISG and its local rules do not have procedures equivalent to the four listed. If that state had its own procedures for bringing the CISG into force, the CISG would be considered in force in that state once those procedural requirements are satisfied *regardless* of the fact that the state’s procedures do not fit exactly into one of the four categories listed in Article 99(2).

<sup>38</sup> *Medellin v. Texas*, 128 S. Ct. 1346, 1357 (2008) (“Because a treaty ratified by the United States is ‘an agreement among sovereign powers,’ we have also considered as ‘aids to its interpretation’ the negotiation and drafting history of the treaty as well as ‘the postratification understanding’ of signatory nations.”).

<sup>39</sup> *See generally* United Nations Conference on Contracts for the International Sale of Goods, Vienna 10 March - April 11 1980: Official Records, Documents of the Conference and Summary Records of the Plenary Meetings and of the Meetings of the Main Committees JX1977 .A2 A/CONF. 97/19 (New York: United Nations, 1981); JOHN O. HONNOLD, DOCUMENTARY HISTORY OF THE UNIFORM LAW FOR INTERNATIONAL SALES (Deventer, Netherlands: Kluwer, 1989).

<sup>40</sup> Technically, the Court requires an examination of the “post-ratification understanding of signatory nations.” *See Medellin*, 128 S. Ct. at 1357. However, the post-ratification understandings of signatory nations *other than* the United States are unhelpful in providing any guidance for whether or not the U.S.’s domestic legal system considers the CISG self-executing or non-self-executing. Therefore, the U.S. government’s post-ratification understanding of the CISG’s executory status is the only signatory nation’s understanding that is relevant in this particular context.

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and this requires no federal implementing legislation to come into force throughout the United States.”<sup>41</sup> While this does not fit neatly into the category of a “post-ratification understanding,” it clearly conveys the intention of the President and the Senate for the treaty to be self-executing.<sup>42</sup>

The President’s statement on the CISG’s self-executing status, the Senate’s ratification of the CISG with full knowledge that the President understands the CISG to be self-executing, and the ambiguous nature of the preamble and Article 99(2) that *could* point to the self-executing nature of the treaty, all act as strong evidence that the CISG will still be considered self-executing pursuant to the *Medellin* majority’s interpretation of its own standard.<sup>43</sup>

### **B. Is the CISG Self-Executing According to the Dissent’s Interpretation of the Court’s Standard?**

The *Medellin* dissent interprets the Court’s holding to mean that the treaty language itself must explicitly state an intention to be self-executing in order for the treaty to be considered self-executing.<sup>44</sup> Thus, because it has been shown that the language of the CISG does not explicitly convey any intention to be self-executing, the dissent’s interpretation of the majority’s standard would render the CISG non-self-executing.<sup>45</sup>

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<sup>41</sup> Message from the President of the United States to the Senate Transmitting the United Nations Convention on Contracts for the International Sale of Goods, Sept. 21, 1983, S. Treaty Doc. No.98-9 (1983). See also Posting of Jeremy Telman to Contracts Law Prof Blog: *Medellin* and the CISG, [http://lawprofessors.typepad.com/contractsprof\\_blog/2008/03/medellin-and-th.html](http://lawprofessors.typepad.com/contractsprof_blog/2008/03/medellin-and-th.html) (Mar. 26, 2008).

<sup>42</sup> See *Medellin*, 128 S. Ct. at 1367 (implying that the intention of the President and the Senate is dispositive of the nature of the treaties executory status. See also John D. Gregory, *Implementing the Electronic Communications Convention: Ratification Isn’t What It Used to Be*, 18-FEB BUS. L. TODAY 43.

<sup>43</sup> Contracts Law Prof Blog: *Medellin* and the CISG, [http://lawprofessors.typepad.com/contractsprof\\_blog/2008/03/medellin-and-th.html](http://lawprofessors.typepad.com/contractsprof_blog/2008/03/medellin-and-th.html) (Mar. 26, 2008).

<sup>44</sup> *Medellin*, 128 S. Ct. at 1389 (noting the dissent’s understanding that the majority’s standard requires “explicit textual expression about self-execution” in order for a treaty to be considered self-executing).

<sup>45</sup> *Id.* at 1383-84 (Breyer, J., dissenting) (expressing fear that the Court’s holding would undermine multiple important international treaties that, until the *Medellin* decision, were considered self-executing).

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### C. The CISG Is Self-Executing

It is clear from an examination of the *Medellin* majority's and the *Medellin* dissent's different interpretations of the majority's holding, that under the majority's interpretation the CISG would be considered self-executing, while under the dissent's interpretation the CISG would be considered non-self-executing. Had the majority merely stated its holding without addressing the *proper interpretation* of its holding, the dissent's analysis would most likely have had a very significant effect on future applications of *Medellin*. However, because the majority explicitly addressed how its holding should be understood and applied, the majority's explanations on the proper application of its own holding will very likely be the dominant analysis used by U.S. courts in future cases involving treaties and the determination of their status as self-executing or non-self-executing. Thus, future courts properly applying the majority's standard must necessarily understand the CISG to be self-executing. Pursuant to the Court's holding in *Medellin v. Texas*, the CISG is a self-executing treaty in full-force in the United States today.

## II. THE BENEFITS OF THE CISG: AN ECONOMIC ANALYSIS

The economic analysis of law provides a system to study the efficiency of the law.<sup>46</sup> Economists define an efficient transaction as one in which at least one person is made better off while no one is made worse off.<sup>47</sup>

In his article, "The Problems of Social Cost," Ronald Coase argues that, regardless of the initial assignments of property rights, the freedom of contract will efficiently distribute property rights to the owner who most values them.<sup>48</sup> Known popularly as the Coase Theorem, Ronald Coase's theory

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<sup>46</sup> See RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 1-10 (2007).

<sup>47</sup> This kind of efficient transaction, where at least one person is made better off and no person is made worse off is called "Pareto-superior efficiency" or "Pareto efficiency." *See id.* Many economists, finding the pareto-superior concept too strict and unrealistic, use a concept of efficiency where a transaction is efficient if at least one person is made better off and the people who are made worse off actually are *or theoretically could be* compensated from the ones made better off. This kind of efficiency is called "Kaldor-Hicks efficiency" or "potential Pareto efficiency." *See* Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 *YALE L.J.* 1211, 1221-22 (1991) ("[A] move is efficient whenever the winners win more than the losers lose, in the sense that, if the winners compensated the losers to their satisfaction, the winners would still be better off than they were before the change . . . This test is sometimes called potential Pareto superiority . . ."). Regardless of which concept of efficiency is used, it is economically true and logically intuitive that a transaction making at least one person better off while not making any people significantly worse off is a beneficial and "good" transaction.

<sup>48</sup> Ronald Coase, *The Problem of Social Cost*, *J. L. & ECON.* (1962). Dr. Coase explains that, in a

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hypothesizes that these property rights will be allocated in this efficient way when the parties come together and make contracts. Therefore, many economists have argued that the entire point of the laws of contracts should be to decrease ex-ante<sup>49</sup> transaction costs which would discourage the act of contracting, in order to efficiently allocate property rights to their most valued and most valuable use.<sup>50</sup> In order to decrease these transaction costs, economists have advocated enacting laws that would mimic “what the parties would have wanted” had they actually bargained for the specific provision and possessed full information.<sup>51</sup> These economists have argued that these “majoritarian rules”<sup>52</sup> would allow the majority of parties to spend less money negotiating these provisions in their own private transactions.<sup>53</sup>

However, in 1989, law scholar Ian Ayres and economist Robert Gertner outlined a groundbreaking theory arguing that there is another important goal of contractual rules when those rules are “default rules” as opposed to “immutable rules.”<sup>54</sup>

Immutable contract rules, such as the restriction against contractual provisions disclaiming obligations of good faith or care,<sup>55</sup> are rules from which there can be no derogation.<sup>56</sup> Parties cannot vary these rules by contract, and

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world where there are no transaction costs, the person who puts the most value in something will pay for the opportunity to have that thing that he or she values.

<sup>49</sup> “Ex-ante” is an economics term meaning “before the transaction.” Its corollary term is “ex-post” meaning “after the transaction.” See Online Glossary of Research Economics: Ex-ante, <http://www.econterms.com/glossary.cgi?query=ex-ante>; Online Glossary of Research Economics: Ex-post, <http://www.econterms.com/glossary.cgi?query=ex-post>.

<sup>50</sup> Cuniberti, *supra* note 7. Cuniberti analyzes the CISG’s ability to reduce transaction costs and concludes that the CISG is not efficient from a Law and Economics perspective.

<sup>51</sup> Full information merely means the full amount of information relevant and related to the particular transaction at issue. See generally Frank H. Easterbrook & David R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1410 (1989) (proposing a general theory on the economic efficiency of default rules that mimic what the parties in a transaction would have chosen with “full information and costless contracting.”).

<sup>52</sup> “Majoritarian rules” is the economics phrase encompassing the concept of contractual rules and laws that mimic what “most parties would have wanted had they actually negotiated the provision.” See CASS R. SUNSTEIN, *BEHAVIORAL LAW AND ECONOMICS* 139 (illustrated ed., Cambridge Univ. Press 2000).

<sup>53</sup> See Easterbrook & Fischel, *supra* note 51.

<sup>54</sup> Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

<sup>55</sup> See U.C.C. § 1-302(b) (1978) (“The obligations of good faith, diligence, reasonableness, and care . . . may not be disclaimed by agreement.”). See also Restatement (Second) of Contracts § 205 (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.”) (emphasis added).

<sup>56</sup> See Ayres & Gertner, *supra* note 54, at 88 (“Immutable rules cannot be contracted around.”).

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any contractual provision that runs counter to these immutable rules will not be enforced.<sup>57</sup> Because today's free-market society is based on the freedom of individuals to make bilateral and multilateral exchanges through bargaining,<sup>58</sup> and immutable rules necessarily restrict this freedom, the overwhelming majority of contemporary rules of contract are "default rules."<sup>59</sup>

Default rules are contract laws that will be applied in the absence of a contractual provision to the contrary.<sup>60</sup> However, when the parties include a provision in a contract that derogates from the default rule, the contractual provision prevails as the "private law" between the parties.<sup>61</sup>

Ian Ayres's and Robert Gertner's 1989 theory, known popularly as the Ayres-Gertner Model, argues that while all immutable rules and some default rules should be majoritarian, there are other defaults that should be designed to induce at least one party to a contract to "draft around" the default rule, in order to openly clarify the parties' preferences in the transaction.<sup>62</sup> Furthermore, they argue that the goal of default rules should not *solely* be to lower transaction costs, because transactions costs are not the only impediments to complete contracts.<sup>63</sup>

The following section will first explore the different goals of default rules. It will then apply these goals to five of the most important concepts/provisions in contract analysis, in order to determine whether these rules are (1) majoritarian defaults or penalty defaults, and (2) economically efficient or economically inefficient.

### A. Transaction Cost Reducing Defaults

When two parties make a contract in a commercial transaction, their ultimate goal is to make a deal that will result in benefits for both parties. In a perfect world, the two parties would have the ability to come together and quickly make a deal without spending any significant amount of time, money, or resources. In that perfect world, the contract would cover every possible contingency, so that any litigation arising from a breach of the contract would

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<sup>57</sup> *See id.* ("[Immutable rules] govern even if the parties attempt to contract around them.")

<sup>58</sup> E. ALLAN FARNSWORTH, *CONTRACTS* 5 (Aspen Publishers 2004) (noting that exchange in the "mainspring" of our economic system of free enterprise).

<sup>59</sup> *Id.* at 37 ("[T]he great bulk of the general rules of contract law, including those of the Uniform Commercial Code and the Vienna Convention [the CISG], are subject to contrary provision by the parties.")

<sup>60</sup> Ayres & Gertner, *supra* note 54, at 87.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.* at 92-93.

<sup>63</sup> *Id.*

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be instantaneously solvable by reference to the pertinent provision in the contract. Moreover, because every provision of the contract is both “obligationally complete” and “contingently complete,” the publicly subsidized court system would have little involvement, and thus the contract would impose the bare minimum amount of social costs<sup>64</sup> onto the taxpayers.<sup>65</sup>

However, in the real world, valuable amounts of time, money, and resources are spent in the simple act of drafting and completing a contract. These transaction costs, including ex-ante legal fees, can become so large that they deter parties from spending much, if any, time properly drafting and negotiating the contract provisions covering the rights, duties, obligations, and legal exigencies involved in the business deal.<sup>66</sup> This, in turn, can result in even greater costs for both the parties and society as the courts spend large amounts of time and money determining an equitable and efficient outcome of litigation in which a party breaches a provision of an incomplete contract.

Therefore, in order to get closer to the “perfect world” of complete contracts, lawmakers have enacted gap-filling default rules tailored to what the majority of parties “would have wanted” had they actually spent time negotiating those particular provisions.<sup>67</sup> These “majoritarian” default rules have the benefit of reducing transaction costs by bestowing on the parties the benefit of these rules as if they had bargained for them, without requiring the parties to expend the large amount of money, time, or effort that is typically needed to get these provisions memorialized into the deal. However, more recent scholarship has shown that transaction costs are not the only issues lawmakers should be concerned with when drafting default gap-fillers.

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<sup>64</sup> “Social Costs” is an economics term referring to the overall cost of an economic activity on the welfare of society. See Online Glossary of Research Economics: Social Costs, <http://www.economist.com/research/economics/alphabetic.cfm?letter=S#socialbenefitscosts>. In the context of this article, the generally referred to social costs are mainly the citizen tax-dollars spent on maintaining and operating the justice system.

<sup>65</sup> “Obligationally Incomplete” is a law and economics term referring to “contracts in which [all] the obligations are not fully specified.” See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 730 (1992). “Contingently Incomplete” is an economics term referring to “contracts that fail to fully realize the potential gains from trade in all states of the world.” See *id.*

<sup>66</sup> Transaction costs can include any costs that are associated with the deal making process (including the contract drafting) before the signing of the contract. These costs can include, but are not limited to, lawyer's fees, time-value, and human resources and their associated expenses.

<sup>67</sup> Ayres & Gertner, *supra* note 54.

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### B. Information Forcing Defaults

Since the early 1990's, law and economics scholars have focused more of their attention on the importance of default rules that do exactly the opposite of "what the parties would have wanted" had they bargained for the rule.<sup>68</sup> These default rules are structured in such a way that the parties will be forced to "contract around" the default rules in order to avoid being penalized by the harsh results of the rule.<sup>69</sup>

For example, assume A is a manufacturer and seller of widgets and B is a purchaser of these widgets. Further assume that a contract for the sale of 100 widgets is negotiated between A and B, but they fail to specify a price for the widgets in the contract. In subsequent litigation over a breach in the contract, the court would easily be able to determine a "reasonable" price for the widgets "that the parties would have wanted" by looking to the market price of widgets at the time that the contract was concluded.

However, assume instead that the contract included a provision specifying that B agreed to buy widgets from A for the price of \$1.00 per widget, but the parties failed to include in the contract the number of widgets to be purchased. In subsequent litigation, how would the court determine the quantity of widgets that both parties would have wanted had they bargained for the amount in the contract?<sup>70</sup> There is no equivalent to "market value" when it comes to determining quantities. Therefore, having no default rule at all in these circumstances would be inefficient for the parties, and a "majoritarian" default rule would be both impossible and inefficient. In this situation, the most efficient solution for the parties involved, and for society at large, would be a default rule that is so harsh it would stand out and force the parties to take notice and provide the relevant and necessary information by contracting around the rule in order to avoid the harsh results of the default rule.<sup>71</sup>

The CISG, as mentioned above, is made up almost entirely of default rules.<sup>72</sup> There is no indication in the legislative history as to whether or not the

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<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> At the very least, the subsequent litigation would require hours, if not days, of testimonial and physical evidence of what the parties claim they contracted for, common business practices, and past business arrangements between the parties.

<sup>71</sup> Ayres & Gertner, *supra* note 54.

<sup>72</sup> The only mandatory rules of the CISG are found in Article 12. CISG, *supra* note 1, art. 12 ("Any provision of article 11, article 29 or Part II of this Convention that allows a contract of sale or its modification or termination by agreement or any offer, acceptance or other indication of intention to be made in any form other than in writing does not apply where any party has his place of business in a Contracting State which has made a declaration under article 96 of this Convention. The parties

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rules were drafted using only the majoritarian standard or if the drafters took into account the equal importance of penalty default rules.<sup>73</sup> The legislative history gives no guidance to determine whether or not the CISG drafters even took efficiency into account when drafting the CISG. However, there *is* a method to determine general efficiency of the CISG as a whole. This method requires a comparison of the CISG and the U.C.C.

The U.C.C. is the standard set of (mostly) default rules applied for all commercial sales transactions in the United States.<sup>74</sup> When the CISG is not applicable to commercial sales transactions in goods, U.S. courts generally apply the U.C.C.<sup>75</sup> An examination of the efficiency of five of the most important contract rules,<sup>76</sup> and a comparison of how the CISG and U.C.C. apply these rules can be used to determine whether or not the CISG is more or less efficient than the CISG. Therefore, if the U.C.C. is determined to be more efficient and beneficial for U.S. businesses, the CISG would necessarily be inefficient for, and detrimental to, U.S. businesses.

*The Statute of Frauds*

The first statute of frauds was enacted in England in 1676 for the purpose of preventing fraud in contractual dealings.<sup>77</sup> The English original, and its American common-law progeny, traditionally required that any contract, in order to be enforced in a court of law, must be memorialized in writing.<sup>78</sup> The

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may not derogate from or vary the effect of this article.”).

<sup>73</sup> Most likely, if the drafters of the CISG even took economic efficiency into account, they applied the majoritarian approach to the CISG's default rules. The CISG was drafted throughout the late 1970's, when the majoritarian approach was the dominant view and the Ayres-Gertner model on penalty defaults was not yet published.

<sup>74</sup> See FARNSWORTH, *supra* note 58, at 33, 37 (noting that Article II of the U.C.C. is generally applied to all domestic sales transactions in goods and is made up of mostly default rules).

<sup>75</sup> Before 1988, US businesses engaged in international sales transactions in goods were generally still subject to the U.C.C. This would have continued to be the case were the CISG not in force in the United States. See *id.* at 33-35 (noting that the U.C.C. generally applies to domestic sales transactions in goods, but the CISG generally displaces the U.C.C. for international sales transactions).

<sup>76</sup> These rules are the statute of frauds, the parol evidence rule, “foreseeability of damages” rules, price term rules, and quantity term rules.

<sup>77</sup> Language and Law: Statute of Frauds (1677), <http://www.languageandlaw.org/TEXTS/STATS/FRAUDS.HTM>.

<sup>78</sup> The original statute referred only to contracts in land, but modern statutes of frauds based on the English original have been applied to numerous other transactions, including contracts for the sale of goods. See generally JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS, § 19.1 (5th ed. 2003) (explaining the general history of the Statute of Frauds and its relation to similar

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statute of frauds does not fit perfectly into the model of “gap filling” defaults.<sup>79</sup> Its purpose is not to fill in a specific contract term that the parties left out of their negotiated contract. Rather, the purpose of the statute of frauds is to encourage parties to actually put their contracts in writing.<sup>80</sup>

Clearly, the statute of frauds is not a majoritarian default. When parties come together to negotiate a deal, their logical preference is to have any deals made between them, including non-written ones, be enforceable in a court of law.<sup>81</sup> Rendering a contract non-enforceable simply because it was not memorialized in writing is not “what the parties” would have wanted when they entered the deal. Quite the opposite, parties normally want all their contracts, regardless of their forms, to be enforced.

Therefore, the statute of frauds must operate as either an Ayres-Gertner model information forcing penalty default, or merely as an economically inefficient default rule. At first glance, it would seem as though the statute of frauds was the ideal version of a penalty default. It seems to operate in such a way that the penalty for failing to put contractual provisions in written form is a completely useless and unenforceable contract. Such a harsh consequence seems to force the parties to take notice and contract around the default by putting the provisions of the contract in writing.<sup>82</sup> But a closer look at the

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American statutes).

<sup>79</sup> Economist Eric Posner would most likely not consider the statute of frauds a contractual gap-filling default rule because the statute of frauds “does not fill a gap in an otherwise valid contract . . .” Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563, 578 (2006) (explaining that only doctrines which fill gaps in otherwise valid contracts are “true” gap-filler default rules). *But see* Ian Ayres, *Ya-Huh: There Are and Should be Penalty Defaults*, 33 FLA. ST. U. L. REV. 589, 593 (2006) (“[I]f the operation of a rule is functionally equivalent to a default, it is both acceptable and advisable to analyze it as a default.”).

<sup>80</sup> This encouragement is formally known as the Statute of Fraud’s “evidentiary” and “cautionary” functions. *See* Monroe H. Freedman, *Contracts: An Introduction to Law and Lawyering* 338 (unpublished casebook, on file with author).

<sup>81</sup> Otherwise, why make any contract in the first place? If people came together and negotiated contracts, without any expectation that the contracts would have the force of law behind them, their thinking would be rather similar to Charles Marlow in the novel *Heart of Darkness* when he says, “It occurred to me that my speech or my silence, indeed any action of mine, would be a mere futility.” JOSEPH CONRAD, *HEART OF DARKNESS* 66 (Penguin Classics 1995).

<sup>82</sup> The statute of frauds in U.C.C. § 2-201 is actually rendered a default rule because it can be varied by agreement and contracted around pursuant to U.C.C. § 1-102(3). However, “contracting around” the statute of frauds default actually results in complying with the very rule one is attempting to contract around, since in order for there to be a written contract provision expressly not requiring the contract terms be written, it is assumed that there is an existing written contract to which this provision can be added, thus rendering the provision that “contracts around” the statute of frauds essentially pointless, and the attempt to “contract around” the statute of frauds in the traditional sense unintelligible.

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language of the rule as found in the U.C.C. shows that the U.C.C.'s statute of frauds default rule<sup>83</sup> fails to force the parties into providing any useful information whatsoever. U.C.C. § 2-201(1) states:

Except as otherwise provided in this section a contract for the sale of goods for the price of \$500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties . . .<sup>84</sup>

This provision proceeds to explain that the only term that need be written in order to satisfy the U.C.C.'s statute of frauds is the quantity of goods.<sup>85</sup> The official comments further elaborate that the writing need only "afford a basis for believing that the offered oral evidence rests on a real transaction."<sup>86</sup> Even an indication of which party is the buyer and which party is the seller is not needed to satisfy U.C.C. § 2-201(1).<sup>87</sup>

At the expense of raising ex-ante transaction costs,<sup>88</sup> penalty defaults are meant to force the parties to provide *important and significant* information that would lower the otherwise high ex-post litigation costs for both the parties and the publicly subsidized court system.<sup>89</sup> But the statute of frauds fails to force the parties to provide any important information whatsoever.<sup>90</sup> The terms of all traditional and modern statutes of frauds, and more specifically, the U.C.C.'s typical version of the statute, allows a valid contract be so informal

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<sup>83</sup> The U.C.C. statute of frauds is supplemented by common law understandings and legal concepts related to the U.C.C. provision at issue, including the common law analysis of the statute of frauds. See U.C.C. § 1-103 (1978) ("Unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions.").

<sup>84</sup> U.C.C. § 2-201 (1978).

<sup>85</sup> *Id.* ("A writing is not insufficient because it omits or incorrectly states a term agreed upon but the contract is not enforceable under this paragraph beyond the quantity of goods shown in such writing.").

<sup>86</sup> U.C.C. § 2-201, Official Comment 1 (1978) (commenting that even a contract "written in lead pencil on a scratch pad" may satisfy the statute of frauds).

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

<sup>88</sup> Michael Braunstein, *Remedy, Reason, and the Statute of Frauds: A Critical Economic Analysis*, 1989 UTAH L. REV. 383, 426 n.154 (1989) ("Certainly, to the extent that a writing requirement raises transaction costs it will make some contracts too expensive to be worthwhile.").

<sup>89</sup> Of course, the "social costs" would be significantly lowered if all contractual litigation were settled by private court systems funded by the litigants themselves. However, in the current system of a publicly subsidized judicial system used for litigating contract disputes, the social costs of litigation are of primary importance in any economic analysis of laws and default rules.

<sup>90</sup> The sole exception being the quantity, discussed *infra*.

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and incomplete that it is ineffectual at both preventing fraud (its original justification)<sup>91</sup> and providing any of the information that would lower ex-post litigation costs. The actual result of the statute of frauds is higher transaction costs for the parties with no significant decrease in ex-post litigation costs or social costs. The statute of frauds as used in the U.C.C. is at best superfluous, and at worst, an inefficient default rule.

The CISG expressly rejects any version of the statute of frauds.<sup>92</sup> Article 11 of the CISG states, “A contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form.”<sup>93</sup> This language stands in stark contrast to the U.C.C.’s insistence that a contract be evidenced in at least “some kind” of writing.<sup>94</sup> The CISG’s rejection of the statute of frauds in its entirety is completely consistent with efficiently reducing transaction costs for the parties while recognizing that unless *every* provision of a contract is required to be in writing, the statute of frauds increases ex-ante transaction costs without reducing any of the ex-post court costs or litigation costs. The CISG’s rejection of the statute of frauds default is economically efficient for U.S. businesses engaged in international transactions.

#### *The Parol Evidence Rule*

The parol evidence rule requires that *if* the parties put all or part of their agreement in writing, they may not contradict the terms of the written agreement with evidence from either a prior oral or written agreement, or an oral agreement made contemporaneous with the signing of the written agreement.<sup>95</sup> The parol evidence rule is similar to the statute of frauds in that they are both provisions dealing with writings in general, however unlike the statute of frauds, the parol evidence rule is properly categorized as a classical example of a majoritarian default.

If parties to a contract were to invest all the ex-ante transaction costs involved in sitting down and memorializing their contract in writing, it would be illogical to assume that “what they want” is the ability of the contract to be contradicted by other outside agreements made before or contemporaneous to the signing of the written agreement. Even if the written agreement is of the most minimalistic type, there is no reason to believe that the parties would want the few provisions that they incurred transaction costs in drafting to be easily

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<sup>91</sup> Braunstein, *supra* note 88, at 426.

<sup>92</sup> CISG, *supra* note 1, art. 11.

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

<sup>94</sup> See U.C.C. § 2-201 (1978).

<sup>95</sup> Freedman, *supra* note 80, at 532.

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contradicted.<sup>96</sup> Instead, the parol evidence rule gives the parties the benefit of their contract term's definiteness without requiring the parties to actually incur the transaction costs of negotiating and drafting this type of provision into the contract itself.

The U.C.C.'s version of the parol evidence rule<sup>97</sup> allows for a written agreement to be explained or supplemented by evidence of *consistent additional* terms agreed to prior, contemporaneous, or after the signing of the written contract.<sup>98</sup> The U.C.C.'s inclusion of these exceptions makes the rule a reliable and efficient majoritarian default.<sup>99</sup>

Despite its proven utility, the CISG rejects the parol evidence rule.<sup>100</sup> Article 11 of the CISG states that "[a] contract . . . may be proved by any means, including witnesses."<sup>101</sup> As opposed to its economically efficient

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<sup>96</sup> For example, if the parties drafted a contract containing only a provision specifying the quantity of goods to be sold, there is no reason to believe that these parties would want this one written term to be so amorphous that it could be directly contradicted by some other agreement written prior (or some other oral agreement made contemporaneous) to the signing of "one-provision" contract. To the contrary, if the parties made the conscious decision that the transaction costs were worth the benefits to memorializing this one specific provision in the written contract, it would be irrational to assume that any person would want the benefits of those incurred transaction costs easily erased by simply presenting evidence of another agreement. The very act of their agreeing to memorialize the term in the first place, negates the possibility that either party did not *actually* want that term to be the true evidence of their agreement.

<sup>97</sup> U.C.C. § 2-202 (1978).

<sup>98</sup> If the Court finds evidence that the parties intended the writing to have been a complete and exclusive statement of the terms of the agreement, no extrinsic evidence will be allowed to explain or supplement the contract. U.C.C. § 2-202(b). This provision is majoritarian in that it requires the court to look to what the parties wanted or would have wanted in the situation.

<sup>99</sup> For example, assume that A is a seller and B is a buyer of widgets. A and B write a contract stating that A will sell B 10 widgets for \$1.00 each. Further assume that A sells and B buys many different types and kinds of widgets. In subsequent litigation, assume that A wants to present evidence of another written agreement made between A and B prior to the signing of the written contract for the sale of widgets. This agreement defines what type of widgets A and B are contracting for, and without this writing, the definition of "widgets" is unexplained and unambiguous. Pursuant to the U.C.C.'s exceptions to the parol evidence rule, most courts would allow this prior written agreement to "explain and supplement" the ambiguous written contract. However, assume that instead of a written agreement defining "widgets," A wants to present a prior written agreement as evidence that "widget" in the contract actually meant "banana." This prior written agreement directly contradicts the exact provision that the parties spent time and effort negotiating. Therefore, pursuant to the U.C.C.'s parol evidence rule and consistent with economically efficient majoritarian default rules, most courts would not allow into evidence this prior written agreement contradicting a written provision of the contract.

<sup>100</sup> CISG, *supra* note 1, art. 11.

<sup>101</sup> *Id.*

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exclusion of the statute of frauds,<sup>102</sup> the CISG excludes a classic majoritarian rule which reduces both the ex-ante transaction costs of the parties, and the ex-post litigation costs to the parties and society. The CISG inefficiently rejects an economically efficient default in the form of the parol evidence rule.

*Foreseeability of Damages*

Ian Ayres and Robert Gertner first pointed out in their article, “Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules,” that the limiting of consequential damages to only damages “that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made,”<sup>103</sup> operates as an information forcing penalty default, not as a classic majoritarian default.<sup>104</sup> The *Hadley* default is a purposeful inducement for the more informed party to reveal the information about possible consequential damages to the party that could most efficiently prevent these damages at a lower cost (the “least-cost avoider”).<sup>105</sup> While this article cannot give a detailed explanation of the intricate and complicated game-theory analysis<sup>106</sup> done on the *Hadley* rule by Ayres and Gertner, and other economic game-theorists, Ayres and Gertner’s eventual conclusion is that the *Hadley* rule limiting recovery only to foreseeable damages operates as an information forcing penalty default.<sup>107</sup>

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<sup>102</sup> Ironically, the CISG’s economically efficient rejection of the statute of frauds and its economically inefficient rejection of the parol evidence rule are contained within the same exact provision. *See id.*

<sup>103</sup> *See* Restatement (Second) of Contracts § 351(1). The U.C.C. applies the Restatement’s understanding of “foreseeability.” *See also* FARNSWORTH, *supra* note 58, at 795 (“[T]he loss need only have been foreseeable as a probable . . . result of the breach.”)

<sup>104</sup> *See* Ayres & Gertner, *supra* note 54, at 101 (“The *Hadley* default of denying unforeseeable damages may not be consistent with what fully informed parties would have wanted.”)

<sup>105</sup> *Id.* (“In *Hadley* a miller in Gloucester contracted with a carrier to have a broken crank shaft transported to Greenwich. The shipment was delayed, and the miller sued the carrier for consequential damages of the profits lost while the mill was inoperative. The court, holding that only foreseeable consequential damages should be awarded, reversed a damage award and remanded for a new trial.”). *See* Least Cost Avoider, <http://home.uchicago.edu/~jmellis/least%20cost%20avoider.html>.

<sup>106</sup> Game theory is a complex economical and mathematical technique for analyzing how parties should behave in certain strategic situations where certain parties may react in numerous different ways to other parties’ actions. *See* Economist.com: Research Tools: Economics A-Z: Game Theory, <http://www.economist.com/research/economics/searchActionTerms.cfm?query=game+theory> (last visited April 08, 2009).

<sup>107</sup> Ayres & Gertner, *supra* note 54. *See also* Ian Ayres and Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 735 (1992) (“[T]he limitation on consequential damages [in *Hadley*] was a ‘penalty’ or ‘information forcing’ default

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The U.C.C. and the CISG seem to apply the same *Hadley* standard limiting the recovery of consequential damages. However, a slight difference in the language of the CISG renders the actual meaning of the CISG completely different than both the U.C.C. and the *Hadley* rule.

Most courts and commentators agree that the U.C.C., in accord with the rule in *Hadley*<sup>108</sup> and the Restatement (Second) of Contracts,<sup>109</sup> requires that consequential damages are only recoverable when the breaching party had reason to know that the damages were “probable” to result from the breach.<sup>110</sup> It has been assumed that CISG’s provision limiting consequential damages to only those that are foreseeable is also in accord with the *Hadley* rule.<sup>111</sup> However, Article 74 of the CISG reads:

Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract . . . as a *possible* consequence of the breach of contract.<sup>112</sup>

At first glance, this difference seems negligible. However, the difference between “probable” and “possible” has the potential to lead to extremely different results. Under the U.C.C.-*Hadley* rule, the party that is well-informed about future risks is induced to reveal that information to the party that can more efficiently prevent these future risks at a lower cost. Under this rule, the well-informed party is only required to reveal information about “probable” consequences and risks. Any losses caused by damages that have less than a 50% chance of being a consequence of the breach cannot be recovered.<sup>113</sup>

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rule.”).

<sup>108</sup> *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng.Rep. 145 (1854) (“Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and . . . reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.”).

<sup>109</sup> Restatement (Second) of Contracts § 351 (“Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.”).

<sup>110</sup> FARNSWORTH, *supra* note 58, at 795-96.

<sup>111</sup> *Id.* at 796 n.21 (citing *Delchi v. Carrier SpA v. Rotorex Corp.*, 71 F.3d 1024 (2d Cir. 1995) (explaining that the CISG follows the foreseeability rules of *Hadley*)).

<sup>112</sup> CISG, *supra* note 1, art. 74 (emphasis added).

<sup>113</sup> For example, assume that a manufacturer of widgets contracts with a carrier to transport the

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However, under the CISG scheme, the well-informed party is required to reveal information about any “possible” consequences and risks.<sup>114</sup> The inclusion of the word “possible,” as opposed to the word “probable,” introduces an entirely new foreseeability of damages concept that is entirely at odds with the traditional *Hadley* rule. Thus, under the CISG’s rule, only losses caused by damages that had absolutely no chance of being a consequence of the breach cannot be recovered.<sup>115</sup> This rule effectively expands the transaction costs infinitely, since the well-informed party is encouraged to strategically inform the least-cost avoider of every possible consequence of every possible breach, so that the well-informed party can recover all the damages which the least-cost avoider had the knowledge or the reason to know of as being *possible* consequences of its breach. Thus, far from efficiently forcing a party with relevant information to give this information to the least-cost avoider, the CISG rule encourages a party with relevant information to exponentially increase transaction costs by negotiating for provisions covering an almost infinite amount of contingencies in the hope that the other party will breach and the well-informed party may recover an extremely large amount of consequential damages.

The CISG’s foreseeability rule *would* be efficient if it were consistently construed as being identical to the U.C.C.-*Hadley* rule. However, because of the CISG’s use of the word “possible” instead of “probable,” the CISG’s foreseeability rule induces the well-informed party to increase transaction costs.

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widget factory’s main conveyor belt to a new factory that has no conveyor belt. Without this conveyor belt, the factory cannot make widgets. If the manufacturer informs the carrier that the factory would lose at least \$100 dollars for every day that the conveyor belt is late in getting to the factory and the carrier delivers the conveyor belt one day late than specified in the contract, the carrier will be liable for \$100 dollars because he knew or had reason to know that the delivering the conveyor belt one day late would probably result in the manufacturer losing of at least \$100 dollars.

<sup>114</sup> CISG, *supra* note 1, art. 74.

<sup>115</sup> Assume the same facts as in footnote 107. But in addition to the manufacturer’s probable loss of \$100 dollars for the one day delay, assume that the manufacturer also informed the carrier that for every day the conveyor belt is not delivered on time, the factory would lose \$1,000,000 because the factory was planning on using its’ earnings from the new factory in order to buy New York mega-millions lottery ticket. Although the carrier had reason to know that this could be a consequence of the breach, it is not a “probable” consequence of the breach, and thus under the U.C.C and *Hadley*, these losses would not be recoverable as consequential damages. However, because these losses are “possible” (even if the possibility is very slight), Article 74 of the CISG allows the manufacturer to recover these damages. See CISG, *supra* note 1, art. 74.

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*Price Terms*

Price terms are considered to be one of the two most fundamental aspects of any contract.<sup>116</sup> Therefore, any economic analysis of contractual default rules would be incomplete without an exploration of the rules' treatments of price terms.

U.C.C. § 594 reiterates that a contract may be validly concluded even if it does not contain a settled price term.<sup>117</sup> The section goes on to state a classic majoritarian default rule: "In such a case [where a contract is concluded without settled price terms] the price is a reasonable price at the time for delivery. . . ."<sup>118</sup> This default rule requires that when no price term is specified in a contract, the courts, in ex-post litigation, will supply a "reasonable term."<sup>119</sup> Typically, this reasonable term will be based on market prices for the goods at the time that the contract was signed.<sup>120</sup> This rule operates as a majoritarian default because an overwhelming majority of self-interested parties would (and do) negotiate for the market price when buying or selling products.<sup>121</sup> This rule eliminates the ex-ante transaction costs of complex negotiations for every price term detail. A reasonable price typically based on

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<sup>116</sup> The other being quantity terms, discussed *infra*. See Ayres & Gertner, *supra* note 54, at 594 ("Quantity and price are the two central terms of any contract.").

<sup>117</sup> U.C.C. § 594(1) ("The parties if they so intend can conclude a contract for sale even though the price is not settled.").

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> Although it is asserted that "reasonable price" does not necessarily mean "fair-market value," U.S. courts will typically look to "prices charged by other sellers of similar products," which, when taken altogether and average, is the very definition of a "market price," in most situations. See *generally* 67 AM. JUR. 2D SALES § 280; *TCP Industries, Inc. v. Uniroyal, Inc.*, 661 F.2d 542 (6th Cir. 1981) (nothing that a reasonable price is not necessarily market value). In any case, the easily obtainable market value of the goods in the contract at issue provides a simple, low-cost, low-time method of determining the reasonable price of goods in a contract that does not specify the price term. See Ayres & Gertner, *supra* note 54, at 96 ("To estimate a reasonable price, courts can largely rely on market information . . ."); *Coltec Industries, Inc. v. Elliot Turbocharger Group Inc.*, Nos. CIV. A. 99-1400, 99-MC-36 1999 WL 695870, at \*7 (E.D. Pa. Sept. 9, 1999) ("[U]nder ordinary circumstances the reasonable price will be the market price for particular merchandise.") (citing *Kuss Machine Tool & Die Co. v. El-Tronics*, 143 A.2d 38, 40 (Pa. 1958)).

<sup>121</sup> This is not so much an "economic" assertion, as it is an *a priori* logical assumption about the rational decisions of economic actors and the very nature of the market. If the majority of parties negotiated for a price significantly lower or higher than a product's "market value," then the market value of those products would actually *become* that lower or higher price. Therefore, it logically follows that the price which a majority of parties bargain for is the almost always the "market value," and conversely that the "market value" is almost always the price which a majority of parties bargain for.

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contemporaneous market pricing is not difficult to ascertain, meaning that this rule will not result in large ex-post litigation costs for the parties or the publicly subsidized court system.<sup>122</sup> The U.C.C.'s "Open Price Term" majoritarian default rule is economically efficient.

Article 55 of the CISG contains an almost identical majoritarian default rule for contracts lacking price terms.<sup>123</sup> Article 55 states:

Where a contract has been validly concluded but does not expressly or implicitly fix or make provision for determining the price, the parties are considered . . . to have impliedly made reference to the price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances in the trade concerned.<sup>124</sup>

This language mirrors the U.C.C.'s "reasonable price" language, and, in practice, allows the court to supply the contract with a price term with the same market-value analysis as is used in these situations under the U.C.C. Thus, the CISG and the U.C.C. both remedy missing price terms with the same economically efficient majoritarian default rule.<sup>125</sup>

### *Quantity Terms*

Considering that quantity terms are considered equally as important to contracts as price terms, one would expect the default rules of quantity terms to be similar to those of price terms. However, neither the U.C.C nor the CISG treat price and quantity terms in the same fashion.

U.C.C. § 2-201(1) has already been analyzed as a statute of frauds provision. This section also includes the U.C.C.'s default rule on missing quantity terms. It states, "[T]he contract is not enforceable under this paragraph beyond the quantity of goods shown in such writing."<sup>126</sup> This rule operates in such a way that if the parties do not supply any quantity in their contract, the contract is unenforceable. As opposed to the price term default of a "reasonable price," the quantity term default is effectively zero."

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<sup>122</sup> In other words, this default rule results in low transaction costs and low social costs.

<sup>123</sup> CISG, *supra* note 1, art. 54.

<sup>124</sup> *Id.*

<sup>125</sup> See also Ayres & Gertner, *supra* note 54, at 96 ("The U.C.C.'s reasonable-price standard can be . . . reconciled with the received wisdom that defaults should be set at what the parties would have contracted for.")

<sup>126</sup> U.C.C. § 2-201(1) (1978).

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Clearly this rule is not majoritarian. A majority of parties would not want to go to the trouble of contracting just to have their contract not enforced because their writing did not include express quantity terms.<sup>127</sup>

This rule is, in fact, a classic example of a penalty default rule. When the parties fail to specify a quantity, they are effectively specifying the quantity as “zero.” Because the provision provides that the law will only enforce the contract insofar as the amount written in the contract, the failure to specify any amount results in the entire contract being rendered unenforceable. This harsh penalty causes the parties to take special care to contract around the rule and include quantity terms in all of their contracts for fear of the penalty default rendering their entire contract unenforceable.<sup>128</sup> The exorbitant ex-post costs of determining a “reasonable quantity” term to be supplied in the contract would render a majoritarian default economically inefficient. Therefore, the U.C.C.’s zero-quantity penalty default efficiently shifts the costs of determining the quantity to those who have the best information to make this determination at the lowest cost—the parties to the contract.<sup>129</sup>

Article 14 of the CISG is clear when it precludes a valid contract from being formed (and thus enforced) when it does not include quantity terms.<sup>130</sup> Article 14 states that if no provision providing for quantity terms is supplied, there is no offer, and therefore, no valid contract is formed.<sup>131</sup> The CISG does not provide a quantity term provision similar to the price term provision in Article 55. This results in the CISG’s Article 14 quantity default rule operating exactly like the zero-quantity penalty default in the U.C.C. by rendering contracts without quantity terms unenforceable under the CISG. Although less clear than their similarities in price term defaults, the CISG and the U.C.C. both contain functionally identical, economically efficient zero-quantity default rules.

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<sup>127</sup> Ayres & Gertner, *supra* note 54, at 96 (“Obviously, the parties would not have gone to the expense of contracting with the intention that nothing be exchanged.”).

<sup>128</sup> *Id.* (“The zero-quantity rule can be justified because it is cheaper or the parties to establish the quantity term beforehand than for the courts to determine after the fact what the parties would have wanted.”).

<sup>129</sup> *Id.*

<sup>130</sup> CISG, *supra* note 1, art. 14.

<sup>131</sup> *Id.* It may be argued that Article 14 also requires definite price terms, rendering invalid any contract allegedly formed after an offer without definite price term. However, Article 14 specifically states that the offer may “implicitly” fix terms for the quantity and price. Article 55 explains the seemingly cryptic idea of “implicit price terms,” when it states that a contract not specifying any price terms at all is assumed to have “impliedly made reference to the price generally charged at the time of the conclusion of the contract . . .” The CISG contains no analogous provision explaining “implicit quantity terms,” which most likely means that a complete lack of quantity terms renders an offer and the subsequent contract invalid.

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## THE CISG AFTER MEDELLIN V. TEXAS

### C. The CISG Is Economically Efficient

After studying what are arguably the five most important contractual concepts/provisions, it is clear that the U.C.C. is economically efficient in its treatment of four out of the five provisions,<sup>132</sup> and the CISG is economically efficient in its treatment of three out of the five provisions.<sup>133</sup> By themselves, the numbers seem to suggest that because the U.C.C. is the usual set of default rules applied to the sale of goods by U.S. businesses, and because the U.C.C. is slightly more efficient than the CISG, the CISG is undesirable. However, these numbers may be misleading. Had there been an extreme disparity between the amount of efficient provisions in the U.C.C. and the CISG, the answer would have been clear. But a more comprehensive analysis of the comparative importance between these five contract provisions/concepts could provide a better picture of the desirability of the CISG as compared to the U.C.C.<sup>134</sup>

As it stands today, the fact that the CISG has only one less economically efficient provision than the U.C.C. can be seen as a testament of the CISG's ability to unify disparate legal systems under one common set of rules (which is an economically efficient accomplishment in itself). Therefore, it would ultimately seem that the CISG contains enough economic efficiency in its important provisions to render it a highly desirable set of default rules for U.S. businesses involved in the international sale of goods.

### CONCLUSION

The Supreme Court's holding in *Medellin* made many legal scholars and jurists (including the *Medellin* dissent) fearful that numerous multi-lateral treaties in force in the United States would now be considered non-self-executing. The CISG is one of these treaties. After studying the *Medellin*

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<sup>132</sup> These four are the parol evidence rule, the foreseeability of damages rules, the price terms, and the quantity terms.

<sup>133</sup> These three are the statute of frauds, the price terms, and the quantity terms.

<sup>134</sup> Furthermore, it could be argued that the five provisions/concepts explored and analyzed in this study are not the only ones that should be characterized as the "most important contractual provisions/concepts." For examples see Catherine Piche, *The Convention on Contracts for the International Sale of Goods And the Uniform Commercial Code Remedies in Light of Remedial Principles Recognized Under U.S. Law: Are the Remedies of Granting Additional Time to the Defaulting Parties and of Reduction of Price Fair and Efficient Ones?*, 28 N.C. J. INT'L L. & COM. REG. 519 (2003) (discussing and comparing the efficiency of the perfect tender, fundamental breach, and *Nachfrist* rules in the U.C.C. and the CISG); Avery W. Katz, *Remedies for Breach of Contract Under the CISG*, 25 INT'L REV. L. & ECON. 378 (2006) (discussing the three main default remedial rules of the CISG).

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majority's holding and its interpretations, it is clear that these scholars and jurists can rest easy with the knowledge that the CISG is safely ensconced in our laws as a self-executing treaty. Even under the *Medellin* Court's new standard, the CISG is still considered self-executing, and is still the default rules applicable to U.S. businesses involved in the international sale of goods.

But do U.S. businesses want the CISG? For strictly domestic transactions of goods, U.S. businesses are subject to the U.C.C. The U.C.C.'s provisions have been shown to be very economically efficient. But the CISG's ability to harmonize and unify international sales law, thus opening up the international sales market to more U.S. businesses, plus the CISG's relative economic efficiency make the CISG a fairly desirable set of default rules for U.S. businesses. Hopefully, future empirical studies and surveys on the CISG and its popularity with U.S. businesses will highlight and emphasize the efficiency of the CISG for U.S. businesses, and the CISG will take its rightful place as an indispensable and beneficial instrument of international sales law.

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compulsory licenses have all been headlining news. Thailand and Brazil's actions have created negative connotations, while Rwanda's use has been widely praised. Part V highlights four main dangers that are likely to arise if the current laws are not amended. Finally, Part VI lays out several suggestions on how to reform the provisions which govern compulsory licenses.

I. PLANTING THE SEEDS FOR CONTROVERSY

**A. Background**

The modern patent system is rooted in the Venetian Act, adopted during the early Renaissance era.<sup>3</sup> The Venetian Act, similar to the modern day patent system, called for the registration of new and ingenious devices reduced to perfection.<sup>4</sup> Further molding the modern patent system was the Statute of Monopolies, which was created by the English Parliament in the sixteenth century.<sup>5</sup> The Statute of Monopolies was implemented in response to the English Crown's practice of granting individuals exclusive rights to produce, import, and sell certain commonplace items such as salt and vinegar.<sup>6</sup> The Statute prohibited these monopolies, but created an exception which permitted a patent to be granted for a 14-year period to a creator of a new invention.<sup>7</sup> These patents granted over novel creations would encourage innovations that would benefit society, as opposed to the Crown created monopolies which restrained the trade of commodities that had previously been in the public domain.<sup>8</sup> Today, the United States' patent system is protected by the Constitution. Article I, Section 8, authorizes Congress to grant exclusive rights to authors and inventors for their respective discoveries for a limited amount of time.<sup>9</sup> In order to receive a patent, an inventor must submit a patent application to The Patent and Trademark Office (hereinafter the "PTO").<sup>10</sup> The PTO then reviews the application and grants a patent if several requirements are met.<sup>11</sup> A patent

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<sup>3</sup> ROBERT P. MERGES ET AL., *INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE* 118 (4th ed. 2007).

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

<sup>5</sup> *See* *Lasercomb America, Inc. v. Reynolds*, 911 F.2d 970 (4th Cir. 1990).

<sup>6</sup> *Id.* at 975 (explaining that these practices lead to shortages and inflated prices).

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

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

<sup>9</sup> *Id.*; *see also* U.S. CONST. art. I, § 8.

<sup>10</sup> MERGES ET AL., *supra* note 3, at 124.

<sup>11</sup> *Id.* (listing the five requirements of a patent: eligible subject matter, usefulness, novelty, not

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grants the patent holder a 20-year exclusive right over his invention, during which time no one, absent authorization by the patent holder, may make, use, or sell the patented product.<sup>12</sup> In exchange for this exclusive right, the patent holder pays his due to society by disclosing the technical information behind how the invention was created, and at the end of the 20-year period the protection expires and the creation enters the public domain.<sup>13</sup>

In the realm of pharmaceuticals, an inescapable tension exists between the aspiration to provide the sick with access to life-saving drugs, and the need to maintain incentives for pharmaceutical companies to create new innovations by ensuring a return on their investments.<sup>14</sup> On one extreme it is argued that “patent protection should end where saving lives or alleviating suffering begins; that is, patent law should be subordinate to certain social interests.”<sup>15</sup> At the opposite end of the spectrum, it is argued that pharmaceuticals should be treated like all other commodities, thus the price should be determined by the basic principles of supply and demand.<sup>16</sup> The former approach is motivated by socio-humanitarian objectives because health, wellbeing, and even death are on the line.<sup>17</sup> The latter approach, on the other hand, is driven by the incentive to innovate.<sup>18</sup> Prospective profits have always been the necessary incentive in encouraging the inventions of marketable products.<sup>19</sup> Most opinions on this issue fall somewhere in the middle of these two extremes, believing that some governmental regulation is necessary in guarantying access to essential medicines. However, the question still remains: when does governmental regulation cross the line from being helpful to becoming destructive?

Intellectual property rights are the fundamental driving forces behind the pharmaceutical industry.<sup>20</sup> In light of globalization, transnational

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obviousness, and sufficient disclosure to allow others to make and use the invention).

<sup>12</sup> *Id.* at 28.

<sup>13</sup> World Trade Organization, *Understanding the WTO: The Agreements* 7 (2007), [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/utw\\_chap2\\_e.pdf](http://www.wto.org/english/thewto_e/whatis_e/tif_e/utw_chap2_e.pdf).

<sup>14</sup> See Robert Bird & Daniel R. Cahoy, *The Impact of Compulsory Licensing on Foreign Direct Investment: A Collective Bargaining Approach*, 45 AM. BUS L.J. 283, 284 (2008).

<sup>15</sup> Amir H. Khoury, *The “Public Health” of the Conventional International Patent Regime & the Ethics of “Ethicals:” Access to Patented Medicines*, 26 CARDOZO ARTS & ENT. L.J. 25, 32 (2008).

<sup>16</sup> *Id.* (explaining that patentees are in general able to set the price of their invention, which in turn determines where and to whom the product is sold).

<sup>17</sup> *Id.* (explaining that medicines are unique from other patented products in the sense that they are capable of easing pain and are even able to pro-long life).

<sup>18</sup> *Id.*

<sup>19</sup> Senator Max Baucus, Hearing on International Enforcement of Intellectual Property Rights and American Competitiveness (July 15, 2008) (transcript available at 2008 WLNR 13295305) (stating that patents are essential for a competitive market).

<sup>20</sup> Jenna Greve, *Healthcare in Developing Countries and the Role of Business: A Global*

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pharmaceutical companies have become paramount agents on the world stage.<sup>21</sup> Due to the massive amount of capital pharmaceutical companies reap each year, they have a crucial impact on the globe's economic order.<sup>22</sup> Currently, pharmaceutical companies profit over \$600 billion each year.<sup>23</sup> This financial power leads to lobbying power, which in turn leads to political power.<sup>24</sup> Although often feared for being too influential, dominant pharmaceutical companies are crucial in assuring a continuously improving quality of life. In light of the fact that pharmaceutical companies are capable of earning these immense profits each year, this provides a built-in guarantee that novel drugs will continuously be produced. Absent this ability to earn vast financial gains, pharmaceutical progress will surely come to a halt due to lack of an incentive to innovate.

### B. Compulsory Licenses

A compulsory license is a prime example of a tool that threatens pharmaceutical companies' ability to develop new drugs. A compulsory license provides a national government with the authority to practice an invention covered by a patent, or authorize another party to do so, without permission from the patent holder.<sup>25</sup> The practice of issuing compulsory licenses is an exception to the general rule that patent holders have an exclusive right over their invention. In this situation authorization is given to exploit an invention without the patent holder's consent.<sup>26</sup> The purpose of a compulsory license is to increase access to essential goods by providing a wider use of the invention than the patent holder intended.<sup>27</sup> As a result, the patent holder is forced to give up a large part of his property right for the purported benefit of the public.<sup>28</sup>

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*Governance Framework to Enhance the Accountability of Pharmaceutical Companies*, CORP. GOVERNANCE, September 7, 2008, available at 2008 WLNR 16938575. Pharmaceutical companies are able to patent vital medicines along with lifestyle drugs.

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

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

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

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

<sup>25</sup> Cahoy, *supra* note 1, at 141-42.

<sup>26</sup> NAT'L BOARD OF TRADE, THE WTO DECISION ON COMPULSORY LICENSING 7 (2008), [http://www.kommers.se/upload/Analysarkiv/Arbetsomr%C3%A5den/WTO/Handel%20och%20skydd%20f%C3%B6r%20immateriella%20r%C3%A4ttigheter%20-%20TRIPS/Rapport%20The\\_WTO\\_decision\\_on\\_compulsory\\_licensing.pdf](http://www.kommers.se/upload/Analysarkiv/Arbetsomr%C3%A5den/WTO/Handel%20och%20skydd%20f%C3%B6r%20immateriella%20r%C3%A4ttigheter%20-%20TRIPS/Rapport%20The_WTO_decision_on_compulsory_licensing.pdf) [hereinafter WTO DECISION].

<sup>27</sup> Cahoy, *supra* note 1, at 133.

<sup>28</sup> *Id.*

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The issuance of a compulsory license comes at a high price in the world of pharmaceutical products. The patent holder's investment-backed expectation of earning a profit from the patented medicine is disrupted when his exclusive right over his patented product disappears.<sup>29</sup> The practice of compulsory licensing is addressed in the World Trade Organization's<sup>30</sup> agreement on Trade Related Aspects of Intellectual Property Rights.<sup>31</sup> The TRIPS Agreement was negotiated at the 1986-1994 Uruguay Round and "is to date the most comprehensive multilateral agreement on intellectual property."<sup>32</sup> The goal of the TRIPS Agreement is to standardize the manner in which intellectual property rights are protected around the world.<sup>33</sup> Although the TRIPS Agreement neither defines 'compulsory license' nor specifies when exactly a compulsory license can be granted, Article 31 of the TRIPS Agreement does authorize any WTO Member to issue a compulsory license after several ambiguous procedures are met.<sup>34</sup>

Taking into consideration the international and domestic law on this issue, an inevitable question arises; how will the current practice of compulsory licensing affect the future of the pharmaceutical industry? As a major force in the international economy, pharmaceutical companies allocate billions of dollars each year into research and development in order to provide the world with life-saving drugs; yet, any Member of the WTO has the authority to essentially override the investment-backed patent a pharmaceutical company holds.<sup>35</sup> This practice will leave the pharmaceutical industry guarded as to

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<sup>29</sup> Greve, *supra* note 20.

<sup>30</sup> Hereinafter the "WTO."

<sup>31</sup> Hereinafter the "TRIPS Agreement."

<sup>32</sup> Vera Zolotaryova, *Are We There Yet? Taking "TRIPS" To Brazil and Expanding Access to HIV/AIDS Medication*, 33 BROOK. J. INT'L L. 1099, 1102 (2008) (quoting World Trade Organization, *Overview: The TRIPS Agreement*, [http://www.wto.org/english/tratop\\_e/trips\\_e/inte12\\_e.htm](http://www.wto.org/english/tratop_e/trips_e/inte12_e.htm)).

<sup>33</sup> Agreement on Trade-Related Aspects of Intellectual Property Rights, art. 27.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, 1869 U.N.T.S. 299, available at [http://www.wto.org/english/tratop\\_e/trips\\_e/t\\_agm0\\_e.htm](http://www.wto.org/english/tratop_e/trips_e/t_agm0_e.htm) [hereinafter TRIPS Agreement]. See also World Trade Organization, *Understanding the WTO: The Agreements*, [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/utw\\_chap2\\_e.pdf](http://www.wto.org/english/thewto_e/whatis_e/tif_e/utw_chap2_e.pdf) (last visited March 20, 2009).

<sup>34</sup> See generally WTO DECISION, *supra* note 26 (stating that a compulsory license should be considered based on the individual merits and the issuance of the license shall be appealable). See also World Trade Organization, *Understanding The WTO: The Organization*, [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org6\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm) (last visited March 31, 2009) (listing all 153 Members of the World Trade Organization).

<sup>35</sup> See Marc-André Gagnon & Joel Lexchin, *The Cost of Pushing Pills: A New Estimate of Pharmaceutical Promotion Expenditures in the United States*, 5 PLOS MED. 29, 30 (2008), available at [http://medicine.plosjournals.org/archive/1549-1676/5/1/pdf/10.1371\\_journal.pmed.0050001-S.pdf](http://medicine.plosjournals.org/archive/1549-1676/5/1/pdf/10.1371_journal.pmed.0050001-S.pdf) (stating that pharmaceutical companies spend

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where and what they invest their money into.

### C. The Need for Stronger Laws Governing Compulsory Licenses

Stricter and more objective laws are needed to govern the practice of issuing compulsory licenses in order to maintain the delicate balance between the right of access to life-saving medicines and the right pharmaceutical companies have to earn a profit from their inventions. Of course, under very limited circumstances, compulsory licenses can be a beneficial tool.<sup>36</sup> However, there is a fine line dividing when the practice of issuing compulsory licenses is proper and when it will cause disastrous results.<sup>37</sup>

There are at least four detrimental consequences that will arise if the language of the TRIPS Agreement is not amended.<sup>38</sup> First and foremost, if compulsory licenses are too easily obtainable, absent the threat of an acute health crisis, innovation funding will erode.<sup>39</sup> It is the monopoly power pharmaceutical companies are capable of obtaining over their patented medicines that induces invention.<sup>40</sup> Therefore, future investment in pharmaceuticals will be viewed as a risk without this monopoly power. Secondly, a decline in global health will result because pharmaceutical companies will be hesitant to introduce new medications into nations with high rates of disease. Additionally, the nation that will manufacture the generic version of drug after a compulsory license has been issued will generally have lower standards of quality than the country that manufactured the named brand drug. Thirdly, absent strong intellectual property protections foreign investment will decline, causing devastating effects on developing nations. Lastly, the American economy will further suffer based on the large, job-producing pharmaceutical industry in America, which is dependent on strong intellectual property rights protections.

The practice of issuing compulsory licenses is likely to increase in the

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up to \$288 billion on research and development).

<sup>36</sup> See generally Holger P. Hestermeyer, *Canadian-made Drugs for Rwanda: The First Application of the WTO Waiver on Patents and Medicine*, ASIL INSIGHTS, December 10, 2007, available at <http://www.asil.org/insights071210.cfm> (explaining the recent success of Rwanda importing generic HIV/AIDS drugs from Canada).

<sup>37</sup> See generally Kevin Outterson, *Fair Followers: Expanding Access to Generic Pharmaceuticals for Low-income Populations*, in *THE POWER OF PILLS* (Jillian Clare Cohen, Patricia Illingworth & Udo Schuklenk, eds., 2008), available at <http://www.cptech.org/ip/health/prizefund/files/outterson-access-to-generics.pdf> (explaining that overuse of compulsory licensing can be dangerous).

<sup>38</sup> Each danger will be discussed in greater detail in Section V *infra*.

<sup>39</sup> Cahoy, *supra* note 1, at 134.

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

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near future,<sup>41</sup> therefore more stringent laws must be implemented to safeguard against abusive issuances.<sup>42</sup> The current language of the TRIPS Agreement is not sufficient to protect the world against compulsory license misuse. If more objective laws are not adopted, the world faces the risk of economic turmoil coupled with declining world health. Moreover, strong international intellectual property protections are essential to the continued progress in the field of pharmaceuticals.

### II. THE SOURCE OF THE GROWING TENSION

In order to fully comprehend the imminent danger the world faces if stronger intellectual property protections are not adopted, it is crucial to understand both the general theories underlying intellectual property rights, and to acknowledge the current health crises facing various nations throughout the world. To begin with, intellectual property rights are “the rights given to people over the creations of their minds.”<sup>43</sup> There is a fundamental difference between ideas and tangible property. With tangible property, your possession is exclusive in the sense that when you possess an object somebody else does not.<sup>44</sup> An idea, on the other hand, is capable of being possessed by more than one person at the same time.<sup>45</sup> Additionally, tangible goods are rivalrous, meaning they can suffer from exhaustion, while intangible goods are non-rivalrous.<sup>46</sup> Although patents place burdens on society, the rationale behind the protection of ideas is that it helps maximize the wealth of the public at large.<sup>47</sup>

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<sup>41</sup> See Zolotaryova, *supra* note 32, at 1109 (explaining that because chronic diseases are now seen as a severe enough health emergency to implement a compulsory license, the use of compulsory licenses is likely to increase).

<sup>42</sup> See Outterson, *supra* note 37.

<sup>43</sup> Zolotaryova, *supra* note 32, at 1101 (quoting WTO Frequently Asked Questions about TRIPS, [http://www.wto.org/english/tratop\\_e/trips\\_e/tripfq\\_e.htm](http://www.wto.org/english/tratop_e/trips_e/tripfq_e.htm)).

<sup>44</sup> MERGES ET AL., *supra* note 3, at 2.

<sup>45</sup> *Id.* (explaining that “[i]deas do not have this characteristic of excludability” and that more than one person can use an idea without diminishing the value of the idea).

<sup>46</sup> Outterson, *supra* note 37, at 3. “Tangible goods are rivalrous. They suffer from exhaustion and congestion. But most intangibles are nonrivalrous, including the biomedical knowledge which forms the basis of the pharmaceutical industry. *Id.* Most pharmaceutical knowledge is nonrivalrous, and this fact enables a transformation from free riding and piracy to fair following.” *Id.*

<sup>47</sup> Khoury, *supra* note 15, at 39. See also MERGES ET AL., *supra* note 3, at 13. “Because intellectual property rights impose social costs on the public, the intellectual property laws can be justified by the public good argument only to the extent that they do on balance encourage enough creation and dissemination of new works to offset those costs.” *Id.* See also Baucus, *supra* note 19 (stating industries that rely on intellectual property protection account for most American exports).

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There are two fundamental philosophical theories justifying pharmaceutical companies' rights to have exclusive ownership over their patented products.<sup>48</sup> The first theory is utilitarianism, which elucidates that absent the protection of a patent, an inventor will spend time and money on an invention only to find others imitating his work without incurring the costs; thereby enabling the copied product to be sold for less money.<sup>49</sup> Ultimately the original creator will be inhibited from earning a reasonable, expected return on his invention.<sup>50</sup> As a result, many industry analysts believe the inventor will no longer have an incentive to innovate.<sup>51</sup> Accordingly, it is argued that pharmaceutical companies will be reluctant to spend exorbitant amounts of money on research and development for novel drugs if there is no financial incentive.<sup>52</sup> The second theory justifying intellectual property rights is the labor theory, which explains that the labor of man and the work of his hands are his and nobody else's.<sup>53</sup> If pharmaceutical companies are no longer able to have exclusive rights to control their products, they will essentially be robbed of the fruits of their labor.<sup>54</sup>

While there are strong theories supporting why medicines ought to be given patent protection, the controversy arises due to the grave public health problems currently plaguing the globe. Approximately 1.7 billion people living on Earth lack access to vital medicines.<sup>55</sup> Each year infectious diseases kill 14 million people, 90% of which are people living in the developing world.<sup>56</sup> It is estimated that close to 40 million people are infected with HIV/AIDS<sup>57</sup> worldwide.<sup>58</sup> Of those 40 million people, approximately 95% of those living

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<sup>48</sup> Khoury, *supra* note 15, at 37 (explaining that if pharmaceutical companies lost exclusive control over their patented products they would be robbed of the fruits of their labor and their incentive to innovate would be offset).

<sup>49</sup> See generally MERGES ET AL., *supra* note 3, at 14 (explaining the economic incentive behind patents).

<sup>50</sup> MERGES ET AL., *supra* note 3, at 14.

<sup>51</sup> See *id.* at 14; Bird & Cahoy, *supra* note 14, at 283; Zolotaryova, *supra* note 32, at 1107.

<sup>52</sup> Khoury, *supra* note 15, at 37. See also Henry J. Kaiser Family Foundation, *Cost of New Drug Development Reaches \$897M, Study Says*, KAISER DAILY HEALTH POLICY REPORT, May 15, 2003, [http://www.kaisernetwork.org/daily\\_reports/rep\\_index.cfm?DR\\_ID=17747](http://www.kaisernetwork.org/daily_reports/rep_index.cfm?DR_ID=17747) (explaining that a pharmaceutical company spent close to \$900 million dollars on research and development per drug, and that there is no guarantee that the drug will be successful).

<sup>53</sup> MERGES ET AL., *supra* note 3, at 2 (describing John Locke's theory of labor).

<sup>54</sup> See Khoury, *supra* note 15 at 37.

<sup>55</sup> WTO DECISION, *supra* note 26, at 15 (explaining one-third of the world's population lacks access to life-saving drugs).

<sup>56</sup> See Khoury, *supra* note 15, at 37.

<sup>57</sup> AIDS stands for Acquired Immune Deficiency Syndrome.

<sup>58</sup> WTO DECISION, *supra* note 26, at 15 (stating the 25 million people have died from AIDS from

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with HIV/AIDS reside in developing countries.<sup>59</sup> In Africa alone, there are 25 million people living with HIV/AIDS.<sup>60</sup> Moreover, Malaria is responsible for killing over one million people each year.<sup>61</sup> Infectious diseases are not the only health concern facing the world, non-communicable diseases are on the rise and 80% of mortality rates resulting from non-communicable diseases occur in developing countries.<sup>62</sup>

After reviewing the various health problems facing the globe it becomes apparent that people around the world, particularly the citizens of developing countries, are in desperate need of medicines. In fact, it has been estimated that if existing medicines were made available to developing countries, millions of lives could be saved each year.<sup>63</sup> These disheartening figures enhance the argument that patents should be suspended when they come into conflict with serious health issues.<sup>64</sup>

### III. THE TRIPS AGREEMENT'S SHORTFALL IN REGULATING COMPULSORY LICENSES

In the recent past, the extent of intellectual property protection afforded by national governments varied widely across the globe.<sup>65</sup> As the importance of intellectual property rights became increasingly central to international trade, economic tension between countries arose due to the various levels of intellectual property protections.<sup>66</sup> The Members of the WTO sought to ease this growing tension by establishing globally recognized minimum levels of protection for intellectual property rights. On January 1, 1995 the WTO achieved this goal by negotiating the TRIPS Agreement, which

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the time it was first discovered in 1981).

<sup>59</sup> *Id.* at 39.

<sup>60</sup> HAOSHEN SUN, RESHAPING THE TRIPS AGREEMENT CONCERNING THE PUBLIC HEALTH – TWO CRITICAL ISSUES 3 (2002), <http://www.cid.harvard.edu/cidtrade/Papers/haoshensun.pdf> (explaining that, of the developing world's citizens infected with HIV/AIDS, only 4% are receiving antiretroviral treatment).

<sup>61</sup> WTO DECISION, *supra* note 26, at 15. Malaria infects 300-400 million people every year, and 90% of these infections occur in Africa. *Id.*

<sup>62</sup> *Id.* at 42 (explaining a non-communicable disease is a disease which is not infectious and can result from genetics or life-style).

<sup>63</sup> Press Release, Department for International Development, New Alliance to Improve Access to Medicine in Developing Countries (May 15, 2008), *available at* <http://www.dfid.gov.uk/news/files/pressreleases/meta-launch.asp>.

<sup>64</sup> Some believe that the right to health is a fundamental human right.

<sup>65</sup> Zolotaryova, *supra* note 32, at 1100.

<sup>66</sup> *Id.*

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“standardized the protection of intellectual property rights throughout the world by establishing minimum levels of protection that each WTO Member country must provide for the intellectual property of other WTO members.”<sup>67</sup> Pharmaceutical products were among the many inventions required to have a minimum level of protection under the TRIPS Agreement.<sup>68</sup> The overall purpose of the Agreement was to reduce obstructions in international trade while promoting intellectual property protection.<sup>69</sup>

Article 31 of TRIPS is the direct source of the compulsory licensing right. The phrase ‘compulsory license’ is not used, but the title of Article 31 is: ‘other use without authorization of the right holder.’<sup>70</sup> The broad text of Article 31 permits any WTO Member to issue a compulsory license after fulfilling certain ambiguous conditions. First of all, authorization for a compulsory license is based on individual merits.<sup>71</sup> Additionally, if a compulsory license is issued, “the right holder shall be paid adequate remuneration in the circumstances of each case, taking into account the economic value of the authorization,” according to Article 31(h).<sup>72</sup> Moreover, the use of a compulsory license will only be permitted if there have been unsuccessful efforts to obtain authorization from the patent holder under reasonable commercial terms, for a reasonable period of time.<sup>73</sup> However, this negotiation requirement is waived for any WTO Member under three circumstances: (1) in the case of a national emergency, (2) other circumstances of extreme urgency, or (3) in cases of public non-commercial use.<sup>74</sup> Lastly, article 31(f) of the TRIPS Agreement

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<sup>67</sup> *Id.*

<sup>68</sup> TRIPS Agreement, *supra* note 33, art. 27. “Patents shall be available for any inventions, whether products or process, in all fields of technology.” *Id.* (explaining the three criteria needed to qualify for a patent: an invention has to be new (novelty), it must be an inventive step (it must not be obvious), and it must have industrial applicability (it must be useful)).

<sup>51</sup> Zolotaryova, *supra* note 32, at 1100.

<sup>69</sup> *Id.*

<sup>70</sup> World Trade Organization, *Fact Sheet: TRIPS and Pharmaceutical Patents*, [http://www.wto/english/tratop\\_e/trips\\_e/factsheet\\_pram02\\_e.htm](http://www.wto/english/tratop_e/trips_e/factsheet_pram02_e.htm) (last visited November 1, 2008) [hereinafter *Fact Sheet*].

<sup>71</sup> TRIPS Agreement, *supra* note 33, art. 31(a). *See also* WTO DECISION, *supra* note 26, at 7.

<sup>72</sup> *Fact Sheet*, *supra* note 70. *See also* TRIPS Agreement, *supra* note 33, art. 31(h); Cahoy, *supra* note 1, at 136. Neither “adequate remuneration” nor “economic value” are defined.

<sup>73</sup> *Fact Sheet*, *supra* note 70. *See also* TRIPS Agreement, *supra* note 33, art. 31(b). Neither reasonable commercial terms nor reasonable time period are defined in the TRIPS Agreement.

<sup>74</sup> TRIPS Agreement, *supra* note 33, art. 31(b) (explaining that, under circumstances of national emergency or extreme urgency, the right holder should be notified of the practice of compulsory licensing on their product as soon as reasonably practicable). Similarly, when a license is used for public non-commercial use, the government shall inform the right holder promptly. *Id.* Additionally, “national emergency”, “circumstances of extreme urgency”, or in cases of “public

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states that after a nation is authorized to issue a compulsory license, the use must be for the supply of the domestic market.<sup>75</sup>

Article 31(f) was the source of much criticism because medicine production is concentrated in high-income countries, and many developing countries lack pharmaceutical production capacity all together.<sup>76</sup> This provision therefore acted like a barrier, preventing countries with insufficient or no manufacturing capabilities from issuing a compulsory license.<sup>77</sup> Article 31 was essentially useless to the countries that were in need of compulsory licenses the most.<sup>78</sup>

In response to the backlash on this matter, the Ministerial Conference of the World Trade Organization met in Doha Qatar, and on November 14, 2001,<sup>79</sup> and adopted a Declaration on the TRIPS Agreement and public health, commonly known as the Doha Declaration.<sup>80</sup> The Doha Declaration acknowledged the problem developing countries were facing in issuing compulsory licenses due to article 31(f) of the TRIPS Agreement.<sup>81</sup> Paragraph 6 of the Declaration stated, “[w]e recognize that WTO members with insufficient or no manufacturing capacities in the pharmaceutical sector could face difficulties in making effective use of compulsory licensing under the TRIPS agreement,” and the Declaration called for an expeditious solution to this problem.<sup>82</sup> The WTO General Council adopted Paragraph 6 of the Doha Declaration on August 30, 2003.<sup>83</sup> The decision was comprised of three

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non-commercial use” are not defined anywhere in the TRIPS Agreement.

<sup>75</sup> *Fact Sheet*, *supra* note 70. *See also* TRIPS Agreement, *supra* note 33, art. 31(f).

<sup>76</sup> WTO DECISION, *supra* note 26, at 7.

<sup>77</sup> World Trade Organization, *Ministerial Declaration of 14 November 2001*, WT/MIN(01)DEC/1 (adopted Nov. 14, 2001), available at [http://www.wto.org/english/thewto\\_e/minist\\_e/min01\\_e/mindecl\\_e.pdf](http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.pdf) [hereinafter *Doha Declaration*]. *See also* World Trade Organization, *Implementation of Paragraph 6 of the Doha Declaration on the TRIPS Agreement and Public Health*, [http://wto.org/english/tratop\\_e/trips\\_e/implem\\_para6\\_e.htm](http://wto.org/english/tratop_e/trips_e/implem_para6_e.htm) (last visited November 1, 2008) [hereinafter *Implementation of Paragraph 6*].

<sup>78</sup> Zolotaryova, *supra* note 32, at 1102.

<sup>79</sup> The Doha Declaration was implemented shortly after the US considered issuing a compulsory license in order to get sufficient amounts of Anthrax antibiotics in a situation on an epidemic.

<sup>80</sup> Frederick M. Abbott, *The WTO Medicines Decisions: World Pharmaceutical Trade and the Protection of Public Health*, 99 AM. J. INT’L L. 317, 317 (2005). *See also* Tom Jacobs, *Bayer U.S. Deal on Anthrax Drug*, Fool.com, Oct. 25, 2001, <http://www.fool.com/news/2001/bayzf011025.htm> (explaining that the US was eventually able to reach an agreement with the German-based drug maker, Bayer AG, after the Anthrax threats following 9/11).

<sup>81</sup> WTO DECISION, *supra* note 26, at 7.

<sup>82</sup> *Doha Declaration*, *supra* note 77, ¶ 6.

<sup>83</sup> *See* Abbott, *supra* note 80, at 317; *Implementation of Paragraph 6*, *supra* note 77 (“‘pharmaceutical product’ means any patented product, or product manufactured through a

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waivers under Article 31. First and foremost, the exporting countries' duty is waived because a compulsory license is no longer only for the supply of the domestic market under article 31(f).<sup>84</sup> Secondly, the obligation under 31(h) is waived because only the exporting country, and not the importing country, is responsible for remuneration to the patent holder.<sup>85</sup> Lastly, re-export of the imported pharmaceutical is allowed among members of a regional agreement.<sup>86</sup> Following the adoption of Paragraph 6 several nations, including the United States, agreed not to use Paragraph 6 as an importing member.<sup>87</sup>

Not only did the Declaration move to correct several problems associated with Article 31, but it also addressed how the TRIPS Agreement as a whole should be interpreted. The Doha Declaration affirmed that the TRIPS Agreement should be construed in a manner supportive of WTO Members' right to protect public health, and the Declaration acknowledged that the TRIPS Agreement provided intentional flexibilities for this precise purpose.<sup>88</sup> Although Paragraph 1 of the Doha Declaration does not explicitly list what diseases are eligible for prompting the issuance of a compulsory license, it does state, "[w]e recognize the gravity of the public health problems afflicting many developing & least developed countries, especially those resulting from

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patented process, of the pharmaceutical sector needed to address the public health problems as recognized in paragraph 1 of the Declaration... 'eligible importing Member' means any least-developed country Member, and any other Member that has made a notification to the Council for TRIPS of its intention to use the system as an importer... 'exporting Member' means a Member using the system set out in this Decision to produce pharmaceutical products for and export them to, and eligible importing Member" (quoting the *Doha Declaration*, *supra* note 73)).

<sup>84</sup> Christina Cotter, *The Implications of Rwanda's Paragraph 6 Agreement with Canada for Other Developing Countries*, 5 LOY. U. CHI. INT'L L. REV. 177, 191 (explaining that developing countries can now import generic drugs from developed countries).

<sup>85</sup> *Id.* (stating that the importing country is no longer burdened with paying the patent holder adequate remuneration).

<sup>86</sup> *Id.* (noting that now developing countries with small populations can declare a joint emergency).

<sup>87</sup> Cahoy, *supra* note 1 at 158 n.86 (noting countries agreeing not to use paragraph 6 of Doha Declaration as importing members: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK, and US, since joining the EU the list also includes Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic and Slovenia). See also *Doha Declaration*, *supra* note 73, ¶ 1.

<sup>88</sup> Abbott, *supra* note 80, at 322 (noting that the Doha Declaration reaffirmed the TRIPS Agreement "can & should be interpreted in a manner supportive of WTO members right to protect public health and in particular, to promote access to medicines for all" (quoting *Doha Declaration*, *supra* note 73, ¶ 6)); *Implementation of Paragraph 6*, *supra* note 77 (paragraph 7 of Doha states that the TRIPS agreement should be interpreted in a way to promote the objective of paragraph 6: "promoting the transfer of technology and capacity building in the pharmaceutical sector").

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HIV/AIDS, tuberculosis, malaria and other epidemics.”<sup>89</sup> Moreover, the Doha Declaration stated, “each Member has the right to determine what constitutes a national emergency or other circumstances of extreme urgency.”<sup>90</sup>

Due to the fact that “each Member has the right to grant compulsory licenses and the freedom to determine the grounds upon which such licenses are granted,” great subjective power rests with developing nations in the determination of whether to issue a compulsory license.<sup>91</sup> The broad text of the TRIPS Agreement was intended to grant each nation the authority to promote public health, but the wording is too flexible and lacks objective guidelines, thereby providing a perfect atmosphere for compulsory license abuse. Misuses of this strong governmental right will lead to detrimental consequences.

### IV. NATIONS THAT HAVE ISSUED COMPULSORY LICENSES

Although compulsory licenses are designed to achieve beneficial outcomes, it is likely that the practice of issuing compulsory licenses will further be abused which will lead to global misfortune. High, middle, and low-income nations have all issued health related compulsory licenses. Examples of high-income countries which have issued compulsory licenses are the United States, Canada, Germany, Italy, and Israel.<sup>92</sup> The United States most recently sought a compulsory license on Bayer’s Ciprofloxacin, an anthrax antibiotic, following the September 11, 2001 attacks.<sup>93</sup> The United States wanted enough antibiotics to treat 10 million people in the event of a mass anthrax attack.<sup>94</sup> Eventually the United States government and Bayer, the German-based manufacturer, came to an agreement in which the United States had the ability to treat 12 million people infected with the anthrax virus.<sup>95</sup>

Following the Doha Declaration large-scale use of compulsory licenses began. In 2002, after facing high rates of HIV/AIDS infections, Mozambique, Zambia, and Zimbabwe authorized compulsory licenses for HIV/AIDS

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<sup>89</sup> *Doha Declaration*, *supra* note 77, ¶ 1.

<sup>90</sup> Brent Savoie, *Thailand’s Test: Compulsory Licensing in an Era of Epidemiologic Transition*, 48 VA. J. INT’L L. 211, 220 (2007) (quoting *Doha Declaration*, *supra* note 73, ¶ 6)).

<sup>91</sup> *Doha Declaration*, *supra* note 77, ¶ 5(b).

<sup>92</sup> See NationMaster.com – Encyclopedia: High income countries, <http://www.nationmaster.com/encyclopedia/High-income-countries> (last visited February 1, 2009) (defining a high income country as a country in which the gross national income per capita is at least \$11,116); Examples of Health-Related Compulsory Licenses, <http://www.cptech.org/ip/health/cl/recent-examples.html> (last visited February 2, 2009).

<sup>93</sup> Examples of Health-Related Compulsory Licenses, *supra* note 92.

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

<sup>95</sup> Jacobs, *supra* note 80.

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medication on the grounds of a national emergency.<sup>96</sup> These nations locally produced antiretrovirals pursuant to article 31(f) of the TRIPS Agreement.<sup>97</sup> In 2004, Malaysia and Indonesia issued compulsory licenses for HIV/AIDS medications.<sup>98</sup> These nations imported generic HIV/AIDS medications from India,<sup>99</sup> and became the first middle-income<sup>100</sup> nations to issue a compulsory license for importation of HIV/AIDS antiretrovirals.<sup>101</sup> Both Malaysia and Indonesia justified the issuance of a compulsory license on the grounds that it was for public non-commercial use.<sup>102</sup> In 2005, Eritrea and Ghana also imported HIV/AIDS medications for public non-commercial use.<sup>103</sup> Starting in 2006 Thailand, a middle-income country joined the group of nations issuing compulsory licenses for HIV/AIDS medications.<sup>104</sup> Thailand imported and domestically manufactured the drug Efavirenz.<sup>105</sup> In 2007, Brazil also a middle-income nation, issued a compulsory license for HIV/AIDS medications.<sup>106</sup> Finally, and most recently, in 2008, Rwanda issued a compulsory license on the HIV/AIDS medication Apo-TriAvir.<sup>107</sup>

The nations of Thailand, Brazil, and Rwanda have all recently issued compulsory licenses, each nation making groundbreaking international news. Thailand and Brazil's actions illustrate the urgent need for more stringent regulations placed on a nation's ability to issue compulsory licenses. Rwanda's

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<sup>96</sup> Savoie, *supra* note 90, at 237. *See also* WTO DECISION, *supra* note 26, at 34.

<sup>97</sup> Savoie, *supra* note 8, at 237.

<sup>98</sup> *Id.* *See also* WTO DECISION, *supra* note 26, at 34.

<sup>99</sup> India did not yet have patents on their pharmaceuticals. *See* Cahoy, *supra* note 1, at 13 (explaining that developing countries were given a transition period to adopt patents on pharmaceutical products under the TRIPS Agreement). *See also* Hestermeyer, *supra* note 36 (explaining India had until January 1, 2005 to start granting product patent protection for pharmaceuticals).

<sup>100</sup> *See* The World Bank, Country Classifications, <http://web.worldbank.org> (last visited February 1, 2009) (defining a middle income country as a country having a gross national income per capital between \$936-\$3,705).

<sup>101</sup> Savoie, *supra* note 90, at 237. *See also* WTO DECISION, *supra* note 26, at 34.

<sup>102</sup> WTO DECISION, *supra* note 26, at 34. *See also* TRIPS Agreement, *supra* note 33, art. 31(b). Public non-commercial use is one of the exceptions to the general requirement that efforts to compromise with the patent holder must have failed before a nation can issue a compulsory license. *Id.*

<sup>103</sup> Savoie, *supra* note 90, at 237. *See also* WTO DECISION, *supra* note 22, at 34.

<sup>104</sup> Savoie, *supra* note 90, at 237.

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

<sup>106</sup> ICTSD, *Brazil Grants Compulsory License*, NEWS & ANALYSIS, May 2007, <http://ictsd.net/i/news/bridges/11643/> [hereinafter ICTSD, *Brazil*].

<sup>107</sup> Andre Picard, *No Room for Petty Politics in Goodwill Program: Canada is the First Country to Ship Cheap AIDS Drugs to Africa, but a Morass of Red Tape Continues to Threaten Humanitarian Efforts*, GLOBE & MAIL, Sept. 25, 2008, available at 2008 WLNR 18185326.

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practice, on the other hand, represents a successful and responsible issuance of a compulsory license. By taking a closer look at each one of these nations' uses under the TRIPS Agreement, it will become clearer when an issuance of a compulsory license is a dangerous misuse and when an issuance is a prudent use.

### A. Thailand's Use

Thailand's most recent practice has caused quite a lot of controversy and deservingly so; their actions demonstrate how the world is rapidly approaching a slippery slope of accepting any nation's arbitrary issuance of a compulsory license over any type of drug available on the market. Thailand issued three compulsory licenses pursuant to the TRIPS Agreement, within a three-month period.<sup>108</sup> First, Thailand issued a license over Merck's Efavirenz which is an HIV/AIDS medication.<sup>109</sup> Subsequently, the Thai government decided to issue two more compulsory licenses over patented prescription drugs, one for Kaletra which treats HIV/AIDS, and another for Plavix which treats heart disease.<sup>110</sup>

There are two fundamental reasons why Thailand's most recent use of compulsory licenses is so controversial. The first reason is because Thailand is a middle-income nation.<sup>111</sup> Secondly and most shockingly, the issuing of a license over Plavix, a heart disease medication, represents the first time a compulsory license was authorized for a chronic disease medication,<sup>112</sup> as opposed to being issued over an infectious disease medication.<sup>113</sup> This issuance might have signaled the start of a new era in which compulsory licenses will be authorized to treat illnesses beyond infectious diseases. The Thai government is

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<sup>108</sup> ICTSD, *Thailand Authorises Generic Production of Two More Patented Drugs*, BRIDGES WKLY. TRADE NEWS DIG., January 31, 2007, <http://ictsd.net/i/news/bridgesweekly/6426/> [hereinafter ICTSD, *Thailand*].

<sup>109</sup> WTO DECISION, *supra* note 26, at 34.

<sup>110</sup> See Press Release, Abbott Laboratories, Abbott Laboratories Won't Introduce New Drugs in Thailand due to Breaking of Patent (March 14, 2007), available at <http://www.aegis.org/news/ads/2007/AD070549.html> [hereinafter Abbott Laboratories]. Kaletra is manufactured by Abbott Laboratories, a US based pharmaceutical company, and Plavix is manufactured by France's Sanofi-Aventis and the U.S. drug maker Bristol-Myers Squibb Co. *Id.*

<sup>111</sup> Zolotaryova, *supra* note 32, at 1107. *But see* TRIPS Agreement, *supra* note 33 (noting that the TRIPS Agreement does not distinguish the income level of WTO Members).

<sup>112</sup> Savoie, *supra* note 90, at 2 (defining chronic disease as "non-communicable diseases that persists for an extended period of time." Examples include heart disease, stroke, diabetes, cancer and chronic respiratory disease).

<sup>113</sup> See Abbott Laboratories, *supra* note 110 (explaining that Plavix is a blood-thinning drug for cardio-vascular disease).

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essentially sending the message that they are willing to invoke a compulsory license over any drug available on the market.<sup>114</sup>

Thailand justified their need to issue a compulsory license for the heart disease medicine under article 13(b)'s 'public non-commercial use' instead of the 'national emergency' provision.<sup>115</sup> 'Public non-commercial use' is not defined in the TRIPS Agreement, and therefore Thailand's action represents how the 'public non-commercial use' provision widens the spectrum as to what health issues are considered severe enough to override a patent.<sup>116</sup> This is disheartening because pharmaceutical companies are now under threat of huge financial losses. The majority of money spent by pharmaceutical companies in research and development goes to drugs that are marketable in the developed world.<sup>117</sup> While infectious diseases are more prevalent in developing nations, chronic diseases are found everywhere in the world. Now that any patented drug is capable of being overridden by a compulsory license pursuant to the lenient text of the TRIPS Agreement, pharmaceutical companies are in danger of not being able to recoup money from the main drugs that drive their industry - drugs aimed at developed nations' markets.<sup>118</sup> This new, unlimited scope of compulsory licenses is likely to cause pharmaceutical companies to decrease investment in all drugs out of fear that they will not earn their expected profits.

Moreover, Thailand angered Abbott Laboratories, the manufacturers of Kaletra when it issued a compulsory license over their AIDS medication because Abbott Laboratories was already selling Kaletra to Thailand at a substantially discounted rate.<sup>119</sup> Abbott Laboratories complained that the Thai government did not engage in proper negotiations with the pharmaceutical company before issuing the license. However, because Thailand issued the license on 'public non-commercial use' grounds, the negotiation requirement was lawfully waived under article 31(b).<sup>120</sup>

If the type of compulsory licensing exercised by Thailand continues,

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<sup>114</sup> Zolotaryova, *supra* note 32, at 1109.

<sup>115</sup> Savoie, *supra* note 90, at 13.

<sup>116</sup> Simon Montlake, *Thailand Widens Scope of Generic Drugs*, CHRISTIAN SCI. MONITOR, January 31, 2007, available at <http://www.scmmonitor.com/2007/0131/p07s02-woap.html>.

<sup>117</sup> Zolotaryova, *supra* note 32, at 1107 (stating that diseases such as malaria, pneumonia, diarrhea, and tuberculosis receive less than 1% of all private and public investment in health research).

<sup>118</sup> *Contra* ICTSD, *Thailand*, *supra* note 108 ("The idea that compulsory licensing of patents is limited to treatments for HIV/AIDS or ebola, as opposed to treatments for coronary disease and diabetes, is flat wrong.").

<sup>119</sup> *Id.*

<sup>120</sup> *See generally* TRIPS Agreement, *supra* note 33, art. 31(b) (stating that nations are not required to negotiate with the patent holder if the nation is issuing the license in response to a national emergency, extreme circumstance, or is producing the drug for public non-commercial use).

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Thailand along with the rest of the world will suffer damaging consequences.<sup>121</sup> For example, Abbott Laboratories reacted to Thailand's actions by stating, "Thailand has revoked the patent on our medicine, ignoring the patent system. Under these circumstances we have elected not to introduce new medicines there."<sup>122</sup> Abbott then withdrew seven registration applications for new pharmaceutical products in Thailand.<sup>123</sup> Five of those applications were targeted at chronic diseases.<sup>124</sup> As a result of Thailand's abuse of compulsory licenses, Thai citizens will now suffer because they will be deprived of new drugs created by Abbott Laboratories and other cautious pharmaceutical companies.<sup>125</sup>

Thailand's actions also promoted trade retaliation by the United States.<sup>126</sup> The United States is Thailand's largest trading partner, but due to Thailand's recent irresponsible issuances, the United States placed Thailand on its' Priority Watch List.<sup>127</sup> This list highlights which of the United States' trading partners the US has concerns over the adequacy and effectiveness of intellectual property right protections.<sup>128</sup> Lastly, Thailand's recent practice has caused worldwide disapproval. The EU Trade Commission has stated that they object to Thailand's approach to issuing compulsory licenses.<sup>129</sup> Although the EU Trade Commission agrees with the overall underlying theory of authorizing developing nations to issue compulsory licenses, it feels that Thailand's

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<sup>121</sup> *But see Thai Health Ministry Takes "Bold Step" in Breaking Patent, Issuing Compulsory License for Antiretroviral Kaletra*, *Editorial Says*, available at

<http://www.thebody.com/content/art39745.html> (last visited April 6, 2009) (explaining that health groups have applauded Bangkok's recent policy because the low drug costs will allow the government to treat thousands more people).

<sup>122</sup> Abbott Laboratories, *supra* note 110 (quoting Dirk Van Eeden, Public Affairs Director of Abbott International).

<sup>123</sup> Savoie, *supra* note 90, at 14.

<sup>124</sup> *Id.*

<sup>125</sup> See Zolotaryova, *supra* note 32.

<sup>126</sup> Khoury, *supra* note 15, at 33.

<sup>127</sup> Ed Silverman, *US Trade Rep: Thailand On Watch List*, PHARMALOT, Apr. 30, 2007, [http://www.pharmalot.com/2007/04/us\\_trade\\_rep\\_thailand\\_on\\_watch/](http://www.pharmalot.com/2007/04/us_trade_rep_thailand_on_watch/) (explaining that Thailand has not violated any world trade rules, but that the Priority Watch List is "reserved for countries that don't 'provide an adequate level of intellectual property rights protection or enforcement'"). See also OFFICE OF THE U.S. TRADE REPRESENTATIVE, 2008 SPECIAL 301 REPORT 37 (2008), [http://www.ustr.gov/assets/Document\\_Library/Reports\\_Publications/2008/2008\\_Special\\_301\\_Report/asset\\_upload\\_file553\\_14869.pdf](http://www.ustr.gov/assets/Document_Library/Reports_Publications/2008/2008_Special_301_Report/asset_upload_file553_14869.pdf) (stating that "Thailand will remain on the Priority Watch List in 2008 due to a broad range of concerns surrounding IPR protection and enforcement") [hereinafter SPECIAL 301 REPORT].

<sup>128</sup> Savoie, *supra* note 90, at 245.

<sup>129</sup> Ed Silverman, *EU Trade Commish Scolds Thailand, Again*, PHARMALOT, May 28, 2008, <http://www.pharmalot.com/2008/05/eu-trade-commish-scolds-thailand-again/>.

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“systematic recourse to compulsory licensing is not a sustainable approach.”<sup>130</sup> Furthermore, the Trade Commission agrees that this practice will be detrimental to the innovations of new pharmaceuticals.<sup>131</sup> Worldwide disapproval will result in a blow to business confidence in Thailand, which will in turn deter pharmaceutical companies from investing there in the future.

**B. Brazil’s Use**

Brazil’s recent practice, similar to that of Thailand, further demonstrates the manner in which national governments are easily able to manipulate the susceptible language of the TRIPS Agreement. President Luiz Inacio Lula da Silva of Brazil agreed on May 4, 2007, to issue a compulsory license on Efavirenez, an HIV/AIDS drug owned by Merck.<sup>132</sup> Before the license was issued, Merck offered to lower the drug price by 30%, but because Brazil justified their issuance of the license under the ‘public non-commercial use’ category of the TRIPS Agreement, Brazil was not required to negotiate with Merck whatsoever.<sup>133</sup> Brazil claimed that importing a generic form of Efavirenz from India would save the nation’s ant-AIDS program \$30 million dollars annually.<sup>134</sup> Brazil received the generic import for \$0.45 a pill, compared to Merck’s offer of \$1.11 per pill. Merck, disappointed with Brazil’s actions, has stated that Brazil’s decision is a major step backward and sets bad policy for two reasons.<sup>135</sup> First of all, Brazil’s actions sets bad precedent in the sense that it will encourage overuse of the compulsory license provision.<sup>136</sup> Brazil is an upper-middle income country with the 12<sup>th</sup> largest economy in the world.<sup>137</sup> Moreover, Brazil has a relatively low rate of HIV/AIDS infection, and has a well-established AIDS program which has been successful in controlling the national spread of HIV/AIDS.<sup>138</sup> Therefore, Brazil has more of an opportunity to pay for HIV/AIDS medications than countries that have less

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<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> Zolotaryova, *supra* note 32, at 1099.

<sup>133</sup> *Id.* at 1105. See also TRIPS Agreement, *supra* note 33, art. 31(b).

<sup>134</sup> Zolotaryova, *supra* note 32, at 1104.

<sup>135</sup> *Id.* at 1107.

<sup>136</sup> *Id.*

<sup>137</sup> ICTSD, *Brazil*, *supra* note 106. See also Merck & Co., Inc., *Merck & Co., Inc. Statement on Brazilian Government’s Decision to Issue Compulsory License for STROCRIN*, Corporate News, May 4, 2007, [http://www.merck.com/newsroom/press\\_releases/corporate/2007\\_0504.html](http://www.merck.com/newsroom/press_releases/corporate/2007_0504.html) [hereinafter Merck].

<sup>138</sup> ICTSD, *Brazil*, *supra* note 106.

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money and that are hit harder with the epidemic.<sup>139</sup> The second reason Merck condemns Brazil's practice is because future foreign investment will be discouraged, which will ultimately result in less drugs being introduced into Brazil.<sup>140</sup> This issuance of a compulsory license has had a negative impact on Brazil's reputation as an industrialized country seeking to attract foreign investment.<sup>141</sup>

Both Thailand and Brazil's recent actions exemplify a new trend in issuing compulsory licenses, likely to have dangerous effects not only on the imprudent nations which practice these methods, but also on the rest of the world. If there were more stringent laws governing the issuance of compulsory licenses Thailand and Brazil most likely would not have been authorized to issue these compulsory licenses.

### C. Rwanda's use

Compulsory licenses can be a powerful negotiating tool for developing nations in ensuring that the high prices set on drugs do not burden the nation to a point that they are unable to respond to a public health crises.<sup>142</sup> The threat of issuing a compulsory license on a pharmaceutical company's patented drug gives the developing country some leverage over powerful pharmaceutical companies. In the past, Brazil, for example has successfully used compulsory licenses as a tool to negotiate lower prices from both Merck and Roche.<sup>143</sup> The practice of issuing compulsory licenses, or even the threat of issuing a license, can be an invaluable tool in promoting public health when used in moderation.

Rwanda's issuance pursuant to the TRIPS Agreement represents how compulsory licenses can be, and were designed to be, a beneficial tool in assisting a nation in need. On July 17, 2007 Rwanda became the first nation to notify the WTO of its' intention to import the HIV drug Apo-TriAvir<sup>144</sup> from Canada, pursuant to Paragraph 6 of the Doha Declaration.<sup>145</sup> Canada, in turn,

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<sup>139</sup> *Id.*

<sup>140</sup> Zolotaryova, *supra* note 32, at 1107.

<sup>141</sup> *Id.*

<sup>142</sup> Savoie, *supra* note 90, at 237.

<sup>143</sup> Zolotaryova, *supra* note 32, at 1102 (citing Naomi A. Bass, *Implications of the TRIPS Agreement for Developing Countries Pharmaceutical Patent Laws in Brazil and South Africa in the 21<sup>st</sup> Century*, 34 GEO. WASH. INT'L L. REV. 191, 209-10 (2002)) (explaining that Merck lowered the price for the HIV/AIDS medicine Stocrin, and Roche agreed to lower the price on the AIDS drug Viracept). Roche is a Swiss pharmaceutical company.

<sup>144</sup> Hestermeyer, *supra* note 36 (explaining TriAvir is a combination of three HIV/AIDS drugs: zidovudine, lamivudine, nevirapone).

<sup>145</sup> Cotter, *supra* note 84, at 177.

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notified the WTO on October 4, 2007 that it had authorized the production of a generic version of the patented antiviral drug for export to Rwanda.<sup>146</sup> The Canadian company Apotex was the pharmaceutical company responsible for manufacturing Apo-TriAvir, which is a drug that has nine related patents.<sup>147</sup>

Rwanda has a population of 9.3 million people, of those citizens, 200,000 are infected with either HIV or AIDS.<sup>148</sup> Less than one-fourth of the HIV/AIDS infected people living in Rwanda were receiving anti-viral treatment.<sup>149</sup> On September 24, 2008 the generic AIDS medication left Toronto for Kigali.<sup>150</sup> The shipment contained 7 million doses of Apo-TriAvir. From this shipment, 21,000 Rwandans will be treated for a full year.<sup>151</sup> Apotex will export Apo-TriAvir at a cost of approximately \$0.20 per tablet, compared to the three brand name components which would run around \$6.00 per dose.<sup>152</sup>

Although Rwanda illustrates a success story, the process laid out in Paragraph 6 of the Doha Declaration has been criticized for being too time-consuming. Rwanda did not receive their shipment of the generic drugs from Canada, for over an entire year after they notified the WTO of their intention to import the drug.<sup>153</sup> Moreover, if Apotex agreed to export this generic version of AIDS medication to another developing country, Apotex would have to go through the entire time-consuming process again.<sup>154</sup> Not only was the process impractical because it took so long, but it also cost the exporting nation a lot of money.<sup>155</sup> Until the process becomes more efficient, developed countries will be deterred from agreeing to manufacture generic drugs for exportation to developing countries in need.

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<sup>146</sup> *Id.*

<sup>147</sup> Hestermeyer, *supra* note 36 (explaining that of the nine patents associated with the HIV drug, four of them are owned by the Glaxo company, two of them are owned by the Wellcome Foundation, two by Shire Biochem, and lastly, one is owned by Boehringer Ingelheim and Dr. Thomae).

<sup>148</sup> Cotter, *supra* note 84, at 178.

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

<sup>150</sup> Picard, *supra* note 107 (explaining under Canada's Access to Medicines Regime they remain the only country in the world which can legally produce low cost generic medicines and deliver them to the developing world).

<sup>151</sup> *Id.*

<sup>152</sup> See ICTSD, Rwanda Should Receive Cut-Price HIV / Aids Drugs In September, Five Years After 30 August Decision, BRIDGES WKLY. TRADE NEWS DIG., May 14, 2008, <http://ictsd.net/i/news/bridgesweekly/11081/>. See also *Apotex Awarded ApoTriAvir Tender From Rwanda Government*, World Generic Markets, May 21, 2008, available at 2008 WLNR 9588676.

<sup>153</sup> See Picard, *supra* note 107.

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

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

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## V. THE POTENTIAL DANGERS ARISING FROM COMPULSORY LICENSES

There are four main dangers likely to arise from the ambiguous language of Article 31 of the TRIPS Agreement. More stringent laws must be in place in order to avoid these dangers. The first of these problems is based on the utilitarian theory.<sup>156</sup> It is well understood that “[p]atents provide incentives to individuals by offering them recognition for their creativity and material award for their marketable inventions.”<sup>157</sup> Compulsory licenses, nevertheless, diminish the incentive to undertake research and development in the pharmaceutical industry because the issuance of a compulsory license causes the patent holder to lose his expected earnings. Human life is continuously advanced because innovation is encouraged by incentives.<sup>158</sup> Without incentive, advances in the pharmaceutical industry will quickly subside.

The high price of medicine stems from the costly research and development process, which is necessary to produce safe and effective pharmaceutical products.<sup>159</sup> In 2001, funding for global research and development was over \$100 billion in the pharmaceutical sector.<sup>160</sup> Approximately 56% of this funding was provided by the private sector.<sup>161</sup> Moreover, most pharmaceutical research does not conclude in a patented medicine, therefore pharmaceutical companies must secure earnings that not only cover their research and development costs and their running costs, but also the costs of unsuccessful research.<sup>162</sup> The monopoly power created by a patent is essential for pharmaceutical companies to earn enough money to stay in business and to finance subsequent research and development projects.<sup>163</sup> A decrease in research will certainly reduce the rate of medical progress and innovation across the globe.<sup>164</sup>

When a government issues a compulsory license the pharmaceutical company’s incentive to continue to invest their private funds into research and development for new medicines for that nation quickly fades away. A major

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<sup>156</sup> The Utilitarian Theory was previously discussed in Section II *supra*.

<sup>157</sup> Greve, *supra* note 20, at 5.

<sup>158</sup> *Id.*

<sup>159</sup> *Id.* (arguing that research and development is time consuming and costly).

<sup>160</sup> Bird & Cahoy, *supra* note 14, at 284.

<sup>161</sup> *Id.* (noting that funding was not coming from the public sector or the government). *But see* Zolotaryova, *supra* note 32, at 1107 (explaining 21% of all global disease come from malaria, pneumonia, diarrhea, and tuberculosis, but these illnesses receive less than 1% of all private investments).

<sup>162</sup> Greve, *supra* note 20, at 8.

<sup>163</sup> *See id.*

<sup>164</sup> *Id.*

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United States drug company, Merck & Co., illustrated this logic when it stated, “[t]his expropriation of intellectual property sends a chilling signal to research-based companies about the attractiveness of undertaking risky research on diseases that affect the developing world.”<sup>165</sup>

A compulsory license is retroactive in nature, meaning that the product is already patented and the patent holder only loses his exclusive right over the patented product after a compulsory license is issued. The private funds have already been invested into the product, so once a compulsory license is issued the investment cannot be taken away.<sup>166</sup> However, once a compulsory license is issued, the incentive to invest in the future will be reduced. “You can compel a private company once [with a CL]. After that they will probably leave your boarders, and you lose the opportunity to get the access and technology in the future.”<sup>167</sup>

The second foreseeable danger is that global health will actually suffer due to the subjective language of Article 31, despite the fact that the TRIPS Agreement was implemented and is interpreted to promote public health. The unfortunate decline in global health stems from the utilitarian argument. In light of Article 31, each WTO Member has the authority to issue a compulsory license.<sup>168</sup> As previously discussed, this practice will reduce the incentive of pharmaceutical companies to invest their private funds into discovering new medicines. Generally, developing nations have weaker intellectual property protections and are therefore more likely to issue compulsory licenses on patented pharmaceutical products than are developed countries.<sup>169</sup> Thus pharmaceutical companies, out of fear of not recouping the cost of research and development, will stop devoting their time and money into discovering cures for diseases which primarily plague the developing world.<sup>170</sup> Instead, the pharmaceutical industry will allocate their resources to innovating medicines that are likely to have a successful commercial market in developed countries.<sup>171</sup> Based on the effect compulsory licenses have on pharmaceutical

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<sup>165</sup> Merck, *supra* note 137 (noting Merck’s reaction to Brazil’s decision to issue a compulsory license for Stocrin, an HIV drug).

<sup>166</sup> Bird & Cahoy, *supra* note 14, at 290.

<sup>167</sup> *Id.*

<sup>168</sup> WTO DECISION, *supra* note 26, at 7.

<sup>169</sup> See SPECIAL 301 REPORT, *supra* 127, at 2. The Special 301 Report is a tool used to pinpoint problems in intellectual property rights protection in countries which are engaged in trade with the United States. *Id.* Most of the countries on the Watch List are developing nations. *Id.*

<sup>170</sup> See Baucus, *supra* note 19.

<sup>171</sup> See Tim Atkinson, Lifestyle Drug Market Booming, 8 NATURE MED. 909 (2002), available at <http://www.nature.com/nm/journal/v8/n9/full/nm0902-909.html> (explaining that lifestyle drugs treat conditions such as weight loss, anti-smoking, impotence, and hair loss and that the market for these

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companies' profits, the pharmaceutical industry will turn their backs on very problematic illnesses found predominately in developing countries. Unfortunately, many developing nations do not have domestic, progressive pharmaceutical manufacturers.<sup>172</sup> If safeguards are not placed on the right to issue compulsory licenses, ill stricken people living in developing countries will be left with little relief in sight.

The health concerns associated with compulsory licensing are not only that pharmaceutical companies will stop manufacturing drugs directed at illnesses plaguing developing nations, but also that the generic drugs that will either be domestically manufactured or imported into developing countries will be of lower quality than the drugs created by the transnational pharmaceutical companies.<sup>173</sup> Both India and China have become major international suppliers of generic drugs.<sup>174</sup> As the manufacturing is allocated to these countries, "the risk to human health is growing exponentially."<sup>175</sup> The concern about low quality drugs arises from the fact that quality-control inspections are rarely conducted by the Food and Drug Administration in India or China.<sup>176</sup> In 2005 alone, the FDA conducted 1,222 quality inspections in the United States, but within the past 7 years the FDA only conducted only 200 inspections in China and in India combined.<sup>177</sup> Of the 200 inspections conducted, few of them measure up to the thorough inspections carried out in the United States.<sup>178</sup> Unlike the surprise visits routinely practiced in the United States, the inspections in India and China were scheduled in advance which gave the manufacturing plants time to prepare.<sup>179</sup>

Private investigations have been conducted to uncover the poor conditions in foreign operated plants.<sup>180</sup> These investigations have exposed that some plants have open walls which invite pests and dust into the production

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drugs is driven by the Western market where people are willing to pay high prices to improve their image and mental agility).

<sup>172</sup> WTO DECISION, *supra* note 26, at 7 (explaining many countries have no production capacity in the pharmaceutical sector).

<sup>173</sup> *Id.* (stating "[t]he problem is that, despite the lower costs for developing the medicines, the new producer generally cannot achieve equally effective production as the patent holder.").

<sup>174</sup> Marc Kaufman, *FDA Scrutiny Scant In India, China as Drugs Pour Into U.S.*, WASHINGTON POST, June 17, 2007, at A01, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007> (explaining over the past seven years imports from China and India has grown drastically).

<sup>175</sup> *Id.* (quoting Brant Zell, the past chairman of the Bulk Pharmaceuticals Task Force).

<sup>176</sup> *Id.* (explaining that the plants are lightly regulated due to very limited government regulation).

<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> *Id.*

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facility, other plants had different chemical equipment so congested that cross-contamination is inevitable, and one study even discovered a hornet's nest on top of a drug making vat.<sup>181</sup> Based on the increase in importation from developing nations, combined with the low levels of quality inspections in exporting nations, the chance that consumers will receive impure or ineffective generic drugs has greatly multiplied.<sup>182</sup> Unfortunately, it is virtually impossible to determine whether the low quality drugs imported from these lightly regulated plants have caused patients to get more ill or remain ill because the medicines are not effective.<sup>183</sup>

The Doha Declaration clarifies that developing nations unable to domestically manufacture drugs are authorized to import generic drugs from nations with manufacturing capabilities.<sup>184</sup> Thus, developing countries suffering from the most severe epidemics are likely to be importing drugs from these lightly regulated Asian plants. These generic drugs have the potential to be both unsafe and ineffective. This is a very serious danger because once a contaminated or ineffective drug hits the market, injuries and deaths are likely to occur before the source of the problem is tracked down.<sup>185</sup> Therefore, the overall health of these importing nations is at risk if the rules that govern compulsory licensing are not amended.

The third potential danger arising from the use of compulsory licenses under the TRIPS Agreement is the reduction in the amount of money that will be invested into developing nations. In developing countries a substantial amount of investment comes from outside the country, which stimulates the growth of local industry.<sup>186</sup> While strong intellectual property protection results in increased investment, likewise, weak intellectual property rights leads to a decrease in investment.<sup>187</sup> When a pharmaceutical company discovers that the security of their property rights are vulnerable in a given nation, they are likely to avoid engaging in foreign direct investment with that nation.<sup>188</sup> This comes at a heavy price for developing nations because foreign direct investment is a major source of economic growth.<sup>189</sup> When a nation exercises their right to issue a compulsory license that nation is viewed by the rest of the world as

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<sup>181</sup> *Id.* (explaining these private investigators were hired by U.S. companies).

<sup>182</sup> *Id.* (quoting Brent Zell the past chairman of the Bulk Pharmaceuticals Task Force).

<sup>183</sup> *Id.* (explaining that it is unlikely that doctors suspect poorly manufactured drugs are the causation of the problem).

<sup>184</sup> *Implementation of Paragraph 6, supra* note 33.

<sup>185</sup> Kaufman, *supra* note 174 (quoting William Hubbard, a former FDA Associate Commissioner).

<sup>186</sup> Bird & Cahoy *supra* note 14, at 284.

<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> *Id.*

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having weak intellectual property rights. Therefore, compulsory licensing will cause a heavy loss in the acquisition of foreign investments.

Egypt is a quintessential illustration of the danger of losing foreign direct investment based on weak intellectual property protection. Egypt is a middle-income country with great potential for economic growth, however foreign direct investment here has continued to decline over the past 20 years.<sup>190</sup> Egypt has one of the poorest records in the Middle East in protecting intellectual property rights, which hinders their ability to expand trade opportunities and lure foreign investment.<sup>191</sup> In 2002, Pfizer entered the Egyptian market with the drug Viagra.<sup>192</sup> After only two months on the market, the Egyptian Health Ministry decided to grant authorization to produce Viagra to all Egyptian companies who applied to produce generic versions of the drug.<sup>193</sup> The generic brand of Viagra would be sold at one-twentieth of the price of Pfizer's market price.<sup>194</sup>

Egypt's actions enraged Pfizer, who eventually cancelled plans to construct a state of the art production facility in Egypt.<sup>195</sup> Additionally, PhRMA<sup>196</sup> was deterred from investing \$300 million into Egypt's pharmaceutical sector due to the weak intellectual property protection laws.<sup>197</sup> Egypt was in desperate need of foreign direct investment from companies like Pfizer to jumpstart their depressed economy. Consequently, Egypt lost a lot by issuing this compulsory license.

The final danger that will arise from issuing compulsory licenses under the current practice is that the United States' economy will further deteriorate. Approximately 40% of the United States' economic growth is dependent upon intellectual property protection in one form or another.<sup>198</sup> Industries that rely on

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<sup>190</sup> *Id.* at 289.

<sup>191</sup> Abeer Allam, *Seeking Investment Egypt Tries Patent Laws*, N.Y. TIMES, Oct. 4, 2002, available at <http://query.nytimes.com/gst/fullpage.html>, (explaining that Egypt's compulsory license statute is very broad). See also Bird & Cahoy, *supra* note 14, at 293; SPECIAL 301 REPORT, *supra* note 127, at 3 (stating that Egypt has moved from Priority Watch List in 2007 to the Watch List in 2008 "due to their improvements in pharmaceutical intellectual property protection").

<sup>192</sup> See Bird & Cahoy, *supra* note 14, at 291.

<sup>193</sup> *Id.* (referencing Richard A. Castellano, *Patent Law for New Medical Uses of Known Compounds of Pfizer's Viagra Patent*, 46 IDEA 283, 289 (2006)) (explaining the Egypt rationalized its issuance of a compulsory license on Viagra in order to benefit the poor).

<sup>194</sup> Allam, *supra* note 191.

<sup>195</sup> Bird & Cahoy, *supra* note 14, at 290-91.

<sup>196</sup> PhRMA, [http://www.phrma.org/about\\_phrma/](http://www.phrma.org/about_phrma/) (last visited November 1, 2008) (Pharmaceutical Research and Manufacturers of America is a trade group representing the pharmaceutical research and biotechnology research companies in the United states).

<sup>197</sup> Bird & Cahoy, *supra* note 14, at 291.

<sup>198</sup> Baucus, *supra* note 19, at 5.

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intellectual property protection employ approximately 18 million Americans.<sup>199</sup> For instance, Pfizer is the world's largest research based pharmaceutical company,<sup>200</sup> and it alone is responsible for providing 85,000 jobs.<sup>201</sup> Pfizer invests almost \$60 billion each year in the search for new drugs.<sup>202</sup> The problem of weak intellectual property protection "is of great importance, not just to the U.S. creative community, but to the U.S. economy and to U.S. society as a whole."<sup>203</sup>

The biopharmaceutical industry spends more money on research and development than any other industry spends in the United States. Specialists in the field of pharmaceuticals recognize a pattern: "[Intellectual property protection] equals innovation. Innovation equals competitiveness. And competitiveness equals jobs."<sup>204</sup> If issuing compulsory licenses becomes an arbitrarily and frequently used tool, which is likely to occur based on the vague language of Article 31, the pharmaceutical industry in the United States will collapse. The failure of the pharmaceutical industry will lead to a devastating impact on the nation's economy including the loss of tens of thousands of American jobs.

## SUGGESTIONS FOR REFORM

It is not contested that the underlying policy behind compulsory licenses is positive, and under certain circumstances this powerful right granted to governments can provide unmatched relief to suffering people around the globe. The fundamental crises that compulsory licenses generate arise from the susceptible language of the TRIPS Agreement and the Doha Declaration, along with bad precedent set by nations like Thailand and Brazil. The law controlling compulsory licenses must be made less ambiguous, more objective, and overall more stringent.

The first problematic aspect of compulsory licenses is Article 5(c) of the Doha Declaration, which affirms that "[e]ach member has the right to determine what constitutes a national emergency or other circumstance of extreme urgency."<sup>205</sup> It certainly would be impractical and nearly impossible

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

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

<sup>201</sup> *Id.* at 7 (explaining that these "employees invent, produce, and provide medicines that save and improve lives.").

<sup>202</sup> *Id.*

<sup>203</sup> *Id.* at 5 (quoting Senator Marcus Baucus).

<sup>204</sup> *Id.* (quoting Jeffery Kindler, CEO of Pfizer).

<sup>205</sup> Doha Declaration, *supra* note 73, ¶ 5(c).

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for the WTO to set out an enumerated list classifying which diseases do and which diseases do not constitute a severe enough emergency to justify the issuance of a compulsory license. Not only do new diseases occasionally surface, but each nation also faces different conditions, and therefore an illness in one country could be a serious national emergency, while that same illness in another country could be nothing more than an inconvenience.

While it is clear that it would be idealistic to explicitly define when it is appropriate for a nation to issue a compulsory license, it ought to be required that each nation demonstrate: (1) they are suffering from 'a national emergency', (2) they are suffering from 'a circumstance of extreme urgency', and (3) the nation will be using the patented medicine for 'public non-commercial use'. These three factors are already set forth in the TRIPS Agreement, but for a different purpose. In article 31(b) the requirement of reasonable negotiations with the patent holder is suspended under the circumstances of a 'national emergency', 'other extreme circumstances of extreme urgency', or a 'public non-commercial use'.<sup>206</sup> These three familiar terms to the TRIPS Agreement should be borrowed from article 31(b), and transformed into a conjunctive requirement that each nation must fulfill before having the option of overriding a patent.

Secondly, The TRIPS Agreement furthered by the Doha Declaration leave the door wide open for abuses by allowing WTO Members absolute subjective power in determining whether to issue a compulsory license. As the TRIPS Agreement reads now, each WTO Member has the authority to determine when their own nation is suffering from a national emergency or circumstance of extreme urgency. This subjective approach is easily manipulated. For example, Brazil abused the system when the nation issued a compulsory license over Efavirenz. Despite the fact that Efavirenz is manufactured to fight the HIV/AIDS epidemic, which is predominantly viewed as a national emergency, Brazil's use was opposed by many nations. The controversy arose because Brazil is a relatively wealthy nation and compared to other nations did not have an extremely serious HIV/AIDS problem.<sup>207</sup> Controversies such as this would be avoided if a nation, other than the issuing nation, were the determinate of whether circumstances are severe enough to warrant the issuance of a compulsory license.

The decision of whether a nation is suffering from a national emergency or circumstance of extreme urgency should be left to the WTO as a whole. There should be a vote conducted before any nation is authorized to

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<sup>206</sup>TRIPS Agreement, *supra* note 33, art. 31(b).

<sup>207</sup>See ICTSD, *Brazil*, *supra* note 106. See also Merck & Co., Inc. Statement on Brazilian Government's Decision to Issue Compulsory License for STROCRIN, *supra* note 137.

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issue a compulsory license. Any WTO Member considering issuing a compulsory license should be required to assemble a report addressing the severity of the illness affecting their nation. This report would then be read by a representative from each WTO nation, and then a vote should then be taken. Based on this procedure, less power would lie on the individual nation advocating for the license and more power and control would be held by the WTO as an organization.

Moreover, article 31(b) of the TRIPS Agreement is problematic. It suspends the requirement of reasonable negotiation with the patent holder under the three circumstances: 'national emergency', 'other extreme circumstances of extreme urgency', or 'public non-commercial use'.<sup>208</sup> There are two different approaches of how to make this reasonable negotiation requirement more equitable. First of all, not one of these three exceptions to the prior negotiation rule is defined anywhere in the TRIPS Agreement or in the Doha Declaration. These three exceptions must be defined in order to avoid abuses resulting from the ambiguity of these terms. Additionally, these three exceptions ought be conjunctive and not mutually exclusive. In other words, for a nation to successfully issue a compulsory license without prior negotiation with the patent holder, the nation must be facing a national emergency, circumstances of extreme urgency, *and*<sup>209</sup> the use must be for public non-commercial use.

The most dangerous of these terms to not be defined is the 'public non-commercial use' exception. An illustration of the dangerous abuse that flowed from this broad terminology is when the Thai government issued a compulsory license on Plavix, the heart-disease medication. The Thai government cleverly justified their authority to issue the license under article 31(b)'s 'public non-commercial' use category, thereby avoiding the task of justifying that heart disease was a 'national emergency' or a situation of 'extreme circumstance of extreme urgency'. The 'public non-commercial use' exception can be used to validate any nation's authority, regardless of their wealth, to issue a compulsory license over any medication, not considering the illness the medication is intended to be used for; so long as the nation uses the compulsory license for public non-commercial use, which is not even a defined term. If these three exceptions were each required to be fulfilled before a WTO Member was in a position to issue a compulsory license, instances like that of Thailand would not occur, and pharmaceutical companies could be more confident in introducing new medicines into developing nations without the fear of the nation issuing an arbitrary compulsory license.

The second approach to strengthen article 31(b) is to outright *require*

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<sup>208</sup>TRIPS Agreement, *supra* note 33, art. 31(b).

<sup>209</sup>*Id.* (uses the word 'and' instead of 'or').

## COMPULSORY LICENSES

prior negotiations with the patent holder before any compulsory license is issued. Under this approach the patent holder would always be given a reasonable amount of time, consisting of at least a set number of weeks, to come to a compromise over the price of their pharmaceutical product. This requirement would lessen the tension between pharmaceutical companies and developing nations because pharmaceutical companies would be guaranteed at least the option of lowering the price of their medicine before their exclusive right was stripped away from them. It is conceivable that under very extraordinary circumstances, a severe emergency could plague a nation to the extent that it would not be plausible to negotiate prices with a pharmaceutical company. This would only occur when there is the possibility that large amounts of people are likely to be infected with a disease within the amount of time it would take to negotiate the price.<sup>210</sup> Under this intense situation, while the WTO representatives were voting as to whether a nation is entitled to a compulsory license, the WTO Members would also have the authority to waive this prior negotiation requirement, if the emergency seemed severe enough.

The TRIPS Agreement would be further improved if all of the terms within the agreement were fully defined, resulting in the governing laws of compulsory licenses being less ambiguous. There are several undefined terms throughout the TRIPS Agreement. In order to make the Agreement less ambiguous these terms must be defined. For example, article 31(h) requires the right holder to be paid 'adequate remuneration' while taking into account the 'economic value' of the authorization.<sup>211</sup> Neither of the terms 'adequate remuneration' nor 'economic value' are defined in the TRIPS Agreement or in the Doha Declaration. Additionally, article 31(b) requires prior negotiation with the right holder on 'reasonable commercial terms and conditions'.<sup>212</sup> Again 'reasonable commercial terms' is not defined in the TRIPS Agreement or in the Doha Declaration. Essentially, this could allow a nation seeking a license to give the pharmaceutical company an unreasonable ultimatum of either delivering the medicine for the fraction of the market price or having a compulsory license issued on their product. The asking price of the nation requesting the license should be in relation to the economic wealth of that nation along with factoring in the amount of drugs the nation needs to import.

In order to safeguard the world against potential abuse of the TRIPS Agreement, more definite language should be implemented. Words and phrases that are fundamental to issuing compulsory licenses should be clear and

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<sup>210</sup>This time should only be a few weeks, to strike a fair balance between the developing country's need and the pharmaceutical company's need.

<sup>211</sup>TRIPS Agreement, *supra* note 33, art. 31(h).

<sup>212</sup>*Id.*

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concise. The current inclusion of broad undefined words in the TRIPS Agreement leaves too much wiggle room for WTO Members to issue compulsory licenses under questionable circumstances.

The TRIPS Agreement would further be enhanced if a non-violation complaint provision were implemented, similar to that of The GATT Agreement, which recognizes non-violation complaints pursuant to article XXIII:1(b).<sup>213</sup> A non-violation complaint provision allows a government to go to the Dispute Settlement Body even when an agreement has not technically been violated.<sup>214</sup> Thus, if a government can show that it has “been deprived of an expected benefit because of another government’s action, or because of any other situation that exists,” that nation can contest the license to the WTO Dispute Settlement Board.<sup>215</sup> For example, Brazil cut negotiations with Merck short because Brazil was not legally required to negotiate under article 31(b);<sup>216</sup> under a non-violation complaint provision Merck would be allowed to argue that even though Brazil did not violate any provision in the TRIPS Agreement, the result of their actions were offensive and the license should be revoked. Similar to this belief, the House Democrats understood that Thailand did not necessarily issue any licenses in violation of the WTO rules, but forewarns issuances like these will hinder innovation which in turn will prevent the development of new life-saving medicines.<sup>217</sup> This type of bad-faith issuing would be stopped pursuant to an outlet like the non-violation complaint provision because nations could argue for revocation of a license even when it technically conforms to all the WTO rules.

Article 64.2 of the TRIPS Agreement specifically states that there is to be no non-violation complaint in the TRIPS Agreement.<sup>218</sup> Some countries, however, such as the United States and Switzerland argue that “non-violation cases should be allowed in order to discourage members from engaging in

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<sup>213</sup>General Agreement on Tariffs and Trade 1994, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1867 U.N.T.S. 187; 33 I.L.M. 1153 (1994), art. XXIII, available at

[http://www.wto.org/english/res\\_e/booksp\\_e/analytic\\_index\\_e/gatt1994\\_08\\_e.htm#article23](http://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_08_e.htm#article23). See also World Trade Organization, *TRIPS: ‘Non-Violation’ Complaints (Article 64.2) - Background and the Current Situation*,

[http://www.wto.org/english/tratop\\_e/TRIPS\\_e/nonviolation\\_background\\_e.htm](http://www.wto.org/english/tratop_e/TRIPS_e/nonviolation_background_e.htm) (last visited March 21, 2009) [hereinafter *TRIPS: ‘Non-Violation’ Complaints*].

<sup>214</sup>TRIPS: ‘Non-Violation’ Complaints, *supra* note 213. See also TRIPS Agreement, *supra* note 33, art. 64.2.

<sup>215</sup>TRIPS Agreement, *supra* note 33, art. 31(b).

<sup>216</sup>*Id.*

<sup>217</sup>House Democrats Endorse USTR Pressure on Thai Compulsory License, August 15, available at 2008 WLNR 15320070.

<sup>218</sup>TRIPS Agreement, *supra* note 33, art. 64.2.

## COMPULSORY LICENSES

‘creative legislative activity’ that would allow them to get around their TRIPS commitment.”<sup>219</sup>

Lastly, and most importantly strong international intellectual property rights must be maintained worldwide. Strong intellectual property protections are fundamental to ensuring stability of the world’s economy and the health of the world’s citizens. It is each individual nation’s responsibility to implement strong intellectual property protections, and strict punishment for violations of these protections.

## CONCLUSION

The controversy that arises from the practice of placing compulsory licenses on pharmaceutical products becomes so complex because peoples’ health and lives are on the line. The underlying aspiration of compulsory licenses is to improve global health, but this goal will not be achieved until more stringent laws govern this practice. The actual benefits that compulsory licenses are capable of affording desperate nations have become overshadowed by imprudently issued licenses that strike apprehension and anger within pharmaceutical companies.

Until the governing laws are amended, nations will abuse the susceptible language of these laws and damaging outcomes, similar to those which occurred in Thailand and Brazil will surely result. In order to protect both the developed and undeveloped world alike, unnecessary issuances of compulsory licenses must be stopped. If only essential compulsory licenses were issued, citizens who were truly in need would be treated and the pharmaceutical companies’ fears of not recouping their investments would be placed at ease.

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<sup>219</sup>TRIPS: ‘Non-Violation’ Complaints, *supra* note 213.

**BELHAS V. YA'ALON:  
THE CASE FOR A *JUS COGENS* EXCEPTION TO THE  
FOREIGN SOVEREIGN IMMUNITIES ACT**

*Graham Ogilvy\**

INTRODUCTION

In *Belhas v. Ya'alon*, the Circuit Court for the District of Columbia dismissed the complaint brought against General Moshe Ya'alon, a retired Israeli general, on the grounds that any potential international law violations committed by General Ya'alon occurred while he was acting in his official capacity with the Israeli military. The alleged violations included war crime, extrajudicial killings, crimes against humanity, and torture. Taking for granted the details alleged in the complaint, General Ya'alon's actions constituted serious *jus cogens* violations. Despite the severity of these violations, the court held that General Ya'alon's position in the Israeli military made him immune from suit under the Foreign Sovereign Immunities Act. This note will argue that, due to the nature of *jus cogens* norms and the standing they hold in the international community, the court should have found and applied a *jus cogens* exception to the immunity provided by the Foreign Sovereign Immunities Act.

I. BELHAS V. YA'ALON: FACTUAL BACKGROUND

Saadallah Belhas and other plaintiffs brought an appeal before the District of Columbia Circuit Court after their claims were dismissed in the district court for lack of subject matter jurisdiction because of sovereign immunity claimed by the defendant Moshe Ya'alon, an Israeli General, under the Foreign Sovereign Immunities Act ("FSIA").<sup>1</sup> The plaintiffs brought their

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\* J.D. Candidate, 2010, Hofstra University School of Law. First of all I would like to thank Morgan McCord, my Notes and Comments Editor, and Elizabeth Strelman, Senior Editor for Articles, for helping to edit and prepare this note for publication. I would also like to thank the rest of the senior staff of the *Journal of International Business and Law* for their support, and Professor Curtis Pew for serving as my faculty advisor. Finally, I would like to thank my family for providing the support and encouragement that has been so vital to my law school career.

<sup>1</sup> *Belhas v. Ya'alon*, 515 F.3d 1279, 1282 (D.C. Cir. 2008).

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claims pursuant to the Alien Tort Claims Act (“ATCA”) and the Torture Victims Protection Act (“TVPA”), alleging that General Ya’alon was guilty of “war crimes, extrajudicial killing, crimes against humanity, and cruel, inhumane or degrading treatment or punishment”.<sup>2</sup>

From 1995 through 1998, General Ya’alon was the Head of Army Intelligence for the Israeli Defense Forces (“IDF”).<sup>3</sup> He has since retired.<sup>4</sup> In 1996, IDF’s Northern Command launched “Operation Grapes of Wrath”, a campaign designed to encourage the Lebanese government to confront and disarm factions of the terrorist group Hezbollah, which was operating in southern Lebanon.<sup>5</sup> At the outset of the operation, the IDF issued radio warnings to civilians unaffiliated with Hezbollah to leave in order to prevent them from being falsely identified as members of the organization and targeted during the conflict.<sup>6</sup> Rather than leave southern Lebanon, many civilians instead decided to take refuge in a United Nations compound in the city of Qana.<sup>7</sup> The plaintiffs allege that, while under the command of General Ya’alon, IDF helicopters attacked the town, including the U.N. compound, leading to the injury or death of more than one hundred civilians.<sup>8</sup> The plaintiffs further allege that General Ya’alon took no action to prevent the injuries and deaths that occurred.<sup>9</sup> The plaintiffs, who are relatives of the injured and the deceased, brought this claim in U.S. District Court as a result, arguing that the conduct of General Ya’alon was inhuman and constituted an act of torture.<sup>10</sup>

## II. LEGAL BACKGROUND

### A. District of Columbia District Court

The plaintiffs brought their claim in the District Court for the District of Columbia under the ATCA.<sup>11</sup> In response, General Ya’alon moved for

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

<sup>3</sup> *Id.* at 1281.

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

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

<sup>6</sup> *Id.* at 1282.

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

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

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

<sup>10</sup> *Id.* at 1282.

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

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dismissal for lack of subject matter jurisdiction.<sup>12</sup> He argued that because his actions, regardless of whether they constituted torture or any other human rights offense, occurred during the course of his official duties as head of the IDF, he was immune from suit under the Foreign Sovereign Immunities Act (“FSIA”).<sup>13</sup> In support of his motion, the Israeli ambassador wrote a letter to the United States Department of State confirming that General Ya’alon acted within his official capacities.<sup>14</sup> The District Court agreed and dismissed the case, holding that Ya’alon was immune from suit because none of the exceptions to sovereign immunity under the FSIA had been met.<sup>15</sup> Belhas and the other plaintiffs appealed the decision to the D.C. Circuit Court.

**B. Court of Appeals**

The court of appeals began by discussing whether or not Ya’alon’s conduct indeed fell within his official capacity as the Head of Army Intelligence. The court found that none of his actions were outside the scope of his official duties, in part by relying on the letter from the Israeli ambassador.<sup>16</sup> Without looking at the FSIA’s exceptions, the court held that Ya’alon qualified for immunity under the statute.<sup>17</sup> The thrust of the plaintiffs’ appeal, however, claimed that the nature of General Ya’alon’s conduct created an exception to the FSIA, and as a result, the district court did have subject matter jurisdiction over the torture claim.<sup>18</sup>

**C. *Jus Cogens* Violations as Possible Exceptions to Sovereign Immunity Under the FSIA**

The plaintiffs contended that if General Ya’alon’s actions constituted *jus cogens* violations, the court should create an exception to the immunity provided by the FSIA.<sup>19</sup> The court rejected the contention that a violation of a *jus cogens* norm is enough to create an exception to the FSIA, regardless of whether General Ya’alon was responsible for committing human rights

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

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

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

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

<sup>16</sup> *Id.* at 1283.

<sup>17</sup> *Id.* at 1282.

<sup>18</sup> *Id.* at 1286.

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

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violations in attacking the Lebanese compound.<sup>20</sup> Instead, the court found that the FSIA provided the only way for the U.S. district courts to obtain subject matter jurisdiction over a foreign sovereign.<sup>21</sup> Moreover, the court held that unless the FSIA explicitly provided an exception to immunity, no exception exists.<sup>22</sup> Because there is no enumerated *jus cogens* exception in the FSIA, the court rejected the plaintiffs' argument.

**D. The Torture Victims Protection Act as a Possible Exception to the FSIA**

The plaintiffs also argued that the TVPA establishes personal liability for acts of torture committed under the actual or apparent authority of foreign law despite the provisions of the FSIA.<sup>23</sup> The court disagreed and found that, while the TVPA may appear to grant subject matter jurisdiction over any defendant when torture claims are involved, it does not constitute an exception to sovereign immunity independent from those listed in the Act.<sup>24</sup> The court held that because the TVPA can still be applied to foreign officials when their conduct falls under one of the FSIA's exceptions, because of precedent to the contrary, and because the legislative history explicitly rejects a TVPA exception to the FSIA, that no independent exception is created by the Act.<sup>25</sup>

**E. Miscellaneous Arguments Asserted by the Plaintiffs**

The plaintiffs make two additional arguments in favor of the idea that General Ya'alon should not receive immunity under the FSIA. Neither of these arguments will be discussed any further in this note, and are mentioned here only to accurately represent the claims made by the plaintiffs. The plaintiffs argue that because General Ya'alon had retired from the IDF before the suit began, that he should no longer receive FSIA immunity.<sup>26</sup> Plaintiffs also argued that because they are seeking relief from General Ya'alon and not from the sovereign, that he should not be protected by the FSIA.<sup>27</sup> The court dismissed both of these arguments rather quickly and instead focused on the arguments for *jus cogens* and TVPA exceptions.

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<sup>20</sup> *Id.* at 1287.

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

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

<sup>23</sup> *Id.* at 1288.

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

<sup>25</sup> *Id.* at 1288-89.

<sup>26</sup> *Id.* at 1284.

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

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## III. THE ALIEN TORT CLAIMS ACT AND THE FOREIGN SOVEREIGN

**A. The Development of the Foreign Sovereign Immunities Act from the Alien Tort Claims Act**

The plaintiffs in *Belhas v. Ya'alon* brought suit in the United States District Court for the District of Columbia under the ATCA, which allows subjects of foreign states to bring claims in U.S. district courts for violations of international law.<sup>28</sup> Specifically, the plaintiffs brought suit under the TVPA, which makes anyone who commits an act of torture or an extrajudicial killing liable to the victim or to the legal representative of the victim.<sup>29</sup> The TVPA, which was added to the ATCA in 1991, modifies the ATCA, making individuals who commit acts of torture under the color of foreign law liable in U.S. district court.<sup>30</sup> The FSIA, on the other hand, provides that foreign sovereign states or “an agency or instrumentality” of a foreign state is immune from suit in U.S. district court unless certain enumerated exceptions are met.<sup>31</sup> It may appear that the TVPA abrogates the FSIA, first, because it makes individuals who act under the color of foreign law liable for their actions, and secondly, because the ATCA appears to permit suit against foreign states and their agents. Despite these interpretations, courts have consistently held that neither the ACTA nor the TVPA provide the basis for U.S. courts to exercise their jurisdiction over foreign sovereigns where there is no explicit FSIA exception.<sup>32</sup>

**B. *Amerada Hess* and Exceptions to the Foreign Sovereign Immunities Act**

In 1989 the Supreme Court held in *Argentine Republic v. Amerada Hess Shipping Corp.*, that the FSIA’s exceptions to sovereign immunity

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<sup>28</sup> Alien Tort Claims Act, 28 U.S.C.A. § 1350 (2008) (“The district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States”).

<sup>29</sup> Torture Victims Protection Act, 28 U.S.C.A. § 1350 (note) sec. 2(a) (2008) (“ (a) Liability.--An individual who, under actual or apparent authority, or color of law, of any foreign nation--(1) subjects an individual to torture shall, in a civil action, be liable for damages to that individual; or(2) subjects an individual to extrajudicial killing shall, in a civil action, be liable for damages to the individual's legal representative, or to any person who may be a claimant in an action for wrongful death”).

<sup>30</sup> Alien Tort Claims Act § 1350.

<sup>31</sup> Foreign Sovereign Immunities Act §§ 1603; 1605.

<sup>32</sup> Foreign Sovereign Immunities Act § 1605; Torture Victims Protection Act § 1350.

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provided the only basis for subject matter jurisdiction in U.S. courts over sovereign states.<sup>33</sup> This case, which did not involve *jus cogens* violations, has become a principle case in subsequent judicial decisions holding that such violations fail to provide an exception to the FSIA.<sup>34</sup>

United Carriers entered into a charter party contract with Amerada Hess Shipping to transport crude oil from Alaska to Amerada's refineries in the U.S. Virgin Islands.<sup>35</sup> At the time, Great Britain and Argentina were fighting over the Falkland Islands at the tip of South America.<sup>36</sup> While in international waters, about five hundred miles from the Falkland Islands, an Argentinean bomber began to circle the ship and eventually attacked, causing extensive damage.<sup>37</sup> As a result of the damage, United Carriers and Amerada Hess brought suit against Argentina under the ATCA in the Southern District of New York.<sup>38</sup> The case was dismissed in district court because of the FSIA.<sup>39</sup> The court found no exception in the Act to allow for the court to exercise jurisdiction over the claims. This decision was overturned by the court of appeals, and that decision was appealed by Argentina to the Supreme Court.<sup>40</sup>

The Second Circuit reversed the decision of the district court and refused to dismiss the plaintiffs' claims because it found that the FSIA was not meant to "eliminate 'existing remedies in United States courts for violations of international law' by foreign states under the Alien Tort Statute".<sup>41</sup> The court of appeals felt that because Congress did not repeal the ATCA when the FSIA was passed, and because much of the FSIA is focused on commercial concerns, that the remedies available under the ATCA were still available after the passage of the FSIA.<sup>42</sup>

The Supreme Court rejected these arguments on multiple grounds. First of all, the Court found that "the text and structure of the FSIA demonstrate[d] Congress' intention that the FSIA be the sole basis for obtaining jurisdiction over a foreign state in our courts".<sup>43</sup> Because the act set out when a

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<sup>33</sup> *Argentine Republic v. Amerada Hess Shipping Corp.*, 488 U.S. 428 (1988).

<sup>34</sup> See *Belhas v. Ya'alon*, 515 F.3d 1279 (D.C. Cir. 2008); *Princz v. Federal Republic of Germany*, 26 F.3d 1166 (D.C. Cir. 1994); *Siderman de Blake v. Republic of Argentina*, 965 F.3d 699 (9th Cir. 1992).

<sup>35</sup> *Argentine Republic*, 488 U.S. at 431.

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

<sup>37</sup> *Id.* at 432.

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

<sup>39</sup> *Id.* at 433.

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

<sup>41</sup> *Id.* (citing *Argentine Republic v. Amerada Hess Shipping Corp.*, 830 F.2d 421 (2d Cir. 1987)).

<sup>42</sup> *Id.* at 435.

<sup>43</sup> *Id.* at 434.

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foreign state is immune from suit, as well as the specific instances when it could not obtain immunity, the court found the statute contained the only grounds for finding exceptions to sovereign immunity.<sup>44</sup> Additionally, the court was unconvinced by the argument that because the ATCA was not repealed, that the causes of action it previously permitted remained intact.<sup>45</sup> The ATCA could be interpreted so as to grant jurisdiction over foreign, non-sovereign defendants, while the FSIA conferred jurisdiction over foreign states.<sup>46</sup> The court found no reason then, especially when taking the language of the FSIA into account, to agree with the circuit court.<sup>47</sup> Ultimately, the Supreme Court held that the FSIA provided the sole basis for exercising subject matter jurisdiction over a foreign sovereign in a U.S. district court.

**IV. *JUS COGENS* VIOLATIONS AND THE FOREIGN SOVEREIGN IMMUNITIES ACT****A. The Prohibition Against Official Torture has Reached the Level of a *Jus Cogens* Norm**

The plaintiffs in *Belhas v. Ya'alon* argued that the attack on the U.N. compound, which caused the deaths and injuries of hundreds of Lebanese civilians, amounted to torture, and therefore, the violation of a peremptory norm.<sup>48</sup> The plaintiffs further contend that such a violation of a peremptory norm creates an exception to the sovereign immunity provided by the FSIA.<sup>49</sup>

According to the Vienna Convention on the Law of Treaties (“Vienna Convention”), “a peremptory norm of general international law is a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character”.<sup>50</sup> *Jus cogens* norms are similar to customary international law, which operates

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<sup>44</sup> *Id.* at 434-35.

<sup>45</sup> *Id.* at 436.

<sup>46</sup> *Id.* at 437.

<sup>47</sup> The court in *Belhas v. Ya'alon* uses a similar analysis to come to the conclusion that the causes of action available under the TVPA are limited by the FSIA. This will be discussed in more detail in a later section of this note.

<sup>48</sup> *Belhas v. Ya'alon*, 515 F.3d 1279, 1287 (D.C. Cir. 2008).

<sup>49</sup> *Id.*

<sup>50</sup> Vienna Convention on the Law of Treaties art. 53, May 23, 1969, 1155 U.N.T.S. 332 [hereinafter Vienna Convention].

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based on the consent of states.<sup>51</sup> As a result, states that object to an international customary norm will not be bound as a matter of international law.<sup>52</sup> *Jus cogens* norms, to the contrary, do not depend on the consent of states.<sup>53</sup> They are considered universal, fundamental norms of the international community that “transcend . . . consent”.<sup>54</sup> All states must accept and follow *jus cogens* norms regardless of objection. Because of the universal nature of *jus cogens* norms, they occupy the “highest status in international law” and can be preempted only by other *jus cogens* norms.<sup>55</sup>

In *Belhas v. Ya’alon*, the plaintiffs argued that the prohibition against torture has reached the level of a *jus cogens* norm, and as such, universally prohibited by international law.<sup>56</sup> The Nuremberg trials following World War II outlined many crimes that have traditionally been held to be violations of *jus cogens* norms; genocide, enslavement, and other inhuman acts were found to be so offensive to the human condition, they subjected the Nuremberg defendants to the jurisdiction of the court regardless of Germany’s assent to the authority of the tribunal.<sup>57</sup> U.S. courts, as well as international treaties, have long recognized the prohibition against torture as part of customary international law, and have since come to consider it a peremptory norm.<sup>58</sup> The court in *Committee of U.S. Citizens of Nicaragua v. Reagan* announced that the prohibition against torture had reached the level of a *jus cogens* norm.<sup>59</sup> In *Siderman v. Argentina*, the court found that “[g]iven this extraordinary consensus, we conclude that the right to be free from official torture is fundamental and universal, a right deserving of the highest status under international law, a norm of *jus cogens*”.<sup>60</sup> In light of these holdings, if the actions of General Ya’alon did indeed rise to the level of torture, he violated a

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<sup>51</sup> *Siderman de Blake v. Republic of Argentina*, 965 F.3d 699, 715 (9th Cir. 1992).

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Comm. of U.S. Citizens Living in Nicar. v. Reagan*, 859 F.2d 929, 940 (D.C. Cir. 1988); *Siderman*, 965 F.3d at 715.

<sup>56</sup> *Belhas*, 515 F.3d at 1287.

<sup>57</sup> *Siderman*, 965 F.3d at 715 (citing Steven Fogelman, *The Nuremberg Legacy: An Unfulfilled Promise*, 63 S. CAL. L. REV. 833, 847 (1990); Belsky, Merva & Roht-Arriaza, *Implied Waiver Under the FSIA: A Proposed Exception to Immunity for Violations of Peremptory Norms of International Law*, 77 CAL. L. REV. 365, 385-86 (1989)).

<sup>58</sup> *Filartiga v. Pena-Irala*, 630 F.2d 876 (2d Cir. 1980), *Forti v. Suarez-Mason*, 672 F.Supp. 1531 (N.D. Cal. 1987); *The Treaty Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment*, 23 I.L.M. 1027 (1984).

<sup>59</sup> *Reagan*, 859 F.2d at 941-42.

<sup>60</sup> *Siderman* 965 F.3d at 717.

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*jus cogens* norm.

**B. *Jus Cogens* Violations are Never Part of an Individual's Official State Duties, and so They are not Entitled to Sovereign Immunity**

The FSIA's definition of a foreign state includes any "agency or instrumentality of [that] foreign state", and the Act extends immunity to such agents as if they were the state themselves.<sup>61</sup> Thus, in order for General Ya'alón to be immune from suit, he must have acted as an agent or instrumentality of Israel, which would require that his actions be of an official nature. This is precisely what Ya'alón claimed, and in support of this position, the Israeli ambassador asserted that Ya'alón's actions fell within his official duties as a general of the IDF.<sup>62</sup> Because the court agreed that Ya'alón had acted in his official capacity, it declined to consider whether his actions constituted war crimes, extrajudicial killings, or various other human rights abuses.<sup>63</sup> By refusing to examine whether General Ya'alón's actions constituted *jus cogens* violations because of his status as a state official, the court begged the question, as growing jurisprudence has held that serious human right abuses can never be official acts of a state.

International courts and tribunals have increasingly asserted that human rights violations committed by state officials are not legitimate acts of state. In 1993, the United Nations established the International Criminal Tribunal for the former Yugoslavia in order to prosecute individuals for war crimes committed in the Balkan nation.<sup>64</sup> In *Prosecutor v. Furundzija*, the court stated that international prohibitions of certain crimes against humanity, in this case torture, "first and foremost address themselves to individuals, in particular State officials" and that "those who engage in torture are personally accountable at the criminal level for such acts".<sup>65</sup> Acts of torture and other human rights violations, according to the court's reasoning, can never be part of an individual's official duties as an agent of the state. This idea of individual liability was subsequently echoed in the charter of the International Criminal

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<sup>61</sup> Foreign Sovereign Immunities Act, 28 U.S.C.A. § 1603(a) (2008).

<sup>62</sup> *Belhas v. Ya'alón*, 515 F.3d 1279, 1282 (D.C. Cir. 2008).

<sup>63</sup> *Id.* at 1283 ("Indeed, the Court noted in the complaint indicates that General Ya'alón took part in any events related to the shelling of Qana that were outside his official authority and role as the head of intelligence for the IDF.")

<sup>64</sup> About the ICTY, <http://www.icty.org/sections/AbouttheICTY> (last visited Apr. 2, 2009).

<sup>65</sup> *Prosecutor v. Furundzija*, Case No. IT-95-17/1-T, Judgment, ¶ 140 (Dec. 10, 1998). While the case and selected quote deal with criminal, rather than civil, liability, this may simply be a function of the nature of the tribunal. It nevertheless stands for the proposition that officials who engage in torture are individually liable for their actions.

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Tribunal for Rwanda, and has been a part of international law as early as the Nuremberg trials.<sup>66</sup>

Courts in the United States have also expressed the idea that conduct by state officials in violation of international human rights norms is not part of an official's duties as an agent of the state. In *Filartiga v. Pena-Irala*, the defendant Pena, the Inspector General of Police in Asuncion, Paraguay, was accused of kidnapping and torture.<sup>67</sup> On appeal, Pena argued that he was immune from suit because his actions were undertaken as an official of the Paraguayan government.<sup>68</sup> The court declined to rule on the issue because Pena had not made the argument in the lower court, however, it did state that they "doubt whether action by a state official in violation of the Constitution and laws of the Republic of Paraguay, and wholly unratified by that nation's government, could properly be characterized as an act of state".<sup>69</sup> Earlier in the decision, the court recognized that when Paraguay enacted its constitution it "[was] bound both to observe and construe the accepted norms of international law", thereby incorporating the law of nations into its own laws.<sup>70</sup> By violating the international prohibition against torture, Pena had acted contrary to the laws of the republic of Paraguay. As a result, his actions could not properly have been called acts of the state, and therefore he was liable as an individual and not entitled to the immunity granted to agents of a sovereign. In *Hilao v. Estate of Marcos*, the Ninth Circuit declined to extend immunity under the FSIA to the Venezuelan head of state because his actions "were not acts of Venezuelan sovereignty. . . . They constituted common crimes committed by the Chief of State done in violation of his position and not in pursuance of it".<sup>71</sup> Even more succinctly, in *Siderman v. Argentina*, the court stated: "International law does not recognize an act that violates *jus cogens* as a sovereign act".<sup>72</sup>

If a *jus cogens* violation can never be a sovereign act, then prior to any

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<sup>66</sup> Statute of the International Criminal Tribunal for the Prosecution of Persons Responsible for Genocide and Other Serious Violations of International Humanitarian Law Committed in the Territory of Rwanda and Rwandan Citizens Responsible for Genocide and Other Such Violations Committed in the Territory of Neighbouring States between 1 January 1994 and 31 December 1994, S.C. Res. 955, U.N. Doc. S/RES/955 (Nov. 8, 1994); Furundzija, ¶ 140 (quoting Trials of the Major War Criminals Before the International Military Tribunal, Vol. I, p. 223) ("Crimes against international law are committed by men, not by abstract entities, and only by punishing individuals who commit such crimes can the provisions of international law be enforced").

<sup>67</sup> *Filartiga v. Pena-Irala*, 630 F.2d 876, 878 (2d Cir. 1980).

<sup>68</sup> *Id.* at 889.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 877.

<sup>71</sup> *Hilao v. Estate of Marcos*, 25 F.3d 1467, 1471 (9th Cir. 1994) (citing *Jimenez v. Aristeguita*, 311 F.2d 547, 557-58 (5th Cir. 1962)).

<sup>72</sup> *Siderman de Blake v. Republic of Argentina*, 965 F.3d 699, 719 (9th Cir. 1992).

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decision on whether an individual was acting in an official capacity, courts must ask whether a violation has occurred. Otherwise a court would take an individual's official status for granted without any real inquiry. If an official violates a *jus cogens* norm, they cannot be acting as an agent of the state. As such, they are no longer immune from liability as agents of the sovereign under the FSIA, but rather, they become liable as individuals for the alleged conduct.

In *Belhas v. Ya'alon*, the court found that General Ya'alon was acting in his official capacity in part because the conduct alleged in the complaint was not personal or private in nature because of his position as the Head of Army Intelligence of the IDF.<sup>73</sup> But as the above examples point out, state courts cannot assume that officials are acting in their official capacity simply because they acted from their official position within the state. Because the court declined to examine whether or not Ya'alon's conduct constituted the crimes alleged in the complaint, it did not adequately determine if he acted in his official capacity. If he had acted in violation of internationally recognized human rights norms his actions could not have been considered acts of the sovereign. By refusing to determine whether Ya'alon had violated *jus cogens* norms, the court took for granted that he was acting in his official capacity rather than examining the issue. The *Belhas* court also gives weight to the Israeli ambassador's averment that Ya'alon acted in his official capacity.<sup>74</sup> While the statements of the foreign state may be useful, such statements do not alter the nature of the conduct. Statements from a foreign state cannot make a *jus cogens* violation into anything less than it is. Assuming Ya'alon's conduct, even though undertaken as an officer of the IDF, did constitute *jus cogens* violations, it could not have been part of his official duties. As such, he was not acting as an agent of Israel and therefore was not entitled to immunity under the FSIA.

**C. There Should Be a *Jus Cogens* Exception to the FSIA**

Even if such violations are considered official acts of a sovereign state, *jus cogens* violations should create an exception to the FSIA. *Jus cogens* norms can only be preempted by other international norms of comparable weight.<sup>75</sup> While sovereign immunity is internationally recognized, it does, by the very nature of *jus cogens* norms, constitute one. As such, immunity cannot preempt a *jus cogens* norm. Even if the *Belhas* court was correct in holding that General Ya'alon acted in his official capacity, he should not be immune from suit under

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<sup>73</sup> *Belhas v. Ya'alon*, 515 F.3d 1279, 1283 (D.C. Cir. 2008).

<sup>74</sup> *Id.*

<sup>75</sup> *Siderman*, 965 F.3d at 715.

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the FSIA because of the particularly heinous nature of his alleged conduct.

Under the Vienna Convention, *jus cogens* norms can be modified or preempted “only by a subsequent norm of general international law having the same character”.<sup>76</sup> While sovereign immunity may be domestically codified, courts have held that sovereignty and sovereign immunity are principles of international law.<sup>77</sup> As principles of international law, sovereignty and sovereign immunity can only modify *jus cogens* norms if they are, as a matter of international law, of the same character as other peremptory norms; that is, they must be peremptory norms themselves.

Sovereign immunity is not a *jus cogens* norm. While the Vienna Convention declined to elaborate on just what were considered to be *jus cogens* norms, “there is wide agreement on past and current *jus cogens* norms”.<sup>78</sup> The Third Restatement of Foreign Relations Law includes genocide, slavery and the slave trade, the murder or causing the disappearance of individuals, torture or other cruel, inhuman or degrading treatment or punishment, prolonged arbitrary detention, and systematic racial discrimination as prohibited *jus cogens* violations.<sup>79</sup> *Jus cogens* norms prohibit “acts that the laws of all civilized nations define as criminal”.<sup>80</sup> While the Restatement’s list is not exhaustive, it illustrates the types of crimes prohibited as violations of *jus cogens* norms. *Jus cogens* norms protect universally observed, fundamental human rights. In particular, they prohibit the type of conduct viewed as the most abusive of human rights and dignity. Sovereign immunity is simply not an international legal principle of this character. A violation of sovereign immunity cannot be equated with slavery or genocide. Sovereign immunity is not a human rights issue. For this reason, the principles of sovereignty and sovereign immunity are not *jus cogens* norms.

Additionally, *jus cogens* norms differ from other rules of international law in that there can be no derogation from adhering to them.<sup>81</sup> United States courts have recognized the mandatory nature of *jus cogens* norms. In *Siderman v. Argentina*, the court stated that “[whereas] customary international law derives solely from the consent of states, the fundamental and universal norms constituting *jus cogens* transcend such consent, as exemplified by the theories underlying the judgments of the Nuremberg tribunals following World War

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<sup>76</sup> Vienna Convention, *supra* note 50, art. 53.

<sup>77</sup> Int’l Ass’n of Machinists & Aerospace Workers v. OPEC, 649 F.2d 1354, 1359 (9th Cir. 1981).

<sup>78</sup> Lyn Beth Neylon & Karen Parker, *Jus Cogens: Compelling the Law of Human Rights*, 12 HASTINGS INT’L & COMP. L. REV. 411, 429 (1989).

<sup>79</sup> Restatement (Third) of Foreign Relations Law § 702 (1987).

<sup>80</sup> *Siderman de Blake v. Republic of Argentina*, 965 F.2d 699, 715 (9th Cir. 1992).

<sup>81</sup> Vienna Convention, *supra* note 42, art. 53.

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II”.<sup>82</sup> In contrast to the mandatory nature of peremptory norms, sovereign immunity is far from universally practiced as a mandatory feature of international law. In fact, states frequently consent to waive immunity.

For example, the United States has consented to being sued by U.S. citizens.<sup>83</sup> Without the consent of the United States to be named as a defendant, it would enjoy sovereign immunity even against its own citizens.<sup>84</sup> States have also waived sovereign immunity and submitted to the jurisdiction of various international courts. Article 27 of the Rome Statute of the International Criminal Court, for example, states:

1. This Statute shall apply equally to all persons without any distinction based on official capacity. In particular, official capacity as a Head of State or Government, a member of a Government or parliament, an elected representative or a government official shall in no case exempt a person from criminal responsibility under this Statute. . .

2. Immunities or special procedural rules which may attach to the official capacity of a person, whether under national or international law, shall not bar the Court from exercising its jurisdiction over such a person.<sup>85</sup>

Because the FSIA defines a foreign state to include agents and instrumentalities of the state, by consenting to the jurisdiction of the International Criminal Court (“ICC”) over officials, including heads of state, any state that ratifies the convention would be, in effect, waiving its sovereign immunity, at least with respect to the offenses covered by the Convention.<sup>86</sup> If sovereign immunity were a peremptory norm of international law, this article of the Rome Statute would violate the Vienna convention, since any treaty in derogation of a preemptory norm is unenforceable.<sup>87</sup> A treaty allowing for the waiver of sovereign immunity would result in a derogation of such a norm.<sup>88</sup> Because states are allowed to freely waive their sovereign immunity, it cannot be a *jus*

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<sup>82</sup> *Siderman*, 965 F.3d at 715.

<sup>83</sup> 28 U.S.C.A. § 1346 (2008).

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

<sup>85</sup> Rome Statute of the International Criminal Court art. 27, July 17, 1998 2187 U.N.T.S. 90 [hereinafter Rome Statute].

<sup>86</sup> Foreign Sovereign Immunities Act, 28 U.S.C.A. §§ 1603(a) & (b)(1) (2008).

<sup>87</sup> Vienna Convention, *supra* note 50, art. 53.

<sup>88</sup> *Id.*

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*cogens* norm.

States also deny sovereign immunity to other states without their consent. The FSIA, while recognizing a foreign state's immunity from suit in United States courts generally, also contains exceptions to that immunity.<sup>89</sup> These exceptions outline the circumstances in which the United States has decided to unilaterally deny sovereign immunity to a foreign state. Because *jus cogens* norms are based on "values taken to be fundamental by the international community", rather than the consent of nations, a state would not be permitted to ignore *jus cogens* norms.<sup>90</sup> A state cannot create exceptions to *jus cogens* norms as the FSIA does with sovereign immunity. This represents a fundamental difference between sovereign immunity and *jus cogens* norms.

Because sovereign immunity is an international law principle that is not comparable in character to *jus cogens* norms, international prohibitions against grave human rights abuses should not be preempted by concerns over state sovereignty. United States federal courts, however, have not recognized a *jus cogens* exception to the FSIA.<sup>91</sup> In *Princz v. Federal Republic of Germany*, the court refused to hear a case brought by Hugo Princz, a United States citizen, against Germany for his treatment in Nazi concentration camps during World War II.<sup>92</sup> Princz had been captured while visiting Slovakia and subsequently turned over to the SS.<sup>93</sup> After he was liberated by American soldiers following the war, Princz sought reparations from Germany with the support of the United States government.<sup>94</sup> His requests were routinely denied, largely because he was not a German citizen.<sup>95</sup> As a last resort, Princz brought suit against Germany in federal district court.<sup>96</sup> The lower court found that it did have subject matter jurisdiction over the case, stating that the FSIA "has no role to play where the claims alleged involve undisputed acts of barbarism committed by a one-time outlaw nation which demonstrated callous disrespect for the humanity of an American citizen, simply because he was Jewish".<sup>97</sup> The circuit court overruled the lower court's finding of subject matter jurisdiction, finding no *jus cogens* exception to sovereign immunity within the FSIA.<sup>98</sup> The court

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<sup>89</sup> Foreign Sovereign Immunities Act § 1605.

<sup>90</sup> *A Theory for the Application of the Customary International Law of Human Rights by Domestic Courts*, 13 YALE J. INT'L L. 332, 351 (1988).

<sup>91</sup> See *Siderman de Blake v. Republic of Argentina*, 965 F.2d 699 (9th Cir. 1992).

<sup>92</sup> *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1168 (D.C. Cir. 1994).

<sup>93</sup> *Id.* at 1168.

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

<sup>95</sup> *Id.*

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

<sup>97</sup> *Princz v. Federal Republic of Germany*, 813 F.Supp. 22, 26 (D.D.C. 1992).

<sup>98</sup> *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1174 (D.C. Cir. 1994).

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relied on *Argentine Republic v. Amerada Hess*, finding the FSIA to be the “sole basis for obtaining jurisdiction over a foreign state in federal court”.<sup>99</sup> The court also relied on the holding in *Siderman v. Argentina* which had previously addressed the question of whether or not *jus cogens* violations created a FSIA exception and found that they did not.<sup>100</sup>

In *Siderman v. Argentina*, the plaintiffs sued Argentina for the torture of Jose Siderman by members of the country’s ruling military junta.<sup>101</sup> The Sidermans claimed that Jose was taken one night by the Argentine military and subsequently beaten and tortured for a week because he was Jewish.<sup>102</sup> After a week of torture, Jose Siderman was driven to an isolated location and thrown from the car.<sup>103</sup> He was then ordered to leave Argentina.<sup>104</sup> The Sidermans argued that “when a state violates *jus cogens*, the cloak of immunity provided by international law falls away, leaving the state amenable to suit”.<sup>105</sup> The court responded that “[as] a matter of international law, the Sidermans’ argument carries much force”.<sup>106</sup> Nevertheless the court relied on *Argentine Republic v. Amerada Hess* to hold that unless the FSIA provides an exception to sovereign immunity, federal district courts have no subject matter jurisdiction over claims brought against a foreign state.<sup>107</sup>

The court arrived at this decision reluctantly. It acknowledged that sovereign immunity “derives from international law” and that “*jus cogens* norms ‘enjoy the highest status within international law’.”<sup>108</sup> The court implied that it agreed with the Sidermans that *jus cogens* violations should create an exception to the sovereign immunity provided by the FSIA, and seemed to find to the contrary only out of deference to the ruling in *Argentine Republic v. Amerada Hess*.<sup>109</sup> But for the decision in *Argentine Republic v. Amerada Hess*,

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<sup>99</sup> *Id.* at 1169 (citing *Argentine Republic v. Amerada Hess Shipping Corp.*, 488 U.S. 428, 439 (1988)).

<sup>100</sup> *Id.* at 1174 (citing *Siderman de Blake v. Republic of Argentina*, 965 F.3d 699, 719 (9th Cir. 1992)).

<sup>101</sup> *Siderman de Blake v. Republic of Argentina*, 965 F.3d 699, 703 (9th Cir. 1992) (The Sidermans were also suing for the expropriation by the junta of large amounts property, but these claims are separate from the torture claims and will not be discussed.).

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

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

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 717.

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

<sup>107</sup> *Id.* at 718-19.

<sup>108</sup> *Id.* at 718 (citing *Comm. of U.S. Citizens Living in Nicar. v. Reagan*, 859 F.2d 929, 940 (D.C. Cir. 1988)).

<sup>109</sup> *Id.* (“Unfortunately, we do not write on a clean slate. We deal not only with customary international law, but with an affirmative Act of Congress, the FSIA. We must interpret the FSIA

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the court would presumably have allowed the Sidermans to sue Argentina in federal court. The court then pointed out that while the *Amerada* court dealt with the issue of whether or not international law can create an exception to the FSIA, the type of international law violation present in *Argentine Republic v. Amerada Hess* was not the type of violation alleged by the Sidermans.<sup>110</sup> In the *Amerada* case, two Liberian plaintiffs attempted to sue Argentina for the sinking of a crude oil tanker.<sup>111</sup> The Siderman court explained that:

In *Amerada Hess*, the Court had no occasion to consider acts of torture or other violations of the peremptory norms of international law, and such violations admittedly differ in kind from transgressions of *jus dispositivum*, the norms derived from international agreements or customary international law with which the *Amerada Hess* Court dealt.<sup>112</sup>

When the *Amerada* court held that there are no exceptions to sovereign immunity outside of those in the FSIA, it was not presented with the challenges of balancing sovereign immunity against the severity of *jus cogens* violations. While the *Amerada* court may indeed have decided the same way had it been presented with a *jus cogens* violation, the *Siderman* court seems to suggest that the serious human rights concerns inherent in *jus cogens* norms may have led the *Amerada* court to decide differently. However, because the language of the *Amerada* decision left no room for a *jus cogens* exception to the FSIA, the *Siderman* court was forced to dismiss the Siderman's claims.<sup>113</sup> So while United States courts have routinely held that *jus cogens* violations do not create an exception to the FSIA, those decisions are based on a case, *Argentine Republic v. Amerada Hess*, which does not involve *jus cogens* violations.<sup>114</sup> Despite its holding, *Siderman v. Argentina* recognizes the validity of the argument in favor of a *jus cogens* exception to the FSIA, but was "foreclosed by the Supreme Court's opinion" in *Argentine Republic v. Amerada Hess* from recognizing such an exception.<sup>115</sup>

Additionally, *jus cogens* violations should create an exception to the FSIA because, as the principle of peremptory norms has become more important in the international community following the Nuremberg trials, the

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through the prism of *Amerada Hess*.”).

<sup>110</sup> *Id.* at 718-19.

<sup>111</sup> *Argentine Republic v. Amerada Hess Shipping Corp.*, 488 U.S. 428, 431-32 (1988).

<sup>112</sup> *Siderman de Blake v. Republic of Argentina*, 965 F.3d 699, 718-19 (9th Cir. 1992).

<sup>113</sup> *Id.* at 719.

<sup>114</sup> *Argentine Republic*, 488 U.S. at 428; *Siderman*, 965 F.2d at 699.

<sup>115</sup> *Siderman*, 965 F.2d at 713.

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importance of the principles of sovereignty and sovereign immunity has waned.<sup>116</sup>

The primitive legal order of classical international law with its 'loose, unorganized society of sovereign states' has been replaced by an increasingly organized and interdependent international community. International society is now characterized by an increasing volume of state cooperation in matters of common concern. The result has been a decreased emphasis on the classical notions of sovereignty in an effort to foster cooperation among the community of nations.<sup>117</sup>

Even the passage of the FSIA in 1976 itself represented a shift in the notion of sovereignty. Before the mid-twentieth century, the United States had granted foreign states almost complete sovereign immunity.<sup>118</sup> By the early twentieth century, however, the restrictive theory of immunity began to take hold.<sup>119</sup> Under the restrictive theory, states enjoy immunity only for their public acts, but not when states act privately; that is, when it engages in commerce.<sup>120</sup> The United States began to rely upon this theory of sovereign immunity in 1952, and in 1976 it was codified in the FSIA.<sup>121</sup> The development of *jus cogens* norms has further restricted sovereignty by limiting the ability of states to act unilaterally.<sup>122</sup> The twentieth century has seen an erosion of traditional notions of sovereignty in favor of "cooperation among the community of nations".<sup>123</sup> In the face of the increasing international concern about the types of human rights issues embodied by *jus cogens* norms, the notion of sovereign immunity in the case of *jus cogens* violations has become "outmoded".<sup>124</sup> This shift in the balance between sovereign immunity and *jus cogens* violations can be seen throughout the international community.

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<sup>116</sup> Belsky, *supra* note 57, at 391-92 (citations omitted).

<sup>117</sup> *Id.*

<sup>118</sup> *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1169 (D.C. Cir. 1994).

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> Belsky, *supra* note 57, at 390 ("The very existence of *jus cogens* limits 'state sovereignty in the sense that the 'general will' of the international community of states takes precedence over the individual wills of states to order their relation.' Thus, the concept that a sovereign is subject to no restraints except those imposed by its own will is inconsistent with the definition of *jus cogens* as peremptory law.") (citation omitted).

<sup>123</sup> *Id.* at 392.

<sup>124</sup> *Id.* at 391.

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Article Six of the statute establishing the International Criminal Tribunal for Rwanda (“ICTR”), and Article Seven of the statute establishing the International Criminal Tribunal for the former Yugoslavia (“ICTY”), both state that an individual’s status as an official of the state, including the position of Head of State, does not make that individual immune from liability.<sup>125</sup> Both tribunals were established to prosecute individuals for human rights violations such as genocide and torture.<sup>126</sup> Both tribunals refuse to grant sovereign immunity to individuals who commit the exact types of crimes prohibited by *jus cogens* norms.<sup>127</sup> Furthermore, in the case of the ICTY, it would have been impossible for the state to waive its sovereign immunity because Yugoslavia was no longer a state when the ICTY was established.<sup>128</sup> Not only do the ratifying states recognize that state officials who commit *jus cogens* violations are not entitled to sovereign immunity, but they granted the tribunal the jurisdiction to prosecute states without their consent as well. Article 27 of the Rome Statute establishing the ICC also declines to extend sovereign immunity to state officials and Heads of State.<sup>129</sup> While the Rome Statute only recently came into force, as of July 2008, one hundred and eight nations have ratified the convention.<sup>130</sup> This represents wide agreement in the international community that serious human rights violators must be brought to justice, even if those violators are state officials who, under traditional notions of sovereignty, would be immune from prosecution. While the United States has not ratified the Rome Statute, both the ICTR and ICTY were established by Security Council resolutions and, as a permanent member of the Security Council, had the United States objected to either resolution, they would not have passed.<sup>131</sup> On the international level, even the United States, at least some degree, has recognized the idea that *jus cogens* norms preempt concerns over state sovereignty.

While the ICTR, ICTY and other international tribunals charged with prosecuting human rights violations have criminal, rather than civil jurisdiction,

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<sup>125</sup> S.C. Res. 955, *supra* note 65, art. 6; Statute of the International Criminal Tribunal for the Former Yugoslavia, S.C. Res. 827, art. 7, U.N. Doc. S/RES/827 (1993).

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> Timeline of the breakup of Yugoslavia, <http://news.bbc.co.uk/2/hi/europe/4997380.stm> (last visited Apr. 8, 2009) (“By 1992 the Yugoslav Federation was falling apart”. Yugoslavia began breaking up before the establishment of the ICTY in 1993).

<sup>129</sup> Rome Statute, *supra* note 85, art. 27.

<sup>130</sup> About the establishment of the ICC, <http://www.icc-cpi.int/Menu/ICC/About+the+Court/ICC+at+a+glance/Establishment+of+the+Court.htm> (last visited Apr. 4, 2009) (While the Rome Statute was passed in 1998 it did not come into effect until 2002, when it was ratified by sixty countries.).

<sup>131</sup> U.N. Charter art. 23, para. 1; art. 27 para. 3.

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the reasoning underlying that jurisdiction applies likewise to civil matters like the *Belhas* case.<sup>132</sup>

The goals of criminal and tort law overlap[.] . . . Although by tort claims private parties may seek vindication of private interests, judgments in these cases affirm much wider interests manifested in the norms that the community is prepared to enforce. Punishment and compensation represent two distinct, but complementary, ways of condemning past, and deterring future, wrongdoing.<sup>133</sup>

Allowing plaintiffs to sue in tort for *jus cogens* violations, then, promotes the same goals as prosecuting human rights violators in international courts and tribunals. If state officials can be held individually liable in criminal courts, it does not make sense to deny their victims the right to recover from the individuals who inflicted on them the worst types of human rights crimes.

In sum, the D.C. Circuit court in *Belhas v. Ya'alon* should have recognized a *jus cogens* exception to the FSIA. Courts have consistently recognized the definition of *jus cogens* found in the Vienna Convention, and that sovereign immunity is a principle of international law.<sup>134</sup> Sovereign immunity, then, can only preempt *jus cogens* norms if it is itself a *jus cogens* norm, which it is not. Despite the Ninth Circuit's recognition that this argument "carries much force", courts in the United States have consistently held that no FSIA exception exists.<sup>135</sup> These decisions are based on the Supreme Court's decision in *Argentine Republic v. Amerada Hess*, a case that did not itself deal with *jus cogens* violations. The court's decision in *Belhas v. Ya'alon*, as a result, contradicts the very idea of *jus cogens* norms. Furthermore, the court's emphasis on the immunity provided by the FSIA is out of step with the diminished importance of sovereign immunity in the international community in the face of increasing human rights concerns. The *Belhas* court's decision was then incorrect according to the recognized definition of *jus cogens* and

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<sup>132</sup> Donald Francis Donovan & Anthea Roberts, *The Emerging Recognition of Universal Civil Jurisdiction*, 100 AM. J. INT'L L. 142, 154 (2006).

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

<sup>134</sup> Vienna Convention, *supra* note 50, art. 53; *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1173 (D.C. Cir. 1994) (The Court recognized the Vienna Convention's definition.); *Siderman de Blake v. Republic of Argentina*, 965 F.3d 699, 714 (9th Cir. 1992) (The Court here also recognized that definition.); *Int'l Ass'n of Int'l Ass'n of Machinists & Aerospace Workers v. OPEC*, 649 F.2d 1354, 1359 (9th Cir. 1981) (The Court found the sovereign immunity is a principal of international law.).

<sup>135</sup> *Siderman de Blake v. Republic of Argentina*, 965 F.3d 699, 718 (9th Cir. 1992).

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anachronistic according to international trends holding sovereigns liable for human rights violations rather than granting them immunity.

**D. States that Violate *Jus Cogens* Norms Waive Sovereign Immunity, Creating an Exception within the Structure of the FSIA**

Even if *jus cogens* violations do not create an exception to the immunity provided by the FSIA, the act alone provides a mechanism for finding federal court jurisdiction for the types of claims brought by the plaintiffs in *Belhas v. Ya'alon*. According to *Argentine Republic v. Amerada Hess*, the FSIA provides the sole basis for finding jurisdiction.<sup>136</sup> If a claim falls under one of the Act's enumerated exceptions, a sovereign can no longer claim immunity.<sup>137</sup> Section 1605(a)(1) provides that "a foreign state shall not be immune from the jurisdiction of the courts of the United States or of the States in any case in which the foreign state has waived its immunity explicitly or by implication . . .".<sup>138</sup> Foreign sovereigns who commit serious human rights abuses have impliedly waived their immunity because of the severity of their conduct, as well as universal abhorrence of such violations, thereby making them amenable to suit within the framework of the FSIA. If General Ya'alon did indeed commit the acts alleged in the complaint, those acts should have been interpreted as a waiver of sovereign immunity, and the case should not have been dismissed.

In *Siderman v. Argentina*, the court held that Argentina had waived its right to immunity by availing itself of courts.<sup>139</sup> Argentina sought to prosecute the Sidermans for the sale of land that it alleged did not belong to them, and used the American courts to try to serve them with process.<sup>140</sup> The sale of the land was linked to expropriation claims made by the Sidermans that, in turn, were linked to their torture claims.<sup>141</sup> The court held that because "Argentina has engaged our courts in the very course of activity for which the Sidermans

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<sup>136</sup> *Argentine Republic v. Amerada Hess Shipping Corp.*, 488 U.S. 428, 434 (1988).

<sup>137</sup> The Foreign Sovereign Immunities Act, 28 U.S.C.A. § 1605 (2008).

<sup>138</sup> *Id.* at § 1605(a)(1).

<sup>139</sup> *Siderman*, 965 F.3d at 722.

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* (The Sidermans alleged that they owned a certain acreage of land and that the Argentine government claimed they in fact owned less than they did by a significant amount. This is part of the basis for their expropriation claims. When the Sidermans sold their land Argentina claimed the fraudulently sold the land that Argentina took when it undervalued the amount of land they owned. This was the basis of Argentina's claim against the Sidermans and the reason they availed themselves of the American courts.).

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seek redress, it has waived its immunity as to that redress”.<sup>142</sup> Despite the court’s earlier holding that the alleged *jus cogens* violations did not provide a basis for jurisdiction, the court allowed the Sidermans to pursue their torture claims on this basis.<sup>143</sup> In its analysis, the court described some of the ways a foreign sovereign can waive immunity. For example, where a state submits to arbitration, agreed to the law of a foreign state, or where the state has filed a response to a pleading, a foreign sovereign has waived its immunity.<sup>144</sup> Where the litigation revolves around a written agreement, as the facts in *Siderman* do because of the sale of land, the central issue according to the court was whether the sovereign envisioned the involvement of a foreign court.<sup>145</sup> Despite the court’s description of the types of activities that constitute an implied waiver of immunity, the full extent of what constitutes such a waiver is far from clear.<sup>146</sup> There are strong indications that what constitutes an implied waiver of immunity extends beyond the situations described in *Siderman v. Argentina*.

The legislative history of the FSIA indicates that it intended for decisions made on implied waivers to be based on international law.<sup>147</sup>

The House Report states that, “the central premise of the bill is that decisions on claims by foreign states to sovereign immunity are best made by the judiciary on the basis of a statutory regime which incorporates standards recognized under international law” . . . . The incorporation of international law . . . suggests that the implied waiver provision should be read to include waivers implied by operation of international law.<sup>148</sup>

The FSIA’s waiver exception does not, by its language, refer to an implied waiver based on international legal norms, and it does not make clear what actions carried out by a foreign state constitute an implied waiver either. But because Congress intended the FSIA to be informed by international law, the implied waiver exception should be interpreted in a way that brings the statute into accord with international norms. Holding that a state waives its immunity

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

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

<sup>144</sup> *Id.* at 721.

<sup>145</sup> *Id.*

<sup>146</sup> Belsky, *supra* note 57, at 395 (citing Jeffery A. Blair & Karen E. M. Parker, Comment, *The Foreign Sovereign Immunities Act and International Human Rights Agreements: How They Co-Exist*, 17 U.S.F. L. REV. 71, 81 (1982)).

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at 397-98 (citing H.R. REP. No. 1487-94, at 14 (1976)).

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when it commits *jus cogens* violations would bring the FSIA into harmony with those norms. This position, while in a dissenting opinion, has been expressed in at least one federal court.

In *Princz v. Germany*, Judge Wald argued in his dissent that Germany impliedly waived its sovereign immunity when it subjected Princz to the horrors of the Holocaust.<sup>149</sup> As he points out, the forms of waiver mentioned by the *Siderman* court are not exhaustive, and the legislative history of the FSIA does not foreclose the possibility that *jus cogens* violations may create a waiver of immunity.<sup>150</sup> Wald also points out that Congress intended the FSIA to “create ‘a statutory regime which incorporates standards recognized under international law’”.<sup>151</sup> For this reason, Wald felt that the FSIA should be interpreted in a way that reconciles the Act with international legal principles.<sup>152</sup> He concluded, therefore, that the only way to bring the FSIA into harmony with international standards is to hold that when a foreign sovereign commits *jus cogens* violations, it waives its right to sovereign immunity under the FSIA.<sup>153</sup>

In this way, *jus cogens* violations can create an exception to sovereign immunity within the statutory scheme of the FSIA. The court’s holding in *Argentine Republic v. Amerada Hess* that the FSIA provides the sole basis for jurisdiction over a sovereign, then, can be reconciled with international norms condemning *jus cogens* violations. For this reason, *jus cogens* violations should be construed as implied waivers of sovereign immunity and the plaintiffs in *Belhas v. Ya’alon* should have been permitted to move forward with their case against General Ya’alon.

#### **E. Courts Should Recognize a *Jus Cogens* Exception Despite any Potential Burdens Such an Exception would Impose on the Courts**

There is also concern that allowing foreign sovereigns to be sued for *jus cogens* violations would flood U.S. courts with foreign litigation. Both the *Belhas* and *Princz* courts expressed this concern, noting that it may lead to a “strain . . . upon our courts”.<sup>154</sup> Despite the worries of these courts, concerns about increased litigation in the United States are likely overblown and, perhaps more importantly, cannot be reconciled with the gravity of *jus cogens*

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<sup>149</sup> *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1179 (D.C. Cir. 1994) (Wald, dissenting).

<sup>150</sup> *Id.* at 1183-84.

<sup>151</sup> *Id.* at 1183 (citing H.R. REP. NO. 1487-94, at 14 (1976)).

<sup>152</sup> *Id.*

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

<sup>154</sup> *Belhas v. Ya’alon*, 515 F.3d 1279, 1287 (D.C. Cir. 2008) (quoting *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1174 (D.C. Cir. 1994)).

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violations.

Creating a *jus cogens* exception to the FSIA is unlikely to lead to an overly burdensome increase in the workload of the courts. First, only a small class of acts are considered *jus cogens* norms. As set out in the Third Restatement of Foreign Relations Law, genocide, slavery and the slave trade, the murder or causing the disappearance of individuals, torture or other cruel, inhuman or degrading treatment or punishment, prolonged arbitrary detention, and systematic racial discrimination as prohibited as *jus cogens* violations.<sup>155</sup> The FSIA would still provide immunity to foreign sovereigns for other torts and suits, including violations of international norms that do not rise to the level of *jus cogens* violations. Only the worst types of human rights abuses would create an exception to immunity.

Second, the FSIA already permits United States courts to exercise jurisdiction over foreign sovereigns in a large number of cases. For example, in addition to the exceptions for express and implied waiver of immunity, the FSIA subjects foreign states to the jurisdiction of United States courts when they engage in commercial activity.<sup>156</sup> By essentially codifying the restrictive theory of sovereignty, allowing foreign states to be sued when they act commercially as private entities, the FSIA allows United States courts to exercise jurisdiction over what is undoubtedly a much larger class of cases than is embodied in *jus cogens* norms. Congress nevertheless expressed in their declaration of purpose that, allowing for such jurisdiction “would protect the rights of foreign states and litigants in United States courts”.<sup>157</sup> Permitting foreign plaintiffs to sue in U.S. courts at all, then, indicates a willingness to accept such litigation in order to protect some rights. The argument that creating a *jus cogens* exception to the FSIA would be a burden on the courts, then, is not by itself a forceful argument. All forms of litigation create work for the courts. The harm of increased litigation must be weighed against the rights that litigation would protect. *Jus cogens* norms by definition prohibit only the worst kinds of human rights abuses, and therefore the most fundamental human rights would be protected. When compared to the rights protected, then, the potential for increased litigation is simply not a weighty enough concern.

The potential harm of increased litigation would also be mitigated by the availability of alternate means of redress for the victims of *jus cogens* violations. In *Princz v. Germany*, for example, before initiating litigation against Germany, Princz repeatedly made requests, often with the support of the

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<sup>155</sup> Restatement (Third) of Foreign Relations Law § 702 (1987).

<sup>156</sup> The Foreign Sovereign Immunities Act, 28 U.S.C.A. § 1605 (2008).

<sup>157</sup> *Id.* § 1602.

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United States government, for reparations.<sup>158</sup> While his requests were unsuccessful, they illustrate that other forms of restitution besides resorting to the courts are available in some circumstances. Additionally, simply because the victims of *jus cogens* violations would be allowed to sue in United States courts does not mean that all victims would sue here. Plaintiffs may choose to sue in the courts of another nation, and United States courts would even be able to send cases to those courts under the principle of *forum non conveniens*.<sup>159</sup> Allowing United States courts to exercise jurisdiction over foreign states in the case of *jus cogens* violations does not mean that United States courts will always be the proper forum for *jus cogens* cases. This would greatly reduce the number of cases American courts would have to adjudicate if a *jus cogens* exception to the FSIA were recognized. For this and the foregoing reasons, the potential harm that would be caused by such an exception would be minor.

Finally, concerns over the increased strain on the courts that would potentially result from a *jus cogens* FSIA exception are contrary to the very notion of *jus cogens*. They are “nonderogable and enjoy the highest status within international law”.<sup>160</sup> They only prohibit activities that are universally recognized as the worst type of human rights abuses. For this reason, they can only be preempted by other *jus cogens* norms. Like sovereign immunity, practical concerns over burdening the courts can only be superseded by *jus cogens* norms, then, if they are of the same character. Mere practicality issues, for this reason, cannot preempt *jus cogens* concerns. *Jus cogens* concerns must therefore take precedence over the potential for increased litigation.

## V. THE TORTURE VICTIMS PROTECTION ACT AND THE FOREIGN SOVEREIGN IMMUNITIES ACT

The plaintiffs in *Belhas v. Ya’alon* also brought suit under the TVPA, arguing that where the TVPA applies, it supersedes the FSIA.<sup>161</sup> The TVPA provides that “[a]n individual who, under actual or apparent authority, or color of law, of any foreign nation subjects an individual to torture shall, in a civil action, be liable for damages to that individual”.<sup>162</sup> They argued that, because in order to be subject to the act, an individual must be acting under actual or apparent authority of a foreign state, that foreign officials who commit acts of

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<sup>158</sup> *Princz v. Federal Republic of Germany*, 26 F.3d 1166, 1168 (D.C. Cir. 1994).

<sup>159</sup> *Belsky*, *supra* note 57, at 406.

<sup>160</sup> *Comm. of U.S. Citizens Living in Nicar. v. Reagan*, 859 F.2d 929, 940 (D.C. Cir. 1988).

<sup>161</sup> *Belhas v. Ya’alon*, 515 F.3d 1279, 1288 (D.C. Cir. 2008).

<sup>162</sup> The Torture Victim Protection Act, 28 U.S.C.A. § 1350 (note) sec.2 (2008).

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torture are liable under the act and are not entitled to FSIA immunity.<sup>163</sup> To hold otherwise, they argued, would render the TVPA useless.<sup>164</sup> The court rejects this argument, and, for the following reasons, was correct in doing so.

The court first pointed out that the TVPA would not be nullified by extending immunity to foreign officials under the FSIA.<sup>165</sup> The FSIA would still permit foreign officials to be sued under the FSIA where their actions are not official acts, or where one of the FSIA's exceptions applies.<sup>166</sup> The court next looked to the legislative history of the TVPA and found that Congress did not intend for the act to create an exception to FSIA immunity.<sup>167</sup> In fact, as the court pointed out, "[b]oth the House and Senate reports on the passage of the TVPA state explicitly that the TVPA is not meant to override the FSIA."<sup>168</sup> Because granting immunity to foreign officials under the FSIA does not nullify the TVPA, there is no reason to find that the TVPA creates an exception to the FSIA. As this interpretation of the TVPA is additionally supported by the legislative history, the court was correct in its ruling that no TVPA exception to the FSIA exists.

## VI. THE CURRENT STATE OF THE LAW, BRIEF POLICY CONCERNS AND POSSIBLE FUTURE DEVELOPMENTS

The decision in *Belhas v. Ya'alon* represents a recent example of jurisprudence; standing for the fact that unless the FSIA provides for an explicit exception to sovereign immunity, United States courts cannot exercise their jurisdiction over foreign states and their agents. Earlier cases addressing the issue, such as *Siderman v. Argentina* and *Princz v. Germany*, have held, like *Belhas v. Ya'alon*, that there is no *jus cogens* exception to the FSIA. At the Circuit court level, judges have routinely followed the decision in *Amerada*, and the Supreme Court has denied certiorari to cases where the argument for a *jus cogens* exception is advanced.<sup>169</sup> For this reason, absent a shift in American policy towards issues of sovereignty and international legal standards, the circuit courts appear unlikely to change their position on the matter. Nevertheless, as the United States transitions from eight years of the Bush

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<sup>163</sup> *Belhas*, 515 F.3d at 1288.

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.* at 1288-89.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* (citing H.R. REP. No. 102-367, at 5 (1991)).

<sup>169</sup> *Siderman de Blake v. Republic of Argentina*, 695 F.2d 699 (9th Cir. 1992) (certiorari denied); *Princz v. Federal Republic of Germany*, 26 F.3d 1166 (D.C. Cir. 1994) (certiorari denied).

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presidency to the Obama administration, the *Belhas* decision represents an opportunity to revisit the issues raised by earlier cases in the faces of possible changes in American international policy and in attitudes toward human rights abuses.

In order to illustrate the likely policy differences between the Bush and Obama administrations, it is useful to examine their positions regarding the ICC. The Bush administration has been openly hostile toward the court. The administration's central objection to the court was that it is a threat to the sovereignty of the United States, and can be summed up by statements made by John Bolton, who under the Bush administration served as interim Representative to the United Nations, who stated that "[t]he ICC is an organization that runs contrary to fundamental American precepts and basic constitutional principles of popular sovereignty, checks and balances, and national independence".<sup>170</sup> American objections to the ICC, then, are founded on the same policy driving circuit court decisions which held that there is no *jus cogens* exception to the FSIA. The Bush administration's policy toward the court reflected the value placed on national sovereignty, even at the expense of holding violators of the worst type of human rights abuses accountable for their actions. There are indications, however, that this stance towards the court may change under President Obama. While still a senator, Barack Obama was asked whether he felt that the United States should ratify the Rome Statute. He responded "Yes[.] The United States should cooperate with ICC investigations in a way that reflects American sovereignty and promotes national security interests".<sup>171</sup> Even though he expressed reservations about the role of national sovereignty should the United States ratify the Rome Statute, his general support of the ICC is a marked departure from the Bush administration's opposition to the court. Hilary Clinton, who will play a pivotal role in shaping United States foreign policy as Secretary of State, has also expressed a more positive view of the ICC and concerns over the types of issues dealt with by the court than the Bush administration.

There is broad support in this country across political and ideological divides that perpetrators of genocide, mass atrocities, and war crimes must be held accountable. . . . Consistent with my overall policy of reintroducing the United

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<sup>170</sup> John Bolton, Under Sec'y for Arms Control and Int'l Sec., Address before the Federalist Society at the National Lawyers Convention (Nov. 13, 2003), *available at* [http://www.fed-soc.org/publications/PubID.58/pub\\_detail.asp](http://www.fed-soc.org/publications/PubID.58/pub_detail.asp).

<sup>171</sup> Presidential Candidate Questionnaire of Barack Obama, Sen. Ill., (2004), *available at* [http://globalsolutions.org/politics/elections\\_and\\_candidates/questionnaire/2004?id=20](http://globalsolutions.org/politics/elections_and_candidates/questionnaire/2004?id=20).

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States to the world, I will . . . evaluate the record of [ICC], and reassess how we can best engage with this institution and hold the worst abusers of human rights to account.<sup>172</sup>

The willingness of American officials to reexamine the role the ICC has to play in bringing human rights violators to justice represents a possible willingness to reexamine the types of issues raised by the *Belhas* case. Ratification of the ICC would signal an acknowledgement that in the face of *jus cogens* violations, at least some degree of national sovereignty should be sacrificed. Such a change in policy could alter the views of politicians and judges on the importance of immunity provided to foreign sovereigns under the FSIA. While the ratification of the Rome Statute by the United States is not definite, and anticipating the adoption of a *jus cogens* FSIA exception even less certain, possible changes in American policy toward respecting international norms at the very least make the issues raised by *Belhas v. Ya'alon* worth reexamining. The shifts in United States policy which are necessary for the creation of a *jus cogens* exception to the FSIA are increasingly possible as the country transitions into the Obama administration.

## CONCLUSION

The conclusion reached by the *Belhas* court that General Ya'alon should not have received sovereign immunity for his actions, while in line with prior decisions finding there to be no *jus cogens* exception to the FSIA, ignores the non-derogable nature of those norms. Acknowledging a *jus cogens* exception to sovereign immunity would bring the FSIA into accord with the universal understanding of *jus cogens* norms, as well as international trends limiting sovereignty in order to hold human rights violators liable for their actions. While General Ya'alon's actions may not have in fact constituted *jus cogens* violations, failing to even address the issue, and instead dismissing the case because of the FSIA, this and previous courts have turned their backs on the developing importance of human rights issues internationally, in favor of an antiquated notion of foreign sovereignty. In order to remedy this, future courts should recognize a *jus cogens* exception to the FSIA.

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<sup>172</sup> Presidential Candidate Questionnaire of Hilary Clinton, Sen. N.Y., (Nov. 12, 2007), available at <http://globalsolutions.org/08orbust/quotes/2007/11/27/quote615>.

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